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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

ALSO PRESENT

Dr. James Gruebele, Land O'Lakes

Ms. Sharon Hale, Crystal Cream and Butter Company

Mr. Scott Hofferber, Farmdale Creamery Inc.

Dr. William Schiek, Dairy Institute of California

Ms. Patricia Stroup, Hilmar Cheese Company, Inc.

Ms. Sue Taylor, Leprino Foods Company

Mr. James Tillison, The Alliance of Western Milk Producers

Mr. Geoffrey Vanden Heuvel, Milk Producers Council

Mr. Benjamin F. Yale, Continental Dairy Products

INDEX

PROCEEDINGS

HEARING OFFICER ESTES: Good morning, everyone. We're reconvening to conclude the hearing today. So we're going to proceed to take testimony from the public as we were doing at the towards the end of the day yesterday. And then well announce one last time the time for filing the post hearing briefs, so that people will know if they haven't heard the 2 or 3 times, it's been mentioned already.

I believe our first -- you can't hear back there? Okay. I believe our first witness today is Ben Yale.

MR. YALE: Good morning.

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

MR. YALE: I do.

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

MR. YALE: My name is Benjamin F. Yale, and the last name is spelled Y-a-l-e.

HEARING OFFICER ESTES: And do you have any written testimony to submit?

MR. YALE: Yes, I do. And I've made copies available.

HEARING OFFICER ESTES: Is this it here?

MR. YALE: Yes.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Yes, that's it.

HEARING OFFICER ESTES: Okay, thank you. Would you like to have that introduced into the record?

MR. YALE: Yes, I would.

HEARING OFFICER ESTES: It will be introduced as Exhibit number 51.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 51.)

HEARING OFFICER ESTES: And I assume that your testimony provides some type of discussion as to how your testimony was developed and approved for presentation today?

MR. YALE: It does briefly, and if you have further questions, you can ask me.

HEARING OFFICER ESTES: All right. Well, thank you. And please proceed with your testimony.

MR. YALE: Good morning. Mr. Hearing Officer and Members of the hearing panel, thank you for giving us this opportunity to present this position.

My name is Benjamin F. Yale, and my address is 527 North Westminster Street, Waynesfield, Ohio. I am appearing today on behalf of Continental Dairy Products

Inc. an Ohio milk marketing cooperative with producers in Ohio, Michigan and Indiana that markets milk in the mideast, midwest and in the southeast.

I'm also appearing on behalf of the Select Milk Producers Inc., a cooperative located in New Mexico with producers in California, New Mexico, Kansas, Oklahoma and Texas. Milk from Select Members is marketed throughout the entire United States with the exception of the northeast and the northwest. The statements which I am giving are supported by and have been property approved by those organizations.

There is only one market for milk in the United States. Regardless of state boundaries or marketing areas, there is one market. This single market prices dairy products and establishes the value of milk. The regulation of milk prices cannot change the existence of this single market. It can only change the impact of the market on producers. The hallmarks of dairy regulation, marketwide pooling and minimum prices, were not created to raise or set prices per se, but rather are tools created to direct market forces to offset some of of the inherent disadvantages dairy producers had in selling their milk.

Due to its imminent perishment, sell or smell, producers cannot hold product off the market until prices recover. It most be removed to market each and every day.

Without any regulation, producers competed against producers for markets to their mutual ruin.

The Federal Milk Marketing Orders and the California Pooling Plan remove this attraction to ruin. The key to this are the twin concepts of discriminatory minimum pricing and marketwide pooling of those sales. These types of regulations facilitate orderly marketing. They take away the producer competition on individual markets as all share in the prices.

Minimum prices were imposed on handlers to insure that the true value of the milk would be paid. These concepts are found in federal and state marketing orders or plans and have served producers, processors, and the consuming public well for nearly a century. The long life of these regulations is due in large part because the prices set were dominated by determining the fair market value not using the prices to unduly enhance milk prices paid or only support draconian prices. Prices have survived the best when they truly represent market value. Whenever the prices do not reflect the market value, the market will respond and adjust creating disorderly marketing conditions.

I provide this primer on dairy market regulations because it speaks fundamentally to the issues that face the Department today in this proceeding. While today we no longer have individual producers competing against producers for a higher value contracts at individual plants, we do have groups of producers doing that same thing. These groups are defined by their regulatory scheme -- FMMO or state. Rather than producers competing for a specific buyer of milk, producers now compete for the larger consumer dairy market.

This hearing is evidence of this broader contemporary competition to mutual ruin. The proposal by Land O'Lakes, as well as the proposal by the Dairy Institute seek to lower the minimum prices for manufacturing grade milk in order to obtain for California plants a greater market share of the national dairy product market. Land O'Lakes made that clear when it argued in support of holding the hearing and the proponent testimony yesterday clearly evidenced that intent.

The notion that California or any regulatory scheme in this country can grow its industry by reducing the prices paid to its producers to provide its plants competitive advantages elsewhere in the country is a failed and futile idea. Rather than foster processing, it will impoverish the producers that supply the milk.

Already, minimum Class III prices under the FMMO significantly and consistently exceed those of California's similar Class 4b. The department's exhibit, which I don't know the number, but Table 6 quantifies this gap. The average spread for the last 5 years has been 39 cents and for 2004 it was 54 cents. This equates to about 5 cents per pound of cheese, a price difference not justified by the location of value of California's cheese to the markets to the east.

Though both the FMMO and the CDFA prices are based upon end product pricing, the the similarities end there. They use different commodity series for the product prices, different make allowances, different yields, different formulas, and the butter price adjustment made for the solids not fat for California Class 4b differs markedly from the butter price adjustment made for protein in the FMMO Class III.

Also, there are means in the regulations under the FMMO whereby the market can and does play a role in final pricing to ensure that despite the regulations, the prices are still in tune with the market.

Among the market adjustments that is made is to compensate for the gap between California 4a and 4b prices as compared to the FMMO Class III and IV prices in 2004, which has been carried over even into 2005. Spreads of the size we are commonly seeing are not sustainable. Market forces will and are narrowing this difference.

Besides the formulas, the FMMO has a much more subtle but significant difference. It views minimum prices for the FMMO as price discovery not price setting. It is more than a difference in words. Prior to 2000, FMMO prices were announced based upon the discovery of what a free market price was for milk used in cheese. The market was the Grade A milk in the upper midwest. That market largely reflected the value of cheese.

When that Grade B market no longer existed, the USDA moved to the use of end product pricing. The concept was the same, discover the market value of commodities in a free market and from that derive the value of milk going into the commodities. This was modeled after what a plant would do to price milk if it purchased from producers in a free market.

The cornerstone of this pricing mechanism is the discovery of the prices at which commodities are sold. The National Agricultural Statistics Service surveys the sales of commodity cheese non-fat dry milk, dry whey and butter. The weighted average prices per pound are used to establish prices for the FMMO. These surveyed prices reflect not the CME price for the commodities, but the bases used in actually selling the product.

That is, cheese is generally sold in terms of the CME block or barrel price plus or minus the basis. The Commodity Price Index, based solely ont CME, misses these fluctuations in actual sales prices. Bases widen and narrow depending upon market conditions locally, nationally and international. These occur day to day. Because the FMMO price is based on actual sales prices, the month-to-month changes in the automatically -- automatically adjust producer prices within the formulas. Unlike a fixed adjuster used for the CME and the CDFA formula, this changes without rulemaking each month and in real time.

The result of any reduction in price in California is predictable. The markets to the east will match it. Through numerous methods, prices paid to producers will be reduced, cheese plants will be wring additional efficiencies, and the prices will match. Thus the old battle between individual producers fighting to their mutual ruin for a market is now being played out between orders of producers for their share of the national cheese market. It does not benefit any producer.

Further, it is possible and not uncommon for surplus milk to be sold at less than minimum prices. This is within the FMMO. These discounted sales blended over all the purchases provided additional market protection to those within the FMMO system. The amount of milk subject to those prices and the degree of any such discount is a direct response to market conditions including prices competing plants in California pay.

The amount of the spread is staggering in terms of actual dollars. We estimate that the spread in 2004 meant that producers in this state received as much as $70 million less than they would have had they received if their milk was priced under the stated FMMO system prices. The markets east of California adjusted to that in various ways reducing producer income in those markets.

Depooling is not one of the those ways. As a general rule, depooling merely changes who shares in the prices not the amount that is shared. Prices for the sale of milk used in cheese and other products are negotiated before the potential for depooling is known and not after. Competition forces sellers to maximize these prices. In markets in which depooling occurs there are multiple parties who do so and through competitive forces must pay out the sums, and they do.

A comparison of the all-milk price for areas in which depooling occurs shows no correlation to the pooling and depooling of milk. Similarly, the NASS prices for cheese and other prices retain their correlation to the CME regardless of pooling.

As I listened to LOL's witness testimony concerning depooling and competing with the plants in the FMMO system, he appeared to be a great advocate for the use of the FMMO regulations for pricing milk, rather than those under the CDFA.

LOL's proposal, if in place, would have increased the existing spread during the period of 2000 to 2004 to 96 cents and for 2004 to $1.13. At its proposed yield of 10 pounds of cheese per hundredweight of milk a price spread on cheese of 11.3 cents per pound results. This is unsupportable. The market will erase that spread and do so almost entirely on the backs of producers nationwide. Similarly, the proposal by CDI to widen the Class 4a and Class IV spread will have its response in the marketplace.

Thus, you can see why producers outside of California are concerned with the proposals that create an intra-market spread that exceeds one dollar, because virtually all of that decrease will be matched in the east at the expense of producers.

If the intent of decreasing prices is to provide additional funds for the establishment of new plants by increasing profits or providing startup capital, this approach is neither effective nor efficient. The approach is not effective because market reactions to the spread will erode any price advantage. The approach is not efficient because all producers supplying cheese plants in California will lose money.

Further, while the reduction of prices may generate enough profit to fund the construction of one plant, the profits here will be spread among processors and not be earned by any single processor.

Finally, the approach is inefficient because there is no guarantee that the funds will be used to build a new plant in California or even in the United States for that matter. Most of the production of cheese in California and most of the beneficiaries of these lower prices are companies with plants in other states and internationally.

It is not the purpose of our testimony to speak directly to the elements of the formulas such as appropriate make allowances, yields, or product series. Rather, it is the general level of the pricing. Rather than widening the gap, the Department should consider narrowing the gap. The result of the proposal by Western United Dairymen, to which Mike Marsh spoke as well as the Alliance's proposed level would bring the two programs more in alignment, healthier for all producers nationwide, and also better for plants as well. The Alliance's proposal for 4b pricing too is appropriate.

In the end, if California reduces its minimum prices by regulation, the rest of the country will reduce prices by market forces and producer income will ratchet down slowly until production is not sustainable. If one removes plants from a production area, the producers will bring back plants. But if you remove the production, you will lose both.

I request permission to file a post-hearing brief. And I thank you for this opportunity to speak. And if you have any questions, I am available to answer them.

HEARING OFFICER ESTES: Your request for a post-hearing brief is granted. And now the panel may proceed with any questions that it may have.

AGRICULTURE ECONOMIST GOSSARD: On page 1 of your testimony, you say there is a single market for dairy prices in the U.S. But isn't it true Federal Orders establish Regional Class 1 prices, that there isn't a single Class 1 market in the U.S. Prices vary by area.

MR. YALE: It's a single market, but the pricing surface increases to reflect the location value of that milk at those locations. To the degree that it can and to the degree it doesn't, then market forces have driven up higher cost for Class 1 milk, particularly in the southeast.

But it's a single market. And the intent of the pricing surface is to correlate the value of milk in the bottle at location E with location B, recognizing that if it's out of kilter because it is a single market with one plan or the other with an inappropriate advantage could take over those contracts or those sales in those areas.

So it's a single market. It's just got a pricing surface that reflects the location value of milk.

AGRICULTURE ECONOMIST GOSSARD: Could you then have a pricing surface that reflects value of milk for cheese, milk and butter powder milk as well?

MR. YALE: I think that that's -- you know, that's an appropriate thing to consider. And I think our indication is I think if we had a price spread that was more in the range of 20 to 25 cents it would probably reflect that location value in California to move the product to the east. I think we could compete at that level and wouldn't find ourselves having to reduce our prices.

Does that answer the question?

I'm not supposed to ask questions, but I just wanted to make sure.

AGRICULTURE ECONOMIST GOSSARD: Yes, it does.

You, on the 5th page of your testimony, were talking about the pooling and depooling. Are Federal Orders trying to address pooling or depooling?

MR. YALE: There are proposals -- there's a consideration I think in Order 32 and Order 30, that's the central and the upper midwest, I think there's decisions pending. A hearing is going to be held early next month in Order 33, the mideast to address, in particular, the issue of the depooling. There are a number of proposals that are being considered, you know, throughout.

You know some markets the producers have, through their agencies and commons and other agreements, have in many ways negated the impact of that simply because they control the market as it is. So although it's not official within the Federal Order, what the practicality is is that the milk goes to the -- the money goes to the producers.

AGRICULTURE ECONOMIST GOSSARD: The LOL witness specific spoke to the Pacific Northwest order. Are there any -- do you know of any proposed changes to pooling regulations in the Pacific Northwest order?

MR. YALE: I don't know of any that are pending right now. I think that proceeding is closed, but I believe that there's talk that they're going to reopen that for that purpose. Because the problem is, you tighten up the pooling in one region, then the milk tends to want to flow and attach to the other. So I mean they're not all in coordination.

