PUBLIC HEARING

STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

DAIRY MARKETING BRANCH

SECRETARY OF STATE BUILDING

1500 11TH STREET

AUDITORIUM

SACRAMENTO, CALIFORNIA

TUESDAY, FEBRUARY 1, 2005

9:00 A.M.

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APPEARANCES

HEARING OFFICER

Mr. Richard Estes

PANEL MEMBERS

Mr. David Ikari, Chief, Dairy Marketing Branch

Dr. Eric Erba, Special Assistant, Animal Health and Food Safety Services

Mr. Tom Gossard, Agriculture Economist

Mr. Ed Hunter, Supervising Auditor

STAFF

Ms. Cheryl Gilbertson, Staff Analys

ALSO PRESENT

Mr. Xavier Avila, California Dairy Campaign

Mr. Richard Cotta, California Dairies Inc.

Dr. James Gruebele, Land O'Lakes

Mr. Joe Heffington, California Dairies Inc.

Mr. Michael Marsh, Western United Dairymen

Mr. Mike McCully, Kraft Foods

Dr. William Schiek, Dairy Institute of California

Mr. James Tillison, The Alliance of Western Milk Producers

Mr. Geoffrey Vanden Heuvel, Milk Producers Council

Mr. C.K. Venkatachalam, Leprino Foods

Mr. Andy Zylstra, California Dairy Campaign

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PROCEEDINGS

HEARING OFFICER ESTES: Good morning everyone. The hearing is now coming to order. The California Department of Food and Agriculture has called this public hearing. And I know many of you have heard this introduction before, but it's necessary to go through it to develop a record of the hearing.

So the Department has called this public hearing in the Auditorium of the Secretary of State Building, 1500 11th Street, Sacramento, California, on this day, February 1st, 2005, beginning at 9 a.m. And I believe we're starting a little bit after -- shortly after 9 this morning.

On September 7th, 2004, the Department received a petition from Land O'Lakes requesting a public hearing to consider amendments to the stabilization and marketing plans for market milk for the northern California and southern California marketing areas.

The Land O'Lakes petition proposes the following amendments: To the manufacturing cost allowances and for freight on-board California price adjuster in a Class 4a pricing formula, milk used to make butter and nonfat dry milk. And, two, to the manufacturing cost allowances for freight on-board California price adjuster in the cheese yield and the 4b pricing formula, milk used to make cheese

other than cottage cheese.

The Department has received six alternative proposals in response to the Land O'Lakes petition. The Department has received these proposals from the Milk Producers Council; California Dairy Campaign; Western United Dairymen; California Dairies, Incorporated; Alliance of Western Milk Producers; and the Dairy Institute of California.

During a prehearing workshop conducted on January 19th, 2005, the Department provided a summary analysis alternative concept proposals. A copy of this summary will be entered into the record of this hearing as an exhibit. According to the purpose of this hearing is to consider the amendments as proposed from the Land O'Lakes petitions and the alternative petitions.

My name is Richard Estes. I am a Department counsel, and I've been designated as the hearing officer for today's proceedings.

Testimony and evidence pertinent to call at the hearing will be received. Anyone wishing to testify must sign a hearing witness roster located at the sign-in table. Oral testimony will be received under oath or affirmation.

Staff available at the back of the room to provide assistance are Karen Dapper and Candace Gates.

As a courtesy to the panel, the Department staff and the public, please speak directly to the issues presented by the petitions. And avoid personalizing disagreements. Such conduct does not assist the panel in its attempt to effectively address the sophisticated economic and regulatory issues presented by the petitions.

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

Only those individuals who have successfully requested a post-hearing briefing period may file a post-hearing brief with the Department.

The hearing panel has been selected by the Department to hear testimony, receive evidence, question witnesses, and make recommendations to the Secretary. Please note the questioning of witnesses by anyone other than members of the panel is not permitted.

The panel is composed of members of the Department's Dairy Marketing Branch and also Animal Health and Food Safety Services, and they include David Ikari, Branch Chief, Dairy Marketing Branch; Ed Hunter, Supervisor/Auditor I, Dairy Marketing Branch; Thomas Gossard, Senior Agricultural Economist, Dairy Marketing Branch; and Eric Erba, Special Assistant, Animal Health

and Food Safety Services, but is well known for his expertise in milk pricing issues.

I am not a member of the panel and I will not be taking part in any decisions relative to the hearing.

The hearing reporter today is James Peters of the firm of Peter Shorthand located here in Sacramento. A transcript of today's hearing will be available for review only at the Marketing Branch headquarters located in Sacramento here at 560 J street, Suite 150.

Anyone desiring copies of the transcript of today's hearing must purchase them directly from Peters Shorthand.

And at this time, we'll have a Department witness introduce exhibits into the record. And right now we have Cheryl Gilbertson to do so.

(Thereupon Mr. Cheryl Gilbertson was sworn, by the Hearing Officer to tell the truth, and nothing but the truth.)

STAFF ANALYST GILBERTSON: I do.

HEARING OFFICER ESTES: And you have a number of exhibits to introduce into the record today relevant to the petitions presented?

STAFF ANALYST GILBERTSON: I do.

Mr. Hearing officer, my name is Cheryl Gilbertson. I'm an analyst with the Dairy Marketing

Branch of the California Department of Food and Agriculture.

My purpose here this morning is to introduce the Department's composite hearing exhibits numbered 1 through 42. Relative to these exhibits previous issues of Exhibits 9 through 42 are also hereby entered by reference.

The exhibits being entered today have been available for review at the Offices of the Dairy Marketing Branch since the close of business on January 25th, 2005. An abridged copy of the exhibits is available for inspection at the back of the room.

Multiple copies of exhibits 1, 4, 5, 6, 7 and 8 are also available at the back of the room.

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

Mr. Hearing Officer, this concludes my testimony.

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

Please come forward to introduce -- oh, before you do introduce testimony, I assume we have no panel questions at this time?

Okay. Please come forward.

The exhibits shall be entered into the record as

exhibits numbers 1 through 42 as described by Ms. Gilbertson in her testimony.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibits 1-42.)

HEARING OFFICER ESTES: All right. Are there any questions from any members of the audience regarding the content of Department's exhibits?

Please recognize that questions are limited to the purpose of clarification. Cross-examination of Department's staff is not permitted. So questioning is not for the purposes of seeking any sort of analytical or substantive information about those exhibits.

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

Do we have any members of the audience that are interested in seeking any sort of clarification of the exhibits as they have been presented?

Okay. Seeing no one, we will now proceed to take testimony from Land O'Lakes. Land O'Lakes now has 60 minutes to make its presentation in support of the petition.

And is Jim Gruebele here?

DR. GRUEBELE: Right here.

HEARING OFFICER ESTES: Will you please come

forward.

DR. GRUEBELE: Okay.

HEARING OFFICER ESTES: I see you have a sort of strategic position back behind the panel.

Dr. Gruebele will be making a presentation in support of the petition, followed by questions from the panel.

(Thereupon Dr. James Gruebele was sworn, by the Hearing Officer to tell the truth, and nothing but the truth.)

DR. GRUEBELE: I do.

HEARING OFFICER ESTES: Perhaps before you -- have you described the method by which your petition and your testimony has been developed in your --

DR. GRUEBELE: I do have in my testimony, yes.

HEARING OFFICER ESTES: All right. Well, go ahead and just proceed with your testimony then.

DR. GRUEBELE: I apologize. I do have a cold, so I'll try my best.

HEARING OFFICER ESTES: I think that's true of most of us here today.

DR. GRUEBELE: Okay. Mr. Hearing Officer and members of the Panel, my name is James W. Gruebele, Dairy industry consultant. I'm testifying on behalf of Land O'Lakes Incorporated, which handles about 14 million

pounds of milk per day and has a California membership of about 249 producers.

The Land O'Lakes Board members from the Western Region endorsed the testimony. We appreciate the call of the hearing. The Class 4b formula needs to be adjusted to reflect cost changes for the cheese operations, the difference between the CME and the price received by cheese operations in California, and of course to reflect the costs for processing whey. CDFA had no information on the cost of processing whey when the whey was added to the Class 4b formula in 2003. The whey make allowance of 17 cents per pound is greatly understated.

Our proposal today is to make cost-justified adjustment to the pricing formulas based upon the most recent cost study by CDFA for Class 4a and Class 4b operations, including energy and labor updates.

Our proposal is as follows: For butter the current formula in make allowance is .132. The proposed by Land O'Lakes is .1321.

The California price less CME is currently at .0332, proposed by LOL it's .031.

Powder, the current formula for the make allowance is .15, proposed by LOL is .1551.

Cheese, the current formula is 17 and a half cents. The proposed by Land O'Lakes under make allowance

is .1734.

The California price less CME for current formula on Class 4b is .0321. And the proposed by Land O'Lakes is .0287.

For whey, the current formula is 17 cents. For the make allowance -- proposal by Land O'Lakes, 80 percent of plant coverage.

We are also recommending that the cheese yield be modified from 10.2 to 10.01 and the fat in the formula be changed from 3.72 to 3.67, and solids not fat be changed from 8.8 to 8.75.

The form of the language in the stabilization and marketing plan for market milk as submitted for southern California marketing area and for northern California marketing areas would be as follows: Section 300(D), the minimum prices to be paid for components used for Class 4a shall be computed as follows:

For all milk fat, not less than the price per pound computed by the formula using the butter price less an f.o.b. price adjuster of three and one hundredth cents (.031), less a manufacturing cost allowance of thirteen and twenty-one hundredths cents (.1321), and the result multiplied by a yield factor of one and two-tenths.

For all milk solids not fat, not fat less than the price per pound computed by the formula using the

nonfat dry milk price, less a manufacturing cost allowance of fifteen and fifty-one hundredths of a cent (.1551), multiplied by a factor of one.

The remainder of Section D remains the same.

Section 300(E), the minimum prices to be paid for components using a Class 4b shall be computed as follows:

The cheese price for hundredweight shall be the price per hundredweight computed by the sum of the following: The price per hundredweight computed by the formula using Cheddar cheese, less an f.o.b. California adjuster of two and eighty-seven hundredths cents (.0287) less a Cheddar cheese manufacturing cost allowance of seventeen and thirty-four hundredths of a cent (.1734), all multiplied by a yield of ten and one-hundredth cents (10.01).

The price per hundredweight computed by a formula using butter less a manufacturing cost allowance of thirteen and twenty-one hundred cents, less 10 cents, all multiplied by a yield factor of twenty-seven hundredths.

The price per hundredweight is computed by a formula using dry whey price less the manufacturing cost allowance representing 80 percent of plant coverage for whey plants included in the study all multiplied by a yield factor of 5.8.

For all milk fat not less than the price per

pound computed pursuant to Subparagraph D1 of this section.

For all milk solids not fat, not less than the price per pound computed by the formula using the cheese hundredweight price established pursuant to Subparagraph E1 less the product of three and sixty-seven hundreds (3.67) multiplied by a Class 4b fat price established pursuant to Subparagraph E2, all divided by eight and seventy-five hundredths of a cent (8.75).

The remainder of Section E remains the same.

Make Allowance:

LOL proposes the make allowance for butter be changed .132 to .1321. The .1321 reflects the weighted average cost for manufacturing butter published by CDFA, including energy and labor updates.

LOL proposes that the make allowance for powder be change from .15 to .1551 because it reflects the weighted average cost for manufacturing powder as published by CDFA including the energy and labor updates.

LOL proposes that the make allowance for cheese be changed from .175 to .1734. This change reflects the most recent cost study by CDFA including energy and labor update.

The LOL proposes the make allowance for whey be changed from 17 cents per pound to 80 percent of plant

coverage for plants in the whey study. The make allowance for whey is currently 17 cents per pound, and based upon the cost study by CDFA this make allowance of 17 cents greatly understates the costs involved in processing whey. The make allowance, in our opinion, should reflect a value which provides 80 percent of the plant coverage for plants in the whey study. When the whey prices are less than the adjusted whey make allowance, the formula should reflect that. When the whey price is above the adjusted make allowance, then the Class 4b price should reflect that.

The cheese operations need to show a positive return on investment, and this includes whey as well as cheese. The whey study clearly revealed that the Class 4b formula that became effective on April 1st, 2003, clearly did not reflect whey costs properly. Cheese operation since April 1st, 2003, have been suffering lower returns due to the inappropriate whey make allowance in the Class 4b formula.

Addendum to the Make Allowance Discussion:

This addendum has to do with the 640 pound cheese operation at Land O'Lakes. This cheese plant is included in the 9-plant CDFA study even though it does not manufacture cheese in 40-pound blocks. One of the adjustments made in the CDFA cost study is the use of average packaging labor costs for other 40-pound cheese

plants in the survey.

However, Land O'Lakes is a union operation, and so our labor costs are more than likely higher than those operations that do not have a similar union contract. It is our opinion that the cost for the LOL cheese operation for packaging 40-pound blocks of cheese is understated. Therefore, the weighted average cost for all cheese operations in the state is understated as well.

Questions Raised:

Some have questioned the appropriateness of CDFA's handling of costs associated with lost solids in the weighted average cheese cost. In our opinion, this approach is valid. Cheese is the primary product and whey is a byproduct. Whey cannot be disposed of in raw form and so further processing is done.

The second area is that CDFA appropriately used some non-Cheddar to evaluate the cost of drying whey. This was necessary because there were an insufficient number of Cheddar plants drying whole whey. Others today will testify to any differences associated with drying whole whey in a Cheddar plant compared to drying whey in a non-Cheddar facility.

The third area has to do with the weighted average cheese costs of plants included in the whey study. The weighted average cost per pound of cheese for plants

included in the whey study was .2327 per pound. It has been alleged that these are inefficient cheese operations; therefore, this means that their whey operations are also inefficient.

Of the four plants included in the study, one was a Cheddar operation, and then the other three were non-Cheddar operations. At least one of these operations was a Mozzarella operation. Other things equal, the cost of making Mozzarella cheese is simply higher than it is for Cheddar operations because of the process itself and also differences associated with packaging costs. The Mozzarella operations are simply more labor intensive.

For example, the packaging costs associated with a 6-pound unit is simply different from the packaging costs associated with a 40-pound or 640-pound block Cheddar operation. And I know this is -- that a 6-pound unit was used in a Mozzarella plant that was used in the whey cost study. Just because the packaging costs are higher for cheese in the Mozzarella operations than the packaging costs for cheese in the Cheddar operations simply has no effect on the efficiency involved in drying whey.

California Price Less CME Average:

The CDFA has always used the average California cheese price less the CME average to develop the

California adjuster for cheese. LOL believes that simple average differences are understandable, and using a long enough period of time, a 45-month period, produces a result that is fair for both cheese plants and producers. Simplicity has great advantages and we don't need added complications. LOL proposes any change from past practice of using the monthly average CME prices received by cheese operations in California as a basis for reflecting the differential between the CME price and prices received by California butter or cheese plants.

We oppose a change to 55 percent current month and 45 percent previous month. Cheese contracts are not written that way. LOL does not want to change procedures from that used in the past for butter and cheese to establish the California adjuster.

Cheese Yield:

Land O'Lakes has always supported the concept to use a typical milk supply for use in establishing a cheese yield for the Class 4b formula. Cheese plants typically fortify milk either with condensed skim or powder and they typically pay premiums to attract high protein milk. Our proposal is that CDFA modify the cheese yield 10.01 pounds per hundred pounds of milk for a milk fat test of 3.67 and solids-not-fat test of 8.75. The 3.67 fat test and 8.75 solid-not-fat test were the average milk tests for

producer milk in 2003, as published in the annual report.

Dr. Phil Tong of Cal Poly University milk component study was used as a basis for calculating the casein as a percent of solids not fat. Tong's study showed casein content and solid-not-fat content in fluid and butter powder operations. The casein to solids not fat was adjusted to reflect the percent of milk used in butter powder plants and in fluid operations in California, and that weighted average number turned out to be .2832. In 2003 according to an annual report by CDFA, the average fat test was 3.67 and the solids-not-fat test was 8.75, and that was for market milk. But when including manufacturing milk as well as market milk the average fat test was still 3.67 and the solids-not-fat test was still 8.75.

We did not include the components of cheese in the Tong study to develop the relationship between casein and solids not fat because the cheese plants provide incentives through the use protein premiums and/or cheese yield formulas to encourage producers to enhance fat and protein in their milk supply through breed selection feeding programs and the like. Cheese operations already pay premiums to attract that kind of milk in cheese operations. This milk does not represent typical milk supply in California.

Based upon a casein-to-solids ratio as reflected above, the average fat and solids-not-fat test for California 2003 results in the following yield: (.91 times 3.67) plus (.2832 times 8.75) minus .1, all multiplied by 1.09, all divided by 1 minus .3778, yields 10.01.

The fat retention used in the above formula is .91, and it's considered to be reasonable for a cheese operation. The conclusion is that a cheese yield of 10.01 is very realistic for the milk supply in California.

I parenthetically remark that I know in the pre-hearing workshop comments were made that if somebody proposed something different in their hearing testimony, they should make the Department aware. These are insignificant differences from what I presented at the pre-hearing workshop. Furthermore, I spent 36 1/2 hours in bed and I didn't quite polish my testimony and didn't have time to call the Department. So I simply did not let you know. But these are very insignificant. I had a 10 yield. Now I have a 10.01 yield. I don't think that's significantly different.

Additional Comments:

Total make production continues to increase in California. Much of the recent additional manufacturing capacity has been filled. California will need additional

processing capacity and it is important that there's a reasonable return on investment for manufacturing operations in California. The California Milk Advisory Board study predicted that milk production in California would increase by about 12.2 billion pounds from 2002 to 2012. Obviously these predictions indicate the need for additional manufacturing capacity in California. The cost of new cheese operations is extremely expensive. Changes will need to be made in the current California Class 4b formula to encourage the construction of new cheese capacity in California.

Depooling Issue:

Many of the California's competitors in Federal Order markets can depool milk. The same rules do not apply in California. In many Federal Order markets, milk can be depooled after the fact, that is, managers have the needed information to determine if depooling makes sense. And as a result, the risk is minimized.

What does this mean? It means that when the Class III price in Federal Order is higher than the blend, in that respective order, the Federal Order handlers are able to retain high value proceeds within their own organization -- I need to restate that. It means that when the blend is higher than Class III price, the Federal Order handlers are able to retain -- I'm sorry. It is

correct. It means that when the Class III price is higher than the blend, the Federal Order handlers are able to retain high value proceeds within their own organization rather than to share those proceeds with other producers in the Federal Order market. That is, they are depooling, that's what they're doing.

The same conditions do not exist within the California system. A proprietary cheese operation in California can be a non-pool plant. And if the supplying producers are independent shippers, the milk going into that plant is automatically depooled as well. But if such a firm decides to depool, they must be in a non-pool plant for at least a 12-month period. But for an independent shipper such an option is open only to -- to ship to a non-pool plant is only open to producers without quota. Quota holders would lose quota within 60 days if it were not pooled. Even in those cases where milk is depooled, they cannot jump in and out of the pool, that is, month by month.

Furthermore, non-pool plants must pay minimum class prices for market milk even if the milk is not pooled. That's a very important point.

Article 10 in Section 1001 under (e) of the California Department of Food and Agriculture Pooling Plan for Market Milk as amended states -- and I quote -- "Each

handled operating a non-pool plant as defined in Section 111 that receives market milk as a direct purchase from producers" -- which it's like an independent producers -- "or from handlers defined pursuant to paragraphs 105(b) and (c)" -- those are cooperatives with plant or without plant, respectively -- "shall pay for such milk at no less than the classified prices established in the Stabilization and Marketing Plans. The total combined in-plant and derived usage of the non-pool plant shall be allocated among all producers each month." End quote.

If milk is depooled in federal orders, there is no minimum price provision that applies. This is not true in California when the milk is market grade. Cooperatives in California cannot depool market grade milk, period. The rules in California are much different than in Federal Order markets.

Comparisons continually are made between the California Class 4b price and the Federal Order Class III price. But such comparisons do not take into account the opportunity to depool milk in Federal Order markets. The following analysis shows the advantage afforded to handlers in the Pacific Northwest Federal Order because of the depooling option. The table below provides the information on month-to-month data on the blend price, the Class III price and those differences and appropriate

action on pooling and/or not pooling milk.

So here we go.

January, the uniform price, 10.76; Class III price, 9.78; difference, a positive 98 cents. Action: Pool, because you can draw money from the pool to pay your producers. That's why you do it.

February, 10.44; class III, 9.66; difference, 78 cents positive. Action: Pool. You can draw money from the pool and so you pay your producers the uniform price.

March, 10.13; 9.11; difference, a dollar two. Again, pool is the answer.

April, 10.21; 9.41; difference, 80 cents; pool.

May, 10.38; 9.71; 67 cents; pool.

June, 10.37; 9.75; 62 cent difference; pool.

Now, July things change. The uniform price was 10.93; the Class III price was higher, 11.78; a minus 85 cents; the action is depool.

August, 11.66 is our uniform price, Class III price is 13.80. Look at the difference, $2.14; depool.

September, 12.54; Class III price, 14.30; a dollar seventy-six difference; depool.

So October, 13.05; 14.39; negative 1.34; depool.

November, 12.95; 13.47; negative 52 cents; depool.

I don't think I have December on there, do I?

You mind if I get some material and I'll tell you what it is?

HEARING OFFICER ESTES: You can --

DR. GRUEBELE: I have it down here.

Can I take the time to get it?

HEARING OFFICER ESTES: You can -- I would suggest that you provide it to the Department in a post-hearing brief.

DR. GRUEBELE: Okay. In a post-hearing brief, okay. I inadvertently left out December. And I can't tell you offhand whether it paid to depool or not in December. Okay?

HEARING OFFICER ESTES: I assume the number is not so sufficiently striking that we can't receive it --

DR. GRUEBELE: Okay. I understand. Thank you.

When a handler decides to pool producer milk in a Federal Order market, it means their Class III price is lower than the blend. When this is done, they are able to draw from the pool so they can pay the producers a uniform price. But when the Class III price exceeds the uniform price, then it is time to depool milk. Because the milk is depooled, the handlers are not obligated to pay into the pool when the Class III price exceeds the uniform price in the Federal Order market. That's why they depool. They don't have to pay into the pool.

The producer receipts in the Pacific Northwest order averaged 400,826,372 pounds from July 2003 through November 2003. The milk was obviously depooled during the months of July 2003 through November 2003. For the months of January through June 2003 plus -- and I have it there -- December 2003 when it paid to pool, the producer receipts in the order pool average 618,903,418 pounds. Did the handlers depool in the months of July 2003 through November 2003? The answer is very obviously yes. You can see it by the amount of milk pooled in the order. Very obvious.

Let's Look at 2004:

For January, uniform price, 12.07; Class III price, 11.61; a difference of 46 cents; pool.

February, 12.67; 11.89; difference, 78 cents; pool.

March, 14.55; 14.49; just 6-cents difference. It just barely paid the pool, but it's still pool.

Look at April: $15.34, uniform price; $19.66, Class III; a difference of a whopping $4.32. It doesn't take any brain power to figure out what somebody should do. Depool.

May, 17.40; 20.58; a negative 3.18; depool.

June, 17.45; 17.68; a negative 23 cents; depool.

July; 15.74; 14.85; A positive 89 cents; pool.

August, 14.15; 14.04; a positive 11 cents; pool.

September, 14.44; 14.72; a negative 28 cents; depool.

October, 14.40; 14.16; a positive 24 cents; pool.

November, 14.75; 14.89; a negative 14 cents; depool.

December, 14.83; 16.14; a negative $1.31; depool.

In one half of the months they paid to depool milk in the Pacific Northwest order market. Again, the producer milk receipts in the pool reveals that the handlers in the Pacific Northwest order did in fact depool milk when it made economic sense in 2004 as well as 2003.

How important is depooling? The answer is: Very important. An example will illustrate. In a month when it pays to depool a handler is able to pay its producers a competitive uniform price, and they can pocket the difference. The dollars and cents cost savings are impressive. Assume that a plant has 10 million pounds of milk a day going into cheese. In April 2004, the advantage of depooling amounted to $4.32 per hundredweight. This means that 10 million pounds per day would result in a cost savings of $432,000 per day or 12,960,000 for the entire month. That is just for one month, the month of April. Please note the cost savings could be even larger if the handler decides to pay

producers less than the uniform price. There is no minimum payment requirement for milk depooled in federal orders. None at all.

Let's go to the numbers.

Milk pounds: April, 10 million pounds. And I already told you about the 12,960,000.

In May, $3.18 is the cost savings. Remember, that number was a negative 3.18. I was using a positive there because it's a positive cost savings. Three hundred eighteen thousand a day, or 9,858,000 for the month of May. And I took into account 31-day month, 30-day month and all that.

June, $23,000 a day, 690,000.

September, $28,000 a day, 840,000.

November, 14,000, 420,000 a month.

December, 131,000 or 4,061,000.

Total cost savings for the year 2004: $28,829,000.

The above table selected the months when it made sense to depool milk. The cost savings for handlers was very large. This opportunity to depool milk provides significant advantages to handlers in Federal Order markets. A cost savings for Land O'Lakes of almost $29 million would represent a very significant contribution to the bottom line and to returns on investment.

I did a similar analysis for year 2003. The cost savings for a 10 million pound a day handler would have amounted to $20,263,000 for the entire year.

The two-year total would amount to almost $50 million. It is important to recognize the tremendous benefits of depooling milk in Federal Order markets.

Handlers whose milk is depooled do not have to share the Class III revenues with other producers. This cannot be done in the same way in California.

It is not surprising to observe that in recent times major cheese operations decided not to build a cheese plant in California but chose rather to build such a facility outside the state. Federal orders provide much more flexibility for such cheese operations including the depooling option, which I can't over emphasize how important that is. Again, this situation is far different in California.

Price Comparison:

As stated earlier, comparisons are often made between the California Class 4b price and the Federal Order Class III price, and I am about to do that. From January 1st, 2003, through November of 2004 the average price difference between the Federal Order Class III price and the California Class 4b price was only 31 cents a hundredweight. But as shown above, the price comparison

does not reflect the tremendous advantage afforded handlers in Federal Order markets that can depool when it makes sense. This situation again is different than California.

The Class 4b Price Formula needs to be Adjusted:

The cost study on whey clearly illustrates that cheese operations in California over paid for milk going into cheese from April 2003 up to the present time. There are times when the values associated with 80 percent coverage for plants included in the whey study would exceed the average of the mostly western whey price. It is important to recognize there are times when the whey becomes a net disposal cost for cheese operations. The whey make allowance needs to reflect that. It is extremely important that CDFA makes the appropriate formula adjustments to reflect the real costs associated with a cheese operation. If that is done, then the California firms are in a better position to invest in cheese operations to accommodate the growth in milk production in California. The cheese operations will also be more able to compete against Federal Order cheese operations whose handlers have the capability to depool milk when Class III prices exceed Federal Order blend prices and they can do so at a minimum risk.

Other Proposals:

Alliance of Western Milk Producers. We disagree that cheese make allowance should be reduced to .1710. We believe that a cost justified number of .1734 should be used. It is of interest to note that CDI proposed an increased in nonfat dry milk powder make allowance from 15 cents to .1650. The .1650 make allowance would cover close to 80 percent of the volume for nonfat dry milk powder plants included in the survey according to Table 2 of the Comprehensive Findings. CDI is a member of the Alliance. The Alliance of Western Milk Producers proposed an increase in butter make allowance from .132 to .1570. Please note that in Table 2 of the Comprehensive Findings does not have a proposed make allowance that would provide 80 percent of volume coverage. So the Alliance went to the category of almost 90 percent coverage by proposing a new make allowance for butter at .1570. Note that Table 2 of the Comprehensive Findings does not show a proposed make allowance that would provide 80 percent coverage for cheese operations. In this case the Alliance chose to cover only 70 percent coverage for cheese plants by proposing a make allowance of .1710. This proposal appears to be somewhat inconsistent; that is, when there is no proposed make allowance for 80 percent in volume coverage, the Alliance chose to cover almost 90 percent of the volume for butter but not for cheese.

We disagree with the Alliance that the California adjuster for cheese should be reduced to $.0232. The simple average difference of $.0287 is appropriate. However, again an adjuster is necessary to reflect the freight cost of moving cheese products to market. Historically, such adjust was applied to butter. At one time the adjuster was simply 5 cents and later was reduced to 4 1/2 cents, and still later it was based upon the difference reflected in data obtained by CDFA.

We disagree that the cheese yield should remain at 10.2:

But our largest disagreement with the Alliance is -- or two things really, 17 cents make allowance and the snubber. Now, the snubber says this: This is a concept that reflects heads, they win non-cheese operations, and tails, cheese plants lose. Whenever the whey price falls below the make allowance, or 17 cents in their case, then the whey factor -- negative factor becomes zero. But when the whey market exceeds the whey make allowance, then the whey factor positive value comes into play and increases the Class 4b price. This concept makes no economic sense. If you're going to have a whey factor at all, the first issue is to use a cost justified make allowance, and 17 cents falls far short of that. And, secondly, the whey factor is applied whether the whey

price is above the make allowance or below it.

This lose-lose situation with a snubber for whey for cheese plants is not acceptable.

The alliance completely disregards the findings of the CDFA whey cost study. CDFA in doing that whey cost study followed a long-standing practice of using the results of in-depth cost studies as a guide to establish and change make allowances for manufactured dairy products. There is no practical way, in a meaningful way, to establish a make allowance for dairy products without such studies. Such a cost study should be -- should have been utilized before the inclusion of a whey factor in Class 4b formula. As a result, cheese plants have suffered lower returns for most of the period -- and I say most -- of the period from April 2003 to the present.

One byproduct of the Alliance position is that the final results would increase the total value of milk for high protein producer compared to more typical milk. Cheese yield formulas and/or cheese programs to attract high protein milk cheese into cheese operations is prominent in cheese operations in California. The Alliance formula would reduce the attractiveness of the protein premiums and cheese yield formulas to attract high protein milk to cheese operations. The high protein milk in and of itself has no particular merit in non-cheese

operations. This is still another reason for opposing the Alliance position.

And pardon me again please.

Western United Dairymen:

Leaving the make allowance on whey unchanged is unacceptable. CDFA did a cost study of four whey plants and we recommend the cost study should be used to adjust the whey make allowance and we recommend 80 percent of the plants -- coverage of the plants in the survey. Land O'Lakes believes that the cost study whey operation by CDFA is a credible study just like the CDFA studies continue to be credible for butter, powder and cheese operations, and the results should be used to adjust the make allowance for whey.

We disagree with the California adjuster recommended by Western United Dairymen because it does not square with the findings of the CDFA survey.

Milk Producers Council Proposal:

Land O'Lakes disagrees with the cheese adjuster of 2.34 cents, or $.0234, proposed by MPC because we believe that data support $.0287 adjuster. MPC would adjust the whey make allowance from 17 to 18 cents per pound, and the whey cost study by CDFA simply does not support the MPC proposal.

The most serious recommendation by MPC is the

snubber. It makes no economic sense to develop a whey factor that works in only one direction. If it is to be used at all, it must be effective when the whey prices are above the make allowance as well -- below the make allowance as well as above.

California Dairy Campaign:

There is little or no agreement with any of the CDC proposals as far as Land O'Lakes is concerned. First, CDC would eliminate the adjuster. Again, this completely contradicts economics of location, which is reflected in commodity markets countrywide whether it is cotton -- uh-oh.

AGRICULTURE ECONOMIST GOSSARD: You repeated the same line twice.

DR. GRUEBELE: I did?

Okay. Economics of location clearly indicate that the freight of moving the product to market is reflected in prices in different locations.

CDC proposes a make allowance of .1634 for cheese. And, again, the cost data does not support that proposal. We disagree with their cheese yield proposal and we oppose strongly the use of a snubber. They propose a whey make allowance, which is the same as a federal make allowance of .159. Again, the CDFA study completely refutes the use of a .159 make allowance.

Dairy Institute Proposal:

LOL does not endorse the proposal to eliminate the use of a price support floor.

California Cheese Capacity Needs to Expand:

Cheese demand growth continues and we need to continue to encourage the construction of additional capacity in cheese in California. The powder markets have improved this year, but the prices are still relatively close to support. The same is not true for cheese as far as the relationship to support. In California it is imperative that we develop policies to ensure reasonable returns on investment. Otherwise plant expansion will not grow fast enough to keep up with the growth in milk production.

