PUBLIC HEARING

STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

AMENDMENTS TO THE STABILIZATION 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

THURSDAY, JANUARY 30, 2003

9:00 a.m.

Reported by:
James A. Ramos

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P R O C E E D I N G S

HEARING OFFICER ESTES: Good morning to everyone. The hearing will now come to order. We're reconvening the hearing yesterday.

For those of you who may have forgotten this is a public hearing related to the petition from the Western United Dairymen requesting amendments to the stabilization and marketing plans for market milk for the northern California and southern California marketing areas.

We also have four alternative petitions. And we received presentations about those petitions yesterday from Western United and the parties that presented the alternative petitions to the Department.

We are now involved in the receipt of public testimony in regard to the petitions, and we are about to conclude this aspect of the hearing today.

The first person that we have in order for testimony today for a period of up to 20 minutes is Michael Brown from National All-Jersey, Incorporated from Reynoldsburg, Ohio. So, you will have up to 20 minutes; so please come forward so I can swear you in.

Also you might note that the reporter that we have today is James Ramos of Peters Shorthand. Again, as I said yesterday, a copy of the transcript of today's hearing will be available for review at the Dairy Marketing Branch here

in Sacramento at 1220 N Street, Room A-247. But if you want your own copy of the transcript of today's hearing for your own evaluation and use, you will have to purchase that directly from Peters Shorthand. I'm sure Mr. Ramos can assist you in that endeavor.

Whereupon,

MICHAEL BROWN

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

HEARING OFFICER ESTES: Could you please state your name and spell your last name for the record.

MR. BROWN: You bet. Michael Brown; it's spelled B-r-o-w-n.

HEARING OFFICER ESTES: And could you identify the organization that you represent.

MR. BROWN: I represent National All-Jersey, Incorporated, of Reynoldsburg, Ohio.

HEARING OFFICER ESTES: And could you describe the number of members in your organization.

MR. BROWN: National All-Jersey is a producer trade association of high protein milk producers. We have 99 members in California and roughly 780 members nationally.

HEARING OFFICER ESTES: And could you describe the process by which your testimony was approved for today?

MR. BROWN: Our Board of Directors establishes a

parameter or policy in which we develop all our testimony within, and then I personally developed our comments based on that policy.

HEARING OFFICER ESTES: All right. I'm going to introduce the written copy of your testimony today as exhibit number 59.

MR. BROWN: Thank you.

HEARING OFFICER ESTES: And please commence with your testimony.

MR. BROWN: Good morning. Thank you for the opportunity to testify at this hearing. Again, I'm Michael Brown, General Manager of National All-Jersey located in Reynoldsburg, Ohio. I have worked in the areas of dairy economics and milk pricing and policy for over 16 years. Prior to my nine years at NAJ I was employed in the areas of dairy marketing and economic policy for Ag-Nomics Research, the Wisconsin Federation of Cooperatives, and the National Milk Producers Federation.

Again, I am presenting my testimony on behalf of National All-Jersey's 99 California members, as well as our 780 members nationally. Also, our California members represent over 40 percent of our members' total milk marketings, and they are located throughout the State of California.

National All-Jersey, or NAJ, is a national dairy

producer organization that assists its members in the marketing of their milk through the development of non-regulated milk pricing and premium programs, and by representing the membership on legislative and regulatory issues in developing milk marketing regulation and policy.

NAJ also provides technical and planning assistance to plants on issues involving milk pricing, and provides market outlooks and milk pricing education information to its membership.

For the last 25 years NAJ has focused most of its resources on end product and component pricing issues. We have also funded research on cheese yield and milk component issues at several different Land Grant Universities.

We believe this hearing in general is a discussion of proper price level rather than what components are to be priced. As a result, we have no overall position on any of the pricing formulas included in the proposals being offered at this hearing.

However, NAJ has been very involved in every federal order hearing involving component pricing, and have always specifically presented or supported proposals that would price the same milk components to both producers and processors.

As a result we are concerned with one portion of the Alliance of Western Milk Producers' proposal which would

add the following language to the California Milk Marketing Branch rules:

Section 300(E)(2)(c) according to their proposal, which I'll state, "When the Department has the capability to do so, cheese manufacturers shall account to the pool for the actual true protein content and actual whey solids content of producer milk processed as determined in 2(a) and 2(b) above."

Because the California Milk Marketing and Pooling Branches are administered separately, we understand that this language would require cheese plants to pay into the pool on a protein and other solids basis, once that becomes technically feasible; but would not require producers to be paid for that protein through the pool.

In effect, it would regulate most of the cheese yield premiums being paid to producers of high-protein milk, and redistribute it based on milk composition for solids-not-fat, as is currently the case in California pooling rules.

We understand that the pooling rules could be changed to redistribute payments based on protein, but that would require a separate hearing, and is, by no means, assured.

We believe that there would be several serious

consequences resulting from requiring cheese plants to pay into the pool on protein while not allowing producers to be paid on the same basis.

One, milk plants that make the best use of high-protein milk could not use premiums to attract that milk to their plants. Cheese and cottage cheese plant efficiency would suffer, and total producer revenue would decline.

Two, producers of high-protein milk would have a strong incentive to become grade B producers and de-pool their milk in following years. Most Jersey producers have little or no quota, and can return a higher income from grade B milk paid on a cheese yield basis than they would from remaining in the pool if their plants were required to pay into the pool on a protein basis, but not pay out the same way. In fact, this would have been true in 2002. The past two butter-powder "tilts" have lessened the recent differences in the class 4a and 4b milk prices considerably, and have made pooling milk less attractive than in the past, especially to producers of high-protein milk.

Three, producers would also be encouraged to seek payment programs in neighboring regions outside the California State Milk Program. While this is perhaps not an issue in the major milk-producing region in the valley, it is very much a possibility; and, in fact, already sometimes happens in the extreme northern and southern parts of the

state.

Four, The Alliance of Western Milk Producers protein payment proposal is inconsistent with their publicly stated goal to develop a milk protein concentrate industry in California. MPC, like cheese, adds value by removing water and lactose from milk solids. It makes little sense to adopt a milk payment program that, through pooling protein receipts and paying them out on a nonfat solids basis, does nothing to encourage producer production of high-protein milk. Such a program especially makes no sense in a state where the majority of the milk supply advocates development of a milk protein industry and also and the greatest use of milk is for cheese.

National All-Jersey believes the protein pricing issue cannot possibly be addressed in the incomplete approach offered by the Alliance of Western Dairymen, but can only be adequately addressed if both the processor payment and producer pool issues are resolved simultaneously.

In fact, we believe that if the California industry decides they want to consider protein pricing as part of their payment programs, they should consider the value contribution of milk protein in all classes of milk, not just 4b.

Just a quick look at the price of nonfat dry milk

and lactose, which is essentially nonfat dry milk without protein or minerals, shows the limited value of lactose. CDFA's own cheese plant data, as discussed in the prehearing workshop, seemed to indicate lactose was as much of a disposal problem as a profit center.

We believe that the true value of dry nonfat dairy products, whether whey, whey protein concentrate, milk protein concentrate or nonfat dry milk, comes from the value of protein, with a lesser contribution from calcium and other minerals.

Thank you for the opportunity to testify at this hearing. I would be happy to answer any questions you may have. And I also request the ability to file a post-hearing brief.

HEARING OFFICER ESTES: All right. Yes, your request for a post-hearing brief is granted.

Now, are there any Panel questions for Mr. Brown?

AGRICULTURE ECONOMIST GOSSARD: Mr. Brown, you didn't directly address the issue of the Van Slyke equation. Would you be willing to answer a few questions about it?

MR. BROWN: Yes, I would.

AGRICULTURE ECONOMIST GOSSARD: Yesterday an issue was brought up, does the Van Slyke formula work in cheese plants that are using concentrated, fortified in-vat with concentrated milk.

MR. BROWN: From our --

AGRICULTURE ECONOMIST GOSSARD: From your experience.

MR. BROWN: From experience, yes, it does. Every cheese yield program that we've developed and administered uses the Van Slyke formula and different permutations. We have some that use a mozzarella formula; most use cheddar. They may use a different fat recovery; they may use a different moisture. But they all use basically the same formula. And I can honestly say, particularly with all the cheddars, they all use -- the protein portion of the formula is essentially the same in every case, which is the same that's been used by the people here proposing the changes.

AGRICULTURE ECONOMIST GOSSARD: Yesterday I asked a number of witnesses the basis for the 0.1 casein lost in whey and the basis for the 1.09 other solids and cheese. Is there a practical theoretical basis for either of those two numbers?

MR. BROWN: Actually there is. We'll start with the 109, and that basically is a factor that accounts for the other solids remaining -- first of all, when you make cheese, if you look at the science of making cheese, casein is what determines how much cheese you're going to make. And then the fat and the minerals and everything else globs onto the casein.

We actually funded some early cheese yield work at Utah State with Tony Ernstrom to help sort of prove that, I guess you could say, or to reinforce it, because the Van Slyke, as we all know, is very old.

And the 109s in that group represents the solids, that's whey, some whey protein solids that may remain in the cheese; also some lactose that remains in the cheese. But it's pretty much a standard factor. In fact, every cheese yield formula that I'm familiar with that we use for cheddar all use 109, whether in Idaho, Wisconsin or wherever.

AGRICULTURE ECONOMIST GOSSARD: And the 109 has been found more accurate than, say, using 108 or 110?

MR. BROWN: It's standard practice. Again, a lot of that early cheese yield work, particularly in Idaho, came out of Utah State research. But I know of no plant personally that has changed that factor. They may change moisture, they may change fat recovery, but they have not changed that factor.

The -.1 factor comes from the fact that it's got to do with casein recovery. Basically what that formula is saying, all the casein but .1 pounds of it per cwt of milk has been recovered in the cheese vat.

Some people use a factor of .96, which can take milk that 3-0-2 protein or 3-2 crude protein comes out to roughly .1. The issue is vat efficiency. And the more

protein you have in the vat, as you add casein to a vat of cheese or protein, which, of course, contains -- milk protein, you lose -- the amount of casein that's lost in the whey is actually pretty constant at that point, one pound. Again, a lot of that comes from Utah State research, and then again, plants have continued to adopt that.

And that's one of the reasons why you concentrate milk. Because if you add protein to a vat, the percentage of casein lost in the whey drops as protein tests of the vat goes up.

So one of the things when I'm marketing my milk to the plants trying to develop a premium program, vat efficiency is a very big part of some of that advantage.

Another place where I've seen that a lot is in cottage cheese. And because cottage cheese is -- cottage cheese, by the way, is basically casein curds. I mean that's what it is, it's casein and water. And you definitely, with lower protein in vats, you also have a problem with shedding of the curd and you have trouble with curd quality. And so that's why a lot of your cottage cheese is also fortified for the same reason.

And it's just that that loss tends to be a constant rather than vary with tests. So if you have 4 percent protein milk with 3 percent protein milk, you're going to lose roughly a tenth of a pound of casein in the

whey per cwt of milk, regardless of that protein test. From my experience.

AGRICULTURE ECONOMIST GOSSARD: Okay, so while some people use a 96 percent recovery on the casein instead of the .1, from your experience the .1 is a much more accurate representation?

MR. BROWN: I think it is more accurate, from my experience, and certainly from industry practice. That being said, in the normal range of protein milk it isn't that big of a difference. But when you're dealing with, like in our case, high solids milk, if you're going to really fortify a vat, that difference can be quite significant.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

MR. BROWN: Thank you.

SENIOR AGRICULTURE ECONOMIST ERBA: Mr. Brown, on page 3 of your testimony you speak to some consequences of having a system in place as suggested by the Alliance of Western Milk Producers, and point to you speak of high protein producers having incentive to de-pool their milk, become grade B producers.

Have any of your membership done that?

MR. BROWN: They have in the past. They haven't this last -- there's no incentive to now unless they're

worried about the 4b price being lower than 4a, overbase being lower than 4b.

They have in the past more because of an ease of use. A lot of our -- as a percentage, the large percentage of our producers are at grade B in northern California. I'm not sure it's the largest volume of milk.

But, looking at that, and I've actually just been doing some work on that northern California area, looking at some marketing options for them. What we find is that the 4 cheese yield formula, and they have a higher make allowance there than they do here in the Valley because there's less competition, the 4b cheese formula outpays the overbase even last year by a significant amount of money.

And if you take away the ability for a plant to pay a cheese yield premium to grade A milk because they're forced to pay that protein as part of the pool, they aren't going to have additional revenue to pay that to producers. That premium will change, and so those producers, looking at their net revenue, are going to be ahead just to go grade B and get the cheese yield formula.

Because that premium is much less an advantage of being overbase -- I mean much greater. In fact, it's triple last year.

SENIOR AGRICULTURE ECONOMIST ERBA: Just based on your membership, can you give me an idea of how many would

have been doing this over the past few years, a percentage?

MR. BROWN: Oh, well, let's look at -- pretty small. Again, it hasn't been an issue because they get that premium based on the 4b price, even if they're pooled. So it's pretty small. In fact, because 4a has been so high the last several years we've had some people become grade A again.

Every November and December I get calls, mostly from Humboldt County, on whether I should be grade A or grade B this year. And this is the first year I've said I don't think it matters. That's been my personal advice. We provide milk marketing advice, and said, do what you see appropriate. It's going to cost you $15,000 to become grade A; this isn't the year to probably worry about it.

But where I do come down, where the issue is for us on this, Mr. Erba -- Dr. Erba, would be if you make -- if the plant is ineligible -- say, for example, our cheese yield formula is going to vary. But in the case of northern California, our producers' average cheese yield premium is going to be somewhere between 90 cents and $1.50, depending on the milk price, because that's all related.

And if the pool advantage is going to be 20 or 30 cents, and if you do pool you can't get a cheese yield premium, it's pretty simple arithmetic that folks are going to be pooling. And I think that they -- and I'll advise

them to. My goal is to improve their revenue the best I can. And that would be their best bet.

SENIOR AGRICULTURE ECONOMIST ERBA: Sure. Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: I just have a couple questions. On that same point that Eric was just asking a question on, you make a statement: Most Jersey producers have little or no quota." On what basis, or what factual basis do you have?

MR. BROWN: I know of one that has more than 5 percent of their milk supply in quota.

DAIRY MARKETING BRANCH CHIEF IKARI: Of the Jersey producers --

MR. BROWN: That are my members.

DAIRY MARKETING BRANCH CHIEF IKARI: Yes, okay.

MR. BROWN: I will be honest with you, I have not done a formal survey. I also know from the standpoint of, I guess I have more experience with that in northern California, because we're looking at some milk marketing options that may involve being grade B, I have none in northern California that have more than trivial amount of quota.

DAIRY MARKETING BRANCH CHIEF IKARI: You haven't any idea of how many of the Jersey producers, what percentage are members of your organization?

MR. BROWN: I don't. Just based on what we know, and I guess you can look at DHI information, I would say it's probably, there are members probably 70 percent of the milk value, and probably 40 to 50 percent of the Jersey producers. That's a rough guess. I don't want to -- I mean if you want me to look into that, I'll try to come up with a better number. But that would be a wild guess just based on what I know about this industry.

DAIRY MARKETING BRANCH CHIEF IKARI: We talked a lot, or you --

MR. BROWN: That's California.

DAIRY MARKETING BRANCH CHIEF IKARI: That's California?

MR. BROWN: Yes.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay.

MR. BROWN: It's actually higher here than in most parts of the country. Our membership percentage.

DAIRY MARKETING BRANCH CHIEF IKARI: We talked a lot about protein, and your testimony refers to protein and cheese. What other dairy products are paying premiums, fluid milk processor paying premium for protein?

MR. BROWN: Not here, no. Where we see protein premiums or -- premiums, and again it depends where you are in the country, is mostly, of course, as you would guess, it would be cheese; some degree cottage cheese. We actually in

the case again, we're talking overall premiums here. Fat, it's ice cream in the midwest. Actually our best market for milk right now is in Iowa, the ice cream plant, because they've got such a big fat premium. Because look at the cost of bringing fat from the west coast.

But it's mostly cheese. But keep in mind half the U.S. milk supply now is used in cheese. That's a huge market for us. And we've been fortunate, we've experienced growth because of that, because of that demand for protein, and payment for it.

So most of it is cheese. We have no, at this point, plans for fluid plants on protein. We do have fluid plants in the federal order system that buy Jersey milk because under the federal order program they pay fat-skim, and they -- that protein at no additional charge. And they'll pay a plant premium to bring in that Jersey milk, but they don't pay a specific protein premium.

We have several. It actually has caused me some problems, plants that have cherry-picked high protein milk producers for fluid because it gives them a better product.

DAIRY MARKETING BRANCH CHIEF IKARI: How do you reconcile producers, and I understand that you're there to help them get as much income as possible, but how do you reconcile that the producers that have high protein who are shipping to cheese plants are getting premiums, but at the

same time they could be drawing, or in some cases, withdrawing from the pool and getting those revenues from the class 1, 2 and 3?

MR. BROWN: Well, every producer who wants to pool, and of course you're must stricter on that in California than most federal orders, has the ability to draw from the pool.

We get premiums because our milk adds value. If you take Jersey standard test milk versus 3-5-8-7 milk, and I'd like to comment, too, it's impossible to do cheese yields with SNF numbers, because SNF doesn't make cheese, protein and casein make cheese, but that's what we have for data in California, so we struggle with it. I'm very appreciative that Dr. Tong at least did a nice research project, is a little better grasp of what we have.

We add value. Our milk yields about 20 to 25 percent more yield out of a vat than standard test milk does. Also our milk, as a result of that, and of course there's more revenue -- your system, as it currently exists, doesn't recognize that added value.

I'll also note from experience to plants buying powder. Cheese plants are getting much more sophisticated when they're buying dry ingredients on what the content is. For example, I work with one plant in Oregon that gets a premium for their nonfat dry milk because it's higher

protein.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, let me ask a question.

MR. BROWN: And so -- so that value is there. And capturing it in the pool to me isn't near the issue of capturing it and then not reimbursing it to the people that are contributing to that higher value.

DAIRY MARKETING BRANCH CHIEF IKARI: I understand that point. Maybe I should ask the question this way. Is there some obligation, if you're going to take the pool blend price whether it's quota or overbase, to serve the higher usages?

MR. BROWN: Well, what's a higher use? I mean --

DAIRY MARKETING BRANCH CHIEF IKARI: Well, the class 1 or class 2 is a higher value.

MR. BROWN: No, not necessarily. Not net value per cwt of milk. I would argue that's not the case.

I mean, again, depending on what your class -- in your case, case 2 and 3 price levels are versus class III, when you have Jersey milk that's 25 percent more valuable in class III than your reference test milk, that would mean that, again, depending on the products. Now in cottage cheese, going to Crystal for cottage cheese, yes, I would say that that would be true.

But if it's going -- if you want to maximize

revenue, total revenue in the system, and the greatest added value of that milk is in a protein yield base product, or in a product even, for example, MPC, which is basically a protein product, which of course you don't make yet, but it's certainly under strong consideration, that milk, that's always going to contribute the most value.

It would make little sense to move Jersey milk -- Jersey milk is worth 2.50 more in cheese because of that .6 of additional SNF, which is all protein. And you move that milk into fluid, and say the SNF price is 80 cents; .6, that's 48 cents. You want to maximize producer revenue, it makes no sense to move that milk into fluid. That milk will maximize total producer revenue at a greater rate going into a cheese vat.