Let me say one thing, though, on that issue. And that is is that in the Pacific Northwest it's my understanding that most of that milk that was depooled was part of an agreement amongst cooperatives up there, and that money went back to the producers. It wasn't capped, as some suggested, by the plants. And in the other situation, my experience has also been with the proprietary plants, is that they have contracts with producers establishing a pricing formula, often times in line with a Class III market, such that even though the blend price might be less than Class III they can be compelled to pay that higher price.

AGRICULTURE ECONOMIST GOSSARD: Thank you very much.

HEARING OFFICER ESTES: Do we have any additional questions?

All right, thank you for your testimony.

I guess we have no. --

DAIRY MARKETING BRANCH CHIEF IKARI: No, I do.

MR. YALE: I can't get away so quickly.

HEARING OFFICER ESTES: Apparently not. Even early in the morning, we still have an inquisitive panel.

DAIRY MARKETING BRANCH CHIEF IKARI: Mr. Yale, I think on page 3 of your testimony you meant to say Grade B, but you said Grade A. You spoke --

MR. YALE: About the upper midwest, the pricing discovery?

DAIRY MARKETING BRANCH CHIEF IKARI: At the bottom, where the statement is, "The Market --

MR. YALE: It was -- the Market was the Grad B milk. The Grade B is unregulated under the Federal Order system.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Thank you. Because when you spoke, you said Grade a.

MR. YALE: Oh, I'm sorry. I meant to say Grade B. There's almost no Grade B milk today. So it's hard to -- it's easy to do. Thank you for catching that. No, it is the Grade B market that was unregulated. Now, it's none existent.

DAIRY MARKETING BRANCH CHIEF IKARI: I'd like to follow up with a question that Tom asked you with respect to depooling. Do the companies that you represent do they ever -- have they ever depooled?

MR. YALE: Oh, yes.

DAIRY MARKETING BRANCH CHIEF IKARI: And when it depools rather than pay the federal Class III price to your producers, I assume that the firm is paying the blend price to the producers?

MR. YALE: No. What we paid is what we get. In other words, that we have our own internal cooperative pool which would reflect the value of the higher Class III milk. And that money is then distributed to the producers. And that's the fallacy of the argument of the depooling is that most cooperatives do that. I mean they -- there's a competition out there and a cooperative or a plant would not be able to underpay its competition by just paying the blend if it has additional resources for that class 3. So we've always -- the months that we depooled, we've paid more than the blend price, at least that was factored into the formula.

DAIRY MARKETING BRANCH CHIEF IKARI: Now, is that just for the Co-ops going to your organization? What about non-Co-op members?

MR. YALE: Well, if you have a -- it's a little complex. But if you have a proprietary plant that has its own independent producers, in which their contract was to pay them the Federal Order blend price, then in that case they would be able to keep the difference between the blend and the Class III if they wanted to.

I think they would have a competitive problem in the field however, because in the field, the cooperatives who had that Class III that decided to depool, have that money available and will distribute it to the their producers.

DAIRY MARKETING BRANCH CHIEF IKARI: You have knowledge about how many -- whether or not the contracts are generally written to pay the blend price or to pay the minimum Class III price?

MR. YALE: To my knowledge, in Idaho -- and of course the problem with Idaho know is that it's out of the Federal Order so the depooling issue is somewhat moot. But during that period of time there was a great deal of contract using -- utilizing the form of contracting and the formulas tend to be a cheese yield formula. And that cheese yield formula tracked the Class III price, sometimes higher, sometimes lower.

DAIRY MARKETING BRANCH CHIEF IKARI: What about in the midwest, what about in the Wisconsin/Minnesota area?

MR. YALE: There's enough competition for the price of milk that if the plant depools, it will pay its producers because other cooperatives will do that.

DAIRY MARKETING BRANCH CHIEF IKARI: Well I was referring to the question about the common practices. Is the common practice for contracting milk to pay the blend price or to pay the minimum Class III price?

MR. YALE: The common practice is to pay -- most agreements and contracts will either state the blend price or they will state a specific formula to establish a manufacturing price.

DAIRY MARKETING BRANCH CHIEF IKARI: So in a month that it behooves the plant to pay the blend price and not -- and to depool, they can keep the difference between the blend price and the Class III price?

MR. YALE: Theoretically, the Federal Order does not require them to pay the higher price. But the market reality, in most cases, they pay substantially all of it, because the cooperatives who are doing the depooling -- they're the biggest depoolers. The cooperatives that are doing the depooling will give that money back to their producers, because they're competing in the field for producers. And the plants in that same situation will be obligated to match that price.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, the statistics show a large amount of milk being depooled. Do you see a large number of producers shifting from one firm to another?

MR. YALE: No. And I think that's -- you know, because of the depooling, that's the point, is that the prices -- they have to be competitive. And if I'm a cooperative, and I have mostly -- I have a higher Class III utilization, okay, and I see an opportunity to depool because if I pay into Class III I get less money back, so I'll just keep what little -- you know, if I have some going to a bottling plant, I'll take that other blend and I'll keep the Class III myself.

I have more money to pay my producers. They will pay their producers that money. That's been my experience. And in the competitive marketplace where you've got multiple cooperatives and multiple cooperatives and proprietors, the others will have to do the same thing.

Where the problem comes into play, is that now the amount of money that's available to one cooperative is more than what money is available to a proprietary plan or to another cooperative, in which case there is some disparity out there, but it's only a month-to-month basis. There's no consistency there for anybody to be able to make a decision to move from plant to plant.

And the statistics tend to show that, if you look at the all-milk prices that are paid in those regions. They do not seem to alter even when we're having depooling. And the money goes to the producers, it's just not a regulated price that goes to the producers.

Does that mean that some plants keep some of the money? I'm sure they. Does that mean that some cooperatives might use it to maybe not pay as much and keep some of it to make up for some losses that they've been carrying on their books? If they can get by with it competitively, I'm sure they do. But my experience is that it goes back to the producers.

DAIRY MARKETING BRANCH CHIEF IKARI: Earlier in the hearing we had testimony from Kraft who indicated that when they depool they pay their blend price.

MR. YALE: Well, you know, if that's what he said, I mean he knows better than I do. But my experience with what I understand, and not so much experience, but producers who have consulted me with their contracts with Kraft, is that they tend to be one based upon -- in the past, before contracting tend to either be a fixed amount irregardless of the blend or, you know, some kind of a product yield formula such that they're obligated to pay that.

Now, if they got some independent ones they've set a price each month, they may be able to do that. And if they can get by with it, then I'm sure they'll try. And they may have done that. I can't speak specifically totally yes or no, but I just know as a general rule it's not happening.

DAIRY MARKETING BRANCH CHIEF IKARI: Okay. Thank you.

MR. YALE: Thank you.

HEARING OFFICER ESTES: Anyone else have a question?

All right, thank you for your testimony today.

And we will proceed to, is it Joaquin Content or Contente?

Not here, thank you.

And then we have Scott, is it Hofferber?

MR. HOFFERBER: I think Patty Stroup is next.

HEARING OFFICER ESTESI: I maybe reading off the wrong page here.

MR. HOFFERBER: Well, they traded with -- there was that trade yesterday in slides.

HEARING OFFICER ESTES: That's correct. I guess we should take Ms. Stroup first.

All right. Good morning, Ms. Stroup. I sort of lost you there for a moment, because I had you back on a page that I'd already turned over.

I had to go back and rediscover you.

(Thereupon Ms. Patricia Stroup was sworn, by the Hearing Officer, to tell the truth and nothing but the truth.)

MS. STROUP: I do.

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

THE WITNESS: Patricia Stroup, S-t-r-o-u-p.

HEARING OFFICER ESTES: And does your statement provide an explanation as to how your testimony was developed and authorized?

MS. STROUP: It does.

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

MS. STROUP: Yes, please.

HEARING OFFICER ESTES: It will be introduced as Exhibit number 53.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 53.)

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

MS. STROUP: Good morning. My name is Patty Stroup. I am the director of dairy policy and producer services of Hilmar Cheese Company, whom I represent today at this hearing. Hilmar Cheese Company operates a cheese and whey products facility in Hilmar, California.

I developed this testimony in cooperation with Hilmar Cheese Company staff and present it today with authorization from the chief executive officer and owners of Hilmar Cheese Company. Hilmar Cheese Company currently has 275 supplying dairy farms.

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

Hilmar Cheese Company's support of the proposals to change the 4b formula is based on 2 primary factors. First, the minimum regulated price dictated by the Class 4b price is too high. And secondly the regulated pricing system in California currently lacks flexibility.

These factors inhibit innovation and focused growth in the state's dairy industry, especially compared to other major milk producing regions in the United States. A minimum regulated price should be just that, a minimum.

Only by decreasing the regulated price level to allow companies to be innovative in product development and pay competitive premiums above the regulated price to dairymen will there be any growth in processing capacity in California.

Without significant changes in pricing regulation, the California dairy industry will experience processing undercapacity as manufacturers decide to shut down current facilities in state, move production out of state and locate new facilities outside of California.

A 2003 study by J/D/G Consulting in Chicago projects annual milk production in California to reach 45.8 billion pounds by 2012. This supports a separate internal analysis by Hilmar Cheese Company that projects we will reach 42.7 billion pounds of milk production by

2009. Our analysis of production growth and processing capacity, given historical growth rates, projects that by the year 2009 we will have 17 million pounds per day of processing undercapacity in this state. That means we would need 3 new processing plants in this state in less than 5 years.

From a producer standpoint, processing undercapacity is a terrible thing. It depresses premiums, distresses milk and costs producers a great deal of money in administration and hauling as they try to find markets for their excess milk. Lowering the regulated price can solve this problem. A lower regulated price will provide incentive for current plants in California to expand or for new plants to be sited in the state. Why?

Not because processors will necessarily have to pay less for milk than they do now on an average basis, but because a low regulated price allows them the flexibility to pay premiums for milk above the regulated price in a manner that is competitive. It encourages milk in the state to move to its highest and best use.

Much has been made of the comparisons between California Class 4b and Federal Order Class III prices. Advocates of a high Class 4b price will point out that for the years 2003 and 2004 these prices differed by an average of 35 cents. Actually, I think that's quite small considering the differences in transportation costs in moving products to market.

But in any case, benchmarking Class 4b to Federal Order Class III is not a valid comparison of either producer pay prices or cheese plant costs. That is because California cheese plants must pay at least the Class 4b price day in and day out if their producers want to be able to participate in the pool. Meanwhile, Federal Order plants have the ability to depool on a monthly basis and still facilitate their producer's participation in the pool when it is beneficial for them.

Of course, cheese plants in unregulated areas of the country do not have any constraints other than the forces of the open market on their pricing relationships with dairymen. These plants, the ones with greater flexibility, in either Federal Orders or unregulated regions, are the ones that we have to compete with to sell our finished products. The bottom line? The Class III price is not an accurate representation of either the price processors must pay nor the price dairymen receive and so cannot be compared to the Class 4b price.

Currently, our primary competitors for cheese exists in Idaho, a State now largely unregulated since the termination of the western order. In the very near future additional cheese capacity will come on line in the southwest. These competitors must still pay a competitive price for milk as they compete with other plants for raw product. But, they have the flexibility to construct mutually beneficial pricing agreements with their suppliers. They also have the ability to pay for milk based on the value of their own specific product mix.

And finally, they have the ability to clear the market in periods of excess milk. With the current high regulated minimum price in California, we do not have these same options. For these reasons, regulated prices in California need to be low enough to clear the market, which benefits both processors and producers.

Hilmar Cheese Company does support removal of the commodity price floors from the regulated pricing formula. In its decision implemented on April 1st, 2003, CDFA inserted a commodity price floor in the Class 4a and Class 4b formulas. This floor was included in an effort to keep minimum regulated prices at or above the federal price support level.

The problem with this rational is that it places the entire burden of supporting milk prices above the federal price support level on California processors. Moreover, the cost of selling cheese to the Commodity Credit Corporation is greater than the cost of selling cheese to commercial customers. Hilmar Cheese Company's total increase in costs in selling to the CCC is 5.96 cents per pound of cheese, and I have attached a detail of those costs as an appendix to this testimony.

In addition to the disconnect between the cheese selling price and the commodity price floor in the Class 4b formula, California processors must also bear the impact on commodity prices resulting from decisions, activities and conditions outside of California and therefore beyond our control.

Federal government decisions, such as the Milk Income Loss Contract, may artificially increase milk supply in other areas of the country, therefore depressing the cheese prices to or below federal support price levels. This is a program that was opposed by much of the California dairy industry and yet has impacted us all greatly.

Finally, and perhaps most importantly, one of the purposes of a regulated price is to clear the market. When prices are at their most depressed, economics would indicate that the low prices are the result, at least in part, of high production. One of my duties at Hilmar Cheese Company is to balance our production needs by overseeing the purchase of spot milk.

What incentive exists for me as a milk buyer to want to purchase that excess milk if I know that I will not be able to recoup those milk costs in the final product? The presence of a commodity price floor will exacerbate the oversupply of milk in those conditions and result in excess hauling costs for producers looking for a market for their distressed milk.

Hilmar Cheese Company opposes any form of a snubber in the regulated price formula. From an economic standpoint, the snubber, much like the commodity price floor, introduces an artificial impact into the pricing formula. The regulated price now recognizes a value for the whey stream. When that value is less than the cost of conversion the whey stream is a liability and should be reflected as such in the regulated price.

I do appreciate the challenge the Department faces in valuing the whey stream. So many diverse whey products are produced in California that it is difficult to choose a standard product and then to evaluate manufacturing costs of that product. For that reason alone, we would prefer removal of the whey factor from the regulated price formula altogether.

