HEARING

STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

AMENDMENTS TO THE STATBILIZATION AND MARKETING PLANS FOR MARKET MILK FOR THE NORTHERN CALIFORNIA AND SOUTHERN CALIFORNIA MARKETING AREAS

HOLIDAY INN HOTEL

CALIFORNIA ROOM

300 J STREET

SACRAMENTO, CALIFORNIA

WEDNESDAY, JANUARY 29, 2003

9:00 A.M.

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PROCEEDINGS

HEARING OFFICER ESTES: Good morning. This hearing will now come to order.

The California Department of Food and Agriculture has called this public hearing in the Holiday Plaza, 300 J Street, in the California Room, on this date, January 29th, 2003, beginning at 9 a.m.

If necessary, to assure opportunity for all persons in attendance on January 29th, today, who wish to testify and present evidence in the hearing record, the hearing may be continued to the following day, tomorrow, January 30th, 2003, at this same location.

On October 21st, 2002, the Department received a petition from the Western United Dairymen requesting amendments to the stabilization marketing plans for market milk for the northern California and southern California marketing areas.

The Western United petition proposes amendments to the yields of Class 4a pricing formula, milk used to make butter and nonfat dry milk, and a 4b pricing formula for milk used to make cheese other than cottage cheese. The proposed yield amendments would result in higher Class 4a and 4b prices.

Western United amended their petition through correspondence with the Department on January 8th, 2003.

The Department has received four alternative proposals in response to the Western United petition. The Department has received these proposal from the California Dairy Women Association, the Alliance of Milk Producers, The California Dairy Campaign, and The Dairy Institute.

During a pre-hearing workshop conducted on January 22nd, 2003, the Department provided a summary analysis of the alternative concepts and proposals, and also including the Western United petition as well. A copy of this summary will be entered into the record of this hearing as an exhibit.

Accordingly, the purpose of this hearing is to consider amendments to the Class 4a and 4b pricing formulas and the stabilization of market plans for market milk for the northern California and southern California marketing areas as were proposed in the Western United petition and the alternative petitions.

As Class 2 and Class 3 pricing formulas are linked to Class 4a prices the call of the hearing includes consideration of them as well.

My name is Richard Estes and I have been designated as the hearing officer for today's proceedings.

Testimony and evidence pertinent to the call of the hearing will be received. Anyone wishing to testify can sign the hearing witness roster located at the sign-in table in the back of the room. Oral testimony will be received under oath or affirmation. And staff is available at the back of the room to provide assistance. And I believe, at this time, that would be Cheryl Gilbertson.

Cheryl Gilbertson will be back there and I think Candace will be as well, although they're up here at this time because they'll be introducing Department's exhibits into the record shortly.

As a courtesy to the panel, the Department staff and the public, please speak directly to the issues presented by the petitions and avoid personalizing any disagreements. As hearing officer, I reserve the right to interrupt and curtail any testimony that is irrelevant to the purpose of this hearing.

As an additional courtesy, if you would please treat the panel, the staff, and the witnesses respectfully and avoid any verbal expressions of approval or disapproval such as cheering or hissing. Such conduct does not assist the panel in its attempt to effectively address the sophisticated economic and regulatory issues presented by the petitions.

Please note that only those individuals who have testified under oath during the conduct of the hearing may request a post-hearing briefing period to amplify, explain, or to withdraw their testimony. Only those individuals who have successfully requested a post-hearing briefing period may file a post-hearing brief with the Department.

The hearing panel has been selected by the Department to hear testimony, receive evidence, question witnesses, and make recommendations to the Secretary.

Please note the questioning of witnesses by anyone other than members of the panel is not permitted.

The panel is composed of members of the Department's Dairy Marketing Branch and includes David Ikari, Chief, Dairy Marketing Branch; Tom Gossard, Senior Agricultural Economist; Eric Erba, Senior Agricultural Economist; and Ed Hunter, Supervising Auditor 1. You can see them. They're all seated here -- alongside me here today.

I am not a member of the panel, although I'm sitting along with them. And I will not be taking part in any decisions relative to the hearing.

The hearing recording is, I believe, James Peters -- is that correct? -- of the firm of Peters Shorthand located here in Sacramento.

A transcript of today's hearing will be available for review at the Marketing Branch headquarters located in Sacramento, 1220 N Street, Room A247. Now, anyone desiring copies of the transcript of today's hearing must purchase them directly from Peters Shorthand. So you can review them at the Department. But if you want your own copy, you need to purchase them from Peters Shorthand.

Now, at this time Candace Gates, Research Manager of the Dairy Marketing Branch, and Cheryl Gilbertson, Analyst to the Dairy Marketing Branch, will introduce the Department's exhibits.

And let me ask each of you in order.

(Thereupon the witness was sworn, by
the Hearing Officer, to tell the truth,
the whole truth and nothing but the truth.)

STAFF ANALYST GILBERTSON: I do.

(Thereupon the witness was sworn, by
the Hearing Officer, to tell the truth
the whole truth and nothing but the truth.)

RESEARCH MANAGER I GATES: I do.

HEARING OFFICER ESTES: Would you now proceed to introduce the Department's exhibits into the record.

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

My purpose here this morning is to introduce the Department's composite hearing exhibits numbered 1 through

44. Relative to these exhibits previous issues of Exhibits 23 through 44 are also hereby entered by reference.

The exhibits we have entered today have been available for review at the offices of the Dairy Marketing Branch since the close of business on January 22nd, 2003.

An abridged copy of the exhibits is available for inspection at the back of the room. Multiple copies of exhibits 1, 4, 5, 6, 8, 7, and 19 are also available at the back of the room.

I'd ask at this time that the composite exhibits be received.

HEARING OFFICER ESTES: All right. Can you please present them to me.

And what numbers were they again?

STAFF ANALYST GILBERTSON: 1 through 44.

(Thereupon the above-referenced documents were marked by the Hearing Officer as Exhibits 1 through 44.)

HEARING OFFICER ESTES: Thank you.

Now, are there --

STAFF ANALYST GILBERTSON: Yes. The exhibit next in order is a document dated January 10th, 2003, from the Department of Agriculture, State of New Mexico, signed by Director Frank DuBois. I ask that this letter be received as Exhibit 45.

HEARING OFFICER ESTES: Please present that for introduction into the record.

(Thereupon the above-referenced document was Marked by the Hearing Officer as Exhibit 45.)

HEARING OFFICER ESTES: And do you have an additional exhibit?

STAFF ANALYST GILBERTSON: No, I do not. But I do request the option to file a post-hearing brief.

And this concludes my testimony.

HEARING OFFICER ESTES: Okay. And this request is on behalf of the Department, the Dairy Marketing Branch?

STAFF ANALYST GILBERTSON: Yes, Dairy Marketing Branch.

HEARING OFFICER ESTES: Okay. The request for a post-hearing brief is granted. In order for the brief to be considered -- and obviously this is not a big issue for the Department, but I guess the Department should be aware of its own deadline for filing the brief. The Department must receive the brief from itself by 4:30 p.m. --

(Laughter.)

HEARING OFFICER ESTES: -- Monday, February 10th, 2003. And the Department may either send or deliver the brief to the Department's Dairy Marketing Branch located at 1220 N street, Room A224, Sacramento California 95814. And it can also be faxed at (916) 654-0867.

Are there any panel questions related to the exhibits at this time?

Okay. Hearing none, does anyone in the audience have any questions regarding the content of the panel's exhibits? Now, please recognize that questions are limited to the purpose of clarification. Cross examination of the Department's staff is not permitted.

Please identify yourself and your organization for the record before asking any question.

And I would also note here that essentially the purpose that we can provide clarification through cross-examination. But we are not able to provide any sort of additional information beyond what is presented in the exhibits. Nor is it really an opportunity for challenging -- for either buttressing or challenging the credibility of the content of the exhibits.

So is there anyone at this time that would like to engage in any question regarding exhibits?

Okay. Mr. Marsh, I believe. Is that correct?

Okay. You're from Western United?

MR. MARSH: Yes.

HEARING OFFICER ESTES: Where do we have the microphone?

Mr. Marsh, if you would first identify yourself and your organization for the record.

MR. MARSH: Michael Marsh. I'm the Chief Executive Officer of Western United Dairymen. I'm also a Certified Public accountant.

HEARING OFFICER ESTES: Please proceed.

MR. MARSH: I'd like to ask a question with regard to Department exhibits dated November 25th, 2002. These are the exhibits that detail the determination of manufacturing costs for butter, nonfat powder, and cheddar cheese.

THE REPORTER: Can you speak in the mike a little bit more? I'm having a hard time hearing.

MR. MARSH: Oh, I'm sorry.

I'd like to ask some questions about Department's exhibits dated November 25th, 2002, the detail -- the weighted average cost -- manufacturing costs for butter, nonfat powder, and cheddar cheese.

The question that I have is for staff, and with regard to allocation of loss within the cost studies.

As I understand this -- for instance, I'll try to clarify this as an example. I just want to make sure that I understand this correctly.

That losses are allocated throughout the system;

and that means that, for instance, that the receipts at the farm are carried all the way through to the output at the end; is that correct? And then there's a reconciliation process that takes place in that.

And, by the way, I can -- actually I can ask a question of illustration.

For instance, if at the ranch the truck picks up a tanker load -- or a truckload that includes a hundred pounds of fat in that product, at the end of the process when it comes out the end of the plant and you have only 99 pounds of fat in the finished product, that would mean then you have a yield of .99 or 99 percent, or somewhere along the line you've lost 1 pound; is that correct?

SUPERVISING AUDITOR HUNTER: Yes.

MR. MARSH: Okay. Now, with regard -- thank you Ed.

Now, with regard to that pound of fat that's lost -- for instance, if you had a cost that you were trying to allocate against particular units at, say, $10, if you took that $10 cost and you were allocating against the whole hundred pounds of product that you picked up at the beginning of the process, then that value would be 10 cents per unit at the end.

SUPERVISING AUDITOR HUNTER: Okay.

MR. MARSH: And if you account then for the one pound that you lost that you have within the process, in other words, ranch to plant, or in-plant, then you would -- as I understand it, you would then adjust your resulting cost allocated to the finished product of 99 pounds would be adjusted from 10 cents to 10.1 cents.

SUPERVISING AUDITOR HUNTER: You're not adjusting your finished pounds. What you are adjusting is your butterfat and solids-not-fat in the finished pounds.

MR. MARSH: Correct.

SUPERVISING AUDITOR HUNTER: This would only affect the general plan expenses, not the direct expenses.

MR. MARSH: I think that's -- yeah, exactly. That's what I was getting to.

SUPERVISING AUDITOR HUNTER: And it's not a 99 percent yield in a sense. It's a 1 percent loss. And that 1 percent loss is taken out of the butterfat and solids-not-fat received in that pound, before dividing into the cost.

MR. MARSH: Okay. And that's exactly what I was getting at.

So that loss that you've incurred, whether it's ranch to plant or in-plant, impacts the final determination of manufacturing cost?

SUPERVISING AUDITOR HUNTER: Right.

MR. MARSH: It either raises it or lowers it.

Okay. Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: One point of clarification though. The milk coming into the plant is tested. So in your scenario, if it's showing that there's any loss between the farm and the processing plant, then that's where the processing cost studies would start with the receipts by the plant, right?

SUPERVISING AUDITOR HUNTER: No.

MR. MARSH: As I understand it, and just for clarification, the cost study starts with receipts at the farm.

SUPERVISING AUDITOR HUNTER: Right. Yeah, it's from the farm, Mike.

MR. MARSH: Okay. Thank you.

In a document dated January 2nd, 2003, the Department responded to a request by Western United Dairymen to provide a graduated table in that document that would display for us what the weighted averages for butter, powder, cheddar cheese were according to the updates for 2002 labor and August 2002 utility update in their costs as they were updated.

And is someone on staff familiar with that document?

STAFF ANALYST GILBERTSON: Yes.

MR. MARSH: And, Candace, in the document it ranges from 75 percent to 80 percent, 85 percent, 90, 95 percent, and 100 percent. And it says that -- in the heading it says weighted average cost per pound for butter, powder, and cheddar cheese, is that --

STAFF ANALYST GILBERTSON: Correct.

MR. MARSH: Okay. And then when it talks about the percentage of total production and -- under the item number for 80 percent, as I'm looking at the document it says 80 percent of the -- of which would be 100 percent of the weighted average cost, as I understand it, covering 80 percent of the total production of butter would then be 11.34 cents.

STAFF ANALYST GILBERTSON: Let me clarify that a little bit.

The way -- with the request that came through industry, they wanted a weighted average cost --

THE REPORTER: I'm having a hard time hearing.

STAFF ANALYST GILBERTSON: Can you hear it now?

THE REPORTER: That's a little better, yeah.

STAFF ANALYST GILBERTSON: The way this table was put together is to come up with 80 percent. And this is what -- you guys can clarify me if I get this wrong. Okay?

To get to the 80 percent or whatever percentage that is on here it took about 3 and 1/2 plants to come up with 80 percent of that volume. Okay. Then that volume -- a weighted average was done on that volume at that time.

So does that --

MR. MARSH: I think so. And the explanation --

STAFF ANALYST GILBERTSON: So it doesn't mean that it's covering 80 percent of -- of the plant's volume. It doesn't --

MR. MARSH: It's a weighted average cost.

STAFF ANALYST GILBERTSON: Yes. But a weighted average in the sense, after you take -- it's going to take 3 1/2 plants to get to 80 percent of that value. Then the weighted average is done.

MR. MARSH: Correct.

So with regard to the example that's included in the letter, the weighted average cost for butter at the 80 percent level is the weighted average cost for 100 percent of the product from the 3 lowest cost plants and approximately 50 percent of the product of the 4th lowest cost plant, which gives the recommended 80 percent, is that correct?

STAFF ANALYST GILBERTSON: Correct.

MR. MARSH: Okay. Thank you.

Now, going back to the exhibits we discussed just a moment before, with regard to the weighted average manufacturing costs. The costs were updated for labor and utilities, but they don't include anything with regard to an update for volume in 2002, is that correct?

SUPERVISING AUDITOR HUNTER: That's correct.

MR. MARSH: And as we understand it, and as we'll discuss a little later, the volume for 2002 is up significantly during that period of time -- during 2002 from 2001, is that correct?

SUPERVISING AUDITOR HUNTER: As far as I know, that's correct.

MR. MARSH: So that adjustment was not made and it's not included in the exhibits that we have before us today?

SUPERVISING AUDITOR HUNTER: Not at all.

MR. MARSH: Okay. In the -- and this is kind of a -- this is an auditing question. As we think about volume -- and I'd like to direct this to Mr. Hunter -- and you've been doing manufacturing costs audits for six months -- no, for a number of years?

SUPERVISING AUDITOR HUNTER: I've been doing it for a number of years, yes.

MR. MARSH: And in your experience as the manufacturing cost auditor with the State, has it been your experience that when you have increased volume as a product is moving through a facility, that it's likely that fixed costs and variable costs within those plants will have an impact on the final outcome of the allocation of cost to an individual product?

HEARING OFFICER ESTES: Well, Mr. Marsh, I believe that's a question beyond the content of the exhibits and their development, and constitutes cross examination of the Department based upon its experience, expertise, and a history in terms of dealing with milk pricing issues. So, therefore, he's under no obligation to answer that question.

MR. MARSH: Would you care to answer the question?

SUPERVISING AUDITOR HUNTER: I would during a workshop, Mike, but not during a hearing.

MR. MARSH: Okay. That concludes my questions.

Thank you very much.

HEARING OFFICER ESTES: Thank you, Mr. Marsh.

We'll be hearing again from you momentarily, I'm sure.

Let's see. Before we go on and take Mr. Marsh's testimony relating to the petition, I'd want to note that, you know, we've recognized that a number of people have just arrived at the hearing. I guess apparently have just -- you know, transportation just brought them here.

So I just wanted to emphasize at this point in the hearing all that we have done is basically introduce the panel and introduced the Department's exhibits and allowed Mr. Marsh of Western United to make some inquiries about the content of those exhibits and seek clarification. So we haven't addressed anything substantively in regard to the petition at this time or had any presentation related to them.

So that's what we'll be proceeding to go on to do now. And we'll have an opportunity for the public to testify after that's been done later today.

So what I'd like to do now is have Mike Marsh again come forward. Western United now has 60 minutes to make its presentation in support of its position, this petition.

Okay. Michael Marsh, Chief Executive Officer, Western United, and Tiffany LaMendola, who's Director of Economic Analysis, will be making the presentation today.

(Thereupon the witness was sworn, by
the Hearing Officer, to tell the truth
the whole truth and nothing but the truth.)

MS. LaMENDOLA: I do.

(Thereupon the witness was sworn, by
the Hearing Officer, to tell the truth
the whole truth and nothing but the truth.)

MR. MARSH: Absolutely.

HEARING OFFICER ESTES: I see that you've passed out a copy of written text of your presentation here today?

MR. MARSH: Yes.

HEARING OFFICER ESTES: Would you like to have that introduced into the record as an exhibit?

MR. MARSH: Please. Thank you.

HEARING OFFICER ESTES: I'm going to go ahead and do that at this time. And we'll introduce that into the record as Exhibit Number 46. So can you do that before you proceed to make your -- to provide your testify today.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 46.)

HEARING OFFICER ESTES: All right. Now, both of you can now proceed.

MR. MARSH: Mr. Hearing Officer, members of the panel: My name is Mike March. I'm the Chief Executive Officer of Western United Dairymen. I'm also a Certified Public Accountant licensed to practice in the State of California.

With me today is Tiffany LaMendola, Director of Economic Analysis. We'll be sharing the testimony on this today.

An elected board of directors governs our policies. Our association is the largest dairy producer trade association in California, representing approximately 1,100 of California's 2,000 dairy families. We are a grass roots organization and headquartered in Modesto, California.

We are grateful for the call of this extremely important hearing based upon our petition. An extensive process was used to arrive at the position we'll present here today. Western United Dairymen starts the process with a committee of dairy leaders from around the State. They ship milk to all type of plants, and many effectively serve the industry on other boards.

At the committee level, members analyze in great detail data provided by staff and the Department. The committee conducts long and thoughtful discussions of all side of the issue at hand. Committee recommendations are presented to the board of directors for review, modification, and approval. The committee met January 6th, 2003, and the board of directors met January 7th, 2003, to approve the position we will present here today.

There are many components of our current Class 4a and 4b price formulas that must be updated. We are grateful that the Department's made available several studies that can be used to accomplish this goal. It is no secret that producers are facing prices that are at historical lows. These extremely low prices have been coupled with higher feed costs, putting many producers in extreme financial distress with no reprieve in the near future. Our petition will not solve the situation, but it will make certain that the correct level of revenues are paid into the pool and distributed to producers. It is vital to the health of the entire dairy industry that the pricing formulas upon which we rely are accurate, updated, and fair.

In our testimony today we will outline our areas of concern, discuss proposed solutions, and provide supporting information for each of our proposals.

Of great concern to our membership is the current disparity between Class 4a and 4b prices in California and Class IV and Class III prices in federal Milk Marketing Orders. A review of Class 4B and Class III prices shows that on average, from January 2001 to December 2002, California's 4b prices average $0.46 per hundredweight lower than Class III prices.

When using the Class 4b formulas currently in place, this disparity increases to $0.50. Of even greater concern is the implementation of the Federal Order final ruling on Class III and IV prices. Once in place, the disparity between Class 4b and Class III will rise to $0.71 per hundredweight. Though there are inherent differences in the pricing formulas, we feel closer alignment to Federal Order prices is attainable.

Concerns have been expressed that the regulated price in California is a true regulated price that must be paid versus a regulated price in federal orders, which does not have to be paid by cooperatives, and in many cases is not paid by private entities because they de-pool.

This is a legitimate concern. However, cooperatives in California has the same option as those in federal orders, and a cursory review of prices over the past two years tells us that plants are not choosing to de-pool in federal orders.

Our data is attached that compares uniform blend prices to Class III prices. It is our understanding that de-pooling will occur when the plant's in-plant blend price, or Class III price for a cheese plant, is greater than the announced uniform blend price. Here the processor obligation to de-pool is greater than his credit back out. Data shows that this situation has occurred in only one month over the past two years, and that was October 2001, for the Western and Pacific Northwest orders. Those plants located in de-regulated areas are likely paying prices equal to or greater than the Federal Class III price to their producers. These plants must be competitive in order to attract an adequate milk supply.

Additionally, a review of Class 4a and Class IV prices show that on average, from January 2001 to December 2002, California's price has averaged $0.32 per hundredweight lower than the federal prices. When using the 4a formulas currently in place, this disparity increases to $0.42. Once the final ruling is in place, the disparity between Class 4a and Class IV will decrease to $0.28 per hundredweight.

The Federal Order Reform has made substantial changes having successfully brought federal order pricing more in line with component pricing in California. However, we cannot overlook the current disparities and we surely cannot overlook the large disparities that will occur given the proposed changes to federal order pricing formulas.

It is imperative, for several reasons, that California's pricing maintain a close relationship to federal order prices. It is only fair that California producers capture income that is equitable and in alignment with producers in federal orders. The regulations in the dairy industry were developed to maintain an orderly and stable market for milk and dairy products both in California and nationwide. The fluctuations and increasing disparity between the prices in California and federal orders is contributing to the degradation and stability that California and Federal Milk Market Orders strive to maintain.

Dairy organizations across the nation have expressed their concern with the current price differences. Because processors outside the State are currently at a significant competitive disadvantage to processors within California, many fear that those processing companies that have the ability to do so will move their operations to California or producers will choose to vote out their federal orders. If this occurs, dairy producers outside the State as well as in California will suffer greatly. Processors and consumers will be harmed by this disruption as well.

Western United Dairymen understands and respects the unique relationship between producers and processors. It is a necessary relationship in which one relies on the others. Processing plants in California must have the ability to be competitive, both with processors inside the State and with those outside California. Without continued prosperity of a number of processing plants, competition for producer milk is reduced. Reduced competition has the potential to lead to lower returns for producers and erode the success of the entire industry.

We understand the necessity to keep California processors healthy, but we do not advocate such a huge raw product cost advantage. The disparities can be resolved in such a way to maintain the health of the processing industry here in California and bring equity to those outside the State.

We're not advocating that prices in California be higher than those in federal, but rather we are asking for closer alignment. It is especially timely that there are many adjustments that need to be made to the Class 4a and 4b pricing formulas. These adjustments are warranted and supported by updated accurate data.

We will now go through each of our proposals in detail.

MS. LaMENDOLA: With regard to Manufacturing Cost Allowances:

Our board recognizes that manufacturing allowances are a necessary component of current end-product pricing formulas. It is necessary that these "make allowances" be set at appropriate levels that cover the costs of manufacturing raw milk into butter, powder, and cheese; no more, no less. This puts a rather large burden on the industry to try and ascertain what the appropriate levels are when only a limited amount of data is made available to us.

Our board, after careful review of the

Department's audited cost data, supports covering 100 percent of the weighted average cost on 80 percent of the volume of butter, powder, and cheese. Data released by the Department on January 2nd shows this level to be 11.34 cents for butter, 14.27 cents for nonfat powder, and 15.92 cents for cheddar cheese. These make allowances take into account the August 2002 utility and 2002 labor updates conducted by the Department.

We hope to accomplish several goals by proposing these make allowances:

First, the weighted average cost to manufacture most of the butter, powder, and cheese in the State will be covered. In fact, according to the latest cost study data, the three powder plants and three cheese plants in the low cost category will still have a weighted average cost lower than what we propose. And the butter make allowance is increased from its current level.

Second, we hope to reduce the volume of butter, powder, and cheese that is processed at a cost far less than the manufacturing cost allowance. According to Department data, 37 percent of the butter, 89 percent of the powder, and 77 percent of the cheese in the latest cost study was processed at a cost less than the existing manufacturing cost allowance. By looking at the cost category information for powder and cheese, we can estimate the exchange of money from producers to processors due to make allowances that exceeded manufacturing costs.

For powder, the weighted average cost for both the low and medium cost groups were two cents and half a cent respectively below the 16.1 cent "make allowance." This represents an estimated total profit of about $9.5 million to the six powder processing plants due to higher than necessary "make allowances."

The analysis is similar for cheese. The weighted average cost for the three plants in the low cost category is far below (2 1/2 cents) the 17.6 cents "make allowance." This represents an estimated total profit of about $9.5 million to these three plants due to higher than necessary "make allowances." Again, it is not the purposes of the make allowance to generate excess profits for plants. The make allowance should account for a return on investment, as it does with the inclusion of a return on investment allowance of 6.2 percent for 2001.

At first glance, data released by the Department at the pre-hearing workshop seems to tell a different story in regard to volume coverage under our proposal. However, it must be understood that this analysis is more plant specific. If a plant's costs are even a tenth of a cent above the given cost, they are not included in the volume covered.

For example, with powder, conversations with the Department indicate that in the case of our petition, if the costs were increased from 14.27 cents, which 21 percent of the volume is covered, to just 14.5 cents, which is less than a half a cent increase, an additional 48 percent of the volume would be covered. Therefore, at 14.5 cents a total of 69 percent of the volume would be covered.

This makes an interesting point in that, according to Department data, 69 percent of the volume is also covered by 15.12 cents. Therefore, if 15.12 cents were chosen due to the goal to cover 69 percent of the volume, wouldn't it be more appropriate to use 14.5 cents, which also covers 69 percent of the volume?

This is where we are at a disadvantage because specific data is not available to us. Therefore, we rely on 100 percent of the weight average cost on 80 percent of the volume.

The weighted average cost should pick up volume with associated costs that are fractionally higher and fractionally lower. As explained by the Department in their January 2nd release in regard to butter coverage, the weighted average cost for butter at the 80 percent level is the weighted average cost of 100 percent of the product from the three lowest cost plants and approximately 50 percent of the product of the fourth lowest cost plant, which gives the requisite 80 percent of the butter.

This seems to be the best approach for the information available to us. However, we trust that the Department will closely analyze specific costs and associated volume coverage when making their final decision.

Furthermore, we feel that by using the weighted average cost across all plants in the cost study to set "make allowances," as proposed in several of the alternative proposals, efficiency is rewarded. The weighted average cost are skewed due to the high cost plants that are, in most cases, running at costs $0.10 higher than plants in the lower and even medium cost groups. We realize that some of these high cost plants are likely balancing plants that run only when milk is long. These plants are essential to the industry.

But some of these high cost plants are likely inefficient plants. We cannot increase make allowances for all the other plants beyond their actual costs to try and cover these balancing or highly inefficient plants. This would simply transfer additional revenues from producers to processing plants. Even if the weighted average costs were used, the make allowance would still fall short by $0.10 for most of these high cost plants.

In addition, we should mention our concern over the fact that although August 2002 utility costs and 2002 labor costs were included in the latest cost study, it is still based on 2001 volume. As we all know, 2001 butter and cheese, especially butter volume -- sorry -- powder and cheese, and especially butter volumes were down significantly. In fact, through November 2002 butter production was up 12.6 percent, nonfat dry milk up 9.8 percent, and Cheddar and Monterey Jack cheese up 9.6 percent over 2001 levels.

Although the Department was unable to provide us with updated cost data using 2002 volumes before the hearing, it is obvious that the fixed and semi-variable costs included in the manufacturing cost data would decline if spread across a greater volume. We ask the Department to take this into consideration when evaluating appropriate make allowances for 2003.

For Yields:

Butter and Powder Yields:

Western United Dairymen proposes to use the butter and powdered yield weighted average -- butter and powder weighted average yields as provided by the Department on December 17th. It is our understanding that these yields are estimated by assigning all the butterfat loss to butter and all the solids-not-fat loss to powder. This compares to the average yields estimated by prorating the butterfat and solids-not-fat loss as was done in the butter and powder yield study released October 2002.

Our petition proposes a butter yield of 1.211 and a powder yield of 1.004.

Although the Department recognizes that these yields are likely too low, we feel that proposing these yields rather than those with prorated losses, industry concern over the assignment of loss can be minimized. In the October 2002 butter and powder yield study, the Department, in discussing alternative methods of assigning plant loss, states:

"One approach was to assign all plant losses to butter, nonfat dry milk, and buttermilk powder. These yield estimates were too low. This is especially true for plants where butter and powder had a small share of total utilization. While butter and powder have higher losses than other products, the other products do need to be assigned some of the loss."

Again, although we recognize this method of assigning loss may result in yields that are lower than what may actually be obtained, we feel these yields should again reduce any industry concern over loss assignment.

We should also point out that since the Department used receipts (butterfat and solid nonfat at the ranch) and usage (butterfat and solid nonfat in finished products), these loss factors account for all possible loss, both ranch to plant as well as in-plant loss. The Department in their January 23rd letter confirms this.

Additionally, it also needs to be recognized that ranch-to-plant and in-plant losses are already accounted for in the audited manufacturing cost data provided by the Department. This occurs again because the Department reconciles receipts and usage. This process is explained in the Department's Audit and Cost Procedures Manual for Dairy Manufacturing Plants:

"Plant loss is a percentage calculated by subtracting the total butterfat and solid-nonfat pounds of the usage section from the total butterfat and solid-nonfat pounds of the receipts section and dividing the difference by the total butterfat and solid-nonfat pounds of the receipts section. The higher the plant loss, the higher the cost per pound of butterfat and solid-nonfat when allocating indirect plant expenses."

The Department in their letter dated January 23rd confirms this as well.

Finally, it is interesting to note that the yield estimates with all the loss assigned to butter and powder do not differ greatly from the yield estimates with prorated losses. For butter, the yield estimate with prorated loss is 1.2183, and with all the loss assigned it decreases to 1.211.

The Department did not supply as much detailed information with all the loss assigned yields, so we will point out a few interesting observations from the original study. Of the six powder -- of the six butter plants included in the study, only one plant has a yield lower than the current 1.2 used, and four plants would still have a yield higher than the 1.211 proposed.

For powder the yield estimate with prorated losses is 1.021, and with all the loss assigned it decreases to 1.012. Of the 10 powder plants included in the study, none have a yield lower than the current 1.0 used, and all but one plant would still have a yield higher than the 1.012 proposed.

With the data before us, it seems apparent that both the butter and powder yields must be updated. We feel the Department's yield estimates provide us with the necessary data to update a butter yield that has not been changed since 1955 and a powder yield that has not been changed since 1972. The receipts and usage figures come from the State's audited cost studies, and each plan in the study was given the chance to comment on its individual results before the study was released.

We really see no better methodology, nor do we have any other data available to us for estimating butter and powder yields than that carried out by the Department.

Cheese Yield:

Many arguments are likely to be made about the appropriate cheese yield level. Western United Dairymen proposes a yield of 10.2. This proposed yield is estimated with the use of the Van Slyke cheese yield formula. Though other methods may have been used in the past, it seems apparent through its use in the federal order system that the Van Slyke cheese yield formula is the most widely accepted formula for estimating cheese yields.

Additionally, it is a formula upon which cheese plants that pay yield premiums and plants in unregulated areas or de-pooled cheese plants base their payments to producers. With virtually everyone else in the nation using the Van Slyke, it seems appropriate to use it here.

Early in 2002, Dr. Philip S. Tong, professor of Dairy Science at Cal Poly and the Dairy Products Technology Center, released data on California milk composition. Data specific to California milk composition has not been available in previous hearings. We have used information from this report to estimate a California cheese yield of 10.2. Below is a summary of the component levels used in the Van Slyke cheese yield formula to arrive at our proposed yield.

A few components warrant additional explanation. First, the fat recovery level is in line with testimony submitted by Dr. David Barbano of Cornell University at the May 2000 federal order hearing. In his testimony Barbano states:

"The value selected for a percent fat recovery (in the cheese) for the calculation can be debated. However, a 93 percent fat recovery in the cheese is achievable with modern cheese making equipment and was achievable in the mid 1890's when Van Slyke developed his cheese yield formula based on observations of cheddar cheese making practice in factories in central New York over a two-year period."

Later he goes on to state, "The value of 90 percent fat recovery in the cheese is probably low for large scale modern cheese factories. In my opinion, the most appropriate value to use is a default value currently in between 90 and 93 percent." Obviously, a 92 percent fat recovery falls within this range, and it's also likely to be supported by testimony submitted today.

As for the 38 percent moisture content, we used a number of sources. First, the moisture content of 36.92 reported in the State's manufacturing cost study includes moisture levels for barrel cheese. Data released by the Department on January 27th shows that barrel cheese moisture levels, which comprise 40 percent of the cost study volume, have averaged 35.25 percent moisture July 2000 through December 2001.

Moisture levels for block cheddar cheese have averaged 38.05. Since our Class 4b formulas are based off block cheddar cheese, the use of 38 percent moisture in the Van Slyke formula is justified.

It is also interesting to note that the maximum moisture content for cheddar cheese blocks sold at the CME is 39 percent and the minimum is 36.5.

Also the standard moisture content for CCC purchases of block cheddar cheese is 37.8 to 39 percent moisture. The price per pound for both bulk cheese purchased by CCC, which contains less than 37.8 percent moisture, can be calculated using the following formula. Essentially anything purchased by the CCC below 37.8 percent moisture is adjusted up to 39 percent moisture.

To arrive at composition levels for milk testing, 365, 878, we calculated the ratios of casein to butterfat and crude protein to butterfat for milk going into butter/powder plants as reported by the Tong study for 364 and 895 milk. We then applied these ratios to 365 and 878 tests to arrive at a 3.29 percent crude protein and 77.13 percent casein as a percentage of crude protein. These levels compared to those reported by Tong for cheese plants at 3.32 percent crude protein and 77.14 percent casein as a percentage of crude protein.

The 3.29 percent crude protein level used is below that for the State of California as reported by the California Dairy Herd Improvement Association for 2001 at 3.33 percent crude protein. It is also below the 3.32 percent crude protein levels as reported by Tong from milk going into cheese plants.

Therefore, the protein levels used to arrive at a 10.2 cheese yield should be in line with the protein test for all milk across the State.

We have chosen to use component levels for milk going into butter/powder plants in order to address concerns over pre-fortified milk that may be included in the samples for cheese plants. It is our understanding that there are two ways in which milk going into cheese can be fortified. First, condensed skim or concentrated milk can be added to the vats. Second, premiums can be paid by the plant to acquire milk with desirable composition for cheese making. Obviously, one or both of these methods have been used on milk represented in the

Department's cost studies for cheddar cheese. This is why vat tests that have 3.89 and 8.81 are reported for block plants. At this test, a cheese yield 10.64 is achieved.

We've confirmed with Dr. Tong that the samples included in the Cal Poly study are raw milk samples from silos at the plant. This tells us that milk represented in the study has not been fortified by the addition of condensed skim or concentrated milk.

However, we realize there is still concern over the fact that perhaps the milk is pre-fortified by the acquisition of milk with desirable component levels. Again, we have used composition data from milk going into butter/powder plants to address this concern.

Furthermore, industry sources frequently indicate cheese yields closer to 12 or 13 pounds being derived from producers' pre-fortified milk. This yield far exceeds the yield of 10.2 that we are proposing.

In addition, we must mention a concern of ours. This is the fact that producers may pay for some fortification of cheese milk through the "make allowance." It is our understanding, per the December workshop as well as discussions with the manufacturing cost unit, that the cost studies include any costs, above the raw product costs, of condensed skim or other products purchased outside the plant that are used for fortification purposes.

For example, if the plant buys outside condensed skim, anything greater than the raw product price would be included as a plant cost and, thus, reflect in the manufacturing cost allowance.

Therefore, producers may be paying part of the costs to acquire products with which to fortify vats but are not credited the subsequent higher cheese yield. This hardly seems equitable.

Finally, we expect that some may argue that cheese yields need to be lowered to account for ranch-to-plant and in-plant losses.

In regard to ranch-to-plant loss, we again note that samples taken in the Tong study were from raw milk in the silos at the plant. These tests are for milk at the plant, not at the ranch. The component levels reported already account for any possible loss occurring from the ranch to the plant.

Any in-plant loss should sufficiently be accounted through the audited manufacturing cost data provided by the Department. This occurs again because the Department reconciles receipts and usage and, as stated earlier, this process is explained in the Department's Audit and Cost Procedures Manual for Dairy Manufacturing Plants.

Furthermore, the in-plant loss that occurs from plants during the manufacturing of cheese will be accounted for as whey loss in the manufacturing cost audits conducted by the Department. Conversations with the manufacturing cost unit indicate that if the loss is non-viable whey that pounds of butter fat and solid nonfat are added back into the cheese when allocating general plant expenses. This will increase manufacturing costs for cheese.