So I would argue it doesn't. And it also frankly works the converse way, the way you price -- milk is priced on 4b in this state overvalues low protein milk.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, how would you --

MR. BROWN: Because -- so --

DAIRY MARKETING BRANCH CHIEF IKARI: How would you respond to the Humboldt's testimony, Mr., what's his name -- Mr. Leonardi, who testified yesterday, about the producer who shipped to a cheese plant to draw a premium? And he was talking about the inequity in that system. I'd like to get

your perspective of that.

MR. BROWN: If a producer produces a product that has higher value shouldn't they be recognized for that? I mean I never thought the idea of regulated pricing, and I don't think you look at it that way based on your price levels, needs to reflect every cent of every value of every pound of milk that's sold. Or frankly, I don't think about pounds of milk, I think about pounds of milk components, because that's where the value is.

I've yet to meet a plant that says, gosh, I need more water. Even fluid plants, particularly in California, don't need more water. It costs money to move water; it costs money to remove water from plants.

So my view is the added value is there, why should not producers be rewarded for that added value. Because your current system doesn't do that.

I think the other question you have, long term, from a policy perspective, and this is one of the reasons again we've had a lot of support because we've advocated protein pricing, but we're certainly too little to do it on our own, we've had lots of friends support us, co-ops, private plants, a lot of who are in this room.

And the reason is is that protein is the component of the highest value in milk. I mean, just look at world markets for any components. Just take a bunch of product

prices and do regressions. You can find out quick what weight goes on protein. It's very very high.

And so it doesn't, to me, make sense to tell a producer don't produce protein, produce SNF, when that lactose is not what's adding value to the products, it's the protein.

So, I am not saying that, obviously reading my last paragraph, I'm not saying you shouldn't price on protein, but I don't think you should discriminate by pooling it and then not letting the producers that contributed that added value, that yield, those total dollars in the system, not being paid that back to producers.

And frankly, what will happen if that happens is that we'll have to de-pool. And I'm not -- I don't think that's the best system. I think it's best to have a system where everybody participates. But we'll be forced to it. And I'll encourage my members to do it. And in some cases I can build outside markets, even -- frankly even the -- if you were to regulate protein pricing on cheese milk and not pay it out back to producers, you'd be the only regulated system in the country ever to do that, to regulate a protein component and not pay it back to producers at that protein rate. You'd be the first time. And I guess I'd have a very difficult time for supporting it.

And second of all, encourage my members to go along with it. Because they're the reason that cheese yield is there. The reason some of the plants in California have 110 percent cheese yield, in the case of one 120 percent cheese yield, compared to average milk is because of that protein from Jersey cows, or Brown Swiss cows, or even high protein Holstein cows.

And to me it doesn't make a whole lot of sense to turn around and tell the producers, and what is by far your fastest growing sector of your industry, that protein doesn't matter. I view this proposal, although I don't think it's necessarily ill-intentioned, I think that I guess I'm quite confident that we would see proposals for pooling that would put protein back to producers. And perhaps from the Alliance, as well. I think it would be dangerous to do that the way your system is set up one step at a time, because it's what, you know, it costs more money to make milk that's high protein. And our system is built to reward that.

We are growing in California. We're, by no means, the majority breed, so I don't think that we're -- frankly, I don't think we're quite as competitive on the farm management side as we need to be. I think we're making great progress there, as well. But, if you want people producing what costs more to make, and protein is the most

expensive component to make, based on most research you're going to look at, then you have to recognize that and pay for it.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay, thank you.

MR. BROWN: Thank you.

AGRICULTURE ECONOMIST GOSSARD: I have a follow-up question. In answer to a previous question you said higher protein in fluid products gives processors a better product. What is the advantage of having higher protein in fluid product for the processor?

MR. BROWN: Well, again, functionality, flavor, fullness of body, particularly in skim products. Again, where I've dealt with this the most is in New York State where when we went to component pricing, particularly since a couple of cheese plants in northern New York, there was a lot of hauling costs to get the milk there, there was one Jersey co-op where the entire co-op is now shipping to a fluid plant in Syracuse.

But I deal with it in the southeast. I deal with it in the southeast all the time. Fluid plants, particularly in the summer, they want those solids because it gives them a better product.

In the case of California it's even a little more -- a couple examples here, Mr. Gossard. In the

southeast it gives them a better product; it gives them a fuller bodied product. Again, the federal standards, and I'm sure you all know, is 8-2-5 for solids. But no one really wants to sell 8-2-5 milk because it's not very nice.

And again, something that has been brought up, too, the ratio of protein -- the relationship between protein and SNF is not a ratio. It's a linear line equation. And if you -- one place you can find that if you go to the upper midwest, federal milk marketing order site, Mr. Sebastian has done a couple different studies looking at composition of milk and looking at the relationships between the components. And the highest correlation is protein to SNF, and it's a fixed number which is 5 -- last year I think it was 5-4-7, surprise, surprise. What is that? Lactose, plus a factor times protein.

And so when you buy high protein milk you get better milk. In California same kind of thing. I think most plants would say that more protein less lactose and my fluid product is better. And we definitely see that, even out here. Fluid plants like Jersey milk when they can get it, although if you're a multi-use company, for example, like Crystal, who by the way has bought Jersey milk for many many years from my experience, they try to use that in cottage cheese, again, because that's where the highest yield advantage is.

The other place we see it is in ice cream because you can use more whey in your ice cream mix if you have high protein milk. Because your protein-to-lactose ratio is higher. One of our jokes at Jersey is that all this talk about -- protein concentrate, and we certainly agree that's a very serious issue, the definition is 40 percent protein. That comes out of our cow. We make MPC. You take the family of Jersey milk, you got about 40.5 percent protein.

So, you know, plants figure out how to use that to their best advantage. And particularly I would argue in the federal orders they don't pay for it. At least directly. We have a lot of competition for our milk between fluid and cheese guys. And sometimes it depends on the market. Sometimes it goes to the cheese market, sometimes it goes to fluid, depending who's going to pay the most for it.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

HEARING OFFICER ESTES: Do we have any more questions? It seems like we do not. Thank you for your testimony today.

MR. BROWN: Thank you.

HEARING OFFICER ESTES: Next we have William Van Dam of the Northwest Dairy Association.

Whereupon,

WILLIAM C. VAN DAM

was called as a witness herein, and after first having been

duly sworn, was examined and testified as follows:

HEARING OFFICER ESTES: Could you please state your name and spell your last name.

MR. VAN DAM: My name is William C. Van Dam; last name is two words, V-a-n D-a-m.

HEARING OFFICER ESTES: And could you identify the organization that you represent.

MR. VAN DAM: Today I'm representing Northwest Dairy Association.

HEARING OFFICER ESTES: And could you describe the number of members in your organization.

MR. VAN DAM: Northwest Dairy Association has approximately 600 members operating in Washington and Oregon, and actually five of them are in California. And those are shipping to the Pacific Northwest order. And another approximately 100 members in the western order located all of them in Idaho -- I'm sorry, Idaho and a few in eastern Oregon.

HEARING OFFICER ESTES: Could you describe the process by which your testimony was approved for today's hearing.

MR. VAN DAM: This testimony was produced by myself operating with Doug Marshall, who's Senior Vice President at Northwest Dairy Association; and with additional help from Dan McBride, who provides statistical

help.

HEARING OFFICER ESTES: I have a copy of your testimony today, as well as an appendix. And I'll introduce the testimony into the record as exhibit number 60, and the appendix shall be introduced into the record as exhibit number 60(a).

And so please proceed with your testimony.

MR. VAN DAM: Mr. Hearing Officer, if I might, if you could give me a ten-minute and a five-minute-from-the-end warning?

HEARING OFFICER ESTES: Sure. Certainly.

MR. VAN DAM: I've got this feeling that it won't quite fit within the 20 minutes, and there's some stuff at the end I would like to make sure gets into the record.

My name is William C. Van Dam. I am testifying today on behalf of Northwest Dairy Association. NDA is often referred to as Darigold. NDA is a cooperative association which acts as a handler in both the Pacific Northwest federal order number 124, primarily Oregon and Washington; and the western order number 135, which is primarily Idaho and Utah.

Currently NDA ranks as the fourth largest dairy cooperative in this country.

NDA is the parent company of WestFarm Foods which operates many plants in both federal orders. In total,

WestFarm Foods operates four milk bottling plants, four nonfat dry milk plants, one byproducts plant, and one large cheddar cheese plant in Sunnyside, Washington.

It is very unusual for NDA to participate in a hearing held in California, and we greatly appreciate the opportunity to testify today. It is not our intent to make or support any specific proposal. But it will be clear from our testimony the kinds of proposals we believe make the best economic and logical sense.

Primarily we are here to put in the record of these proceedings some observations that we believe are relevant to the long-term success and well being of all dairymen located in the western states.

All producers of milk in the western states are in a similar economic boat. In states where NDA operates, Washington, Oregon, Idaho and California, all produce far more milk and milk products than can be sold to their own populations. Indeed, the combined production of these four states far exceeds the needs of the combined population of the entire region.

The simple truth is that our region must sell large quantities of dairy products to the eastern half of this country where two-thirds of the population resides.

It is, of course, the residual hard storable products that are the easiest and cheapest to move the

distances required. We in the west, those of us in the federal order, as well as those in the California system, must sell our product to the same customers, and we both have to sell all our product.

To further illustrate how similar are the circumstances facing producers in California and Washington, we have used the magic of Mapquest to determine the distances involved in reaching the market.

NDA's cheese plant is in Sunnyside, Washington. The largest single plant in California is Hilmar. The destination chosen for representing the eastern customer base are Chicago, Illinois for the northeastern part of the country, and Altanta, Georgia for the southeast.

You'll note on the table there that from Sunnyside to Chicago is 1971 miles; Hilmar to Chicago is 2159 miles; a difference of 188 miles. The 188 miles on that long of a trip is not a big difference in distances.

I was surprised to see when I calculated up Atlanta, Georgia, that the distance is only two miles apart, showing that we have almost exactly the same distance to reach the same customers.

Some of the many other areas of similarities between California and the dairy production areas of Washington, Oregon and Idaho, which NDA represents, are both have large, efficient dairies, high production per cow,

decreasing class 1 utilization of milk, increasing total production of milk, increasing percentage of milk going into cheese, butter and nonfat dry milk, and relatively large new and efficient processing plants.

This is not intended to be, nor is it, an exhaustive list of similarities. The differences, on the other hand, are fewer, and for all intents and purposes are limited to those caused by the differing market regulation systems.

California uses its own statewide pooling system to regulate their dairy industry; and we are impressed with the way your system works.

The States of Idaho, Washington and Oregon are, of necessity, part of the federal milk marketing order system. We say of necessity because while these states share all the features of relative isolation that allows California to have its own pricing, they are three separate states. And as a practical matter, cannot operate state orders.

The Interstate Commerce clause of the U.S. Constitution is, without a doubt, a very important part of what makes the United States of America a great country. But it does get in the way of local regulation of milk markets.

Participants in the California pricing system have perhaps grown weary of the criticism directed at California

by all other sectors of the national dairy community. We may surprise you by stating there are very important parts of the California system which we, in the northwest, admire and even envy.

First, in your system you can petition for, notice, hold and issue findings for a public hearing at a pace we in the federal order can only dream of.

Second, the issue of producer-handlers has been neatly handled over the 33-year life of your pooling plan. Whereas that issue remains unresolved in the federal orders, and thereby threatens the fundamental purpose of the federal order system.

Third, you have been able to establish fluid milk standards that are progressive, logical and fair to all parties.

And fourth, the item we admire the most is the explicit recognition of the fact that the west is now the residual supply of milk in this country. And that a logical pricing system has to recognize that the cost of moving product to eastern markets must be factored into producer price formulas.

The clearest expression of California's approach to this is your butter formula where a transportation differential of 4.5 cents is deducted from the Chicago Mercantile Exchange price prior to calculating the butter

fat price. Whether the 4.5 cents is the right number or not, some such distance factor is necessary if milk going to manufacturing uses is to be valued properly from a midwest basing point.

We note that a transportation is nearly as clear and is equally logical when the nonfat dry milk prices are based on the actual sales price fob California plants.

Unfortunately, your California 4b formula is not quite as clear in making the same point about a transportation factor. We suggest it is to the advantage of everyone, both in the California and the federal order systems, for the thinking behind each element of the formula to be clear, so that the differences can be understood.

USDA does earnestly consider work done in California, such as the yield studies and make-allowance surveys. We encourage both systems to look toward each other because much can be learned by each party from the experiences of the other.

That process is most useful if all the thinking and logic about the formula values is clear in the formula and clearly discussed in the findings.

We urge CDFA to do so, and we will encourage USDA to more clearly articulate its thinking and rationales.

We must have a fire in the kitchen or something.

MR. SPEAKER: The Fire Marshal checking out this

room.

MR. VAN DAM: Well, we haven't got a big crowd.

Appendix 1 attached to this written testimony provides a discussion, including exhibits, are the factors that have caused the price of the class 4b milk in California to be misaligned with the federal order class III price. This appendix will not be read into the record, but we request that it be included as part of the official record of this hearing. And that is an exhibit marked 60(a).

The following testimony will highlight and summarize the material included in the appendix. Base price issues. Over time there has been little difference in the average base market price used by California, CME block, compared to the average base price of the federal order formula, the so-called NASS average, of the blocks and barrels.

Over the 36 months of the operation of the revised federal order formulas beginning January 1, 2000, there was only an average difference in the base price used between the two systems of .8 of one cent. The CME block averaged $1.25.6, and the NASS weighted average was $1.24.8.

Because the California formula deducts 1.2 cents from the base price, the effective difference in the formulas was just .4 of one cent.

However, there were large differences in some months. The biggest differences between the announced California class 4b price and the California order class 3 price occurred when there were rapid changes in the CME block prices. The CME prices reflected immediately in the California 4b price.

But the NASS price typically lags the market by ten days to two weeks. In October 2001 the resulting California class 4b price was $2.30 per cwt below the federal order class III price. Clearly this is an extreme, but large differences were not that uncommon.

In October 2000 the California class 4b was $1.01 lower; and in February 2002 it was $1.23 lower.

In fairness, we point out that over time these wide disparities, which all occurred at times of rapidly falling prices, are canceled out by the opposite, but never as dramatic, results when the cheese prices are rising. These timing differences do cause market disruption and turmoil. For that reason we urge CDFA to consider ways to bring the two prices in closer alignment.

In addition to the pure timing differences there can be, over short-run periods, unusual differences in the relationship of block and barrel prices that can cause great distortions in a given month. That occurs because the federal order formula considers both blocks and barrels,

while the California considers only blocks.

Over time the price differences between block and barrel cheese have traditionally self-adjusted. But occasional market oddities can occur. A case in point is the period from late August through early October of 2002, which was a protracted period during which the block market stayed about 10 cents per pound over the barrel market.

California prices, being tied only to the block market, moved up to levels that were, for two months, slightly above the federal order class III prices. In our collective memory we cannot recall another period of time when the block price stayed so high above the barrel for so long. Although we may be seeing the start of another such period this month.

And I depart from the text just for a moment to say I checked the market for yesterday and there was a 12-cent difference as of yesterday. The big spread started last Friday, or Thursday maybe. So we may be in the same kind of period again.

HEARING OFFICER ESTES: Mr. Van Dam, you have ten minutes.

MR. VAN DAM: Thank you. I'm doing good. That operation last fall had the effect of raising California 4b price quite significantly. Without this aberration the 2002 average price advantage held by California cheese

manufacturers over those in the federal order would have been even bigger.

We respectfully observe that it is incomplete for the base price used in California 4b formula not to include barrel cheese. Over 60 percent of the cheese reported to the NASS is barrel cheese; and the CDFA reports that 45 percent of the California cheddar production is barrel cheese. It strikes us as risky that California would let so much pricing ride on such a small portion of the available market information, and thereby ignore a large part of the commodity market.

We respectfully suggest that it would make good sense for California to use the barrel cheese factor used by the rest of the country.

Since there is no hearing proposal before this hearing to deal with these issues, these observations are offered as food for thought. We have detected a strong desire on the part of our friends in California to stay with the CME block price. However, if there is no long-term negative impact, and if there is some benefit in more closely aligned pricing, and some improved orderliness in marketing, we respectfully suggest the idea is worthy of added discussion in the future.

Formula issues. While the use of different market references to establish the market price for cheese often

accounts for substantial differences between the two systems, the more fundamental reason for price misalignment is that California does not include a value for whey.

Using the final order formula we have calculated for each of the previous 36 months the value of whey in the federal order class III formula. For all of the year 2000 this added only an average of 16.6 cents per cwt to the class III price. But in 2001 the whey value added was 67.4 cents. In 2002 it dropped back to 23.2 cents per cwt. This is a pretty impressive fluctuation in prices which results in significant differences in the two announced prices.

Whatever the normal relationship has been between California 4b and federal order class III over the last three years, it was about 45 cents more per cwt in 2001 solely because of the increased value of whey solids.

During that year the ability of California cheese plants to directly benefit from the high price of whey meant that their cost of raw milk used to make cheese really cost California plants 45 cents per cwt less than intended. That is 4.5 cents per pound of cheese. All of us who have ever participated in the marketing of cheese recognize that as a huge advantage.

One other way to look at this increase is that the same effect would have been created if the plants in California had been handed a 25 percent increase in their

make allowance. This 4-cent-plus increase in manufacturing margin given to California plants has a very familiar ring to it.

Three years ago NDA was honored to have been designated supplier of the year as a provider of block cheese to a major grocery chain headquartered in the eastern half of this country. It was a great honor to be recognized for the quality of both the product and service. This is usually interpreted as a sign that there is a special long-term relationship between the seller and buyer.

Early last year, 2002, this same company notified NDA that in order to keep this same business we would have to drop our prices, compared to the CME, by coincidentally, 4 cents per pound cheese. You have probably guessed that it was a California company that had pitched the lower prices.

Trying to reason this through will make your head spin. But to keep the business NDA would have had to give up about 25 percent of the make allowance allowed under federal order formulas while the California plant can offer that price and not give up any of its make allowance.

As others have said, unless there's relatively close price alignment between California and the federal order system on both the butter powder and cheese, neither system is likely to survive.

If considered long enough one will conclude that

the historical price misalignment represents an impossible pricing dilemma that will do two things. First, the favorite competitor will always get the business. And second, prices will always be pressed down more than they need to be.

NDA has not been bashful about the fact that there must be better alignment between prices in California and the federal order. Or NDA may be forced to consider voting out the Pacific Northwest federal order. This would be an unfortunate result and is not a good solution for anybody, but the box we are in is extremely confining.

Price misalignment is a problem which both the federal and California systems have recognized, and one which we respectfully suggest is in everybody's interest to solve, whether California moves closer to the federal system, or vice versa.

HEARING OFFICER ESTES: You have five minutes.

MR. VAN DAM: Thank you. There is nothing that CDFA can do at this hearing to change the class 3 formulas. But there are two things that could happen at this hearing which would help ease the transition and provide a roadmap toward moving the California and the federal order systems closer together in ways that would benefit both systems. The two things are alignment and clarity, and they are closely intertwined.

We respectfully urge California to clearly and explicitly identify during this hearing process each factor and its formula so that the entire dairy industry can better understand the differences between the two systems.

Earlier we praised the clarity of the California formulas for butter and nonfat dry milk. We find the California 4b formula to be less clear in its market adjustment location value, and it had not discrete value of whey included, which combine to make it impossible for the federal order formula to align with California.

