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STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

DAIRY MARKETING BRANCH

DEPARTMENT OF FOOD AND AGRICULTURE

1220 N STREET

AUDITORIUM

SACRAMENTO, CALIFORNIA

THURSDAY, JUNE 1, 2005

9:07 A.M.

JAMES F. PETERS, CSR, RPR
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APPEARANCES

HEARING OFFICER

Mr. Michael P. Krug, Senior Staff Counsel

PANEL MEMBERS

Ms. Candace Gates, Research Manager II

Mr. David Ikari, Chief, Dairy Marketing Branch

Mr. Tom Gossard, Agriculture Economist

Ms. Venetta Reed, Supervising Auditor I

STAFF

Ms. Cheryl Gilbertson, Staff Analyst

ALSO PRESENT

Mr. Joe Augusto, California Dairy Campaign

Mr. Domenic Carinalli

Mr. Jerry Corda

Mr. Richard Cotta, California Dairies, Inc.

Mr. Greg Dryer, Saputo Cheese

Dr. James Gruebele, Land O'Lakes

Mr. Joe Heffington, California Dairies, Inc.

Ms. Tiffany LaMendola, Western United Dairymen

Ms. Linda Lopes, California Dairy Women's Association

Mr. Scott Magneson, California Dairy Campaign

Mr. Michael Marsh, Western United Dairymen

Mr. Mike McCully, Kraft Foods

APPEARANCES CONTINUED

ALSO PRESENT

Ms. Monique Moretta

Ms. Vickie Mulas, Mulas Dairy Company

Mr. Craig Rasmussen, Blue Ribbon Cheese Company

Mr. John Rossi, John Rossi Hay Company, Inc., AMPSI

Dr. William Schiek, Dairy Institute of California

Ms. Belinda Silva

Mr. Jim Tillison, Alliance of Western Milk Producers

Mr. William C. Van Dam, Milk Producers Council

Mr. Geoffrey Vanden Heuvel, Milk Producers Council

Mr. Carl Van Vliet

Mr. Tom Wegner, Land O'Lakes

Mr. Benjamin Yale, Continental Dairy Products

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PROCEEDINGS

HEARING OFFICER KRUG: We're on the record. Good morning. This hearing will now come to order. It's 9:07 on June 1st, 2006.

The California Department of Food and Agriculture has called this public hearing in the auditorium at 1220 N Street at the Department's Headquarters Building.

My name is Michael Krug. I'm Staff Legal Counsel for the Department of Food and Agriculture, and I've been designated as the Hearing Officer for today's proceedings.

On February 7th, 2006 -- you can hear me?

On February 7th, 2006, the Department received a petition from the Dairy Institute of California requesting a public hearing to consider amendments to the stabilization and marketing plans for market milk for northern and southern California marketing areas.

This hearing will consider the Dairy Institute's petitioner's proposal to:

1. Change the manufacturing cost allowances and f.o.b. California price adjuster in the Class 4a and 4b pricing formulas.

Number 2. Change the cheese yield employed in the Class 4b formula.

Number 3. Change the dry whey manufacturing cost allowances in the Class b formula with eventual removal of the dry whey factor from the 4b formula.

The Department has also received six alternative proposals in response to the petition.

In order of receipt, those alternative proposals were received from Western United Dairymen, the Alliance of Western Milk Producers, California Dairies, Incorporated, California Dairy Campaign, the Milk Producers Council, and Land O'Lakes.

During the pre-hearing workshop conducted on May 18th, 2006, the Department provided an analysis of alternative concepts and proposals. A copy of the analysis will be entered into the record of this hearing with the exhibits. Please keep in mind that any discussion that occurred during that workshop will not be part of the official hearing record and will therefore not be considered in rendering the decision.

If you desire any comments made at the workshop to be considered, those comments must be entered into the record of this hearing either through written or oral testimony.

Accordingly, the purpose of this hearing is to consider the amendments as proposed by the California Dairy Institute's petition and all the alternative proposals. As a courtesy to the Panel, the Department staff, and public, please speak directly to the issues presented in the call of the hearing which includes the petition and the alternatives.

Please avoid personalizing any disagreements. This such conduct does not assist the Panel, the interested parties, or the public in their attempt to effectively address these sophisticated economic and regulatory issues.

For the record, testimony given at this hearing does not necessarily reflect the position of the Department regarding the proposed amendments.

Please note that only those individuals who have testified under oath during the conduct of the hearing may request a post-hearing brief. The briefing is limited to amplify, explain, or withdraw the testimony given under oath. And only those individuals who have successfully requested a post-hearing briefing may file a post-hearing brief.

The Hearing Panel's been selected by the Department to hear testimony, receive evidence, and question the witnesses, and make a recommendation to the Secretary. Questioning of the witnesses by anyone other than members of the Panel is not permitted.

The Panel is composed of to my left -- they're all members of Dairy Marketing Branch. David Ikari, who's the Chief of the branch. To the left of him is Candace

Gates, Research Manager. To the left of Candace is Venetta Reed, Supervising Auditor. To the left of Ms. Reed is Tom Gossard, Senior Agricultural Economist.

I'm not a member of the Panel and will not be taking part in the decisions relating to the substance of the petitions.

The hearing recorder today is James Peters, of the firm Peters Shorthand Reporting Corporation located in Sacramento.

Transcripts of today's hearing will be available for review at the Marketing Branch headquarters located in Sacramento at 560 J Street, Suite 150. Anyone desiring copies of the transcript of today's hearing must purchase them directly from Peters Shorthand Reporting.

Testimony pertinent to the call of the hearing will now be received. Anyone wishing to testify must sign the hearing roster located at the sign-in table. That's not the three-minute one. Oral testimony will be received under oath or affirmation.

I'm going to jump in ahead here and explain something regarding the three minutes. Ms. Gilbertson of the Department's Dairy Marketing Branch will introduce the Department's exhibits. After Ms. Gilbertson introduces the Department's exhibits, she will respond to appropriate questions regarding clarification of those exhibits.

After completion -- after the Department's exhibits are entered, oral testimony will commence. Because of the unusual amount of people interested in this hearing, there will be a small divergence in the hearing process. As usual, the oral testimony will begin with a petitioner's presentation of the petition. However, after the petitioner's initial presentation, the Department has set aside a special one-hour period to receive limited testimony. During this one-hour period, anyone may present comments to the Panel for the record.

During this special period, testimony will be limited to three minutes. Since it is anticipated that this hearing will continue for another day, this period has been provided to afford those persons with only a few comments to testify without waiting through the presentations of all the proposals and other testimony.

Anyone who has other than very brief testimony will be accorded the full 20 minutes after presentation of the proposals. In order to provide as many people as possible with the opportunity to testify during this one-hour period, the three-minute period will be strictly enforced, and we please ask your -- that you respect this period.

There will be a few additional ground rules regarding this hour. Witnesses will be called in order they sign up. You may only sign up for yourself. If you do not respond when you were called, your turn is forfeited.

If you testified during this period, you're not precluded from making comments during the regular comment period. But please keep in mind that this period was provided for those persons who do not expect or prefer or cannot attend this hearing tomorrow. You all have cows to milk and operations to run. This is to provide you with some flexibility so you can get to that without devoting two days to it.

Now, we'll take a five-minute break. And the period for signing up for the three-minute comment period will commence.

(Thereupon a recess was taken.)

HEARING OFFICER KRUG: Let's go back on the record.

At this time, Cheryl Gilbertson, Research Analyst with the Department's Diary Marketing Branch, will introduce the Department's exhibits. After the introduction of exhibits, she will respond to appropriate questions regarding clarification thereof.

Ms. Gilbertson, will you now present the Department exhibits?

STAFF ANALYST GILBERTSON: Mr. Hearing Officer, my name is Cheryl Gilbertson. I'm an analyst with the Dairy Marketing Branch of California Department of Food and Agriculture.

My purpose here this morning is to introduce the Department's composite hearing Exhibits Number 1 through 43.

HEARING OFFICER KRUG: Ms. Gilbertson, before you go any further, let me swear you in.

Do you swear of affirm to tell the truth?

STAFF ANALYST GILBERTSON: I do.

HEARING OFFICER KRUG: Continue.

STAFF ANALYST GILBERTSON: Relative to these exhibits, previous issues of Exhibits 9 through 43 are also hereby entered by reference. The exhibits entered here today have been available for review at the Office of Dairy Marketing Branch of since the close of business on May 25th, 2006. And abridged copies of the exhibits is available for inspection at the back of the room. Multiple copies of Exhibit 6a are also available at the back of room. Additionally, I am entering a letter received from A Vitoria Dairy as Exhibit 44, and a letter from Circle H Dairy Ranch as Exhibit 45.

I ask that at this time the composite exhibits be received. I also request the opportunity to provide a post-hearing brief.

Mr. Hearing Officer, this concludes my testimony.

HEARING OFFICER KRUG: Thank you, Ms. Gilbertson.

Does anyone have questions for Ms. Gilbertson regarding the Department's exhibits?

I see one hand. Will Mr. Marsh please come forward?

Okay. There you go. That's right.

MR. MARSH: Mr. Hearing Officer, at this time, Western United Dairymen would like to object to a number of the items that will be included as exhibits. One, of course, is a letter dated May 17th and accompanying documents from David Ikari, the Branch Chief, identifying that estimated impact analysis of 2005 utility labor rates, et cetera, document that was as a result of an independent CPA reviewing some of the data that had been compiled by the Department under cost manufacturing studies. And on page I believe it is 3 of the CPA's report actually recommended to the Department that these updates not ever be performed again.

Unfortunately, that direction by the independent CPA was not followed, and of course we object to that. And we encourage the Secretary to maintain his independence throughout this hearing and instead of perhaps putting himself in the position of an advocate of one position or another within the scope of this hearing.

That's our first objection.

Another objection that we do have is with regard to the return on investment calculation that was amended within the manufacturing cost studies this year. We are under the impression that not adequate notice and comment went out to all the members of the industry, nor all of the members of the Dairy Advisory Committee when the change was made to effectively increase the return on investment by about 50 percent to the processors within the state in the data that was collected by the Department.

Of course, I'm unaware of any dairy producers who received a 50 percent return on their investment, an increase in their return on investment. And of course we object to that as well.

We again renew our objection to the call of this hearing. We believe it is extremely untimely. Dairy producers at this point are struggling very mightily to stay in business. And this was not a good decision on behalf of the Secretary. We renew our objection to the call of this hearing.

Those are my objections.

HEARING OFFICER KRUG: Thank you, Mr. Marsh. And those objections were presented on behalf of Western United Dairymen.

MR. MARSH: That is correct.

HEARING OFFICER KRUG: Thank you very much. Your objections are noted for the record. They will be considered in due course with the consideration of this hearing. And the hearing decision will reflect the Department's decision regarding the objections.

Does anyone have any additional questions or comments regarding the Department's exhibits?

Not hearing any objections or comments, the Department's exhibits are now entered into the record. Thank you very much, Ms. Gilbertson.

(Thereupon the above-referred document was marked as Exhibit 44 and 45.)

HEARING OFFICER KRUG: The petitioner, Dairy Institute of California, will now present their petition. They have 60 minutes to do so.

Will the witness please come forward?

Is witness ready?

DR. SCHIEK: Yes.

HEARING OFFICER KRUG: Okay. Please state your full name and spell your last name for the record.

DR. SCHIEK: My name is William Schiek. That's S-c-h-i-e-k.

HEARING OFFICER KRUG: Mr. Schiek, do you swear or affirm to tell the truth?

DR. SCHIEK: I do.

HEARING OFFICER KRUG: And are you representing the petitioner, Dairy Institute of California?

DR. SCHIEK: I am.

HEARING OFFICER KRUG: Do you have any written statements or other things that you would like entered into the record at this time?

DR. SCHIEK: Yes. I've given you two documents. One is the testimony that I will be presenting reading today, and the second is a list of exhibits and attachments.

HEARING OFFICER KRUG: Okay. The first document entitled, "Testimony of William Schiek on behalf of the Dairy Institute of California" is noted Exhibit Number 46. It is entered into the record entered and admitted into the record.

(Thereupon the above-referred to document was marked as Exhibit 46.)

HEARING OFFICER KRUG: A document, "Diary Institute's Exhibits and Attachments" is labeled Exhibit 47. It is now entered and admitted into the record.

(Thereupon the above-referred to document was marked as Exhibit 47.)

HEARING OFFICER KRUG: Please proceed with your testimony, Mr. Schiek.

DR. SCHIEK: Thank you.

Mr. Hearing Officer and members of the Hearing Panel, my name is William Schiek. I am an economist for Dairy Institute of California. I'm testifying today on the Institute's behalf.

Dairy Institute is a trade association representing 35 dairy companies which process approximately 75 percent of fluid milk, cultured, and frozen dairy products, over 60 percent of the cheese products, and a small percentage of the butter and nonfat milk powder processed and manufactured in the State. Member firms operate both marketing areas of the State. The position presented at this hearing was adopted unanimously by Dairy Institute's Board of Directors.

The role of government and the market in determining price. Dairy Institute is grateful for the opportunity to testify at this hearing. We note that the price volatility experienced in the past few years has been difficult for producers and processors alike. As difficult as these price swings have been, they've provided critical economic signals to both producers and processors. In past periods of high prices which developed when milk supplies are short have been followed by periods of low prices which evolve after milk producers have increased output and product inventory levels have recovered.

These periods of low prices are transitory and serve as a breaking mechanism to slow the growth in milk production brought on by higher prices. After milk production and dairy product consumption return to their normal trends, milk prices will return to more moderate levels. These price cycles are how the market works to allocate resources so that supply and demand are in balance.

We strongly caution that changing pricing formulas as a response to transitory milk and dairy commodity prices distorts critical economic signals that are sent by such price movements. It also leads to potential misallocation of resources as critical market information fails to reach the decision makers who have responsibility for adjusting production plans in response to these signals.

There is a general misconception among some that the Department sets the month to month minimum price level for milk purchased in California. While the Legislature has given the Department the authority to do so, the Secretary for many years now has adopted a policy of utilizing end product pricing formulas to determine the monthly price level.

Under these formulas, it is the national supply of demand -- the national supply and demand for dairy commodities that determines the general level of prices that producers will receive. When milk supplies are long relative to demand, prices for dairy commodities and milk will be low. When milk supplies are tight, prices will be high.

It is useful to remember that the structure of our pricing formula means that what the Department does regulate is not so much the price level received by dairymen, but rather the operating margins that dairy product manufacturers are allowed.

The price level will ultimately be determined by the market, but the operating margins of the state's manufacturers are determined at these hearings. The Secretary can thus dramatically impact the marketing opportunities of the leading agricultural commodity of this state with a single hearing decision.

The Department's decisions will determine whether or not plant margins are adequate to ensure that there's enough plant capacity to absorb the state's milk supply. Such capacity will be present only when the formula allows existing plants to be competitive and when plant margins are sufficient to attract new investment. The Secretary therefore must take extreme care in setting the structure and parameters of the pricing formulas.

Prior to 2003, the Department had for many years maintained a consistent policy of ensuring that plant margins were both adequate for existing plants to be competitive in the national market for manufactured products and large enough to attract plant investments so that the growing milk supply could be accommodated. Unfortunately, in a hearing decision rendered in March 2003 under the previous administration, the Department made three significant changes to the Class 4b formula that would seriously curtail the operating margins of cheese plants. First, it adopted a commodity price floor. Second, added a dry whey factor. Third, increased the cheese yield in the pricing formula.

In a decision driven by political concerns as much as economic ones, the Secretary attempted to redress transitory market-driven low prices by adopting policies that distorted market signals and put an unnecessarily high regulatory burden on California's cheese manufacturers.

Governor Schwarzenegger was elected in the fall of 2003 based on his promise to bring businesses and jobs back to California by creating a more favorable business climate. The Secretary's decision in 2005 to remove the price floor was a welcome step in the right direction, but he failed to adopt the Hearing Panel's recommendation with respect to dry whey which called for its removal from the formula. Cheese maker margins have continued to suffer as a result.

We believe minimum milk price regulations should be based on market oriented economic principles and analysis. We also believe that the greatest risk in any minimum milk price regulation decision is setting prices too high, which may lead to enhanced producer income in the short run, but will lead to loss of product sales and manufacturing capacity in the longer run.

When regulated prices are set too high, or more specifically when there is not enough of a wedge between the commodity price and the milk price, manufacturing plants have no ability to create the margin they need to operate successfully. If they increased finished product prices to customers, they are in turn reflected in higher commodity prices that then translates through the formula into even higher raw milk prices. The circuitousness pricing formula means that there is no escape for plants from regulatory pricing mistakes. Regulated prices that are too high also artificially stimulate milk production, at least initially, while at the same time the formula's inadequate plant margins reduce the incentive for plants to procure milk. The result is more milk looking for a home in plants that have reduced incentive to buy it.

Milk then becomes distressed and must seek a home in unregulated venues outside the state or be dumped, which returns no value to the producer. The consequence of this scenario is for effective or mailbox producer prices to fall below regulated minimum prices, undercutting the milk order price structure. The scenario just described is at least partially reflective of dairy marketing conditions in California this spring.

Conversely, if regulated milk prices are set too low to bring forth a sufficient supply of milk, market forces will quickly signal this to the industry through such market oriented changes as higher commodity prices and the development of incentive payments from processors to producers. Thus, while there is no escape for producers and processors from the negative consequences of setting regulated prices too high, the market quickly makes the necessary corrections if regulated milk prices are set too low.

Most of the proposals offered today by producer organizations would increase Class 4a and 4b prices, some quite dramatically. We recognize the Department needs to take into consideration a number of economic factors involved in the marketing of milk, including milk production costs. However, we believe that the priority of the Department must be need to establish prices which maintain and build market outlets for the growing supply of raw milk in California.

Higher regulated prices will not result in long-term revenue gains for producers. If the price paid to achieve these gains is an uncompetitive dairy processing manufacturing sector, such changes lead to disinvestment in manufacturing and a loss of markets for California producers.

California has become a significant net exporter of milk products. We must continue to be competitive not only in our own state, but in transporting products and competing in other areas of the country and other nations as well.

Dairy Institute believes that minimum prices should not be increased artificially by government agencies setting prices based on either short-term spikes in milk production costs or the unavoidable, cyclical and transitory decline in dairy commodity and farm level milk prices.

The current milk supply and demand situation.

California dairy product manufacturers will tell you that they are facing an increasingly competitive market for sales of their products. In such an environment, it is more important than ever for California's plants to be competitive from a raw product standpoint in order for all of California's milk production to be marketed.

In the past few years, some California milk processing and dairy manufacturing plants have closed, while other companies have made decisions to build plants elsewhere, bypassing California as a location. And still others that had seriously considered building in California have elected to build elsewhere or not at all. And there's a list of these plants in Exhibit A on your second document.

Given our growing milk supply, California needs to be attracting manufacturing plant investment, not driving it away. An appropriately valued raw milk cost is an important ingredient in attracting plant investment. Furthermore, given that California already supplies about half the U.S. market for nonfat dry milk in over 30 percent of the market for butter, attracting investment in cheese plants or in other higher valued uses would be a better policy for the state and encouraging greater capacity in butter powder operations.

And I'd like to make a quick comment on Exhibit B. You'll note there is a point given there in the graph for 2006. And that is only the first quarter of 2006. So that's the California share during the first quarter.

I would also add that for nonfat dry milk, the data for 2005 and 2006 includes skim milk powders.

HEARING OFFICER KRUG: Mr. Schiek, just so the record reflects correctly, when you are referring to Exhibit A and Exhibit B, you are referring to the Dairy Institute's Exhibit A and B which are our Exhibit 47 and labeled there in Exhibit A, B. Thank you very much.

Please proceed.

DR. SCHIEK: Thank you.

Incentives to build new cheese plants in California appear to have diminished in recent years. The decisions to build the newest cheese plants were made no later than 1999. Since that time, there have been no commitments to build new cheese plants. While a variety of reasons may be at work, the reductions in cheese maker margins that occurred after the 2003 hearing decision was implemented have certainly played a major role.

California milk production growth has been averaging 4.1 percent per year over the past 10 years. In 2003, 2004, and 2005, the state's milk output growth was 1.0 percent, 2.9 percent, and 3.0 percent respectively. It is uncertain whether this slower rate of growth is a latest in a series of periodic pauses from the long run milk output growth rate that have been seen since the 1970s or the establishment of a new significantly slower growth trend. Factors such as high feed costs, low

2002-2003 milk prices, poor weather, limited availability of replacements and rationing of rBST have lowered milk output per cow during the past couple of years and caused modest slowing of the dairy herd growth. However, in the first four months of 2006, California milk output growth has resumed its robust pace with monthly milk output increasing an average of 5.5 percent over the previous year's production.

Putting these growth trend numbers in some perspective, with a 4.1 percent average growth rate, the state must have enough plant capacity to take an additional 4.2 million pounds of milk per day every year. This capacity need is equivalent to the addition of one new large cheese plant per year. The conclusion is obvious. The state must have manufacturing outlets for the milk -- for this milk production growth or California milk will have to travel outside the state to find a home at great cost to California producers.

In order attract manufacturing capacity and investment, raw milk costs must be set at a level that will allow California plants to compete, especially given the state's higher cost for other inputs such as energy and labor.

Alternatively, the state could stop growing its milk output. However, raising regulated prices will give dairymen an addition incentive to expand output. Now, some will maintain that raising prices will choke off manufacturing capacity. And they will further argue that even though higher prices will continue to encourage expansion of milk production, once producers experience the lower returns that come from having to dump milk or find a home for it outside the state, they will begin to curtail milk production. The problem with that line of reasoning is the length of time it takes for the scenario to play out. In the meantime, producers are making the wrong investment decisions, expanding their operations when they should be curtailing them. Pursuit of this policy is exceedingly wasteful. Promoting expansion and then pulling the rug out from under it is the wrong policy choice for California.

At the end of the day, the growth or curtailment of milk supply is a producer decision. Thus, if the state determines that production incentives should be reduced and the industry should cease growing, the best way to bring this about is to reduce regulated prices. If the state wishes to encourage growth of the industry, it cannot be accomplished without incentives for increasing plant capacity. The continued growth of the California milk supply is evidenced that significant numbers of California producers have been able to thrive under the existing regulated pricing structure. But the difficulty in handling the milk supply is testimony to the fact that plants have not been thriving under current conditions. An adjustment that will give plants greater operating margins is the logical solution to the situation facing the industry.

Before we get to the specifics of our proposal, we need to be clear about what is at stake and what is needed. While it is important that the technical parameters of our formulas be consistent with logic and sound economics, we do not want the larger picture to be obscured in discussions about minutia. Indeed, several of the alternative proposals under consideration at this hearing would increase the complexity of the pricing formulas substantially, and it would expand the number of parameters about which we argue at venues such as this one.

The crucial issue here is that California plants, particularly cheese plants, need greater operating margins. Adoption of proposals that merely reshuffle the formula parameters while yielding little or no decrease in the regulated price level put the industry in an untenable position.

The regulated price level must be reduced to a meaningful degree, or plant capacity will not be sufficient to ensure that all of California's milk production will be marketed.

Dairy Institute's proposals are consistent with our long established policies on 4a and 4b pricing formulas. We propose the use of a consistent set of parameters for determining product prices, yields and make allowances between Class 4 and 4b prices. In the past, we have argued for consistent application of these principles to both Class 4a, 4b formulas and that application of those principles should help avoid economic tilt that would favor one complex over the other.

However, from a policy perspective, there are some serious concerns about continued encouragement of increasing butter powder capacity, because the state is already over-represented in the production of butter and nonfat dry milk.

The risk to the industry of encouraging 4a production over 4b production is two-fold. First, the reliance on Class 4a on the support price program to prop up commodity values and as an essential consumer for California's milk output to be marketed put the state in a tenuous position. And second, the relatively lower value return to the pool by Class 4a production means California producer incomes are unnecessarily reduced.

When looking at the operation of a support price program, it is clear that the nonfat dry milk market is much more dependent than cheese on government assistance. Ninety-eight percent of the product procured by the Commodity Credit Corporation under the price support program during the past 10 years was nonfat dry milk. And that's illustrated in Exhibit C.

We also point out that the World Trade Organization discussions are calling for reductions in U.S. agricultural subsidy levels, making the price support program vulnerable. Furthermore, since January of 1994, Class 4b prices generated by the current formulas have averaged 74 percent -- excuse me -- 74 cents per hundredweight higher than comparable Class 4a prices.

If we look at the period since January 2003 -- and this is shown in Exhibit D. When USDA finally began managing the butter powder tilt in a manner required by statute, that is to minimize the program's costs, Class 4b prices have averaged $1.40 per hundredweight more than Class 4a prices assuming current formulas were in place. At the margin, producer pool prices would increase if new capacity were directed towards Class 4b. Based on these realities, the State should endeavor to encourage cheese manufacturing capacity growth over butter powder capacity growth.

Dairy Institute's proposal was developed following these general principles.

First, product values should reflect the prices received by California manufacturers for their products. Butter and cheese values should be based on CME prices for butter and cheese adjusted to reflect prices actually received by California processors.

Second, manufacturing cost allowances or make allowances should be set on a consistent basis for butter powder and cheddar cheese based on the most recent CDFA cost studies updated with the most recent fact or cost information available so that the make allowances used reflect current cost conditions as closely as possible. The product volume covered by the make allowance including return on investment should be as consistent as possible across butter and powder and cheese in the 4a and 4b formulas with a tilt toward more commercially valuable cheese as opposed to butter and powder. Make allowances should be high enough to maintain and enable processing capacity that is adequate for the growing milk supply.

Thirdly, product yields should be established based on California milk of average farm level composition from milk that has not been incentivized to alter its composition. In the case of cheese, average composition should include casein content for raw milk at average producer tests. Average California finished product moisture should be used. Fortification should not be considered in determining product yields, and fortification-related costs should be deleted from make allowances.

And finally, changes to Class 4a pricing formulas should not disadvantage California Class 2 and 3 manufacturers relative to those in nearby states.

Dairy Institute's proposals are contained in the following paragraphs. We have specific proposals for the formulas for Class 4a, Class 4b. We do not have any specific proposals for Class 2 and 3 but recognize that their price levels will be affected by changes in the Class 4a formulas.

And our Class 4b formula proposal is listed there. I'm not going to read that. It was in our updated petition that was submitted in advance of the alternative proposal deadline. But I will discuss each of the factors and the changes that we're proposing.

Calculation of the f.o.b. price adjuster. We propose that the California cheese price should be represented by CME cheddar block price, less a .0252 cent location of adjustment.

Node that proposed f.o.b. adjustment is equal to the simple average monthly difference between California's weighted average cheese price and the CME price for

40-pound cheddar blocks during January 2004 through December 2005 period.

In the past, we have advocated that a longer period be used in establishing the f.o.b. adjuster. We observed that the relationship between California and CME prices varied widely on a month to month basis due in part to the lags and the response of the observed California weighted average price to the market discovery occurring at the Chicago Mercantile Exchange.

Given the wide differences occurring from month to month, we felt that it was proper to include a longer range of data to reveal the true underlying relationship. However, in the past couple of years, the cost of transporting product from California to the midwest, costs have increase substantially. These changes in transport costs have made the older data less relevant than it would have otherwise been had transportation costs been relatively stable.

Month to month differences in the relationship between the California price and the CME price for cheddar can be explained by price movement at the CME and the lag response of the California weighted average price to those movements. The lag response is caused by the same factors that make NASS prices lag CME prices. Many plants price product to some of the regular customers on a day-of-make basis. That is, the price the customer pays for cheese is based on the CME cheese price the day the cheese is made or ordered. However, the product sale is not necessarily recorded the day the product is made, but rather when the product is shipped to the customer, which might be two to three weeks later or even longer. Thus, the California cheese price data for today often reflects the CME market for the previous two to three weeks. When the market price at the CME is especially volatile, the difference between the monthly average of CME price and the California price can move erratically from one month to the next.

For these reasons, a 12-month period would be too short, especially for cheese since it would not provide enough observations to average out the impact of the lag response to California cheese -- lag response of California cheese prices to the CME movements. Therefore, we've advocated a 24-month average.

Unfortunately, pricing and delivery arrangements vary greatly among customers. So attempting to specify an alternative structure in a relationship between the CME and California prices is fraught with problems, particularly when using monthly data.

If one attempts to specify California's price is a function of current and lag CME prices, specification bias is a likely result, especially if there is no underlying structural basis for the lag structure imposed. The estimator produced might have a smaller variance than some other method. But if the estimator is biased, then the wrong relationship is being predicted.

For the above reasons, the best approach in estimating the relationship between the monthly CME prices and the California prices is to take a simple average of the monthly differences between the two prices. Such an average would be unbiased because you are using actual observations of the relationship you are trying to estimate and weighting all such observations the same. Using a weighted average, that is, weighted by the product volume of a given month, introduces bias into the estimator because there is no theoretical or practical reason why one month's observation of the price difference should be more heavily weighted than another in predicting the monthly relationship.

While we concede that weighting the average by the volume sold does appear to make a difference in the value of the estimator, we do not believe that these differences constitute a valid reason for adopting a biased estimator. The purpose of the f.o.b adjuster is to find some number that when applied to the CME price predicts the average prices received for cheddar cheese or butter by California plants. If we are using monthly aggregations of these prices, then a simple average of the monthly price differences will yield the best predictor of California prices from a given month's CME price.

A fundamental question here is whether large variations in monthly price differences are caused by different amounts of product marketed on a month to month basis or whether they are caused by rapid and inconsistent movements in CME prices and the California prices lag response to such movements.

We hold the view that it is the price movements and lag response that drive the variations in the monthly price wedge. So using a weighted average of the differences in the monthly price observations will bias the f.o.b. adjuster.

The Hearing Panel agreed with us in its 2005 report. "Absent more thorough information and data on both butter and cheese sales, and based on underlying rational, the Panel is inclined to support the notion that using the weights twice would introduce bias into the estimator." That's a quote from the Hearing Panel report from the Class 4a and 4b hearing that was held February 1st, 2005.

We do not advocate discarding the highest and lowest values of difference between the CME and the

California price because there is no valid reason for doing so. The only justification for discarding such observations is because of measurement error or if they represent true outliers whose presence is due to unusual factors that are unlikely to occur again. Neither of these reasons for discarding data appears to be present in this situation.

Removal of dry whey from Class 4b formula. A review of past hearing records will show that Dairy Institute opposes the inclusion of dry whey, arguing that the old formula, pre-2003, did not shortchange producers by its failure to explicitly incorporate non-cream whey. We have argued at past hearings that there are several reasons that non-cream whey value should be incorporated into the Class 4b formula. I reiterate some of these reasons here. There is no inherent raw whey value; hence this lack of an underlying raw whey value is evidence that non-cream whey processing is undertaken primarily as a cost minimization strategy rather than a profit generating opportunity.

The data pertaining to whey processing and disposal costs, quantities of different whey products produced, and the actual California yield of whey from raw milk used to make cheese vary too widely to design a pricing formula that is reflective of all the market circumstances in California.

Dry whey is but one of the avenues used by California cheese makers for disposal of waste solids from their operations. Other products manufactured from the whey stream include whey protein concentrates, whey protein isolates, and lactose. In the past, lactose from cheese-making operations has also been converted into alcohol.

The important thing to remember is that each of these products has its own unique market, a unique market price, and distinctly different manufacturing costs. Even within a particular group, such as whey protein concentrate, protein concentrations and associated prices and costs vary significantly. Furthermore, a product like WPC 80, 80 percent protein concentration, is not homogeneous but will have different characteristics and functionality according to needs of the purchasers. Each of these product variations will have different associated market prices and manufacturing costs.

Thus, there seems to have been an erroneous notion among the producer community that dry whey is a minimum value whey product and that plants making whey products other than dry whey are receiving even greater net returns.

This is simply not the case. For example, WPC which is often held up as a more profitable whey product carries with it a byproduct known as lactose. The instances when plants make positive returns on lactose are few and far between. It is on balance a money looser. Thus, any comparisons of the relative profitability of WPC must include the losses generated by the lactose side of the operation.

The past year illustrates the point that there is no real hierarchy of earnings with respect to various whey products. WPC 34 prices began declining in January -- excuse me -- July 2005, while dry whey prices continued climbing until March, 2006.

WPC 80 was value lower than WPC 34 on a protein equivalent basis from late 2004 through early 2006. Likewise, WPC 34 prices on a protein equivalent basis have been below dry whey prices throughout much of the past four years, strikingly so since the middle of 2005.

And I've included in my attachment as Exhibit E the prices for pre-whey products. I have the western dry whey price series. That's the most priced series. Central and west WPC 34 price series, and I've constructed a California WPC 80 series. This is reflective of the most commodity type WPC 80 rather than a value added WPC 80 data that was reported to me by California plants.

And what I then did over in the far right columns was to express this data on a pound of protein basis, price per pound of protein, essentially dividing the dry whey price by 12 percent, .12, dividing the WPC 34 by .4 and dividing WPC 80 by .78. And the reason that's not .8 is because the WPC 80 is expressed on a dry matter basis. And so 78 percent is more accurate in terms of the product than its typical protein component.

And those are graphed below. It's pretty easy to see that on a protein equivalent basis dry whey prices have surpassed the other two series significantly in the latter half of 2005 and early 2006. It's also pretty apparent that the assumption that prices moved together through time if you take a long enough series, there may be a correlation there that's acceptable to some people. But certainly in the short run, and when plants can lose a lot of money, they're not correlated particularly well at all. So that's the point I wanted to make there.

The important point is that dry whey does not appropriately represent the disposal of the waste stream in California, but neither does any other whey product. The diversity of whey processing disposal in the state makes it impossible to adequately represent California's plant operations with a single pricing formula. The notion that dry whey is appropriate because it is strongly correlated with the price movements of other whey products has also been proven to be false. Attempting to create a composite whey price or whey cost as some have suggested results in a formula that fails to represent any of the state's cheese and weigh operations.

Because the inclusion of representative non-cream whey operations is so problematic from a pricing formula construction standpoint and because of the need for higher cheese plant operating margins to allow existing cheese plants to compete and attract new plant investments to handle the growing milk supply, we have advocated removal of the dry whey factor from the formula.

The problems associated with incorporating dry whey into the Class 4b formula were noted by the Hearing Panel last year in explaining its recommendation to remove dry whey. And I'm quoting, "The panel is mindful of using a manageable pricing formula. It seems clear from the positions taken by the producer/processor witnesses that incorporating a factor for the value of the whey stream appears to be in intractable. Given the testimony and evidence before the Panel, it would far wiser to simply remove the skim whey factor from the Class 4b pricing formula than to continue to expand this factor an inconsistent manner with butter and nonfat dry milk cheddar cheese pricing formulas." We agree with that statement strongly.

While Diary Institute is advocating for the removal of the dry whey factor, we are mindful of the fact that removing it at this point in time when whey prices are quite high would have a negative impact on current producer prices. For this reason, we advocate removing the whey factor in two steps. The first step is increase the make allowance for dry whey consistent with the manner used in setting the make allowances for butter, nonfat dry milk, and cheese in the Class a and 4b formulas.

Final step we propose is the removal of the dry whey factor from the formula when it begins to negatively impact producer prices. That is, when the market price for dry whey falls below the new make allowance of 27.42 that we're producing, 27.42 cents per pound.

Further explanation of why the first step of this proposal requires a dry whey make allowance of 27.42 per pound is contained in the section as follows.

We have proposed a manufacturing allowance for cheese of 17.91 cents per pound, which is equal to the most recent weighted average manufacturing costs for cheddar blocks as released by the Department adjusted for the January through September 2005 labor and energy rates. The whey cream portion of the cheese hundredweight value is the same as under the current formula. Our first step proposal for whey manufacturing allowance is to set it equal to the Department's weighted average manufacturing costs adjusted for the January through September 2005 labor and energy rates. Again, that's 27.42 cents per pound.