However, if a whey factor is to be included, enough latitude must be there to -- in evaluation to allow those plants that do not produce straight whey to continue to operate and innovate.

Once again as a milk buyer, if I am faced with purchasing milk that is going to cost more than I can get in a final product, why would I want to buy it?

A snubber in the whey factor or in any part of the formula, shifts milk back and forth between products in a random manner. In other words, snubbing the whey factor fails to recognize the cost of whey disposal when whey operations result in a net loss. A snubber overvalues the whey proteins in milk and necessitates that the revenues in our cheese operation have to quote "make up the difference." The components going into cheese are already accounted for in the formula and they already carry their own costs.

We have heard the argument that many operations in California are whey protein concentrate or WPC operations, and that they never lose money or that they're extremely profitable. So the whey factors should be snubbed. This is not logical. Hilmar Cheese Company operates a WPC plant. As was pointed out in the Department analysis for the last hearing, WPC prices are not correlated to the dry whey market. So it's highly likely that a WPC plant can experience periods of negative returns just like any other business.

In the case of the whey factor, it is very much a case of be careful what you ask for. Formulating the whey factor so that it intentionally or intentionally encourages cheese plants to produce a certain type of whey product will risk oversupplying that market and causing extreme price depression.

It is actually in the best interests of the milk producers to have multiple forms of whey manufactured in California. If the whey factor is constructed so that cheese plants have little incentive to produce diverse whey products, all plants would simply dry whole whey as a disposal method. Imagine the price decrease in the whey market if the majority of the waste stream went into single product. And that would go for if a majority of the whey stream went into a certain WPC product as well.

Handicapping any one form of whey production is just not good pricing policy. Once again, the minimum regulated price should be just that, a minimum.

Also, just as a note of clarification, it has been suggested in at least one alternate proposal that the cost of disposing of minerals is allocated to the cheese manufacturing process in the state cost study. In the case of Hilmar Cheese Company that is not true. I have verified with the Department in our recent cost study exit interview that Hilmar Cheese Company's disposal costs are allocated between cheese and whey production.

Hilmar Cheese Company encourages the use of average producer milk profiles when determining yield factors in regulated pricing formulas. Some alternate proposals suggest that the use of other component percentages based on vat yields determined by the Department's cost studies or on milk profiles in isolated milk classes.

However, neither of these sources are valid for determining yields. First, vat fields incorporate fortification with products such as ultrafiltered milk. The use of UF as an ingredient and the premiums associated with this product are not accounted for in cost study yields.

Secondly, the profile of all producer milk, not just cheese milk, should be the basis for yield assumptions in any regulated pricing. Therefore, we support the dairy industry's use of 3.67 fat and 8.75 SNF, resulting in a cheese yield of 10.05. Use of any milk profile other than the average producer milk would necessitate the incorporation of premiums in the manufacturing allowance.

Premiums are a cost incurred by many cheese makers, Hilmar Cheese Company included, to incent dairymen to produce higher component milk. If we're not going to account for those premiums in the cost study, then we cannot use the cheese milk profile in the pricing formula yield assumption.

Finally, I would like to comment on the big picture of pricing regulation. As we at Hilmar Cheese Company look at our business and try to develop a strategic plan for the next several decades one of the decisions we need to make is how we can grow the business. We feel we have maximized our current manufacturing site. And so the next step is to figure out where we can put a new facility.

Our owners have a long history in California, their farms are here. Their homes are here, and their familiar are here. In short, their loyalties are here. They have been supportive of the California dairy industry and contributed a great deal of time, talent and resources to California's collective dairy business success.

However, as we look at site selection, we have to look at many factors that reach beyond tradition. We look at the cost of doing business, of getting our products to market, and of regulation. And frankly California is not very attractive right now in any of those categories.

The last decision to site a major processing plant in California occurred in 1998 and 1999. Since then, plants have left the state or have chosen to locate new facilities outside of the State. The last hearing decision in 2003 that resulted in increased regulation in milk pricing, both in terms of price level and flexibility cemented many companies decisions to avoid California.

I realize that the 2003 decision was not the recommendation of this hearing panel, but the resulting increase in pricing risk from that decision has made us nervous about growing in this state. You may hear testimony, in fact have heard testimony, from out-of-state interests that complain about the difference in regulated prices between their region and California, in other words Class III versus Class 4b. But I would ask you to notice that for 6 years those companies nor any other dairy processing company have chosen to locate in California. There is a reason for that.

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

HEARING OFFICER ESTES: Your request is granted. And now are there any panel questions?

DAIRY MARKETING BRANCH CHIEF IKARI: A real quick question. I think toward the end of your statement where you said the last 6 years cheese companies have chosen?

MS. STROUP: Has not chosen, sorry. Clarification.

AGRICULTURE ECONOMIST GOSSARD: On page 2 of your testimony, you mentioned that by 2009 we will have 17 million pounds per day of processing undercapacity in this state; is that correct?

MS. STROUP: Yes.

AGRICULTURE ECONOMIST GOSSARD: So you estimate the current processing capacity in the state is 42.7 billion pounds of milk on a daily basis -- yes -- less the 17 million pounds? That would be your -- basically I'm asking, what is your estimate of the plant capacity currently?

MS. STROUP: That's our current competitive estimate of what capacity exists, yes, and that's correct.

AGRICULTURE ECONOMIST GOSSARD: Further in that same paragraph at the bottom, "It encourages milk in the state to move to its 'highest and best use.'" But don't premiums also force Class 1 processors to pay higher premiums to compete with the milk, and thereby, since generally we think of Class 1 as being the highest and best usage, isn't that a contradiction?

MS. STROUP: I would question whether a Class B utilization of 15 percent is necessarily the best usage of milk. I would -- I have to make a distinction that there is a difference between the regulated price and the price that producers receive and the price that plants pay. Regulated price is not necessarily the price.

AGRICULTURE ECONOMIST GOSSARD: On page 6 you make some general comments on the yield equation, and what you think should be the basis of establishing a yield and test in a 4b formula. In your post-hearing brief, could you please review the panel report from 2003 and its discussion of the yield factor?

MS. STROUP: Certainly.

AGRICULTURE ECONOMIST GOSSARD: And finally --

MS. STROUP: And comment on that?

AGRICULTURE ECONOMIST GOSSARD: Yes. Finally, turning to Appendix A, could you go into a little detail of the addition -- of what the additional labor -- how the additional labor comes about, what's the additional material composed of, and why the administrative costs are so large?

MS. STROUP: Additional labor and materials come from the differences that are necessary to produce product for the CCC. Packaging is probably the biggest difference. Administrative costs also includes the cost of money difference. I think you've heard in prior testimony the differences in time to receive payment from the CCC versus commercial customers.

AGRICULTURE ECONOMIST GOSSARD: Okay.

MS. STROUP: Plus additional lab work, plus additional paperwork and bureaucracy in dealing with the CCC.

AGRICULTURE ECONOMIST GOSSARD: No further questions.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Good morning Ms. Stroup. I appreciate your input this morning. I have a couple questions for you. On the 1st page you state that the regulated pricing system in California currently lacks flexibility. What does that mean?

MS. STROUP: Currently, the Federal Orders or any plant outside of the Federal Order does not have to pay a minimum price. A cheese plant located in any region other than California does not have to pay a minimum price. We do.

And so I'm not necessarily recommending that we allow depooling, although that would be an option. But if we're not going to allow depooling, then we have to have the flexibility -- we have to have a lower minimum price to account for that difference or that inflexibility.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: So flexibility is really just about depooling then, a minimum price?

MS. STROUP: Yeah mainly about depooling, correct.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: You also mentioned that a lower regulated -- this is on page 2 -- "A lower regulated price will provide incentive for current plants in California to expand or new plants to be sited in the state." We heard yesterday from Dr. Schiek included in one of his appendices that several plants have decided not to build in California. Do you know the reasons for why they decided not to build in California?

MS. STROUP: I think -- I really can't speak for other plants, but I could give you our perspective of what we're considering, which I think would be parallel. One of the things that we look is that inflexibility. If we have to pay the memorandum price day-in and day-out, when we have no way to get away from that and no way to offer our producers any kind of innovative pay system or anything like that, we have to have a low minimum price to be able to operate, you know, above that level. And if we can't, then we would look for an area of the country where we could do that.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: What about other factors have nothing to do with dairy regulation?

MS. STROUP: Well, there's plenty of factors that may -- I think I detailed some of those things that are not very attractive about California. Level of regulation. Distance to market is a huge factor for

California, as far as the cheese processor goes. We have to get -- 60 percent of the population lives east of the Mississippi River and we have to get our product to that market.

And I think your FOB adjuster in the formula helps to account for that. But it's just one other factors that makes California challenging. And so to compensate for that we need to have some kind of latitude and regulation on pricing.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: There are a number of factors. I think we can agree on that much. What I'd like to know, at least from your point of view, is how much the dairy regulation in total is considered when you've got all the other factors to think about of building a plant?

MS. STROUP: Pricing dairy regulation?

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Any other regulation. And you've got other things to consider like the cost of land and availability of labor and those kinds of things.

MS. STROUP: I sit on our site collection committee. We have 3 people on our site collection committee: A financial person; a construction manager, facility manager, land, tax, rebates all that; and then I'm the milk person. The cost of milk and availability of milk is our number 1 factor that we look at in sighting any plant.

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

One last question -- actually 2 last questions.

You say that the Federal Class III price is not an accurate representation and you should not compare the 4b price to it. Let's just pretend that I agree with you for a moment. Now, what do I use to set the fair market value for -- a fair price for the California price of milk for cheese milk? What do I use? What's my target?

MS. STROUP: I think you look at what price is going to clear the market in California in all circumstances, and you figure out what that price is.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: So it would be considerably lower than it is today?

MS. STROUP: It would be. I know that because in periods of -- if I'm going to buy milk at Christmas time or Thanksgiving or any holiday or we have flush like we did, you know, we have every spring, I can't buy that milk for less than a regulated price. I don't have any incentive to want to buy that milk for less than a regulated -- I mean for a regulated price, because I'm already running at capacity. I'm not going to push my capacity above that, if I'm not going to be able to make a decent amount of money on that incremental capacity.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Last question. When is the last time Hilmar Cheese sold any cheese to the CCC?

MS. STROUP: Gosh, I would have to look that up. I don't know, but we do sell cheese to the CCC. I can let you know in the post-hearing brief. I have no idea.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: That would be great.

Thank you.

AGRICULTURE ECONOMIST GOSSARD: As a follow-up to Mr. Erba's question -- Dr. Erba. In sales to the CCC, could you distinguish between competitive sales and sales at the support purchase price?

MS. STROUP: I'm sorry, I don't understand the question.

AGRICULTURE ECONOMIST GOSSARD: Oh. The CCC buys cheese 2 ways. One, at the support purchase price, two, on a competitive bid basis. And I was just asking in terms of Hilmar selling cheese to the CCC, distinguish between that which is sold under the support purchase price system and that which is sold under the bid competitive bid system.

MS. STROUP: Okay, we'll do that.

DAIRY MARKETING BRANCH CHIEF IKARI: On the last page of your testimony, you indicate that the last decision to sight a major plant in California occurred in 1998 or '99. As a major cheese plant in the nation's cheese supply, was that the last time a cheese plant was built in California?

MS. STROUP: In California?

DAIRY MARKETING BRANCH CHIEF IKARI: Yes.

MS. STROUP: That's the last time a decision was made to build a cheese plant in California that I know of.

DAIRY MARKETING BRANCH CHIEF IKARI: Are you talking about the Leprino plant?

MS. STROUP: It would LOL, Leprino plants, yes.

DAIRY MARKETING BRANCH CHIEF IKARI: Are you aware -- I assume that your company is aware of the building of major plants from 1999 to current. Would it be possible for you to provide us with a list of plants that have been built -- I'm talking about major plants -- built in the nation from 1998?

MS. STROUP: Including significant expansions?

DAIRY MARKETING BRANCH CHIEF IKARI: Sure.

MS. STROUP: Okay.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

MS. STROUP: That would only be from our competitive analysis. It wouldn't be necessarily from the horses mouth.

DAIRY MARKETING BRANCH CHIEF IKARI: Right.

MS. STROUP: Okay.

DAIRY MARKETING BRANCH CHIEF IKARI: I understand. But it's a perspective of what's going on in areas outside of California.

MS. STROUP: Sure.

HEARING OFFICER ESTES: Apparently, there are no further questions, so thank you for your testimony today.

Is it a Mr. Hofferber?

MR. HOFFERBER: Yes.

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

MR. HOFFERBER: I do.

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

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

HEARING OFFICER ESTES: And does your written statement today provide a summary of how your testimony was developed and approved?

MR. HOFFERBER: Cursory summary.

HEARING OFFICER ESTES: All right. Would you like to have it introduced into the record?

MR. HOFFERBER: Yes, I would.

HEARING OFFICER ESTES: It will be introduced as Exhibit 54.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 54.)

HEARING OFFICER ESTES: So go ahead and proceed with your testimony today.

MR. HOFFERBER: Thank you. Good Morning, Mr. Hearing Officer and members of the hearing panel. I am Scott Hofferber, the Controller at Farmdale Creamery. And I am here at the direction and on the authority of the Board of Directors of Farmdale Creamery.

My testimony is co-signed by Michael W. Shotts, one of our owners. And he and I co-wrote this testimony together with the approval of our board, subsequent review.

