PUBLIC HEARING

STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

DAIRY MARKETING BRANCH

DEPARTMENT OF FOOD AND AGRICULTURE

1220 N STREET

AUDITORIUM

SACRAMENTO, CALIFORNIA

FRIDAY, JUNE 2, 2006

8:05 A.M.

JAMES F. PETERS, CSR, RPR
CERTIFIED SHORTHAND REPORTER
LICENSE NUMBER 10063

PETERS SHORTHAND REPORTING CORPORATION (916) 362-2345

APPEARANCES

HEARING OFFICER

Mr. Michael Krug, Staff Counsel

PANEL MEMBERS

Mr. David Ikari, Chief, Dairy Marketing Branch

Ms. Candace Gates, Research Manager II

Mr. Tom Gossard, Agriculture Economist

Ms. Venetta Reed, Supervising Auditor I

STAFF

Ms. Cheryl Gilbertson, Staff Analyst

ALSO PRESENT

Mr. Richard Cotta, California Dairies

Ms. Sharon Hale, Crystal Cream and Butter Company

Mr. Joe Heffington, California Dairies

Mr. Scott Hofferber, Farmdale Creamery

Mr. David Inman, U.S. Milk

Ms. Tiffany LaMendola, Western United Dairymen

Mr. Michael Marsh, Western United Dairymen

Mr. Albert Nunes

Dr. William Schiek, Dairy Institute

Mr. Mike Shotts, Farmdale Creamery

APPEARANCES CONTINUED

ALSO PRESENT

Ms. Patricia Stroup, Hilmar Cheese Company

Mr. Ray Souza

Ms. Sue Taylor, Leprino Foods

Mr. William C. Van Dam, Milk Producers Council

Mr. Geoffrey Vanden Heuvel, Milk Producers Council

Mr. Case Van Steyn

INDEX

PROCEEDINGS

HEARING OFFICER KRUG: Okay, good morning. The hearing will now come to order. Let's go on the record.

This is Friday, June 2nd. We're continuing the hearing which commenced yesterday June 1st. It's 8:05 in the morning. And we will continue with our hearing from witnesses.

MR. VAN DAM: He's not under oath.

(Laughter.)

HEARING OFFICER KRUG: Okay. It's 8:05 according to this computer over here.

(Laughter.)

HEARING OFFICER KRUG: And which will be the official clock we use.

(Laughter.)

DR. GRUEBELE: I wouldn't push that any further.

(Laughter.)

HEARING OFFICER KRUG: Off the record.

Back on the record.

Okay. The first witness to be called this morning is Albert Nunes. Is Mr. Nunes here?

I'm not seeing him reply. If he arrives later, he may testify at that time.

The next witness in order is Scott --

MR. HOFFERBER: Go for it. Hofferber.

HEARING OFFICER KRUG: -- Hofferburger and Mike Shotts.

MR. HOFFERBER: Hofferber.

HEARING OFFICER KRUG: Hofferber. Well, you can correct that on the record.

As we're preparing here for these witness, I just wanted to make a note for you all. Yesterday, we did receive some additional letters into evidence. If anyone would like to comment on them in their post-hearing briefs, they will need to make some comments in their oral testimony through their comments with regard to those letters. So just keep that in mind.

And now we will proceed with the testimony. Will the witnesses please state their name and spell their last name for the record.

MR. HOFFERBER: I am Scott Hofferber, H-o-f-f-e-r-b-e-r.

MR. SHOTTS: I'm Michael Shotts, S-h-o-t-t-s.

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

MR. HOFFERBER: I do.

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

MR. SHOTTS: I do.

HEARING OFFICER KRUG: Are you representing any organization with your testimony?

MR. HOFFERBER: We are here on behalf of Farmdale Creamery, Inc. and their board of directors.

HEARING OFFICER KRUG: Could you briefly explain how your testimony was arrived at?

MR. HOFFERBER: Yes. As the controller at Farmdale, I analyze the petition and the alternative proposal and gathered other data and drafted testimony that I presented to my board, revised per their comment and are here to present it.

HEARING OFFICER KRUG: Okay. Can everyone in the back of the room hear?

Yes.

HEARING OFFICER KRUG: That's fine. Do you have any written statements or other things that you would liken entered in to the record?

MR. HOFFERBER: Yes, our statement titled Farmdale Creamery, Inc. June 1st and 2nd, 2006 is submitted.

HEARING OFFICER KRUG: Okay. That document will be labeled Exhibit Number 69 and is as admitted into the record at this time.

(Thereupon the above-referenced document was
marked Exhibit 69.)

HEARING OFFICER KRUG: You may proceed.

MR. HOFFERBER: Good morning, Mr. Hearing Officer and members of the hearing panel. I am Scott Hofferber the controller of Farmdale Creamery, Inc. and I am here at the direction and on the authority of our board of directors. With me today is Mike Shotts, one of Farmdale's 2 third-generation family owners and a member of our board of directors.

Farmdale is a small family-owned and operated dairy processing facility in San Bernardino, near the diminishing Chino Dairy Preserve. With 72 employees currently, Farmdale processes around 25 million pounds of milk and cream per month in to block jack and cheddar cheeses, sour cream, buttermilk and butter. We are here today to gratefully take advantage of the opportunity to provide our perspective.

Economic issues. As processor businesses go, Farmdale is the small family farm of the block cheese makers. At 100,000 pounds per day in cheese products produced, we are dwarfed by our competitors in the block cheese arena who are 15 to 25 times our size. We survive by a) filling a niche which is benefited by our small family-owned business culture and b) from one other large factor an orderly milk market.

Like many of the smaller dairy producer families represented at this hearing, Farmdale relies on the

Department and the Secretary to render a reasonable and orderly milk market environment in which all parties, large and small, can prosper. Our reliance comes from an expectation that sound economic principles will prevail over political and emotional pressures that are brought to bear on the decision makers.

If, on a level regulatory playing field, we find that we cannot compete just because we are too small, we understand that the rules of the economics game dictate we should not continue to play. Similarly, small farmers face the same fate as Farmdale if their smaller size prevents them from operating profitably against their larger-sized peers.

Pooling and such regulations, however, exist to protect smaller farmers within the producer community, but smaller processors like Farmdale are not afforded the same protections. Instead, we go head-to-head against larger competitors, relying on our quickness and flexibility to take advantage of market opportunities. This has worked well for us in the past, but as costs of production continue to climb, our margins get every tighter and as a commodity cheese maker, we are unable to raise revenues to offset these costs, relying entirely on the State regulatory system to provide an adequate make allowance to maintain the viability of our business.

We do not own directly or indirectly an interest in dairy cows nor are we affiliated by ownership with any of the co-ops or individual producers. We think this is an important distinction because we believe that the co-ops acting as producer handler processors have an unfair market advantage in finished goods over proprietary processors, those processors not owned by a co-op.

This advantage results from their raw product procurement not really being an arm's-length transaction, in essence they're selling raw milk to themselves. The fact that there is no accountability to the State and thus the dairy market generally for service charges or premiums paid on raw milk transfers begs the question as the degree to which the farmer is actually subsidizing their co-op owned and thus their own manufacturing plants.

We believe, though we do not have access to supporting hard data, that sales-below-cost and/or sales-below-regulated-minimum-price provisions are being violated and go undetected in this protected environment.

We, Farmdale, need the Department to uphold the cost-justified make allowances and the sales-below provisions if we to be able to compete.

Validity of CDFA Cost Data. I went to work in public accounting in 1982, becoming a Certified Public Accountant in California in November of 1987, upon completion of the required auditing experience and passing the 2 and half day exam. While in public accounting my work included auditing, tax preparation and audit response, litigation support work, and I talked cost accounting at a 4-year college for a time. I was hired in 1997 by Farmdale and have recently completed an MBA program.

My first job out of college, lasting 6 years, was for an engineering company contracted to the Department of Defense. Nearly all of our contracts were the cost-plus-fixed-fee variety, and thus we were audited by defense contract audit agency on a regular basis. Our costs were audited annually in order to validate our claimed overhead and other indirect cost rates. Additionally, each contract was audited as many times as necessary to validate claims for additional costs, as well as at the time of application to close out a completed contract. This personal background the given to support 2 comments.

First, as a CPA I understood early that the term audit applied to all sorts of examinations, surveys, statistical sampling and other testing procedures all aimed at gathering competent evidence to support an opinion or other presentation of information. An audit that results in I GAAP financial statement is properly conducted in accordance with GAAS, Generally Accepted Auditing Standards, by accountants certified by the State as qualified to conduct such an audit and render an opinion, like CPAs.

An audit conducted for another purpose, such as tax compliance or cost justification, in accordance with the appropriate guidelines and by qualified or authorized personnel is certainly an audit. When CDFA staff audit our cheddar cheese sales -- audited our cheddar cheese sales, their procedures conformed to my expectations of an audit, based on my auditing experience, and I certainly felt audited. The resulting presentation, therefore, has authority within the conduct it was intended, as far as Farmdale is concerned.

Secondly, CDFA cost survey data are collected for the purpose of supporting cost justified make allowances. Some procedures used are auditing techniques, but we know that the survey process relies on other statistical and analytical methods as applied to the data, which are used to achieve the published results. The methods seems sufficiently comprehensive to us and we call the survey work an audit for our internal purposes.

As such, we prepare the data and our responses as we would for any auditor. To paraphrase, an audit by any other name would smell like an audit.

The bottom line to this part of our testimony is that the Department, whose job it is to provide unbiased administration of dairy marketing laws and regulations, has spent significant time and energy in developing data through various audits and surveys for the purposes of setting cost-justified make allowances and appropriate minimum prices. The data indicates that the cost-justified make allowance portions of the minimum price formulae should be at the level set forth in the petition of the Dairy Institute of California.

Our company's survival as a California-based organization is dependent on the State adhering to the cost-justified principle in setting make allowances. We strongly urge the Secretary to recognize the validity of those figures, honor the hard work that went into building them and implement them at the earliest opportunity.

A comment made at the hearing workshop to the effect that the Department might be seen as employing Enron accounting methods to achieve the results in the updated cost information is nonsense. The Enron execs are now convicted of fraud, which means they intended to manipulate, mislead and misstate the information. Farmdale sees no such intent in the Department's procedures and relating disclosures. As stated above, providing unbiased administration of dairy marketing laws and regulations is what we believe to be the case.

We are not at this hearing to reform a process that has successfully maintained and grown an industry. Instead, we are here to make the appropriate periodic adjustments to certain parameters of that proven model, such that prosperity can continue for all involved, attrition notwithstanding.

Milk Supply. In 2005 we testified to our understanding that once Monsanto's rBST issues were resolved, milk supply growth would return to its usual 3-plus percent. We also understood that there was little, if any, new processing capacity coming on-line to service such growth. We had said then that quote, "If we producers and processors together are to continue to move the milk being produced, we must either a) encourage processor capacity to grow by offering an economic environment that presents the possibility of a reasonable return on investment, or b) see a disorderly reduction in the milk supply through the failure of farms unable to get their milk to market for the lack of processing capacity. Such capacity must be able to compete for sales within and without California," end quote.

Well, we've seen no new cheese plant capacity in the planning for California and we hear that milk is finding its way out of state, or worse, being dumped with information yesterday from CDC -- I'm off the testimony right now, the written. CDC testified yesterday to a couple of plants and provided some photographs. We can provide some specific information with respect to the Hanford project. Having visited that facility myself, a year ago, I'm aware that they did complete a new whey plant there and understood that they were going to retool their cheese side. There's some increase in capacity anticipated in that. I can't tell you how much, but the Hanford site, part of their intent is to replace their existing processing capacity. I imagine the Department may, by now, have some idea of the extent to the increase in capacity on the Hanford plant.

Back on my written testimony. In fact, companies with plants in California have planned for or started new construction outside the state specifically because they cannot justify the cost benefit of additional investment here, siting Hilmar and a couple others that have already been entered into the testimony.

Restating from our 2005 testimony, "Setting minimum milk prices at appropriate minimal levels allows risk of investment to be appropriately shared between processors and producers, provides the possibility of a more attractive ROI or NPV of investment in additional processing capacity, and frees the market to drive necessary corrections to over/under-supply conditions on its own, without the need for regulatory intervention on a frequent basis," end quote.

A minimum pricing system in our are opinion should minimal, so as to allow free-market forces to work more freely not less freely. Supply and demand 101, if there is too much milk for consumer demand milk prices will be low. If prices are too low, either supply will be cut by attrition of suppliers or processor capacity will increase as long as adequate cost-benefit margins can be achieved. Without proper cost-justified make allowances for processors, no new capacity is coming on-line -- virtually no new capacity is coming on-line, leaving producer attrition as the proper corrective measure.

If there is too little milk for consumer demand, prices will be high. If prices are high, more supply might be added, but again without proper cost-justified make allowances for processors, no new capacity will come on-line.

What we are saying is that if you boil away all the rhetoric and complexity of the system that has accumulated over the years and simplify the matter to the most black and white level, in our view, net producer prices have only to do with milk production issues and nothing to do with what it costs us to convert milk into cheese.

Dealing With Whey. They are related, but one doesn't drive the other. Dealing With Whey. We dispose of our waste whey stream by converting it into a dried popcorn whey product for animal feed because. Our 2005 average cost per pound to produce is greater than the Department's current studied whey processing cost figure of 26.73 cents as based on our internal cost model, and therefore significantly above the 20 cents currently in the 4b formula. The shortfall is accounted for in our regards as an additional cost of making cheese.

In the 15 months since we last testified about our whey processing capabilities, we underwent a formal cost-benefit modeling exercise to address the viability of processing whey differently than we do now. We discovered that economies of scale play a very significant role in reaching a critical mass of volume necessary to overcome the baseline fixed cost of such an installation.

It takes a certain baseline level of investment to built a new whey plant infrastructure. From there, incremental investment can be determined by the projected size of the whey stream to be processed. The larger the whey stream, the shorter time required to recapture the baseline cost of a whey plant.

We looked at about 10 different approaches for liquid and powder WPC at various protein concentrations, liquid and powder permeate and partially processing the whey stream into a 65 percent liquid to be dried at another facility. In our looking, we included preliminary site design and receiving responses from requests for quotes on the required equipment. One facility offered to take our potential 65 percent liquid into their WPC-80 plant, but we could not find enough revenue between us to cover the dual baseline investment and the transportation costs to transfer the liquid to them.

For that project, we attempted to find a reliable price index to value our 65 percent liquid. One thought was to tie their WPC-80 sales to the WPC-34 price index and then relate it to our 65 percent liquid as a direct percentage or a sales price make allowance scheme. That negotiation bogged down when we agreed there was not sufficient correlation between the 2 price curves for the type margins that we were looking at and that WPC-80 might not consistently be the end product produced.

The best approach we observed of the 10 or so, assuming our existing cheese-making capacity and assuming no increases in our milk premiums, resulted in the need to operate at a 24/7 pace for around 7 years in order to recover the fixed costs incurred and achieve a reasonable return on our investment. We have no belief our milk premiums will not rise over that term and could not therefore commit to an investment that could be as much as twice the total cost of our existing plant equipment.

The 4b Floor. We believe that in all fairness floor prices should remain out of the 4b formula. We must maintain an environment of shared risk between producers and processors. It is not in the best interests of current and future cheese processing in California to have the processors indemnify the producers in low markets through the use of a floor. This is especially true when the processor doesn't materially participate in the benefits of higher cheese prices when those markets occur.

The Petition and Selected Alternative Proposals.

We support the Dairy Institute of California proposal as outlined in their petition because we believe they fairly reflect proper economics necessary to maintain a successful working relationship between the producers and the processors.

Without an expectation for a reasonable return on investment, new processing capacity will not come to California as we have seen over the last 6 years. Specifically, Farmdale cannot consider investing the capital necessary to upgrade our whey plant and with increasing regulatory controls and pressures within the dairy industry and in the general business environment in

California, we are now looking outside the state for an opportunity to expand or relocate.

The Western United Dairymen proposal states quote, "This proposal would reinstate the floors that were eliminated as a result of the February 2005 hearing.", end quote. What is lost in this statement is that those same floors were only put into effect in 2003 in a politically charged hearing environment. The 2005 removal was a proper correction of a prior improper decision, a mistake that need not be repeated.

As to quote, "...the timing could not be worse for the call of a hearing that seeks to lower producer prices", we reiterate our assertion that net producer prices have nothing to do with what it costs us to convert milk into cheese.

The Alliance of Western Milk Producers' proposal advocates indexing energy costs. This seemed an interesting idea to us from the standpoint of keeping things as current as possible. On further reflection however, indexing an electricity component will open a door to indexing more components and make an already complicated process more complicated. And we question just how the mechanics of such an index would work.

Considering the variety of electricity producers and the procurement contracts employed around the industry, we think that the current annual survey is an adequate methodology for our purposes. As to the cost of whey production, our own whey processing cost data above stands in stark contrast to Dr. Ling's assertion of .1141 cents per pound. As to dry whey make allowance snubbing, we apply our same argument against flooring, let the markets work.

The California Dairy Campaign proposes a very low make allowance. Again diversity in practices and costs around the state may make such a system too complicated, so we favor the status quo. We would be happy to participate in an investigation in to discussions surrounding or a model-building exercise to assess the viability of indexing the make allowance or its components, but to change to such a system at this time without adequate planning would be highly disturbing to our operations.

Having said all that, the CDC also proposes flooring prices and snubbing the whey make allowance, which seems to contradict the sharing intent of their variable make allowance idea, share and share alike, both risk and reward.

HEARING OFFICER KRUG: You have about 2 and half minutes left.

MR. HOFFERBER: Thank you.

The Milk Producers Council proposal expresses grave concern about Dairy Institute's increasingly aggressive approach. This comment, is an our view, testimony to the validity of the Institution's petition. It is time for the cost-justified make allowances to be based upon the unbiased data collected and not based upon water-down, ignored or protectionism-filtered assertions as to what the data should be. Again, flooring, snubbing, indexing, tweaking, kicking and screaming all add complexity to the process and reduce market efficiencies.

As to Package B and the comment quote, "That modern cheese plants seldom, if ever, make whey cream butter Grade B..." end quote, we must assert for the record that the "if ever" portion can be stricken as we do convert our whey cream into Grade B butter. Oh, and we think we are a modern plant having completely retool our cheese line over the last 6 years.

In summary, we continue to believe that a whey factor should not be included in the pricing formula as a way to increase overall producer prices. The concern voiced in '03 and '05 was that having such a factor in the formula would mostly serve to complicate matters already too complicated and that has certainly come to pass. See how different ideas we are contemplating at this hearing. The benefit to producer revenues surely has not been what was hoped for. If it has had the desired effect, why did the producer-driven proposals seek to change the whey factor construct in the formula.

Lastly, I recently ran across this piece in my E-mails one fine day when the California anti-business gremlins had gotten the best of us:

Get fined for reporting an accident in 8 and a half, instead of 8 hours, W dollars;

Develop and implement a high pile storage plant for a city fire department that does nothing to enhance their ability to respond to a fire, X dollars;

Modifications to the sewer discharge system that have no benefit to the city sewer plant, Y dollars;

Develop and implement a risk-management plan for a county fire department in a 50-year safe ammonia operation, Z dollars;

Getting my business the hell out of California, priceless.

(Laughter.)

MR. HOFFERBER: By the way, the total of W, X, Y and Z was $395,000.

With out request for the ability to submit a post-hearing brief, this testimony is respectfully submitted.

HEARING OFFICER KRUG: Your request to submit a post-hearing brief is granted. Before we start with the panel questions, I'd just like to reiterate, during your testimony you made reference to other documents you might have or documents or information you think the Department has or should have in consideration of this. Keep in mind our record of this is a public document, but we only can consider what is presented to us. If you have anything in addition, please provide it.