Some of our friends in California have told us they suspect that the California formulas were intentionally restrictive on plants to make up for the fact that there was no whey factor. We would all be better off if a whey factor were explicit, and if the other factors, the make allowance, the yield and marketing adjustments were all accurately and clearly outlined in the forthcoming decision.

The current 4b formula loses clarity in that the market adjustment factor included is not based on fact, or at least not on the current fact. It seems clear to us that the reason some processors in California are willing to accept an obviously incorrect market adjustment is because they recognize that in return there is no recognition in the formula for the value of whey.

We would suspect that the make allowance announced

by the CDFA is a bit lower than otherwise would have been acceptable for the same reason.

Clarity, and with it, a chance to align federal order prices with California prices requires that first the market adjustment be set at a correct level. Second, that a proper value for whey be included in the formula. And third, that it be clear how the make allowance was arrived at.

Market adjustment. CDFA has a great deal of experience with this factor. It is openly included in the butter formula which is based on the CME market. For nonfat dry milk it's included because the base price is the actual price of product in this state.

Either approach is possible in your cheese market. NDA submits that a clear inclusion of a proper market adjustment will be invaluable to NDA as we continue to discuss this very issue with USDA.

HEARING OFFICER ESTES: You have two minutes, Mr. Van Dam.

MR. VAN DAM: That's fine. We're going to make it.

Whey value. There are several proposals at this hearing to provide suggestions for including whey in California 4b formula. These are all based on the value of dried whey. Dried whey is the most common product made out

of whey in this country.

While whey protein concentrate continues to grow in volumes and is widely made in California, it is not the base product. Plants make their decision to make WPC based only on the potential that it will be a more profitable use of their whey. Dried whey is the commodity product; WPC is a refinement of that product. Making dried whey is usually not a big profit operation. And on occasion the returns from the whey market are less than the cost of processing.

In the final decision, this is the federal order final decision, the formula actually reduces the value of class III milk when the whey value is negative.

Inclusion of whey will, in normal whey market circumstances, add very little to the California 4b price. But we emphasize that any chance of achieving a rational alignment of the class III and 4b prices lies in having the California formula pick up the value of whey when prices of whey are strong.

Make Allowance. This is interesting, I am missing page 8 of my own testimony.

(Laughter.)

MR. SPEAKER: We're all willing to help.

MR. VAN DAM: That's old proper prior planning at work again. I may not make it within the minute I got left.

On the make allowance I'll skip over that one;

I'll go to summarize. To summarize our suggestions regarding the California 4b formula we urge CDFA to take steps toward a closer price alignment that you feel are appropriate, while explaining clearly the differences in approach that you feel are appropriate, such as transportation or market adjustment. So that USDA and those regulated by federal orders can better consider whether the federal system should be brought into alignment with California.

The last part on California 4a compared to the federal order class IV, our observations about California 4a pricing have been sprinkled throughout this testimony. There is clarity in your 4a formulas. There is somewhat better price alignment in the sense that the 4a prices track well with the federal order class IV prices.

The second part of alignment is that the prices, themselves, need to be in reasonable alignment with the real economic factors that dictate market values.

We would hope that as this process goes on that the only remaining difference between the California prices and the federal order prices would be related to easily understood factors which we believe should ultimately be predictable and modest in size.

HEARING OFFICER ESTES: Your time has expired, Mr. Van Dam.

MR. VAN DAM: Okay. Thank you for allowing us to participate at this hearing. I skipped one paragraph there.

HEARING OFFICER ESTES: Do we have any Panel questions for Mr. Van Dam?

AGRICULTURE ECONOMIST GOSSARD: I have two questions. On page 2 of your testimony you chose Chicago and Atlanta as the basing points for your two eastern markets. What was the reason for choosing Atlanta?

MR. VAN DAM: One of the fastest growing populations in this country is down in the southeast. And any marketing of product from the west coast we have to, you know, and it's very short on milk production area. They will be buying a lot of product. And so I'm just trying to --

AGRICULTURE ECONOMIST GOSSARD: No, that -- I'm sorry, let me restate the question. I understand that aspect. You wanted a northeast and a southeast location. But why did you pick Atlanta rather than Houston or Tallahassee or Raleigh? Why Atlanta?

MR. VAN DAM: I guess the best answer for that, it was arbitrary. I just picked a city that's major down there. But I will say, for the record, that I did not pick a series of cities and run them all to see which one made my point most clearly. I chose only Atlanta.

(Laughter.)

MR. VAN DAM: And I liked the answer. I thought it was kind of neat that it was only a two-mile difference.

AGRICULTURE ECONOMIST GOSSARD: My other question deals with page 5 of your testimony. The second paragraph you point out in your discussion that we don't use barrel cheese prices; that 45 percent of the cheddar cheese is barrel.

However, we do have a situation where cheddar only makes up 34 percent of all our cheese. It's been our general understanding that most of the other 66 percent is probably priced off the block market, and not the barrel.

Other than barrel cheddar cheese, what other products is the barrel market CME price used as a reference price?

MR. VAN DAM: Unfortunately I do not know the answer to that question. But when you try and track these markets you know some is. And I suspect that some work with snubbers in them saying we will be tied to the CME market unless the difference is of a certain size and then the barrel market will have an influence. Because that's the only way I can explain some of the movement you see in NASS versus CME. But I have no direct knowledge of that; that's a suspicion rather than a fact.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

MR. VAN DAM: You're welcome.

SUPERVISING AUDITOR HUNTER: Mr. Van Dam, I just have one question. You talk about using dried whey in our cheese formula. Would you have any idea what the make allowance should be on dried whey?

MR. VAN DAM: No. I don't have any idea, but I do understand that there is a lot more water to evaporate out of whey compared to each pound of solids than there is in the skim milk. And the federal order testimony that was corroborated by several witnesses was that they thought that the cost of drying whey was 2.6 cents more than the cost of drying nonfat dry milk. That strikes me as a logical number. The evidence was just based on the experience of a series of people. Just seems logical; there's a lot more water there. It's 50 percent more water per pound of dry matter that you're evaporating.

Our objective here is not to saddle California with the weight price that's going to be difficult to live with. If it works negatively for part of the time, that's just fine, just so that we've got something in there so that when it becomes very positive we aren't left dragging way behind or stuck with the price of whey higher than yours and just not able to compete in the market.

SUPERVISING AUDITOR HUNTER: You testified that Darigold has one cheese plant. Have you ever done any cost studies on the whey operation on that plant?

MR. VAN DAM: Well, I'm sure they have because all of the whey out of that plant is dried, not fractionated.

SUPERVISING AUDITOR HUNTER: Is there any numbers you can give us today as far as the cost per pound on that dry whey?

MR. VAN DAM: I certainly do not have them with me today. And I would be delighted to ask them if they're willing to share. If they will, I'll send it to you.

SUPERVISING AUDITOR HUNTER: Okay, fine, thank you.

SENIOR AGRICULTURE ECONOMIST ERBA: Mr. Van Dam, on page 4 of your testimony on the second complete paragraph you speak to the cases where the 4b price was substantially lower than federal class III price, but don't mention if it was ever higher. Did you look into that?

MR. VAN DAM: I'm sorry, --

SENIOR AGRICULTURE ECONOMIST ERBA: On page 4, --

MR. VAN DAM: Yeah, on page 4, --

SENIOR AGRICULTURE ECONOMIST ERBA: -- second --

MR. VAN DAM: -- starting with However, --

SENIOR AGRICULTURE ECONOMIST ERBA: Second complete paragraph, --

MR. VAN DAM: Yeah.

SENIOR AGRICULTURE ECONOMIST ERBA: -- about midway through the paragraph you give a couple of examples

where the California 4b price was substantially less than the federal class III price. Did you look at the opposite where the California price was higher?

MR. VAN DAM: I certainly did. And in your appendix, which I handed out to everybody, there is a chart in there which shows it. I think the biggest difference in favor of the federal order was 52 cents -- no, 56 cents in September. It's exhibit A, the far right column, it is listed there what the differences were for every month. And I've got triple x's on the -- that means it's x-rated -- on those situations where California's price is higher than the federal order price. And I've used very bold print on the most obvious of the three where it went the other way. My point being that it does go the other way.

SENIOR AGRICULTURE ECONOMIST ERBA: Okay.

MR. VAN DAM: But never as dramatically.

SENIOR AGRICULTURE ECONOMIST ERBA: Yesterday we heard testimony from Mr. Reinke from Kraft Foods who said that the California price needed to be about 55 to 60 cents per cwt lower than federal class III price to make it feasible to be able to move that product back east where it's sold. Do you have a reaction to that?

MR. VAN DAM: Well, I certainly do. And it's a logical statement that he's making. My testimony makes it clear that we believe there should be a proper

transportation differential to get the product from the west to the east coast markets.

I think one of the things that's not been mentioned that should be considered is that the federal order price that's used is based on the NASS pricing. And the NASS pricing is at least 60, maybe 70 percent, 72 percent in some cases, based on prices reported out here in the west. So that is already somewhat lower.

The key thing, if there were to be clarity, and that's what we're asking for is clarity in this whole thing, there would be a class III price that applies in Chicago on east. And there would be a different one out here in the west. Because we have to get the product to that market just like the California people do.

If you really get down to the nuts and bolts of this thing, that is what our objective is, is to end up with the federal formula that recognizes the fact that we got to get the product over there.

SENIOR AGRICULTURE ECONOMIST ERBA: Have you tried pursuing that with the federal system?

MR. VAN DAM: What a set-up question. Yes. And hard, and repeatedly, and frequently, and we're at it and we continue to be at it. We think that any argument that we have will be greatly enhanced if there is clarity in your formula here. We think that this is such an important state

with such incredible influence over what happens in the country, that from the western perspective we need to have a clear formula from you with which we can go argue with the USDA some more. It's a slow process at USDA, I assure you.

SENIOR AGRICULTURE ECONOMIST ERBA: Do you think it's possible that the California system can make the 4b formula clear, as you've asked repeatedly in your testimony, without raising prices?

MR. VAN DAM: Certainly. You could. I think that -- let me take that back. That's true in all cases except when whey prices are really strong. When the whey prices are really strong, your lack of it, inclusion in our place, causes our prices to drift further apart. And we lose predictability in what the price relationships are going to be.

But other than that caveat, you need to use your own make allowances, you need to recognize the distance, too, to the eastern seaboard. You need to recognize the fact that you've got a growing milk industry that needs to have more plants. All those things are California issues. We're in the same boat, we know that. So we aren't here trying to say, hey, you've got to bring them up to our levels. You need correct levels, and then we need to work on getting the similar situation for ourselves.

I think it is interesting to note that we've got

one cheese plant and we've got four powder plants. And that's not hard to figure out when you consider what's happening with this pricing and the box we get placed into with the cheese plants.

Your system almost dictates that we cannot, out here in the west, put in cheese plants and succeed.

SENIOR AGRICULTURE ECONOMIST ERBA: Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, I'm going to give you an opportunity to talk about the make allowance. You did not, it's in your written comment, but would you elaborate on the make allowance?

MR. VAN DAM: Well, we purposely stayed away from talking about make allowances and the actual transportation factors you'll see in our testimony no recommendations on that. Part of that is driven by the fact that we are not part of the California system, except as it impacts us. We're guests here, and we don't want to pretend like we know more than you do on the pricing.

You need to calculate your own numbers; they need to cover enough of your production. We like your system better than what we're facing, quite frankly. So, --

DAIRY MARKETING BRANCH CHIEF IKARI: Well, I meant -- it looks like you're trying to, in your testimony it looks like you're trying to make some principles. Are you trying to say, and correct me if I'm wrong, are you trying

to say that the volume covered should be a majority of the volume? Are you trying to say that the make allowance for butter versus cheese should be about the same in terms of the volume covered?

MR. VAN DAM: Okay, my answer to that would be it's somewhere in the testimony. We feel that the California Department of Food and Agriculture has a much more rational approach to pricing than what the federal order does. The federal order uses a simple average of the numbers they have available. That's not adequate. That means half the people lose money.

It makes much better sense to us that those numbers are set to include 80 percent, which is arbitrary, I know, whatever that number is. And I accept the fact that you can't set it to cover everybody; that doesn't make sense, either.

We like your approach. We think it makes sense. And as Eric has already said, I said do it with clarity, repeatedly. I'll repeat it again. It needs to be clear.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, I just noticed you have a figure of 18.02 cents is reported to cover the cost of processing of about 52 percent. So I was just wondering if that 52 percent that you had in here, you pulled that out of the air? Or is that kind of the area that you were looking at?

MR. VAN DAM: No, no, that is not the area we're looking at. The point of that paragraph, which I didn't read into the record, is to make the point that you have, at the California Department of Food and Agriculture have in butter and in the nonfat dry milk, covered the 80 percent. But it looks like you did it differently in the case of cheese covering only 56 percent.

And our point was that we believe the reason you did that is because of the squirrelliness that enters your formula because there is no whey factor. And we admire the process you use in butter and powder.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay.

MR. VAN DAM: In fact, we love 'ya.

(Laughter.)

SENIOR AGRICULTURE ECONOMIST ERBA: I have one follow-up question in response to an answer you gave previously. If USDA believes there ought to be a price surface for class I, why don't they believe there should be a price surface for other classes?

MR. VAN DAM: If we had the answer to that question we'd do a much better job of arguing with them about what they have decided to do. Deep down I suspect that the political power and the history is that this is a midwest business, and the midwest is served well by that kind of reasoning. The west is not served well, but they

don't care. Maybe I said that a little strongly, but that's roughly what it boils down to.

They do not want to set up a system that they see as encouraging production in the west. I think their view is that most of the evils that happen in the dairy business are because of the west.

SENIOR AGRICULTURE ECONOMIST ERBA: Thank you.

HEARING OFFICER ESTES: Do we have any more questions?

I just have a question for you. Have you and your members investigated the possibility of annexation to the State of California?

(Laughter.)

AGRICULTURE ECONOMIST GOSSARD: Make sure if you annex make sure you don't get part of our budget deficit.

(Laughter.)

MR. VAN DAM: Yeah, we have plenty of that -- we have water --

AGRICULTURE ECONOMIST GOSSARD: A trade.

MR. VAN DAM: I happen to live in Idaho and we don't -- interesting that you suggest that even though it's somewhat tongue-in-cheek. When we were considering what to do over the past number of years, we have tried hard to find a way to create an Oregon/Washington/Idaho kind of situation that is similar to what California does. It is so much more

effective in terms of dealing with our specific issues.

It's just that we got that commerce clause, and after the first attempt to do that, the rulings have come down in other cases making clear that even if we could get through the problems of trying to get exactly the same legislation passed in three different states, there are now some new rulings out there that say that can't happen anyway. So annexation may be the only answer.

(Laughter.)

HEARING OFFICER ESTES: Well, that's certainly beyond the scope of our authority at CDFA.

(Laughter.)

MR. VAN DAM: You're not making law here, huh?

HEARING OFFICER ESTES: Thank you for your testimony today.

MR. VAN DAM: Thank you.

HEARING OFFICER ESTES: And I think we'll proceed on.

MR. VAN DAM: Post-hearing brief?

HEARING OFFICER ESTES: Yes, I believe we granted that request. Or did I neglect to do so? If I did, you certainly --

MR. VAN DAM: I forgot to ask, so --

HEARING OFFICER ESTES: -- able to do so.

MR. VAN DAM: -- thank you.

HEARING OFFICER ESTES: Scott Hofferber of Farmdale Creamery, Incorporated.

Whereupon,

SCOTT HOFFERBER

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

HEARING OFFICER ESTES: Could you please state your name and spell your last name for the record.

MR. HOFFERBER: My name is Scott Hofferber, spelled H-o-f-f-e-r-b-e-r.

HEARING OFFICER ESTES: And could you identify the organization you represent.

MR. HOFFERBER: I'm the Controller for Farmdale Creamery in southern California.

HEARING OFFICER ESTES: And could you describe your organization or the number of members, if that's applicable?

MR. HOFFERBER: We're a sole proprietorship corporation operating a family-owned business. We have about 65 employees.

HEARING OFFICER ESTES: And could you describe the process by which your testimony was developed and approved?

MR. HOFFERBER: Through my readings and take on the petitions and alternative proposals. I had discussions with our board members. I drafted the material that we're

going to present today, and my board members read it and approved it for delivery.

HEARING OFFICER ESTES: All right. I will introduce your testimony into the record as exhibit 61. And you have 20 minutes, please start your testimony.

MR. HOFFERBER: Very good. Good morning, Mr. Hearing Officer and Members of the Hearing Panel. I am Scott Hofferber, the Controller at Farmdale Creamery. And I am here at the direction and on the authority of the Board of Directors of Farmdale Creamery.

We are here to voice our opposition to the petition submitted by Western United Dairymen and to support the alternative proposal submitted by the Dairy Institute of California. We also oppose all other alternative proposals before the Panel pertaining to this hearing.

We appreciate this opportunity to present our views and provide you with our perspective on the issues at hand.

Our company, Farmdale Creamery, is a family-owned and operated dairy processing facility in San Bernardino just east of the Chino Dairy Preserve. We are not affiliated with any of the co-ops by ownership. We have enjoyed good working relationships for milk and cream procurement with the different co-ops over the years, and look forward to continuing these mutually beneficial

relationships. We process cheddar and jack cheeses in 40-pound blocks, sour cream, buttermilk and whey butter.

In order to expedite our part of the proceedings today we've attached a copy of the testimony we provided March 28, 01 at similar hearings regarding the inclusion of a whey component in the 4b formula. By doing so we will not take up valuable time here refreshing the Department on our company's history. Rather, we gratefully acknowledge the Department's action taken at that time, choosing not to add a whey component to the 4b formula.

To update the history portion of the prior testimony suffice it to say that our capital expenditures over the last two years have gone to expanding our capacity to produce food grade products. We continue to process the dairymen's milk to the best of our capabilities, but are concerned that the level of milk production in California has exceeded the consumers' demand for dairy products.

If we, producers and processors together, are to continue to move the milk being produced, our already strained ability to compete for sales outside of California cannot be diminished by the cost increases indicated by the petitioners.

Dealing with the whey we cannot justify the expense and capital to install a whey processing line adequate to create a profit center. Instead we must

continue to treat our roller dried whey process as a cost minimizing effort in dealing with the waste whey material.

With the increase in gas and electricity costs the efficiency of this waste disposal system has been dramatically negatively impacted because the roller dryers are heavy consumers of gas and electricity. It will be years before the effects of the state's attempt to deal with the energy crisis are dissipated and energy prices return to pre-2000 norms.

We believe the Department's action to raise the make allowance, done on an emergency basis earlier, resulted in an appropriate and timely make allowance adjustment which should continue indefinitely; or at least until we've seen a significant return to normalcy.

Anything in the petitioner's proposal that suggests a reduction in the make allowance because energy prices have fallen fails to recognize that the Department's action never addressed the full impact of the crisis at its worst. Rather, the adjustment to the make allowance for energy has, in fact, done a good job of recognizing the new normal price levels. We believe the current cost study data supports this conclusion.

It has been nearly two years since we testified that, quote, "whey disposal is not a for-profit business for Farmdale." If it were, people would be knocking on our door

every day wanting us to let them take the waste whey off our hands. To this day, no one has come knocking. So we continue to use our own innovation, assess our own risks and invest our own capital to minimize the cost of this disposal.