The petition and the many alternative proposals before you offer a wide variety of ideas and approaches to addressing economic issues which directly impact Farmdale. I and we at Farmdale wish to voice our support for the alternative proposal submitted by the Dairy Institute of California. We feel that the Dairy Institute's alternative better represents the interests of our company by addressing additional important issues regarding California milk economics, when compared with the petition itself.

We oppose all other alternative proposals before the panel pertaining to this hearing. And we appreciate this opportunity to present our views and perspectives on the issues at hand.

Farmdale Creamery is a small family owned and operated dairy possessing facility in San Bernardino just east of Chino Dairy Preserve. With about 70 employees, Farmdale processes in the neighborhood of 24 million pounds of milk and cream per month into block Jack and Cheddar cheese, sour cream, butter milk, whey butter and roller-dried whey for animal feed. We do not own, directly or indirectly, an interest in dairy cattle nor are we affiliated with any of the co-ops or individual producers by ownership.

To update the history portion of prior year's testimony, suffice it to say that our capital expenditures over the last 4 years have gone to expanding our capacity to process food grade products.

Like many of the smaller dairy producer families, we will hear from at this hearing, either directly or through their representatives, Farmdale relies on the Department and the Secretary to render a reasonable and orderly milk market environment in which all parties, large and small, can prosper. Our reliance comes from an expectation that sound economic principles will hold sway over political and emotional pressures that are brought to bare on the decision makers.

We at Farmdale were disappointed in 2003 when the decision of the Secretary failed to respect portions of the hearing panel's recommendations. And we sincerely hope that the panel's efforts in this hearing are better valued this time around.

We enjoyed good working relationships for milk and cream procurement with the different co-ops over the years and look forward to continuing these mutually beneficial relationships.

In my undergraduate Accounting 101, Professor "Machine Gun" Harry stated many yarn with, "Now, back at Monsanto," and proceeded with one or another real world example of an accounting process or situation. Monsanto was his prior employment to teaching. With the recent rBST shortage, we all have been given an opportunity, maybe, to see the impact on prices of the constrained supply of raw product.

I understand that the rBST rationing is not the only factor contributing to the reduction in the supply growth rate, but it works for me as a rallying point for the broader discussion. Now, back at Monsanto, when Monsanto gets their situation fully resolved, the production growth rate will certainly rise again as a direct result.

If we, producers and processors together, are to continue to move the milk being produced, we must either encourage processor capacity to grow by offering an economic environment that presents the possibility of a reasonable return on investment, or see a disorderly reduction in the milk supply through the failure of farms unable to get their milk to market for the lack of processing capacity. Such capacity must be able to compete for sales within and without California.

Setting minimum milk prices at appropriate minimal levels allows risk of investment to be appropriately shared between processors and producers, provides the possibility of a more attractive ROI on, or NPV of investment in additional processing capacity. NPV being net present value for those who are unfamiliar with that. And frees the market to drive necessary corrections to under-or over-supply conditions on its own without the need for regulatory intervention on a frequent basis.

Now, I'm going to jump off the written text for just a second and interject something about partnership. I speak often in my testimony about shared risk and reward between the producers and the processors. What is a business partnership, but an agreed -- what is a business partnership? But an agreed arrangement between arms-length parties to pool their monetary and intellectual cap with an intent to share the benefits of gains as well as the risks of loss. Farmdale understands its role in the California dairy industry as a partner.

We are here these 2 days to consider changes to the de facto partnership agreement created and maintained by the regulatory environment in which Farmdale does business. For our partnership to succeed, the partnership agreement must equitably share the risk of loss and not disproportionately allocate gains. Floors and snubbers do not make for equitable risk sharing amongst partners.

Now I'll return to my text.

Our perspective on the continuing whey disposal issue has 2 facets: A micro-economic and a macro-economic view are on our minds. From the micro viewpoint we can not yet justify the expense in capital to install a whey processing line adequate to create a profit center. Instead, we must continue to treat our roller dried whey process as a cost minimizing effort in dealing with the waste whey material.

With the increase in gas and electricity costs, the efficiency of this waste disposal system continues to be negatively impacted, because the roller driers are heavy consumers of gas an electricity. It will be years before the effects of the State's attempt to deal with the energy crisis are dissipated and energy prices return to pre-2000 norms if they ever do.

We thank the Department for its prior actions to address this situation in the make allowances and can only strenuously request that such consideration continue indefinitely or at least until we see a significant return to energy cost normalcy. Anything before this hearing that suggests a reduction in the make allowance because energy prices have fallen, fails to recognize that the Department's prior action did not address the full impact of the crisis at its worst. Rather, the adjustment to the make allowance for energy has in fact done a good job of recognizing the new quote "normal" price levels. We believe the current cost study data supports this conclusion.

Our macro-view is that whey disposal is still a not-for-profit business in our economy. If it were, people would be knocking on our door at Farmdale every day wanting us to let them take the waste whey off our hands. To this day, no one has come knocking, so we continue to use our own innovation, assess our own risks and invest our own limited capital to minimize the cost of this disposal.

Much of the discussion surrounding the whey component and the make allowance appears to be predicated on the idea that everyone is making WPC, which is certainly not the case. The diversity and methods of post-cheese making whey processing defies standardization. To skew a price component for whey based on the processor with the highest return on their whey process would cripple all others competitively speaking.

Additionally, it seems to us that the diversity in processing methods is important to the broader whey disposal issue. Farmdale has found a market willing to take our animal feed material. Others have found various other alternatives for converting their whey streams to products other than WPC.

If we all were to go to WPC making the glut of that product would tank that price and make the overall WPC market untenable to investment. Then what?

And now I'm going to jump off again to this.

Then there's this issue in the testimony of some left over penny getting allocated somewhere in the cost studies. This is the tip of the complexity iceberg that Farmdale, the Dairy Institute and many others feared would surface as a result of including a whey factor in the formula.

By adding this additional dimension to the discussion matrix, the possible combinations of formula constructs goes up exponentially. How will we ever get it right now.

Milk in, products out. Products are only worth what they're worth in the market. The overall value of the milk does not increase just because we call it something else. Dropping the whey factor and returning it to a more orderly marketing plan is not proposed at this hearing, but Farmdale would support such an idea.

Instead, working with what we have, Farmdale asserts that a whey make allowance of the 2675 approaches equity in terms of the direct costs associated with processing and disposing of our whey stream, which we treat as a byproduct for cost accounting purposes.

With respect to the floor, we believe that in all fairness the floor price should be removed from the 4b and 4a formulas. We must return to an environment of shared risk between producers and processors. It is not in the best interests of our current and future cheese processing in California to have the processors indemnify the producers in low markets through the use of a floor. This is especially true when the processor doesn't materially participate in the benefits of higher cheese prices when those markets occur.

At the very least, the floor should be set to allow for the additional costs of making, packaging and administering government specs and procurement at the support price.

And one more departure. As to the grossly inefficient and poorly managed plants contributing to the cost studies, so be it. These labels are merely unsubstantiated and inflammatory opinion. The truth is basic economics teach us that a smarter, faster, cheaper enterprise will invariably enter a market and supplant the inefficient or mismanaged entities.

This is not happening. And why? Because the barriers to new entry including burdensome and complicated regulation, along with the lack of a reasonable expectation for profitability under the current raw product pricing schemes, prevent it.

Further, what one observer might consider inefficient is reality to those actually doing it, as it is borne out in the whey cost study and our own experience.

We support the Dairy Institute of California's alternative proposal because we believe it fairly reflects the best balance in applied economics necessary to maintain a successful symbiotic relationship between the producers and the processors. Although not perfect in our view, it is the best step in the right direction for Farmdale's survival.

Without an expectation for a reasonable return on investment new processing capacity will not come to California. Specifically, Farmdale cannot consider investing the capital necessary to upgrade our whey plant. In addition, working out the make allowances to address California-based costs will only not completely address -- will only -- costs -- start over. Specifically, Farmdale cannot consider investing the capital necessary to upgrade our whey plant. In addition, working out the make allowances to address California-based costs only will not completely address the disincentive to capital investment.

Without proper recognition of the pricing structure of the presence of cheaper raw and finished products in the surrounding regulated and unregulated states, the ever-growing supply of raw product in California is at risk of not finding a home in the near future.

We did not agree that a whey factor should be included in the pricing formula as a way to increase overall producer prices, but must now accept this as a change in the rules of the game. The results of the April 2003 hearing process however need to be adjusted to allow a significantly better return to the processor for the whey disposal when prices are lower.

Mechanisms in the formulae that would result in a lop-sided sharing of the cost, without the opportunity for a commensurate reward, are inappropriate. Specifically, if the producers benefit from the whey factor when the prices are high, they should participate similarly when the prices are low. Let's be fair about this.

And that's the end of my testimony today. I request an opportunity to file a post-hearing brief.

HEARING OFFICER ESTES: You may do so.

And the panel may proceed with questioning at this time.

SUPERVISING AUDITOR HUNTER: Mr. Hofferber, let's talk about your whey production.

MR. HOFFERBER: Okay.

SUPERVISING AUDITOR HUNTER: Kind of take us through your whey stream leaving the vat and how it ends up.

MR. HOFFERBER: To the extent that I'm able to, I will share what I can.

SUPERVISING AUDITOR HUNTER: I'm not an expert on it either.

MR. HOFFERBER: Not being the plant manager, it's -- we have double load vats, the whey is streamed out of that, the curd is pumped to a finish table, more whey is taken off at that point. That whey is pumped into an intermediary holding tank. It is then through a process concentrated with -- I don't get the effluent thing -- the waterside of that going off into another storage and disposal process, with its own set of costs. But the concentrated whey itself then gets pumped over to steam-heated roller dryers and is made into what's generally called popcorn whey. That's bagged up in a 1,200 pound bag and shipped to the midwest for inclusion in animal feed.

SUPERVISING AUDITOR HUNTER: Are you taking out the whey cream before?

MR. HOFFERBER: Yeah, we are running it through a separator and fine savers before -- you know, to capture any fat back through the cheese process.

SUPERVISING AUDITOR HUNTER: So otherwise, all remaining whey, after the water is taken out, most of the water is taken out, it is made and it's called popcorn whey. And there's nothing left over after that basically, except for the wash water and --

MR. HOFFERBER: That's right.

SUPERVISING AUDITOR HUNTER: In your animal feed, is there any months that you actually make a profit on that?

MR. HOFFERBER: Not so far.

SUPERVISING AUDITOR HUNTER: Is the lost quite substantial? If you can tell us kind of a ballpark.

MR. HOFFERBER: Well, with respect to what the current make allowance?

SUPERVISING AUDITOR HUNTER: No.

MR. HOFFERBER: It's quite substantial.

SUPERVISING AUDITOR HUNTER: As far as your bottom line on your company?

MR. HOFFERBER: Because -- well, this brings me to a discussion I didn't include in my testimony. But having taught cost accounting at the college level for a very brief time, I can speak to cost accounting models and some general theories. If you're going to consider internally that you've got a profit center product in your whey stream, you're going to treat this as a split product -- a split cost stream. You're going to make the curd. And once you separated the whey from the curd, now you're going to have parallel processes going down the line, each of them bearing their own incremental cost and your going to find away to allocate the actual raw milk costs between the 2 streams in order to measure your profitability.

SUPERVISING AUDITOR HUNTER: I understand.

MR. HOFFERBER: In our case, we don't see it as a profit center at al. What we're treating it as is a byproduct, which means once it's split off, you only allocate whatever direct costs are necessary to get the thing out the door, and you minimize those direct costs as much as possible in order to reduce the impact on the cheese model itself.

SUPERVISING AUDITOR HUNTER: Right, I got you.

MR. HOFFERBER: So you get into kind of a game with this indirect cost allocation issue. And that is, we would tend to allocate all of our indirect costs back against the cheese line. There's no point in us allocating any indirect costs to the whey stream because it's part of the cheese cost anyway.

SUPERVISING AUDITOR HUNTER: Let me ask you a follow-up question then. Just by allocation of direct cost into the whey stream -- the whey product, you're still having a substantial loss?

MR. HOFFERBER: Yes.

SUPERVISING AUDITOR HUNTER: Okay. And how about the whey butter, is that a break-even item? Is that a money-maker on the average for you?

MR. HOFFERBER: Because of the nature of the source of some of the cream that we're using for the butter, we can term that as a profitable thing for us, but it's a very narrow agreement that we have with the supplier in our situation. It's kind of a outlier to the whole rest of the -- the world is processing. Our own internally generated whey cream is probably not profitable, but it's such a minor component to this other arrangement, that we have going on, we can't really speak to that at this point.

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

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Mr. Hofferber. I appreciate your testimony this morning and good morning.

Just one question. Is your company planning to expand capacity any time soon?

MR. HOFFERBER: We completed an extensive capacity expansion in 2000 on our cheese side. We've also expanded our capacity for sour cream production went into service in '03. Our ownership is tapped in terms of what they're willing to risk at this point. We've probably invested double the dollars in the last 5 years of all the dollars invested in the previous 15.

So, no. We are always looking to improve process. And if that requires some minimal additional investment capital to make what we do now a little more efficient, we will of course consider that. And our capital budget is probably about 1 percent -- 1 to 2 percent of our total revenue right now, which is not a lot of money, if you're considering adding a line or your considering retooling of the entire process.