MR. HOFFERBER: So when we're quoting our prior testimony, we should then attach that prior testimony to the post-hearing brief?

HEARING OFFICER KRUG: No, that's not necessary. You were making reference to some other cheese plants and their progress, what's occurring with them, that's what caught my attention.

MR. HOFFERBER: Are you talking about my comments regarding the Hanford situation?

HEARING OFFICER KRUG: Yes. If you have some additional information you think we should consider, you need to present that to us.

MR. HOFFERBER: Sure.

HEARING OFFICER KRUG: Okay, thank you.

Does the panel have any questions for these witnesses?

Mr. Gossard?

MR. HOFFERBER: It's a new day, Tom.

AGRICULTURE ECONOMIST GOSSARD: In your testimony you mentioned the diminishing Chino milk supply. You also said that you had been given consideration to relocating out of state. Two things, has the milk supply in southern California become a problem for you -- the diminishing supply, I'm sorry?

MR. HOFFERBER: Because of -- there was some discussion earlier here about that being about balancing plants and balancing capacity. And a little plant our size often has played that role in the past. When supplies got heavy, we would be approached by our suppliers to take additional milk. We are not getting that call at this point. We think, though, what we would have been getting called to do is being absorbed at this point by DFA's plant in Corona, through the arrangement they've got going with CDI in that thing.

There's a whole broad discussion about the impact of the Corona plant on our outlook and our future. If you take the Corona plant out, the argument for the milk supply might change. But every time we think that might actually happen, something else changes in their business model that keeps them in place, which continues to keep pressure on us, keeping us away from making a long-term decision to stay put. That's the crux of the problem there. They're so big that if they were to go away, there would be a flush, again for a time, for a plant relative to our size, assuming no new capacity comes on line in the southern area.

AGRICULTURE ECONOMIST GOSSARD: On page 2 of your testimony you mentioned your concerns about sales below cost. Have you formally brought your concerns to the Dairy Marketing Branch, particularly the Enforcement Unit?

MR. HOFFERBER: No, not formally.

AGRICULTURE ECONOMIST GOSSARD: Wouldn't that be appropriate, if you have these concerns?

MR. HOFFERBER: Yes, it would.

AGRICULTURE ECONOMIST GOSSARD: You spent some time discussing what is and is not an audit. When you talked about the GAAP financial statement, that would be a general financial audit, which has a certain specific meaning, it's one type of audit?

MR. HOFFERBER: Sure a GAAP audit is what you see presented for concerned business, where an opinion has been rendered on whether those financial statements fairly present the position of the company. It's a traditional company financial statement, and the audit thereon examines that through auditing procedures and tests and whatnot so that the auditor can render an opinion as to whether they think that financial statement fairly presents the condition of the company.

That is the capital audit. But there's all kinds of other small "a" audits, which is the point of what I'm talking about.

AGRICULTURE ECONOMIST GOSSARD: Finally, you were address the Alliance of Western Milk Producers' proposal for indexing and you mentioned electricity. Their index actually uses natural gas.

MR. HOFFERBER: Okay.

AGRICULTURE ECONOMIST GOSSARD: Would the same statement apply if you substitute natural gas?

MR. HOFFERBER: Sure.

AGRICULTURE ECONOMIST GOSSARD: The variety of natural gas providers --

MR. HOFFERBER: Sure. Oh, absolutely. In fact, we're probably more aware personally -- as a company more aware of different ways of going about procuring natural gas, you know, for pricing and whatnot sort of agreements. Everybody is going to be in way different places depending on their particular risk tolerances as to what they're actually paying.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

MR. HOFFERBER: Yes.

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: No.

HEARING OFFICER KRUG: Mr. Ikari.

DAIRY MARKETING BRANCH CHIEF IKARI: No, I don't.

HEARING OFFICER KRUG: Thank you very much. You're excused.

Our next witness is Patricia Stroup.

Is the witness ready?

MS. STROUP: Yes.

HEARING OFFICER KRUG: Okay. Thank you, Ms. Stroup. Will you please state your full name and spell your last name for the record.

MS. STROUP: Patricia Stroup, S-t-r-o-u-p.

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

MS. STROUP: I do.

HEARING OFFICER KRUG: Are you representing any organization today?

MS. STROUP: Yes. I am representing Hilmar Cheese Company, and I developed this testimony in cooperation with the staff there and it's approved by the chief executive officer and the board of directors.

HEARING OFFICER KRUG: So is this testimony -- this is Hilmar Cheese's testimony?

MS. STROUP: Correct.

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?

MS. STROUP: Yes, a statement titled Statement of Patricia D Stroup on behalf of Hilmar Cheese Company Incorporated.

HEARING OFFICER KRUG: Okay. I have a document here you previously provided to the panel. It will be marked exhibit 70, 7-0, and it's now admitted into the record.

(Thereupon the above-referenced document was marked Exhibit 70.)

HEARING OFFICER KRUG: You may proceed.

MS. STROUP: Thank you.

I am the Director of Dairy Policy and Producer Services at Hilmar Cheese Company Incorporated, which I represent today at this hearing. Hilmar Cheese Company operates a cheese and whey products facility in Hilmar, California.

This plant currently processes approximately 12 million pounds of milk per day into American-style cheeses such as cheddar and Monterey jack. In addition to our California facility, Hilmar Cheese Company is building another American-style cheese plant in Dalhart, Texas, with plans to begin operations in the fall of 2007. We plan for the Texas plant to eventually process at least 9 and a half million pounds of milk per day.

My qualifications for presenting this testimony are attached as Appendix A. Hilmar Cheese Company currently procures milk from about 275 direct-ship California dairy farms, as well as from several California cooperatives and other proprietary handlers.

My testimony today is in support of the petitioner's request for changes to the Class 4b formula. My time will focus on a few of the specific details of the formula and explained from our perspective why there must be changes.

Hilmar Cheese Company's support of changes is based on 2 primary factors. First, the minimum regulated price dictated by the Class 4b price is too high. Second, the regulated pricing system in California suppresses product innovation and handicaps our state's industry because of its lack of flexibility. When compared to other regions of the United States and particularly to other areas of the globe, California's system is restrictive and stringent. I understand that this pricing system is designed to protect and enhance dairymen income. And I also realize that current dairy commodity prices make now, in the eyes of dairymen, an unfortunate time to change that system. However, we are at a cross-roads in the state where the short-term producer returns are battling against the long run success of this entire industry. Currently, the short-term is winning and it does not bode well for the future of our industry.

We at Hilmar Cheese Company are for high producer prices, that is why we were founded, to return more money to dairymen, but high regulated prices are not the answer. I understand the motivation behind pooling, but pushing minimum class prices up so that there is more money from certain products to redistribute is not a long-term solution to improving producer income. We want an industry that is innovative and brings in more dollars to producers because of increases in demand due to innovative and popular dairy products, not an industry that simply redistributes dollars we already have, and in the case of Class 4b right now, dollars we really don't have.

High regulated prices that incorporate proceeds from all dairy products even byproducts like whey, do nothing to encourage innovation. In fact, at this extreme, pooling only takes money from those producers who have invested in innovation and consumer demand and gives it to those who haven't.

Did any of us go out last year and purchase a computer manufactured in 1991? I would venture that none of us did. Why not? Because there are newer and better models. There are computers now that meet our needs better than those manufactured 15 years ago. The State's behavior in not allowing manufacturers the margins necessary to invest in research and development, and more importantly trying to incorporate every one of the new products into a regulated price gives manufacturers little incentive to innovate.

So what happens? We end up with an industry with shrinking Class 1 is utilization because consumers turn to other, more innovative and interesting beverages. We end up with a shrinking Class 4b utilization, because protein consumers turn elsewhere, like to soy, and cheese makers can't afford to do business here, and we end up with a growing Class 4a utilization because we have a federal support program, not real customers that will buy the product. We are still pursuing dairy policies and a regulated pricing mind-set crafted many decades ago. That hard drive is crashing. So, in the dairy industry, consumers are left buying 15-year old computers. And you know what? They're not interested. Is that the future we want for the industry of this state.

A minimum regulated price should be just that, a minimum. Unless the regulated price level for milk is decreased, dairy companies will not build facilities in this state, dairy companies will not try to make innovative products in this state, and dairy companies will choose to expand facilities outside of this state.

This hearing distills down to basically one thing, regulated price level. The regulated price level is too high. I will go in to the details of what is driving that later, but the result is that it is pushing dairy processing facilities out of California and it is scaring away potential investors. Sure, there are other reasons that businesses are anti-California. But you add an inflexible regulated price of milk to that, and you erase any glimmer of opportunity that processors might see here.

So, if processors choose not to put in manufacturing capacity in California, what happens? Will growth in milk production in California stop? Contrary to economic logic and the opinions of some producer leaders, it's apparent that milk production will continue to grow. If proprietary processors choose not to grow capacity in the state, producers themselves will need to build plants to accommodate the excess milk production.

What will they build? The margins for cheese plants, as you've heard already many times yesterday and today, are not high enough to justify building cheese facilities, and the demand for Class 1, 2 and 3 is not increasing fast enough to stimulate -- or at all to stimulate processing growth in those sectors.

That leaves Class 4a. Sure enough according to news releases the next major diary plant to come on-line in California is a Class 4a plant owned by producers and is slated for 2007.

Given historical growth in milk production in California, we can expect a conservative average increase in milk production of about 3 to 4 percent. That's enough new daily milk production to fill a new plant every single year. With the current structure of the regulated pricing formulas, we must assume that all new production will go into class 4a products, not even considering the likely drop in butter prices because of increased production and only using historic commodity prices, increases in Class 4a utilization means decreases in producer pay prices, so the long-term loses.

Hilmar Cheese Company supports the elimination of the whey factor. There are several mechanisms that are driving the high regulated price in California. First, the inclusion of the whey factor in the Class 4b price without an accurate make allowance has driven up the regulated price. What CDFA estimated using historical markets as a .19 cent increase in Class 4b price, when the whey factor was implemented has turned into a .37 cent increase and more recently a .66 cent increase. Because of this, cheese maker margins have been driven down to critical levels.

I've attached an illustration of the cheese milk spread as Appendix B. If you look at that graph, what I have is the CME price times 10, minus the Class 4b price. Cheese makers don't get the CME price, because cheese is usually sold in discounts to the CME, but you can use this as an index. We also probably pay more than the Class 4b price because of premiums.

But if you just look at this little index, you can see that simple cheese margins were relatively consistent until the implementation of the whey fact or.

While the absolute milk costs are not as simple as Class 4b because of premiums, it is safe to say that what used to be a fairly consistent spread between cheese prices and milk costs has turned into a rollercoaster headed downhill. Whey proceeds have not increased to make up the difference. One of my employees summarized this graph aptly. He said, "It looks like we built an industry in this state and now we are trying to kill it."

It is no secret that Hilmar Cheese Company eliminated its minimum premium payments this year. Frankly, we did this because we could not afford them. Only 22 percent of our producers now receive premiums. So much of our revenues are going into the Class 4b price that we have little left for premiums. The biggest danger in incorrectly setting a minimum price is if that price is set too high. If it is too low, the marketplace will step in and competition will increase premiums to producers, but the minimum is too high, there is no remedy. The inability to pay premiums essentially means that only ranch to plant transportation cost differences will move milk.

This strategy assumes that all milk is the same. We would argue that it is not. Milk has a highly complex chemical makeup and can differ greatly. Premiums should be available to attract different milks to different markets, to move each milk to its highest and best use.

The excessive regulated price is not a problem unique to California. Cheese plants in federal orders have addressed part of this problem at an emergency federal hearing earlier this year. Other issues related to the federal order pricing and its whey factor will be addressed in the future. In the meantime, when whey prices become untenable plants in federal orders were able to depool and pay below the Class III price. I've attached Appendix C as a discussion of why Class III and Class 4b are not valid price comparisons.

Those plants in situations outside of regulated pricing systems have not faced the same challenges with whey pricing. Instead, they have been able to channel profits in to competitive cheese pricing, expansions and upgrades and attracting high solids milk to their plants.

I appreciate the challenges the Department faces in valuing the whey stream. So many diverse whey products are produced in California that it is difficult to choose a standard product an then to valuate manufacturing costs of that product. For that reason alone, the whey factor should be removed from the regulated price formula. I appreciate that hearing panel has agreed with this position in the past and the foundations for this stance still hold true.

Arguments could be made that diverse cheese products are made within the State and we manage to be able to use cheddar cheese as a base line for pricing milk going into all types of cheese. However, while cheeses are marketed into similar markets and generally priced off of the CME market, whey products have completely different end uses, and at some levels are not priced off of any published market at all. It may seem that an easy solution would be for all of us to price our whey products at some premium to a standard market.

However, this is not likely for 2 very important reasons. First, more than a third of whey protein concentrate is exported and faces international competition not reliant on U.S. published prices. Secondly, and extremely important for the long-term viability of the category, whey products' biggest competition is not from other dairy products, but from soy proteins. Soy is not subject to regulated prices and is not correlated to dairy prices, even dairy competition for whey proteins, usually skim milk powder is not included in California's regulated price. So we end up with a whey market place included in the milk price that may or may not be related to the markets that our whey products actually face.

In the case of a whey factor, it is very much a case of be careful what you ask for. The use of a whey factor encourages cheese plants to produce a certain type a whey product and risks oversupplying that market and causing extreme price depression. Because whey operations by nature are not flexible enough to switch drastically between products and because they are so capital intensive, investments in one form of whey can end up being a liability.

For example, since 1991 Hilmar Cheese Company invested $98 million into a whey protein concentrate facility and companion lactose facility. But the rules of the game have changed. Since the 2003 addition of the whey factor, we have paid for milk based on, among other things, the dry whey market. We do not make or sell dry whey, but do make whey protein concentrate and lactose. Per pound of protein, this meant buying whey proteins based on a market that has on average since 2003 been 15 cents per pound greater than what we sell our products for.

In 2005 and 2006 to date, the negative spread has increased to 39 cents per pound of protein. Because lactose is produced as co-product to WPC and the lactose cost of production is higher on average than its selling price, the difference between cost and revenue for whey solids is actually even higher for us. This is all exacerbated by an unrealistically low make allowance on dry whey.

I, by the way, am not a CPA, one of the few testifying who is not, but it does not take an accountant to figure out that this is a losing proposition. And if I were not able to figure this out for myself, the people who are CPAs at my company are in my office constantly reminding me of this fact. They point out to me that I cannot spend this much money for whey solids and still have a viable business. And my only answer to them is that I don't have a choice.

It is actually in the best interests of milk producers to have multiple forms of whey manufactured in California, because it results in a stronger manufacturing industry and more competition for milk. A whey factor gives cheese plants little incentive to produce diverse whey products. So a simply solution to the current pricing problem would be for all plants to simply dry whole whey as a disposal method.

Imagine the price decrease in the whey market if the majority of the whey stream went into a single product. Our engineers estimate that adding a whey processing facility to enable us to switch between whey and WPC facilities would mean an additional capital investment of at least $45 million, and would result in idle capacity in one of those plants all the time. Worse yet, it would mean trying to turn customers off and on to each of these products, which are generally not substitutable.

Removing the whey factor from the Class 4b pricing formula could bring the regulated minimum price back just to that, a minimum. Does that mean that whey proceeds will not be distributed to dairymen? Absolutely not. It just means that those proceeds will not be part of a regulated and pooled price, much as the proceeds from skim milk powder or buttermilk powder are not incorporated into the regulated price.

It has been suggested in an alternative proposal to construct the whey factor so that it incorporates more than one whey product. And perhaps that sounds like a good idea. However, there are several problems with this approach.

First, most of the testimony at both this hearing and at the 2006 federal order hearing revolves around the difficult in determining a fair and accurate manufacturing allowance. As it is, we only have 3 straight whey plants in California that we can use for a cost study. The numbers of each variety of WPC an WPI would be equally small. The WPC manufacturing allowance suggested by alternative proposals is at best capricious. As we have been analyzing the whey industry to decide how to cope, we did extensive analysis on the cost of production of various whey products.

As some in the industry like to quip, one thing we know for sure is that dry whey processing costs somewhere between 12 and 30 cents. Given that the CDFA cost studies are held up as a model for the industry, they are quoted at federal order hearings, have been used as a model for federal cost surveys, and are used extensively in other parts of the California milk pricing formulas, and given that the whey studies with significantly lower costs have been discredited extensively at this year's federal order hearing, the best that we can do to approximate the appropriate manufacturing costs for dry whey in California until it is removed from the formula is to use the CDFA numbers. That is what we do for cheese. That is what we do for butter. And, that is what we do for nonfat dry milk. It should be consistent for whey.

Additionally, while the alternative proposal calls for inclusion of WPC-34, this does not solve the problem of those manufacturing WPC-80 or WPI. And even including 34 would then mean that not even the makers of dry whey would have an input highly correlated to their markets. We constantly analyze the relationships between dry whey WPC-34 and WPC-80. Those relationships, as measure by R-squared values or correlations are not within any significant confidence level. Over certain time periods correlations are even negative, meaning the price of one product is going up while the price of another is going down. I have attached a graph as Appendix D that illustrates these unpredictable relationships.

You'll note that I have not listed, because of proprietary pricing reasons, I do not have cost per pound listed. However, the scale on the graph is accurate.

As a side note, an alternative proposal recommends pricing whey cream at the CME butter price. In our case, we do not reincorporate any whey cream into our cheese because the practice is known to cause quality and yield issues. I would not consider reincorporation of whey cream into cheddar cheese to be an industry standard. The CME butter price would greatly overvalue the fat in whey cream.

Hilmar Cheese Company opposes any form of a snubber including commodity price floors in the regulated pricing formula. From an economics standpoint a snubber introduces an artificial impact in to the pricing formula. The regulated price recognizes values for various commodities. When those commodity prices are lower than the cost of conversion, those commodities are a liability and should be reflected as such in the regulated price. A snubber shifts value back and forth between products in a random manner.

For example, a snubber in a whey make allowance overvalues the whey proteins in milk and necessitates that the revenues in cheese operations make up the difference. The components going into cheese are already accounted for in the formula and carry their own costs.

A commodity floor does the same thing. It puts an artificial value on one or more components in the regulated price. A floor in commodities in regulated California prices puts the entire burden of supporting milk prices above the federal order support level on California processors.

Finally, and most importantly, one of the purposes of a regulated price is to clear the market. When prices are at their most depressed, economics would indicate that the low prices are the result, at least in part, of high production. I don't think there's any doubt by economists that the low milk prices we are seeing now, are the result of huge increases in milk production. Why, at a time when milk production is too high, would we pay an artificially high price? For this reason, I also oppose any form of a variable manufacturing allowance that mutes supply and demand signals between the marketplace and producers.

Manufacturing allowances that share the gain and that share the pain may be politically attractive and make us all feel good, but from an economic point of view, they will actually exacerbate swings in milk production by distributing too much money to producers when milk production is high and not enough to producers when milk production is low.

We support an overall reduction in the overall regulated price. Last year in testimony I predicted that we would run out of processing capacity in the state by the end of 2006. Apparently, that has already happened. We feel that cheese plants will be shutting down in California within the next 24 months. That will take even more processing capacity out of the market.

As Director or Procurement at Hilmar Cheese, my staff and I have taken countless distress calls from co-ops and other handlers in California this year looking for a home for milk, and I quote, "at any price." This milk was and is clearly distressed. Dispatchers have told me that they are having to dump milk, that they were shipping as much as they could out of state, and the receiving stations at California plants had waiting times upwards of 10 hours in some cases. Hauling companies have complained to me that their milk trucks are being used as portable milk silos at other plants because those plants were out of room. Dispatchers have shared that they would send more milk out of state, but that so many trucks were tied up trying to get into plants within the State, that there were not enough trucks available to send milk out of state.