We also understand that disposal costs for any non-viable whey are included as a direct disposal cost in the manufacturing cost data.

The Van Slyke formula by its very nature, through the use of the fat recovery percentage and the constant .01 expected casein loss, also accounts for the fact that not all the protein or fat present in the vat is captured in the cheese. This indirectly allows for component losses after the vat. Though our proposed whey powder yield also takes this into account, we again reiterate the fact that any loss of non-viable whey is picked up in the manufacturing cost figures.

Though we feel the aforementioned items adequately account for all the losses that may occur, we have gone one step further to address concerns. We asked ourselves, what are the actual butterfat and solid-nonfat levels of milk in the vat? The following is what we have to work with:

Cost study vat information represents fortified milk. Tong data for cheese plants may represent pre-fortified milk, but it does not represent milk further fortified by condensed. Both data sources indicate butter fat and solids-nonfat above average California milk tests. Even milk going into butter/powder plants has a higher than average solid-nonfat test.

So what is the appropriate butterfat and solid-nonfat to use when trying to account for fortification and loss? We feel that 365, 878 used in the current 4b formula is reasonable. These levels are below both the fortified vat tests as well as below the test of milk at silos, at cheese plants reported by Tong.

The Department in current Class 4b formulas with the use of 365, 878 recognize this is slightly higher butterfat and solid-nonfat content of milk in the cheese vat. We have continued with this line of thinking. The 365, 878 tests are slightly lower in butterfat content and slightly higher in solid nonfat content than that seen in the average California milk. They are also sightly higher in butterfat and lower in solid-nonfat than milk going into butter/powder plants.

By using 365, 878 versus the 372, 894 reported by

Tong for cheese plants, we have accounted for .07 percent fat and .16 percent solid nonfat difference. This difference should, in addition to the cost studies, account for loss occurring between the silo and the vat as well as account for differences between pre-fortified and non-fortified milk.

And, again, applying these tests to milk going into butter and powder plants, we have further alleviated concerns over pre-fortified milk. Therefore, given the above methods for accounting for loss and best estimations using data available, we feel loss factors, both ranch-to-plant and in-plant, as well as fortification are more than accounted for here. For this reason we believe our proposed cheese yield is both credible and fair to all parties.

Adjustments to Chicago Mercantile Exchange Cheese and Butter Prices:

As it was explained to us, these adjustments to the CME prices should result in prices that would mimic butter and cheese prices received by California plants. Instead of actually surveying plants weekly or monthly, as is done for California Grade A and Extra Grade nonfat dry milk, we simply use the national market prices and adjust them to accurately reflect sales prices in California.

This is the goal of the end-product pricing formulas. Start with a price of the finished product, in our case, the price in California, and work backwards through yields in manufacturing costs to establish a price for raw milk in California.

One could argue that this adjustment should be thought of as transportation costs. Undoubtedly, the difference likely approaches transportation costs, as they would be a major factor in the selling price of butter or cheese, but there are likely other factors at play. If cheese or butter manufacturers are selling product outside the State of California, they will need to account for higher transportation costs. But they will also be pricing competitively to capture market share as well as pricing based on the quality of their product or perhaps company service.

Looking at this adjustment as solely transportation would also suggest that all the butter and cheese in California is shipped to Chicago. With over 34 million people in California capable of consuming roughly 4.6 pounds per capita of butter and 29.9 pounds per capita of cheese per year, this hardly seems the case.

Though California is likely a net exporter of butter and cheese, these numbers show that nearly 40 percent of the butter and 63 percent of the cheese produced in California in 2001 could possibly have been consumed in California. Therefore, this brings us back to our original statement that the adjustment should result in butter and cheese prices that accurately reflect what butter and cheese manufacturers are receiving for their products in California, taking all factors into account.

The butter and cheese sales data is the best data available on which to rely when setting this adjustment. Though we would have liked to see data updated through the end of 2002, we propose using the averages released by the Department on November 26th.

For butter, the data indicates that, on average January 2001 through September 2002, butter in California sold for 3.32 cents less than butter at the CME. For cheddar cheese, the data indicates, on an average January 2001 through July 2002, cheddar cheese in California sold for 3.21 cents less than cheddar cheese at the CME.

As a side note, we are perplexed by the large difference between the 2001 and 2002 average differences for cheddar cheese and would ask the Department to research this before making any final decisions as to the correct adjustment for cheddar cheese.

Skim Whey Powder Component:

We propose that a skim whey powder component be added to the Class 4b pricing formula. The bottom line is that, as an industry, we rely on end-product pricing formulas. Therefore, to accurately reflect the value of raw milk we must take into account the end-products that are made from that milk. Directly or indirectly, we currently account for butter, nonfat dry milk, buttermilk powder, whey butter, and cheddar cheese. However, we overlook skim whey, which is undeniably a byproduct of cheese making. Because it is a product produced directly from the manufacturing of raw milk into cheese, producers should share in its value.

Many arguments have been made in the past by those opposed to including a skim whey component. We feel it is appropriate to address several of these concerns.

Is the manufacturing of whey a cost-minimization strategy or profit-generating opportunity?

First, and most importantly, the Department data tells us that the manufacturing of skim whey products is no longer a cost-minimization strategy. While in the past plants may have struggled to find means for disposal, they are now processing skim whey into value-added products. In fact, none of the plants in the cost study are dumping the product, and only one is selling it as animal feed. The rest are manufacturing skim whey powder or higher value whey protein concentrates. These plants represent 95 percent of the Cheddar and Monterey Jack cheese processed in California. If the other cheese plants in

California are not processing whey, they're likely selling specialty cheeses for which much higher prices are obtained.

It is evident that there is a market for these products and, therefore, some of the value should be returned to producers through the Class 4b price. Department data shows that California now comprises 14.3 percent of the nation's skim whey powder production and 34.1 percent of the whey protein concentrate production. This compares to just 7.2 and 21.2 percent respectively just five years ago.

A review of production levels and average prices gives us a feel for estimated revenues generated by the sale of these two products alone. Unfortunately, price data is not available for whey protein concentrate greater than 34 percent protein.

It seems only equitable that producers, given the correct formula revisions to Class 4b, including a manufacturing cost allowance and product yield, share a portion of these revenues generated from byproducts of their raw milk.

Is Class 4b price adequately compensating producers for the value of their raw milk? And will California cheesemakers lose their competitive advantage with the addition of a skim whey component?

Though perhaps the case in the past, California's Class 4b price is not adequately compensating producers for the value of their raw milk. Based on our estimations over the past two years, an average $0.37 cents per hundredweight is not accounted for due to the fact that a skim whey component is not included in the Class 4b price.

Furthermore, when compared to producers across the nation, Department data shows that California producers are receiving a far lower price for their milk going into cheese. It is apparent that the $0.37 per hundredweight makes up a large portion of the disparity between California's Class 4b and Federal Order Class III prices. Adding a value for skim whey will not eliminate the competitive advantage currently enjoyed by California cheese manufacturers. It will only narrow the rather large spread that currently exists.

Additionally, not only have the Federal Milk Marketing Orders deemed skim whey a necessary factor in establishing a value from milk going into the cheese, $9.90 per hundredweight support price for milk directly relies on a value for skim whey as well. The Commodity Credit Corporation supports the price of milk by purchasing cheese, butter, and nonfat dry milk from processors. It purchases these products at prices that on average should enable processors to pay producers the support price.

Though the CCC does not purchase whey powder, the whey powder value is included in the formula used to derive the $9.90 support level. Therefore, the support price program rests on the fact that producers are paid a value for skim whey powder. In fact, according to the formula, about $0.23 of the $9.90 per hundredweight is credited to a whey powder component. How can producers in California fairly benefit from the support price program if their prices do not capture value for weight powder?

What about the large capital investments that must be made by processors?

We understand that large capital investments have been made by cheese manufacturers in order to be able to manufacture and market skim whey products. However, we must note that producers have made substantial investments as well. Not only have producers made investments on their own dairies and through their plants, they have also funded research through the monthly advertising and promotion deductions that help fund the California Milk Advisory Board.

A study soon to be released by the Agricultural Issues Center at the University of California Davis focuses on new applications for edible films and coatings made from whey protein and the potential gains to producers from adoption of these methods. The study, while comparing research and development expenditures to possible revenues generated from the new uses of whey proteins, highlights the funding that producers have contributed to this one single research project alone:

"From 1990 through 2005, the projected date of the first commercial adoption of whey coatings, the whey research project will have cost at present value $4.9 million, including actual outlays through 2002 and an estimate of whey research expenditures in 2003 through 2005, based on the recent annual outlays.

Of the total research costs, $3.1 million have been paid by research grants from the U.S. dairy industry; the California Milk Advisory Board will have contributed $2.2 million to the California Dairy Research Foundation, which supports research that potentially benefits the California dairy industry; and Dairy Management, Inc., and other national sources will have contributed $0.7 million."

Furthermore, data collected by the California Dairy Research Foundation outlines expenditures by CMAB on whey research projects over the last two years. While most manufacturers have been able to reap their benefits of their research investment, most producers have not. In fact, the Agriculture Issues Center study estimates a benefit of $1.9 million could be captured by California producers with the adoption of these new uses for whey protein. However, without a skim whey component in the formula, producers will never realize these revenues.

Is skim whey powder the appropriate cheese byproduct to use in the Class 4b pricing formula?

Skim whey powder seems to be the most appropriate product to use in estimating the revenues that should be passed on to producers from the value derived from skim whey products. Data from the Department indicates that many plants are manufacturing types of whey protein concentrates rather than skim whey powder. Some plants are also manufacturing lactose or other products. However, just as cheddar cheese is used as a surrogate for all other cheeses and powder is used for nonfat dry milk and buttermilk powder, we can use skim whey powder as a surrogate for all other skim whey products.

Every type of cheese, 160 varieties according to CMAB, produced in the State have different market factors at play. However, we have chosen cheddar cheese as the basis for the Class 4b price. The same can be done with skim whey powder.

According to the Department, in 2001 cheddar cheese accounted for only 34 percent of the total cheese production in California, though we still use it as a basis. The same can be done with skim whey powder.

It would be unfeasible to try and capture the value generated by all skim whey powder, whey protein concentrate, and lactose products. Using skim whey powder simply provides us with the most conservative estimate.

Obviously skim whey powder, whey protein concentrate, and lactose all have different values and associated processing costs. Skim whey powder sells for prices fairly in line with lactose, but far below whey protein concentrate 34 percent protein or above. Though a price series is not available for whey protein concentrate 70 percent or above, we can assume it is sold at some price higher than whey protein concentrate 34 percent protein.

Unfortunately, we have very limited data available to us in regard to these skim whey products. Due to the proprietary nature of the data obtained by the Department, we are not privy to this information. Therefore, we had to rely on other available published data in formulating our proposal. Though released some ten years ago, a well known study released by the Cornell Programs on Dairy Markets and Policy titled "Whey Powder and Whey Protein Concentrate Production Technology, Costs and profitability" can provide us with useful benchmarks when estimating the net value of much skim whey powder versus whey protein concentrate.

In the study different manufacturers costs were estimated for whey powder and whey protein concentrate. These costs vary by plant size and production schedules.

Using the average prices above, a simple analysis shows that on average net return of $0.07 per pound is obtained on whey powder and 22 percent on whey protein concentrate 34 percent. The net return on whey protein concentrate assumes that there is a breakeven on handling of permeate (or lactose). Data from the Department for the 1997 hearing indicates that in '96-'97, eight of the nine plants were doing something with the lactose other than dumping it.

Obviously, though additional processing is needed, these products may be returning some profit to the plant. Though this is an oversimplified estimate of the profitability of these products and manufacturing costs have likely changed, as long as manufacturing costs for whey powder and whey protein concentrate have increased proportionately, it serves the purpose of proving that the use of skim whey powder in the Class 4b pricing formula provides the most conservative estimate when estimating the potential revenues generated by skim whey powder or whey protein concentrate.

What is the appropriate manufacturing cost to use?

Again, we are unfortunately limited with the amount of cost data available for skim whey powder. The cost data provided above dates back to fall 1988 and is far too outdated to rely upon. We have proposed skim whey powder manufacturing costs of 15.9 cents per pound. This is the same manufacturing costs allowance used in federal orders, and was obtained through a study conducted by the National Cheese Institute. In the absence of other studies or direct evidence submitted into the record in the latest Federal Order Class III and IV hearing, USDA decided to use 15.9 cents per pound as reported by the NCI study. This manufacturing cost seems to be in line with information provided by the Department at the pre-hearing workshop that indicates that skim whey powder processing costs fall in the higher range of nonfat dry milk costs.

Looking at the nonfat dry milk cost data released by the Department, 97.2 percent of the nonfat dry milk volume falls in the low and medium cost category. The medium cost category shows a weighted average cost of 15.58 cents. The proposed 15.9 cents is also 1.6 cents above our proposed nonfat dry milk manufacturing cost allowance.

Finally, what is the appropriate yield to use?

The yield of 5.75 per hundredweight of milk can be derived in a few different ways. First, the Hurst study indicates a whey powder yield 5.8 per hundredweight of milk. Using methodology outlined by Barbano in his testimony during the May 2000 federal order hearing, a skim whey powder yield of 6.1922 is obtained. And that is attached as an exhibit. We have lowered the proposed yield to 5.75 in order to once again address concerns of loss assignment. Though, as stated earlier, we feel this loss is captured in the State's audited manufacturing cost figures, we have chosen a conservative approach.

We have done our best to use reputable sources and methodologies in our skim whey proposal. We encourage the Department to continue to make available as much data as possible on the manufacturing of skim whey and whey protein concentrate. The formula can be further refined as more data is made available.

MR. MARSH: There were several alternative proposals submitted to the Department upon the Secretary's call for hearing on the Western United Dairymen petition. One of the encouraging things from the different proposals is that they all result in positive changes in producer prices. Overbase price changes range from $0.32 average increase including the Western United proposal to the $0.02 increase included in the proposal submitted by the Dairy Institute.

California Dairy Women.

The proposal submitted by the California Dairy Women mirrors a petition for a change previously submitted to the Department by Western United Dairymen. Their petition floors prices at the CCC purchase price. We support the idea included in the petition to assure that the dairy safety net intended by Congress in implementing a support purchase program is not a net full of holes.

Western United -- and with regard to the Alliance of Western Milk Producers alternative proposal.

Western United supports the notion that producers should be paid for the value of all of the components of their milk through the California pooling system. We agree with increasing the adjustment in the 4b formula to negative .0321, but disagree with the Alliance's proposed 4b and 4a butter make allowances because they are in excess of covering 100 percent of the weighted average cost on 80 percent of the product volume.

We also support adding a whey powder pricing component to the Class 4b formula, as the Alliance does. Our board does not take position on the Alliance's proposal to establish a true protein or other solids price in the Class 4b formula.

California Dairy Campaign's Proposal:

Western United Dairymen supports establishing floor prices for butter, powder and cheese at the CCC support purchase prices included in the CDC petition because it copies a previously heard Western United Dairymen petition. We disagree with the butter and cheese adjustments requested by CDC because they are at odds with those included in our own petition.

We oppose the variable make allowance proposed by the California Dairy Campaign due to the extreme damage that it would cause California producers. According to CDFA's original analysis performed on CDC's petition submitted prior to the workshop, CDC's petition for average make allowance as compared to current make allowances and Western United Dairymen's proposed make allowances are set out in the table below.

We note that subsequent to the hearing workshops, CDC submitted provisions to their original alternative proposal, which will very slightly reduce their requested make allowance increases. On average, the variable make allowances as proposed by CDC would have caused an estimated loss of nearly $200 million to all producers for the period 1998 to 2002. This would have cost the average 300-cow dairy an estimated additional $40,000 due to increased "make allowances." CDC's January 23rd modifications do not substantially change these estimates.

CDC's costly variable make allowance proposals should be rejected because of the harm it would do to dairy producers.

We disagree with CDC's proposed powder yield of 1.0 because it is lower than our proposed yield of 1.004. We support CDC's proposed cheese yield increase to 10.2 and inclusion of a whey powder pricing component to the 4b formula because it mimics the Western United Dairymen proposal.

Dairy Institute of California:

We take no position with regard to the Dairy Institute's proposal to replacing the term "freight adjustment" in the 4a formula with "marketing adjustment". We agree with the Institute's proposal to change the adjustment of the Class 4a formula to negative .0332 because it coincides with our own, but disagree with their make allowances because they are at odds with our proposal.

We also disagree with all of the Dairy Institute's proposed changes to the 4b formula because they are not consistent with our petition changes. Once again we are -- the Dairy Institute also recognizes that an increase in producer prices should take place.

We would like to again thank the Secretary for granting our petition for a hearing, and hope that we were able to disclose some of the disparity between California prices and those contained in federal orders. We thank the CDFA staff for their efforts in preparing for this hearing as well the assistance of the hearing panel. We would be pleased to answer any questions that you might have. If possible, we would like to reserve any of our remaining time for rebuttal. We also request the option to file a post-hearing brief.

HEARING OFFICER ESTES: Before I proceed with panel questions, I would like to just address three items related to the content of the hearing.

After conferring with the panel, it's been determined that the post-hearing brief period will conclude on Friday, February 7th, instead of Monday, February 10th. So any post-hearing brief must be received by the Department by the close of business on Friday, February 7th as opposed to February 10th.

Secondly, in regard to those of you who arrived after the beginning of the hearing, if you want to testify today after the presentation of the petitions and the alternative petitions, there is -- you will need to sign up on the witness list at the back of the room. And there are Department staff there available to do that for you. So I want to make sure that you're aware of that.

Lastly, it is anticipated that we will have a lunch break today some time around 11:30 this morning, going from about 11:30 to about 12:15. Of course that's somewhat subject to the way that testimony is presented, and we're a little bit at the mercy of those testifying.

But that's what we tentatively are planning to do.

And now, at this point, we can go ahead and proceed to allow the panel to ask any questions of Western United in regard to their petition.

MR. MARSH: Excuse me. I requested whether we could reserve our remaining time for rebuttal.

HEARING OFFICER ESTES: I have like -- basically I have here that you have about 15 minutes. Would that be an acceptable amount of time for that?

MR. MARSH: Yes, it would.

HEARING OFFICER ESTES: And I would just like to note that in terms of people being able to testify in regard to the alternative petitions and public testimony, that the presenters in support of the alternative petitions will be given 30 minutes -- up to 30 minutes. And then -- of which there are four. And then the public will be allowed to testify for periods up to 20 minutes. And I will allow you to reserve 15 minutes for testimony during the public testimony period.

Does the panel have any questions at this time?

SUPERVISING AUDITOR HUNTER: Yeah, let me start out here. I'll be fast.

On page 3, when you talked about excess profits, I'm not quite sure what you're saying there. Is that excess profits with the make allowance as it is? Are you factoring in any kind of marketing costs in there?

MS. LaMENDOLA: We simply took the difference between the current make allowance in place and the weighted average cost for the different cost categories, took the difference and multiplied it by the volume.

SUPERVISING AUDITOR HUNTER: Okay. And then you call all that excess profits?

MS. LaMENDOLA: Due to higher than necessary -- make allowances that are higher than their costs.

SUPERVISING AUDITOR HUNTER: Right. Over the make allowance. And everything over the make allowance is excess profits?

MS. LaMENDOLA: That's right.

SUPERVISING AUDITOR HUNTER: And without considering any kind of marketing costs?

HEARING OFFICER ESTES: Before the panel asks an additional question, I just wanted to note for the record that your request for a post-hearing brief is granted.

MR. MARSH: Thank you.

SUPERVISING AUDITOR HUNTER: The only other question I have is around pages 9 -- no, I'm sorry --

around 10 and 11. On your whey components and your whey powder components, is there any consideration on the solids-not-fat losses that are in most, if not all, of the cheddar plants in California even after the processing of, say, WPC or lactose? There's always some solids-not-fat loss. Are you factoring in any kind of raw product costs in that solids-not-fat loss?

MS. LaMENDOLA: We try to capture that in lowering our yield to 5.75 from that. That would have been indicated through Barbano's methodology. But, you know, as the cost studies now don't reflect raw product cost for any loss, we didn't do that in our whey yield either.

SUPERVISING AUDITOR HUNTER: Okay. That's all I have.

AGRICULTURE ECONOMIST GOSSARD: With regards to your proposal on the whey component for the Class 4b pricing formula, you're proposing to use a -- starting over.

In your proposed whey formula for the 4b pricing formula, the whey price you use is the simple average of the most range whey, skim whey powder prices reported in Dairy Market News.

Why did you choose this price as opposed to the mass skim whey powder price?

MS. LaMENDOLA: I think we thought it was more representative of prices here in California where -- although the mass does comprise plants in California, we may have had a look at another adjustment for something like we do to cheese and butter. It just seemed pretty representative of prices here in California.

AGRICULTURE ECONOMIST GOSSARD: When the current -- or the pricing formula you used that yielded 10, with a fat and solids-not-fat test of 3.65 and 8.78, prior to the current factors the Department used a yield of 9.8. When the yield was moved from 9.8 to 10, there was also an increase in the fat and solids-not-fat components.

Now, you're moving a yield from 10 to 10.2. Why are you not increasing the component levels at the same time in it?

MS. LaMENDOLA: I think there's better data available today to -- that we used in the Van Slyke. And we just simply left the components, took the appropriate ratios that are currently in the Tong study, and applied it to the tests that are in place today. There's just more data -- there's better data.

AGRICULTURE ECONOMIST GOSSARD: Now, finally, referring to the Van Slyke formula. Much of the parameters that you used in the formula were California based. In the case of the fat recovery you're using 92 percent from testimony by Dr. Barbano. Do you have any data to suggest what the California fat recovery might be?

MS. LaMENDOLA: Unfortunately, we don't. I mean that's where we're limited. We haven't -- we don't have anything from the Department. And I don't know if that's something you can release. So basically we have to go off, you know, credible sources.

AGRICULTURE ECONOMIST GOSSARD: Did you ask the Department for such data?

MS. LaMENDOLA: No, we did not.

AGRICULTURE ECONOMIST GOSSARD: Finally, on page 8 of your testimony, again referring to the Van Slyke formula, you mentioned that you used a factor of 0.1 for casein lost in whey.

What is the basis for using 0.1?

MS. LaMENDOLA: Oh, that's just the fact that that's in the Van Slyke formula -- currently in the Van Slyke formula.

AGRICULTURE ECONOMIST GOSSARD: But what's the basis for -- you gave a basis for the other factors. Do you have a basis for the 0.1?

MS. LaMENDOLA: No, we just took the Van Slyke formula as given, and changed the components that -- it's my understanding that that's a fixed component.

AGRICULTURE ECONOMIST GOSSARD: There's also a component that adjusts for other solids of cheese. In your testimony you didn't mention what number you used for that factor in the formula.

MS. LaMENDOLA: Are you referring to the 1.09 or --

AGRICULTURE ECONOMIST GOSSARD: Did you use 1.09?

MS. LaMENDOLA: Yes, we did.

AGRICULTURE ECONOMIST GOSSARD: And, again, what basis did you have for using 1.09 in the formula?

MS. LaMENDOLA: Just that it was an inherent part of the Van Slyke formula.

AGRICULTURE ECONOMIST GOSSARD: I have no further questions.

DAIRY MARKETING BRANCH CHIEF IKARI: I notice in your testimony that the board of director's approved the testimony on January the 7th. Was the board aware of the data that the Department distributed and made public regarding the analysis of the percent of volume covered when they took a position?

MR. MARSH: I don't believe that information was made available to us prior to the date of the hearing. Actually I know it wasn't.

DAIRY MARKETING BRANCH CHIEF IKARI: That's correct. Well, that's correct, because the workshop was on the 22nd, and you met and approved the -- Western United board approved it on the 7th. But do you have an opinion whether or not the information in that volume coverage would have an impact on their policy?

MR. MARSH: I wouldn't speak to the opinion of the Board. I would -- I think that it would have been -- if it had been made available to us prior to that date, then we could have presented that information also to the Board of directors.

DAIRY MARKETING BRANCH CHIEF IKARI: So I assume that you did not make the information available to your board after the workshop?

MR. MARSH: As indicated in our testimony, we met -- we had the meeting on January the 6th, back -- board meeting on January 7th. And as a grass roots organization, we have a committee structure that we work through in order to make recommendations to the board of directors.

DAIRY MARKETING BRANCH CHIEF IKARI: Do you have a feel as to whether or not that might -- the information had a probability of affecting the position that the board took with respect to the proposal?

MR. MARSH: Well, historically Western United Dairymen has had a position supporting covering 100 percent of a weighted average cost and 80 percent of the volume. And that was information we asked for from Mr. Hunter.

And so as we developed that information, we asked for that from the State. That was provided to us.

DAIRY MARKETING BRANCH CHIEF IKARI: Are you sure that that was the position of Western United, 100 percent of the weighted average?

MR. MARSH: Actually -- to correct myself, it hasn't been that all of the time. Because in the May 2001 hearing they went to covering 95 percent of the weighted average cost, to the hearing we had in November 2001, it covered -- let me see, we covered 100 percent of the weighted average cost using the September utility updates.

So it has varied from time to time.

DAIRY MARKETING BRANCH CHIEF IKARI: Let me remind you -- and excuse me -- perhaps I can help you. In Fresno '97, Jay Gould testified -- at that time he testified that you were trying to cover -- Western United's position was to cover 80 percent of the volume. But at that hearing, the board of directors of Western United proposed that 70 percent of the volume of cheese, butter, and powder be covered by the make allowance. So your position today is a little bit different than was the position in '97.

MR. MARSH: Well, this was a position that was adopted by the board of directors at our meeting on January 7th.

MS. LaMENDOLA: David, if I might. I was not there obviously then. But you indicated that in those numbers the cost study categories -- the low and high, medium cost categories were used to establish that position.

So in that case, it would also be a weighted average. I think that's what you indicated to me in our previous conversations.

DAIRY MARKETING BRANCH CHIEF IKARI: I can only read what Jay Gould testified, and says that only the cost associated with 70 percent of the volume of product manufactured will be covered by the make allowance.

MR. MARSH: And, again, as Ms. LaMendola indicated in her conversation with you, Mr. Ikari, that seemed to be a weighted average as well.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. How does the Western United board reconcile -- maybe they haven't looked at this -- covering the different percentage on butter versus powder versus cheese?

MR. MARSH: Well, again, the board made the recommendation to cover 100 percent of the weighted average cost on 80 percent of the volume from data supplied to us by the Department on January 7th, 2003.

DAIRY MARKETING BRANCH CHIEF IKARI: That's why I asked the question, whether or not these data would have an impact on their decision?

MR. MARSH: I don't make board decisions. The board makes board decisions.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. I have no further questions.

SENIOR AGRICULTURAL ECONOMIST ERBA: On page 4 of your testimony, you speak to butter and powder yields. By your discussion and your testimony, I see you're familiar with the methods used to obtain yields that -- release notice last year?

MS. LaMENDOLA: Yeah. You know, obviously I'm not as familiar as you guys are. But through discussions and workshops, we feel we're pretty familiar.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. Based on your knowledge of the methods that were used, do you think that that kind of an approach allows you to give yields to the kind of decision, in your case three decimal points that you've made there, 1.211 on butter and 1.004 on powder?

MS. LaMENDOLA: Surely you can round it if you would like. But we just went with what the Department released.

SENIOR AGRICULTURAL ECONOMIST ERBA: What would you like to round it too?

MS. LaMENDOLA: I'll leave that up to you, Eric.

(Laughter.)

SENIOR AGRICULTURAL ECONOMIST ERBA: This is kind of a follow-up question that has to do with your cheese yield. It goes along the same lines. You proposed a yield of 10.2. If you obtained the yield of 10.2 from the approach you used in the Van Slyke, obviously you get more decimal points than just one. So why did you round this one to one decimal point?

MS. LaMENDOLA: Oh, okay. Well, you didn't provide us with this data. And it's the case that's been -- a cheese yield before. We tried to stay with that.

On butter and powder we tried to use exactly the data that the Department provided to us.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. This is in reference to the table up at the top of page 11, which looks at the price and revenues generated from skim whey powder and whey protein concentrate.

You have any idea what associate costs there might be with the number you generated or in the plant to making any profits at all?

MS. LaMENDOLA: No. And this wasn't meant to imply these are profits. These are just simply revenues -- gross revenues brought on these products. We've attempted to estimate a cost through our 15.9 cent make allowance.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. I have no further questions.

Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: I have just one other question.

On page 2, under I guess it's the 4th paragraph, there's a sentence there. I wonder if you could elaborate. I'm not sure what you mean. "The fluctuations and increasing disparity between the prices in California and federal orders is contributing to the degradation of stability."

MR. MARSH: I'm sorry. If I could just ask for the -- where did you read --

DAIRY MARKETING BRANCH CHIEF IKARI: Well, it's the fourth paragraph and the last sentence in the paragraph.

I was wondering if you could elaborate on what you mean there.

MR. MARSH: "The fluctuations and increasing disparity between the prices in California and federal orders is contributing to the degradation of stability that California and Federal Milk Market Orders strive to maintain."

One of the goals of course, as you know, Mr. Ikari, with regard to the purpose of the market orders is to provide stability to the marketplace for both the producer and consumer as well as to the processor.

The relative low prices that we have in California compared to federal orders has created stability without the State. Inside the State has relative low prices, of course causing a great deal of financial distress on dairy farmers in the State because we don't enjoy, you know, the same relatively high pricing, comparing our price to what they do in federal orders. So, therefore, it has created a degradation of stability of orders.

One other item, just to jump back to a previous question, on asking about the other exhibit that was made available to us at the workshop. We also -- the board was also not provided access to volume information with regard to manufacturing cost allowance, which of course is -- we would all agree -- will substantially change some of the figures included in the table of Department on January 22nd workshop.

HEARING OFFICER ESTES: Do we have any more questions related to the petition?

All right. Thank you very much, both of you.

At this time, representatives of the California Dairy Women Association, Alliance of Milk Producers, the California Dairy Campaign, the Dairy Institute will now receive 30 minutes each to present their alternative petitions.

Testimony shall be received in the following order. First, the California Dairy Women Association, then the Alliance of Milk Producers, then the California Dairy Campaign and, lastly, the Dairy Institute.

So if the representatives of the California Dairy Women Association would come forward for the presentation of their alternative petition at this time.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MS. LOPES: I do.

HEARING OFFICER ESTES: And I have a copy here of -- a written copy of your planned testimony here today. Would you like that entered into the record as an exhibit?

MS. LOPES: Yes.

HEARING OFFICER ESTES: The written statement shall be entered into the record as exhibit number 47.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 47.)

HEARING OFFICER ESTES: Please proceed with your testimony.

MS. LOPES: Mr. Hearing Officer and members of the panel: I am Linda Lopes, President of the California Dairy Women Association, and also a dairy producer from Turlock, California.

CDWA has filed a proposal to change California's Class 4 pricing formulas. This proprosal is filed on behalf of the membership of the California Dairy Women Association. CDWA represents 180 dairy producers from Sonoma to Tehachapi.

The CDWA is a unique group. We do not claim to be experts in milk pricing formulas. Most of our members are in charge of the financial business of the dairy operation. We have become experts in balancing the checkbook and knowledgeable in the business's income and expenses. We know that we are not covering our costs of production with the prices we have received in the past six months. We also do the shopping and are aware of the retail prices for dairy products. We know that we are not receiving our fair share of the market price.

The CDWA request 4a and 4b prices be established at the higher of the calculations of market prices or the USDA announced support price. We know the support price is far from covering our costs of much production.

However, we are confident that the support price of $9.90 was intended by Congress to be the base for our price. We are aware, due to the California 4a and 4b pricing formulas, that the result is a decrease of approximately $.10. Thus our support price would be $9.80.

The CDWA proposal was offered to stop prices from falling below support. We are confident that our proposal would validate any price relief proposal that may be granted from this hearing.

The California milk pricing system is unique in itself. By adding this concept, California would still maintain a competitive advantage in the national market. With California's volume of production, we set the pace for commodity values.

The dairy price support program needs to function as it was intended, supporting the price of milk at the dairy, close to $9.80. That has not been the case in the past three years.

Since January 1, 2000 there have been ten months during which the National Agricultural Statistics Service cheese price averaged below the Commodity Credit Corporation block cheese price. In 9 out of the last 35 months, the Class III price in federal orders has been less than 3.5 percent butterfat support price of $9.80. In one month the Class III price was $8.57, and in Year

2000 the Class III price averaged $9.74, below support price for the year. That hasn't happened since 1986 when the support price was $12.60.

In the past year of 2002, there were three months that the overbase was under $9.80 support price. It is projected to be below for January and February of 2003 also.

Today, some manufacturers are succumbing to pressure from buyers to continue to sell directly to them at per pound prices considerably below the support price. These decreased prices are passed down to the California dairy producers.

This marketing scheme does two economically devastating things to California producers. It eliminates the price safety net and drops their pay far below support. It allows accumulation of cheaply priced cheese solely in the hands of commercial marketers, indefinitely prolonging the period until producer price recovery would otherwise normally occur. While this marketing strategy presses California producer prices continually downward, the system allows cheese manufacturing plants to continue with their operating margins (make allowance) in place.

Flooring the 4a and 4b prices at the higher of the market price or the $9.80 support price will not stimulate production since according to the CDFA statistics the support price is far below the California cost of production.

The Department identifies the Year 2002 to date average cost production at $12.98. During this time of record low milk prices to producers, the prices to consumers have not decreased accordingly.

We are requesting modification of both Class 4a and 4b petitions, in order to be fair to both manufacturing entities and to prevent butter and powder manufacturers from being coerced into similar below-support-price selling to accommodate their buyers.

We believe these price-modifying provisions, 4a and 4b, should be immediately put in place. Many prominent dairy economists are projecting an extended period before producer price recovery begins. It is imperative that the total product value is adequate to cover both the cost of processing and producing milk.

According to the Department of Food and Agriculture's cost study the average cost producing milk for September to October 2002 was $13.28. That is $.10 per hundredweight great than July through August 2002, $.03 per hundredweight greater than July through August 2001. This is $3.63 per hundredweight greater than the base period.

Costs of production has been rather constant.

However, the milk prices continue to stay below input costs. The November 2002 milk price is $9.74. With these costs, that is a difference of $3.54 per hundredweight. For a 500-cow dairy, using the State herd average of approximately 20,000 pounds of milk annually, that is a $29,205. That is just the loss for one month.

We are experiencing many increased costs:

The increase in make allowance to the plants due to their increased costs; the increase in minimum wage; increases in our workers' compensation rates due to the passing of Bills SB 749 and AB 486; and increases in costly environmental regulations. The list goes on and on.

How do you think we can cover these costs? We cannot pass the increases on to anyone. We are at the end of the line. The only way is for the Department to now increase our price. I know that by putting a floor on the price will not cover these costs, but it will stop our prices from going below $9.80. Prices below support are not doable.

The USDA has supplemented our incomes for the Market Loss Income Contract payments of $1.39 to $1.59 based on 45 percent of the difference of $13.69 per hundredweight. In California, soon these payments will be ending. We will now feel the impact of these low milk prices even more.

The dairy price support program has been one of the most effective government programs. It impacts all dairy farmers equally, regardless of the size of the dairies or where the dairy is located. It costs the least of virtually any other agriculture program.

The dairy business is at this very moment disintegrating before our own eyes. The number one in production is your own state. And you now have a choice as to whether you will choose to take steps and try to salvage it or you will allow it to die. The dairy industry is not an "it" but rather a living thing, composed of living animals that once dead cannot be resurrected. The milk price dilemma facing the milk producer is not relevant to just issues before you in this hearing.

More has to be done to salvage this industry. You cannot hold industry in bondage and torture them in this way and at the same time order them to suffer in silence. For no other industry is tied to the floor without a sense of compassion and without the ability to pass on to the consumer their price of production just as other industries pass on to us.

Even though we are an industry which is also affected by the elements and so many other issues, we find ourselves on our knees before those that have control over our prices and who insist on having a system that holds us down on our knees without the capability of passing on the cost of production to the consumer as other industries do.

You are the ones in power in the State of California who can appeal on behalf of our industry and make the necessary changes that are needed at the State or national level. It's in this place right here that it must all start. And again I repeat, the problem in the industry is beyond the issues at hand in this hearing today. This is just the beginning of what must be done.

What the dairy industry is experiencing in this day and age is unjust and pure torture, torture without mercy, unacceptable. Dairymen are now receiving prices that were received in the 1970's when the cost of production was a fraction of what it is today.