At the last hearing, producer organizations expressed concerns about whether this weighted average accurately reflects the cost of dry whey in California. Specific concerns related to high costs in one of the survey plants that may have been caused by low volumes associated with start up.

Now the whey costs survey has been completed a second time. And interestingly, the cost came in very close to the previous year's survey. We note that all three study plans had whey drying costs that were greater than the current make allowance of 20 cents per pound. And actually greater 24 cents per pound according to the Department's data. Therefore, an upward adjustment to whey make allowance is surely warranted.

I want to drew attention to again our attached exhibits, Exhibit F in our attachment. This is the data that was provided by the Department for the pre-hearing workshop. And it lists the percent of volume covered for various manufacturing allowances of various amounts. And the thing I want to draw attention to first of all is over on the extreme right-hand column, the skim whey powder number. As you can see, at a make allowance of 24 cents per pound, zero percent of volume would be covered. At 25, a little over half the volume would be covered. And you have to get up into 27 in order for 80 percent of the volume to be recovered. So, again 20 cent make allowance would appear to be woefully inadequate based on California whey processing costs.

The other point I wanted to make was in looking at the butter and nonfat dry milk information versus the cheese information, you'll note that the lowest cost volume in butter is processed at a cost somewhere between 10 and 11 cents per pound, yet we have a current make allowance of 15.6 cents per pound. For convenience sake, you know, if we were to argue that the make allowance of the lowest cost plant were, say, 10.6, just to get an even number, that's 5 cents a pound extra profit that plant is making versus where the make allowance is set.

Looking at nonfat dry milk, you know, we have a 15.1 cent make allowance, yet 62 percent is processed at a cost somewhere between 13 and 14 cents.

Again, there's a sort of a long tail down there in the lowest end of the price range of those products. And I think you have to look at those together because of the joint nature of that product processing. Many of the firms that make powder nonfat dry milk also process butter. And those profits generated from butter from those most efficient plants are available to fund investment in butter powder operations.

Contrast that with cheese, we have a make allowance of 17.1 cents. Yet at 17 cents, zero percent of the volume is covered. What I'm saying is even if you were to look at the weighted average cost and bump it up to what we propose, we're still talking about less of a margin to make new plants investments, even for most efficient plants in California than you have in butter powder. Again that highlights one of the reasons we feel like trying to get greater margins in the cheese manufacturing is essential if we're going to go past the -- in this state.

I'll return to my written statement.

Several industry representatives testifying today have proposed snubbing the dry whey factor in the 4b formula, so that when whey prices fall below the manufacturing allowance, there is no resulting decrease in the Class 4b milk price.

This proposal is without economic justification and therefore without merit. It represents an attempt by the producer leadership to have their cake and eat it too. They're basically making the claim that they should share in the revenue generated by whey when it is profitable, but when weighted as a net cost to the cheese operation, all the costs should be borne by the manufacturers.

This proposed arrangement violates the main principles of end product pricing, namely that the value of producer's milk is derived from the various finished manufacturing products after deducting all the costs of manufacturing and accounting for the amount of product yield from producer milk.

The proposed snubber would clearly violate these tenants and overvalue producer milk. The Hearing Panel tackled this issue in its report from last year's hearing again quoting, "The concept proposed by producer representatives to implement a price floor or snubber below which the whey factor cannot drop greatly magnifies the problem. By implementing this provision, the Class 4b price could not reflect the negative values when the commercial price of dry whey falls below the cost of manufacturing. This policy could create serious competitive disadvantages to California cheese products."

It seems to us that the producer organizations' insistence that the dry whey factor never have a negative impact on the Class 4b price amounts to an admission that dry whey does not belong in the Class 4b formula.

If whey losses cannot be recognized in milk price computations through the formula, then neither should whey profits. For this and the reasons we have stated previously, we reiterate the need for the dry whey factor to be removed.

Cheese yield. We have proposed a cheddar cheese yield of 10.0 pounds per hundredweight of milk. The cheese yield used in pricing raw milk must be representative of what can be obtained from typical milk in California. Thus, the yield should not be derived from fortified vats which evidence a yield that can be achieved only with fortification ingredients that have composition different from typical milk. Using fortified vat yields transfers the cheese-making value of the fortification ingredients and assumes that that value is contained in typical milk. This is an erroneous assumption. At a minimum, if fortified vat yields were to be used in formula, all costs associated with the fortification ingredients including all protein premiums should be included in the manufacturing allowance.

The Hearing Panel noted in its recommendation stemming from the last hearing that the Panel's preference in so far as practical is to use the actual yield experience achieved in the actual plan environment.

In California, that is derived from producer milk composition, not from fortified vat yields. Unfortunately, we do not seem to have plant data on producer milk yields because most plants fortify their vats. Thus, if we are to have yields that are representative of the producer milk composition, our only alternative would seem to be to use theoretical cheese yield formulas that have been shown to be fairly accurate of predicting cheese yields in practice, such as the VanSlyke formula.

The method that the Department had used in the past to determine cheese yields from producer milk composition has involved taking the fortified vat yield information and interpolating the data through linear interpolation to obtain a yield of milk at more typical tests. Unfortunately, this method has the effect of transferring the value derived from the fortification ingredients to the producer milk and effectively over values the producer milk. Therefore, use of VanSlyke formula is preferable.

We continue to believe that the yield used in the formulation not be derived from milk that has been incentivized through use of premiums to achieve higher protein and casein tests. Using such milk in the formulation yield calculations would essentially require processors to pay twice for the components that are in their manufacturing operations. Under such a scenario, processors would pay once through the protein premium and then a second time through the regulated price.

It may be true that plants could adjust premiums to reflect the fact that they are paying for higher yielding milk through regulated price. But there may not be enough room in the plant margins for this reallocation to occur. Also signals to producers would be mooted under this approach because the class price paid to pool and the value of the higher protein milk would then have to be blended out to all producers.

Using such incentivized milk to determine the cheese yield using the formula would create a transfer of income from dairymen who make investments and incur the costs of making high yielding milk to dairymen who do not produce higher yielding milk.

In the past, the Panel has noted that cheese plants have benefited from pooling, implying that higher value from fortification and high yielding milk should be shared with all producers through the pool. However, this argument fails to recognize that the underlying assumption that the advent of pooling was that all Grade A milk is identical and could be used equally well in making any type of product.

Now we have a milk supplier that is more differentiated, and it is important that yield assumptions be representative of what can be achieved with typical producer milk.

We note that the Panel recommended in 2005 that the Department convene a workshop to study this issue in some detail, and unfortunately that workshop was never held.

We do, nonetheless, believe it's important that realistic yield assumptions be made in the formulas, especially given the challenges the State has had in attracting new plant investments.

The next couple of paragraphs talk about the VanSlyke formula. This is testimony that has been presented several times in the past, so I'm not going to go over it. Here if you have questions about it, you can ask me during the question time.

I will say that we are advocating a 90 percent fat retention factor, which we feel is appropriate. It's the one that was used as a basis for setting the cheese yield in Federal Order make allowance formula. And we think we also feel it's consistent with both the notion that regulated prices should be minimum prices and with need of California cheese plants to have greater operating margins.

Another point, the finished moisture assumption we use for the VanSlyke formula is 38 percent. This number is essentially the average moisture content per cheddar blocks. Some years, CDFA data has shown block moisture slightly below this, and some years such as this one slightly above. But 38 percent I think is viewed industry wide as being a fairly representative number for finished block cheddar moisture.

We also note that we have not included an allowance for ranch to plant losses of components for which processors pay based on farm tests but for which they received no value because the loss components never reached the vat. Based on testimony at the 2000 Federal Order Class 3-4 hearing, ranch to plant losses of components average .15 percent in regions like California which are accommodated by large farms.

Also there's an additional loss of fat due to milk fats propensity to cling to stainless steel surfaces. This additional fat loss is equal to .015 pounds per of fat hundredweight of milk. Given that there are these losses that we haven't specifically accounted for, we feel like the 90 percent fat retention factor is adequate to reflect the yield of cheese from farm milk.

In developing our Class 4a formula for 4a fat, we used the existing manufacturing allowance. This allowance covered about 75 percent of the volume process in the state. For solids nonfat, we have used the 2004 weighted average manufacturing costs for nonfat dry milk adjusted for the January through September 2005 energy and labor rates. We do not have any specific information that would suggest a need to change the yield factors for butter and nonfat to dry milk, so we advocate leaving them unchanged.

Note that the butter f.o.b. adjustment is equal to the simple average monthly difference between the CME AA butter price and the weighted average California price for butter for January 2004 through December 2005. This is consistent with what we proposed for cheese.

Moving on to the other proposals, we note that most of the alternative proposals would establish a CCC commodity price floor or snubber on the product values used in the manufacturing class formulas. A price floor of this type proposed was recently removed from the formula after the last hearing. In recommending removal of the price floor, the Hearing Panel noted again quoting, "The incorporation of the federal support price in California's pricing formulas places California processors at a greater disadvantage during times of depressed commodity markets when competing for sales with unregulated processors on a national basis. In the long run, their continuance of commodity support purchase prices as price floors within California's milk pricing formulas may further exacerbate this problem. The crux of this matter is that if California processors are prevented from competing for markets with processors located in other states, some California plants may decide to curtail their production of manufactured milk products. This will lead to inadequate manufacturing capacity within California. Without adequate processing capacity, California producers will be forced to consider other alternatives, including but not limited too shipping milk out of state for processing, relocate their dairy facilities out of state, and/or sending cows to slaughter. These alternative options will all individually and collectively reduce producers' welfare."

The Dairy Institute agrees with the Panel's finding in this situation and we believe that price support floors should not be adopted.

We explained the problems associated with the support price floor in our hearing testimony from February 2005. We restated those arguments as Attachment 1 in this second document.

Turning to the various alternative proposals with regard to Land O'Lakes, LOL's proposal would establish a variable make allowance for dry whey. Dairy Institute, we appreciate, you know, their concept of sharing through the variable make allowance, but we're philosophically opposed to variable make allowances because we believe they mute economic signals that the prices are trying to transmit through the marketplace. Establishing a very variable make allowance for dry whey would set a dangerous precedent that might later be extended to other products. Therefore, we cannot support LOL's proposal in its entirety. However, we do support the updating of the base dry whey make allowance of 27.42 per pound.

Alliance of Western Milk Producers. The Alliance has advocated adjusting the make allowances for butter, cheese, nonfat dry milk and whey monthly based on an index of natural gas prices. This proposal has some appeal, but it is one which we feel merits greater study. Perhaps the Department would be willing to convene a workshop to consider the question of indexing the make allowances used in the formulas. In such a form, the entire industry would have input and we can analyze the Alliance proposal and other alternative approaches to keeping make allowances as current as possible. However, we are uncomfortable moving forward with this concept at this hearing.

Also, taken as a whole, the Alliance proposal would raise 4b prices at a time when cheese plants need greater operating margins, not thinner ones. We do not agree with the Alliance's uses of 12 month weighted average price differences in setting the f.o.b. adjuster levels. The time period use is too short to capture the underlying relationships, and the use of the weighted average difference introduces bias into the adjuster.

Make allowances proposed by the Alliance are based on the Department's cost survey adjusted for September 2005 energy and labor rates. September 2005 was a high price month for energy. We believe that January through September 2005 energy rates will be more representative of what we will be facing going forward with respect to energy costs in 2006.

The Alliance continues to question the CDFA survey cost for dry whey citing the rbCS survey of whey dry costs done by Dr. Charlie Ling. The limitations and shortcomings of Dr. Ling's dry whey cost estimates were discussed in detail at the January 2006 Federal Order Class 3 and 4 hearing. Comments contained in a post-hearing brief submitted by Sue Taylor of Leprino Foods summarized these problems. That's been included on Exhibit H.

It appears Dr. Ling's cost data were incomplete. Also, they were not reflective of California's whey drying costs, and therefore were not particularly relevant for this hearing.

The Alliance also sets a lower dry whey make allowance than is suggested by CDFA data and suggests snubbing the dry whey contribution to the 4b price at zero. We've already addressed the dry whey snubber issue and we urge the Department to reject the Alliance's proposal in its entirely.

California Dairies, Inc. The CDI proposal has many of the same drawbacks as the Alliance proposal with respect to f.o.b. adjusters and make allowances. We urge the Department to reject the CDI proposal for reasons we stated previously.

CDC'S proposal would lead to substantially higher 4b prices which would damage the competitiveness of California's cheese makers in the national market. The CDC proposals are not supported by CDFA data. During periods when milk's abundant and prices are low, CDC's proposal could result in milk being left unpurchased. And plant margins would be squeezed by their proposed variable make allowance.

With regard to Milk Producers Council, we think there's merit to the concept of a cheese marketing allowance and CCC sales credits as proposed by MPC. However, the remainder of their proposal is so problematic we must urge its rejection. MPC's proposed f.o.b. adjuster employs an implicit double discount as a cost of moving product to eastern markets that is without merit or sound rationale. Inclusion of the WPC in the formula is done in a way that ensures that whey value is not well correlated with any of the whey products made by California cheese plants. Furthermore, the rationale for replacing the Grade B butter value for whey cream with a Class 4b fat price is not valid. The issue of whey cream recycling that they bring up was discussed in a hearing held in 1998. We have included excerpts from our May 1998 post-hearing brief as Exhibit I.

The proposed make allowances and yields for WPC do appear verifiable from a broad survey of data from California cheese plants. The proposed dry whey and WPC snubbers are likewise lacking economic justification as we discussed earlier. Finally, the MPC proposal would increase the Class 4b regulated price by an average of 54 cents a hundredweight, a change that would put California cheese makers out of business. We urge the Department to reject MPC's proposal.

We have argued for a different set of f.o.b. adjusters as proposed by Western United, and we continue to stand by our justification for the adjusters we proposed. We urge the Department to reject their support price floor proposal.

In summary, Dairy Institute believes that minimum milk price regulations are the most powerful policy tools that the Department currently possesses. The Secretary can dramatically impact the market opportunities and viability of the state's dairy product manufacturers with a single decision. The Department must therefore take extreme care in setting minimum prices. We believe that the greatest risk in any minimum price regulation is in setting prices too high, which may lead to enhanced producer income in the short run but loss of product sales in the manufacturing capacity in the long run.

We believe that the priority of the Department must be to establish policies which maintain and build market outlets for the growing supply of raw milk in California. High regulated prices will not result in long-term revenue gains for producers if the price paid to achieve these gains is an uncompetitive and nonviable dairy processing and manufacturing sector.

Finally, I think I just want to reiterate again milk production continues to increase. Plant capacity has not, particularly cheese capacity. And we need to address that situation.

Thank you for the opportunity to testify, and I'm willing to answer any questions the Panel has at this time. And I also respectfully request the Department grant a period for filing a post-hearing brief.

HEARING OFFICER KRUG: Thank you, Mr. Schiek.

Do members of the Panel have any questions for the witness?

Mr. Ikari?

DAIRY MARKETING BRANCH CHIEF IKARI: No.

HEARING OFFICER KRUG: Ms. Gates?

RESEARCH MANAGER II GATES: Not at this time.

HEARING OFFICER KRUG: Ms. Reed?

SUPERVISING AUDITOR REED: No, I don't.

HEARING OFFICER KRUG: Mr. Gossard?

AGRICULTURE ECONOMIST GOSSARD: Yes. I do.

At the top of page 3 of your testimony, you state the scenario just described is at least partially reflective of dairy marketing conditions in California this spring. Could you elaborate on what you meant by that sentence, and do you have any supporting evidence?

DR. SCHIEK: I do not have supporting evidence, but I would encourage the Panel to ask that question of other folks presenting testimony here today who deal more with milk dispatchers on a daily basis.

But what's been reported to me is that milk has been shipped out of the state to find processing homes, because there's not enough room for it in the state of California. We have heard that plant capacity -- some of our members have been told by their suppliers not to take any down days for repairs or equipment installations because they need the room.

There's been a lot of concern about the potential for milk having been dumped and not finding a home anywhere in any plant because there's not room for it. And all those discussions are out there in the industry. And I don't have the supporting documentation, but I would encourage you to ask some of the other witnesses here today.

AGRICULTURE ECONOMIST GOSSARD: On page 4, you advocate at the top that because cheese is a higher valued use, it would be a better policy for the State to encourage greater capacity of cheese processing than butter powder, but haven't there been times when the 4a price has been above 4b price for significant time periods?

DR. SCHIEK: Yes, that's true. In the mid nineties beginning about 1996 or '97 continuing through 2002, it wasn't unusual for the 4a price to be above 4b. But I'll point out that that was really a consequence of the management of the price support program rather than a market driven consequence. In other words, the tilt between butter and nonfat dry milk purchase prices was managed in such a way that there was never any butter being purchased, but nonfat dry milk support price was kept very high, and that, you know, lots of nonfat dry milk was made and sold to the government during that time period.

And it's interesting that was done, because the law statutes governing the support program required that that program be operated in a way to minimize government program cost, which means the Secretary should have -- once he saw that powder was being purchased and no butter was being purchased, once he saw that the government support price was the price for powder and that butter was trading above the support price for butter, the Secretary should have made a tilt and adjusted the purchase prices as he's required to do. Once that was done in the early years of the Bush administration by Secretary Veneman, the last adjustment was made in November 2002 I believe, and so from December 2002 forward, once that was done, cheese has been fairly consistently above nonfat dry milk. And I think you look at the fact that so much of the market for nonfat dry milk is in government warehouses, not in commercial outlets. I think that lends credence to the idea that as a commercial product, cheese, 4b, has a higher value than 4a.

Going forward, I think it's likely to say with the budget pressures that we have, the idea that we're going to just open the doors and let all kinds of powder come in to government warehouses and not manage that tilt more appropriately is -- I mean, that's crazy. We've got severe budgetary crunch on a national basis and I think they're going to be looking for every way they can to reduce government costs. One of those is going to be not only managing the program more tightly, but potentially reducing the level of support as well. And as I think I stated with WTO negotiations going on, the U.S. may have to make cuts in its subsidy programs and the support price program for milk and dairy foods is one way to do that.

AGRICULTURE ECONOMIST GOSSARD: Given the legislative mandate the Department faces in setting prices, in terms of equity, can we favor 4a over 4b?

DR. SCHIEK: Can you favor 4a over 4b? I'd rather --

AGRICULTURE ECONOMIST GOSSARD: Or favor one or the other. I'm sorry.

DR. SCHIEK: Well, I guess what I'm saying is a little bit more nuance than that. When you look at make allowances relative to weighted average manufacturing costs, you could say consistent application of that principle means that you're going to set the make allowance at the weighted average manufacturing costs for one product, you should set it at the other.

What I attempted to point out I think my point in Exhibit F where you have volume covered, that table, is that you've got cheese plants with a very clustered -- if the most efficient cheese plants are clustered around very tight costs, nonfat dry milk and butter, the most efficient plants are well below the cost. So I think treating them equitably might look on the surface as if you're favoring cheese, because you might be going for a make allowance that's closer to the weighted average manufacturing costs or even above it. But the reason is really the distribution of those costs.

It's so much different for nonfat dry milk and butter that I think those products could sustain a lower make allowance relative to the weighted average and still have plenty of margin to operate, particularly most efficient plants. Margin to operate and margin to invest in new facilities. Whereas, the cheese plants don't. Because like I say, you know, at 17 cents, zero volume is covered. And 17.1 is the make. That's not a lot of margin.

AGRICULTURE ECONOMIST GOSSARD: In your proposal regarding skim whey powder, you've asked us to initially institute a manufacturing cost allowance of 27.42. But as soon as the price goes below 27.42, the whole whey factor disappears from the 4b formula. If the Panel decided that was just a little too complex, which would you rather have, a whey factor with an allowance of 27.42 or no whey factor at all?

DR. SCHIEK: I think philosophically we've always argued that no whey factor at all would be more appropriate. Because even with a 27.42 make allowance, you know, if whey -- dry whey price is 35 cents, you know, the margin of a plant that's making another whey product could be strongly negative impacted by that formula, even a 27.42. Obviously, you know, plants -- I'm arguing plants need greater operating margins, and increasing the whey make to 27.42 would create a greater operating margin. But I think we've -- to be consistent, we've argued that whey because of the complexity because dry whey doesn't represent all of the whey products made in the state, that the best thing to do is to take it out.

AGRICULTURE ECONOMIST GOSSARD: I've touched on this question in the past regarding the cheese yield. You have consistently suggested that the cheese yield should be based on the average test of farm milk rather than on a fortified vat test.

The problem I've always had with that concept is our costs for cheese plants are costs for fortified vats. And the higher you get a yield, the lower you get your costs. If we want a theoretical yield for the VanSlyke based on incoming milk tests, do you have any theoretical costs that would go with it to figure out what a reasonable make allowance should be?

DR. SCHIEK: Well, that's a good point. And I guess the short answer is no, I don't have those costs. I will say though we were asked at the last hearing that, you know, if we were arguing for non-fortified milk cheese yields should the fortification costs that are now included in the surveys and included in the weighted average manufacturing costs, those should be removed. Of course, to be consistent, they should be. But in terms of the loss of efficiency and the costs implied by that, I do not have data on that. I can try to investigate that, but I don't know what's out there.

AGRICULTURE ECONOMIST GOSSARD: Turning to the issue of the whey butter, the proponents -- as I understand it, the proponents of using the 4a fat price in lieu of a pseudo whey butter or Rate B butter price are arguing that most of the whey fat does not go into butter but is put back into the vat. It's a fortifying product.

Is this true that most of your -- most cheese plants are putting the fat back into the vat from the whey stream?

DR. SCHIEK: I just know that significant volumes of cheese made in California that is not the practice. The term most -- you know, I don't have a census of, you know, six do and five don't or whatever. But it is by no means representative of the industry as a whole in California. I don't know about the rest of the country.

But in California it's not representative of the industry.

AGRICULTURE ECONOMIST GOSSARD: The other question I had --

HEARING OFFICER KRUG: Is the microphone on? Can you hear it in the back? Try it again.

AGRICULTURE ECONOMIST GOSSARD: Okay. You mean -- I'm sorry. Did you ask that he re-respond to my question about the yield and cost or just the question on the Grade B butter?

Okay. The question on the Grade B butter. Dr. Schiek, the argument has been made that instead of producing whey Grade B butter, plants are putting the cream back into the vat as a fortifying process.

From your information, your cheese plant members and other cheese plants in California, is this typical?

DR. SCHIEK: The recycling of whey cream, in my understanding, is something that does happen in some cheese plants. But in significant volumes, some major cheese plants in the state it has not happened.

I noted in the exhibit that I furnished that we addressed this more fully at the hearing some years ago, and these comments are still valid. That there are a lot of problems associated with sort of recycling whey cream back into the vat. First of all, it's not a costless phenomenon. It creates extra cost. There's extra ingredients that have to be put in in order to get cheese out of that. It just -- you can't just put it in and get more cheese. You can get more product with a higher fat content, but then that reduces the quality of the cheese, and you end up having cheese discounted because of it.

There's lots of technical issues regarding the bacteria that will impact the starter and reduce the yields of the cheese. So there are a lot of problems with it. To be able to do it successfully, there may be some plants that can. But there are a lot of plants just don't mess with it either because their customer doesn't want them to do it or because they just are concerned about the quality and yield and the costs and haven't been able to make it work. I guess, you know, you'll probably hear some more testimony about that.

AGRICULTURE ECONOMIST GOSSARD: The other thing, if it were true that most of the whey butter was going back into the vat, wouldn't that imply the weigh butter yield?

HEARING OFFICER KRUG: Does the reporter need a break?

Continue.

DR. SCHIEK: You know, I haven't thought about it that way, but obviously if it's reused, there would be no whey butter. Yeah, it's true. I mean it would all be captured in the product. There may be some double counting there in that proposal.

AGRICULTURE ECONOMIST GOSSARD: In your discussion of whey protein concentrates, you said that you had gotten some plant costs on WPC from your members.

DR. SCHIEK: I don't think I said I had costs. I had price information on WPC.

AGRICULTURE ECONOMIST GOSSARD: That's a misunderstanding.

Then actually I do have a question about your Exhibit E which does have your price information.

Do you have prices going back before January 2005, or do you only have the data listed here?

DR. SCHIEK: I only have the data listed there that I can put together in format for presentation.

AGRICULTURE ECONOMIST GOSSARD: Okay. And -- I'm sorry. I know you said this and I just missed it. What was your assumption about the protein concentration and skim whey powder?

DR. SCHIEK: Twelve percent.

AGRICULTURE ECONOMIST GOSSARD: Twelve percent.

Thank you. No further questions.

HEARING OFFICER KRUG: Do any of the other Panel members have questions at this time?

No. Thank you, Dr. Schiek.

It's now 10:40. We'll take a 10-minute break. After that time, we will commence the special one-hour period for the shortened comments.

Off-the-record.

(Thereupon a recess was taken.)

HEARING OFFICER KRUG: All right, folks. Lets everybody re-take your seats.

Will every one please re-take your seats. The hearing is going to reconvene.

Okay. Thank you very much. The one-hour period for three-minute comments will commence now. I'll call up two speakers at a time. So if you could testify over there, we have here a signal. When it's green, your time to speak is on. When the amber light comes on, you have 30 seconds left. When the red light comes on, your time is finished. Please finish your sentence. Thank you.

Our first speaker is Mr. John Rossi. After that, Linda Lopes, would you please come forward?

Will you please state your full name and spell your last name for the record?

MR. ROSSI: John Rossi. That's R-o-s-s-i.

HEARING OFFICER KRUG: Do you swear or affirm to tell the truth?

MR. ROSSI: Yes, I do.

HEARING OFFICER KRUG: You may proceed with your testimony.

MR. ROSSI: My name is John Rossi. I'm President of John Rossi Hay Company, Inc. and AMPSI, and I'm here to testify on behalf of my dairy customers and the hay farmers.

The John Rossi Hay Company will support a 50 cents per hundredweight raise in the make allowance for the creameries, if the creameries will support a raise in the national milk support price to $12.50 per hundredweight. Timing for this increase in the make allowance today cannot be worse. Today, milk prices are at an all-time low, taking inflation into a factor. How can a dairyman today give a raise to their creamery and keep them profitable with resources they do not have?

Overproduction is not the fault of the individual dairymen. He produces milk for sale. If the creameries or buyer says he will buy all that can be produced, the producer has a duty to fill the order the best he can.

To allow one section of the dairy industry to become profitable while the other one dyes on the vine is wrong. Acceptance of an increased make allowance at this point with the depressed milk prices without a plan for the dairymen to become profitable as well is a sign of incompetence.

If the increase of a make allowance today is totally necessary, my recommendation for this -- for the creameries is to borrow the extra money from the dairymen in the form of a make allowance until the $12.50 support price legislation has been completed. This money can be paid back in a timely manner after profitability is restored back to the dairy producer.

Most dairymen belong to co-ops, and it is now time for co-ops to look at recovering their losses due to inflation from the marketplace with the help of an increased support price. I will now give an example of what low producer prices have done to my hay business. Talking about hay prices today, they are off approximately $1250 per load or $50 per ton from this winter's prices. With the make -- which makes farm prices for good hay near cost of production and off grade hay below cost of production, and this is just the beginning of the 2006 season.

Tonnage this year is down from last year, and last year we had a record year for profitability due to the good milk prices of 2005. Growing costs have become more expensive for hay farmers because of inflation affecting the prices of herbicides, insecticides, labor, fuel, water, bailing, and hauling. Accounts receivable in my business have been skyrocketing in the last six months, and bankruptcies are beginning.

Banks are chilling up on loans because they need to see the dairymen's ability pay them back. Dairymen do not want to sell their cattle today because the market price has dropped 30 to 50 percent from last year's prices because of low milk prices.

All this has happened because of overproduction, which the producer is not at fault and low prices have occurred without correction.

HEARING OFFICER KRUG: Thank you, Mr. Rossi. Your time is up.

You have presented written testimony. It will be -- would you like it entered into the record?

MR. ROSSI: Yes.

HEARING OFFICER KRUG: Yes, this written testimony is labeled Exhibit 48. It is entered into the record. And please be aware that the full text of your testimony is a part of the record and will be considered into the deliberations.

(Thereupon the above-referred to document was marked as Exhibit 48.)

HEARING OFFICER KRUG: Thank you very much.

Ms. Lopes will be the next witness. Following that will be Domenic Carinalli.

Ms. Lopes, you may proceed. Would you please state your full name and spell your last name for the record?

MS. LOPES: Linda Lopes, L-o-p-e-s.

HEARING OFFICER KRUG: Ms. Lopes, do you swear or affirm to tell the whole truth?

MS. LOPES: I do.

HEARING OFFICER KRUG: You may proceed.

MS. LOPES: I am Linda Lopes, President of California Dairy Women's Association and also a dairy producer from Turlock, California.

This hearing was called to consider the reasonableness and economic soundness of market milk prices of all classes, giving consideration to combined income from those classes in relation to cost of production of marketing for all purposes including manufacturing. The cost production figures calculated by CDFA for the first quarter of 2006 was not available at this time due to the information now collected on a quarterly basis rather than bimonthly as done in the past.

The CDWA is opposed to the Dairy Institute's proposal and any other proposal that calls for reduction in producer price. Producer overbased prices could drop an estimated 51 cents per hundredweight. An overbased reduction of this magnitude would be devastating to the California dairy families and related businesses.

The timing could not be worse. At today's prices per every 500 cows, we're losing $17,000 a month, $204,000 a year. We are all eating up equity, equity that took years for us to build. With today's increased costs, we need $16 milk, not $9 milk. According to Genske, Mulder & Company, the average dairy will lose about $1.62 per hundredweight of milk in 2006, and this loss does not provide cash flow for principal debt repayment or owner's personal living. Because of the increased costs for feed, interest, environmental compliance, energy, et cetera, the operating costs for running a dairy farm are now more than $14 hundredweight. The USDA has supplemented our incomes with the Market Loss Income Contract payments. These payments will be ending soon, and we will now feel the impact of those low milk prices even more.

Dairy Institute's proposal states processing plants have experienced increased energy and labor costs, so have producers. As processing plants have experienced rising transportation costs, so have producers.

We are experiencing many increased costs. Environmental regulations will lead to added costs. We cannot pass these increases on to anyone. We are at the end of the line. It is not right that CDFA covers the costs of the processing side of the dairy industry but not the producer side. You might say that we must keep the processors in business to process the milk. CDFA makes a statement that there's always an adequate supply of milk. Someone will always produce the milk for less. Let us turn the table and compare it to your jobs. The State of California is in need of money. They cut your salaries by 30 percent. They tell you to survive on your equity. The Governor says he can hire someone else to do your job for less money. How would you like it?

Processors can also become more efficient. I am sure there's a lot of waste going on in the plants. Maybe they could take cuts in pay. The lists goes on and on. These are tough times for both sides of the dairy industry.

HEARING OFFICER KRUG: Ms. Lopes, your three minutes are up. Thank you very much. You've offered a document here. Would you like it entered into evidence?

MS. LOPES: Yes.

HEARING OFFICER KRUG: This document is labeled Exhibit Number 49. Please keep in mind that the full text of your comments written are in the record and will be considered.

(Thereupon the above-referred to document was marked as Exhibit 49.)

HEARING OFFICER KRUG: Ms. Lopes, would you desire to submit a post-hearing brief?

MS. LOPES: Yes.

HEARING OFFICER KRUG: Mr. Rossi, I forgot to ask you, would you like to submit a post-hearing brief?

MR. ROSSI: Yes.

HEARING OFFICER KRUG: Thank you.

Mr. Domenic Carinalli is next. After that, Craig Rasmussen.

Mr. Carinalli, would you please state your name and spell you last name for the record.

MR. CARINALLI: Domenic Carinalli, C-a-r-i-n-a-l-l-i.

HEARING OFFICER KRUG: Mr. Carinalli, do you swear or affirm to tell the truth?

MR. CARINALLI: I do.

HEARING OFFICER KRUG: You may proceed.

MR. CARINALLI: My name is Domenic Carinalli, Jr., and I am representing myself as a dairyman from the North Bay area. Our dairy has been in existence since 1924, and I have been the owner/operator since 1962.

I have attended dozens of hearings before pooling the quota times, when consumers and dairymen were wearing cow costumes marching in the streets yelling at each other. We were arguing about pennies, sometimes even a dime. A small group of forward thinking dairymen like Ray Gambonini, Louie Barcellos, and others, developed a Pooling and Quota System where all monies were be pulled and distributed to dairymen. This eliminated competition between dairymen whether they shipped to a Class 1 plant or manufacturing plant. A quota system was part of pooling where producers in high cost areas like myself could remain in the dairy business.

The formula by which producers are paid through pooling has changed from time to time to reflect current conditions. This is the way it was designed to operate in 1969, and it has worked remarkably well the last 37 years.

This is the first time I've testified at a hearing, and I feel compelled to make comments at this time. My friends -- and I do mean friends -- at the Dairy Institute I feel are attacking the very core to the pooling system. Some examples are cherry picking costs, wanting to eliminate dry whey from the formula, which we worked for many years to get it into the formula.

They contend that milk is too costly in California. Some have chosen to move to other states under the Federal Marketing Order. In the Federal Milk Marketing Order, whey and protein are pooled. This should make milk more expensive. But the fact is that milk is depooled in at whatever the plant can negotiate under the federal system.

I could go on with many comments on how to improve the California system. One would be to eliminate depooling in the Federal Order. With the time restriction today, I will close with a comment that a cut in my price of 51 cents a hundredweight will be a fatal blow to many dairymen in California and particularly in a high cost area like the north bay. For the good of the California dairy industry, I'm asking you to reject the Dairy Institute proposal its entirety.

That's the end of my comments, if there's any questions.

HEARING OFFICER KRUG: Thank you, Mr. Carinalli. You provided the Panel with a document here of your comments. Would you like that entered into the record?

MR. CARINALLI: Please.

HEARING OFFICER KRUG: Your document's labeled Exhibit Number 50 and it is entered into the record.

(Thereupon the above-referred to document was marked as Exhibit 50.)

HEARING OFFICER KRUG: Mr. Carinalli, would you like the opportunity to submit a post-hearing brief?

MR. CARINALLI: Sure.

HEARING OFFICER KRUG: Yes. That request is granted, as is the request from the previous two speakers.

Our next speaker is Craig Rasmussen followed by Vickie Mulas.

Mr. Rasmussen, would you please state your name and spell last name for the record.

MR. RASMUSSEN: Yes. Craig Rasmussen, R-a-s-m-u-s-s-e-n.

HEARING OFFICER KRUG: Ms. Rasmussen, do you swear or affirm to tell the truth?

MR. RASMUSSEN: I do.

HEARING OFFICER KRUG: You may proceed with your testimony.

MR. RASMUSSEN: Gentlemen and ladies, good morning. I am Craig Rasmussen, Vice President of Operations of Blue Ribbon Cheese Company who I represent today at this hearing.

My testimony today is in support of the petitioner's request for changes to the Class 4b formula. We specifically support the Dairy Institute's alternative proposal. Blue Ribbon Cheese Company is prepared to begin construction in the great central valley this year of a state-of-the-art cheddar and mozzarella cheese and whey derived products facility that will handle approximately 6.8 million pounds of milk per day. This project will represent an investment into California exceeding $200 million and will provide approximately 225 new jobs.

Through our years of planning this project and exhaustive due diligence, it is clear that the cost of processing milk into cheese continues to rise. Moreover, the wild fluctuations in the whey markets cut directly against some of the arguments you will here today to the value of whey products.