And, yet, if I wanted to buy that milk, I would have to pay the state-regulated price for it and not a penny less. Why? Why would I want to buy it when I know that I would not be able to recoup the cost of that milk in my final products because of the disconnect between the whey factor and revenues from our actual whey products? The minimum regulated price must come down.

Last year I reported to this panel that we were in the midst of a very difficult and consuming strategic decision. We knew we needed to expand our business by building a new plant. I pointed out some of the challenges that we see with doing business in California including transporting our product to market and the level of uncertainty of regulation in both milk pricing and business issues. I applaud this panel for making the right recommendation to the Secretary last year, when it suggested removing the whey factor and commodity floors from the Class 4b price. I'm extremely disappointed that the Secretary did not heed that complete recommendation.

In this case it lost the state of California a $190 million long-term plan investment, more than 1,800 dairy industry jobs and a home and viable market for up to 9 and a half million pounds of milk per day. The Perryman Group in Waco, Texas estimated in a report to the state of Texas that the total economic impact of our cheese facility to the region at maturity will be $2.3 billion and 11,000 total industry and support jobs. Processors will continue to make the conclusion that we did to avoid California if this state cannot make the decisions that are write for this industry as a whole rather than what is emotionally popular at the time.

I recognize that when dairy product prices are low, causing low milk prices, it is difficult to make formula changes. But there is no more capacity to process milk in this state and that problem will only get worse. The long term is at stake.

A couple of notes on prior testimony yesterday and today just as clarifications. I do note in the MPC written testimony that there is a table on yields that lists 3.7, 3.1 milk is producing 10.2. I just want to point out to the panel that that is true protein and not total protein in California. We use total protein, so if you had a 2.9 percent total protein, and 3.7 fat, that would be a 9.91 yield.

Also, as a note, on the federal order hearing, in questions of why we have not addressed the existence of a whey factor in the federal order hearing. The call of the federal order hearing in January was specifically limited to changes in the make allowances and we were not even permitted to discuss the possibility of removing the whey factor from the formula. That will be something that we address in the future.

Thank you for allowing me to express the views of Hilmar Cheese Company. I'd be happy to answer any questions you may have and be respectfully request the opportunity to submit a post-hearing brief.

HEARING OFFICER KRUG: Thank you very much. Your request to submit a post-hearing brief is granted.

Do we have any questions for this witness?

Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: On page 7 of your testimony you state, "The WPC make allowance suggested by alternate proposal..." -- from Milk Producers Council -- "...is not even close to the projected cost of processing WPC-34."

What were those projected costs?

MS. STROUP: That we projected?

AGRICULTURE ECONOMIST GOSSARD: Yes.

MS. STROUP: I think that that's a proprietary issue that I can't share. But if I can share it, and I will check, I will put it in a post-hearing brief.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much. No further questions.

HEARING OFFICER KRUG: Ms. Reed?

SUPERVISING AUDITOR REED: No questions.

HEARING OFFICER KRUG: Ms. Gates?

RESEARCH MANAGER II GATES: Just one.

Ms. Stroup, on page 10 when you spoke to the distressed milk in California and what was going on, if there's any documentation to that, could you include that in the post-hearing brief, when you were talking to the hauling companies?

MS. STROUP: Could it logs of phone calls?

RESEARCH MANAGER II GATES: That would be great.

Thank you.

HEARING OFFICER KRUG: Mr. Ikari.

DAIRY MARKETING BRANCH CHIEF IKARI: No questions.

HEARING OFFICER KRUG: Thank you very much, Ms. Stroup. You're excused.

Our next witness is Sharon Hale. Would you please come forward.

Is the witness ready?

MS. HALE: Yes.

HEARING OFFICER KRUG: Thank you. Will the witness please state your name and spell your last name for the record.

MS. HALE: Sharon Hale, H-a-l-e.

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

MS. HALE: I do.

HEARING OFFICER KRUG: Are you representing any organization today?

MS. HALE: Yes, Crystal Cream and Butter Company.

HEARING OFFICER KRUG: Could you please tell us how your testimony was arrived at today.

MS. HALE: The testimony was written by myself and approved by our president.

HEARING OFFICER KRUG: And is this testimony to be considered the testimony of Crystal Cream and Butter?

MS. HALE: Yes, it is.

HEARING OFFICER KRUG: Thank you very much.

Do you have any written statements or other things you would liken entered into the record at this time.

MS. HALE: Yes the one that I handed to you just a minute ago.

HEARING OFFICER KRUG: Thank you. I have a document here, Consolidated Public Hearing dated June 1 - 2, 2006. It's Labeled Exhibit number 71 and is now admitted in the record.

(Thereupon the above-referenced document was marked as Exhibit 71.)

HEARING OFFICER KRUG: You may proceed.

MS. HALE: Thank you.

Mr. Hearing officer and members of the panel, my name is Sharon Hale and I am vice president, dairy policy and procurement for Crystal Cream and Butter Company. Our administrative offices are located at 1013 D Street, Sacramento, California. We operate 2 production facilities in Sacramento that produce fluid, cultured and frozen dairy products. Our primary distribution area is northern California, but we also export ice cream mix and ultra pasteurized fluid milk to other countries. Crystal is a privately held company and this testimony has been approved by our president.

At this point in a hearing of considerable complexity and voluminous documentation, the panel may well be relieved to learn not a single chart or graph is included in my testimony.

(Laughter.)

MS. HALE: We simply felt the events this spring involving Crystal and the independent producers who supply our milk were unique, at least in my 22 years with the company, and relevant to the call of the hearing. Perhaps the Department will find them useful in its deliberations.

Manufacturing allowances. This hearing represents a mile-marker for Crystal, as it's the first hearing to be held without our company having a personal stake in the absolute level of the manufacturing allowance selected for use in the Class 4a formula.

Crystal ceased nonfat dry milk production in 2002, and earlier this year stopped producing butter. In both cases, we were simply priced out of the business as other manufacturers chose to grow and we did not. The economies of scale and the larger plants were reflected in manufacturing costs collected by the Department and subsequently translated into manufacturing allowances that were too low to sustain our operations. This was textbook economics and clearly an anticipated outcome.

Since abandoning the dryer, your approach to milk balancing has been to keep our independent supply at a point where minimum needs are covered and additional needs are met with supplemental purchases on an as-needed basis. This worked fairly well as we were able to place the seasonal excess -- we do a lot of school milk -- in local manufacturing facilities with relative ease. Our independent producers continued to grow, but periodic dairy departures often to urbanization created space for those who remain.

That was before 2006. Shifts in retail business and operational changes pushed our needs downward as dairies continued to grow. In February, we discussed our concerns about excess milk with large manufacturers and were given assurances that they would be able to help us out when the need arose. Feeling somewhat comfortable, our first calls went out during Easter vacation in April, only to be met with sizable limitations due to the lack of available processing capacity. We eventually placed some of the milk locally, moved some over 200 miles for processing and worked around the rest, which in turn causes operational and qualitative challenges that we had hoped to avoid.

By early May, we were able to anticipate the amount of excess milk we would generate due to schools going out for the summer and the flush volumes expected from our dairies. With this, we combined the cost of disposing of this milk and our bottom line fear that space would simply not be available to handle our excess milk. At that point, we made an extremely difficult decision that was not made quickly nor taken lightly. We notified our dairies they would be held to contract, thereby sharing the burden of excess milk with those who had increased their production over contractual amounts.

I tell this story because it's current and factual. Right now manufacturing capacity in the state is at a premium. Dr. Schiek of the Dairy Institute discussed in his testimony the need to attract investment into manufacturing facilities if California's dairy farmers are to grow in the future. Based on our experience, it seems critical that existing capacity be retained as well through adjustments in manufacturing allowances to reflect the current costs of converting milk in to butter, nonfat dry milk and cheese and urge the Secretary to use the

Department's own audit information and documented information from this hearing to make such a finding.

It's unfortunate I was unable to spare 2 days to listen to all the testimony at this hearing. I need to understand the thinking behind some of the alternative proposals, which advocate raising prices. We know producer prices are very low at this time, but how is the dairy producer to understand the market if not through price. Mandatory reductions on a selected basis will quickly create the "haves" and the "have nots" and generate another whole host of problems for the industry. And while higher prices signify the current volume of milk is okay and producers should carry on despite the very real possibility there will be no local home for that milk? I must admit, I am anxious to understand this perspective.

Class 2 and 3 prices. In light of the fact that neither the original petition not the alternative proposals for this hearing suggest altering the current relationship between Class 4a and Class 2 and 3 prices, we do not feel it necessary to address this issue in any length. We simply wish to go on record as supporting the status quo relative to the price relationships between these classes. Our expectation is that any adjustments made to Class 4 prices as a result of this hearing will carry forward for the current pricing formulas to Class 2 and 3. In addition, as a consolidated hearing, we anticipate changes would impact prices on an equal basis in both marketing areas.

That concludes my written testimony. I thank you for the opportunity to express my company's views and welcome any questions you may have.

HEARING OFFICER KRUG: Thank you, Ms. Hale.

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

MS. HALE: Yes.

HEARING OFFICER KRUG: Your request is granted.

Do we have any questions for this witness?

Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: On the last page of your testimony as regards to Class 2 and 3, with your understanding that the relationship between 2 and 3 and 4a will remain unchanged, would you therefore oppose any increase in the 4a price, based on its impact on Class 2 and 3?

MS. HALE: Well, we wouldn't relish it, but at this point in time we are wedded to the current connection, based on the way of this hearing and this process thus far.

AGRICULTURE ECONOMIST GOSSARD: Have you had any competitive problems with the current level of 2/3 prices?

MS. HALE: We have an ongoing competitive issue in these products, and I have testified to that in the past. Basically though, some of those, particularly the Class 3 products are storable and transportable, and do in fact come in from other states. Class 2 products as well as sour creams easily come in from out of state, other cultured items. Yogurts come in from out of state. And it's not a situation that has improved through the years. We continue to get more and more national providers of these items and we see that more so in the marketplace than we ever have in the past.

AGRICULTURE ECONOMIST GOSSARD: Thank you. No further questions.

HEARING OFFICER KRUG: Any additional questions for this witness?

Mr. Ikari.

DAIRY MARKETING BRANCH CHIEF IKARI: Let me see if I can ask Tom's question in a different way. If the Department decision resulted in a decrease in the Class 4a price, I assume that Crystal would be in favor, as you've testified. But assume that the Department's decision on Class 4a price resulted in an increase in the Class 4a price, would your position -- your company's position be the same?

MS. HALE: I think, as I indicated, it's not something that we relish. We don't want the prices actually to go up and change our competitive position, but I don't believe that this -- the way this hearing has progressed to this point that the rest of the industry addressed this issue well enough probably for you to make that decision.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. I wondered if you could provide, and you can do it in a post-hearing brief, but if you can give us any -- put it in terms of numbers percentage, when you notified your dairies that they would be held to the contract, how much was that excess production going to be cut back or what percentage of what you were receiving?

MS. HALE: The total amount may well be somewhat proprietary, but I can tell you that a good number of the producers it will not impact at all, because of the way their operations are situated now compared to our contract period is based on October, November and December. We went from 0 up to 15.9 percent, and that was based on production that we had received from these same dairies the first week of May. And now that the end of May has come, their production has increased even more so, so those percentages are probably off a bit. So some of them had a significant decision to make because of the impact and others it was minimal.

DAIRY MARKETING BRANCH CHIEF IKARI: Have producers given you notice for that because of that reason or --

MS. HALE: Yes, we have had a variety of responses certainly and we understand very well. Their initially actions were shock, anger, those sorts of things. We have told them all that we want them to make decisions that are appropriate for their business. Because we started the process, they have to make decisions now that will keep them viable. And so we have, in fact, received notice from 2 shippers that they can't live with this. We have one, I know of, and one probably and maybe one more by today that has made the decision to ship to us their contract amount and then ship to someone else the additional portion. And then we have I know of one that has already sold a significant number of milking cows and we have some that are looking at nutritional solutions. So they have chosen a variety of ways to come in to compliance. And our deadline is the 15th of June, so we're right at a period where we are learning what their choices are.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

HEARING OFFICER KRUG: Any additional questions for this witness?

Not seeing any additional questions, thank you very much Ms. Hale.

MS. HALE: Thank you.

HEARING OFFICER KRUG: You're excused.

Our next witness is Case Van Stein.

Is the witness ready?

MR. VAN STEYN: Yes.

HEARING OFFICER KRUG: Mr. Van Steyn, would you please state your full name and spell your last name for the record.

MR. VAN STEYN: My name is Case Van Steyn and the last name is V-a-n space S-t-e-y-n.

HEARING OFFICER KRUG: Thank you, Mr. Van Steyn. Do you swear or affirm to tell the truth?

MR. VAN STEYN: Yes.

HEARING OFFICER KRUG: Are you representing any organization today?

MR. VAN STEYN: I'm support -- I'm the president of Western United Dairymen. I'm supporting their testimony, but not in detail, just as supporting their position.

HEARING OFFICER KRUG: So you're not representing Western United Dairymen?

MR. VAN STEYN: In my comments today I'll represent myself.

HEARING OFFICER KRUG: Thank you. Do you have any written statements or other things that you would like to be admitted?

MR. VAN STEYN: No, I do not.

HEARING OFFICER KRUG: Okay. Thank you. You may proceed.

MR. VAN STEYN: Our family has been in the dairy business since -- in California since the 1950s and this is not forte testifying and I didn't prepare anything on purpose. I had some notes and I tossed them to be able to do this. So it reminds me of recently a friend of mine or another person told me that if you're not at the table, you'd probably be on the menu, so I decided to attend this function and see if I can get through it.

We've been in the dairy business since the fifties. I have witnessed, when I was a few years younger, what happens when you have a home for your milk or a contract one day and no contract the next, and how that affects families and dairy people, employees, et cetera, and how those frustrations and stresses go forward. And we have worked, myself included, and the dairy industry, to come up with a system in California that in my opinion is probably one of the premier systems -- one of the best systems in the world that I've ever heard of being -- having a stable system, a -- with some -- with a quality product, delivered to the consumer at a reasonable price. And I do believe that we have maintained with tweaks and pulls and tugs accomplished that.

And we have had issues with out-of-state pricing or out-of-state milk moving around. And slowly but surely, you can win some you lose some, we keep coming around to the -- you know, it ends up where we can live with it or adjust to it or make it work or continue litigation. You can always do that, but that, as we all know, that's expensive.

And, you know, the system we have we didn't get there by accident. It's slowly -- we added things to the formulas, if you want -- you know talking about whey and the potential in the discussion of taking it in or out. We've added things and taken things away and tweaked here and there, and it's still working.

Right now the prices are at an -- not maybe all-time low, but they're pretty darn bad. So you better have a good relationship with your bank if you're in the dairy business today, because that's where it's going to be at. If they won't support you, you're not going to be around long.

We assumed that the future will adjust and the things will come around. But when we have a system like we have, my distress or my concerns are that some of the comments I'm hearing we seem to have an attitude of maybe dismantling it or slowly pulling and tugging at it that will cause pressures that could end up unraveling it, and that's a very critical concern of mine, because I remember what it was like when we didn't have any security as a dairy farmer. When you invest in a cow or a calf today, you're looking out 3 years, 2 to 3 years, to get any return and longer actually to cash flow that particular animal, as with feed and facilities and building -- adding facilities.

So it's not a price cycle thing. You make commitments for a lot longer. And we need and we have gained some stability through pooling and pricing that are even, you know, better than a lot of things in the federal order, where you have depooling and things that can tweak it the other way from a -- to an advantage for somebody else.

And I'm -- there are adjustments that need to be made, I'm sure, in time. But I'm very concerned that at this time with the prices where they are, that making significant changes followed in the proposal by the Institute are going to hurt the California dairy industry farther than we can anticipate today and will have longer term effects. We have needs, and I understand those, and

I'm willing to discuss those or listen to those. But basically lowering prices for -- at point in time when it's already at a very negative state it's hard for me to understand or why we would want to go there when the basic needs I see is that processors are on a level playing field and have an equal advantage in competition with each other. And we should maintain some relationship with surrounding states on pricing.

And I think that we are not out of range in those areas. We're not getting into specifics, because I didn't bring any notes with me purposely, so that I wouldn't get caught in that trap because my numbers are -- there's better people out here, including Tiffany and Mike that do the numbers than I probably could.

So anyway those probably are my thoughts is that if you guys when these decisions are made could specifically consider those parts of it that we -- the job of doing these hearings and moving forward on these things is also to protect the consumers, protect a quality, a viable supply of milk at a reasonable cost and relationship. And in most things I found bottled water higher than milk, so I think that relationship is probably adequate.

And those are the benefits of the hearing process is also to look out towards the future and accomplish things that as they might impact the future of the dairy business. I think I covered my basic points. If I missed anything, I'll be happy to reconsider.

HEARING OFFICER KRUG: Thank you very much, Mr. Van Steyn. Would you care for the opportunity to submit a post-hearing brief?

MR. VAN STEYN: Not at this time.

HEARING OFFICER KRUG: No request?

MR. VAN STEYN: No.

HEARING OFFICER KRUG: Okay. Are there any questions for the witness?

AGRICULTURE ECONOMIST GOSSARD: No.

HEARING OFFICER KRUG: Not seeing any questions, Mr. Van Steyn, you're excused.

Thank you very much.

MR. VAN STEYN: You guys let me off easy, so that's good.

Thank you.

HEARING OFFICER KRUG: Our next witness is Ray Souza.

MR. SOUZA: My name is Ray Souza. I'm a dairy producer -- third generation dairy producer --

HEARING OFFICER KRUG: Excuse me. Just so I can get you to go through the formalities.

MR. SOUZA: I'm sorry. I was in a hearing last night till quite late, so I'm a little off balance. I'm ready to finish this thing.

HEARING OFFICER KRUG: You're in the starting gate. Okay. Would you please state your full name and spell your last name for the record.

MR. SOUZA: My name is Ray Souza. Last name S-o-u-z-a. I'm a dairyman in Turlock, California.

HEARING OFFICER KRUG: Okay. Thank you.

Do you swear or affirm to tell the truth?

MR. SOUZA: Yes, I do.

HEARING OFFICER KRUG: Are you representing any organization today?

MR. SOUZA: I'm a member of Western United. I'm currently their vice president. I support their testimony, but I will be testifying on my own behalf.

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

MR. SOUZA: The only thing I have written is some notes and you wouldn't be able to understand my handwriting or read my handwriting anyway.

HEARING OFFICER KRUG: Okay. Thank you very much. You may proceed.

MR. SOUZA: Thank you. As I said, my name is Ray Souza. I'm a third-generation dairy farmer from Turlock, California. I'm here really to speak to the issue of plant capacity and how it relates to the testimony here.

In my family, the first generation, my grandfather, when he spoke of tough times, he talked about the hoof and mouth disease, which took his herd out many, many years ago. My father, the second generation, when he spoke of hard times, he spoke of the pre-pooling inequities that he dealt with as a family and how fortunate we are to have a pooling system in California that works as well as it does.

I speak about plant capacity. I lived through the time in California when there simply wasn't enough plant capacity and we had to move milk and find a home for it wherever we could. In those days, of course, it didn't travel quite as far as it can today, but it was still an issue. I am very well aware of the serious problems that limited plant capacity can bring to California.