California milk producers are number one nationally for production and quality. We have invested millions of dollars in our businesses to do this. Many other support businesses, both small and large, depend on a dairy industry to survive in their business also. We all hear how bad the economy is in our state. Please accept the CDWA proposal, and that will be the beginning of an economy on the rise.

The California Dairy Women Association would like to thank the Western United Dairymen for their persistence in the call of this hearing. CDWA supports all dairy organizations that have submitted alternative proposals that will give producers price relief. We believe that our proposal is a first step for a price relief. Without a minimum price tied to the support program, all other price relief proposals presented at this hearing would only be temporary due to marketing trends.

I know you are very knowledgeable on the dairy situation. I just feel that it is a shame that the number one dairy state for production is the lowest priced dairy state.

CDWA is requesting that Secretary Bill Lyons and CDFA take the initiative to work at the national level to bring emergency price relief. I leave this problem in your very capable hands, and I thank you for your time.

(Applause.)

HEARING OFFICER ESTES: Do we have any panel questions for Ms. Lopes?

SENIOR AGRICULTURAL ECONOMIST ERBA: I have one question.

Ms. Lopes, you're aware that we have several alternative proposals before us, some of which increase the class prices and pool prices dramatically over what you've suggested. Do you have any feel for those proposals in support of?

MS. LOPES: Like I said, I'm in support -- we are in support of anything that brings price relief.

But without a floor, that could only be temporary -- the other thing could only be temporary and we could go down below support again. That's why our first step is putting the support price in, and then go above that because you know $9.80 is not enough. And those other ones would just add to it and we would pay for the rest in that way.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. Thank you.

HEARING OFFICER ESTES: Does anyone else have any questions for her?

All right. Thank you very much for your testimony here today.

And we will now proceed to take testimony from, I believe, the Alliance of Milk Producers.

Mr. Tillison.

MR. TILLISON: Yes, sir.

(Thereuopn the witness was sworn, by the Hearing Officer, to tell the truth the whole truth and nothing but the truth.)

MR. TILLISON: I do.

HEARING OFFICER ESTES: And I see that we have a written copy of your planned testimony today. I assume that you would like to have this entered into the record as an exhibit?

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

HEARING OFFICER ESTES: Your request is granted. And I'm sure you're aware, as I stated earlier, that the deadline for that is at the close of business Friday, February 7th, not Monday, February 10th.

Your statement shall be entered into the record as Exhibit Number 48.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 48.)

And you may now commence your testimony.

MR. TILLISON: Thank you.

Mr. Hearing Officer, members of the hearing panel: My name Jim Tillison, CEO of the Alliance of Western Milk Producers. I am testifying today on behalf of the Alliance and its member cooperatives as directed by the board of directors.

The Alliance cooperative members both supply milk to and process milk into all of the uses of milk.

Almost two years ago the Alliance proposed adding a whey revenue factor to the Class 4b formula. At that time, the Department gave a number of reasons for rejecting taking that step, not the least of which was milk price levels:

"The Department considered the relative market value of whey, but considered other relevant economic factors as well -- the current level of milk production, the number of cows milked and prices received by producers. None of these three primary economic factors indicates that a price increase is warranted. In combination these three factors outweigh any consideration given to the relative market value of products yielded from milk."

The Alliance believes that good policy decisions should not be rejected for economic reasons. Sound policy, not temporary economic conditions, should be the basis for Department decisions. Sound policy decisions will result in a pricing system that works. Decisions made on the basis of current economic conditions are bound to be ineffective and ultimately short-lived.

Section 62076 of the Food and Agriculture Code, as passed by the State Legislature, clearly identifies what it considers to be the major relevant economic factors that the Department should take into consideration when making decisions in establishing producer prices:

A) The relative market value of the various products yielded from milk.

B) The market price of other milk which may be used for the same purposes that are set forth in the respective classes.

C) The value of milk used for manufacturing purposes giving consideration to any relevant factors including, but not limited to, product prices, product yields, and manufacturing costs of Class 4a and 4b.

In evaluating the Alliance's proposal for changing the 4b formula, the Department is urged -- no, we challenge you to look beyond the economic factors of price, milk production and cow numbers, and to consider the legislative directive of Section 62076 in reaching a decision on this and other proposals.

Our proposal:

The Alliance proposal to change the Class 4b pricing formula addresses the three major provisions of Section 62076 as stated above. It mimics the federal order Class III formula in that it develops a value for butterfat, protein, and whey solids. It departs from the Class III formula in that it uses the commodity values used in the current Class 4b formula, the Chicago Mercantile Exchange cheddar cheese block price, and the CME butter price. For whey solids, our proposal uses the simple average of the west mostly dry whey value as reported by USDA's Dairy Market News.

The Alliance proposal uses the weighted average manufacturing cost numbers as published by CDFA in a letter from Ed Hunter, Supervising Auditor, dated December 23rd, 2002. The butter make allowance would be 12.11 cents per pound. The cheese make allowance used in the proposed protein value calculation would be 17.46 cents per pound.

And editorial comments is necessary at this point. The Alliance urges CDFA to move away from the snapshot approach used in producing the above document. Arbitrarily picking a single month to adjust manufacturing costs does not provide an accurate picture of actual costs. It is critical to get back to annual average costs to accurately produce actual average manufacturing costs.

For whey solids, the Alliance proposes using a manufacturing cost of 15.9 cents. This is the same level as used in the federal order system and is based on a survey of seven cheese plants producing 28.4 percent of the dry whey in the U.S. I believe that two of the plants were Leprino plants in Michigan and New York. This is the most accurate data available and we believe is superior to a guesstimate based on one California cheddar plant. We urge CDFA to collect manufacturing cost data from all dry whey plants in California, not just a cheddar plant, in order to develop its own make allowance for dry whey.

Regarding yields, the Alliance proposal maintains the current yield level for 4a-4b butterfat calculation. As was disclosed at the pre-hearing workshop, the yield data for one of the largest, if not the largest, butter production operations was not included in the CDFA study. In addition, the study itself recognizes that these yield estimates are too high. Rather than make changes based on incomplete and questionable data, the Alliance believes that the butter yield factor should be left alone.

In determining the yield factors used in the protein value calculation, the Alliance used data provided from the Cal Poly research done by the -- done for the California Dairy Research Foundation on the composition of milk for cheese manufacturing plants. The objective of the project was to determine the composition of silo milk from cheese plants and non-cheese plants in different regions of California for a 12-month period.

Four of the eight cheese plants contacted participated in the study, which included a total of 13 dairy plants. Four butter/powder plants and five fluid plants participated in the project also. Cheese plants in the survey were located in the south San Joaquin Valley, the Sacramento Valley, and the north Bay Area. The study covered the months of May 2000 through April 2001.

Three factors determined cheese yield -- butterfat levels, casein levels, and moisture content. The Alliance used the Cal Poly study for the percentage of casein in California milk to determine the protein, cheese yield factor of 1.39. This is arrived at by dividing the cheese yield attributed to the protein portion of the Van Slyke formula divided by the true protein level measured in the milk. The data used are the mean figures, the average figures, from the Cal Poly study for the 13 plants for the 12 months covered.

Given that four of eight cheese plants chose not to participate in the Cal Poly study, and looking at the butterfat levels of participating plants, we suspect that plants participating did not include all of those plants paying producers protein premiums currently. Had those plants been included, we believe the protein cheese yield factor would have been even higher.

To determine the cheese yield factor for butterfat in milk, one needs to use a fat recovery value. To do this, the Alliance used the CDFA manufacturing cost yield of 10.71 pounds of cheese at 36.92 percent moisture, with a vat content of 3.95 percent butterfat and 8.93 percent solids-not-fat.

The fat recovery level was set as X in the Van

Slyke cheese yield formula. Working the formula backwards, using a casein factor of 82 percent in the true protein, resulted in a fat recovery factor of 95 percent. According to Dr. David Barbano of Cornell, a modern cheese plant should be able to achieve a fat recovery of 93 percent. The Alliance chose a fat recovery level of 92.5 percent. It is our understanding that the Dairy Institute proposal used 92 percent, as did the Western United proposal, in terms of fat recovery to determine the cheese yield factor. So it appears that the Alliance number is reasonable.

The market price of other milk which may be used for the same purposes:

California participates in the national market for manufacturing dairy products. Almost 40 percent of cheese produced in the U.S. is produced in the Western United States. Over 50 percent of that cheese is produced in California. Over 25 percent of the Western Region cheese is produced in Oregon, Washington, Utah, and Idaho.

Looking at cheddar cheese specifically, the percentage of cheese produced in the West climbs to 45 percent, with California accounting for 46 percent of the Western total. Washington and Idaho produce 27.4 percent of the West total.

As stated previously, the State Legislature in

Section 62076 of the Food and Agriculture Code says that CDFA should consider, quote, "the market price of other milk which may be used for the same purposes that are set forth in the respective classes." In doing so, CDFA needs to consider serious consideration to the market price of cheese milk in the federal orders.

Preliminary CDFA data comparing the current 4b price formula to the current federal order Class III prices shows that the California 4b price averaged 26 cents less, 56 cents less, and 44 cents less in 2000, 2001 and 2002, respectively, when compared to the Class III price. The final federal order decision increases those price differences to 40 cents less, 92 cents less in 2001 and 51 cents less in 2002. That puts the California price an average of 61 cents below the federal order Class III price for that three-year period.

Adding a value for whey and adjusting yields and make allowances will narrow the average price difference. However, in its decision for the March 2001 hearing, CDFA expressed concern that this would do little to alter the month-to-month fluctuation between the California Class 4b price and the federal order Class III price. The Alliance's analysis of the proposals indicates that our proposal improves that situation.

For the 36-month period of January 2000 through

December 2002 the average fluctuation between the current 4b price and the federal order final Class III price is a negative 56.03 cents and ranges from a negative $2.50 to 38.01 cents above the federal order final price. The Alliance proposal average fluctuation is just 12.28 cents, ranging from $1.64 below to $0.66 above. The Western United proposal ranges from a $1.65 above to $0.70 below.

Perhaps most important, however, is that the Alliance proposal, unlike the federal order final Class III -- not unlike the federal order final Class III, maintains a basic value for protein and whey solids which is adjusted based on the relationship of the value of butterfat in cheese to the value of butterfat in butter. All the other proposals continue to have solids-not-fat in cheese as a residual value for the Class 4b milk value less the butterfat value.

The Alliance proposal moves the California cheese milk pricing system in the direction it must go. There is absolutely no question that protein has a definitive value per pound of cheese produced, as does butterfat. The amount of cheese a plant gets from a pound of milk is dependent on both the level of butterfat in cheese and the level of protein in the cheese.

The table below shows exactly what that statement means.

Both of these cheese components are essential to the production of cheese. Both have a recognizable value. To account for the product value of one component and not the other in pricing cheese is wrong.

Contrary to comments made by those with a vested interest in maintaining the status quo -- read competitor advantage -- market signals to producers will not be dulled, will not be diminished. Adoption of the Alliance proposal will result in a higher quality of milk supply for all uses of milk. Remember, the vast majority of milk is marketed by producer-owned cooperatives. This milk goes to all uses of milk -- fluid, ice cream, sour cream, cheese, butter, and nonfat powder. The individual producer doesn't know where his or her milk is going. They will know, however, that by increasing butterfat content and protein levels, they will get more money for their milk. That means higher quality milk will go to all uses.

Finally, there are those who will argue that, because CDFA milk pooling is not able to collect and pay out on the basis of protein and other solids, the Alliance proposal should not be adopted at this time. That is a weak argument at best. The Alliance proposal will not negatively impact producers currently being paid premiums any more than the Western United or CDC proposals. All three proposals raise the 4b milk price. All three proposals will have an impact on the amount of money those paying protein premiums have available to pay those premiums.

The difference between the three is that the Alliance proposal puts into the stabilization plan the changes necessary to bring California cheese milk pricing methodology more in line with how cheese milk is priced in the rest of the country. It removes the necessity of having to have another stabilization plan hearing, leaving only a pooling plan hearing to be called.

The value of products yielded from milk:

When milk goes into a vat, cheese and the byproducts of the cheese-making process, whey cream and whey, are produced. The cheese is packaged, the whey cream is separated from the whey and either recirculated into the cheese-making process or sold as whey cream. And the remaining whey is further processed into dry whey or whey protein concentrate.

The production of whey products has grown dramatically in California. According to USDA and CDFA data, production of dry whey has more than doubled, from 66.3 million pounds in 1991 to 140 million pounds in 2001. California whey protein concentrate production has grown from 19.7 million pounds in 1991 to 93.8 million pounds in

2001. That's an increase of nearly five fold.

Using the USDA's Western Mostly average prices for the year of 2001, dry whey and whey protein concentrate generated over $108 million of revenue in California. That is the equivalent of an additional 6.6 cents per pound of cheese produced in 2001. Clearly, whey has a market value and it is time that that product value be recognized in the California 4b formula.

The Alliance recognizes that the WPC is a product requiring a larger investment to produce and to market. It is also a product that can vary greatly in composition, generally ranging from 30 to 75 percent true protein content. The lactose content of WPC can vary from as much as 46 percent to as little as 3 percent. In other words, it's a specialty product, tailored to a customer's needs.

Dry whey, by comparison, is a commodity, like cheddar cheese, bulk butter, nonfat dry milk powder. For this reason, we believe it's appropriate that it be used as the value for whey solids.

The Department should take note that even the Dairy Institute's 4b proposal alternative recognizes that dry whey has a value. At the pre-hearing workshop a Dairy Institute representative said that one of the factors that went into its .8 cent market adjustment was the value of dry whey. Unfortunately, the Dairy Institute treatment of dry whey does nothing to address any of the issues raised by CDFA in the March 2001 decision. More importantly, it does nothing to address either the price difference or the price stability issue between California 4b and the final federal order Class III prices.

At the March 2001 hearing it was stated that dry whey was not a good barometer of the true value of whey. This statement was repeated at the workshop. Comparing the Western mostly dry whey prices to the Western mostly WPC prices for the period from 1996 through 2002 shows that as not exactly the case. The following chart shows that these prices definitely tend to move relative to one another.

Just as it is time for CDFA to recognize that protein has a discernable value, so too it is time for CDFA to recognize that whey products come from producer milk and that the Class 4b milk price should include a factor for whey as well.

Other proposals:

The Alliance would also like to express support for the proposal by the California Dairy Women with the modification that the commodity prices used in Class 2, 3, 4a and 4b be the higher of the CME price for butter and cheese less transportation in the case -- less transportation in the case of butter or marketing adjustments in the case of cheese, or the dairy support program purchase price for 40 pound block cheese and bulk butter. These changes are recommended because there is no marketing effort or transportation cost involved in selling to the Commodity Credit Corporation.

Our members believe that the dairy price support program is not functioning as it should. Commodity prices, specifically cheese, have on several occasions fallen well below the point at which product should have moved to the Commodity Credit Corporation. Flooring the commodity values as proposed will encourage movement of product to the CCC.

The Alliance is opposed to the Dairy Institute's 4b proposal. It does nothing to address the policy issues that need to be addressed. In addition, the 9.98 cheese yield factor is based on an incorrect assumption that the ratio of protein to nonfat solids is a constant percentage. Analysis of Cal Poly data shows a variation in true protein to solids-not-fat ranging from 3.4 percent to 35.5 percent.

We oppose the CDC 4b proposal because of its complexity and the variable make allowance approach. A variable make allowance treats neither producers or processors fairly.

Alliance members are opposed to any proposal that includes manufacturing allowances that cover only a small percentage of the production of a commodity. A healthy dairy industry must have both producers and processors.

Unquestionably, the true protein level in milk has definitive value in terms of the amount of cheese which milk will produce. Each additional tenth of a pound of cheese 100 pounds of milk will yield enhances the profitability of the cheese manufacturer. It takes the same amount of effort, equipment, investment, utilities to process 100 pounds of milk that yields 9 pounds of cheese as it does to process 100 pounds of milk that yields 11 pounds of cheese.

Two components determine the amount of cheese that milk will yield, butterfat and true protein, just as two components, butterfat and solids-not-fat, determine the quantities of butter and nonfat powder milk will yield. Whey is no longer a disposal problem, but a profit center. Therefore, it is as proper to recognize the value of protein and whey solids in producers' milk as it is to recognize the value of butterfat and nonfat solids.

Nineteen percent of California's milk goes into the bottle, ten percent goes into Class 2 and 3, and thirty percent goes into class 4a, butter/powder. All dairy men and women share in the values generated by those uses of milk and, therefore, it's appropriate that all producers share in the true values generated by Class 4b milk.

If the Department believes that the milk pricing system should do that, it should adopt the Class 4b proposal and conforming changes to the Class 4a butterfat value put forth by the Alliance.

We appreciate this opportunity. And I'll answer any questions you may have.

HEARING OFFICER ESTES: Do we have any panel questions for Mr. Tillison?

SUPERVISING AUDITOR HUNTER: Mr. Tillison, on the second page, where you mention on that whey cost study survey, manufacturing cost of .159, how old is that cost study -- those studies.

MR. TILLISON: That data was generated for the May hearing -- the May 2000 hearing that they had in the federal orders. And the number was not changed till when they recently issued the final decision.

SUPERVISING AUDITOR HUNTER: So it was released in May of 2000?

MR. TILLISON: It was presented at the hearing in May of 2000.

SUPERVISING AUDITOR HUNTER: No, what time period was it used on as far as the plants? Was it a 1999 cost study, '98 cost study? How far back was it?

MR. TILLISON: No, it was a survey that was done by NCI, and it covered the most recent 12-month period that was available.

SUPERVISING AUDITOR HUNTER: Okay. So that would be '99-2000?

MR. TILLISON: Yes, most likely.

SUPERVISING AUDITOR HUNTER: Okay. On that same page you offer a make allowance at 12.11 on the butter, 17.46 on hard cheese. But on the powder, you deviate off the December exhibit and offer a larger make allowance in the 15 -- in the 16 -- I'm sorry. Wait a minute.

-- in the 15.12.

MR. TILLISON: Yeah.

SUPERVISING AUDITOR HUNTER: You're going up to 15.90.

Is there a reason why you're differing off the powder?

MR. TILLISON: Well, the reason we differ off the powder in California is the same reason that they differed off the powder make allowance in the federal orders. It costs more to process dry whey than it does to process nonfat dry milk powder. Unfortunately, for California the only data that we -- the only actual data we have available for processing dry whey is one cheddar cheese plant. And as the Department data clearly shows, there's a lot more dry whey being produced in the State of California. As I said in my testimony, barring a more accurate data, we feel that the best data available at the current time is the 15.9 cents.

SUPERVISING AUDITOR HUNTER: Okay. I have one more question. And it has to do with the Van Slyke formula, which I am not an expert on, by any means. But I'm wondering how accurate is the Van Slyke formula when it comes to a fortified milk vat? Like we find most of the cheddar plants in California fortify the vats.

Is the Van Slyke formula as accurate on that as, say, a non-fortified vat?

MR. TILLISON: Yeah, because basically all you're doing is plugging in the fat and the solids-not-fat numbers that are either in the vat or in the milk. And that will tell you the amount of milk that that vat should yield, subject to the casein content, the moisture level of the cheese, and the fat recovery.

So what I did is I took the Van Slyke formula and plugged in your values for yield solids-not-fat -- I'm sorry -- yields moisture solids-not-fat in the vat, and then worked back to determine what the fat capture rate was.

Now, the only deviation I made was that I used the casein recovery level in the Cal Poly study, which is

82 percent in the Van Slyke formula. And if you do that, you come up with a fat recovery level of 95 percent.

SUPERVISING AUDITOR HUNTER: Okay. Thank you. I have no more questions.

AGRICULTURE ECONOMIST GOSSARD: Mr. Tillison, in your proposal you're asking that the freight adjustment on cheddar cheese be changed, but the freight adjustment on butter not be changed.

What was the reason for this?

MR. TILLISON: Well, first of all, the factor on cheese, as came out in the workshop, is not a freight adjustment. It's a marketing adjustment. In other words, it's the difference between the FOB price of milk at California cheddar cheese plants and the CME. And it was clearly said to me at that hearing that it was not a transportation factor, just as the 1.2 cents was not a transportation factor, but that it was a marketing adjustment.

In terms of cheese, cheese is priced at the CME. And cheese, unlike cheddar cheese, when it's sold at the CME, has to physically move to a warehouses within a certain range of Chicago. And that 4.5 percent transportation adjustment, we believe, in consultation with our members, continues to be a justified factor. But you're comparing apples and apples. They're both not transportation factors.

AGRICULTURE ECONOMIST GOSSARD: But given the adjusting factor the Department released in its study, in one case you're adjusting the cheese number based on that study result and you're not adjusting the butter now, is that correct?

MR. TILLISON: That's correct, because of the difference in the way the CME treats cheese and treats butter. It does not treat cheese and butter the same. If you sell cheese at the CME, the transportation adjustment is the difference between the cost of where the selling plant is, moving it to the cost of where the buying plant is. Whereas with butter, the transportation factor is straight, moving it from the plant to Chicago -- to a warehouse within a certain range of Chicago.

So one could argue that the 3.X cents for cheese because of the difference in the way they're treated by the CME is a usable number. And, again, I point out that the cheese formula has always used a marketing adjustment factor and the butter has always used a transportation factor. And we can continue with that policy.

AGRICULTURE ECONOMIST GOSSARD: Given your holding with the 4.5 cents, why did the Department study come up with a number that said it should be 3.3 cents?

MR. TILLISON: The Department didn't come up with a number that said transportation should be 3.3 cents. The Department came up with a number that said the marketing adjustment on butter was 3.32 cents. In other words, the difference between the CME butter price and what California plants are selling butter for FOB plant is 3.2 cents. That's not a transportation adjustment.

AGRICULTURE ECONOMIST GOSSARD: Then why not go with the California price using 3.3 cents?

MR. TILLISON: Because, as I said previously, the difference in the way the CME treats the two commodities in terms of transportation. You cannot sell cheese at the -- or butter at the CME and have the transportation difference be me shipping it from Turlock to Tulare. There's a transportation adjustment factor based on the distance between where the plant is located and the CME in Chicago.

AGRICULTURE ECONOMIST GOSSARD: In your formula, using the whey factor in the Class 4b, you're suggesting for the price of whey you use the Dairy Market News mostly price.

Why did you suggest that rather than the NASS price?

MR. TILLISON: Well, because the West mostly price reflects what people are getting for whey in the West, just as I assume the marketing adjustment to the CME price reflects what people are getting paid for cheese in California.

And, frankly, the NASS number is a survey of plants through the United States, not just in the West. Whereas, that's what the West adjustment is.

AGRICULTURE ECONOMIST GOSSARD: On page 4 of your testimony, in the first full paragraph, the last sentence says, "All the other proposals continue to have solids-not-fat in cheese milk as a residual value for the Class 4b milk value less the butterfat value."

For clarification, by this do you mean that with the current formula, if the cheese price remains unchanged, when the butter price goes up, the solids-not-fat price goes down, and when the butter price goes down, the solids-not-fat price goes up? Is that what you were getting at?

MR. TILLISON: Yes.

AGRICULTURE ECONOMIST GOSSARD: Isn't it also true that under your proposed formula the cheese price and the skim whey powder price remain the same, if the butter price goes up, solids-not-fat price goes down, and if the butter price goes down, the solids-not-fat price goes up?

MR. TILLISON: No, that's not true. What's true is that in my formula, as the butter price goes up, the value of protein goes down, as the butter price goes down, the value of protein goes up.

The difference is, if you look at the two formulas and chart them out, using the different changes, is that our prices don't fall as quickly as do the prices in the current formula.

In other words we are calculating a price factor that goes in there that is not related to the butterfat value at all. That is the whey value. Whereas in the other formulas the whey value is just another way of increasing the solids-not-fat value. And that value goes up and down with butterfat. Our whey value does not.

AGRICULTURE ECONOMIST GOSSARD: And, finally, I have some questions about your use of the -- technical questions, on the use of the Van Slyke formula.

You mentioned most of the factors that you used in your assumptions. In your testimony on page 3 though I wasn't able to discern what farm protein level did you use when you did your estimate of the yield?

MR. TILLISON: Did my estimate of the --

AGRICULTURE ECONOMIST GOSSARD: Oh, if you come out --

MR. TILLISON: Which number are we talking about, Mr. Gossard?

AGRICULTURE ECONOMIST GOSSARD: Okay. On page 3 of your testimony you talk about how you've used the Van

Slyke formula to generate a cheese --

MR. TILLISON: For the fat recovery factor?

AGRICULTURE ECONOMIST GOSSARD: No. The 1.39 on bottom of page 2. "The Alliance used the Cal Poly study for the percentage of casein in California milk to determine the protein cheese yield factor of 1.39."

And to do that you used the Van Slyke formula. To use the Van Slyke formula, you assumed 92.5 percent fat recovery, 82 percent casein in protein, cheese moisture at 36.92, and the fat at 3.95 percent.

I was asking: What did you assume for the farm protein percentage?

MR. TILLISON: Eighty-two.

AGRICULTURE ECONOMIST GOSSARD: No, no, no. The test of the milk. Did you use 3 percent protein in the milk? You assume 3.95 percent fat in the milk. What did you assume --

MR. TILLISON: Three point one percent true protein.

AGRICULTURE ECONOMIST GOSSARD: Okay. And what was that based on?

MR. TILLISON: That was based on the simple average of the 13 plants for the 12-month period that the Tong study covered.

AGRICULTURE ECONOMIST GOSSARD: Okay. And you came up with .925, .82 for casein.

What did you use for casein lost in the whey, 0.1?

MR. TILLISON: Yeah, the normal factor in the Van Slyke formula.

AGRICULTURE ECONOMIST GOSSARD: Other solids in cheese did you use 1.09?

MR. TILLISON: Yes.

AGRICULTURE ECONOMIST GOSSARD: You used 36.92 for cheese moisture?

MR. TILLISON: No, I used 38. I used the 36.92 when I calculated the fat recovery value of 95 percent. When I calculated the protein factor, I used 38 percent moisture.

AGRICULTURE ECONOMIST GOSSARD: Okay. Now I've got your number.

In using the 92.5 fat recovery, did you ask the Department for data on what fat recovery was in California at these plants?

MR. TILLISON: No, I did not.

AGRICULTURE ECONOMIST GOSSARD: What was the basis for using the 0.1 casein loss in whey?

MR. TILLISON: That is the standard accepted level in the Van Slyke formula that Dr. David Barbano, probably the foremost recognized person in product yield pricing in the country, uses. And I'm not going to argue with Dr. Barbano.

AGRICULTURE ECONOMIST GOSSARD: Does he also use 1.09?

MR. TILLISON: Yes, he does.

AGRICULTURE ECONOMIST GOSSARD: Okay. That answers my questions. Thank you.

MR. TILLISON: Thank you.

SENIOR AGRICULTURAL ECONOMIST ERBA: Mr. Tillison, your testimony today does not address this directly. I'll just have to ask you to clarify this.

You've adjusted the cheese manufacturing cost allowance to what was released by the Department in December 2002, you've adjusted the butter manufacturing cost allowance based on the same exhibits, but you did not adjust the powder manufacturing cost allowance.

Why is that?

MR. TILLISON: That's because the Alliance does not have a 4a proposal. Our change to the 4a butterfat value was simply a conforming change to arrive at an appropriate -- what we feel is an appropriate value for milk going into cheese.

SENIOR AGRICULTURAL ECONOMIST ERBA: You have a table on page 4 that looks at cheese yields. Can you tell me how you developed that table?

MR. TILLISON: Well, this table is actually taken from data generated by Dr. Barbano for the May 2000 hearing. And what it basically shows is is the various yields depending on the milk fat content and the true protein content of milk.

And it uses 38 percent moisture, 9.9 fat recovery. But the purpose of this is to show that true protein has an impact on the amount of cheese that butterfat will yield, butterfat has an impact on the amount of cheese true protein will yield. It's interesting in looking at the Tong data. What you find is is that California milk in that study actually is deficit in terms of butterfat relative to the true protein necessary to get the yield factor of .64 -- or the fat to protein ratio of .64.

SENIOR AGRICULTURAL ECONOMIST ERBA: Do you know that this was based on using Van Slyke formula or some modified version of it?

MR. TILLISON: No, this was used on the Van -- based on the Van Slyke formula. I can provide you with the whole document, if you'd like, that this comes off of.

SENIOR AGRICULTURAL ECONOMIST ERBA: Actually what I'm more interested in is, could you make me a similar table but using the numbers that you suggested today in your proposal?

MR. TILLISON: Yes.

SENIOR AGRICULTURAL ECONOMIST ERBA: Would you be willing to submit that?

MR. TILLISON: Sure.

SENIOR AGRICULTURAL ECONOMIST ERBA: Thank you.

I have no more questions.

DAIRY MARKETING BRANCH CHIEF IKARI: I just have one question, Mr. Tillison.

You indicated that -- so I just want to explore this one question. You oppose any proposal that you cover only a small percentage. Can I take it by that you mean that the make allowance should cover 50 percent of the volume? Is that what you --

MR. TILLISON: What I'm saying is the make allowance should cover a majority of the product that's produced, whether it's cheese, butter or powder.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. Thank you.

HEARING OFFICER ESTES: Do we have any more questions?

Thank you very much for your testimony today, Mr. Tillison.

MR. TILLISON: Thank you.

HEARING OFFICER ESTES: I believe it's about what, 11:25, is that correct?

We will adjourn for lunch at this time. And we will reconvene at about 12:15 and proceed to take testimony related to the California Dairy Campaign petition.

(Thereupon a lunch break was taken.)

AFTERNOON SESSION

HEARING OFFICER ESTES: We'll proceed with the afternoon portion of the hearing.

So if the representative of the California Dairy Campaign would please come forward to make their presentation in support of their alternative petition.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. AVILA: Yes.

MR. MAGNUSON: Scott Magnuson.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. MAGNUSON: Yes, I do.

HEARING OFFICER ESTES: All right. Mr. Avila, I have a copy of your proposed testimony today. I assume you'd like to have that entered into the record?

MR. AVILA: Yes.

HEARING OFFICER ESTES: All right. It will be entered into the record as Exhibit Number 49.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 49.)

HEARING OFFICER ESTES: And you may now proceed with your testimony today.

MR. AVILA: Thank you.

Mr. Hearing Officer and members of the panel: My name is Xavier Avila, and I'm a dairy producer from Hanford, California. And I am testifying today on behalf of the California Dairy Campaign, which represents over 400 dairy producers throughout the State of California. CDC speaks today on behalf of the farmer and rancher members of the California Farmers Union.

The testimony I'm presenting today is based on positions adopted by the CDC board of directors on our January 23rd, 2003, board meeting.

And I'd like to say for the record, we have about 90 people. Some of them are still out at lunch today. But we have about 90 of our people here today to represent their interests. And we would probably have more if not due to the fact that producer prices are so low that a lot of our members have had to lay off people. And, as you know, dairying is 24-7. And they've laid off people to do their own work. So if it hadn't been for that, we'd probably have a lot more.

So I'll start.

Dairy producers are receiving milk prices well below their cost of production. This all too familiar situation has left dairymen in a very precarious financial position.

A California producer of average size and average cost of production without quota lost $500,000 from January '98 to October 2000 due to dairy prices that did not cover his cost of production. For all of the Year 2000, 90 percent of the dairies surveyed showed incomes that were below zero.

Dairy farmers also face rising costs as a result of operational changes that are necessary to meet water quality and other environmental standards. In addition, feed costs fluctuate while insurance costs and other costs continue to rise. Last year was a particularly difficult year for producers. From January to October 2000, the blend price averaged $1.95 below cost of production.

Section 61802(h) of the Food and Agriculture Code states, quote, "It is further recognized by the Legislature that in order to accomplish the purpose of this chapter and to promote the public health and welfare, it is essential to establish minimum producer prices at fair and reasonable levels so as to generate reasonable producer incomes that will promote the intelligent and orderly marketing of milk in various classes, and that minimum producer prices established under this chapter should not be unreasonably depressed because other factors have affected the levels of retail prices paid by consumers."

Section 61805(b) states that the CDFA director is authorized, quote, "to prescribe marketing areas and to determine minimum price to be paid to producers by handlers for market milk which are necessary due to the varying factors of cost of production, health regulations, transportation, and other factors in the marketing area of this state."

I think it is important to review these sections of the Food and Agriculture Code that show the importance of including producer costs of production in the California milk pricing system. As well as it is important to remember that the Legislature directed CDFA to establish minimum producer prices that are at fair and reasonable levels.

Producer prices are not at fair or reasonable levels when 90 percent of the dairies in this state have a net income that is less than zero. Producer prices are not reasonable when the blend price on average was nearly $2 lower than our cost of production for the Year 2002.

Action must be taken to improve dairy prices paid to producers in this State. We believe our proposal will be a good first step towards ensuring that producer prices are more fair and reasonable in the future.

The alternative proposal submitted by CDC calls for CDFA to:

Update the make allowances, yields, and transportation adjustments to reflect current CDFA studies; establish a variable manufacturing cost allowance that would be adjusted monthly based on the dairy producer's cost of production and the prevailing commodity prices; floor the commodity prices at the higher of the market price or the federal support purchase price as called for by the California Dairy Women's Association; and include the whey skim value in the 4b formula.

This CDC petition calls for CDFA to update the make allowances, yields and transportation adjustments to reflect current CDFA studies.

The CDC proposal updates and -- updates the make allowances, yields, and transportation adjustments to reflect current CDFA studies. In Article III Section 300.0 Subparagraph (D)(1) of our proposal, we update the freight adjustment for the 4a all milk fat formula to 2.42 cents and the yield factor to 1.2.

The 2.42 cents was taken from the November 26th, 2002, CME butter price versus California prices for September 2002. We updated the yield factor to 1.2 based on the 1.2183 weighted average powder yield included in correspondence from CDFA dated October 11th, titled "Butter and Powder Yield Study."

We updated the yield factor for 4a milk solids-not-fat to 1.0 based on Table 2 of the correspondence from CDFA dated October 11th, titled "Butter and powder Yield Studies," which documented a weighted average powder yield equal to 1.0208.

In Subparagraph (E)(1) of our proposal we eliminated the marketing adjustment because the most recent data showed that the difference between the CME and the California prices continue to narrow, and in the future we believe the marketing adjustment will no longer be necessary.

In Subparagraph (E)(1)(a) we updated the yield factor of cheddar cheese to 10.2. We arrived at the cheese yield base on the document attached in Exhibit D.

We updated the manufacturing cost allowance in Subparagraph (E)(1)(b) to $0.12, which was taken from the most current processing cost study dated November 25th, 2002, titled "The Weighted Average Manufacturing Cost for Butter, Nonfat Powder and Cheddar Cheese, 1989-2002."

In Subparagraph (E)(1)(c) we included the price per hundredweight computed by the formula using the dry whey price, less a manufacturing cost allowance of 15.9 cents, all multiplied by a yield factor of 5. The 15.9 cents amount is the amount adopted by the federal milk marketing order. The 5 cent factor is a low estimate based on information in Exhibit E Table 3.

The CDC petition calls for CDFA to establish a variable manufacturing cost allowance that would be adjusted monthly based on dairy producers' cost of production and the prevailing commodity prices.

We believe the current make allowance system overall sends a false signal to processors to continue to production regardless of market demand. Under the current system, the incentive to run as much raw milk through a plant regardless of market conditions is great. The result from this system is that it puts the needs of the processor at odds with the needs of the dairy producer. Too much milk reduces the price to the dairy farmer. And milk shortages decrease the amount of milk available to the processor.

We believe the make allowance system should be reformed so that it provides benefits to the producer and the processor. We favor the establishment of a variable make allowance that would tie processor and producer prosperity together. A variable make allowance would increase significantly when milk prices are high, thereby giving an incentive to processors to continue production because the return would be greater.

However, when milk prices are low, the make allowance would decrease and send a signal to processors to limit production in order to allow demand to catch up with production.

We believe a variable make allowance is a win-win proposal because it would enable producers and processors to make a higher return when milk prices rise.

The main factors involved in establishing CDFA's current producer milk price formulas are dairy product price, the product yield, and the plant make allowance.

The make allowance is the plant production costs for manufacturing the dairy product, which is subtracted from the dairy producers' price to determine the value of milk in the product -- the price received by the producer.

The problem with CDFA's milk pricing is that the make allowance is a fixed number while the price received by the producers is highly volatile and until now has not included dairyman's cost of production.