MARKETING BRANCH ACTING CHIEF ERBA: If you had the opportunity or wherewithal to expand the next few years, would your whey possessing facility need to be rethought completely or --

MR. HOFFERBER: The primary concern for us is our outlook on the Chino Dairy Preserves survivability. Milk supply in our micro-ozone -- you know down where we are -- is of paramount concern to us, at this point, in terms of our long-term -- actually mid-term to long-term survivability. We would more have to go into a discussion like Hilmar about site collection and consider moving the entire operation as that dwindles.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: So you probably would not be inhibited by your whey processing capacity --

MR. HOFFERBER: In terms of expanding cheese?

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

MR. HOFFERBER: Our chose to expand would be into other product lines besides cheese.

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

MR. HOFFERBER: We are at -- under the current deal right now, we are disincentivized to go forward with cheese expansion at this point.

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

MR. HOFFERBER: I definitely can say that.

DAIRY MARKETING BRANCH CHIEF IKARI: You provided testimony in response to questions that Mr. Hunter asked. I wondered if there's anyway that you could, in your post-hearing brief, provide more objective information in terms of quantifying the amount of whey that's processed and the prices that you receive and the losses you're incurring. You don't have to release confidential information, but if you could provide as much detail as you could, I think that would be helpful to us.

MR. HOFFERBER: Right. We'll do what we can in a post-hearing brief in terms of meeting confidentiality issues. And maybe there's cost study information or whatnot. There may be another way to transfer some of the other information.

DAIRY MARKETING BRANCH CHIEF IKARI: Or just an estimate of the losses that you're incurring.

MR. HOFFERBER: Yeah, and I have that number.

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you.

MR. HOFFERBER: All right.

HEARING OFFICER ESTES: Any other questions?

All right, thank you for your appearance today.

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

First, Ms. Hale, if you hear a little reverberation in the microphone, I'll go back and try to adjust it, so that we don't have any.

MS. HALE: Reverberation?

HEARING OFFICER ESTES: There's a little bit of reverberation beginning to emerge toward the end of Mr. Hofferber's testimony. So if you see me depart the table, as well as for people in the audience, it's for the purpose of trying to make sure the system doesn't start creating feedback problems.

MS. HALE: Okay I've got you.

(Thereupon Ms. Sharon Hale was sworn, by the Hearing Officer, to tell the truth and nothing but the truth.)

MS. HALE: I do.

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

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

HEARING OFFICER ESTES: And your statement provides an explanation as to how your testimony was developed and approved?

MS. HALE: As a matter of fact it doesn't. But I'd be happy to tell you.

HEARING OFFICER ESTES: Why don't you go ahead and do that for the benefit of the record.

MS. HALE: Actually, it was developed and written by myself and approved by our president.

HEARING OFFICER ESTES: All right. Would you like your written testimony to be entered into the record as an exhibit?

MS. HALE: Yes, please.

HEARING OFFICER ESTES: It will be introduced and admitted as exhibit number 55.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 55.)

HEARING OFFICER ESTES: And please proceed with your statement.

MS. HALE: Thank you. Mr. Hearing Officer and Panel Members, my name is Sharon Hale and I am vice president, Dairy Policy and Procurement for Crystal Cream and Butter Company. Our administrative offices are located at 1013 D Street, Sacramento, California, 958-- that should be 14. We operate 3 production facilities in Sacramento that produce dairy products in all classes, except Class 4b.

Crystal, along with its wholly owned subsidiary McColl's Corporation, located at 2500 Angelo Avenue, Redding, California distributes dairy products throughout northern California. We also sell frozen novelties into several western states and export ice cream mix and ultra pasteurized fluid milk to other countries.

As a member of the Dairy Institute of California, Crystal's position on the initial and alternative hearing proposals has been skillfully articulated by Dr. Schiek. We have long been an advocate of making timely adjustments to manufacturing allowances that are both cost justified and generally equal as to their level of cost coverage for each product category. And despite operating a small butter operation that lacks the benefits derived economies of scale, we have always supported manufacturing allowances that are set at levels below the cost of converting all milk at all plants into butter, powder and cheese.

We believe some incentive to achieve greater efficiency in the manufacture of these products is necessary when setting manufacturing allowances.

No proposals were submitted prior to this hearing to make changes relative to the Class 2 and 3 prices. Past hearings generated interest in altering the pricing formulas relative to price mover, changing the relationship between Class 2 and 3 prices and shifting the price relationship between marketing areas.

With no similar proposals surfacing for this hearing, one could surmise the industry is satisfied with the current formulas and relationships and further comment is unnecessary. But I'm reminded of the situation where a last will and testament is challenged because its maker chose to ignore a potential heir instead of creating clarity by leaving that individual a single dollar.

So to avoid conjecture, Crystal would like to go on record as supporting the current Class 2 and 3 pricing formulas, which includes the pass-through impact of any change made to the Class 4a formula, as a result of this hearing.

From the Department's analysis of the Class 4a proposals, the predominant result of adopting one of these proposals would be a slight reduction in Class 4a component prices. A direct pass-through to Class 2 and 3 prices would cause a similar decrease in those prices as well. We believe this outcome is appropriate, since the factors driving the increases in butter and powder manufacturing are present in all manufacturing. The cost of manufacturing yogurt or cottage cheese or ice cream has also been pushed upward by the same wage increases, skyrocketing health insurance rates, exorbitant worker's compensation premiums, and higher utility costs that were found by CDFA in the Class 4a manufacturing cost audits.

It is also important to appreciate there is nothing robust about California's Class 2 and 3 market. In fact, it is quite the opposite. CDFA's exhibit entitled Hearing Background Resource contains 2 graphs that specifically relate to Class 2 and 3 products. Figure 4, Dry Curd Annual Production Share contrasts California's production of curd for cottage cheese as a percent of U.S. production with that same statistic for other western states.

While the other west has steadily increased and grown well above their population share, California has dropped miserably. In absolute terms, publications and data found on CDFA's dairy web site shows total cottage production from 1999 to 2004 as being down 2.28 percent.

Figure 5, all frozen annual production share from CDFA's hearing background resource shows ice cream production in the entire west including California, falling below our population share in 2002 and 2003. Unfortunately, California's production of ice cream has not been close to its share of the nation's population in the past 10 years.

Again, CDFA's web site data shows actual frozen product production in California to be down since 1999 by 6.68 percent, the worst of which occurred in 2004. For a variety of reasons that we suspect includes high fat prices and low carb, low fat diet concerns, 2004 was a particularly bad year for frozen products.

In past hearings Crystal has included information gleaned from an informal survey of markets in the Sacramento area, which lists cultured products manufactured outside the state of California. We made a quick check of local stores before this hearing and interestingly enough found essentially the same out-of-state products in our area as were found in January 2003.

It would appear local retailers are satisfied with these supply arrangements, consumers are happy with the products, and out-of-state manufacturers are still interest in serving this market. The success of out-of-state manufacturers in both capturing and retaining local market share illustrates the keen level of competition present in our area. The survey results are shown in Attachment A.

Found on Attachment B is information relative to ice cream and novelty plants known to sell frozen products in California. The significant changes since 2003 include Arctic novelties and Darigold ice cream having been recently purchased by a California cooperative. Von's/Safeway closing their southern California ice cream plant and replacing it with a plant located in Phoenix Arizona and Wells Blue Bunny opening a new frozen novelty plant in St. George, Utah.

In conclusion, we believe CDFA is justified in making a finding from this hearing that results in a modest decrease in Class 2 and 3 prices. CDFA's manufacturing cost data supports making Class 4a manufacturing allowance adjustments and competitive conditions within our marketplace, combined with increased costs associated with manufacturing Class 2 and 3 products validate the impact a lower Class 4a price will have on 2 and 3 prices.

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

HEARING OFFICER ESTES: Your request to do so is granted.

MS. HALE: Thank you.

HEARING OFFICER ESTES: The panel will now proceed with questions.

AGRICULTURE ECONOMIST GOSSARD: At the bottom of page 1 of your testimony, you say you support the adoption of a proposal of a slight reduction in the Class 4a component prices. Which -- there are several proposals that would lower the 2 and 3 prices. Are you supporting all of them generally? Is there one you like better than the others?

MS. HALE: As a member of the Dairy Institute, we are actually in support of their proposal. But if the others are -- that lower the price are adopted, we'll go with that, too.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

HEARING OFFICER ESTES: Any other questions?

Thank you for your appearance today, Ms. Hale.

The last witness that we have on the witness roster lives is Sue Taylor, unless there are others that have signed up to testify, and potentially there may be.

I think we have a couple other people that would like to sort of amplify their previous testimony briefly. So we'll provide that opportunity as well. So if there's anyone who wants to testify who has not done so, please take the opportunity now to sign the witness roster list, so we can go ahead and incorporate your testimony into the record.

Otherwise, additional evidence for the consideration of the hearing panel will be limited to what is presented by those people who have already testified and have been given the opportunity to submit post-hearing briefs.

(Thereupon Ms. Sue Taylor was sworn by the Hearing Officer to tell the truth and nothing but the truth.)

MS. TAYLOR: I do.

HEARING OFFICER ESTES: And as with the other witnesses, would you please state your name and spell your last name for the record?

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

HEARING OFFICER ESTES: And I assume your written statement today provides some explanation of how your testimony was developed and approved?

MS. TAYLOR: Not specifically. My primary responsibility with Leprino Foods is to develop our policy positions. I've developed these positions and reviewed them with senior management who also agreed with them.

HEARING OFFICER ESTES: All right. Would you like to have your written statement introduced into the record as an exhibit?

MS. TAYLOR: Yes, please.

HEARING OFFICER ESTES: Okay. It will be introduced as Exhibit number 56.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 56.)

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

MS. TAYLOR: I am Sue Taylor, vice president of dairy policy and procurement for Leprino Foods Company.

Leprino operates 9 mozzarella plants in the United States. Three of these are located in California, 2 in Lemoore and one in Tracy. Leprino markets mozzarella cheese domestically and internationally to major pizza chains and independent pizza restaurants and to many of the nation's food companies.

I am testifying in support of Dairy Institute of California's proposal for the 4b formula. This proposal is based upon sound economics and is supported by objective analysis. I fully support Dr. Bill Schiek's testimony presented at this hearing.

I am also testifying today in opposition to the Class 4b formula proposals put forth by the Alliance of Western Milk Producers, Western United Dairymen, Milk Producer's Council, and California Dairy Campaign.

Each of these proposals is technically flawed and would result in a regulated price enhancement that would send signals to an already expanding producer sector to accelerate production expansion, and at the same time would discourage the development of additional plant capacity to process and market the additional production.

Sound milk price regulations must be consistent with several basic economic principles. I've testified to these principles at prior hearings. And, Dr. Schiek, of Dairy Institute also elaborated on those principles in his testimony at this hearing. Rather than consuming my testimony time to reiterate these principles today, I've attached a brief elaboration of these principles as Addendum A. However, at the conclusion of my testimony, I welcome any questions related to the basic principles or other aspects of my testimony today.

I will focus my testimony on the following specific issues: Cost studies and several aspects of those cost studies; price numbers; yields and the need for plant capacity.

On the category of cost studies. The validity of incorporating plants in the whey cost study that produce cheeses other than cheddar will be my first topic. The questions regarding the relevance of cost from plants that produce whey powder from skim whey generated in the production of non-cheddar variety cheeses were very clearly addressed by Venkat, the director of whey technical services at Leprino.

Venkat's testimony indicated that skim whey from cheddar, Parmesan, Swiss and other non-mozzarella cheese is virtually identical with the exception of the need for bleach. To equate the whey cost study results from Parmesan, Swiss or other non-mozzarella plants to cheddar whey costs, the Department can simply add a factor to these other plant costs that is reflective of the bleaching costs that ordinarily would be incurred by a plant producing whey generated from the production of colored whey -- colored cheddar.

Such a factor would also need to be added to costs of whey from mozzarella cheese production since it also does not require bleaching. In addition, Venkat's testimony provided a clearly defined road map for the Department to use to adjust the mozzarella plant whey costs downward to account for the lower initial solids into higher mineral content in the skim whey from mozzarella production.

Although, Venkat's calculations were based upon the weighted average energy costs from the whey cost study, the framework provided in his testimony will enable the Department to replicate the calculation using the specific energy costs associated with the plants for which costs are being adjusted. The Department's whey cost survey is both valid and relevant.

Allocation of orphaned indirect costs in the cheese and whey cost studies. Allocation of orphaned indirect costs in the cheese and whey cost studies from solids not recovered in either cheese or whey production has been the subject of much discussion at this hearing.

My understanding from the pre-hearing workshop is that CDFA's cost study methodology allocates indirect costs in proportion to the total dairy solids and finished products. Given normal plant losses, some costs become orphaned by the lack of finished product to which to be attached. These orphaned costs are currently rolled back into the cheese costs in the cost study.

Some parties at this hearing have questioned the approach of absorbing orphaned costs in the cheese cost study. We believe that the cheese cost study is the most logical place to assign these costs, because it is the primary product produced from milk.

We also urge the Department to reconsider which indirect costs are allocated on a total solids basis. Specifically, I my understanding from the pre-hearing workshop, is that milk receiving costs are allocated on a total solids basis and generally are attached to whey at the same rate per pound solids as they are attached to cheese. From our perspective, this overstates the cost of producing whey which is not produced from milk and understates the cost of producing cheese, which is produced from milk.

From the business and policy perspectives, we do not believe milk costs, whether actual costs or milk receiving costs, should be allocated to whey. Within our plants, milk related costs are allocated strictly to cheese for several reasons. First of all, the primary product of milk is cheese. Whey is not produced from milk but is recovered from a byproduct of cheese production.