Unfortunately, I believe that some of my producer friends still believe that somehow restricting plant capacity will someway raise prices to producers. I'm here to tell you, as living through it, it doesn't. And I keep talking about living through it, I feel like I'm talking about history. And as I look at my fellow dairymen and look at their hair coloring, and I look at my own I kind of feel like I'm the Taylor Hicks of the dairy industry.

I'm the gray-haired guy now, so I can talk a little bit about history.

The idea of raising -- of restricting plant capacity and somehow producing a less finished product while raising the price to producers is strictly a fallacy. The experience that I had was that we were pretty clever in finding ways of getting our milk processed. We had milk moving out of state. I know personally at some point in time I had milk going to Idaho at a cost of about $6 a hundredweight, which was just about the entire price of milk I was getting at the time.

So that's what led to this whole issue of how were we going to handle it, and we developed the cheese industry and part of that was the make allowance. And I think the make allowance in conjunction with developing a new market, the cheese industry, which we really weren't players in the cheese industry, was very successful. We are a major cheese producer today, as you know. The second largest cheese producer in the nation and probably soon to become the leading cheese producer in the nation.

So I think the argument that it's not a friendly climate for cheese producers, we have to examine that closely, because history doesn't tell us that. We've had an expanded cheese market and an expanding ability to produce cheese.

I can tell you that I make a living -- I'm not an economist, as you clearly can tell. I make a living milking cows. We milk cows. We try to pay our bills. We raised our family. We put our children through school. It appears that I may be the last one willing to do so.

But I'm concerned. I'm still -- just the same, I'm very concerned about the future. This decreasing price of living through now -- someone said earlier today that it's an unfortunate time to lower milk producers. I think that's terribly understated. That to me is equal to saying Napoleon picked an unfortunate time to go to Waterloo. It's disastrous. We cannot take another hit. We are far below the cost of production.

The cost of production today we're looking at -- we're typically -- dairy farmers are generally -- at lest like to talk about price, but we're far below -- price isn't the issue. It's the margins that are the issues. We've seen these kind of prices before, but not with these kind of expenses. Hay costs are at an all-time high, and you've heard this before. And it is doesn't look like it's going to get any better. The future tells us now that we're going to be dealing with competition for our corn. In looking at corn next year, I contracted corn 2 years ago for $105. Next year's corn price is $140.

We thought that our $200 premium hay cost last year was a temporary issue. They're not. The delayed rains this year in the spring have basically for all practical purposes ruined the hay crop in California. My brother deals in some hay, he's telling me he's having trouble finding hay over 53 or 54 percent total TD, Total Digestible, nutrients, and that's really inferior hay. So we don't -- I don't see these prices coming back, as far as our costs go.

When I talked -- yesterday I had lunch with a banker. He's kind of a portly guy and he usually has a big lunch. He really wasn't in to eating lunch yesterday. And I asked him what the problem was. And he was very upset. He was going to see one of his old friends, one of his old customers and count his cows because they're taking him out of business. The milk production is going to slow down.

This is an industry that doesn't stop on a dime. It's like trying to stop a train, as opposed to trying to stop a Volkswagen. It takes time to reduce -- to cut down production. And we don't do it individually. We don't sit there and look at our operation and say well, we need to reduce our production by 10 percent. We can't afford to do that. We need to maintain certain efficiencies.

The way this industry slows down is you take out -- individual producers go out of business, and that's how it's going to slow down, but that takes time. And so the rest of us have to wait through -- those of that survive. And I don't know that I'm going to and I don't know that anyone in this room is going to, even the producers here. But to do that we just -- it's a game of attrition. And once it does turn around we're all injured. It takes a long period of time for us to recover, even those that do recover.

But I will tell you, even though as concerned as I am with the plant capacity. And it's an issue that has been long held by me as an important issue -- being again -- having been seriously affected by that. I don't know that reducing make allowances or devaluing producer commodity prices values in their milk at this particular time is a way to do that. That is not a long-term solution to plant capacity.

As I stated before, the make allowance system is a wonderful system. I think we have the premier system in the country. It is designed to keep plants in California. But it was successful only because we had a second component with that. We were committed to an expanding cheese industry. Those 2 together are what led to the success. Increasing make allowances to keep cheese plants or any type of plant afloat, that alone is not a long-term solution. If we break -- if we do make this significant -- what I believe to be a significant policy change, I think it could lead to some very serious consequences down the road.

If producers or plants get the idea that we can at anytime that we need to -- that we're going through some economic difficulties, we can come to a hearing and basically extort monies from the processor -- producers from the processor or conversely processor from the producer, I hope we're ready to hold a hearing every week. I think that will lead to additional hearings. I think it will change the entire flavor of hearings, and I think it could further divide our industry.

I think that this hearing's decision today has to be based on the evidence presented, the cost verifications for make allowances, and be careful that we don't undervalue the commodities in our milk strictly for the purpose of increasing plant capacity. We need to keep the 2 issues divided. I also would suggest that I think out of this hearing -- one of the good things that's going to come out of this hearing is raising the issue of plant capacity, because it's kind of been something that producers don't generally talk about when they're trying to deal with $10 overbased milk and $200 hay and $140 corn, plant capacity -- once that milk leaves their farm, out of sight, out of mind.

I think this hearing is going to be very helpful in a sense it's going to raise that issue, that you'll see producers talking about it, and understand the importance of it. And I hope out of that, we can get to a reasonable long-term solution through a good industrywide strategy, comprehensive strategy, that's going to include producers of all commodities -- or processors of all commodities and producers as well, so we can get to a real solution for our plant capacity issue, without trying to tweak it through some kind of make allowance formula change or a devaluation of a particular commodity.

With that, that concludes my comments.

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

MR. SOUZA: I don't believe so.

HEARING OFFICER KRUG: Okay. Thank you very much. Are there any questions for the witness?

AGRICULTURE ECONOMIST GOSSARD: No.

HEARING OFFICER KRUG: Not seeing any questions, you're excused. Thank you very much.

Our next witness is David Inman.

Is the witness ready?

MR. INMAN: Yes.

HEARING OFFICER KRUG: Mr. Inman, would you please state your full name and spell your last name for the record?

MR. INMAN: My name is David Inman, I-n-m-a-n.

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

MR. INMAN: I do.

HEARING OFFICER KRUG: Are you representing any organization today?

MR. INMAN: Well, I am a member of California Dairy Campaign and I support their testimony. I'm a dairy producer and I also am a co-founder of a group of producer friends we call U.S. Milk.

HEARING OFFICER KRUG: Are you representing them or is your testimony on your own behalf?

MR. INMAN: I am U.S. Milk. It's just my friends, so I'm presenting testimony today as a dairy producer.

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

MR. INMAN: Just my testimony.

HEARING OFFICER KRUG: Okay, and that's the document that you just passed out to the hearing panel?

MR. INMAN: Yes, sir.

HEARING OFFICER KRUG: I have a document here.

It's dated June 2nd, 2006, identified as from David Inman. It is labeled Exhibit number 72 and is admitted in to the record.

(Thereupon the above-referenced document was marked as Exhibit 72.)

HEARING OFFICER KRUG: You may proceed with your testimony.

MR. INMAN: Okay. I'd like to preface this testimony that some of these, where I was informed I would only have 3 minutes to testify, so I made a statement here kind of as a -- a lot of -- some of this is tongue and cheek, but it is a little bit harsh and very quick, because I knew my time would be limited, so I apologize, but --

HEARING OFFICER KRUG: This is not the 3-minute period. You have your full 20 minutes.

MR. INMAN: Thank you, I appreciate that.

Mr. Hearing Officer and panel, my name is David Inman. I'm a broke dairyman currently residing in Turlock, California. My testimony before you today is based on my sincere and honest efforts to support all dairy farmers and their issues.

Many times I've been asked to testify or volunteer to testify in hopes that I may somehow trigger a change in a system that's severely flawed. Since my future as a dairyman in this state draws closer to a bitter end, I believe it is my duty to point out and shed some light on several inequities facing the California dairy farmer.

As I use up my 3 minutes -- in this case 20 minutes -- so the processors can have their 30 minutes to testify, I apologize I must be very direct and somewhat politically incorrect in my statements.

Today's hearing is a farce. Since I became involved in the political aspect of dairy farming in 1998, it has become evident to me that our industry is on a path to self destruction. I wouldn't give a dollar for the California dairy farmer's future under the pricing control that California Department of Food and Agriculture's Dairy Marketing Branch. The reason I say this is because this Department's past and current actions have been calculated only to help processors stay profitable without market accountability, which is the same rod you should measure us producers with.

We need a floor on Class 4a and 4b that would be based on our cost for production, according to CDFA's cost survey analysis, and don't forget to add the 10 percent return on investment. I believe this Department could not have chosen a better time to show its true colors than to call a hearing to review their Dairy Institute's proposal at a time when milk prices are so low.

This Department has transposed into a grand soup line where processors seek raises in their make allowance, welfare checks, and using this same milk make allowance money to come beg for more make allowance, and at the end of the year these begging efforts count as costs and this Department audits them and will show -- and will somehow justify their bleedings and give them another raise to make up for the money they spent begging for more.

This is, my friends, is a processor's grand casino. This Department's unethical changes to pricing formulas in recent years that included so-called energy indexing, transportation allowances and increased manufacturing allowances are systematically eliminating the dairymen from this state. It seems every time we come up here to the casino to testify we lose more money. That's because we can't afford to play the high-limit table and we're forced to play for nickels and pennies.

This hearing today is an immoral action, and I'll reference the Bible, which I believe is the highest stabilization plan, particularly the 27th through the 37th Psalm, in which I invite all of you to read tonight with your family.

Additionally, this Department refuses to address the disparity between the federal order price and the

California price when we are already approximately 40 cents below the neighboring federal order price. This Department has stated they are required to review the pricing formula when the California order price goes above the neighboring federal order price. Why is the Department refusing to review it and adjust it back up to the price in the neighboring federal order.

We dairymen are paying to haul our product to a processor. We pay almost $2 a hundredweight to process their finished product that we do not market. We pay 15 cents to an agency that helps to advertise a dairy product only when they feel like it. When then pay a transportation allowance for the processor to get rid of his or her product. And then if they're energy cost goes up, we pay that too. If the processor loses money, because their CEO built a gazebo in his backyard from wood he took from the plant, I know the trend here, we pay that too plus 10 percent return on investment.

With this in mind, my suggestion to every dairyman in this room is if we join the federal order and use this Department's budget to buy off the quota that producers are holding with the value returned to the order, we could pay some of our bills.

This Department's inability and unwillingness to stop the use of illegal and potentially dangerous additives, such as milk protein concentrate in standardized and nonstandardized foods or enforce California fluid standards that producers pay for, in order to help protect our California milk -- California markets is appalling.

This Department's stabilization plan is anything but stable. Today, we producers are double-dipped on energy costs and fuel charged 9 ways to Sunday. We have no mechanism in place nor a Department of Food and Agriculture willing to be innovative in order to index back our costs with a floor price or review a variable make allowance or consider allowing our beloved processors to stand on their own 2 feet by eliminating the manufacturing allowance altogether. You could call this a dairyman viability plan.

I am not a hypocrite, in a sense that I know I get a little welfare check too. The creamery I ship to has said many times that MILC program is wrong, since it allows a producer protection from the natural market changes and it subsequently hurts the majority of producers by allowing lower-end producers, such as myself, to stay in business. This is a poor statement for any processor to make, since my little MILC payment isn't equal to half his make allowance on my milk. Once again, the dairymen pays.

The state's largest trade association had an official quoted in an article stating that the MILC program encouraged milk production in areas where it was not needed. What kind of BS is this? In this state, we have to export 50 percent of the products we produce to states elsewhere and the producers get the privilege of paying to haul it there, thanks to CDFA implemented transportation allowances.

It appears he did not think before he opened his mouth. He obviously still subscribes to this Department's antiquated theory that milk shouldn't be produced by smaller dairy farmers in other states and that California producers could subsidize our California plants to steal their market share. But those little dairy farmers in other states fought back and responded by lowering their producer price an shafted us back and then we adjust our plan to mirror their plan. And here we are 25 years later back and forth. We're making $2 less a hundredweight than we were -- than in 1978. Good job guys.

In the last 3 years there's been an organization called CWT. The dairymen pays this organization so that herds in this country could be bought and sold, sent to beef or allow a failing producer or one that ready to retire to get out of business and eliminate the surplus milk.

This, too, is another grand casino for the processor, because these same people running this organization are testifying here as processors, and tomorrow they'll go back to their office and change their ads and pretend to represent farmers wile running CWT. Then they'll put on their processor hat again and import milk protein concentrates in order to illegally replace milk from cows that went to slaughter and drive our price down, so they can ask for more money to do it all over again. This systematically eliminates American dairy farms with the cooperative efforts and their producers pay for this too.

Which country does this CWT program help? Am I the only person that noticed that every time the CWT has a buyout, the milk price goes down? The reason for this phenomenon is that when the CWT program is announced it is also a call for the processors to increase their illegal imports in order to meet market needs.

In fact, we don't have enough cows in this country to feed our people. We have to import just to feed our country. It is evident to me that this Department has willingly entered into race that will end up with its undoing. As dairymen go out of business one by one you will have less work to do, more time to play golf. Unless you're a great golfer, you're not going to get paid much longer. With illegal immigrants and CRLA suing dairymen based on false accusations, OSHA laws and regulations, pending environmental regulation changes and air permit restrictions, my advice to this Department is to start looking for another industry to ruin.

You're about to completely ruin this one. In light of the happy cow lawsuits, the PETA peoples' antics and this hearing, I'm not sure which one is the most ridiculous today.

I will say, however, I think -- I must thank the California Milk Advisory Board for their adds that say very accurately and honestly, "Happy cows come from California." And to be "from" anywhere that means you had to leave there. For happy cows to come from California must mean they moved to another state.

Thank you.

HEARING OFFICER KRUG: Thank you, Mr. Inman.

You indicated that you prepared this testimony expecting to only have 3 minutes. You have another 10. Do you have anything you'd like to add?

MR. INMAN: No. Like I said, I must apologize for being a little bit direct, but I was thinking with my pocket book and my personal experience in this business, and my heart is broken as I'm going to be going out of business probably pretty soon.

HEARING OFFICER KRUG: Thank you for attending the hearing. Would you like the opportunity to present a post-hearing brief?

MR. INMAN: No, thank you.

HEARING OFFICER KRUG: Okay. Do we have any questions for this witness?

No questions for this witness. Thank you, Mr. Inman. You're excused.

MR. INMAN: Thank you.

HEARING OFFICER KRUG: Let ME call Albert Nunes again. Has he arrived?

Okay. At this time, we'll take a 10-minute break.

(Thereupon a recess was taken.)

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

The Department has received an additional letter to be admitted in to the record. It will be presented by the Department's witness, Cheryl Gilbertson.

Ms. Gilbertson, would you please proceed.

STAFF ANALYST GILBERTSON: Yes, Mr. Hearing Officer. I have one letter received from Archie Dairy, dated May 24th, 2006, that I'd like to enter in to the hearing record. And there will be copies of this letter available at the back of the room.

HEARING OFFICER KRUG: Thank you very much. If you'll present the letter, it will be marked as Exhibit number 73.

(Thereupon the above-referenced document was marked as Exhibit 73.)

HEARING OFFICER KRUG: Exhibit 73 is now entered in to the record.

We will proceed with our next witness, Ms. Sue Taylor.

Ms. Taylor, are you ready?

MS. TAYLOR: Yes, I am.

HEARING OFFICER KRUG: Ms. Taylor, will you please state your full name and spell your last name for the record.

MS. TAYLOR: My name is Sue Taylor. Last name spelled T-a-y-l-o-r.

HEARING OFFICER KRUG: Thank you, Ms. Taylor.

So you swear or affirm to tell the truth?

MS. TAYLOR: I do.

HEARING OFFICER KRUG: Are you testifying or represent on behalf of or representing any organization today?

MS. TAYLOR: Yes. I'm testifying on behalf of the Leprino Foods Company, for which I'm the vice president of dairy policy and procurement and am primarily responsible for formulating the company's positions. This testified has also been reviewed by some members of the senior management team.

HEARING OFFICER KRUG: Does your testimony represent the testimony of Leprino Foods?

MS. TAYLOR: It does.

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

MS. TAYLOR: Yes, I do, and they have been distributed to the panel.

HEARING OFFICER KRUG: Okay. I have a document here, statement of Sue Taylor Leprino Foods dated June 2nd. It's marked Exhibit number 74 and is now admitted in to the record.

(Thereupon the above-referenced document was marked as Exhibit 74.)

HEARING OFFICER KRUG: You may proceed.

MS. TAYLOR: I'm going to consolidate the introduction of my written testimony in terms of the background and our general position, which I could easily summarize to say that we are in support of the Dairy Institute proposal and in opposition to the balance of the proposals.

And I'm going to jump down to the bottom of that first page. I'll focus my testimony on the following specific issues: Need for plant capacity; whey factor; yields; and price snubbers.

Need For Plant Capacity. The continued growth of milk production in California is well documented. This milk production growth will necessitate additional plant capacity in California. The ability to attract proprietary investment substantially reduced by the Department's Class 4b formula changes effective with April 2003 milk.

Although the hearing decision effective with April 2005 milk removed the onerous support floor from the April 2003 decision and increased the whey make allowance modestly, the decision still failed to realistically reflect whey processing costs and locked and overstated cheese yield factor in place.

There are many factors that accompany whey when deciding where to locate a plant. Milk availability and price are 2 of the most critical factors we consider. The milk price must allow us to be competitive from a manufacturing facility in the national marketplace when considering the total cost of manufacturing and delivering the product to the customer from that location.

Our decision to build our newest facility in Lemoore was made in 1999, prior to the chilling effects of the April 2003 decision. We constructed much of the infrastructure to facilitate cost effective expansion of milk throughput. This sunk investment and the scale efficiencies that are gained as a result of expanding and existing facility should make a decision to expand the Lemoore West facility an easy one.

However, the current milk price formulas and business environment in California have caused us to explore greenfield opportunities outside of California, as we explore options to satisfy our need for additional plant capacity. We believe that the data provided by CDFA for use at this hearing already understates the current California disadvantage because energy and transportation costs have continued to escalate beyond average 2005 levels.

We believe that the prices received by processors FOB California is now lower than the prices received in 2004 and 2005. This is because capacity constraints in the trucking industry due to driver shortages and DOT hours of service regulations, implemented a few years ago, and increased fuel costs have resulted in escalating transportation costs. Much of our California production is shipped into the southeast, either by truck or by rail. Our rates for rail shipments into the southeast have increased by a minimum of 15 percent from the 2004 to 2005

FOB price survey base period and have increased by 20 percent at a minimum for rail from California to the southeast over the same period.

Our experience is that freight rates outbound from California are increasing at roughly double the rate of increase we are seeing outside of California. The greater distances that California products must be shipped to reach the ultimate consumer markets and the higher rate of increase in outbound hauling rates from California is resulting in an even greater transportation cost disadvantage on a per pound basis than ever before for the California source products.

We have not yet concluded our plant siting analysis and have therefore not made a decision regarding our next source of capacity. The current construction at the Lemoore West facility referenced by the CDC witness at this hearing will increase our line flexibility and will not result in expanded milk throughput capacity.

Whey Factor. Make Allowance. The Diary Institute proposal cause for an increase in the whey make allowance to a level that is consistent with the Department cost studies is an initial step. This proposal is entirely consistent with the longstanding principle of establishing the make allowances in the minimum regulated milk price formulas, based upon the objective analysis embodied by the cost studies.

The Department has now conducted 2 whey processing cost studies with very similar results. To reject these costs studies is tantamount to rejecting the longstanding and sound policy of the Department to rely on objective analysis to establish the appropriate make allowances in the milk price formulas.