The facts are that rising energy, labor, workmen's compensation, and transportation costs are very real and are major obstacles to growth of the California cheese industry. In fact, our company has been forced to consider alternative states for this project as a result. Some of the proposals before you today may foreclose our investment in California.

Will California continue to grow its dairy herd and milk production, while disincentivizing the processing of that milk within the state? California is currently experiencing a major oversupply of milk relative to daily processing capacity. We all know that Hilmar Cheese Company has decided to expand in the state of Texas rather than here. Can California afford to lose another major milk processing plant?

Our strong desire is to construct and operate our plant on land we already own here in California. We understand that the California Milk Advisory Board has identified the creation of incentives for additional cheese plant capacity in California as its number one recommendation. And we could not agree more. You now have a chance to encourage a real project that is ready, willing, and able to make a major investment into the California dairy industry.

By adopting the Dairy Institute's proposal, our company can make a significant investment in California. Thank you, gentlemen.

HEARING OFFICER KRUG: Thank you, Mr. Rasmussen.

You provided the Panel with a document. Would you like this document entered into the record?

MR. RASMUSSEN: I would, sir.

HEARING OFFICER KRUG: The document, "Statement of Craig Rasmussen" is labeled as Exhibit Number 51 and it is hereby entered into the record.

(Thereupon the above-referred to document was marked as Exhibit 51.)

HEARING OFFICER KRUG: Mr. Rasmussen, would you like to submit a post-hearing brief?

MR. RASMUSSEN: Yes.

HEARING OFFICER KRUG: Your request is granted.

The next witness in line the Vickie Mulas. Following -- did I have your name right? Following Ms. Mulas is Belinda Silva.

Ms. Mulas, would you please state your name and spell your last name for the record.

MS. MULAS: Vickie Mulas, M-u-l-a-s.

HEARING OFFICER KRUG: Ms. Mulas, do you swear or affirm to the truth?

MS. MULAS: Yes.

HEARING OFFICER KRUG: You may proceed with your testimony.

MS. MULAS: Good morning. My name is Vickie Mulas, Mulas Dairy Company in Sonoma, California, third generation dairy family.

I am extremely concerned the Department of Food and Agriculture is considering the proposal by the Dairy Institute to reduce producer overbase prices. At a time when milk prices are at an all-time low, consideration of a price reduction of any kind would add to the already existing burden caused by increased production costs associated with high energy and labor as well as the current and proposed environmental regulations. Unlike processing plants, producers have no opportunity to pass these burdens on.

To assume that only the processing plants have experienced rising transportation costs is shortsighted. We have been paying a surcharge on all commodities hauled to our dairy as well as increased transportation costs to all our product to plants.

I find it extremely bothersome that processors are looking to the producers to offset their increased costs when they have been passing these costs on to consumers regularly. While producers are getting less money for their milk, the consumers' cost remain at the same level as it was when producers were being paid more. It's apparent to me that the pricing mechanism being used to pay producers does not adequately reflect the true cost of operating in California, nor does it compensate producers for having the highest standards in the nation.

Before the Department considers any type of decrease to producers, I might suggest you consider a formula that would allow us to recoup the environmental costs and operating costs not regulated by the State or any other entity. Another suggestion might to be consider regulating the price processors can charge consumers for products based on what is paid to producers. When dairymen are paid more for their product, the processor can pass this on the consumer. When dairymen are paid less, then the consumer benefits.

The dairy industry is very important to the economic survival of other support services in our respective communities. Many businesses are currently experiencing the effects of our already too low milk prices. A determination by the Department to decrease by any amount at this time will surely have costly implications. I encourage you to consider the alternatives which would be to pay the producers enough to at least break even, if not be given the opportunity to work on the same profit margin as processors. Thank you.

HEARING OFFICER KRUG: Ms. Mulas, you handed the Panel a document. Would you like this document entered into the record?

MS. MULAS: Absolutely.

HEARING OFFICER KRUG: It's labeled Exhibit Number 52, and it's hereby entered into the record.

Ms. Mulas, would you like to submit a post-hearing brief?

MS. MULAS: Yes, please.

HEARING OFFICER KRUG: That request is granted.

(Thereupon the above-referred to document was marked as Exhibit 52.)

HEARING OFFICER KRUG: Our next witness is Belinda Smith. Following that will be Carl Van Vliet.

MS. SILVA: That's Belinda Silva, S-i-l-v-a.

HEARING OFFICER KRUG: I beg your pardon, Ms. Silva.

MS. SILVA: Same thing in Portuguese terms.

(Laughter.)

HEARING OFFICER KRUG: I'm wearing glasses and contacts, and I still can't read.

Ms. Silva, would you please state your name and spell your last name for the record?

MS. SILVA: It's Belinda Silva, S-i-l-v-a.

HEARING OFFICER KRUG: Ms. Silva, do you swear or affirm to tell the truth?

MS. SILVA: Yes, I do.

HEARING OFFICER KRUG: You may proceed.

MS. SILVA: I brought no written testimony to submit. You just get me. It's the real thing.

What I would like to tell you is I'm a dairy farmer in Denair, California, central valley. I dairy along with my partner and my spouse, Mr. Joe Silva. And he's here today as well. We love it. We chose dairying. We couldn't see doing anything else given the choice of doing what we would do. That doesn't mean that we automatically should get paid for what we like to do. But we'd like to think we work hard and that, you know, there should be equity in that we provide a product that people actually -- there's a huge demand for.

What I'd like to share with you is the fact that the cost of operation has increased to all industries, including dairying and dairy farmers are businesses as well, so we do like to think that California has a business-friendly environment, and that should include dairy farmers as well.

I received letters coming in to fall's farming season from my customer cropping company actually apologizing to us for having to increase their costs to us because they knew it was going to be tough. But they had increased their costs. They had pass it on to us because their fuel costs, their energy costs, and their workman's comp had all increased, so they did pass that on to us.

I brought with me -- I probably have 85 percent of my vendors that I'm paying right now a fuel surcharge or energy surcharge. I brought some of the more interesting ones just to demonstrate how huge this is in my accounts payable. It's just about everybody.

This is the Alhambra water guy, and I have a fuel surcharge on Alhambra water guy. I suppose we could go back to drinking out of the tap, which is an option. This is the dead stock pickup man. He had to increase his costs to us because it was costing him more. And we have no choice other than bury them, which I'm not sure that we could get away with that for very long.

(Laughter.)

MS. SILVA: This is the tire service man. We love this man. Because without this man, we wouldn't get our cows fed sometimes, because these are tires on our feed truck. But he had to charge us a $15 fuel surcharge. And the one of the most interesting ones is -- and I do depend on this man as well because we do have employees who live in houses on the facility. This is Yates Waste

Water Service. This is our septic pump people. And they had to add a fuel surcharge as well. Not to mention our handler, Hilmar Cheese. I value them. I value all the handlers in the state. I want to keep them all here. It's to my benefit to have all handlers and to have competition.

But we've been paying a fuel surcharge to them for quite some time. And in the past 12 months, it's totaled $5,357. So they have the ability already to pass on these costs at this point and we're paying it already.

I understand all this. I don't understand this hearing. This makes sense to me. This hearing doesn't. That's all I have to say.

HEARING OFFICER KRUG: Thank you, Ms. Silva.

Ms. Silva, you have --

MS. SILVA: I did reference to you --

HEARING OFFICER KRUG: I was going to ask you, you did bring some documents with you. Would you like them to be entered into the record?

MS. SILVA: Yes, I would.

HEARING OFFICER KRUG: Do you have copies of them?

MS. SILVA: Yes, I do.

HEARING OFFICER KRUG: Okay. We won't ask staff to make copies. If you'll bring those forward, they will be marked as a group Exhibit 53 and will be entered into the record.

(Thereupon the above-referred to document was marked as Exhibit 53.)

HEARING OFFICER KRUG: And one last thing, Ms. Silva.

MS. SILVA: Yes.

HEARING OFFICER KRUG: Would you like to submit a post-hearing brief?

MS. SILVA: Sure.

HEARING OFFICER KRUG: Ms. Silva responded in the affirmative, and she is granted the opportunity to submit a post-hearing brief.

Mr. Van Vliet and then Jerry Corda, would you please come forward?

Mr. Van Vliet, would you please state your full name and spell your last name for the record?

MR. VAN VLIET: My name is Carl -- can you hear me?

HEARING OFFICER KRUG: Is the light on?

MR. VAN VLIET: Comes with instructions. Okay. Good morning. My name is Carl G. Van Vliet. The last name is spelled capital V as in Victor, a-n, V as in Victor, l-i-e-t.

HEARING OFFICER KRUG: Mr. Van Vliet, do you swear on affirm to tell the truth?

MR. VAN VLIET: I do.

HEARING OFFICER KRUG: You may proceed with your testimony.

MR. VAN VLIET: I am a dairyman in San Joaquin County. I'm a fourth generation dairyman. My parents came from Holland, and I'm here to oppose the Dairy Institute's petition and other petitions put forward by the processors.

June is dairy month, and June 1 is payday for workers. I believe this room would be overflowing with dairymen and women if this hearing date was not carefully planned at this time. I kind of think there was maybe a little bit method to this timing. And we try to get more and more dairymen here. In 2003, we had two or three buses that came. And today, you know, we couldn't get people here because they're facing low milk prices and they can't afford to not be on their ranch to try to eliminate the losses.

Okay. When farmers are not struggling to get all jobs done so as to reduce more losses and possibly stay in business in California, so as I speak, I know it has -- as I speak, know it has come with a big cost to me at this time. I don't get paid to be here as some CEOs. Processor prices are already 30 percent below our cost of production. Now is not the time to lower producer prices even further.

I believe and want to urge CDFA to adopt the CDC's petition that would floor the 4a and 4b price and all producer groups throughout the state are working together in support of a price floor for producers.

Producers continue to pay record high energy prices that -- that increase all our costs to operate. Producers should not also be required to cover the processors' increasing costs. We have to make decisions on a daily basis. Why are they not required to live in the same environment but make others to cover their costs?

I urge CDFA to oppose the Dairy Institute and the Land O'Lakes petition in their entirety. I urge CDFA to oppose the portions of California Dairies, Incorporated, Land O'Lakes, and all the Alliance of Western Milk Producers petition that increase the make allowance and lower producer prices.

We as producers are governed by a market of supply and demand. When supply is up, then producer prices fall. However, in stores this is not reflected, and consumers are not given the opportunity to buy more to create a greater demand.

Yes, years ago, I remember touring a powder plant and soon afterwards reading in the newspapers too much milk. As of today, too much milk.

HEARING OFFICER KRUG: Mr. Van Vliet, your time is up. But you don't have written comments to submit. Could you please finish up?

MR. VAN VLIET: I'll do it quickly in a minute.

Okay. I hear in the first testimony adjusting production plants. I believe in processors being accountable to the market. Plants don't need to process just to process because of healthy make allowances but need to process because of a true market.

To accept big increases in production without increases in market will lead to a glut of milk and drive milk prices to drop like a rock, to sell excess to government in forms of powder and similar products and allow processors to purchase dairy ingredients at cheaper prices which gives them an incentive to do this which allows a bigger profit margin. Managing warehouses, if there is too much milk, then let them say so. Let them be part of the solution. Let them be accountable to the market.

I support a variable make allowance which would give processors the incentive to keep the supply and demand healthy. Imports have increased also. A variable make allowance would give processors incentive to use local products which would increase their make allowance.

HEARING OFFICER KRUG: Thank you, Mr. Van Vliet.

MR. VAN VLIET: Thank you.

AGRICULTURE ECONOMIST GOSSARD: I had one question.

HEARING OFFICER KRUG: Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: Mr. Van Vliet, you said today was a bad day in terms of being able to get dairy farmers out. You said part of it was because prices are so low, it's hard for people to afford to be away. But I think you also said something about the first of the month is a bad day. Would yesterday or tomorrow have been better like the 2nd or the 31st?

MR. VAN VLIET: We're under a time thing and we're encouraged to use time cards. Well, those time cards aren't done until the last day of the month. And me and my wife were up until 11:30 last night figuring out paychecks. And they want to get paid today. I'm not going to be there. And so we had figure them all out. And I'm thankful to my wife. She did most of the figuring. But there's always little incentives that we have to get our workers to try to do a little bit better job, and I have to figure those out because she doesn't know the ins and outs.

But I know that there was lots of producers that wanted to be here today and they chose not to, kind of because the winter we had. Because it was so wet, and they couldn't get that crop off. And then when they did get it off, they all wanted to get it off. And then you had to wait, and now they're trying to get their corn in. And if they don't get their crop in, they don't have feed. So if they don't have feed, then they can't feed their cows cheap enough to stay in business. It's a vicious cycle.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

HEARING OFFICER KRUG: Thank you, Mr. Van Vliet.

Would you like the opportunity to submit a post-hearing brief?

MR. VAN VLIET: Yes, please.

HEARING OFFICER KRUG: Mr. Van Vliet answers in the affirmative, and that request is granted.

Our next witness is Jerry Corda followed by -- bear with me. I can't read this name. John Bartlin or Bartlini.

MR. BARTLIN: By the way, I'd like to the decline.

HEARING OFFICER KRUG: Excuse me?

MR. BARTLIN: I'd like to decline.

HEARING OFFICER KRUG: Okay. Thank you very much. That would be the last witness we have signed up for this period. If anyone else would like to testify during this three minute, this special hour period, please sign up now.

Mr. Corda, are you ready to proceed?

MR. CORDA: Yes.

HEARING OFFICER KRUG: Please state your name and spell your last name for the record.

MR. CORDA: Jerry Corda, C-o-r-d-a.

HEARING OFFICER KRUG: Mr. Corda, do you swear or affirm to tell the truth?

MR. CORDA: Yes, I do.

HEARING OFFICER KRUG: You may proceed.

MR. CORDA: Just like many speakers before me, I also oppose the Dairy Institute's proposal. I'm fourth generation. I have a dairy ranch in northern Marin County. Been dairying there with my family since 1941 we were on that dairy. My great grandfather came here originally from Tacchino, Switzerland in 1884. Started a legacy and a family tradition of our family being in the dairy industry. They had hard times too. They survived them. For us with these hard times, it seems as though we can't even let the next generation like my children or possibly my grandchildren carry on that tradition because of the pricing system and the cost to the dairymen burden today.

Even on my own dairy, my close family -- my brother is a partner with me. His four children, one of them the become an electrician. One's a nurse. One's a legal secretary. And one's becoming a flight paramedic.

My two children, my son is a promotions guy for a computer company, and my daughter works for Cargile in the livestock region of Modesto. And it just seems like we have no chance for them to survive in this industry and to carry on that tradition, which is kind of I feel sad. I know they would like to do it. They have seen how hard we've worked. They have seen what we have had to do. And they see our burden of the debt load we have today. Even my daughter made the statement the other day. She says, "Dad, I don't think I need to take over your debt load. I love to just, you know, do my own job. And although I like to be on a dairy" -- they just see the problems. And for some reason, some way we need to keep our price in tact and be able to survive and to pass this tradition on.

With that, I will close.

HEARING OFFICER KRUG: Thank you very much, Mr. Corda. Mr. Corda, would you like the opportunity to present a post-hearing brief?

MR. CORDA: Yes, I would.

HEARING OFFICER KRUG: That request is granted.

That completes all the persons we have signed up so far. I believe there's one or more coming. One more.

Whoever you are, why don't you come forward.

MS. MORETTI: Thank you.

HEARING OFFICER KRUG: You're welcome. Will the witness please state her name and spell the last name for the record?

MS. MORETTI: My name is Monique Moretti, M-o-r-e-t-t-i. I'm a dairy operator in Northern California, north bay.

HEARING OFFICER KRUG: If I could just swear you in here. Ms. Moretti, do you swear or affirm to tell the truth?

MS. MORETTI: Yes, I do.

HEARING OFFICER KRUG: Now you may proceed.

MS. MORETTI: This is only the second hearing I've ever attended. I'm not going to sit up here and pretend I understand the complex pricing structure of California, because I don't. I concentrate on running my farm with my husband.

But as I sit here and I listen to all the testimony, I'm compelled to speak on behalf of the industry and my family. This is an industry we're proud of. As many of us are producers, we do it because we love it. But it is also something that, you know, we strive to make a living and raise our families.

So I couldn't say this proposal comes at a worse time in our industry. We're struggling to make ends meet. We can't pass on our costs. So as I listen to all this, I just felt compelled to sit up here and speak my peace and say I encourage you as a panel to really take into consideration, you know, the hard work that we put in our industry and how we are struggling too and have no opportunity to pass on those costs.

So really I object to this proposal, and I hope you take into consideration how we all as producers feel about this. And the impact it can have on us is dramatic. That's all I have to say. Thank you.

HEARING OFFICER KRUG: Thank you, Ms. Moretti. Would you like the opportunity to file a post-hearing brief?

MS. MORETTI: I don't really know what that is, but I guess I should say yes.

(Laughter.)

HEARING OFFICER KRUG: I'm sure someone can explain it to you. Your request is granted.

Is there anyone else who would like to testify during this period?

Hearing no one else, we'll close this special one-hour period. I do want to express a special thank you to those that have testified during this period. The

Department is most interested in obtaining all the evidence and testimony that you have to offer, and we appreciate your coming today.

Could we go off-the-record for one minute?

(Thereupon a recess was taken.)

HEARING OFFICER KRUG: Okay. Back on the record.

Will now reconvene with the normal course of the hearing with the alternative proposals. The first alternative proposal was presented by Western United Dairymen. Would their representative please come forward.

Your witnesses ready?

MR. MARSH: Yes.

HEARING OFFICER KRUG: Okay. Will the witnesses please state your full name and spell your last name for the record?

MS. LA MENDOLA: Tiffany LaMendola, L-a-m-e-n-d-o-l-a.

HEARING OFFICER KRUG: Ms. LaMendola, would you swear or affirm to tell the truth?

MS. LA MENDOLA: I do.

HEARING OFFICER KRUG: Okay. Will the next witness please state --

MR. MARSH: Michael Marsh, M-a-r-s-h.

HEARING OFFICER KRUG: Mr. Marsh, do you swear or affirm to tell the truth?

MR. MARSH: I do.

HEARING OFFICER KRUG: Are the two you representing Western United Dairymen?

MR. MARSH: Yes, we are.

HEARING OFFICER KRUG: Okay. Do you have any written statements or other things that you would like entered into the record?

MR. MARSH: Yes, we do, and we have distributed them to the Panel.

HEARING OFFICER KRUG: Okay. I have here a document that's labeled, "Testimony Western United Dairymen." It's labeled Exhibit Number 53. It's now entered into the record. And you may proceed with your testimony.

(Thereupon the above-referred to document was marked as Exhibit 54.)

MR. MARSH: Thank you, Mr. Hearing Officer, members of the Hearing Panel. My name is Michael Marsh. I'm the Chief Executive Officer of Western United Dairymen. I'm also a certified public accountant licensed to practice in the state of California. Joining me today is our Director of Economic Analysis, Tiffany LaMendola.

An elected Board of Directors governs our policy. Our association is the largest dairy producer trade association in California representing approximately 1,100 of the state's 2,000 dairy families. We're a grassroots organization headquartered in Modesto, California. Western United Dairymen was opposed to the call of this hearing.

I'm going to skip to some pertinent parts, because we do have a lot of information contained within our written testimony that I'm sure to Panel will get to.

Relationship to Federal Order Minimum Class Prices. Under Section 62062 of the Food and Ag Code, it states that the methods or formulas should be reasonably calculated to result in prices that are in a reasonable relationship and sound economic relationship with the national value of manufactured milk products.

According to Department analysis for the period 2001 through 2005, California's Class 4b price fell short of Federal Order Class III price an average of 52 cents per hundredweight. Had the Dairy Institute proposed changes been in effect, the disparity would have been 88 cents to a $1.16 per hundredweight. Likewise, California's Class 4a averaged 35 cents per hundredweight below the Federal Order Class 4 price. This disparity would have grown 47 cents per hundredweight had the Alliance or CDI proposal been in place.

We realize that part of disparity is contributible to f.o.b. adjusters which we support.

Differing manufacturing costs allowances, which is the topic of recent debate in Federal Order, is also at play. However, even accepting the differences due to these components, we cannot ignore the fact that if the Dairy Institute petition were implemented, the incredible disparity created would clearly violate the mandates outlined in Section 62062 of the Food and Ag Code.

The Hearing Panel report was clear that the gap between California's for 4a and 4b prices relative to corresponding Federal Order prices was not a focus of the Panel. However, a great deal of time was spent explaining California's manufacturers' disadvantage due to competition with plants in Federal Order that are able to depool. So we find it prudent to point out that two Federal Orders, the upper Midwest and Mideast, have instituted changes through the public hearing process to limit the ability of plants to depool and repool from month to month. A third Federal Order, Central Federal Order, is currently considering similar limits. While we realize these changes will not eliminate depooling entirely, we are confident it will have some positive impact.

We ask the Department to be cognizant of mandates outlined in the Food and Ag Code and the recent changes in Federal Order in their consideration the proposed changes at hand.

Given current conditions in the industry, the years ahead will undoubtedly be more challenging for California's dairy families. Economic and regulatory pressures are mounting on producers in the state and no reprieve is in sight. The Dairy Institute cites a "deteriorating business climate in California" and increasing business costs as part of the rationale for the current hearing. What of that same claim for the 2,000 dairy families in the state of California? Though we acknowledge that processors are facing challenges, we must point out that the dairy families that we represent are already very familiar with such pressures.

Current and proposed environmental regulations placed upon producers will lead to added costs. With no way to pass along added costs, dairy producers will have no option but to take on additional debt or find alternative funding sources in order to comply with the myriad of new regulation. For some, these additional costs will result in the demise of their dairy operation.

As processing plants experienced increased energy and labor costs, so too have dairy producers. As processing plants have experienced rising transportation costs, so too have dairy producers. However, processing plants have the ability to pass on some of these added costs, while dairy producers have no such mechanism.

As production costs continue to increase for producers, they are simultaneously faced with declining income as producer prices have begun a steady downward trend. The already declining producer price is coupled with the reductions sought by the Dairy Institute especially after the draconian Step 2 of eliminating the dry whey component of the formula is an untenable economic hit for many dairy families. Many will go out of business or acquire additional debt as noted above. Neither outcome will be positive for the industry as a whole.

The California Legislature established statutes requiring the Secretary to consider relevant economic factors when establishing minimum prices. Section 62062(a) of the Food and Ag Code in part states, "The reasonableness and economic soundness of market milk prices from all classes giving consideration for the combined income from those class prices, in relation to the cost of producing and marketing milk for prices shall be considered."

According to data contained in the 2005 Cost of Production Annual, "Higher feed, fuel and herd replacement costs led the way in 2005 resulting in costs increasing 5.4 percent since 2004 and 8 percent since 2003." Price levels, which in the past may have been sufficient to provide a healthy margin to producers, no longer suffice.

Given the increased costs of production experienced by producers, especially in 2005, margins have been squeezed significantly. The table below compares statewide mailbox prices to statewide cost of production by year. Though the mailbox price in 2005 reached levels enjoyed in 2001, due to significantly higher costs, the margin for producers was actually reduced by nearly $1.30 per hundredweight. CDFA analysis shows that during the months of August and September 2005, producers faced increased costs of 16.4 cents per hundredweight from increased fuel prices and hauling surcharges alone. 2006 is showing no mercy as costs continue to escalate and prices continue to decline. Given estimated year-to-date mailbox prices and costs similar or higher than 2005 levels, producers are likely to experience negative margins that surpass those of 2002 and 2003.

An estimate for 2006 indicates that the California mailbox price may well be about 11.51. But the cost of production would be 13.43 or higher, resulting in a net loss to producers of 1.92 per hundredweight. And this is, of course, before the slash policy of the Dairy Institute.

The Institute has made the claim that we must increase California's plant capacity to deal with the increasing milk supply. However, long-term policy of ratcheting down prices threatens the economic viability of the producers' responsible for providing those plants with milk. We need to work together to address these larger issues.

It is unlikely the adjustments sought to minimum prices will provide incentives for new plant capacity in the state of California. The impediments to building plants in the state go beyond regulated minimum prices. In contrast, the regulated minimum prices have much more direct impact of producers' financial viability and ability to stay in business. It would be appropriate for the industry to work together outside the hearing process to tackle those larger issues.

And to that point, Western United Dairymen has invited the Dairy Institute of California to co-host a public dialogue with dairy producers, dairy processors, and dairy cooperatives with the purpose of discussing the issues such as producer viability, plant capacity, incentives for plant construction, pooling and pricing, and how best to meet shared environmental and energy challenges. We look forward to working with the industry to address these challenges.

In the Statement of Determination for the last Class 4a and 4b hearing, it was pointed out that CDAA is committed to the long-term viability of the producer, producer cooperative, and processor sectors of the California dairy industry. As outlined above, actions have been taken recently to maintain the health of the processing sector. We ask that action now be taken to protect the viability of producers by implementing proposals put forth by Western United Dairymen and denying those proposals that seek unjustified reductions to producer prices.

MS. LA MENDOLA: In relation to flooring butter, nonfat dry milk and cheese at the commodity corporation purchase prices. According to the Department, from 1973 to 1995 and April 2003 through April 2005, the commercial prices for butter and nonfat dry milk present were floored at their respective support purchase prices. Price floors at least for butter and powder obviously have history in California. Price floors for all three commodities was proposed by Western United Dairymen in 2001 and adopted by the Secretary following the January '03 hearing.

We appreciate the findings in 2003 and ask the floor be reinstated.

The price support program was put in place by Congress to provide a safety net for producers. Because processors are not required to avail themselves of the opportunities to sell to the government, the only means to reap the benefits of the safety net is in the pricing system. Arguments have been made in the past that implementation of floors in California alone places the whey cost of the federal dairy price support program squarely on the shoulders of California processors. To this unfounded claim, it is interesting to note a few observations.

According to Department analysis, the price floors would have been triggered infrequently, given market conditions during the period '01 through '05. Producers are asking that given times of extremely low prices that the safety net is made available. Even with a support purchase price as price floors, neither the California 4a or 4b prices are guaranteed to be at or above the 980 hundredweight target price. The disparity could be exaggerated immensely if the dry whey component were removed.

In looking at the nonfat dry milk market, it is clear the market price rarely if ever falls below the CCC purchase price because processors sell to the government during low price times. Obviously, the same could be witnessed with cheese if processors were to sell to the CCC. Sales to the government would help relieve the market of excess supplies. When supplies tightened back up, that product could then be made available to the marketplace.

However, it has historically been documented that the cost of selling to the CCC outweighs the benefits. Given the recent announcement by the CCC to streamline the purchase process, we are hopeful this will no longer be the case. And during times of depressed prices, cheese will move to the government. Implementing the floor may help move along this process.

The increase in the CME cheese price immediately following the implementation of the floors is dramatic proof of the influence of California's milk pricing policies on the national market. Even though prices at the CME had hovered at or below the purchase price since mid-2002, the price advanced beyond $1.1314 almost immediately following the announcement to implement the floor in California. Giving California's share of the nation's cheese production, it's hard to imagine this was only by chance.

The inclusion of a safety net in our pricing formulas highlights the flexibility of California's milk regulatory environment during fluctuating economic times. We ask the Secretary to reaffirm California's leadership by reinstating the floors.

In respect to f.o.b. adjusters, these adjustments to the CME prices should result in prices that would mimic butter and cheese prices received by California plants. Instead of actually surveying plants weekly or monthly as is done for nonfat dry milk, we simply use national market prices and adjust them to accurately reflect the sales prices in California. Undoubtedly, the difference likely approaches transportation as it would be a major factor in the selling price of butter or cheese, but there are likely other factors that play.

Looking at this adjustment as solely transportation would incorrectly suggest that all butter and cheese in California is shipped to Chicago. We know this is not the case, but we also recognize that California processors depend on f.o.b. adjusters to allow their products to compete in markets east of California. Removal of f.o.b. adjuster would greatly impede California processors from capturing market share outside the state. The resulting reduction in market share and profitability would either force a reduction of plant capacity or a cut in premiums or dividends that are paid to producers.

The verified butter and cheese sales data released by the Department is the best data available in which to rely when studying this adjustment, and we propose using the updated '04 through December '05 weighted averages, omitting the largest positive and negative differences as verified and released by the

Department in April of 2006.

On a cheese yield, there should be no adjustment made to the cheese yield or components used in the current 4b formula. The Hearing Panel report from the February '05 hearing states, and I quoting, "The panel does not feel appropriate and economically rational adjustments can be made to the cheese yield with key gaps in crucial data sets and a lack of consensus amongst industry leaders. Industry stakeholders and the Department must work outside the hearing process to develop the acceptable parameters needed to calculate an accurate cheese yield for California. Based on the hearing record, any decision at this time tends to incorporate a degree of subjectivity. Such decision would prolong the long-term debate without providing a step towards long-term resolution."

The Panel recommended that the manufacturing costs unit obtain some crucial data in order to assist in the debate over setting the correct cheese yield. They recommended that during the next review set of cheese plants the following data would be collected. And I've listed those.

None of this data has been collected in preparation for this hearing.

The Panel also recommended that the Dairy Advisory Committee meet to explore relevant issues towards developing a cheese yield based on the actual yield achieved in California plant environments that are derived from producer milk composition. This meeting has not taken place. Therefore, nothing has changed since the last hearing that merits any adjustments in the current cheese yield.

At the January '03 and February '05 hearings, substantial evidence and testimony for using the VanSlyke cheese yield formula was provided. However, in January '03, CDFA chose to use a prorated method that incorporated the cheese yield and tests from the block cheddar cheese plants and cost studies. Because the petitioner along with others will use the formulas, justification for different yield we too must address the matter.

Our various calculations of the VanSlyke formula as well as explanation of input factors follow.

With regard to fat retention, a fat recovery level of 92 percent is in line with testimony submitted by Dr. David Barbano of Cornell University at the May 2000 Federal Order hearing. In his testimony he states that, "93 percent fat recovery in the cheese is a cheese -- achievable with modern cheese making equipment and was achievable in the mid-1890s when VanSlyke developed his cheese yield." He later goes on to state that the value of 90 percent fat recovery in cheese is probably too low for large scale modern cheese factories.

Arguments have been made in the past that a 92 percent fat recovery is too aggressive and a ranch-to-plant and in-plant losses need to be accounted for. However, we feel that ranch-to-plant as well as in-plant losses are adequately accounted for through several means of current pricing formulas. Early in 2002, Dr. Philip S. Tong, professor at Cal Poly, released data on California milk composition. In regard to ranch-to-plant losses, we note that samples taken in the Tong study were from raw milk in silos at the plant. The tests are for milk at the plant, not at the ranch. The component levels reported already account for any possible loss occurring from ranch to plant. Averages reported for Tong for butter/powder and fluid milk plants are comparable with 2005 average tests that producer milk as reported by CDFA. Even more importantly, any in-plant loss should sufficiently be accounted for through the manufacturing costs data provided by the Department. This occurs because the Department reconciles receipts, pounds of butter fat and solids nonfat at the ranch, and usage pounds of butter fat and solids nonfat in the final product. This process is explained in the Department's Audit and Cost Procedures Manual for dairy manufacturing plants.

Furthermore, it is our understanding that the in-plant loss that occurs for plants during the manufacturing of cheese will be accounted for as whey loss in the manufacturing cost studies. Previous conversations with the cost unit indicated that if the loss is non-viable whey, that pounds of butter fat and solids nonfat are added back into the cheese when allocating general plant expenses. We also understand that disposal cost for any non-viable whey are included as a direct disposal cost in the manufacturing costs data.

Also, the VanSlyke formula by its very nature with the use of fat recovery percent at a constant point one expected casein loss accounts for the fact that not all protein or fat present in the vat is captured in the cheese.

Concerns have been raised over the use of cheese vats has likely included pre-fortified milk. Obviously one or both of the methods to fortify milk have been used on milk represented in Department's cost studies which report back tests of 394, 895, and a yield of 11.55 for block plants. Higher vat tests are also evidenced in the tong data for cheese plants.

We support maintaining a current yield of 10.2 at component levels of 372 and 8.8. For comparison purposes, we also calculated VanSlyke formula with the use of average components from the Tong data for butter/powder and fluid plants.

Though we agree that cheese yield should not be based on fortified vats, we are concerned about producers pay for some fortification of cheese milk through the make allowance. It is our understanding that cost studies include any costs above raw product costs of condensed skim or other products purchased outside the plant that are used for fortification purposes. For example, if the plant buys outside condensed skim, anything greater than the raw product price would be included as a plant cost and reflected in the manufacturing costs allowance.

Therefore, producers may be paying part of the cost to acquire products with which to fortify vats, but are not credited to subsequent higher cheese yield. We agree that cheese yield should not be determined by results achieved from fortified vats. However, it hardly seems equitable for producers to agree with this policy yet then be required to fund a portion of the fortification costs.

Sue Taylor of Leprino Foods agreed in her February '05 testimony stating, "To be consistent with unfortified yields, the Department should also remove fortification costs from the make allowance to the extent that such costs are currently captured."

Dr. Bill Schiek of the Dairy Institute agreed as well stating, "Fortification should not be considered in determining product yields and fortification costs should not be deleted from make allowances."

We ask the Hearing Panel to take this concern into careful consideration when examining the cheese yield and cheese manufacturing costs.

In order to be representative of non-fortified milk, we have used the average casein to solid nonfat percentage obtained by averaging that reported for butter/powder and fluid plants in the Tong study.

For moisture content, we've used the data recently released by the Department so that shows the average moisture content for block cheddar cheese plants at 38.09 percent. The use of anything other than the 38.09 percent would be unjustified.

So for results, a current yield of 10.2 is supported by incorporating all of the arguments above and using the corresponding inputs into the VanSlyke formula. Given the aforementioned arguments, it is obvious that the Department should make no adjustments to the current yield, the cheese yield of 10.2 at 3.72 fat and 8.8 percent solid nonfat is supported by data currently available.

With regards to skim whey powder. A value for whey, a byproduct of cheese making, should be included in the formula. At the 2003 4a, 4b hearing, data indicated that manufacturing skim whey products was no longer a cost minimization strategy as it had been historically. While in the past plants may have struggled to find means for disposal, they were now processing skim whey into value added products.

It was also agreed that if other cheese plants were not processing whey, they would likely sell specialty cheeses for which much higher prices are obtained. The Department realized that for many years the value of whey was not captured in the minimum pricing formula. And even though in the investment to implement whey processing abilities was large, this gave cheese plants ample time to invest in technology to further process whey. It seemed only equitable that producers, given the correct formula revisions to the 4b formula, share a portion of the revenues generated from the byproducts of the raw milk. Three years have passed since the addition of a dry whey component in the 4b formula, and six years have passed since the inclusion of Federal Orders. We asked ourselves has anything changed that supports the removal of the dry whey component from either formula?

Our findings support the contrary. In fact, we find even more reasons today than ever before to maintain the dry whey component. Accounts of the value of whey to cheese manufacturers can be found almost everywhere. An article in the February 2006 edition of Cheese Market News highlights the shift from waste to asset. In fact, in the last part of that quote it says that some cheese makers even say they could not remain competitive without the value whey adds to their companies.

We understand that large capital investments have been made by cheese manufacturers in order to be able to manufacturer market whey. However, we must note that producers have made substantial investments as well. Not only have producers made investments in their plants, they've also funded research to develop new markets for whey products.

We are also curious as to how the capital costs associated with the whey facilities are accounted for in the cost studies. We assume the capital costs are originally included in the book value of assets for cheese plants and subsequently include the return on investments calculations captured manufacturing cost studies.