A milk pricing system that is balanced requires that dairy product prices, producers' cost of production, and plants' cost of production all be given consideration when determining the value of milk. Each of these items send signals to one another in a free market environment, so that proper price and production adjustments will occur. Under a variable make allowance, when the supply of process products is in line with demand, the make allowance is generous. As the market signals oversupply through lower prices, the make allowance would automatically drop, causing manufacturing to slow until once again supply and demand are in balance.

However, in California's milk pricing system there is insufficient marketplace balance between these factors because the make allowance guarantees that the cost of the processing segment of the industry are covered. In fact, since the make allowance includes cost plus profit for an efficient plant, an over supply can actually be a benefit to proprietary processors because it lowers the raw product costs. This a less true for cooperatives whose members are dairy farmers affected by lower milk prices.

California has allowed plants to be profitable and expand processing to the lowest value dairy products regardless of true market demand because producers covered the plant costs. This has resulted in lower producer milk prices. Processors with a generous make allowance level use this margin to discount the product price to gain market share at the expense of producer pay prices and at the expense of other manufacturers in the rest of the United States.

Unfortunately, the plants are merely operating by the rules of the system. We have entered into a race to the bottom where all producers will lose. The CDC variable make allowance proposal is aimed at creating a true market oriented system rather than continuing the mistakes of the past.

Looking at California's milk production history may allow us to see forward into the future in terms of how the California style system has affected milk production and farmer income. In 1975 California production was 10.06 billion pounds, with a 57 percent Class I utilization. In 2002, California produced 35 billion pounds of milk, with an 18 percent Class I utilization. That's a 240 percent milk production increase in 24 years. We now produce 100 percent more than what is consumed in this state, even with 10 percent of America's population residing in California. Fifteen percent of California's production has been purchased by the Commodity Credit Corporation. California sales account for 80 percent of all CCC dairy product purchases.

California dairy producers have been in constant growth mode. When prices are good, we add cows. When prices are go down, our bankers tell us to add cows in order to cash flow, even though historically California has had some of the lowest mail box prices in the nation. California's milk pricing system has been the largest contributor to creating a dairy industry that is constantly dependent on the Commodity Credit Corporation as the customer of the last resort.

Currently CCC stocks of nonfat dry milk amount to over a billion pounds. There is no economic signal that communicates to the processor to regulate the amount or kind of product the market demands.

This has been a very lucrative time for processors in the State of California. The fixed make allowance mechanism has led to development of mega-dairies in the State. The mega-dairies are welcomed by the processors that benefit from abundant supply and zero risk as they expand production -- zero risk since producers are covering plant manufacturing costs. At the same time as we are financing their expansion, the high supply levels drive our prices down.

As the long as the manufacturing allowance is fixed at the processor's cost plus a return on investment, and is paid for by farmers, the processing segment of the industry will be unconcerned with market signals. We need a system that works with the marketplace at all levels -- producers, processors, wholesalers, retailers, and consumers -- to provide an equitable, stable, and viable economic environment for all segments of the dairy industry.

Our members support a variable make allowance based on all the producers' milk prices. It is unfair and market distorting to force the producer to continually cover the cost of processing, including a profit, when he has no similar resource. Certainly, the producer is not guaranteed that his production costs will be covered. Markets signals need to be given to both the producing and processing sectors of the industry.

The CDC proposal incorporates the Commodity Reference Price, which is used to calculate the value of the commodity in the market, and compare that amount to the cost of production to show what percentage of our costs are being covered by the prevailing commodity prices. That same percentage is used to adjust the make allowance up or down from the base make allowance. When commodity prices are high enough, 100 percent of the average producer's cost of production and 100 percent of the processor's average cost of production is covered. When commodity prices do not cover the cost of production to the producer, the make allowance would adjust downward accordingly.

The Commodity Reference Price and the Milk Production Price Index shall be those specified in subparagraph (F) of the proposal. In our original proposal we used a CRP based on the month when the cost of production data was available. Since then we have requested to modify our proposals so that the CRP price corresponds to the most recent month. For January the most recent cost of production index available would be September/October index. Using the most recent CRP price allows the make allowance adjustment to track the current commodity price.

Class 4a:

For all milk fat, the CDC variable make allowance formula would equal $0.12 times the Commodity Reference Price calculated pursuant to Subparagraph (A)(4)(b), divided by the Milk Production Cost Index. The $0.12 amount was taken from the weighted average make allowance cost study issued by CDFA November 2002.

For all milk solids-not-fat, the CDC variable make allowance formula would equate $0.15 cents times Commodity Reference Price calculated pursuant to Subparagraph (A)(4)(b), divided by Milk Production Cost Index. (Exhibit F)

Class 4b:

For cheddar cheese the CDC manufacturing cost allowance would equal 17.35 cents, times the Commodity Reference Price calculated pursuant to Subparagraph (A)(4)(a), divide by Milk Production Cost Index. The amount was taken from the weighted average make allowance cost study issued by CDFA November 2002.

The CDC petition calls for CDFA to floor the commodity prices at the higher of the market price or the federal support purchase price as called for by the California Dairy Women's Association.

We call for the CDFA to reinstate provisions similar to those included in the June 1995 stabilization plans as called for in the California Dairy Women's Association petition. We have included language similar to the CDWA proposal in our petition. The 1996 farm bill contained a provision that would sunset the $9.90 support purchase price program in the year 2002. In the 2002 farm bill, the U.S. Congress and the Bush Administration agreed to continue a $9.90 federal support purchase price. Although we believe producers should be paid from the marketplace, it was the intent of Congress that all producers nationwide should be eligible for this important safety net.

California producers should be able to benefit from the support program which is a fundamental component of U.S dairy policy included in the last two farm bills. To be consistent with the 2002 farm bill, California producers should receive prices that are the higher of the prevailing market prices for the USDA announced federal support purchase price.

Include the whey skim value in the 4b formula:

CDFA issued a letter dated January 21st, 2003, which showed that all the processing plants CDFA surveyed used the whey byproduct for other uses. A substantial amount of the whey protein is sold as skim whey powder, standard whey protein concentrate or high-end protein concentrate, which demonstrates that processing plants derive significant value from whey products. We firmly believe that producers should be able to benefit from the value of whey by including it in the formula which determines the producer price.

Beyond the issues we have discussed today, we believe the current end-product pricing system in California should be improved overall. The current 4b formula should be modified to make it more market-oriented. The current 4b formula is based on price of cheddar cheese, which is one of the least profitable cheeses sold in the marketplace today. We believe 4b formula should be based on the current market demand and prevailing market prices. Demand for mozzarella cheese and high moisture cheese represents a significant amount of the cheese market today. Producers should be able to reap the rewards of these products as processors have for some time now.

As president of California Dairy Campaign, I have the chance to meet with producers throughout the State. I have heard firsthand from producers about how low milk prices are affecting their families and their communities. The other day one of our members told me that he was $1,000 per day because he was not able to cover his cost of production. And he is not alone by far. I hear these stories again and again as I travel up and down the State. Not only have I heard from producers, but I have heard how low prices have been -- are having a ripple effect on the rest of our state economy. I have talked to hay dealers who are not willing to sell any more hay because many producers are unable to pay their bills. The list of those affected by low dairy prices go on and on because dairy producers play an integral role in the health of our state economy.

Unless prices start to recover soon we'll begin to see more and more producers go out of business. Even some dairy producers who have been in the business for generations are now talking about leaving the dairy because they simply can't afford to lose any more money.

There has been much in the press recently about the sale of milk to unlicensed processors. A Modesto Bee article dated January 11 stated that, "Legal milk sells for 80 cents her gallon. Dairies can get up to $2 a gallon selling the milk under the table."

Producers can earn up to $14 per hundredweight more on the black market today than they could receive through normal channels. Although we do not, and I stress, we do not condone this practice, we sympathize with those producers who are struggling today due to low prices. The fact that producers can make so much more on the black market shows that milk does have a higher value than the price paid to producers today.

Money is being made on the dairy industry, but producers are being left out of the profit opportunity. In our system today large processors are able to manipulate our market to keep producer prices artificially low. Far more must be done to address the concentration in the dairy sector that has allowed such market manipulation to lead to such chronic low producer prices.

In conclusion, we call upon CDFA to:

Update the make allowances, yields, and transportation adjustments to reflect the current CDFA studies; establish a variable make allowance cost allowance that would be adjusted monthly based on dairy producer's cost of production and the prevailing commodity prices; floor the commodity prices at the higher of the market price or the federal support purchase price as called for by the California Dairy Women's Association; and include the whey skim value in the 4b formula price.

We believe acceptance of our petition will be a good first step towards ensuring that Dairy producers will receive a fair price in the future. We acknowledge that far more must be done to bring us out of these chronic low producer prices. We look forward to working with CDFA to improve the outlook for dairy producer prices in this state.

California Dairy Campaign would like to thank the Department for the opportunity to present our alternative proposal today. We'd also like to request the opportunity to submit a post-hearing brief. And I have just a few comments off of that.

Yeah, I'd like to just make a few comments, not in any order. You know, I'd like to point out that the midwest dairy producers currently receive an average of $1.25 premium from their shippers to ship milk. So that still gives an advantage to California processors.

And I would like to state that contrary to information that was provided earlier today, the CDC petition would result in a $345 million dollar increase to the producers over the last five years. That comes out to a $32,000 per farm increase over the last five years.

And, you know, I would like to point out that -- I think somebody mentioned that a variable make allowance would not be fair to producers or processors. And I don't see how. You know, I think you have to understand, you know, motivation. I think you have to understand human nature. And there's two components I think that involve that. There's fear and greed. And I think at this point the processors are operating on the greed factor.

I think our variable make allowance would give a huge incentive for processors to keep milk prices high by various means, by lobbying our federal government to keep more of the imports out that are devastating our price, to look at other pricing mechanisms that are fair, and to, you know, balance supply with demand.

And, let's see.

Well, I think that'll do it for now.

HEARING OFFICER ESTES: All right. Your request for a post-hearing brief is granted. Please have it to the Department by the close of business Friday, February 7th.

HEARING OFFICER ESTES: Now, do we have any -- do we have panel questions?

SUPERVISING AUDITOR HUNTER: Yeah, I just have one question.

When you set up the make allowance -- can you hear me now?

Good.

(Laughter.)

SUPERVISING AUDITOR HUNTER: My question has to do with the make allowance that you're purporting.

On the butter you want $0.12; on the powder, $0.15; on the cheddar cheese, $0.1735.

MR. AVILA: Correct.

SUPERVISING AUDITOR HUNTER: That comes out of the November exhibit.

Is there any reason that you're not using the December exhibit that we put out December 23rd?

MR. MAGNUSON: Well, when we put the proposal together, that hadn't been available yet. And with our variable make allowance, the exact level -- variable make allowance, the exact level within a few cents isn't this critical because it's going to be changed every month. So I feel like it wasn't really necessary to update it again.

MR. AVILA: And I would like to say that we use the 1.0 on powder. But when we're doing that, our intentions that the make allowance -- the variable make allowance is going to take care of what we want done. If we weren't proposing the variable make allowance, we probably would have used the 1.004 as a figure.

SUPERVISING AUDITOR HUNTER: Thank you.

HEARING OFFICER ESTES: Before we ask any more questions, can we have the microphones adjusted. I think they were turned down before the afternoon session. And I think -- you know, we had a problem in the morning because some microphones were too brittle and had too much reverberation. And now we seem to have a problem because some microphones are adjusted too low.

All right. Let's hopefully -- I mean we may not have any problems with hearing at least for a brief period until people suffer some potential hearing problems.

(Laughter.)

HEARING OFFICER ESTES: But, anyway, let's go ahead and proceed with the panel questioning.

AGRICULTURE ECONOMIST GOSSARD: Is this one working now?

First, the question I asked of several previous witnesses. In your whey component of the 4b pricing formula you use the Dairy Market News mostly to price skim whey powder. Why did you choose that price rather than the NASS survey price?

MR. MAGNUSON: In looking at the comparison with the Western and the NASS price, there was very little difference with the two.

Western is specifically for western states. And in the document that you provided, the western states now produce maybe 37 percent of the whey nationally, which has a great impact on the NASS survey. So we just thought --

AGRICULTURE ECONOMIST GOSSARD: My next questions have to do with your use of the Van Slyke formula. I was looking at your Exhibit D, page 3 of that exhibit.

The page has two variations on the Van Slyke formula. The first one uses a 93 percent fat retention. The second one uses a 90 percent fat retention.

Is it one of those two formulas that you used?

MR. MAGNUSON: We were referring to --

AGRICULTURE ECONOMIST GOSSARD: -- Exhibit D --

MR. MAGNUSON: -- Exhibit E, on Table 1.

AGRICULTURE ECONOMIST GOSSARD: No, no, no. This is Exhibit --

MR. MAGNUSON: This is it right here.

For our yield on our --

AGRICULTURE ECONOMIST GOSSARD: Yeah, the Van Slyke formula.

MR. MAGNUSON: The yield on the cheese formula was taken from the Table 3, I believe.

AGRICULTURE ECONOMIST GOSSARD: Table 3 of Exhibit --

MR. MAGNUSON: Exhibit E there's Table 1 --

AGRICULTURE ECONOMIST GOSSARD: No, no. Exhibit D. Sorry. Page 3 of Exhibit D.

MR. MAGNUSON: And what was the question?

AGRICULTURE ECONOMIST GOSSARD: Okay. Sure.

There are two Van Slyke equations on the table on this page. One uses a fat retention of .93. The other uses a fat retention of .90. You say in your document that this is an exhibit that you used.

Which of these two formulas was the one that you actually used to calculate your 10.2 yield?

MR. MAGNUSON: Well, the -- that's why I was going back to -- it might be mislabeled, our exhibit. Because we were using the table listed in Exhibit E, which is supposed to be on Exhibit D, but it's listed as Exhibit E.

In the Table 1, which has the yield broken down, which we corrected to a higher fat content. This one showing a 3.5 fat content in milk with a 9.72 yield. With a higher fat content, we used a higher yield.

And then we also referred to Table 3, which shows that with 3.5 milk, it's a yield of 11.75. Although that one was -- on that Table 3 the yield was -- 11.75 was referring to mozzarella. But like with over 40 percent of the cheese manufactured in California being mozzarella, that we felt that it would capture part of that value to a higher yield.

AGRICULTURE ECONOMIST GOSSARD: Then for clarification I'll probably have to ask, in the Van Slyke formula that you used, what fat retention value did you use? I mean do you show the work calculation?

MR. MAGNUSON: In Table 1 they're using an 85 percent fat retention.

AGRICULTURE ECONOMIST GOSSARD: Okay. Is that what you used?

MR. MAGNUSON: We used basically a combination between the two, which would have been higher.

We didn't -- I didn't run the Van Slyke formula. I used the numbers off of the table.

AGRICULTURE ECONOMIST GOSSARD: Oh, Okay. So you -- in referring to the Van Slyke in your testimony, you were referring to the information produced by these documents, which in turn did use the Van Slyke, but you didn't actually do, as two previous witnesses have done, actually make certain assumptions and use the Van Slyke directly to calculate the --

MR. MAGNUSON: We used the table that was already there.

AGRICULTURE ECONOMIST GOSSARD: Okay. Thank you very much for that clarification. Sorry it took so long.

SENIOR AGRICULTURAL ECONOMIST ERBA: I just have two questions. One I think is a real simple clarification.

On the top of page 3 you state that "We updated the yield factor to 1.2 based on a 1.2183 weighted average powder yield."

MR. MAGNUSON: Yes, that was supposed to be butter.

SENIOR AGRICULTURAL ECONOMIST ERBA: I thought that was the case. I just wanted to make sure.

My second question has to do with the freight adjustment for butter. You chose only to use one month, I believe the most recent month, that was at least five, the Department, to get the 2.42 cents.

Why do you use only one month to make that adjustment on the freight adjustment?

MR. MAGNUSON: The freight adjustment -- well, like that, the trend over that period of time, that the lower freight adjustment is within the range of what it had been trading for recently. And that the difference between the CME and the California weighted price -- the CME really hadn't been tracking the California price as much as the NASS price, which probably has a bigger indication -- or better indication of what a cheese has been selling for in California than what the CME does.

So with the comparison between the California butter price and the NASS butter prices, our figure of 2.4 is very close.

SENIOR AGRICULTURAL ECONOMIST ERBA: So it's more of an indication of what the CME is relative to the NASS rather than what the releases was trying show?

MR. MAGNUSON: Yes.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: I just had a question -- as I listened to your testimony, I can draw inferences. And I'd rather be more clear.

Is it your position that your proposal on the variable make allowance and the higher support or market price, that those are prerequisites, that we should consider those before we make any changes proposed like by Western United or the other groups?

MR. AVILA: I would say yes. I would say I think the variable make allowance would solve a lot of issues. I mean -- I want to say this: If you look at the five-year average -- you know, you guys did a good job of compiling all the numbers. But I think you'd have to -- how you assess that is look at the -- three of those five years were high producing years. And we actually increased the make allowance to the processor. What we're saying is -- we're not against processors. We're for processors. We need processors. But we need their -- I mean this is a tragedy of the commons. We're the grass, you know. No grass, no sheep. So there's a -- if you compared two low years -- 2000, 2002 -- we're pretty favorable to dairymen. So I mean -- I guess what I'm saying, if you take -- depending on which five years you want to take, if you were to cut out the high years, we didn't need that money then. We had 14, 15 dollar milk in '98. We had 12, 13 dollar milk in '99. We had 9 something in 2000. We had 12, 13 dollar milk in 2001. And we're here with 9 dollar milk in 2002. And we're continuing that in 2003.

So we're not trying to take money when we don't need it. We're trying to have money when we do need it. And we're trying to balance the market, trying to give incentive to co-ops, which control 85 percent of the milk in the United States, to do more things with trade, more things with supply controls, and just make everything more market oriented.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

MR. AVILA: I'm known for being long winded.

(Laughter.)

HEARING OFFICER ESTES: Have we concluded with questioning?

All right. Thank both of you.

(Applause.)

HEARING OFFICER ESTES: If the Dairy Institute could now come forward.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

DR. SCHIEK: I do.

HEARING OFFICER ESTES: We have a copy of your proposed testimony today. Do you want to have that entered into the record?

DR. SCHIEK: Yes, I would.

HEARING OFFICER ESTES: It'll be entered in the record as Exhibit Number 50.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 50.)

HEARING OFFICER ESTES: You have half an hour to present your proposal to the panel.

DR. SCHIEK: Thank you.

Mr. Hearing Officer and members of the hearing panel: My name is William Schiek and I'm an economist -- am I coming through now?

Mr. Hearing Officer and members of the hearing panel: My name is William Schiek and I'm an economist for the Dairy Institute of California, and I'm testifying on the Institute's behalf.

The Dairy Institute is a trade association representing 40 dairy companies which process approximately 75 percent of the fluid milk, cultured, and frozen products, over 60 percent of the cheese products, and a small percentage of the butter and nonfat milk powder processed and manufactured in the State. Member firms operate in both marketing areas in the State. The position presented at this hearing was adopted unanimously by Dairy Institute's Board of Directors.

Dairy institute is grateful for the opportunity to testify at this hearing. Much attention has been given to the recently announced, and long awaited, final decision with respect to Class III and Class IV prices in federal orders. While the decision has not yet been implemented, the formula set forth by USDA would increase federal Class III prices and decrease federal Class IV prices.

The changes in federal order pricing formulas are being touted by some as justification for requiring similar adjustments to the California pricing formulas. We maintain that changes in federal order manufacturing milk price levels do not always require corresponding changes in California's milk price levels. And in this case such changes are not only unwarranted, but could be detrimental to the continued health of the California dairy industry.

The current milk supply and demand situation:

California milk production growth has been averaging more than 4.5 percent per year over the past 20 years. In 2002 preliminary estimates put the State's milk output growth at 5 percent. Putting these numbers in some perspective, the State must have enough plant capacity to take an additional 3.5 to 4 million pounds of milk per day every year. This is the equivalent of one new large cheese plant per year.

The conclusion is obvious: We must have manufacturing outlets for this milk production growth, or California milk will have to travel outside the State to find a home. In order to attract manufacturing capacity and investment, raw milk costs must be at a level that will allow California plants to compete, especially given the State's higher plant costs in other areas such as energy and labor.

Milk production growth nationwide has been robust and above the recent trend in 2002. But, unfortunately, demand for manufactured dairy products has been lackluster during the 2001 and 2002 period in comparison to recent years. This reduced growth in demand is generally attributed to the slower growth rate in the national economy of the past two years. However, there are some signs that are pointing to more troubling and perhaps longer lasting trend in consumption. In particular, we are beginning to see a maturing market for certain types of cheese uses.

One of the largest demand segment users of cheddar and mozzarella cheese, which together account for

78.5 percent of California cheese output, is the food service sector. Total U.S. production was flat in 2001 -- cheese production, that is -- and commercial use growth was modest at best. The well publicized problems of McDonald's Corporation are attributed in part to the nation's sense of "fast food fatigue." The same store sales growth of many of the large restaurant chains were disappointing in 2002. Some of the greatest disappointments have been in the restaurant pizza business, where some of the largest chains saw same store sales shrink this year and others face slower than anticipated growth.

Some industry watchers wonder whether the days of rapid growth in mozzarella sales are over. They see a pizza business that is beginning to take on the characteristics of a more mature market, with slow overall sales growth, industry consolidation, and especially vigorous competition for sales growth.

Given this apparent state of affairs cheese marketers will tell you that they are facing an increasingly competitive market for sales of manufactured products. In such an environment it is more important than ever for California's plants to be competitive from a raw product cost standpoint in order to be successful at gaining sales and assuring that all of California's milk production will be marketed.

In the past year two California cheese plants have closed, with one company going bankrupt and the other making a decision to serve the western market from a recently purchased plant in Idaho. California needs to be attracting cheese plant investment, not driving it away.

California dairy farm income problems -- real solutions come from the market:

The California dairy industry, and indeed the national dairy industry, has been experiencing relatively low prices since the end of 2001. Periods of low prices ensue when milk output expands more rapidly relative to the commercial use of dairy products. In the past periods of low prices have ended when lower returns have forced production adjustments on the dairy sector. Adjustments have typically been made by smaller dairies which exist in large numbers in the midwest and the northeast regions of the country.

With this current phase of low prices, adjustment is slower than usual due to the national Milk Income Loss Contract, or MILC, program, which targets benefits more heavily toward smaller farms. It is unfortunate that they are faced with a national dairy program that punishes large and economically efficient farms and rewards farms that generally have higher cost structures and are less efficient. However, this is the solution we are faced with, and increasing California's regulated price will do nothing to correct this underlying national policy problem.

Recovery of demand for milk products and adjustments in milk output are the only legitimate and lasting means to higher prices and better returns for dairymen. Increasing the regulated price will only send a signal for dairymen to produce more, prolonging the period of low farm milk prices that we are now experiencing. Increasing the regulated price will make plants less competitive in national and international markets, and will do nothing to improve the demand for dairy products.

While it is certainly understandable that dairymen and dairy farm leaders are searching for any possible solution to low prices, raising the regulated price is not a solution. In fact, short-term revenue gains from a higher regulated price will likely exacerbate the existing over-supply situation, making matters worse for California dairymen.

Real solutions to dairy farmers' income concerns will come from fixing the problems with national dairy policy, a rebounding market for existing dairy products, expanding dairy product uses, and developing new products few investment in new technologies.

A representative of one of Dairy Institute's member companies will expand on this last point during his testimony later today.

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

In developing formulas for Class 4a, fat and solids-not-fat, we have used the weighted average manufacturing costs developed by the Department as the make allowances for butter and nonfat dry milk. With respect to product yields, we note that the yield factors calculated by the Department appear to have neglected allowances for degraded product that does not receive the highest value product price. For butter, this would be off-grade, or non AA, butter as well as products that must be reworked or otherwise sold at a discount. For nonfat dry milk, degraded product would include sweepings, or cleaning, of the driers, which must be sold as animal feed or disposed of in another fashion at a minimum -- or a fraction of the nonfat dry milk price; as well as buttermilk powder, which usually sells at a discount to nonfat dry milk. We do not know what the yields for butter and nonfat dry milk would be if these factors were appropriately taken into account. But in the absence of better information, we advocate leaving the yield factors for butter and nonfat dry milk unchanged.

The Class 4a fat formula is as follows: The Chicago Mercantile Exchange AA butter price per pound from the 26th of the prior month to the 25th of the current month, less a marketing adjustment of 3.32 cents, less a make allowance of 12.11 cents, all multiplied by a yield factor of 1.2.

Note that the marketing adjustment is equal to the average monthly difference between CME AA butter price and the weighted average California price for butter as computed by the Department.

I must mention that we have some reservations regarding the use of the 3.32 cent factor. Primarily we question whether it adequately covers the freight associated with moving butter to Chicago. The freight factor is important because at the margin the butter price in California would be determined by the value of butter sold at the CME less the cost of moving that product to the Chicago market for sale. If California plants are selling butter locally for more than the CME price less freight, one or more of the following reasons may be involved:

Reason A: The CME price may not represent the prevailing wholesale butter price but rather a discounted price where all wholesale trade occurs at a premium. As such, the price difference between California and the CME may not be expected to reflect the cost of moving butter to Chicago. However, the transportation would be reflected in the price difference between the prevailing Chicago wholesale price and the California price.

Reason B: The cost of butter freight to Chicago may have fallen from the past numbers and may actually now be 3.32 cents per pound.

Reason C: California butter makers may be exercising market power and selling to local, or distant, buyers at a premium to the CME.

And Reason D: The prices for product sold to commercial users by California butter makers may include some embedded services or bundled deals that lead to ostensibly higher prices for the California butter, but where the price is not really a pure commodity price as it is for product sold to the CME.

It could also be the case that a combination of one of the aforementioned reasons is at work. In our judgment it seems unlikely that either Reason A or B is operative in this case. There may be some reason to suspect that butter makers could be exercising market power, especially given the consolidation that has occurred in butter making during the past few years, although there are still different entities that compete for butter sales and such market power could not persist in the long run in the competitive national market. The notion that prices to some customers contain embedded service is perhaps the most likely reason that the price difference between the CME and California is less than the freight cost.

However, given that Dairy Institute members make very little butter from a commodity market, we leave it to the big makers of butters to address this issue. If the Dairy Institute formula had been in place over the 2000-2002, the Class 4a fat price would have fallen slightly, by about .88 cents per pound.

The Class 4a solids-not-fat formula is as follows:

The California weighted average Grade A and Extra Grade nonfat milk powder price less a make allowance of 15.12 cents per pound, all times a yield factor of .99.

Our proposed formula would have increased the average Class 4a SNF price by .97 cents per pound over the 2000 to 2002 period. The Class 4a hundredweight price would have increased by about 5 cents a hundredweight under the proposal during the same period.

Class 4b, our formula proposal was developed in three stages:

In Stage 1 we looked at the impact of making technical changes only to the existing cheese hundredweight formula. We assumed the California cheese price was equal to the CME cheddar block price less a 3.21 cent marketing adjustment. This number came from the Department's analysis of the difference between the California's weighted average cheese price and the CME price for 40 pound cheddar blocks.

We used a manufacturing allowance of 17.46 cents per pound, which is equal to the most recent weighted average manufacturing cost for cheddar blocks as released by the Department. The whey cream portion of the cheese hundredweight value is the same as under the current formula, except that the whey butter make allowance has been increased to 12.11 cents per pound, which is the Department's weighted average manufacturing cost for butter.

Cheese yield:

Throughout our analysis, we assumed a cheddar cheese yield of 9.98 pounds per hundredweight of milk. We understand that some have suggested that the use -- some have suggested the use of the vat yields contained in Department's cost surveys in the 4B formula.

We urge the Department to reject any such proposal. The cheese yield used in pricing raw milk must be representative of what can be a obtained from typical milk from California. Thus, the yield should not be derived from fortified vats, which evidence a yield that can be achieved only with fortification ingredients that have a different composition than that of typical milk.

Using fortified vat yields transfers the cheese making value of the fortification ingredients and assumes that that value is contained in typical milk. This is an erroneous assumption. At a minimum, if fortified vat yields were to be used in the formula, then all costs associated with the fortification ingredients, including all protein premiums paid, should be included in the manufacturing allowance.

It is also important that the yield used in the pricing formula is not derived from milk that has been incentivized through the use of premiums to achieve higher protein and casein tests. Using such milk in formula yield calculations would essentially require processors to pay twice for the components that are of value in their manufacturing operations. Under this scenario, a processor would pay once through the protein premium and then a second time through the regulated price. It may be true that plants could adjust premiums to reflect the fact that they are paying for the higher yielding milk through the regulated price. However, the signals to producers would be muted under this approach because the class price is paid to the pool and the value of that higher protein milk would then be blended out to all producers.

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

To obtain a cheese yield from typical milk, which is ultimately what is being priced, it is appropriate to use the Van Slyke cheddar cheese yield formula. The Van Slyke formula is a widely recognized predictor of the amount of cheese yielded from a given quantity of milk of known component test. It is used widely by the cheese industry to benchmark cheese plant operations, and was the basis for the yields in the protein component price formula used in the federal order system.

The Van Slyke formula has the following form:

Cheese yield basically calculated from the pounds of milkfat in milk times the fat retention percentage; added to that is the pounds of casein in the milk less a casein loss factor of .1. And that entire term is multiplied by other solids retained in the cheese; and that factor is 1.09. And then the whole thing is divided by 1 minus the finished moisture percentage.

Since the number of pounds of casein in producer milk is generally not tested directly, an assumption is often used regarding the percentage of protein that is casein, and then that is multiplied by pounds of protein. Or an assumption is made on the percentage of solids-not-fat that is casein, and then is multiplied by the pounds of solids-not-fat.

To calculate the yield from typical California milk, we used the Van Slyke formula with the following assumptions:

Milk was assumed to have a statewide average test of 3.68 percent fat and 8.76 percent solids-nonfat. A fat retention of 92 percent, a casein to SNF ratio of .2832, and a finished moisture of 37 percent. When these numbers are plugged into the Van Slyke formula, the result of yield is 9.98 pounds of cheese.

The milk composition assumption of 3.68 percent fat and 8.76 percent solids-not-fat is the average producer milk test for calendar year 2001 as reported by CDFA in the Dairy Statistics Annual Summit. The assumption of the 92 percent fat retention is an exceptionally aggressive one. This fat retention percentage is at a level that many plants do not attain.

By contrast, the fat retention assumption that was employed in the development of the federal order pricing formulas is 90 percent.

The assumed casein to SNF ratio of .2832 was derived from data contained in a milk composition study conducted by Dr. Phil Tong of Cal Poly University. A summary of the data contained in that study is attached to this testimony as Attachment 1.

In the study, Dr. Tong presented summary data of milk composition by plant type. The casein to SNF value of .2832 was calculated by constructing the weighted average of the casein to SNF ratios of the fluid and butter-powder plants in Dr. Tong's study. This calculation is shown as Attachment 2.

Cheese plants were excluded from the calculation because their composition has likely been altered through the use of the incentives that are paid to dairymen to encourage them to produce components that increase cheese yield. As I mentioned earlier, component tests from milk that has been incentivized should not be used in determining the yields in the pricing formulas. Such a practice effectively requires processors to pay twice same benefit, and ultimately transfers value from the producers who create it to those who do not.

The finished moisture assumption we used for the

Van Slyke formula was 37 percent. This number, actually 36.92 percent, was presented by the Department with its manufacturing cost survey results. Our members questioned whether in fact this number represented finished moisture in block cheese, expecting that finished moisture might be higher. We assumed, since the surveys were used to obtain estimates of the cost of making cheddar blocks, that this number represented finished moisture for block cheese in California. Apparently, we assumed wrong.

At the pre-hearing workshop we were informed that some barrel-type cheese was included in the moisture estimates. And very recently we received data from the Department which indicated that the finished moisture in plants making 40 pound cheddar blocks was closer to 38 percent. Despite this new data, we stand by our assertion that average test milk yields 9.98 pounds of cheese per hundredweight.

We note that our fat retention assumption was aggressive at 92 percent, whereas the federal orders assume a fat retention of 90 percent in their formula cheese yields.

We also initially did not include an allowance for ranch-to-plant losses of components, for which processors pay based of farm tests, but for which they receive no value because the lost components never reach the vat. Based on testimony at the Federal Order Class III and IV hearing, ranch-to-plant losses of components average .15 percent in regions like California, which are dominated by large farms.

Also, there's an additional loss of fat due to milkfat's propensity to cling to stainless steel surfaces. This additional fat loss is equal to .015 pounds of fat per hundredweight of milk.

So when these losses are incorporated into the Van Slyke formula, along with the fat retention of 90 percent and a finished moisture of 38 percent, we get a cheese yield of 9.97, virtually identical to our earlier yield estimates. The cheese yield calculations are shown as Attachment 3.

So as this stage in the development of our proposal, the Class 4b formulas were as follows:

The cheese hundredweight price took the CME cheddar block price, less marketing adjustment of 3.21 cents, less the make of 17.46 cents multiplied by a yield factor of 9.98. Added to that is the CME AA butter price, less the 10 cents, less a make allowance of 12.11 -- there's an error there, it should be 12.1 -- no, .1211 -- sorry -- times a yield of .27.

The Class 4b fat price is equal to the Class 4a fat price. And the Class 4b SNF price takes the cheese hundredweight price and subtracts 3.68 times the Class 4b fat price and divides by 8.76.

Okay. This is similar in structure to the current formula; just with different assumed milk tests.

These formula changes would result in a Class 4b price that would be lower by about $0.23 per hundredweight relative to the current formula.

Stage 2 of the formula development involved looking at the impact of adding dry whey explicitly in the cheese hundredweight calculation. During the March 2001 Class 4b hearing, institute testified that the current Class 4b formula overvalues milk used in cheese making, and that the different between the value of the milk used in cheese making alone and the value generated by the current formula provided an explicit allowance for whey.

In keeping with our earlier testimony, we looked at the impact of explicitly adding a dry whey factor to the formula, making use of some realistic assumptions regarding whey manufacturing costs and yields derived from plant experience. We assumed that the relevant whey price equal western dry whey, mostly, price averages reported by the Agricultural Marketing Service of the U.S. Department of Agriculture. This price uses a telephone survey price and would have major shortcomings relative to an audited price survey, but is the only price quote available that reflects western dry whey values.

We also maintain that dry way processing costs are 3.06 cents per pound greater than the cost of drying nonfat milk, or 18 cents per pound -- excuse me -- 18.18 cents per pound.

The May 2000 federal order pricing hearing led to the establishment of a whey make allowance of 15.9 cents per pound, which is too low and does not take into account all the incremental costs of drying whey in comparison to drying nonfat milk.

Testimony explaining the derivation of these incremental whey drying costs will be entered into the record later today by a representative of one of Dairy Institute's member companies.

Our assumption regarding the yield of dry whey begins with a typical milk test of 8.76 percent solids-not-fat and 3.68 percent fat. The derivation of the whey yield is contained in Attachment 4 and includes allowances for losses in the ranch-to-plant and milk movement and whey solids losses in effluence. Loss assumptions are those presented in testimony given at the Federal Order Class III/IV hearing during May 2000 and in subsequent brief filings. I have included as Attachment 5 a Federal Order brief filed by Leprino Foods in January 2002, which describes the loss assumptions employed in this whey yield calculation. Based on our assumption of milk composition and losses, the calculated whey yield is 5.82.

By including dry whey as described above, the addition to the cheese hundredweight value formula developed in Stage 1 is the AMS western dry whey price less 18.18 cents, all multiplied by a yield factor of 5.82. All other aspects of Class 4b formula remain the same under the Stage 2 as in Stage 1. Under the Stage 2 formula, the Class 4b price averages slightly lower, by about 5 cents per hundredweight than the current formula.

The main point of this illustration is that the current formula does not shortchange producers by its failure to explicitly incorporate non-cream whey.

In Stage 3 we assessed the desirability of explicitly incorporation of whey into the pricing formula. We argued at past hearings that there are several reasons why non-cream whey value should not be incorporated into the 4b formula. We have reiterated and we further explained some of those reasons here. This has been entered in previous testimony. But basically the first reason is that there is no inherent raw whey value.

The second reason is that data pertaining to whey processing and disposal costs, the quantities of different whey products produced, and the actual California yield of whey from raw milk used to make cheese are either insufficient or vary too widely to design a pricing formula that is reflective of actual market circumstances in California. And then CDFA's hearing exhibit kind of backs that up.

Third reason is that dry whey for human consumption is produced by only one of the plants included in the manufacturing cost survey. And one plant is not really a good basis for a pricing formula. There are other plants that make dry whey, like mozzarella plants. But they have different waste stream composition and, therefore, would have different yields of processing costs. And they shouldn't be used.