In conclusion, Land O'Lakes recommends the removal of the whey factor. I want to emphasize that point. We recommend the removal of the whey factor in the Class 4b formula if as a result of this hearing the cheese formula includes a whey snubber or if there is failure to adjust the whey make allowance to reflect a cost justified value. In other words, if the whey factor were removed whey would have no impact on the Class 4b formula regardless of the price for whey. Contrariwise, Land O'Lakes would recommend the continued use of a whey factor if the whey make allowance is adjusted on a cost justified

basis and no snubber is implemented.

Finally, Land O'Lakes manufacturers butter, powder and cheese. Our experience is that the net return for butter and powder are significantly higher or larger than for cheese. Land O'Lakes is urging the Department to reflect a balanced approach. The net returns and/or returns on investment for cheese and for butter powder operations should be very similar.

Based upon our experience at Land O'Lakes, that is not the case today. Returns on investment for butter powder operations are clearly superior to returns on cheese at Land O'Lakes.

One board member recently told me that one of the significant strengths of the California program has been that it has allowed California producers to grow. And I agreed with that statement. The results of the hearing today will have a significant influence on future changes in manufacturing milk capacity in California.

This concludes my testimony. I would appreciate the opportunity to file a post-hearing brief.

Thank you.

HEARING OFFICER ESTES: Dr. Gruebele, your request is granted for that purpose.

I forgot to inquire initially, but I assume you would like your written testimony incorporated into the

record as an exhibit.

DR. GRUEBELE: Yes, I would.

HEARING OFFICER ESTES: Do we have any panel questions?

SUPERVISING AUDITOR HUNTER: Dr. Gruebele, can you hear me okay?

DR. GRUEBELE: Yes.

SUPERVISING AUDITOR HUNTER: Am I coming through?

DR. GRUEBELE: I can. That's another thing I have is a hearing problem, and besides everything else.

(Laughter.)

SUPERVISING AUDITOR HUNTER: I have a couple questions to ask.

On page 4 on your testimony, when you talk about the California price compared to the CME average, I'm kind of curious. Why do you want to use a 45-month period, as opposed to a 12-month or 24-month?

DR. GRUEBELE: Okay. There are periods of time when cheese markets are close to support. And there are times when cheese markets don't even approach support. There tends to a compression of the difference between the cheese -- the CME price and the cheese -- the price that's received by California cheese makers when the price is close to support because it is the option to market the cheese with the government.

So the reason I use a 45-month is to include months in which cheese is closest to support but also months -- a lot of months where cheese is above support. And that's the reason I suggested the 45 months.

SUPERVISING AUDITOR HUNTER: Okay. That's such an uneven number though, 45 month. I was just kind of curious, you know --

DR. GRUEBELE: I guess it -- I guess it was -- maybe it was 48 months. Yeah, I see your point, yeah. I'd have to cheek to see whether it was 45 or 48.

SUPERVISING AUDITOR HUNTER: Okay.

DR. GRUEBELE: And that may be a misprint. I didn't mean to use just 45 months. That was not the intention.

SUPERVISING AUDITOR HUNTER: Okay. On that same page, the paragraph above that you mentioned the cost of making Mozzarella cheese is simply higher than it is for Cheddar operations. And then you mentioned the packaging costs is one difference. Are there other known differences that you might talk about between the two operations?

DR. GRUEBELE: Yeah, the -- first of all, the equipment is different once it reaches a certain point. The brine is used in Mozzarella operations. And then of course if you're using 40-pound operations, then you have

towers, you know, that type of thing. So you have different equipment that is used at some point in the two operations that do differ significantly.

Also, it's my understanding in terms of the process -- I'm not sure I understand all the reasons why. I talked to somebody at Land O'Lakes yesterday who has been in charge of both Mozzarella cheese operations and Cheddar operations. And his comment was -- Dr. Lee Blakely's comments were that it's more labor intensive in the Mozzarella operations as far as the process is concerned as well as packaging. Not only packaging labor, but also in the process of manufacturing Mozzarella cheese. To the degree that I can, I will illustrate further differences in the post-hearing brief. I didn't have time to get into the depth that I wanted to on this particular question.

SUPERVISING AUDITOR HUNTER: Yes, if you could. And if you could -- any kind of cost figures at all in the comparison of those --

DR. GRUEBELE: Any comparison?

SUPERVISING AUDITOR HUNTER: Yeah. I mean hard costs figures, instead of just --

DR. GRUEBELE: Yeah, I understand. And your point is well taken. And, you know, one of the differences that I saw, and it's a concept that the

Department uses for our operations, in particular because we have a 640-pound operation, you use the packaging costs associated with average of the other 40-pound block operations in the cost study. And the packaging labor costs associated with the 40-pound operations cost study to replace a 640-pound packaging costs; is that correct?

SUPERVISING AUDITOR HUNTER: Right.

DR. GRUEBELE: And labor costs.

When I made that comparison I found that if you applied the same principle -- and remember that even if a plant may be less than full capacity, when you get to packaging, you should only buy the packaging equipment material you need. And you should put on the line only the packaging labor that you need.

So if I applied the same concept and applied it to this one Mozzarella operation, I found that the 45 -- if I use a 45 -- the 40-pound block average, you know, for packaging labor costs and packaging costs combined, I would reduce the cost of packaging and labor associated with packaging in that Mozzarella operation by less than half.

There's is a number that is there. It's published and it's a concept you're actually using in Cheddar operations. For example, a 640-pound operation. The reason that the Mozzarella plant operation is so much

more expensive from a packaging cost standpoint is they're making 6-pound units, not 40-pound blocks, not 640-pound blocks. But it is included in the weighted average cost that you have replied to other folks as to what the weighted average for cheese costs are for plants associated with the whey cost study. That's why I think that's important.

SUPERVISING AUDITOR HUNTER: Okay.

DR. GRUEBELE: Now, that's a hard number I can address today.

SUPERVISING AUDITOR HUNTER: Yeah, right. And if you could put that in your brief afterward.

DR. GRUEBELE: I will. I'll put that in my brief.

SUPERVISING AUDITOR HUNTER: I have one more question, if I can find it.

Yes, on page 5, where you mention about the yields. You want to use a yield of 10.01?

DR. GRUEBELE: Yes.

SUPERVISING AUDITOR HUNTER: And that's based on the actual milk in California that goes --

DR. GRUEBELE: Yes, I'm basing it --

SUPERVISING AUDITOR HUNTER: The unfortified milk, right?

DR. GRUEBELE: Yeah, this is unfortified milk.

SUPERVISING AUDITOR HUNTER: Okay. I understand that.

You know, that the fortification costs are included in the cost study?

DR. GRUEBELE: Yes.

SUPERVISING AUDITOR HUNTER: So how do you rectify the differences by using the unfortified yield but the fortification costs are in the cost study?

DR. GRUEBELE: That's a good question. Frankly, one of the problems you don't include is the protein premiums. Those are not included, the private protein premiums, which are used to get the milk supply to those high protein levels. And because that encourages producers to go through breed selection and other things.

That is an issue I'll have to address in a post-hearing brief. I hadn't thought about the fact that the fortification costs are included. I'll address that in the post-hearing brief.

SUPERVISING AUDITOR HUNTER: Okay. Fine.

That's all I have.

HEARING OFFICER ESTES:

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Good morning, Dr. Gruebele.

DR. GRUEBELE: Good morning.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I'm on page 2 of your testimony. For your proposal for the dry whey manufacturing cost allowance you recommend 80 percent coverage of the plants --

Dr. GRUEBELE: That's right.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA:

-- rather than actual cost, an actual figure. And I'm trying to figure out how that would work. How would we practically do that? Do we update it annually? Do we do it as we accumulate data? And I think you can appreciate that that cost information as it comes in is discrete in its distribution, meaning there aren't that many plants. So you may not hit 80 percent every single time. So how would you address that? I'm trying to --

DR. GRUEBELE: Excuse me. It's not of the volume coverage. It's 80 percent of the plant coverage.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Sorry. Okay.

DR. GRUEBELE: Does that change your question or not --

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Not really, no.

DR. GRUEBELE: Okay.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Again, how do we do this?

DR. GRUEBELE: I was hoping it would.

(Laughter.)

DR. GRUEBELE: How do we do that?

When we made this proposal the board felt the reason -- first of all, let us give you the legitimacy of why we did what we did. We used weighted average costs for everything else. Whether it's butter, whether it's powder, every thing else, cheese, we used weighted average costs. The board felt that the .2675 was -- was fairly -- significantly higher costs than the current make allowance of 17 cents. So the board felt, and management agreed -- which is always wise for management to do --

(Laughter.)

DR. GRUEBELE: -- to cover 80 percent of the plant coverage. And that's the reason we did what we did.

Now, I gather from the pre-hearing workshop that you gentlemen have come up with a number to reflect the 80 percent plant coverage, at least a number was given to us at the pre-hearing workshop. So apparently it's doable. That's number 1.

Number 2, how would that change? It would change like anything else. When there's another cost study, if there's another hearing, we go through the same procedure

again. And at that particular point in time I can't guarantee you that we would come up with the same proposal of 80 percent plant coverage. It might be something else. Our board may decide a different number or a specific number. So I can't answer that as far as future is concerned.

But for this year you have come up with a number. And in the future, how does it change? Just like all of our make allowance changes in the past: We have a petition. Then either that petition is accepted or not. Then you have a hearing and we testify and proposals are made. And at that time we will make a proposal. Whether it's 80 percent of plant coverage or something else, I couldn't tell you.

Okay. Does that answer your question?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Well, Sort of. You've already said that for this year we've been develop --

DR. GRUEBELE: You did have a number for this year?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Well, the 80 percent cover.

DR. GRUEBELE: That's correct.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL

ASSISTANT ERBA: Why not just use that number --

DR. GRUEBELE: What's that?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Why not use that number then?

DR. GRUEBELE: Oh, okay. I mean --

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I don't know what the number is.

DR. GRUEBELE: I'll be glad to put it in my post-hearing brief. I'll use the specific number you came up with. Okay?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA:

Excellent.

On page 3 you talked at some length about Land O'Lakes operation on 640-pound blocks. And the -- my take is you don't like what the Department's done with the cost studies. Is that accurate?

DR. GRUEBELE: On page 4, you're saying?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Page 3, the bottom of --

DR. GRUEBELE: Page 3 at the bottom it says, "Questions raised."

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Above that. The paragraph above that.

DR. GRUEBELE: Above that? Okay.

Oh, I see, okay.

Oh, yes, yes. It has to do with the fact that they used average packaging labor costs for 40-pound cheese plants in the survey. And I'm suggesting that our Plant 3 at Tulare has a union contract that is pretty steep and it's pretty severe.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: So what's the solution --

DR. GRUEBELE: So my point is that when you use the average of 40 pound -- of the other plants, they may not have similar union contracts or they may have no -- they may be nonunion. And what we're doing is we're using an average of those costs. And I'm suggesting that the likelihood -- very distinct likelihood is that if we reflect the union contract we have, that that number would be higher than reflected in the number that was used to adjust our packaging costs to reflect 40-pound plant operation rather than 640-pound block operation. And so by using that average -- and they have a different labor union contract -- those costs are lower because union contracts are different or they may be -- some of those plants may be nonunion. I don't know. But I'm just making the suggestion, there's a possibility that our number therefore is understated as far as our packaging labor costs are concerned. Therefore, our total plant

costs for the key operation in plant 3 is understated, which means, as it reflects a weighted average of all the plants in the cost study, that number may be understated. The .1734 weighted average cost may be higher than that.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Should we drop your plant from the study?

GRUEBELE: Pardon?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Should we drop your plant from the study?

DR. GRUEBELE: I didn't say that. I just -- I would suggest that we need to reflect that. And I don't know how to do that at this setting.

This is something that maybe for future use we adjust to reflect to see whether or not the union contracts are similar or different. And if they are different, could we accommodate that in future use?

But for this hearing, I would only say that the .1734 is a very conservative number.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay.

On page 5 you use the -- looks like the Van Slyke formula to me and a 37.78 percent moisture. Where do you come up with 37.78 --

DR. GRUEBELE: I use the -- I talked to the plant people in Tulare and came up with the 37.78.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Is that your injure plant's moisture --

DR. GRUEBELE: That's what -- that's the -- yeah, about the average.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: You cite the California Milk Advisory Board and their prediction of over 12 billion pounds of milk growth in the next 10 years.

What is your feeling as an expert in the industry on what that estimate looks like?

DR. GRUEBELE: Well, you know, we can experience 3 to 4 percent growth very easily, in my opinion. I haven't -- I think that -- there are a group of us who make -- as plans on the ad hoc committee -- and there were a group of us that -- let's put it this way, they're all in same role that I am, sort of retired. And some of them you know pretty well.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I'm familiar with the group.

DR. GRUEBELE: And we came up with a number and would have cost the State of California a whole lot less than the study that they employed to come up with a 12.2. Our number didn't turn out to be all that different.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: You say that --

DR. GRUEBELE: We did it independently of that study. It was interesting, when we saw it we'd say, "Well, they came pretty close to our number."

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: So you would support that that number is probably in the ballpark pack of being --

DR. GRUEBELE: That's in the ballpark. Very possible. I mean anything's possible of course.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: On page 8 you talk about the difference in the Federal Order Class III price and the California Class 4b price being 31 cents per hundredweight over a January 2003 - November 2004 timeframe.

DR. GRUEBELE: Yes.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: My question to you is: Is 31 cents a hundredweight, is that reasonable?

DR. GRUEBELE: No.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: No?

DR. GRUEBELE: No.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: What should it be?

DR. GRUEBELE: It should be a lot larger because, first of all, we don't take into account depooling. I'd

just gone through a major discussion about the depooling issue. I don't think 31 cents gets you there at all. I think it should be much larger than that.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Well, I'm glad I asked the question. That's not my take on that at all. So I'm glad I asked.

DR. GRUEBELE: The number through December, by the way, is .349. I didn't put it in. But at the time I did all this work I had it through November -- I only had November. But if you go all the way through December, the difference between the two numbers is .349 instead of .31.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I've just got one last question. It has to do with your comments oh the whey factor. And I wrote in this earlier, did you consider deleting the whey factor from the formula? And you said, yes, if you don't get these things that you've asked for.

Let me ask a different question. Did you consider a different product other than dry whey?

DR. GRUEBELE: I think it's -- this is one of the reasons Land O'Lakes opposed even the inclusion of whey at all because it becomes so complicated. There is no standard WPC either, unfortunately. The people do different things all over the place. And they handle -- what's left over the lactose is so many different ways.

To be very honest with you, I think it's -- you're going down a path that is almost impossible to establish any meaningful cost relationship by going into WPC operations, because there are so many different things done. It is -- and it's just not realistic, in my opinion. You know, Federal Order did the same thing probably for the same reason, because they had a lot of WPC's in their operations and all that. But they went the whey route.

For some of the same reasons and some different reasons we go with Cheddar cheese too. We don't do a cost study for Mozzarella cheese or jack cheese or all the other cheeses we can think of.

We go to Cheddar, which is a basic commodity. And I think this is the way we have to look at it.

And I think the reason in whey is that it just becomes horribly complicated when you go to WPC and see that numerous ways, numerous percentages that they take those proteins up, 80 percent, 70 percent 60 percent, you name it, it's all over the board.

And the way they handle lactose, some dry their permeate. Some make lactose. Some make alcohol. We've had all that. We've gone through all that stuff.

So I'd say no. The answer -- I think it's the wrong direction for California to go. Either we develop a way whey factor that is right or just stay away from it.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Given a choice -- I'm going back on my word. I said I had one question. Now I have another one. Given a choice, would you take the whey factor out of the formula or leave it in and tinker with it?

DR. GRUEBELE: I said what I said at the conclusion. And the conclusion very specifically said, if a cost justified adjustment is made based upon the whey study that has been made by the Department, and no snubber is implemented, keep it in.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. Just to be clear. Thank you.

I permeated your testimony today.

DR. GRUEBELE: Okay.

AGRICULTURE ECONOMIST GOSSARD: Dr. Gruebele, I have a series of questions. But the 1st one is purely technical.

On page 9 of your testimony, under the Alliance of Western Milk Producers, you cite Table 2 from the handout that was done at the pre-hearing workshop.

Actually Table 2 has to do with the whey snubber and the support purchase price --

DR. GRUEBELE: Excuse me?

AGRICULTURE ECONOMIST GOSSARD: Table 2 actually has to do with the whey snubber and the support purchase

price floor.

DR. GRUEBELE: That I misnamed the table?

AGRICULTURE ECONOMIST GOSSARD: I believe you want Table 3, which shows percent volume --

DR. GRUEBELE: Why don't you make that change in your copy there.

AGRICULTURE ECONOMIST GOSSARD: Okay. I just --

DR. GRUEBELE: And I'll want to do it in my post-hearing brief. Thank you for your correction.

AGRICULTURE ECONOMIST GOSSARD: Now, for the more serious questions.

HEARING OFFICER ESTES: Excuse me. What page is that in the testimony?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Nine.

AGRICULTURE ECONOMIST GOSSARD: Sorry. I pulled it out, then I lost it.

DAIRY MARKETING BRANCH CHIEF IKARI: Page 9.

HEARING OFFICER ESTES: I have the formal exhibit, so I want to make the change there.

AGRICULTURE ECONOMIST GOSSARD: Page 9, "Other proposals, Alliance of Western Milk Producers," I spotted the use of Table 2 on three occasions. I think that's it.

HEARING OFFICER ESTES: And that should be Table 3?

AGRICULTURE ECONOMIST GOSSARD: I believe so, yes.

DR. GRUEBELE: I'll make sure when I look at the table. I'll correct it in the post-hearing brief.

AGRICULTURE ECONOMIST GOSSARD: Dr. Gruebele, on page 3 of your testimony you talk about covering 80 percent of the plants --

DR. GRUEBELE: Yes.

AGRICULTURE ECONOMIST GOSSARD: -- for your proposed whey number. However, with only four plants in the study, is it not possibly that a single outlier could skew the results using this approach?

DR. GRUEBELE: It's -- without knowing all the data, that's always possible.

AGRICULTURE ECONOMIST GOSSARD: Right. And on page 10 of your testimony, you mentioned the cost studies should be used as a guide rather than using the exact number; is that correct?

DR. GRUEBELE: I'd say that's correct. I think there are times when we have suggested more liberal make allowances. Sometimes the economics of a situation suggested that, particularly when processing capacity was short in California.

AGRICULTURE ECONOMIST GOSSARD: On page 5 of your testimony, the fat and solids-not-fat test you are

proposing at 3.67, the 8.75 is based on all milk in California?

DR. GRUEBELE: It's based upon market grade milk. But when you include manufacturing milk, it turns out to be the same number in the annual report that's put out by the Department of Food and Ag.

AGRICULTURE ECONOMIST GOSSARD: Now, approximately -- over 40 percent of that Grade A milk goes to cheese plants, does it not?

DR. GRUEBELE: Yes, it does.

AGRICULTURE ECONOMIST GOSSARD: Now, when you were using the Van Slyke formula, you chose a casein solid-not-fat ratio that was based only on butter, powder and fluid operations.

Wouldn't it have been more appropriate to use a ratio based on all plants since your test is based on all milk?

DR. GRUEBELE: We talked about that. And I decided to use what I did because I felt that the milk supply -- that there were a lot of protein premiums paid to make the milk what it is. And the protein premiums are not included in the cost study. That's why I did what I did.

AGRICULTURE ECONOMIST GOSSARD: In your post-hearing brief, could you please address the concerns

in the 2003 panel report about using the Van Slyke formula to establish the Class 4b cheese yield.

DR. GRUEBELE: Could I review the panel report, is that what you're saying --

AGRICULTURE ECONOMIST GOSSARD: Yeah --

DR. GRUEBELE: -- for the 2003 hearing and your concerns about using the Van Slyke formula?

AGRICULTURE ECONOMIST GOSSARD: Yes, could you review those?

DR. GRUEBELE: I will review those. I'll certainly do that.

AGRICULTURE ECONOMIST GOSSARD: And Comment on them in your post-hearing --

DR. GRUEBELE: I certainly will do that, sir.

AGRICULTURE ECONOMIST GOSSARD: Under your proposed formula but taking out and adjusting out the f.o.b. price adjuster, the 4b price would average about 60 cents less than the Federal Class III price. And you feel that 66 cents is necessary because of the depooling option for cheese plants?

DR. GRUEBELE: I would say that's -- that part of it, yes. Part of it is -- remember what I said earlier, what I said in the conclusions, is my concern that the returns -- and we have both kinds of operations. Our Plant 3 compared to butter powder operation is no where

close. I think -- it is my opinion that the return on investment for cheese operations ought to at least be equal to butter powder if we're going to promote the continued growth in cheese in the state. And I validate that, because I think that's a growth in demand. That's the area where demand is growing. And I think it means a lot to producers over the long term to have cheese plants continue to grow as the milk production grows in California and that that percentage grows. And I think in order for that to happen, then it just makes economic sense for a plant operation like LOL, who are making decisions, profit and loss decisions, and say, "What do we do with the next cheese" -- "with the next plant expansion? Is it butter powder or is it cheese?"

If the economic signals that we get through the hearing process is to make butter powder, maybe that's what we should do. But I don't think that's the direction we should go.

And that I think -- also that's still another reason. The depooling option is simply a competitive relationship between us and other cheese operations outside the state. But we have a problem within the state and, that is, the relationship between returns of butter powder operations and cheese operations. I don't think we ought to discourage the development of cheese operations

in California.

AGRICULTURE ECONOMIST GOSSARD: My final question is on page 11. Excuse me, because I know Dr. Erba touched on this as well. You're recommending that if it would appear a whey snubber was justified and a fairly low manufacturing cost allowance was still justified relative to what it is now, you would wish that the whole formula -- the whole whey factor be removed for the Class 4b --

DR. GRUEBELE: Yeah. And our board of directors as a matter of fact made that strong recommendation, that they felt that unless we get adequate return -- unless we get reflective returns on whey and the adjustments are made there's no snubber used, if there is -- if either one of those doesn't happen, the whey factor should be thrown out.

AGRICULTURE ECONOMIST GOSSARD: On the other hand, given that any make allowance we establish for whey above about 20 cents is going to mean the whey factor is going to be a net loser -- a net -- will cause on average a net decrease in the 4b price and that over the last 10 years your make allowance would have exceeded the price of western whey 87 percent of the time, wouldn't it be justified if we thought we should use your make allowance, that the thing should be thrown out?

DR. GRUEBELE: I really -- I didn't hear your question. I'm sorry. I tried.

AGRICULTURE ECONOMIST GOSSARD: Okay. I'll go a little slower.

With your make allowance most of the time --

DR. GRUEBELE: What make allowance? The --

AGRICULTURE ECONOMIST GOSSARD: With your make allowance for dry skim whey.

DR. GRUEBELE: Yes.

AGRICULTURE ECONOMIST GOSSARD: Most of the time, 87 percent of the time, your make allowance would exceed the price of whey, and any make allowance above about 20 cents, and yours certainly is, means the 4 -- the whey factor in the 4b formula is going to be a negative on average for the 4b class price. If we did adopt your make allowance as a reasonable make allowance, wouldn't we just be better off removing the factor?

DR. GRUEBELE: All right. Let me make a comment, both -- with regard to both of your points.

And, that is, that remember what the language says. It doesn't say unless you accept the Land O'Lakes specific number thrown out. That's not what it says. It says a cost justified number. We do depend on your professionalism and the decisions that you make and that Land O'Lakes does not have the answer a hundred percent of

the time. Just 99. I'm sorry.

(Laughter.)

DR. GRUEBELE: So I would say -- when I said a cost justified, I would say that if you're going to keep the make allowance at 17 or 18 cents, forget it. Okay? But If you make a cost justified adjustment to the make allowance in whey, which works both ways, that covers plants or they really -- you know, we'll have both positive and negative influences on the formula, then we say keep the formula in. And when I said cost justified, I didn't say that it had to be Land O'Lakes specific number.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: I just have a couple questions.

And, Dr. Gruebele, thank for your testimony. I understand more of it than in previous testimonies.

That's a compliment.

(Laughter.)

DAIRY MARKETING BRANCH CHIEF IKARI: You testified -- and I'm trying not to touch on areas that the other panel members went. But 45 months was mentioned.

DR. GRUEBELE: Yeah, that was a mistake.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, let's say it's four years. In the prior -- in 2003, I think you

testified to considerably less time basing the price difference.

When the plants want to use the most updated processing costs, is it reasonable -- what kind of principle should the Department follow in adjusting the price factor?

DR. GRUEBELE: I think in that case, again, because we have so much variation in prices, that we have the lows and the highs, I think you have to use a longer period. When you do costs, naturally you want the most recent costs. I don't there's any question that that's valid. I mean you don't want to use five years ago or four years ago or three years ago. It doesn't make sense. But when you're doing something like this, I think if you use a long enough period of time, then I think you take into account when the price is compressed, when the prices -- when the prices are wider. I think a longer period of time is valid.

Now, the other -- I think when -- previously testified -- you know, I'd have to think back how long have we done this? I don't know, maybe the time was shorter because we hadn't done it for -- maybe we didn't do it for four years in those days. Maybe we started the process to cover the difference. I don't know -- time goes so fast, I don't remember. But we felt that, you

know, a longer period of time is relevant.

Now, would three years work? Yeah, probably. But I think a longer period of time is valid. And I think a four-year period is not unreasonable. And I think you add a year, drop off a year as you go on, maybe we could learn over time as to what is the most reasonable, you know, method to use. But we do want to be reflective of what the average price differences are. It would reflect something about the freight, of moving a product to market. And, again, when prices are low, it's important. Then the prices tend to be compressed, as I said earlier, and it's not reflective of the real world.

DAIRY MARKETING BRANCH CHIEF IKARI: If we had a sudden increase in the difference between the CME and the California prices that California processors are receiving, would we still be talking about going to a 48-month time period?

DR. GRUEBELE: If we had a sudden increase?

DAIRY MARKETING BRANCH CHIEF IKARI: If we had a sudden spread between -- let's say in the last 12 months the spread between what California processors paid versus the CME widened, would we still be talking about 48 months versus using 12 months?

DR. GRUEBELE: Well, I guess to be consistent I'd have to say yes. I think you'd wanted to -- you'd want to

reflect both the times when the prices are -- if you're going to be fair to both, if you're going to be fair to processors and producers, then I think you ought to include times when the price is compressed as well.

DAIRY MARKETING BRANCH CHIEF IKARI: And you think that 48 months is fair?

DR. GRUEBELE: I think it is.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. Let me ask you another line of questioning.

With respect to the federal orders, I understand these equity problems of the plants that depool. Is there any evidence that when they depool they are not paying the Federal Order minimum Class III price?

DR. GRUEBELE: Well, let's -- I'll put it to you this way. I talked to someone the other day and I said, "Suppose that you were operating a cheese plant like we are and you're having real trouble making ends meet. And I happen to know that in the Pacific Northwest cheese operations historically have had a little difficulty because the formulas do not reflect the freight factors like California does." And they're also competing against us and that type of thing. And you had the opportunity and you see a $4.32 price spread and you say to yourself, "Cheese plants having trouble not showing red ink," what would you do? Would you pay the full price -- the full

Class III price and continue the red ink or might you adjust and say, "I know that I can compete for the milk. There's no problem. I don't have to pay $4.32 to keep my producers." Because everybody else is getting the uniform price. That's all they can pay. They can't pay any more than that.

Well, they could. They could pay premiums, I suppose. But now we're talking about other butter powder plants, Class 2 plants, Class 1 plants, and those producers who ship their milk there. And we're talking about a uniform price that is $4.32 lower. Do you have to pay the whole $4.32 to keep yourself competitive in the field? I don't think so. I just don't think so.

Now, do I have evidence, hard evidence that they don't pay? Then I'll still say there's still an advantage for them to depool. Why are they doing it? They are doing it. You can see the evidence. You know, I showed you the producer receipts. There's no question.

Then if what you say is true, heck, might as well pay into the pool, and se la vis.

But it turns out that if I depool, I can pay my producers $4.32. That widens the difference between me and my competitor. Even that is of help to you, if you know what I'm saying. Now, I show I'm really outpaying everybody else by $4.32. There's still an advantage for

depooling that does not -- the same does not exist in California. We don't have the same opportunity.

DAIRY MARKETING BRANCH CHIEF IKARI: But without -- there's hard evidence, the other alternative -- are you aware of -- does Land O'Lakes take the position that when it behooves plants operating under federal orders, that rather than paying a minimum established Federal Order price when they depool, they're paying the uniform blend? Does Land O'Lakes or do you know anybody that's publicly made that position or stated that opinion?

DR. GRUEBELE: I can't -- first of all, I was comparing the Pacific Northwest specifically. I don't know -- I can only tell you by, you know, word of mouth. I've heard some rumors that in -- and I don't know whether it's true or not. Unless I go out and survey the situation and actually -- and I didn't have time to do that, to be honest with you -- view the situation in Idaho and say, "Well, I understand that when milk is depooled" -- of course they're no longer in the Federal Order now -- "when milk is depooled, you guys really are getting hurt." Might not even get the uniform price. That's possible too. Remember, there's no minimum price. They could pay less than minimum if they wanted to.

I don't think that would happen because they'd want to at least keep, you know, their producers equal to

their competitor, you would think.

But do I have hard evidence? Do I have a survey? I don't, to be honest with you. But is it advantageous us to depool? Without a question. Even if they pay the full price, it's an advantage because now they've really separated themselves from aggressive producers and not paying them. But they really don't have to pay at all because, man, if it's $4.32, that's a monumental difference. Wow, if you paid a dollar more than the overpaid -- than the uniform price, you're a lot better than everybody else, presumably. You don't have to pay the full $4.32 in my opinion.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

DR. GRUEBELE: That's again my opinion. I don't have any hard numbers.

HEARING OFFICER ESTES: Do we have more questions?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I have one more question.

In your proposal, your petition, you've suggested using make allowances for cheese exactly reflect the cost studies weighted average cost. And yet you don't use the back tests and the yield that are produced from that same cost study. Why not?

DR. GRUEBELE: That's the same question I think

Mr. Mr. Hunter asked, is it not?

SUPERVISING AUDITOR HUNTER: In different words.

(Laughter.)

DR. GRUEBELE: That's what I thought.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I'm going to see if you give us the same answer.

(Laughter.)

DR. GRUEBELE: Probably.

(Laughter.)

DR. GRUEBELE: It hasn't improved any as I sit up here.

(Laughter.)

DR. GRUEBELE: The answer is that, yeah, I'd have to agree with that, that Mr. Hunter puts in the fortified costs, that we didn't use the milk going into those plants on the casein study. I presume that's what you're referring to; is that correct?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: You're taking a different direction and I was asking -- I was just asking a very surface question. Why did you choose to use a formula to replace the actual numbers that we have collected from those costs --

DR. GRUEBELE: Oh, you're talking about the fortified milk formula?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Well, we've got a fat test or a solids-not-fat venue and those come from the cost studies and you chose not to use those. I just want to know why --

DR. GRUEBELE: I chose not to use the cost study?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: No, the yields -- the yields in the fat tests come from --

DR. GRUEBELE: Oh, the yield in the fats.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Right.

DR. GRUEBELE: So far as I know, any decision that you guys have made in the past at the 10.2 yield did not reflect the fats yield either. You adjusted it to reflect more the -- currently we're using 372 and 88. We're close to the 367, 875 even today. Even, you know, in the past we've made decisions as a result of hearings. We haven't used those high yields, which are the fortified milk and all the other ancillary things you do, you UF and all the other stuff they do now. Protein enhancement stuff in the fats, we haven't used them as a result of that, and used a 10.2 yield with a 372, 878 or 88 solids not fat. All I'm saying is I'm suggesting that number be 10.01 with 367, 875. That's all. And I -- so I'm doing a

similar thing as to what we've done historically in the State of California, that is, to have a cheese yield that approximates the milk supply in California. And that's approximately what we have done in the past.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Got it.

Thanks.

HEARING OFFICER ESTES: Are we concluded with the questioning?

All right. Thank you, Dr. Gruebele, for your appearance today.

Before we proceed to address the alternative petitions, I just want to make a number of announcements.

First, it's anticipated that there will be a lunch break around 1 p.m., depending on the status of the testimony at that time. So the panel anticipates taking a lunch break around the period, say, between 1 to 1:45 or 1 to 2, somewhere in that timeframe, depending where we are with the testimony.

The other thing of note to recognize, given that we have a lot of alternative petitions, it's anticipated the hearing will be going over tomorrow. And so that the likelihood of any significant testimony other than the testimony by the presenters and in support of the alternative petitions is likely to be minimal.

And then, finally, I believe at least at this time that the panel will likely conclude today probably around 4:45 p.m.

So I wanted everyone to be aware of those facts.

