VOLUME II

BEFORE THE SECRETARY OF

THE UNITED STATES DEPARTMENT OF AGRICULTURE

AGRICULTURAL MARKETING SERVICES

In the Matter of Proposed	) Docket Numbers
Amendments to Tentative	) AO-14-A77, et al ,
Marketing Agreements	) DA-07-02
and Orders	)

National Public Hearing

Tuesday, February 27, 2007

9 10 o'clock a m

Holiday Inn Select

15471 Royalton Road

Strongsville, Ohio 44136

BEFORE

JUDGE VICTOR W PALMER

US ADMINISTRATIVE LAW JUDGE

UNITED STATES DEPARTMENT OF AGRICULTURE

COURT REPORTERS OF AKRON, CANTON AND CLEVELAND

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I N D E X

I N D E X (CONTINUED)

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E X H I B I T S

(Thereupon, Exhibit 5-A was marked for purposes of identification.)

JUDGE PALMER: This is the second day of the hearing in this milk marketing revision or amendment proceeding. We have heard some testimony from a Mr. McDowell and Mr. Cessna at the end of the day. But earlier in the day, we had heard from Mr. Wellington and Mr. Dennis Schad. We had not gone into the cross-examination of Mr. Wellington or Mr. Schad, because there were some attendees, or some participants, I should call them, who were not here at that point in time. So we are going to have the cross-examination now.

So Mr. Wellington, if you would return to the stand, sir, you have already been sworn. And I was just handed a copy of a document called "Revision to Wellington's Testimony." and we marked that as Exhibit 5-A.

Everybody will shut off their cell phones, please. All right, sir, as I say, you are under oath. Maybe your counsel wants to say a word or two to you. I don't know. Bring us back together or whatever.

MR. VETNE: No, he is on his

own.

JUDGE PALMER: He can handle it. Who wants to ask some questions?

MR. WELLINGTON: Well, can I --

JUDGE PALMER: You want to talk about your revision. Okay.

MR. WELLINGTON: I gave out written testimony yesterday. As I reviewed that later in the day, I saw that there was an error in Table 1.

So I wanted to correct that error. and in doing so, it also changed the paragraph immediately preceding that table, which is on page 2 of my testimony.

So what I have handed out now, which I gather is Exhibit 5-A?

JUDGE PALMER: Right.

MR. WELLINGTON: Basically eliminates the last paragraph on page 2 and the table that immediately follows it on page 3. That is called Table 1. And so I would read, at least read the text into the record. Is that okay, Your Honor?

JUDGE PALMER: Sure.

MR. WELLINGTON: Okay. The

resulting calculated make allowances. including the $.0015 marketing cost factor, are $.1780 per pound for cheese, 8.1351 per pound for butter. 8.1510 per pound for nonfat dry milk and 8.2090 per pound for whey powder. Once again. Agri-Mark is not proposing that these specific make allowances be adopted, but rather showing how the calculations would work using actual survey product volumes in place of national volumes. Then the table follows that.

The only change in the table was under the row marked NFDM, for nonfat dry milk. and under that is CDFA, for California Dairy. Food and Agriculture. And M-E-D for medium, there is a replacement number, which is now 84,374,618. And then in addition. I ran the calculations across, and I added the marketing cost of .0015 to all the calculated numbers to get the total make allowance with the marketing costs involved.

So that was the only change that was made.

JUDGE PALMER: All right. Who wishes to examine?

MR. YALE: I guess I will.

JUDGE PALMER: Yes, sir. Mr. Yale.

MR. YALE: Everybody is staring me down.

JUDGE PALMER: You have the advantage of getting the witness while he is fresh.

MR. YALE: Yeah.

(Laughter.)

CROSS-EXAMINATION

BY MR. YALE:

Q. Okay. Benjamin F. Yale on behalf of Select Milk. Lone Star Milk Producers, Dairy Producers of New Mexico, Continental Dairy Products.

Good morning.

A. Good morning, Ben.

Q. In your proposal, you have asked the department to consider an annual updating of the make allowances using a study, which you discuss I think more in Proposal 2, as well as the California Dairy -- or California Department of Food and Agriculture's manufacturing cost; is that right?