And we highlight a few ways that producers have invested in developing whey markets.

The U.S. Dairy Export Council, whose primary funding comes from farmer funded marketing, DMI, has also spent considerable resources. In a recent brochure, they taut whey is a perfect protein. And I stated there what the brochure says.

USDEC also provides interesting statistics as to the growing markets for whey saying that for '98 to '04 dry whey export volume rose 63 percent. WPC shipments nearly doubled. Exports of whey protein isolates are now a 35 million per year business. And lactose exports more than doubled. Additional trade data indicates a continued increase in exports.

It certainly seems that both domestic and international markets continue to expand for whey products. With California being the number one dairy state in the nation and home to some of the largest cheese manufacturers in the U.S., it's hard to fathom that our manufacturers are not sharing in the tauted successes of these markets.

There will likely be much discussion over ranch-to-plant and in-plant losses of fat in solid nonfat through the cheese making process. However, we take this opportunity to use a concept of losses as an analogy to removing the dry whey component from the 4b formula. If the dry whey component were eliminated, we would consider this to be an extreme loss of components and producer's raw milk. Some value for whey must be accounted for if the 4b formula aims to calculate and therefore pool the appropriate value of producers' raw milk use for cheese.

While it may be difficult for the industry to agree on specifics to accurately represent the value of whey, it needs to stay in the formula. In our discussions to follow, we provide support.

Is skim whey powder the right product to use? The industry sought to determine the most reasonable way to capture the value of the whey stream and cheese making. Among proponents of the dry whey factor, it was a general consensus that skim whey powder was the most appropriate product and that should -- used in estimating of revenues that should be passed on producers.

Data from the Department indicate that many plants are manufacturing types of whey protein concentrates rather than skim whey powder. Some plants also manufacture lactose or other products. However, just this cheddar cheese is used as a surrogate for other cheeses, powder. And powder is used for nonfat dry milk and butter milk powder. We can use skim whey powder as a surrogate for all other whey products. Every type of cheese, some 160 varieties of according to CMAB, produced in the state have different market factors that play. However, we have chosen cheddar cheese as the basis, even though it represents only 24 percent of the total cheese produced in California.

The same can be done with skim whey powder. It would be unfeasible to try and capture the value generated by all the products derived from the waste stream. Using whey skim powder simply provides us with the most conservative estimate.

In the February '05 hearing, Hilmar Cheese stated, "It's actually in the best interest of milk producers to have multiple forms of whey manufacturing in California. If the whey factor is construed so that cheese plants have little incentive to produce diverse whey products, all plants would simply dry whole whey as a disposal method. Imagine the price decrease if the whey marker into a majority of the waste stream went into a single product.

We couldn't agree more. This is why we support the use of skim whey powder. And it is the basic lowest price whey product derived from producers' milk used for cheese making.

This is a bit outdated. According to CDFA data, out of the eight cheddar cheese plants included in the costs studies in 2000, none dumped the product. Only one sold whey for animal feed. One manufactured skim whey powder 13 percent. And the rest are manufactured whey protein concentrates with higher protein percentages.

Discussions with CDFA staff seem to indicate this is still the situation. Department data shows California comprised 12.4 percent of the nation's skim powder production and almost 40 percent of the whey protein concentrate production in 2004.

We've not asked to capture these higher values, but we also feel the argument that skim whey cannot be used to represent other whey products is unfounded. In fact, the Department recently released data showing the price relationship between prices of skim whey powder and whey protein concentrate 34 percent.

While historic data shows a rather small relationship between the two price series and ours scored 58 percent for the period indicates a relationship does now exist. It can be determined by this analysis that some movement in the whey protein concentrate 34 percent prices can be explained by movement in the skim whey price.

Unfortunately, we are not privy to the exact costs associated with manufacturing higher whey protein products. But we assume there is a higher margin. Our assumption is based on the difference between the skim whey powder and whey protein concentrate 34 percent prices which average 42 cents for the period we looked at. Unless the added cost to manufacture whey protein concentrate over skim whey exceeds approximately 42 cents, then the net return is likely higher. We are assuming a break even on the handling of permeate, because data from the Department showed that most plants did something other than dumping it. We assume this is still the case.

We find it necessary to compare and contrast all the available data that might be considered when setting the appropriate dry whey make allowance. We believe there's substantial evidence and expert testimony available to shed serious concern over the sole use of dry whey cost studies. In reviewing testimony from previous CDFA hearings as well as the most resent Federal Order hearing, two facts seem to be supported by most industry experts, and that is the differences between processing whey streams generated in the production of mozzarella cheese and other types of cheese such as cheddar. There is a difference. There is also quantifiable cost difference between the processing costs associated with nonfat dry milk production and that of skim whey powder.

HEARING OFFICER KRUG: Excuse me. If I could interrupt. The witnesses, you've exhausted your 30 minutes allocated.

There is a provision which allows for an extension of time. I at this time would ask the Panel or the Department if they have any desire or input regarding whether or not an additional allotment of time should be afforded the witness.

DAIRY MARKETING BRANCH CHIEF IKARI: Mr. Hearing Officer, the historical precedence is that the witnesses -- the folks with the alternative proposal would come at the end of testimony of all the other witnesses.

HEARING OFFICER KRUG: Such is the procedure, and we will abide by that.

Given that I interrupted you, you'll have two minutes to finish up.

MS. LA MENDOLA: So you can review our point number one, I suppose.

Our point number 2 takes a different approach to setting the make allowance. That was supported by almost all participants at the recent Federal Order hearing and supported by quite a few folks. And the table below summarizes available data that could be used to set the dry whey make allowance.

Just a few points to throw out there. At the February '05 hearings, Sue Taylor with Leprino Foods stated Leprino had no dry whey facilities within the state of California and at the request of the Hearing Panel submitted some costs and came back with reporting a 21.9 cent per pound manufacturing cost. This is substantially lower than the 26.73 pound cost reported in the CDFA cost studies.

Also in a post-hearing brief submitted by the recent Federal Order, Dr. Yonkers of National Cheese Institute supported a 22.2 cent per pound make allowance and several others testified to very similar manufacturing costs. Proponents of the 26.73 per pound or higher dry whey make allowance likely discredit this discussion because it's not specific to California.

Even so, the figure is supported above by cheese manufacturers all over the nation including some plants and interesting in California seem to support a dry whey make allowance far below that detailed by the cost studies.

Testimony from cheese manufacturers at the Federal Order hearing tells us that dry whey facilities across the U.S. are able to manufacture dry whey costs at closer to 20 to 22 cents per pound.

This begs the question, what is happening in California?

HEARING OFFICER KRUG: Thank you very much. I encourage the witnesses that you may return during the period for testimony and complete your presentation at that time.

MR. MARSH: Our economist is very loquacious. I apologize for that.

HEARING OFFICER KRUG: Well, I doubt that that's unusual for economists.

(Laughter.)

HEARING OFFICER KRUG: Speaking of which, do our Panel members have any questions for the witnesses?

Mr. Ikari?

DAIRY MARKETING BRANCH CHIEF IKARI: I do not.

HEARING OFFICER KRUG: Ms. Gates?

RESEARCH MANAGER II GATES: No.

HEARING OFFICER KRUG: Ms. Reed?

SUPERVISING AUDITOR REED: No, I don't.

HEARING OFFICER KRUG: Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: I'll hold off my questions until they have a chance to return and complete their testimony.

HEARING OFFICER KRUG: Okay. Thank you very much.

MS. LA MENDOLA: Can I ask, will it be at the end of tomorrow or at the end of today?

HEARING OFFICER KRUG: It will be when we complete the alternative proposals, we will begin with the testimony -- open testimony. And your guess is as good as mine.

I do want to correct the record. Your testimony is labeled Exhibit Number 54, not 53.

MR. MARSH: Thank you.

HEARING OFFICER KRUG: And just so we're aware, would you like the opportunity to present a post-hearing brief?

MR. MARSH: Yes.

HEARING OFFICER KRUG: The witness indicated yes, and that request is granted.

Thank you very much. Again, I'm going off the record for just a moment.

(Thereupon a discussion occurred off the record.)

HEARING OFFICER KRUG: We'll go back on the record now.

We'll proceed with the alternative proposals. The next alternative was presented by the Alliance of Western Milk Producers. And will their witness please approach the podium.

Will the witness please state your full name and spell your last name for the record.

MR. TILLISON: Yes, my name is Jim Tillison T, as in Tom, i-l-l-i-s-o-n.

HEARING OFFICER KRUG: Mr. Tillison, due you swear or affirm to tell the truth?

MR. TILLISON: Yes, I do.

HEARING OFFICER KRUG: Are you testifying on behalf of the Alliance of Western Milk producers?

MR. TILLISON: Yes, I am.

HEARING OFFICER KRUG: Do you any written statements or other things that you would like entered into the record at this time?

MR. TILLISON: Yes, I would like the two documents presented to you, my testimony and the accompanying graph, entered as exhibits.

HEARING OFFICER KRUG: Okay. Thank you.

The first document is titled "The Alliance of Western Milk Producers," dated June 1, 2006. It is labeled Exhibit No. 55 and is entered at this time.

(Thereupon the above-referred to document was marked as Exhibit 55.)

HEARING OFFICER KRUG: The other is a one-page document. It's a graph, which will be labeled Exhibit No. 56, and it is entered into the record at this time.

(Thereupon the above-referred document was marked as Exhibit 56.)

HEARING OFFICER KRUG: Mr. Tillison, please proceed.

MR. TILLISON: Thank you. The Alliance of Western Milk Producers alternate proposal was developed the direction of the Board of Directors. And I am testifying today as directed by the board.

The Alliance decided to submit an alternative proposal because our members feel that the milk pricing system needs to be adapted to stay current by reflecting the volatility of energy costs, in particular natural gas costs, that are a key component of the manufacturing cost. In addition, the Alliance believes that the Dairy Institute proposal and those that mimic it is flawed in the same ways their 4b proposals were flawed at the January 2005 hearing.

It's time for indexing:

The attached data provided to the Alliance, a statement by the Department, shows why it is time for automatic adjustments to natural gas costs in the manufacturing allowances for butter, nonfat dry milk powder, cheese and whey. The current system of pricing where a hearing is held and the natural gas costs are fixed until the next hearing is held is a system that creates winners or losers.

For example, the natural gas cost (NGC) in the 2004 cost study released November 5th has nonfat dry milk powder natural gas costs of 2.44 cents. The average natural gas cost for January through September 2005 was 2.77 cents. However, for September of 2005, the NGC was 3.3 cents. Adopt a fixed NGC of 2.44 cents and plants lose. Adopt a fixed NGC of 3.3 cents and producers lose.

And the exhibit that I handed out, No. 56, I think shows you the volatility of the gas prices -- the industrial gas prices. And these are for California for a five year three month period. And as you can see, there's tremendous volatility. And if you pick a point in time as setting the price, somebody's going to win and somebody's going to lose.

A make allowance which includes a monthly natural gas cost adjustment based on a reliable natural gas index such as the California State Natural Gas Industrial Price as published by the U.S. Energy Information Administration is the only way to keep this loser and winner situation from happening.

Therefore, what the Alliance is proposing is that the make allowance for cheese, butter, nonfat dry milk powder and whey reflect the updated make allowance data less the updated natural gas costs plus the result of the natural gas costs in the 2004 cost study times the most current monthly California Natural Gas Industrial Price available on the 25th of the month divided by the Natural -- by the California State Natural Gas Industrial Price for the same month in 2004.

If you go to the website in which this data is presented, you'll see that -- for example, for the month of May, the price for March of 2006 was available. So you would multiply the energy costs from the 2004 study by that value for March of 2006 divided by the value in March of 2004. That would give you the multiplier adjustment.

There are those that say -- there are those who may say that the Alliance indexing proposal is an interesting one that deserves further study. One of the things I've learned in going to Washington as well as at the state capitol is that asking for a study is a way of delaying something from happening.

The Alliance believes that it's time that it's time that -- we're dealing with a fairly clear-cut situation as far as manufacturing allowances are concerned and energy costs. Delaying implementation in order to do further study of natural gas costs indexing will cost either producers or processors millions of dollars. A monthly adjustment to natural gas costs done in the real world is essentially the same as doing a study of real world occurrences, but not applying the result in the real world. The results will be the same. The difference will be that one has a real world benefit, while a study is just interesting.

The Alliance urges CDFA to adopt its indexing pro proposal in its final decision. It is a major step in making manufacturing allowances more current and timely.

Why the Institute's and similar proposals are flawed:

Cheese yield. First and foremost is the assumption on which the Institute's proposal is based, that the purpose of the Class 4b formula is to price typical California milk. This in our opinion is wrong. It is also wrong according to the Department hearing panel for the January 2005 4a and 4b price hearing:

"The panel does not share the view that the purpose of the 4b pricing formula is to price typical California milk. The purpose of the 4b pricing formula is to price milk going into cheese plants." We agree 100 percent.

Proponents of the Institute proposal argue that the reason cheese yields are higher than typical is because cheese plants pay premiums for milk that yields more cheese. I would suspect that you will hear from dairy farmers during this hearing that have seen those premiums shrink in recent months as cheese plants have seen their costs of doing business rise.

The purpose of making adjustments to manufacturing costs is to reflect changes in the actual cost of producing manufactured product. The basic value of milk is determined by the pounds of product 100 pounds of milk will produce. The 100 pounds of milk going into California cheese plants would appear to produce a yield far greater than 10.2 pounds per hundredweight current used in the 4b formula. In fact, the corrected cheese manufacturing cost data released in January 2006 indicates that cheese yields exceeded 11 pounds per hundredweight at 37.8 percent moisture. Milk in the vat tested over 4 percent fat, over 9 percent solids not fat. The Alliance believes that the current 10.2 pound yield factor is already generous and arguably does not reflect the real yields achieved by modern well-run cheese plants.

Rather than reiterate the testimony given by us at the January 2005 hearing on cheese yields, I have attached my testimony from that hearing to this testimony.

Dry whey make allowance. The Alliance proposal adjusts the dry whey make allowance possible increases in labor and G&A costs by adding 1.6 cents to the 20-cent make allowance. It then puts in the proposed adjuster -- NGC adjuster by deducting the 2004 NGC and adding back the 2004 NGC times the adjuster.

Our proposal reinstates snubbing the other solids value at zero. There are several reasons for this.

First, the Alliance continues not to believe that the Department's survey of dry whey manufacturers in California reflects anywhere near a reasonable cost for processing dry whey. At the Federal Order make allowance hearing held in January 2006, USDA's Charles Ling entered testimony that data from 9 cooperatives with 17 cheese plants reported that their whey processing costs -- dry whey processing costs were under 12 cents. And I want to remind the panel that they were testifying at a hearing to increase make allowances. So there would be no benefit for them to report to Charles Ling exceedingly low prices if that was their goal. That cost is two and a half times less than the adjusted California dry whey processing costs as reported in the most recent make allowance study. Even if one adds the manufacturing cost of producing condensed whey solids to the manufacturing cost of dry whey, the Ling data indicates that the cost of producing dry whey is less than 20 cents a pound.

In her post-hearing brief for the January 2006 national Federal Order hearing -- make allowance hearing, Sue Taylor, a recognized expert in whey processing, of Leprino, quotes a technical witness from WestFarm Foods, Seattle, Washington, who analyzed the differences in costs attributable to whey that are absent from the nonfat dry milk manufacturing costs. He concluded that under a more traditional system, quote, "the whey processing estimates showed a whey drying cost difference of 2.559 cents over nonfat dry milk costs." Now, I want to point out that WestFarm Foods is located in the western United States. They're a modern facility that has whey processing capability. And that needs to be taken in by the

Department -- into consideration by the Department.

Ms. Taylor, the expert, goes on to state, quote, "We calculate the 2.71 cent cost differential between whey and nonfat dry whey." So in other words, she's saying that it's even higher than the 2.5 cents that was put on the table by Mr. Burleson.

Clearly, the 2.71 cents that Ms. Taylor says is more accurate whey drying differential when added to the California weighted average cost of producing nonfat dry milk powder in California from the 2004 cost study, which is 15.43 cents, results in a more realistic dry whey manufacturing cost of 18.14 cents. The whey manufacturing allowance proposed by the Alliance, adjusted monthly for changes in California natural gas costs, is a fair number -- it's a very fair number.

It is true that the Ling cost study is in fact a cost survey, and it is not as complex or as thorough as what the Department does. However, that alone does not explain the huge difference between his data and the CDFA cost data. While the Alliance believes the California cost study data should be the basis for manufacturing allowances, those allowances should not result in a windfall for the modern cheese plants with modern whey processing equipment producing a more valuable end product, whey protein concentrate.

Secondly, CDFA data shows that the above same quantity of dry whey -- shows that about the same quantity of dry whey (119 million pounds) was produced in California in 2005 as whey protein concentrate (122 million pounds). However, the Alliance should point out that almost five times as much whey protein goes into WPC as goes into dry whey -- 75.9 million pounds of whey protein into the whey protein concentrate versus 14.3 million pounds.

I have attached the Ling data to my testimony. I'd also urge the panel members to review the testimony of Scott Burleson, WestFarm Foods, at the website indicated in my testimony in more detail. As with cheese yield discussion, in order to save time, I refer the panel to the attached Alliance testimony from January of 2005 dealing with dry whey manufacturing costs.

Formula adjusters. The Alliance proposal also believes that the adjusters used in the Class 4a and 4b formulas should be for the most recent year available. The data provided by the Department shows a great variation from month to month and year to year. Using the most current data, assuming that hearings on these formula will be held every year, makes the most sense.

The Alliance is opposed to the Dairy Institute's proposal to do away with other solids part of the 4b formula once the dry whey price falls below their proposed make allowance. Whey protein is a valuable commodity, generating over 50 cents a pound for 34 percent content protein and much more than that for 80 percent protein WPC. As stated previously, the vast majority of whey protein is going into whey protein concentrate. A review of CDFA's data would appear to indicate that more and more whey protein is moving into the higher valued WPC with over 50 percent protein content.

Rather than drop the other solids value from the 4b formula, the Alliance again encourages the Department to gather manufacturing cost data for WPC. What does it cost to produce WPC? Is there a significant difference in the cost of manufacturing 80 percent WPC versus 34 percent WPC? Of the 90 million pounds of whey protein captured in dry whey and WPC, 66 percent went into the higher protein content WPC and 85 percent went into WPC in total, while just 15 percent went into dry whey.

Clearly, other solids value based on dry whey significantly under-values the whey proteins in producer milk. The Department should rectify this situation by gathering the necessary data from cheese plants so it and the industry can evaluate the appropriateness of using WPC instead of dry whey in the Class 4b formula.

The Alliance also urges the Department to institute the snubber on the other solids value. When disposal of whey becomes a cost, the manufacturing allowance data reflects that fact. Allowing the other solids factor to become a negative value allows cheese manufacturers to recover a single loss twice, once in the cheese make allowance and again in the negative solids factor.

The Alliance also believes that the cost of disposing of retentate from further processing of whey should not be included in the non-labor processing costs in the cheese make allowance. The Class 4b formula includes a make allowance for converting liquid whey in to dry whey. This essentially covers the cost of disposing of all the components of liquid whey. A plant receiving the financial benefit of selling WPC, but only paying producers for the value of whey protein in dry whey, should not get the additional financial benefit of producers paying for the disposal of retentate.

Formula adjusters. The Alliance also believes the adjusters used in the 4a and 4b formula should be for the most recent year available. The data provided by the Department shows a great variation month to month. Using the most current month assumes that hearings on these formulas will be held every year, and that makes sense.

Flooring commodity prices. The Alliance joins the other producer organizations in urging the Department to reinstate the commodity credit price -- dairy product purchase prices as the floor commodity values in the 4a and 4b formulas. In spite of complaints from processors about placing California at a competitive disadvantage, the fact is that when floor prices were in effect in California, the opposite was true. Within days of California flooring cheddar cheese prices in the 4b formula at the support purchase price, the CME block price moved up to and then over the support purchase price.

With manufacturing allowances and plants paid for cheese at the CME block plus a premium, there is little incentive for plants to move cheese to the CCC. Butter and powder are primarily products produced by cooperatives, in part to balance the milk supply with the demand for milk by moving butter and powder to the CCC. Flooring milk price formula commodity values at the support purchase price will share the cost of balancing market among all kinds of plants.

And I think you -- the Alliance members produce a lot of butter and powder, and they support flooring those prices even though they do sell product to the government.

And, finally, I want to reiterate comments that I made to the Dairy Marketing Branch staff at a meeting earlier this year. Milk pricing formulas should not be adjusted to either encourage or discourage farmers from producing milk. The marketplace will take care of that. Commodity prices move up and down based on the supply of milk and the demand for dairy products. That price movement is reflected in milk pricing formulas. The Department should not make changes to manufacturing allowances, yield factors, or transportation adjusters in formulas for the purpose of discouraging dairy farmers from producing milk.

With that, I will conclude the Alliance testimony by urging the Department to adopt the Alliance's natural gas cost adjuster proposal, snub the other solids value in the 4b formula at zero, and floor the commodity values in the milk pricing formulas at the CCC purchase prices.

Thank you for the opportunity to testify. And I'll be happy to answer any questions you may have.

HEARING OFFICER KRUG: Mr. Tillison, before we go to the panel for questions here, your testimony touches upon an issue that gets -- of some complication and difficulty in records -- hearing records. And that's where you reference a website.

MR. TILLISON: Yes.

HEARING OFFICER KRUG: Various hearings have struggled with this. But I want to make clear what it is you are seeking to put into the record. You mention, as you quote, "I also urge the panel members to reviewed the testimony of Scott Burleson, WestFarm Foods," and then you have the website. Is that -- can you clarify. The testimony of Scott Burleson, is that at the January 2006 national Federal Order make allowance hearing that you referenced previously?

MR. TILLISON: Yes, it is. And if you go to that -- the AMS website, there's a section there called hearings. And they list the national hearing. Mr. Burleson's comments are in volume 3 of the recorded testimony. And I believe it's in pages 140 through 158. I was going to attach a copy of his testimony, but I didn't need to carry that much paper around with me.

HEARING OFFICER KRUG: Thank you very much, Mr. Tillison. This is necessary to avoid the volumes that could be incorporated by reference as people start to cite websites.

Now, we'll proceed with questions from the panel.

Mr. Ikari, do you have any questions for the witness?

DAIRY MARKETING BRANCH CHIEF IKARI: No.

HEARING OFFICER KRUG: Ms. Gates?

RESEARCH MANAGER II GATES: No.

HEARING OFFICER KRUG: Ms. Reed?

SUPERVISING AUDITOR REED: No.

HEARING OFFICER KRUG: Mr. Gossard?

AGRICULTURE ECONOMIST GOSSARD: Yes.

On page 3 of your testimony, in talking about costs of processing skim whey powder relative to nonfat dry milk, you say that the cost differences you think is represented at 2.71 cents; is that correct?

MR. TILLISON: Yes.

AGRICULTURE ECONOMIST GOSSARD: But that would be for plants of comparable size?

MR. TILLISON: Well, I assume it's plants of comparable size. Once again -- but again I think when you look at the data that the Department gathers, there's variations in size of those plants, and you basically come up with a weighted average situation.

I also think that the possibility exists that those plants could be running whey on a regular basis at a full operational situation. When you look at the data that the Department has collected, one has to wonder how much those plants are running, what their efficiencies are and so forth. And as I -- I mean the bottom line, Mr. Gossard, is that I don't think we should take worst-case scenarios and build a make allowance based on the data from those worst-case scenarios.

If the make allowances that were put forth at the national hearing were somewhat closer to the numbers that the Department came up with, I guess there would be a lot more comfort in my comfort factor. But there's such a divergence between the numbers, that I just don't think the data that is generated in California is -- should be used.

AGRICULTURE ECONOMIST GOSSARD: The three plants that we had on a cost study for skim whey powder process on average about 31 million pounds a year. So we should compare that size of plant with a nonfat dry milk plant of about 30 million pounds of nonfat dry milk a year and add 2.71 cents to it?

MR. TILLISON: No, because I don't believe that a dry whey facility such as you're talking about in California is really typical of dry whey on a national basis. Don't forget --

AGRICULTURE ECONOMIST GOSSARD: Are we purchasing milk on a national basis for California?

MR. TILLISON: No. But what I'm saying is is that the data CDFA provided would indicate that there are about -- that there are about 90 million pounds of dry whey -- of whey protein available to be processed in California on an annual basis. You're saying you've got three plants with the ability to process 31 million pounds of dry whey. Yet, the data also shows that only about 15 percent of the whey protein is going into dry whey.

So, you know, I would contend that those are small plants, those are plants that are not associated with modern cheese facilities and with modern dairy plant facilities, and therefore are not representative at all of what a modern up-to-date cheese plant would have.

California modern up-to-date cheese plants don't dry whey. They make whey protein concentrate. And to set a make allowance based on out-of-date low volume plants and allow that to be applied to modern facilities is just not correct.

And, frankly, we support what the Department did the last time. You picked a make allowance that, frankly, is higher than the national numbers would appear to indicate, or the data presented at the 2006 hearing would appear to indicate, but certainly is less than what the plants currently appear to be generating.

AGRICULTURE ECONOMIST GOSSARD: Then should we replace skim whey powder with another whey skim product?

MR. TILLISON: Well, one of the things that I suggest is that the Department take a look at the value of -- the value of what it costs to produce whey protein concentrate. You know, there's this assumption that, well, there's such a variation of whey protein being produced, how do you price it? Well, it would appear that a growing -- the growing market is the high protein content product. And pricing 34 percent whey protein and making that the whey factor would certainly be more representative of what's occurring in the California dairy industry than to use the dry whey number.

DAIRY MARKETING BRANCH CHIEF IKARI: You seem to be testifying that the current type of dry whey should not be used in the pricing formula.

MR. TILLISON: No, no, no, that's not what I'm saying. I'm saying that we need to look at an alternative. But given that there is not an alternative with data that we can look at, we need to at least maintain the dry whey factor to allow producers to recover something from a component of their milk that plants are processing and marketing.

Don't forget, before whey was being processed in California, producers covered the cost of disposal of that whey. Now we've got plants that are manufacturing whey into a product for which they are generating at least break even, if not income. And producers should share in the income that that generates, just as they in the past have played for the loss that disposing of those -- of that product has cost.

DAIRY MARKETING BRANCH CHIEF IKARI: A question for you. Should the plants recover their investment in manufacturing an added value whey product?

MR. TILLISON: I assume they do.

DAIRY MARKETING BRANCH CHIEF IKARI: Should the Department consider that in setting -- in determining adjustments in the formula to make sure that that has happened?

MR. TILLISON: Well, you're already doing that in the cheese, butter and powder formulas, are you not? Or in the make allowance studies, you put in a return-on-investment factor, do you not?

And I assume the same thing holds true with the whey formula. Is there a return on investment put into the whey make -- the whey cost studies? If it is, then it's in there. But I don't believe that they deserve a return on investment that could be as much as 5 cents higher than what people say is an adequate number on a national level. There's not that much difference between California and the rest of the country.

HEARING OFFICER KRUG: Any additional questions for the witness?

Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: Yes.

Mr. Tillison, in your FOB California price adjusters, you said you were using the most current 12 months of data. Were you using a simple or a weighted average?

MR. TILLISON: The weighted average I believe is the number that's in there.

AGRICULTURE ECONOMIST GOSSARD: At the last hearing the panel stated it was concerned there'd be a bias if we use the weighted versus the simple average. How do you address that concern now brought up in its last panel report?

MR. TILLISON: Well, there's a simple solution to that. And that's to do the same thing you do for nonfat dry milk powder. And that's come up with a weighted average price for cheese, rather than taking the CME plus some FOB adjuster. The only problem -- the only issue that we have with that approach is that then when a cheese plant does an outstanding job of marketing product and is able to capture more money for their cheese than somebody else does, it becomes part of the -- part of the basic price, and that's a concern we have.

But, you know, when you look at the -- when you look at the variations that exist in the data that you present for the two years -- I'm sorry, but I have to disagree with Mr. Schiek. I don't believe a 21 cent or an 11 cent swing is within the realm that could be considered even close to a normal variation on a month-to-month basis. And it's not just explained by lags and stuff like that.

AGRICULTURE ECONOMIST GOSSARD: You are proposing that we put a snubber in for the skim whey powder at your proposed manufacturing cost allowance?

MR. TILLISON: Yes.

AGRICULTURE ECONOMIST GOSSARD: At the last hearing the panel found that a snubber -- adding that snubber 4b price would not reflect the negative values when the commercial price of dry whey falls below the cost of manufacturing. This policy could create serious competitive disadvantages to California cheese products.

How do you address those concerns of the panel?

MR. TILLISON: Well, in the past at least when cost studies were done, if the marketing of whey was a negative factor, it became part of the make allowance situation. So in fact they weren't placed at a disadvantage. They -- that that would be recovered at least partially through the adjustments in the manufacturing allowances.

AGRICULTURE ECONOMIST GOSSARD: Do you have anything to support that that's still a practice in the way the cost studies are presented?

MR. TILLISON: Well, in her testimony at the Federal Order hearing, Ms. Reed testified that retentate was part of the -- was part of the -- was added into the process -- the processing, not labor, costs. So you've got a situation right there where part of the -- and that's one of the problems we have, is that part of the disposal of whey is still being charged to dairy farmers, when in fact the make allowance for whey is for dry whey. So if you dry whey, there is no retentate left. It all goes away in water. It's all either evaporated and that cost is recovered in the make allowance, and the dry whey is sold in the marketplace.

But if a processor makes WPC, you've got a situation where not only are they getting the benefit of the make allowance which factors in getting rid of all of the components, but they also get a deduct in the make allowance for the retentate. And unless I read your -- Ms. Reed's testimony incorrectly, I believe that's the case.

The other --

AGRICULTURE ECONOMIST GOSSARD: How does that address the issue of the price going below the make allowance?

MR. TILLISON: Well --

AGRICULTURE ECONOMIST GOSSARD: I mean the price is the price, isn't it?

MR. TILLISON: The way it addresses the price going below the make allowance is that -- as I said, in the past a loss from disposing of whey, if that was even processing and drying whey before the whey factor was in the formula, was considered a processing non-labor cost.

AGRICULTURE ECONOMIST GOSSARD: So are you suggesting that if the whey price goes below the whey make allowance and is snubbed, we should increase the cheese make allowance because suddenly those costs are being thrown in to the cost of making cheese?

MR. TILLISON: I'm saying that when the audit department goes out and looks at the profit and loss of the plant -- if I'm a plant and I lose money selling whey, that's going to be part of my non-processing -- non-labor processing cost. It's a cost of doing business. And I don't believe Venetta -- I'm sorry -- I don't believe Ms. Reed would be able -- would allow her auditors to ignore that cost. That's why we believe that that value needs to be snubbed.

AGRICULTURE ECONOMIST GOSSARD: No further questions.

HEARING OFFICER KRUG: Mr. Tillison, you made reference to testimony of a Ms. Reed. Just to clarify for the record, the testimony that you are speaking of, can you give us some further identification of who the testifier was and what the testimony -- where it was?

MR. TILLISON: Yeah, the testimony was given at the January 2006 make allowance hearing that they held in the Federal Orders. Again, Ms. Reed's testimony is available at the AMS website.

HEARING OFFICER KRUG: By Ms. Reed, who do you mean?

MR. TILLISON: Ms. Venetta Reed, who is one of the panel members --

HEARING OFFICER KRUG: -- of the Department of Food and Ag?

MR. TILLISON: -- of the California Department of Food and Agriculture.

HEARING OFFICER KRUG: Thank you.

MR. TILLISON: And her testimony can be found in volume 1, I believe starting on page 130.

HEARING OFFICER KRUG: Thanks very much.

MR. TILLISON: You're welcome.

HEARING OFFICER KRUG: Any additional questions for the witness?

No questions from the panel?

You're -- well, Mr. Tillison.

MR. TILLISON: I would like to request the opportunity to submit a post-hearing brief.

HEARING OFFICER KRUG: And your request is granted.

Thank you very much.

MR. TILLISON: Thank you.

HEARING OFFICER KRUG: The next alternative proposal was presented by California Dairies, Incorporated.

Okay. Excuse me. It's been suggested that this is a good time to take lunch. So we will accept that suggestion.

One hour?

It's now 12:45. We'll reconvene at 1:45.

Thank you very much.

We're off the record.

(Thereupon a lunch break was taken.)

AFTERNOON SESSION

HEARING OFFICER KRUG: Okay. Let's go on the record.

Completion of our lunch period. We've now reconvened for the afternoon session here on June 1st.

We will begin with the representatives of California Dairies, Incorporated, who will present their alternative proposal.

Would each of the witnesses please state your name and spell your last name for the record.

MR. HEFFINGTON: My name is Joe Heffington H-e-f-f-i-n-g-t-o-n.

MR. COTTA: Richard Cotta C-o-t-t-a.

HEARING OFFICER KRUG: Mr. Heffington, do you swear or affirm to tell the truth?

MR. HEFFINGTON: I do.

HEARING OFFICER KRUG: Mr. Cotta, do you swear or affirm to tell the truth?

MR. COTTA: I do.

HEARING OFFICER KRUG: And are you both representing California Dairies, Incorporated, today?

MR. HEFFINGTON: We are.

HEARING OFFICER KRUG: Do you have any written statements or other things that you would like entered into the record at this time?

MR. HEFFINGTON: My testimony, which I've handed the copies to the panel.

HEARING OFFICER KRUG: Okay. I've got a copy here of a document, California Dairies, Inc., dated June 1, 2006.

It will be labeled as Exhibit 56 and is now entered into the record.

(Thereupon the above-referred document was marked as Exhibit 56.)

HEARING OFFICER KRUG: You may proceed with your testimony.

MR. HEFFINGTON: Thank you, Mr. Hearing Officer.

My name is Joe Heffington and I'm Senior Vice President and Chief Financial Officer of California Dairies, whom I am representing here today.

California Dairies is a full service milk processing cooperative owned by approximately 700 dairy farmer members located throughout the State of California, and collectively producing over 17 billion pounds of milk per year, or 42 percent of the milk produced in California.

California Dairies supplies nearly 50 percent of the milk our member/owners produce directly to customers located in California. Additionally, our producer/owners have invested over $250 million in five large processing plants which produce butter, powdered milk products, cheese, and bulk fluid processed products.

Our dairy farmer members are also in the process of making an investment in a new plant, number six, which will have the capability of handling over five million pounds of milk per day, with completion scheduled for the late fall of 2007. The new plant has an estimated cost of $125 million and is not projected to be profitable even at the make allowance levels we are requesting here today.

Our Board of Directors, which is comprised of 20 producer/owner representatives, elected from our dairy farmer members, unanimously approved our proposal regarding Class 4a issues presented today at their April 25th, 2006, board meeting and confirmed their approval at their May 23rd, 2006, board meeting.

They also confirmed their support of the proposal and testimony by the Alliance of Western Milk Producers regarding Class 4b issues at their April 25th, 2006, board meeting, and confirmed their approval again at the May 23rd, 2006, California Dairies board meeting.

First, I'd like to point out that we recognize all California producers, including our producer/owners, are in a cost squeeze as a result of increased costs and dramatically lower milk prices. And we belief that the negative impact of an increase in the Class 4b make allowance at levels proposed by the petitioner would be very damaging to the entire California dairy industry.

In regard to flooring at support:

Next I would like to express our support for re-implementing a floor for commodity prices used to calculate California milk prices at the Commodity Credit Corporation purchase prices for butter, powder and cheese. We believe that the implementation of a floor will send a market signal and encourage processors to sell to the CCC when prices fall to support price levels. We have firsthand knowledge of how to offer and sell to CCC at times when market clearing action is needed.