Also, the witness roster -- for anyone who arrived late, the witness roster list is in the back of the room. And we attempt to take people sequentially to testify after the presentation of all the petitions.

So that essentially gets us up to date on how the hearing's likely to proceed from here on.

On more practical matters, I haven't really been in this building a great deal. So if you have something more mundane, such as understanding where the restrooms are located, you'll have to speak to the security guard about that. I'm not very familiar with this building.

So with that in mind, we will proceed to take testimony in support of the alternative petitions.

The first one we'll call for is the Milk Producers Council.

(Thereupon Mr. Geoffrey Vanden Heuvel was sworn, by the Hearing Officer to tell the truth and nothing but the truth.)

MR. VANDEN HEUVEL: I do.

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

MR. VANDEN HEUVEL: Geoffrey Vanden Heuvel. First name, G-e-o-f-f-r-e-y; last name, V-a-n-d-e-n capital H-e-u-v, as in Victor, e-l.

HEARING OFFICER ESTES: Does your written testimony reflect how the decisions were made by your organization to come to these policy decisions?

MR. VANDEN HEUVEL: Yes, it does.

HEARING OFFICER ESTES: All right. Then I -- would you like your testimony introduced in the record?

MR. VANDEN HEUVEL: Yes, I would.

HEARING OFFICER ESTES: It will be introduced as Exhibit No. 44.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 44.)

HEARING OFFICER ESTES: And please proceed with your testimony. You'll have 30 minutes.

MR. VANDEN HEUVEL: Mr. Hearing Officer and members of the Panel, my name is Geoffrey Vanden Heuvel. I'm a dairy producer with operations in the San Bernardino Riverside Counties. I'm here today on behalf of Milk Producers Council, which is the producer trade association, with about 175 members located primarily in southern and central California.

My testimony today is based on a policy adopted by the Board of Milk Producers Council at its meetings in

December of 2004.

Oppose Return to Cheap Milk Policy of the Past:

The main issue before the Department today is whether or not California should return to a cheap milk policy for the purpose of incentivizing through government regulatory action a significant expansion of California manufacturing plant capacity. Milk Producers Council objects in the strongest possible way to the return to this policy.

Deliberately reduced California manufacturing milk prices was the policy pursued by the Department during the early 1980's. At that time, California's producers were exporting distressed milk to far-off places almost year around. It was thought that there might be an opportunity to create a significant California cheese industry to profitably process all that excess milk. To bring this about the Department used the minimum pricing authority inherent in the California state order to grant California manufacturers a large milk cost advantage relative to their out-of-state competitors. This policy established California 4b prices that at times were well in excess of a dollar per hundredweight lower than the Federal Order prices that our out-of-state competitors had to pay.

This policy facilitated the rapid expansion of

the California cheese industry to a point where now California is a dominant player in the national cheese market.

Over the past decade the influence of California both in the marketplace and as a regulatory trend setter has forced the Federal Order program to be adjusted to minimize the difference between the California system and the Federal Order system. The spread between the Federal Order price for cheese milk and the California 4b price has been significantly narrowed over time and the two systems are basically moving in synch with each other.

What the petition is proposing to do and what unfortunately the Dairy Institute is also proposing to do is to return California to the days of regulated cheap milk. There are at least two reasons the Department should not do this:

No need. One, there is no need for a state granted incentive to significantly expand California manufacturing plant capacity. Far from having significant amounts of distressed milk being exported from California because of a lack of capacity, we are now witnessing unprecedented importation of raw milk into California from out of state. In addition, whereas in the 1980's and '90's central California communities were actively courting southern California producers to try to attract

them to relocate to the San Joaquin Valley, today communities throughout the Central Valley are actively opposing the location of dairy producers in their communities.

The rate of new dairy expansion has dramatically slowed, while the environmental requirements placed on new and existing dairies makes it highly unlikely that the rate of dairy expansion experienced in the latter part of the 20th century can be sustained very far into the 21st century.

The Dairy Institute in their letter supporting the call of this hearing cite the departure of cheese plants from California and the lack of recent new cheese plant expansion as their justification for requesting a return to the cheap milk policy. It must be noted that during the past five years the California business climate has caused many businesses, including quite a number of California's dairy producers, to leave the state. The energy crisis, the workmen's comp crisis and the overall anti-business environment that led to the recall of Governor Davis have all contributed to a lack of confidence of investors to make a big commitment to California. There is no need at this time for the state to dramatically lower producer income for the purpose of artificially stimulating a large expansion in

manufacturing plant capacity.

Will not work. The second reason the Department should not go back to the cheap milk policy as proposed by LOL and the Dairy Institute is that it will not work. In the 1980's when we last launched a cheap milk policy, the upper midwest was the great surplus milk area in the United States. And the national milk pricing surface was priced off of the Minnesota/Wisconsin price series. California could exploit this situation with a cheap milk policy, which resulted in cheap California cheese being able to undercut the competition which was forced to pay for milk based on a midwest price series.

This is no longer the case. The federal Class III price is driven off of a NASS cheese price survey, which is dominated by California and other West Coast cheese plants. If the state were to return to the cheap milk policy of the past and the California cheese plants were to attempt to increase market share by discounting prices, those discounted prices would be picked up in the NASS survey. This lower NASS price would lower the Federal Order milk price paid by our competitors, which would deprive the California plants of the advantage of the state would be trying to give them. This policy would ultimately result in no gain for California manufacturers, only pain for California producers.

The MPC Alternative Proposal:

So what should we do? Milk Producers Council strongly believes that the current 4b pricing formula produces about the right price. In our alternative proposal we have suggested only minor changes to the formulas. We are proposing to change the adjusters to the CME prices for butter and cheese used in the 4a and 4b formulas. We note that the panel report of the January 2003 hearing stated on page 12, and I quote, "The most recent data collected and summarized by the Department shows that California cheese processors received a CME price less 3.21 cents per pound in 2002. Clearly, the price relationships of California manufacturers and the CME must continue to be monitored," end quote.

The Department has produced updated price data for this hearing. We particularly appreciate the Department's analysis which discovered that there is a lag between the time the CME price for a particular day is set and when that price influences the California cheese plants sales prices. In our alternative proposal we use data derived from this study. In the format that the Department has published this data in the past, there has been an average price on that sheet that excluded the high and low differences between the California price and the CME price. The fact that there are such highs and lows in

the traditional table is clearly a function of the lag that exists in the marketplace. The data in the new format does not throw out the high and the low and, therefore, captures all of the data, which we think gives the data more credibility. We use the January 2003 through October 2004 timeframe because we believe the adjuster should be based on the most recent data available. The current 3.21 adjuster was based on 19 months worth of data, so we too picked a data set that is less than 24 months.

Dry Whey Make Allowance:

With regards to the dry whey make allowance used in the 4b formula, we are proposing a modest increase in the make allowance for dry whey. The reason for this is that the best cost study on dry whey we are aware of was done by the National Cheese Institute for the year 1999. The results of this study were entered into the record in the May 2000 Federal Order hearing. That study concluded that the average cost to dry whey in the United States was 15.9 cents per pound. Interestingly, USDA used 15.9 cents per pound as the make allowance for the Federal Order Class III formula. In all three proposals in the California hearing on this issue in 2003 suggested using 15.9 as the make allowance for dry whey in the 4b formula.

The Department decided to use 17 cents per pound

as the make allowance and it referred in the panel report to the relationship between the cost to dry whey and the cost to make nonfat dry milk. Since 1999, when the NCI study was done, the cost to make nonfat dry milk appears to have increased about two cents per pound. The validity of this approach is confirmed by the communication from West Farm Foods of Washington State. And I have that attached as an exhibit. The West Farm Food report shows an average cost for making a pound of dry skim whey from their two Cheddar cheese plant operations to be 17.6 cents her pound. Therefore, we are willing to support a modest increase in the dry whey make allowance in exchange for a snubber, which will keep the dry whey portion of the 4b formula from having a negative impact on the producer price.

Snubber Needed:

The justification for the snubber comes out of the history and practice of the way the Cost Auditing Branch treated whey solids disposal costs in their audits. Our understanding is that if a whey solids product had a valuable marketplace, the cost to make that product was not allocated against the cost to make cheese. However, costs associated with the whey stream that are not attributable to a market whey solids product are included as a cheese manufacturing cost. We are told that

approximately 1 cent of the cheese manufacturing cost in the study is attributable to the whey solids disposal cost. Our view is that with a generous make allowance of 18 cents per pound and a cheese make allowance that takes into consideration the excess whey disposal costs, there is no reason for the dry whey factor in the 4b formula to be allowed to be a negative factor on the producer price.

Irrelevant Dry Whey Study:

At this point we would comment on the Cost Auditing Branch of dry whey cost study. While the study itself may be an accurate description of what the four plants on the study spent to dry a pound of whey solids, it is not particularly relevant to the process of establishing a dry whey make allowance for a 40-pound block Cheddar cheese milk pricing formula. Using this study to determine a make allowance for the 4b formula would be like using a per hundredweight cost of production study on a small Jersey herd to set minimum California producer prices. It truly is a case of comparing apples and oranges.

No Reason to Change Cheese Yield:

MPC opposes any change to the cheese yield factor in the 4b formula. In the last hearing in 2003 as well as in the hearing held in 2001, MPC supported an increase in the cheese yield factor. While we did not get everything

we asked for in terms of a cheese yield, the price resulting from the current 4b formula is approximately what it ought to be. We could make a case that the yield in the current formula, given the vat tests in the cost study and the vat yields, is still too low. But we oppose changing it because we have heard no new arguments and seen no new data which justifies changing what the Department did in the 2003 hearing.

No Reason to Change Make Allowances:

Likewise we oppose any changes to the make allowances for butter, nonfat dry milk and cheese. The data shows that the cost of manufacturing these products is bouncing around within a range and that the current allowances are within that range. It is important to remember that the Department is responsible for establishing a 4a and 4b price and that the cost of manufacturing butter, powder and cheese is a factor that must be considered, but manufacturing costs are only one of a number of factors that must be considered.

Support Price Floor Vital:

With regards to the Dairy Institute's proposal to eliminate the support purchase price floors from the Class 4a and 4b formulas, we cannot think of a greater service the California Department of Food and Agriculture has done for dairy producers nationwide than the price floor

implemented in April of 2003. The almost malicious depression of cheese prices that occurred in the early spring of 2003 was a disgrace to our industry. The courageous action by CDFA to implement a support price floor in the 4a and 4b formulas in effect shifted the cost of the massive cheese price discounts that manufacturers were offering, from producers who were powerless, to the processors who were in a position to set those prices. This action was one of the finest moments in recent CDFA history. The increase in CME cheese prices in the weeks following the implementation of this price floor in April and May of 2003 was dramatic proof of the influence of California milk pricing policies on the national market. We totally oppose the Dairy Institute's misguided attempt to eliminate this part of the Class 4a and 4b formulas.

In conclusion, Milk Producers Council believes that the minimum prices produced by the current 4a and 4b formulas are about right, and that if any changes are made to those formulas, they should be minor.

We request an opportunity to file a post-hearing brief.

HEARING OFFICER ESTES: The request for the post-hearing brief is granted.

Do we have panel questions at this time?

SUPERVISING AUDITOR HUNTER: Yes, Mr. Vanden

Heuvel. Good morning.

MR. VANDEN HEUVEL: Good morning.

SUPERVISING AUDITOR HUNTER: I want to go back to page 3. You talk about the relationship between nonfat powder make allowances and the whey make allowances. And you mentioned that it appears the nonfat dry milk costs have increased about 2 cents per pound since 1999. Where is that information coming from, the 2 cents?

MR. VANDEN HEUVEL: It's an observation of CDFA's historical costs on powder.

SUPERVISING AUDITOR HUNTER: Do you have that page with you?

MR. VANDEN HEUVEL: I do. It's just where.

Okay. I've got one of the various dry's.

SUPERVISING AUDITOR HUNTER: Oh, good. If you look on the February 1999 information, which is the closest thing we have for '99 cost information, you have the nonfat powder at .1277. And if you drop down to the unadjusted November 2004 information, it's 1560.

MR. VANDEN HEUVEL: Yeah. But, Mr. Hunter, I think in fairness, the '97 was 1327, the '96 was 1333, the 2000 was 1356. So the '99 -- I mean, you know, it's about 2 cents. I mean in '99 --

SUPERVISING AUDITOR HUNTER: If you go back to the prior years -- all right. So it's not exactly '99 you

want to use as far as --

MR. VANDEN HEUVEL: What we're trying to do -- granted, we've got a challenge in trying to come up with an appropriate dry whey study -- a dry whey make allowance because of the lack of perfect information. We just don't have access to the kind of information like we do on butter and nonfat dry milk.

The 2 cent approximate increase in costs is in that range. It's not exactly 2 cents.

SUPERVISING AUDITOR HUNTER: Okay. And you're basing your whey make allowance originally on that cheese study that was arrived at in 1999, right?

MR. VANDEN HEUVEL: Well, the cheese study that the National Cheese Institute submitted to the Federal Order hearing. First of all, you know, when you look at the National Cheese Institute's motivation, it would be to come up with as high a number as they could justify because they were representing the processors. They did a study, and it's as an exhibit -- everything that's on the website of USDA from the 2002 hearing is in -- attached as an exhibit. And the website address is there. So it's submitted by Dr. Robert Yonkers. And the -- it involved seven plants. Total cost of manufacturing 15.92 cents. That was the NCI survey weighted average.

So that was a study that was submitted. And

USDA, coincidentally or otherwise, picked the 15.9 as their make allowance for dry whey when they adopted their study.

SUPERVISING AUDITOR HUNTER: Okay.

MR. VANDEN HEUVEL: And then also, if I could, Mr. Hunter -- maybe you're going to lead to this. But the West Farm Foods data, which is current data from two dry whey plants that they have, that's the exhibit just before the Federal Order, is what we use as another validation point.

SUPERVISING AUDITOR HUNTER: And their costs are -- have that information?

MR. VANDEN HEUVEL: Seventeen point six cents.

SUPERVISING AUDITOR HUNTER: Oh, okay.

Are any of these -- do any of these cheese cost studies have California costs in them?

MR. VANDEN HEUVEL: I don't know.

SUPERVISING AUDITOR HUNTER: They may or may not?

MR. VANDEN HEUVEL: They may or may not. I don't know.

SUPERVISING AUDITOR HUNTER: All right. That's all I have.

AGRICULTURE ECONOMIST GOSSARD: Mr. Vanden Heuvel, on the West Farm Foods study, they have two plants. One that produces 84 -- or, pardon me -- 85

million pounds of dry whey annually; and then one that is a hundredth of the size, less than a million pounds. Are -- I'm not questioning the cost. I'm questioning the volume. We don't have -- even our smallest nonfat dry milk plant is much bigger than a million pounds a year. Are you sure about that number? And could you check on it for your post-hearing brief?

MR. VANDEN HEUVEL: Well, I talked to Mike Brown yesterday. And Mike assures me that that is exactly the size. It's a very, very small plant, very, very small plant.

AGRICULTURE ECONOMIST GOSSARD: Okay. My second question has to do with page 4. You feel that the dry whey study done by the Department is not relevant. Is that because you think these plants are too small? You were using the Jersey as an example.

MR. VANDEN HEUVEL: Yeah -- well, no. It's because they're not representative. I mean we've decided to do a product value formula to create a 4b price in support. And I realize we don't have to use a formula. We do use a formula. We choose -- that's what we historically chose to use to determine a minimum pricing formula. Everything else about our formula is driven off of the Cheddar and off of -- not just any Cheddar, but 40-pound block Cheddar. So we do on our cheese costs. We

adjust our 640's to get it at 40-pound block. There's other things that you need to adjust to try to get to a Cheddar cheese.

We don't have -- it's clear that our Cheddar cheese plants in California don't make dry whey. They make something else. So we're looking for a surrogate. And I don't fault the Department at all for the study that they did, because, you know, that's what they had available to them in terms of trying to figure out where to find, you know, some relationship on dry whey or what it costs.

But the Department also has an awful lot of discretion as to what's relevant and what's not relevant. And these costs are so completely out of line that they're not -- that they're not relevant to the tasks that we have. They're interesting. They're accurate. I don't doubt the Department did a very capable job. But if these plants are making other products besides 40-pound Cheddar -- everything else about our formula is driven off of the fact we start with the value of Cheddar at 40-pound blocks, and then we subtract from that value the cost to get to those blocks, to come out with a residual milk price that then becomes applicable in the marketplace. And that's a very rational approach to take. We know that in the marketplace other types of cheeses, even though

they may be very different from Cheddar cheese, they adjust their pricing based on the Cheddar cheese market. But they have their own internal cost structures. And it would be entirely unfair to take the costs for these -- and my illustration on the Jersey herd -- you know, if you just do a cost of production for a small Jersey herd, this cost of production percentage-wise could be much higher per hundredweight of milk than a large Holstein herd. Does that mean that the small Jersey herd is unprofitable? Not at all. That Jersey milk may be quite profitable when sold on its components to a cheese plant, which really would value that milk.

So the very same situation here. We've got clearly four plants in this dry whey study, some of whom don't make Cheddar cheese -- most of which don't make Cheddar cheese. They're making some type of cheese that must have some market value out there. We're not capturing the market value. We really can't, in fairness, charge the cost that they're incurring to get to a market value that we're not considering. And that's why I think it was important that the Department do a study. But I think this is clearly a case where the Department has to use its discretion to make a value judgment as to whether this information is really valid given the fact that we have a 4b formula that's driven off of Cheddar cheese.

And so what we've attempted to do -- and it's a difficult thing -- but what we've attempted to do is to give you data that is relevant. And I really appreciate West Farm Foods in Washington State, because they have one of the largest, as I understand, dry whey -- Cheddar cheese dry whey operations in the country. And I suspect, given that volume, they've got a pretty significant impact on what dry whey sells for in the west as well as pretty good data on what it costs to make that dry whey. So we offer that to the Department for you to use in your attempt to come up with a valid number to make the 4b formula work.

AGRICULTURE ECONOMIST GOSSARD: You use -- in an answer to the question, you used the statement that the costs in the Department's cost study are out of line. Out of line relative to?

MR. VANDEN HEUVEL: Out of line relative to any other data that we have about the cost of actually drying dry whey for -- out of a Cheddar cheese operation. You got the National Cheese Institute study. And now we've got the West Farm study. The West Farm had also done a study in '97, which was entered into the record in the '97 hearing. And by reference it's probably in the record in this hearing as well. And at that time there definitely was a relationship between the cost of dry whey, as I

recall, and the cost of nonfat dry milk; somewhere between a penny and 2 penny higher cost to dry whey than nonfat dry milk if we're talking about whey from a Cheddar cheese operation.

AGRICULTURE ECONOMIST GOSSARD: Well, if the cost is a couple cents more than nonfat dry milk, should we compare the -- given the size of the skim whey plants, about 30 million pounds averaged over the four of them, should we compare that to comparable costs for a 30 million pound nonfat dry milk plant to see if it's reasonable?

MR. VANDEN HEUVEL: No, I -- well, I mean my opinion, which I think I've stated quite clearly, is that the study that the Department did on these four plants is interesting, but it's not relevant for what we're about here, which is establishing a correct 4b price.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: I just have a couple questions.

Given your testimony about the lag in the cheese price, is it practical to incorporate -- well, I assume that because you didn't propose it, that we should ask why didn't you propose adjusting the price formula reflecting the lag?

MR. VANDEN HEUVEL: Well, you know, one of the --

well, I did it because I -- pretty much the cheese data that the Department gives us is -- this is all very proprietary information. I mean you get the cheese plants to tell you what they're selling their cheese for. We don't. And that was a relatively new -- recent development. I mean -- I mean I think our first -- we got real serious about doing this three, four years ago. And this was a first attempt, at least it seemed to me, by the department to actually account for the lag and do a price series. So we don't have enough information to be able to propose a -- try to lag it in terms of the price formula.

It's something that it might be, you know, valid for consideration in the future.

DAIRY MARKETING BRANCH CHIEF IKARI: But using two months, lagging one month -- or two months, would delay -- would make it more difficult to establish prices, wouldn't it? Wouldn't there be some practical problems in that --

MR. VANDEN HEUVEL: It could. Now, from what I'm told, this 55/45 split is about what cheese plants that are operating in a Federal Order. I'm told they take the CME and they use this -- it's a very similar type of formula to try and predict what the NASS price is going to be for that timeframe. So, you know, you've got different challenges.

You know, when you work it all out, it all ought to work out in the wash. If you're considering all the data and all the numbers, there's some timing issues. And I think what we found -- I didn't do an update on this. But in reviewing my testimony and exhibits from the 2003 hearing, I think I went back four or five years and compared the -- at that time the California 4b formula was CME minus 1.2 -- and compared the actual cheese price that was driving the 4b formula and compared that to the NASS price, calculated quite differently, including some barrels and blocks and some other weighting. But over a long period of time, the number that was driving the Federal Order formula and the number that was driving ultimately the 4b formula were less than a penny apart over that period of time.

Now, from month to month there could be large variations in those prices. But averaged out over time they were very, very close.

DAIRY MARKETING BRANCH CHIEF IKARI: Do you know if Mike Brown will be testifying at our hearing?

MR. VANDEN HEUVEL: I don't believe -- I don't believe he will. He told me if he absolutely had to be here, he could slip on a plane and come down. But I don't believe, as of yesterday, that he was going to be here.

DAIRY MARKETING BRANCH CHIEF IKARI: A question

about the -- did you hear the question that I asked Dr. Gruebele in terms of using a principle from one hearing to the next, adjusting the price off of CME? You use 19 months. Dr. Gruebele testified in favor of four years.

What are you comfortable with?

MR. VANDEN HEUVEL: Well, you know, with all due respect to my colleague, Dr. Gruebele, if the numbers would have produced a different result using a shorter timeframe than he -- you know, he would have used, you know, it's pretty arbitrary in terms of what the petitioner used.

DAIRY MARKETING BRANCH CHIEF IKARI: I'm trying to get to, what is the principle the Department should use to just --

MR. VANDEN HEUVEL: I think that here -- the principle which I laid out in my testimony -- and I appreciate the opportunity to expand it -- is that all of that -- everything that's gone into what was considered in the last hearing is expired. We set a -- you know, we trued it up on that last hearing and it was -- 3.21 was the number that the Department decided was the true-up number. That was a pretty significant change, because the previous number had been 1.2.

So the Department made an adjustment, trued it up. And now since that time, since that, you know, this

is what has happened. Okay? And I think you can't look at these things in isolation, because -- you know, we contended for a long time that what manufacturers sell their product for is in addition to a lot of -- you know, some other factors driven by what they have to pay for milk and what their competitors are paying for milk. And so when you make major changes in formulas, either a federal system or a California system, you know, there are changes. And so the more recent data is of more relevance than the more faraway data.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, let me give you a hypothetical. Suppose the Department holds a hearing 12 months from now. Then 3 years from that date it holds another hearing on Class 4. What should the Department look at? Should it look at the last 12 months? Should it look at the time between hearings as the data to adjust the price adjuster?

MR. VANDEN HEUVEL: I think you've got to look at the data and make the best decision that you can. I don't think there's a hard and fast principle here that could be applied. Same as with make allowance -- those make allowance --

DAIRY MARKETING BRANCH CHIEF IKARI: But you're testifying that we should look at the most recent data because --

MR. VANDEN HEUVEL: Yes, I am, because you made a major change in this price in 2003 based on short-term data. You made -- okay? Because if you would have included longer term data in 2003, it wouldn't have been 3.2, because it would have been more reflective of the 1.2. But you took a shorter timeframe and then you said in your findings or in the panel report that this is something that has to be watched closely. Which I took as a signal that this is a very relevant piece of information, this relationship between what California plants are selling their product for and the CME price. And that's why we came up with the proposal we did.

Okay. Since the last hearing, 2003-2004 data, what does that data tell us? We prefer the 55/45 because I think you lose something statistically when you throw out the highs and the lows, because the highs and the lows are a factor in the marketplace. And so I think that a 55/45 split is a more statistically accurate way to deal with a lag question.

DAIRY MARKETING BRANCH CHIEF IKARI: And it doesn't bother you that we're pricing formulas, basically using one month, but using an adjuster that has a lag in it?

MR. VANDEN HEUVEL: It doesn't bother me -- look, what we're interested in -- and this is -- you know, I

appreciate the opportunity to kind of reemphasize this point. What's critical here is not that we get the make allowance rights to the third decimal point or the, you know, adjuster to the third decimal point. That's not -- what's key here is: What is the appropriate 4b price level? That's what's -- that's what's important here. You got a lot of moving parts in these formulas. And you could tinker with any one of these or a whole bunch of them. But what's the bottom line is: What's the price that comes out the other end?

And, you know, we've been sitting across the table from each other for over 20 years now. And I think Milk Producers Council has been quite consistent. We believe there should be a relatively narrow difference between the California price and our competitors in the Federal Order. That's what we're interested in. We are willing to live -- even though it's a little bit wider in 2004 than we would like, we think the formulas are running on the same track basically. They're in synch. That's very important to us and I think it's very important nationally.

We no longer can just do our own thing out here. We have to be sensitive to the impact of what we do on the rest of the country. And if we stay in synch, we're going to be okay. If we get out of synch, we're going to create

problems for ourselves. And so I think it's very important that we stay in synch. The current formulas I think are functioning well.

Frankly, if we hadn't come up with the -- if the Department hadn't released the study -- and I don't fault the Department for releasing the study. But if the Department wouldn't have come up with the study that showed a 26.75 average make cost for dry whey in these four plants, we probably wouldn't have even had a hearing. Because there are -- given -- our make costs are operated in a pretty narrow range. They're up a little -- you know, in one study they're up a little, one study they're down, and they're moving around. That the inner workings of those studies, you know, driven by energy prices, a lot of -- you know, right now we've got really high demand for dairy products. I mean the milk price is good. And so the milk's flowing a little differently today than it may have flowed a year ago or may flow a year from now.

And that has impacts on some of our plants. Sometimes they're running at a hundred percent or 90 percent of capacity. Sometimes they're running much lower than that. But their costs per pound jump around.

Hey, we've got it about right. And we don't see any reason for any major tinkering.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

HEARING OFFICER ESTES: Any --

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I have no questions. Thanks for your testimony today, Mr. Vanden Heuvel.

MR. VANDEN HEUVEL: Thank you.

SUPERVISING AUDITOR HUNTER: Excuse me. I have one additional question on the West Farm information. I want to be very clear.

Those costs are on whole whey powder processing only, that there's no WPC costs in there, lactose --

MR. VANDEN HEUVEL: As I understand it, that's correct, yeah.

SUPERVISING AUDITOR HUNTER: Okay.

MR. VANDEN HEUVEL: As I understand it.

SUPERVISING AUDITOR HUNTER: And those are based on actual costs, not budgeted?

MR. VANDEN HEUVEL: Yes.

SUPERVISING AUDITOR HUNTER: Not budgeted costs. These are actual historical costs in the prior years they're talking about, is that --

MR. VANDEN HEUVEL: Well --

SUPERVISING AUDITOR HUNTER: Because that's what it sounds like, and I want to make sure.

MR. VANDEN HEUVEL: When I said -- you know, I'm not prepared to do more than what's in the letter.

DAIRY MARKETING BRANCH CHIEF IKARI: Geof, since you've introduced this and you're not sure, could you ask Mike Brown and add it to your post-hearing brief?

MR. VANDEN HEUVEL: And specifically -- I will do that. And specifically what is the question, actual versus budget?

SUPERVISING AUDITOR HUNTER: Right. Yeah, the actual historical -- he says it's a one-year cost, for a year. But I'm wondering is it a one-year forwarded budgeted costs or is it a one-year prior historical costs? And what year are we talking about here?

DAIRY MARKETING BRANCH CHIEF IKARI: And then you asked about the protein of the --

SUPERVISING AUDITOR HUNTER: Yeah, and also if any other whey products are involved in these costs. I think just -- like there's more information on the cost studies he did basically.

MR. VANDEN HEUVEL: Okay. And I will do my best to produce -- as you can see, the letter's addressed to a couple of my colleagues. And between the time I'm here and maybe the time that they come up, we may be able to get, you know, some additional information for you.

SUPERVISING AUDITOR HUNTER: Okay. Thanks, Jeff.

HEARING OFFICER ESTES: Are we finished with this witness?

All right. Thank you for your appearance today.

MR. VANDEN HEUVEL: Thank you.

HEARING OFFICER ESTES: Our next alternative petition is the California Dairy Campaign.

Will all three of you be providing testimony today.

MR. AVILA: I'm going to be giving the main testimony. He's got a little bit. He's here for any technical questions.

HEARING OFFICER ESTES: Okay. Let me swear each of you in.

Starting on my far left, could you please -- you swear or affirm to tell the truth and nothing but the truth today?

MR. MAGNESON: I do.

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

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

HEARING OFFICER ESTES: All right. And proceeding across.

(Thereupon Mr. Xavier Avila was sworn, by the Hearing Officer to tell the truth, and nothing but the truth.)

MR. AVILA: I do.

HEARING OFFICER ESTES: And could you please

state your name and spell your last name for the record.

MR. AVILA: Xavier Avila A-v-i-l-a.

(Thereupon Mr. Andy Zylstra was sworn, by the Hearing Officer to tell the truth, and nothing but the truth.)

MR. ZYLSTRA: I do.

My name's Andy Zylstra Z-y-l-s-t-r-a.

HEARING OFFICER ESTES; All right. Thank you very much.

Does the testimony -- does your testimony here today set forth the process by which the presentation has been approved for presentation to the Department?

MR. AVILA: Excuse me?

HEARING OFFICER ESTES: Is the process by which the testimony has been developed, is it set forth in the written statement?

MR. AVILA: Yes.

HEARING OFFICER ESTES: All right. Then please -- would you like these statements introduced into the record as exhibits?

MR. AVILA: Yes.

HEARING OFFICER ESTES: The document entitled "Testimony of the California Dairy Campaign Before the California Department of Food and Agriculture," 2/1/05, will be Exhibit No. 45.

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

HEARING OFFICER ESTES: And then I believe there's also a hearing panel report that you've also presented?

MR. AVILA: Yes.

HEARING OFFICER ESTES: Is this a CDFA document?

Okay. Do we already have this --

MR. ZYLSTRA: If I may note, just an abbreviated of the report panel, so I could point out to what I was referring.

HEARING OFFICER ESTES: Okay. I'll go ahead and introduce it into the record as Exhibit No. 45a to avoid any possible confusion from what we already have preexisting in the record of what you presented --

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

MR. ZYLSTRA: And I believe it actually references 42a. It's -- the whole report is in there, but --

HEARING OFFICER ESTES: All right. Then please proceed with your testimony.

MR. AVILA: Mr. Hearing Officer and members of the panel, my name is Xavier Avila and I'm a dairy producer from Hanford, California. I am testifying today

on behalf of the California Dairy Campaign, which represents more than 350 dairy producers throughout the State of California. CDC speaks today also on behalf of the farmer and rancher members of the California Farmers Union.

The testimony I am presenting today is based on positions adopted by the CDC Board of Directors at our January 22nd annual meeting. Recently the National Farmers Organization sent a letter of support for the CDC proposal, which is included as an attachment in our testimony today.

As a member of Land O'Lakes I would also like to point out that more than 60 of that cooperative's own members signed a petition strongly objecting to their own LOL petition. These producers understand that the LOL petition is completely unjustified and they were willing to speak out publicly against their own cooperative to set the record straight.

Furthermore, the LOL petition was never voted on by the Leadership Council, which consists of regional directors and delegates. Additionally, it was understood by the Leadership Council that the petition was submitted following some encouragement from CDFA.

Before I outline alternative proposal, it is important to mention the increasing costs that producers

are forced to bear in today's market. Producers face an increasing number of costs due to labor, environmental and other regulations. However, they are unable to pass on any of these costs. Producers are not guaranteed a fixed cost allowance based on their expense. Plants alone are granted that luxury. The fact that processing plants are attempting to further increase the make allowance is completely unjustified and has caused outrage among our producers we represent.

In examining the impact on producers from the current pricing formula and the LOL petition, it is important to look at the dairy producer cost of production and net income. We have projected a monthly income or loss per month based on blend price and the cost of production indexes using a 600-cow herd with 60 pounds of milk produced per cow. We calculated the accumulated net income for eight years, with the last three years presented in attachment 2. As you can see, even with the relatively strong prices of last year, the average producer is still digging out of an accumulated debt of over $400,000.

In the lower graph on the same page we added the 25 cents per hundredweight that our proposal would provide. Under our proposal producers' accumulated losses would have been eliminated from the recent higher prices.