Each processor must make his own way, or whey, if you prefer, and the resulting diversity in methods defies standardization. To include a price component based on the processor with the highest return on their whey process would cripple all others, competitively speaking.

More generally, to suggest changes in the pricing formulae, where a conflict of interest is present, creates exceptional problems in perception, fairness and long-term stability. Farmdale sees this comment as there are nine cheddar cheese processors in the state's cost study. And I'm going to make a correction to this next line -- seven of these plants are co-op controlled and operated.

Cheese plants owned by producer groups are able to rebalance their streams of funds and are not hurt by a whey factor or other price-enhancing actions. Their producers simply get the same revenue through differing channels. So what becomes a cost to the right hand is a revenue stream to the left hand.

For the proprietary, non-producer-owned processor the effect would be to create a significant competitive

disadvantage within the state because the privately owned processor can only go to the marketplace for the revenue necessary to pay the added costs. The result would be to drive away needed processing capacity.

We support the Dairy Institute of California alternative proposal because we believe it fairly incorporates a whey factor into the pricing formula, a concept we oppose but must grudgingly accept in the current political environment, while properly addressing the yields and make allowance elements.

The immediate impact on the pricing formulae, though minimal, properly assesses the market conditions and avoids an improper subsidy or encouragement of the over-supply conditions the producers have created.

The petition and most of the other alternative proposals raise the cost of milk to processors for reasons beyond reason. Others have, or will, testify that the markets for the products processed should dictate the related price levels for the milk utilized. We agree with this assertion.

Further analysis of the market conditions affirm that the market cannot bear higher prices. Basic economics then indicates a cut in production. Yet milk production in California continues to grow unabated. The processors should not be made to underwrite the producers' business

decision to over-supply the market.

Last week I was having lunch with a few CPA peers at a continuing education course. I spent some time explaining the milk marketing plan in California to them, including a description of this hearing process and the mechanics surrounding implementing the plan.

Later in the day one of those gentlemen approached me, identifying himself as a dairy family member living on a local farm. He indicated he appreciated my perspective on the topic because he previously could not understand why the dairymen he came in contact with regularly discussed the over-supply issue, but never took any action to manage their growth.

From his comments I concluded that even though the producers know what the problem is, they would rather have my company pay than take responsible action.

Geoffrey Vanden Heuvel, speaking as a dairy farmer from Chino, California, stated in a San Bernardino Sunday's paper article dated November 29, 2002, quote, "We need dollars and that meeting (this hearing) is about pennies."

We take this statement as an acknowledgement of where the responsibility lies with regard to the current state of producer prices. The responsibility for over-production and thus the current deflated producer price condition is not the Department's, and it is not the

processors'. And the burden for correcting the problem should not be borne by either.

In summary, we do not agree that a whey factor should be added to the pricing formula as a way to increase overall producer prices. We accept the idea of including a whey factor where the other components in the formula are adjusted to reflect revenue neutrality.

The excess supply of milk coming off the farms should not cause prices to rise, hurting the competitive stance of the California products in the marketplace. Raising the costs of proprietary plants in the state will certainly cause this to happen.

Where we would prefer the Department take no action to change the pricing formulae at this time, we recognize the Dairy Institute's proposal to be the best of the alternatives presented with respect to sound economic principles and long-term viability of the California dairy industry.

Respectfully submitted, Farmdale Creamery.

And we request the post-hearing brief capability.

HEARING OFFICER ESTES: Yes, you may file one. Again, for the benefit of the audience, although everyone's heard this before, I just want to state it for the record so that it's clear that everyone today has heard it, the deadline for filing post-hearing brief is the close of

business Friday, February 7, 2003.

And, again, I do that because this is a second day of the hearing, and I do want the record transcript of the hearing to reflect that everyone in attendance today did hear it. So I recognize that you know that, but it's a sort of record-keeping requirement.

So, do we have any panel questions for Mr. Hofferber?

AGRICULTURE ECONOMIST GOSSARD: On page 2 of your testimony you discuss that you currently have a roller dryer operation for handling the whey. You've looked at other alternatives but the capital costs at this point are prohibitive.

Just in terms of operation, does a roller dryer consume more gas and electricity than a comparable conventional dryer? Would your variable costs for electricity and gas be less if you had a conventional dryer rather than a roller dryer?

MR. HOFFERBER: I don't have that in my experience. I wouldn't know that answer.

AGRICULTURE ECONOMIST GOSSARD: Okay. The second has to do with the Dairy Institute proposal. You've spoken in support of it. Their proposal is developed in a three-step process. In the second step they looked at what they felt might be reasonable whey factors in terms of a make

allowance and yield, and then we took the third step and went on to modify just the cheese price and leave the whey out all together.

In their concept of step two they had a make allowance of 18.18 cents, and a yield of 5.82, thank you, there it is. Are you comfortable with that 5.82 and the 18.18?

MR. HOFFERBER: Without having really analyzed these numbers in any great detail, and even relating them to our own operation, what we are comfortable with is the revenue neutrality approach to what Dairy Institute did. And that's what we're mostly in support of. To get any deeper into the numbers would be outside my expertise at this point in time.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

SENIOR AGRICULTURE ECONOMIST ERBA: Mr. Hofferber, are there other plants in the state that are in your similar situation, cannot afford to invest in a whey operation as you said you can't?

MR. HOFFERBER: It's hard for us to know that exactly because, of course, we only see summarized data in the cost studies. And we don't spend a lot of our resources doing a lot of competitive analysis with other firms our size.

My understanding of the information in the cost study is that we are, in fact, the smallest commodity cheddar maker in the state, by volume and by plant size.

I'm confident that there are other cheese plants similarly sized to us who are not making commodity cheeses, making more specialty cheese, but since our focus is in competing with much bigger organizations than ours, we try to confine our comments and concerns in that narrow context.

SENIOR AGRICULTURE ECONOMIST ERBA: Okay, thank you.

MR. HOFFERBER: Um-hum.

HEARING OFFICER ESTES: We don't seem to have any more questions. Thank you for your testimony today.

Our next witness is Sharon Hale from Crystal Cream and Butter Company.

Whereupon,

SHARON HALE

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

HEARING OFFICER ESTES: Could you please state your name and spell your last name.

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

HEARING OFFICER ESTES: And identify the organization that you represent.

MS. HALE: Crystal Cream and Butter Company.

HEARING OFFICER ESTES: And could you describe that organization and its membership, if applicable?

MS. HALE: We're a proprietary corporation, family owned.

HEARING OFFICER ESTES: And what was the process by which your testimony was approved and developed for today's hearing?

MS. HALE: It was drafted by myself and approved by our President.

HEARING OFFICER ESTES: I have a copy of your written testimony that you're going to be presenting today. It will be introduced in the record as exhibit number 62. So, please proceed with your testimony.

MS. HALE: Thank you. Mr. Hearing Officer and Panel Members, my name is Sharon Hale and I'm Vice President of Dairy Policy and Procurement for Crystal Cream and Butter Company. Our administrative offices are located at 1013 D Street, Sacramento, California. We operate three production facilities in Sacramento that produce dairy products falling within all classes except class 4b.

Crystal, along with its wholly owned subsidiary, McColl's Corporation, located at 2500 Angelo Avenue, Redding, California, distributes dairy products throughout northern California. We also sell frozen novelties in several western states, and ice cream mix, dry cottage

cheese curd and ultra-pasteurized fluid milks to other countries.

Dairy Institute of California testified yesterday to numerous changes in the pricing formulas for class 4a and 4b products. The pricing formulas presented by Bill Schiek incorporate much of the data coming from recent CDFA studies to reflect the latest conditions and practices within the dairy industry without losing sight of the competitive environment in which we in California must operate.

Crystal is a member of Dairy Institute and is in support of their position at this hearing. I intend to take a few brief minutes to express my company's perspective regarding the marketplace for class 2 and 3 products.

At previous hearings we have testified to the level of competition found within the northern California marketplace relative to class 2 and 3 products. In addition to products manufactured within California an informal survey done by Crystal Staff turned up numerous class 2 and 3 products coming from different parts of the nation. This week we again checked the store shelves in the Sacramento area and the list has grown. This information can be seen on attachments A and B, and reflect the depth of market penetration already enjoyed by manufacturers of class 2 and 3 products located outside California.

I'm turning to those attachments which are on

pages 4 through 6. You'll note that the states from which some of these products come, we have Colorado, Connecticut, Kentucky, Minnesota, Missouri, New Hampshire, Ohio, several Oregon, Washington, Texas and Utah frozen products. Those are class 2. Frozen products, we have a Nevada thrown in, and then similar states for the rest. But certainly we have a large amount of product coming from other states into the Sacramento marketplace.

When considering the number of consolidations made within both the retail and the manufacturing sectors during recent years, combined with advancements in transportation and logistical systems it's not unexpected to see more out-of-state products in our market.

But meetings between our sales staff and the buyers for some regional and national chains lead us to believe locally produced products still have a strong appeal, and will have a place, provided the price is competitive.

It might be helpful to some to understand in the simplest of terms how Crystal markets its products to learn why competitive pricing is so critical to our business.

First, we serve as a supplier of high quality branded products. These carry the Crystal label and move through a distribution chain eventually reaching the ultimate consumer, often one unit at a time.

The other approach is known as, quote, "private label business" end quote. This is when we manufacture products to someone else's specification and package it in their label. These products move in large lots to the customer for their distribution or use. And, yes, we do have times when products manufactured in our plants occasionally compete against each other on the retail shelf.

Private label business is by far the most price sensitive because it is the label, and not the product inside the container, that the ultimate consumer purchases. If the price is not agreeable to the private label customer they move the business.

And in the case of highly transportable products, such as class 2 and 3 items, this may mean the production moves completely out of state, thus depriving the pool of the higher priced usage.

We appreciate the Department's recognition in the past of the need to remain competitive, and feel the evidence available at today's hearing indicates a similar sensitivity is in order.

CDFA's hearing background resource discusses California's share of the annual dry curd and frozen product production as compared to the state's share of the U.S. population. Dry curd, a reflection of cottage cheese production, and therefore a class 2 product, has shown a

precipitous decline since 2000 in California's share of production, while the other-west share seems to have grown a similar amount. The same graph for frozen products shows a leveling off as to a decline in the production share, but it levels well below the population share, a trend which began in the mid 1990s.

We believe the Department's data substantiates Crystal's informal surveys and tells us, despite California's seemingly favorable price relationship when compared to surrounding federal orders, erosion within the California marketplace has continued to occur. If price was Crystal's sole criteria we would support the proposal that generates the widest gap between northern California prices and those in the Pacific Northwest. But that's not how we operate. Crystal has a history of supporting cost-justified make allowances, and while today's proposals are more complex than those in the past, Dairy Institute's alternative proposal utilizes current costs and actual sales data to update the class 4a formula. These updates result in modest changes that we are willing to accept.

As we understand the various proposals analyzed by CDFA and presented at the January 22nd public workshop, only Western United Dairymen's proposal seems to substantially increase class 2 and 3 prices. Based on the Department's analysis, had their proposed formulas been in effect, prices

in northern California would have exceeded those in the Pacific Northwest during the past three years.

While we recognize the financial situation currently enveloping many of California's dairy farmers is bleak, adjustments which cause a price inversion are neither prudent nor justified. Any loss of class 2 or 3 usages within California will do one of two things. Either push the volume into lower price class 4a or 4b products; or cause some dairy farmer or group of dairy farmers to reduce production. It seems trying to maintain sales in the higher priced usages would be a better choice.

Additionally, CDFA's hearing background resource reports pool utilization of class 2 products at 4 percent and class 3 at 5 percent on a total solids basis. Considering the extent to which California has become a manufacturing state causes one to question whether or not the current prices are actually in proper alignment. But that is a discussion that should be saved for another day.

We'll end our comments by reiterating our support for Dairy Institute's proposed formulas and the modest price adjustments resulting from their changes.

I appreciate having the opportunity to testify and request the option of filing a written brief following the close of today's hearing.

HEARING OFFICER ESTES: Do we have Panel

questions?

AGRICULTURE ECONOMIST GOSSARD: A previous witness spoke to the advantage of the higher protein milk for fluid users. What has your experience been at Crystal with higher levels of protein in your fluid milk?

MS. HALE: I heard the testimony and from our purposes that's not something that we have taken advantage of, or been able to take advantage of. And the individual who was speaking was familiar and a representative of the Jersey organization. We have long since lost our Jersey dairies. They can't stay with a fluid operation. Frankly, they've all gone to cheese operations. There may be some colored cows still amongst the Holstein herds, but the outright Jersey dairies are all gone.

AGRICULTURE ECONOMIST GOSSARD: So you don't have any experience in whether higher protein levels makes a better product, a fluid product that --

MS. HALE: No, no. That was news to me.

AGRICULTURE ECONOMIST GOSSARD: Okay. The other issue, Hilmar testimony yesterday suggested that an increase in the 4b price would reduce premiums that they would be paid, or potentially reduce premiums. And that might cause a ripple effect across the industry.

Does Crystal -- well, actually, you just acknowledged that you are competing with cheese plants for

milk. Is that a fair characterization?

MS. HALE: That we compete? Yes, it is.

AGRICULTURE ECONOMIST GOSSARD: To any extent do you have to pay premiums above minimum prices to attract milk?

MS. HALE: Yes, we do. And I believe that was initially why Crystal began paying premiums. There's different terminology quality premiums. We have paid what we've called a competitive premium for many many years that was instituted basically because of the competition with the cheese plants.

AGRICULTURE ECONOMIST GOSSARD: So if an increase in the 4b prices resulted in a decrease in premiums being paid by cheese plants, would that possibly have impact on the level of premiums that Crystal is paying?

MS. HALE: It would be certainly something that we would look at. We would have to look at all the other buyers of milk in the area and see what, in fact, they are doing to encourage milk to move in their direction. But certainly a decrease at the cheese plant level would give us the opportunity to review premiums and perhaps the cost of our milk for the class 1, 2 and 3 price products could go down.

AGRICULTURE ECONOMIST GOSSARD: My last two questions are directly from your testimony. In the middle

of page 2 you're discussing the graphs the Department prepared from the background material, the declining market share of class 2 and 3 products. You also, I believe, in your testimony say that currently the price differences aren't that great. Why is the share continuing to decline if product prices in California are not uncompetitive?

MS. HALE: Raw product is only a part of the whole issue. I think doing business in the State of California, whether you are a processor of dairy products or any other product, I think the expense of being in California, itself, does add to that.

Additionally, I think bringing in the national companies, the consolidations that have taken place, there are supplier arrangements that those companies already enjoy. And those move into the state when those companies start doing business here, or they take over another company that's in the state already. I think that has an impact on it.

AGRICULTURE ECONOMIST GOSSARD: But then at the end of page 3 you said doing something about this issue should be reserved for another day, since the class 2 and 3 pricing formulas were open for amendment at this hearing. Why did you feel it was appropriate to wait another day?

MS. HALE: Well, I think the financial situation in the dairy producer community doesn't make that a

discussion that we should have. And perhaps it should be combined with class 1, as well, so we actually looked at class 1, 2 and 3, and whether or not those price levels were proper considering how much manufacturing usage we actually have in the state now.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

SENIOR AGRICULTURE ECONOMIST ERBA: Ms. Hale, if the dairy industry proposal was adopted by itself in its entirety and class 2 and 3 prices were increased, even modestly, do you think that would impact your company's ability to sell products both within and outside of California?

MS. HALE: There's always a possibility. Some of that impact would certainly go to those products that are going offshore. Perhaps those -- there are other suppliers that are out of the State of California that might be able to secure that business instead of us. It may well. But we felt that again, in the financial situation that the dairy farmers are facing, that we would just take that chance.

SENIOR AGRICULTURE ECONOMIST ERBA: Thank you.

HEARING OFFICER ESTES: Thank you for your testimony today.

MS. HALE: Thank you.

HEARING OFFICER ESTES: Next we have Jim Gruebele

of Land O'Lakes. The audience is admonished not to show express approval or disapproval of any of the witnesses.

(Laughter.)

HEARING OFFICER ESTES: No hissing allowed.

DR. GRUEBELE: -- some hissing going on? I can't imagine.

PANEL MEMBER: Jim, it was from the Panel, not from the audience.

HEARING OFFICER ESTES: Mr. Gruebele, could you please -- first let me start with --

Whereupon,

JAMES W. GRUEBELE

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

HEARING OFFICER ESTES: And could you please state your name and spell your last name.

DR. GRUEBELE: James W. Gruebele, G-r-u-e-b-e-l-e.

HEARING OFFICER ESTES: And could you identify the organization that you represent.

DR. GRUEBELE: Land O'Lakes.

HEARING OFFICER ESTES: And could you describe the number of members in that organization or structure.

DR. GRUEBELE: Approximately 270, and they are dairy cooperative.

HEARING OFFICER ESTES: And what is the process by

which your testimony was developed and approved for today's hearing?

DR. GRUEBELE: The Board Members of the Western Region endorsed the testimony.

HEARING OFFICER ESTES: Would you please proceed with your testimony.

DR. GRUEBELE: Right.

HEARING OFFICER ESTES: Please proceed.

DR. GRUEBELE: Yes.

HEARING OFFICER ESTES: Oh, excuse me, before you start I will introduce your testimony into the record as exhibit number 63.

DR. GRUEBELE: And I'd like to file a post-hearing brief, if I may.

HEARING OFFICER ESTES: That request is granted.

DR. GRUEBELE: My name is James Gruebele, Dairy Industry Consultant. I'm testifying on behalf of Land O'Lakes. The Land O'Lakes Board Membership Western Region endorsed the testimony.

We oppose most of the proposals on class 4b yesterday. Our position is similar to that of Dairy Institute. Our position is that the class 4b formula should remain unchanged until the Department is able to obtain accurate information on the protein content and the casein content as a percent of crude protein in order for

California's milk supply to make a reasonable judgment on the yield adjustments that might be reflective of actual yields for cheddar cheese in California.

In the general comments I'm going to skip over a good share of that which you already know. I don't have to tell you what's new in California because we all know that California milk supply has grown, that cheese production has grown, that butter production has grown and powder production has grown. That's nothing new to any of us.

In order to accommodate the tremendous growth in milk supply it's necessary to build manufacturing facilities to manufacture milk into class 1, 2 and 3 products. It is extremely important to maintain realistic pricing formulas to insure that reasonable return on investment is maintained in the manufactured dairy industry.

Significant additional manufacturing capacity has been added in the years 2001 and 2002; the point is it is needed. The past policies by the Department of Food and Agriculture have encouraged the development of highly efficient manufacturing facilities in California. And that's indeed true when you compare our manufacturing facilities with those of the upper midwest, which through my organization I am somewhat familiar with. This is a highly important point.

Construction costs are very high. The banking

firms are willing to finance projects only if there are adequate returns on invested capital with a reasonable payback period.

We urge the Secretary to maintain the course. We particularly resist any downward shift in gross margins in cheese operations in California. This sector needs to be encouraged rather than discouraged. One of the big differences between California and the midwest is that the milk production tends to decline in the midwest rather than increase. This has led to an over capacity problem in the form of plants in the midwest because of the stagnant production trends.

The situation is so far different in California. The California capacity needs to grow just to accommodate the tremendous growth in milk output. Plants in a declining industry tend to stay in business so long as total revenue achieves total variable costs. In the long run those businesses die.