A. That's correct.

Q. Now, are you prepared to present any witnesses on behalf of CDFA or anybody about the

2006 report?

A. We had -- through our coalition, we had asked the CDFA if they would send a witness here. And I gather the conversation led to that they would need a request from USDA. So our coalition asked USDA, and my understanding is that they then asked California and then they then declined to come here.

Q. They couldn't tell you "no" without the USDA --

A. We went around in a circle. At this point not. I am hopeful maybe in the reopened hearing, maybe when we will be in a more exciting place than Cleveland, they will be willing to come. We will attempt to do that. Ben, we tried to do that, but as of right now. they haven't agreed to come.

Q. This is an exciting place. Who is in the coalition?

A. It is Land O'Lakes --

Q. Okay.

A. -- Foremost Farms, Associated Milk Producers, Northwest Dairies and Michigan Milk Producers.

Q. Let's go ahead, do you want to bring those up? We have an exhibit we want to make -- I don't know what number that would be.

JUDGE PALMER: It would be 9.

(Thereupon, Exhibit 9 was marked for purposes of identification.)

JUDGE PALMER: I have been handed a document entitled California Manufacturing Cost. Annual 2005, and it is published by CDFA. which I gather is initials for the California dairy something or other.

MR. YALE: No, Department of Food and Agriculture.

JUDGE PALMER: Food and Agriculture. We are marking it for identification as Exhibit 9.

MR. YALE: And I would note for the record that this is available on the Web site at their Dairy Programs, which is www.cdfa.ca.gov, and you can get to the dairy thing and they have a lot of wonderful publications, this being one of them.

Have you seen this?

THE WITNESS: I have seen some tables within it, but I have not read the entire document.

BY MR. YALE:

Q. Okay. Let's start with the cover. The title of this is the Manufacturing Annual Cost for 2005; is that correct?

A. That is the way it reads.

Q. That is the one you want to use; is that right?

A. That's correct.

Q. And it -- notice down here that it is published in 2006.

A. Yes.

Q. Are you aware of anything more recent than that?

A. I am not aware of it.

Q. Now, if you would, turn over to 6.

(Witness complies with the request.)

Q. And the bottom of the paragraph, does that indicate what period of time that this study covered?

A. Each plant -- well, it says -- it is saying that the 12-month period was in January 2004 to December 2004. I am a little confused by that. but that is what it says.

Q. If you would look over at page 8, at the top of page 8.

A. It also refers to 2004.
Q. Page 17. By the way, page 8 talks about the cheese study, right?
A. Yes.
Q. Okay. Then page 17?
A. Yes.
Q. And page 25?
JUDGE PALMER: Yes, meaning 2004.
THE WITNESS: Yes, 2004.
BY MR. YALE:
Q. Just as another example, there are a number of them through there. But let's look over here at page -- well, look at page 34, a little different paragraph, paragraph number 1.
A. That refers to 2004 also.
Q. So it appears not to be just a typographical error in one paragraph. It seems to be pretty consistent throughout here that this is looking at cost data in 2004 that was audited in 2005 and reported in 2006. Does that appear to be a --
A. It appears to be the case. I will be straightforward with you, Ben, when I pulled the numbers I used, I used them from the summary tables, when I went on the Internet and got

that. So I didn't go through the report, the entire report at the time.

Q. That is fair. It was confusing to me and I was making sure that there was not another report out there.

MR. VETNE: Your Honor, may I object? John Vetne for Agri-Mark, et cetera. There is confusion here, because there was this report that has been marked which was released in 2006 and has a date of 2005 on the cover, but it involves 2004 data.

There is, in fact, on the same Web site 2005 manufacturing cost information released November 29th, 2006, which is material that Agri-Mark relied upon. Apparently that was not extracted from the Web site for this purpose. But it was for our purpose and we will refer to it later.

JUDGE PALMER: All right. We will allow your statement to be part of the record, and the witness notes it, too, and so does counsel.

