EXHIBIT # _____

Testimony of
Michael McCully
On behalf of
Kraft Foods
At the
Federal Order Product Price Formulas Hearing

Strongsville, OH
February 26, 2007

My name is Mike McCully, Associate Director of Dairy Procurement at Kraft Foods, and I am testifying on their behalf. I have worked for Kraft over 10 years and currently have responsibility for US milk procurement, US and global dairy market analysis and price forecasting, and US dairy commodity risk management. Kraft is a member of the International Dairy Foods Association, and this testimony supports IDFA's position and proposals.

Kraft is both a manufacturer and purchaser of dairy products used in our retail and foodservice businesses. Kraft has manufacturing facilities and buys milk in the following states: NY (Lowville, Campbell, and Walton), PA (Lehigh Valley), WI (Beaver Dam), MO (Springfield), AR (Bentonville), and CA (Tulare and Visalia). Kraft also has other facilities that receive dairy commodities (e.g. cheese, cream, NFDM) for the production of products such as process cheese, natural cuts and shreds, frozen pizzas, and macaroni and cheese. For these facilities, we procure cheese from CA, ID, NM, CO, SD, IA, WI, MN, IL, MI, NY, and VT, as well as import cheese from New Zealand and Australia. Kraft has closed or sold many manufacturing plants over the last 25 years and relies increasingly on dairy products we purchase from others.

In the interest of time, I will not address each proposal directly. Instead, I will focus on several proposals or issues and defer to IDFA for our position on the other proposals.

Pricina Class III Fat

Fat pricing issues in this hearing include how much milk is lost in shrinkage between the farm and the plant and how to value the fat not recovered in the cheese but which comes out in the whey. I will address each of these.

Farm to Plant Milk Loss. Like all plants, we also experience loss of fat between the farm gate and our cheese vat or from farm gate through someone else's separator to our vat in the form of cream. All this milk must be accounted for at the Class 3 price, not just the milk that ends up in the vat. Therefore, any yield or fat recovery expressly or implicitly included in the formula must account fully for shrinkage between farm and the vat so that the yield or fat recovery is not artificially or arbitrarily inflated.

The valuing of whey cream. The current price formulas set the minimum milk price by starting with the price obtained by processors for their finished products. The current formula assumes butter made from whey cream has the same price (value) in the marketplace as grade AA butter, but this is not supported by data. It is also incorrect to assume that whey cream should be valued highly because it can just be added back into every cheese vat. In fact, Kraft does not allow the addition of whey cream for most of the cheddar cheese that we buy.

The fat that is not recovered in cheese, but is sold instead in whey cream or whey butter, does not command a market price equal to fat in AA butter. Whey cream and butter are equivalent to Grade B butter since whey cream cannot be used to produce grade AA butter.   Back when all 3 grades of butter traded at the Chicago Mercantile Exchange, grade B butter was about $0.07 less than AA butter during the 7 year period from 1991 to 1997, but the spread widened to about $0.10 in the last 2 years of B market trading in 1997-98. While the CME grade B market no longer exists, grade B butter is still bought and sold. Kraft's experience in selling whey cream suggests this $0.10 discount to the AA market still exists. One of our butterfat suppliers from CA also sells grade B butter for a $0.10 discount to the AA market. In addition to the lower valued whey cream, there is also fat in the whey stream that ends up in whey powder and other whey products. According to USDEC specifications, sweet whey powder contains 1.O-1.5% fat. In summary, the fat in whey is of lower value than grade AA butter, and the Secretary should revise the current formulas to account for that lower value, based on all of the evidence presented at the hearing on the amount of that lower value.