In California it is imperative that we maintain the policy of adequate returns on investment for manufacturing capacity or for manufacturing operations otherwise plant expansion will not grow fast enough to keep up with the growth of milk production.

There is really only one major cooperative that has continued to expand capacity in cheese making in

California and that is Land O'Lakes. The proposals yesterday would significantly reduce gross margins and returns on investments for cheese operations in California.

Some of the proponents are proposing a status quo position, or even reduction in prices of milk going to class 4a plants. The argument is that producers need an increase in milk prices. They why do they not advocate an increase in the class 4a milk price?

We think it's extremely important for the Department of Agriculture to maintain a balanced position with respect to gross margin and return on investments for butter, powder and cheese operations. The goal in most cases by petitioners such as Alliance, Western United at 4a and 4b hearings appear to be focused significantly on increasing the price of milk for 4b, class 4b.

Meanwhile the butter/powder operations do not seem to be under attack. It is interesting for many years now the powder marketing plan has been very simple, and certainly not costly. Simply place the powder in a government bag and ship it to the government. This is an extremely efficient marketing program. By the way, the support price can be $1.10 or it can be 80, just as it is now; or it could be 70 cents, the results are the same.

The powder operations make just as large a return on investment whether support price for powder is $1.10, as

when the support price were reduced to 70 cents, or any other number, for that matter. The powder plants are protected by a make allowance and the use of a concept of the California weighted average price.

Are net margins higher for butter powder operations than cheese operations? We believe they are. The evidence for the Land O'Lakes operations, since we have a multiplicity of products that we make, show that the net margins per cwt for powder operations in the western region are 1.26 times higher for butter powder operations than they are for cheddar plants in the western region for calendar year 2002.

That means the butter powder operation in Tulare and the western region entirely was 26 percent higher for butter powder than it was for cheese.

The net margins for cheese operations on per cwt basis include whey, as well. So this does not leave whey out; it includes it. If the Department wishes to do so they may audit our records on this matter.

Producer prices are low. The reason is simple. The reason is that supply of milk has simply increased more rapidly than demand. High producer prices at 2001 stimulated producers to increase herd sizes and generally increase milk production. At the same time the U.S. economy has gone flat, and there's barely any growth at all.

Unemployment rates are still high. The stock market has gone down tremendously and continues to be bearish due to the uncertainties of war. Every state in the country appears to have budget problems. People who have jobs are afraid they will lose them. And as a result, the consumption of dairy products is less than they otherwise would be.

Unfortunately the MILC federal direct payment to producers is impeding the economic signals to producers. MILC program is going to have the similar effects as the support price did in the late 1970s. The difference is in the support price -- in that case the support price was adjusted, and in the case of MILC it's a direct payment to dairy producers around the country. And, of course, it's discriminatory against the big producers.

Regulatory programs, state or federal, to the extent they are used to enhance producer prices, also impede the true economic signals that would otherwise exist. As a final result the production adjustment that otherwise would occur will be nonexistent or smaller than it would be if the MILC program were not in place and if or the artificial federal and state regulatory upward adjustments of milk pricing formulas were not made. I'm talking about the federal order reform, the new one.

What this means is that overall butter, cheese and

to a lesser extent, powder prices, will be lower in 2003 than they otherwise would be than if the MILC program had not been implemented, and/or if the regulatory programs would not be implementing price enhancing formulas for manufactured dairy products. And always the emphasis is on the cheese side for some reason.

At the risk of being repetitive the cheese, for the most part, is marketed commercially but a substantial portion of the powder sold to the government. Land O'Lakes is urging the Department to reflect a balanced approach. The net returns, annual returns on investment for butter, powder and cheese should be very similar. Our analysis shows us that it is not the case.

Last year's result of the hearing due to the energy crisis, the Department made an adjustment in the make allowances for butter, powder and cheese. The largest of these adjustments was in powder because of the substantial energy requirements to dry nonfat dry milk.

Nevertheless, the make allowance for cheese was adjusted from 16.9 to 17.6, and that had the effect of reducing the class 4b price by 7 cents/cwt. Of course, the Department has updated their cost for butter, powder and cheese plants, and has in addition updated energy and labor costs for the plants in the survey. The bottomline is that the weighted average cost for cheese plants in the survey

was 17.46. The current make allowance is 17.6.

Data were also collected on cheese prices received on a monthly basis from January 1, 2001 through July 2002 on a weighted average basis. The analysis showed that the CME prices were 3.21 cents higher than the weighted average prices received by these plants for the 19-month period. The current formula deducts .012 from the CME price in the current class 4b formula.

While the Department collected information for cheese plants in the study it is impossible to arrive at any conclusions from the finding. The yield found by the Department reflects milk that was fortified with extra cream, condensed, powder or a combination thereof. The fat test was 3.95; the solids-not-fat was 8.93 percent.

In any case, these fat and solids-not-fat percentages are substantially above the average milk components. In order to utilize the environmental yield information it would be essential that we know the protein or casein content in the milk.

Phil Tong, a professor at CalPoly University, in his milk component study, has summarized information on the fat, protein and casein as a percent of protein by cheese plants, by butter/powder plants and by fluid plants and so forth. The fat, protein and casein as a percent of protein for those cheese plants is not very useful because the use

of the cheese yield premium programs by some cheese operations that encourages producers to enhance the fat and protein content in their milk supply through breed selection, feeding programs and the like.

It is, however, useful to look at the milk going into butter/powder operations as indicative of California's milk supply. The average fat test for this kind of milk was 3.63; the crude protein was 3.27; and the casein, as a percent of protein, was 77.05. The average moisture content in cheddar cheese is somewhere between 37 and 38 -- and I wrote this before the Department sent some more information out on block operations. The average moisture content for cheddar cheese in the Tulare operation is 37.5 percent for cheddar cheese. The cheese yield for this kind of milk, using 37.5 percent moisture, would be: And I have the formula there, using the typical Van Slyke, which we've had a lot of discussions about -- Mr. Gossard probably is going to ask me the same question -- is 10.04.

Even if one were to use 38 percent moisture the yield would be 10.12.

Well, what are the effects of the changes in yield, make allowance and market adjustment factor? If one were to change the current class 4b price to reflect the new market adjustment factor, the new make allowance at the weighted average price cost to manufacture cheese to the end

yield of 10.12, the answer would be a decline in the class 4b prices, 6.9 cents/cwt. And I go on to say what the individual factors contribute, and you can read that for yourselves.

The Land O'Lakes' official recommendation is that the class 4b formula remain unchanged until the Department is able to obtain information on the average protein and casein, as a percent of protein, for California's milk supply.

Western United and Alliance of Western Milk Producers. We strongly oppose the Western United proposal and the Alliance proposal because either of them or both of them would enhance the class 4b price very significantly. Both proposals would result in class 4b price which would exceed the current class III price in federal orders, and that makes no sense. Tables 1 and 3.

Both the Western United and Alliance are proposing the addition of whey to the current formula. While California class 4b price does not specifically include whey, one needs to observe the overall results.

The California class 4b price is in reasonable relationship to the current federal order class III. The federal order class III pricing formula includes whey, but so what. The California class 4b price uses a cheese price that is significantly higher than -- well, that is higher,

significant is a matter of terminology -- than the survey price used in the current federal order formula.

The California class 4b formula includes a factor for whey cream. There's no need to complicate the California class 4b formula by adding whey if the current formula does a reasonable job of reflecting cheese milk value.

There is no standard whey in California. And California has always depended on very detailed cost studies to make an analysis of what the make allowance should be. There are not enough plants that dry whey so the Department can even publish numbers on cost. Furthermore, whey continues to be a disposal issue for many plants. And I say many. Some of the smaller ones and that type of thing is what I'm talking about.

In the Land O'Lakes Orland plant there's difficult problems associated with permeate. Permeate is also a problem at the Land O'Lakes Tulare operation. At one time it was possible to dispose of whey or permeate by offering it to calf raisers. But there's more whey and permeate than can be used by calf raisers. So it is necessary to further process the product even if it is at a loss.

If whey was added to the formula it would be necessary to change other factors in the formula so that the class 4b price would be the same as it is today.

The proposals by Western United and Alliance of Western Milk Producers would be extremely harmful to the future of California's cheese industry. Their proposal would seriously erode gross margins and net margins for cheese plants.

The capital investments of the cheese industry have been very large. Land O'Lakes, in fact, invested almost $150 million in a new mozzarella plant. Leprino also made a very large investment in a mozzarella plant, as well. It is unfair to change the rules of the game after those investment decisions are made.

The proposals by Western United and Alliance would provide the greatest rewards to producers who have no part in investments in cheese operations. Their proposal would discourage investment in cheese operations. The only other alternative is powder, because milk production is going to continue to increase in California, and the addition of manufacturing capacity is absolutely necessary.

A main reason for the proposal by the Alliance is to stifle competition from very efficient cheese operations that have had the vision to introduce a private protein pricing program that encourages high protein milk to be utilized in cheese. And that's exactly where such milk should be utilized.

The Alliance of Western Milk Producers is

proposing a protein pricing program, but ironically the cheese plants purchasing such milk would not be paying on the basis of protein by individual producers because the Department is not geared up to do that.

In addition, the producers would continue to be paid on the basis of fat and solids-not-fat rather than the basis of protein. Their program makes no sense at all. It's simply an effort to increase the price paid for class 4b milk. That's as simple as that.

And, of course, the protein pricing proposal by that firm is not new. The Alliance made earlier proposals. There may be some differences between the current proposal and the earlier, I didn't even bother to check. But there's one common thread that I do know, and that is it would always enhance the overall class 4b price. The only protein pricing program that would make sense is one that is revenue neutral.

The current class 4b pricing program is very efficient. It provides for a reasonable price for class 4b milk to producers and a reasonable return on investment for cheese operations. And at the same time it allows cheese plants to operate protein premium programs to attract milk to cheese plants.

If producers were paid the same protein premium under state regulation, such producers could ship their milk

to a fluid plant, a cheese plant, a powder plant and get the same price for that milk. The incentive to ship high protein milk to a cheese plant would be gone.

Land O'Lakes urges the Department to reject proposals by the Alliance and Western United. The Department needs to maintain the course. It is essential that manufacturing operations realize a reasonable return on investment. The Department's goals should be to maintain a balance in net returns for cheese and for butter/powder operations. And that's not true today. As I mentioned earlier, it's easy to sell powder to the government. There are few risks. Compare this with what Land O'Lakes did and what Leprino has done with mozzarella operations. The risks are very large. And that's an understatement.

The yield proposals by Western United cannot be justified. The current yield by the Department is very realistic. The cheese yield should be predicated on the components in the overall milk supply in California.

We oppose the use of higher of support or CME prices for cheese. The cost to move cheese to CCC is substantial. There is no way such a program makes sense. We disagree on their position of powder and butter, as well. It is our opinion that the market forces work to establish CME prices necessary to cover the cost of marketing product with the government.

In our opinion the cost for marketing cheese with the government is more expensive than it is for butter. And the least expensive commodity to move to government is powder.

The California weighted average powder price reflects both commercial and government sales. It is not necessary; it does not make sense to use the concept of a higher-of in the case of powder, either. The federal order system uses the NASS price to establish class III and IV milk in its federal orders.

HEARING OFFICER ESTES: Mr. Gruebele, you have about four minutes in case --

DR. GRUEBELE: Oh, good grief. I've got about 15 or 20 left.

The higher of the concept is not used.

The prices for cheese under the current class 4b formula are very realistic. And I have some comparisons, and I make the comparison with the current class III price, and I'll explain that later. But when I look at those, the relationship is very reasonable compared to the federal order prices; 27 cents lower in the year 2000; 44 cents less in 2002; 2001 was a very unusual year, butter prices exceeded $2 and cheese was over $1.70. And for reasons I cited earlier, because of MILC and all these other price enhancing features, we're not going to see those kind of

butter and cheese prices in the foreseeable future.

And, of course, there's also the matter of, and I want to make this point. The cheese plants in federal orders can de-pool, easily. That's not practical for most of us in California.

Secondly, the costs of manufacturing cheese are lower based upon our plant information in federal order areas than in California. Third, there's the matter of moving the cheese into the marketplace. So there are a lot of differences. And two-thirds of the population live east of the Mississippi.

The other thing about using the new federal order reform price, which a lot of people are doing, is that, according to excellent sources in Washington -- went right to the top, as a matter of fact -- not the President of the United States, of course, but other people -- that there will be challenges in the court. And there's no assurance the new federal order program will ever be implemented in its current form. And we certainly don't know when that will happen.

We do know how long court cases take; how procrastinated those procedures are. So there is just no guarantee at all that a new federal order reform price would be in existence in the year 2003. There's no assurance that will happen. And the new formula could be forced on federal

order system.

The other point I wanted to make, and in the interest of time I'll just summarize it, California's always been a leader in the milk pricing arena. The USDA does not have nearly the kind of information California does, in terms of cost information, to establish reasonable make allowances. And as a result I think that it seems to be obvious to me that California ought to be a leader in the milk pricing at the federal order pattern, their formulas in line with ours, rather than the other way around.

The federal order has not recognized, as we heard this morning, location economics in pricing of manufactured dairy products. And, of course, I will say this, California has done an excellent job of doing that in the past.

It makes no sense that the class III price should be the same from the State of Washington to the New England States to the State of Florida. This does not happen for other commodities. The Chicago Mercantile Exchanges, both in the cash and futures market, recognize location economics. Prices vary from one geographic area to another for other commodities like oranges, wheat, barley, corn; and they reflect the economics of location. Yet the federal order system does not recognize those kind of locations.

The California Department of Food and Agriculture should not have the responsibility to change its pricing

policies to compensate for the failures in the federal order pricing policies.

In the interest of time we simply support the Departmental findings for class 4a. How's that? Pretty short.

And I will just simply say that we, again, urge the Department to stay the course. Do not raise the price of milk going to class 4a -- 4b. But, if you raise any price at all, it should be 4a, because they're out of balance. And otherwise, if we don't make the proper adjustment we're going to encourage more powder production and less cheese production. And that's not good for the dairy industry or producers or anybody else in California.

And that concludes my testimony.

HEARING OFFICER ESTES: Do we have Panel questions for Dr. Gruebele?

SUPERVISING AUDITOR HUNTER: Yes. Dr. Gruebele, I've got two easy questions for you.

DR. GRUEBELE: Oh, good. I hope they all stay easy.

SUPERVISING AUDITOR HUNTER: You're talking about page 3, I think on the bottom of the second page and the top of the third page, return on investment for cheese and for powder. And you say the powder return investment is quite a bit higher.

DR. GRUEBELE: Yes.

SUPERVISING AUDITOR HUNTER: Could you give us the actual numbers on that?

DR. GRUEBELE: I do, but I'm not going to share them with you.

SUPERVISING AUDITOR HUNTER: Do you have them?

DR. GRUEBELE: I'm not -- yes, I do. Yes, I do.

SUPERVISING AUDITOR HUNTER: Okay. In private?

DR. GRUEBELE: I'm not going to share them publicly, put it that way.

SUPERVISING AUDITOR HUNTER: All right, fair enough. And the other question I have, on page 7, at the top of the page, where you talk about marketing costs as far as selling cheese to the government. Could you kind of expound on what type of marketing costs are involved?

DR. GRUEBELE: One of the big factors, Mr. Hunter, is the grading; seems to be a significant problem. I guess it's been years really since we've had to move cheese to the government. For some reason there are more problems being encountered this time around than I certainly experienced when I was at DCCA. And grading is a big problem; containers are a problem. And, by the way, Mr. Prince has specific information on this that I will include in the post-hearing record.

SUPERVISING AUDITOR HUNTER: Okay. How much

freight costs? Is that also higher?

DR. GRUEBELE: Freight costs to the government?

SUPERVISING AUDITOR HUNTER: Right. Who pays for the freight?

DR. GRUEBELE: It's fob to plant, yeah.

SUPERVISING AUDITOR HUNTER: All right, thank you.

AGRICULTURE ECONOMIST GOSSARD: Mr. Gruebele -- Dr. Gruebele --

DR. GRUEBELE: Oh, thank you so much. I worked so hard for that degree.

(Laughter.)

SENIOR AGRICULTURE ECONOMIST ERBA: You and me, both.

DR. GRUEBELE: There you go. Dr. Erba.

AGRICULTURE ECONOMIST GOSSARD: On page 6 of your testimony, speaking to the Dairywomen's Association proposal on flooring, you mentioned the cost of cheese to the CCC is substantial. Under their proposal they do allow the market adjustment to help defray that cost. Do you feel the market adjustment would not be sufficient to defray the additional cost of moving butter and cheese to the CCC?

DR. GRUEBELE: In my opinion I think the market forces will automatically identify what those costs are. I don't think we need to regulate that part of the business. So I would urge the Department not to adopt even the

proposal that has some lesser-of, 3 cents, whatever they're using. Let the market forces work.

People are going to -- I marketed cheese when I was at DCCA. And believe me, we always took it, if it was to our advantage to market cheese with the government, we were selling cheese to Kraft at the time, I would indicate to Kraft that if you want to buy our cheese here's what you'll have to pay. That was the government price at that particular point. That we had to come out even with what we could do with government.

And so that was always the position I took. And I'm saying that's the way firms will act. They will market with the government if that's the best option.

The only reason it's going below support --

AGRICULTURE ECONOMIST GOSSARD: Thank you, Mr. --

DR. GRUEBELE: Yeah, okay, okay. All right.

AGRICULTURE ECONOMIST GOSSARD: -- Dr. Gruebele. Continuing on page 6, point 8 you state the cheese yield should be predicated on the components in the overall milk supply in California.

DR. GRUEBELE: That's true.

AGRICULTURE ECONOMIST GOSSARD: You don't think it's appropriate to use the yield in vat test information from the cost studies?

DR. GRUEBELE: I do not.

AGRICULTURE ECONOMIST GOSSARD: Why not?

DR. GRUEBELE: Because I think it should reflect the overall milk supply rather than the milk supply that's going into the cheese vats. Because that is milk that's been selected by breed and otherwise.

AGRICULTURE ECONOMIST GOSSARD: But the manufacturing cost that helps determine the manufacturing cost allowance for class 4b is all predicated on milk coming into cheese plants. And the 4b price --

DR. GRUEBELE: Are you saying --

AGRICULTURE ECONOMIST GOSSARD: -- only applies to cheese plants. So why shouldn't the yield be specific to cheese yields for cheese plants rather than on some general test --

DR. GRUEBELE: I fail to understand why, if you have milk which comes in with 3-6 and 8-6 or 8-8 or whatever it is, some coming in at 8-4 and some other solids-not-fat percentage, why the cost of processing that milk should be that different going into cheese or butter/powder.

I think it's completely different to say that we ought to have a program which reflects the overall milk supply in terms of components because once we do that, we establish a pricing program, you know, the higher -- so I think that the prices, the yields for cheese should be predicated on the general milk supply, not on the vat

yields.

AGRICULTURE ECONOMIST GOSSARD: Let me repeat my question and rephrase it. The make allowance is based on information on cheese plants.

DR. GRUEBELE: Yes.

AGRICULTURE ECONOMIST GOSSARD: The 4b formula applies to cheese plants.

DR. GRUEBELE: Um-hum.

AGRICULTURE ECONOMIST GOSSARD: Given that, why isn't it appropriate to use the yields from the cheese plants?

DR. GRUEBELE: Because there have been a lot of programs to incentivize the higher yields, higher protein, higher fat, higher solids-not-fat for milk going to cheese, that's why.