There are several plants producing whey protein concentrate, but there's considerable variability in these operations. And it would be unlikely that a formula could be developed that fairly represents those operations.

Another problem with including dry whey in the 4b pricing formula is that movements in dry whey prices correlate poorly with movement in the prices of other products derived from whey. We have some evidence in the hearing exhibit from CDFA that backs that up.

Rather than include whey explicitly, the marketing adjuster for cheese can be altered to yield the same price level attained under the current formula. This result can be accomplished by setting the market adjustment factor at .008 per pound rather than the 3.21 cents per pound suggested by Department data.

As we have stated earlier, we believe that the price level generated by the existing Class 4b formula adequately compensates dairymen for the milk that is used in cheese making even when the value of non-cream whey is taken into account. The formula we propose here makes technical corrections to the formula, using more recent information on the manufacturing costs, product prices, yields. But it results in a price level that is basically the same as the one generated under the current formula.

And the formula is listed there.

Most of the other proposals being considered, especially those that address Class 4b, seem to assume a legislative directive to maintain the same prices, or some constant price relationship, between Class 4b and Federal Order Class III prices. No such directive exists. Rather, the prices generated by the Class 4b formula must be a reasonable relationship to the national value of manufactured milk products. The issue of the relationship to federal order prices is of secondary importance to consideration of whether the combined income from all classes of milk is adequate, and whether the formulas generate prices in sound relationship to the national value of manufactured milk products. California plants need to maintain their competitiveness so that producers can continue to have viable outlets for there milk.

The proposals put forth by the following groups jeopardize the market by negatively impacting the competitiveness of the manufacturing sector:

Alliance of Western Milk Producers' proposal encourages an unnecessary intermediate step toward protein pricing. Protein pricing should not even be considered until payment into the pool and out of the pool can be made on the same basis.

The Alliance proposal initially would enhance the price paid by Class 4b processors and hurt their competitive position. Later it would result in a transfer of income from high protein producers to lower protein producers because it makes changes to the stabilization plan without corresponding changes to the pooling plan.

If protein pricing is to be considered in any fashion, it must be done with simultaneous pooling and stabilization hearings so that necessary corresponding changes can be considered on that.

Not surprisingly, the Alliance's proposal substantially raises the price cheesemakers will pay for milk, while lowering the price butter-powder makers will pay for milk. This will improve the competitive position of the industry sector whose chief market is the federal government, and reduce the competitive position of the sector that has more viable commercial demand for its products. This is not a sound policy and the Department should reject this proposal.

CDC's proposal would lead to substantially higher Class 4b prices, which would damage the competitiveness of California's cheesemakers in the national market. During periods when milk is abundant and prices are low, CDC's proposal could result in some milk being left unpurchased as plant margins are squeezed by the variable make allowance. When milk prices are low due to excess milk supplies, it is not in the best interest of the industry to encourage milk plants to forego milk purchases by restricting their marketing. As we stated earlier, there is no economic justification for the explicit incorporation of dry whey in the formula. We urge the Department to reject this proposal.

Federal order formulas do not snub the commodity prices used in the formulas at the higher of the CCC price or the market price. In periods of low prices, California manufacturers could be at a competitive disadvantage relative to their counterparts in other regions of the country if the California Dairy Women's proposal is adopted.

California Dairy Women's proposal does not recognize the California prices must be lower than federal prices to pay for the shipment of California manufactured dairy products to eastern markets.

Western United's proposal inappropriately enhances the price for Class 4a and Class 4b, making California cheese, butter, nonfat dry milk, ice cream, yogurt, and other Class 2 and 3 products much less competitive. The cheese yield factor of 10.2 is too high for milk testing 3.65 percent fat, 8.78 percent solids-nonfats. The yield factors used for butter and nonfat dry milk do not account for degraded product as described earlier in the testimony.

Western United's use of make allowances constructed from a selected weighted average of only the lower-cost plants in the cost surveys is without technical, mathematical, or economic merit. By definition, a weighted average cost will be higher than the cost of some plants and lower than the cost of others. By constructing a selected weighted average of plants in the survey, the proposed make allowances cover a much smaller portion of the plants' costs and will likely lead to a contraction of the number of plants that operate in California. This approach is simply a device to lower the make allowance and raise the regulated price and is without sound rationale.

We oppose explicit incorporation of the dry whey factor in the Class 4b formula for the reasons previously mentioned. However, with respect to the formula presented, we note that the proposed manufacturing allowance for dry whey did not cover the cost of such operations in California. We urge the Department to reject Western United's Class 4a and 4b proposals.

Dairy institute believes that minimum milk price regulations are the most powerful policy tools that the CDFA has. The Secretary can dramatically impact the marketing opportunities of the leading agricultural commodity of the State with a single hearing decision. The Department must therefore take extreme care in setting minimum prices. We believe minimum milk price regulations should be based on market-oriented economic principles and analysis. We also believe that the greatest risk in any minimum milk pricing regulation decision is in setting prices too high, which may lead to enhanced producer income in the short run, but a loss product sales and manufacturing capacity in the longer run.

We believe that the priority of the Department must be to establish policies which maintain and build market outlets for the growing supply of raw milk in California. Higher regulated prices will not result in long-term revenue gains for producers if the price paid to achieve these gains is an uncompetitive dairy processing and manufacturing sector. Such changes lead to disinvestment in manufacturing and a loss of markets for California producers. California has become a significant net exporter of milk products. We must be competitive, not only in our own State, but in transporting products and competing in other areas of the country and other nations as well.

Thank you for this opportunity to testify. And I'm willing to answer any questions you have at this time. We also respectfully request that the Department grant us a period for filing a post-hearing brief.

HEARING OFFICER ESTES: Thank you, Mr. Schiek. Your request for a post-hearing brief is granted.

And at this time the panel may have questions for you.

AGRICULTURE ECONOMIST GOSSARD: Just one.

Mr. Schiek, with reference to the California Dairy Women's Association proposal, on page 10 you state that the proposal does not recognize that California prices must be lower than federal prices to pay for the shipment of California manufactured products to eastern markets.

Since their proposals are the higher of the support group price or a CME price less the market adjustment, whatever you want to call it, doesn't that address that issue?

DR. SCHIEK: In part. But the thing you've got to remember is that when product is being sold to the government, very few of the manufacturers are selling 100 percent of the product to the government at that time. Some of the product is still being sold to the commercial markets. And there are a lot of reasons you would do that. One is to keep customers than have them go to another supplier long run.

And the price demanded in that market may in fact reflect the fact that you've got to move that product, that commercial usage.

AGRICULTURE ECONOMIST GOSSARD: And so, say, from -- your proposals you talk about a 3 cent adjustment on both butter and cheese. That's -- I realize that's Step 1 in the cheese part.

You don't think 3 cents would be sufficient to sell commercially below support?

DR. SCHIEK: No, I think it probably -- maybe I didn't understand the California Dairy Women proposal. I thought that 3 cents disappeared when the support price was enacted. But if it's still in there, then I retract my statement.

AGRICULTURE ECONOMIST GOSSARD: Yes, they subtract out the market adjustment both to support purchase price and the --

DR. SCHIEK: Then that's fine.

AGRICULTURE ECONOMIST GOSSARD: Okay. So that clarifies --

DR. SCHIEK: That issue's gone.

AGRICULTURE ECONOMIST GOSSARD: That issue's gone.

Okay. On page 3 and 4 you're speculating why the butter adjuster went from four five down to about three two.

The data on that adjusted that and changed --

DR. SCHIEK: Page 4?

AGRICULTURE ECONOMIST GOSSARD: On page -- bottom of page 3, top of page 4. You mentioned that it's important because at the margin the butter price in California would be determined by the value of butter sold at the CME.

Is it possible that the survey was done at a time when butter was well above support purchase price, and a survey done now where the butter is traded near the support purchase price the results might be different?

DR. SCHIEK: I think -- yeah, I think those prices can always be different depending on the time period chosen.

And as I mentioned, you know, you can have situations that might persist for a short period of time, but they may not reflect the longer-run relationship between the price of butter in Chicago, say, and California or the -- essentially the longer run in California price.

AGRICULTURE ECONOMIST GOSSARD: The Dairy Institute, as I understand it, is proposing that in lieu of an implicit consideration of dry whey price, that some adjustment be made in the cheese price to generate additional revenues and offsets. Is that kind of it, or are you --

DR. SCHIEK: Yeah, that's kind of it in a nut shell. We noted in March 2001 that the 1.2 factor in current formula, the marketing adjustment doesn't really reflect -- doesn't really get cheese price down to what California value is.

But we argued at the time that in fact that price level generated by that formula was effectively incorporating an allowance for whey, just not specifically. And we just -- part of our proposal, that notion.

AGRICULTURE ECONOMIST GOSSARD: Now, one criticism you made of using the price for skim whey powder explicitly was it doesn't necessarily correlate with prices for other dry whey products, is that correct?

DR. SCHIEK: Um-hmm.

AGRICULTURE ECONOMIST GOSSARD: But isn't it true that cheddar cheese and -- the price of cheddar cheese may or may not correlate with the price of any dry whey product?

DR. SCHIEK: That's a good question, and I'm going to attempt to answer it. But I think we ought to ask it again to one of the cheesemakers here because they could probably give you more specifics.

But my understanding is that a lot of the commodity-type cheeses that are sold, whether they be mozzarella or Monterey-Jack-type cheeses or cheeses, all move pretty much in relation to the CME cheddar price. That there's usually some premium or discount to that price that affects the prices received for those products. They don't move independently. It's true that they aren't the same, but they tend to move in the same direction.

I'm not sure based on the data that was presented and the data that's available publicly that the same thing is true for dry whey and WPC. I'm not seeing that relationship, at least not in -- that exists over a period of time.

AGRICULTURE ECONOMIST GOSSARD: Now, in the case of the data the Department released that showed that there was an R Squared value of about 7 percent between cheese prices and skim whey prices; now, if the relationship between cheese prices and dry way powder prices were the same 7 percent R square range, would you say that would indicate that cheese is not a good indicator of value of dry whey at any given time?

DR. SCHIEK: Oh, I think that's probably true. And, you know, what we attempted to look at was what if you were to turn from dry whey over a longer period of time on an average term return. Because sometimes -- you know, if you had whey explicitly in formulas, and whey prices are 30 cents a pound, you're going to return more money than when they're 16 cents a pound.

So we were looking more at an average. It's true that -- you know, that formula would not track the dry whey values.

AGRICULTURE ECONOMIST GOSSARD: Would that create a problem for cheese plants -- if you took an average value for the whey stream from the price of cheese when, say, whey prices were depressed, would that create a problem covering plant money?

DR. SCHIEK: I suppose it could if the plant margins are that tight. I mean if you have that regulated price set so tight that, you know, there's not much operating margin room, then, yeah, that would pose a problem.

We've consistently argued that the regulated price should really reflect minimum prices.

AGRICULTURE ECONOMIST GOSSARD: And, finally, to no surprise, I'm going to ask you some very specific questions about how you'd use the Van Slyke formula.

You used an assumption of a 92 percent fat retention. You argued about that which is a 90 percent. But how did you arrive at 92 percent to begin with? What -- as opposed to 91 or --

DR. SCHIEK: Well, you have to go back to testimony we gave at the stabilization plant hearing in Fresno in 1997. And we had members that were testifying that they did not achieve a 92 percent yield. And we said at the time we were kind of setting an aggressive target for the industry.

And, you know, I think you have to also realize that what most plants are looking at is, is their regulated price for the milk they buy sufficient to cover the cost of the various operations that they have.

And so whether it's 92 percent -- you know, some plants can get 92 percent, some can't.

And I think what we've seen over the past few years is that the most efficient plants are getting, you know, fat retention of that level, but they're still some that are not.

AGRICULTURE ECONOMIST GOSSARD: When you derived a percent of casein and solids-not-fat from a Cal Poly data, you excluded the cheese plants. You just looked at butter-powder plants because you felt the cheese plant data would reflect protein --

DR. SCHIEK: Right.

AGRICULTURE ECONOMIST GOSSARD: Then wouldn't it have been appropriate instead of using the average milk test for all of California, to use an average milk test for milk going into plants other than 4b plants?

DR. SCHIEK: You might have a point there. And there may be some logical consistency to that. But I don't have that data. I mean the -- the Tong data is milk in a silo, not milk in the farm. And I don't have that data on that --

AGRICULTURE ECONOMIST GOSSARD: Could you have used the fat and solids-not-fat test for the non-cheese plants from the Tong data?

DR. SCHIEK: Again, those are tests of milk in a silo, not farm tests. And what we're pricing is -- ultimately is farm milk. So the yield needs to be reflected in farm milk.

So there are some differences. And in fact when you look at those silo tests and compare them to the farm milk tests by month, there are some differences that appear. So it's a -- and it's a -- I mean it's a small sample. Let's be honest. I mean he's not out there every day collecting -- he wasn't out there every day collecting, you know, samples at the silo. It was a selected sample and it suffers to some degree from small sample by itself.

AGRICULTURE ECONOMIST GOSSARD: No further questions. Thank you.

SENIOR AGRICULTURAL ECONOMIST ERBA: Dr. Schiek, just a couple questions for you.

On page 1 you make that statement that you maintain changes in federal order manufacturing milk prices do not require corresponding changes in California price levels.

What basis do you have for saying something like that?

DR. SCHIEK: Well, unlike the legislative mandate on fluid milk products where there's specific reference to the prices of milk in other states, the main reference here is to price of national value manufactured dairy products. And, you know, what we're saying is that competitive considerations are important. But -- for example, if the Department were to look at the decision made by -- final decision made by USDA, and let's assume that they made some errors, we don't think we should be obligated to follow them in those errors, plain and simple.

SENIOR AGRICULTURAL ECONOMIST ERBA: On page 4 of your testimony you've cited four reasons for the difference of the CME price relative to California butter price. And one of them was that cost of moving butter to Chicago may have fallen and that should now be 3.32 cents per pound instead of 4.5 cents. And then you later reject that as being probably an unlikely reason for that.

Do you know what the cost of moving butter is?

DR. SCHIEK: I do not. And like I said, most of my members are not involved in shipping commodity butter. From industry discussions, I just basically gathered from the discussions that it's more than 3.3 cents.

And I know you've got a couple representatives of CDI here today. They make a lot of butter. And that would be a good question to pose to them.

SENIOR AGRICULTURAL ECONOMIST ERBA: On page 6 of your testimony you -- on the bottom of the page, you speak to the assumption that you used for the Van Slyke formula was 37 percent. And you state later in the paragraph that it's probably closer to 38 percent. Although you stand by your original assertion that the yield ought to be 9.98

pounds.

Did you actually run through a calculation to see what would be the yield if you moved the moisture from 37 to 38?

DR. SCHIEK: Without making any other changes?

SENIOR AGRICULTURAL ECONOMIST ERBA: Yes.

DR. SCHIEK: Yeah, it would go up. I don't recall that, what it was.

SENIOR AGRICULTURAL ECONOMIST ERBA: Would you care to submit that in your post-hearing brief?

DR. SCHIEK: Yeah, I will go through that calculation.

SENIOR AGRICULTURAL ECONOMIST ERBA: The whey yield that you site at 5.82 on page 7, does that come from the mozzarella plant?

DR. SCHIEK: You know, the yield -- you know, it would be -- the yield there is indicative of a cheddar operation. And there are some assumptions that -- some of which I think are derived from the Cornell study that was referenced earlier -- basically that the fat recovered from the whey cream -- 90 percent of the whey cream fat is actually recovered as whey cream. A certain amount ends up going into the dry whey. So there is some fat in the dry whey.

Those kind of assumptions came from the Cornell study. But basically it's a cheddar cheese operation that's been modeled. And the assumptions of the Van Slyke formula are also imbedded in that.

SENIOR AGRICULTURAL ECONOMIST ERBA: So is this your theoretical number, not actually --

DR. SCHIEK: Well, yes, it's not actually a plant -- where I've gone to the plant. This would be, again, making the assumptions of typical milk testing, 3.68 fat, 8.76 percent solids-not-fat. You put in different starting component tests into the cheese vat, you're going to end up with a different whey stream and a different yield.

SENIOR AGRICULTURAL ECONOMIST ERBA: Given that you might come up with a different whey stream based on what kind of plant it is, how do mozzarella plants yields look like compared to this 5.82 yield?

DR. SCHIEK: Mozzarella yields are lower. Dry whey yields are lower, at least --

SENIOR AGRICULTURAL ECONOMIST ERBA: How much?

DR. SCHIEK: Well, the numbers I saw were -- a couple of charts that were put together by the Food Science Department at the University of Wisconsin. And the number for cheddar was essentially the same as -- 5.84, in that range. I believe the mozz number was -- I believe 55 something -- 555, something like that.

Again, those aren't exact numbers. That's what I recollect from looking at those charts. I could provide those you for you if you'd like.

SENIOR AGRICULTURAL ECONOMIST ERBA: If you could provide them, that would be super.

I have, I believe, just one more question. And it's on page 9. Your statement that the existing 4b formula adequately compensates dairymen for the milk that is used in cheese.

Is that relative to what the federal order prices are or just a statement by itself?

DR. SCHIEK: It's a statement by itself relative to the value that plants are able to get out of their --

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. Thank you.

HEARING OFFICER ESTES: Do we have any more questions?

All right. Thank you, Dr. Schiek.

And at this time we'll take a 10 minute break before we proceed on to take public testimony.

(Thereupon a recess was taken.)

HEARING OFFICER ESTES: All right. We're ready to proceed with taking public testimony. So if you could please sit down and get settled so we can take the testimony from those of you who have signed up.

All right, people, please sit down so that we can commence in taking testimony.

Could we proceed with taking public testimony at this time?

Members of the public, you may now testify with each speaker provided with 20 minutes, followed by questions from the panel.

So to assure the accuracy of today's hearing record, I request that each witness answer the following questions.

Do you swear or affirm to tell the truth and nothing but the truth? State your name and spell your last name. Identify the organization that you represent, the number of members in your organization, the process by which your organization finalized your testimony today.

So that will essentially be the process by which we will have to take testimony today.

I would also note that although we have reserved this room for hearing tomorrow, and a number of you have prepared for testimony today with the idea of taking 20 minutes, if there are any of you that are able to provide your testimony in a lesser period of time, please do so.

But we want to get, you know, the comment from everyone and with the depth of comment that's been prepared. So we will provide 20 minutes for you. But, again, for those of you who can provide your testimony more expeditiously and get your point across and your written testimony into the record, we would be most appreciative.

So at this time we'll take the testimony of Michael Reinke.

MR. REINKE: Is this on?

HEARING OFFICER ESTES: I belief so.

At this time we'll take testimony from Michael Reinke.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. REINKE: Yes, I do.

HEARING OFFICER ESTES: Could you state your name and spell your last name.

MR. REINKE: My name is Michael Reinke R-e-i-n-k-e.

HEARING OFFICER ESTES: Could you identify the organization that you represent.

MR. REINKE: Kraft Foods, Incorporated.

HEARING OFFICER ESTES: Could you identify the number of members in your organization.

MR. REINKE: Boy, I think the employees are in the thousands -- 50,000, 60,000.

HEARING OFFICER ESTES: And the process by which your testimony was finalized today?

MR. REINKE: This was developed by me in consultation with our attorney.

HEARING OFFICER ESTES: All right. I have a copy of your written testimony today. Would you like to have that entered into the record?

MR. REINKE: Yes, I would, please.

HEARING OFFICER ESTES: It will be entered into the record as Exhibit Number 51.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 51.)

HEARING OFFICER ESTES: And please proceed with your testimony.

MR. REINKE: My name is Mike Reinke. I am presenting this testimony in support of the proposal of the Dairy Institute of California, in opposition to proposals that would unreasonably increase the Class 4b and 4a prices, further stimulate California milk production, and effectively eliminate any profit and return investment to California cheddar cheese plants.

Kraft Foods operates two manufacturing plants in California. Our plant in Visalia makes Knudsen brand cottage cheese and sour cream, as well as nonfat dry milk and butter. And the Tulare plant makes Italian cheese, with is shipped and bulked to Wisconsin for drying, grating, packaging and national distribution.

Kraft operates its own manufacturing and processing facilities in eight other states.

Kraft procures cheese on a regular basis from its own plants and plants operated by other companies. These source plants are located in California, Arkansas, Idaho, Minnesota, Missouri, South Dakota, New York, North Dakota, Wisconsin, Illinois, Iowa, and Vermont.

Kraft has closed many manufacturing plants over the last 20 years and relies increasingly on dairy products we purchase from others. Similar to national production trends, we have continued to increase our purchases and production from the Western states. Eight years ago we built the Tulare facility, and have recently expanded its capacity. This replaced we previously produced in the midwest. We began sourcing cheese from Idaho ten years ago. And we have significantly increased cheese purchases from California since 1995.

Our decision on where to buy and where to make cheese boil down to simple economics. Among factors we must consider are: Reliability of a quality supply of milk and cheese, transportation and marketing logistics, the State and federal regulatory climate and, of course, raw product or ingredient price.

The WUD, Alliance, and CDC proposals to increase Class 4b price by taking profit and return on investment from cheddar cheese manufacturers will damage California's competitiveness in the national and regional markets for manufactured milk products and threaten the availability of local manufacturing capacity of California milk. The proposals are off the mark for reasons of economics, policy, and fact. Whey production and revenues are implicitly included in the current Class 4b price. Whey production costs and revenues might be included in the Class 4b price, but only if corresponding adjustments are made to the cheese components in the Class 4b formula.

The existing 4b formula produces a price that is too high relative to the federal order Class III prices.

Much of California's bulk cheese production, like that of Kraft, is shipped to the midwest where it is cut, wrapped, processed, and distributed to the nation's primary population centers in the eastern and central time zones. It costs Kraft about 5.5 cents per pound to transport bulk parmesan from California to processing and packaging plants in the east. For this reason, among others, California regulators have recognized that the Class 4b price must be a little lower, not greater, than the federal Class III price in order to permit the

California cheesemakers to compete in the national market and provide an outlet for milk produced by California dairymen.

The current adjustment of 1.2 cents per pound of cheese off the Chicago Mercantile Exchange price in the Class 4b pricing formula, to account for the lower value of California cheese f.o.b. the manufacturing plant, is not enough to allow for transportation. The California butter price formula, which allows 4.5 cents off the CME (or 3.32 cents, as proposed by the Dairy Institute) to account for manufacturing location and shipments to the midwest, better reflects the reduced value of California-produced milk products, including cheese.

To maintain competitive parity in raw milk costs for cheese delivered to the midwest plants, the California Class 4b price should be about 55 to 60 cents per hundredweight below federal Class III prices. Since the Class 4b price is already too high relative to the federal Class III price, any formula which attempts to add the product value of whey should provide a corresponding and equal (or greater) reduction in the value of milk used to produce cheese, by increasing the cheese location adjustment or the make allowance for both.

All costs must be considered in the formula.

The proposals to increase the Class 4b price would produce the same effect as lowering the make allowance. If rates are to be based on costs and revenue, all costs must be considered. Costs may be understated by unrealistic estimates of manufacturing efficiency or simply by pretending some cost elements do not exist. Just like imputing revenue that does not come in or yield that does not occur, any failure to account fully for all costs will produce confiscatory results in the regulated margin. Costs include not only processing, packaging, and administrative, but also marking, shrinkage, product loss, premiums paid, service costs, and balancing costs. Any costs actually incurred that are not factored into the formula serve to reduce or eliminate the meager return on investment.

Recent federal order experience has revealed that California's current make along fails to include any central factor for marketing of finished manufactured products. Two months ago, USDA explained:

"Both the marketing allowance and return on investment factors should be included in the manufacturing allowances provided in the component price formulas at the rates supported by the California data. If the processors are not providing enough of a manufacturing allowance to market the product they process or to earn any return on investment, they will not continue to provide processing capacity for producers' milk."

California's failure to include a marketing component in its make allowance formulas understates manufacturing costs and fails to recognize that in order to produce revenue available to dairy farmers, buyers must be found. Marketing costs money, which is not included in the current formula, and the formula therefore understates plant costs to convert producer milk to product dollars.

Although Kraft does not produce cheddar cheese in California, its cost experience for parmesan cheese and whey are relevant. Whey powder production costs at the Tulare plant are currently 18.62 cents per pound. And about 18 percent of the whey produced is not edible grade and must be sold for animals to use at a substantially reduced cost.

Kraft produces nonfat dry milk at is Visalia plant. Its drying costs are 13.1 cent and packaging is 1.1 cents, for a total of 14.2 cents. One percent of the powder produced is not edible grade and is sold at substantially reduced prices.

Reflecting the shortage of manufacturing capacity in California, Kraft pays significant charges for alternative disposition of milk when it cannot received the committed volumes at its Tulare plant. In December of 2002 Kraft paid 72-cents a hundredweight for milk not purchased to cover freight and alternative disposition costs.

As noted above, Kraft's cheese transportation costs to the midwest are 5.5 cents per pound. The current location adjustment in the Class 4b formula is only 1.2 cents off the CME price. This is well short of actual costs. It is also well below CDFA's survey of differences between CMD and California cheese prices, which averaged 3.2 cents for January 2001 through July of 2002.

If any change is made to the 4b formula, the lower value of products originating in California, due to transportation, must be fully included.

The threat to manufacturing capacity.

An increasing portion of California's surplus milk, as in the past, must now be transported to Idaho and other states to find available capacity.

CDFA, working in harmony with the California dairy industry, recognized many years ago that if dairymen were to have a market for their milk, and the industry were to reach its growth potential, the State must establish manufacturing milk prices at a level which allows California plants to compete effectively with plants in the midwest and the unregulated northwest and southwest to provide manufacturing capacity to handle California's expanding milk production, and to market products to the midwest and east where the nation's primary population centers still lie. California and other western states produce far more milk and cheese than is needed by local markets. The extra cheese production, including local cheese displaced by out-of-state cheese sales into California, must be sold at competitive prices to buyers in the east.

The proposals at this hearing are similar to several advanced at a hearing held in Fresno on September 3rd, 1997, to significantly reduce manufacturing margins of California milk plants with the hope that this would benefit California producers. Responding to those issues over three ago, CDFA explained in its Statement of Determination that the approach advocated then, and revisited today, disregards competitive reality and is contrary to regulatory policy.

And rather than reading this, I'll just skip through it. Because it's there, and you know what you read, not what you said.

The economic policy considerations which CDFA relied five years ago are even more compelling today, as milk products manufacturing continues to consolidate and interstate markets are increasingly integrated. In its decision on March 5, 2001, CDFA reiterated -- and, again, I won't read that to save some time.

CDFA's consistent regulatory policy expressed in October 1997 and in March 2001 has given competitive strength to the California dairy industry. These policies should not be abandoned or compromised in response to the proposals under consideration today.

Number 4: The WUD, the Alliance, and the CDC proposals would stimulate milk production and further reduce milk prices.

It is an economic fact that dairy farmers, over time, expand production when prices are good relative to production costs. When prices are too low, farmers cull cows, sell assets, reduce costs, and cut production.

Milk prices have been relatively low nationwide for the past year. But while dairy farmers in most milk-producing states have reduced milk cow inventories, farmers in California have continued to expand cow inventories and milk production. California farm milk prices are, no doubt, at distress levels for some milk producers; but overall, they continue to stimulate expansion. The most recent data from NASS (Milk Production, January 2003, excerpts attached) reveal that in December 2002 California farmers expanded milking herds by 58,000 cows and milk production by 118 million pounds over December 2001. The 49 other states experienced an aggregate loss of 32,000 milking cows. Dairy cow slaughter for the second half of 2002 was up 106,000 over the same period in 2001, according to USDA's January 24, 2003, livestock slaughter report.

California's continued expansion of milk and dairy product production, as also revealed in the most recent California Dairy Information Bulletin, is a significant factor in current low manufacturing milk prices. In the absence of a commercial market for much of March California's nonfat dry milk production, and some of its cheddar cheese production, products must be sold to the CCC under the milk price support program as the market of last report. The DIB shows monthly powder sales to the CCC, representing the majority of production in many months. There have been fewer sales of cheese to the CCC, but California has made more than its share of cheddar sales to the CCC during 2002 according to published USDA reports.

Conclusions:

The WUD, the Alliance, and the CDC proposals, in short, would sharply discourage future investment in California milk manufacturing capacity and make California cheese less competitive in the west, midwest, and east. If California cheese delivered to the midwest locations is not competitively priced, midwest cheese buyers and food processors will inevitably replace cheese from California with cheese from other sources. If California Class 4b prices are increased relative to the Federal Class III prices, more midwest cheese will find its way to California grocery store shelves. Neither scenario is in the best interests of California dairy farmers or the larger California dairy industry.

Thank you for this opportunity to present our views.

HEARING OFFICER ESTES: All right. Do we have any panels questions for Mr. Reinke?

SUPERVISING AUDITOR HUNTER: Mr. Reineke, on the second page -- I'm sorry -- on the third page --

HEARING OFFICER ESTES: I think Reinke -- What did you say, Reinke or Reineke?

SUPERVISING AUDITOR HUNTER: I was close.

MR. REINKE: I wasn't going to argue.

HEARING OFFICER ESTES: Was a Lieutenant Governor a long time ago, and I don't think he's here representing Kraft Foods today.

SUPERVISING AUDITOR HUNTER: All right, Mike, on page 3.

(Laughter.)

MR. REINKE: Page 2 or 3?

SUPERVISING AUDITOR HUNTER: Page 3, where you say it's -- on the 5 1/2 cents, you're calling that a hauling charge, not a marketing charge?

MR. REINKE: Yeah, I guess -- well, I looked at our freight rates. Our primary processing plants where we take California cheese are New Ulm, Minnesota; Wausau, Wisconsin; Champaign, Illinois; Springfield, Missouri; and sometimes also Allentown, Pennsylvania. But the freight bills run anywhere from 5 to 6 cents. It's roughly -- the lowest freight we have is $1800 to Springfield; and it runs $2400 to Wisconsin. And we get roughly 38,000 pounds of cheese on a load.

SUPERVISING AUDITOR HUNTER: And that's from your Tulare plant in California?

MR. REINKE: And also the other two plants that we buy cheese from them, we don't own in California.

SUPERVISING AUDITOR HUNTER: Now, that'd be a block cheese or barrel cheese?

MR. REINKE: It's both barrel and what we call 640's. We don't buy in 40 pound block cheese.

SUPERVISING AUDITOR HUNTER: Okay. So a 640 or barrels.

So the marketing charges would be extra on top of that?

MR. REINKE: Yes.

SUPERVISING AUDITOR HUNTER: How much would you estimate on a per-pound basis the marketing charge is?

MR. REINKE: Well, if I gave you Kraft's numbers, you probably wouldn't believe that. But I think what the federal program -- when they calculated the federal program, it was equivalent to about 1 1/2 cents per hundredweight of milk or .0015 per pound of cheese.

SUPERVISING AUDITOR HUNTER: And on page 5 where you're quoting -- on that first quote at the top of the page, where you mention about return on investment factors.

In our cost studies we have the current return on investment factors in there, right?

MR. REINKE: Yeah --

SUPERVISING AUDITOR HUNTER: You're talking about something else?

MR. REINKE: I was talking about primarily the marketing factor, which is in there.

SUPERVISING AUDITOR HUNTER: Okay. So that's marketing again you're talking about --

MR. REINKE: Right.

SUPERVISING AUDITOR HUNTER: -- more than anything else?

Okay. Thank you.

AGRICULTURE ECONOMIST GOSSARD: Just to make sure I heard you correctly. On a per pound basis, you said the cheese -- you said it was 0.15 cents, or what --

MR. REINKE: It was .0015, which -- per pound of cheese, which on a 10 pound yield I think comes back to about 1 1/2 cents a hundredweight on milk. That's what the federal decision incorporated for marketing. You know, I think that's -- I know our numbers would be much different than that.

AGRICULTURE ECONOMIST GOSSARD: My other question has to do with your opposition to including the support purchase price in the pricing formulas.

In your opposition, did you realize that the proposal is different than it had been used before? In this case they would subtract the marketing freight adjustment from the support purchase price. Would that 3 to 4 cents be sufficient?

MR. REINKE: Yeah, I -- but were they going to floor at the support price?

AGRICULTURE ECONOMIST GOSSARD: No, they would floor at the -- the cheese price would be floored -- under their proposal the butter price would be floored at the support purchase price for butter less 4.5 cents, the cheese price at support less is 1.2 cents. That is given what is currently in place. People have also talked about changing the adjusters to about 3 cents. And I'm asking this --

MR. REINKE: Yeah, I guess the concern I have is more just flooring and add the support, because I think there are some issues with selling it to the Government and that don't necessarily always return support. And if that needs to be corrected, it needs to be someplace other than here.

AGRICULTURE ECONOMIST GOSSARD: Would 3 cents be sufficient to cover the additional cost of selling to the government?

MR. REINKE: The numbers that I've heard in the past, you know, the last several years it has been more like 5 to 6 cents, cost of going to the government.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

DAIRY MARKETING BRANCH CHIEF IKARI: I've just got a couple of questions.

You indicated on page 4 that California's Class 4 prices should be about 55 to 60 a hundredweight lower than the Federal Class III price.

Could you tell us how you got that or how you know --

MR. REINKE: Basically what we're saying is, you know, to be able to compete with midwest plants because of the freight differential, you know -- from our perspective, most of the processing capacity, to further cut, wrap and process -- barrels of processed cheese is in the midwest. And so to get cheese at a competitive relationship, it needs to reflect that freight differential, which we said is 5 to 6 cents, which would, you know, equate to 50, 60 cents.

DAIRY MARKETING BRANCH CHIEF IKARI: Then the next sentence you say that since the Class 4b price is already too high relative to the Class III price. Because it's not meeting that 55 to 60 cents?

MR. REINKE: Yes.

DAIRY MARKETING BRANCH CHIEF IKARI: How do you explain that -- during the last five years it hasn't averaged that 55 to 60 cents, has it?

MR. REINKE: Well, it's been all over the Board. I mean we had an MW Class III price for a period. And then I think initially USDA -- initial decision, you know, had lowered the regulated price, which I think narrowed the difference with California for a year or two when the final rule came in.

Then we got this internal decision that we've had, I think which actually raised the regulated price probably 15 cents in the federal order. And now there's a pending decision that could possibly raise it from 20 to 40 cents, depending on the relationship of cheese, butter/powder. You know, we don't know just what's going to happen to it, if there's going to be legal challenge to that or not.

DAIRY MARKETING BRANCH CHIEF IKARI: You also mentioned on page 7 about unregulated plants operating in the midwest -- or I guess the northwest and southwest.

Do you have any idea how much for the national cheese is coming from the unregulated markets?

MR. REINKE: No. I just know that -- you know, we operate a plant in Idaho. And up until this last year we had been completely unregulated there.

But there's a fair -- we've got two primary cheese suppliers in Idaho. And I think a bigger percentage of their milk is unregulated. Beyond that I don't know.

SENIOR AGRICULTURAL ECONOMIST ERBA: Mr. Reinke, on page 2, top of page 2 you speak to -- I'd like to get your input on. You say that whey production, costs, and revenue might be included in Class 4b price, but only if corresponding adjustments are made to cheese components in the Class 4b formula.

Cue expand on that?

MR. REINKE: Yeah, I guess what we're saying there is you can't pick and choose the only parts of the formula that actually enhance the price if you're going to -- I mean we think whey is, you know, included in the formula implicitly now and not explicitly. But if you're going to have to do away with a component, then you need to correct the other parts of the formula to get the yield right, add for marketing costs, and also -- you know, where now we have 1.2 cents off the CME, we need to try and reflect what the freight costs are and look at the whole picture rather than, you know, ice pick pieces and isolate them.

SENIOR AGRICULTURAL ECONOMIST ERBA: But it sounds to me that you would not be opposed to putting in a -- some kind of an explicit whey factor if it was somehow revenue neutral or something along those lines?

MR. REINKE: Well, I think, you know, that's -- the Dairy Institute proposal kind of pointed that out. I mean they said -- you know, you could calculate whey. I think it came back to a penny less than what the price had averaged. And they said, well, rather than complicate the formula and make it depart from what the Department's always used in the past, because a lot of these make allowance which you don't have for whey, you know, continue doing what you're doing and implicitly reflect whey. But, you know, I think -- if the Department so chooses to do whey, then we're saying that you need to look at the other parts of the formula to make sure you get them correct.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. Thank you.