Continued Use of **NASS Prices**

Kraft supports the continued use of the NASS survey prices in the milk price formulas. Even though this represents prices for only one-third of all cheese produced in the country, it represents significantly more volume than the CME market and is national in scope. Reliance on the CME prices alone would measure from a thinner market and exclude the substantial and growing volume

of cheese produced in the Western states, such as CA, ID, and NM. This point is particularly important when realizing the cheese market is national in scope and that this is only reflected in-the NASS price surveys. Let's work through a simple example. The CME price is based on the price of cheese within a 300 mile radius of Green Bay, WI. Any distance greater than 300 miles is discounted by a freight differential. If a cheese plant in Tulare, CA sells a load of cheese for $1.3'5 at the CME to a buyer in Chicago, the price would be discounted by 4.27 cents per pound which is Rhe freight differential for 2100 miles. The cheese plant would report $1.3073 as the sales price to NASS since that is their net sales price, not the $1.35 price that the CME would report for that cheese. Therefore, the NASS price is a measure of the national market price for cheese, while the CME only represents a locally adjusted price for the Green Bay area. (the section on delivery points and freight differentials from the CME Rulebook are included as Appendix A)

We appreciate the fact there are issues with the NASS survey, such as the time lag in reporting. However, instead of eliminating the NASS survey as some recommend, we feel it would be more prudent to address the root cause of the time lag. One solution would be to require more timely reporting of prices that would reduce or eliminate the current lag impact. As an example, livestock and meat prices are reported by USDA AMS on a daily basis. This information is available for all market participants to use on a real-time basis with no lags. Moving to daily price reporting is not something new for dairy since we transitioned from weekly to daily cash markets at the CME. So, instead of

"throwing the baby out with the bathwater", the industry would be better served by improving the existing NASS survey and developing a pricing system that is transparent, easy to understand, and transmits market signals immediately.

Continued Use of Barrel Cheese Prices

The USDA should continue to use both block and barrel cheese prices in calculating milk prices and reject proposals to eliminate barrels from the formula. The first reason is simple – there are more barrels reported in the weekly NASS price survey than blocks. Since 2000, the NASS survey has been approximately 57% barrels and 43% blocks. Some quick math confirms these figures. In 2005, US cheddar cheese production was 3.05 billion pounds. We estimate approximately 20%, or 600mm pounds, were for aging. Another 1.1 billion pounds were in barrels. Of the remaining 1.3 billion pounds, we estimate 45% was packaged in 640 lb blocks and 55% in 40 lb blocks. Comparing the volume of 40 lb blocks to barrels results in about 60% barrels and 40% blocks, so we feel the NASS survey is reflective of the US cheese market for 4-30 day old cheddar cheese.

Continuing the use of barrels in the formula is consistent with past USDA decisions. In the Federal Milk Marketing Order Reform in March 1999, "many commenters insisted that barrel cheddar cheese prices should be included in a weighted average with block cheddar prices since much more barrel cheese is produced than block cheese." And in their explanation of the new product formulas, USDA stated "including both block and barrel cheese in the price computation increases the sample size by about 150 percent, giving a better

representation of the cheese market." The same logic used then still holds true today, therefore barrels should remain in the price formula.

Another reason to keep barrels in the formula is that barrel and block cheese are different commodities with different supply and demand dynamics. Block cheese is primarily used in cutting or ready-to-eat applications, whereas barrel cheese is primarily used in process cheese applications. As the narrow and sometimes inverted spread between blocks and barrels over the past year have demonstrated, there are clearly different supply and demand drivers for each blocks and barrels. If the goal of USDA is to reflect the value of cheddar cheese, it is imperative both blocks and barrels are included in the price formula.

Eliminate 3 Cent Barrel Adjustment

For the reasons detailed above, it is clear both barrels and blocks should remain in the milk price formulas. But the current formula contains a problem when adjusting the barrel prices to a comparable block price. First, the barrel price is adjusted to 38% moisture from the reported moisture. Then, 3 cents is added to the barrel price. Several proposals advocate reducing or eliminating that 3 cent addition. We believe the 3 cent addition should be eliminated. The average block moisture is just under 38%. We agree with the adjustment of the barrel moisture to 38% to give an apples-to-apples comparison. However, the 3 cent differential added to the barrel price to account for manufacturing, packaging, and testing differences is not needed. Following is an example to illustrate this point. It starts with the 2006 average producer tests for Federal Order milk with a fat test of 3.69% and a protein test of 3.05%. Using a 90% fat

retention and the current yield formula, the cheese yield is **10.07** for block and **9.53** for barrels. Using a **$1.40** market for block and a **$1.37** market for barrel, this converts to a **$1.40** block price and a **$1.471** barrel price adjusted to 38% moisture. To calculate a gross return, the yield is multiplied by the moisture adjusted prices. For block, this is **$14.099** per hundredweight and **$14.023** for barrel. On a cheese basis, this equates to approximately a **$0.0075** per pound difference for blocks, well below than the 3 cent adjustment currently used in the price formula. The table in Appendix B provides **2** additional examples with higher and lower market prices. However, the result is the same − the difference in the gross return between blocks and barrels is well below the 3 cents currently used in the formula.