AGRICULTURE ECONOMIST GOSSARD: But doesn't that all --

DR. GRUEBELE: And that's been paid for by the plants through the protein pricing programs and the like.

AGRICULTURE ECONOMIST GOSSARD: But doesn't that also then affect the cost in those plants, having different components of milk gives you a higher yield and lowers your cost because you have a higher yield?

DR. GRUEBELE: Perhaps. And maybe we ought to look at general milk supply there, as well, for cost

considerations, if that's the case.

AGRICULTURE ECONOMIST GOSSARD: Finally, at the top of page 5 of your testimony, the 4b formula should remain unchanged until the Department is able to obtain information on the average protein and the casein, as a percent of protein, for California's milk supply.

CalPoly University did a 12-month study of 13 plants in the State of California where they collected information on protein, casein and casein as a percent of protein. Why is that study not adequate to address your issue?

DR. GRUEBELE: Because it's a sample. And because when you get your average vat test on solids-not-fat for the State of California, you include all milk. And that's what I'm suggesting here. You need to know what the protein content is, what the casein, percent of protein, is for all milk. And that doesn't exclude anybody.

AGRICULTURE ECONOMIST GOSSARD: But --

DR. GRUEBELE: I'm not at all -- I haven't evaluated everything that CalPoly did, but I assume it was a sample. I don't think it was 100 percent of the milk.

AGRICULTURE ECONOMIST GOSSARD: And what's wrong with a sample?

DR. GRUEBELE: It doesn't reflect the total necessarily. I think it's an estimate of the total, but it

doesn't necessarily reflect the total.

AGRICULTURE ECONOMIST GOSSARD: Do you have any empirical data that would suggest the information generated by CalPoly is not reflective of the average California milk supply --

DR. GRUEBELE: I could look at it for the firms I represent and maybe I could demonstrate that in a post-hearing brief. I'll be glad to do so.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

SENIOR AGRICULTURE ECONOMIST ERBA: Dr. Gruebele, your client -- pardon me?

DR. GRUEBELE: Dr. Erba.

SENIOR AGRICULTURE ECONOMIST ERBA: -- you client processes cheese in at least two plants I know of, is that correct?

DR. GRUEBELE: We process -- yes.

SENIOR AGRICULTURE ECONOMIST ERBA: And do they also process whey products?

DR. GRUEBELE: Yes.

SENIOR AGRICULTURE ECONOMIST ERBA: What kinds of products?

DR. GRUEBELE: The whey products are fractionated,in both cases.

SENIOR AGRICULTURE ECONOMIST ERBA: How long have

they been processing whey, do you know?

DR. GRUEBELE: In the case of the plant three, it was when I was there still, which was in the 1980s. In the case of Orland, of course that plant was acquired after I left the organization, and I cannot say for sure, but I'd be glad to provide you with the information in a post-hearing brief, specifically when they changed, or if they ever did change, their procedure for processing whey in the Orland operation.

SENIOR AGRICULTURE ECONOMIST ERBA: Okay, thank you. On page 7 of your testimony you make a point, one of your second points in the paragraph, that it's highly likely that the costs of manufacturing cheese are lower in most federal order areas as compared to California. What basis do you have for making that --

DR. GRUEBELE: I have that only on the basis of the manufacturing operations that Land O'Lakes owns in the upper midwest.

SENIOR AGRICULTURE ECONOMIST ERBA: And it would be your experience, at least with your client, that the economies of size do not compensate for the higher input costs?

DR. GRUEBELE: In the cases that I have cited, it appears that the costs are higher in California than they are in the upper midwest.

SENIOR AGRICULTURE ECONOMIST ERBA: On a per-pound basis?

DR. GRUEBELE: Yes.

SENIOR AGRICULTURE ECONOMIST ERBA: Okay.

DAIRY MARKETING BRANCH CHIEF IKARI: Can I ask a follow-up question on that? When you're comparing the cost is the age of the plant and the investment in the plant about the same?

DR. GRUEBELE: No. The -- not necessarily, --

DAIRY MARKETING BRANCH CHIEF IKARI: Do you find that the older --

DR. GRUEBELE: -- they're older plants in the midwest, yeah.

DAIRY MARKETING BRANCH CHIEF IKARI: -- plants are less efficient?

DR. GRUEBELE: There's some loss of efficiency because they're older, yes. That is true. But the labor costs, other costs compensate for some of those differences. I will be glad to submit specific information in a post-hearing brief on that.

DAIRY MARKETING BRANCH CHIEF IKARI: And if you could, could you put like plants together?

DR. GRUEBELE: Sure.

SENIOR AGRICULTURE ECONOMIST ERBA: Just one last question for me. On one of your final statements it said in

the interest of time we simply support the Departmental findings for class 4a. What does that mean?

DR. GRUEBELE: That's what it means.

SENIOR AGRICULTURE ECONOMIST ERBA: But what findings did we have?

DR. GRUEBELE: Okay, no, it means that you have looked at some -- information; you have looked at the make allowance, you've looked at cost-of-plant information. And the weighted average costs are lower for powder than the current make allowance. The weighted average costs for butter are higher than current make allowance.

We do have some concerns about the powder yield information in particular because I have observed, my client knows this, as we've observed that the Department took into consideration in the yield, consideration that all powder, whether it's off-grade or good grade, is handled the same way. And so we do have some questions about the yield in powder.

But other than that we recommend that you take into consideration the findings that you, as a Department, found for class 4a. And if you raise the price of class 4a milk it just means that the difference between the return on investment for cheese and butter/powder have just been reduced.

SENIOR AGRICULTURE ECONOMIST ERBA: You also

include in that the adjustment factor that looks at the difference between the CME price and what California processors received, as also released by the Department?

DR. GRUEBELE: Oh, yes, that is true.

SENIOR AGRICULTURE ECONOMIST ERBA: That would be included?

DR. GRUEBELE: Yes, it would be included, yes, sir.

SENIOR AGRICULTURE ECONOMIST ERBA: So the yields, other than powder, so just the yield on butter as released by the Department?

DR. GRUEBELE: Right.

SENIOR AGRICULTURE ECONOMIST ERBA: The manufacturing cost allowances released by the Department, I assume the ones that are updated for both energy and labor?

DR. GRUEBELE: Yes.

SENIOR AGRICULTURE ECONOMIST ERBA: And the adjustment factor on butter?

DR. GRUEBELE: Yes.

SENIOR AGRICULTURE ECONOMIST ERBA: Okay, thank you.

HEARING OFFICER ESTES: No further questions? Thank you for your testimony today.

We're going to take a ten-minute break at this time. And we have, I believe, three more witnesses before

we conclude today.

(Brief recess.)

HEARING OFFICER ESTES: We are going back into session to conclude this hearing. We will now take the testimony of Sue Taylor of Leprino Foods Company.

Whereupon,

SUE TAYLOR

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

HEARING OFFICER ESTES: And could you please state your name and spell your last name for the record.

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

HEARING OFFICER ESTES: And could you describe the organization that you represent and its membership.

MS. TAYLOR: Leprino Foods is a proprietary cheese maker, focusing on mozzarella, with 11 plants across the country.

HEARING OFFICER ESTES: And would you describe the process by which your testimony was developed and approved for presentation today?

MS. TAYLOR: I'm the Vice President of Dairy Policy and Procurement, so I'm the person responsible for formulating our policy positions which are then reviewed by our senior management team.

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HEARING OFFICER ESTES: I have a written statement of your testimony today. That will be entered in the record as exhibit number 64. You've also presented a separate document to us entitled, Dairy Plant Product Loss Analysis utilizing effluent BOD. That will be entered in the record as exhibit number 64A. And you've also provided a separate statement of C.K. --

MS. TAYLOR: Venkat.

HEARING OFFICER ESTES: What's that?

MS. TAYLOR: Just call him Venkat, makes it easier.

HEARING OFFICER ESTES: I guess it's Venkatachalam?

MS. TAYLOR: Yes.

HEARING OFFICER ESTES: Leprino Foods Company. That will be entered into the record as exhibit number 64B. Obviously he's not here to testify today, but his statement will be entered into the record for consideration by the Panel.

So, please proceed with your testimony.

MS. TAYLOR: I am Sue Taylor, Vice President of Dairy Policy and Procurement for Leprino Foods Company. Leprino operates 11 plants in the United States.

I am testifying today in support of Dairy Institute of California's proposal for the class 4b formula.

This proposal is based upon sound economics and is supported by objective analysis.

I'm also testifying today in opposition to the class 4b formula proposals put forth by the Alliance of Western Milk Producers, Western United Dairymen, California Dairywomen and California Dairy Campaign. Each of these proposals is technically flawed and would result in regulated price enhancement that would send signals to an already expanding producer sector to accelerate production expansion and, at the same time, would discourage the development of additional plant capacity to process and market the additional production.

The regulated price of milk in California must continue to be set based upon factors specific to California. Because of the critical role that class 4 products play in marketing farm milk beyond the borders of California it is crucial that the price formulas remain market oriented reflecting the values of California manufactured products.

To accomplish this the commodity prices used should be reflective of the commodity values of products sold by California manufacturing plants. Yields should be achievable under normal plant operating conditions. And make allowances should be set in the context of manufacturing costs identified through a cost study of

plants within the state.

A further elaboration of these factors follows: Product prices. The recent release of the prices received by manufacturers of cheddar cheese, butter and nonfat dry milk in California from January 2001 through July of 2002 provides useful information regarding the general price levels for these products.

My general observation, however, it that the average California price level, relative to the CME, might be slightly over-stated due to the CME market trends immediately prior to January 2001 and toward the end of July of 2002. In other words, the discount relative to the CME is under-stated.

There's further elaboration on this issue that I'm going to skip over and move on to product yields.

Formula yields should be based on yields that can be reasonably achieved in the actual plant environments. Although our general bias is to base formula factors on actual experience, data on raw milk yields in California is not available. Therefore, we support a Van Slyke yield approach, modified to reflect the milk pricing system applies to milk components measured at the farm rather than in vat.

The yield data that is collected with the CDFA cost studies is based on fortified vat yields. The use of

fortified yield in valuing raw milk is conceptually flawed for several reasons. First, it effectively transfers the value of the fortification ingredient to the value of milk. This is because fortification value is based on a separate business decision and is not a value inherent to the raw milk.

Second, the economics of fortification varies seasonally and year to year as the relative value of raw milk and fortification ingredients fluctuate. Therefore, capturing the net economics of one period and applying it through the milk price formula over a future period is not appropriate.

Third, fortification ingredients cannot be assumed to contain the same casein to SNF ratio as the raw milk from which it was produced. As an example, in the footnote point out that the UF milk that comes typically out of New Mexico, and I think there's some other dairies that are now doing on-farm ultrafiltration, that process would shift the protein-to-SNF ratio from roughly 37 percent up to over 63 percent.

Given the variability of casein to SNF ratios unless casein data is available for the fortified vats, the yield data is meaningless.

Finally, many noneconomic factors influence the ability of cheese makers to fortify milk, including the

variety of cheese being produced, quality control issues and the seasonality of raw milk composition.

For all these reasons the Department information regarding fortified vat yields should be discarded for the purposes of establishing raw milk yield expectations.

Rather the cheddar yield should be determined using the Van Slyke cheddar yield formula modified to reflect plant operating reality. The Van Slyke yield formula is commonly used within the cheese industry to evaluate plant performance and was designed to estimate the amount of cheese that should be yielded from a given set of milk components in a vat.

However, the regulated milk pricing system applies to milk measured at producer weights and tests. Therefore, the use of the Van Slyke formula for the purposes of pricing farm milk must include an adjustment for losses that occur between the farm and the vat.

Our experience in California is that plant receipts are, on average, .15 percent below farm-measured volumes. And there's an additional loss of fat from farm to plant of approximately .015 pounds fat/cwt milk.

Additionally, significant component losses occur in plants even when using best management practices. These losses are associated with several aspects of plant operations including production and the required cleaning

protocols for food-grade products.

If production losses occur due to the propensity of fat to cling to stainless during receiving, separation and pasteurization, in piping, in other vessels throughout the cheese production and finishing process, and throughout the way in whey cream recovery and finishing process.

Dr. Barbano of Cornell testified at the federal order class III hearing that fat losses in the cheddaring and pressing steps alone, in good operations, ranged from 1.5 to 2.5 percent.

Cleaning protocols required in human food manufacturing environments also contribute to significant in-plant losses. Attached to my testimony is a paper written by Bob Lenehan of EcoLab elaborating on EcoLab's ongoing study of BOD loads in plant effluent. This expert testimony, which was presented by Mr. Lenehan at the federal order class III hearing in May -- that should be 2000 rather than 2002 -- is based upon a study of effluent leaving 51 cheese plants; and concluded that an average cheese plant loses 2.35 percent of the plant's BOD intake in its effluent.

Since milk is virtually the only source of BOD loading in cheese plants, this 2.35 percent loss is believed to be fully attributable to milk. This 2.35 percent loss present in the effluent understates the overall milk

component loss in plants because it does not account for the high BOD waste streams that are diverted to animal feed, land application or other disposal methods. The yields assumed in the milk price formulas must be consistent with these losses.

Skipping on to the support for the Dairy Institute of California proposal. Bill Schiek clearly articulated in his testimony the basis for the factors in the Dairy Institute of California proposal.

The cheese make allowance and butter yield factors in make allowance are based directly upon the recent studies released by the Department and do not warrant further comment. I will further focus my testimony on the complex factors of whey value and cheese yield.

Whey factor addition. Dr. Schiek clearly demonstrated in his testimony that the Dairy Institute proposal implicitly captures an estimated sweet whey revenue stream as part of the cheese price. Although a whey factor could explicitly be added to the formula, the addition of such a factor is unnecessary and should be rejected by the Department.

Many of Leprino's concerns regarding explicitly including a whey factor in the 4b formula outlined in our testimony during the September 3, 1997 and the March 28, 2001 hearings remain relevant today. Those points are

elaborated on in my written testimony and I will not belabor them with an oral.

I'm moving on to the middle of page 5. If a whey factor is added to the formula the make allowance must be a minimum of 3.06 higher than the nonfat dry milk make allowance. The practical impossibility of developing a California-based manufacturing cost study for sweet whey, due to the lack of sufficient sweet whey processing capacity, is a powerful argument against the explicit inclusion of a whey factor in the 4b formula.

However, if the Department decides to include a whey factor in the 4b formula, the make allowance must be a minimum of 3.06 cents higher than the nonfat dry milk make allowance. This 3.06 cents is an estimate of the additional energy, capital and depreciation costs associated with sweet whey processing relative to nonfat dry milk processing.

The analysis supporting the 3.06 cents has been submitted as written testimony by Venkat of Leprino Foods. The following is a summary of Venkat's testimony.

Whey processing is similar to nonfat dry milk processing to the extent that milk for both of these products is processed through clarifiers for fines removal, separators for skimming fat to an acceptable level, and is legally pasteurized in an HTST system.

However, the difference beyond this point are very

significant. In addition to all the processes required in the production of nonfat dry milk, whey powder production requires additional separation and pasteurization, a crystallization process and a two-stage dryer. After the initial pass-through of clarifier, separators and pasteurizer prior to cheese production, the whey stream coming off the vats must again pass through a clarifier, separator and pasteurizer a second time. The solids level of dilute whey is lower than that of dilute skim, requiring additional energy to concentrate the whey.

The additional energy costs, based upon the August 2002 rates published by CDFA, associated with the higher evaporation requirements equates to .516 cents per pound. The refrigeration for the crystallizers equates to .268 cents per pound. The additional dryer gas equates to .047 cents per pound. And the additional power required to power the additional equipment equates to .441 cents per pound. The total of these additional energy costs is 1.273 cents per pound.

The capital costs of additional equipment required in whey processing that is not required in nonfat dry milk production is 1.1 cents per pound. And the depreciation is .685 cents per pound. The 1.273 cents incremental energy cost, the 1.1 cent incremental cost for capital, and the .685 cent additional depreciation total 3.058 cents per

pound in costs associated with whey processing that are not associated with nonfat dry milk processing.

Since all nonfat dry milk production functions are also required in whey processing, this 3.06 cents per pound must be combined with a 15.12 cent per pound nonfat dry milk weighted average cost from the cost study to establish a whey cost estimate of 18.18 cents per pound yield.

As noted in my earlier comments, the cheddar yield in the formula should be based on theoretical yields using a methodology that recognizes that the formula was intended to predict yields of vat components rather than farm components.

The fat retention factor of the Van Slyke should be 90 percent. The literature on cheddar yields and testimony by cheddar makers at various hearings indicates a typical range in actual practice of 90 to 93 percent.

In past hearings we've been willing to accept a retention assumption of 92 percent. However, the 92 percent retention factor was being used in the context of a formula that omitted whey value.

Several proposals being considered at this hearing either exclusively add a whey factor or calculate an average whey value to implicitly add a whey factor. If adopted, these proposals would remove all room for over-stating prices or yields or understating manufacturing allowances.

Additionally, since this analysis is being done to calculate minimum regulated prices above which premiums are paid, the low end of the achievable range should be used. Therefore 90 percent is the appropriate fat retention factor for the class 4b formula.

Opposition to Alliance of Western Milk Producers, Western United Dairymen, California Dairywomen and California Dairy Campaign proposals. Opposition to addition of whey factor. Leprino opposes the aspects of the Alliance of Western Milk Producers, Western United Dairymen and CDC proposals that add a sweet whey factor to the class 4b formula.

Opposition to Alliance protein pricing proposal. The proposal by the Alliance to allocate the SNF value to a combination of protein and other solids should be rejected. Implementing protein pricing on the plant obligation side while the Department lacks the technical capability to pay producers on protein pricing would result in a significant and harmful redistribution of income from producers who have invested in producing high protein milk to those producers who have not done so.

Opposition to Alliance yield proposals. The Alliance proposal suffers from several significant errors. Most troubling is the assumption that plants can capture in finished product 102.5 percent of the fat that is measured

at the farm. This assumption is buried in the protein price formula.

Specifically, the Alliance assumes that 92.5 percent of fat measured at the farm is captured in the cheddar cheese. That's the basis of the 1.3 factor. Because cheese makers are already paying for the fat component at the butter value, the protein formula credits a portion of that payment against the cheese yield value of fat in the protein equation.

However, the Alliance proposal reduces the cheese yield value of fat by only 90 percent of the fat component price, leaving 10 percent of the fat measured at the farm values at AA butter value. 92.5 percent captured in cheddar plus 10 percent captured in AA butter equals 102.5 percent of the farm fat.

The problems with pricing 2.5 percent more fat than is even measured at the farm at the combination of cheddar and AA butter should be obvious. Components are lost as milk moves from farm to finished product, not spontaneously created.

Additionally, the assumption that fat recovered from the whey stream can be used to produce AA butter is erroneous. Grade AA butter cannot be produced from whey cream. In fact, whey cream commands a significantly lower market value than sweet cream. This was historically

recognized by valuing whey cream relative to the grade B butter market, or discounted grade AA market. Leaving any portion of the whey cream valued at the AA butter value severely overvalues the whey cream.

Additionally, the fat losses that occur throughout the production process are significant as indicated by the EcoLab study. The volume of whey fat that is recoverable from whey cream equates to roughly half of the fat not captured in cheddar, if assuming a 90 percent fat retention.