HEARING OFFICER ESTES: Do we have any more questions?

DAIRY MARKETING BRANCH CHIEF IKARI: I just have one other question.

You mentioned -- you raised the question about the -- question about whether or not the implementation of the amended federal order. Do you have any information to share with the us today?

MR. REINKE: No, I don't. I mean as far as I know, that the --

DAIRY MARKETING BRANCH CHIEF IKARI: There's no schedule on implementation?

MR. REINKE: I guess I'm a bit surprised that it hasn't been put in because as far as know the referendums have been held. And I don't know what's holding it up.

HEARING OFFICER ESTES: All right. Thank you, Mr. Reinke.

Our next witness is Richard Cotta. I also have Joe Heffington.

Will both of you be testifying.

MR. COTTA: Yes.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. COTTA: Yes, I do.

HEARING OFFICER ESTES: Could you state your name and spell your last name.

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

HEARING OFFICER ESTES: And please identify the organization you represent.

MR. COTTA: California Dairies, Incorporated.

HEARING OFFICER ESTES: What is the number of members in your organization?

MR. COTTA: We have 680 producers in the association.

HEARING OFFICER ESTES: And could describe the process by which your testimony was finalized for today?

MR. COTTA: Our testimony was originally approved at our board of directors' meeting on December 17th. And reapproved yesterday after discussion and viewing of the Department's material held at the January 22nd workshop.

(Thereupon the witness was sworn, by the
Hearing Officer to tell the truth, the
whole truth and nothing but the truth.)

MR. HEFFINGTON: Yes.

HEARING OFFICER ESTES: And could you please state your name and spell your last name for the record.

MR. HEFFINGTON: Joe Heffington,

H-e-f-f-i-n-g-t-o-n.

HEARING OFFICER ESTES: All right. You have 20 minutes for the both of you.

MR. HEFFINGTON: Mr. Hearing Officer and members of the panel: My name is Joe Heffington and I am Senior Vice President and Chief Financial Officer for California Dairies, Incorporated, whom I am representing here today.

California Dairies is a full service milk processing cooperative owned by approximately 700 dairy farmer members located throughout the State of California and collectively producing 14.6 billion pounds of milk per year or 42 percent of the milk produced in California.

Our producer-owners have invested nearly $200 million in five large processing plants which produce butter, powered milk products, cheese, and bulk processed fluid products.

Our board of directors, which is comprised of 20 producer-owner representatives, elected from our dairy farmer members, unanimously supports our testimony given today.

HEARING OFFICER ESTES: We'll allow you -- before you start over again, let me just state that your testimony -- unless you have an objection, your two written statements will be entered into the record as Exhibits 52 and 53.

(Thereupon the above-referenced documents
were marked by the Hearing Officer as
Exhibits 52 and 53.)

HEARING OFFICER ESTES: And please start again. We'll start your time now.

MR. HEFFINGTON: We recognize that California producers, including our producer-owners, are in a price squeeze on the farm. That is caused primarily by historically low prices driven by currently depressed commodity markets for butter, powder, and cheese.

We would like to point out that non-cost-justified reductions in the Class 4a make allowance further reduces our member owners' net income in favor of those producers in California without an investment in milk processing facilities, which balance the State's growing milk supply. Therefore, it is our position to support cost-justified make allowance changes to the 4a formula.

The California Dairies supports the following cost justified 4a make allowances:

The weighted average cost per CDFA, which is shown on Exhibit A, at .1211 per pound of butter and .1512 per pound of powder as adjusted for cost increases is documented on Exhibits B-1 and B-2, for an adjusted weighted average cost of production of .1221 per pound of butter and .1525 per pound of powder.

The increase in California Dairies' costs represents the impact of known increases of electrical costs not included in the California Department of food Agriculture's weighted average based on a weighting of the production of butter and powder in California Dairies' plants served by the utilities with known cost increases.

These increases are the result of increases in rates for 2003 for plants serviced by PG&E, an increase of 2.7 cents per kilowatt-hour, and Turlock Irrigation District, an increase of 6 percent.

The respective cost increases have been weighted by California Dairies' plant production volume of butter and powder for 2001, the year currently costed by the Department. We would suggest and support a new weighted average calculated by the Department utilizing the increase in rates for all California plants included in the cost study affected by these cost increases.

California Dairies was unable to Calculate this, as only the Department has the data from which a complete weighted average calculation could be made.

California Dairies, like nearly all California companies, continues to be impacted by escalating costs in energy, insurance, payroll, and related costs. However, I'd like to point out that if the above make allowances were implemented, that increase in make allowance since 1995, the last time a full all-cost make allowance adjustment was made, is just 1.23 percent compounded annual increase for powder and a 3.34 percent annual compounded increase for butter. We think these low annual rates of increase illustrate the plant cost efficiencies that have been achieved since 1995.

Next, regarding the concept of covering the arbitrary percentage of plant costs for the make allowance.

We assume some plants have unusually high costs in certain categories for various reasons, such as having a low volume and/or operating seasonal. We agree that coverage of 100 percent of these plant costs is inappropriate. However, as larger, more efficient plants are built and inefficient plants shut down, leaving fewer larger plants in a cost study, the percentage of coverage of costs becomes a circular equation that would eventually cover only a percentage of even the most efficient operations.

Additionally, a concept of an arbitrary percentage of volume coverage can distort the amount necessary to cover a reasonably efficient plant. This is illustrated in the exhibit -- or in the percent of plant costs that would be covered on the attached Exhibit C.

We support using the full weighted average costs, as published by the Department, as adjusted.

The return on investment factor used in the cost study is based upon the undepreciated book value of plant and equipment and the weighted average prime interest rate for the cost study period. From a practical standpoint, a plant and its equipment could never be replaced at today's higher costs than the plant's historical depreciated book value.

In addition, investors would not incur the risk of investing in new facilities if their projected return were the prime interest rate on a declining depreciated balance at best. Both realistic replacement values and a longer term rate of return that includes a factor for risk would better reflect what a company could earn if capital were not tied up in plant assets. We believe this factor should be incorporated in the weighted average costs if, as we expect will occur, facilities continue to be built in California to handle the ever-increasing milk supply.

Additionally, the practice of utilizing actual short-term interest rates in the cost study should be amended. Actual short-term interest rates will vary from company to company and, for multi-plant, multi-product operations, maybe subjective in allocation. We proposal an allocation formula that would provide financing coverage for 30 days of inventory and 30 days of receivable, reduced by 23 days credit already provided by producers in milk payment privileges.

We suggest that the Department consider an industry workshop to review the above changes on return on investment and short-term interest.

In regard to yields, we support no change to the current yield factors. We base our conclusion on experience in our own plants and the true economic yield which would include not only pounds yielded, but also dollars received for end-products.

We have reviewed the study's findings and offer the following comments:

Regarding data used, it is our understanding that the information on which the study was based came from each individual plant's records, which are used to prepare monthly reports to milk pooling. The milk pooling or Form 800 reports are designed to help assure that all milk is reported to milk pooling and also to account for each plant's milk usage, thereby assuring that plants are charged by the pool proper usage for all milk purchases.

None of the reports we generate to prepare our milk pooling reports were designed or intended to evaluate product yields. In fact, the reports requested by milk pooling perform quite a different function, accounting for fat and solids-not-fat, not yields.

These reports used to prepare our reports to milk pooling are affected daily by things such as proper sample procedures, measurements and laboratory tests, performed simply to capture the information from milk pooling. Because these reports were designed to report product usage not evaluate product yields, the results of this study are not accurate.

Multiple products. Most plants in the study manufacture a number of products. In our opinion without analyzing each product at each plant for property yields and loss and evaluating the data used to prepare milk pooling reports, and assuring consistent methods are used at each plant, the results of study are not accurate.

Dollars received for product is not considered at all in the Department's yield study, but must be considered as the formula currently assumes that all product is made perfectly and full value is received. The reduced sales value of buttermilk powder as compared to nonfat powder which establishes the 4a price is well documented. Exhibit D.

We would also like to point out that buttermilk powder is partially composed of butterfat. A complete and accurate analysis of the difference in the price received for buttermilk powder, which is nonfat powder, should include this fact. Therefore, we have attached Exhibit E, which shows that additional economic loss.

Off-spec powders are not reported to the Department for inclusion in the California weighted average price used to calculate the 4a price, nor do we suggest that they be. However, they must be recognized in the yield in the formula, as they are not currently costed in the weighted average cost and they are meaningful.

Off-spec production is a function regarding any dairy plant. All plants attempt to minimize production outside the commercial standards. Off-spec butter also should be considered in the yield formula, as it is not considered elsewhere.

Milk and milk components are lost in a variety of ways in a number of places from farm tank to end-product. We offer the following and partial listing as examples of where and how product was loss. I won't bother to read the list, for time.

Failure to include all plants costed in the yield data due to problems incurred in properly allocated product in multi-product plants illustrates the difficulties in these allocations.

We believe further in-depth review would find other plant data allocated incorrectly. The fact that three separate companies whose data was included in the yield study had expressed concerns over the accuracy of the data used to prepare the yield study, as the Department noted in response to questions at the pre-hearing workshop, and as documented by California Dairies' written response to the publication of the yield study, Exhibit F, further illustrates that those companies included have serious concerns regarding the study's accuracy and the problems incurred in allocating product in multi-product plants.

We have also attached for your review a copy of the comments to the USDA by Land-o-Lakes and others. Exhibit G. We have attached this document to illustrate others' comments in regards to yields.

Based on the above factors we feel confident that the results of the Department's yield study are not accurate, and can only conclude that additional products have been accounted for in products other than butter and powder in multi-product plants, thereby overstating product yields for butter and powder. We would recommend the Department not make any adjustments to the butter and powder yields based on this inaccurate data.

Additionally, we would like to point out that a consequence of overallocating product to other non-butter or powder products, as stated above, would be to overallocate plant costs to non-butter or powder products in multi-product plants. Therefore, we conclude that not only are the yields of butter and powder overstated by the study, but also that the weighted average cost produced in butter and powder and is audited by the Department is understated as a result of overallocating costs to other products.

In conclusion, we recognize that California producers are in a milk price squeeze, and we support efforts to increase milk prices where the increases can be obtained from the market. Non-cost-justified reductions that make for a make allowance for a nonjustified increases in yields further reduce California's Dairies' member owners' net income in favor of those producers in California without investment in milk processing facilities.

Thank you for your attention to my testimony. I would like now like to introduce Mr. Richard Cotta, Senior Vice President of California Dairies, who will add to California Dairies' testimony.

MR. COTTA: In interests of time I'll skip down to about the middle of the first page.

In regards to proposed changes in butter yields, we believe it would be a mistake to change the current yield numbers based on the fact the yields from California's largest butter plant are not part of the new data on yields.

Secondly, the Department's letter dated October 11th, 2002, and is attached, butter and powder yields October 2, 2002, states on page 2, quote, "The Department recognizes that these yield estimates are too high," post-quote. The 1990 study referred to in the above-quoted document was probably as accurate as any, as we assume the plants involved were high percentage butter/powder production. That range was from 1.16 to 1.20. The 1998 study included more plants but with more varied uses of solids and butterfat.

We believe the Department should not change yields until a process is developed that answers concerns of the butter manufacturers regarding yields, and certainly not until the yields from the largest California butter plant can be refined and included.

On the issue of freight adjustment for butter, we oppose any proposal to lower the current 4.5 cents.

The northern and southern California stabilization and marketing plans state in section 300(D), "The minimum prices to be paid for components used for Class 4a shall be computed as follows: 1) for all milk fat, not less than the price per pound computed by the formula using the simple average of Grade A butter price quotations for the last significant trading action for sale, offer and bid of butter at the Chicago Mercantile Exchange, less a freight adjustment of 4.5 cents, less a manufacturing cost allowance of 10.2 cents, and the result multiplied by a yield factor of 1.2."

Wile section 300(E)(1)(a) dealing the 4b pricing calls for a marketing adjustment; Section 300(D)(1) specifically calls for a freight adjustment. We believe it was and is the intent of the freight adjustment language to allow for the actual freight costs.

It appears the Department backed its way into the new freight adjustment numbers of .0332. This method of guesstimating the freight adjustment is loaded with pitfalls. For one, it does not take into account the credits which may have been given for other products purchased from the same company; i.e., a buyer gets a discount on butter because of additional cream or condensed purchases.

The freight allowance factor has a long history in California butter pricing. At one point the factor was 5 cents per pound. In talking with some who were around many years ago when the freight adjustment factor was adopted, it served more than a couple of purposes.

One, it allowed California butter to be competitive in midwestern and eastern markets; and 2) it made it more difficult for out-of-state manufacturers to ship cheap frozen butter into the California marketplace. This has served California producers and processors well over the years. It has also served the California consumers well, assuring them a fresh, wholesome supply of butter.

Our company believes the Department should use the actual audited freight costs. These numbers would be easily attainable at the time plant costs are gathered.

We have summarized the data for California Dairies from January 2002 through November 2002. If December data is complete by the time post-hearing briefs are due, we will be happy to provide that updated data. However, I believe it would change the numbers very little.

Our data reflects the freight costs of moving bulk butter from our plants in Fresno, Tipton, and Turlock. During the 11-month period total bulk shipments totaled 98,715,000 pounds from those plants. Of this amount 83,788,000 pounds were shipped out of California. The average cost per pound on those shipments was $.048.

The first invoices for December shipments for butter shipped out of state and into the Chicago market are $.0496 per pound. While we did not use this number in our average figures because the entire month's invoices have not been received, it certainly indicates that freight rates are increasing.

In-state shipments total 14.927 million pounds at $.0281 per pound. The actual freight rate on all shipments averaged $.04499 right at the current freight adjustment. In-state costs increased over 8 percent from the August through December period. This trend seems to be accelerating as fuel prices continue to increase.

I would not be surprised to see the 2003 freight costs up 15 to 25 percent for the year over 2002 prices.

We are opposed to language changes proposed by the Dairy Institute to Section 300(D)(1) changing "freight adjustment" to "marketing adjustment."

We encourage the Department to maintain the current 1.2 yield factor and the current .0457 freight adjustment in determining the butter price.

California Dairies also supports the testimony given by the Alliance of Western Milk Producers. And we would request a post-hearing brief.

HEARING OFFICER ESTES: Your request for a brief is granted. As I've stated repeatedly, the deadline for that brief is the close of business on Friday, February 7th.

MR. COTTA: Thank you.

HEARING OFFICER ESTES: Do we have any panel questions?

AGRICULTURE ECONOMIST GOSSARD: Mr. Cotta, on the bottom of the first page of your testimony you state that yield estimate should not be put forward until all the data is in from all the plants. And you cite one plant particularly.

Since that plant was asked three times to supply the data, the plant never supplied the data, at what point is it the Department's responsibility and --

MR. COTTA: I think the Department, by law, you can get about any amount of data you want from the plant, can't you?

AGRICULTURE ECONOMIST GOSSARD: Not if they don't deliver.

MR. COTTA: And you don't have the authority to generate that?

AGRICULTURE ECONOMIST GOSSARD: We could get a court order. But it wouldn't have been in time for this hearing.

MR. COTTA: I think --

HEARING OFFICER ESTES: Let me just emphasize that Mr. Gossard is not a staff counsel with the Department, so he's not really capable of rendering a legal opinion as to whether the Department is or is not able to compel the production of marketing production data --

(Laughter.)

HEARING OFFICER ESTES: -- or any other type of information from a producer of California milk products.

MR. COTTA: I think going beyond and referring back to Mr. Heffington's testimony, I think that three manufacturers questioned the data and the process for yields. Those three manufactures make up at least 7 or 8 of the plants that you've audited. That indicates to us as a company that there is some problems with the process here.

AGRICULTURE ECONOMIST GOSSARD: My next question is for Mr. Heffington.

On page 7, the second to the last paragraph, you state, "Based on all the above factors, we feel confident the results of the Department's yield study are not accurate, and can only conclude that additional product has been accounted for in products other than butter and powder and multi-product plants, thereby overstating product yields for butter and powder."

Do you mean that there was a misallocation of fat and solids-not-fat to other products and not to the butter/powder? I didn't quite understand your meaning of the last part of that sentence.

MR. HEFFINGTON: That's the only conclusion we can draw.

AGRICULTURE ECONOMIST GOSSARD: Well, I understand that. But I don't understand your wording. Could you rephrase it? That's my only problem. Are you saying that too much fat and solids-not-fat were assigned to products other than butter and powder?

MR. HEFFINGTON: Yes.

AGRICULTURE ECONOMIST GOSSARD: Thank you for the clarification.

SUPERVISING AUDITOR HUNTER: Mr. Heffington, the second page. On your increases for your utilities, electricity. Are those temporary increases or permanent increases?

MR. HEFFINGTON: Those increases are increases for -- that the CPUC has approved for direct access customers. That would be customers that buy their electricity not through the traditional utilities, but through independent marketers to save costs. That it's a charge that's being put on those customers to recoup costs that are in the system right now from the energy crisis that we had. And that is what the 2.7 cents is about.

SUPERVISING AUDITOR HUNTER: Those costs are effective in 2003?

MR. HEFFINGTON: One is effective -- one of the costs is effective January 1, and the other February.

SUPERVISING AUDITOR HUNTER: Okay, what about natural gas costs? How is that shaping up for 2003?

MR. HEFFINGTON: Natural gas costs are up. If you look at the natural gas costs, the spot market has gone up with the concerns of the war.

SUPERVISING AUDITOR HUNTER: Okay. But you have long-term contracts on that?

MR. HEFFINGTON: We have -- some of our gas is long term. Some of it is spot.

SUPERVISING AUDITOR HUNTER: Okay. A just have one more question. I want to go back to what Tom Gossard was talking about, on page 7.

On that same paragraph, he stopped, but I'm going to keep reading. "The weighted average cost of producing butter and powder as audited by the Department is understated as a result of overallocated costs to other products."

So you're talking about the cost study there. In one sense are you overstating cost to other products in the cost item?

MR. HEFFINGTON: Well, we assume if the yield is overstated on butter and powder, that there's more solids in fat than allocated to other products in multi-product plants. I believe in your cost studies, if there's more product allocated to non-butter/powder plants, that would draw more costs into those non-butter and powder products and away from butter and powder.

SUPERVISING AUDITOR HUNTER: Are you talking about the fat and solids-not-fat in the finished product, right? That's what -- the general allocation.

MR. HEFFINGTON: Yes.

SUPERVISING AUDITOR HUNTER: And it's all based on your records the fat and solids-not-fat in those products.

MR. HEFFINGTON: We understand.

SUPERVISING AUDITOR HUNTER: Okay. So where is the rub at, so-called?

MR. HEFFINGTON: The yields that are achieved in our plants -- the one plant that we have is not -- has no other products in it is why we're making that comment.

SUPERVISING AUDITOR HUNTER: Okay. So you're basing this from the yields, not on the actual costs? This is more --

MR. HEFFINGTON: Well, we're assuming that the yields are overstated, again; that there must be too much product assigned to non-butter/powder products. And you assigned costs on a fat and solids basis when you assign plant costs in your cost study. And so, therefore, more costs are in the non-butter and powder price.

SUPERVISING AUDITOR HUNTER: All right. That's enough for now on that one.

That's all I have.

(Laughter.)

SENIOR AGRICULTURAL ECONOMIST ERBA: Mr. Cotta, on -- I don't see a page number -- one of the pages of your testimony, going through some detail about the freight costs of butter out of California. And according to your number comes right at the 4.5 cents we have currently.

MR. COTTA: Yes.

SENIOR AGRICULTURAL ECONOMIST ERBA: Can you explain why then the, albeit small study that the Department did, but a study nonetheless, which looked at the difference between CD butter prices and California butter prices of what butter plants in California would receive, why that's so much different from your own numbers?

MR. COTTA: Well, I think number 1, the Department did not audit the costs of freight under any condition in that study. I think you backed your way into it. And I think Dr. Schiek and Jim Tillison both did a good job of explaining what the pitfalls were to that. And that there are a number of companies that bundled up services. And sometimes when you bundle up those services, you get a discount on one end to pick additional sales on another. Those would distort the numbers that you backed your way into of .0332.

And what I am suggesting in the future -- that the freight costs are very easy to get, very straightforward. And those numbers are what I've reflected in my testimony. And as I also reflected, the December -- the first of the December numbers are in in shipments to Chicago, and that number is increased to .0496.

And I think Dr. Erba that these are -- these are actual numbers. And, again, if the December numbers are complete, we'll be happy to submit them in post-hearing brief. But I didn't want to give you part of the month. The 11 months you have are actual.

SENIOR AGRICULTURAL ECONOMIST ERBA: If you wouldn't mind, I'd appreciate receiving that additional information once you do receive it if you can get it in by the deadline.

MR. COTTA: We may not have it by the 7th of February, but we'll get it to you.

SENIOR AGRICULTURAL ECONOMIST ERBA: If you do, I'd appreciate receiving it.

MR. COTTA: Our freight bills for December are just now being invoiced for payment.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. I have just one more question.

Did you say at the end of your testimony that you supported the Alliance's position?

MR. COTTA: Yes.

SENIOR AGRICULTURAL ECONOMIST ERBA: The Alliance did not make an adjustment to the powder manufacturing cost allowance, if I'm not mistaken.

MR. COTTA: No, we supported their position on the 4b pricing.

SENIOR AGRICULTURAL ECONOMIST ERBA: Oh, just on the 4b?

MR. COTTA: That's correct.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. Not on 4a though?

MR. COTTA: No.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: I just have two questions.

I understand the concern that you've raised with respect to the butter/powder yields. Are you aware of any other information that the Department should be looking at in terms of butter/powder yields?

MR. HEFFINGTON: We've attached a copy of one of the few documents, if not the only document, that we found in researching butter/powder yields from others. And that's why we've attached the Schedule G. And that's -- we would like you to read that.

DAIRY MARKETING BRANCH CHIEF IKARI: Is there anything conclusive in your review that you find in terms of butter/powder yields?

MR. HEFFINGTON: We can conclude that the yields that we currently have -- when you consider all of the economic factors involved including all the off-spec, buttermilk powder squeeze, and the actual yields of the product, we feel confident that the yields that we currently have are the proper yields.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

Mr. Cotta, you were very clear that you want to maintain the freight adjustment.

MR. COTTA: Yes.

DAIRY MARKETING BRANCH CHIEF IKARI: What about the concept of cheese? If you're unwilling to change the butter fund, should we -- should the concept be the same on the 4a formula as it is on the 4b? Or are they uniquely different and should we have a different factor on the 4b?

MR. COTTA: I think there's no question they're uniquely different. And I think that was the reason for Section 300(D) and 300(E) to being different in the first place. And I think you need to look at the merits of each of those to see where we ought to go with them.

But certainly addressing merely the 4a side and section 300(D), I think that's very, very specific. It doesn't call for marketing allowances or anything else. It is a freight adjustment. And I believe the intent was to have that freight adjustment based on your findings in a 1995 hearing, which -- and I may not quote it exactly correct, but that at a time when butter/powder sales seemed to be in balance with supply, that the proper number that was reached was 4.05 cents. Well, certainly since 1995 to today freight costs have not decreased.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. Thank you.

HEARING OFFICER ESTES: No further questions?

All right. Thanks to the both of you for appearing and testifying today.

Next we have Kevin McLaughlin of Security Milk Producers.

We're going to take about 5 minutes here to kind of have an examination of the microphones system. So please do not go anywhere, as we will proceed with the hearing as soon we get this problem -- this technical evaluation.

(Thereupon a recess was taken.)

HEARING OFFICER ESTES: All right. The hearing is now called back to order.

People, if you could please sit down and we will reconvene so that we can continue to take public testimony.

We will now take the testimony of Mr. Kevin McLaughlin from Security Milk Producers.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. McLAUGHLIN: I do.

HEARING OFFICER ESTES: Would you please state your name and spell the last name.

MR. McLAUGHLIN: My name's Kevin McLaughlin. Last name is M-c-L-a-u-g-h-l-i-n.

HEARING OFFICER ESTES: Please identify the organization that you represent.

MR. McLAUGHLIN: Security Milk Producers Association.

HEARING OFFICER ESTES: And could you describe the number of members in your organization?

MR. McLAUGHLIN: We represent dairy men and women that produce about a billion and a half pounds of milk annually.

HEARING OFFICER ESTES: And what is the process by which your testimony was finalized and approved?

MR. McLAUGHLIN: The board of directors at their January 15th, 2003, meeting authorized me to testify today on their behalf.

HEARING OFFICER ESTES: All right. Please proceed with your testimony. And I will introduce your written statement today as Exhibit Number 54.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 54.)

MR. McLAUGHLIN: Thank you.

First, I'd like to thank the Department for the opportunity to testify here.

The Security Milk Producers Association recognizes the hard work put forth by the Department in compiling the manufacturing cost exhibits released in December 2002. We appreciate not only the data, but the analyses provided at pre-hearing workshop. From these efforts we find substantial evidence of the need to adjust the yields, the manufacturing cost allowances, and even the products valued in the 4a and 4b pricing formulas.

We also thank Western United Dairymen for their work for identifying some product value shortfalls in the State's pricing formulas.

Security Milk supports Western United Dairymen's proposed amendments to the Stabilization and Marketing

Plans. In the 4a formula, we support the use of a weighted average butter yield of 1.211 as defined by the Department in its December 17th, 2002, release. We support the use of a weighted average powder yield of 1.012, also defined in the Department's December 17th document. We can even justify giving up the pennies per hundredweight Western United offers by recognizing the weighted average nonfat dry milk and buttermilk powder price over time of .992 and multiplying the yield by the price for and end yield result of 1.004 as proposed for use in the 4a solids-not-fat calculation.

For manufacturing cost allowances in the 4a calculation, we support the proposed corrections, accounting 100 percent of the weighted average cost for 80 percent of the butter and powder volume, as indicated by data released January 2nd, 2003, by the Department. The data indicates these levels to be $0.1427 powder and $0.1134 for butter.

I'd like to add that it's -- in our opinion, it's appropriate to use 3 and 4 decimal points. That's the way the data is available. Those fractions likely amount to some significant dollars.

For Class 4b, we support the petitioner's proposal that corrections to yield factors, manufacturing cost allowances, and the inclusion of a whey solids component are justified by the Department's data. We agree that the current yield value of 10 is woefully inadequate.

However, we believe the Department's cheese vat yield data released December 17th would more appropriately be used in the calculation of the cheese hundredweight price. The data from the Department indicates a weighted average yield of 10.71.

For manufacturing costs allowances, we support Western United's proposal that 100 percent of the weighted average cost for 80 percent of the cheese volume in the Department's latest should be covered by the manufacturing cost allowance. CDFA's document indicates that level to be $0.1592 for cheddar cheese.

Security Milk's support for the inclusion of a value for whey solids in the class 4b formula is based on the requirement of Section 62076 the Food and Ag Code, which requires the Secretary in establishing prices to be paid producers to take into consideration, quote, "the relative market value of various products yielded from such market milk," end quote. Cheese plants have been processing whey into marketable products for years. And there's evidence to support the addition of a whey solids value into the 4b calculation. We support the Western United Dairymen proposal to add a dry whey component, as currently published by USDA in the Dairy Market News, less a $0.159 manufacturing cost allowance times a yield of 5.75, to the current 4b calculation.

The Department received extensive testimony at hearings in 1997, and again in 2001, regarding the value of whey solids. In the Department's hearing panel report, one objection to including whey solids in the 4b calculation was relative newness of whey byproducts in California. In response to questions at the pre-hearing workshop, the Department provided the industry with data collected since 1989 regarding California's share of the nation's cheese, skim milk powder, and whey protein concentrate production. That data, reproduced below -- it's actually on the last page -- clearly indicates California market share growth in whey solids.

Interesting accomplishments are indicated from the data:

Between the years of 1993 and 1996, California's share of cheese production remained relatively flat, increasing less than one percent. During that time though California's skim whey powder sales increased by just more than 1 percent, while California sales of the higher valued whey protein concentrate increased 8.2 percent.

In 1997 California produced 16 percent of the nation's cheese, 10.5 percent of the nation's skim whey powder, and 20.9 percent of the nation's whey protein concentrate.

Five years later, 2001, California's share both cheese and skim whey powder has increased about 4 percent, and whey protein concentrate sales from California increased an impressive 13.2 percent to capture 34.1 percent of all whey protein concentrate produced in the United States.

California is not merely a player in the national whey powder marketplace. We are dominant.

We applaud the Department's decision to hear this petition and the extent which CDFA has identified necessary changes to yields, manufacturing cost allowances, and products recognized in the 4a and 4b price rating calculations.

The Department's data clearly shows powder yields, butter yields, and cheese yields to be higher than those currently recognized in the 4a and 4b formulas. The time to correct these deficiencies is here.

The Department's data clearly shows manufacturing costs for powder and cheese are lower than those currently offered in the 4a and 4b formulas. Let us make the necessary changes to manufacturing costs.

There's significant value resulting from the processing of whey into its many salable forms. The time to add whey solids to the calculation of prices paid for milk utilized in the production of cheese is here. Adding a price for dry whey in California's formula is justified and appropriate.

Security Milk Producers thanks the Department for the opportunity to participate in this hearing and requests the option to submit a post-hearing brief.

HEARING OFFICER ESTES: Your request for submitting a post-hearing brief is granted.

Do we have panel questions for Mr. McLaughlin?

AGRICULTURE ECONOMIST GOSSARD: On page 3 of your testimony, at the top, you recommend a yield of 10.71 for the cheese based on the Departmental exhibit.

Do you also recommend that the vat test for fat solids not -- also be incorporated into the pricing formula?

MR. McLAUGHLIN: Yeah, the yield 10.71 net result is the net result of what the Department's found as --

AGRICULTURE ECONOMIST GOSSARD: The 10.71 was based on the vat test for fat and solids-not-fat -- let me -- just hold it a second.

SENIOR AGRICULTURAL ECONOMIST ERBA: Three nine five.

AGRICULTURE ECONOMIST GOSSARD: Oh, 3.95 percent fat and 8.93 percent solids-not-fat. And that was the basis for the yield of 10.71.

If you want to increase the yield to 10.71, should the Department also increase the vat solids-not-fat test formula to 3.95, 8.93?

MR. McLAUGHLIN: I don't know whether I have an opinion on that.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

SENIOR AGRICULTURAL ECONOMIST ERBA: Mr. McLaughlin, does Security as a co-op operate any processing plants?

MR. McLAUGHLIN: No, they do not.

SENIOR AGRICULTURAL ECONOMIST ERBA: Do you know if there are any plans to obtain or build processing plants for any kind of processing in the near future?

MR. McLAUGHLIN: There are none to my knowledge.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. Thank you.

HEARING OFFICER ESTES: All right. Thank you, Mr. McLaughlin.

MR. McLAUGHLIN: Thank you.

HEARING OFFICER ESTES: Our next witness is John Jeter of Hilmar Cheese Company.

Could you please come forward.

(Thereupon the witness was sworn, by the Hearing Officer to tell the truth, the whole truth and nothing but the truth.)

MR. JETER: Yes, I do.

HEARING OFFICER ESTES: Could you please state your name and spell your last name.

MR. JETER: John Jeter, J-e-t-e-r.

HEARING OFFICER ESTES: Please identify the organization that you represent.

MR. JETER: Hilmar Cheese Company.

HEARING OFFICER ESTES: And could you describe the number of members in your organization.

MR. JETER: We are a producer-owned private company of 12 owners. We purchase milk for 275 dairies, about 10 percent of the California milk supply.

HEARING OFFICER ESTES: All right. And could describe the process by which your testimony was finalized and approve.

MR. JETER: It was developed by myself and other staff, and approved by our owners.

HEARING OFFICER ESTES: All right. Please proceed with your testimony.

Oh, and -- excuse me. By the whey, your written statement here will entered in the record as Exhibit Number 55.

(Thereupon the above-referenced document
was marked by the Hearing Officer as

Exhibit 55.)

MR. JETER: Thank you.

My name is John Jeter, and I'm Chief Executive Officer and President of Hilmar Cheese Company, whom I represent at this hearing today.

Hilmar Cheese Company is a producer-owned private company. We purchase about 10 percent of the California milk supply. And we were created to pay more for milk. And as a result of that we've really driven competition and premiums through most of the State of California to the benefit of the majority of California dairymen.

Thank you for letting us testify at this hearing today regarding the 4a and 4b classified prices in California.

We also want to take this opportunity to commend the California Department of Food and Ag for the critical role you played in the development of the California dairy industry in the past 20 years. The California dairy industry has been one of the most dynamic segments of agriculture. A critical element of this has been the role of milk price regulation, which has been manifested by you.

We think that in almost every case CDFA has made decisions that have been envied by most others in the dairy industry. All of us in California have been afforded the opportunity to succeed, and many have. While there's always much complaining about pricing decisions on both sides, in general you've been very close to on target and have done an excellent job. And the fact that California has grown from approximately 10 percent of the national milk supply in 1980 to 20 percent today tends to say it all. You've made decisions which have facilitated the use of the valid economic strengths of the California dairy industry. We urge you to continue to do this in the future.

We as a state industry have the opportunity to continue this dynamic growth if correct decisions are made, that continue to facilitate the use of valid economic strengths of the California dairy industry. These are very challenging times for the California dairy industry -- very low milk prices, very low dairy prices. And we believe it's the lowest milk prices in the last 20 years. I do, however, think that the near-term future could be even much more challenging. Each of us will have to make difficult choices and decisions.

As a sideline to what's written in front of me, this hearing really is not about higher milk prices. And that may sound odd. It's really about where you go for higher milk prices. At the last two hearings we opposed efforts to increase the make allowance for energy reasons.

And we just felt it was the wrong way to solve problems. And in this case it was lowering the regulated price and taking money out of dairymen's pocket via the regulated price. We opposed those.

This hearing was called by those requesting you to increase the price of milk going into cheese, specifically to move the California 4b regulated price much closer to what the Class III price is in federal orders. These requests, if granted, will do great damage to our state dairy industry. We oppose these requests and would ask you to make virtually no changes in the California 4b regulated price. We support the Dairy Institute of California proposal because it maintains nearly the current level of regulated price. We also would ask you to make little or no change in the 4a price.

And to support this we'll make three primary points:

The first reason we ask you to not make any changes in the 4b price level, or regulated price, is that we critically need to invest in markets and products to increase milk prices, and not in additional milk supply via a regulated price change. The current 4b regulated price in California is at an appropriate level that allows very efficient plan operators to invest wisely with appropriate risk to facilitate growth of commercial markets for California milk.

And I included in there an excerpt from your CDFA March 18th hearing decision, which I think is very applicable. And I'm not going to read through that. It's there for your benefit. I'll actually quote a couple of items in it.

In the middle of page 3 on my testimony:

"With the continued trend toward a manufacturing state, it is beneficial to the California dairy industry to maintain its comparative advantage in selling any manufactured dairy products." End quote of a quote from your hearing decision of March 18th, '01.

And down below: "It is, therefore, clear that the amendment" -- and these would be the proposed changes to increase the 4b price -- "would affect negatively the competitive environment facing California cheese processors by disrupting the existing price relationship between California cheese processors and cheese processors located in federally regulated markets. Again, the ultimate result of the proposal would to be reduce California's market share vis-a-vis out-of-state processors and possibly leave milk without on outlet in California." Again, that's a quote from your hearing decision.

Much of the growth in the dairy industry in

California in the last 20 years has come from the cheese industry. The cheese industry has allowed California to fight for and obtain valid commercial markets for milk. Without the growth of the cheese industry in California, where would California milk have gone? And even more challenging, where will it go in the future?

This is what I call California dairy basics:

Every day 1800 to 1900 loads of milk are produced. In each year California dairymen produce 90 to 100 more loads of milk per day every year. Those are just basic facts, plus or minus. This year will likely not be any different. At a time when demand is sluggish one has to ask, "Where will this new product go?" And this is a very tough question, but it's a question we ask, is: "Why invest in additional milk supplies when we have a desperate need for more markets?" We need more markets.

As each person comes forward today to ask you to increase the minimum regulated price, I think you should, respectfully probably, ask them where the 90 to 100 more loads per day will go; what is their business plan to build plants to make products to go into commercial markets for these 90 to 100 more loads of milk that will come forth this year and next year and possibly the next and the next?

Additionally, we believe that there will be a large influx of new milk production that will come as a result of the growing clarity regarding the environmental situation in the California dairy industry. Not that it's a good situation, but I think it's just becoming more clear.

The 90 to 100 more loads per day of milk could easily be low. I recently took a trip down south and drove along I-5 in Kern County. Massive dairies are being built. And, again, I was even struck at, where will that milk go? And what about the existing dairies, what are they to do with that type of expansion going on?