Further evidence that whey is a secondary product is the fact that we do not purchase milk because we have a market for whey; rather we purchase milk because we have a market for cheese. Although, we increase or decrease our milk intake in response to increased or decreased demand for our cheese, we do not increase our decrease milk intake in response to increased or decreased whey product demand. Whey is a byproduct that we do not expect to carry the milk and receiving costs.

Implications of WPC production on loss levels associated with orphaned costs. Several witnesses have suggested that the existence of component losses within cheese plants is a consequence of the production of high valued products such as WPC. And that such higher valued products should bear the cost of all losses. Leprino's total solids capture rates per 1,000 pounds skim whey when making WPC 35 or WPC80 lactose and Delactose Permeate are roughly equivalent to the total solids capture rate in whey powder.

The inference that the cheese cost studies are grossly distorted by the inclusion of costs that are orphaned because of significantly higher losses in plants producing WPC appears to be grossly exaggerated.

Significant component losses occur in all plants even when using best management practices. These losses are associated with several aspects of plant operations including production and the required cleaning protocols for food grade products.

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

Dr. Barbano of Cornell testified at the Federal Order Class III hearing in May 2000 that fat losses in the cheddaring and pressing steps in goods operations range from one to one and half to percent. Woops, excuse me. That should be one and half to 2 and a half percent. These losses are real and all costs attached to the lost components should be assigned back to the primary production operation, that is cheese making.

Efficiency of surveyed whey plants. Many conclusions have been drawn by witnesses at this hearing regarding the efficiency of the plants included in the whey cost study. The many statements regarding lack of efficiency are based upon the Department's statement that the weighted average cost of producing cheese in the whey survey plants is significantly higher than the cheddar plants in the cheese survey.

It is impossible to accurately assess efficiency from cheese cost alone. Many factors can contribute to a higher cost structure. These factors include such things as a production of a lower yielding variety of cheese or the higher cost of packaging that is typically associated with cheese sold in less than 40-pound block form.

Additionally, questions have arisen regarding the smaller volumes processed by plants in the whey cost study comparison with the volumes processed by plants in the nonfat dry milk cost study. Conclusions that the whey plants are smaller and inefficient because their throughput is less than that of plants included in the CDFA nonfat dry milk surveys are erroneous.

A cheese plant processing a given volume of milk will process fewer total solids through its whey operation than a nonfat dry milk plant of the same milk intake. Whereas, nonfat dry milk facilities are processing the vast majority of the incoming solids not fat into nonfat dry milk. Cheese manufacturers capture a portion of the SNF in cheese.

At the Class 4a and 4b formula yields for whey nonfat dry milk respectively, whey processing volume in a cheese plant will be two-thirds the processing volume of a dry milk plant receiving the same volume of raw milk. The scale differences between nonfat dry milk and cheese plants are further exacerbated by the difference in complexity of the 2 businesses.

Cheese and whey manufacturing and marketing are considerably more complex than butter and nonfat dry milk manufacturing and marketing. This complexity constrains the size of cheese plants to a greater extent than butter powder and nonfat dry milk plants.

Comparison between whey plant and nonfat dry milk processing costs. Witnesses have referenced testimony from the May 2000 Federal Order hearing regarding an approximate 2 cent difference between the manufacturing costs of nonfat dry milk and whey. I would like to bring greater clarity to that testimony because it was entered in the Federal Order hearing record by Venkat of Leprino foods, the same whey expert who testified in this hearing regarding the similarities and differences between whey from various cheese sources.

Venkat's Federal Order testimony concluded that, "In summary, incremental whey, energy & equipment costs associated with producing whey powder as compared to producing nonfat dry milk is 2.559 cents. As I stated earlier, the additional equipment in whey operations requires other costs such as extra laboratory equipment, additional maintenance, as well as increased overhead costs. My testimony only covers the additional energy and equipment costs in whey processing, however these other operating costs should not be overlooked."

Similar written was entered into the record during CDFA's January 2003 hearing. The same methodology was used, but energy costs were updated with California specific energy costs and the cost difference that was quantified was 3.058 cents per pound. This testimony was offered in the absence of a whey cost study. Venkat was once again clear in his testimony that the analysis did not fully capture the cost differences between nonfat dry milk and whey, but merely estimated a portion of the cost difference based upon energy and equipment costs.

Suggestions that the whey make allowance should be set at the nonfat dry milk make allowance plus a number derived from Venkat's testimony is flawed. First of all, as already noted, Venkat's analysis captured only a portion of the differences in processing costs for identically sized evaporating and drying facilities.

Secondly, the scale efficiencies achieved by California nonfat dry milk plants are far greater than those achieved by California whey plants. A full whey cost survey, study as the study conducted by CDFA, is far superior in determining the actual whey powder costs than using the nonfat dry milk study of much larger plants adjusted for differences in drying costs for like-sized plants.

Use of the 1999 NCI whey cost study. Several witnesses have proposed that the whey make allowance be based upon the whey cost study commissioned by the bid national cheese institute that was offered in testimony at USDA's federal milk marketing order Class III hearing in May 2000. Additionally, Tillamook's feasibility analysis from the same timeframe has been incorporated in testimony. My post hearing brief supporting the 15.9 cent result from the NCI cost study from the same rulemaking process has also been entered into this hearing record.

The NCI study is not relevant to this hearing due to both timeframe and composition. The NCI cost study covered plant costs during 1999. Many cost factors have changed significantly since that time, including such things as energy, labor and insurance. For example, our electrical and natural gas costs were 61 percent and 109 percent higher in 2004 than in 1999 respectively.

Additionally, at least 6 of the 7 plants in the NCI cost study were located outside the state of California. A quick review of Leprino's 2004 energy costs showed that our electrical rates in California were 60.2 percent higher than natural gas costs were 7 percent higher than our next closest plant outside the state. Therefore the out-of-date and out-of-state data is irrelevant to California's milk pricing.

Price snubbers. Snubbing whey prices at the make allowance. Several proposal include a snubber that does not allow whey prices that fall below the manufacturing cost to reduce the Class 4b price. The very existence of a snubber in an end-product price formula is contrary to the primary objective of an end-product price formula. That is, the snubber by definition precludes the formula result from the reflecting the market values of the finished products at the those times when the market price falls below the make allowance.

The snubber forces manufacturers to absorb losses during low price periods without allowing those same manufacturers to retain revenues that can be used to absorb the losses when the market value exceeds the manufacturing costs. The revenues are passed to producers in the form of higher milk prices. Since the producers effectively are the holders of these beneficial revenues, the losses should be recovered from those who are holding those beneficial revenues, namely the producers through the milk price.

The Alliance of Western Milk Producers suggests that whey processors should discontinue the production of whey powder when market prices fall below the manufacturing costs. Suggestions included land-applying the whey or diverting the whey stream to WPC facilities when whey powder markets fall below the manufacturing costs. Both suggestions are fraught with problems.

First of all, land application is not allowed by most jurisdictions due to environmental concerns. And as for transporting the dilute whey to a WPC manufacturer, the cost of moving dilute whey relative to the solids value makes such movement uneconomical.

Excess WPC capacity is also unlikely to be available. The capital costs of whey equipment, particularly the fractionation equipment required to produce WPC and lactose is extraordinarily high. Therefore, WPC operations are typically sized to accommodate the whey produced by the plant that it regularly serves and cannot accommodate temporary surges in available whey solids for processing.

Snubbing commodity prices at the price support floor. Leprino Foods supports the elimination of the CCC commodity price floor as a snubber in the Class 4a and 4b formulas. The existence of a support floor in the formula, places the cost of a dysfunctional federal dairy support program squarely on the shoulders of California cheese makers.

California cheese makers are being asked to guarantee market value for cheese that is not guaranteed under the federal program. This value is sometimes not realized in the marketplace due to supply and demand imbalances and problems in the implementation of the cheese purchase program.

Dr. Schiek has already testified regarding the underlying problems that result in commodity and prices falling below support. I will not be redundant with his testimony. However, I will amplify Dr. Schiek's point that such a floor is and impediment to clearing milk during the very period that milk is most in surplus.

When CME prices fall below support, we would be forced to minimize milk throughput in our California facilities. To the extent that we had inventory to continue to service customers during that time period or could services those customers from our 6 plants outside of California, we would. Ultimately, this results in more milk being moved out of state to find plant capacity. Clearing the market to out-of-state locations because in-state processing capacity locations -- are unwilling to accept it, should be inserted here -- might be more costly to producers than allowing the commodity prices to fall below the support price.

Yields. The profile of vat milk in California cheese plants should not be used to calculate cheese yields for the Class 4b formula for 2 major reasons. One, milk delivered to cheese plants contains a higher protein to SNF ration than average California make due to incentives paid by cheese plants to induce producers to produce higher protein milk.

The other reason is that fortified milk in vats distorts the cheese yield in the Class 4b formula by attributing the same characteristics of the fortified milk to that of the incoming raw milk. Consequently, the only viable method to determine a raw milk yield is to calculate a theoretical yield using the Van Slyke yield formula, based on the components of noncheese plant raw milk as laid out in the Tong study. To be consistent with unfortified yields, the Department should also remove fortification costs from the make allowance to the extent that those costs are currently captured.

Further elaboration on this issue is also contained in Addendum A.

Need for plant capacity. The continued growth of milk production in California is well documented and has been discussed by several witnesses. We agree that current milk production growth will necessitate additional plant capacity in California and that the ability to attract proprietary investment was substantially reduced by the Department's Class 4b formula change that was made effective April of 2003.

Specifically, the decision increased minimum 4b prices by incorporating a price enhancing whey factor without make offsetting adjustments to other factors in the formula resulting in an overstatement of the Class 4b milk value. We had believed that the prior formulas captured whey revenue indirectly by overstating factors such as yield.

Although, several factors were adjusted in the 2003 decision, the net effect was a substantial increase in Class 4b price levels. This increase averaged 23 cents per hundredweight in 2004. Additionally, the support floor already discussed adds significant risk to manufacturing cheese in California.

There are many factors that a company weighs when deciding where to locate a plant. Milk availability and price is one of the most critical factors we consider. Our decision to build our newest facility in Lemoore was made in 1999, prior to the chilling effects of the April 2003 decision. Although I cannot say with certainty that we will not again consider California for another facility, the current policy environment and continuing high costs of doing business in California greatly diminish the probability of our next plant being located in California.

In conclusion, many witnesses have spoken powerfully about the need to maintain a market oriented milk pricing system. The Dairy Institute proposal is based upon sound economics and maintains this market oriented framework. The Department should adopt the Dairy Institute proposal and reject the proposals put forth by the Alliance of Western Milk Producers, Western United Dairymen, Milk Producers Council and California Dairy Campaign.

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

HEARING OFFICER ESTES: Your request is granted. And the panel may have questions for you at this time.

SUPERVISING AUDITOR HUNTER: Yes, Ms. Taylor, I just have one question. Towards the bottom of page 6, when you're talking about removing the fortification costs, you're talking -- is that in the cost phase itself if a plant was say purchasing condensed skim fortified with vat or condensed whole milk and non fat powder. You're talk about eliminating all those processing costs out of the cost study then?

MS. TAYLOR: Yes, I am, so long as the yield is shifted over toward a raw milk based yield.

SUPERVISING AUDITOR HUNTER: Okay. Otherwise, not the 10.2 yield, but the 10.02 that the Dairy Institute is talking about?

MS. TAYLOR: Right, the Dairy Institute.

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

AGRICULTURE ECONOMIST GOSSARD: On page 3 of your testimony, you talk about the sources and quantities of fat loss in the cheese operation. What about solids not fat, which is the other component of milk?

MS. TAYLOR: Solids nonfat also are lost. There are several different studies around. There was a study by Ecolab that actually I included in my testimony at the last hearing, was produced by Bob Lenihan and presented also at the Federal Order Class III hearing in May of 2000. And he showed a range of -- he was not segregating fat from SNF, but it was a total solids loss in cheese plants that he's studied, as I recall, I think it was 65 or more cheese plants. And I believe that their average total solids loss was in the neighborhood of 2.35 percent.

Dr. Barbano in his testimony did not specifically address SNF. He did acknowledge the loss, but he did not quantify it.

AGRICULTURE ECONOMIST GOSSARD: On page 4 of your testimony you cite the 3.058 cents per pound difference in cost of making skim whey compared to not fat dry milk for plants of comparable sizes.

MS. TAYLOR: And of course that is strictly on a few cost factors that is not quantifying the entire cost difference.

AGRICULTURE ECONOMIST GOSSARD: Did you do an update for 2005 with more current energy?

MS. TAYLOR: I did not, because I didn't feel that it was relevant now that we have a whey cost study.

AGRICULTURE ECONOMIST GOSSARD: And at the top of page 5, you expressed a concern of comparing the weighted average skim whey cost with weighted average not fat dry milk cost because of size differences in the plants. Do you have a problem in comparing the cost at the skim whey plants with the cost of not fat dry milks of the same size?

Specifically, there are about 6 not fat dry milk plants on our cost study that span the volume of the 4 skim whey plants. Does a comparison of the costs there at least give you some ballpark figures?

MS. TAYLOR: I suspect it could be interesting, but I'm not sure that it really adds anything to the discussion, because you're starting out with a skim whey cost study that needs no other comparison. It can be used straight up.

AGRICULTURE ECONOMIST GOSSARD: And finally, on page 6 the yield discussion Addendum A. In your post-hearing brief could you review the 2003 panel report discussion on yields and comment based on your feelings and what the Department felt in 2003?

MS. TAYLOR: Sure.

AGRICULTURE ECONOMIST GOSSARD: Thank you.

No further questions.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Good morning, Ms. Taylor. I appreciate your input this morning. Just a couple of questions for you.