Opposition to price floor. Leprino opposes the California Dairywomen and California Dairy Campaign proposals to floor the class 4b price. Although we share the proponents' concerns regarding market prices falling significantly below support at times, this proposal is misguided in that it effectively asks California cheese makers to should the costs of a dysfunctional federal dairy support program. Again, I previously testified on this issue at another hearing. I'm going to skip forward, over my written testimony, to the lower part of page 9, opposition to CDC's flexible make allowance proposal.

The incorporation of a farm level cost of production factoring the regulated manufacturing prices should be rejected. The dairy industry has no discipline on over-production other than the price signals that are delivered to the producers through the milk price.

The dairy price support program results in an open-ended market for certain manufactured products and cooperatives typically guarantee a market for the members' milk with no limitation on growth. The primary governor on milk supply increases come from the interrelationship between the milk price and the farm cost of production. The CDC proposal would mute those market signals that are required for a supply side correction.

California/federal order price alignment. Some of the proposals submitted for this hearing justify price enhancing proposals, in part, upon the recent federal order class III decision. Their theory is that lower regulated California milk prices are resulting in lower prices nationally. This theory does not hold up to basic economic logic.

It has been well established over the years that cheese prices are determined by cheese supply and demand, not by milk prices. Cheese production is largely driven by farm level milk production in competitive balance with the butter/powder complex. Raising the milk price in California does not result in lessened competition from California produced manufactured products. In fact, the opposite is the case.

A study by the Food and Agriculture Policy Research Institute several years ago found that increasing

the California milk price to federal levels stimulates additional milk production. This milk ultimately is manufactured into cheese and butter/powder, which further depresses national commodity prices. These lower manufactured product values result in lower milk prices.

Raising the manufactured milk prices in California also does nothing to address the concerns of those plants operating in the federal orders in the west. Their concerns are rooted in the federal order system and must be addressed through the federal order system.

The recent class III decision achieves the bulk of its price enhancement through an assumption that all of the fat that reaches the plant, but is not captured in cheddar cheese, can be converted to grade AA butter. Interestingly, they assume that all the same fat goes through the vat resulting in degradation of the fat to whey cream. This is a very significant and grave error in the federal system. But the California State order hearing is not the venue to correct that error. Misery loves company, but does not make for good policy.

We urge the state to continue to recognize that milk produced and processed in California must be priced relative to its market value which is related to the finished product value, yields and costs in California, not the raw product price elsewhere in the country.

Many witnesses have spoken powerfully about the need to maintain a market-oriented milk pricing system. The Dairy Institute proposal is based upon sound economics and maintains this market-oriented framework. The Department should adopt the Dairy Institute proposal and reject the proposals put forth by the Alliance, Western United, California Dairywomen, and CDC.

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

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

Do we have Panel questions?

AGRICULTURE ECONOMIST GOSSARD: An earlier witness asked the Department to consider using both barrel and block prices in its class 4b pricing formula, citing the fact that about 45 percent of cheddar cheese in California is barrel type.

A second question came up about the other 66 percent of the cheese, which is not cheddar.

Leprino makes mozzarella cheese and other Italian cheeses. Is any of the cheese Leprino makes in California priced off the barrel market?

MS. TAYLOR: No, it is not. It's priced off the

block market.

AGRICULTURE ECONOMIST GOSSARD: Other than barrel-type cheeses, the -- 640s 500 pound barrels, are there any cheeses -- what other cheeses use the barrel market as the price indicator?

MS. TAYLOR: I am not aware of any other cheeses. There may be some industrial uses that do price relative to the barrel market, due to private contracts, but I'm not aware of that.

AGRICULTURE ECONOMIST GOSSARD: As a consumer, I purchase a processed mozzarella cheese product -- food, whatever the FDA requires on the label, made by a previous witness' company. That processed mozzarella, however, originally started off as a mozzarella that was priced off the block market rather than the barrel?

MS. TAYLOR: I'm not familiar with the product.

AGRICULTURE ECONOMIST GOSSARD: Oh, okay. My other questions specifically deal with your testimony. On page 2 of your testimony you reiterated some of the reasons that you feel that while the plant data is appropriate for setting the make allowance, that the plant data is not appropriate for establishing a yield.

Do you feel there's an inconsistency there?

MS. TAYLOR: I would prefer to have clean plant data to set yield, as well. But the fact is that we don't

have that data. We don't have casein composition for your vat composition on the yields. We also don't have the protein premiums that are paid in order to achieve those levels of casein in the vat.

I did have an illustration, I think, that should cause people to pause who might not go directly off of your data, relative to the potential distortions in the protein to SNF relationship, some of the fortifying ingredients, and specifically ultra-filtered milk.

AGRICULTURE ECONOMIST GOSSARD: At a previous hearing for the Departmental exhibit, the Department made an effort to break out fortification costs. Not only the purchased products they're already in, buried; those were broken out. We also added to fortification costs protein premiums.

Would data along that line help to address some of your concerns?

MS. TAYLOR: It would be helpful, however that wouldn't overcome my concerns. You still have the issue of transferring value from something that is not inherent to raw milk to the raw milk, in using fortified vat yields of any sort. You still have the issue of lack of the casein data so that you can't translate truly the milk component relationship to the final yield.

AGRICULTURE ECONOMIST GOSSARD: The next two

questions are both on page 3. You talk about since the Van Slyke is based on tests of milk going into the vat, you suggest that there should be additional adjustments to represent ranch-to-plant loss.

Are these the same adjustments that are currently proposed in the final rule by USDA that was released in November of 2002?

MS. TAYLOR: No, they're slightly lower. They are consistent with my testimony at the federal order hearing, however. The adjustments incorporated in the federal order side would be a quarter percent volume loss ranch-to-plant, rather than .15 percent.

In the milk sheds where we have larger dairies we experience slightly lower ranch-to-plant losses. And so I've advocated here .15 percent for the purposes of California.

AGRICULTURE ECONOMIST GOSSARD: And with the fat number of 0.015 pounds per fat would be the same?

MS. TAYLOR: Yes, that's relatively consistent across our system, and we believe that that difference is mostly attributable to the fat cling to stainless at the farm and truck, going through.

AGRICULTURE ECONOMIST GOSSARD: Also on page 3 you refer to the attachment, which was entered as exhibit number 64a, you're talking about BOD loads; you mention a loss of

2.35 percent. To the extent possible, listening to your testimony and glancing over the attachment, I apologize if I ask a foolish question, but I tried -- this is a measure of the total BOD load coming into the plant from the protein, fat and lactose, 2.35 percent of that load typically ends up as an effluent.

MS. TAYLOR: That's correct.

AGRICULTURE ECONOMIST GOSSARD: But that doesn't mean that it's 2.35 percent of the fat, 2.35 percent of the protein, 2.35 percent of the lactose. This is a single number that lumps everything together.

MS. TAYLOR: That's correct.

AGRICULTURE ECONOMIST GOSSARD: Presumably the 2.35 percent is probably mainly lactose?

MS. TAYLOR: I have no data to support the allocation across the components.

AGRICULTURE ECONOMIST GOSSARD: Okay. On page 5 of your testimony you suggest that should the Department add a whey factor with a manufacturing cost allowance, that you believe the allowance should be 3.06 cents above whatever allowance is established from nonfat dry milk.

An earlier witness for the Northwest Dairy Association suggested a figure of 2.6 cents. Would you care to comment on the differences? Are they more efficient than you are?

MS. TAYLOR: No, in fact the 2.6 cents came from Venkat's testimony at the federal order hearing; and it is available over USDA's website.

The only difference between the 2.6 cents and the 3.06 cents here is this analysis that's submitted for the purposes of the hearing today is based on California energy costs. The analysis that established the 2.6 cents was based on national energy costs as of the hearing in May of 2000.

AGRICULTURE ECONOMIST GOSSARD: So the 2.6 U.S. energy as of 2000. The 3.06 is California energy costs as of 2002, 2003?

MS. TAYLOR: I used the August 2002 data published by the Department.

AGRICULTURE ECONOMIST GOSSARD: Okay. The final question relates to the California Dairywomen's Association, page 8. With the understanding that under their proposal to floor the price, using the freight adjustment off the support purchase price, and the fact that over five years it generates 2 cents/cwt, on average, to the pool, do you, one, still feel that that would be enough price enhancement to stimulate production? And is the freight adjustment not sufficient to cover the additional cost of moving cheese to the government?

MS. TAYLOR: The price enhancement question, it's

not a significant price enhancement. However, that price enhancement is coming at the very time that the signal should be sent to the producers to cut back on production. So any price enhancement at that time prolongs the low price period and is contrary to what we should be doing from a policy perspective.

As far as whether the freight adjustment accommodates all the costs of moving product to the government, that highly depends on how effective USDA is in implementing their program.

In late 2000 they were very ineffective; and the cost of moving product to the government, as I understand it, became very high due to a range of things. Labs that weren't turning around test results; product that ended up being held then for a period of months before USDA cleared it; and then finally rejected it, making it unsuitable for the commercial market because it had been packaged for USDA, been in that holding pattern for so long.

There are a number of costs that shouldn't be a part of the price support program of doing business with the government. If product is constantly moving to the government, but because cheese typically doesn't move to the government, the cost of implementing the support purchases is far in excess of the old rule of thumb of 2 to 3 cents.

So, no, the freight adjustment does not cover that

cost.

AGRICULTURE ECONOMIST GOSSARD: Thank you. I have no further questions.

SUPERVISING AUDITOR HUNTER: Yes, I have a couple questions, Ms. Taylor. Going back to that 3 cents, or 3.06 cents higher than nonfat dry milk, were those costs, they based on the whey plants that you have in California, or cheese plants in California where you make the whole whey?

MS. TAYLOR: No. We make WPC and lactose in California. If you have an opportunity to review Venkat's testimony, he has over 40 years of industry experience, including work with GEA -- the major designer and provider of that whey equipment.

His testimony is based on much of his experience prior to joining Leprino, as well as there is some cost data in here that's based on an estimated two million pound a day cheese plant. We do have two sweet whey operations in the country. They're in the east. That's approximately the size of both of those plants. That's why I suspect that did serve --

SUPERVISING AUDITOR HUNTER: Okay.

MS. TAYLOR: -- as a backdrop. And as I looked at that and thought about the applicability to today's hearing, and the size of plants out here, the thing that got me comfortable that it was still applicable is my sense is any

of the sweet whey processing that does exist in California is from plants that are roughly that size. Or smaller.

SUPERVISING AUDITOR HUNTER: But there's no California costs in here, then is what you're saying, right? It's all back east? So the cost could be higher or lower in California from what he's saying?

MS. TAYLOR: On --

SUPERVISING AUDITOR HUNTER: Except for the energy costs, our energy costs?

MS. TAYLOR: Right. The testimony of Venkat is based on the mechanics of evaporating fluid, and so it --

SUPERVISING AUDITOR HUNTER: I got you. So it's not -- it's not actual cost he's basing it on, he's basing it on the current nonfat powder processing in a sense to whey processing and the differences?

MS. TAYLOR: It's strictly the energy costs. There are also labor costs, management costs in excess of this that are not incorporated in here.

If you'd like to look at page 4 of his testimony I think it might become more clearer. The composition is, I believe Mr. Van Dam referenced, of dilute whey is lower than that of skim. And so it requires greater water removal, almost six pounds more water to be removed in order to get that product up to 54 percent total solids.

There's a crystallization cost that's associated

with it; it's a whole process that is associated with sweet whey that's not associated with nonfat dry milk. So there are additional costs there.

And then both products, drying to 97 percent total solids, we have a comparison there. He also breaks out the additional power required for each of those operations.

SUPERVISING AUDITOR HUNTER: Okay, very good. The other question I had, going back to the second page, I believe, or the third page, I'm sorry, and talking about the Van Slyke.

If we have the casein information in the fortified vats how accurate would the Van Slyke be in that case? As accurate as it always is?

MS. TAYLOR: Yes, that would actually be more precise than -- I mean the typical use of the Van Slyke is starting with a protein number. Casein is always more accurate than protein, but we don't typically test for casein due to the difficulty of testing for casein.

But that --

SUPERVISING AUDITOR HUNTER: If it -- okay.

MS. TAYLOR: -- that would take out some additional slush factor.

SUPERVISING AUDITOR HUNTER: Right, if we had the protein numbers in the fortified vats, the Van Slyke formula would be as accurate as it would be on just raw milk? Or

pretty close?

MS. TAYLOR: The true protein would be preferable because I believe that some of the fortification ingredients may have a different level of nonprotein nitrogen that would distort total protein numbers.

So if you had true protein numbers, yes.

SUPERVISING AUDITOR HUNTER: Okay. Thank you.

SENIOR AGRICULTURE ECONOMIST ERBA: Ms. Taylor, if we have actual data on California plant yields, California fat tests why would we want to go to a theoretical formula instead of just using the information we have that's specific to California?

MS. TAYLOR: As I answered to Mr. Gossard's question, it's because right now we don't have that clean data. Because it's fortified data, which is problematic in many ways.

SENIOR AGRICULTURE ECONOMIST ERBA: Your discussion of the difference between the CME price and the NASS price you state that there's probably an overstatement of some sort. And the price that the California manufacturers' price, how much they received relative to the CME. And you admonish us to be mindful of the overstatement when considering policy deliberations. We have it estimated at 3.21 cents. How much lower or higher should it be?

MS. TAYLOR: I did not run through, because I

don't have the weekly data for California to really establish the regression equation, I did not run through and re-estimate. I suspect it's not a huge difference, but just consistent with the minimum pricing concept, consider that there may be, I don't know, might be a tenth of a cent difference. I really don't know. But consider that that's not absolute black and white in your current analysis.

SENIOR AGRICULTURE ECONOMIST ERBA: One final question. In discussing your opposition to the increase in the cheese yield to 10.2, Western United and CDC both used the Van Slyke type approach. Where is it in their reasoning, in their thought process, that they are making mistakes so that they're getting a much higher yield than you think they ought to be getting?

MS. TAYLOR: There are two aspects. They do not recognize a ranch-to-plant loss. And the other is they have a higher fat retention factor.

And, again, if we're going to be adding a whey factor to the formula it's very important that we set all the factors at a level that's achievable by all plants in the state, or the majority of plants.

SENIOR AGRICULTURE ECONOMIST ERBA: Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: At the risk of beating a dead horse I'm going to ask you a question that's slightly different. You've testified, as Dr.

Gruebele has testified, to eliminate the use of fortified vat in calculating yields. He's testified we should use the average test of California milk. What about the concept of using the average test of the milk purchased by cheese plants?

MS. TAYLOR: That's highly problematic because that's incented milk for which there's been premiums paid out to attract that higher protein milk. The protein to SNF relationship going into cheese plants typically would be, well, just as a rule of thumb range, and this is just a gut, I don't recall exactly what the Tong study might have said on this, I always figure Holsteins protein/SNF ratios 36, 36.5 percent. And Jerseys can get up in the 42, 43 range.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. But is the milk they purchase in running through their plants.

MS. TAYLOR: Yes, it is, but they're purchasing that with protein premiums. If you were to capture that into the regulated pool, there would be no reason for those Jersey shippers to ship to the cheese plants. And so they would lose that benefit and be paying for effectively the higher protein milk that they're not getting.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. This is just with respect to yields now, though.

MS. TAYLOR: By increasing the yields you're removing the ability of cheese plants to attract milk.

AGRICULTURE ECONOMIST GOSSARD: A follow-up to Mr. Ikari's last question. You responded by increasing the yield you're increasing the 4b price, lowering the potential for premiums. But that assumes increasing the yields with no other adjustments to the formula, is that correct?

MS. TAYLOR: That's correct.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

HEARING OFFICER ESTES: Have we concluded with the questioning? Thank you for your testimony.

Next we have Geoffrey Vanden Heuvel of the Milk Producers Council.

Before Mr. Vanden Heuvel testifies I just wanted to note that if there's anyone else who wishes to testify today, please sign in at the back so that we know that you wish to do so, because Mr. Vanden Heuvel is currently the last witness that we have. And Mr. Marsh, I believe, will testify, so please sign in the back so that we have your name on the list, as we would like to have some idea at this time, as to which people, if any, wish to provide additional testimony.

Whereupon,

GEOFFREY VANDEN HEUVEL

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

HEARING OFFICER ESTES: Could you please state

your name and spell your last name for the record.

MR. VANDEN HEUVEL: My name is Geoffrey Vanden Heuvel; that's last name is V, as in Victor, -a-n-d-, as in David, -e-n H-e-u-v-, as in Victor, -e-l.

HEARING OFFICER ESTES: All right, Mr. Vanden Heuvel, could you please describe the organization that you are representing here today.

MR. VANDEN HEUVEL: Yes, I'm representing Milk Producers Council which is a dairy producer trade association.

HEARING OFFICER ESTES: And how many members do you have in your organization?

MR. VANDEN HEUVEL: About 175 members, located primarily in southern and central California.

HEARING OFFICER ESTES: What was the process by which your testimony was developed and approved for presentation here today?

MR. VANDEN HEUVEL: It was based on policy direction given by the Board of Directors at the November 2002 board meeting.

HEARING OFFICER ESTES: I have a written statement of your proposed testimony today. It will be entered into the record as exhibit number 65. And you may now proceed with your testimony.

MR. VANDEN HEUVEL: Thank you, Mr. Hearing Officer

and Members of the Panel. My name is Geoffrey Vanden Heuvel and I'm a dairy producer located in San Bernardino County in California.

At today's hearing there will be a great deal of testimony, there has been, regarding the mechanics of the class 4a and 4b formulas. Product yields, product values and make allowances will all be discussed. And that is entirely appropriate.

However, the overriding policy decision that must be made by the Department is whether or not to make a net change in the producer price as a result of this hearing. Milk Producers Council strongly believes that the gap between the California 4a and 4b prices and the comparable federal milk marketing order class III and IV prices must be significantly narrowed, if not eliminated.

The continuation of a significant gap between the prices generated by these two systems will cause, in our opinion, significant harm to the California dairy industry for two reasons.

First, our neighbors in the west who are currently subject to federal milk marketing order regulation have made it abundantly clear that if California persists in maintaining the existing large gap they must seriously consider voting out the federal order system, which would be extremely destabilizing for the dairy industry in

California.

Secondly, California's all milk price is now falling significantly below the all milk price in other parts of the country, with milk prices now falling below producers' cash cost of production for an extended period of time. There's a growing risk of permanent damage to the production capacity of California producers.

Especially at the bottom of the market cycle, California producers cannot afford to fall so far behind the milk price revenue of the national dairy industry without doing serious damage to our equity position.

Therefore, it is absolutely essential that the gap between the California 4a and 4b prices and the comparable federal order prices be closed, and that is our goal. We are convinced that once the Department receives the information contained in the proposals and testimony at this hearing the Department will have the tools to change the California class 4a and 4b formulas so that gap in the federal order prices can be eliminated.

The federal order class III price is now a western price. It's important for us to realize that there has been a fundamental shift in the nature of how the federal order establishes their class III price for cheese milk. Up until a few years ago the basis for the federal order class III price was what cheese plants in Minnesota and Wisconsin pay

for unregulated grade B milk in a very competitive environment. It was claimed, with some justification, that the M/W price and therefore the federal order class III price that was derived from it was a midwestern price and therefore some gap between the California class 4b price and the federal order class III price could be justified.

Now, however, the federal order class III price is established with the use of a product value formula that is based not on what cheese plants in the upper midwest are paying for milk, but instead what cheese plants nationally are receiving for cheese.