While this may seem like a rhetorical question, it really isn't. It's a very real question, and a very good question to ask now, and even to get it answered, before you make a decision as a result of this hearing. You're well aware of the fact that the decision you make has a great bearing on whether or not new plants are built and, even more importantly, whether or not incremental supplies of California milk find a home in commercial markets in the future.

So where will these new supplies of milk go?

The basis choices are simple:

1. We process and sell the incremental product to the CCC, for as long as this market exists, at very low prices. And, frankly, everyone loses.

2. We take existing markets from others. This has been a major part of our past growth. Very critical to all of us, as we literally have competed against other regions and beat them.

And I would term this Alternative 2 as what I call just redividing the existing pie, taking markets.

And,

3. We grow existing markets or generate and sell into markets that don't currently exist via new products and technology. And that one I would term "making the pie bigger."

The interesting thing is that the degree of difficulty grows as you go down the list. In other words, it's easiest to do number 1. You have a guaranteed customer, you know they're going to pay you, and so and so forth. And really the most difficult to do number 3, which is to make the pie bigger.

However, it is just the opposite when it comes to investment and rewards. There is greater investment and potential rewards in number 3, meaning making the pie bigger. And the investment and potential risk and rewards are much lower in number 1, selling to the CCC.

We clearly need to facilitate the growth of commercial markets for California milk, and put the majority of our efforts into taking existing markets from others. And that means being a tougher competitor, growing existing markets through more effective marketing of the products we currently make, and even create new markets and products that don't exist today.

And the point is that majoring in number 2 and number 3 above will take even greater incremental investment in products and markets, not less. We clearly need to invest more in products, markets, and technology; and not invest more in incremental milk supplies via a regulated price unless appropriate investment is made in new products and new market first.

Keeping the 4b price where it is will continue to send the right economic signals, which really has been the case for the last 15 to 20 years in California. By the way, investing in more incremental milk supply through government intervention is what has already been done through the MILC program nationally. And that's a terrible program. At a time when we desperately need new markets, the federal government invested in new milk supplies. They paid people to make more milk. And really it was a killer in terms of -- even in California -- at a time when the east and the midwest supplies should be responding to these low prices, they're waiting for checks. And it's really hurt the market response that we would have seen, and it's an example of federal intervention, of injecting money into a situation that makes it worse.

And in one sense raising the 4b regulated price now would tend to do the same thing as the MILC. At a time when we need more processing capabilities to put more milk in the commercial markets across the country from California, don't invest in more milk via the regulated price. Raising the regulated 4b price for milk would be a major shift in the regulated price level. The current level is a level that has fueled the growth of the California dairy industry in the recent past.

Lastly, we encourage you to send a clear message to those who ask for a higher regulated price. The message is, "Go to the market from more money."

We at Hilmar Cheese Company are clearly for higher prices that come from the market. We are clearly for higher prices that are earned by investment and appropriate risk taking. And I say this in the face of dramatically low milk prices, and I know those things are hear to hear.

HEARING OFFICER ESTES: Mr. Jeter, I just wanted to inform you for a moment, just in terms of the length of your statement, that you've used half of your time. So you have 10 more minutes, so you can use that time judiciously.

MR. JETER: Thank you.

Tell those who seem to be good at asking you to increase their prices via the regulated price to go to the market. The California regulated minimum price for milk going into cheese is just that, a regulated minimum price. Anyone can pay more if they earn it.

The hard facts are -- and these are not fun facts -- we are at a point of having very ample milk supplies into the foreseeable future and are looking at a shortage of markets. More investment needs to be made in markets and products, not in milk via an increase in the minimum regulated price.

The second key reason not to change the level of the California 4b price is that the current level allows for appropriate non-regulated price signals, efficiently allocating milk and increasing the competition for milk.

Critical to the dairymen in California is competition for their milk. A key element in competition is adequate plant capacity and the ability to pay premiums. Raising the 4b price will diminish plant capacity in the future as processors see less favorable environment for the plant margins. A higher 4b price will also mean that processors will pay less premiums for milk going to cheese, decreasing competition for milk, taking the pressure off many in the industry to improve and innovate. And actually what needs to happen is people need to feel the competition for milk, which will push premiums and give dairymen choices where they can ship their milk. Raising the 4b price will decrease plant capacity, decrease competition for milk, and give us less ability to appropriately allocate milk for commercial markets, rather than selling to the government.

Let me give you an example. Last year when you decreased the 4a and 4b price for milk for energy reasons, plant margins were increased relative to what they would have been if there had been no decrease in the regulated price. When you made the change to decrease the 4b regulated price, Hilmar Cheese Company made the decision to increase our premiums to make up the difference. We actually put the money from the decreased regulated price into higher quality premiums, a new environmental premium (designed to stimulate CDQAP certification) and higher cheese yield and minimum premiums. This increased competition for milk resulted in others having to make decisions as well regarding what to do with their premium programs.

Just the opposite will happen if you increase the regulated 4b price for milk. Premiums will be decreases and competition will decrease as well. And we think that's not good for California dairymen in the short run or in the long run. We believe there needs to be more competition. And to do that there needs to be premiums and adequate plant capacity.

The last reason to not change the level of the 4b pricing in California is that a valid relationship now exists between Federal Order Class 3 and the California Class 4b price.

Many who advocate increasing the 4b price do so on the basis that we should have a minimum price in California which is close to or equal to the federal minimum Class 3 price.

At the recent dairy forum, Mark Stephenson, dairy economist from Cornell, said that in general a $.70 to $.80 per hundredweight all-milk price difference should exist between California and the eastern part of the U.S., which reflects the cost to move the product between those two regions. He commented that 60 percent of the population of the U.S. is located east of the Mississippi, and the difference in minimum price allows California product to be competitive in these markets. Almost all new markets for California milk exist east of the Mississippi River. That's a corporate differential.

At the same dairy forum, Doug Marshall from Westfarms commented that federal order minimum prices did not take into account the cost to transport product to the east, like the California 4b does. His comment recognizes the same price differential acknowledged by Mark Stephenson mentioned above. Doug Marshall was basically saying that manufacturers on the west coast need this lower regulated price to compete in midwest and eastern markets. He was saying that the California price is correct and the federal order price is wrong for those located on the west coast. Unfortunately, he's in the federal order. So if he were at this meeting he would advocate us raising our price, so that it too would be wrong, and we too will be uncompetitive if we have to pay a price that's comparable to the federal order price.

The prices in California and the federal orders really have different rules -- I'm going to skip that because I think you guys know that.

I'm going to go to page 9. And I'm going to quote again from the March 18th hearing decision. I'll skip that, and go down to that next paragraph.

The difference in federal order prices and California prices is also justified by the difference in cost of production at the dairy level, if minimum prices are truly to be market clearing. See the attached Exhibit A, which shows the Pacific region cost of production compared to the northeast and upper midwest. This data is through 1999. What we can see from this exhibit is that the Pacific region dairymen -- California, Oregon, and Washington -- had a much lower economic costs to produce milk.

Essentially, California dairymen make more net income with a lower price than the federal order counterparts because the difference in the average cost of production between California and the upper midwest is less than the average difference in the all-milk price or the mailbox milk price. And the result of this has been much more dramatic growth in the milk supply in the west than in the midwest or the east. And that's also shown in Exhibit A.

California dairymen are very efficient. They do a great job.

While current price levels are very low -- let's see, I'm going to skip down to -- I'm going to go to the next page.

The one thing that could damage this trend of growth would be a regulated price in California that is too high, that is not market clearing. And that is one of the main dangers of the proposals before us presented by Western United Dairymen, the Alliance of Western Milk Producers, California Dairy Campaign, and California Dairy Women.

The other danger is that a higher regulated price will make us less able to garner new markets for California dairymen. And we badly need new markets.

I think this can be illustrated as follows: I was at a meeting of dairy economist and industry people in Chicago in early January. There were about 40 people from all across the country at this event. The purpose of this meeting was to dialogue about dairy policy and dairy economics. Inevitably the issue of regional economics came up. One eastern dairy economist from Dairylea cooperative in New York commented that the regulated price surface should be used to enhance producer revenue. Several disagreed with his thinking and eventually asked him, "What will you do about California?"

The implication was that raising or keeping prices high in the east would only give California more room to grow and take market share, as has been the case in the past.

In response the eastern dairy economist turned and looked at a California person who was at the meeting and said that the answer was for California to raise their price through the hearing we are all now in the midst of. The eastern dairy economist clearly realized, as I think we all do, that the growth in the western milk supplies and the markets where this milk ends up has come at the expense of higher priced midwestern and eastern milk. The east and midwest realize that the only way to derail this trend is to raise the minimum price that must be paid in California so that California milk is less competitive in midwestern and eastern markets.

I'm going to go to the next page.

Other regions in the country want us to increase our price so our strategic advantage of low cost milk will be taken away. It's critical for ongoing growth that we maintain the advantages we have in terms of lower cost, efficient milk production.

I'm going to go down to the next paragraph.

I think there could be an illustration for us internationally concerning Australia and New Zealand. What if Australia and New Zealand were by regulation to raise their minimum regulated milk price to something that was less than the freight differential between Australia, New Zealand and the U.S.? The result would be to make Australia and New Zealand less competitive in the United States, In Europe, and around the world for that matter, with their dairy products. While our dairy industry would like this, and I would for one, it will obviously never happen. To do this would be to give away a primary advantage -- their efficient milk supply relative to the U.S. and Europe.

Yet this is exactly what you were being asked to do in California. You're being asked to raise the minimum regulated price for milk going into cheese and give away the advantage that California has, an efficient milk supply, which will result in us being less competitive and thus less able to garner new markets.

Let's skip over to page 12.

Lastly, I'd like to make a comment about whey and the inclusion of a whey formula. And I'm going to put in another excerpt in from your March 18th hearing decision, which I won't read.

HEARING OFFICER ESTES: Mr. Jeter, you have a couple of minutes.

MR. JETER: That will be fine.

Skip to page 13, bottom of it. In that quote, CDFA acknowledges again the importance of an appropriate price level generated by the formula. You also acknowledge that cheese is sold by California possessors for significantly less than what is depicted the formula mover. This is still the case today and was verified by your price surveys.

I'm going to skip to page 14.

We also acknowledge that whey can provide net revenue. A simple and accurate perspective would be that net earnings from whey could potentially make up the significant shortfall in the price mover. I think that this was the point in your 3/18 decision. The level of the current 4b price is correct.

One last comment on whey. It's critically important for the continued development of the cheese industry nationally and in California that we invest in and develop even more uses for whey and whey fractions. This must be done, specifically in California if we want to grow the cheese industry in terms new markets. While whey proteins have in recent years been a relatively hot marketing item, during the last 18 months we've seen a commoditization of what used to be unique specialty whey products and dramatic erosion in the margins in whey. We've also seen a growing surplus in what we in the whey business know as whey permeate. Whey permeate is what's left over after you generate whey proteins. As whey protein concentrate production has grown, so has the supply of whey permeate. We lose money processing our whey permeate. We've invested over $45 million to process a product from which we make no money. And environmentally we have to do it. We have no choice.

We are at a critical time in our company's history where we must make decisions regarding growth. And a key part of that decision will be what to do with our whey and whey permeate if we fractionate whey. There are no easy decisions. I can't overestimate this point.

We as a company should have made growth decisions already in we want to have new capacity up and running in two years. But we have held off making the decision for several years, one of which is the massive investment required in whey permeate and the fact that we just can't afford to make any investment errors or invest like we have in the past -- $45 million just to lose money.

We believe that a new facility must be large to drive efficiencies, yet the cost of a new facility to compete nationally would be at least $150 million including whey processing.

HEARING OFFICER ESTES: Mr. Jeter, your time has expired.

MR. JETER: I think I'm done.

HEARING OFFICER ESTES: Did you have any brief comment you wanted to get across before I turn you over to the panel for questions?

MR. JETER: No, I think I'm fine.

HEARING OFFICER ESTES: Do we have any questions for Mr. Jeter?

Mr. Jeter, before you get any panel questions, I just want to emphasize one point, is the fact that you were not able to read all of your testimony today of course does not mean that the full content of it will not be considered.

MR. JETER: Thank you.

Can I submit a post-hearing brief?

HEARING OFFICER ESTES: Certainly.

AGRICULTURE ECONOMIST GOSSARD: On the top of page 10 you characterize the proposals by others at the hearing, including California Dairy Women, as being those that would result in higher prices and stimulate production.

But on the case of the California Dairy Women's proposal, the average effect over two years would be a 2-cent increase in the hundredweight price. And I'm not sure how you see that damaging to --

MR. JETER: I don't think that would stimulate production. That's a mistake.

SENIOR AGRICULTURAL ECONOMIST ERBA: Mr. Jeter, maybe you said so in your testimony and I didn't pick up on it. But are you in support of the Dairy Institute's proposed changes to the Class 4b formula?

MR. JETER: I think I said that.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. I wasn't sure.

MR. JETER: Yes, I am.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. I just wanted to make sure about it.

Also I have a question about a -- and

unfortunately you didn't have time to go over this, but it's on page 14, top of the page. I guess it would be the first paragraph -- the first complete paragraph anyway, that you "acknowledge the whey can provide net revenue. A simple and accurate perspective would be that net earnings from whey could make up the significant shortfall in the price mover. I think that was point of the 3/18/01 hearing decision."

Could you expand on that paragraph a little bit? I'm not quite sure what you're getting at there.

MR. JETER: Well, I think I'm acknowledging that we all invest hard, and we do that to make money in the whey business. And it's really allowed us to do a couple things. To expand cheese markets, certainly. But also in our case to pay premiums out for milk. And it's really -- we've invested hard. It allows us to pay premiums. And we do acknowledge that there is definitely a shortfall in that price mover. I think your survey indicated that.

So it's sort of -- you know, we're short on the price mover. We acknowledge there is some net revenue available in whey. And I think that's why we supported the Dairy Institute, which I believe they basically acknowledge that as well.

SENIOR AGRICULTURAL ECONOMIST ERBA: In the Dairy Institute's proposal, they didn't include an explicit whey factor formula. And you support that as well, not to include explicitly --

MR. JETER: Right.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. Thank you.

HEARING OFFICER ESTES: Any further questions?

All right. Thank you very much, Mr Jeter.

Next we have Richard Ghilarducci and Dennis Leonardi from Humboldt Creamery.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. GHILARDUCCI: I do.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. LEONARDI: I do.

HEARING OFFICER ESTES: And let's start and go with you, Mr. Ghilarducci. Could you please state your name and spell your last name.

MR. GHILARDUCCI: Rich Ghilarducci. My last name is spelled G-h-i-l-a-r-d-u-c-c-i.

HEARING OFFICER ESTES: And, Mr. Leonardi.

MR. LEONARDI: Dennis Leonardi L-e-o-n-a-r-d-i.

HEARING OFFICER ESTES: All right. Mr.

Ghilarducci, could you please identify the organization that you represent.

MR. GHILARDUCCI: Humboldt Creamery Association.

HEARING OFFICER ESTES: Could you describe the number of members in your organization.

MR. GHILARDUCCI: We have 70 members.

HEARING OFFICER ESTES: And the process by which your testimony was developed and approved?

MR. GHILARDUCCI: It was developed by myself and my staff. And It was approved on January 13th's board meeting.

HEARING OFFICER ESTES: I'm going to enter both of your statements as Exhibits Number 56 and 57.

(Thereupon the above-referenced documents were marked by the Hearing Officer as Exhibits 56 and 57.)

HEARING OFFICER ESTES: So please proceed with your testimony.

MR. GHILARDUCCI: Mr. Hearing Officer and members of the panel: My name is Rich Ghilarducci and I'm the Chief Executive Officer of Humboldt Creamery Association. Our membership consists of approximately 70 dairymen located in northern California. My appearance today is on behalf of our board of directors and the 70 family farms that own our cooperative.

Humboldt Creamery processes and markets powdered milk, ice cream, and fluid milk products. Our dairymen have made substantial investments during the past 10 years in their facilities and developing markets for California ice cream and powdered milk. In addition our facilities are used to balance the raw product requirements of fluid milk an cheese processors in our region similar to other butter/powder facilities throughout the State of California.

The California Department of Food & Agriculture has granted Western United Dairymen a public hearing to consider amendments to the Class 4a and 4b product yields. Also, the Secretary of Agriculture broadened the hearing to include all aspects of Class 2, 3, 4a and 4b pricing formulas.

We recognize that California dairymen, which include our owners, are experiencing milk prices which are a 20-year low and cost of production increases in all aspects of their businesses. As a result, many dairymen and their organizations are looking towards the Department and this hearing to solve the inequity of their revenue to expenses. Sound policy, not temporary economic conditions, should be the basis for the Department's decisions.

Current milk prices are a reflection of supply and demand and not the State of California milk pricing system.

In fact, the changes proposed in the hearing would actually reduce our dairymen's income. Since 95 percent of all 4a products are produced by dairymen-owned cooperatives, any reduction in the 4a manufacturing allowance is simply a form of income redistribution away from dairymen who have invested in facilities to dairymen who have no investment in manufacturing plants.

Our board of directors, that is comprised of California dairymen, and the management of Humboldt creamery support the current manufacturing allowance of powder at $.16 per pound, which is justified by the complete State of California manufacturing cost audit released November 26th.

We support the California Dairy Women's proposal to establish a floor price of the USDA commodity price and the Alliance of Western Milk Producers' 4b price structure, which recognizes the value of protein in whey.

Listed below is support for our position on manufacturing allowances, product yield formulas, commodity price floors, and Class 4b price structure.

The State of California annual audited weighted average manufacturing cost ending with the 2001 year was 16.19 cents per pound for nonfat powder. After the State of California announced these figures, they presented a cost study adjusting for the cost of energy for the single month of August 2002. This process of partial audits is misleading and not a truly reflection of the associated manufacturing costs. Beyond these audits, there are many aspects of the manufacturing allowance the Secretary of Agriculture should consider.

For example, the natural gas market in August 2002, was $2.70 per deca-therm. The average for the year was $3.35 per deca-therm. And the current price is $6.12 per deca-therm. By arbitrarily choosing the single month of August to review natural gas costs, this resulted in the manufacturing allowance being reduced by $.01 per pound. However, if you look at the current price today, the Department's audits would reflect an increase in the manufacturing allowance.

Also, there are inequities in the California electrical rates. Humboldt Creamery purchases electricity from Pacific Gas & Electric, which raised our commercial rates due to the State of California energy crisis by 74 percent in 2001.

Processing plants that are located in the Modesto or Turlock irrigation districts pay 60 percent less than our California PUC imposed rates. So it's easy for plants within those districts to state that the last increase to the make allowance wasn't warranted when they have not seen those electrical costs.

Before these increases, historical electrical rates throughout California varied by less than $.04 per kilowatt-hour. Since the electrical crisis during 2001, there is now a variance of $.10 per kilowatt hour. For Humboldt Creamery this difference equates to electrical costs that are $.03 per pound higher in our powdered milk operation than plants located within these regions. Since the manufacturing allowance has to cover plants located throughout California, the Department should consider these variances.

In addition, we just received notice that the PUC will implement a 2.7 cent per kilowatt-hour surcharge effective January 2003 to recover costs for self-generation.

Next, on December 31st of this year we received a 54-percent increase in our workers' compensation insurance rate, which is not included in any state audited costs. In 1999 how Humboldt Creamery had a rate of $2.95 per $100 payroll. For 2003 our rate is $12.99 per $100 of payroll. This equates to a 340 percent increase in four years. Graphed below are current rates for creameries located in Oregon and Arizona compared to California.

What needs to be understood is that all

California processors are burdened with higher manufacturing costs than surrounding states, and this must be taken into consideration by the Department.

We should also recognize the relationship of the California Class 3 pricing to surrounding federal orders, as graphed below.

This pricing relationship is critical to our organization since over 50 percent of our sales are in ice cream and our outside the State of California.

It is important that California manufacturers not be disadvantaged compared to other U.S. manufactures. It is also imperative for both producers and processors to maintain competitive class pricing with surrounding federal orders. If this price parody is eroded, the California producers and processors will lose the Class 3 market value to surrounding federal orders. This will mean more of their product will be diverted into the commodity products such as butter, powder, and cheese at lower values.

In referring back to that graph, as you can see, we already paid a higher butterfat value than the federal orders in Class 3 in the State of California, and with the proposed changes by Western United we even move that farther out of the line with federal order.

Next, the return on investment calculation used by the State of California, Department of Food and Agriculture does not reflect the true cost of capital to maintain processing facilities within the State. More advanced customer specifications mean additional investment requirements on the part of processors. Let's not discourage investment that would keep our facilities efficient, cost effective, and competitive. The Calculation uses the prime rate, which is a reflection of short-term money. The facilities used for processing are all long-term assets. And the return on investment calculation should be tied to a minimum 10-year note, which would be a closer reflection of financing used to maintain or build facilities.

In Western United Dairymen's proposal, they recommend reducing the powder manufacturing allowance to 14.27 cents per pound. This would mean that 80 percent of all powdered manufactured in the State of California would be at a loss. Their initial proposal called for 80 percent of the volume to be covered by the manufacturing allowance. And this would set the manufacturing allowance at over $.16 per pound. Therefore, from the standpoint of economic justification, based on the relative market value and manufacturing costs, no make allowance reduction's warranted; and, in fact, an increase, which we have not asked for, could be justified with year-end increases.

We recognize that California dairymen are in a cost-of-production squeeze, and we support efforts to increase milk prices where increases can be obtained from the market.

The California Department of Food Agriculture -- and this is going to product yields -- issued a report on butter and powder yields dated October 2002. We believe that the yield numbers reported in the study are significantly overstated. The allocation process of plant loss by component usage is not accurate.

We would agree with the Department's assessment that assigning plant loss is a complex task. Since powder products are the most highly processed products in a powder operation, the Department states in their findings that they recognize their yield estimates are too high. We would concur with this finding based on our actual results. There are other factors not even considered in the study such as loss encountered by running diverse products and varying component tests per finished product container.

Commodity floor prices:

Humboldt Creamery believes the State of California should reinstate provisions similar to those included in the 1995 stabilization plan to floor commodity prices in the 4a calculation and to also include 4b.

These provisions will provide for prices to be established at the higher of the calculations of market prices or the USDA announced support purchase price for butter, powder, and cheese. Allowing sales prices to be used in the calculation of pay prices to dairymen that are below the support purchase price for butter, powder, and cheese is a way to circumvent the intent of minimum pay prices to dairymen.

Under the current structure there is no incentive for a manufacturer to sell at the support purchase price for butter, powder, or cheese because there is a fixed manufacturing allowance. This structure results in dairymen getting paid below the $9.90 support price, which was never the intent of Congress.

Class 4b price structure:

We support the Alliance of Western Milk Producers' structure for 4b pricing. This structure recognizes the raw product value for whey solids and the effect of protein to cheese manufacturing yields.

The processing and marketing of whey solids has become a profit center for many cheese manufacturers. California manufacturers should have an adequate manufacturing allowance and should be rewarded for innovative marketing by developing and selling above the average of the western mostly dry whey value as reported by USDA Dairy Market News or efficiencies recognized by processing below the manufacturing allowance.

Processors should not be allowed to prosper by not paying the true value for the milk they are processing.

The California milk pricing system has to recognize the value of protein in the dairymen's raw product value. With over 42 percent of the milk produced in California being processed in class 4b, it is imperative that our pricing system recognizes the value of protein and butterfat in the manufacturing of cheese. The volume of product yielded for manufacturing cheese increases in direct correlation with the composition of butterfat and protein. California dairymen should recognize the raw product benefits of these component values. The Alliance proposal recognizes the raw product value of whey solids and protein and allows our 4b pricing to be in a reasonable relationship on a month-to-month basis with the federal order Class 3 pricing.

In conclusion, the 70 family farms, the board of directors, and the management of Humboldt Creamery Association encourage the members of the panel to recommend, and the Secretary of Agriculture to adopt, the commodity price floors as proposed by the California Dairy Women; adopt the Class 4b pricing structure as proposed by the Alliance of Western Milk Producers; make no changes to product yield formulas for both butter and powder; and establish manufacturing allowances based on the complete annual audited costs dated November 26th.

At this time our testimony will be continued by Dennis Leonardi, our Chairman of the of Board and a California dairyman. Humboldt Creamery Association appreciates the opportunity to testify at this hearing. After my Chairman's testimony, we would be happy to respond to any questions the hearing panel may have.

HEARING OFFICER ESTES: Please proceed, Mr. Leonardi.

MR. LEONARDI: My name is Dennis Leonardi. I serve as Chairman of the Board of Humboldt Creamery Association. Our association is comprised of California dairy men and women who have invested in our processing facility for over the past 70 years. I am here on behalf of that board of directors from the 70 family farms that own our cooperative. My Board has directed me to underscore our CEO, Mr. Ghilarducci's testimony, but in much more direct terms.

We support the current manufacturing allowance of powder at 16.1 cents per pound. It is disturbing to our Board to see that any month singled out when used in an expense audit process. This is especially concerning when it is a very low cost month compared to others. It is also concerning to see only energy costs considered when we as the owners of the plant have to bear all the increased costs, including health care costs, workers' compensation, in addition to electrical and gas costs.

We have very serious concerns regarding the proposal from Western United Dairymen. Some of our dairymen are members, including myself. And I must say, I'm disappointed in their proposal and its possible impact on our plant and markets. We support a manufacturing allowance in powder that will allow us to cover our costs. Not adjusting the 16.1 cents per pound at this time made sense. Based on our costs, we could easily testify for an increase in the 4a manufacturing allowance.

We support the California Dairy Women's proposal to establish a floor price of the USDA commodity price and the Alliance of Western Milk Producers' 4b price structure, which recognizes the value of protein and whey.

We support a Class 3 price that allows us to be competitive nationwide. We as owners of an ice cream production facility already have higher raw product costs than the federal orders we compete in with over 50 percent of our finished product. It is also imperative for our producers and processors to maintain competitive class pricing with the contiguous federal orders. If this price parity is eroded, the California producers and processors will lose Class 3 market value to surrounding federal orders. This will mean more of our raw product will be diverted into commodity products such as butter, powder and cheese, thus even lowering mailbox prices.

We strongly support the concept of pooling, that all milk value is pooled and all value be recognized. And let me share with you an example.

One of my neighbors has a market milk permit and ships to a 4b plant. This neighbor has a cheese yield higher than the standard 10-pound yield that is accounted for by the State formula.

At the end of the month we all receive our pay checks and everyone shares in the Class 1, 2 and 3 sales. Then the discrepancies arrive because the pool has not accounted for all the milk value.

This producer takes money from all the markets and yet it's a bonus on top of the market. The processor doesn't account for all the value of this milk as cheese or whey to the pool and is able to selectively give the producer bonus. This is not fair, this is not equitable, an it's not the intent of pooling. This situation needs attention and it needs to be fixed. Milk needs to be recognized for its true value and for what it yields. California needs to be a leader in the nation regarding pricing. Our dairymen deserve it.

We recognize that the California dairy men and women, which include our owners, are experiencing milk prices which are at a 20-year low and a cost of production increases in all aspects of their business. As a result many dairymen and their organizations are looking towards the Department and this hearing to solve the inequity of their revenue to expenses. Sound policy should guide the State of California milk pricing system, not reactions to supply and demand imbalance. In fact, some changes proposed in the hearing would actually reduce our dairymen's income. Any reduction in 4a manufacturing allowance is simply a form of income redistribution away from dairymen who have invested in facilities to dairymen who have no investment in manufacturing plants.

We need to understand that all California processors are burdened with manufacturing costs which are higher than surrounding states, and it must taken into consideration.

We as California dairymen are in a cost-of-production squeeze and we support efforts to increase milk prices, where increases can be obtained from the market. Allowing sales prices to be used in the calculation of pay prices to dairymen that are below the support purchase price of butter, powder, and cheese is the way to circumvent the intent of minimum pay prices to dairymen.

Processors should not be allowed to prosper by not paying the true value of milk they are processing.

On behalf of the member/owners of the Humboldt Creamery Association, I would encourage the members of the panel to recommend to the Secretary of Agriculture to adopt the commodity floor price as proposed by the California Dairy Women, adopt the 4b pricing structure as proposed by the Alliance of Western Milk Producers, make no changes to the product yield formulas for both butter and powder, and to establish manufacturing allowances based on the complete annual audited cost dated November 26th.

Thank you very much for the opportunity to testify. And I'd direct our questions to our CEO, Richard Ghilarducci, and request an opportunity to provide a post-brief testimony.

HEARING OFFICER ESTES: Request for a post-hearing brief is granted.

And do we have any panel questions?

SUPERVISING AUDITOR HUNTER: On your second page, on your natural gas pricing, you talk about the average for the year was $3.35 per deca-therm and the current market price is over $6 per deca-therm.

What are you are paying now at your plant per deca-therm?

MR. GHILARDUCCI: We have a blend price between the spot market, which is January's price, and getting up being probably $6 range on one contract -- one plant. And the other plant is contracted out and a long-term contract.

SUPERVISING AUDITOR HUNTER: Long-term contract at what rate?

MR. GHILARDUCCI: I would feel that that information is proprietary. And the Department has all the information anyway.

SUPERVISING AUDITOR HUNTER: All right.

That's all I have.

HEARING OFFICER ESTES: Do we have any other questions?

SENIOR AGRICULTURAL ECONOMIST ERBA: I have a couple of questions for Mr. Ghilarducci.

On the third page of your, in workers' compensation rates for different states, where did you get that information?

MR. GHILARDUCCI: We got that through our insurance provider or broker. And those are for creameries located within Oregon and Arizona.

SENIOR AGRICULTURAL ECONOMIST ERBA: Is that an

average, do you know?
MR. GHILARDUCCI: That's a creamery, yes.
SENIOR AGRICULTURAL ECONOMIST ERBA: On the same page you have a graphic that shows the butterfat pricing, comparing federal order with California and Western United's proposed changes.
Do you have a similar feel for how things are changed on the solids-nonfat side?
MR. GHILARDUCCI: On the solids-nonfat side of it, the prices as Western United proposed would increase. But I can't tell you how that would be comparatively, off the top of my head. And just to -- you know, just to emphasize, you know, in manufacturing ice cream, the major component is butterfat.
SENIOR AGRICULTURAL ECONOMIST ERBA: I understand.
SENIOR AGRICULTURAL ECONOMIST ERBA: On the next page you make the suggestion of time return investment to a minimum 10-year note.
Do you know what the effect of doing that would be?
MR. GHILARDUCCI: Short-term would probably make a difference of -- probably 6 percent for the cost of funds used in that. And I can't say what -- you know, you could run that through all the blended costs of plants. I

can't say exactly what that would make a difference in the cost of manufacturing. But I could run that through our own study and respond to that.

SENIOR AGRICULTURAL ECONOMIST ERBA: Could you include that in the post-hearing brief, if you submit one?

MR. GHILARDUCCI: Sure.

SENIOR AGRICULTURAL ECONOMIST ERBA: I'd appreciate it.

And this is just a clarification question between the two of you.

In Mr. Ghilarducci's statement he says the State should reinstate the provisions included in the 1995 stabilization plan to floor commodity prices. But the California Dairy Women's proposal is not exactly the same in how they handle the higher-of concept.

Do you or do you not include the adjustment to the freight before or after you take the higher of? So what one are you supporting?

MR. GHILARDUCCI: We could not take the freight differential into consideration.

SENIOR AGRICULTURAL ECONOMIST ERBA: So you take the higher of first and then apply the freight differential?

MR. GHILARDUCCI: Yes.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay.

That's all the questions I have.

HEARING OFFICER ESTES: Do we have any more questions?

Thank you for your testimony.

We're going to take a 10-minute break at this time and then come back and take some more testimony before we adjourn the hearing for today.

(Thereupon a recess was taken.)

HEARING OFFICER ESTES: All right. We'll call the hearing to order. We're calling the hearing back into session. This will be the final segment for today.

We'll take some more testimony, and then we will adjourn and conclude tomorrow.

At this time I'd like to call, let's see, Robert Naerebout; is that correct?

MR. NAEREBOUT: That's good enough.

HEARING OFFICER ESTES: Could you please state your name and spell your last name.

MR. NAEREBOUT: Robert Naerebout. Spelling the last name is N-a-e-r-e-b-o-u-t.

(Thereuopn the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. NAEREBOUT: Yes, I do.

HEARING OFFICER ESTES: And could you please identify to organization you represent.

MR. NAEREBOUT: Yes, I represent the Idaho Dairymen's Association. It is a trade association that represents all the dairy producers in Idaho, presently with 787 members.

HEARING OFFICER ESTES: And how did you finalize your testimony?

MR. NAEREBOUT: I prepared the testimony. We have -- we're a grass roots organization. We have an Industry Relations Committee that met on this past Monday and approved my testimony.

HEARING OFFICER ESTES: I see you presented us with a written statement today. We will introduce that into the record as Exhibit Number 58.

MR. NAEREBOUT: Thank you.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 58.)

HEARING OFFICER ESTES: And please proceed with your testimony.

MR. NAEREBOUT: Thank you.

My name is Robert Naerebout. I am the Executive Director of the Idaho Dairymen's Association, and am testifying on behalf of their 787 dairy producers in Idaho.

HEARING OFFICER ESTES: Mr. Naerebout, excuse me.

Could you people all quiet down a little bit so Mr. Naerebout can provide us his testimony. We can all have the benefit of hearing his knowledge and expertise related to dairy matters.

MR. NAEREBOUT: Thank you.

IDA was established under the provisions of Chapter 3, Title 30 of the Idaho Code as a non-profit cooperative association on July 5, 1944. Our principal purpose has been and will continue to be to promote the dairy interests in the State of Idaho and to take action necessary to stabilize and protect the dairy industry of Idaho.

Although it may seem unusual to you for an out-of-state organization like ours to participate in a hearing that is discussing your pricing mechanisms or cheese and powder, we do believe the outcome of your hearing will have a direct impact on the producers in Idaho. We want to express our gratitude for your willingness to allow us to participate.

Approximately 95 percent of the milk production in Idaho goes into manufactured products, with the vast majority of that production going into cheese. Some of that production is covered under varying federal orders and paid for by using the federal order pricing system.

The production pricing that is not based on the federal orders is paid off the cheese yield formula.

I would like to take a moment to explain the three areas we believe your decisions will have a direct impact on the dairy producers in Idaho. Those areas are the NASS survey, whey value, and market stability.

As you are aware, the NASS survey is used in the federal order milk pricing formulas. With approximately 80 percent of the information on the cost of cheese production coming from the western states and with California facilities participating in the NASS survey, a lower value for 4b inevitably will lower the Class III price for all producers paid under the federal order system.

Whey Value:

As stated before, much of the Idaho production is priced under a cheese-yield formula. Although the different companies use varying methodologies in their formulas, they all recognize a value for whey and pay their producers accordingly.

The California Food and Agriculture Code 61802-h states, and I quote, "in order to accomplish the purpose of this chapter and to promote the public health and welfare, it is essential to establish minimum producer prices at a fair and reasonable level." A case could and should, and I would add, has been made today that while being fair with the processing sector by recognizing their costs from make allowances and transportation credits, you're ignoring an additional value of raw milk for the producer sector by failing to establish a value for whey. By recognizing a true value for whey, you inevitably will recognize the value in an increase in the 4b price.

Market Stability:

The California Food and Agriculture Code considers market stability to be a key factor in milk pricing. As a consolidation of the dairy industry continues and the milk produced in one state is in competition for a market share, which we heard today, with milk produced in a neighboring state, market stability for like products will be an issue. When an organization representing dairy producers considers eliminating federal order based on a competitive disadvantage due to the California pricing of 4b milk, it creates an opportunity to evaluate what market stability to California producers and processors really means.

The question needs to be asked: Will the elimination of adjacent federal orders because of competitive disadvantages promote stability for the California dairy industry or instability? We are confident for Idaho the elimination of the federal order system will create market instability, with the loss of classified pricing and federal order minimums.

In conclusion, we support the proposals before you that add a whey pricing component to the Class 4b formula.

On behalf of the dairy producers of Idaho, again I express our gratitude for allowing us to participate in this hearing.

HEARING OFFICER ESTES: Do we have any panel questions for Mr. Naerebout?

MR. NAEREBOUT: If I may, sir, I would like to add, after hearing some discussion, just a few items that I think would be important and pertinent to you:

The first being, the amount of milk in Idaho that is unregulated is about 44 percent on any given month. So that milk isn't under the federal order pricing system. It is under the cheese yield system, and has to be competitive with the federal system.