Several pieces of evidence that were authored by either me or Venkat have been entered into the record by other witnesses at this hearing in an attempt to develop an alternative approach to establishing the make allowance. While I consider myself a poor substitute for Venkat, I will elaborate on this earlier testimony, because we tragically lost Venkat's wonderful presence and great talent to death last summer.

The reference pieces of evidence are mostly focused on the differences in energy and equipment costs for nonfat dry milk and whey processing plants of similar milk throughput. The testimony was submitted during hearings in which either there was a lack of whey cost data or in which there were significant questions regarding the validity of the available whey cost data. In these circumstances, we felt that it was helpful to develop an alternative approach as a frame of reference, even though we knew we were not capturing all of the costs.

These pieces of evidence are largely irrelevant to this proceeding for a variety of reasons that are summarized below and I'll paraphrase some of these reasons from the table to get through it more quickly. Venkat's testimony from the May 2000 federal order hearing, which was attached to the MPC testimony focused on costs -- energy costs that were outside of the State of California and in a much earlier timeframe. Additionally, these -- this testimony focused strictly on the difference in energy and equipment costs for the processing of whey versus nonfat dry milk. And in that testimony he specifically elaborated that there were additional costs in terms of labor and management and other costs that he did not attempt to capture in that cost study.

That same issue follows through to the Scott Burleson testimony from the January 2006 federal order hearing, which is the third item on the table. It was essentially an update of Venkat's cost study, but also did not attempt to capture all of the incremental costs. It was strictly from a technical approach on energy and equipment cost differences.

The post-hearing brief that I filed last February, as a result of the CDFA hearing, provided some data from our Allendale, Michigan and Waverly, New York sweet whey processing facilities, where we had restated the key rates for energy, labor and some of the other major cost factors to California costs. While this, I think, is interesting, and we were hopeful that it would be helpful in the context of that hearing, where you had a cost study presented by CDFA that was the first time around and some people were questioning that cost study, I don't think that it's relevant in the context of CDFA now having 2 costs studies done on whey under the rigorous process that they conduct -- that essentially endorse and validate each other with consistent results.

And finally my post-hearing brief from the federal order hearing this January, a similar statement. This was put together and endorsed because in the federal order hearing in January there still was not an accurate whey cost study for whey processing plants outside of the state of California. Some advocates were looking at using Charlie Ling's data, which clearly was shown in the testimony to have lacked some aspects of the cost. Therefore, we were attempting to provide some point of reference recognizing that we weren't capturing all of the cost differences.

I'll proceed on to the text. The use of the incremental approach, nonfat dry milk plus energy and equipment cost differences to produce whey, to establish the whey make allowance is a far less desirable approach than using an accurate cost study of whey processing costs. In addition to the noted omission of certain incremental costs in the Venkat and Burleson analysis, there is a significant mismatch of plant capacity between the average California nonfat dry milk plant, included in the cost study, and the average cheese plant.

Additionally, since roughly a third of the SNF is captured in the cheese and not available in the whey stream in a cheese plant, a cheese plant of comparable milk intake with a butter powder operation does not have comparable drying scale as the nonfat dry milk plant. Therefore, the base data for nonfat dry milk costs would significantly understate the cost of processing whey.

In contrast with the hearings for which the referenced testimony was prepared, CDFA has completed whey cost studies 2 consecutive years using a proven and rigorous methodology. The results of these cost studies are very close. Discarding CDFA's own cost studies in order to utilize an estimation method with the noted deficiencies would be wholly inconsistent with CDFA practices and would be poor policy.

Returns disconnect amongst various whey products. Sweet whey was historically viewed as the lowest common denominator amongst all whey products. This was because it is the most generic whey product requiring the least advanced technology, and returns were generally lower than those for the more highly refined whey proteins. So long as the milk price was based upon the sweet whey prices, it was thought the whey contribution to the milk price would not be overstated.

This long held assumption is no longer true. As more processors have invested in whey fractionation technology, the increased production of whey protein concentrates has depressed those prices. Simultaneously, as older plants producing sweet whey have been mothballed, the supply and demand balance has pushed sweet whey prices up. Consequently, the milk price factor attributable to the sweet whey value has outstripped the returns from the WPC/lactose complex numerous months over the past year.

Although, I generally believe markets equilibrate over time if the returns from one product outstrip the returns of another, there are several reasons to expect that the whey markets will not equilibrate as quickly and gracefully as other markets.

Specifically, number 1, whey products fill different market niches that are driven by different demand factors. Although, WPC and lactose can be substituted for sweet whey in some applications, most applications are looking for the specific attributes of either WPC or lactose. High protein WPCs are typically competing with other sources of protein, such as soy, that are disconnected from the overall dairy supply and demand situation.

Number 2, few plants can justify investing the substantial capital to enable them to shift production amongst the various whey products on a short-term basis to exploit more beneficial returns. Many plants cannot even flip between WPC-35 and WPC-80 production since WPC-35 production requires an evaporator that is not required in WPC-80 production. And WPC-80 production requires significantly greater filtration capacity than does WPC-35. Although new plant investments will be made in the highest return product, this capacity adjustment occurs over years rather than over weeks or months.

Number 3, substantial volumes of whey products are exported and are therefore subject to many additional supply and demand factors unrelated to domestic supply and demand factors.

Because of the diversity of demand for the various way products, the product prices move independently of each other. This contrasts sharply with the cheese side of the complex, in which virtually all commodity cheese produced in the United States is priced relatively to a common price series, the CME cheddar price, and therefore cheddar prices serve as an effective surrogate in the milk price formulas.

Diversity of whey production in California and its consequences. CDFA's summary of dry whey and whey protein concentrate production during 2004 and 2005 clearly illustrates the challenge of identifying a whey product representative of statewide production. While helpful data, it does not reveal the full complexity of whey production within the state of California.

Leprino Foods processes its whey protein stream into WPC-35, WPC-80 and some specialized whey proteins within the state of California. As part of this production, lactose is produced and delactose permeate is generated. Focusing specifically on the WPC products, we produce 28 WPC-35 product codes and 33 WPC-80 product codes. Many of these codes have been developed by our R&D staff to address specific applications requiring such attributes as high jelling properties or high heat stability applications for retort applications. Our production of generic WPC-35 or WPC-80 is only a portion of the volume that CDFA would have categorized as WPC-35 and WPC-80 and will likely diminish over time as we expand in to these more specialized markets.

The lack of concrete yield and cost data in the hearing record upon which to calculate net returns for the various whey products has led to speculation, by some witnesses, that WPC returns are higher than returns from sweet whey. The witness for Western United speculated that, assuming lactose at break even, an average price difference between sweet whey and WPC-34 of 42 cents from January 2000 through, I believe it was, December, 2005, should translate -- through current, whatever her data was -- should translate in to greater profits from WPC-34 than from sweet whey, unless quote, "...the added costs to manufacture WPC-34 over skim whey exceeds approximately 42 cents per pound."

This conclusion is based upon an assumption that the same yield can be achieved when producing WPC-34 as when producing sweet whey. This logic is clearly flawed on its face. The removal of lactose in order to move the protein content from 12 percent to 34 percent directly results in a yield reduction. The fractionation also results in some of the protein being lost. But ignoring those losses, only .35 pounds of WPC-34 could be produced from the raw whey used to produce a pound of whey at 12 percent protein.

Again, ignoring the losses that we know are associated with whey protein fractionation, applying the yield for the prices over the time period quoted by Western United shows that WPC-34 produced from the equivalent volume of raw whey would have generated slightly less, that's 23.08 cents, per equivalent raw whey volume, than the 23.58 cents per pound sweet whey. From this price the processor of WPC-34 must also pay the higher capital and processing costs associated with fractionating the whey.

Applying these optimistic yield assumptions to the year to date 2006 price date submitted by Western United further illustrates the challenges facing manufacturers of WPC-34 this year. The Western skim whey price series that is used in the 4b calculation has averaged 33.72 cents, while the WPC price on the equivalent volume of WPC-34 has averaged only 25.13 cents, again according to the Western United testimony.

Therefore, the WPC-34 manufacturer has paid 8.59 cents per pound whey equivalent or 49.2 cents per hundredweight more in the Class 4b formula than they receive for the WPC-34. Again, this is before even covering the additional costs of fractionation. Additionally, Western United's assumption that lactose is a break-even proposition is optimistic. While lactose prices climb intermittently above the processing costs, they have not remained there over a sustained time period.

Lest the Department interpret these arguments incorrectly, I am not advocating the replacement of the current sweet whey factor with a WPC-34 factor. The point is that there is not a common whey product produced within California and the nature of supply and demand in the various whey markets, both domestically and abroad, make it nearly impossible to identify a whey product that will accurately reflect the returns generated by the whey complex. Therefore, the whey factor should be eliminated from the formula.

Yields. In interests of staying within the testimony time limitation, the bulk of my discussion on vat yields can be found in Addendum A. However, I would like to take a moment to address 2 items.

First, the VanSlyke theoretical yield formula remains the only objective way to determine the cheddar yield in the absence of actual data related to yields from unfortified unincented milk. Within that formula, the fat retention factor should be set at 90 percent. As the Western United witness noted, Dr. Barbano testified at the May 2000 federal order hearing that fat retentions in cheddar operations typically range from 90 to 93 percent, to be consistent with the minimum milk pricing use of the yield factor, at the low end of the range 90 percent, should be used in the formula.

Second, the Western United witness implied that ranch to plant losses were incorporated in the Tong milk composition data and therefore need not be considered in the calculation of the yield. Although the witness is correct that Dr. Tong tested milk at the plant using that data directly in the VanSlyke yield formula does not automatically capture the ranch to plant losses. The only way to capture those losses using the Tong data would be to calculate the theoretical yield based on the Tong data, but equate that yield to the weight and test data as measured at the ranch. Dr. Tong's data does not include ranch level data, therefore the methodology recommended by Dr. Schiek of Dairy Institute is necessary for the accurate application of the theoretical vat yield formula to ranch milk.

I'm going to move to my conclusion.

The Department's decision from this hearing will determine whether sufficient plant capacity is developed to handle the increasing California milk supply. The alternative route is an increasing level of the dairy industry equivalent to constipation. In this scenario milk remains overvalued relative to the net returns that can be achieved from its manufacture, the lack of sufficient investment in plant capacity results in difficulty digesting the milk, and the end result is neither comfortable nor pretty.

The Dairy Institute proposal is founded on the sound principles of valuing milk based upon California prices, costs and yields. The nuance of eliminating the whey factor is necessary due to the disconnects in the whey market. We urge the Department to adopt the dairy Institute proposal in its entirety.

However, we recognize that there is a sense amongst the producer community that whey is an important factor in the 4b formula. If the Department is swayed by such arguments from the producer sector, it is absolutely critical to the viability of the cheese processing sector that the whey make allowance be increased to be consistent with the CDFA whey cost study, and that no snubber be applied.

This concludes my written testimony. I appreciate the opportunity to provide input to the Department on these very important issues and respectfully request the opportunity to file a post-hearing brief.

HEARING OFFICER KRUG: Thank you, Ms. Taylor. Your request to file a post-hearing brief is granted. And I'll just note also that it appeared that you skimmed over parts of your written testimony in respect for the time limits. Please be aware that the full text of your comments are in the record and will be considered and given equal weight with all the other oral testimony.

MS. TAYLOR: Thank you.

HEARING OFFICER KRUG: Does the panel have any questions for this witness?

Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: Ms. Taylor, on page 2 of your testimony you stated in general terms how transportation costs have increased 15 percent in one case and 20 percent in another. In your post-hearing brief, could you more fully document these actual hauling costs?

MS. TAYLOR: Actually, I cannot. I had that discussion with my senior management team, and due to sensitivity with customers, we're not going to disclose, in writing, the per pound basis on -- in a format that will be posted on the web. I can tell you in rough terms it's 1 to 2 cents a pound.

AGRICULTURE ECONOMIST GOSSARD: On page 6 you make the assumption that skim whey powder is 12 percent protein. I think at least somewhere else in the record somebody assumed 12.5 percent. Is 12 percent the standard assumption?

MS. TAYLOR: I inquired of our vice president of whey marketing and sales who's been in the business for over 30 years, and his rule of thumb is 12 percent across the industry. He indicated that there is a range of 11 to 14. Mozzarella whey is typically a slightly lower protein. Cheddar whey is slightly above the 12 percent.

Acid whey would be somewhere in the 13 percent neighborhood. But he was very confident that 12 percent is the accepted rule of thumb in the industry.

AGRICULTURE ECONOMIST GOSSARD: On page 7 you addressed many -- well partly -- on pages 5, 6 and 7 you addressed many of your concerns regarding the whey factor currently in the Class 4b pricing formula. Over the long run, however, it is presumed that the industry will respond to changing production and prices of the various whey components. And one would assume over the long run that the whey stream will be a profit center of some sort for the cheese industry.

How are we to capture that profitability as part of the 4b formula?

MS. TAYLOR: I'm not sure that I can draw the conclusion that over the long run whey will be a profit center. Your contention that the price -- the prices and returns will equilibrate, as I indicated in my testimony, is an assumption I generally do hold for most markets. However, in the whey complex, because of the extraordinary level of capital investment and the disincentives due to that capital investment to invest in redundancy within the same plant, you will not see the convergence, I don't believe, that you normally would in other market places. Yes, as new plant capacity comes on, it will help move us toward a convergence, but that may be over a period of years as opposed to a period of months.

Additionally, we'd have all the other market factors, including the international dynamics, where lactose may be very much in demand in a particular marketplace, but WPC not be, so you have, you know, lack of consistent feedback through the entire system.

AGRICULTURE ECONOMIST GOSSARD: To summarize your answer, is a good economist in the long run dead?

(Laughter.)

MS. TAYLOR: That could be the case. The pain that you endure to get there may be too much.

AGRICULTURE ECONOMIST GOSSARD: Finally, you support the Dairy Institute's proposal that in the cheese formula the yield should be 10.0 based on 367 fat 8.8 solids nonfat as being more representative of farm milk. Unfortunately, or fortunately, the cost studies that you so highly praise are based on plant operations where the yield factor is in the high 10.8, 10.9. Do you have any costs for a cheddar plant operating with 367 8.8 milk and a yield of 10?

MS. TAYLOR: I do not have those costs, but I would observe -- I would expect the costs based on the cost studies, which reflect fortified vat yields to be lower per pound of cheese than they would be if you didn't have the fortified vat fat yields, because you are gaining something in yield efficiencies and cost efficiencies, otherwise you would not be fortifying.

AGRICULTURE ECONOMIST GOSSARD: No further questions.

Thank you.

HEARING OFFICER KRUG: Are there any additional questions for this witness?

No additional questions, thank you very much, Ms. Taylor. You're excused.

At this time, we've completed with the public comments portion, unless Mr. Albert Nunes has arrived?

MS. LaMENDOLA: He currently is on his way but he is not here yet.

HEARING OFFICER KRUG: Okay. We will fit him in when he arrives, if he arrives. In that case, we will recommence with the testimony for Western United Dairymen followed with the completion of the testimony from the Milk Producers Council.

Will the witnesses please be aware that you are still under oath from yesterday's testimony. And just for clarification yesterday, you submitted and we admitted into evidence text of your testimony. It's labeled Exhibit number 54. You may proceed.

MS. LaMENDOLA: I believe we left off right around our point number 2 in respect to dry whey make allowance, which is on page 15.

A different approach to setting the dry whey make allowance was taken by almost all participants at the recent federal order manufacturing cost allowance hearing. Brian Scott Burleson, director of manufacturing for ingredients, Division of WestFarm Foods, presented data detailed regarding the incremental cost to dry whey above the cost to dry nonfat dry milk.

Even though CDFA dry whey manufacturing cost data was available, most testified in support of this method for determining the dry whey make allowances. Supporters included, but not limited to, National Cheese Institute, Agri-Mark Dairy Cooperative, Land O'Lakes, Northern West Dairy Association and Leprino Foods. Our table below summarizes available data that could be used to set the dry whey make allowances and the various sources from which the data was gathered.

It's interesting to note a few points that highlight the large discrepancies between the CDFA dry whey cost study figures and those figures supported by a number of industry experts nationwide.

First, the USDA reported a weighted average cost 11.4 per pound for the 6 plants surveyed nationwide. Though testimony at the federal order hearing seems to indicate that these costs may be understated due to the misunderstandings in reporting processes. This figure is considerably lower than that report by CDFA.

Number 2 at the February '05 California hearing Sue Taylor of Leprino Food stated that Leprino had no dry whey facilities within the state of California. At the request of the hearing panel she supplied dry whey manufacturing costs for their plants in New York and Michigan. The weighted average costs, adjusted to better reflect costs in California, were reported at 21.9 cents per pound. This is substantially lower than the 26.73 per pound cost reported in the CDFA cost studies and is derived from mozzarella plants with higher dry whey costs.

In a post-hearing brief submitted for the recent federal order hearing Dr. Yonkers of the National Cheese Institute supported a 22.2 per pound dry whey make allowance. This is substantially lower than that supported by California cheese manufacturers at this hearing.

Number 4, in a post-hearing brief submitted for the recent federal order hearing, Sue Taylor of Leprino Foods states quote, "The proposed whey make allowance of 22.15 cents is also consistent with the cost that would be determined by adding the change in Leprino's sweet whey processing cost since the survey period that was used to establish the current whey make allowances," end quote. This is substantially lower than the 26.73 per pound cost reported in the CDFA cost studies.

Number 5, in a post-hearing brief submitted for the recent federal order hearing on behalf of Agri-Mark, Inc., Northwest Dairy Association, Foremost Farms U.S.A. Cooperative, Associated Milk Producers Inc., and Land O'Lakes, a 21.6 per pound dry whey make allowance was supported. This is substantially lower than the make allowance being requested by some today.

Proponents of a 26.73 per pound or higher dry whey make allowance will likely discredit this discussion because it is not specific to California. Even so, the figures supported above by cheese manufacturers all over the nation, including some with plants and interests 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 cross the U.S. are able to manufacture dry whey at costs closer to 20 to 22 cents per pound. This begs the question, what is happening to California?

Substantial evidence was provided at the federal order hearing to support the addition of approximately 2 and a half cents to the nonfat dry milks cost to capture the incremental costs associated with drying whey over nonfat dray milk. Given the concern over the dry whey cost studies released by CDFA, we concur that this could be an appropriate method to take care of California. At the very most, it supports maintaining the current 20 cent per pound allowance.

Concern was previously raised over comparing dry whey processing costs to those of nonfat dry milk because of the differences in plant sizes. The nonfat dry milk cost studies showed 4 plants with similar volumes at the dry whey plants. The 4 nonfat dry milk plants in the medium cost category process a total volume of 238.5 million pounds or an average of 59.6 million pounds at a weighted average cost of 17.33 cents per pound.

The 3 dry whey plants processed an average of 31.1 million pounds, adding an estimated 2 and a half cents per pound of incremental costs associated with the dry whey to the 17.3, results in an approximate dry whey manufacturing cost of 19.83 cents per pound. If something higher than a 20 cent per pound make allowance is set, say 26.73, then we would expect an explanation as to why dry whey manufacturing costs in California exceed costs at comparable nonfat dry milk plants by 9.4 cents per pound, when plants in the rest of the U.S. experience only a 2.5 cent per pound difference.

Additional concerns.

First, it's disturbing that even though the CDFA dry whey cost study was available for use at the federal order hearing very few relied on it, even though witnesses testified to the fact that the average volume of the California plants add approximately 31 million pounds was consistent with average whey plants nationally. No one relied solely on the results.