And unfortunately, due to current market conditions, California Dairies, through DairyAmerica, has recently offered and sold to CCC.

The estimated additional cost of these sales made to the CCC is 1.8 cents per pound. The members of DairyAmerica recognize this additional cost, but still utilize the support purchase program. DairyAmerica has worked very hard as a producer owned cooperative to minimize costs to dairymen and maintain a competitive price for nonfat powder at above support price levels. This has meant a loss to each DairyAmerica member. But, importantly, all dairymen's pay price has benefited from a higher powder price.

Processors that are not owned by dairymen use the economics of their enterprise to make their business decisions. And in the past when facing the additional cost of selling to the CCC, they have chosen to discount their sales price to match their commercial competition. This has resulted in the CME price falling below the support purchase price level and producer prices have dropped to levels below what they would have otherwise been.

The California state costing system captures a portion of the cost to sell to the government. These costs ultimately find their way to the make allowance. Therefore, the processor's cost of selling to the CCC is partially borne by dairymen anyway. Processors should be given the incentive to use the CCC program to avoid additional losses to producer revenues at times producers can least afford it. The support program is intended to floor prices and act as a safety net for producers. The industry should use this tool as it was intended to be used.

Regarding the Class 4a make allowance:

We would like to point out that non cost justified changes in the Class 4a make allowance, either reducing the allowance, or increasing it at an amount less than justified by cost studies, reduces our member/owners net income and the value of their investment in milk processing facilities in favor of those producers in California without an investment in milk processing facilities and, therefore, carry no responsibility in balancing and stabilizing the state's growing milk supply.

Based on this, it is our position to support cost justified changes to the Class 4a formula. California Dairies supports the following cost justified Class 4a make allowances:

And you see the table. And I'll refer you to exhibits A, B and C at this time.

Exhibit A represents the updated cost study for 2000 -- September of 2005 utility and labor rates. And Exhibit B does the same for nonfat powder. A is for butter. And Exhibit C are the -- is the 2004 cost study that was in place at the time the last hearing decision was made.

HEARING OFFICER KRUG: Mr. Heffington, just to clarify for the record. Where you're referring to Exhibit A, B and C, you're referring to exhibits attached to your testimony, which has been entered as Exhibit 56?

MR. HEFFINGTON: Yes, that's correct.

HEARING OFFICER KRUG: Thank you.

MR. HEFFINGTON: I'll move on.

California Dairies' position was arrived at based on the weighted average manufacturing cost data as published by CDFA. These exhibits show weighted average cost increases equivalent to the change in make allowance proposed by CDI. We further believe that the updated cost estimates, exhibits A and B, more accurately reflect the current cost of our operations than does the 2004 cost study.

In regard to energy costs:

Our proposal is based on updated cost data which was re-released on May 17th, and includes September 2005 utility prices. We would like to point out that CDI's utility costs have continued to increase. In fact, the cost for natural gas in September of 2005 compared to future contracts available as of May 26th, of this month -- the previous month, May 2006 -- as quoted to us by our energy broker yields the following weighted average costs for California Dairies' five plants.

The information we submitted for the September update, for September 2005, yielded a weighted average cost per therm for all five of our plants at .8180. Those same comparable rates weighted on September's usage of natural gas yielded a one-year contract rate of .8583 per therm, a two-year rate of .9099 per therm, and a three-year rate of .9159 per therm.

The cost for electricity in September 2005 compared to future contracts available as of May 30th, as quoted to us by our energy broker, yields the following weighted average cost for California Dairies' five plants:

Again, the rates that were submitted in September of 2005 for the update yielded an average cost per kilowatt-hour, a weighted average basis in our plants, of .1052. The one-year rate is .1114, the two-year rate currently is .1164, and the three-year rate .1167.

Again, this is weighted based on September 2005 actual usage of natural gas and electricity.

This illustrates that the cost of contracted gas and electricity has gone up beyond the average cost CDI paid in September of 2005, the last cost update.

This also illustrates that there is a premium for forward contracting into the future, indicating the market has risk and that the market's expectation is for continuing higher costs in the future.

These increases in rates equate to the following cost per pound increases above September 2005 for powder and butter:

Now, remember, these increases are above what we're asking for at this hearing. So this is above the September 2005 updates.

For one-year contract rate powder is .0026 per pound; butter, .0003. The two-year rate, .0052 for powder; butter, .0007. And the three-year rate for powder, .0055; and for butter, .0008.

In regard to energy surcharges:

There have consistently been comments made that increased costs should be passed along to the customer. And if processors need more, they should get it from the market, not from the dairyman's milk check.

DairyAmerica and California Dairies has done just that. Over the past two years DairyAmerica has instituted an energy cost surcharge. The surcharge has been reported to the Department as each sale was made and the increase in sales price has been included in the California weighted average price. As a result of this effort the milk price paid to all dairymen has been increased.

Because the milk price was increased, the special energy charge did not contribute to the margins of DairyAmerica members and powder manufacturers still had to absorb cost increases. We have and will continue to go to the market to recover whatever costs we can. However, our cost increases are real and the make allowance needs to be adjusted to recognize this.

In regard to current costs:

Some may argue at this hearing that costs as audited are not current, and they're right. As costs continue to increase, manufacturers are continually operating with a make allowance based on historical data that does not cover these higher current costs. This may be workable for expenses that are not increasing at as rapid a rate as energy, labor, health and welfare, interest, and inventory storage costs. When major cost items rapidly increase, it puts manufacturers at a severe disadvantage. We offer the following information for those who claim that additional volumes have offset these cost increases. California Dairies cost increases for the first quarter of 2006 exceed the entire contribution of the additional volumes run through our plants.

In regard to buttermilk powder values, a byproduct:

Next we would like to point out that all butter manufacturers are currently in an additional cost squeeze, caused by the drastic reduction in sales value of a byproduct, buttermilk powder. The sales value of buttermilk powder is now approximately 15 to 20 cents per pound below the value of nonfat powder. I've attached the latest Dairy Market News as Exhibit D.

This negative price spread has been caused by the large volume of buttermilk powder currently available to the market and, after including the cost of butter fat included in the buttermilk powder, is a cost equivalent loss of .0083 per pound of nonfat powder and .0169 per pound of butter produced.

In recent years the value of buttermilk powder was closer to the nonfat powder price, and in some cases actually higher, helping to recover the cost of the nonfat solids and butter fat in the buttermilk powder.

We feel this shortfall in sales revenue created by the lower buttermilk price should be considered in the Department's hearing findings.

In regard to the butter price adjuster:

Next, regarding the California price adjuster for butter, we offer the following data which represents the difference between California Dairies' weighted average sales price and the weighted average CME price for the periods indicated:

We've included 2003, 2004 and 2005 calendar year weighted average differences that you can see there. And then we've gone further.

The following table compares the results of the Department's sales price audits for the 12 months ended December 31st, 2004 and 2005, to the above CDI sales information for 2004 and 2005. The CDI sales information importantly was also audited by the Department's cost audit staff.

For 2004, the CDFA weighted average difference was .0088, whereas the California Dairies' audited difference included in that total was .0362, 2.74 cents per pound difference.

For 2005, the numbers were much closer. You see CDFA was .0270, California Dairies was .0256, a difference of just .0014, not 2.74 cents.

We cannot understand how the Department's audited 2004 results could be so different from the CDI audited data. We can only conclude that sales that exceed the CME price must be included in the survey results. Sales at above the CME seem unrealistic since a customer could buy butter at the exchange for the CME price. This butter would already be located in the Midwest, or would have a freight price reduction for delivery in western warehouses of 4 cents per pound. When you buy butter on the exchange the manufacturer delivers -- has it in a warehouse on the West Coast. You get a 4 cent credit on your purchase price off of the exchange price. And that's documented on exhibits E-1 and E-2. The only explanation appears to be the forward pricing sales have been included in the CDFA reports. If this is the case, we do not believe that these types of sales should be included. We do not believe it is reasonable for dairymen to take the risk for forward priced sales by manufacturers.

I'd like to point out at this point that the last exhibit, Exhibit I, is a copy of the NASS report for butter. And there are a couple of arrows there at the bottom under the "Instructions" category that instruct the manufacturers to exclude forward pricing sales from those sales reported. And I'll come back to that Exhibit I later on in my testimony.

After considering the above, we have chosen to support a change to the butter price adjuster at the .027 level. This equals the weighted average difference for the 12 months ended December 31st, 2005, as shown on Exhibit F.

I've noticed with other -- or alternate proposal and people testifying that the questions come up as to whether a simple average or a weighted average is correct. A weighted average from this simple, mine, CFO of California Dairies, would not properly reflect the revenues received by manufacturer. You do not receive simple average prices every month. You receive -- if you sell ten pounds in one month at one price and one pound in another month, then you need to do a weighted average to calculate the revenues to the plants. There is no bias in doing a weighted average. The bias is in not doing the weighted average when you're calculating the revenue to a plant.

Additionally, we would like to point out that the coming year will require additional freight and costs to move the growing supply of butter to markets outside of California. The large markets for California butter that continue to grow are in the Midwest and East. And servicing these markets continues to become more costly. Current freight rates to the Midwest are 6.89 cents per pound by truck and 4.82 cents per pound by rail. These are actual rates paid by CDI as documented by the attached invoices, exhibits G and H.

Suggested changes for the future:

We recognize that the collection of this data has been difficult for the Department to assemble and to audit. We would like to offer the following suggestions that we believe would improve the data collection process and allow for the calculation and comparison of a weighted average sales price to the weighted average CME price.

We believe that it's mandatory for all manufacturers of bulk 25 kg salted butter and block cheddar cheese to report sales to the National Agricultural Statistic Service (NASS) on a weekly basis. And again that's Exhibit I. We suggest that the Department request these reports or similar reports each week from California manufacturers and tabulate the sales price results throughout the year. In this way the Department's survey could be kept current, avoiding a rush just prior to a hearing, allowing for the most current information to be used as part of the hearing record.

Please note, we are not recommending that the Department publish the weekly results of these surveys. We are recommending that the Department use the weekly reports as the source for data from which to calculate the difference between the price received by California processors and the CME price.

An additional benefit would be that weekly sales prices could be compared to weekly average CME prices. This is the basis for most butter sales, with pricing indexed to the weekly CME average. This would allow for the calculation of weighted average sales prices in comparison to weighted average CME prices for the same period, thereby eliminating the inaccuracy caused by comparison of average sales prices for a calendar month to the average CME prices for the 26th of the prior month to the 25th of the current month.

You recognize that these surveys that have been published, the price adjusters, are comparing calendar month sales for manufacturers to average prices on the CME from the 26th of the prior month to the 25th of the current month. So there's additional inaccuracy that this would eliminate.

Additionally, we suggest that the Department audit these reports for accuracy throughout the year.

Next, in regard to percentage of coverage:

We are concerned about the concept of selecting a percentage of volume as appropriate to cover. We assume that some plants have high costs in certain categories for various reasons, such as having extraordinarily high administrative costs or operating at a low volume and/or operating seasonally. We agree that coverage of 100 percent of these extraordinary costs is inappropriate. However, as inefficient plants close and fewer are included in the cost study, the percentage of coverage becomes an equation that would eventually cover only a percentage of even the most efficient operations.

This mindset would surely discourage investment in new plant capacity in California.

Current plant capacity:

As the largest supplier to plants located in California, we perform a daily balancing function. Any change in our member/owners milk production or our California plant customer orders must be accommodated 24/7/365. We utilize our five plant capacities to accomplish this everyday. We'd like to point out that in times of increased milk supply, such as what we are currently experiencing, the increase is accommodated by our plants, not our customers.

California Dairies believes that an appropriate level of make allowance is required to encourage standby balancing capacity to stay available in California. The level of coverage should not encourage less efficient plants to continue in operation year-round, but should provide some incentive for standby capacity to remain available and continue to provide the balancing function for California's ever increasing milk supply.

At today's historical growth rates, with an industry as large as ours, balancing capacity becomes a critical part of handling the milk supply. No one wants the burden of carrying inefficient high cost plants that balance the growing supply. However, with each passing month, our balancing requirements become more important. The need for proper balancing plants with the current swings in milk production (low to high) is more critical today than ever before in California.

Additionally, the continued movement of dairies out of southern California places additional burden upon balancing the needs of southern California processors. Larger and larger milk volumes are being moved to southern California from northern California and standby capacity is needed in the San Joaquin Valley to accommodate transportation interruptions caused by weather or by other unpredictable events.

In the past, additional balancing capacity has been available in nearby states. This availability of balancing capacity, combined with ample equipment and lower fuel costs, made it acceptable to move milk out of state at close to cost of production levels. Currently we're not aware of any significance surplus balancing capacity in nearby states. And even if additional balancing capacity were available, the shortage of trucks, tankers and drivers and the high cost of fuel make moving milk out of state in any significant volume impractical from a cost and logistics standpoint. We believe this shortage of equipment and drivers is not a temporary phenomenon, but a serious long-term problem.

We believe that the need to keep balancing plants and plant capacity available to our industry should be considered in the Department's hearing findings.

In regards to future growth:

The California Dairy industry has recently become a major supplier of milk powders to the world market. Investment in California's powder manufacturing is needed to provide the capacity to process the solids that need to be exported to balance the state's milk supply. We believe this is a large growth area available to the California dairy industry, with DairyAmerica's powder exports growing to over 400 million pounds of milk powders in 2005. Investment to meet this world market should be encouraged and we believe should be considered in the Department's hearing findings.

Plants are needed in California to balance, process and market the ever increasing supply of milk. In the past, facilities have been built here in California because of the ample milk supply, but also because of the California system which responds quickly to changes in industry conditions as opposed to the slower federal system.

This consistent adjustment to costs and other factors has created stability. Consistent adjustment, and not overreaction, is the key to the expansion and financing of facilities in California. Because of it, there is less investment risk in California facilities, as opposed to other areas of the country, and financing for new facilities can be accessed more readily when the make allowance keeps up with costs.

Consistency of balance between producer and processor needs is the key. And with the milk growth that we've had this year, that's balanced with butter and powder plants that are principally owned by dairymen, we urge the Department to not overreact to the petitioner's request for a large Class 4b make allowance increase.

Thank you for your attention to my testimony. And we request the ability to file a post-hearing brief.

HEARING OFFICER KRUG: Thank you very much, Mr. Heffington.

You have a few minutes remaining. Mr. Cotta, do you have anything to add?

MR. COTTA: I'm ready for questions.

HEARING OFFICER KRUG: Okay. Your request for a post-hearing brief is granted.

Does the panel have any questions for the witnesses?

Mr. Gossard, we'll start with you.

(Laughter.)

AGRICULTURE ECONOMIST GOSSARD: What if somebody else actually has questions?

HEARING OFFICER KRUG: Mr. Gossard, we'll start with you.

(Laughter.)

AGRICULTURE ECONOMIST GOSSARD: On top of page 3 of your testimony you mention the additional cost for sales to the CCC was 1.8 cents. Is this for nonfat dry milk or --

MR. HEFFINGTON: Yes, it's nonfat.

AGRICULTURE ECONOMIST GOSSARD: Okay. Are you aware if there -- the cost for butter and cheese are comparable?

MR. HEFFINGTON: I don't know.

AGRICULTURE ECONOMIST GOSSARD: At the bottom of the same page you mention that the industry should use the support purchase price program as it was intended to be used. Since most of the cheese processed in this State is not cheddar cheese, how is a mozzarella plant supposed to utilize the CCC?

MR. HEFFINGTON: Well, it would encourage -- it's not going to be workable for a mozzarella manufacturer to sell to CCC. But I believe that with all the cheddar cheese that is produced in the State of California, and with California balancing basically California's growing milk supply as well as the nation, that that milk that ends up in California going into basically commodity products at times in surplus production, we would anticipate the cheddar cheese makers would offer to the government if they had a floor on the price.

MR. COTTA: Mr. Gossard, I think another area that's often overlooked, one of the reasons and the needs for balancing plants, the very fact when our customers cut back on product or whatever, that product flows back into our plant and then --

HEARING OFFICER KRUG: Excuse me. Is your microphone turned on?

Move a little closer.

MR. COTTA: I think that's the very reason you need balancing plants in the state. When a number of manufacturers cut back, what they do is they move the product into whoever's supplying the milk and whoever's balancing the milk. And then that -- those products indeed function through the butter powder facilities.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

On page 5 and, comparably, on page 6, you list the September 2005 actual cost for natural gas, and then one-year, two-year and three-year rates for fixed contracts into the future.

Were these rates comparable to what you were actually paying in May?

MR. HEFFINGTON: In May?

AGRICULTURE ECONOMIST GOSSARD: Oh, okay. You said the 81.8 cents is what your therms were weighted average over all your plants for natural gas in September 2005. And as of May 26th, you could have signed a one-year contract for 85.83 cents; two-year, 98.99; and three-year, 91.59.

Did you sign those contracts? And what was your actual gas price in May?

MR. HEFFINGTON: I don't have those numbers. It's June 1st -- well, close for May is not completed yet. So I do not have that information.

AGRICULTURE ECONOMIST GOSSARD: April?

MR. HEFFINGTON: I'd have to go back to March. And I can certainly answer that question in a post-hearing brief if you'd like.

AGRICULTURE ECONOMIST GOSSARD: And the same question as regards to electricity.

MR. HEFFINGTON: Okay.

AGRICULTURE ECONOMIST GOSSARD: At the bottom of page 6 you show the one-year contract price in one-, two-, and three-year price impacts upon the cost of processing butter and powder -- incremental cost increases. That's a combination of both natural gas and electricity?

MR. HEFFINGTON: Yes, it is.

AGRICULTURE ECONOMIST GOSSARD: On page 8 you were discussing the issue of buttermilk powder. Would a solution to whole buttermilk powder issue just be to take a weighted average monthly price of nonfat dry milk and California buttermilk powder and use that as the price indicator?

MR. HEFFINGTON: With as much butterfat as included in buttermilk powder, I think that certainly has to be considered a different type of product. I wouldn't want to -- you know, the CWAP is also used for sales and benchmarking sales and to the customers.

AGRICULTURE ECONOMIST GOSSARD: No, I wasn't referring --

MR. HEFFINGTON: I wouldn't want to put that --

AGRICULTURE ECONOMIST GOSSARD: I wasn't referring to having a single number presented to the industry. I was envisioning having a CWAP with a volume for the nonfat dry milk -- the buttermilk with a volume for industry information, and then a weighted average of the two actual used in the 4a formula.

Would that address your concerns about buttermilk powder?

MR. HEFFINGTON: That would be one solution to -- if you wanted California manufacturers to report buttermilk. But with the volumes of buttermilk, you know, you just have the same issue as you might have with butter or with cheese. And certainly if you wanted us to report buttermilk sales on a weekly basis, then we could report cheddar cheese sales and butter sales on a weekly basis. I think that wouldn't be a bad idea considering DairyAmerica's added energy surcharges. And I'm not sure what kind of surcharges cheese manufacturers may have added to cheese. And we'd certainly capture those revenues by doing that type of a weekly survey, if you wanted to put that into 4a and 4b pricing series.

AGRICULTURE ECONOMIST GOSSARD: On to page 11. You mention in the last paragraph --

MR. HEFFINGTON: Excuse me, Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: Oh, certainly.

MR. HEFFINGTON: If whey were to stay in the pricing as well, I would anticipate a survey for whey as well. If you're going to expand it for one, you need to expand it for all.

AGRICULTURE ECONOMIST GOSSARD: Okay. In your last paragraph on page 11 you mention in the second sentence, "This is the basis for most butter sales, with pricing indexed to the weekly CME average."

Do you know if that's also true for cheese?

MR. HEFFINGTON: I believe cheese, as was reported earlier -- I'm not sure what volume. I know some of the volume of cheese -- and we don't make a lot of it -- is priced off date of make. And that was referenced by one of the previous testimonies here. So there's a little difference between pricing cheese and pricing butter.

AGRICULTURE ECONOMIST GOSSARD: And at the bottom of the page you were concerned about using actual sales prices for a calendar month compared so the CME price for the 26th to the 25th.

The use of the 26th to the 25th precedes the 21 years I've been with this outfit. But I was told that that was requested by the industry because the prices at the market in the prior week set the actual prices for the following week. And so that it is appropriate to compare the 26th to the 25th to a calendar month.

Are you saying that's no longer appropriate?

MR. HEFFINGTON: In -- well, I think it creates differences when you're looking at the major kind of swings that we've had -- when that comparison was developed years ago, we had much more stable commodity prices. We didn't have the huge swings in cheese prices and butter prices that we have now. Now that we have these huge swings, you need to look at it on a weekly basis.

AGRICULTURE ECONOMIST GOSSARD: Starting on page 12, you have a lengthy discussion of current plant capacities. Do you currently have adequate capacity to handle the milk you're receiving?

MR. COTTA: I think if you're talking currently about this week, we probably do. But I think you need to take a look at the ups and down swings that we do have in the industry.

Two months ago, quite frankly, there was no -- not enough capacity in the State of California to handle the milk being produced there. And I use as evidence for that, milk was going out of state. And if you had the perfect storm where you had a snow storm on the grapevine and we normally ship about 110 loads of milk a day or 120 over the grapevine, and with the trucks that you have available in this state, there were not enough trucks, nor was there enough capacity in this state to handle the milk flow during that period of time. Some milk, quite frankly, was not processed.

AGRICULTURE ECONOMIST GOSSARD: And this occurred during the peak flush and is abated somewhat?

MR. COTTA: I don't know if it's occurred -- I don't know what a peak flush is. I assume we're over it at this juncture. But I know that if you take a look at the increase in production we've had in California over the last year -- or last 24 months, there are a lot of us very apprehensive about what's going to occur next year during the flush. Whether that flush occurs in March or April or June or July, I'm not sure when that occurs. But I can tell you that there's no excess capacity in this state to handle the product.

AGRICULTURE ECONOMIST GOSSARD: One of the things you mention, at the bottom of 13, for the problem is the shortage of trucks, tanks and drivers, which in the -- you'd mentioned in the past wasn't a problem. Just for information, what happened to the trucking industry that there isn't the excess capacity?

MR. COTTA: Well, a number of things occurred. First of all, the trucking companies tell us that it's very difficult to find drivers. Secondly, if you take a look at the growth in milk in California, that wiped out about any excess trucking capacity that there was just to handle the product within the state.

Another phenomenon that's taking place across the country is -- we used to use orange juice trucks coming from Florida delivering orange concentrate to southern California. We would backhaul those trucks to go to the Midwest with dairy product. Florida is expanding and their ability to handle their juice business, so that -- in California because of the tough business climate is shutting down. Those trucks are not available in either quantity or abundance that we've used in the past up until this last year.

We think the same is probably occurring with the whiskey market. Although -- the whiskey market I don't know a lot about. But I do know we --

(Laughter.)

MR. COTTA: I can tell you this. We've used a lot of whiskey trucks for backhauls that were coming out of Kentucky and Tennessee and the Midwest and would haul dairy product back. And I know those trucks are in lot shorter availability than they were.

So I think that's just a phenomenon that's taken place.

AGRICULTURE ECONOMIST GOSSARD: Do you expect over time that rates will go up to be able to hire more drivers and buy more trucks to meet the need, or is this --

MR. COTTA: No, I don't think that's going to change. And I think -- you know, a lot of reasons I think it won't change. Number 1, I think the business climate in California is not such that -- I don't think you're going to see the juice processing industry increase in California, nor do I think you're going to see the whiskey business increase in the State of California. And I just see that as part of the overall business climate. And I don't see that changing. And I don't see that changing at all on a local basis. Our local transportation companies are having a lot tougher time now than they had five years ago.

AGRICULTURE ECONOMIST GOSSARD: No further questions.

HEARING OFFICER KRUG: Ms. Reed, do you have any questions for the witnesses?

SUPERVISING AUDITOR REED: No, I don't.

HEARING OFFICER KRUG: Ms. Gates?

RESEARCH MANAGER II GATES: Just one.

Mr. Heffington, I have a question on page 11, when you were referring to the Department collecting the weekly prices for butter and cheddar cheese.

Did I understand correctly that you wanted that -- you didn't necessarily want that published weekly; you just wanted that collected so that we're not scrambling at the last time to come in and do the butter cheese sales?

MR. HEFFINGTON: Let me explain that. We're not suggesting that there's another competing price series for people to index off of. We are not suggesting that we -- that California create that. What we are suggesting is due to the difficulties and -- in auditing the data, when -- from my experience with Deloitte & Touche, which would have been for seven years. Left them as an audit manager -- a senior audit manager. And, you know, when you go out to a company and they have a set of books and you want to audit the 25 kg salt butter sales or the cheddar cheese sales for a month, and you have to go back in time, a lot of times the controllers -- you know, there's controllers and there was controllers, okay. They're going to give you the data to get you out of their hair. I'll guarantee you that. Some of them are going to take the time to make sure it's exactly right and what you're asking for. But a lot -- there's no instructions given to people. They don't say -- you know, I'm not aware of saying exclude all cheddar cheese that was too low of moisture or too high of moisture from your cheddar cheese sale. I'm not aware of a request to not include pre-price sales like the NASS report. And also when they're giving you their ledgers, they're not signing a document that says this is right.

If you had a weekly report that someone had to sign and submit, then there's some personal responsibility for submitting it correctly. And the Department has a lot more teeth going out and it's a lot easier to audit a report that's done on a weekly basis by manufacturers than coming back a year later and trying to go back in history and have them dig out their records. So that's why I'm suggesting -- one of the reasons I'm suggesting you do a weekly survey.

RESEARCH MANAGER II GATES: And you're not looking at that being published then?

MR. HEFFINGTON: Not at all.

RESEARCH MANAGER II GATES: Okay. Thank you.

HEARING OFFICER KRUG: Mr. Ikari.

DAIRY MARKETING BRANCH CHIEF IKARI: Just have a few questions to follow up in terms of plant capacity.

There are probably some fundamental changes -- or tell me what's different between the 2006 and the period in the eighties and the seventies when we regularly shipped milk out of state. Sometimes producers -- we had

$5 a hundredweight.

MR. HEFFINGTON: I'm going to assume that's for Richard.

(Laughter.)

DAIRY MARKETING BRANCH CHIEF IKARI: Well, whoever.

What are some of the differences today that that's not a possibility? Or is it a possibility?

MR. COTTA: Well, we're not aware, Mr. Ikari, of additional processing availability -- plant availability in the western U.S. There may be a little here and maybe a little there. But the very fact of the growth that we've experienced in the State of California, which has been enormous, the growth that's been experienced in Idaho and in Arizona, New Mexico -- just about everything west of the Mississippi River has pretty well filled up all plant capacity.

Now, moving that in the 1980s, we moved it at a tremendous cost to producers. In fact, one of the decisions this Department made was we didn't want to see producers getting $5 a hundredweight for that milk. We'd rather have them pay 10 cents or 20 cents more on a make allowance than to try to cover those $5 return they were getting on the product. And I think that combined with the transportation and the tanker availability, the inability of those -- that industry to move the quantity of product that we now have in the state, and the inability to find processing plant in the western United States to handle it, that is the major change. And I mean it's been a tremendous growth market west of the Mississippi River or certainly west of the Rocky Mountains.

DAIRY MARKETING BRANCH CHIEF IKARI: There's some consolidation within the national dairy industry and there's been closing of plants. Does that have an impact on this?

MR. COTTA: Oh, absolutely. I think those plants -- you've had a number of plants that have closed. Obviously --

DAIRY MARKETING BRANCH CHIEF IKARI: Most of those closures have been on the East, haven't they?

MR. COTTA: There's been a number of them East. But you see plants closing in Minnesota, you see them closing in Wisconsin. You've seen plants close in Nebraska. And I think you've seen plants close pretty well throughout the U.S., including California.

DAIRY MARKETING BRANCH CHIEF IKARI: There's the discussion about -- I'm curious. The plant capacity question is going to be an issue that we're going to have to deal with as a hearing panel. And you testified that two months ago there was a problem in California. At what point given our current production trends -- if you assume current trends will remain the same in terms of our production and our consumption or usage, when do you think we will be in chronic over-production relative to our capacity? When will we be there? Will we be there next year? Will we be there --

MR. COTTA: You're there now.

DAIRY MARKETING BRANCH CHIEF IKARI: We're there now?

MR. COTTA: You're there now. You've already had days in this state when you couldn't handle the milk. And you heard some testimony earlier that, you know, a lot of plants we've asked not to shut down to make repairs or whatever. But, quite frankly, plant capacity at the current time is stretched in California. Next year there's no question in my own mind, if production continues to increase as it has, if consumption continues to increase as it has, we are not going to be able to handle all the milk produced in the state.

Now, production goes down or you have two weeks of 120 degree weather or 22 inches of rain in three days, that may change. But I don't think as an industry it's responsible to sit back and say we're going to let the weather decide whether or not we have over-production or not. And, quite frankly, we have reached that point already in the state where we could not physically handle milk on an everyday basis.

DAIRY MARKETING BRANCH CHIEF IKARI: So giving a reason, demand suddenly fell or we had a sudden surge in production on a given month, we could be in a problem in terms of processing the milk production?

MR. COTTA: I Think we're already there, Mr. Ikari. And we've seen that -- you know, one of the things -- you asked about what's changed from the eighties. In the eighties we had a different base line. We produce a hundred million pounds plus of milk a day right now. You know, you get a 4 percent growth in that, that's 4 million pounds of additional capacity you've got to find. I guess what I'm telling you is there's not 4 million pounds of additional capacity available in the state right now. We are by that period of time.

MR. HEFFINGTON: If I might add one item and, that is, that plants I believe are much larger and -- there's fewer plants, but they're larger. And when those larger plants have breakdowns, you have a lot more milk to deal with than in the eighties maybe when you had smaller plants and they had a breakdown.

MR. COTTA: It's not unusual for us to see some swings of three to four million pounds a day. Now, there isn't standby capacity in this state for three or four million pounds of milk a day. I mean it just isn't there.

DAIRY MARKETING BRANCH CHIEF IKARI: When CDI made -- early on in your testimony, on page 1, you mentioned that your cost of your new plant is 125 million. And even though it was going to be -- you don't project it being profitable, you went ahead with a decision. There must have been some compelling reason from the producer end why the producer would be willing to go ahead with that decision.

MR. COTTA: We went through a process -- we went to our producer members. We held meetings in all our producer districts. We laid out the plans for the plant -- Joe laid out the financing for the plant and laid out the very fact of what we could expect in the way of profitability or lack of profitability. All our members saw that. We asked the members to vote -- what was their desire? Their desire was, "We want to increase milk production and we want you to handle the milk." That being said, every producer in the organization had the ability to vote on it and decide whether or not they wanted to take that risk and lose money and pay for that out of their pockets at the plant level and -- and from a management standpoint, we had no choice but to follow what the members basically told us. Management's recommendation was, "We're not sure you ought to do this, guys." And, yet, our membership spoke loud and clear and won the 51/49 vote.

DAIRY MARKETING BRANCH CHIEF IKARI: Do you annually survey your members in terms of their intentions of production in the future to -- say, to the next year?

MR. COTTA: We ask our Board of Directors on a very regular basis what they think production will do in the state. And, quite frankly, I've not seen a survey yet where producers came close. And they tell us, "We're going to increase a percent and a half this year because we've got water problems, air quality problems, high hay price," and that, and we get a 6-percent increase.

So next year we ask, and how we're going to increase at 2 percent this year because we got air quality problems, we got water quality problems -- and I'm not diminishing the volume of those problems -- and we get an 8-percent increase. So it's a very, very frustrating --

DAIRY MARKETING BRANCH CHIEF IKARI: So the actual is always higher than what they estimated?

MR. COTTA: I've never seen it lower. But maybe Joe has. No. And it always seems to be at least twice as high or three times as high as what we were told initially.

DAIRY MARKETING BRANCH CHIEF IKARI: Is it your sense that the capacity problems that you see with your size is evident with all the other manufacturing processing plants?

MR. COTTA: Well, I think so. Now, remember, a great deal of those use our facilities for balancing. But, yeah, it's evident. And when we presented our new project, we said one of the areas that we want to concentrate on and, that is, international sales of specialty powders. And we think there's a tremendous opportunity there. And it's not going to be a short-term opportunity. It's a long-term opportunity. And that was one of the items we pointed out when we made our presentations. And I think that that does offer some real potential for California producers. But the plant capacity -- the plant that's now under construction is going to be filled when we're finished constructing it.

DAIRY MARKETING BRANCH CHIEF IKARI: So we'd be in the same dilemma if the production continues?

MR. COTTA: Oh, unless producers don't increase. But, you know, take our production at almost 50 million pounds a day -- that's just about what we peaked out -- 50 million pounds a day, you add 3.5 percent increase on that every year, if we can hold it at 3.5, calculate that back into the 5 million pound number that Joe used. By the time the plant opens up it's virtually filled unless producers produce the one and a half percent. And, quite frankly, I don't see that.

DAIRY MARKETING BRANCH CHIEF IKARI: Toward the end -- just about the last sentence in your statement, you urge the Department not to overreact to the petitioner's request. I wonder, Joe, if you can give us a better idea or go into a little more detail about what overreaction would mean.

MR. HEFFINGTON: I think you have to look at the costs and react the way that you have in previous hearings and balance the needs. That's the balance that the Department has. If you look at your last hearing findings, I think on the first page you say that one of the most critical things is balancing the producers' and the processors' needs. I took that to mean that there was not going to be any type of significant overreaction. I don't think an increase in the make allowance on 4b of 50 cents a hundredweight is going to build any plant any sooner than a rational -- more rational change in make allowance.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, maybe I misunderstood. But do you mean by overreact, the change in the make allowance of 4b relative to 4a, or just the absolute amount?

MR. HEFFINGTON: I think that's certainly part of it. You have to look and compare. And I think there's organizations that have -- you have to keep the entire industry balanced. And that is on the Department's shoulder now.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. Thank you.

HEARING OFFICER KRUG: Are there any other questions for these witnesses?

Thank you, Misters Cotta and Heffington. And I don't recall, did you request a post-hearing brief?

MR. HEFFINGTON: Yes, I did.

HEARING OFFICER KRUG: And it was granted.

(Laughter.)

HEARING OFFICER KRUG: The next alternative proposal was presented by -- or submitted by the California Dairy Campaign. And will the representative of the California Dairy Campaign now approach.

DAIRY MARKETING BRANCH CHIEF IKARI: While they're getting ready, Mr. Hearing Officer, I think that last hearing exhibit was 57.

HEARING OFFICER KRUG: Clarified the testimony from California Dairies, Incorporated, will be marked No. 57.

Thank you very much, Mr. Ikari.

DAIRY MARKETING BRANCH CHIEF IKARI: Would you pull that mic real close to you.

AGRICULTURE ECONOMIST GOSSARD: We need one more.

Good afternoon.

Good afternoon.

HEARING OFFICER KRUG: One moment.

Okay. Each have a handout?

All right. Are the witnesses from the California Dairy Campaign ready?

MR. AUGUSTO: Yes.

MR. MAGNESON: Yes.

HEARING OFFICER KRUG: Remember, when you speak into the microphone, keep the microphone close to you so it will resonate throughout the auditorium.

Will the witnesses please state their name and spell their last name for the record.

MR. AUGUSTO: Joe Augusto. That's A-u-g-u-s-t-o.

MR. MAGNESON: Scott Magneson, M-a-g-n-e-s-o-n.

HEARING OFFICER KRUG: Mr. Augusto, do you swear or affirm to tell the truth?

MR. AUGUSTO: I do.

HEARING OFFICER KRUG: Mr. Magneson, do you swear or affirm to tell the truth?

MR. MAGNESON: Yes, I do.