I would like to begin by outlining the alternative proposal CDC submitted to the Department of agriculture on January 3, 2005. Later I will state the position we have taken on some of the other proposals that have been submitted for this hearing. Given the number of petitions put forward to increase the manufacturing cost allowance paid by producers, I think it is important to remind ourselves that the California 4b price is already 40 cents below the Federal Order price and in 2004 it was 56 cents lower. Not only are the prices higher in the Federal Order; plants in major cheese producing regions are paying premiums of between one and two dollars. To increase the make allowance at this time will only give California processing plants the ability to lower the 4b price and lower producer prices even further below the Federal Order price.

The Alternative Proposal Submitted by CDC Calls for CDFA to:

Snub the 4b price formula whey price to prevent it from having a negative impact on the formula. Without the snubber, plants with costs that are lower than the whey make allowance can drive down the price of milk they purchased without losing money on the whey they sell. Putting in the snubber will ensure plants don't sell whey below the make allowance. We recommended adjusting the

whey make allowance to 15 9/10 cents so that it is equal to the level used in the federal orders.

The Federal Order based its make allowance on the National Cheese Institute's survey. The NCI survey showed a weighted average of 0.1592 for 307.2 million pounds, which is more in line with the powder drying costs and also includes three times the production of the California survey.

The current CDFA whey cost study looks at four plants, three of which are not included in the Cheddar cheese cost study. If three-fourths of the plants are not being audited on their cheese operations, it is possible that some of the cheese costs are being included in the whey operation. The accountability of the costs from one part of the plant to the other is critical in finding an actual whey cost because many expenses can be removed between enterprises.

Surely with historic whey prices close to 17 cents, it seems illogical that a whey drying plant would have been built only to lose 10 cents a pound. Since most of the whey protein concentrate produced is not dried, the actual costs for Cheddar plants would be less than those reflected in the CDFA study.

What other reason could contribute to the overinflated whey processing costs in the California

survey? In the example below we can see how the cost per pound can vary dramatically when the fixed capital costs for a typical whey drying facility built for 30 million pounds per year operates at less than capacity.

I'll just read off:

A hundred percent is 17 cents. At 50 percent capacity you're at 34 cents per pound.

The CDFA whey cost study began in January of 2002 and continued through October 2003. During that period at least one of the plants on the study was operating at less than 50 percent capacity. Without plant capacity information the whey cost study is very misleading and should not be relied upon to establish the whey make allowance.

In addition, we recommend the 4b cheese make allowance be set at 0.1634 per pound, which is the weighted average price from the CDFA December 2004 cost study less one cent. Prior to the workshop it was our understanding that the one-cent deduction be used because it was already attributed to the whey cost. We now understand that this is not the case, and we would accept the use of the 0.1734 as a cheese make allowance.

We also call upon CDFA to eliminate the marketing adjustment. It is apparent from the CDFA surveys that cheese plants are using the marketing adjustment to

undermine the Federal Order prices. California's cheese pricing uses the Chicago Mercantile Exchange less an adjuster. And as a result, our 4b price automatically lowers the national cheese price. The marketing adjustment is taken at the expense of not only California producers, but also manufacturing plants and dairy producers throughout the rest of the country. The impact that California has on the CME has been demonstrated in the past because the CME price has changed in response to changes in our pricing formula.

The 4b cheese yield should be set at 10.92 and the formula should incorporate a vat average fat and solids not fat of 3.94 and 8.95 percent respectively. These are the actual yields reported in the December 2004 cheese manufacturing cost study.

Other Proposals:

We oppose the proposals put forward by the California Dairies and the Alliance of Western Milk producers to increase the 4a make allowance to 0.1570. We further oppose the CDI proposal to increase the manufacturing cost allowance for nonfat powder to 0.1650 and whey butter to 0.1570. We believe these proposals significantly exceed the CDFA's survey weighted average. However, we do favor lowering the f.o.b. price adjuster, if not eliminating it altogether.

We oppose the proposal put forth by the Dairy Institute calling for the elimination a support purchase price. California producers deserve some sort of price floor when prices drop.

We strongly oppose all proposals put forward today that would result in any increase in the make allowance. We consider any increase in the make allowance to be completely unjustified. Two of the largest processing facilities in the state are currently engaged in a price war over Mozzarella cheese. As they each race to the bottom in price to capture market share, the make allowance enables them to stay profitable. The inflated make allowance and market adjustment is actually subsidizing this out-of-control price war.

We believe the acceptance our petition will be good for the first step towards ensuring that dairy producers receive a fair price in the future. We acknowledge that far more must be done to make a pricing system more equitable for producers. We look forward to working with CDFA to improve the outlook for dairy producers in the state.

The California Dairy Campaign would like to thank the Department for the opportunity to present our alternative proposal. We would also like to request the opportunity to submit a post-hearing brief.

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

I think at this time too I'll take the opportunity to state, although I will mention this at the end of the hearing as well, but I want make sure that I say this while everyone is present.

The four people who testified today and request a post-hearing brief -- so it only applies to these individuals -- the time period for filing the brief is that it must be received by the Department by the end of the business day on Tuesday, February 8th, 2005, at 4:30 p.m. And the brief may be sent to the Department's Dairy Marketing Branch located at 560 J Street, Suite 150, Sacramento, California 95814. And a brief may also be faxed to the branch at 916-35 -- excuse me -- 916-341-6697. And I wanted to interject that at this time because the hearing could be somewhat lengthy and there's the prospect that witnesses may not be here at the conclusion of the hearing to actually discover the time by which the brief must be filed. So please keep that in mind.

Do we have any questions?

MR. ZYLSTRA: I'd like to put my input in before we go to questions.

I'd like to refer to reference 42a, which is the

handouts I gave you earlier, specifically the last three pages for -- on my hearing panel report would be pages 31 through 33.

In what I consider somewhat strong language, the panel at the January 29th-30th, 2003, report says, "The variable make allowance as proposed would tend to increase farm milk prices when supplies are long giving an economic signal to produce more milk and, thereby, worsening the supply-demand imbalance. Similarly, it makes little economic sense to reduce farm milk prices when milk supplies are either in balance with or short of market demand."

I would like to reiterate that last sentence there. "Similarly it makes little economic sense to reduce farm milk prices when milk supplies are either in balance with or short of market demand."

Thank you.

HEARING OFFICER ESTES: Do we have any additional testimony?

All right. Do we have panel questions at this time?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I have a couple questions.

Thank you for your testimony today, by the way. Appreciate it.

You mentioned on page 2 that there -- about the price spread between California and Federal Order pricing. It's 40 cents now; you say it was 56 cents in 2004. And to some degree I think Mr. Vanden Heuvel is right: The hearing is really about what is an appropriate price level and, moreover, what's an appropriate price spread.

So I ask you, what do you think is an appropriate price spread?

MR. AVILA: Well, I'll agree with Mr. Vanden Heuvel, that they need to track each other. And my personal opinion is they need to be as close together as possible. Because if we keep lowering our price here with price adjusters and make allowances, that forces our competitors to do the same. And ultimately all it does is put more burden on the producer. I mean those processors pass that on to us.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: You cite the National Cheese Institute study on the whey make allowance, a study that was conducted in 1999. We're obviously not in 1999 anymore.

Is it relevant that that cost figure should be adjusted by inflation factors, or are you satisfied with the fifteen nine as being representative?

MR. AVILA: We're satisfied.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL

ASSISTANT ERBA: Okay.

Last question. On page 3 you have Table 1, which shows the relationship of plant capacity to the cost per pound of dry whey.

Where did you get that information?

MR. AVILA: This at the bottom, Table 1?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Yes.

MR. AVILA: This is from Tillimook Cheese.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Do you know what the timeframe is, what year that data might represent?

MR. MAGNESON: I have the -- I believe that was submitted at the Federal Order hearing also.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: So it was back in '99?

MR. MAGNESON: In 19 -- in 2000.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. Could you clarify that in your post-hearing brief so that we're sure.

MR. MAGNESON: Yes.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Thank you.

AGRICULTURE ECONOMIST GOSSARD: On the second page of your testimony, in answer to Dr. Erba's question,

you said that the -- you would like to have the federal Class III price and the California Class 4b price approximately equal, is that --

MR. AVILA: That's correct.

AGRICULTURE ECONOMIST GOSSARD: Under your proposal, the California 4b price would average about 53 cents above the federal Class III price. Is that in -- does that contradict what you just said about fairly equal?

MR. AVILA: Not really. Because everybody does what we do, don't they? I mean look what happened with the decision that Geof pointed out, when we put a floor. What happened within a few days of the CME? Cheese price came up to our floor.

AGRICULTURE ECONOMIST GOSSARD: Do you have any evidence that it costs 53 cents less to produce cheese in California than in federal orders?

MR. MAGNESON: The difference between our proposal and the Federal Order price is -- it's going to be there for now. But we believe that price would be adjusted somewhat in the future.

AGRICULTURE ECONOMIST GOSSARD: You believe the federal orders will adjust their formulas in the future?

MR. MAGNESON: Yes, I think they will.

AGRICULTURE ECONOMIST GOSSARD: Turning to page 4

of your testimony, you asked the Department to use yields and vat tests that reflect the weighted averages from the cost study?

MR. MAGNESON: Yes.

AGRICULTURE ECONOMIST GOSSARD: In your post-hearing brief, could you please address the concerns in the 2003 panel report about using the weighted average yield and vat tests in the Class 4b formula.

MR. MAGNESON: Address the problem with using --

AGRICULTURE ECONOMIST GOSSARD: Yes, in their 19 -- 2003 panel report, the panel found concerns about using the weighted average yield and weighted average vat test in the formula. Could you review that and at least comment on it in your post-hearing brief?

MR. MAGNESON: Sure.

MR. AVILA: I would like to just add something in regards to the price war we mentioned in our testimony. When you have two big Mozzarella plants undercutting their market, the traditional price, right now it's 6 cents below the market and it's been known to be higher. So for us it's kind of hard to justify a make allowance increase in whey that would only fuel that war. The more efficient plant -- if you grant a higher make allowance there, you'll help the more inefficient plant bring in money, but you will also help the more efficient plant with a higher

margin. The result would be that that more efficient plant's going to undercut the market even more. And then we will be back to where we were again. We'll be back here another year, year and a half asking for another increase in the make allowance.

And I don't think anybody's going to talk about that today. But that is a fact, that the market is being -- Mozzarella is being sold under the price. So I think that is the problem with plants being profitable. If somehow they could go back to the price they should be getting, I think it would eliminate that problem.

AGRICULTURE ECONOMIST GOSSARD: At the top of page 5, you say that -- you believe one of the plants in the Department study was operating at less than capacity would not really reflect processing costs to skim whey powder; is that correct?

MR. MAGNESON: That's correct.

AGRICULTURE ECONOMIST GOSSARD: What concerns do you have about the cost in the other three plants? As Dr. Gruebele said, the cost studies are -- if we eliminate any outliers and look at the other three plants, why are those costs not reflective of processing costs for skim whey powder in California?

MR. MAGNESON: Well, we pointed that out because, as our table shows, that if a plant is running at half

capacity, it has a big impact on the cost per hundredweight. And we're not saying that to throw them all out. But that is indicative of what could be happening on other operations could be part of the reason why those costs of whey are so high.

I also brought a document that I'd like to enter into the record when I'm done bringing it up to you. This is a document that Leprino Foods submitted to the Federal Order hearings in 2000. And in here they're endorsing the use of the 15.9 cent make allowance on whey. If that would be all right to add to the hearing record.

HEARING OFFICER ESTES: Sure. Go ahead. We'll introduce that in the record once the questioning is concluded.

MR. AVILA: Another point on that is Mozzarella -- the studies done -- if I could ask a clarification. Of those four plants, how many were Mozzarella plants?

AGRICULTURE ECONOMIST GOSSARD: Sorry, We can't answer questions. We can only ask them.

MR. AVILA: Okay. I think it was most of them. So -- three of the plants. Okay.

So if you're going to use the cost study on Mozzarella, then we believe you should also use the yields of Mozzarella and also use the price of Mozzarella, since

Mozzarella is about half of the cheese produced in this state. Otherwise disregard Mozzarella cost studies for drying whey and go strictly on Cheddar, because that's what we're being paid on, that's what producers are being paid on is Cheddar.

AGRICULTURE ECONOMIST GOSSARD: Finally, we had proposals before us to establish make allowances for dry skim whey significantly above the 17 cents where we're currently at. Given that any make allowance above 20 cents would in effect on average lower the 4b price, if the Department determines that a reasonable make allowance exceeds that 20 cents, would you prefer that the whey factor be eliminated altogether from the 4b formula?

MR. MAGNESON: Well, that's --

AGRICULTURE ECONOMIST GOSSARD: You can pass on the question.

MR. MAGNESON: That's tricky because -- I think that the whey price can be -- the fact that it has an impact on the price that they paid for milk can influence at what price they'd be willing to sell the whey at. It is possible that if they wanted to have a negative impact on the price, they could be selling it at below the make allowance or -- and so if you eliminate it, then the whey price could actually increase and we would get no benefit out of it.

So I would not -- it's very difficult to say to eliminate it and then see the price then go up to 25, 26 cents, and we would be nothing. But I think it's fair to put a snubber on it. That's why we asked for a snubber.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

No further questions.

HEARING OFFICER ESTES: Do we have any additional panel questions?

All right. Thank you for your appearance today.

(Applause.)

MR. AVILA: Thank you.

HEARING OFFICER ESTES: Next we have I believe Western United Dairymen.

Oh, and one last thing here as the Western United Dairymen representative comes to present testimony. The document referenced by the witness concerning Leprino Foods in front of the United States Department of Agriculture will be entered into the record as Exhibit 45b.

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

HEARING OFFICER ESTES: As soon as we receive the written copy of the testimony, we're going to take a short two-minute break. I've just been informed by the panel

that there's apparently some particular urgency.

(Thereupon a recess was taken.)

HEARING OFFICER ESTES: All right. The hearing will now reconvene at this time.

All right. So now we're reconvened at about 11:53. And we will proceed to take the testimony of the representative from Western United Dairymen in support of an alternative petition.

(Thereupon Mr. Michael Marsh was sworn, by the Hearing Officer, to tell the truth and nothing but the truth.)

MR. MARSH: Yes, I do.

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

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

HEARING OFFICER ESTES: And does your written testimony describe the process by which this testimony was developed and approved?

MR. MARSH: Yes, it does, Mr. Hearing Officer.

HEARING OFFICER ESTES: All right. And I assume you would like to have this written statement introduced into the record?

MR. MARSH: Please. Thank you.

HEARING OFFICER ESTES: All right. It will introduced as Exhibit No. 46.

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

HEARING OFFICER ESTES: And please proceed.

MR. MARSH: Mr. Hearing Officer, members of the Hearing Panel, my name is Michael Marsh. I'm the Chief Executive Officer of Western United Dairymen. I'm also a Certified Public Accountant licensed to practice in the State of California. An elected board of directors governs our policy.

Our association is a large dairy producer trade association in California representing approximately 100 of California's 2000 dairy families. We are a grassroots organization headquartered in Modesto, California.

An extensive process was used to arrive at the position we'll present here today. Western United Dairymen starts the process with a committee of dairy leaders from around the state. They ship milk to all types of plants, and many effectively serve the industry on other boards.

At the committee level, members analyze in great detail data provided by staff and the Department. The Committee conducts long and thoughtful discussions of all sides of the issue at hand. Committee recommendations are presented to the board of directors for review, modification and approval. The committee met on December

10th, 2004, and the board of directors met December 17th, 2004, and January 21st, 2005, to approve the position we will present here today.

Our revised alternative proposal contains three changes to the Class 2, 3, 4a and 4b formulas. We recommend updating the cheese and butter f.o.b. adjusters as well as snubbing the dry whey component. We are opposed to all other proposed changes to the current formulas.

Our reasoning and concerns are as follows:

Adjustments to the Chicago Mercantile Exchange Cheese and Butter Prices:

As it was explained to us, these adjustments to the CME prices should result in prices that would mimic butter and cheese prices received by California plants. Instead of actually surveying plants weekly or monthly, as is done for California Grade A and Extra Grade nonfat dry milk, we certainly use national market prices and adjust them to accurately reflect sales prices in California. This is the goal of the end-product pricing formulas. Start with the price of the finished product, in our case the price in California, and work backwards through yields and manufacturing costs to establish a price for raw milk in California.

One could argue that this adjustment should be

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

Looking at this adjustment as solely transportation would incorrectly suggest that all the butter and cheese in California is shipped to Chicago. With over 34 million people in California capable of consuming roughly 4.6 pounds per capita of butter and 29.9 pounds per capita of cheese per year, this hardly seems the case. Therefore, this brings us back to our original statement, that the adjustment should result in butter and cheese prices that accurately reflect what butter and cheese manufacturers are receiving for their products in California taking all factors into account.

The butter and cheese sales data released by the Department is the best data available on which to rely when setting this adjustment. We propose using the updated 24-month averages, omitting the largest positive

and negative differences, that outliers, that is, as revised by the Department on January 12, 2005, and January 18, 2005. This is a revision to our original alternative proposal due to the fact that this data was not available at earlier committee and board meetings. For butter, the data indicates that on average from November 2002 through October 2004, butter in California sold for 2.8 cents less than butter at the CME. For Cheddar cheese the data indicates that, on average, November 2002 through October 2004 Cheddar cheese in California sold for 2.74 cents less than Cheddar cheese at the CME.

With Regard to the Cheese Yield:

There should be no adjustment made to the cheese yield or components used in the current Class 4b formula. At the January 2003 hearing substantial evidence and testimony for using the Van Slyke cheese yield formula was provided. However, CDFA chose to use a prorated method that incorporated the cheese yield and tests from the block Cheddar cheese plants in the cost studies. A three-year average was used to result in a 10.69 yield, with 3.9 percent butterfat and 8.84 percent solids not fat. However, these were considered fortified vat figures. So the figures were compared with the current, at that time, 10-pound yield at 3.65 percent butterfat and 8.78 percent solids not fat. Two lines were charted which

encompassed both of the figures. At a yield of 10.2 the lines were used to determine a fat test of 3.72 percent and a solids-not-fat test of 8.8 percent. The yield obtained by CDFA staff in this fashion was similar to that proposed and supported by Western United at the last hearing. There is no justification for any change to be made to the current yield.

Land O'Lakes is proposing a yield of 10 pounds at 3.65/8.78 and uses the Phil Tong study and the Van Slyke formula to support their request. However, a review of the Tong study shows the numbers used by Land O'Lakes are incorrect. The average fat test for butter/powder plants in the Tong study was 3.64, not 3.63 as used by Land O'Lakes. The average solids-not-fat test for butter/powder plants in the Tong study was 8.95, not 8.8 as used by Land O'Lakes. The percent casein in solids not fat for butter/powder plants in the Tong study was .2827, not .2832 as used by Land O'Lakes. Using the correct figures, the Van Slyke formula yields to the following result, which is a yield of about 10.12 pounds.

However, we would go further and also insert the correct moisture content. According to data released by the Department for the January 2003 hearing, the average moisture content for the block Cheddar cheese plants in the cost study was 38.05 percent. Correcting for this

figure, the Van Slyke formula gives the following results, as noted in my testimony, for a yield of 10.17 pounds.

Obviously, even using their own assumptions, the yield proposed by Land O'Lakes is far too low. CDFA should make no adjustments to the current yield or component values in the Class 4b pricing formula.

With regards to Skim Whey Powder:

Cheese plants included in the manufacturing cost study. It is our understanding that four cheese plants were included in the skim whey manufacturing cost study. Only one is a Cheddar cheese plant, while two are Mozzarella plants, and then a fourth is a Parmesan plant. We recognize that only one Cheddar cheese plant included in the cost studies manufactures skim whey powder, 13 percent, while the remainder manufacture higher priced whey products, such as whey protein concentrate, 34 percent, or WPC, 70 percent and higher. In fact, according to data released by CDFA, out of the eight Cheddar cheese plants included in the 2000-2001 manufacturing cost studies, none dumped the product, only one sold whey for animal feed, one manufactured skim whey powder, at 13 percent, three manufactured whey protein concentrate, 34 percent, and the other three manufactured WPC, 70 percent plus. Discussion with CDFA staff seems to indicate that this is still the situation. So in order to

acquire manufacturing data for skim whey powder, plants other than Cheddar cheese plants were used in this study. While we realize the necessity of this, we at the same time question the validity of using the results in the current pricing formula.

It is our understanding that there are five cheese plants that manufacture skim whey in California. Four out of the five are represented in the cost study. However, only 75 percent of the volume is captured. This volume is far less than the volume represented in the manufacturing cost data for butter, which is at 99.8 percent, Cheddar cheese at 95.1 percent, and nonfat dry milk at 100 percent. Even more interesting is the fact that there are only 5 plants that manufacture skim whey powder out of the 58 plants that manufacture cheese listed on our recent CDFA plant list. Does this mean that they would not -- they should not be -- the whey should not be a component in the Class 4b formula? No, This simply, once again, points to the case of Cheddar cheese plants where six out of the eight major manufacturers are producing higher valued whey products such as WPC 34 or WPC 70 plus.

Plants are choosing to manufacture higher valued whey products. Unfortunately, we do not know which plants are included the skim whey powder cost study. However, it

is interesting to note that if most new cheese plants are choosing to manufacture higher-valued whey products instead of skim whey powder, we could assume that the plants included in the study are either older or highly inefficient cheese plants.

Furthermore, it was noted at the pre-hearing workshop held on January 19th, 2005, that the weighed average manufacturing cost for the cheese plants included in the skim whey powder cost study was 23.27 cents per pound. This information confirms extraordinary inefficiencies in manufacturing processes at the plants in the skim whey cost study. This weighted average cost contrasts negatively with the 17.06 weighted average cost per pound detailed in the Department's November 2004 cheese processing cost study.

Also, we can't help but recognize the reasons newer plants are manufacturing products other than skim whey powder, the main being that there is a higher return associated with these products. We will explore this more later in our testimony.

The use of skim whey powder in the Class 4b formula. At the 2003 hearing, the Department's data indicated that the manufacturing of skim whey products was no longer a cost minimization strategy for cheese plants in California as it had been historically. While in the

past plants may have struggled to find means for disposal, they were now processing skim whey into value-added products. It was also agreed that if the other cheese plants in California were not procession whey, they were likely selling specialty cheeses for which much higher prices were obtained. It was evident that there was now a market for whey products and, therefore, some of this value should be returned to producers through the Class 4b price. Department data showed that California comprised 14.3 percent of the nation's skim whey powder production and 34.1 percent of whey protein concentrate production. This compared to just 7.2 percent and 21.2 percent respectively just five years earlier.

The Department realized that for many years the value of whey was not captured in the minimum pricing formulas and that even though the investment to implement whey processing abilities was large, this gave cheese plants ample time to invest in technology to further process whey. The Department also recognized the need for alignment of the Federal Order Class III price and the California Class 4b price. The inclusion of a dry whey component in the Federal Order Class III price widened the gap between the two, putting California producers at a disadvantage. It seemed only equitable that producers, given the correct formula revisions to Class 4b, including

the manufacturing cost allowance and product yield, share in a portion of the revenues generated from byproducts of their raw milk. We appreciate the Department's recognition of this fact through the addition of the skim whey component in the Class 4b pricing formula.

When implementing the skim whey component in the Class 4b formula, CDFA chose to use a manufacturing cost allowance of 17 cents per pound. This compares to a manufacturing cost allowance of 15.9 cents per pound included in the Federal Order Class III formula. It must be noted that any increase in the California skim whey make allowance will only, once again, widen the disparity between the Class 4b and Federal Class III price. Certainly, if a make allowance of 26.75 cents per pound were implemented, the skim whey component would typically draw from the Class 4b formula. In fact, if the LOL proposal were accepted, the Class 4b formula would decline by about 56 cents per hundredweight. On average over the past five years, the Class 4b price has lagged the Class III price by 39 cents per hundredweight. Adding another 56 cents per hundredweight to that disparity would put California producers at nearly a dollar per hundredweight disadvantage and completely contradict the reasoning for the addition of the skim whey component in the formula.

Is skim whey powder the right product to use in

the 4b formula? The industry sought to determine the most reasonable way to capture/represent the value of the whey stream in cheese making in the Class 4b formula. It was a general consensus that skim whey powder was the most appropriate product to use in estimating the revenues that should be passed on to producers from the value derived from whey products. Using skim whey powder simply provided us with the most conservative estimate of the value of the whey stream from cheese making.

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

Unfortunately, we are not privy to the exact costs associated with manufacturing higher valued whey protein products. Though released some ten years ago, a well-known study performed by the Cornell Program on dairy markets and policy titled "Whey Powder and Whey Protein Concentrate Production Technology, Costs and Profitability" can provide us with useful benchmarks when estimating the net value of skim whey powder versus WPC 34.

In the study, different manufacturing costs were estimated for whey powder and WPC. These costs varied by plant size and production schedules, and are displayed in the table below within my testimony.

Using average prices for whey powder and WPC 34 over a five-year period and the average costs above, a simple analysis shows that on average a net return of 8 cents per pound is obtained on whey powder and 22 cents on WPC 34.5 percent. The net return on WPC assumes there was a break-even on a handling of permeate, or lactose. Data from the Department for the '97 hearing indicates that in 1996-'97 eight of the nine plants were doing something with the lactose other than dumping it. Obviously, though additional processing is needed, these products may be returning some profit to the plant. Though this is a simplified estimate of the profitability of these products and manufacturing costs have likely changed, as long as manufacturing costs for the whey powder and WPC have increased proportionately, it serves the purpose of proving that use of skim whey powder in the 4b pricing formula provides most conservative estimate when estimating the potential revenues generated by skim whey powder or WPC.

Due to the fact that most plants in California are manufacturing these higher valued products, the

Department should not implement a higher skim whey manufacturing cost allowance. Doing so would inappropriately drive down the 4b price and ignore the revenues obtained by the cheese plants through the manufacture of these higher valued products.

The Class 4b formula is based on Cheddar cheese. As we all know, the current class 4b pricing formula is based off Cheddar cheese. That is, the sales price of 40-pound Cheddar cheese blocks at the CME; the Cheddar cheese yield; the Cheddar cheese moisture; the Cheddar cheese manufacturing cost, with some Monterey Jack included; the Cheddar cheese whey cream byproduct, et cetera. It is the industry's intention to keep the addition of the skim whey component in the same vein. Obviously the 4b formula is designed to capture the value of milk used to make Cheddar cheese.

Making Cheddar cheese involves a process of many stages. Along those stages byproducts are captured. Skim whey powder is one of those byproducts that has a value and is now recognized in the pricing formula. To isolate the skim whey component of the pricing formula and structure its contribution to the overall 4b price to be based off manufacturing costs at plants other than Cheddar cheese plants seems contrary to the whole concept of the Class 4b formula.

It does not take a food scientist to realize the process of making Cheddar cheese varies from the process of making Mozzarella, as do the yields, the moisture, the price, the whey cream byproducts, et cetera. So to assume the manufacturing costs for skim whey from Mozzarella and Parmesan cheese plants is identical to those at Cheddar cheese plants is obviously incorrect. Whether the costs are higher or lower for Cheddar cheese or Mozzarella/Parmesan plants, we are not privy to. But we do understand that looking at incorporating just one process within a chain would prove illogical. Assuming the manufacturing costs for skim whey at a Mozzarella plant is the same for skim whey at a Cheddar cheese plant would be the same as to assume the Mozzarella yield is identical to the Cheddar cheese yield, and obviously this is not the case.

While we do not consider ourselves experts in the cheese-making process, we are aware of some differences inherent in the process of making Cheddar cheese versus making Mozzarella or Parmesan cheese that we feel must be explored and recognized when setting the appropriate make allowance. Through review of the process involved for each type of cheese and discussions with Dr. Phil Tong, the most apparent difference seems to be in the whey expulsion. Obviously there are a number of steps in the

process of making cheese and extracting whey. Though the initial bulk flush of whey from the curd produces similar results in both types of cheese processing, according to the information provided by Dr. Phil Tong at Cal Poly's Dairy Products Technology Center, the steps following are significantly different.

The moisture of the curd after the initial flush is approximately 48 to 50 percent for Cheddar cheese and 45 to 55 percent for Mozzarella cheese. However, there are a number of steps following the initial flush of Cheddar cheese curd that lead to additional expulsion of whey. These include Cheddaring of the curd, dry salting and molding and pressing of the curd. And please see Exhibit 1, which does come a textbook being used at Cal Poly.

And I hope It's attached to your copy.

Yes. That is for Cheddar cheese.

Each of these steps lead to additional capture of whey and lowers the moisture content of the Cheddar curd. According to Dr. Tong, the final Cheddar cheese curd is approximately 37 to 39 percent moisture. However, for Mozzarella cheese, a higher curd moisture is desired. Though there is some addition whey expulsion during the heating and stretching phase, a greater amount of the whey will actually be taken up into the curd as added moisture.

And please see Exhibit 2, which is again from another textbook at Cal Poly, "Fundamentals of Cheese Science". And it describes the Mozzarella process.

Before the heating and stretching of the curd, the moisture content in Mozzarella is approximately 40 to 48 percent. However, afterwards, due to retention of whey and water in the curd during the heating and stretching phase, a pickup of 1 to 2 percent moisture can be obtained, resulting in an end curd moisture approaching 50 percent. For Mozzarella cheese, the whey that is captured in the cheese is of much greater value than the whey byproduct itself.

Additionally, it is clear that due to the desire to capture whey in the curd for added moisture, there's less extraction of skim whey powder for the same amount of milk going into Mozzarella production as there is going into Cheddar cheese production. Obviously, a lower volume of skim whey produced by Mozzarella plants will increase the fixed and semi-variable cost components in the cost study. However, the additional value from a higher yielding cheese, such as Mozzarella, would not be captured in the current Class 4b formula due to the fact that Cheddar cheese is used to determine the yield factor.

One might argue that more whey is lost in the water with making Mozzarella cheese. However, we know

that the in-plant loss that occurs for plants during the manufacturing of cheese will be accounted for as whey loss in the manufacturing cost studies conducted by the Department. Conversations with the manufacturing cost unit indicate that if the loss is non-viable whey, the pounds of butterfat and solid not fat are added back into the cheese when allocating general plant expenses. This will increase manufacturing costs for cheese. We also understand that disposal costs for any non-viable whey are included as a direct disposal cost in the manufacturing cost data.

So to summarize, just these most obvious differences -- there are likely more we have not explored -- in the manufacturing of skim whey from Cheddar cheese versus Mozzarella leads us to seriously consider the relevance of the cost figures released. While we do not know whether skim whey manufacturing costs are higher or lower for Mozzarella plants, we do know there is a difference. Therefore, we argue that the Mozzarella skim whey cost figures should not be used in a formula that relies on capturing the value of milk using Cheddar cheese. Doing so would ignore the fact that cheese making is a process and that to accurately represent the value of milk used to make a certain type of cheese, we must be consistent in the use of the components in the formula,

including manufacturing costs.

While we would like to support the sole use of the Cheddar cheese plant used in the study to set the skim whey manufacturing cost, we cannot support this due to the fact that the plant is highly inefficient and it does not accurately represent other cheese plants in California or the rest of the United States. In fact, information shared with us by Cheddar cheese plants in the northwest indicate that their costs to manufacture skim whey are approximately 17 cents per pound.

Due to the multitude of reasons explored above, we would urge the Department to maintain the current manufacturing cost allowance of 17 cents per pound until better and more representative data can be collected.

We would also encourage the Department to implement a snubber on the dry whey component. As argued above, the formula should capture the value of the milk used to manufacture Cheddar cheese. The appropriate value of the raw milk captures the value of the byproducts produced by the milk. If there is no value to dry whey in any given month, due to a low selling price, then its contribution should be zero, not negative.

We are also concerned with the implementation of the correct manufacturing cost allowance. We are not confident, even with the current level of 17 cents, let

alone something higher. The implementation of incorrect make allowance should not drive the dry whey contribution into negative territory. Also, once again, we draw notice to the fact that most plants are enjoying returns from the sale of higher valued whey protein byproducts.

Manufacturing Cost Allowance:

The recent manufacturing cost data released by CDFA does not justify any changes to the manufacturing cost allowances at this time. The data released in November 2004 shows a weighted average manufacturing cost for butter and cheese at levels lower than the current manufacturing cost allowance. The weighted average cost for nonfat dry milk is only fractionally higher. The current allowances cover 59 percent of the butter, 63 percent of the nonfat dry milk, and 79 percent of the Cheddar cheese, according to the Department. This coverage is consistent, perhaps with the exception of butter, with the targeted coverage detailed in the Department's determination from the last hearing (77 percent of the butter, 69 percent of nonfat dry milk and 77 percent of Cheddar cheese). Adjusting the manufacturing cost allowances to cover 80 percent of the volume for each commodity would be contrary to the Department's previous positions. Furthermore, we would like to remind the Department that despite proposals

submitted by Western United, no changes were made to the manufacturing cost allowances as a result of the data released in November 2003. This was despite the fact that a reduction in all three manufacturing cost allowances were supported by the data.