THE WITNESS: That is what I used at the time. Actually, I had not seen this exact report. I had seen past versions of it.

So when I looked at the tables, I assumed this is where the tables came from. But perhaps they did not.

BY MR. YALE:

Q. That may add to the confusion or go to the simplification.

But in your direct examination, you did not submit a copy of those tables as part of your presentation, did you?

A. Oh, no, I did not.

Q. Okay.

A. Not yet.

Q. All right. So let's talk for a moment -- let's go back. The data that we have for the current, if you want to use that word loosely. the Cornell study basically covers 2004, does it not?

A. It is a mix of 2004 and part of 2005.

Q. Right. Okay. So for purposes of some discussion in relationship to the Cornell study. it is not inappropriate to look at a 2004 cost study from California to do the comparison? It may not be relevant to exactly today. but between the two, they roughly cover the same period, do they not?

A. Well, no. I think that the Cornell study said that most of the observations were between. if I recall right, June of 2004 and June of 2005. So I believe it was sort of split almost six months on either side, is what was said by Dr. Stephenson.

So I guess you can look at it either way. But what we want to do is use the most current information. If Cornell were to update their information to be even more current than what was last presented, we would like to use that also.

JUDGE PALMER: Do you have enough copies to distribute that?

MR. VETNE: I will.

MR. YALE: We are going to use the 2004, that was all that was available, Your Honor. And if they -- we will proceed with that.

MR. VETNE: I have a copy that I am willing to show to counsel right now. I was going to take that to the desk and get it copied.

MR. YALE: Why don't you make copies. I have got enough to work with with what I have right now. Let me just check one thing.

THE WITNESS: Can I add something, or should I wait?

BY MR. YALE:

Q. Do you have something to add?

A. Yes, I do.

Q. What is that?

A. That is that my understanding is that when the department did their analysis, that they discussed yesterday, that they also used the figures from that Web site for the November 29th released data. That is what I was using in corresponding with that.

So I believe their analysis used that level of data also.

MR. YALE: We are going to have to delay some of our cross-examination until that is put in the record and we can examine that. I still have some more from this report that I do wish to go through.

JUDGE PALMER: Sure.

BY MR. YALE:

Q. And I noticed in that study, sir, I do want to point to you -- if you would, look at page 10 of this report.

(Witness complies with the request.)

Q. And this identifies the yield, does it not. from their low and high cost plants?

A. Yes, it does.

Q. And do you know what the implied yield is currently in the Federal formula?

A. I don't recall.

Q. Does 9.6 something sound about right. pounds, per hundred pounds of milk?

A. Yes, yes, it does.

Q. And this yield listed here suggests a much higher number, does it not?

A. It does. But I believe the 9.6 in the order refers to 3.5 percent butterfat milk and 2.99 percent protein milk. And it appears that at least the butterfat is higher in this table, and I don't know what the protein is, because I don't report the protein.

Q. But one could, using that information, back it down to a 3.5 percent butterfat and determine what that yield, what kind of recovery -- are you familiar with the Van Slyke formula?

A. Yes, I am. Yes, it can be done then.

Q. Okay. We will leave that at that.

JUDGE PALMER: Mr. Vetne handed me some documents. Should we mark them to be on the safe side?

MR. YALE: Let's mark it in case the discussion comes up.

MR. VETNE: That is the print from the CDFA Web site of the 2005 survey released November 29th, 2006, which Mr. Wellington used and which is incorporated in his Preliminary Economic Analysis.

JUDGE PALMER: So we should mark it?

MR. VETNE: Please.

JUDGE PALMER: Let's pick the next number and make it 10.

(Thereupon, Exhibit 10 was marked for purposes of identification.)

JUDGE PALMER: The Government counsel and the other people get a copy of it too?

MR. YALE: I am not going to ask any questions on it right now anyhow.