HEARING OFFICER KRUG: Are you both here today representing the California Dairy Campaign?

MR. AUGUSTO: Yes.

MR. MAGNESON: Yes.

HEARING OFFICER KRUG: Do you have any written statements or other things that you would like entered into the record at this time?

MR. AUGUSTO: Other than we've handed out, no.

HEARING OFFICER KRUG: Okay. They've distributed a document here titled "Testimony of the California Dairy campaign," dated --

MR. AUGUSTO: Actually, sir -- oh, I'm sorry.

There was a written petition regarding the floor price we had a number of producers -- I think we had a couple hundred petitioners sign. We would like to submit that as part of our post-hearing brief, if we may. I don't have it here with us today.

HEARING OFFICER KRUG: Keep in mind that your post-hearing brief is limited to amplifying, clarifying or withdrawing your oral testimony. So long as it meets those qualifications, you may submit the document.

MR. AUGUSTO: Okay. Thank you.

HEARING OFFICER KRUG: And just to finish up, the document that you've presented today is labeled Exhibit 58 and is now entered into evidence.

(Thereupon the above-referred document was marked as Exhibit 58.)

HEARING OFFICER KRUG: You may proceed.

MR. AUGUSTO: Mr. Hearing officer and members of the Panel, my name is Joe Augusto. I'm a dairy producer from the State of California.

I'm testifying today on behalf of the care a California Dairy Campaign (CDC), which represents more than 300 dairy producers throughout the State of California. I also speak today on behalf of the farmers and rancher members of the California Farmers Union (CFU).

The testimony Scott and I will present today is based on positions adopted by the CDC Board of Directors at our May 25th, 2006, board meeting.

Prices paid to dairy producers throughout the state today are 30 percent below the cost of production and the outlook for the future is uncertain. Producer prices have reached the lowest level in two years. A thousand-cow dairy with average costs is currently losing more than $60,000 per month or 720,000 per year.

It is difficult, if not impossible, for producers to pay their feed and other input costs when our price does not cover the cost of production. As a result, low dairy producer prices are having a ripple effect on the rest of the dairy -- on the rest of the state's agricultural economy.

At the same time that producer prices have dropped, our input costs continue to go up and up. Record high energy prices affect every stage of our dairy operation. High fuel prices increase the amount producers spend to grow or to purchase their feed for their cows. CDFA estimates indicate producers are paying on an average 16.4 cents her hundredweight in surcharges on their feed and transportation bills.

Under the current system, producers are not able to recoup our higher energy costs from the market. It is processors and retailers who have the ability, not the producers. Processor to testify here today in favor of taking more out of producer's pockets to pay for their higher energy costs is simply outrageous.

The California pricing system the is causing two things to happen that negatively impact producer prices. Due to the make allowances rate, price adjusters and other factors, California processors are able to sell dairy products at prices that are below prevailing market prices. California prices in turn lower the CME price upon which producers' prices are based.

Also, due to the current formulas, California plants are continuously asking for more milk than the market is demanding.

CDC stands today in strong opposition to the proposal put forward by the Dairy Institute. The Dairy

Institute claims increases in the make allowance and other changes are necessary because the prospect for new plant investment are dim due to the rising costs.

I would like to point out in two towns near our dairy, in Hanford and Lemoore, significant plant expansion is occurring. The expansion suggests that current make allowance rates and pricing formulas continue to attract plant investment. Attached please find documents of plant expansion in my area. We further oppose all aspects of the proposals put forward by Land O'Lakes, California Dairies, and the Alliance of Milk Producers that would lower producer prices.

The Dairy Institute's proposal would lower producer prices by 29 cents per hundredweight. Adding that amount to the energy surcharges of 16.4 cents per hundredweight amounts to 45 cents per hundredweight drop in producer prices. Given today's low prices, a 45-cent drop in producer prices will put many dairy operations throughout the state in jeopardy. We urge CDFA to adopt CDC's alternative proposal because it will be a first step towards stabilizing producer prices and reforming our pricing system so that the market -- it is more market oriented.

The alternative proposal submitted by CDC calls for CDFA to:

Floor the butter, nonfat dry milk and cheese prices at the higher of the market value of the federal support purchase price.

Establish a variable make allowance that compares the producer's cost of production with the commodity values. This relationship is then used to adjust the base make allowance for butter, nonfat cry milk and the cheese on a monthly basis.

Eliminate the transportation allowance on butter and cheese and insert language to prohibit the whey value from having a negative impact on the formula.

CDC supports flooring the 4a and 4b price at the federal support purchase price.

CDC has joined other producer organizations here today in calling for CDFA to immediately floor 4a and 4b price at the federal support purchase price. The federal support purchase price provides a much needed safety net for producers throughout the country, especially now when today's prices are low. California producers deserve to benefit from this important safety net that was passed during the last federal farm bill and extended through 2007.

I and other CDC members traveled extensively to Washington DC to urge lawmakers to pass strong dairy policy that included a safety net provision when prices dropped. Although we believe producers should be paid from the marketplace, it is the intent of Congress that all producers nationwide be eligible for this important safety net. To be consistent with the federal farm bill, California producers should receive prices that are the higher of the prevailing market prices or the USDA announced federal support purchase price.

The CDC petition calls for CDFA to establish a variable manufacturing cost allowance that would be adjusted monthly based on producer's cost of production and the prevailing commodity price.

We believe that the current make allowance system overall sends a false signal to processors to continue production regardless of market demand -- continue production regardless of market demand. The current fixed make allowance system provides a strong incentive for processors to run as much raw milk as possible through the plant regardless of market conditions. The result from this system is that it puts the needs of the processor at odds with the needs of the dairy producer. Too much milk reduces the price to the dairy farmers and milk shortages decrease the amount of milk available to the processor.

We believe a make allowance system should be reformed so that it provides benefit to the processor and the producer. We favor the establishment of a variable make allowance that would tie processor and producer prosperity together. A variable make allowance would increase significantly when milk prices are high, thereby giving an incentive to the processor to continue production because the return would be higher. However, when milk prices are low the make allowance would decrease and send a signal to the processor to limit production in order to allow demand to catch up with production. We believe a variable make allowance is a win-win proposal because it would enable producers and processors to make higher returns when milk prices are higher.

Under the current pricing formulas, a plant's make allowance is fixed; while the price received by the dairy producer is highly volatile and, until now, has not included the dairyman's cost of production. A milk pricing system that is balanced requires that dairy product prices, producers' cost of production, and the plants' cost of all be given consideration when determining the value of milk. Each of these items sends signals to one another in a free market environment, so that proper price and production adjustments will occur.

Under a variable make allowance, when the supply of processed product is in line with demand, the make allowance is generous. As the market signals oversupply through lower prices, a make allowance would automatically drop causing manufacturing to slow until once again supply and demand are in balance.

In California's milk pricing system there's an insufficient marketplace balance between these factors, because the make allowance guarantees that the costs of the processing segment of the industry are covered. In fact, since make allowance includes costs plus a profit for an inefficient plant, oversupply can actually be a benefit to proprietary processors because it lowers the raw product costs. This is less true for cooperatives whose members are dairy farmers affected by lower milk prices.

California has allowed plants to be profitable and expand processing of the lowest value dairy products regardless of true market demand because producers covered the plant costs. This has resulted in lower producer milk prices. The generous make allowance levels enable processors to use the additional margin to discount their product price to gain market share at the expense of producer pay prices and at the expense of other manufacturers in the rest of the United States. Plants are merely operating by the rules of the system. CDC's variable make allowance proposal is aimed at creating a true market oriented system.

As long as the manufacturing make allowance is fixed at the processor's cost plus a return on investment, and is paid by the farmer, the processing segment of the industry will be unconcerned with market signals. We need a system that works with a marketplace at all levels: Producers, processors, wholesalers, retailers, and consumers, to provide an equitable, stable, viable economic environment for all segments of the dairy industry.

Our members support a variable make allowance based on producer milk prices. It is unfair and market distorting to force the producer to continually cover the costs of processing, including a profit, when he has no similar compensation guarantee. It is far from certain if and when the producer is able to cover his production costs. Market signals should be sent to both the producing and the processing sector of the industry.

At this point Scott Magneson will provide additional details about the variable make allowance formulas and the other provisions in our alternative proposal.

MR. MAGNESON: Thank you, Joe.

The CDC variable make allowance proposal incorporates the Commodity Reference Price, which is used to calculate the value of milk in the market, and compare that amount to the cost of production to show what percentage of our costs are being covered by prevailing commodity prices. That same percentage is used to adjust the make allowance up or down from the base make allowance. When commodity prices are high enough, a hundred percent of the average producer cost of production and a hundred percent of the processor's average cost of production is covered. When commodity prices do not cover the cost of production to the producer, the make allowance would be adjusted downward accordingly.

Under the 4a: For all milkfat, the CDC variable make allowance formula would equal 12.4 times the Commodity Reference Price calculated under the Subparagraph (A)(4)(b), divided by the milk production costs. The 12.4 cents is the estimated cost needed to cover approximately 75 percent of the volume of production from the make allowance cost study. And we looking at the one released in January of 2006.

For all milk solids not fat, the CDC's variable make allowance formula would equal the 15.9 cents times the commodity reference price calculated under the same Subparagraph (A)(4)(b), divided by the milk production cost.

On 4b, the cheddar cheese, the CDC manufacturing cost allowance would equal 16.8 cents times the Commodity Reference Price calculated under (A)(4)(b), divided by the milk production cost. The 16.8 cents is estimate equal 71 percent of volume of cheese as per the same make allowance study amended in January of '06.

The elimination of the transportation allowance on butter and cheese was done to bring the California's milk price into a closer relationship with those in the Federal Order. The Federal Order prices for milk going into the cheese is 50 cents higher than the California price and butter powder milk is 35 cents higher. Elimination of transportation allowance will help to narrow the gap between the California prices and the Federal Order prices.

We inserted the language to prohibit the whey value from having a negative impact on the formula. And the floor on the whey values will keep whey prices above the make allowance and prevent whey from having a negative impact on the 4b price.

Beyond the issues we have discussed today, we believe the end-current pricing system in California should be improved overall. The current 4b formula should also be modified to make it more market oriented. The current 4b formula is based on the price of cheddar cheese, which is one of the least profitable cheeses sold in the marketplace today. We believe that the 4b formula should be based on current market demand and prevailing market prices. Demand for mozzarella cheese and high moisture cheese represents half the cheese market today.

Producers should be able to reap rewards of these products as processors have for some time now.

Money is being made in the dairy industry, but producers are being left out of the profit opportunity. In our system today large processors are able to manipulate our market to keep producer prices artificially initially low. Far more must be done to address the concentration in the dairy sector that has allowed such market manipulation to lead to such chronically low producer prices.

In conclusion, we call upon CDFA to:

Floor the butter, nonfat dry milk and cheese prices at the higher of the market price and the federal support purchase price.

Establish a variable make allowance that compares producer costs of production with the commodity values. This relationship is then used to adjust a base make allowance for butter, nonfat dry milk and cheese on a monthly basis.

Eliminate the transportation allowance on butter and cheese.

And insert language to prohibit the whey value from having a negative impact on the formula.

We believe acceptance of our petition will be a good first step towards ensuring that dairy producers receive a fair price in the future. And we look forward to working with CDFA to improve the outlook for the dairy producers in the state.

The California Dairy Campaign would like to thank the Department for the opportunity to present our alternative proposal today. And we'd also like to request the opportunity to submit a post-hearing brief.

HEARING OFFICER KRUG: Your request to submit a post-hearing brief is granted.

Before we have panel questions, I do have a couple of questions for you.

Apparently there were two other sets of documents delivered with your testimony. One is a group labeled City of Hanford. And the other are is a group of documents, first page is labeled City of Lemoore.

Do you wish these to be entered into the record?

MR. AUGUSTO: Yes.

MR. MAGNESON: Yes, we do.

HEARING OFFICER KRUG: The documents with the first page "City of Lemoore" is labeled Exhibit 59 and is hereby admitted into the record.

(Thereupon the above-referred document was marked as Exhibit 59.)

HEARING OFFICER KRUG: And the group of documents, the first page "City of Hanford", is labeled Exhibit 60 -- that's 6-0. And it's now admitted into the record.

(Thereupon the above-referred document was marked as Exhibit 60.)

HEARING OFFICER KRUG: Does the panel have any questions for these witnesses?

Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: Your proposal would raise Class 2 and 3 prices. Are you concerned that that would make California Class 2 and 3 processors less competitive with processors in other parts of the country?

MR. MAGNESON: I think that I'm -- we have a -- most of our commodities we have a pretty good price advantage. Our prices have been lower than the Federal Orders on a number of times. And I don't -- you know, I'm not concerned with it.

AGRICULTURE ECONOMIST GOSSARD: On page 4 of your testimony, you discuss your base make allowances for 4a and 4b, 12.4 cents for butter, 15.9 cents for nonfat dry milk and 16.8 cents for cheese. And you say that these represent 75 percent of the volume for the cost studies.

How did you estimate that these would cover 75 percent?

MR. MAGNESON: Well, we were using the -- like I said, I was using these amended January. And since then, some of the data that -- or these particular ones I guess are not accurate according to the -- are inaccurate representation of an actual cost to the plant. So now there's new costs data that's been released, so I'm not really -- the number -- the exact number is not as important with our proposal because it's going to fluctuate month to month. And so I tried to -- by looking at the data on that sheet, on the right-hand side of the data there's a percent of the group that is covered. And since they're in-grouped, it's very difficult to find an exact amount. So basically I just went between the groups, estimated --

AGRICULTURE ECONOMIST GOSSARD: But your intention was to cover then 75 percent of the volume in each category?

MR. MAGNESON: That seemed to be close to where we were currently with the current make allowances. So I tried to keep it within that range.

AGRICULTURE ECONOMIST GOSSARD: You have proposed to eliminate the f.o.b. adjusters. Do you believe based on the departmental data that this CME price is the price that California processors sell their butter and cheese for?

MR. MAGNESON: I believe that the -- they probably are selling it below that sometimes and some of it's above that. The -- I know what the price for milk going into those same products in Federal Orders is. And it's quite a bit higher than what we are receiving. That's what I'm concerned about, trying to narrow that gap. And by eliminating those adjusters I was able to keep our price -- using the variable make allowance over that period of time, average close to where prices are today, but improve them a little bit.

AGRICULTURE ECONOMIST GOSSARD: Finally, you are proposing to snub the whey value at the manufacturing cost allowance. At the last hearing the panel stated that this policy would create serious competitive disadvantages to California cheese products.

What information do you have that would indicate the panel was incorrect in making that statement?

MR. MAGNESON: I don't have any specific data that you were incorrect, other than that I don't -- we don't believe that that should have a negative impact on our prices when prices drop. I'm concerned that if we do allow that to have a negative impact, prices could be driven down, the whey prices could be driven down in order to pay less for the milk.

And the overall 4b price is most important. I mean and that's what they have to pay for the milk going into that plant. And that's what we receive for it. And I think that by incorporating in our proposal with a variable make allowance, that has big rewards for plants when prices are good and encourage production, encourage new plant growth. So I think the benefits in our variable make allowance would outweigh whatever negative impact prices going below a snubber would.

AGRICULTURE ECONOMIST GOSSARD: No further questions.

Thank you.

HEARING OFFICER KRUG: Ms. Reed, do you have any questions for the witnesses?

SUPERVISING AUDITOR REED: No, I don't have.

HEARING OFFICER KRUG: Ms. Gates, do you have any questions for the witnesses?

RESEARCH MANAGER II GATES: No.

HEARING OFFICER KRUG: Mr. Ikari, do you have any questions?

DAIRY MARKETING BRANCH CHIEF IKARI: I just have a couple.

HEARING OFFICER KRUG: And I think you need to be a little closer.

DAIRY MARKETING BRANCH CHIEF IKARI: A number of times, Mr. Magneson, you compared the California prices to the Federal Order prices. But do we know how much milk in the Federal Order is unregulated and what the price is on the milk that is manufactured into manufactured products that doesn't have to pay the regulated Federal Order price?

MR. MAGNESON: I believe that most of the milk is paying that price or higher through premiums. So even if it's unregulated, potentially it's paying that price. I don't have any evidence to show that, but I'm just --

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. On page 1 you talk about plants -- California plants are continuously asking for more milk than the market is demanding.

And I was curious. How are they asking? Are they asking in the form of higher premiums? How are they asking for more milk?

MR. AUGUSTO: By simply not discouraging producers -- you have a situation here where you have depressed prices that -- you know, we're at $10 milk. And we have processors building plants. And that just encourages more production. So in that sense --

DAIRY MARKETING BRANCH CHIEF IKARI: Do we have California processors building plants or do they -- I think there was some testimony that there hasn't been a manufacturing plant built in California.

MR. AUGUSTO: You have a number of them, I believe. I don't want to mention any names, but CDI is building a new butter powder plant. You have a number of expansions of cheese plants that are going on currently. One in Lemoore and a smaller one in Hanford. So there is some increase in capacity -- processing capacity.

DAIRY MARKETING BRANCH CHIEF IKARI: One other question just for my edification.

Is it the plant's responsibility to turn off the milk production? Is it the plant's responsibility to tell producers don't produce it?

MR. AUGUSTO: Well, I think -- there's a common -- this argument is used a lot by the processing side. But plants do have an effect on what producers produce. They can tell -- they can limit them to their production.

There's an example just recently. Up north there's a processor who is limiting their producers by contract because they simply don't have room to process the milk. So they do have an influence on production.

DAIRY MARKETING BRANCH CHIEF IKARI: But if you go back in history in the seventies and eighties, the plants must have done a very poor job when California producers were shipping milk out of the state that exceeded our ability to process the milk.

MR. AUGUSTO: Well, I can't remember back that far. If you could -- you're talking about the early seventies or -- did you say eighties or seventies?

DAIRY MARKETING BRANCH CHIEF IKARI: Seventies and eighties -- the late seventies and eighties.

MR. AUGUSTO: Well, I can't speak specifically to that time. I don't recall what was going on back then.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, did you hear Mr. Cotta's testimony in terms of we might be right at surplus production today?

MR. MAGNESON: I think that there is the potential to build more plant capacity. You can build plant capacity and the market is -- and as long as product isn't going into surplus, into the government -- into CCC, then the market is -- the consumers are taking that production and utilizing it.

So there is potential to build more plant capacity, I think. Although there is some product going to surplus product.

But our proposal with a variable make allowance would have encouraged, when production -- when prices were high, would have encouraged -- or the plants would have had the ability to increase production with an increased make allowance that they would have been receiving. And we probably wouldn't find ourselves in the situation we are now with short plant capacity.

DAIRY MARKETING BRANCH CHIEF IKARI: It would be helpful if you could provide in your post-hearing brief a list of the plants that are expanding or new in, say, the recent last five years.

MR. AUGUSTO: Okay. I mean we do have some evidence that I presented. But could produce more --

DAIRY MARKETING BRANCH CHIEF IKARI: Could you describe those two documents? What are those two documents?

MR. AUGUSTO: Okay.

HEARING OFFICER KRUG: And if you could describe their -- or explain their relevance to this proceeding.

MR. AUGUSTO: Yeah, there was testimony, I believe it was by the Dairy Institute, that suggested that there are no expansions or there's a threat to expansions of processing capacity.

What I have is a -- there's a processing facility in Lemoore. I didn't really want to mention their names. And they've asked for a -- this is a -- they have a conditional use permit, but they've asked for a site plan review and they're asking the city for an expansion to their cheese making process.

And --

DAIRY MARKETING BRANCH CHIEF IKARI: Does it say -- it could be for storage or warehouses. Is it for processing?

MR. AUGUSTO: Yeah. I haven't been able to quantify it. But there are -- I did take some photos, and there are -- I don't know if these are cheese vats or what outside. But it appears that they are increasing capacity to take more milk. But I think that I could provide more evidence in the post-hearing brief.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. And it might helpful to know where they are in the process.

MR. AUGUSTO: In the process of expansion?

DAIRY MARKETING BRANCH CHIEF IKARI: No, in terms of the approval process. Is it still under consideration or has this --

MR. AUGUSTO: No, this particular project has been approved --

DAIRY MARKETING BRANCH CHIEF IKARI: Okay.

MR. AUGUSTO: -- for a certain amount. And they've asked for a limited go ahead, I believe is what it is. I'd have to get you more details. But that's what I was told by the Planning Commission.

And then there's a small cheese plant in Hanford, California, that's being put up. And if you look at the schematic, it says that -- in addition to the cheese plant, a yogurt facility. And the schematic says, "Under construction cheese plant" here in the corner. It's being put up now. And there are pictures of, you know, scaffolding, construction equipment. And it's obviously that they're putting up a cheese plant or some kind of a dairy facility to process more milk. But it does say cheese plant here.

But I think I can obtain more information and submit it.

DAIRY MARKETING BRANCH CHIEF IKARI: If you can get information in terms of how much processing --

MR. AUGUSTO: -- the volume --

DAIRY MARKETING BRANCH CHIEF IKARI: -- the volume that these plants will -- or these permits will approve.

HEARING OFFICER KRUG: Will the witnesses with regard to these two sets of documents we're referring to, Exhibit 59, the ones labeled "City of Lemoore - Application for Site Plan Review" and Exhibit 60, "City of Hanford - Application for Site Plan Review" -- keep in mind that the Department can only consider the information that is presented to it. If these documents don't explain what it is that is being built, the capacity, why it's relevant to the call of the hearing, the Department can't infer anything that's not patently inferable. But don't count on anything being obvious. If you've got -- or want us to consider this, you need to provide us with the explanation. And that goes as to both Exhibits 59 and 60.

Any more questions for the witnesses?

Thank you very much.

We'll now call the representative from the Milk Producers Council to approach and present their alternative proposal.

While the representatives of the Milk Producers Council are preparing, if I could just request that pagers and cell phones, the volume either be turned very far down or to silent, and that your discussion amongst yourselves, while it's understandable, please keep in mind it can be distracting to the witnesses, many of which aren't as used to shouting over people as your hearing officer and other such attorneys in the room.

So please keep your courtesy in mind.

And if the Milk Producers Council representatives are ready.

MR. VANDEN HEUVEL: We are.

HEARING OFFICER KRUG: Okay. Thank you very much.

Will you please each state your full name and spell your last name for the record.

MR. VANDEN HEUVEL: Geoffrey Vanden Heuvel; last name, V, as in Victor, a-n, d, as in David, e-n capital

H-e-u-v, as in Victor, e-l.

MR. VAN DAM: William C. Van Dam; last name, V-a-n D-a-m, two words.

Thank you.

Mr. Vanden Heuvel, do you swear or affirm to tell the truth?

MR. VANDEN HEUVEL: I do.

HEARING OFFICER KRUG: Mr. Van Dam, do you swear or affirm to tell the truth?

MR. VAN DAM: I do.

HEARING OFFICER KRUG: Are you both here today representing the Milk Producers Council?

MR. VANDEN HEUVEL: We are.

HEARING OFFICER KRUG: Do you have any written statements or other things that you would like entered into the record at this time?

MR. VANDEN HEUVEL: Yes, we would like the document that Mr. Van Dam presented to you and the panel to be entered as an exhibit.

HEARING OFFICER KRUG: Okay. I have here a document titled "Testimony of Milk Producers Council." It's dated June 1st, 2006. It will be labeled Exhibit 61. And it's now admitted into the record.

(Thereupon the above-referred document was marked as Exhibit 61.)

You may proceed.

MR. VANDEN HEUVEL: Mr. Hearing Officer and members of the Panel, my name is Geoffrey Vanden Heuvel and I'm a dairy farmer with operations in San Bernardino and Riverside Counties. I'm here today testifying on behalf of Milk Producers Council, a dairy producer trade association with approximately a hundred members located primarily in southern and central California.

Also testify on behalf of MPC is our Executive Director, Mr. William C. Van Dam. Bill has a degree from UC Davis in Agriculture Economics. He has earned a Masters Degree from Cornell University in Agriculture Economics, with a minor in Agricultural Policy. In addition to a fine education, Bill has spent a good part of his career as a manager and owner of various dairy processing operations. He's a native Californian and has extensive experience here, but he has also spent considerable time working in Washington, Oregon and Idaho dairy industries.

Our testimony today is based on long-standing policy principles of Milk Producers Council and was endorsed by the Board of Directors at their May 2006 meeting.

MPC strongly urged the Secretary to deny the Dairy Institute petition for this hearing. The current class 4a and 4b formulas were the topic of a thorough hearing just 16 months ago. In that hearing the Secretary found that while some modest adjustments could be made to the existing formulas, the fundamental outline of these formulas met the requirements of the Food and Agriculture code. While you can always tweak the various components of the formula based on the most recent completion of either manufacturing cost surveys or the updated California pricing reports, that was not the reason the Dairy Institute called this hearing.

They have something much more significant in mind. They are interested in taking California back to the days when California deliberately discounted the price of 4a and 4b milk to give California processors a, quote-unquote, competitive advantage over processors located out of state who were subject to the minimum price requirements of the Federal Milk Marketing Order system.

We are aware that Undersecretary AJ Yates, in a letter to Jim Tillison of the Alliance of Western Milk Producers dated March 8, 2006, noted that, quote, "When the hearing is held on June 1, 2006, a period of 16 months will have elapsed since the last hearing that considered Class 4a and 4b modifications. Significant adjustments in the milk markets have occurred and will likely continue to occur before June. Milk supplies that were in balance with demand during our February 2005 hearing have increased dramatically. Various stakeholders have expressed concern that California milk processing capacity may not keep up," end quote.

We are concerned about the implications of Undersecretary Yates' comments. Yes, production has significantly increased in 2006. This is in direct response to the high milk prices in 2004 and early 2005. High milk prices send the signal to producers to increase supply. Producers responded. This spring, the market became saturated and the price of milk crashed. Producers are getting that message right now. And while the last couple of months have been difficult, there are signs that the supply and demand is beginning to come back into balance. This is entirely appropriate and necessary and it is a function of the marketplace. CDFA should not seek to interfere in this process by adopting the cheap milk policy that's being advocated by the Dairy Institute.

I just want to go off the testimony, because I think both Western United and the Dairy Institute provided some data in their testimony that really backs this up.

Contrary to what Mr. Cotta has said -- and I think possibly somewhat in jest -- about 6 and 8 percent production increases, the reality is is that the Dairy Institute in their testimony earlier today said in 2003 the growth of production was 1 percent; 2004 was 2.9 percent; 2005, 3 percent.

You look at Western United's testimony -- they have the California cost of production compared to the mailbox price in their chart on page 3 -- and you can see exactly why 2003 production growth was only 1 percent, because there was a negative margin of a dollar sixty-three a hundredweight; 2003, a negative margin of 95 cents a hundredweight. Well, producers get the message. We're not - we don't -- we can't react overnight. But low prices will have an impact on producers' decisions as will high prices. That is an entirely appropriate function of the marketplace.

This same issue about getting rid of the whey -- dry whey and making California milk really cheap again was discussed in February 1 -- February 1 of '05. We have the same objections today that we had then. We have attached a copy of that testimony for entrance into this hearing record.

But there are a couple of additional points that we want to make that we didn't make last year. And the first one is this:

The Federal Milk Marketing Order program no longer regulates Idaho, the home of our major current cheese plant competition. While this was already true in

February of '05, the full magnitude of the termination of Federal Order No. 135 was not understood or yet felt at that time. The termination seems to be permanent with little chance of returning to the Federal Order system for 135. What this means is that any discount CDFA would give California cheese plants could be matched penny for penny by the Idaho competition.

Furthermore, when CDFA adopted the cheap milk policy in the 1980s -- and this gets directly to Mr. Ikari's questioning of some prior witnesses -- there was significant industry support for this policy. The federal support price -- and I think this is a really important point -- the federal support price for milk was over $12 a hundredweight. The Upper Midwest looked like it was in decline. California producers were making money and wanted to dramatically increase production. Central Valley communities were courting Chino dairymen, inviting them to relocate where water and feed looked plentiful and environmental regulations were few.

In 1982, the California Milk Advisory Board sponsored a study by the Stanford Research Institute that identified the potential for building a cheese industry in California. And producers were generally in favor of providing the resources necessary to make the investments which allowed this industry to grow. That support no longer exists. The support price at $9.80 per hundredweight no longer provides a risk free safety net. Competition for water and feed as well as the overall business climate in California have dramatically increased the cost of production in the Central Valley. Environmental regulations and public attitudes have had a huge impact on the ability of producers to increase production inexpensively. That is why all three producer trade associations and most of California cooperatives are adamantly opposed to the Dairy Institute's proposal.

In the face of this kind of division in the ranks, no potential cheese plant investor can be assured that a new cheap milk policy that might come out of this hearing would have any shelf life. This is clearly demonstrated by the fact that here we are a mere 16 months after last considering the same topic with the same issues and the same objections. Nothing is certain about policy established through a process that lacks consensus.

We did not support this hearing and we are willing to accept the status quo as exists today. But since this hearing has been called, we must respond to the specific proposals that are on the table as well as offering up some constructive alternatives for the Department and the industry to consider.

So I'll turn it over to my colleague, Mr. Van

Dam.

MR. VAN DAM: Mr. Hearing Officer and members of the Panel, my name is William C Van Dam and I am the Executive Director of the Milk Producers Council.

In preparation for this hearing I spent some time reviewing the testimony and findings of the February 1st, 2005, hearing on these same issues. Much to my dismay, there is really little new to add to the discussion that took place at that time. It is partly for this reason that we have attached our testimony from that hearing to this record today. And that, by the way, is attached as Exhibit A to this material.

There is little reason to say those same things again. Neither the facts nor the circumstances are much changed, and the technical parts of adjusting prices based on updated data are well understood.

The thing that is different this time is that this is the first hearing on these matters since the panel's 2005 recommendation that the whey factor in the Class 4b pricing formula be removed. While this recommendation was not accepted by the Secretary, much to our relief, it behooves us to respond to the issues raised by the panel. The following is our responses to the issues raised in the panel's recommendation as well as our view of how all the parts fit together to deliver a successful value for the whey stream.

MPC has supported the inclusion of the whey factor in the Class 4b price and will continue to do so in the future. But it is important to note that we are not chasing the last penny, nor are we attempting to include an inappropriate portion of the value.

It is critical to the long-term viability of our industry that the plants that convert our products are healthy and that innovation continues. This is particularly true in the area of whey processing where the size of the market growth and the innovation are both nothing short of stunning. We are after a fair and sensible price that reflects a meaningful minimum value. The value established by formula must be a value that a reasonably well equipped and well run plant can expect to recover from the marketplace.

CDFA has for the last 25 years conducted cost audits of various types of manufacturing plants. The data generated is, I believe, among the best and most useful such data available anywhere. This excellent data has made it possible to generate formulas that are responsive to the conditions in this state. That, coupled with the relative ease of calling a hearing and conducting hearings, has allowed the development of what by all measures is a very successful dairy industry. It is, all told, a good system that overall generates about the right price.

Given this success it is completely logical to attempt to value when in the same manner used to value milk processed into butter, nonfat dry milk and cheese. Unfortunately, the valuing of whey in the words of this panel's report has, quote, not been easy nor straightforward, unquote. The cost studies for skim whey powder, while done in a manner consistent with other products, does not yield a useful answer. The reasons for this are many and have been recorded in past hearings in great detail. The reasons given are all correct to some degree and lead to, in our mind, the inescapable conclusion that they will stay useless unless all the plants are, or at least a significant amount of them, are forced to process all their whey as skim whey powder. That of course is absolutely the worst possible result. Plants must not be discouraged from innovation in the use of whey. It would be wise to abandon cost audits for the skim whey powder in California.

Of particular concern is the fact that the size of the skim whey powder volumes processed in California make no sense compared to the volume of whey being generated by cheese plants in this State. There are only three plants on the skim whey powder cost study. The average volume of the skim whey powder production in these three study plants is $85,180 pounds per day. Contrast this with the average volume of the whey solids available at the seven cheddar cheese plants in the cost study, they average over 181,000 pounds per day. It is obvious that the volume of skim whey powder process is far less than that of the average cheese plant.

Now, consider that the three largest plants average over 350,000 pounds of whey solids per day -- whey solids available per day. The disparity between the whey solids available and the whey solids dried is huge. Overall only about 14 percent of the whey protein that shows up as a powered product either as skim whey powder or as whey protein concentrate show up as skim whey powder in California. The remaining proteins that are converted into powders represent the remaining 86 percent. Against this backdrop, we cannot expect the manufacturing costs of drying skim whey powder at California plants to come even close to meeting the criteria needed to be useful for the pricing formula purposes.

And I have to find some water. Anybody got some?

MR. VANDEN HEUVEL: You have to reset this for our time?

(Laughter.)

HEARING OFFICER KRUG: You get 30 seconds. We don't want anybody dropping over here.

MR. VAN DAM: You were about to lose one. It would be a first.

(Laughter.)

MR. VAN DAM: In addition, we have no data available on the capacity of the powder plants at the cheese plants. It is clear from what we do know that even if the dryers are sized to process the full supply of whey from a plant into skim whey powder, they're not doing so. It is very likely that the dryer is used to dry whey protein concentrate or lactose permeate instead. This is not a critical statement. Overall we are pleased that this is happening because it indicates that whey flows are being diverted to better uses.

While we are not privy to precise information to verify our statements, we do point out that this is the kind of information that is readily available to the panel as they consider the issue.

As it is correctly noted by the panel, whey, quote, can be made into a wide variety of both food and non-food products, unquote and that, quote, each of these whey usages require their own unique processing equipment, processing procedure, and with vastly differing associated costs, end quote.

MPC concludes from the above that the cost audits, no matter how well done, cannot possibly expect to properly adjust and allocate data within California plants to give a useful cost for drying skim whey powder. The debate would be endless. A simpler, more reliable procedure needs to be identified.

There is, thankfully, a good, defensible and very precise way to determine the appropriate value to apply as the manufacturing costs of skim whey powder. And it has the huge advantage of being based on the cost of drying nonfat dry milk in California. These are numbers that we know and these are numbers that we trust. There are only two adjustments, and both are relatively minor, that need to be made to the nonfat dry milk cost to make this number useful. First, one needs to add on the extra costs required to dry whey compared to drying skim milk. They are: Removing the extra water, the cost of crystallization of whey, and perhaps a few other minor things in that. These costs have been carefully calculated and entered into the record in the past two Federal Order hearings. Copies of these are attached for this record. And I have attached an Exhibit C by a man named Mr. Venkat of Leprino Cheese. And then it was updated in the most recent hearing, Mr. Burleson from WestFarm Foods. And it's attached as Exhibit D, which answers your problem about getting the website referenced.

Now you have a copy.

This data indicates that approximately 3 cents per pound needs to be added to the costs of drying nonfat dry milk.

Secondly, it will be necessary to choose a properly sized plant. Volume is critical to cost, as clearly shown in the cost audits. Note, Producers Council suggests the Department determine the volume of sweet whey powder that could be made from cheese plants in this state and then scale that amount against the actual cost study from nonfat dry milk plants. CDFA has the experience, the ability and, most importantly, the data to do this. We have made an attempt at using this available data. And it was a rough attempt because I don't have the detailed data. From that, it appears that the proper manufacturing costs would be about 17 cents in comparable costs -- and by comparable, I mean from plants of a comparable size -- plus the 3 cents for an added costs, for a total of 20 cents per pound. That happens to be the current manufacturing cost, which appears to us to be a well judged compromised finding. That came out of the last hearing.

It is worth noting that the Federal Order Class 3 hearings held this February -- actually it's January -- of 2006, there was no testimony suggesting that the whey factor be removed from the Federal Order calculations. Apparently the rest of the dairy industry in this country is satisfied that a whey factor is valid, and we certainly agree.