I would also like to note that in the previous hearing that we had, Western United supported using 80 percent of the weighted average cost associated with each of the -- with each of the products and used those factors as make allowances. When you go back and you look at what actually came out of the 2003 cost studies, Western United is within 2 1/2 percent on virtually every one of the products. We were the closest of anyone.

Furthermore, the proposal by the Dairy Institute of California would eliminate the price floors in the California system. This safety net was first proposed by Western United Dairymen in 2001 and adopted by the Secretary following the January 2003 hearing. The price support program was put in place by the Congress to provide a safety net for producers. Because processors are not required to avail themselves of the opportunity to sell to the government, the only means to effect the safety net is the pricing system. The inclusion of this safety net in our pricing formulas is yet another advantage of a California system that works as opposed to

a federal system that does not.

This concludes my testimony. Western United Dairymen thanks CDFA staff for their efforts in preparing for this hearing.

I will be pleased to answer any questions that you might have. And we would also request the option to file a post-hearing brief.

HEARING OFFICER ESTES: All right. Request for a post-hearing brief is granted.

And now, members of the panel, you may proceed to question the witness.

AGRICULTURE ECONOMIST GOSSARD: Turning to page 4 of your testimony. You're talking about the inefficiency of the plants in the skim whey cost study. There's always a possibility in any cost study there is an outlier. Does having one outlier mean the other three plants can't be viewed as a possible basis for setting a make allowance?

MR. MARSH: Yeah, Tom -- Mr. Gossard, I'm not sure if that would be appropriate, for a number of reasons. One of course is that primarily what we're looking at in the skim whey processing cost study was Mozzarella production. As we also understand from the pre-hearing workshop held on the 19th, the weighted average costs of those plants that were included were at 23.27 cents, when the November 2004 cost studies disclosed

that those costs were at 17.06 cents for the Cheddar cheese plants. So, consequently, the inefficiencies are gross inefficiencies within those plants. And I'd like to touch on that briefly, because it is a concern to us at Western United dairymen. But those inefficiencies should not drive a make allowance for skim whey.

Now to touch on that other issue, we are very concerned at Western United Dairymen with the inefficiencies that are being depicted within those plants. How we capture those costs or -- I think is a question for the industry to look at at some point in the future. It is very disturbing that perhaps one of those Mozzarella plants is losing money -- or is -- it is losing money at such a rapid rate, because that does jeopardize the stability of the processing industry in California.

AGRICULTURE ECONOMIST GOSSARD: On page 8 of your testimony, you mentioned that the Cheddar cheese plants in the northwest indicate their manufacturing costs for skim whey is approximately 17 cents. Do you have comparable figures for manufacturing costs for nonfat dry milk in that same area?

MR. MARSH: I do not.

AGRICULTURE ECONOMIST GOSSARD: Finally, you make the statement: "While we would like to support the still use of the Cheddar cheese plant used in the study to set

the skim whey manufacturing costs, we cannot support this due to the fact that the plant is highly inefficient and does not accurately represent other cheese plants in California or the rest of the U.S."

On what basis do you believe that this Cheddar cheese plant is inefficient?

MR. MARSH: On a couple items. One, representations made by staff -- to my staff. And, secondly, of course the information that we received at the pre-hearing workshop indicating that the weighted average costs of the plants in the skim whey study were at 23.27 cents.

AGRICULTURE ECONOMIST GOSSARD: Actually the weighted average cost was 27 cents. But --

MR. MARSH: I wasn't referring to the skim whey -- weighted average, manufacturing cost of the cheese, not the skim whey.

AGRICULTURE ECONOMIST GOSSARD: Okay. Thank you.

MR. MARSH: You're welcome.

SUPERVISING AUDITOR HUNTER: Mr. Marsh, I just wanted to follow up on that statement that you made on the inefficient Cheddar cheese plant.

MR. MARSH: Yes.

SUPERVISING AUDITOR HUNTER: Even though four-plant weighted average of 23.27, that would not

signify that all four plants were inefficient. Would you agree with that?

MR. MARSH: I may or may not. If I saw the actual data for each of the plants, then I could probably have a better opportunity to answer your question. But with weighted average costs that -- what, 6 cents above the weighted average of the Cheddar manufacturing costs included in the November of 2004 cost study, it's probably fairly safe to assume that inefficiencies are inherent within the plants. Now, they may not be inefficient relative to the Mozzarella plants. But there is a different cost associated with manufacturing Mozzarella versus Cheddar cheese.

SUPERVISING AUDITOR HUNTER: Okay. I just wanted to get your opinion on that.

MR. MARSH: Okay. Thank you.

SUPERVISING AUDITOR HUNTER: That's all I have.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Mr. Marsh, in regards to the cheese yield, obviously we have new information that came out with the cost studies that were released last year. And some of that information includes things like the yield and the vat test for butterfat and solids not fat. And yet you don't want to update those -- the yield figure that we have. Why is that?

MR. MARSH: We feel that the Department made a correct decision with the January 2003 decision with regard to those yields and their inclusion and the levels as well for solid not fat and butterfat included within the formula. We didn't see any reason at this time to go ahead and revise those.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. Most of the rest of your testimony looks at the skim whey powder component of the 4b formula. And there's a host of stuff that you talked through in here. And one of the things just strikes me -- and maybe you can give me some feedback on this. If the skim whey powder in the way these studies were conducted, the way the prices are falling, whatever this component's effect is on the overall Class 4b formula, why not consider just using a different product?

MR. MARSH: Using a different product such as WPC 34 and WPC 70?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA:

Something other than skim whey powder.

MR. MARSH: Well, I think that -- I think we use that of course as a surrogate, and clearly the most conservative costs that we can include within the formula -- are the most conservative price measures we

could include within the formula. To the best of my knowledge there doesn't exist a reliable price series under WPC 70, nor -- for that matter, for WPC 34 that we have available to us. I do note the one study that came out from Cornell in. -- was it 1999?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: '88.

MR. MARSH: I'm sorry?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: '88.

MR. MARSH: '88? Thank you.

But we would suggest continuing to use the dry whey.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Even though it's got all the problems you've identified and spoke to in your testimony?

MR. MARSH: Yes.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: I have no questions.

HEARING OFFICER ESTES: Anything else?

No further questions. All right.

Thank you for your testimony today.

I think what we'll do here -- it's about 12:25,

shortly thereafter. We'll proceed to hear the testimony in support of California Dairies -- CDI petition. And so we'll do that. But be aware that there may be a break between the presentation of the testimony and the subsequent questioning, depending on how long the presentation takes.

Let me swear the both of you. And I'll start from my far left.

(Thereupon Mr. Joe Heffington was sworn, by the Hearing Officer to tell the truth, and nothing but the truth.)

MR. HEFFINGTON: I do.

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

MR. HEFFINGTON: Sure. Joe Heffington H-e-f-f-i-n-g-t-o-n.

HEARING OFFICER ESTES: Okay. And can I safely assume the process by which this testimony's been developed and approved is set forth in the written testimony?

MR. HEFFINGTON: Yes, it is.

HEARING OFFICER ESTES: Okay. And moving to your right -- or to his left, my right.

(Thereupon Mr. Richard Cotta was sworn, by the Hearing Officer, to tell the truth,

and nothing but the truth.)

MR. COTTA: Yeah, I do.

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

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

HEARING OFFICER ESTES: All right. You want both statements introduced into the record?

MR. COTTA: Yes.

MR. HEFFINGTON: We do.

HEARING OFFICER ESTES: All right. The Testimony, Butter/Powder Make Allowance, by Richard Cotta, Senior Vice President, will be introduced in the record as Exhibit 47.

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

HEARING OFFICER ESTES: And then the Testimony, Class 2, 3, 4a and 4b Hearing, by Mr. Heffington, shall be introduced in the record as Exhibit 47a.

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

HEARING OFFICER ESTES: And please proceed to provide your testimony, whichever you consider appropriate.

MR. HEFFINGTON: Thank you.

Mr. Hearing Officer, members of the Panel, my

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

California Dairies is a full service milk processing cooperative owned by approximately 700 dairy farmer members located throughout the State of California and collectively producing over 15 billion pounds of milk per year, or 42 percent of the milk produced in the State of California.

Our producer/owners have invested over $200 million in five large processing plants, which produce butter, powdered milk products, cheese and bulk processed fluid products.

Our board of directors, which is comprised of 20 producer/owner representatives elected from our dairy farmer members, unanimously approved our proposal regarding Class 4a issues presented today at their December 21st, 2004, board meeting, and confirmed their approval at the January 25th, 2005, board meeting. They also confirmed their support of the proposal and testimony later today by the Alliance of Western Milk Producers regarding Class 4b issues at the January 25, 2005, California Dairies Board meeting.

First, we'd like to point out that non-cost justified reductions in the Class 4a make allowance

reduces our member/owners net income in favor of those producers in California without an investment in milk processing facilities and, therefore, carry no responsibility in balancing the state's growing milk supply. Therefore, it is our position to support cost justified make allowance changes to the 4a formula.

California Dairies supports the following cost justified 4a make allowances:

And listed there, cost to cover 80 percent per CDFA, that's shown in Exhibits A-1 and A-2, shows a cost of 15.7 cents for butter and 16.5 cents for powder.

California Dairies' proposal includes the coverage of 80 percent of the production of butter and powder. And that proposal is a departure from our historical request for a make allowance equal to the weighted average cost of production for plants surveyed.

California Dairies' position was arrived at based in part on the Department's Hearing Panel Report from the last Class 2, 3, 4a and 4b hearing held January 29th and 30th, 2003. In its report the Department acknowledges that the weighted average costs from the cost studies provide valuable information to the hearing panel, but that those -- that same number does not allow the hearing panel further assessment of all relevant economic conditions.

The results of the last hearing established manufacturing allowances for butter, powder and cheese that ranged from 55 percent to 77 percent in coverage of the product processed. We support an equal coverage of product manufactured at 80 percent for all three products, butter, powder and cheese. Cheese coverage at 80 percent will be as included in the Alliance of Western Milk Producers' proposal and testimony later today on cheese.

California Dairies believes that a level of 80 percent is required to encourage standby balancing capacity to stay available in California. This level of coverage does not encourage less efficient plants to continue in operation year round, but does provide some incentive for standby capacity to remain available and continue to provide the important balance function for California's ever-increasing milk supply.

And I'd like to point out that in those exhibits that the coverage at the 15.7 and the 16.5 cents respectively, it does not appear that there's a real plant that is skewing that number. Because, as you can see, the 15.7 cents is well below the high cost category, Exhibit A-1, and the 16.5 cents actually falls in the medium cost category on powder on the nonfat exhibit.

Next, regarding California price adjuster for butter, we offer the following:

We believe that the calendar year price differences are more reflective of actual experience. That's a full market cycle. We believe this is a more representative timeframe because the historical low price/low demand time for butter is the end of December or first of January, and data surveyed on a different timeframe can and, we believe in this case, does result in erroneous annual averages. We offer the following information:

And this was calculated from CDFA data. If you turn to Schedule B-2. This was the information released by the Department from which our Schedule B-1 was calculated. This shows the prices and the volumes for different months. And then if you look at Exhibit B-1, we have calculated the weighted average -- comparison of the weighted average CME to the weighted average sales price for 2002 and 2003.

The sales difference as reported by CDFA, calculating those weighted averages, shows a .0350 difference of sales price below the CME for the time period from January of 2002 through December of 2002.

And for January of 2003 through December of 2003 a difference of .0332.

Also I'd like to point out on Exhibit B-1 that the CME price fluctuations were minimal during the

calendar years ended 2002 and 2003, with low market values dominating this pricing period. So we did not have fluctuating market value during 2002 and 2003. Unfortunate for milk prices because these were historical low prices.

We believe that the Department's survey results for the November 2003 to October 2004 time period have been impacted by both the time period surveyed -- it was not a full market cycle -- and higher commodity market value fluctuations. As shown in the Department's survey of CME butter prices versus California butter sales, that's shown on Exhibit C, the CME price for November 2003 was $1.1998 per pound, and for October it had increased to a level of $1.6863 per pound. We believe that price fluctuations during this period of time have led to lower calculated differences. This most likely was caused by the comparison of weighted average sales data to the simple average index of the CME price that's data released from the 26th of the prior month to the 25th of the current month. We offer as support of this the following data which represents the difference between California Dairies' weighted average sales price and the weighted average CME price for the periods indicated.

And the difference was calculated based off the volume CDI sold and on a week-by-week basis.

The sales difference as reported in our numbers to the Department of Food and Ag for January of 2003 through December of 2003 was .0370 cents. The update that was submitted to the Department from January of 2004 through October of 2004 was .0284. And if we update for the last two months of the year, the sales difference for the full 12-month period, the full market cycle, was .0373.

Again, we believe that the calendar year survey will include the full market cycle, with the end of December being a historically low watermark for butter price and that if the Department's survey could be updated through December 31st, 2004, and compared to the weighted CME values for the weeks of reported butter sales, the Department's updated report would reflect averages closer to California Dairies' data shown above. Therefore, California Dairies supports a California price adjuster that exceeds the 24-month average of .0285 as shown in the latest CDFA update on Exhibit C. And absent the update that we discussed above where you would compare weekly sales prices to weekly weighted average CME prices, California Dairies supports an adjuster of .0315 as shown on Exhibit D.

We recognize that the collection of this data has been difficult for the Department to assemble, as

evidenced by the number of data releases and various revisions provided for this hearing. We would like to offer the following suggestions that we believe would improve the data collection process and allow for the calculation and comparison of a weighted average sales price to the weighted average CME price.

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

An additional benefit would be that that weekly sales prices could be compared to weekly average CME prices. This would also allow for the calculation of weighted average sales prices and comparison to weighted average CME prices for those time periods that you would compare, thereby eliminating the inaccuracy caused by

comparison of weighted average sales prices to simple average CME prices.

Additionally, we suggest that the Department audit these reports for accuracy throughout the year, as it is our understanding that an audit of the existing data submitted to CDFA is difficult.

Next, I would like to offer our comments on the subject of the calculation of the return-on-investment factor used in the cost study calculations.

The return-on-investment factor used in the cost study is based on the undepreciated book value of plant and equipment and the weighted average prime interest rate for the cost study period. From a practical standpoint, a plant and its equipment could never be replaced at today's higher costs for the plant's historical depreciated book value. In addition, investors would not incur the risk of investing in new facilities if their projected return were the prime interest rate on a declining depreciated balance at best. Both realistic replacement values and a longer term rate of return that would include a factor for risk would better reflect what a company could earn if capital were not tied up in plant assets. We believe this factor should be incorporated in the cost study, as we expect additional facilities will need to be built in California to handle the ever-increasing milk supply.

We have provided the Department information on this subject and the industry has discussed this issue at an industry workshop during the past year. We suggest that the Department consider the changes to the return-on-investment calculations used in their cost studies, and we have attached as Exhibit F our letter to the Department on this subject dated December 23rd, 2004.

Our letter points out that such a change would stabilize the return-on-investment calculation, thereby reducing the need for return-on-investment changes to the make allowance.

Thank you for your attention to my testimony. And now I would like to introduce Mr. Richard Cotta, who will add to California Dairies' testimony.

MR. COTTA: Mr. Hearing Officer and members of the Panel, my name is Richard Cotta, Senior Vice President of California Dairies. Today's testimony will support and add to the testimony given by Mr. Heffington.

California's share of milk production has continued to grow with a 4-plus percent range over the last 10 years and now surpasses 100 million pounds of milk a day. It does not appear this growth pattern will change much in the near future in spite of more burdensome regulations in the area of water and air quality regulations.

At historic growth rates of 4 percent a new 4 million pound a day plant is required each year to handle the new growth. Currently, two new large cheese plants are taking in milk to reach maximum capacity, because the ultimate efficiencies can be achieved at full capacity. However, with an industry as large as ours, balancing capacity becomes a critical part of handling our milk supply. No one wants the burden of carrying inefficient high cost plants that balance the supply of milk sporadically. With this thought in mind, I fully support the position of Mr. Heffington, covering the cost of 80 percent of the production of butter and powder. This level of coverage does not provide an incentive -- excuse me -- does provide an incentive to keep standby capacity available to balance the supply on weekends, holidays, during mechanical breakdowns other hardship situations. With each passing month our balancing requirements become even more important.

Our operations people tell us the largest swings we have experienced so far in our operations 7.8 million pounds of milk a day. That's a 150 tanker loads of milk. There is no way we could move that volume of milk out of state and continue picking up milk produced at our producers' dairies without standby capacity.

Next in regards to pricing. With the

Department's change in language from the January 29th and 30th, 2003, hearing from, quote, "The cost of shipping one pound of butter from California to Chicago" -- that's Exhibit A -- to, quote, "The different between the Chicago Mercantile Exchange butter price and the price received by California butter processor" -- Exhibit B -- we believe it is more important to use a full year marketing cycle that compares the weighted California butter price with the weighted CME price on a weekly basis for evaluating changes from period to period than it's been in the past. The current method of comparing weighted average California prices with CME monthly average of the daily prices results in misleading and inaccurate data.

An example of this would be a week of high sales volumes and high sales prices followed by a week or two of low volumes and dropping prices. The follow example is taken for a four-week period involving different but consecutive months. This was done to protect proprietary information, but serves our purposes in illustrating the point.

This actually falls in two separate periods. But Week 1, $1.83 CDI weighted average price compared to a CME simple average price of $1.98. Week 2, $2.041 CDI average price, with a CME average of 2.0725. Week 3, a 1.9591 weighted average price compared to a 1.8667 CME average

price. And Week 4, a 1.6185 compared to a 1.55. That difference on a simple CME was a negative .0135 cents.

Volumes varied from a high of 2.8 million pounds per weak to a low of 172,000 pounds her week. If you weighted the CME average against the actual CDI weighted number on a weekly basis, the difference becomes a negative .106375 cents a pound. This is a very, very significant difference.

An exaggeration? Maybe. But this example shows the real world scenario.

For the month of December 2004 the simple average of the CME daily prices published by the Department is 1.7705. The weighted average of the CME based on a product sold by CDI for the same period is 1.8701, a difference of 9.96 cents per pound. Most butter is sold on the weekly average of the CME price, not on a daily average. We believe the Department should adopt the methodology that compares apples to apples.

With the volatility we have been experiencing in the markets it is entirely appropriate to use weighted average figures. For the week of December 4th to the week of December 18th, the market dropped 50 cents per pound and CDI sales dropped almost 90 percent. These kinds of price and sales swings can only be accurately accounted for by comparing like data, i.e., weighted average data.

We believe our sales swings are probably no different than our competitors in the industry.

Our own internal data shows the significant differences a short period of time can make. For the period of January 2004 through October 30, 2004 showed a difference between CDI weighted average price and CME butter price of negative .0284. For the period January 2004 through December 31st, 2004, the difference between the CDI weighted average and the CME butter price was a negative 3.73, a difference of 31 percent.

How can two months make such a difference? Very simply, volume and price. Over 25 percent of the annual dollar sales occurred during a two-month period of time. Also, for the better part of that time period the price was near the highest sales average for the year.

We believe the Department's exhibit presented at the pre-hearing workshop "CME Butter Prices versus California Butter Price," revised 1-18-05, Exhibit C, contains errors in calculations; i.e., the October 2003 shows a negative .0269 for the difference. If both the CME butter average and the California weighted average numbers are correct shown in the exhibit, the difference would be a negative .0565. This would change the 24-month average to a negative .0298.

Without including data through December 31st,

2004, we would support an adjuster of .0315 as per Exhibit D.

However, we would encourage the Department to follow Mr. Heffington's suggestion on gathering data from the NASS. This data is readily available, could be selectively audited for accuracy.

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

HEARING OFFICER ESTES: I believe that request has been previously granted.

I believe it's 10 till 1. So my suggestion, unless the Panel has objections, is that we recess for lunch at this time so that we don't have a -- okay. We'll go ahead and proceed and take a break shortly after 1 o'clock or whenever the panel concludes, depending on their levels of interest.

AGRICULTURE ECONOMIST GOSSARD: This is for Mr. Heffington, I believe.

In your testimony on page 3, I want to make sure I understand what I'm looking at.

MR. HEFFINGTON: Excuse me. What page?

SUPERVISING AUDITOR HUNTER: Page 3 down at the bottom where you have a weighted average for -- the first figure is January 2003 through December 2003, .037.

MR. HEFFINGTON: Yes.

SUPERVISING AUDITOR HUNTER: And then the next figure is .0284 for 2004 through October. And then .0373 through December 2004.

If I head over to the Exhibit -- the D Exhibit, the 33 month average, you have your 2002 figures, January through December. If I average those out I would get the .0370?

MR. HEFFINGTON: No.

SUPERVISING AUDITOR HUNTER: So it's not same thing we're looking at here?

MR. HEFFINGTON: Just a moment.

No, this data that you're looking at at the bottom of page 3 is select -- is just California Dairies' sales and the weighted average of the CME based off our sales difference. It is not calculated from the CDFA data. It's calculated from the data we submitted to the CDFA to be included in your data.

SUPERVISING AUDITOR HUNTER: But you took the weighted average on the CME as opposed to simple average, is that the main change we're talking about?

MR. HEFFINGTON: What we did was we used our sales price, which would be our average sales price for each week, as reported to NASS and as reported to CDFA. That's the way we submitted our data.

SUPERVISING AUDITOR HUNTER: Yeah.

MR. HEFFINGTON: And we compared it to the CME for that week, the average of that week's CME. And we weighted the CME also for the pounds sold during each week. So we have a weighted average sales compared to a weighted average CME by the time you get to the end of the pricing period.

SUPERVISING AUDITOR HUNTER: Okay.

MR. HEFFINGTON: And that we believe is much more accurate than comparing weighted average sales data to simple average CME data.

SUPERVISING AUDITOR HUNTER: Okay. So what you're saying, Mr. Heffington, is on the weighted CME data each pound is carrying its own weight throughout the time period; you're not -- you're not getting a separate pound for every week -- I'm sorry -- a separate price for every week?

MR. HEFFINGTON: What we're doing is we're comparing --

SUPERVISING AUDITOR HUNTER: You're weighting -- you're weighting a week's within the month?

MR. HEFFINGTON: We're weighting each individual week. It's the -- the NASS report is due weekly. We're comparing the sales price for that week to the CME for that week. And if we sold a million pounds in one pricing period and only a hundred thousand pounds in another week,

we've weighted it, so that the one we -- the week that we --

SUPERVISING AUDITOR HUNTER: The larger time period's all right.

MR. HEFFINGTON: Excuse me?

SUPERVISING AUDITOR HUNTER: The larger time period you're weighting them for?

What time period is the weighting --

MR. HEFFINGTON: A week --

SUPERVISING AUDITOR HUNTER: Each weak individually then?

MR. HEFFINGTON: Each week individually.

SUPERVISING AUDITOR HUNTER: Okay.

MR. HEFFINGTON: But if we have a week that we sell a million pounds in, that week is weighted heavier on the difference by the time you get to the end of the whole pricing period -- at the end of year than a week that only has a hundred thousand pounds.

SUPERVISING AUDITOR HUNTER: That's what I was getting at. Otherwise you're weighting a week, but you're coming out to a yearly figure?

MR. HEFFINGTON: Yes.

SUPERVISING AUDITOR HUNTER: Okay. Thank you.

MR. COTTA: If I can.

In taking the example that I've given in my

testimony, one week sales were 2.8 million pounds. Two weeks later it was 172,000 pounds. We think it is difficult to use a simple average and compare what really took place without weighing for the sales volumes for that period of time. It gives you a skewed number.

SUPERVISING AUDITOR HUNTER: Thank you. That's all I have.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA:

Gentlemen, I'm with Ed. I had the same questions he did. And there's one question I still have that's unanswered.

Do you consider the CME price on a weekly basis, do you consider any of the sale that goes through the CME in any of your calculations, or is the weighting all done on what you individually sell as CDI?

MR. HEFFINGTON: This is driven off of our NASS reports, which require it to be a manufactured sale.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Right. So when you say you're doing the weighting, you're not weighting the CME price on that. For example, CME prices sometimes get reported even though there's no transactions and sometimes there are, you know, 60 carloads of selling.

MR. HEFFINGTON: No, we're not weighting it on

the CME transaction. We're weighting it on our pounds of butter sold.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: And on --

MR. COTTA: There's a reason not to weight it on the CME transactions even though there's no sales. Because our sales still take place -- or our competitors' sales -- for that week.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Sure. I understand that.

On Exhibit D, what you have labeled -- and it's called a volume. It looks like 1, 2, 3, 4 -- 5th column over it says volume. Is that a CDI volume only?

I think these -- these are the same, aren't they?

MR. HEFFINGTON: Exhibit D in my testimony is the CDFA's volume. We did not want to submit our volume for confidentiality purposes. So the best we could do was -- with this exhibit was to use the -- this is the information and the volume used off of Exhibit B-2. If you look at the volume of butter shown on Exhibit B-2, that will match with the volume on Exhibit D.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. So that's not -- that includes CDI, it's not only CDI. Got it.

Thank you very much.

DAIRY MARKETING BRANCH CHIEF IKARI: I just have a couple questions.

Is there any information or data that would support the statement that most butter is sold on a weekly basis that you could share with us?

MR. COTTA: Well, I -- my guess is we probably have 95 to 97 1/2 percent of the butter in the state is sold probably on weekly basis. We don't make any sales based on a daily basis. I'm sure you could check with the other manufacturers in the state, and I think their practices are probably about like ours.

DAIRY MARKETING BRANCH CHIEF IKARI: What about the applicability of your proposal to cheese? Do you think it holds true for cheese sales?

MR. COTTA: Well, we think you have good data that's submitted to NASS. We think that data is readily available. We think you have the ability to audit that data. I think what you need to do is collect it. And then let's take a look at it and see if it does work. We think it does work. But I think -- the Department is interested in correct, accurate information. And I think this is a place to start. I mean we can argue later about how you want to divvy up the money. But I think this gives you an apples-to-apples comparison and I think it's data that's readily collectable.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

HEARING OFFICER ESTES: Do we have any other questions for the witnesses?

All right. Well, thank you for coming today.

All right. We'll have a lunch break at this time. It's 12:58, so we did conclude in advance of the anticipated 1 o'clock break time. And we will reconvene at 2 p.m.

(Thereupon a lunch break was taken.)

AFTERNOON SESSION

HEARING OFFICER ESTES: All right. We're back in session.

And can people in the back hear okay?

MR. TILLISON: It looks like only that speaker is on for your microphone. And I think only this one's on for -- it's strange.

HEARING OFFICER ESTES: Yeah, I tried to turn them down slightly because there was a reverberation problem that was emerging. So we may have to turn them back up.

But I think the acoustics here are such that with a minimal amplification everyone should be able to hear the testimony.

So now we're back in session at this time. We will be hearing the testimony in support of the alternative petition submitted by the Alliance of Western Milk Producers.

(Thereupon Mr. James Tillison was sworn, by the Hearing Officer, to tell the truth, and nothing but the truth.)

MR. TILLISON: Yes, I do.

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

MR. TILLISON: My name is Jim Tillison. That's

T-as in Tom-i-l-l-i-s-o-n.

HEARING OFFICER ESTES: And have you set forth the method by which your testimony was developed and approved?

MR. TILLISON: Yes.

HEARING OFFICER ESTES: All right then. I assume you would like to have your written testimony introduced in the record as an exhibit.

Mr. Tillison: Yes, I would.

HEARING OFFICER ESTES: It will be introduced as Exhibit No. 48.

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

HEARING OFFICER ESTES: And please proceed with your testimony today.

MR. TILLISON: Thank you.

My name is Jim Tillison, Executive Vice President and CEO of the Alliance of Western Milk Producers. The Alliance proposal was approved by the board of directors, and I am testifying as directed by that board.

The Alliance decided to submit an alternative proposal because our members feel that the Land O'Lakes (LOL) Class 4b proposal is flawed in a number of ways. Since it mimics the LOL proposal, we believe the Dairy Institute's proposal is flawed as well.

Cheese Yield:

First and foremost is an assumption on which LOL's proposal is based, that the purpose of the Class 4b formula is to price typical California milk. This is in our opinion is wrong. The purpose of the Class 4b formula is to determine the value of milk going into cheese plants, just as the purpose of the 4a formula is to determine the value of milk going into butter/powder plants and so on with the other classes.

The Class 4b formula starts with the value of the product, Cheddar cheese. From that value is deducted the cost of converting milk into cheese. The cheese make allowance is based on all the costs associated with receiving raw milk at the plant, all the way through the solids -- all the way through the solids and the milk being converted into cheese and being packaged. Those cheese-related costs -- total costs are then divided by the pounds of cheese produced to determine the weighted average manufacturing cost of a pound of cheese. The pounds of cheese produced are directly related to the composition of the milk received by the cheese plants that the Department surveys for its cost study. This means that the make allowance determined by CDFA is directly related to the composition of the milk received by the cheese plants. That in turn means that the cheese yield

factor used in the Class 4b formula must reflect the composition of milk that the plant receives for the purpose of making cheese.

The cheese cost study released by the Department in November 2004 indicates that the cheese yield factor for the cheese plants surveyed was 10.92 pounds of cheese with a moisture content of 37.12 percent. The composition of the milk in the studied plants' vats was 3.94 percent milk fat and 8.95 percent solids not fat. The Cal Poly study by Dr. Phil Tong for milk going into cheese plants indicates that the average composition of milk received by 13 California cheese plants was 3.67 milk fat and 8.93 solids not fat. More importantly, as regards cheese yield, the average crude protein percentage of nonfat solids was 3.3 percent. And the casein as a percentage of crude protein was 77 percent. The actual average casein content of the milk determined by test by Dr. Tong was 2.54 percent.

Without going into too much detail, Van Slyke determined that the ideal ratio of casein to milk fat for Cheddar cheese making is .64. The data from the Tong study showed that the casein-to-fat ratio of the milk received by the cheese plants surveyed averaged .69. To achieve the ideal casein to milk fat ratio requires fortifying the milk in the vat with additional milk fat.

My calculations indicate that to achieve the ideal casein-to-fat ratio, the average milk fat in the vat would have to be raised to 3.97 percent.

The table below shows how close these figures are to the Department's own data from the cheese cost study.

Taking the Cal Poly cheese milk composition data and plugging it into the Van Slyke formula with 92 percent fat recovery that LOL insists is aggressive and using the Department's block moisture value of 37.98 percent as disclosed at the pre-hearing workshop results in a cheese yield factor of 10.22.

Interestingly, the Alliance analysis shows that working the Van Slyke formula backwards to determine the fat recovery with CDFA's yield of 10.92 vat milk and a vat milkfat of 3.94, vat solids not fat of 8.95, it should be, not .93, and moisture of 37.12 percent results in a fat recovery of 98 percent. Now, that's based on the casein -- the casein and the solids not fat that the Tong study came up.

Let's not forget that the original Van Slyke formula used 93 percent fat recovery and was developed in the days of open vats with much hand labor. The formula was modified to 90 percent fat recovery to allow some leeway for curd loss during manufacturing product. Today's modern Cheddar cheese plants are totally

mechanized, enclosed systems that are vastly superior to the equipment in the days when Van Slyke developed his formula.

Therefore, in its proposal the Alliance retains the 10.2 yield factor which, frankly, is extremely conservative and not aggressive at all.

Cheese Price Adjuster:

The Alliance proposal also uses a different price adjuster from either the current 4b formula or the LOL proposal. We believe using a weighted average price adjuster is superior and more accurate than using a simple average of two years of monthly weighted average prices.

The Alliance urges CDFA to use the full market cycles in determining cheese and butter price adjusters. This is accomplished by using prices from January through December. For both cheese and butter significant price changes can and have occurred between November 1st and December 31st. To use a two-year cycle that only includes this time period once does not accurately reflect the market for these commodities.

We would also encourage the Department to have cheese and butter manufacturers report to CDFA the weekly data that they file with USDA for the NASS price surveys. Doing this would give CDFA something to compare on a spot basis when doing plant audits to ensure that California

cheese manufacturers are providing accurate data.

The Cheese Make Allowance:

The Alliance proposal calls for the cheese make allowance to be set at 17.10 cents her pound of cheese. This number is slightly lower than the weighted average make allowance reported in the Department's cost study data. However, our members believe this number is appropriate.