In the Federal Order reform decision, it was stated "the three cents that is added to the barrel cheese price is generally considered to be the industry standard cost difference between processing barrel cheese and processing block cheese."   It added that comments noted the 3 cent difference was due to the difference in packaging costs. Over the past 10 years, **40** pound block manufacturing efficiency has improved and the advantage in barrel manufacturing efficiency has narrowed. We believe the **3** cent adjustment overstates the difference and does not reflect the extra investment in additional steps needed to package cheese in barrels. Depending on the plant, these steps include recrumbling, pressing, vacuum sealing, and cooling. It is clear the **3** cent adjustment is overstated. Importantly, the Cornell manufacturing cost survey contains both block and barrel cheese plants and are reflective of costs for both

container types. Therefore, the price formula should continue to adjust the barrel moisture to 38%, but the 3 cent adjustment should be eliminated completely from the formula.

Impact on Futures Markets

A number of proposals have the potential to negatively impact the CME futures markets. The elimination of barrels in the milk price formulas would greatly reduce the volume of cheese represented in the NASS survey used to establish milk prices. This seems to be counter to the goal of having the most accurate representation of the value of the underlying commodities in the price formulas used to settle futures contracts. Additionally, the proposal to add an energy adjuster would add basis risk to futures prices. Specifically, adding an unknown energy adjuster introduces an unpredictable element to the price formula and would likely deter market participants from using futures for hedging. Given the volatility of milk prices and need for risk management tools, any proposal that would negatively impact these tools should be rejected.

I appreciate the opportunity to present Kraft's viewpoint on this issue, and welcome questions regarding my testimony. Thank you.

In adjusting the stated price for moisture content the measured moisture shall be rounded to the nearest one-half percent. For example, if the measured moisture is **36.2** percent, it shall be considered to be **36** percent moisture, while if the measured moisture is **36.3** percent, it shall be rounded to **36.5** percent moisture.

The seller of cheese on the moisture basis shall furnish the buyer and to the Exchange, a manifest showing for each vat the seller's lot number, date and vat number, number of boxes, weight, moisture test, price per pound and extension in dollars and cents.

53S04.C.　　Weight

The delivered carload may vary between **40,000** and **44,000** pounds in gross weight. Payment shall be made on the basis of the exact net weight delivered, with cheese delivered in steel barrels receiving a 3-cent per pound discount.

53SO4.D.　　Delivery **Points** [1]

Cheese may be delivered at any point within the continental United States. Cheese delivered from points more than **300** miles from Green Bay, Wisconsin, shall be subject to a freight differential. The freight differential shall be deducted from the gross weight and shall be the amount by which the cost of shipment from the shipping point to Green Bay, Wisconsin, exceeds the cost of shipment for **300** miles. To comply with this rule, distance from the shipping point to Green Bay shall be arrived at by reference to the current issue of the Household Goods Carriers' Bureau Mileage Guide. The cost of shipment shall be determined by reference to a table provided from time to time by the Exchange based on reasonable competitive rates per mile for minimum load of **44,000** pounds gross weight. In no event shall the deduction for the freight differentials exceed the actual cost of shipment as noticed by the buyer's shipping and routing instructions. The freight differential to be deducted is the lower of the Green Bay delivery point or the actual mileage exclusive of the first **300** miles to the noticed delivery point. See the notes at the end of this chapter for tables used in determining freight differentials and for examples of calculations.

53S05.　　PACKAGING [2]

Ail containers used in the packaging of cheese sold on the Exchange shall meet the requirements of all 'applicable Federal and State laws and the applicable requirements of the Consolidated Freight Classification, sometimes known as the Uniform Freight Classification, and of the National Motor Freight Classification.