This seems peculiar given the CDFA cost data for butter, nonfat dry milk and cheese plants was used in conjunction with the RBCS study without reservation.

Second, at the February '05 hearings, Sue Taylor of Leprino Foods discussed the allocation of milk receiving costs to whey at the same rate per pound solids are attached to cheese. In her testimony she stated that, "From the business and policy perspectives, we do not believe milk costs, whether actual costs or milk receiving costs, should be allocated to whey." We concur. Discussions with the cost unit verify this allocation does, in fact, occur. Whey, as a byproduct of cheese, should not carry milk and receiving costs as these costs are accurately reflected in the cheese manufacturing costs.

Finally, only 79 percent of the skim whey powder processed in California is represented in the cost studies. This volume is far less than the volume represented in the manufacturing cost data for butter at 99.9 percent, Cheddar and Monterey cheese 98.5, and nonfat dry milk at 99.17.

Due to the multitude of reasons explored above, we support the approach taken at the recent federal order hearing of adding 2 and a half cents to the powder processing costs. This supports maintaining the current 20 cent per pound make allowance for dry whey. We urge the Department to make no changes to the current make allowance. There are simply too many unanswered questions regarding the dry whey cost studies, and the current allowance can be supported by recent expert testimony.

MR. MARSH: The 2004 manufacturing cost data released by CDFA does not support any changes to the manufacturing cost allowances at this time. We thank the Department for withdrawing the labor and energy updates to the cost studies and we do encourage, once again, the Department to follow the advice of their independent CPAs and discontinue publishing false financial information, such as that anymore.

According to past hearing panel reports, the Department has adhered to a historical policy establishing manufacturing cost allowances that are consistent with volume coverage among butter, nonfat dry milk and cheddar cheese. According to the 2004 cost studies the current allowances covered 75 percent of the butter, 63 percent of the nonfat dry milk and 62 percent of the cheddar cheese.

Further review of the data sheds some additional insight. For butter, the 75 percent processed at a cost less than the make allowance was manufactured at a weighted average cost of 12.3 cents per pound or 3.3 cents below the current make allowance. For nonfat dry milk, the 63 percent processed at a cost less than the make allowance was manufactured at a weighted average cost of 13.73 cents per pound or 1 and a half cents below the current make allowance. For cheese, nearly 77 percent was manufactured at a weighted average cost of 17.1 cents per pound, exactly at the level of the current make allowance.

The coverage is consistent, perhaps even exceeding in some areas, with the targeted coverage detailed in the panel report from the last hearing: 65 percent of butter, 67 percent of nonfat dry milk and 79 percent of cheddar cheese. Clearly, no increases are justified at this time.

We understand the need for adequate plant capacity within the state. However, we know that adjustments to the current make allowances, at least of the magnitude requested, will not encourage additional plant capacity. As explained above, impediments to additional plant capacity in the state go far beyond the make allowance.

Therefore, we realize the goal of setting the correct make allowances is tied more directly to the health of the current plant capacity. Given the manufacturing cost data released by the Department and the corresponding volume coverage, we feel this goal has been met with the allowances currently in place. No changes should be made to the current manufacturing cost allowances and department data clearly supports this notion.

With regard to the alternative proposals, we'll comment briefly on items not yet addressed in our testimony above.

California Dairy Campaign. We cannot support the implementation of the variable make allowance proposed by CDC. According to Department analysis for the period 2001 to 2005, the variable make allowance proposed would result in a reduction in Class 4a prices in 3 of the 5 years with an average reduction of 11 cents per hundredweight. Likewise, the proposed variable allowance would result in a reduction of the Class 4b price in 4 of the 5 years, with an average reduction of 15 cents per hundredweight. We cannot support a decrease in producer prices of this magnitude. Clearly this is similar to the last time that this was brought forward, which resulted in a decrease in producer prices of about $175 million over a period of 5 years.

These reductions are mostly offset, however, by the increases in the Class 4a and 4b prices due to CDC's proposed elimination of FOB adjusters, which we cannot support. The elimination of FOB adjusters could have potentially devastating implications for California processors. And we do need processing capacity in the state. The potential of eastern markets that could result from a loss the adjusters would undoubtedly result in a direct negative impact to producers, either through reductions in premiums or dividends paid. The loss of markets for California manufactured products could eventually also have long-term impacts on the ability to maintain plant capacity in the state.

California Dairies Inc. We are supportive of the CCC purchase price floor, but not of any changes to manufacturing cost allowances as noted above.

Alliance of Western Milk Producers. We're supportive of the CCC purchase price floor, but not of any changes to manufacturing cost allowances.

Milk Producers Council. We support the implementation of a snubber on the dry whey price at 20 cents per pound as proposed by MPC. As argued above, the formula should capture the value of the milk used to manufacture cheddar cheese. If there's no value to dry whey in any given month due to a low selling price, then its contribution should be 0 not negative. We are also concerned with the implementation of the correct manufacturing cost allowance.

The implementation of any incorrect make allowance should not drive the whey contribution into negative territory. Doing so, at the expense of producers, would ignore the revenues obtained by cheese plants through the manufactured of higher valued WPC products. While we have not asked that producers get to enjoy the returns of the higher value whey products, we do ask that if the price of the lowest valued whey product, skim whey, does fall below the manufacturing cost allowance, the producers are not penalized for settling for the lower valued whey product.

Our board found MPC's idea of incorporating WPC 34 percent into the dry whey component intriguing, but felt that the specific details of its inclusion had yet to be fleshed out. Additionally, the idea of a credit to processors for the sale of cheese to the CCC has some merit. However, due to the streamlines recently implemented by the CCC, we don't feel a credit is needed at this time.

Land O'Lakes. We do not support the change to the dry whey manufacturing cost propose by LOL, as we are supportive of the current 20 cent per pound allowance in place. Our extensive arguments are detailed above.

A couple of other things off the written items. On the capacity issue, which we've heard many of the processing folks paternalistically discuss with regard to taking care of the dairy producers in the state, we believe that that is clearly a different issue. I think as former president of the board of Western United Dairymen Ray Souza discussed, that's likely an issue that should be discussed by the industry and then brought to the Secretary versus having this type of forum at a hearing make that determination as to whether or not we have adequate plant capacity or whether or not that should be incented through the make allowance.

Of course, again as indicated, that should be an industry impetus and it should occur in a different venue, particularly when we're looking at a potential situation coming out of an outcome of this hearing where you're looking to tax dairy producers in the state of California at the rate of about $200 million a year and transferring that money to the processors in the state of California. That's too big of an issue and a policy issue to be determined at this hearing.

Milk production, as we've heard from producers who have testified, is likely not sustainable in the state given the current negative margins that producers are experiencing within the state of California. We have seen a decline in milk production. But at the same time I believe that once again, as Mr. Souza noted in his testimony, how can farmers continue to operate at $1.92 below their cost of production with the regard to their pay price?

Again, we renew our objections to the call of this hearing. We also renew our objection to the lack of adequate notice on the return on investment adjustment that was made in the manufacturing cost studies. And we also renew our objection to the inclusion of specious financial data in the hearing record over the objection of CDFA's own independent CPAs.

This concludes our testimony. Western United Dairymen thanks CDFA staff for their efforts in preparing for this hearing. We would be pleased to answer any questions that you might have. And we also request, as noted before, the option to file a post-hearing brief.

HEARING OFFICER KRUG: Thank you, Mr. Marsh and Ms. LaMendola for your testimony. Your request to file a post-hearing brief is granted. And as with the previous witness, I'll note that there were portions of your written testimony that you seem to skim over in respect for the time, the full text of your testimony is entered into the record. And it as well as any of your supplementary comments will be fully considered by the Department.

Do the panel members have any questions for the witnesses?

Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: An earlier witness, Mr. Van Vlecht, stated that having a hearing on the first of the month or the last day of the month created problems for some dairy farmers who might wish to attend this hearing, in general, because of doing payrolls. Is that something that Western United's aware of among its producer members?

MR. MARSH: We did receive some notice of concern over that and it did cause some problems for producers getting here. Actually, I think from some of the producers that I did have an opportunity to visit with, they were also very concerned because they got so far behind this year with regard to planting of crops and harvesting of hay, because of the wet weather we had.

AGRICULTURE ECONOMIST GOSSARD: But in general in the long run, it might be better to hold a hearing on the second rather than the first?

MR. MARSH: That may be a good idea.

AGRICULTURE ECONOMIST GOSSARD: Twice, page 4 and then later in your testimony, you mentioned the streamlining of the CCC purchase plans. Could you document those changes in your post-hearing brief.

MR. MARSH: We'd be happy to.

AGRICULTURE ECONOMIST GOSSARD: On page 5 of your testimony, in making your recommendation for the FOB price adjusters, you used a weighted average rather than a simple average. At the last hearing, the Department had expressed some concern that weighting the data twice might lead to some bias in the estimator. Do you have any comments on the concern the panel raised at the last hearing on that issue?

MS. LaMENDOLA: Well, we would agree with prior testimony, in that we were trying to capture what the majority of cheese or butter sold for. So we thought in a weighted average you would capture, for instance, you know, one pound was sold at a lower price, one pound at a higher price, you could accurately capture what the majority of the product was sold for by using a weighted average.

AGRICULTURE ECONOMIST GOSSARD: On page 16 of your testimony you have an extensive table on whey processing costs or dry -- skim whey powder processing costs. Do you have any data connected with these costs as to the relative size of an operation that would generate these costs?

MS. LaMENDOLA: We are simply citing testimony that was presented at prior hearings. And that testimony came from plants with experiencing in drying whey. So in reviewing their testimony, I don't recall actual plant sizes. I do recall reference to, you know, sort of the average capacities at dry whey facilities in California's plants being, you know, consistent with that average, but I didn't see specific reference to any volumes, at least in the review that I did.

AGRICULTURE ECONOMIST GOSSARD: On page 17 next to the last paragraph, it starts concern was previously raised over comparing dry whey costs to nonfat dry milk because of plant size differences, and then you cite some data from CDFA. Was that data based on the cost studies that were entered into the exhibit or was that based on another departmental document?

MS. LaMENDOLA: Yeah, that's the 2004 unadjusted cost studies. And the number we cited was for the medium range nonfat dry milk costs, weighted average for that range.

AGRICULTURE ECONOMIST GOSSARD: Given that the size of the skim way powder plants are half that of the nonfat dry milk plants, wouldn't it be more likely that the costs would fall somewhere between the medium nonfat dry milk plants with an average size of 60 million pounds and the 3 high cost plants with an average size of 13 million pounds?

MS. LaMENDOLA: Well, the costs for the 13 million pounds seem to me to be kind of an outlier. We don't really know what size the specific plants are within any category. And to prior testimony, I guess we would ask you in that you know each plant's actual capacity. In getting as close as we could, that seemed like a reasonable comparison on size.

Now, I don't know some of those within that range might be quite smaller, some might be larger. We really just aren't privy to that information.

AGRICULTURE ECONOMIST GOSSARD: Finally, on page --

MS. LaMENDOLA: Can I add one more thing, in that, in using that low cost, we've heard a lot of testimony as far as efficiencies and economies of scale. So to go all the way down to an average size of 13 million pounds might seem to skew it in the other way quite a bit. So there again we just would rely on you to look at the actual plant sizes.

AGRICULTURE ECONOMIST GOSSARD: Finally, on page

18 again, the second to the last paragraph that begins, "According to past hearing panel reports...", you estimate the volume covered with the current manufacturing cost allowances. What document did you use to come up with those estimates?

MS. LaMENDOLA: Those are the -- it's actually what's cited on the individual cost study pages for the 2004 cost studies. You guys put that up at the top or, I guess, down at the bottom, how much volume was covered under each product. And that was simply pulled from the cost study pages.

AGRICULTURE ECONOMIST GOSSARD: Okay. Thank you very much. I just wanted clarification on the data source.

No further questions.

HEARING OFFICER KRUG: Are there any additional questions for the witnesses?

Ms. LaMendola, in your last statement you referenced a prior cost study, is that cost study in the record?

MR. MARSH: I'm sorry?

HEARING OFFICER KRUG: It is.

The cost study that you referenced in your testimony in your responses to Tom. All I'm saying is --

MS. LaMENDOLA: Yes.

HEARING OFFICER KRUG: -- if it's not in the record, you should ensure that it is.

MS. LaMENDOLA: No, it should be. I imagine it's the current cost study, yeah.

HEARING OFFICER KRUG: Thank you very much.

Thank you very much four your testimony.

You're excused.

We will now proceed with the testimony from Milk Producers Council who will continue with their testimony from yesterday.

Okay, just for the record, yesterday the Milk Producers Council submitted written testimony that was marked Exhibit 61 and admitted at that time. If you'll please again identify yourselves, and then you may proceed with your testimony. Again, keeping in mind you're still under oath from yesterday's hearing.

MR. VANDEN HEUVEL: Geoffrey Vanden Heuvel.

MR. VAN DAM: And William C. Van Dam.

HEARING OFFICER KRUG: Proceed.

MR. VAN DAM: Both from Milk Producers Council. Yesterday when I was giving the testimony, I got as far as the bottom of page 7, if you'd care to follow along in your copies there. Earlier in my testimony I made reference to us using a correlation coefficient rather than the multiple regression, and Exhibit E attached to our testimony is a write-up of what the 2 are for your reference and to show where we got our information.

Cheese issues. Milk Producers Council has repeatedly ask for and defended the snubbing of prices at the federal support price for butter, nonfat dry milk and cheese. Of these 3, cheese is the only product for which there are production and packaging requirements for the sales to CCC that are substantially different than the norm for commercial sales. It is important to note that only in cheese have prices ever dropped substantially below support price. In November of 2000, cheese prices over a 4-week period averaged 11.6 cents per pound less than the support price. The lowest price during that period was 98 cents per pound on November 4th of 2000 or 15 cents below the support price for cheese. This is the extreme example, but it happened and it can happen again.

There is no good, reasonable or rational answer to that market of 2000, but it happened. Data prepared by NMPF indicates that the extra costs of preparing cheese for sale to this CCC are equal to 5.6 cents per pound of cheese. Why then did the price not stop dropping once it was low enough to cover the added costs?

We'll never know for sure, but equally for sure it makes no sense for dairy producers to just sit and wait for it to happen again. The cost in terms of producer income was staggering, and it happens while there is a safety net in place, put in place by Congress, called a support price. This makes no sense to us and we feel the greatest shortfall of the current system, both in California and in the whole nation, is that this can happen. And, of course, if something can happen, eventually it will happen.

When I wrote this material -- I'm going off the text now. When I wrote this material, the cheese prices had been steadily climbing for several weeks and I was feeling like, okay it's probably not going to happen. And then we come here to Sacramento, I stop watching the market, and it starts dropping on us again, as it has been the last couple of days, once again, renewing the worry that this -- we're headed in that direction towards support and it could just blow right though it going down. I'm not saying it will. I can't predict. I'm just saying it can happen and some day it will happen.

This is easy to fix by adding a snubber to prevent the average price of cheese, as now measured by CME prices, to drop below support. We propose just such a snubber. And in return for getting that snubber, we offer to offset the costs of actual sales to CCC by instituting a CCC transaction allowance to cover the added cost and offer the added incentive to cheese plants of a market margin allowance.

CCC Transaction Allowance. MPC recognizes the added cost of selling cheese to CCC and is proposing that producers agree to pay 5 cents of the 5.6 cents of those added costs for those cheese plants making sales to CCC. We are calling this a CCC transaction allowance and the objective is to compensate the cheese plant 5 cents per pound of cheese sold to CCC under the support price program.

However, since payments by CCC are made FOB to production plant here in California, it is not appropriate to allow the California price adjuster -- to allow the deduction of the California price adjuster and we suggest that this amount be deducted from the 5 cent transaction cost. If the current 2.9 cent adjuster remained in place, the CCC transaction allowance would be 2.1 cents per pound. And I've got the math there 5 cents minus the 2.9 adjuster leaving 2.4. Another example would be that if the California price adjuster was set at 2.4 cents per pound, indicated by the audited price survey, the CCC transaction allowance would be set at 2.6 cents per pound. Again, the math is there, 5 cents less the 2.4 equals 2.6.

Market Margin Allowance. Early versions of the 4b pricing contained a sliding scale on the make allowance that was in effect -- that, in effect, allowed cheese manufacturers a better deal when prices were high and a close-to-actual-cost-deal when prices were low. This was in place for quite some time, but was finally eliminated when after a period of high cheese prices the margins allowed were no longer sensible.

Our proposal avoids the pitfalls of indexing, while giving a significant boost to cheese plant profits in times of higher prices. The proposal is to add another allowance in the cheese formula that reduces the 4b milk cost by 2.5 percent of the difference between the support purchase price for cheese and the actual CME price.

As the 4b formula now works hundred percent of any increase or decrease for that matter in the market price gets passed on to the producer via the 4b price. With the market margin allowance that changes to 2.5 percent gets added to the cheese plant margins via a lower milk price and the remaining 97.5 percent is passed on to the producer.

The CCC transaction allowance and the market margin allowance are proposed in conjunction with a snubber being added to the 4b formula that prevents the cheese price used in the 4b formula from dropping below the federal support purchase price. We are offering a deal. Of course, we would take the snubber without giving either allowance, and snubbers have been in place before, but pressures build to remove the snubbers an eventually they did get removed. On the other hand, we are not suggesting that either the CCC transaction allowance or the market margin allowance would be acceptable without a snubber being added. Our goal is to remove the objections to the snubber and have it stay in the formula without continuous attack.

The use of a snubber on cheese will not put plants in California at a competitive disadvantage because the marketplace needs the cheese produced here. It also needs the cheese from all other parts of the country and all of those plants already have access to the market and sell their cheese into that market. The only change will be that everyone in the cheese market will know that support is truly the floor price, just as it is in butter and nonfat dry milk markets.

The California Price Adjuster. Milk Producers Council has long thought that the California price adjuster was out of step with reality -- with the reality that California is now, and has been for quite some time, the residual source much cheese in this country. As such, prices for cheese should increasingly act as if they were priced here in California instead of in Chicago or Greenbay. The result of that should be that the difference between the price -- in price between the CME and the actual sales price in California should gradually narrow.

Our proposal to apply only 50 percent of the difference was designed to force that result. However, much of our thunder and indignation was removed when the new audited data was released showing that the difference was 2.34 cents instead of 3.24 cents per pound first reported. The new numbers indicated a gradual decrease in the difference as opposed to the first reported number which was an increase in the difference. Instead of pressing this particular issue now, we are content to wait and watch and appreciate the workings of the market.

Cheese yield. While we believe that the cheese yield used in the 4b formula is, if anything, low, it is our position that overall the formula does yield a rational price. The issue of cheese yield has been thoroughly debated in previous hearings and the Department has wisely left the yield alone. All of this early testimony has been referenced into this hearing record. In light of this history and the consistency of the Department findings in the past, it is time to judge any changes against a higher standard that demands compelling new evidence to support the change.

We would like to add one new piece of evidence that supports no change in the yield factor. We call the panel's attention to an article on page W-86 and W-87 of the April 25, 2006 edition of Hoard's Dairymen. The article is about Hilmar Cheese's ground breaking at their new plant in Dalhart, Texas. The article includes a table of cheese yields that was used by Patty Stroup, the spokesperson for Hilmar Cheese during her presentation on how Hilmar Cheese Company's cheese yield based pricing program works. According to that table on their, at 3.7 percent butterfat and 3.1 percent protein, the yield is listed at 10.2 pounds per hundredweight. Need we say more. A copy of that table is attached. It's exhibit B.