Also, as it was stated today, on the competitive advantages that you have in 4b, obviously that means you're competitive above us. We have to go to the same markets in Idaho that you're going to. And it also seems that you're failing to recognize the advantages that you have versus the over order premiums that are established in the midwest.

And we also would like to ask the permission to submit a brief.

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

Have you concluded your testimony?

MR. NAEREBOUT: Yes, I have. Thank you.

HEARING OFFICER ESTES: As there are no panel questions -- excuse me. We do have panel questions.

SENIOR AGRICULTURAL ECONOMIST ERBA: Yes.

Mr. Naerebout, I'm not familiar with your association. So if you would just help me out with some very elementary questions.

Do have any processing facilities you, operate, that you lease, that you own?

MR. NAEREBOUT: No. What this is -- our membership would -- for example, the membership of Dairy Builder Northwest has processing facilities in the State. We are an association of all the dairy producers in the State, an umbrella organization for them.

SENIOR AGRICULTURAL ECONOMIST ERBA: So you would not directly operate plants --

MR. NAEREBOUT: We do not directly operate any plants.

SENIOR AGRICULTURAL ECONOMIST ERBA: -- actually members of plants?

MR. NAEREBOUT: Pardon me, sir?

SENIOR AGRICULTURAL ECONOMIST ERBA: Some of your members may actually have --

MR. NAEREBOUT: Our members would either -- if they're cooperative members, obviously they have an ownership in the plant. If they're not co-op members, they're going directly to some of our processors.

SENIOR AGRICULTURAL ECONOMIST ERBA: Okay. Just one more question.

You say that you support -- actually I've got a govern multi-part question. You say that you support any of the proposals that would add a whey pricing component. And obviously we've got differences among what has been suggested. Do you have a feeling for any one of them that might be --

MR. NAEREBOUT: As a board we went over the concept of a whey pricing, where it should be. And we didn't feel it appropriate for us to impose on you where we think it would be. But, you know, I just say for our board as a whole and our producers, the highest one would be the best one.

(Laughter.)

SENIOR AGRICULTURAL ECONOMIST ERBA: Thank you.

(Applause.)

HEARING OFFICER ESTES: Wait. We have another question, Mr. Naerebout.

DAIRY MARKETING BRANCH CHIEF IKARI: You indicated that 44 percent of the market is unregulated.

Do you have an idea in terms of the price of that milk compared to the regulated price?

MR. NAEREBOUT: Yes, I do. When you look at the milk in Idaho and by coming up with unregulated numbers, part of that milk is pooled in order 135, which includes Idaho and Utah, part of it is pooled in order 30, which is basically in Wisconsin. The other part is pooled in order 124. But in order for the cheese processors that -- by the way, have to be competitive with the federal order price. And if you look at the past year, and I'd submit this in my brief for direct facts, that federal order price would be the Class III price plus roughly a 30 cent what's called a producer pay price differential. So their prices are going to -- half to hit and half to target will be Class III plus about 30 cents.

DAIRY MARKETING BRANCH CHIEF IKARI: You indicated that Oregon or the northwest could be destabilizing to California. Isn't Idaho, the fact that there's some unregulated parts of it, destabilizing to the other federal orders?

MR. NAEREBOUT: If you go back to my testimony, the part that becomes destabilizing is if we lose federal orders and lose component pricing and lose classified pricing. All the milk in Idaho, even though it's not all under the order, is in competition to be paid at that order price. And so --

DAIRY MARKETING BRANCH CHIEF IKARI: I'm going to go a different way.

Is there any attempt to go under state or federal regulation on the unregulated milk?

MR. NAEREBOUT: No, there's not a mechanism for us to do that right now, except for what's already been pooled. If you look at the federal orders, and each order is different, the milk that's going into Wisconsin had to touch base. And then it doesn't go back to Wisconsin, but it's on that pool and it's on that order. By touching base, I mean it had to have one physical delivery in the State of Federal Order 30.

Same is true in Federal Order 135. If you wanted to bring milk in to 135, you have to come into a pool plant once, and then you don't have to come back again but you have to be associated with that plant.

And in order 124, and this is changing because of the federal order hearings that will change it, but you didn't have to touch base at all. I could have taken milk from Vermont and pooled it in order 124 without moving one drop of Vermont milk. So it's all based on each order and how they are.

DAIRY MARKETING BRANCH CHIEF IKARI: Does the fact that you have that unregulated milk in Idaho create market instability then to the federal orders?

MR. NAEREBOUT: Yes, it does. And probably the best case of that would be if you look at most of the milk that's pooled out of Idaho, it'd have to be pooled on 135, and that's a Salt Lake City market. And then Salt Lake City market would be 30 cents higher than the Boise market or the Magic Valley market, which you would consider normally the Idaho market. And the instability factor is of people in that 135 market being afraid of the milk that's in Idaho moving in and taking their market share. That can occur at roughly about 60 cents. The cost of transportation to get it out of the Magic Valley into Salt Lake City is roughly 60 cents. And the market's already recognizing part of that cost through the Class 1 differential that are there. So that is an issue, that is a destabilizing factor.

And there was a federal order hearing in Salt Lake City I believe April 16th in which there was petitions to try and tighten up the Utah-Idaho market and pull some of that Idaho milk off the Utah Market.

DAIRY MARKETING BRANCH CHIEF IKARI: And let me just -- one other question follow up with what Eric asked you.

Is Idaho Dairymen's Association -- is it an organization of cooperatives or is it more of a membership of producers?

MR. NAEREBOUT: A Membership of producers. Strictly producers.

DAIRY MARKETING BRANCH CHIEF IKARI: But you said some of the organizations also process milk.

MR. NAEREBOUT: Well, all the members -- everyone who produces milk in the State of Idaho is a member of Idaho Dairymen's Association. And so within that membership, some of them belong to Dairy Gold, some of them belong to Dairy Farmers of America, some of them belong to Magic Valley Co-op, some of them belong to Jerome Cheese. You get the idea.

And so through their -- through the membership of the companies that market their milk. We don't market their milk with their association to go issues like this.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

MR. NAEREBOUT: Thank you.

HEARING OFFICER ESTES: Great. Thank you very much, Mr. Naerebout.

(Applause.)

HEARING OFFICER ESTES: We are approaching five o'clock. And we've reserved -- we've both noticed the hearing for an additional today tomorrow as well as reserved this room for that purpose. And we have, I believe, 14 more people who have signed up to testify.

So what I'm going to do as the hearing officer in the exercise of my discretion so the Department can develop the most thorough hearing record possible is go down the list and give each person who's already signed up an opportunity to speak today, subject to a five-minute speaking period.

If you feel that you need additional time, we will reconvene tomorrow and we will permit you to speak up to the full 20 minutes allotted for such public comment.

But I want to go through the list and determine whether or not there are people that would prefer to speak today. And if so -- if they are capable of doing so within a five-minute speaking period, then you will be given an opportunity to speak today and you will not have to return tomorrow.

And so what I'm going to do is go down this list, as I said, and call out your name. And if you affirmatively indicated that you're willing to testify today for five minutes or less, you may come forward and testify. You'll be sworn in, your testimony will be taken.

If you want to wait until tomorrow and have a full 20-minute period to speak, then I will inform the court reporter -- the reporter that we have today that you have decided to hold over till tomorrow. Because obviously will not be up here to speak in the microphone and he's not necessarily going to be able to hear you very well.

So that's how we will conclude business today. And that way at least we can avoid just immediately adjourning and losing the opportunity for some people to speak; and instead utilize a half hour or 45 minutes to get that testimony, fill out the hearing record and give the Department a full record for rendering a decision in this matter.

So let me start with, I think, Joaquin Contente.

MR. CONTENTE: Yes.

HEARING OFFICER ESTES: Are you willing to testify today within five minutes?

Would you please come forward.

Before I swear Mr. Contente, also note that if you have a written statement prepared and you feel confident in doing so, you can go over the high points of your statement, and the full statement will be entered into the record for consideration by the Department, as was partially the case with Mr. Jeter earlier today where he was able to speak and present about 70 percent of his statement. But the full statement is part of the hearing record.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. CONTENTE: Yes.

HEARING OFFICER ESTES: And could you please state your name and spell your last name.

MR. CONTENTE: Joaquin Contente, C-o-n-t-e-n-t-e.

HEARING OFFICER ESTES: And could you identify the organization you represent.

MR. CONTENTE: California Farmers Union, and I'm the President.

HEARING OFFICER ESTES: And could you describe the number of members in your organization.

MR. CONTENTE: In the State we have about 2500 members, and nationally we have about 300,000.

HEARING OFFICER ESTES: And could you describe the process by which the organization approved your testimony today.

MR. CONTENTE: We basically have left it up to myself to comment on the brief subjects that I'm going to cover.

HEARING OFFICER ESTES: Okay. Certainly. Proceed.

Do you have a written statement for entry into the record?

MR. CONTENTE: Actually I don't have an official written statement. Just some notes here.

HEARING OFFICER ESTES: That's fine. I just wanted to make sure that we had it into the record if you wanted to submit it to us.

All right. Please proceed with your testimony.

MR. CONTENTE: I thank you and members of the panel for the opportunity. As I said, my name is Joaquin Contente, President of the California Farmers Union, representing the National Farmers with over 300,000 members.

I am here to speak to you about the inequities between what the producer receives and the retail price that consumers pay.

This morning at five o'clock I stopped in at a store to purchase some products. One of the products I purchased was this nonfat dry milk product.

If you can pass that down.

That weighs 25.6 ounces and costs $5.98. After adjusting for moisture, the package contains 24.3 ounces of milk solids.

At the price of $5.98 for the package, the consumer is paying $3.93 per pound of milk solids, and the producer receives about $.70 for the solids, or 17 percent of the consuming dollar.

I also purchased a package of cheese, a store brand cheese of natural medium cheddar cheese. After adjusting for moisture, the package contains -- it's a two pound package -- the package contains about a pound and a quarter of milk solids. At the price of $6.49 -- here's the receipts on it.

(Laughter.)

HEARING OFFICER ESTES: Are we to entering these in the record?

MR. CONTENTE: Yes, I think so.

HEARING OFFICER ESTES: Please, members of the panel, you are not to consume.

(Laughter.)

MR. CONTENTE: At the price of $6.49 for the two-pound package, the consumer is paying $5.23 per pound of milk solids, and the producer receives a little over $.80 cents, or 15 percent of the consumer dollars.

Can we address the imbalance between what the producer receives and the retail price that consumers pay?

Does 16 percent of the retail dollar reflect an equitable system?

Section 61802 of the California Food and Agricultural Code states, and I quote, "It is essential to establish minimum producer prices at fair and reasonable levels so as to generate reasonable producer incomes," end of quote.

Does our system reflect true market conditions to all segments, producers, manufacturers, and retailers? Does the current system with the fixed margins at the manufacturing level drive a wedge between producers and retailers?

True market conditions are not conveyed properly from consumer to producer. It is the manufacturing sector -- no -- is the manufacturing sector insulated from the true market signals?

The CDC variable make allowance proposal attempts to address these inequities through the addition of market signals to the manufacturing sector. CDC's proposal to make the manufacturing allowances variable will bring equity by rewarding manufacturers when the price is equitable to producers. And when the market is oversupplied, that market signal is also conveyed to the manufacturer.

California has been and could continue to be the national leader in the standards and pricing issues. The introduction of the variable make allowance to our pricing system would begin to address the imbalance between what the producer receives and the retail price that consumers pay.

At this time I would also like to testify in support of other components of the CDC petition, calling for CDFA to update the make allowances, yields, and transportation adjustments to reflect current CDFA studies; floor the commodity prices at the higher of the market price or the federal support purchase price as called for by the CDWA petition; and include the whey skim value in the 4b price formula.

I also would like to request the opportunity to submit a post-hearing brief.

And I thank the panel for the opportunity.

HEARING OFFICER ESTES: Your request to submit a post-hearing brief is granted.

Does the panel have any questions for Mr. Contente?

There are no questions.

Thank you for your testimony today.

(Applause.)

HEARING OFFICER ESTES: Before you proceed with the next witness, giving that it's kind of late in the day, we would be appreciative if you would keep your applause down or do so somewhat briefly. We understand that you enjoy some of the speakers, perhaps not others. But if you could kind of do so -- I don't want to necessarily terminate your ability to do so, but if you could just do so briefly. And please don't whistle.

(Laughter.)

HEARING OFFICER ESTES: Our next person is Brenda Knutson of the California Dairy Women.

Are you willing to testify today within five minutes?

MS. KNUTSON: Yes.

HEARING OFFICER ESTES: Please come forward.

MS. KNUTSON: I'm Brenda Knutson. I am a member of the California Dairy Women. But I'm really here just testifying as just -- my husband's a dairy farmer and I'm his wife. And I'm just going to give you the best I got in five minutes.

HEARING OFFICER ESTES: Okay, great. Let me first swear you in.

(Thereupon the witness was sworn, by the
Hearing Officer, to tell the truth, the
whole truth and nothing but the truth.)

MS. KNUTSON: I sure do.

HEARING OFFICER ESTES: And could you please state your name and spell your last name for the record.

THE WITNESS: Brenda Knutson K-n-u-t-s-o-n.

HEARING OFFICER ESTES: And from what you've just said, you're here testifying on behalf of yourself and your awe family, is that correct?

MS. KNUTSON: Yes.

HEARING OFFICER ESTES: And so I guess we don't really need to get into how you got your testimony?

(Laughter.)

MS. KNUTSON: No.

HEARING OFFICER ESTES: All right. So please proceed.

MS. KNUTSON: You know, with California Dairy Women, you know, the cost of production is absolutely crucial to keep your family going. And I think we all know that. And I think what Linda had to say was just right on.

You know, we have environmental, we have cow comfort to deal with, we have paying bills. And you can't do that without the cost of production.

You know, I know within the last 12 months our personal business has not received cost to production. And I think Linda had it at $12.98. When I got it, I got $12.89. I probably was a little dyslexic, but we'll work with that.

Well, you know, we have to contain our water. We all know that. We get big -- and that gets off the property. You know, all these guys, they all take tests to use chemicals. There's nobody out there that's stupid.

When they -- they go out and mix them, they take tests.

And then OSHA came on to our property, and we got informed that we get to put life jackets around our lagoon. So I'm up, I'm buying life jackets and I'm getting them around. Well, I think everybody from San Francisco to Lake Tulloch realizes we have life jackets. They just run on by J&B Dairy Sporting Goods and pick them up on their way out to the lake. But that's all part of business. That's all figured into the, you know, cost of production. That's what it's all about. They just happen.

And we always talk from birth of a calf is touchdown to the springer, which is going to have the calf. And you have to -- right from the beginning you have to have healthy animals or you're out of business. You've got to have the clean birthing areas. You've got to have them fed. You've got to have an area where they can kick up their heals. And those little calves, they want to kick up their heals, believe me. We know that. And, you know, that all takes money. It takes cost of production to be able to supply that.

And my husband -- his father was also a dairyman. And, you know, you guys, four o'clock in the morning with a flashlight and you're out there checking those little hutches, and you see the little calves. And John's dad says, "Well, wait a minute. Back up. There's two in this hutch." And it's John. And at five years old he's in there with this little baby calf. And I always wondered, is that injected into the veins here? How does someone love dairy that much? I don't know. But they do.

And one day I'm walking in. And its' -- we got our paycheck and we're going to pay the bills. Very sad day. And I walked in. I say, "Okay, honey, today's the day. We got to pay our bills." And you want to know the response? The response was, "How am I going to pay the bills? How is it going to happen?" He says, "How do you want me to do it? What have I got to do it with? We don't have cost of production." I'm sorry, John.

You know what I saw? I saw despair. Have you guys ever looked into the face of despair? It's ugly. I don't want you to.

It's ugly.

I'm sorry.

But I know, Bill Lyons came to the California Farmers Union and he spoke. And he said, "You know, what's going on here you guys have created?" And he's right. But we want off the cross now, and give the wood to somebody else. We're here because we know it can be changed. We need cost of production. And I think half the people here will agree, we need cost of production to be able to survive.

That's it. I'm so sorry.

(Applause.)

HEARING OFFICER ESTES: Mr. Van Vliet, you're willing to testify within five minutes?

MR. VAN VLIET: Yes.

HEARING OFFICER ESTES: All right. Please come forward.

MR. VAN VLIET: Too busy to have to come back.

HEARING OFFICER ESTES: Well, we definitely want to take your testimony today. So if you're able to do so within five minutes, we want you to come forward and speak.

MR. VAN VLIET: Appreciate the opportunity.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. VAN VLIET: Yes, I do.

HEARING OFFICER ESTES: And could you please state your name and spell your last name.

MR. VAN VLIET: Name is Carl G. Van Vliet V-a-n V-l-i-e-t.

HEARING OFFICER ESTES: And could you please identify the organization -- do you represent an organization?

MR. VAN VLIET: Yes.

HEARING OFFICER ESTES: And could you state --

MR. VAN VLIET: Well, I say yes, but -- I don't know, officially or unofficially?

HEARING OFFICER ESTES: Or are you a member of an organization?

MR. VAN VLIET: I'm a member of several.

HEARING OFFICER ESTES: Okay. If you wish to, do you want to state those for the record.

MR. VAN VLIET: I'm a member of California Dairy Campaign. I'm also a member of the Western United Dairymen.

HEARING OFFICER ESTES: But you're here speaking on your behalf?

MR. VAN VLIET: Basically as a personal testimony.

HEARING OFFICER ESTES: Okay. Please proceed with your testimony then.

MR. VAN VLIET: Thank you.

Thank you, Department of Food and Agriculture to testify today.

My name is Carl Van Vliet. I'm a fourth generation dairy farmer from San Joaquin Valley. I thank the Department for having this hearing. I am a producer. I'm a small, but have a great God who has sustained my family of five and work force of four families.

The last year has been very tough. And times look impossible, with 20 percent below cost of production. The cost of production for plants due to energy costs rose, has been -- I've got to keep this straight here.

The cost of production for plants due to energy costs has been forced too high for too long. It came at a time when producer prices were falling below cost of production.

Every month I send out an average of 35 large bills to associated businesses. I thank Western United for their homework and calculations. However, I'm concerned that this is not enough increase to producers at this time.

The dairy has to buy and/or rent dairy facilities. The dairy pays for the feed, the dairy -- the labor. The producer pays for the transportation for the milk, versus our commodities we paid for the transportation. We paid for the processing, which is a make allowance. And we paid for the advertising.

So sometimes my question is, well, we paid for most of the stuff and they get all the good stuff. They get the money, you know.

We just -- anyway, move on.

Currently records show plants making huge profits due to low cost of commodities or milk products. The variable make allowances encourages plants to try to keep milk prices up versus the regular make allowance encourages plants to lower prices to have cheap milk, resulting in more profit. Also encourages all plants -- the variable make allowance also encourages all plants away from cheap uninspected imports.

HEARING OFFICER ESTES: Mr. Van Vliet, you do have three more minutes.

MR. VAN VLIET: Okay. Thank you very much.

The variable make allowance solution. The concept of the variable make allowance uses the cost of production of milk as one of its factors in determining the make allowance. Producers operate at a very competitive capitalistic environment on a daily basis. Everyday producers make decisions to improve the competitive and risky atmosphere that they operate in. Cost of production are monitored and the constant drive to improve on those costs is a daily endeavor. But this is an essential -- this is the essence of capitalistic system which we have embraced in our American way.

Plants are no different than producers in regard to facing costs of doing business. In order to be able to operate, obviously these costs must be accounted for and covered by the plant to survive in this capitalistic system.

The other main justification for the variable make allowance is the price producers receive for their milk, including the risks in this competitive system. Capitalism's basic concept uses supply and demand or market conditions to monitor or establish the value of goods or services. Producers are operating by these concepts as the milk they sell is affected by the supply and demand element. Producers make adjustments to those signals in order to survive the risk of doing business.

Plants, however, operate in a regulated system. That isolates the plant from operating in the same capitalistic environment. The producers are forced to operate in it.

Producers are not protected from receiving less than the cost of producing their milk. In fact, the support prices are over 20 percent below cost of production. Incredibly, in the fall of 2000 the milk price fell below $9.90 support price, surprising many who believed this would not happen.

The current make allowance system decouples plants from contributing to the decision-making process that must occur from all segments of the industry in order for the fiscal well being of the industry as a whole.

Decisions of how much product is needed by the markets are not made by producers, but by the plant operators. That desperately lacked the link to receive a signal by the markets. This communication to the markets is essential to maintaining a proper balance of supply in order to receive the needed value for the products. Without this vital link to the markets, we will continue to cause havoc such as the futile attempts by the U.S. Secretary of Agriculture to adjust the till that cost producers in California over $150 million a year ago.

The CDC variable make allowance proposal will bring much needed missing element to the table of California pricing system. Plants will be participating in the market atmosphere more completely. The element of supply now becomes not just a producer issue, but also a factor affecting the fiscal well being of all plants. After all, this is how manufacturing plants for cars and gadgets operate.

HEARING OFFICER ESTES: Mr. Van Vliet, your time has expired. But if you could just kind of briefly sum up what you'd like to present to the panel.

MR. VAN VLIET: I heard many times some of the plants' operators, say, you know, "Well, you know, we understand how the dairy producers are hurting, and we want to help. But we want it to be done by the market." Well, every time, you know, those same words kept on ringing, you know, market, they want market. It's almost like they want market driven. But as long as -- I have an article here too. And, you know, it all hits us. It says, "Too much milk. Too much powder milk." Well, you know what happens, you know, as long as they keep on getting paid for it, "bring on more milk, bring on more milk. We could use more milk. More milk that we run through our plant, the more money we make." They're not sending any signals to the dairymen saying, "We've got too much milk. Cut it back. We can't make any money on that extra milk you're sending."

So they need to send -- they need to have some responsibility to send that signal back to the producers who are sending the milk to the plants. They say, "Well, you reported for a thousand gallons. You know, you're going to sell 1200. We'll take" -- you know, this is how it is in other places -- "you send that extra 200 gallons, we're not going to pay you for that." Well, then we could make that decision whether or not -- well, we can dry some cows up, we could feed less grain. We could do a lot of things.

Anyway, I just, you know, feel that the processors have responsibilities in flooding the market with too much milk. And they want to keep on putting it on our back and saying it's our fault.

HEARING OFFICER ESTES: All right. Well, thank you.

Oh, Mr. Van Vliet, don't disappear yet.

Do we have any panel questions for Mr. Van Vliet?

All right. Thank you very much.

(Applause.)

HEARING OFFICER ESTES: Next we have Michael Brown.

MR. BROWN: I'd prefer to wait till tomorrow.

HEARING OFFICER ESTES: Okay. We will certainly do that.

We have William Van Dam of the Northwest Dairy Association.

MR. VAN DAM: I'll wait.

HEARING OFFICER ESTES: Okay. Tomorrow.

Okay. We have Dr. Wade Havens, I believe, with Lander Veterinary Clinic.

Okay. He went home.

We have Tim Padrozo, NFO.

He went home.

All right. We have Scott Hofferber, is that correct:

MR. HOFFERBER: Yes. I'll defer till tomorrow.

HEARING OFFICER ESTES: Tomorrow. All right.

We have David Inman from Hilmar California.

MR. INMAN: I'd like the opportunity now.

HEARING OFFICER ESTES: All right. So you're willing to speak within five minutes?

MR. INMAN: Yes, sir.

HEARING OFFICER ESTES: Please come forward.

(Thereupon the witness was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. INMAN: Yes, I do.

HEARING OFFICER ESTES: And could you please state your name and spell your last name.

My name is David N. Inman, I-n-m-a-n.

HEARING OFFICER ESTES: And are you here to testify on your own behalf today?

MR. INMAN: Yes, sir, I am.

HEARING OFFICER ESTES: All right. Please proceed with your testimony.

MR. INMAN: Okay. I'd like to thank, Mr. Hearing Officer, members of the panel, for this opportunity especially since I wouldn't have had the opportunity to come tomorrow.

My name is David N. Inman. I am a new dairyman, started in July. I am a field representative for California Dairy Campaign as well and a member as well.

I'd like to show my support for the California

Dairy Women's proposal and petition as well the CDC petitions, adjustments.

I'd like to say that I am a true believer that the variable make allowance can be an important asset to this industry, bringing producers as well the processors together, which we seem to have done in this room. However, we're not negotiating for a better life style for all of us.

There were several testimonies today that said that the milk program was a detriment to our way of life or a detriment to our future. Personally, as a dairyman, I cannot survive without it. I use the efficiency factor as this excuse that processors tend to use about an end as well as people buying the products that our processors are producing. They need to get more efficient. Gentlemen, we've gotten as efficient as we can get. We have a world market price of $6.50. And there's not a producer in this room that can produce it for that price. So if they keep looking to world markets and use that as a justification to bring our price down, in order to compete in a global economy, it just can't be done.

Fortunately I have slave labor on my dairy. I have three kids and a wife that help me out. And so I'm able to take advantage of certain aspects that maybe some people aren't entitled to. Plant manufacturing allowances as they currently are piecework. They are not market oriented. They are simply a justification to gain revenue, and at the same time are a detriment to my milk price.

Without -- several of the gentlemen here that have testified have been on record in federal testimony and state testimony as well that we need a $9.90 support price. But a support price is not good unless it's implemented as a floor. It's like currently we have a safety net that's laying on the ground and it doesn't provide us any protection. A $9.90 support price or an implemented floor price of $9.90 would keep everybody continuously on a level playing field. It's the federal support price. And we know that the CCC will make those purchases. So there is a market for it.

We're an area where we could -- we have accurate data, yet we continue to see our costs of production stated on Department's newsletters. Yet the plants' cost of production we have to wait for certain audits and have them requested. I request that both of those be compared and sent out on the monthly newsletters.

There's been a concern about bathtub cheese being made in this state, cheese that's made illegally. Well, it shows that the black market cheese has value. But we have some large bathtubs in legal plants that are being used in which illegal components are being used to standardize cheeses, which this Department was given proof of back in March of last year.

Cost of production index auditing plants. You know, like I said, it would be nice if we had that information.

There's also made mention -- could you tell me my time please.

HEARING OFFICER ESTES: Yes, you have two minutes.

MR. INMAN: Thank you.

Investment in California plants. Lately it seems like our make allowances allowed us to build bigger plants, not encourage more plants to come in.

And I agree with Mr. Jeter. Yes, we need more market. We need more market share. We need to develop new markets for our products. But right now we're just trying to stay alive.

I understand the schematics of putting this hearing together. I was a little bit disheartened about the hearing filibuster that I've seen here today. I've spent all day here listening to the same rhetoric, rhetoric over and over again. And I wish that we had an opportunity to either limit the time -- especially since such a large gathering. I'm willing to do mine in five.

I believe they could do theirs in 15. And force them to stay on the topic.

Also I'd like to just say that under the current laws that are written, we have certain pricing based on certain yields. Mozzarella -- I don't understand how a plant in Lemoore that just fired up can take 600 -- or 6 million pounds of milk and make a million pounds of cheese, based on the yields that are provided by this Department and as well as some of the yields that have been presented here. Now, I don't know if their figures were correct, but this is something that was stated in a tour.

So if we're not directing the -- if our yields aren't reflective of the moisture content, maybe we have some cheeses and some products in the wrong classes.

Finally, I'd like to say in closing, that I understand the position you guys are in. But I want you to look out there and you see the dairymen that have come here. They're interested because they probably got kicked out of bed just like my wife did this morning and said, "You got to go do something about it, at least make the stand."

We're going backwards, gentlemen. And I know it's not your fault. But let's look at controlling illegal imports. Let's enforce our standards.

And to answer one gentleman's testimony here. He's worried about where the other hundred loads come in. We have documented proof that 600 loads a day milk equivalent are coming in as imports, and some of those are illegal.

So if we can do a better job enforcing, increase possibly work on the tariffs issues and work with the federal government as well -- I understand we're in a separate order -- I think that we would have some type of a response in some more of a knowledgeable approach. I'm not here to say, you know, I want my way. I'm offering solutions. And I'd be willing to help you in any way.

I'd also like to take this opportunity to challenge every processor, trade association, dairyman in this room: Let's get those milk chugs into our schools. I live in a town in Hilmar where there's 25 cows per one man, and my high school doesn't have a chugs machine. And I've asked for people to help finance it because I can't afford it myself. But if we could take in one school at a time -- let's take our kids back, and we'll sell some more milk and we'll all get a price for it.

And I'd like to encourage anybody who wants to help or would like to, call me, E-mail me. But you can get ahold of me through CDC.

And I'd like to thank you for this opportunity.

HEARING OFFICER ESTES: Do we have any panel questions for Mr. Inman?

Thank you very much.

MR. INMAN: Thank you.

(Applause.)

HEARING OFFICER ESTES: I believe I have Tito Rabello NFO.

Is Mr. Rabello here today?

He appears to have departed.

Sharon Hale from Crystal Cream and Butter Company.

MS. HALE: I can wait till tomorrow.

HEARING OFFICER ESTES: All right. We'll certainly do that.

Then I have Darwin Ribiero from Albus & Ribiero Dairy in Modesto, California.

I guess he's gone.

Then we have Jim Gruebele.

MR. GRUEBELE: Wait till tomorrow.

HEARING OFFICER ESTES: All right, fine. We'll certainly look forward to it.

(Laughter.)

HEARING OFFICER ESTES: You'll have to address that through regulations.

And, lastly -- well, I think we have a few more here.

We have Sue Taylor from Leprino Foods.

MS. TAYLOR: I'll wait till tomorrow.

HEARING OFFICER ESTES: Tomorrow.

And I believe I got -- Candace, did you bring another sheet up to me?

Let me see where I placed it here. There's one or two more names I need to find.

Oh, yes. Jeffrey Vanden Heuvel of the Milk Producers Council.

MR. VANDEN HEUVEL: Tomorrow.

HEARING OFFICER ESTES: Okay, tomorrow.

And I have Carl Souza, White River Dairy.

MR. SOUZA: Mr. Inman basically said everything I wanted to say in a nicer way. But I appreciate the time.

(Laughter.)

HEARING OFFICER ESTES: All right. That's an excellent model for future testimony.

(Laughter.)

HEARING OFFICER ESTES: And I actually do mean that sincerely. I think its very helpful. And the point does get across when people make it clear.

MR. SOUZA: No sense in beating a dead horse, right?

HEARING OFFICER ESTES: And I have Joe Perreira, I guess.

Joe Perreira.

All right. And you're willing to speak in five minutes today, sir?

MR. PERREIRA: Yes.

HEARING OFFICER ESTES: All right. Please come forward.

You have the honor of being the last witness of the day.

MR. PERREIRA: Okay. My name is Joe Perreira P-e-r-r-e-i-r-a.

HEARING OFFICER ESTES: All right. Can I swear you in first.

MR. PERREIRA: I'm going to testify like a consumer.

HEARING OFFICER ESTES: All right. Well, let me -- do you swear or affirm to tell the truth and nothing but the truth today?

MR. PERREIRA: Yes, I swear.

HEARING OFFICER ESTES: And I believe you just stated -- Mr. Reporter, Mr. Peters, you got his name for the record?

All right. And you're on your own behalf?

MR. PERREIRA: Yes, I'm on behalf of them and my behalf. That's the reason I came up here.

HEARING OFFICER ESTES: Okay. Them being?

MR. PERREIRA: Yeah, the consumer. But I want to testify for -- on behalf of the dairymen. That's the reason I come up here. If not, I'm not testifying.

HEARING OFFICER ESTES: All right. Please proceed with your testimony.

MR. PERREIRA: Okay. I'm Joe Perreira. I have a dairy before. And I sell my business about three years ago because I first sell -- my health condition. Why the health condition forced me to sell? Some like -- we're here, that woman here that got emotional, that's what happened to the dairymen, the way it is. The milk price -- a lot of families, you got the crisis at home because all the stress life, all the pressure you go through because he not to receive what is supposed to receive for his product.

He cannot point -- the dairymen and the farmers, these the ones produce the food for us, for me, for you, for all of us, here, for the world. But you come and -- if you want to buy the food for his own family, he can't go buy it.

This is not right.

And we hear yesterday that the President, George Bush, said you have to stimulate the small business. We need more small business. How? He said that. But the politicians, what we can -- I mean we have to be honest, we got to put the cards on the table. I'm not here for to hear from your guys, the politicians. But we have tell them the truth.

And about 10 years ago we got David, Mr. Gossard. That's the two I know is on the panel. We got all the same politician about 10 years ago. We hear -- all we here today -- we hear all the same questions, just come out here and come out the same. We see not -- if put out this on the squeezer, we squeeze but no juice come out. That's the final thing.

This is simple. What dairymen is need and all the farmers, he needs not the cost of production. He needs above the cost of production because he deserve it.

(Applause.)

MR. PERREIRA: Because he's worked real hard to put the food on the table. Some like I said, on the end, you want to go buy at this time food for his own family, he can't.

One other thing. That's a stress. And like that woman said -- it's come to me, maybe that's why I got open got hear surgery because this. See, because you -- when he come home, he see the check. The check you receive, when is going to make the payments is not got enough for cover all the bills he have to pay. When the telephone is ringing because is the truth -- when telephone is ringing, he's scared to answer the telephone because most of the times he answers the telephone, you don't have to -- you don't have -- because when he's answered the telephone, he's so scared because that's the guy -- lights or the --

HEARING OFFICER ESTES: Mr. Perreira, you have two more minutes. And I'd just admonish the audience, to the extent Mr. Perreira, then his time is reduced.

MR. PERREIRA: I'm almost done.

He's so scared to answer the telephone because when he's answered the telephone, you know -- you know what happened to you when you were a kid. This happened to my a lot of times. When you do it -- things we not supposed to do it because mommy said, "Not do that, because if you do that, we go the police." And the kid becomes so scared, so shaky, the -- every minute is on this position. When he get up in the morning he wondering what to do he's so scared, because the stress life.

Who the ones make this stress? I see it here, that woman is -- that one that got emotional. I see it here some, is be wrong, the processors is laughing. This is not a joke. That's human being here, got involved here. We -- is not the respect to dairymen, of this human being when is got emotional like that. You know why he's laughing? Sorry, I got a little aggressive, but we have to. You know why he's laughing? Because the government -- our government here in the United States -- I said because I'm a citizen now -- has allowed maybe 4 or five processors has got all the packets full. When he stay away from the people who's worked real hard. This is not right.

That's what happened. That's why he's a stress life. That's why some times when -- I got the friend of mine, who told -- got home, sometimes my wife is scared talk to me because I got so stressed, that I got so aggressive. I believe that.

Why? Because the dairymen is not receive what is deserved -- not paid what is deserved what the kind of work put on this. That's the people is work out -- that's the more honest people in the world, that's the dairymen, Ninety-five percent of this people here is all honest people. They Like to pay the bills. If not pay the bills is not because he's not -- he's not crooked people. That's because the processors is not paying them what is supposed to pay.

HEARING OFFICER ESTES: Could you wrap up your remarks now, Mr. Perreira.

MR. PERREIRA: So that's what I have to say to all this people here. And one other to tell them before I -- because guy some confusion. See, one thing a lot time we heard, some guy said, "Oh, the dairy industry, agriculture is no effect to them direct. It's not directly." No, sir. This industry, agriculture, is affect everybody direct, because when you lose your job, that one lose the job, that one lose the job is affected directly. Some like me, I don't have the dairy. But on my conscience, I feel -- come over here to testify because I still got my income from the dairy. I need that counsel -- they forgot my income.

So that's why I make appeal for the politicians. First, I think that 10 years -- and some, like I said, all this 10 years, I no see nothing change. I think it's time to change something before everybody pay half price.

That's it.

HEARING OFFICER ESTES: Thank you very much, Mr. Perreira.

(Applause.)

HEARING OFFICER ESTES: Do we have any panel questions for Mr. Perreira?

MR. PERREIRA: I take no questions.

(Laughter.)

HEARING OFFICER ESTES: Apparently it's mutually agreed that Mr. Perreira will not answer questions today.

(Laughter.)

HEARING OFFICER ESTES: Thank you very much, Mr.

Perreira, for your testimony.

And at this time we will adjourn until tomorrow. And we will reconvene here tomorrow morning in this very same room at the Holiday Inn at 9 a.m.

(Thereupon the Department of Food and Agriculture Hearing recessed at 5:35 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 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 10th day of February, 2003.

JAMES F. PETERS, CSR, RPR
Certified Shorthand Reporter
License No. 10063