Cheese shall be packed according to the following specifications:

53S05.A.　　**40#** Block

Cheese in 40# block style shall be wrapped in a sealed film resulting in an airtight package and shall be packed in corrugated or solid fiberboard containers with a reinforcing inner liner or sleeve.

53S05.B.　　Steel Barrels [3]

The barrel shall be an airtight 16 gauge steel, straight side, universal style drum with full open removable head and bolt locking ring closure. It shall be **55** gallon capacity with inside dimensions of **22 ½"** diameter by **33 ½"** depth.

The closing ring shall be **12** gauge steel, type 17-H, either dipped or sprayed with aluminum enamel, with forged lugs--one flanged and the other drilled and threaded to accommodate a **518** National Coarse, zinc or cadmium plated bolt.

The barrel cover or head shall have 2" I.P.S. Reike zinc plated fitting with rubber plug gasket (No. **G-43-W** supplied by Reike Metal Products Co., Auburn, Indiana), or equivalent.

The barrel cover gasket shall be white, odorless, tasteless, non-toxic, fat resistant rubber. Gasket dimensions shall be **318"** outside diameter, 1/8" inside diameter, approximately 70" long, vulcanized endless, 75 to **80** durometer on **"A"** scale. It shall be free of extrusion marks or ridges.

Barrels shall be lined with not less than **.0015"** thick polyethylene bag liner not less than **3 6** wide by **62"** long.

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[1] **Revised July 1997.**
[2] **Revised June 2001.**
[3] **Revised December 2002.**

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Government, will subject one or both parties to a penalty of $500 per contract, per calendar day payable to the Exchange at the close of each day. Repeated failure may result in suspension of trading privileges or expulsion for one or both parties.

Seller or Buyers who submit late, materially incomplete or erroneous delivery information or who cause material adjustments to delivery information shall be fined $200 per contract per day, payable to the buyer or seller depending on the party that is harmed.

(End Chapter 53S)

INTERPRETATIONS AND SPECIAL NOTICES RELATING TO CHAPTER 53S

INTERPRETATION TO RULE 53S04.B.

The method used in computing the moisture price adjustment tables noted in Rule 53S04.A. is as follows:

1. Legal cheddar cheese may contain 39% moisture; therefore, 61% of solids. A cheese containing 37% moisture would have 63% solids, etc.

2. Price to be paid for 37% cheese on a "dry basis" where market level is 52.75 cents for 39% moisture would be figured: multiply solids (100 less 37 equals 63) by market price (52.75) and divide by 61 (100 less 39).

   This gives the price per pound of 37% cheese as compared to 39% cheese at the 52.75 cent market level (54.48 cents)

3. For 35% cheese on basis of 52.75 cents for 39% cheese: 65 times 52.75 divided by 61 equals 56.21 cents.

INTERPRETATION TO RULE 53S04.D.

Table for use in determining freight differential to be deducted from the sale price pursuant to Rule 53S04.D.:

Miles from delivery point to Green Bay, WI	Deduction per hundredweight on gross weight of invoice
300-319	$.03
320-339	.07
340–359	.11
360-379	.15
380–399	.20
400–419	.24
420-439	.29
440-459	.34
460-479	.40
480–499	.45
500-519	.50
520-539	.55
540-559	.61
560-579	.66
580-599	.71
600–619	.76
620-639	.82
640–659	.87
660-679	.92
680–699	.97
700-729	1.03
730-759	1.10
760-789	1.17
790–819	1.25

Miles from delivery point to Green Bay, WI	Deduction per hundredweight on gross weight of invoice
820–849	1.34
850-879	1.42
880–909	1.50
910-939	1.57
940-969	1.64
970-999	1.73
1000-1029	1.80
1030-1059	1.88
1060-1089	1.94
1090–1119	2.02
1120-1159	2.10
1160-1199	2.18
1200–1239	2.26
1240-1279	2.36
1280–1319	2.45
1320–1359	2.54
1360-1399	2.62
1400-1439	2.72
1440-1479	2.82
1480-1519	2.90
1520-1559	3.00
1560–1599	3.09
1600-1649	3.18
1650-1699	3.28
1700-1749	3.39
1750–1799	3.50
1800-1849	3.62
1850-1899	3.72
1900-1949	3.83
1950–1999	3.93
2000-2049	4.05
2050-2099	4.16
2100-2149	4.27
2150-2199	4.38
2200-2249	4.49
2250-2299	4.60
2300–2349	4.71
2350-2399	4.82
2400-2449	4.93