You said the NCI study is not relevant to this hearing due to both timeframe and composition. And your discussion that follows that, as far as I can tell, strictly deals with timeframe. What's the composition piece of it?

MS. TAYLOR: The composition that I'm referring to is what plants participated in the study. And I note in my testimony that 6 out of the 7 plants are from out-of-state.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I was thinking product composition.

MS. TAYLOR: No, no.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Okay. Got it. Also to follow up with Mr. Gossard's question on the Van Slyke formula. I know that Dairy Institute specified how they would like to use the Van Slyke formula. And I suppose if we all greed that we would just agree to use the Tong study, as at least some of the primers for the Van Slyke arm, we could at least move in that direction. But there are still some pieces in there, some parameters that are not going to be covered by the Tong Study that we'd all have to come to some agreement to.

And based on what we've heard, yesterday and today, I think we're still quite a ways apart on agreement on things. Even if we couldn't agree on the milk piece of it, how do we agree upon the other factors? And that's my question to you is, how do we resolve -- if we were to use the Van Slyke formula, how do we resolve getting agreement amongst all of us? What's the right pieces to put in that formula?

MS. TAYLOR: I think it's actually very straightforward, if you are looking at milk price policy as a minimum price policy. There are -- there is a range of fat retention. And I think that prior testimony has referenced that range as roughly 90 to 94 percent fat retention in cheddar cheese. Most would be in a 90 to 92 percent range. And, you know, consistent with minimum price policy, I would advocate that the Department adopt something closer to the bottom end of that range, 90 percent, which is consistent with the Federal Order approach on the Van Slyke yield formula.

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

DAIRY MARKETING BRANCH CHIEF IKARI: Thank you for your testimony. You obviously, you and, is it Dr. Venkat or?

MS. TAYLOR: No.

DAIRY MARKETING BRANCH CHIEF IKARI: Venkat had a lot of expertise when it comes to whey. My question is, whether you can provide information on Leprino -- you can provide information on Leprino's whey cost. If you can't disclose confidential information, could you tell us averages? Could you give us something, is it below 20 cents? Is it above 17 cents? Some kind of way to characterize what your whey costs are.

MS. TAYLOR: We do not produce any sweet whey in the state of California. We do have two sweet whey production facilities. One is located in New York State. And one is located in Michigan. I'm not sure the relevance of that data without providing also all the comparisons in terms of the rate differences between those states and California.

DAIRY MARKETING BRANCH CHIEF IKARI: Well, perhaps you could qualify the obvious differences, but we'd be interested in looking at what costs that you could share with us.

MS. TAYLOR: Okay. I will take a look at how we might put that together in a format that wouldn't be too confidential, and consider including that in our post-hearing brief.

DAIRY MARKETING BRANCH CHIEF IKARI: Obviously, we've taken a lot of testimony about the validity of our whey cost studies. And so the more information we can get, I think, is helpful to us.

Thank you.

MS. TAYLOR: Okay.

HEARING OFFICER ESTES: Anymore questions?

Seeing none, we appreciate you appearing here today and providing us with your testimony.

We have 2 more witnesses who I think will, at least from my impression, will probably testify fairly briefly. But I would like to note at this time that if there's anyone else here who wants to testify, I'm going to be taking testimony from Dr. Gruebele, who I believe wants to clarify some of his testimony from yesterday, and also from Dr. Schiek of Dairy Institute who wants to take advantage of the public comment period to finish up with the brief remainder of his testimony from yesterday.

If there is anyone else here who wants to testify, please sign the witness roster list within the time period that Dr. Gruebele and Dr. Schiek are testifying, so that we can avoid one of these inelegant scrambles to try to come to the last person to testify in the hearing record. Because obviously everyone is here, there should not be any difficulty in signing the list if you want to testify as has been available throughout the whole hearing process.

So at this time --

MR. TILLISON: Mr. Hearing Officer, I just wanted to give the Department a copy of the signed letter from Northwest Dairies regarding the information that was testified to by several witnesses yesterday.

HEARING OFFICER ESTES: All right. Why don't we take people in this order then. Mr. Tillison, I assume you can address that issue -- introduce that in the record like in about 20 seconds. So we'll bring you forward first. We'll bring Dr. Gruebele second and Dr. Schiek last. And then anyone else who wants to testify, I guess will have to watch the clock, if there's more than one, to determine if they want to contest the order in which they want to appear.

Mr. Tillison, you've already been sworn, so there's no need to do so again. For what purpose did you want to appear at this time?

MR. TILLISON: I want to present to the Department a signed copy of the actual letter that was entered into the -- was attached to some of our testimony yesterday. I believe the testimony of Western United and Milk Producers Council, as well as my testimony had segments of this. So I thought it would be useful for the Department to have an actual signed copy of the letter for the record.

HEARING OFFICER ESTES: We will accept that. Let me just look through here briefly. I'd like to sort of try to number the exhibit in close proximity to your exhibit testimony. So if you could just wait just a moment. I think we have exhibit 48 here is your testimony. So we'll introduce this into the record as Exhibit 48A.

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

HEARING OFFICER ESTES: So if you would please bring that forward.

Thank you very much.

You don't, I assume -- is the only purpose for which you were testifying?

MR. TILLISON: Yes.

HEARING OFFICER ESTES: I just want to clear it up and make sure.

Dr. Gruebele, if you would come forward at this time.

Dr. Gruebele, again as with Mr. Tillison, you've already been sworn, so please proceed with any additional remarks you want to make.

DR. GRUEBELE: My comments have to do with the obvious problem that we encountered yesterday when I was presenting the formal testimony. I had unfortunately inserted some pages and didn't realize that it changed the pages you were following. So, for example, I couldn't find December 2003 numbers, that was only because I inserted page 6 and page 7 changed. And I should have rerun the entire transcript at that time.

It also affected page 11, where I repeated the same statement at the top, as it appeared on the bottom of page 10, the way I represented. So all I was requesting is a revised completed copy, which was in my computer. I reread it. And submitting that to replace the formal testimony, that written testimony, that I presented yesterday.

HEARING OFFICER ESTES: All right. Let me just ask the panel one question. Is the panel clear on the differences to which Dr. Gruebele is referring?

SUPERVISING AUDITOR HUNTER: You're not going to reread the whole thing, are you?

(Laughter.)

DR. GRUEBELE: I will if you really want me to.

(Laughter.)

DR. GRUEBELE: I think Dr Gossard -- Mr. Gossard wants me to do that.

(Laughter.)

HEARING OFFICER ESTES: Well, my impression is he's probably outvoted on that intention.

(Laughter.)

HEARING OFFICER ESTES: Dr. Gruebele, would you please bring that forward. We'll introduce that as Exhibit -- I guess what we'll do is we'll substitute this for the original Exhibit 43. And the other Exhibit 43 will be excised from the record.

We will leave it -- just to be clear, we will leave it in the record just to record the fact that we did receive it, and that it was -- that you did substitute your subsequent testimony in the event that there's some reason to have make future reference to the record for litigation or others. So I don't want to leave you with the impression that it will be totally gone from the file, but it will not be considered part of the official record.

It will be maintained separately.

Dr. Schiek.

Let me just make one last comment on your Exhibit. Dr. Gruebele's testimony as part of the official record will be Exhibit 43A. Exhibit 43 will be marked as such, but will not be part of the official record, just for record keeping purposes.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 43A.)

HEARING OFFICER ESTES: Dr. Schiek, I understand you wanted to take this opportunity to make some concluding remarks in regard to your earlier testimony.

DR. SCHIEK: Yeah, mainly to -- I had to -- obviously pressed for time, I had to skip over some of the stuff and summarize it very briefly. I'd like to read those portions into the record now that I skipped over. It's not that much material.

HEARING OFFICER ESTES: No, I didn't recall that it was. I just want to note again for the record, you have previously been sworn. So there is no need for us to do so again. So please proceed with your comments.

DR. SCHIEK: Yeah. If you still have copies of my testimony and want to follow along, I'm starting on page 6 where we're talking about commodity price floors. It's about the middle of page. Starting with right under

Item 4. There is a common misconception that the use of the support floor prevents the cheddar market from going below the support floor price. Many point to the market rising from 109 at the end of March 2003 to above the support price by the end of April 2003.

They correlate the support floor price in the California's formula with pushing the market price up. This is a spurious correlation. Market prices increased in April of 2003 due to the tightening of supply side market conditions. Numerous factors prove that this was the case. Soy Bean prices were on the rise from earlier 2003 into the summer of 2003, rising over 60 cents per bushel during this timeframe.

This resulted in an increase in the composite feed price per ton for dairy farmers. The increase costs squeezed margins for farmers encouraging them to tighten rations and cull milk of milking cows. Milk cow numbers fell substantially in April of 2003.

Production growth which had been humming along at 2 and a half percent in 2002 and was still greater than or equal to 1 percent gain in each month of January through March of the 2003 period. In April 2003, the year-over-year growth in milk production came to a virtual stand still just 0.2 percent. And then was near 0 or negative for the remainder of the year.

The turn around in milk production was due to an extended period of poor farm level milk prices that sent the signal to farmers to decrease milk production by culling cows or exiting the business.

In addition to this relative decrease in milk production, there were continued talks by major cooperatives during this timeframe about a self-funded supply management program, which ultimately became known as CWT and was implemented July 1, 2003.

American cheese inventories, which includes cheddar in January 2003 were 12 percent above the previous year, and 10.1 percent above the previous 5-year average. By April, the year-over-year increase in inventories had decreased to 4.1 percent above the previous year and 5.2 percent above the 5-year average. And by May, the year-over-year increase had decreased to 0.5 percent above the previous year, and 3 percent above the previous 5-year average.

These year-over-year changes indicate that the supply of cheese compared to the previous periods was tightening, from January through May 2003. So again we conclude that it was the tightening supply conditions that led to the market price for cheese rising through April 2003 and into the remainder of year and not California's support price floor in the 4b formula.

We also mentioned about the problem with the CCC purchase price with the market prices for cheese, butter and powder falling below the CCC purchase price. It was a national problem created by the cost of doing business with government. And it's a problem that needs national solutions.

I just want to reemphasize the fact that the current California system with the support floor snubber in the formula creates a disincentive for Dairy Institute's members participating in some of the proposed solutions. If a problems is going to be solved at the national level, it's going to require a support of both the producer and the processor community.

I see the floor as it exists in the California formula as an impediment to the processor participation, because of the risk that any increase in CCC purchase prices or offsets that are put into the CCC formulas might end up raising the regulated minimum price in California. So in our view to solve the problem at the national level, the CCC purchase price floor in California must be eliminated from the formula.

Let's see, turning now to the last part of my testimony where we talked about other proposals, starting with Land O'Lakes. LOL's proposal is substantially similar to Dairy Institute's, and we support most aspects of their proposal. The main difference in our proposal is to eliminate the support price snubber in the current formulas, and we've already explained that.

I talked about the Alliance proposal yesterday, so I'm not going to repeat that here. California Dairies. I did want to say that there is some merit to the proposed 80 percent volume coverage under the butter powder make allowance. It seems to me the issue here is the Department has to balance this worthwhile goal of covering 80 percent of the volume in light of the individual cost and plant data.

If a make allowance that is much higher than the weighted average cost is needed to cover 80 percent of the butter powder volume, the reason could be that there is a large or are large high cost plants in the survey. CDFA must weigh the goal of covering 80 percent with the incentive for expansion that will be created among the lower cost plants if the make allowances are raised substantial from current levels or from the weighted average.

By covering 80 percent, CDFA might inadvertently tilt the make allowance in favor of the butter powder complex. This would be likely if the cheese plant costs were bunched closely about the weighted average, while butter powder costs were widely disbursed. Only CDFA staff has the data available to them to make these judgments. We leave it to their discretion to make the appropriate choice so as to encourage adequate manufacturing capacity, but not the favor investment in butter and powder plants over cheese.

California Dairy Campaign. CDC's proposal would lead to substantially higher Class 4b prices, which would damage the competitiveness of California cheese makers in the national market. This CDC proposals are not supported by CDFA data. During periods when milk is abundant and prices are low, CDC's proposal could result in milk being left unpurchased as plant margins are squeezed.

Given the cost of drying whey in California, CDC's proposal would ensure that plants do not have adequate margin to cover their costs of producing whey. As we stated earlier, there is no economic justification for a lower whey make allowance, a whey snubber or the elimination of the FOB cheese adjuster. We urge the Department to reject their proposal.

Milk Producers Council. We reject the dry whey make allowance proposed by MPC as not being supported by the CDFA data. End-product pricing formulas must be based on values representative of what California plans actually receive. The actual cost of manufacturing dairy products in California and the actual yields achieved by California plants. MPC's proposed dry whey snubber is a violation of these principles and should be rejected.

We disagree with the FOB adjusters proposed by the MPC in favor of the ones we have proposed for the reasons we stated earlier.

Western United Dairymen. Again, we've argued for a different set of FOB adjusters, and those proposed by Western United. We continue to stand by our justification for those adjusters that we have proposed. Western United proposed snubbing the dry whey factor, and again that has a negative influence on the 4b price, and we addressed that as being without valid economic justification or merit. So we urge the Department to reject Western United's class 4a and 4b proposals.

Again, I just want to reiterate that we believe the greatest risk in any minimum price regulation is setting prices too high, because there's essentially no way to correct for that problem. If you set prices lower than the market would arrive at on their own, competitive premiums and market prices will adjust to bring those up. And so we see the danger in setting prices too high.