In the recommended decision the panel makes it clear that it understands the risks associated with an inappropriate decision on this factor. That's in quotes.

We take just a moment to consider the impact of setting the whey make allowance too high. The results of the cost survey for skim whey powder are at least 7 cents higher than made sense. The effect of using a make allowance is that -- the effect of making -- okay. The results of the costs are making -- you can lose a line once in a while here. The effect of using a make allowance is that the plant will have as its gross margin only the amount of make allowance, assuming of course that they get the marketplace for their product.

If the make allowance were set at that level shown in the cost studies, there will be a guaranteed profit of, we calculate, at least 7 cents per pound. This would create great joy in the boardroom of cheese plant owners, and many investment dollars would flow towards skim whey powder production.

A large increase in skim whey powder production would undoubtedly decrease the price of the whey powder.

But there would be no shifting out of whey powder production to other products because even at very low skim whey powder prices, the net benefit to the cheese plant in the absence of a snubber would still be the full make allowance -- the full make allowance cost because the shortfall in price would be matched by a corresponding decrease in the 4b price.

Clearly, it would be an inappropriate decision to set the manufacturing costs too high. There is far more risk of unintended consequences in setting the make allowance too high than there will be in setting it too low.

Skim whey powder, in spite of Dairy Institute's comment that it is not broadly representative of California whey use, continues to be the product upon which to base a formula to calculate a minimum whey value. It is and always will be the simplest and most complete recovery of the whey in a marketable form. All other processes take the basic whey and adjust it in some way to make a different value added product. There is always the hope and the expectation of plant managers that the added processing will generate added profit, and that that profit will be above and beyond the profit available in the base product, skim whey powder.

CDFA data prepared for this hearing contains a

Multiple Regression Correlation Coefficient analysis. This is, we believe, an inappropriate statistical measurement to use. While it is nice to know statistically that 58 percent of the variability of skim whey power prices is explained by the variability of Whey Protein 34 prices, or vice versa, that fact is not helpful to our discussion. We have applied the more appropriate correlation coefficient on the same data set over the past five years beginning January 1st, 2001, until the most recent entry of April 2006.

Overall the correlation is a very high 87 percent. For the two periods of January 1 -- of January 2001 to April 2003, which is the period prior to whey being added to the California formula, and then from April 2003 until now, the correlation coefficients were 90 percent and 88.5 percent respectively. For our purposes, all we need to know is whether or not the values of skim whey protein -- skim whey powder and Whey Protein Concentrate 34 move together. And they clearly do.

These numbers are just statistical verification of the common sense observation that all whey protein products are the same product in different forms. Prices for whey proteins in their various forms are impacted by the economics of the world marketplace for high quality proteins. These products also compete with each other for the basic supply of raw whey. And therefore all decisions to make various products will be based in both the short run and in the long run on the expected value outcome. Those values decisions will constantly pull the whey protein values toward each other.

Attached just after Exhibit A is a graph which shows the skim whey powder and the Whey Protein Concentrate 34 prices on a normal time line Y axis. The bottom two lines are the skim whey powder and the Whey Protein Concentrate 34 prices. The relationship is clear, but certainly not dramatic.

However, the upper two lines are based on the values of the protein portion of each product. This gives a clear visual image of what the correlation numbers show. And they clearly show that they track together.

With regard to the recent increase in skim whey protein prices compared to the drop in the whey protein concentrate prices which so concerns Dairy Institute, we point out that this too is correcting itself. Again, common sense tells you that if the skim whey powder prices are good compared to whey protein concentrate, it is time to shift production to skim whey protein -- skim whey powder. While these short run decisions happen quickly, it does take some time for the volume shifts to impact prices. But in time they always do.

Milk Producers Council suggests that there be a snubber included in whey formula so that the contribution of whey to the 4b price will not drop below zero. We cannot resist pointing out that the only part of Dairy Institute's whey proposal that we like is their offer to snub the formula at zero. They offered to stop applying the whey formula as soon as the make allowance matches the price. In that sense they agree that zero is as low as it should go. We emphatically disagree, however, with their ultimate snubber concept that once it reaches zero, it stays zero forever.

Good policy, however, is not generated by emotional negative reactions to the suggestions of others. There are we believe excellent reasons to include a snubber in the formula. The most compelling argument for having the snubber is that without it innovation in whey protein concentrate product pricing could well be stifled, as is discussed above. Without a snubber a plant could well decide that the risk -- that the risk free production of skim whey powder is all that makes sense, especially if the net payout is never less than the make allowance amount.

Secondly, we are bit concerned that only 14 percent of the whey proteins are converted to skim whey powder. It seems to us that with so few plants producing skim whey powder, that this entire area could be subject to manipulation. For every pound of whey protein sold as skim whey powder, another six pounds are sold as whey protein concentrate in all its forms.

The best of all worlds for a plant making whey protein concentrate is to have a high make allowance for sweet whey powder and a low sweet whey powder price ideally below the make allowance amount. Under these conditions and without a snubber at zero, producers will be subsidizing all whey product production. Not only will the sweet whey powder plant be getting the full make allowance for their product; every whey protein concentrate plant will be getting its whey at a negative price, as in less than zero. In this situation there is little incentive to become efficient in processing sweet whey -- skim whey powder, nor in selling it aggressively. The combination of using nonfat dry milk costs for the basis of costing and the western whey price reports for value and a snubber at zero will combine to remove the temptation to manipulate and, more importantly, leave in place the incentive to innovate.

Milk Producers Council's alternative proposal for this hearing contained a suggestion to add whey protein concentrate to the 4b formula. We offered this, not to enhance the value of whey, but to address the concerns expressed in the Dairy Institute's petition that skim whey powder production is not broadly representative of California whey usage and that dry whey prices are not well correlated with other whey products. We were fooled by the clever phraseology of the Dairy Institute's petition and too easily impressed by the Department's statistical analysis. Our intent, as stated above, is not to greatly enhance the value of whey in the current formula. We find it to be at a sensible level now. The cost factor we proposed, while not unreasonable for a large specialized whey protein concentrate plant, does not seem to fit the conditions here in California. Particularly troublesome is how the -- how to account for the added cost of handling the lactose permeate. That being said, if the only other option for us is removal of the whey factor from the 4b formula, we would support adding Whey Protein Concentrate 34 with a manufacturing cost allowance that is calculated to have made whey pricing neutral over the past five years.

In summary on the whey issues, MPC urges the Department to leave in place the whey value portion of the 4b formula, to continue to base that price on the value of skim whey powder, to apply a manufacturing cost in that formula that is based on the manufacturing costs of nonfat dry milk in plants of the size that that cheese plant would have had if they had dried all their whey plus the added costs of drying whey and, last but not least, that the whey value be snubbed at zero.

HEARING OFFICER KRUG: The witnesses, if I may interrupt, you have about -- a little over two minutes left of your allotted time. I see that you have about another three pages of your testimony, which is in another section. Would you like to summarize now, use your two and half minutes to finish up, come back later. I'll leave it to you.

MR. VAN DAM: I think we'd prefer coming back later. This stuff doesn't summarize well.

HEARING OFFICER KRUG: That's fine.

At this time does any of the panel members have questions for the witnesses?

Mr. Gossard?

AGRICULTURE ECONOMIST GOSSARD: (Shakes head.)

HEARING OFFICER KRUG: Ms. Reed?

SUPERVISING AUDITOR REED: No.

HEARING OFFICER KRUG: Mr. Gossard, that's a "no"?

AGRICULTURE ECONOMIST GOSSARD: Yes. I'll reserve questions till they complete their entire testimony.

HEARING OFFICER KRUG: Okay. Thank you.

Ms. Reed?

SUPERVISING AUDITOR REED: No, I don't.

HEARING OFFICER KRUG: Ms. Gates?

RESEARCH MANAGER II GATES: No.

HEARING OFFICER KRUG: Mr. Ikari?

DAIRY MARKETING BRANCH CHIEF IKARI: No.

HEARING OFFICER KRUG: Okay. Thank you very much.

Just so we don't forget later, would you like the opportunity to present a post-hearing brief?

MR. VANDEN HEUVEL: Yes, we would.

HEARING OFFICER KRUG: And that request is granted.

MR. VAN DAM: Thank you for the water.

DAIRY MARKETING BRANCH CHIEF IKARI: The last one.

MR. VAN DAM: Saved my life.

HEARING OFFICER KRUG: And the final alternative proposal will be presented by Land O'Lakes now.

Will the representatives of Land O'Lakes please approach.

Okay. Are the representatives of Land O'Lakes ready?

MR. WEGNER: We are.

HEARING OFFICER KRUG: Okay. Will you please state your full names and spell your last name the record.

MR. WEGNER: My name's Tom Wegner W-e-g-n-e-r.

DR. GRUEBELE: My name is James Gruebele G-r-u-e-b-e-l-e.

HEARING OFFICER KRUG: Mr. Wegner, do you swear or affirm to tell the truth?

MR. WEGNER: I do.

HEARING OFFICER KRUG: Mr. Gruebele, do you swear or affirm to tell the truth?

DR. GRUEBELE: I do.

HEARING OFFICER KRUG: Are you both representing Land O'Lakes at this hearing today?

DR. GRUEBELE: Yes.

MR. WEGNER: We are.

HEARING OFFICER KRUG: Do you have any written statements or other things that you would like entered into the record at this time?

MR. WEGNER: I do. The statement that's been handed to you previously.

HEARING OFFICER KRUG: Okay. I have a document here labeled "Consolidated Public Hearing to Consider Amendments - Testimony of Tom Wegner, June 1st, 2006." It will be labeled Exhibit 62 and is now admitted into the record.

(Thereupon the above-referred document was marked as Exhibit 62.)

HEARING OFFICER KRUG: You may proceed with your testimony.

MR. WEGNER: Thank you.

Mr. Hearing Officer and members of the panel, my name is Tom Wegner and I'm here to testify on behalf of Land O'Lakes. My business address is 4001 Lexington Avenue North, Arden Hills, Minnesota. My current title is Director of Economics and Dairy Policy. We want to thank the Department for promptly calling this hearing to address these issues of critical importance to all of our dairy producer members.

Land O'Lakes is a dairy cooperative with over 3,300 dairy farmer member-owners. The cooperative has a national membership base whose members are pooled in a California State Program and six different federal orders.

Land O'Lakes members own and operate several cheese, butter powder and value added plants in the Upper Midwest, East and California. Currently our 275 California member-owners supply us with over 15 million pounds of milk per day that are processed at our plants in Tulare and Orland.

I'm here to testify in support of our alternative proposal filed with the Department on April 27th, 2006, involving the whey portion of the Class 4b formula.

LOL supports increasing the whey make allowance to the level reported in the CDFA cost study, adjusting the allowance with updated energy and labor costs from the period January 2005 through September 2005 and adding a variable component based on the prevailing whey market price.

Land O'Lakes believes that the whey study conducted by CDFA is valid and the results should be used to adjust the whey make allowance from 20 cents to a base of 27.42 cents. After the last hearing the Department chose to raise the make allowance for whey from 17 cents to 20 cents even though the cost study prepared for the hearing revealed that the adjustment should have been much larger.

The inadequacy of this 20 cent make allowance for whey has been further exacerbated by the fact that prices for whey protein concentrates have declined while whey markets strengthened.

Currently the Class 4b formula reflects whey; but, in fact, a much larger proportion of the whey stream is converted into whey protein concentrates. This has been particularly problematic this year because of the general strength in the whey markets while whey protein concentrate prices, including WPC with 80 percent protein, have been weaker.

Additionally, we propose that this whey make allowance be variable and change as the whey market price rises or falls. When the western dry whey price as reported by dairy market news exceeds 27.42 cents, the whey make allowance would be adjusted upward by adding 50 percent of the difference between the whey market price and 27.42 cents. But when the whey market falls below 27.42 cents, the whey make allowance would be adjusted downward by the same 50 percent factor.

Simply, when the whey market is above 27.42 cents both the producers and cheese plants share in the game. By contrast, when whey markets fall below the base make allowance of 27.42 cents, both the producers and cheese plants would share in the loss.

The formal plan would be as follows. And I've listed the sections with the language here. I'm not going the read those specifically because they're quite clear from the pros.

Unless the whey make allowance is adjusted to reflect the weighted average cost for whey reported in the CDFA study, updated for the changes in energy labor costs from January 2005 through September 2005 and adjusted for monthly changes in the whey price, Land O'Lakes recommends completely eliminating a whey factor from the Class 4b formula.

In this next paragraph I'm making several small adjustments to the wording. And I'll explicitly note that in my post-hearing brief if I'm granted permission to submit one.

Land O'Lakes supports adjusting the make allowance for cheese and powder based upon CDFA adjusted weighted average costs including the energy and labor updates for the period January 2005 through September 2005 for cheese and nonfat dry milk powder. Land O'Lakes recommends a change in the price adjusters for butter and cheese based upon audited survey results by CDFA. We recommend the price adjuster of 1.68 cents for butter and a price adjuster of 2.52 cents for cheese. On make allowances we support a continued make allowance of 15.6 cents for butter, an adjustment in the make allowance to 15.91 for powder, and an adjustment in the make allowance to 17.91 cents per pound for cheese.

Land O'Lakes participated in the Federal Milk Marketing Order hearing held in January 2006 to consider changes in the make allowance used -- make allowances used in the Class 3 and Class 4 formulas. We supported changes to update the make allowances for cheese, butter, powder and whey on an expedited basis. Many cooperatives and proprietary firms from across the U.S. participated and testified in support of updating the Federal Order make allowances.

At this time the USDA has not yet issued their decision on the January 2006 hearing, but we anticipate and are hopeful that the USDA will release their decision soon. We cannot predict what changes, if any, USDA will recommend be made in the Class 3 and 4 formulas. But there is a strong likelihood that their could be significant adjustments in the make allowances for cheese and other dairy products.

Capacity issues:

As you well know, California milk production has been increasing very rapidly. February 2006 milk production increased by 6.7 percent and March production increased 6.2 percent over 2005 levels. The production increase in these two months alone is enough to fill a 6 million pound per day plant.

With this volume increase, it is not surprising to find that the state's plant capacity is being pressured. We have heard reports of distressed milk getting dumped because of plants being too full to process the milk.

The relatively knew CPI plant is operating at full capacity. The same appears to be true for the new Leprino plant in Lemoore.

Loss of plant capacity:

Meanwhile, there has been a loss of plant capacity in California. The recent plant closings include:

In 2005, the Gustine plant that handled 30 loads per day closed.

In 2004, the DFA plant that handled 20 loads per day closed.

In 2003, the Sorrento plant that handled 32 loads per day closed.

And in 2002, the Suprema plant that handled 26 loads per day closed.

The total plant capacity lost amounts to 108 loads her day or about 5.5 million pounds of milk per day. This is roughly the capacity of the CPI plant Tulare. This volume of lost plant capacity is significant in light of the continued growth of California's milk supply. Any additional loss in plant capacity would put more stress on the milk processing sector.

Without a significant adjustment in the make allowances, including whey, it would not be surprising to observe further decreases in plant capacity in California.

Equity issues:

As a result of these inadequate make allowances, Land O'Lakes producers are not earning a reasonable return on their invested capital, and have in fact incurred losses on their invested capital.

By way of contrast, producers, either independent producers or producers that belong to a captive cooperative or producers who belong to a cooperative that have not invested in cheese operations, have benefited at the expense of Land O'Lakes members who have made a significant investment in a new cheese plant.

To highlight, the addition of the whey factor in the Class 4b formula has been costly to Land O'Lakes. The accompanying chart, which is at the end of the testimony labeled Attachment A, shows the disparity in the distribution of benefits from the increased Class 4b prices to Land O'Lakes producers and producers outside of Land O'Lakes. The share of the benefits from the increased Class 4b prices going to producers outside of Land O'Lakes far exceeds the share of the benefits to Land O'Lakes producers. This chart does not show the cost to Land O'Lakes producers due to inadequate or even negative returns on the huge investment in a new cheese operation.

Land O'Lakes members -- excuse me -- Land O'Lakes member-owners took the financial risk of building a new modern cheese facility in California. We realized the risks involved in building a new plant, including product quality, start-up problems, running at less than full capacity, and other operational challenges.

But in our case, there turned out to be significant risk associated with the change in the Class 4b formula involving the addition of a whey factor. The addition of the whey factor has increased the cost of milk.

When Land O'Lakes made the decision to build a new cheese plant the whey factor was not included in the Class 4b formula. However, the addition of the whey factor had a direct impact on the return on investment. The addition of the whey factor combined with inadequate make allowances led directly to inadequate returns on investment from our new cheese operations and losses experienced by Land O'Lakes members. This change in the ground rules for the Class 4b formula has had a direct impact on all of California's cheese plants.

Land O'Lakes not only processes its own producer members' milk, but also receives and processes milk from non-member producers. As such, Land O'Lakes is performing an important balancing function in the state.

Still another equity issue is that the current make allowances and formulas for Class 4a and Class 4b milk result in unbalanced returns. The returns on investment for Land O'Lakes butter and powder operations are clearly much higher than for cheese operations. This raises significant questions about the direction of the future investments in new plant operations in California.

Will this imbalance lead to a shift from cheese to butter and powder in California?

Federal Order Cheese Operations versus California Cheese Operations:

As mentioned earlier, USDA has not yet issued their decision on Federal Order make allowances. Based on the hearing record and the overwhelming support from the proponents, there is a very strong likelihood that the Class 3 and Class 4 prices in Federal Order markets will be lower than they are now. This will make California cheese plants even less competitive than is currently the case. Not only that, cheese plants in Federal Order markets can depool, an option not available to California cheese plants.

Additionally, California manufacturing plants face different and sometimes higher level operating costs than costs faced by plants in other states. Environmental, labor, transportation, and energy costs are all areas where the Upper Midwest operations may have a significant cost advantage over manufacturing operations in California. The challenges associated with the construction of a new plant, such as obtaining permits, is likely more costly in California than for constructing a similar operation in other states.

We have stated previously that handlers whose milk is depooled do not have to share the Class III revenue with other producers. This cannot be done in the same way in California. Our testimony at the January 31st, 2005, hearing clearly identified the positive benefits of depooling by cheese plants in Federal Order markets. The ability to depool provides cheese plants in federal Order markets a significant advantage over California cheese plants. In light of these advantages, we were not surprised to observe that Hilmar recently chose to build their new cheese plant in Texas over California and that Glanbia chose to build in New Mexico over California.

Conclusions and summary:

To conclude, Land O'Lakes recommends the removal of the whey factor in the Class 4b formula if, as a result of this hearing, the cheese formula includes a whey snubber or if there's a failure to adjust the whey make allowance to reflect a cost justified value. In other words, if the whey factor were removed, whey would have no impact in the Class 4b formula regardless of the price of whey.

To restate, Land O'Lakes recommends using a whey factor only if the whey make allowance is adjusted on a cost justified basis and no snubber is implemented.

Land O'Lakes manufactures butter, powder and cheese. Our recent experience within the California State Program is that the net returns for better and powder are significantly higher than for cheese. Land O'Lakes is urging the Department to reflect a balanced approach. The returns on investment for cheese and for butter powder operations should be very similar and both need to be adequate based on economic factors within the marketplace. Based upon our experience at Land O'Lakes, that is not the case today. Returns on butter powder operations are clearly superior to returns on cheese.

Currently, California's manufacturing plants are operating at full capacity to process the continued growth in milk production. If long-term returns to producers' investments in cheese plants do not improve, more cheese plants may cease operations, putting even more stress on the remaining plants.

Several proposals emphasize short-term enhancement of producer returns. Land O'Lakes urges the Department to consider producers' long-term returns as well. Ironically by further reducing long-term returns to manufacturing plants, the Department risks losing more manufacturing capacity, which could lead to even lower short-term producer returns as milk ends up being dumped or shipped out of state and sold at distressed milk prices.

This concludes my testimony. And I would like the opportunity to file a post-hearing brief.

Thank you.

HEARING OFFICER KRUG: Your request to file a post-hearing brief is granted.

Do we have any questions for the witnesses from the panel?

Mr. Gossard?

AGRICULTURE ECONOMIST GOSSARD: How was your testimony developed and approved by Land O'Lakes?

MR. WEGNER: It has been reviewed by our Senior Vice President Alan Pierson, shared with our California members and board, shared within the management of Land O'Lakes.

AGRICULTURE ECONOMIST GOSSARD: Did Land O'Lakes experience any problem with an inability to process all its members' milk any time this year? In Land O'Lakes operations in California, I should specify.

MR. WEGNER: We've been able to process all of our members' milk in California, as I understand it.

DAIRY MARKETING BRANCH CHIEF IKARI: Let me ask a follow-up question to that.

How close have you come to reaching maximum capacity?

DR. GRUEBELE: My understanding that plants are relatively full at Tulare and Orland. But we are also applying outside milk. And that is also included. In other words we're handling not only our own members' milk, but outside producer-members -- non-members as well. And a first call would be to reduce some of the non-member milk if we had a problem converting our own producer-member milk into products.

DAIRY MARKETING BRANCH CHIEF IKARI: So if we had a surplus situation in a given month, could Land O'Lakes California operations handle it? What's your ability to --

DR. GRUEBELE: Are you talking about our own producer milk?

DAIRY MARKETING BRANCH CHIEF IKARI: No.

DR. GRUEBELE: Well, I --

DAIRY MARKETING BRANCH CHIEF IKARI: Surplus production beyond your supply, how much could you provide in terms of providing capacity to handle that?

DR. GRUEBELE: We're just about at full -- I mean we're operating full capacity now, relatively speaking.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay.

DR. GRUEBELE: So the answer is no more.

HEARING OFFICER KRUG: Any additional questions for the witnesses?

AGRICULTURE ECONOMIST GOSSARD: Yes. You mentioned the advantage that processors have in Federal Orders where they can depool. An earlier witness spoke to changes in some of the Federal Orders regarding depooling. What, if anything, will this do to the advantage of cheese plants in Federal Orders?

MR. WEGNER: Well, the decision is in the recommended status right now. And as I understand it, it's limiting the amount of milk that can be pooled after you have depooled, so that it's the monthly change. I think in most of the orders the Central, the Eastern -- yeah, the Central, the Upper Midwest -- and then I can't remember which -- it's one that's further east -- the varying amounts are as much as 25 percent -- or 125 percent of the previous month can be pooled again. So you'd be allowed essentially to depool 20 percent and not have any loss in pooling opportunity the next month.

I don't speak as an expert in that. I'd suggest you check in with the Department of dairy programs to get those decisions a little bit more clearly stated. They will have an impact on the depooling activity though in those three orders.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

HEARING OFFICER KRUG: Ms. Reed, do you have any questions for the witnesses?

SUPERVISING AUDITOR REED: No, I don't.

HEARING OFFICER KRUG: Ms. Gates?

RESEARCH MANAGER II GATES: Yes, I do.

I just have one question. On page 6 of your testimony you speak to the net returns for butter and powder are significantly higher than for cheese in California. And with your proposal you're talking about, you know, the cost increasing from the 20 cents to the 27.42. Is that what you're explaining as the difference in the cost or the returns? Is it just to the whey factor or are there other --

MR. WEGNER: I think it's to the cheese business in -- the cheese -- how do you say? -- the cheese complex in general, the byproduct being whey. The byproduct being whey, it's combined. It's definitely the cheese and the whey.

RESEARCH MANAGER II GATES: Okay. But your proposal only spoke to the whey piece of it --

MR. WEGNER: Correct.

RESEARCH MANAGER II GATES: -- not the cost --

MR. WEGNER: It spoke to the make allowance, yeah, adjusting the make allowance to the level of --

RESEARCH MANAGER II GATES: Okay. Thank you.

DR. GRUEBELE: The cost justified that were developed by the Department are being used for cheese as well as whey.

RESEARCH MANAGER II GATES: As well as whey.

Okay. Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: I have a question to follow up that.

In that section where you talked about your returns are greater on cheese than butter and powder --

MR. WEGNER: The other way around.

DAIRY MARKETING BRANCH CHIEF IKARI: I'm sorry. I misstated that.

But how is the efficiency of your cheese operations relative to the industry -- the California industry versus your butter powder operations relative to the rest of the California industry?

MR. WEGNER: I'm unable to speak to the specifics of efficiency of both operations. Perhaps Jim can.

DR. GRUEBELE: I'm not clear. Are you saying that we have a deficiency versus other cheese operations? Is that what you're suggesting or -- is that what your question was?

DAIRY MARKETING BRANCH CHIEF IKARI: Well, you just said that your returns are greater for butter and powder.

DR. GRUEBELE: That is a true statement.

DAIRY MARKETING BRANCH CHIEF IKARI: My question is: Is your butter powder operation more efficient relative to the California -- you know, the balance of the California processors versus the relative position of your operations on cheese?

DR. GRUEBELE: That's probably true, particularly since we have a front-end loaded cheese plant, you know, recently built, a lot of depreciation and interest. And certainly that is a consideration. Our butter and powder plants are relatively efficient relative to other plants that operate in the State of California.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. On page 3 you indicated your position on the various butter and cheese -- I want the say, your price adjuster and a whole bunch of things in terms of make allowance. But I didn't really see, and perhaps you could file in your post-hearing brief, the rationale in how you got there. I see what you're recommending. But I didn't really understand what was your rationale for arriving at those points.

DR. GRUEBELE: We will certainly do that in post-hearing brief elaborate on -- I assume you're talking about the make allowance adjustments in cheese and powder and also the --

DAIRY MARKETING BRANCH CHIEF IKARI: Yes, the fourth paragraph down where you have --

DR. GRUEBELE: -- recommendation for the price adjuster?

DAIRY MARKETING BRANCH CHIEF IKARI: Yes.

DR. GRUEBELE: We could elaborate in the post-hearing brief on --

DAIRY MARKETING BRANCH CHIEF IKARI: On Page 3, your fourth paragraph, yes.

DR. GRUEBELE: We understand.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay And then on page 5 you also talk about you do receive non-member milk. And I wondered if you could provide us with information as to the relative volume of non-member milk that your plant receives.

DR. GRUEBELE: We could do that in post-hearing brief. I don't have those numbers here directly at hand.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

HEARING OFFICER KRUG: Are there any additional questions for these witnesses?

Okay. The witnesses are excused. Thank you very much for your testimony.

At this time we'll just take a quick five-minute break.

(Thereupon a recess was taken.)

HEARING OFFICER KRUG: All right. Could everyone return to your seats. We're about to reconvene.

The day's getting late. So if we could move along, we can get a little bit more done.

If the people in the back would please find your seats. Thank you very much.

Now is the portion of the hearing where we typically go into statements -- or public testimony. However, we have recently received three additional pieces of written testimony that will be entered into the record by the Department's witness, Ms. Cheryl Gilbertson.

Could you please proceed.

STAFF ANALYST GILBERTSON: I have three documents. One dated May 24th, from the Center on Race, Poverty & the Environment. A second dated May 11th, '06, from Bacchetti & Silva Dairy. And a third dated March 31st, from Circle H Dairy Ranch, Incorporated.

HEARING OFFICER KRUG: Thank you very much, Ms. Gilbertson. If you'll present those, I will mark them and admit them into the record. And we will have copies of those letters shortly, certainly by the end of today's session.

Thank you.

Okay. The letter from the Center on Race, Poverty & the Environment is labeled Exhibit No. 63, and it is admitted into the record at this time.

(Thereupon the above-referred document was marked as Exhibit 63.)

HEARING OFFICER KRUG: The letter from Bacchetti & Silva Dairy is labeled Exhibit No. 64, and it is admitted into the record at this time.

(Thereupon the above-referred document was marked as Exhibit 64.)

HEARING OFFICER KRUG: And the letter from Circle H Dairy Ranch, signed by Margo Souza, is labeled Exhibit No. 65, and it's now admitted into the record.

(Thereupon the above-referred document was marked as Exhibit 65.)

HEARING OFFICER KRUG: We'll now proceed with the public testimony section of this hearing.

And our first witness is a Benjamin Yale.

Mr. Yale, will you please come forward.

Okay. Mr. Yale, will you please state your full name and spell your last name for the record.

MR. YALE: It's Benjamin F. Yale. And it's spelled Y-a-l-e.

HEARING OFFICER KRUG: Mr. Yale, do you swear or affirm to tell the truth?

MR. YALE: Yes, I do.

HEARING OFFICER KRUG: Are you representing any organization today?

MR. YALE: I'm here on behalf of Select Milk

Producers of Artesia, New Mexico, and Continental Dairy Products.

HEARING OFFICER KRUG: Can you please describe how your testimony was arrived at today?

MR. YALE: This testimony was arrived by discussions with the officers and the policy makers of those two organizations as well as members of the board. And it also reflects longstanding policy positions established by both boards.

HEARING OFFICER KRUG: And, Mr. Yale, do you have any written statements or other documents or things that you would like admitted into the record at this time?

MR. YALE: Yeah, I have submitted a written statement that I'd like to have admitted into the record.

HEARING OFFICER KRUG: Okay. I have here a written statement titled "California Department of Food and Agriculture Hearing on Proposed Changes to the Manufacturing Prices," dated June 1-2, 2006. Identifies you as the witness. It will be marked as Exhibit 66 and it is admitted into the record.

(Thereupon the above-referred document was marked as Exhibit 66.)

HEARING OFFICER KRUG: You may now proceed with your testimony.

MR. YALE: Thank you.

Mr. Hearing Officer, members of the Hearing Panel. Thank you for giving us this opportunity to present this position.

My name is Benjamin F. Yale. My address is 527 N. Westminster Street, Waynesfield, Ohio 45896. I'm appearing today on behalf of Continental Dairy Products, Inc., an Ohio milk marketing cooperative with producers in Ohio, Michigan and Indiana that markets its members' milk in the midwest, Mideast and Southeast. I'm also prepared on behalf of Select Milk Producers, Inc., a cooperative located in New Mexico, with producers in New Mexico, Kansas, Oklahoma and Texas. Milk from Select members is marketed throughout the entire United States with the exception of the Northeast and Northwest. Select has interest in various cheese and other dairy product operations in the Southwest. The statements which I am giving are supported by and have been properly approved by those organizations.

Decreasing producer prices to increase cheese production in California is the wrong policy. It will not work. Market forces will offset any purported increase in the spread between minimum prices for manufacturing milk under the California system and that of the Federal Milk Marketing Orders.

According to the CDFA, the five-year average spread of 52 cents between Class 3 and 4a is already too much. The national market has responded to this spread with lower prices and will respond to other changes whether from the FMO or from California. This response, both in California and outside of California, in the form of lower basis on cheese sold and lower prices actually paid to producers for milk used to make cheese. The Dairy Institute's proposal to widen the California FMMO spread to as much as a dollar 16 (a dollar 30 in some years) will necessarily result in market adjustments in cheese and milk prices both in and outside of California. As a result, dairy producers throughout the nation, not just California, will see lower prices for milk.

There is now an uneasy equilibrium in the pricing structure. Adoption of increases in the price spread will upset that equilibrium and create instability in the marketplace. Because we cannot support reduced producer income in general nor support any policy that will destabilize the marketplace, we have no choice but to vigorously oppose any reduction by CDFA in the minimum prices for milk used in manufacturing.

Though we oppose the Dairy Institute petition, with or without whey, we are not directly supporting other proposals. We do note with approval the response from producer groups such as Western United, Milk Producers

Council and California Dairy campaign to stand up against this assault on their members' income.

The national response to changes in CDFA minimum price regulation happens quickly. There are no hearings or regulatory changes needed. Unlike California, the rest of the nation cheese manufacturing is not limited by regulatory pricing. Idaho is not subject to any minimum pricing or pooling. New Mexico and west Texas are virtually self-regulated. And the Upper Midwest responds almost entirely to market conditions. Further, cheese plants have always had the ability to price milk in response to the market values independent of the FMMO minimum price. As a result, these cheese-making regions, whose total production exceeds that of California, can and will respond to any change in the price of milk for a 4a in California. Such reduction will reduce prices in the rest of the cheese making in the United States.

There is a sharing of markets and milk sheds between the U.S. and California. This isn't to suggest that California is not a part of the U.S., but the rest of the nation. This is because California too is an integral part of the national market. There are no walls that totally encapsulate it from outside market forces, nor are outside markets protecting against what happens in California. Regardless of state boundaries or marketing areas, there is only one market. This single market prices dairy products and establishes the value of milk. This presence of California in the national scheme is not news to anyone. It is the largest producer of milk and, now, of cheese. It produces so much of these products that it cannot consume them all. It exports large volumes of its products to other states. At the same time, California imports about one-fifth of the milk used in Class 1 from outside the state.

Because of this sharing of production of products among the states, prices also adjust between the regions. The prices at which California plants sell cheese, butter, dry whey and nonfat dry milk are weekly captured by the USDA and a major part of the product prices for setting FMMO prices. If California product prices go down, the price for milk in the FMMO goes down in direct response. Further, plants throughout the nation adjust the basis of their prices to reflect their relationship to the California sellers.

This adjustment of prices of a commodity across the national market is known as arbitrage. And arbitrage is alive and well in the dairy industry.

Because of this integration into a national market in the presence of large production and processing capacity that it is able to nimbly respond to the market, the growth of the California dairy industry cannot be sustained in the future by regulating an underpriced milk. The old model, successful in the past, cannot now provide California plants any marketing advantage. National, global, market forces will adjust, and adjust quickly, to erase any such price advantage.

At the same time, due to the higher level of regulation and the nature of the California system, the result of such reduced prices to producers is protected -- or protects the producers or isolates them from market forces to allow them to avoid the effects of this system.

Although the California dairy industry continues to grow, it is almost entirely internal growth. It is virtually unheard of for a non-Californian to consider building a new dairy in California. Further, non-dairy regulatory, tax and other issues create significant economic disincentives to build a dairy in this state.

These same non-dairy anti-business factors also work against new capacity coming into the state. Trying to shove all of that cost onto one part of the industry, that is, producers, when it is not of their making nor their ability to undue is not only counterproductive and ineffective. It is also unfair.

There are other signs that the economic environment is not conducive to new construction. Not only are new interests not coming into the state, but old interests are leaving the state. Large amounts of wealth accumulated by California dairy producers and processors are being invested elsewhere. The announcement of Hilmar's building of a large cheese plant in west Texas is the most recent example. Producers from California are building new dairies in New Mexico, west Texas, Idaho, and elsewhere. The vast majority of milk produced in Texas, New Mexico and Idaho, that collectively now approximate two-thirds of the milk produced in California, have been built and started using money generated in California.

At the same time, the Department cannot rely upon the prospect of the USDA using its regulatory power to lower Class 3 prices so as to narrow the spread. The market will respond to what the USDA does as well. In any event, the current process to reduce all class prices in the FMMO faces serious political, economic and procedural hurdles. The hearing proposals being considered do not have sufficient producers support. A letter to the Department from cooperatives representing all or a majority of the milk in half of the orders and large portions of the milk in the remaining orders oppose the proposal as it is now being considered. Under law, producers have to approve changes to any FMMO. Depending on what the Secretary recommends, it is possible that one or more orders may opt for being unregulated rather than being regulated at lower prices. After all, it does not take the Government to lower producer prices; producers can do that on their own. Further, the Federal Order hearing is subject to numerous procedural flaws and obstacles making the actual adoption of the reduced prices unlikely.

Because a reduction of prices by CDFA will rip through the nation's dairy pricing, any significant reduction in the 4a price will destabilize the market. In response to this destabilization, producers will seek other ways to bring stability to their prices. And I would say out of the statement, that would include pricing through the CME. But even then the prospect of regulatory changes in the pricing of milk will undercut the stability found in Class 3 futures on the Chicago Mercantile Exchange.