The NASS cheese price data shows that the largest percentage of cheese that makes up the national cheese price does not come from Minnesota and Wisconsin sources. Anecdotally we are told that the vast majority of the cheese that makes up the NASS cheddar cheese price survey is western cheese. The federal order class III price is now driven by primarily a western cheese price.

When you compare the monthly NASS cheese price that drives the federal order class III formula with the CME 40-pound block price, less 1.2 cents, that drives the California class 4b formula, you discover that over time they produce virtually identical results.

Using the 52 months of data contained in the monthly cheese price table in the Department's exhibit, the

difference between the average of these two prices is less than .6 of a cent per pound of cheese. That is remarkable. Clearly the product value price driving the California 4b formula and the NASS cheese price that drives the federal order class III formula are in synch. I'd just refer you to that exhibit A.

Because not only is it over the 52 months, but even internally, on an annual basis, the difference between the two prices, although different from month to month, the average, on an annual basis, is very very narrow. The realignment of the federal price has happened. And it is now a western price. Very clearly.

CME minus 1.2 cents is the right product value for cheese. What is clear from the data is that there is a strong and steady relationship between what the California 4b formula is using as its product value basis, and what ends up becoming the NASS cheese price that drives the federal order formula.

Therefore, it is quite safe to assume that lowering the California basis off the CME, as is proposed by some at this hearing, will not only drag the California price down, but will also likely drag the NASS price down, as well. And so the whole point of that, which is to somehow or another account for a misalignment, will very likely not happen because of the very clear connection

between these two prices.

The California weighted average cheese price data, the survey that the Department produced, is inconclusive. Proponents of lowering the cheese price product value in the 4b formula cite the California weighted average cheese price data that was compiled by the Department as its justification for change. A simple observation of this cheese price data reveals no discernible pattern or logic to the numbers that are produced. There are wide swings in the difference between the CME price and what California plants said they sold 40-pound block cheddar for.

This is in contrast to the California butter data provided by the Department. The spread between California butter prices and the CME is much more consistent. The range is narrower. And when larger differences occur it corresponds to larger market price movements.

But there are fundamental differences between the nature of the butter business and the nature of the cheese business. For one thing, it's very likely that the five cheese plants on this survey also make other types of cheese than cheddar. While there may be different package sizes of butter, butter is butter. Cheese, however, comes in different varieties with 40-pound cheddar blocks being typically on the bottom of the value scale.

This fact gives the cheese plants the opportunity

to get higher prices for their other types of cheese while reporting lower prices for the 40-pound blocks. I learned something in testimony that I heard. This is called bundling, apparently. And so it's a practice that's used in this industry.

But more significantly is the fact that in the year 2001 when the surveys showed that the gap between the California 40-pound block price and the CME was the greatest, dry whey prices were at very high levels. This fact gave California cheese makers a tremendous opportunity to increase their market share by discounting their cheese.

John Jeter, the CEO and President of Hilmar Cheese, explained how this strategy works at a hearing on March 28, 2001. He said, and I quote, "Essentially what we have done to stay competitive is to lower our costs through the economies of scale, CDFA is privy to our costs over the last 15 years, and to invest aggressively in the whey side of our business so that we can get more out of the milk we buy. If we would not have grown more efficient through effective use of the economies of scale, and if we would not have developed an effective whey business, we would be out of business or the business would be a fraction of the size it is today, clear and simple."

"The combination of these two have allowed us to grow the market for California cheese throughout the United

States. Had we not done these things we would not have been competitive in the majority of markets we are in today."

"Essentially we have lowered our prices over the past 15 years to obtain key markets for California cheese and milk. If we had not, we would not have been competitive, and would not have grown. But just investing in our cheese operations and lowering our cheese manufacturing costs was not enough. We also had to invest heavily in whey processing so that we could get more value from the milk." End quote.

2001, with its high whey values, offered a golden opportunity, clearly taken, by California's cheese makers to, quote, "lower cheese prices" to quote, "obtain key markets." End of quote.

When whey prices dropped in the spring of 2002 so did the gap between the California 40-pound block price and the CME price. See exhibit B. The California cheddar cheese price data, as presented by the Department, cannot be used as a justification for lowering the cheese product value basis off of the CME price used in the class 4b formula.

It's very clear that a price surface does still exist and we've heard some talk about that, Mr. Reinke talked about, and others about this Cornell study. There is a price surface. But we need to recognize that the federal

order class III has now shifted to the west and the midwest are receiving premiums over and above that. We had a couple witnesses talked about premiums in the midwest. They've committed to putting some of that into post-hearing briefs documenting some of the midwestern premiums that are taking place.

The pricing surface exists; it just exists in different forms. Instead of the M/W price being a midwestern price, and we being down below that, our minimum price is now a western price where it used to be in premiums above that price.

Next, a value for whey solids should be added to the 4b formula. It's quite clear from the information developed by the Department that further processing of whey solids into marketable products has become the norm for California's cheese plants. While those cheese plants will claim that they invested in this technology and should therefore keep all the profits, it's important to know that California producers have invested similar amounts of money into production efficiencies. Market forces require that efficiencies be adopted in order to stay competitive.

Much of the cheese makers' margin is protected by the make allowance, and when new products are developed that generate constant values in excess of their costs, the regulators are obligated to make adjustments to the formulas

to account for those values.

While it is true that dry whey is not the predominate product made from whey solid stream in California, it is also clear that dry whey represents the lowest value marketable product that can be made from the whey solid stream. That's why both the federal order system and the federal government support purchase program use dry whey as the surrogate product to establish a whey stream value for producers. MPC strongly supports the specifics of the Western United Dairymen proposal to add a whey solids value.

The 4b formula cheese yield of ten pounds of cheese from 100 pounds of 3.65 butter fat/8.78 solids-not-fat is too low and should be increased. Much will be said in this hearing about the Van Slyke cheese yield formula. MPC has, in the past, made those arguments, as well, and we fully support Western United Dairymen's approach on this issue.

According to the yield numbers published by the cost auditing branch, the average California cheddar cheese yield is 10.71 pounds of cheese from 100 pounds of milk, testing 3.95 percent butterfat and 8.93 solids-not-fat at 36.2 percent moisture.

At the workshop the Department indicated that nearly half the volume in the study was barrel cheese.

Barrel cheese is typically made with low moisture and receives a moisture premium to adjust it to 39 percent.

If we adjust the average California yield to 38 percent moisture, that increases the yield from 10.71 to a yield of 11.02 pounds of cheese from 100 pounds of milk.

We have created a table, exhibit C, which compares what the current 4b formula, which includes a 10-pound yield from milk, testing 3.65 and 8.78, what that produced in the way of a 4b price, to what the 4b price would be if the formula simply used 11.02 pound yield for milk testing 3.95 percent butterfat and 8.93 percent solids-not-fat.

What is very clear from this table is that the formula using the 10-pound yield generates much less value than the yield that the Department is finding that California cheese plants actually get. This is a very strong indication that the 10-pound yield number used in the current 4b formula is too low and should be raised.

Western United has proposed raising it to 10.2 pounds for milk testing 3.65 and 8.78; MPC supports that change. Interestingly, Dairy Institute, while showing a 9.98 yield, when they correct the moisture from 37 to 38 percent, and you run the same Van Slyke formula that Bill uses for the Dairy Institute with a higher moisture, it comes out to about a 10.14. Dr. Gruebele had to concede a 10.12 in his usage of Van Slyke.

As to Ms. Taylor's assertion about the casein levels in fortified vats, and in the reference to the New Mexico ultra-filtrated milk, the very interesting example. To our knowledge there's very little, if any, of this new Mexico ultra-filtrated milk that's ever gotten into a California cheese vat. And it's hard to imagine that there's enough of that to make a discernible difference in the data the Department has developed. Forty percent of California's milk goes into cheese.

The Tong data shows a slightly higher casein level in the amount of milk -- in the milk stream that's going into cheese plants, but not near to the levels that Ms. Taylor seems to imply. So, I think that reference to the New Mexico milk needs to be substantiated with some evidence that that's a relevant thing for California.

The make allowance for cheese needs to be reviewed. It seems that the manufacturing costs for cheese plants have been reduced somewhat. MPC generally supports the Western United approach to make allowances. There's a couple of points here about losses picked up. In the losses that exist, it's our understanding, are picked up, product losses, in the manufacturing costs, because the manufacturing cost unit tracks the milk from the farm all the way to the finished product. And so we think that those losses are already accounted for in the manufacturing costs.

The gap between California 4a prices and the federal order class IV also needs to be eliminated. The gap between the California 4a price and the federal order class IV price gets less attention than does the 4b gap, but in some ways it is even more damaging.

The generosity of the current 4a formula is creating a tremendous incentive to make powder. When the making of powder becomes the most profitable option for milk, as appears to be the case currently, then the regulation creates a distorted market signal. Powder is in chronic national over-supply; it is not wise for California to give California's powder makers the kind of raw product cost advantage that exists in the current 4a formula.

Milk Producers Council strongly supports the specifics of the Western United proposal on class 4a, and applauds them for their remarkable courage in making this proposal.

HEARING OFFICER ESTES: You have four minutes, Mr. Vanden Heuvel.

MR. VANDEN HEUVEL: Okay. The challenge, we are little concerned in terms of the make allowance that there have been some challenges, both by CDI and the Dairy Institute on the validity of the Department's cost figures.

We rely on those cost figures and there's an awful lot of history that goes on behind that cost. As we

understand, the Department has had outside people look at the methodology, and has given the Department high marks on the quality of that cost data. So, we're concerned about that; want to make note of that.

We also want to make note of the fact that while the labor and energy costs were updated for 2002, apparently there seem to be quite a bit more volume of product that was processed by manufacturing plants in 2002. So, the cost dollars were added. We're concerned that they may have overstated the 2002 costs because the volumes were not also updated. So you got costs spread over greater volumes -- costs could have dropped.

On the other proposals the Dairywomen proposal should also be adopted. MPC strongly supports the proposal by the California Dairywomen to floor the commodity value in the 4a and 4b formulas at the federal support purchase price. The Commodity Credit Corporation stands ready, willing and able to purchase all butter and powder and cheese that's offered to it. And it is a legitimate market price.

If processors decide to sell their product to someone else at a cheaper price, they should not be able to transfer the cost of that discount to the producer.

The California Dairy Campaign variable make allowance proposal has merit. One of the major flaws of

both the California and the federal order butter, powder and cheese milk formulas is that they have a fixed margin for the plants regardless of the price the end product is sold for. In effect, the processor is inoculated from the market signals.

The CDC variable make allowance proposal seeks to put a market signal mechanism into the 4a and 4b formulas. We support this in concept, and urge the Department to seriously look at creating a more direct market signal for processors in the 4a and 5b formulas.

The Alliance 4b proposal achieve the right result. We applaud the bottomline of the Alliance proposal. The net effect of the Alliance proposal is to close the gap between California 4b price and the federal order class III price, and that's our goal, as well.

MPC is still skeptical about moving to a protein pricing system for 4b which seems to be the underlying goal of the Alliance proposal. Protein pricing milk in the regulated formula in California would have broad implications which deserve much more scrutiny than can be given at this time.

The Dairy Institute proposal for how to deal with the whey solids stream is interesting. MPC is happy that the Dairy Institute has finally acknowledged that the value of the whey solids stream needs to somehow be acknowledged

in the class 4b formula. And so we appreciate that they acknowledge that. We don't necessarily agree with their approach.

In conclusion the California dairy industry has reached a new phase. We have had a number of competitive advantages that we have used over the years to grow our industry. We have better weather; a large population; good quality alfalfa. And most importantly, some of the most progressive producers in the world.

We have also benefitted from having a state-controlled milk pricing system that could very efficiently create an incentive to expand processing capacity by manipulating the class 4a and 4b formulas.

But times have changed. Some of our most progressive producers have taken what they've learned in California and set up shop in other parts of the country where the weather is worse, the feed is cheaper, and the price of milk is higher.

The growing population in California is beginning to impact us. Their demands for water and for higher environmental scrutiny have already begun to drive up our cost of production. This will only continue.

The reallocation of water from traditional farming areas to the urban population will mean that feed will continue to be more expensive. The dairy industries in our

neighboring states are no longer willing to simply be quiet about our generous plant margin policies. They seem them as unfair and undermining the entire regulated milk pricing system in the west.

California is no longer an island. We're part of the national dairy industry. This is a crucial moment for the Department and for California. Is our policy going to change? This hearing has provided the tools for change. MPC strongly urges the Department to adopt a hearing finding that eliminates the price gap between California and the federal order system.

There is one other thing I wanted to address. Dairy Institute has a very interesting quote on the bottom of page 2, Bill said, "Increasing the regulated price now will only send a signal for dairymen to produce more, prolonging the period of low farm milk prices we are now experiencing."

I think Western United very clearly outlined what this hearing is really about in their testimony on page 1. They said, "these extreme 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."

This hearing is about the correct level of revenues. That's what it's about.

I'd be happy to answer any questions, and I would request the opportunity to file a post-hearing brief.

HEARING OFFICER ESTES: Your request is granted. Do we have any questions from the Panel?

SENIOR AGRICULTURE ECONOMIST ERBA: I have just one question. Mr. Vanden Heuvel, you mentioned the idea of a cheese milk price surface. And I wasn't sure where you fell down on that. Do you believe one exists, or that one does not exist?

MR. VANDEN HEUVEL: I believe one absolutely does exist. It currently exists. The NASS price that -- the price that drives the federal order class III formula is a western price. And the minimum federal order price then is based on the western price.

And as we heard from a number of witnesses, in the upper midwest there are significant premiums that are being paid over and above this class III price by the cheese plants. And it's in that where the price surface is created.

SENIOR AGRICULTURE ECONOMIST ERBA: If you believe a price surface exists, then how do you reconcile that with your statement that we need to narrow the gap between the federal price and the California price? Aren't you

essentially flattening it out then?

MR. VANDEN HEUVEL: The price surface exists, and in California -- the price in the west, the federal order minimum price in the west is below what cheese plants pay, even that are subject to federal order requirements in the west, our neighboring states. It's less than what cheese plants in the east have to pay; because they're paid significant premiums over the federal order prices in the east.

And then California has an even greater advantage. If we eliminate the gap between the federal order class III and the California 4b, we will come up to where the other western plants are in the west; and we will reduce somewhat the difference between California and the upper midwest.

But the premiums that are being talked about in the upper midwest, no one's proposing getting anything close to filling that gap.

SENIOR AGRICULTURE ECONOMIST ERBA: Thank you.

AGRICULTURE ECONOMIST GOSSARD: Mr. Vanden Heuvel, on page 5 of your testimony where you are addressing the Dairywomen's proposal for price floor, you say it is certainly appropriate for support purchase price floor be put back into the 4a formula.

And just after that you say that flooring in cheese product value in 4b could very well have the effect

of flooring the NASS cheese price.

One way to read that paragraph is that you are pushing a little stronger for flooring 4a than the 4b. So I wanted to clarify that. Do you feel both should be floored, or do you feel stronger about flooring one rather than the other?

MR. VANDEN HEUVEL: Yeah, the reference is that historically we have floored 4a. So we ought to reinstitute that 4a. And we should also floor 4b.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: I have a question, Geoff, in terms of the variable make allowance proposal. You say it has merit. Just so that I understand where you're coming from, do you support implementation of the California Dairy Campaign's proposal on variable make allowance?

MR. VANDEN HEUVEL: I don't have the authority to say I support that specific proposal.

DAIRY MARKETING BRANCH CHIEF IKARI: You like the concept?

MR. VANDEN HEUVEL: I think the concept has some real merit. I think there's some -- there's just a real flaw in the way we've constructed our product value formulas that you got this fixed market for the manufacturers. So all of the burden of balancing the supply is falling onto

the producer. And it's a very indirect way.

And so there needs to be some signal also sent to processors. The processors are not without the ability to affect prices and supply and demand. And yet our systems are designed to essentially inoculate them. And I think it's a fundamental flaw that we need to address.

And CDC has put forward an idea. And I think we need to give it much more serious consideration than I think people are giving it.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay.

HEARING OFFICER ESTES: Do we have any other questions? Thank you for your testimony.

MR. VANDEN HEUVEL: Thank you.

HEARING OFFICER ESTES: And I believe -- do we have anyone else signed up to testify, other than Mike Marsh?

Okay, our last two witnesses today will be Jim Tillison and Mike Marsh. They were involved in the presentation of the petitions yesterday, but they also are entitled to speak during the public comment period if they are inclined to do so.

So, first we'll take Jim Tillison, and then we'll conclude with Mike Marsh, if that's agreeable to the two of you.

Whereupon,

JAMES E. TILLISON

was recalled as a witness herein, and having been previously duly sworn, was examined and testified further as follows:

MR. TILLISON: I'm still under oath, I assume?

HEARING OFFICER ESTES: Yes, you are.

MR. TILLISON: I just wanted to make a clarification that I think apparently it was not evident in my testimony.

There have been references how our proposal will move money from producers with high protein and that sort of thing. In our petition we made it very clear that until the Department is ready to collect and pay out on the basis of protein, that our formula would be used to calculate a solids-not-fat value based on 3.1 percent protein and 5.9 percent other solids to determine the value of solids-not-fat.

When the Department has the capability of paying out for protein, as was the case in the proposal we withdrew a couple years ago, our intent is that producers with high protein would receive the highest value for their milk. In other words, we would pay out on the same basis as it was paid in.

Thank you.

HEARING OFFICER ESTES: Do we have any questions?

AGRICULTURE ECONOMIST GOSSARD: Thank you for that

clarification.

HEARING OFFICER ESTES: Thank you for your testimony. And Mr. Marsh, you have the privilege of providing the testimony to conclude our proceedings today.

Whereupon,

MICHAEL L.H. MARSH

was recalled as a witness herein, and having been previously duly sworn, was examined and testified further as follows:

MR. MARSH: Thank you. On behalf of the Board of Directors of Western United Dairymen I'd like to thank you, Mr. Hearing Officer, and the individual Members of the Hearing Panel for your time and attention in this hearing.

I'd also like to thank the many participants who testified at this hearing, even those whose testimony has been at odds with our own.

I would like to thank Secretary Bill Lyons for calling this hearing based upon the petition of Western United Dairymen. We again encourage the Secretary to adopt the proposals contained in our petition. And our comments and rebuttal will be reserved for a post-hearing brief.

HEARING OFFICER ESTES: Thank you.

MR. MARSH: Thank you.

HEARING OFFICER ESTES: And that concludes our hearing today.

The Department, upon receipt of post-hearing

briefs, will consider the testimony and all other relevant -- post-hearing briefs, testimony and all other relevant materials. And will render a decision consistent with the statutory and regulatory authority.

So the hearing is now concluded at 12:44 p.m.

(Whereupon, at 12:44 p.m., the hearing was adjourned.)

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CERTIFICATE OF REPORTER

I, JAMES F. PETERS, a Certified Shorthand Reporter, of the State of California, and Registered progressional Reporter, do hereby certify:

That I am a disinterested person herein; that the foregoing Department of Food and Agriculture hearing was recorded under my supervision, transcribed in typewriting, and thereafter personally proofread by me, James F. Peters, a Certified Shorthand Reporter of the State of California.

I further certify that I am not counsel or attorney for any of the parties in this matter, nor in any way interested in the outcome of said meeting.

IN WITNESS WHEREOF, I have hereunto set my hand this:

DATE

JAMES F. PETERS, CSR, RPR
Certified Shorthand Reporter
License No. 10063