Whey butterfat. The average butterfat content of milk in cheddar cheese plants is nearly 4 percent. Even if all the Jersey milk produced is allocated to cheese plants, as most of it is, there is not enough of it to move the average up to 4 percent. Since we know of no cheddar plants actually purchasing fresh cream and we do know that cheddar plants do purchase condensed skim, it seems clear that they are wisely tailoring their milk components to maximize the use of whey cream in cheese.

Seldom, if ever, do cheese plants make or sell whey cream butter. Plant managers have learned over the years that rotating the whey cream after processing back into later vats of cheese is a far more preferable recovery than making off-grade butter. Because of this, it no longer makes sense to apply the 10 cent per pound deduction for whey cream presently found in the 4b formula.

We propose that the whey cream be valued at the butterfat values established in 300(D)(1). Because this section already contains a make allowance and the FOB California price adjuster and is adjusted for butter yield, the butterfat value should be used without additional adjustments times the yield of whey cream.

Formula manufacturing cost allowances. MPC has no objection to changes in existing manufacturing cost allowances as long as they are done on the basis of actual cost increases. The indexing proposal of Alliance of Western Milk Producers is a major change from existing procedure in that for the first time cost allowances would be adjusted based on factors other than real costs. As such, it removes the incentive for plants to aggressively manage their input costs, because the indexing formula would always protect them.

Additionally, experience has shown that in the volatile market conditions -- that in volatile market conditions indexing will often lead to unacceptable results. For these reasons, we cannot support this indexing proposal.

We have already requested an opportunity to file a brief.

MR. VANDEN HEUVEL: Yeah. We do have a few other comments to make based on things that had been said earlier in the hearing. One was a question that Mr. Gossard asked of a witness in regards to buttermilk powder. And we did want to note that there is no proposal in front of this hearing with regards to changing the way we calculate the 4a price with regards to solids nonfat, but that question did come up, and so we wanted to address that.

It's important to note that we have known for a long time that 4a solids nonfat is a combination of sale of nonfat dry milk and buttermilk powder. And the Department did yield studies, probably a decade ago already, that calculated the amount of nonfat dry milk and buttermilk powder that was yielded from milk that went to California powder plants. And those yield -- that yield study showed that -- and I am going from memory -- but it was about 103 to 104 pounds combined of powder was produced from 100 pounds of SNF, which is logical, because there's moisture in the finished product of somewhere between 3 and 4 percent. And yet the yield -- so that means for every 100 pounds of SNF that they're paying to farmers, they're getting to 103 to 104 pounds of finished product that they're able to sell.

The yield we use is 1. And we don't argue with that 1, because we realize that buttermilk powder is kind of the wild card in that, and sometimes it returns as much as nonfat, sometimes a little less and it will vary. And you also didn't hear the witness who brought that issue up asking for any change, but I would -- we wanted to bring that point into the hearing with regards to buttermilk powder and the yield.

The other issue, and I don't know, maybe Mr. Gossard is going to ask us about this with regards to whey cream and our proposal to value the whey cream portion at the butterfat value, because it's very clear from and very consistent over really many, many years that -- and there is way more vat -- fat butterfat in the vat in California than can be accounted for by the amount of milk that comes into that plant. I mean, three six five to three seven, you know, it changes a little from year to year, but that's where farm milk is.

I did check with the DHIA and the Jersey population while increasing is still, I think, less than 10 percent of the cows in California. And so there's just mathematically not enough fat to get to the those vat fat levels, absent some supplemental fat. And we don't know of any cheese plants that are buying fat to put in a vat. So we have to conclude that -- I mean that is why we conclude that the whey cream in cheddar -- and this is the main point for Mr. Gossard. We are dealing with a cheddar pricing formula.

And while I understand in other cheese products, because of the nature of those products, this may not make sense, we are -- we have decided as a matter of policy and practice to price milk for cheese at the 4b formula based on a cheddar formula. And those cheddar vats have got additional fat in them. And that fat has got to come from somewhere and that whey cream is where it's very likely coming from.

With regards to then not having a whey cream yield, well, there has to be a whey cream yield, because we're not valuing the full 11 pounds that they're making out of that vat in our 4b formula. We have a yield that's based on 91/92 percent fat recovery. And you can kind of back your way into it using the VanSlyke, and we're not going there.

But the fact remains that the yield that we use in the 4b formula is based on a, somewhere between, 90 and 93 percent fat recovery, and that they're not throwing that additional 7 to 10 percent fat away. It has to be accounted for in the 4b formula. We're valuing it as whey cream, and it seems like the evidence is really pointing that that whey fat is coming back into the cheese vat.

And so those are -- that's realty the answer to Mr. Gossard's question.

You have to have full accounting of all 100 percent of the butterfat that goes into a cheese plant. We decided to value some of it as cheese and the other portion as a whey fat value. We're just making the point here that they're not making "b", so there's no reason for the 10 cent deduction to correct for double A to B and they're already getting a make allowance in the butterfat price that we're suggesting the 4a butterfat price has already taken out of it a make allowance to convert regular fat to butterfat -- to butter. So those are answers to those couple of questions that came up.

And then just probably one last comment. There's a lot of talk about, you know, plant capacity. And this is a difficult issue for the industry to wrestle with and for the Department to wrestle with. I appreciate the difficult job that you've had. And, you know, I can think back to the first time I testified I think it was 19 -- I don't know -- '85 or '86. And in the old Department auditorium, the panel sat way up here. We sat down here. We kind of looked up and this was a pretty intimidating thing. We were battling about those same issues then.

It's a different industry today. It's a much more mature industry today than it was then. And I really hope that the Department -- I find it fascinating that it's the processors who are worried about plant capacity. I would think most buyers would be thrilled to have their suppliers just dying to give them everything they could get, which I think should tip you off that, you know, maybe there's something else going on here.

When you look at the base economics of the proposal of the Dairy Institute, it's to transfer somewhere between 100 million and 200 million out of producer's pockets into theirs, with no corresponding commitment to build anything. And I think there's a lot wisdom. I really admire my colleagues like Domenic Carinalli and Ray Souza who have been in this industry for decades and not typically testify, but they came up here and they shared with you.

What Dairy Institute is proposing is a radical policy change. It is not supported by producers. When this policy was implemented in a more modest form in the early eighties, it was supported by the vast majority of producers. It is not today. We need to look at other alternatives. We've got to talk about plant capacity. But I think the Department took upon itself in the eighties to provide a California home for every gallon of milk any California dairymen wanted to produce. And you could do that with when you had a pretty strong industry consensus, which you don't have today.

But what you're essentially being asked to do today is to socialize the cost of expanding plant capacity to take money from Domenic Carinalli up there in the north bay who has no opportunity to grow to take advantage of that new plant capacity, or the gentleman from Marin county, and any number of the other producers in this state. We have to -- we're being asked to support a policy that works for on -- maybe one region, you know, the central valley. Although, I would argue, and have argued, that it really doesn't work long term there either.

We have to come to grips with the fact that this industry is probably about as big as it can get in terms of big capacity. We can still grow small -- with small increments, but we can't see the kind of 5 to 10 percent gains. We just don't have the ability to do that. It's not sustainable. And, you know, the amount of money we're losing right now, you know, the numbers will speak and you will see by later this year reactions from the producers in terms of production and supply and demand will come in to balance.

And so I think, you know, the Department has a difficult job. They've got to weigh a lot of conflicting testimony. I imagine you guys will spend a lot of time trying to sift through this and do the write thing. I've got huge respect for you, and I think you will do the right thing and we'll survive, and do okay. But I think the Dairy Institute is proposing a radical solution that doesn't work for the next century.

HEARING OFFICER KRUG: Thank you very much. Your request for a post-hearing brief was granted yesterday. Yes, it's clear. It's been granted.

Are there any questions for the witnesses?

HEARING OFFICER KRUG: Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: On page 4 of your testimony, when you were estimating the protein value in the skim whey powder, what assumptions did you make about the protein level?

MR. VAN DAM: I was thinking about that this morning. I'm pretty sure I used 12 and a half. I could get back to you with the exact number.

AGRICULTURE ECONOMIST GOSSARD: If you'd put that in your post-hearing brief.

MR. VAN DAM: Yes, I will. And then 34 percent for the whey protein concentrate.

AGRICULTURE ECONOMIST GOSSARD: My next question is on page 8. You have a proposal for the cheese formula for a snubber and then a transaction allowance for sales to the CCC. That's only going to work for cheddar cheese.

What about mozzarella plants? They would still be having a problem. They don't have the support purchase price for mozzarella.

MR. VAN DAM: Mozzarella cheese is almost totally made to market. They already have to deal with the market conditions. And if the price that the world has for cheddar cheese is above support and their entire pricing, system, as they've admitted and it is so, is based on the price of cheddar cheese off the CME exchange, there will be no harm. They still have to make their adjustments for volume based on what their customers want, not based on anything that's in the pricing system.

MR. VANDEN HEUVEL: Let me add to that. You know the whole idea behind this is to keep the price from dropping below support by making the support price a meaningful price. And I think what was demonstrated in 2002 was that because both the federal and the State -- both the federal order system and the State 4b price allowed processors to essentially -- I mean, they were inoculated. I mean it's amazing they stopped at 98 cents, really. Theoretically, they could have gone all the way down to 50 cents or whatever. And I guess if they got, you know -- if they gave the cheese away, we'd have to write them checks for the make allowances.

I mean, theoretically we could come on with a negative 4b price the way this thing is currently constructed. And the idea was -- but what we found was -- an interesting history was that when Secretary Lyons put in that snubber, you know, days before it became implemented, boy, that market price started moving up, which was a pretty clear signal that what California decides to sell its cheese for -- what our processors' cheese plants decide their cheese for has a huge role in what the national price surface is for cheddar cheese and therefore all cheese.

AGRICULTURE ECONOMIST GOSSARD: Thank you. No further questions.

HEARING OFFICER KRUG: Do any other panel members have questions for the witnesses?

Mr. Ikari.

DAIRY MARKETING BRANCH CHIEF IKARI: I just have one. Maybe I missed it, but I didn't see testimony with respect to the floors on had 4a. Has MPC taken a position on that?

MR. VAN DAM: We would be for the floor, but we have not taken a position at this hearing on that.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. Because I didn't see that in your testimony.

MR. VAN DAM: No, we did not mention it. Our concern is the floor on 4b, that's where we think the big payoff is and the big concern is.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. And the federal government has never implemented a floor is my understanding, am I correct, in their Class III or Class IV price?

MR. VAN DAM: I'm afraid I can't answer that. I don't remember. I don't remember that they've done it, so I can't argue that they did.

MR. VANDEN HEUVEL: Their history -- you know, for many years they operated with EMW, which was a, you know, a different type of a pricing series, so then they adopted a product value system like we have really in the last decade. And they make changes really, really slow. There is no floor, and I don't think there ever has been in the last decade in that system.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, we can agree that since end product pricing has been used in the federal orders, they have not implemented a floor.

MR. VAN DAM: I think that's correct.

MR. VANDEN HEUVEL: That's correct.

DAIRY MARKETING BRANCH CHIEF IKARI: What do you think the long term ramifications would be if California had a floor and the federal orders don't have the floor and the price could drop below the floor?

MR. VANDEN HEUVEL: I think the California sellers will make sure that the CME price doesn't drop below floor to protect their markets and they have the capacity to do that as we saw demonstrated in 2002. No one else really wants to sell below that price. It creates lots of political problems if nothing else. But economically by having the California cheese makers have a financial incentive to keep it at that -- at the CCC price, we're setting that market. And remember that we are not -- we are offering a CCC transaction allowance and we are also offering a market margin allowance in exchange for that snubber.

DAIRY MARKETING BRANCH CHIEF IKARI: On page 2 you talked about no longer having Federal Order 135. And does a deregulation of major market undercut or enhance the regulated price in a state program?

MR. VANDEN HEUVEL: In which state program?

DAIRY MARKETING BRANCH CHIEF IKARI: In the California program.

MR. VANDEN HEUVEL: Bill, as you know, has quite a bit of knowledge and so I'll say a few things, but certainly Bill might be able to add to this. I think Order 135 going out is a disturbing trend. I understand why it happened. Through the affiliation that we have with producer trade associations with the dairymen that are in Idaho and Utah, we have gotten to know the producers there, they have voted out 135 because they're very, very frustrated with the slowness of USDA's hearing process. And, you know, I think some of those guys are regretting it today. Some others in Idaho are not regretting it. They have a different attitude.

I think it's a danger signal for us in terms of, you know, how you maintain regulated prices when you have neighboring areas that are unregulated. And I do think, you know, over the next 5 to 10 years we could go a variety of directions. And I think this -- so, you know, I can't answer your question as to, you know, whether it's good or bad for us, but it's certainly something that we ought to be concerned about. But I don't think you can be just a little bit regulated, you're either regulated or you're not regulated. And trying to be regulation light doesn't work in this context. By having a low regulated price in California, they'll just match it. I mean, it won't work for us.

DAIRY MARKETING BRANCH CHIEF IKARI: But isn't there also a risk if you have a large amount of milk that's unregulated that the higher you raise the regulated price can you really sustain that in terms of you have an artificially high price, but can you really market your product?

MR. VANDEN HEUVEL: No, you can't, but we're not asking you for an artificially high price. We're not asking -- you know, it was very interesting to us -- you know, we tried to -- we're in favor of the current 4b formula, okay. We opposed and strongly urged the Secretary not to hold this hearing. The 4b -- we're not asking for a price increase. We came up with some ideas and some alternatives which then your staff, you know, ran the numbers on and we were surprised as anyone to see that our proposals, when the Department did the analysis, resulted in a price increase. That was not our intent.

So, you know, the premise of your question -- if the premise of your question is can you support an artificially high price? No, but we don't think we're asking for an artificially high price. We think the current 4b price is about right. And, you know, the only thing that's made it a little bit skewed is the fact that we've had a situation the last number of months where dry whey appears -- the price appears to be high relative to the whey protein concentrate price. And so it's created some tension, but it will correct and it's been correcting already. I mean, the dry whey price is coming down in the market place and these markets will correct.

So I don't accept the premise -- yet, you cannot maintain a high regulated price on Class 4 or on Class 1. I mean, you've got the same, you know, types of issues and so you've got to be sensitive to that.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

HEARING OFFICER KRUG: Are there any additional requests for the witnesses?

RESEARCH MANAGER II GATES: Just one question.

HEARING OFFICER KRUG: Ms. Gates.

RESEARCH MANAGER II GATES: Mr. Vanden Heuvel, just one quick question. On page 7 at the bottom of the second paragraph. "That being said, if the only other option is removal of the whey factor from the 4b formula, we would support adding WPC-34 with a manufacturing cost allowance that is calculated to make whey price neutral over the past 5 years." What did you mean?

MR. VANDEN HEUVEL: If you take the existing -- you know, we had a difficult time. I was very intrigued with Tom's question of -- who did he ask? He asked someone to put on the record a manufacturing cost, I think it was Patty from Hilmar on WPC. You know, we scoured the record for a cost for WPC. And, you know, the record is pretty empty, so we're hoping Patty comes through with some numbers there to help educate us.

But lacking that, we just take the whey values -- the dry whey value generated over the last 5 years, take the whey protein concentrate market prices and back our way in to a make allowance for WPC-34, so that the end result is the same price as what we would have had in the dry whey formula.

RESEARCH MANAGER II GATES: Okay. Thank you.

HEARING OFFICER KRUG: Any additional questions for the witnesses?

No additional questions. Thank you very much. You're excused.

We have one more witness signed up. Mr. Richard, Cotta would you please come forward. And after Mr. Cotta testifies, has Albert Nunes arrived yet?

MS. LaMENDOLA: He should be here within minutes. We're have someone watching for him.

HEARING OFFICER KRUG: Okay. These then are our last witnesses present. If anyone else wishes to testify, respond or add to, your opportunity will be following these witnesses.

Mr. Cotta, I see that you're not alone there. Could you both please identify yourself?

MR. COTTA: Richard Cotta, California Dairies.

MR. HEFFINGTON: Joe Heffington with California Dairies. Last name is spelling H-e-f-f-i-n-g-t-o-n.

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

MR. HEFFINGTON: I do.

HEARING OFFICER KRUG: I don't recall whether I swore you in yesterday or not. You were both sworn and you remain sworn at this time.

And you are representing California Dairies Incorporated?

MR. COTTA: Yes.

HEARING OFFICER KRUG: You're continuing to represent California Dairies Incorporated?

MR. COTTA: Yes.

HEARING OFFICER KRUG: Okay. You may proceed with your testimony.

MR. COTTA: And we've been sworn at since yesterday too.

(Laughter.)

MR. COTTA: I merely wanted to clear up one of the answers to Mr. Ikari's question yesterday on plant capacity.

If you took it to mean what was the entire -- the plant capacities available in all the states, I took your question to indicate what is the balancing capacity left in the state of California. And from our perspective, the balancing has capacity been used up, as evidenced by what's occurred this winter, as evidenced by what's occurred during the peak time of production. And I wanted to come back up and just clarify that point, not speaking as to what maybe available for cheese manufacturing plants or whatever, but our balancing capacity is stretched and is full. So I wanted to clarify that.

HEARING OFFICER KRUG: Do you have anything else to add?

No.

HEARING OFFICER KRUG: Any questions for the witnesses?

Not seeing any questions, thank you very much, Mr. Cotta and Heffington.

Now, would anyone else like to testify? I see Mr. Schiek has indicated a request. Would you please come forward.

DR. SCHIEK: Thank you.

HEARING OFFICER KRUG: Would you please identify yourself again for the record.

DR. SCHIEK: Yes. I'm William Schiek, S-c-h-i-e-k.

HEARING OFFICER KRUG: Yes. And as with the others, you were sworn in yesterday and you remain sworn. Please proceed.

DR. SCHIEK: Yeah. I wanted to get on the record with some testimony responding to some of the new information that was submitted, so that I can address it in a post-hearing brief.

HEARING OFFICER KRUG: And you are speaking on behalf of --

DR. SCHIEK: Of the Dairy Institute.

HEARING OFFICER KRUG: Thank you.

DR. SCHIEK: The Center for Race, Poverty and the Environment has submitted a letter to the Secretary that has been entered into the hearing record suggesting that this proceeding and the potential amendments to the stabilization and marketing plans are subject to CEQA requirements. I would like to make some comments here and reserve the right to elaborate further in my post-hearing brief, which was granted yesterday.

This proceeding and any amendments to the plans do not mandate any entity to undertake activities that would impact environmental quality. Any activity in this industry that might have the potential impact on environmental quality, such as building or expanding processing plants or constructing or expanding new dairies, are reviewed by a variety of State, regional and local agencies.

It is my understanding that procedures and proceedings by which product manufacturers or milk producers gain approval from these oversight agencies for new and ongoing activities are subject to extensive review, that includes determinations as to whether the activities requires CEQA review. Since CEQA requirements are reviewed by these oversight agencies, it is, in my view, and backed by extensive history of CDFA hearings, such as this one, that amendments to the milk stabilization and marketing plans are not subject CEQA. I just wanted to put that on the record and elaborate on it in my brief.

I wanted to make a comment on the issue of R squares versus correlation coefficients in terms of appropriateness. This is just one of those picayunish sorts of things that economists get really concerned about. It's my contention that R square is more appropriate in a correlation coefficient. And that's a technical, statistical argument that I'll put in my brief and not bore everybody here with it, but I wanted to address that.

And finally, comments from Western United Dairymen in their testimony regarding their offer to host a public dialogue on a bunch of the issues confronting the industry. I just have to say we really welcome that offer and we are always eager to participate in industry discussions about how to handle to meet new challenges facing the industry.