In the past, the Department has rejected the idea that a fixed percentage commodities production should be covered by the make allowance. However, Alliance analysis indicates that the cheese and butter make allowances that the Department has selected for use in the product formulas in the past have been close to a level up to which approximately 80 percent of the product could be produced. We are not talking on a weighted average basis or even an average. We're talking an absolute number.

The cheese and butter cost sheets released by the Department December 21st, 2004, state that the cheese make allowance of .1017 -- I'm sorry -- .1710 covers up to 79 percent of cheese production. That is the level at which we are recommending the Class 4b cheese make allowance be set.

The Alliance has a caveat regarding the level of the cheese make allowance as regards to processing of whey

by cheese plants in the Department's cost study. According to Ed Hunter, approximately one cent of the weighted average cheese manufacturing cost results from costs associated with disposing of lactose and minerals left when cheese whey is processed into whey protein concentrate. This should not be the case. The Class 4b price formula includes a make allowance for converting cheese whey into dry whey. In that process all the whey solids are converted into dry whey. There is no permeate left over to be disposed of. Even if there were, that cost should not be part of the cheese make allowance.

The make allowance for cheese is the make allowance used in establishing the price of milk regardless of the type of cheese that is produced. There are no compensations or adjustments should a cheese plant choose to produce Swiss, Brie or Italian cheese.

Whey processing should be treated the same way. There should be no adjustment to the cheese make allowance or the whey make allowance, for that matter, because cheese plants in the cheese cost study choose to make WPC instead of dry whey. There is a make allowance for dry whey in the Class 4b formula to cover all costs associated with processing whey regardless of the whey product a cheese plant chooses to produce. As with those who produce different varieties of cheese, the additional cost

of producing a different whey product should be recovered from the marketplace and not from the milk.

Because the number provided by Mr. Hunter isn't exact, rather than reduce the cheese make allowance by one cent, the Alliance proposes keeping the cheese make allowance at 10.7 cents and keeping the whey make allowance at 17 cents. However, should the Department decide to raise the whey make allowance, then it should lower the cheese make allowance by removing any costs associated with processing or disposing of whey.

Clearly, cheese plants are more than recovering the cost of producing WPC from the marketplace. Last week's AMS Dairy Market News' Dry Products report showed this. The simple average West dry whey price was 26 cents a pound. The West WPC price averaged 71.75 cents.

An analysis by the Alliance of the amount of whey solids produced from milk being converted into cheese of all varieties in California shows that the dry whey produced in California annually only utilizes about 15 percent of all those whey solids. Virtually all of the other 85 percent of whey solids are going into whey protein concentrate. And the majority of that product is the high protein content WPC according to CDFA data. The Department needs to take a long hard look at using WPC rather than dry whey as the basis for determining the

value of other solids in the Class 4b formula.

In the whey cream calculation, the Alliance proposal uses 15.7 cent butter make allowance, which the Department indicates covers approximately 80 percent of butter produced.

At this point I guess I will take exception with Dr. Gruebele's comment that our -- that number covers 90 percent of the butter produced. If you look at the exhibit that the Department had on table 3, a number of 15.6 cents I believe covers 70 percent of the production. And what the table shows is that 16 cents covers 90 percent of the butter production, not 15.7 cents.

I think, as was explained at the workshop, the reason the Department did that was because it didn't exactly fall in a number.

Dry Whey Make Allowance:

The Alliance proposal maintains the dry whey make allowance as 17 cents a pound and snubs the other solids value at zero in its proposed 4b formula. There are several reasons for this.

The Alliance does not believe that the Department's survey of the dry whey manufacturers in California reflects anywhere near reasonable manufacturing costs for processing cheese whey into dry whey.

Based on data submitted at the May 2000 federal

Class III milk price hearing, the Department's own information regarding the cheese make allowances for the plants in the whey study and information the Alliance has received from a cooperative operating two-way drawing facilities, the California plants studied are extremely inefficient and not representative of well run facilities.

At the May 2000 Federal Milk Marketing Order Hearing on Class III, cheese milk, and on class 4, butter/powder milk pricing, the International Dairy Foods Association presented data resulting from a survey of its member plants as to the cost of drying whey. The survey data for the dry whey came from seven plants, including at least one in California. And I think if you check the testimony of Dr. Yonkers, you'll find that he does say that -- he believed that at least one California plant was included in that survey. That survey, conducted in 1999, came up with a weighted average cost of drying whey of 15.9 cents a pound.

At the hearing, Tillimook Creamery entered an analysis it did in considering the construction of its Boardman cheese plant regarding a dry whey facility. Their analysis showed it would cost 16.8 cents a pound to dry whey in a new facility.

And, finally, attached is data provided to the Alliance which indicates that the weighted average cost of

processing dry whey in its two dry whey plants in the Pacific Northwest is 17.64 cents including an ROI of 1.5 cents per pound of dry whey.

I point out at this point that I did have an opportunity to talk with Mike Brown and a Mr. Mike Bass who works at West Farm Foods, and he indicated to me that the figures in the chart in the letter are forecast numbers. However, he also indicated that the forecast numbers when checked against the year-end actual numbers come out very close to the numbers in that figure -- or in that forecast rather.

All these numbers confirm that a 26.75 cent cost of manufacturing dry whey is not even close to what cheese plants of the size, age and efficiency of those that participate in the cheese manufacturing cost study would produce dry whey for if they produced that product.

The statement is supported by the fact the Department revealed at the pre-hearing workshop, that the weighted average cheese manufacturing cost of the four plants in the dry whey survey was 23.27 cents a pound. This compares to the plants in the cheese manufacturing cost study which had a weighted average cost of 17.34 cents a pound.

In his testimony, Dr. Gruebele talked about the difference between the cost of producing Italian cheese

and the cost of producing Cheddar cheese. I would also point out that there is a significant difference between the yield a Mozzarella plant gets from milk versus a Cheddar plant. As a result, when you factor in the difference in yield, I think that the weighted average of 23.75 cents does in fact indicate these plants -- the plants on a weighted average are not very efficient.

It's interesting, when you take the dry whey data that was produced and add up the minimal and the maximum numbers that you have on the form, the minimum was 15. -- I think it was 27 cents or something like that, and the maximum was over 47 cents.

However, as the Department itself pointed out, there wasn't any plant that could produce cheese at the 17 cent level. And when asked -- when I asked for a number that would cover 80 percent of the production, that number was just under 26 cents a pound. So I would argue that the plants involved in the study are in fact not typical plants and not very efficient plants.

Considering all this information, the only decision the Department can reach is to maintain the 17 cent dry whey make allowance, as proposed by the Alliance and others.

The Alliance also proposes snubbing the value of other solids at zero in the Class 4b formula. That is,

when the price of dry whey falls below the cost of producing the product, the value of other solids would not be negative.

The reason for this recommendation is that the vast majority of whey solids produced in California are not being made into dry whey, but are being processed into much higher value and more profitable WPC products. When dry whey prices fall below the cost of production, plants have the option of selling their cheese whey to WPC operations, offering the liquid whey to others as a feed supplement or, at worst, applying the product to cropland as a nutrient.

Oppose Dropping the CCC Purchase Price Floor:

In proposing that the Department remove the requirement in the stabilization plans that cheese, butter and powder prices used in Class 4a and 4b formulas be the higher of the CME cheese price, the CME butter price and the California weighted average nonfat powder price, the Dairy Institute said:

"We also recognize that the level of prices established for Class 4a and 4b must result in California's entire milk production being marketed. In recognition of that requirement, we have proposed removing the commodity price floors that were put in the 4a and 4b formulas as a result of the January 2003 hearing."

Excuse me a minute. Gruebele gave me his cold.

(Laughter.)

MR. TILLISON: "The cost of doing business with the government, which has been discussed at previous hearings, leads to a net effective price received by plants on government sales that is lower than the announced CCC purchase price. Using the CCC purchase price as a floor commodity value in the formulas creates a disincentive for plants to purchase milk when market prices are below CCC support prices."

The reason commodity prices fall below the CCC support prices is that more cheese, butter and nonfat powder is being produced than the commercial market can absorb. When that occurs, excess product is supposed to move to the CCC. When the market is short, product moves from the CCC back into the marketplace. Product offered by the CCC to the market is currently sold at the support price or the market price, whichever is higher. This protects both the wholesaler's market price and inventory values from being undercut. Conversely, setting the commodity prices at the higher of the CME and CWAP or the support purchase price prevents the producer milk price from being significantly under the support price level as occurred prior to California's pricing system adopting this provision.

Since the support price for milk was dropped to 9.90, the amount of cheese and butter offered to the CCC has been minimal in relationship to the total amount of Cheddar cheese and butter produced and marketed. And still, during various sustained periods, the CME block price has fallen far below the support purchase price with no product moving to the CCC.

In the above statement, the Institute talks about the additional cost of selling product to the CCC. The Alliance submits that covering those additional costs should not be the producer's responsibility. A couple years ago the National Milk Producers wrote to the USDA asking it to adjust the make allowances and the commodity support purchase price formulas to account for those additional costs. The Institute and its membership should join NMPF in pushing USDA to make those adjustments.

Another reason that the Department should not remove the commodity support price floors from the 4a and 4b stabilization plan is the fact that running plants at optimum capacity, even when some product has to be offered to the CCC, makes that plant more profitable. I believe, based on my experience, that the profit margins from running a plant at optimum capacity more than offsets the additional cost of moving a portion of cheese production to the government. The Institute's statement regarding

the support price floor creating a disincentive for plants to purchase milk just doesn't hold water in that regard.

And the Alliance's final reason why the Department should not remove the commodity support prices is the price adjusters used in Class 4a butter and Class 4b cheese formulas. Those price adjusters are the difference between CME prices and the prices California processors are actually receiving for block Cheddar cheese and butter that they sell. Therefore, the price those products are sold for to the marketplace and to the CCC are accounted for in the price adjusters.

In Summary:

The Alliance agrees wholeheartedly with the statement that the Dairy Institute made in its letter describing its alternative proposal. I quote in part, "...that allowances be cost-justified, prices be reflective of what California plants actually receive for the products they produce, and that yields be reflective of what California plants can actually attain."

The make allowances that the Alliance proposes for cheese, butter and especially dry whey are cost justified. The Department adjusted cost study show that approximately 80 percent of the cheese and butter produced by the studied plants can be produced at or below the make allowances that the Alliance proposes.

The information provided in our testimony clearly shows that the dry whey make allowance proposed by LOL and the Dairy Institute cannot be justified because they are not reflective of the cost for cheese plants of normal efficiency to produce dry whey. This is confirmed by their weighted-average cheese manufacturing cost of 23.78 cents per pound compared to that of cheese plants in CDFA's regular cost study, 17.34 cents.

However, should the Department determine that an increase in the dry whey make allowance is justified, then the cheese make allowance should be reduced by the one cent attributed to the cost of disposing of WPC permeate.

The cheese price adjuster as proposed by the Alliance better reflects what cheese plants receive for their products. A true weighted average rather than a simple average of monthly weighted averages is a better number for the Department to use. A true weighted average factors in all the market factors such as product volume and demand.

And, finally, the Alliance's proposed cheese yield is much closer to what California cheese plants can attain from the milk that they receive than -- much closer than the LOL or Dairy Institute proposals. The Cal Poly cheese milk composition study clearly shows what cheese yield can be achieved from California milk going into

cheese plants with 92 percent milkfat recovery and blocks containing 37.98 percent moisture.

The Alliance urges CDFA to adopt its proposal for Class 4b pricing.

Thank you. And I'm ready to answer questions.

I might point out attached to my testimony are three exhibits. The Exhibit No. 14 is the dry whey total cost survey data from NCI that was presented at the hearing in May of 2000.

Also attached, and it's numbered Exhibit 5, is the Tillimook whey plant study summary that indicates a make allowance of 16.8 cents is realistic.

And then finally I include the spreadsheet that I was sent from West Farm Foods, annualizing the costs for whey processing.

And as I said, as a segue in my testimony, these numbers are budget numbers. But according to Mr. Bass, they reflect very close to what the actual costs turn out to be in the -- have turned out to be for them in the past. And also it includes a return-on-investment factor of 1 1/2 cents a pound.

And with that I'll be happy to answer questions.

HEARING OFFICER ESTES: Do we have questions?

SUPERVISING AUDITOR HUNTER: Yes, Mr. Tillison. On that last exhibit you were talking about, the West Farm

Foods, is that strictly on whole whey?

MR. TILLISON: Yes, that is. When I requested the information I asked that they only provide information for dry whey. And I know at the Sunnyside plant that's all that they process.

SUPERVISING AUDITOR HUNTER: Okay. So they don't make WPC. That wouldn't be included in there?

MR. TILLISON: No, that's not included in there.

SUPERVISING AUDITOR HUNTER: All right. On page -- there's no page numbers.

MR. TILLISON: Yes, I know that. You've pointed that out to me, as I recall.

SUPERVISING AUDITOR HUNTER: The top of page 4, the second paragraph.

MR. TILLISON: An analysis by the Alliance?

SUPERVISING AUDITOR HUNTER: No, this is on breaking down the 15 percent of whey solids going to the whey powder. And then you say that all the other 85 percent of whey solids are going into whey protein. But they wouldn't all end up in whey protein, right? It could -- a majority of ought to go to lactose.

MR. TILLISON: Let's put it this way: The vast majority of the protein goes into whey protein concentrate. And, yes, there would be lactose left over.

SUPERVISING AUDITOR HUNTER: Right, the protein?

MR. TILLISON: Right.

SUPERVISING AUDITOR HUNTER: But not the solids?

MR. TILLISON: Right. Not the lactose and perhaps some minerals.

SUPERVISING AUDITOR HUNTER: Okay. And my last question goes back to the third page, right at the bottom. Where you're talking about the extra costs. This is like the end of that statement. You're talking about removing any costs associated with the process in your disposing of whey. If we happen to raise the whey make allowance and knock that out of the cheese make allowance, right?

MR. TILLISON: Right.

SUPERVISING AUDITOR HUNTER: Where would the costs end up then? If you don't put them in the cheese and they're not going with the whey products, where would those costs supposedly end up?

MR. TILLISON: Well, they should go with the whey products. What I'm basically saying, if you say -- let's say you decide that you're going to increase the whey make allowance to 18 cents or 19 cents. Then I would say you should reduce the cheese make allowance by the 1 cent or whatever the exact number is.

My feeling is is that when you have a whey make -- a make allowance for whey, regardless of what that plant chooses to do with the whey, whether they choose to

field spread it, make WPC, make dry whey. Whatever it is, there should be no costs associated with whey in the cheese make allowance.

SUPERVISING AUDITOR HUNTER: Okay. So you're field spreading the whey. All the lactose is being field spread.

MR. TILLISON: Yeah.

SUPERVISING AUDITOR HUNTER: All those costs associated with those solids going out to the field should not be put back in the cheese; it should be --

MR. TILLISON: It should not be put back in the cheese. Because if I choose to make WPC, I have something left over. I have a permeate left over. But I don't have to make WPC. If I made dry whey, virtually all of the solids are going to be captured in the dry whey.

SUPERVISING AUDITOR HUNTER: Okay. So the first thing is it should go back in the WPC as opposed to the cheese?

MR. TILLISON: Exactly, exactly. And that's why when I say if you choose to raise the make allowance for whey, then you should take all factors out of the cheese make allowance that are associated with whey.

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

AGRICULTURE ECONOMIST GOSSARD: Mr. Tillison, on

page 4 of your testimony where you address the attachments on the processing costs for skim whey powder at plants outside of California, do you have comparable costs for nonfat dry milk in those same areas?

MR. TILLISON: Well, basically there was testimony at the hearing in terms of Class IV as well as Class III. I imagine I could dig that out of the testimony for the May 2000 hearing and provide that.

AGRICULTURE ECONOMIST GOSSARD: Also in terms of the West Farm Food plants, I believe they also operate nonfat dry milk plants?

MR. TILLISON: Yes.

AGRICULTURE ECONOMIST GOSSARD: It would be particularly interesting to compare relative costs between making nonfat dry milk and skim whey powder in a comparable area. They may have different costs, labor, utilities costs. And that might be helpful if you can get that.

MR. TILLISON: I'm not sure if their nonfat powder facilities are located in the same towns per se. I know they have a facility in Idaho. But I will get that information.

AGRICULTURE ECONOMIST GOSSARD: On the top of page 5, you state, given the exhibits attached, "All these numbers confirm that 26.75 cent cost of manufacturing dry

whey is not even close to what cheese plants of the size, age, efficiency of those participating in the cheese manufacturing cost study would produced dry whey for if they produced that product." And you also cited that -- you figure out the min and max. -- theoretical min and max. It comes out to 15.5 and 47 -- well, actually 48 rounded.

Given the 48 might indicate an outlier, what if the Department just looks at three of the plants?

MR. TILLISON: Well, I think -- again, I think if you look at the philosophy behind our proposal, the philosophy is is that a make allowance should cover approximately 80 percent of the product that's being produced. However, I don't believe that 26 cents is a number that accurately reflects what modern whey drying operations operating at capacity are capable of producing dry whey for.

AGRICULTURE ECONOMIST GOSSARD: Then do you think we should look at the Cheddar cheese plants we have, how much whey they would produce for the amount of cheese they're producing, and compare that volume of product to the volumes for the nonfat dry milk plants to get a sense of what reasonable costs are?

MR. TILLISON: Well, that's obviously something that could be done. However, I think that when you look

at -- I think there are significant differences in drying whey than in producing WPC. Other witnesses have referred to the study done by Cornell University. I talked with Dr. Mark Stephenson at Cornell. The latest data that they had was -- and he gave me rough numbers. He said that to dry whey in 1990, the average cost was 9 cents, whereas the average cost of producing WPC was 21 cents.

Okay. So if you take that logic and apply it even to the 26.75 cents and look at the weighted average WPC price in the west, plants are clearing anywhere from 15 to 19 cents a pound on whey protein concentrate. But, again, the only reason that we didn't -- we didn't put in a proposal for whey protein concentrate was because we didn't have any cost data.

AGRICULTURE ECONOMIST GOSSARD: I'm sorry. I did not ask my question very well. I apologize.

MR. TILLISON: Maybe I didn't answer it very well.

AGRICULTURE ECONOMIST GOSSARD: No, you gave an excellent answer to what you probably thought you were doing.

Okay.

MR. TILLISON: I'm used to testifying before Congress.

AGRICULTURE ECONOMIST GOSSARD: We know the

volume of cheese produced by the cheese plants in the Cheddar study. Given that we currently assume that for every 10.2 pounds of Cheddar you get 5.8 pounds of skim whey powder. If we use that conversion and looked at how much skim whey powder our Cheddar plants would produce in terms of volume, could we then compare those numbers to the cost for the nonfat dry milk plants we have?

MR. TILLISON: Well, sure you could. I don't know if they would be good numbers or not. But if you assume, as Milk Producers Council testified to, that the difference between whey and nonfat dry milk is about 2 cents, well, I guess you could do that.

AGRICULTURE ECONOMIST GOSSARD: Finally, next to the last page on your testimony, just before your summary, you state the final reason not to remove the commodity support prices from the formulas. And then you state something. And I think what you're saying is the f.o.b. price adjusters to cheese and butter to some extent compensate processors for the additional selling costs to the CCC. Is that what you were implying there?

MR. TILLISON: Well, what I'm saying is that those costs are -- you know, whatever they receive for the product when they sell it to the government is factored in that number. So in other words, the possibility exists that they are in fact getting a lower -- they are

reporting a lower price than that. But, again, I think the bottom line is -- and this is what National Milk determined -- was if there's a problem with the cost of doing business with government, then change the cost of doing business with government. Don't expect dairy farmers to pick up the tab for that.

In addition, I think since the one theory that I have is that since the government went to a make allowance approach as California does, essentially when you sell cheese you get so many cents a pound over the CME price plus, one could argue, a make allowance. So, therefore, it doesn't matter what the CME price is. All it matters is you're getting 2 cents a pound over, plus credit for a make allowance. So there's less incentive to move product to the government because it does in fact cost somewhat more to move product to the government.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Mr. Tillison, you spend the first page and a half talking about the yield for cheese you feel is appropriate, 10.2. I understand that.

Do you have associated fat tests that you're dragging along with that 10.2? Are you looking to keep those the same as what they are now?

MR. TILLISON: Basically our proposal says instead of using 3.72, use 3.67 as the fat factor in the formula.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: And the solids not fat?

MR. TILLISON: Solids not fat would be increased to 8.93.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. Got it.

MR. TILLISON: In other words that's the milk that the Tong study says -- that the Cal Poly study rather says is going into cheese plants.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. On the cheese price adjuster you suggest that you've got a proposal that differs for the -- from the LOL proposal or from what's current. And yet I don't really understand what it is you're suggesting we use.

MR. TILLISON: Well, basically what I'm suggesting -- my understanding is that the current number is a simple average of monthly weighted averages. Okay? In other words, you take -- and you take the simple average price of the CME and subtract that from the weighted average price of the people who are actually selling product for. And then you take that number and

simply add it up and divide by 12 or by 24 or whatever the number is.

What I'm saying is, and I think the CDI testimony is applicable to cheese as well and, that is, is that weighted averages should be used across the board including not just the -- including the CME, including what people are selling for and including on an annual basis. If you've got 52 weeks of data, then the amount of cheese marketed in those 52 weeks should be divided into the dollars -- the total dollars received to come up with a weighted average difference.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: So do you suggest using a weekly rather than a monthly?

MR. TILLISON: Yes.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Is that in here?

MR. TILLISON: It's not in there. I'm simply saying -- you can either use a weekly weighted average or a monthly weighted average, but you need to use a weighted average, and all the way across the board.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: And you would like to see a weekly even though we don't do it right now that way?

MR. TILLISON: Well, what I say is that you

should collect the NASS numbers and use those as a method of determining the weighted average price difference.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. And I'm sure they'll be useful in the future. But for this hearing we still need to use something that we have, I think.

MR. TILLISON: Well, that's what I say in there, is use the NASS -- use the NASS -- use the NASS numbers reported.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. But we don't have those, right?

MR. TILLISON: You don't have -- well, you don't have them now, but you can certainly get them. We are talking about the formula in the future.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Right.

Okay. I'm just wondering about this particular hearing though. We don't have -- I mean I'm going to defer to Mr. Gossard on this. But I'm not sure we even have NASS numbers -- whether we can use them even if we wanted to.

MR. TILLISON: No, you'd have to start collecting the data a month in advance or so to be able to do this.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Right.

MR. TILLISON: And since all the plants in California that manufacture Cheddar cheese, butter and nonfat dry milk powder are required to submit that data, they got the data. It exists. And it would be relatively easy to get, I would imagine. Or you could walk across the hall and talk to the guys at NASS and see what they have.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. Are you going to submit this data into the hearing record so we can use it?

MR. TILLISON: If I can get it, I'll submit it.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: You're finally saying the words I want to hear.

(Laughter.)

MR. TILLISON: Now, should I write USDA and say that that data is requested on behalf of Dr. Eric Erba of the CDFA?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I don't think that's a good idea.

MR. TILLISON: Okay. I won't do it.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: In regard to the dry whey studies, we've heard quite a bit of testimony about the results of that study, and I think some people are surprised anyway. What

I'm wondering, based on the results of that study how do we set -- how does the state set a manufacturer cost allowance that we know is below any of the plants in our study?

MR. TILLISON: Well, first of all I think what you have to do is look at -- look at the weighted average dry whey prices that have been -- or the average dry whey prices that plants in the west have been paid for dry whey. And what you find is is that the 26 cents -- I think there was only one month in the last four years or something like that when those plants made money. So my question is: How can you set a make allowance that basically is going to far exceed what these people receive for the product? Essentially by doing that what you're doing is encouraging them to continue to produce a product for which the market will not support the cost of manufacturing. However, the cost of manufacturing in the study, in our opinion, does not accurately reflect what an average -- what a plant the size that's in the study -- in our cheese cost study would be able to dry whey for. The numbers just don't -- they just don't add up. No where else can you find numbers that even approach that level, whether you look at the 2000 hearing, whether you look at the data that's provided by the West Farm Foods. The numbers aren't real.

They may be real for those facilities that run part-time or whatever the situation is. But that would -- it would be a travesty to use a make allowance anywhere near that level in the formula.

AGRICULTURE ECONOMIST GOSSARD: Eric, I've got a follow-up --

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Yeah, go ahead.

AGRICULTURE ECONOMIST GOSSARD: In the analysis the Department distributed at the pre-hearing workshop, which is 6a in the hearing record, we have a Table 3 that shows various percents of volume of approximately what price -- or what make allowance would cover that volume. And the skim whey powder we have 9.3 cents for 20 percent and 23.0 cents at 40 percent.

Now, you definitely described the weighted average of 26.75 as not being reasonable. Is the 19.3 or the 23.0 reasonable or unreasonable?

MR. TILLISON: Well, as I said, I don't believe that the numbers are reasonable, period. Okay? What I'm saying is that what I've been told by the Department is is that the current 17 cent make allowance will not cover any of the plants in the study. Okay? We've got data that shows that there are plants outside of California that have and can produce whey at close to that level.

Number 2 is is that when I asked for what price -- what make allowance would cover 80 percent of the dry whey produced, I was told it was like 25.95 cents. I don't -- you know, what we're basically saying is that a make allowance should cover around 80 percent of the product. And I have full faith in the Department's cost studies for cheese, for butter and for nonfat dry milk powder. I think that the whey make allowance numbers don't add up.

AGRICULTURE ECONOMIST GOSSARD: Including the 19.3 and the 23.0 in the exhibit?

MR. TILLISON: What level does that cover?

AGRICULTURE ECONOMIST GOSSARD: Twenty percent, forty percent.

MR. TILLISON: So you'll set a make allowance that would only cover 20 percent of the production of a product?

AGRICULTURE ECONOMIST GOSSARD: Well, as I asked --

MR. TILLISON: -- consider only 15 percent of the whey produced in this state is converted into dry whey?

AGRICULTURE ECONOMIST GOSSARD: As I asked LOL, given there are only four plants in the study, an outlier will skew things like 80 percent coverage, a weighted average cost.

MR. TILLISON: Okay. But what you told me is what, 23 cents covers how much, 40 percent?

AGRICULTURE ECONOMIST GOSSARD: Forty percent of the four plants.

MR. TILLISON: Sounds like there's a lot of outliers in there.

HEARING OFFICER ESTES: I'm a little confused here.

AGRICULTURE ECONOMIST GOSSARD: Back to you, Eric.

HEARING OFFICER ESTES: Who's the witness and who's the questioner here?

MR. TILLISON: We're having a conversation.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: One last question, Mr. Tillison.

On unnumbered page 5 of your testimony you state that when dry whey prices fall below the cost production, plants have the option of selling their cheese whey to WPC operations, offering liquid whey to others as a feed supplement, et cetera.

Are plants making any money when they do something like that?

MR. TILLISON: Well, it's not a question of -- maybe it's not a question of making money. It's a question of reducing your losses. And my experience in

Wisconsin was is that there was a lot of demand for whey. Now, for some plants it might cost them a nickel to have a WPC plant take that whey. But certainly paying a nickel is better than losing 10, 11 or 12 cents a pound on processing dry whey.

And I guess the question is: Are they really losing it if you've got a whey make allowance factor in the cheese formula?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. Thank you.

DAIRY MARKETING BRANCH CHIEF IKARI: I just have one question on Tom's question to you and your response. I just wanted to make sure.

On page 4 you talk about the Federal Order hearing in May 2000, that you were going to look at the -- my understanding is you're going to try and include that in your post-hearing brief, the data?

MR. TILLISON: Yes.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

AGRICULTURE ECONOMIST GOSSARD: Mr. Tillison, did you request a post-hearing brief?

MR. TILLISON: My understanding was that if you testified directly you would be allowed to have a post-hearing brief. However, I would like to request a post-hearing brief.

(Laughter.)

MR. TILLISON: Thank you, Dr. Gossard.

HEARING OFFICER ESTES: Yes, that request is granted.

Also, it might be a good time to just note again that those briefs need to be filed by the close of business on Tuesday, February 8th. I like to get that on the record just because I don't want to create the prospect of someone saying they didn't stay around long enough to hear when it was required and then subsequently object.

So it's due by the end of the close of business Tuesday, February 8th, by 4:30 p.m., delivered to the Department's Dairy Marketing Branch located at 560 J Street, Suite 150, Sacramento, California 95814, or faxed at 916-341-6697.

And do we have any additional questions?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I've got one more question.

Back to your NASS numbers. Should you be unable to come up with those NASS numbers to submit into the hearing record, or should we determine that we cannot use those because they're not entered into the record, is there a price adjuster that's been spoken to that you could support as the Alliance?

MR. TILLISON: Well, basically we propose a price adjuster of 2.34 cents.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: That's for cheese?

MR. TILLISON: Yes.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: And for butter?

MR. TILLISON: For butter, it's 3.15, I think. And that's -- basically we've got that information -- I don't know what the Department's table is. But on the CDI proposal their Table D I think had from 2002 through October of 2004. And I took a -- I calculated a weighted average all the way through to come up with that number.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Thank you.

MR. TILLISON: Okay. Is that it?

HEARING OFFICER ESTES: Apparently so. Thank you for your appearance today.

DAIRY MARKETING BRANCH CHIEF IKARI: You can take the cup with you.

MR. TILLISON: Can I take the water?

HEARING OFFICER ESTES: Our last alternative petition today is from the Dairy Institute of California.

(Thereupon Dr. William Schiek was sworn, by the Hearing Officer, to tell the truth and

nothing but the truth.)

DR. SCHIEK: I do.

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

DR. SCHIEK: Yes, it's William Schiek. That's S-c-h-i-e-k.

HEARING OFFICER ESTES: And does your written testimony set forth the process by which your testimony has been developed and approved?

DR. SCHIEK: Yes, it does.

HEARING OFFICER ESTES: All right then. Do you want your written testimony introduced in the record as an exhibit?

DR. SCHIEK: I do.

HEARING OFFICER ESTES: It shall be introduced as Exhibit No. 49.

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

HEARING OFFICER ESTES: And proceed with your testimony.

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

Dairy Institute is a trade association

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

Dairy Institute is grateful for the opportunity to testify at this hearing. We note that the price volatility experienced in the past few years has been difficult for producers and processors alike. As difficult as this price swings have been, they provide critical economic signals to both producers and processors.

In the past, periods of high prices, which develop when milk supplies are short, have been followed by periods of low prices, which evolve after milk producers have increased output and inventory levels have recovered. These periods of low prices are transitory and serve as a braking mechanism to slow the growth in milk production brought on by higher milk prices. After milk production and Dairy product consumption return to the their normal trends, milk prices return to more moderate levels.

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

In a market-oriented industry prices provide the key signals that both encourage production and ration consumption when prices are high and curtail production and stimulate consumption when prices are low. Unfortunately, some aspects of the hearing decision rendered in March 2003 by the previous administration attempted to address low market prices by adopting policies that distort market signals and put an unnecessarily high regulatory burden on California dairy product manufactures. It is crucial that market-oriented policy be reinstated.

Dairy Institute believes that minimum milk price regulations are the most powerful policy tools that the California Department of Food and Agriculture currently possesses. The secretary can dramatically impact the marketing opportunities of the leading agricultural commodity of this state with a single hearing decision.

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

When regulated prices are set too high, the result is artificially stimulated milk production, which reduces, perhaps permanently, dairy product consumption. The potential then exists for real mailbox prices to fall below regulated minimum prices, undercutting the milk order price structure. If regulated milk prices are set too low to bring forth a sufficient supply of milk, market forces will quickly signal this to the industry through such market-oriented changes as higher commodity prices and the development of incentive payments from processors to producers. Thus, milk prices in fact do respond to supply and demand forces.

Some of the proposals offered today would increase Class 4b prices, one quite dramatically. We recognize the Department needs to take into consideration a number of economic factors involved in the marketing of milk, including milk production costs of milk producers.

However, we believe that the priority of the Department must be to establish policies which maintain and build market outlets for the growing supply of raw milk in California.

Higher regulated prices will not result in long-term revenue gains for producers if the price paid to achieve these gains is an uncompetitive dairy possessing and manufacturing sector. Such changes lead to disinvestment in manufacturing and a loss of markets for California producers. California has become a significant net exporter of milk products. And we must continue to be competitive, not only in our own state, but in transporting products and competing in other areas of the country and other nations as well.

Dairy Institute believes that minimum milk prices should not be increased artificially officially by government agencies setting prices based on short-term spikes in milk production costs or the unavoidable, albeit painful, ongoing social and economic restructuring of the farm milk production sector. A market-oriented policy must be maintained.