With regard to the need for flexibility in the pricing system, the market prices have to be set at levels that clear the market. And I think one of the issues about depooling in Federal Orders that gives flexibility -- it's not just the cheese plants or butter powder plants, whoever depools gets to take extra revenue, but it's the ability to clear the market. And if you look at dairy market news at certain times of the year, you'll see reports of milk moving to plants that are not being pooled or at least portions of the milk not being pooled at some amount of money below class.

Sometimes it moves in above class, but a lot of times when milk is long, it moves in below class. And that's an important function to be able to clear the market. In California, we don't have the option to depool. So regulated minimum prices have to be low enough, so that the market clears. And we feel like that's an important component of regulated pricing needs to be looked at.

A final note is on Appendix A, which was the list of plants. And I just want to make a comment on one plant that wasn't terribly complete. And that's down at the bottom where we mention cheese companies that were considering building plants in California, but elected to build -- not to build or build elsewhere. And one of the built a plant in Clovis, New Mexico. It had been talking with suppliers in California about building a plant here, but ultimately decided to go to New Mexico.

One of the things you should know about that plant and this is generally seen in the industry press, when that plant opens it's expected to be taking in about 3 million pounds of milk a day. And within the 1st year up to 6 million pounds of milk a day. It's generally been discussed around the industry that the ultimately capacity will be around 9 million pounds of milk a day.

With a plant that size, while there is growth in the cheese industry, and some of that growth can be accommodated by that plant, they're going to have to take business away from other plants in order to sell the plant -- the capacity of the product that they're producing.

And I just wanted to note that there are some partners in that plant -- Glanbia is going to operate it, but they're not the only investors. The other investors include Dairy Farmers of America, Zia Milk Producers, Loan Star Milk Producers, and Select Milk Producers.

We had a person testifying on behalf of Select today arguing for a higher regulated price in California, and he neglected to disclose that they're a major investor and a competitor with California cheese plants for sales. So I just wanted that on the record.

And that's all I had.

HEARING OFFICER ESTES: Are there any questions for Dr. Schiek?

AGRICULTURE ECONOMIST GOSSARD: One question. The New Mexico plant what type of cheese are they making?

DR. SCHIEK: It's going to be American cheese.

HEARING OFFICER ESTES: I believe he said he had one question, although that's not always --

AGRICULTURE ECONOMIST GOSSARD: Yeah, that was the one question.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: Dr. Schiek, in reference to your discussion on the price floors, you have a number of reasons that would possibly explain the uptake in the cheese market, are you suggesting that the uptake in the cheese market is possibly attributed to your factors or is definitely attributed to your factors and in no way is the price floor responsible for the uptake we saw?

DR. SCHIEK: I'm saying it's due to the supply tightening factors. The uptake, despite the California support floor, could not have happened without that supply tightening. It just simply wouldn't have been in the supply -- the market supply forces that would allow that to happen.

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: If all of these other factors were greater than the price floor in terms of their effect -- so I mean I'm kind of paraphrasing you -- the price floor was a minimal effect, if any effect at all, then why not just leave it in? Leave this as it is, a minimal effect?

DR. SCHIEK: I'm saying it has a minimal effect on the ability of the market to recover. I'm not saying that it has a minimal effect on the profitability and viability of plants in California.

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

HEARING OFFICER ESTES: Any other questions?

All right, thank you, Dr. Schiek. Our last witness today -- as the opportunity to testify on the witness roster list is now closed -- is Geoffrey Vanden Heuvel of Milk Producers Council.

Again, Dr -- excuse me, Dr. Vanden Heuvel.

(Laughter.)

MR. VANDEN HEUVEL: That's good to have a joke this early in the morning.

(Laughter.)

ANIMAL HEALTH AND FOOD SAFETY SERVICES SPECIAL ASSISTANT ERBA: I'll teach you the secret handshake afterwards.

(Laughter.)

HEARING OFFICER ESTES: You've been sworn, so you can just proceed with your testimony.

MR. VANDEN HEUVEL: Thank you, Mr. Hearing

Officer and members of the panel. There's a couple of things that I wanted to readdress. I'll start with what Dr. Schiek talked about in terms of the support price floor.

Certainly, the overall milk supply demand situation ultimately impacts whatever price emerges. But the timing of when those impacts come into play can be, and I think very clearly were, a function of regulatory action. There was no downside risk to cheese sellers to sell the price -- to bring down the price of cheese below the support purchase price. That's the nature and the function of our product value formulas that now we both have in California and in the Federal Order.

You start with that product value. Essentially, the margin for the plant is fixed. They could sell the cheese for a buck and a half, they could sell it for a buck, they could sell it for 50 cents. And if you believe their rhetoric and just this total principle opposition to snubbers, if they sold cheese for 10 cents a pound, they could expect that the producers would write out a check at a dollar a hundredweight to add to our milk as it got on the tanker for them to go process it.

It's the nature of the formula. It's not reasonable. That's an extreme. And so there had to be put in place some incentive for the manufacturers to sell the price at a particular level. And the federal government establishes a support purchase program specifically to put a floor under dairy prices. And they carry that out by establishing a purchase price for commodities, because they don't purchase fluid milk.

And they establish a price. We can argue about whether they -- you know, it costs more to sell to the government. That's a legitimate discussion.

The price floor that was implemented by the Department in April of 2003 included the 3 cent plus adjuster off of the support price as well to help compensate for those additional costs. And it was a very reasonable, and a very important signal to the market. And the market got it. They moved the CME price up. And so I think the facts speak for themselves on that.

On the essence of this hearing. We spent a lot of time talking about the details of the formulas. But what you really have today is 2 different visions of where policy ought to go. If you believe that California is really going to be producing 45 million pounds or billion bounds of milk or some huge amount of -- if we're going to continue to grow at that rate, then by extension then you can say well, then maybe we've got to have more plants.

The reality of the situation may be quite a bit different than that. There's no. -- despite the fact that we have grown, the plant capacity has by and large kept up with our production. And we're getting our milk processed on the manufacturing side. But we've got this other phenomenon, which is a tremendous amount of milk being imported for Class 1, which I think is a problem that the industry may want to address in the not too distant future.

Why do we want to expand manufacturing capacity and why do we want to get all this milk -- more milk in the lowest class usage and just write off and give up? I mean, to hear Hilmar's witness say basically that Class 1 is not the highest and best usage, I think challenges the entire basis upon which our entire order is structured, which is that Class 1 is the highest and best usage.

And I think as the Department evaluates what they do in a macro sense, whatever adjustments you make, if they change the status quo, is either going to take money out of producers' pockets and put it in the processors' pockets or vice versa. It's really a zero-sum game.

And if we're going to take money out of the producers' pockets on the manufacturing milk side, you know, what income do we have to address the Class 1 side, if, in fact, adjustments need to be made to try to make California milk more competitive for Class 1?

I think I spent -- let me kind of close with some overall policy things that haven't been mentioned in these hearings. I serve on a number of water boards and have spent quite a bit of time over the last decade working California water policy. And also not only Milk Producers Council but Western United Dairymen to some extent, the Alliance producers and now given what's happening in the press, processors are not unaffected by a tremendous amount of scrutiny on our industry on environmental issues.

We really our industry -- I've got a colleague of mine who says we've turned from darlings to dogs. And that's the way we feel as producers. Ten years ago, Kings County came down to Chino and did a bus tour and was courting the Chino dairymen who they knew would eventually need to relocate to come to Kings county.

Last November the residences of Wasco in Kern County voted overwhelmingly to prohibit any dairy from being located within 10 or more miles from their community. When you have a rural community that votes like that, you know you've got a significant public relations problem.

When you see the tremendous amount of water that has been transferred from the Imperial Valley and the Palo Verde valley, the Colorado River supplies that. They grow a tremendous amount of the alfalfa that supply our industry. That's been diverted to urban uses, because of the growth of the urban population. When you see the lack of storage that exists on the state water system -- you now, the one benefit of the Colorado river system is that you have Lake Mead and Lake Powell, which combined store about 65 million acre feet of water. The Colorado River allocates out about 14 million acre feet. And so you've got, theoretically, 4 to 5 years worth of reserve supply that sits in those lakes.

Now, if you look at the Sacramento River system it delivers about the same amount of water as the Colorado. But it's 2 reservoirs, Shasta and Oroville store about half of that, about 6 million to 7 million acre feet. And there are competing demands for that water.

I can go on and list the water challenges, the recent court case to rewater the San Joaquin River, and restore the Salmon Fishery on the San Joaquin River. It will have profound impacts on water availability for agriculture. To think that the growth of the past is going to be repeated in the future, is not -- it's something to be watched and to be considered, but to begin to reallocate significant dollars based on what happened in the past and an assumption that it's going to happen in the future would not be wise policy.

And that's what you're being asked to do today. The processors got lucky. This initial skim whey study showed much Higher costs than I suspect even they anticipated. I mean we all know the capabilities of Leprino. They are extremely capable folks in testifying. And they testified in the Federal Order hearing that 15.9 cents was acceptable to them in terms of the dry whey. Their witnesses have testified to a 2 and a half to 3 cent difference between dry whey and not fat dry milk. Do you think if they thought it was 9 cents, that they wouldn't have delivered that testimony here?

This was a surprise. So it comes in and it's a great leveler. It's a great leveler. And so we can spend a lot of time trying to figure out how to deal with a study that's pretty inconsistent and yet done in a credible way by a credible organization, and so we've got to deal with it.

But the bigger issue is what we're talking about, is what is the appropriate 4b price and should the Department as a result of this hearing increase the spread between the California price and the Federal Order price that applies pretty much everywhere else in the country? Or leave it about the same or decrease it?

And we've argued and continue to argue that we got it about right. And I just don't think that, although you can focus on specific parts of this formula and make a case one way or the other in the big picture, making any big moves and taking money out of the producer's side on manufacturing would be extremely costly. We have gone through -- you know, right now producers are feeling better because we've had a pretty good year in the last year and we've recovered substantially from the bad times of 2002, 2003.

But to take anymore money out of the 4b formula -- I mean, do we really want to have and get to get rid of the price floor? I mean, it's entirely conceivable that we could get well into the low 8's maybe even the high 7's in terms of a 4b price and going through the next time we go through a down period. It's just -- it blows the mind. I mean, you want the processors talk about risk, that kind of risk on the producer's side is just scary beyond dimension.

So you've got a big job in front of you. Really, the Department, you know, is being asked by the petitioner to go back down a road we've been down before. And I always opposed that road, but I will concede that it was successful. It was successful in building a California cheese industry. Let's be proud of our success. Let's not risk the same factors will be there that we can do it again. I don't think we can.

Thank you very much.

HEARING OFFICER ESTES: Do we have any questions for Mr. Vanden Heuvel?

DAIRY MARKETING BRANCH CHIEF IKARI: I do.

Mr. Vanden Heuvel, one of the things that I just heard you say is that you don't want to change the manufacturing product prices for 4a, 4b price. Yet, there's testimony from -- and this is not a Class 1 hearing, because you also testified about the import of milk going into our Class 1, but it is a Class 2, 3, hearing. And there was testimony by Sharon Hale who talked about the decreasing production of Class 2, 3 products, and we're not keeping pace with our California population.

Would you support a lower price for Class 2 and 3, so that we could expand the California production of Class 2, 3 products, perhaps be a supplier of the other western states of those products?

MR. VANDEN HEUVEL: Well, I tell you, it's difficult. And I think Ben Yale made a good point about using one system. You know we kind of got our producers organized, and do we want to use the California system to -- and the tools that we have in the State order to basically go after and compete with other producers who are in a different regulatory scheme. And I think his caution against doing that is worth considering.

On the 2, 3, I'm not convinced at all that the reason why we may be declining in 2, 3 production in California is necessarily a function of our milk price. This has been a brutal 5 years for us as Californians, in terms of what we've had to deal with in the business cycle.

And, you know, there's -- you know, the movement of a plant or 2 from here to someplace out of the state could have nothing to do with the price of milk but simply -- you know, I've got colleagues in other businesses and they're always telling me that Texas is out there and Nevada and other states looking to steal California businesses.

In fact, as you leave state Staple's Center in downtown LA and get on the freeway, there's a great big billboard that says Tired Of California, Come to Nevada, right there in downtown LA.

And so -- I mean, you know theoretically if we could be assured that if we lowered the Class 2 and 3 prices by a very modest amount that that would shore up or 2, 3 business, you know, then that might be worth considering. But I don't think there's any guarantee that we'll able to do that, because I'm not at all convinced that it's just the price of milk that's making those 2, 3 folks move.

HEARING OFFICER ESTES: Okay.

Any other panel questions?

All right, thank you, Mr. Vanden Heuvel.

At this time, the hearing is closed. The Department will be rendering a decision consistent with the statutory and regulatory authority. And finally again, as one last reminder, for the people who will be submitting post-hearing briefs, they are due at the Department by 4:30 p.m. February 8th, 2005, which is a week from yesterday, I believe. And they can be submitted to the Dairy Marketing Branch, 560 J Street, Suite 150, Sacramento, California, 95814. And they may also be faxed at (916)341-6697.

So, again, we thank all of you for appearing and testifying and just observing, and the hearing record is now closed, with the exception of post-hearing briefs.

(Thereupon the Department of Food and
Agriculture, Market Milk Hearing adjourned
at 10:35 p.m.)

CERTIFICATE OF REPORTER

I, JAMES F. PETERS, a Certified Shorthand Reporter of the State of California, and Registered Professional Reporter, do hereby certify:

That I am a disinterested person herein; that the foregoing Department of Food and Agriculture, 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