Examples of calculations for freight differentials:

		Example 1	Example 2	Example 3	Example 4	Example 5
A.	Seller location	Eau Claire, WI	Twin Falls, ID	Dallas, TX	Fresno, CA	Mankato, MN
B.	Seller mileage to Green Bay	194	1,586	1,095	2,218	343
C.	Seller deduction per cwt. gross wt. vs. Green Bay	$0.00	$3.09	$2.02	$4.49	$0.11
D.	Buyer location	Milwaukee, WI	Ogden, UT	Springfield, MO	Mankato, MN	East Atlantic City, NJ

E. Buyer mileage to Seller	234	**184**	421	1,895	1,230
F. Seller deduction per cwt. gross wt. vs. buyer	$0.00	$0.00	$0.29	$3.72	$2.26
G. Net seller deduction per cwt. (lesser of C. or F.)	$0.00	$0.00	$0.29	$3.72	$0.11

Example 1:   The seller to buyer mileage (E) is greater than the seller to Green Bay mileage (B). Both are less than 300 miles. The seller pays $0 freight differential.

Example 2:   The seller to buyer mileage (E) is less than the seller to Green Bay mileage (B). The seller to buyer mileage is also less than 300 miles. The seller pays $0 freight differential.

Example 3:   The seller to buyer mileage (E) is less than the seller to Green Bay mileage (B). Both are greater than 300 miles. The seller to buyer mileage applies. The seller pays $0.29 freight differential.

Example 4:   The seller to buyer mileage (E) is less than the seller to Green Bay mileage (B). Both are greater than 300 miles. The seller to buyer mileage applies. The seller pays $3.72 freight differential.

Example 5:   The seller to buyer mileage (E) is greater than the seller to Green Bay mileage (B). Both are greater than 300 miles. The seller to Green Bay mileage applies. The seller pays $.11 freight differential.

Block & Barrel Price Analysis

<u>Assumetions</u>

Milk Fat %	3.69
Milk Protein %	3.05
Fat retention %	90%
Yield Formula - Cheddar	((Milk fat % * Fat retention %)+(TrueProtein % * 0.822 -.1))*1.09/(100 - cheese moisture)
Barrel Price Formula	Barrel Market * (100-barrel moisture)/(100-39% legal max moisture for cheddar)
Gross Return per cwt milk	Return per cwt of milk = cheese yield * cheese price

Example #1 - Typical Cheese Plant

	Block	Barrel	Block - Barrel
Typical Moisture	38.00%	34.50%	
Cheese Yield	10.07	9.53	
Market	1.400	1.370	0.0300
Market + moisture for barrel	1.400	1.471	
Gross Return = Yield * price	14.099	14.023	
Block vs Barrel ($/cwt)			0.0759
Block vs Barrel ($/lb)			0.0075

Example #2 - Lower Market Price

	Block	Barrel	Block - Barrel
Typical Moisture	38.00%	34.50%	
Cheese Yield	10.07	9.53	
Market	1.200	1.170	0.0300
Market + moisture for barrel	1.200	1.256	
Gross Return = Yield * price	12.084	11.975	
Block vs Barrel ($/cwt)			0.1090
Block vs Barrel ($/lb)			0.0108

Example #3 - Higher Market Price

	Block	Barrel	Block - Barrel
Typical Moisture	38.00%	34.50%	
Cheese Yield	10.07	9.53	
Market	1.600	1.570	0.0300
Market + moisture for barrel	1.600	1.686	
Gross Return = Yield * price	16.113	16.070	
Block vs Barrel ($/cwt)			0.0429
Block vs Barrel ($/lb)			0.0043