California milk production growth has been averaging 4.4 percent per year over the last 15 years. In 2003 and 2004 preliminary estimates put the state's milk output growth at 1 percent and 2.9 percent respectively.

This slower rate of growth appears to have been the latest in a series of periodic pauses from the long-term milk output growth rate that have been seen since the 1970's, rather than the establishment of a new significantly slower growth trend. Factors such as high feed costs, of the low 2002-2003 milk prices, poor weather, limited availability of replacements, and rationing of rbST have lowered milk output per cow during the past couple of years and caused a modest slowing of the dairy herd growth. However, in the second half of 2004, California milk output growth has resumed its robust pace, with monthly milk output increasing an average of 4.6 percent over the previous year's production.

Putting these growth trend numbers into some perspective the state must have enough plant capacity to take an additional 4.3 million pounds of milk per day per year. This capacity need is equivalent to the addition of one new large cheese plant per year. The conclusion is obvious: The state must have manufacturing outlets for this milk production growth, or California milk will have to travel outside the state to find a home. In order to attract manufacturing capacity and investment, raw milk costs must be set at a level that will allow California plants to compete, especially given the state's higher plant costs in other areas such as energy and labor.

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

In the past few years some California milk processing and dairy manufacturing plants have closed, while others have made decisions to build plants elsewhere, bypassing California as a location, and still others that had seriously considered building in California have elected to build elsewhere or not to build at all. And I refer you to a table on Exhibit A, end of the document, that lists plants in each of those categories for the cheese industry.

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

better policy for the state than encouraging greater capacity in butter/powder operations.

Incentives to build new cheese plants in California appear to have diminished in recent years. The decisions to build the newest cheese plants, that we were talking about earlier -- I think Mr. Cotta referred to them -- were made no later than 1999 -- 1998, 1999. Since that time there have been no commitments to build new cheese plants. While a variety reasons may be at work, we cannot help but notice how differences between California and Federal Order prices have changed. During the 1994 to '98 period the California price averaged 65 cents per hundredweight below the federal Class III price. In the 1999-2003 period the California price averaged only 25 cents her hundredweight below the Class III price. The narrowing difference in regulated price levels, coupled with the ability of plants to depool under federal regulation, makes California a less attractive location for cheese plant investment.

General Pricing Policy Principles:

In general, Dairy Institute's proposals are consistent with our long-established policies on 4a and 4b pricing formulas. We propose the use of a consistent set of parameters for determining product prices, yields and make allowances between Class 4a and 4b prices.

Consistent application of these principles to both the 4a and 4b formulas should help avoid an economic tilt that would favor one complex over the other. However, if a tilt is made, it should be in favor of the cheese industry over butter/powder because of the greater long-run growth in the cheese market and because California is already over-represented in the production of butter and nonfat dry milk.

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

a) The proposal should contain a consistent application of principles for both Class 4a and 4b.

b) Product value should reflect the prices received by California manufacturers for their products. Butter and cheese values should be based on CME prices adjusted to reflect prices actually received by California processors.

c) Manufacturing cost allowances should be set on a consistent basis for butter, powder and Cheddar cheese based on the most recent CDFA cost studies, updated with the most recent factor cost information available, so that the make allowance used reflects current cost conditions as closely as possible. The Department should endeavor to include all California processing plants producing the commodities used in developing the Class 4a

and 4b prices when developing its cost data to the extent possible. The product volume covered by the make allowance, including return on investment, should be as consistent as possible across butter, powder and cheese in the 4a and 4b formulas, with a tilt toward more commercially viable cheese as opposed to butter and powder, if any tilt is made. Make allowances should be high enough to maintain and enable processing capacity that is adequate for the growing milk supply.

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

e) The competitive positions of Class 2 and 3 manufacturers relative to those in nearby states must be taken into account when considering changes to the pricing formulas.

Dairy Institute's proposals are contained in the following paragraphs. We have specified proposals for the

formulas for Class 4a and 4b. We do not have any specific proposals for Class 2 and 3, but recognize that their price levels will be affected by changes in the Class 4a formulas. And our proposed formula is listed there. You've seen the alternative proposal. So it's identical.

Elimination of the Support Price Floor:

The panel will note that our proposed formula eliminates the CCC commodity price floor, or snubber, on the product values used in Class 4a and 4b formulas. We feel the elimination of the price support floor is essential for the following reasons:

1) It creates a disincentive to purchase milk when the market supplies of milk are abundant. During periods when milk is abundant and commodity prices fall below the CCC purchase prices, the floor could result in California milk being left unpurchased as plants forego taking in discretional milk supplies to avoid making products that they will have to sell at a loss.

Commodity prices will sometimes fall below CCC purchase prices because plants would rather sell at a lower price on the open market than sell to the government due to both the higher costs of dealing with CCC and a higher risk of product being rejected.

The high costs associated with selling to the CCC are caused by:

a) The government's lack of timeliness in paying for product purchased. Government sales sometimes don't receive payment for 120 days or longer. Commercial sales payment terms are usually much shorter.

b) The high chance of product being rejected by government inspectors because of differences between government and commercial product standards. Also the chance of rejection is greater due to inexperienced government product graders. Once product is rejected by the CCC, it cannot easily be sold at full value in the commercial market and often must be discounted.

c) Higher cost of packaging for government sales.

d) Low numbers of government graders due to the occasional nature of CCC cheese purchases and the considerable time lag to get product approved, which increases the cost of the sale.

e) Total cost of doing business with the government due to reasons a) through d) above have been estimated by the National Milk Producers Federation at 1.5 cents per pound for butter, 2.25 cents per pound for nonfat dry milk, and 5.6 cents per pound for Cheddar blocks. And you can refer to Attachment 1, which is some material from National Milk on this issue.

Now, National Milk Producers Federation is a

producer organization that has recognized the valid reasons why commodity prices sometimes fall below support. We refer the panel to Attachment 1 for a more detailed and complete discussion of these issues. Moreover, we point out that estimates on costs for barrel cheese, which were not included with the results of the National Milk survey, are generally higher than the cost estimates for blocks.

2) The support price problem, defined as market prices falling below CCC purchase prices, is a --

HEARING OFFICER ESTES: Dr. Schiek, Can I just interrupt you for a brief moment.

You have half an hour for your presentation. And I notice your testimony is about 13 pages in length and you've gone through about 5 of those pages. So I just want to make you aware of the time restricture you're addressing.

DR. SCHIEK: Okay. The support price problem, defined as market prices falling below CCC purchase prices, is a national one because the support price program is a national program. It is poor public policy to put the burden of dealing with a problem created by a national program solely on the backs of California's processors

3) A problem with a national program should be fix at the federal level, not the state level. In fact,

California's current policy has created a disincentive for California processors to embrace at least one potential solution to the problem of market prices falling below intervention levels. One national producer group proposed that increasing the CCC purchase prices to account for the higher costs of doing business with the government would be a way to make the 9.90 per hundredweight support price effective. Again, I refer to attachment 1. This proposal had to be rejected by California manufactures out of hand because raising the CCC purchase price would raise their raw product costs without the guarantee of commodity market prices responding. That's because of the support floor in California. Given California policy, the proposed solution to the problem would have increased the burden on California processors rather than lessening it.

4) When commodity prices fall below CCC purchase prices, it's usually the case that prices are low due to excess in milk supplies. The flooring of the formula product value at CCC prices creates a disincentive for plants to procure extra milk at a time when milk is looking for a home. A strong likelihood in these situations is that milk will become distressed and travel out of state at a heavy discount to be processed.

There is a common misconception that the use of a support floor prevents the Cheddar market from going below

the support floor price. Many point to the market rising from 1.09 at the end of March 2003 to above the support price by the end of April 2003. And they correlate the support price with pushing the market price up. That is the floor here in California. This is a spurious correlation. Market prices increased in April 2003 due to a tightening of supply side market conditions. Numerous factors would prove this is the case.

And the next paragraphs address feed prices that were rising over that time, cost margins getting squeezed for producers, milk cow numbers going down because cows were being culled because the margins were tightening, inventory levels for cheese falling. And production eventually having hummed along at 2.5 percent per year in 2002 on a monthly basis year over year coming to a virtual standstill in April 2003.

So all those issues are supply side factors.

So these year-over-year changes, as I said.

Ultimately, poor farm level economics resulted in less milk produced in April 2003. Less milk was then made into fewer dairy products, tightening the cheese supply available to the industry. This tightening of supplies, and not the implementation of the support floor snubber in Class 4a and 4b formulas, led to the increase in the Cheddar market prices experienced in April 2003. The CCC

price floor snubbers are bad policy and they should be eliminated from the 4a and 4b formulas.

Calculation of the f.o.b. Price Adjuster:

We proposed that the California cheese price should be represented by the CME Cheddar block price less a .0287 f.o.b. adjustment. Note that the adjustment is equal to the average monthly difference between California weighted average cheese price and the CME price for 40-pound Cheddar blocks during January 2001 through October 2004 period. We observed that there were inconsistencies on a month-to-month basis in relationship between CME and California prices, with the difference being higher in some months and lower in others. Therefore, it's important to include a longer range of data to smooth out those differences.

Month-to-month differences in the relationship between the California price and the CME price for Cheddar can be explained by the price movement at the CME and the lagged response in the California weighted average price to these movements. The lagged response is caused by the same factors that make NASS prices lag CME prices. Many plants price product to some of their regular customers on a day-of-make basis. That is, the price the customer pays for the cheese is based on the CME price the day the cheese is made. However, the product sale is not

necessarily recorded the day the product is made, but rather when the product is delivered to the customer, which might be two to three weeks later. Thus, the California cheese price data for today often reflects the CME market for the previous two to three weeks. When the market price at the CME is especially volatile, the difference between the monthly average of the CME price and the California price can move erratically from one month to the next.

Unfortunately, pricing and delivery arrangements vary greatly among customers. So attempting to specify a lag structure in a relationship between the CME and the California prices is fraught with problems, particularly when using monthly data. If one attempts to specify the California price as a function of current and lagged CME prices, specification bias is a likely result, especially if there's no underlying structural basis for the lag structure imposed. The estimator produced might have a smaller variance than some other method. But if the estimator is biased, then the wrong relationship is being predicted.

For the above reasons, the best approach in estimating the relationship between monthly CME prices and monthly California prices is to take a simple average of the monthly differences between the two prices. Such an

average would be unbiased, because you are using the actual observations of the relationship you are trying to estimate and weighting all such observations the same. Using a weighted average would introduce bias into the estimator if there's no -- because there is no theoretical reason why one-month's observation on the price difference should be more heavily weighted than another. The reason we supported using all of the data available in 2001 through 2004 period is because application of the Central Limit Theorem suggests that the larger the sample size, the more normal the sampling distribution of the estimated mean. Essentially, the larger sample size leads to a better estimator of the true underlying relationship between the CME and the California price.

Manufacturing Allowances for Cheese and Whey:

We have proposed a manufacturing allowance for cheese of 1734 per pound, which is equal to the most recent weighted average manufacturing cost for Cheddar blocks as released by the Department. The whey cream portion is increased to 1321 per pound, which is the Department's weighted average manufacturing cost for butter.

There have been some questions raised about the appropriateness of the Department's inclusion of direct and indirect costs associated with lost solids in the

weighted average cheese cost. We believe the Department's treatment of these allocations is appropriate. Cheese manufacturing is the primary enterprise, and whey processing is often viewed by plants as a cost center rather than a profit center. The whey operation is undertaken primarily out of necessity, because whey solids cannot be disposed of in other ways. While some plants do make money processing and selling whey products, the whey solids that are not recovered are appropriately allocated back to the cheese operation because cheese is the primary product.

Our proposed whey manufacturing cost is equal to the Department's weighted average manufacturing cost from its study of dry whey costs. There have been numerous discussions as to whether this weighted average accurately reflects the cost of drying whey in California. Specific concerns related to high costs in one of the survey plants that may have been caused by low volumes associated with start up. While there may be some validity to these concerns, only CDFA staff has access to the individual plant data and, therefore, only they are able to judge what adjustments should be made to the dry whey make allowance based on the data. However, one thing is certain: All four study plants had whey drying costs greater than the current make allowance of 17 cents per

pound. Therefore, an upward adjustment to the whey make allowance is surely warranted.

Some have questioned the appropriateness of using whey drying costs from non-Cheddar plants in setting the manufacturing allowance for dry whey. While there are some differences in the whey stream of Cheddar and Italian cheese making, the difference in costs that arise are not excessive and are quantifiable. Other Dairy Institute members will be offering testimony on this issue, and we encourage the panel to question them for the record. We maintain that the whey costs derived from the plants in the survey are appropriate for use in setting dry whey make allowances in the 4b formula. At the pre-hearing workshop, CDFA staff noted that cheese manufacturing costs in the whey survey plants were in excess of 23 cents per pound, making these plants appear inefficient when compared to the Cheddar study average of 1734 per pound. However, these plants were not all Cheddar plants, and the cheeses they make use different processes or packaging, so their costs cannot easily be compared to Cheddar costs as a gauge of the plant's efficiency.

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

the 4b price. This proposal is without economic justification and, therefore, without merit. It represents an attempt by producer leadership to have their cake and eat it too. They are basically making the claim that they should share in the revenue generated by whey when it is profitable, but when whey is a net cost of the cheese operation, all cost should be borne by the manufacturers.

This proposed arrangement violates the main principles of end-product pricing. The proposed snubber would clearly violate these tenets and over-value producer milk. It would be just as valid to devise a snubber where producers share in the costs of drying whey when it cannot be sold at a profit, but get none of the whey revenue when prices move above the make allowance. We doubt that producers would favor this type of snubber, but it would be just as valid economically as the snubber that they propose, which is to say, not valid at all.

We should point out that producers wanted a whey factor in the formula because they were certain that it would enhance their revenue. The record will show that Dairy Institute opposed the inclusion of dry whey, arguing that the old formula did not shortchange producers by its failure to explicitly incorporate non-cream whey. We have argued in the past that there are several reasons that

non-cream whey value should not be incorporated into the 4b formula, and we reiterate some of those there.

There's no inherent raw whey value. Hence, this lack of underlying raw whey value is evidence that non-cream whey processing is undertaken primarily as a cost minimization strategy rather than a profit generating opportunity.

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

Despite these policy difficulties, we now have a dry whey factor in the formula, and producer representatives feel that whey should only have a positive impact on the 4b price. Unfortunately, the reality that whey processing is not always profitable for every plant cannot be ignored. Our view is that now that dry whey is in the formula, the impact on the 4b price must be reflective of what plants receive for dry whey less what it costs to process dry whey. To do otherwise violates the basic economic principles underlying all of our formulas.

On cheese yield we proposed a Cheddar cheese

yield of 10.05 pounds per hundredweight of milk. The cheese yield used in pricing raw milk must be representative of what can be obtained from a typical milk in California. Thus, the yield should not be derived from fortified vats, which evidence a yield that can be achieved only with fortification ingredients that have a different composition from typical milk. Using fortified vat yields transfers to cheese-making value of the fortification ingredients and assumes that value is contained in typical milk. This is an erroneous assumption.

It is also important that the yield used in the pricing formula is not derived from milk that has been incentivized through the use of premiums to achieve higher protein and casein tests. Using such milk in the formula yield calculations would essentially require processors to pay twice for the components that are of value in their manufactured operations.

To obtain a cheese yield from typical milk, which is ultimately what is being priced, it is appropriate to use the Van Slyke Cheddar cheese yield formula. The Van Slyke formula is a widely recognized predictor of the amount of cheese yielding from a given quantity of milk of known component test. And it's listed there, and the panel's seen it before.

Since the number of pounds of casein in producer milk is generally not tested directly, an assumption is often used regarding the percentage of protein that is casein multiplied by pounds of protein -- or the percentage of SNF that is casein multiplied by the pounds of SNF. To calculate the yield from typical California milk we use the Van Slyke formula with the following assumptions:

Milk was assumed to have 2003 statewide average test of 3.67 percent fat, 8.75 percent solids not fat, a fat retention of 91 percent, casein to SNF ratio of .2832, and a finished moisture of 37.98, which is the Cheddar block moisture average from the most recent survey. When these numbers are plugged into the Van Slyke formula, the resulting yield is 10.05 pounds of cheese.

The milk composition I said was average producer milk for 2003. And the .2832 number came from the Phil Tong study, and that analysis of how that was derived is contained in Attachment 2.

Okay. I also note that we do not take into account farm plant losses and losses in the plant of components, which do happen, and lower cheese yield. And for that reason we think the fact that we've used the 91 percent fat retention factor is appropriate, because we're not explicitly accounting for those losses.

On Class 4a, again there's our proposal. We're using the weighted average manufacturing costs for butter and nonfat dry milk. We're keeping the yields the same. The f.o.b. adjuster is the January 2001 to September 2004, a simple average of the difference between the CME price and the weighted average California price. And, again, the rationale on that is the same as we talked about for Cheddar.

I think I've run out of time. But I'll just say, with regard to the other proposals, basically where they don't agree with us, we obviously oppose them.

The Alliance proposal I will just point out would shift the value from SNF -- value in cheese from SNF to fat, just because of the way the yield in tests is structured in their formula. And that would have the real effect of creating an impact on producers that make higher fat milk. Maybe Jersey producers that would pool more of the revenue that would go to them and distribute it to other producers; essentially taking money from producers who incur a higher cost to make a differentiated product and giving that money to the whole pool. Whereas those producers have incurred a higher cost because the cost of Jersey milk production, as noted by Department cost studies, is higher than for average milk. So we think it should be rejected on that basis.

And of the other proposals, like I said, they tend to snub the whey price, and we obvious oppose that for all the reasons we stated earlier.

So that's pretty much what I have. Thank you for the opportunity to testify. And I'm willing to answer any questions that you might have at this time. And I also ask for a post-hearing brief filing period.

HEARING OFFICER ESTES: All right The request is granted.

And the panel can now proceed with questions.

SUPERVISING AUDITOR HUNTER: I just have one question for you, Bill.

On page 4, when you say -- towards the bottom -- towards the bottom middle -- "Fortification should not be considered in determining product yields and fortification-related costs should be deleted from make allowances," are you saying there that all the fortification costs should not be considered in the cost studies?

DR. SCHIEK: No, I think what I'm talking about there is the cost of premiums fortifying that milk.

SUPERVISING AUDITOR HUNTER: What about things like if they're fortifying with condensed skim or nonfat powder or condensed whole milk? That is included in the cost studies.

DR. SCHIEK: Okay. Those are included in the cost study.

SUPERVISING AUDITOR HUNTER: Not the raw product cost of them, but the actual processing charges.

DR. SCHIEK: Yeah, if -- I think what I'm referring to there is that if you're going to -- we want to make sure we're getting -- and that's in the paragraph where we're talking about incentivizing milk supply. So what I'm really talking about there I think, Ed, is that -- and I think in the past there's been this discussion and debate whether we -- if we took protein premium numbers, we should put them in the make allowance or in the manufacturing costs or not. And my sense is, and what I'm trying to say here is that we should go with producer milk with average composition in terms of the yield, and that those protein premiums shouldn't be included.

Again, if you're going to talk about vat yields, then all costs -- if that's where you're going to start is with vat yields, then all costs ought to be in there, including protein premiums. But if you're going to do producer milk, then don't include the protein premiums. And I would say then it would be consistent -- I have to think about that a little bit more, but it might be consistent then not to include fortification costs as

well. But I'll --

SUPERVISING AUDITOR HUNTER: -- think about that.

DR. SCHIEK: -- think about that and address that in a brief.

SUPERVISING AUDITOR HUNTER: Okay, bill. Thanks.

AGRICULTURE ECONOMIST GOSSARD: Dr. Schiek, starting on page 3 at your testimony, close to the bottom. You mentioned that '94 to '98 California 4b averaged 65 cents less than Federal III, while it only -- it averaged only 25 cents less in 1999 to 2003. I have to two questions there.

One, if your members were happy at 65 cents, why were you proposing a dollar two, which would have been the five-year average for the difference under your proposal?

DR. SCHIEK: Yeah. Let me talk about two issues there. Because when you're addressing milk product pricing, there are really a couple of conditions you need to look at. The first one I'll call the necessary condition -- minimum necessary condition for regulated minimum pricing.

There has to be adequate margin between the price paid for milk and the price received for the product, so that plants can operate profitably. That's a necessary condition. If you don't have that, plants are going to go out of business. Okay, so that's number one.

And I think if you look at our proposal, the numbers are based on costs of processing products in California, prices received by California plants for product. So we're basically using the cost numbers, and not looking at some price difference wedge between the Class III price and the California price that we're trying to achieve and come up with numbers to get that price. We're taking the numbers and letting it fall where they may. I think a lot of our members when we put this proposal together looked at that difference and they went, "Whoa!" But the reality is we're working with the numbers that came out of the Department cost studies, which are the best numbers we have to represent the costs of processing products in California.

These numbers that were presented by the Alliance and Western United and MPC talk about the cost of drying whey in Washington State are interesting. But they are in Washington State; they're not operating plants in California. And to my mind, you know, they're not that relevant.

We're talking about valuing milk in California, and it has to be based on what it costs to process in California.

And so that's the first issue, is that margin has to be based on what do we receive for the commodity

prices, what does it cost to process it, so that we have an appropriate margin to work with to keep plants operating profitably.

Then after you look at that, you have to address the competitive situation. I might be able to conclude from that first analysis that I have a margin that's sufficient to operate in and that gives me a profitable rate of return, at least in the short run as I look at commodity prices today and I look at my costs. But if I find out that a competitor is operating in another area and my margin's here but their margin's here, then I've got a problem, because they're going to use that margin against me in the marketplace. So that's the sufficient condition, I guess, on whether the policy is good in terms of encouraging plants to stay in the state. Has to be.

The necessary conditions of meeting the margin as we normally define it in end-product pricing, and then it has to be a competitive price as well.

So I'm not looking to achieve a certain price difference between California and federal orders. I only put that in as an indicator that the competitive relationship has likely changed, and that that is likely a factor as to why you don't see plants rushing in to build cheese plants in California today versus five years ago when the last decisions to build plants were made.

AGRICULTURE ECONOMIST GOSSARD: Now, I'll follow up on your answer. Then I'll get to my second question.

If a competitor depools, has a better margin, drops his prices to be more competitive, won't that go through the NASS prices, begin to affect the CME? Won't that work its way back into the marketplace -- and reflect in the marketplace?

DR. SCHIEK: If a competitor depools and they --

AGRICULTURE ECONOMIST GOSSARD: If they discount more off the CME, won't that show up in NASS and affect the CME?

DR. SCHIEK: Assuming they're part of the NASS survey, it will show up in the NASS price. But they're one plant. And so it's going to be diluted by all the other plants in the survey. So it's not a one-for-one impact. But even though they're one plant, the business they may be taking away may be a California plant's business. And the impact then on the state's industry may be not diluted through the ultimate national scene in the way of price impact on a NASS survey, if that makes sense.

AGRICULTURE ECONOMIST GOSSARD: Yes.

My second question. On page 3 you compared the '94-'98 period to the '99-2003 period. Since Federal Order reform became effective in January of 2000, isn't part of that difference perhaps changes in federal pricing

rather than anything else?

DR. SCHIEK: It's possible. It's possible. I mean the reason that breakpoint was chosen, as I said earlier, I'm looking at when the decision to make the build -- you know, the last two major plants where the decision was made to build new cheese plants in California, that's when the decision was made. Obviously it didn't come on line till quite a bit later. But the decision to locate to California was made at that point. So I'm saying look over the last five years. At that point what did the competitive situation look like in terms of comparing California 4b and Class III prices? And then looking at the next five year period, how did it change?

AGRICULTURE ECONOMIST GOSSARD: Now, I want to address a couple questions on page 8.

First, at the top you ask that we use the longest period possible in establishing f.o.b. price adjusters. I think it's in the central limits there. We've also heard other witnesses testify that we should use multiples of 12 months -- 12, 24, 36 and 48. I think your time period might be 46 months.

DR. SCHIEK: Yeah. It's different for cheese than it is for butter because there was a one-month difference. But, you know, that was an interesting

argument. And I'll be honest with you, I'm not sure I fully grasp the arguments for doing it in 12-month periods. You know, I know that the guys from CDI understand the butter market a heck of a lot better than I do, and so they may be aware of things that go on at that time of year in the butter market.

But my point here is that there are a lot of differences on a month-to-month basis, and you see them in the data. If you take the CME price and you subtract the California weighted average price, some months, you know, maybe it will be a difference of 4 cents negative and then in the next month it will be 8 cents positive, the next month it will be 12 cents negative or something like that.

And the point is that there's -- a lot of those wide differences are due to this lag pricing structure. If you've got the CME price ramping up but the California weighted average price is kind of lagging behind that, you get these disconnects or these periods where the two seem to be quite far apart. But really it's a leader-follower kind of thing. We've noticed this before when comparing Class 2 prices in California to federal Class 2 prices. Because of the lag structure in our formula, we tend to follow-up when prices are moving. And you can see some big month-to-month differences. But if you average the thing out over a long enough period of time, you'd

probably notice that, you know, a lot of that's just created by the movement in the market, and that the long-run difference is narrower. And so that's really what we're trying to look at here, is by including more data, we're going to get a better picture. And the estimate, which is the mean that we're calculating, is more likely to be more true to the actual difference between those two price series.

AGRICULTURE ECONOMIST GOSSARD: Now, on the center of page 8 you get to your proposal on manufacturing costs allowance for whey.

Two things: After the pre-hearing workshop when the Department had released its Analysis Table 3, which gave a little more detail about the skim whey powder, about volumes and numbers, did the Dairy Institute give any consideration to modifying its proposal based on those numbers, the 19.3 cents covering 20 percent of the volume or 23.0 covering 40 percent, given that you can have outliers with four plants?

DR. SCHIEK: No, we didn't. And I'll tell you why. We basically aren't in as good a position as you are to judge which of those numbers are valid and which aren't. I mean our point is, if there are problems with one plant where costs are extraordinary for some transitory reason, like a start-up operation, we kind of

expect you, maybe fairly or unfairly, to exercise some judgment of Solomon there to make a decision to either include or not include that plant or to adjust the weighted average make allowance or adjust the average in some way to be more reflective.

Obviously, I think if you just pick the lowest plant, I don't think our members would agree that that would be an appropriate way to go.

Clearly all the plants are above 17 cents, which to me represents something. I think you'll be hearing from some other members of the Institute to talk a little bit about this charge that these are inefficient plants.

But there's another possibility here as to why costs are higher in California. And that's, one, I think there's a sensitivity to the costs of drying whey to energy prices. And, as we know because of the recall election last year, California has a host of higher business costs in a number of areas. And that was really a subject of the recall election, that businesses were having a hard time because of higher costs in workers' comp, higher tax burdens, higher energy costs and the energy crisis. So all those things factor in.

And so, you know, basically we proposed the weighted average manufacturing costs. But we recognize that if there are problems with the data of one of the

plants, that some adjustments need to be made. And we trust you to exercise judgment to do that.

AGRICULTURE ECONOMIST GOSSARD: You mentioned that one of the considerations of skim whey powder -- your answer is energy costs. Those are the same considerations for nonfat dry milk because it's another energy intensive. So both -- in California, both skim whey powder and nonfat dry milk face potentially higher costs?

DR. SCHIEK: Um-hmm. I just -- you know this, but the whey product though obviously is a more dilute product. And I'm not sure we have -- we'll probably have some technical experts talking about this, but I'm not sure the -- you know, for example, there's been a lot reference to the study -- the NCI study that was done and the incremental costs above powder. And that powder I think they were talking about 14 cent and 15.9 was whey. A couple of points on that -- that number.

One, 1999 energy costs were a heck of a lot different than they are today.

Two, when you -- you can't just sort of say, okay, now it costs 18 cents -- 16 cents, to pick a number -- 16 cents to dry nonfat dry milk. So we just add the 1.9 on top of that. That 1.9 is not an invariant number. And I think that incremental cost is sensitive to the changing energy costs as well. That's the only point

I would make.

AGRICULTURE ECONOMIST GOSSARD: The make allowance of skim whey powder -- as mentioned early, any make allowance of skim whey powder above about 20 cents would over the last five years have on average decreased the 4b price. If the Department based on it's considerations and the various studies and the testimony received today establishes a make allowance for skim whey powder or is considering establishing one that's above 20 cents, is there any validity in keeping the skim whey factor in the pricing formula?

DR. SCHIEK: The hearing record from 2003 in terms of Dairy Institute's position was pretty clear. We opposed including a whey factor -- a dry whey factor or a non-cream whey factor in the formula. And our rationale is basically borne out by the problems that are being brought up for discussion at this hearing, that it's really a difficult task when you have products that vary virtually plant to plant, that have different price series associated with them, different cost structures. No two plants are the same really when you start talking about these larger plants.

Yes, a lot of plants make WPC. I'm not even sure -- I could be wrong -- but at one point when we sort of informally surveyed, I was not aware that WPC 34, which

is the only one where there's -- I know of a published price series on a regular basis in dairy market news -- was even being made in the state. We had WPC 60, 70, 80, protein isolates being made. All have different costs, all have different prices. These tended to be almost individual customer-focused markets. And the assumption or the assertion that, you know, we've got this formula that's patterned after dry whey and the fact that more solids might be going out the door from a WPC operation, therefore we've got to penalize the dry whey formula in some way to account for that, I just don't buy that argument.

If you want to sort of put it in your structure that if you're going to get the maximum benefit from the formula, you have to be dry whey operation, the dry whey market pretty quickly would drop dramatically.

I mean the basic issue with whey markets is they just -- they're not that big that they could handle these large plants sort of moving into a market that's already occupied by someone else. The prices will begin to collapse, because -- one of the reasons we have all these different products is people are looking for a way to deal with whey that has -- you know, results in a way of mitigating the costs of dealing with whey. So it's just hopeful you'll have a salable product that you can sell at

a profit.

And somehow creating a formula that creates an incentive to move everybody into one product so that everything is neat and tidy, I think would be really detrimental to producers because the whey markets just couldn't handle that. Everybody has to kind of go out and meet different niches in order to keep the markets viable.

So I didn't answer your question: Would we be better off without dry whey? My board has directed me to basically propose what I did, which is changing the dry whey make allowance, and that's what our position is.

AGRICULTURE ECONOMIST GOSSARD: Finally, you use the Van Slyke formula on page 10 of your testimony. In your post-hearing brief, could you please address the concerns in the 2003 panel report about using the Van Slyke formula to establish a Class 4b yield?

DR. SCHIEK: Yes, I will do that.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I have no questions of Dr. Schiek. Thank you for your testimony.

DR. SCHIEK: I'm disappointed.

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

I notice in your testimony your comments about

CDI didn't address their proposal about the price adjuster. If you're not prepared to testify today, if you could include that in your post-hearing brief. I don't want to make an assumption, but reading your testimony about the price adjuster, I could go either way in terms of where Dairy Institute might be in their proposal.

DR. SCHIEK: Yeah. To me the issue boils down to the question of whether you use a weighted average or -- the question on whether you use a weighted average or a simple average. It comes back to: What is it that we're trying to estimate? We're trying to be able to take a CME price, which we've averaged from the 25th -- 26th to the 25th -- and adjust it somehow so that it reflects the value of that product in California.

DAIRY MARKETING BRANCH CHIEF IKARI: One of the key things that they seem to be saying is take it on a week-by-week basis, which would comprise your month. You've indicated in your testimony that plants sell on the day of the make -- you know, the day they're making the product.

So I could assume that you're supportive of that concept.

DR. SCHIEK: Yeah. But, again, there's an issue of sort of the attractability of the formula. You know, you need to have a formula that's reasonably simple. I

mean we don't want to, you know, have to build these million dollar spread sheets to calculate our pricing formulas. So what I'm mentioning with the day-of-make pricing is that there are lags in the pricing structure.

DAIRY MARKETING BRANCH CHIEF IKARI: Right. And I'm trying to separate out the operation of the pricing formula on an ongoing basis versus when we have a hearing and we make an adjustment, a price adjustment, using what data is appropriate. And that part is -- of CDI'S proposal, I'd like you to address in closing brief -- post-hearing brief.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Now I have a question, Dr. Schiek.

(Laughter.)

DR. SCHIEK: I knew if we waited long enough, you would.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: The wheels are rusty, but they still turn.

(Laughter.)

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Over a long enough time period -- as you suggest, that we should use a long enough time period. Is there going to be any impact using the weighted -- the weighted weekly or the weighted monthly price difference

versus a simple average?