Forcing lower prices on California producers will also undermine stability because it challenges the economic viability of the producers it should be serving. Producers face the same economic issues of rising fuel and other costs as plants do. They face newer, higher costs of environmental stewardship. And producers can only recover these from higher, not lower, prices from the plants.

Too low prices for Class 4a will increase the likelihood of a new -- too low prices for 4a will not increase the likelihood of a new cheese plant or even existing one, in California being completely unregulated -- I'm sorry -- will increase the likelihood of any new production coming -- by going and being an unregulated plant.

HEARING OFFICER KRUG: Excuse me, Mr. Yale. And I don't mean to interrupt. But that sentence, if you could again clarify that --

MR. YALE: That sentence doesn't make sense.

(Laughter.)

HEARING OFFICER KRUG: Do you mean it will or will not increase the likelihood --

MR. YALE: It will increase the likelihood that any new capacity for production -- or processing in the State of California will have to come from an unregulated means rather than regulated milk.

HEARING OFFICER KRUG: Thank you.

MR. YALE: Class 4a is higher than the overbase and will be for some time. By opting out of the system, producers can receive a higher price and plants pay a lower price. Further, the plants and producers can agree to profit and loss sharing in the sales without regard to a regulatory price.

Finally, reducing the 4a price will render the market less stable because it will empower currently profitable plants to use additional a profits from the regulation against producer and market interests in this state in several ways. It can reduce the prices in order to expand market share in the rest of the U.S. It could use the extra profits to expand operations elsewhere in U.S. or in the world. Or it can create a disparate producer pricing structure for milk by outpaying the competition.

At the same time a lower price will not attract the capacity as desired. Other fundamental issues facing business in California discourage expansion or construction of new facilities.

The money shifted from California's producers to plants will not go to new construction. The 200 million projected reduction of producer prices will go to the profits of existing plants, not new ones. For a new 6 million pound per day plant, the lower costs for milk means at most $11 million per year in a projected profit lose statement. But the market will quickly absorb that. Even if the market would not, the extra cost advantage assumes that the new plant will not be offset by selling at lower cheese prices to capture market share. And it also assumes that its competitors will not use the extra margin to reduce prices to maintain or keep market share.

By causing this shift of funds to plants, not only will it not officially result in additional capacity; producers will not participate in any of the profits to the plants from this reduced minimum pricing while bearing the costs.

Finally, reducing producer milk prices still does not solve the real problem facing the California plant. Today the location is wrong. Already the existing plants have more than enough capacity to meet in-state and nearby needs. Plants located further East, nearer the market, will be more competitive by virtue of transportation costs.

I'd like to discuss some aspects of the pricing process that is at the core of this hearing's purpose. Although end-product pricing can be used to estimate the value of milk at the farm, it is not the only part of the equation. Milk has its own value and may exceed the value at an individual plant. Lowering prices so that milk is at the right value for all plants will necessarily reduce the overall value of milk.

One of the serious problems with the use of end-product pricing is the fact that there is no effort to look at it in total. The term I like to use is "mass balance," which means looking at all of the inputs and account for them through the system and at the same time look at the income and costs associated with that flow. The reason this is important is that by focusing on just segments such as pricing or plant operation, the unitary nature of the business and the come upon fact that income or expenses are offset elsewhere in the business is often lost.

There are two examples of this: The discussion on recycling whey butter. There is a cost to recycle the whey butter, but there's also a greater return for doing so. Thus it should be measured and returned to producers in the formula. At the same time there are plants that do not recycle whey butter. This is because they are producing a higher value cheese and the loss of income from the yield is reflected in higher sales. Both are legitimate business goals. Both reflect higher value of the milk, either a higher end price for non-recycled or a higher yield in gross for recycled. In any case, the 90 percent represents a very low butter fat yield today. In the mid-nineties was probably more realistic.

Another example is fortification. Fortification occurs largely to maximize the amount of butter fat received at the plant. In short, it makes the milk more valuable and should be included in the formulas. To say on one hand that we want to use end-product pricing to reflect value but at the same time ignore key profit centers is unrealistic.

Another issue has been mentioned regarding farm to plant shrink. Reference was made to testimony in 2000 at an FMMO hearing. That data was out of date when given and does not reflect the state of the industry today. In the Southwest we monitor farm to plant shrink and have found that it is virtually non-existent. Often there is as overage as shrink. Further, the amount of solids and fat remaining in the system is vastly overstated in that study.

In conclusion, Select and Continental request that the Department not reduce producer prices. The spread is already too much. The national market will adjust downward to match any change and, thus, reduce producer income elsewhere. The continued reduction of producer prices threaten to undermine the stability of the markets and work against the vitality of regulated markets. Above all, it will not do what is has hoped. It will not attract the capacity that the state needs or wants.

We also request the right to file a post-hearing brief. And I'm available for questions.

Thank you.

HEARING OFFICER KRUG: Yes, your request -- your request to file a post-hearing brief is granted.

Do any of the panel members have questions for the witness?

Mr. Gossard?

AGRICULTURE ECONOMIST GOSSARD: First a clarification.

You used the term "4a" throughout your testimony.

MR. YALE: It's 4b.

AGRICULTURE ECONOMIST GOSSARD: Okay.

MR. YALE: That was just pointed out to me. Being a foreigner, maybe I misunderstood that.

AGRICULTURE ECONOMIST GOSSARD: That's all right. It's easy enough to do.

HEARING OFFICER KRUG: Excuse me, Mr. Gossard.

MR. YALE: All reference in here to 4a should be to 4b.

HEARING OFFICER KRUG: Thank you.

AGRICULTURE ECONOMIST GOSSARD: My other questions focus on the two cooperatives you're representing.

You say Continental Dairy Products markets its members milk in three areas of the country.

Does it have plants as well as --

MR. YALE: Continental has no plants.

AGRICULTURE ECONOMIST GOSSARD: No plants. Okay.

MR. YALE: Strictly marketing cooperative.

AGRICULTURE ECONOMIST GOSSARD: And Select, does it have plants?

MR. YALE: It has interest -- it operates a UFRO or fractionating plants. It has three of those. It also has an interest in southwest cheese as a member of no partner, along with other cooperatives in the southwest. It also has just recently acquired a bottling plant in El Paso, Texas.

AGRICULTURE ECONOMIST GOSSARD: So how much of the member milk goes through the ROU -- combined how much goes through the bottling plant, the cheese plant, and the UFRO facility?

MR. YALE: No, I couldn't tell you -- I don't know that number. And the fact that Select, in cooperation with DFA, ZIA, and Lone Star Milk Producers, efficiently markets all the milk produced in that state to the closest plant irrespective of who the member is, it would be difficult to identify that on the basis by a cooperate --

AGRICULTURE ECONOMIST GOSSARD: I understand.

Thank you for the clarification.

No further questions.

HEARING OFFICER KRUG: Ms. Reed, do you have any questions for the witness?

SUPERVISING AUDITOR REED: No.

HEARING OFFICER KRUG: No.

Ms. Gates, do you have any questions?

RESEARCH MANAGER II GATES: No.

HEARING OFFICER KRUG: No.

Mr. Ikari, do you have any questions for the witness?

DAIRY MARKETING BRANCH CHIEF IKARI: Am I correct in listening to your testimony -- and maybe I got a sense that it was wrong. But I assume from your testimony that you participated in the federal hearing and you posed the increase in the make allowance there?

MR. YALE: Yes.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay.

HEARING OFFICER KRUG: Any further questions for this witness?

Thank you, Mr. Yale.

MR. YALE: Thank you.

HEARING OFFICER KRUG: You're excused.

Our next witness is Mr. Mike McCully.

DAIRY MARKETING BRANCH CHIEF IKARI: Mr. Yale?

MR. YALE: Yes.

DAIRY MARKETING BRANCH CHIEF IKARI: One thing. If you're going to file a post-hearing brief, on that 5th page where -- I think the hearing officer got it right.

But to be clear, could you put the corrected statement down in your hearing brief?

MR. YALE: I'd be happy to do so. Thank you.

HEARING OFFICER KRUG: Okay. Is the witness ready?

MR. McCULLY: Yes.

HEARING OFFICER KRUG: Okay. Mr. McCully, will you please state your full name and spell your last name the record.

MR. McCULLY: My names is Mike McCully, last name M-c-C-u-l-l-y.

HEARING OFFICER KRUG: Mr. McCully, do you swear or affirm to tell the truth?

MR. McCULLY: Yes.

HEARING OFFICER KRUG: Are you representing any organization with your testimony?

MR. McCULLY: Kraft Foods.

HEARING OFFICER KRUG: Yes, you're representing Kraft Foods.

Could you please explain how your testimony was arrived at today?

MR. McCULLY: First it was -- I work in a dairy procurement group. And it was several of us that are responsible for this type of activity regarding -- directly responsible for milk procurement. We also have a couple of people that work with Regulatory Affairs. Once that was put together, we then review this with our Corporate Affairs, State and Federal Government Affairs, and Legal and Operations. So it's a, you know, large organization. We've unfortunately a lot of people involved.

HEARING OFFICER KRUG: Okay. So this does represent the testimony of Kraft Foods?

MR. McCULLY: Yes.

HEARING OFFICER KRUG: Do you have any written testimony, written statements or other documents you would like admitted into the record at this time?

MR. McCULLY: Yes, I do.

HEARING OFFICER KRUG: Is that the document that you handed, Testimony of Mike McCully, dated June 1, 2006?

MR. McCULLY: That's correct.

HEARING OFFICER KRUG: Yes, that document will be labeled Exhibit 67 and is hereby admitted into the record.

(Thereupon the above-referred document was marked as Exhibit 67.)

HEARING OFFICER KRUG: You may proceed.

MR. McCULLY: Mr. Hearing Officer and members of the Hearing Panel: My name is Mike McCully. I'm Associate Director of Dairy Procurement at Foods in Glenview, Illinois, with responsibilities for U.S. milk procurement, in addition to U.S. and global dairy market analysis and dairy commodity risk management.

Kraft currently operates two dairy plants in California: One in Tulare, which produces primarily Parmesan and cheddar cheese, along with dry whey powder; and another in Visalia, which produces primarily cottage cheese, sour cream, butter and nonfat dry milk.

In addition, Kraft purchases cheese and other dairy ingredients from several companies located in California. Kraft is a member of the Dairy Institute of California and fully supports their proposal.

California has achieved a leadership position in the dairy industry given its large, efficient farms and supporting infrastructure of milk processing plants. California accounts for over 20 percent of total U.S. milk production, with nearly 80 percent of this milk processed into cheese, butter and nonfat dry milk. These commodities are transported to other parts of the country and also serve a developing export market.

In order to be competitive in these markets it is necessary that the regulated milk price structure in California allow the state's dairy industry to remain viable and also grow market share.

Manufacturing capacity:

Before 2003 cheese manufacturing capacity in

California had grown steadily, which had accommodated the growth in the state's milk production. However, in the last several years cheese plants have been expanded or built in other states such as New Mexico, South Dakota, Oregon and Idaho. But California has seen little to no expansion, and this is not expected to change over the next few years.

The April 2006 Dairy Foods magazine listed 41 projects in the United States for dairy plant construction or expansion that have been recently completed, are underway or in the planning stages. And I list -- the full story and list is provided as Appendix 1. There's about three pages of text story. And then the last two pages is actually each of the plants -- plant expansions, new plants listed out individually by company, as well as completion date, cost and square footage and so forth and what the products are.

Only 3 of those 41 projects are in the State of California: Dreyer's ice cream plant in Bakersfield, Straus Family Creamery's organic plant in Petaluma, and CDI's butter powder plant in Visalia, with this being the only one that will add any meaningful manufacturing capacity to the state. Of all the projects listed, one-third are cheese plants, yet none are in California. It's become evident the State of California is not the preferred location for building a cheese or dairy plant.

In 1993 California passed Wisconsin as the number one milk producing state in the country and will soon double Wisconsin's milk output. To handle that increase in milk production we estimate the State of California will need one new cheese plant per year or another type of manufacturing facility such as butter powder or milk protein concentrate. As just detailed, the investment needed for additional manufacturing capacity is not being made in the state. At last year's hearing it was noted that milk supplies would continue to grow and producers and cooperatives may be forced to ship milk outside the state to find manufacturing capacity. And as a result producers would incur higher shipping costs and, thus, lower net milk prices. In fact, there's been milk shipped out of California this year to find a home for processing as well as milk being dumped on the farm. This situation damages the entire infrastructure of California's dairy industry. Therefore, it is imperative California's processing sector continue to grow to support future milk production growth.

Manufacturing Costs:

Dairy cooperative leadership on a national level recognizes the business challenges facing dairy processors. In the May 2006 CEO's Corner, Jerry Kozak, President/CEO of the National Milk Producers Federation, discussed this issue in detail. He pointed out how, quote, the surge in natural gas, oil and electric expenses have presented a huge challenge to the profitability of many dairy co-ops. Dairy production and processing are both energy-intensive enterprises, and there's no escaping the pressures that come when energy prices soar, end quote.

Ahead of the January 2006 Federal Order make allowance hearing National Milk Producers Federation decided to support the increases and make allowances in Federal Order formulas. Their reasoning was as follows:

Quote, even though higher manufacturing allowances could mean lower producer prices in the short term, it's crucial for the long-term economic health of cooperatives, and ultimately farmers, to support those higher allowances. In the end, if manufacturing cooperatives continue to struggle with profitability issues, that affects the patronage that farmers ultimately receive from being part of the co-op. We've already seen an exodus of a number cheese plants in the East and Midwest, in part due to the higher operating costs of the past several years. Fewer processing outlets for farmers milk means greater hauling expenses and less competition for their raw milk, end quote.

While this refers to only cooperatives, all manufacturing facilities are facing the same challenges.

One specific example of the financial challenges faced by cheese manufacturers is DFA's Golden Cheese operation in Corona, California. At DFA's annual meeting in March operating losses were noted in their commodity cheese operations last year. Most relevant to California and this hearing was the loss of approximately $35 million at their Golden Cheese operation in Corona in 2005. Senior DFA management said they were looking at various options for the plant in an attempt to mitigate the losses. While the plant is in a declining milk shed, it is valuable in terms of both manufacturing and balancing capacity for the state.

In April 2006, Kraft announced the closure of its Visalia plant. This plant produces cottage cheese and sour cream for the Knudsen brand and also has a butter powder operation. The plan consolidates cultured products and the butter churn operation from Visalia into the Kraft facility in Tulare since the Tulare plant had available space to absorb the manufacturing equipment and has a strong infrastructure. It is our plan to discontinue milk powder production at Visalia and not transfer those assets to Tulare.

Furthermore, Kraft evaluates the regulatory and political environment in determining investment decisions. If the State of California is perceived as an unfriendly environment for processors, investment money will not be forthcoming.

California's competitive position in the U.S. Dairy industry is negatively impacted by the fact that manufacturing costs are higher in California than in other parts of the country. Kraft operates plants in several regions and incurs higher cost for electricity and natural gas at our Tulare, California, plant than in other parts of the country. We analyzed costs to several of our plants and compared them to the Tulare plant. For comparison to an eastern plant we used our Italian cheese and dry whey manufacturing facility in New York, which is similar to the output of the Tulare plant. During the 2004-05 time period electricity costs were 80 percent higher in California than New York and natural gas costs were at 45 percent higher. For a comparison to a Midwest plant, we used our cheddar cheese manufacturing facility in Arkansas. During the same 2004-05 time period, electricity costs were 120 percent higher in California than Arkansas, while natural gas costs were actually 35 percent lower.

In summary, when comparing California to the two plants averaged together, California electricity costs were 100 percent higher and California natural gas costs were 5 percent higher. Since California manufacturers operate in a national marketplace, these cost differences need to be considered when setting regulated milk prices.

The additional costs faced by California manufacturers are negatively impacting their competitive situation in U.S. dairy market. Over the last several decades Kraft has shifted its purchases of cheese to the West, specifically California and Idaho, given its advantage in scale and cost. However, over the last one to two years we have shifted purchases away from California. In 2006 we will buy nearly 25 percent less cheddar cheese from California than we did last year. This cheese is now being purchased from Idaho and New Mexico, as it is more competitive than California cheese.

Until the last few years, California's regulated pricing environment encouraged dairy industry growth and provided an advantage over other areas of the country. Now that advantage is gone and other areas are taking market share from California.

To support the dairy industry's growth in California, it is critical the minimum regulated prices for milk take into consideration the need to ship manufactured products to the population centers in the Midwest and East.

Kraft operates four large processed cheese plants in Minnesota, Missouri, Illinois, and Pennsylvania, and partners with co-manufactures with cut & wrap operations an Wisconsin, Ohio, and Mississippi. We evaluate suppliers across the country that can deliver products that meet our specifications and do so at a competitive price. As a supplier to these facilities, cheese plants in the West require a cost structure that enables them to manufacture cheese, ship it several thousand miles, and be priced competitively with locally producing cheese. Therefore, it is critical have minimum regulated milk prices that allow for California plants to be competitive with plants in other parts of the country.

It is no secret fuel prices have increased dramatically over the last one to two years. From early 2005 to May 2006 the national average diesel fuel price has gone from $2 a gallon to 2.90 a gallon. As a result, we have seen fuel surcharges increase by 20 cents per gallon. What is less publicized is the impact on shipping product off the West Coast to the Midwest and East Coast. As an example, the cost to truck a load of cheese from Tulare County, California, to Marathon County, Wisconsin, has increased from around 6 cents per pound to around 9 cents per pound in the last year or so. We have seen similar increases of 30 to 50 percent to other parts of the Midwest. This puts product from California at a disadvantage to product from other areas.

Price Floors:

A number of alternative proposals are asking for a price floor to be implemented using CCC support prices for cheese, butter and nonfat dry milk. We concur with last year's Hearing Panel decision to remove the price floor from the formula. Price floors are bad policy for the following reasons that are more thoroughly discussed in Dairy Institute's proposal.

1) It creates a disincentive to purchase milk when the market supplies of milk are abundant;

2) The support price problem, defined as market prices falling below CCC purchase prices, is a national one because the support price program is a national program;

3) A problem with a national program should be fixed at the federal level, not the state level; and

4) When commodity prices fall below CCC purchase prices, it is usually the case that prices are low due to excess milk supplies.

Whey Issues:

Valuing the whey component in the price formula is problematic and therefore should be eliminated. Before 2003, whey was not included in the price formula for 4b milk. But since it was added, numerous issues have arisen. Last year's hearing went into detail on the manufacturing allowance and CDFA's manufacturing cost survey data. Unlike the manufacturing allowances for cheese, butter and nonfat dry milk to cover a large percentage of production, the current manufacturing allowance for whey covers none of the dry whey production included in the manufacturing cost survey. Arguments have also been made regarding the addition of WPC or other whey proteins into the formula. Unlike cheese, butter and nonfat dry milk, there's not one standard whey product that is appropriate to use in pricing formulas. Additionally, several proposals advocate snubbing the whey price. As described above, price floors and snubbers are bad policy and should not be adopted. In short, attempting to value whey is complex. We believe last year's Hearing Panel decision to remove the whey factor from the 4b formula was the correct decision and should be implemented following this hearing.

There has been some discussion earlier in this hearing regarding the addition of whey cream back into cheese production. For the cheddar cheese Kraft buys in California, mostly used in aging programs, we do not allow the addition of whey cream. Additionally, for the Parmesan cheese production at Kraft's Tulare plant, we do not add back any whey cream into the cheese production process. The whey cream is sold and not used internally.

In summary, I would like to encourage the Department to adopt the Dairy Institute proposal. It best addresses the needs of California's dairy industry, and positions the entire industry, both producers and processors, for future growth.

I thank you for the opportunity to testify here today and welcome any questions at this time.

I'd also like to request to be able to file a post-hearing brief.

HEARING OFFICER KRUG: Your request for a post-hearing brief is granted.

Do we have any questions for the witness?

Mr. Gossard?

AGRICULTURE ECONOMIST GOSSARD: On page 2 of your testimony, you quote Mr. Kozak. I take it you used the quote because you agree with his sentiments. And he mentions the exodus of a number of cheese plants in the East and Midwest.

Don't those plants have the option to depool and avoid minimum pricing? So is it a regulatory situation that closed those plants or just economics?

MR. McCULLY: First I'll answer the question, that the context of the -- Jerry Kozak's column is actually called "Making Allowances." So the whole topic is on make allowances following the hearing.

Specifically to your question about the East and Midwest, there are some plants that could depool, probably more so in the Midwest than the East. And I can speak specifically to one in the East because we did close a plant there roughly two years or so ago, Canton, New York. And that was a -- as I testified at the Federal Order make allowance hearing in January, that was more of an issue of not being able to recover the costs. And it turned out to be, you know, those types of smaller plants that were more of a balancing function for the market could not -- were not financially viable in the new system of make allowances and so forth.

AGRICULTURE ECONOMIST GOSSARD: My second question has to do with the use of the whey factor and the federal Class 3 formula. Has that been a problem for cheese plants, having a whey factor and the Class 3 price?

MR. McCULLY: There's probably -- probably have a couple other people testify a little later, either today or tomorrow, that are -- probably can better address that that have -- we tend to have in the Federal Orders a couple cheese plants that -- we have one in Campbell, New York, that does do dry whey. That is -- to my knowledge, it's not a huge issue. Our other plants are cream cheese and so forth. This is not -- we do not make dry whey at those plants.

So I think there'll probably be other people that will testify that can better address that.

AGRICULTURE ECONOMIST GOSSARD: I meant more that you were suggesting on having the whey factor in our formula create some problem in general for cheese pricing. Does having a whey factor in the federal Class 3 formula create general problems for pricing for Class 3 -- federal Class 3?

MR. McCULLY: To my knowledge it's not as much of an issue. It will be interesting to see the new -- like Mark Stephenson is finalizing data for cheese and butter and whey, nonfat manufacturing costs with the Federal Order formulas. And it will be interesting to see what comes up out of those as far as what the actual numbers are. I heard some earlier testimony quoting 11 cents or, you know, Dr. Ling's numbers from a long time ago. I think it has -- I don't know if it's really been talked about a whole lot. I believe Dr. Stephenson gave some preliminary results of his findings here or month or so ago in Wisconsin. And I think the whey number may have been closer to 20 cents of what he was coming up with. So if you come up with a number like that, it's probably more appropriate for use in there.

The other thing that -- what I want to point out, as I said, electricity costs and some energy costs here in California are a lot more than other parts of the country. So you would expect to see, you know, versus the two areas a more of an issue here in California for those costs can't be recovered.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

No further questions.

HEARING OFFICER KRUG: Ms. Reed, do you have any questions for the witness?

SUPERVISING AUDITOR REED: No, I don't.

HEARING OFFICER KRUG: Ms. Gates, do you have any questions for the witness?

RESEARCH MANAGER II GATES: No.

HEARING OFFICER KRUG: Mr. Ikari, do you have any questions?

DAIRY MARKETING BRANCH CHIEF IKARI: I just have one.

You made the statement in fact there has been milk shipped out of the state and as well as being dumped. To the extent that it's possible, can you provide us with more details about that in your post-hearing brief?

MR. McCULLY: Sure. I can either do that now or in the post-hearing brief.

DAIRY MARKETING BRANCH CHIEF IKARI: Oh, if you can do it now.

MR. McCULLY: Okay. Well, first, obviously as being in charge of milk procurement for Kraft, I need to keep up on with these types of things around the country.

This -- by two different milk suppliers as well as another large cooperative here in California did tell me that back in the last several months that there was milk dumped. It's not something that obviously is -- that anybody wants to make very public. It was not huge amounts of milk. But just the fact that it was dumped, it is a problem. I know in some cases it was -- there was milk that was put on trucks and just sent out of state to try to find a home. And, you know, in addition to being dumped, it was just milk heading out to the Midwest or, you know, back to the East to find manufacturing.

There is also milk that --

DAIRY MARKETING BRANCH CHIEF IKARI: How much milk do you --

MR. McCULLY: Being dumped or --

DAIRY MARKETING BRANCH CHIEF IKARI: Or the one that was shipped.

MR. McCULLY: Well, there's probably not a large amount back east. There was also I believe a -- and, again, I don't want to speak for them, but there is a cooperative I believe had an agreement with WestFarm Foods or Dairy Gold, or whatever they're calling themselves now, up in the northwest that they were hauling surplus milk from California up into the northwest for one of their plants for either cheese or butter powder or whatever it went into.

So that would be a couple examples.

Of course there's also the CDI's Tipton plant, UF, that processes four and a half or so million pounds a day. And half or so of that moves out of state in the form of UF milk.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

HEARING OFFICER KRUG: Are there any additional questions for this witness?

Seeing no questions.

Thank you very much, Mr. McCully.

MR. McCULLY: Thank you.

HEARING OFFICER KRUG: You're excused.

Okay. Next witness is Greg Dryer.

And it's anticipated this will be the last witness for today.

And tomorrow morning we will start at 8 o'clock, same place.

Mr. Dryer, are you ready?

MR. DRYER: Yes, I am.

HEARING OFFICER KRUG: Okay. Mr. Dryer, will you please state your name and spell your last name for the record.

MR. DRYER: My name is Greg Dryer D-r-y-e-r.

HEARING OFFICER KRUG: Mr. Dryer, do you swear or affirm to tell the truth?

MR. DRYER: I do.

HEARING OFFICER KRUG: Are you representing any organization today?

MR. DRYER: I'm representing Saputo Cheese USA.

HEARING OFFICER KRUG: Okay. Could you describe how your testimony was arrived at today?

MR. DRYER: I drafted the testimony, and it was shared with the Corporate Communications Department, our Divisional President, and the CFO of the company and approved.

HEARING OFFICER KRUG: Okay. So this testimony does represent the testimony of Saputo Cheese USA?

MR. DRYER: Yes, it does.

HEARING OFFICER KRUG: Thank you very much.

Do you have any written statements or other things you would like entered into the record at this time?

MR. DRYER: I have a written statement distributed.

HEARING OFFICER KRUG: Okay. I have here

"Testimony of Greg Dryer," dated June 1-2, 2006.

It will be labeled Exhibit No. 68 and is now admitted into evidence.

(Thereupon the above-referred document was marked as Exhibit 68.)

HEARING OFFICER KRUG: You may proceed with your testimony.

MR. DRYER: Thank you.

My name's Greg Dryer. I'm Executive Vice President of Administration and Services for Saputo Cheese USA. My responsibilities in that position, among other things, include milk procurement for all of the company's U.S. manufacturing facilities. I serve on the Board of Directors of the National Cheese Institute, the American Dairy Products Institute, and the Dairy Institute of California. And I'm a member of the Wisconsin Cheese Makers Association, the Institute of Food Technologists, and the American and Wisconsin Institutes of CPAs. I've been directly employed in the U.S. dairy industry for the past 25 years. Our company, Saputo, has 13 manufacturing facilities across the United States, employing about 2,000 people. We buy from three to four billion pounds of milk annually, primarily from farmer-owned cooperative organizations.

The two plants we operate in California, located in Tulare and South Gate, utilize about one-third of our total milk needs. And I'm here to testify in support of the petition filed by the Dairy Institute of California dated February 7th and, as amended, April 26th of 2006.

By way of background: The systems that cheese manufacturers must rely on to establish minimum milk prices that permit our businesses to remain economically viable have failed us. One should not infer that because the California 4b price tends to be lower than the USDA Class 3 price, that the problem does not exist here. Similar shortcomings exist in both systems and have placed many cheese manufacturers in dire financial jeopardy regardless of their location. Evidence of this is readily available from recent published financial results of non-private organizations. A substantial number of outright business failures and plant closures have been observed across the country. The magnitude and duration of the accumulated losses observed in the past two years is staggering.

The fault lies primarily from milk price formulas that impute enormous profits from whey byproducts in periods when the dry whey market is unusually high and from make allowances that has failed to keep pace with rapidly escalating costs. U.S.D.A. is currently considering a petition for revision of make allowances in their price formulas.

The Whey Factor:

The whey market, which has averaged about 20 cents a pound since 1983, has been above 25 cents since December 2004 and has peaked at an unprecedented 35 1/4 cents in January 2006. Whey processing facilities tend to be highly specialized and exceptionally capital intensive. Because of the capital investment required, most plants are configured to produces one type of product or another and are unable to switch back and forth due to the unique and expensive requirements of each alternative process. In recent years most companies have pursued higher value and more sophisticated whey products, hoping to enjoy higher returns and less volatility. Over the long run it's reasonable to assume that dry whey is among the lowest common economic denominators of alternative whey products.

But since 2004 this has not been the case. High prices driven by increasing export opportunities in the face of sluggish domestic production have driven prices to remarkable levels. Companies which have structured to produce higher ended WPCs and isolates were unable to switch over to enjoy revenues from the dry whey market upsurge. In fact, prices for many of their products were declining while the cost of their milk was rising dramatically in response to the high whey market.

In California, Saputo produces WPC of varying protein levels and participates in a venture which produces whey protein isolate. The lactose permeate byproduct from producing WPC in California presents us with a large disposal cost that offsets profits obtained from the sale of WPC. Since 2004 we've been unable to attain anywhere near the profits implied for whey byproducts in the California 4b formula. The difference between 30 cent and 20 cent dry whey markets represents an enormous milk cost increase to a company of our size operating in California.

If the 4b formula employed an up-to-date and adequate make allowance, then we believe that over the long term the 4b -- the whey factor in the 4b price might make sense. However, extended periods of unusually high or low prices have the potential of placing either producers or processors in serious jeopardy. We strongly support the Dairy Institute proposal to remove the whey factor from the 4b formula.

Make allowances:

Saputo does not make cheddar cheese in the United States, so I'm unable to testify as to its cost. But we support revisions to the California make allowances utilizing the most recent cost study data available. Like most companies, many of our cost categories have risen dramatically over the past three years. Notably, natural gas costs in California are more than 35 percent higher than they were three years ago. Diesel fuel transportation costs related to shipping products East from California have risen by a similar percentage.

California competitiveness:

For the most part, we've enjoyed our participation in the state's dairy industry. Until recently, the desire by the state to remain competitive on a national basis has been apparent in the milk pricing system. A system which is responsive to rapid change can be refreshing in contrast to the slow moving and archaic federal system.

It should be noted, however, that implications of site selection decisions of dairy companies are by their nature of considerably extended duration. Changes made to the system subsequent to these major investment decisions can dramatically affect the longevity of such an investment.

Consideration should also be given to the fact that California presents many unique challenges not attributable to other regions. For example, our engineers tell us that dairy quality process space will cost approximately $120 per square foot in Wisconsin, while comparable space in California will run $300 per square foot.

Many states, including Wisconsin, Vermont, and Maryland, for example, exempt manufacturing machinery and equipment from sales and use tax charges. California does not. Here we're forced with paying -- we're faced with paying around 8 percent -- maybe "force" was Freudian -- faced with paying around 8 percent extra on those types of expenditures.

The construction permitting process in California takes three to five times as long as other regions we operate in.

Rising transportation costs impair servicing the major markets in the Central and Eastern U.S. Now it costs about 9 cents per pound to ship cheese back to the Midwest, up from about 6 cents in 2003. For East Coast shipments, costs have risen from about 8 to 9 cents to about 12 cents per pound of cheese.

A review of labor rates in our Tulare plant reveals costs that are 25 to 30 percent higher than the average across all of our U.S. plants.

Electricity costs per unit of production in California are basically double those we experience in Wisconsin and about 40 to 50 percent higher than Vermont's.

So in conclusion, we have been cautioned by milk suppliers about concerns related to the declining supply of milk in southern California. If we should ever be confronted with the necessity of relocating our existing southern California production capability or as we look for new locations to fulfill our desire to continue to grow our U.S. business, please consider that the rulings made here by the Department will undoubtedly have a major impact on those decisions

Thank you for your attention and for the opportunity to testify on behalf of Saputo. And I'll attempt to answer any questions you may have at this time. And I respectfully request permission to file a post-hearing brief.

HEARING OFFICER KRUG: Yes, your request to file a post-hearing brief is granted.

Are there any questions for the witness?

Mr. Gossard?

AGRICULTURE ECONOMIST GOSSARD: You stated that one reason for plants to go into the various WPCs is that there appeared at the time to be less volatility in the prices. Has that been borne out by experience?

MR. DRYER: Yes, I would say that the prices are less -- somewhat less volatile. But when you get into the more sophisticated markets, they tend to be small markets.

And what tends to happen over time is more and more manufacturers start entering those markets and they trend lower over time.

So we've experienced declines in many of those markets. Which if they start out looking like tremendous opportunities, they tend to wane with the increase in competition.

One thing, if I might volunteer, you asked the previous witness about the whey factor on the USDA side.

AGRICULTURE ECONOMIST GOSSARD: In the federal Class 3?

MR. DRYER: Right.

AGRICULTURE ECONOMIST GOSSARD: That's my next question.

MR. DRYER: I was hoping you would ask, because I was involved in those discussions. And there was fairly intensive debate that took place in processor members in the federal system about whether to seek a change in that factor in the formula as well on the Class 3 side. And the decision was made, given the amount of time it takes to get a decision from USDA, that it was more expedient to go for something that was cleaner and more straightforward, like increases in costs impacting the make allowance, rather than to attack things that would be more contentious such as the whey factor. And the thought was it would have delayed the decision on the part of USDA. And it was not an overwhelming agreement. There was a lot of debate and disagreement among the members -- and I'm speaking of the National Cheese Institute -- about that issue. But it is as punitive a factor on the USDA side as it is in California. And it is hurting processors.

AGRICULTURE ECONOMIST GOSSARD: My last question is specific to the situation in southern California.

Have you found any problems to date getting adequate milk for your South Gate facility?

MR. DRYER: No, we haven't fortunately. We have a contractual relationship with a co-op and they supply us. But they -- you know, we're concerned that over time we may have to bring milk in from greater distances, which would cause the cost to increase and so on. So it's a matter of concern.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

No further questions.

HEARING OFFICER KRUG: Ms. Reed, do you have any questions for the witness?

SUPERVISING AUDITOR REED: No, I don't.

HEARING OFFICER KRUG: Ms. Gates, do you have any questions for the witness?

RESEARCH MANAGER II GATES: No.

HEARING OFFICER KRUG: Mr. Ikari, do you have any questions for the witness?

DAIRY MARKETING BRANCH CHIEF IKARI: No.

HEARING OFFICER KRUG: No further questions.

Mr. Dryer, you are excused. Thank you very much.

MR. DRYER: Thank you.

HEARING OFFICER KRUG: That will conclude our testimony for today. We will reconvene tomorrow in this room at 8 o'clock in the morning.

Just a matter of housekeeping here. In the event that I failed to admit any document, all the documents that have been marked as exhibits so far are hereby admitted into evidence. Any requests to file post-hearing briefs, if I failed to adequately respond, are granted, those requests that have already been made. We'll deal with tomorrow's requests tomorrow.

And we'll see you in the morning.

We're off the record.

(Thereupon the Department of Food and Agriculture Market Milk Hearing adjourned at 5:25 p.m.)

CERTIFICATE OF REPORTER

I, JAMES F. PETERS, a Certified Shorthand Reporter of the State of California, and Registered Professional Reporter, do hereby certify:

That I am a disinterested person herein; that the foregoing Department of Food and Agriculture, Dairy Marketing Branch hearing was reported in shorthand by me, James F. Peters, a Certified Shorthand Reporter of the State of California, and thereafter transcribed into typewriting.

I further certify that I am not of counsel or attorney for any of the parties to said hearing nor in any way interested in the outcome of said hearing.

IN WITNESS WHEREOF, I have hereunto set my hand this 7th day of June, 2006.

JAMES F. PETERS, CSR, RPR
Certified Shorthand Reporter
License No. 10063