However, I'm kind of concerned, possibly with the potential inference from their testimony from statements by Mr. Ray Souza early this morning that might be that the hearing panel need not address the plant capacity issue because the producers and the processors are going to get together and figure this out and come up with an agreement on how to solve the problem.

Now, I don't want to be a pessimist, but my experience in the industry today here in California and even in the industries back east earlier is that issues -- on issues such as these, the industry can get together and have discussions and there is a considerable exchange of opinions and views, respect for other people's view points, even education that occurs between the different parties involved, but little agreement on how to proceed. The Secretary and Department staff will probably remember the Costa Round Table in 1997, where producer and processor groups could not really even agree on what had happened in the past, let alone what was going to be the best course to pursue in the future.

This is just but one example. Others more recent include the workshop held by the Department last fall that was part of the may hearing decision, and the CMAB Study Steering Committee meetings this year where there's likewise been little consensus. Another example would be the transportation allowance series of workshops that the Department invested a lot of time. Again, a lot of discussion, very profitable, people learn a lot from it, but there doesn't seem to be anything that really comes out of it. I'm not trying to jinx it before it happens, but I think we've got to be realistic.

The Legislature, I would also point out, has given the Secretary both the authority and the responsibility to operate the milk stabilization marketing plans and program, such that the public interest is served. And I think it's, therefore, appropriate and necessary for the Department to engage and make needed changes to the stabilization plans based on hearings such as this one. And we urge the Department not to abdicate its responsibility by leaving it to an industry discussion that has never, in my experience, reached consensus on pricing or policy issues.

It's also been said repeatedly at this hearing that the time could not be worse for the hearing. And we understand producer costs are up compared to where they've been in the past years and that milk prices are down, and we understand that. I think we talked at length in our testimony about the margin crisis that's facing the manufacturers, particularly cheese makers. Again, from my experience, I would say that looking at producer statements in the past, it's really never a good time to make pricing adjustments downward. And, you know, in 2005 I'd say the producer community argued just as vehemently against any corrections or any increase in cheese maker margins as they have today.

And prices were high in 2001 and in 1999, and likewise there were arguments against any increases in plant margins. So I just want to say that delaying an adjustment that is needed in the formula will only make matters worse for producers in the long run as milk supply continues to outstrip capacity.

Thank you. That's all I have.

HEARING OFFICER KRUG: Are there any additional questions for this witness?

Not seeing any additional questions, you're excused.

Yes, is there an additional --

MR. VAN DAM: Just a question of the hearing officer about admissibility of material in post-hearing briefs. There were a couple of things that I have not mention in my testimony, I'll respond to from other people. Do I need to have gone up there and responded to those things in order to put them in the post-hearing brief, because I'm clear what your instruction was earlier.

HEARING OFFICER KRUG: Okay, and thank you for mentioning that. I was going to address that right now. Post-hearing briefs are limited to amplifying, explaining or withdrawing your testimony that was provided. So if you didn't raise the issue in your testimony, you are precluded from addressing it in your post-hearing briefs.

Having said that, why don't we take about a 5-minute break and you can gather your thoughts as to whether or not there is something you want to supplement in your testimony with to allow for your post-hearing brief, to reply to additional things. And, you know, as we've noted there have been letters that have been submitted probably after you prepared your testimony, if you want to respond to those letters, you might consider that now and we'll go off the record and take 5 minutes.

(Thereupon a recess was taken.)

HEARING OFFICER KRUG: Okay. We're back on the record ready to proceed with our next witness. Mr. Albert Nunes. Mr. Nunes, would you please state your full name and spell your last name for the record.

MR. NUNES: My name is Albert Lewis Nunes. My last name is spelled N-u-n-e-s.

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

MR. NUNES: Yes.

HEARING OFFICER KRUG: Are you representing any organization today?

MR. NUNES: No.

HEARING OFFICER KRUG: Thank you very much. Do you have any written statements or other documents or things you'd like entered in to the record.

MR. NUNES: Yes, I do.

HEARING OFFICER KRUG: Okay, do you have copies of them or --

MR. NUNES: No. Can I get them to you later, fax or E-mail or something like that or do I have to have it when I'm here? The problem is is I didn't realize I was going to do this and I don't have information in a format I can give to you.

HEARING OFFICER KRUG: Okay. Certainly. Why don't you just submit them with the post-hearing brief.

MR. NUNES: Okay. Actually, that's what I meant to say a post-hearing brief.

HEARING OFFICER KRUG: That would be fine.

Proceed.

MR. NUNES: A little bit of who I am. I'm an accountant. I'm a CPA and partner in the firm of Genske, Mulder and Company. We do -- about 20 percent of the milk produced in California are our clients. So when I'm giving you our data set, it's coming from a pretty large sample size of dairies. We also have dairy clients in about 27 or 28 other states.

What I did was when I heard this hearing was going to come about, I went back and I looked at our cost studies. And what our cost studies are are basically P&L statements. And we just summarize them all together and cost are broken down per hundredweight. And I compared 2004 and 2005 together. And the first thing that I noticed when I did that was costs to dairymen went up 61 cents a hundred. The other thing I've got to clarify a little is when I'm looking at that data set, the average dairy, in the data set that I'm looking at, is 1,935 cows.

If I take an average dairy of say 500 to 600 cows, my experience tells me their costs are 20 to 40 cents higher than a dairy this size, because they simply don't have the economy of scale to have costs cheaper like usually insurances is 5 or 6 cents higher, fuel and oil, a little bit on feed supplies. They're just not big enough to get deals on what they buy.

Then I took it and I did, what I call, a cash-flow break even, what does it take -- what costs does it take for a dairy to break even? And so I took the costs in '05 and I looked at putting a 1040 milk price, which is from what best I can understand myself and hear from other people 1040 is probably a pretty close to the milk price you're going to get in '06. That average dairy is going to lose 2.48 cents a hundredweight or $507 a cow.

Two other things that are not in this. One is interest rates in '05 average prime rate was 6.1 or 6.2 percent. Prime today is 8 and probably going to go a little higher. Everyone 1 point increase in interest rate is going to add 13 cents a hundredweight to the dairyman's cost, so you've got at least 26 cents more coming in to '06.

The other thing that's going on is feed costs. When I look at my 2005 numbers, that's January through December, most clients, at least that I have that I look at, contract their feed, so they contracted feed in '04 at a much cheaper price, and is fed January through usually June July. And then they don't to have start buying the higher price feed, because feed went up in '05, but they didn't actually physically have to pay for that until probably July on.

So I've got a blend of a little cheaper at the beginning of the year, a little higher at the end. My guess, it's about 10 cents to 15 cents higher in '06 then what I'm looking at here from 2005.

And just to put cents to dollars, 50 cents is equivalent to $102-a-cow loss. So if I increase my costs by 50 cents, my $507 loss per cow will turn to $609 a cow. The other thing is so these are just strictly hard numbers, just looking at what would happen. I read the -- well, I don't remember what the wording of it was, but basically the hearing what it was about and I was looking at I think it was Western United Dairymen calculated a 50 cent increase or 50 cent possible decrease in the price of milk to dairymen. Well, that's -- again, that's $102 loss that you're going to add to the dairymen which is going to take them from 507 to 607, and then that doesn't include the increased costs that I know are going to already hit them in '06.

Most banks are going to loan a guy no more than $900 a cow. If a guy is going to lose $500 to $600 a cow, where is he going to fund this at? You're going to -- you know, he's going to -- he's toast. Unless he has no debt or very little, they're going to have a hard time making it through this year.

My experience is most dairymen are carrying probably about $500-a-cow debt. That's their cow debt normally. And so they have the ability to borrow 400. People who have been in it a long time, have strong balance sheets, obviously are going to have no debt or very little per cow. The average guy is probably $500 a cow debt he's going to carry right now.

The other thing what I was looking at is, I -- you know we have clients in a lot of other states, and I'm noticing more and more people wanting to leave our state. You know, California was, by far, the number one dairy state in terms of milk produced, but also in terms of profitability. It was a good place to operate. We have good weather, cheap feed, a lot of good reasons to stay here.

But now with escalating land prices dairymen are having to get bigger and bigger. Some people get bigger just because they're greedy. They want more money and all that. But other people are getting bigger just because they have to to be able to compete, to be able to stay in business. They've got to be able to spread their fixed costs over a lot more cows and they're getting bigger.

To get bigger now you're going to have to buy land. Well, land in California is at least 2 to 4 times cheaper almost anywhere else you want to go. I mean, you can go to the midwest, you can go to Kansas, $1,200 to $1,500 an acre, Texas close to the same, Colorado. And all those places have much cheaper feed costs than we have here. So we're seeing -- I'm seeing myself more and more people want to leave our state because it's very hard to dairy in this state. It's very hard to expand because of the land prices. It's also very hard to expand because we have very strict environmental standards that are hard to meet. They're hard to meet and also very expensive. They're not even having to pay these costs but, you know, down the road these costs are going to hit. They're going to have to do, be it lagoon, be it air, whatever you have to do, that's going to cost money, which is reflected nowhere in my numbers, because that cost that's eventually going to hit the dairies aren't even in my numbers yet, because they're not doing it yet.

Those 2 reasons people are leaving -- are starting to leave our start. We're already seeing Washington more profitable than California and Texas. We're seeing other states getting closer and closer to California.

The other thing that I'm seeing in California that the dairymen need to do, which I just went over, they actually have to more profitable than the other states just to be able to afford to buy the land to expand that, to be able to afford the environmental costs that we know are coming down the road. So my point was, is when I look at these numbers, I actually never looked at them until I was going to come and speak at the hearing and go over the numbers. I was shocked at the loss that would happen if milk stayed at 1040. And I already know in my practice starting already in probably April, May, I noticed dairymen were saying hey, we're having a hard time paying bills. You know, what's going on? Is there anything we can do?

My first gut reaction was like, I mean, milk has only been down a couple of months, why would you guys be crying so early? Butt when I go back and look at the numbers, I can see why. When I went back to '05, and most people assume that '05 was a pretty good year, because milk only dropped 70 cents a hundredweight over '04. But because of the increase costs, the average dairy, this 1,935 dairy only made 29 cents a cow per hundred.

So when we came into '06 and milk dropped, milk only had to drop 29 cents and they're already breaking even. Well, when it came down to 1050, I can see very quickly why they're crying, because it -- the costs went a lot higher than I expected myself, and I know that dairymen expected and everybody else.

That's all I have.

Anybody have any questions?

HEARING OFFICER KRUG: Thank you very much, Mr. Nunes. And as referenced in our prior dialogue, you are granted the opportunity to submit a post-hearing brief, during which time you can submit the documents you referenced.

Do any of the panel members have questions for this witness?

Mr. Gossard.

AGRICULTURE ECONOMIST GOSSARD: Yes. These costs you were giving, those were just for your California clients, correct?

MR. NUNES: Correct.

AGRICULTURE ECONOMIST GOSSARD: So the 1,900-cow dairy was California average?

MR. NUNES: Correct.

AGRICULTURE ECONOMIST GOSSARD: When you submit your post-hearing brief, as a good CPA, you will carefully layout all those figures you were talking about, so we can see them in tabular form?

MR. NUNES: I'll tell you what I'll do I'll show it to you and you tell me what format you want it in and I'll do it.

AGRICULTURE ECONOMIST GOSSARD: Okay. Finally, you mentioned the increase in land costs in California, is this -- do you do anything besides dairies?

MR. NUNES: Yes.

AGRICULTURE ECONOMIST GOSSARD: You do other agriculture.

MR. NUNES: Correct.

AGRICULTURE ECONOMIST GOSSARD: Is this increasing land cost a problem in other agricultural areas of California?

MR. NUNES: Yes, but the only thing that affects the dairy is the dairy too expand has to have land because you need, you know, so many cows per acre. A farmer doesn't have to expand. He can keep where he wants to go. He can rent ground. A dairyman has to buy ground to be able to expand. And so they're going to have a little bit harder -- it affects them more than I would say a regular farmer.

AGRICULTURE ECONOMIST GOSSARD: And what's the reason for the increase in land costs in California?

MR. NUNES: Too many people, jobs.

AGRICULTURE ECONOMIST GOSSARD: Urbanization.

Thank you.

No further questions.

HEARING OFFICER KRUG: Any additional questions?

Mr. Ikari.

DAIRY MARKETING BRANCH CHIEF IKARI: Yes. When you file your post-hearing brief, it would be helpful for me, how many dairy -- maybe you said this, how many dairy farmers are included your cost and kind of the spread between of -- how long have you been doing this?

MR. NUNES: Myself?

DAIRY MARKETING BRANCH CHIEF IKARI: Yes.

MR. NUNES: Ten years. And I'll give you my back ground. I was born and raised on a dairy, and I have a dairy. So my background was basically my whole life was dairy related. The amount of -- we have 20 percent of the milk produced in California are our clients. In terms of dairies, it's not going to be 20 percent of the dairies, because we tend to have a little larger over the smaller dairies.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, you gave averages, but I'm curious about ranges.

MR. NUNES: Can you clarify what you mean by range to me? You mean, like 600-cow dairies?

DAIRY MARKETING BRANCH CHIEF IKARI: Well, in terms of -- in terms of costs, what are some of the low-costs producers doing, because, you know, we have an interesting phenomenon for 20 years we've increased production. And I assume that those producers at the bottom end or the most efficient producers are the ones expanding. And you indicated that, you know, that dairies are getting larger.

MR. NUNES: I'll tell the most -- the unique thing when I looked at the numbers were this, we have a thing called our top 25 percent. It's the 25 percent most profitable clients. We use that as a benchmark to compare the people to say if you're not making money, what are you doing wrong to be able to do that.

The top 25 percent obviously makes money than the average. But the average herd size in the top 25 percent is 3,500 cows. There's not -- you know, there's not that many 3,500-cow dairies other than the Tulare area, a couple in the Modesto and Stanislaus are. But these larger guys are basically Tulare.

When I took the top 25 and I looked at '04 and I found what they did with the money in '05, the top 25 paid debt down in '05. The average client debt increased. He expanded. He made money in '04 and he expanded because he wants to get bigger and more efficient and actually had a little bit more debt in '05 than he did in '04, because he had a good year in '04. That's what he used his money to do.

DAIRY MARKETING BRANCH CHIEF IKARI: The persons that are going to survive are the ones with a low debt load, I imagine.

MR. NUNES: No, the most efficient. When we look at our top 25 percent, and I compare them to the average guy, the odd thing is sometimes interest costs are actually higher on the top 25 than it is on the average. It's still -- you know, in a diary all you can do is control your costs and be efficient. And if you incur debt the right way and leverage it the right way, whatever you use your debt to buy is going to make enough money to make your payment. And also it's the structure of your debt, if you can make it long term on land, the smaller the payment, there's a bunch of different ways.

DAIRY MARKETING BRANCH CHIEF IKARI: The

information that you have is with respect to California?
MR. NUNES: Yes, but I can give you any other state you wanted. I mean we have Texas, New Mexico, Arizona, Idaho, Washington, high plains, which is Kansas, and Oklahoma and Nebraska, I believe.
DAIRY MARKETING BRANCH CHIEF IKARI: Because the interesting thing is with low prices what area of production goes out first in the nation. And if you can correct the production problem, you can raise the prices and so those people who survive, you know, how long is this going to last, but we won't see it until production comes in to balance with the demand. And the question is does more of the California farmers goes out before more of the mid-western farmers go out?
MR. NUNES: Who will go out first is the last to have built and started a dairy. Say, somebody started within the last 3 years, which there's a decent amount in the midwest dairy or high plains area, they're going to hurt a little bit more because they have -- they're much higher leveraged than they are here. They're going to have a lot -- probably double the leverage we have here.
DAIRY MARKETING BRANCH CHIEF IKARI: So based on the cost of production information that's available to Genske Mulder, can you -- will that information kind of give you an estimate of what areas you think might be

hurting?

MR. NUNES: What areas are going to be hurting? Wow, I'm not sure I understand your question right, but if I just look at California, and if my numbers are real, and they are real, these come from, you know our clients, you're going to have a huge blood letting in California if milk stays at 1040. You knock 50 cents off of that and -- you can only borrow 900 bucks a cow.

DAIRY MARKETING BRANCH CHIEF IKARI: Yeah. Well, that's a comparative advantage. And I guess I'm asking the question if you have information on costs throughout the U.S., what areas are the most vulnerable to low prices and which should you see the impact on their production levels, first?

MR. NUNES: You know, I couldn't give you that answer. I don't know. That's a good question. I couldn't give you that answer.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay.

HEARING OFFICER KRUG: Any additional questions for this witness?

Thank you very much Mr. Nunes.

MR. NUNES: You're welcome.

HEARING OFFICER KRUG: That completes the list of persons that have signed up. I know Mr. Van Dam would like to speak again. If anyone else has anything or would like to testify or supplement their testimony, please come forward.

Mr. Van Dam.

Just state your name for the record and proceed.

MR. VAN DAM: My name is William C. Van Dam. And the only reason I'm up here is to touch on 3 topics that I intend to discuss in the post-hearing briefs. And since I don't believe I touched on them during my testimony, I want to make sure that the record stays complete.

The first is with regard to Hilmar's Appendix B. I believe there's flaws in the presentation on that table having to do with gross manufacturing margins for cheese plants. And I intend to submit a corrected, at least in my eyes, version of that table.

Number 2 is a list of plants that went out of business. There's a point to be made there about dairymen going out of business that has been -- not -- we have not touched on or talked about the counterpoint to that, and I will discuss that in my post-hearing brief.

And the last one is the issue that was touched on by lots of people, that was the issue that the pricing of milk in California is only part of the reason for plants deciding not to build their new -- or companies deciding not to build their new plants here. And I want to spend some time discussing that and pointing out that the other issues are undoubtedly of greater consequence than the price alone.

That's it. Thank you very much.

HEARING OFFICER KRUG: Thank you very much, Mr. Van Dam.

Does anyone -- you're excused.

AGRICULTURE ECONOMIST GOSSARD: Wait.

HEARING OFFICER KRUG: Oh, Tom.

(Laughter.)

AGRICULTURE ECONOMIST GOSSARD: Mr. Van Dam, you stated that you, in one of part of your post-hearing brief, you were going to discuss dairies going out of business; is that correct?

MR. VAN DAM: It was plants with a list in there, and part of what I was to going to comment on is dairies have gone out of business too and I'm not sure it's a relevant point.

AGRICULTURE ECONOMIST GOSSARD: Okay. But have the cows gone out of business?

MR. VAN DAM: Some of them. I'm a CWT guy, so I know about some of that stuff, too.

AGRICULTURE ECONOMIST GOSSARD: Okay. But if you would address both dairy numbers and cow numbers, it would be helpful.

MR. VAN DAM: I will.

HEARING OFFICER KRUG: Anything else for the witness?

Okay, now you're excused.

MR. VAN DAM: Thank you.

Does anyone else have anything that they would like to testify to?

Not seeing anyone else, all persons present and desiring to testify having done so and no additional evidence to be presented, this hearing is now closed at 12:14 on June 2nd.

We're off the record.

Back on the record.

Post-hearing briefs will be due to the Dairy Marketing Branch by 4 p.m. on Monday, June 12th. The briefs can be E-mailed to the Dairy Branch that's dairy@cdfa.ca.gov or faxed to (916)341-6697 or mailed to the Dairy Marketing Branch at 1220 N Street, Sacramento, California, 95814; or if you wish to hand deliver in person, please deliver the briefs to 560, that's 5-6-0 J Street, Suite 150, Sacramento, California.

Is there anything else?

Thank you very much.

We're off the record.

/////

/////

(Thereupon the Department of Food and Agriculture Market Milk Hearing adjourned at 12:20 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