DR. SCHIEK: My gut sense is that -- tells me that over a long enough time period those would begin to converge. Over a short period, you know, diverge considerably. And to me the issue is, you know, how independent is the amount sold in a given month from the price difference, in other words? So If I sell 400,000 pounds more of cheese in month X than month Y, did that really -- did that change the difference, or is the difference from the CME, the discount from the CME or the adjustment from the CME, kind of independent of that decision?

And I suspect that the answer could be different from butter versus cheese. I mean it's quite possible.

It would seem to me the larger your share of the national market, the more you could argue there might be some dependency between how much is sold in California in a particular month and how that affects that relationship. That's a possibility.

Obviously, if you have a smaller share in the total market, then maybe there are more independent. My general sense was that those were independent decisions, at least with regard to cheese prices in California. But, again, I'm not an expert on the butter market.

DAIRY MARKETING BRANCH CHIEF IKARI: One final

question that I have. You talked about using the four-year period. Would you be comfortable for the Department to adopt a principle that every time it has a hearing that's going to adjust the 4a-4b price, that would use a four-year period in looking at data to make that adjustment?

DR. SCHIEK: Yeah, you know, I agree with Geof Vanden Heuvel on this. I think you have -- it's hard to use a hard and fast rule, because if there are some major structural changes in the industry, then you could make an argument that you don't want to go back beyond a certain point. One example is, I wouldn't go back to the 1996 data, because that was the NCE, not the CME. So that would be an example of a limit. But if -- you know, if the data are consistent enough, if you feel like the conditions are consistent enough, then maybe -- you know, maybe use five years, not four years. You know, at some point you've got to kind of look at the data and make a judgment based on the structural changes that have gone on in the industry.

DAIRY MARKETING BRANCH CHIEF IKARI: I understand the point. But it's difficult for the Department to have a hearing and have segments testifying on one hearing why we should look at 12 months, and then the next -- the very next hearing we should be using 4 years.

DR. SCHIEK: Well, and I think -- you know, 2003 -- I believe Dr. Gruebele made that point. But we had data from 2001 and 2002. So we only used two years because that's all we had. This time we have the luxury of a longer period, and we're proposing to use a longer period. And I think when you look at the kind of movement, bouncing around the meeting that we see, you know, I'm not comfortable using a shorter period. Put it that way.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. Thank you.

HEARING OFFICER ESTES: Any final questions?

All right. Than you for your testimony today.

We're going to take a five-minute break here and then we'll be back. And we'll take some additional testimony, although it's not likely that we will get through everyone. But we'll do the best we can today and see where we are at the end of the day.

(Thereupon a recess was taken.)

HEARING OFFICER ESTES: We're back in session.

At this time members of the public will now -- may now testify, with each speaker provided with 20 minutes, followed by questions from the panel.

As I said earlier, we have a witness sign-in sheet in the back. And so we have names of people who've

signed in. And we'll be taking people from that list in the order that they have signed the list today.

And you may still sign-in and testify if you're inclined to do so.

All right. Would the people in the back begin to sit down and be a little quieter. That would be very helpful.

Our first witness is from Leprino Foods Company.

And I'm going to ask you to state your name for the record, because I'm not familiar with you. I don't want to embarrass myself and mispronounce your name.

MR. VENKATACHALAM: Sure. It's a difficult one.

My name is Venkatachalam, spelled V-e-n-k-a-t-a-c-h-a-l-a-m. Since it is quite a tongue twister, you can call me Venkat for short.

(Thereupon Mr. C.K. Venkatachalam was sworn, by the Hearing Officer, to tell the truth, and nothing but the truth.)

MR. VENKATACHALAM: Yes, please.

HEARING OFFICER ESTES: All right. Please proceed with your testimony. Then we'll have some questions for you from the panel.

MR. VENKATACHALAM: As I said, I'm Venkat, and I'm the Director of Whey Products Technical Service for Leprino Foods Company headquartered in Denver. My

business address is 1830 West 38th Avenue, Denver, Colorado 80211. I have 43 years industrial experience. The last 26 years of this has been in the dairy field. The last 11 years I've been with Leprino Foods, and 15 years before that with an equipment manufacturing company called GEA, design and engineering all kinds of processing equipment for whey products.

My background includes design and installation and commissioning of preheaters, evaporators, HTST equipment, flash coolers for milk, whey, whey protein concentrate and permeate products while working with the GEA Wiegand Group.

I have worked with Wiegand for 15 years. And during that time I was responsible for planning, project engineering, design, installations and startup of 50 plus evaporator systems that were associated with operations manufacturing a variety of cheese types. I have also -- whey from cheese types. I have also performed cost benefit analysis for evaporators, reverse osmosis system and helped several customers optimize their process equipment.

In my current position with Leprino I'm responsible for analyzing whey operations with a view of improving efficiencies, maintaining and improving product quality. I also specify major piece of equipment such as

separators/clarifiers, membrane system, HTST, evaporators, dryers, packaging powder handling system.

The purpose of my presentation today is to provide technical information regarding the similarities and differences between processing whey stream generated in the production of Mozzarella and other varieties of cheese. I have been told that the whey powder cost study recently released by the California Department of Food and Agriculture includes data from plants that process -- that produce American cheese, Mozzarella, Parmesan, and potentially other kinds of cheese.

Additionally, I have been told that the milk pricing model used by CDFA is based on a Cheddar cheese manufacturing model. And that the Department may therefore be interested in understanding more about the processing of these various whey streams. Therefore, I am presenting testimony that may help the Department understand the similarities and differences between whey generated in the production of these different varieties of cheese.

The cost differences that I will quantify have been calculated based on the average natural gas and power costs in the CDFA whey cost study provided by Mr. Ed Hunter. However, it is my intent to provide sufficient details so that the Department in the future can use this

methodology as energy costs change.

Sue Taylor will testifying on behalf of Leprino Foods on the policy issues under consideration on this hearing. Therefore, I will confine my testimony to the specifics of whey processing only.

Processing skim whey from most cheeses is virtually identical. The one exception is Mozzarella whey, which requires more energy and additional cleaning chemicals in the evaporation phase of processing. Prior to elaborating the specific differences, it is helpful to describe the overall process.

I have shown in my sheet a block diagram to summarize. To start with, the skim whey is pasteurized and stored for a minimum period in order to guarantee the adequate feed downstream. The pasteurized whey is then evaporated to about 50 to 53 -- 55 percent total solids in the flash cooler -- sorry -- an evaporator and a flash cooler, and is cooled down to about 85 to 95 degrees in flash cooler to form nuclei of fine lactose crystals. This product is then cooled in jacketed and agitated crystallizers and the temperature is brought down to 45 degrees Fahrenheit. The resulting slurry is then spray dried in a two-stage drier to produce a free flowing non-caking powder. The powder may be stored in bins for later packaging and marketing.

Mozzarella versus Other Cheese Whey:

The primary difference between skim whey from Mozzarella production versus other cheese, such as Cheddar, Jack, Swiss, and even Parmesan, is the initial solids and mineral content of the skim whey. To achieve the stretch and melt characteristics of Mozzarella cheese, the curd is washed. This curd-washing process results in additional dilution of the whey and significantly higher mineral content. This additional dilution and higher mineral content require higher energy consumption, but achieves the same level of concentration in the flow leaving the evaporator.

The higher mineral level also results in additional cleaning requirements in evaporators used for Mozzarella whey than for evaporators evaporating Cheddar and other cheese whey. Once the whey streams are evaporated 55 percent solids, the balance of the process is identical. All differences in cost of processing can be isolated to those steps that occur through the evaporation process.

Skim whey from Cheddar, Swiss, Parmesan, and other non-Mozzarella cheese production is typically about 6.3 percent in total solids content. In contrast, typical skim whey from Mozzarella production is about 6 percent total solids due to the additional water that is added

during the curd washing process.

Table 1 below shows the impact the additional of dilution of Mozzarella whey has on whey possessing costs. This example is built on a model of a hundred thousand pounds per hour feed through the pasteurizer and into a three-step evaporation process. In the evaporator the whey moves through an MVR LoCon -- MVR stands for mechanical vapor recompression system. It's the latest state-of-the-art technology for evaporation. And concentrates the whey up to about 45 percent solids, after which it goes through a two-stage TVR, which is thermal vapor recompression system, and high concentration that gets solids up to about 53 percent. The whey then -- the condensed whey then is flashed cooled to about 85 degrees, and it concentrates the whey to about 55 percent solid during flash cooling. The calculations shown are per hour of production through the evaporator. The balance of the process is identical for Mozzarella, Cheddar and other kinds of whey possessing, so is not detailed in my testimony.

I will briefly walk through the table. As noted above, the primary difference between skim whey from Mozzarella and Cheddar and other cheeses is the initial concentration. In the hundred thousand pounds initial hourly feed 6300 pounds of solid -- that is hundred

thousand times 6.3 percent -- are contained in the Cheddar whey, where 6,000 pounds solids are contained in Mozzarella, which is hundred thousand times 6 percent.

These different solid levels then impact the volume of water that must be removed at each stage of evaporation. The volume of fluid at the end of each evaporation stage can be calculated by dividing the solids in the feed by the targeted percent total solids.

The required water removal at each stage can be calculated by subtracting the finished volume from that stage from the finished final volume from the prior stage. For example, 86,000 pounds of water must be removed to increase the Cheddar and other non-Mozzarella whey from 6.3 percent to 45 percent solids in the LoCon. In contrast, 86,667 pounds of water must be removed from Mozzarella whey to increase the concentration from 6 to 45 percent solids in the LoCon. Once the whey is concentrated to 45 percent, less water needs to be removed from Mozzarella whey to move to the next concentration because 300 fewer pounds total solids available.

The energy efficiency in the evaporation process also is different from Mozzarella versus Cheddar. The higher mineral content in the Mozzarella whey reduces the evaporation efficiency. What it really does in this -- is the minerals are couched in the magnesium phosphates.

They deposit on the evaporator tubes. When they deposit on the tubes, the heat transfer gets -- so you're putting more energy for the same BTU's across the tube, and that's what costs you more money in terms of processing.

For example, 170 pounds of water is removed per kilowatt in Mozzarella whey, whereas 180 pounds of water in Cheddar and other whey in the LoCon stage. Now, in an MER evaporator we used electric energy for generating the heat in the system. So that's why evaporation is expressed per kilowatt consumed.

Then in the next stage of HiCon, which is a steam-heated operation, you can evaporate about 2.7 pounds of water per pound of steam. In Mozzarella whey about 3 pounds per steam use can be evaporated in the Cheddar, Parmesan, and other wheys. Again, it is because of the deposit of the minerals in the tubes which impair the heat transfer in the system.

The details of the energy costs of each stage are shown in Table 1. As noted earlier in my testimony, the energy cost assumptions are based on the weighted average costs In CDFA's whey cost study as provided by Mr. Ed Hunter of CDFA. The cost calculation is detailed in Appendix A attached to my testimony. As can be seen in Table 1, the combined energy cost for pre-heat -- I will explain a little bit about pre-heat. An evaporator

operates at a certain design temperature. Technically whey, after skimming and pasteurization, is still around 145 degrees. It needs to be heated to about 165 prior to adding it to the evaporator. So there's a pre-heating stop. There's an evaporation stop using electric energy, which is the most efficient way of removing bulk of the water, and a high concentrate -- which you use steam and flash cooled to get the temperature down. That's a processing along with that.

So the steam cost calculation is based on Appendix A attached to my testimony.

As can be seen in Table 1, the combined energy cost for the pre-heat LoCon and HiCon evaporation is $82.69 per hour from Mozzarella whey and $79.04 per hour for Cheddar whey. On a finished product basis this equates to 1.35 cents for Mozzarella whey and 1.23 cents for Cheddar and other whey.

The conclusion is that energy costs per pound of Mozzarella whey powder are .12 cents higher than in whey from Cheddar and other cheese through this efficient system.

The Table 1 is reasonably sufficiently explanatory. But if explanations are needed, I'll be more than happy to answer the questions as we go along.

Continuing further, as noted earlier the cost

differences calculated in Table 1 are based upon an efficient four-step evaporation system. Sorry. I missed out something in between.

Yeah -- are based on an efficient four-step evaporation system. Attached to my testimony as Appendix B is a similar table that is based on a less efficient system with a four effect TVR heated LoCon and flash cooler. Now, this is the old state of the art, like maybe 15 years back. Evaporators used to be TVR steam heated with thermal vapor recompression. Those are not terminally very efficient. So I've also provided a comparative cost between Mozzarella whey operation and Cheddar and other whey operations based on a four-stage TVR operation and a flash cooling.

The increased cost of evaporating Mozzarella whey on a less efficient system is 0.25 per pound of finished whey powder. Only .13 cents higher than the efficient system. Regardless of the type of evaporator used, the energy cost difference between evaporating Mozzarella whey and whey from Cheddar, Parmesan and other cheese is very minimal.

The second cost difference between processing Mozzarella and other whey is attributable to additional evaporative cleaning due to the higher mineral content on the Mozzarella whey coating on the inside of the

evaporator system. To remove the minerals, an additional acid wash is necessary on a daily basis. The acid costs can be summarized below.

I am only mentioning acid costs typically because in a Cheddar evaporator the cleaning process consists of washing with caustic soda and an acid wash. In a Mozzarella whey you need to do a pre-acid wash followed by a caustic and an acid wash. So I have not compared the cost of caustic, which is common just compared to cost of total acid consumption in the system.

Son 100,000 pounds in our evaporator, our daily acid consumption for a Cheddar, Parmesan whey is about 84 gallons, while the Mozzarella whey is 210, making a difference of 126 gallons per day. At a cost of a buck fifty per gal, an acid cost differential works out $189 a day. And hours of production on a daily basis is 19 hours. So acid costs per hour of production is 9.95. And translated that per dollar per pound of powder is 0. -- is about .1 cent for Cheddar and Parmesan, .27 cents for Mozzarella, making a difference .17 cent between the two.

As can be seen in the table, the additional acid costs per day for Mozzarella is 189. I think -- I'm just narrating what I read on the table.

Combined energy and acid costs. As has been illustrated from the examples, the difference in Cheddar

and Mozzarella whey processing costs are easily quantifiable. In summary, additional energy cost per pound whey represent .12 to 0.25 cents per pound of whey. And the additional cleaning costs associated, this is the difference between .12 and .25, the most efficient and the least efficient evaporators. And the additional cleaning costs associated with Mozzarella represent .17 cents per pound. The total different is 0.29 cent to 0.42 cents per pound of finished powder.

Bleaching. One area of difference that I will quantify, but should be quantifiable by the Department cost studies relates to bleaching cost associated with the colored Cheddar cheese production. Since I am not specifically familiar with the breakout of colored cheese in the plants studied by CDFA, I cannot offer a cost estimate on this. However, it is important to note that the whey produced from Mozzarella and other non-colored cheese does not require the additional bleach to remove color. Therefore, the costs estimated based upon whey processing in these non-colored cheese plants would be understated by the bleaching costs ordinarily associated with colored Cheddar.

Before I go into the conclusion I would like to offer an explanation to the energy costs that is in Addendum A.

A therm of gas is defined as 100,000 British Thermal units. Boiler efficiency is typically 82 percent. So BTU's in a usable term is 82,000. What it means is 18,000 BTU out of every therm that is burned is released to the stack losses in a boiler. It is not available for usage. This represents one of the most modern efficient boilers today.

BTU's per thousand pound of steam is about 1,150,000. Therefore, the therms required for a thousand pounds of steam is 14.0244. Cost per therm is 0.5215 dollar. Therefore, energy costs per thousand pounds of steam is 7.31. Then there are chemical costs associated with cleaning the boiler water for feeding the boilers, estimated at .5 per thousand pounds. And blow-down costs associated with boiler steam production is .05. In order to avoid buildup of solids in the boiler we need to continuously blow down the deposit in the tube and effect the efficiency in the boiler. That's the why you have a blow-down cost.

So the total cost for a thousand pound of steam is 8.31, which is the cost I have used in my cost calculations in Table 1 and Addendum B.

In conclusion, the processing of skim whey from all cheese is virtually identical with the exception of differences that I have highlighted in my testimony. The

cost differences due to the skim whey composition are easily quantified. And I have done so using CDFA's average energy costs. Additional costs that would be included in Mozzarella plants that can be attributed to a difference in the skim whey composition from that of Cheddar, Parmesan, and other cheese range from .29 to .42 cents per pound of whey powder.

Thank you for this opportunity to testify. I would welcome any questions you might have at this time.

HEARING OFFICER ESTES: Would you like your written testimony enter into the record?

MR. VENKATACHALAM: Yes, please.

HEARING OFFICER ESTES: It will be introduced as exhibit No. 50.

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

HEARING OFFICER ESTES: And do we have questions?

AGRICULTURE ECONOMIST GOSSARD: Mr. Vencat, as I understand, that this whole explanation is comparing plants of comparable size. The amount of whey being processed out of Mozzarella is the same as the amount being processed from a Cheddar cheese plant?

MR. VENKATACHALAM: I don't understand the question.

AGRICULTURE ECONOMIST GOSSARD: Oh, sorry.

You're assuming the same scale in comparing the costs? These are comparisons of two plants, one making Cheddar cheese and one making Mozzarella, both producing the same amount or the same volume per hour of skim whey?

MR. VENKATACHALAM: Um-hmm. That's correct.

But I would like to also say that whether the Cheddar makes at 50,000 an hour or at 100,000 pounds an hour, the cost differences are not significant, because the evaporation process, the factors of 180 pounds of water more -- for Cheddar is still valid. Those are in my table. They are there, my testimony. They don't materially alter at all. What will change will be the investment per pound of powder you make. And that's not included in my testimony. It's only the operating costs and the cleaning costs.

AGRICULTURE ECONOMIST GOSSARD: At our last hearing in 2003, Sue Taylor of Leprino Foods entered a document into the record that you had prepared comparing costs of making nonfat dry milk to making skim whey powder. Again, this was comparing operations of comparable size, the plant making the same amount of nonfat dry milk for skim whey powder?

MR. VENKATACHALAM: Um-hmm.

AGRICULTURE ECONOMIST GOSSARD: No further questions.

SUPERVISING AUDITOR HUNTER: Hello, sir. Could you go over again why the Mozzarella whey has a higher mineral content than the Cheddar whey? I didn't quite follow that.

MR. VENKATACHALAM: To achieve the stretch that you need in a Mozzarella cheese -- you know, when you apply the Mozzarella cheese on pizza and then bite it, you want it to be stringy and rubbery. To achieve that you need to wash the curd and remove lactose and minerals out of the system. And that's what the washing of the curd does in the system.

So in the process the mineral content increases in the whey. So that's really necessary to achieve the desired attribute of the cheese. And the purpose of -- but the main purpose is to make the Mozzarella cheese and deal with the whey that you get.

SUPERVISING AUDITOR HUNTER: So what you're saying is there's less minerals in the Mozzarella because it is stringier?

MR. VENKATACHALAM: Yes. So there's less minerals over there, that's right.

SUPERVISING AUDITOR HUNTER: All right. That's good.

Your recap, where you say that the total difference of all the things you've talked is between --

actually it's a quarter -- it's less than a half a cent what you're talking about?

MR. VENKATACHALAM: Exactly.

SUPERVISING AUDITOR HUNTER: About a third of a cent -- third to a half.

MR. VENKATACHALAM: Between two different plants, if it is a little more than a quarter cent it's a most efficient plant. And the most inefficient plant probably is in the region of 42 cents -- .42 cents.

SUPERVISING AUDITOR HUNTER: Not 42 cents?

MR. VENKATACHALAM: No, .42 cents.

SUPERVISING AUDITOR HUNTER: Yeah. Otherwise less than a half a cent.

MR. VENKATACHALAM: You are right, absolutely right.

SUPERVISING AUDITOR HUNTER: But this is not the only difference in the processing costs. What about labor costs? Find any difference in labor costs?

MR. VENKATACHALAM: No, there shouldn't be in terms of whey. I'm only talking in terms of whey.

SUPERVISING AUDITOR HUNTER: Right, in terms of whey. But if the evaporator -- if you're using the evaporator longer to make the same amount of whey Mozzarella -- Mozzarella -- you know, whey from Mozzarella as opposed to whey from Cheddar, there would be a little

bit of labor involved in that?

MR. VENKATACHALAM: Well, little difference.

SUPERVISING AUDITOR HUNTER: Not much maybe.

MR. VENKATACHALAM: You've got operation of the pasteurizer, the evaporator, the crystallizer, and the drying and the packaging would be very similar. I do not anticipate a difference in labor costs at all.

SUPERVISING AUDITOR HUNTER: Really?

MR. VENKATACHALAM: No. No, I wouldn't think so.

SUPERVISING AUDITOR HUNTER: All right. And my final question would be -- you've seen the weighted average on our whey studies at about 27 cents a pound. How do you -- how do you see -- what's your opinion about our costs on the four plants we did?

MR. VENKATACHALAM: I'm afraid I haven't looked at the studies at all. And I'm not an economist. I am a civil engineer. So I cannot comment on -- perhaps that should be addressed to Sue Taylor tomorrow and she can allude on that. I --

SUPERVISING AUDITOR HUNTER: You're not going to hazard a guess on that one?

MR. VENKATACHALAM: I haven't looked at that at all. I can't -- there are lots of costs associated with -- I have only looked at the differences between the two. There is a cost -- if you really look at it, whey

has got to be again separated and clarified, because there are cheese finds. There's a cost associated with that. You've got a pasteurizer. You've got an evaporator, which is very energy intensive. You've got a -- process where there's a lot of refrigeration involved. You need to cool it down from like 85 to about 45 degrees. There's a lot of refrigeration involved. Then there's a drying process, which is also costly. That's not the most efficient operation. And then there's the bagging costs under the final, you know -- and labor associated with the whole train.

But specifics, I am unable to throw any light. But I can only give you in general an explanation why those are so much higher. You know, your 27 or 30 cents, is possible but I can't throw anything more. I'm sorry.

SUPERVISING AUDITOR HUNTER: Thank you then.

DAIRY MARKETING BRANCH CHIEF IKARI: I just had a question whether or not you've come across any trade journals or any publications that tend to support the testimony that you've provided here in your example.

MR. VENKATACHALAM: No, these are based on my own actual experience running evaporators and designing these things for about 25 years. It's based on my own -- I don't think there is too much published data on this. A lot of these are proprietary. And I do stand behind every

statement there.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. Thank you.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I have no questions. I appreciate your testimony. Thank you.

HEARING OFFICER ESTES: We concluded with questioning?

It's about 4:25. I know we want to conclude about 4:45.

Do we want to go ahead and proceed and call Mr. McCully to testify at this time?

Why don't we go ahead and do that and see if we can -- Mr. McCully, would you please come forward.

(Thereupon Mr. Mike McCully was sworn, by the Hearing Officer to tell the truth, and nothing but the truth.)

MR. McCULLY: I do.

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

MR. McCULLY: Mike McCully M-c-C-u-l-l-y.

HEARING OFFICER ESTES: And would you like your testimony -- your written testimony entered into the record?

MR. McCULLY: Yes, please.

HEARING OFFICER ESTES: It will be entered into the record as Exhibit No. 51.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 51.)

HEARING OFFICER ESTES: Please proceed with your testimony.

MR. McCULLY: Mr. Hearing Officer and members of the Hearing Panel, my name is Mike McCully. I'm Associate Director of Dairy Procurement at Kraft Foods in Glenview, Illinois, with responsibilities for U.S. milk procurement in addition to U.S. and global dairy market analysis and dairy commodity risk management.

Kraft operates two plants in California, one in Tulare, which produces primarily Parmesan and Cheddar cheese along with dry whey powder, and another in Visalia, which produces primarily cottage cheese, sour cream, butter and nonfat dry milk. In addition, Kraft purchases cheese and other dairy ingredients from several companies located in California.

Kraft is a member of the Dairy Institute of California and fully supports their proposal. We feel CDFA's latest cost survey data for cheese, butter, nonfat dry milk and whey are consistent with our costs and other data we've seen and should be used to update the 4a and 4b price formulas.

California has achieved a leadership position in the dairy industry given its large, efficient farms and supporting infrastructure of milk processing plants. California now accounts for 20 percent of total U.S. milk production, with a large share of this milk processed into cheese, butter and nonfat dry milk and transported to other parts of the country.

Cheese manufacturing capacity has grown steadily over the years, which has fostered growth in the state's milk production. However, in the last 24 months cheese plants have been expanded or built in other states such as New Mexico, South Dakota, Oregon and Idaho, but California has seen little to no expansion.

In 1993 California passed Wisconsin as the number one milk-producing state in the country. Given historical trends, California will double Wisconsin's milk output by 2008. To handle that increase in milk production, we estimate the State of California will need three additional large cheese plants, or about one new plant per year, or another type of manufacturing facility such as butter/powder or milk protein concentrate.

At this time, we know of no plans to expand existing facilities or to build a new plant in the state. As milk supplies continue to grow this year, producers and cooperatives may be forced to ship milk outside the state

to find manufacturing capacity. As a result, producers will incur higher shipping costs and, thus, lower milk prices -- net milk prices. This situation damages the entire infrastructure of California's dairy industry. Therefore, it is imperative California's processing sector continue to grow to support future milk production growth.

To support the dairy industry's growth in California, it is critical that the minimum regulated prices take into consideration the need to ship manufactured products to the population centers in the midwest and east. Kraft operates four large process cheese plants in Minnesota, Missouri, Illinois, and Pennsylvania, and partners with co-manufacturers of cut-and-wrap operations in Wisconsin and Mississippi. We evaluate suppliers across the country that can deliver products that meet our specifications and do so at a competitive price. As a supplier to these facilities, cheese plants in California require a cost structure that enables them to manufacture cheese, ship it several thousand miles and be priced competitively with local reproduced cheese. Therefore, it is critical to have minimum regulated milk prices that allow for this competition.

Depooling of federal orders also complicates the comparison between California and Federal Order prices.

Unlike in California, cheese plants in the federal orders can move in and out of the pool each month. The majority of the time cheese plants pool their milk and draw money out of the pool to pay their producers. However, with the current structure of Federal Order price formulas and the volatility seen over the last several years in commodity prices, negative PPD's, or producer price differentials, have become more common and are sometimes quite large.

The negative PPD occurs when the Class III price is above the blend price and creates an incentive to depool milk that month. For example, in April of 2004, the PPD in Federal Order 30 in the upper Midwest was a negative $4.11. A cheese plant could either pay money into the pool or depool their milk that month and pay the blend price. Obviously, nearly every cheese plant depooled their milk. This resulted in a 67 percent drop, which is about 1.25 billion pounds, in milk receipts versus the prior year, April 2003, and thereby reduced the total value of producer milk pooled that month by nearly $90 million.

For further illustration, a mid-size cheese plant receiving two million pounds of milk per day that decided to pool their milk that month would have been required to have met the minimum order price at a cost of $2.5 million.

Several alternative proposals are asking for a snubber on the whey price. In short, this is a bad idea. Over the past 10 years central U.S. whey prices have averaged about 22 cents a pound and exceeded .2675, the average whey processing costs in the CDFA survey, less than 20 percent of time. Therefore, most of the time applying a snubber of .2675 would not allow cheese plants to recover the cost from whey processing. The losses from whey operations would result in a higher cost structure for California cheese plants, thereby making them less competitive versus plants in Idaho, Washington, New Mexico and other states. In general, snubbers are price floors in milk price formulas are bad policy and should be rejected.

I would also like to discuss the CDFA's cost survey data for dry whey operations. Kraft's Tulare plant is one of four plants included in the survey and may be the only plant that produces both Italian styles, in this case Parmesan, and Cheddar cheeses. The Tulare site was converted from a meat processing plant to a cheese production plant in 1994 and can be considered a mid-size to large efficient facility.

And I would take up just a moment for the purpose -- several claims here earlier today that, you know, plants in this are inefficient, grossly inefficient

and poorly run. And I can assure you that the Kraft plant is none of those. Like I said, it's an efficient facility.

Our experience operating the plant indicates no difference in dry whey production costs between Parmesan and Cheddar whey streams. The solids levels in the whey stream are similar, and the whey from the Parmesan production does not have to be bleached, whereas the whey from yellow Cheddar production does. A review of scientific literature also does not support any proposals that point to significant differences in whey production costs between Cheddar and non-Cheddar whey streams, specifically Italian styles that I've talked about, the Parmesan or Romano.

In summary, I would like to encourage the Department to adopt the Dairy Institute proposal. It best addresses the needs of California's dairy industry and positions the entire industry, both producers and processors, for future growth.

I thank you for the opportunity to testify here today, and welcome any questions at this time.

And I'd also like add a request for the opportunity to file a post-hearing brief.

HEARING OFFICER ESTES: Your request is granted.

And now we can proceed to questions.

AGRICULTURE ECONOMIST GOSSARD: I have one question.

You state that with depooling cheese plants pay a blend price. An earlier witness suggested that they don't even have to pay that if they don't want to, because they're unregulated. In your experience do they pay the blend price or do they occasionally pay less than the blend price when they depool?

MR. McCULLY: Yeah, that was a question this morning. And It's a good question for us, because we've operated plants around the country. I've had producers that have had to operate -- experience in the past with negative PPD's. And what we have done is depool the milk and pay the blend price. And we think that's very consistent with other -- other companies have done the same in the federal orders.

AGRICULTURE ECONOMIST GOSSARD: No further questions.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Mr. McCully, why wouldn't all cheese plants depool when the opportunity presents itself in a Federal Order? You said that nearly all. Why not all?

MR. McCULLY: That's a good question. I was actually very surprised when I saw April 2004, which is the most extreme example which I used here, that there

was -- and I think it was a very small amount of Class III milk that was pooled that month. And I'm not sure -- and I'm not just guessing. It could be a philosophical reason that they always want to be in the pool. I'm not sure. Anyone that, you know, would -- could quickly look at the numbers, it doesn't make any sense to stay in the pool.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Thank you.

MR. McCULLY: But it's a very, very small amount.

DAIRY MARKETING BRANCH CHIEF IKARI: Just one question.

When a plant does that, do they fear losing those producers because the producers want to go somewhere else?

MR. McCULLY: If they -- the majority of people when they depool and pay the blend price, everyone is competitive. Why there would want to be, you know, one out there -- there's really no incentive to go out and pay a lot more that month unless they had a track record of being uncompetitive and pay prices and wanted to stay in that month and offer a little more. They'd look at it more long-term average. But, again, that's just a guess. But, you know, it's a very limited number of the people who've done that.

DAIRY MARKETING BRANCH CHIEF IKARI: I think it would be more relevant if the plant depooled and didn't

pay even the blend price. Then wouldn't we expect in a long term that the producers would go somewhere else?

MR. McCULLY: But if they were, probably real quickly, if there is one plant that would -- you know, in that instance say pretty much everyone is going to pay the blend price, if you get one outlier, one plant there that would not, they're quickly going to lose producers.

DAIRY MARKETING BRANCH CHIEF IKARI: You mentioned toward the end of your testimony about review of scientific literature also does not support any proposals that point to differences in whey production, costs between Cheddar and non-Cheddar cheese whey streams. Could you share that with us in your post-hearing brief?

MR. McCULLY: Sure.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

HEARING OFFICER ESTES: Are there any additional questions?

All right. Thank you for your testimony today.

MR. McCULLY: Thank you.

I think it's about -- it's almost 4:40, so I think now is probably a good time to adjourn the hearing today.

We'll be returning back this same location tomorrow at 9 a.m.

DAIRY MARKETING BRANCH CHIEF IKARI: 8 a.m.

HEARING OFFICER ESTES: Well, be here at 8 a.m. So perhaps we'll be finished here around 10. But in any event, we will be here at 8 a.m. tomorrow morning. And we'll take additional testimony here from the people that have signed in. If you have not signed in and you still want to testify, you certainly are free to come tomorrow and sign the roster to do so. And anyone else who arrives as a member of the public is entitled to do so as well.

So we are adjourned at this time. We'll be back here tomorrow at 8 a.m.

(Thereupon the hearing recessed at 4:40 p.m. until Wednesday, February 2 at 8:00 a.m.)

CERTIFICATE OF REPORTER

I, JAMES F. PETERS, a Certified Shorthand Reporter of the State of California, and Registered Professional Reporter, do hereby certify:

That I am a disinterested person herein; that the foregoing Department of Food and Agriculture, Dairy Marketing Branch hearing was reported in shorthand by me, James F. Peters, a Certified Shorthand Reporter of the State of California, and thereafter transcribed into typewriting.

I further certify that I am not of counsel or attorney for any of the parties to said hearing nor in any way interested in the outcome of said hearing.

IN WITNESS WHEREOF, I have hereunto set my hand this 6th day of February, 2005.

JAMES F. PETERS, CSR, RPR
Certified Shorthand Reporter
License No. 10063