BY MR. YALE:

Q. I would like you to turn to page 11, Figure 2, this is Exhibit 9. And it is styled

"Simplified product flow in a cheese plant with by-product processing." Have you seen this before?
A. No, not this particular flow chart. We have other flow charts in our own operation and things. But not this one.
Q. As a simplified one, does this appear to fairly well represent the flow of cheese in a cheddar plant?
A. I don't know. I would have to go through it in detail to see if it follows through. I have no reason to doubt that it would, though.
Q. Now, cheddar cheese that is reported on the NASS, is a -- it is a specific type of cheese, is it not?
A. Yes.
Q. And it has to meet certain standards?
A. Yes.
Q. And those standards are set forth in the specifications that are reported to NASS?
A. Yes.
Q. Okay. And do those -- and then also it has to meet the standard of identity for cheddar cheese; is that correct?
A. That is my understanding.

Q. I want to talk a moment about prices. Does Agri-Mark report any products to NASS?
A. We report nonfat dry milk prices.
Q. You do not report any cheddar?
A. No.
Q. So your cheddar price that you sell yours at is not reported to NASS and does not become part of the weighted average of the cheddar price?
A. That is correct.
Q. Are you aware of any plants in the Northeast that report commodity cheddar to NASS?
A. I am not aware of it. There may be, but I am not aware. I know the plant, like I said, the plants that we have do not.
Q. So yours is just powder?
A. Just powder.
Q. And do you report any butter?
A. No, because we considered that at one point, reporting butter, but we don't have it -- our butter production is very seasonal at our balancing plant. So we would have butter that meets the criteria on occasion, but it would not be a year-round supply. When we talked with NASS, we felt that was probably not appropriate

to be reporting butter.

By the way, we do meet some cheddar cheese that would do that also, we do some commodity cheddar. But, once again, it is not on a regular basis. And it could go a variety of places within our own system or be sold as commodity cheddar.

So we felt we were not consistently meeting NASS standards. That is why, when we spoke with NASS, we made the decision not to include it.

Q. So to follow up with that with the cheddar. if you had higher cost at your plant and wished to pass that on to the consumer, customer of your cheese plants and they agreed to that, that would not be reflected in a higher cost for your milk; is that correct?

A. It would not be -- it would not be reflected in a higher cost for the milk. There are higher costs at our plants than typically we see under the make allowance. There are also higher costs that we incur to meet different standards that our customers have.

But the answer to your direct question would be "no."

Q. And those costs you try to shift off to the

customer; is that correct?
A. You always try to shift costs off to your customers, as often as possible. You are not always successful, by the way, Ben.
Q. I understand. I represent a group that is not very successful at that, in terms of their producer milk.
I am going to wait until we get the other record in.
Now, in your statement, in your proposed statement, you indicated that for the powder plant, you did not want to use the low cost, but instead you wanted to use the medium cost plant.
A. I believe that is what USDA used in their interim final decision. So we felt that we would continue to use that
Q Right now, the NASS prices reported, does that represent -- for nonfat dry milk, does that represent a weighted average so that half the nonfat dry milk is sold at or below or half is sold at or above that price?
A. It is a weighted average price
Q. A weighted average price?
A. Yes.
Q. So it represents that 50 percent of the

milk is at or below that price or at or above that price, isn't that right, isn't that what an average means?

A. No, I don't think so

Q. What does it mean?

A. I think on the weighted average, you could have small volumes being sold at extremely high or extremely low price, which would then influence the weighted average price, and you wouldn't necessarily have a 50/50 split on the volumes.

Q. But it represents a weighted average?

A. That is true.

Q. What is the weighted average cost for California's nonfat dry milk plants?

A. That was reported?

Q. Was it higher or lower than the medium cost?

A. Well. I mean, actually, what I did was. I know maybe you don't want to go to Exhibit 10 yet, but what I used on that was on Exhibit 10, the third page in, the medium cost was $.1872 per pound. That is the number I used. And that is higher than the current make allowance of the interim decision

Q. What is the weighted average for that period?
A. The weighted average of all the plants?
Q. Of all the plants.
A. That would be .1659.
Q. So you are proposing -- I take it you are opposed to replacing the NASS with the CME?
A. There has been a lot of discussion within my own organization on that. But I would say as a straight replacement, I think we would oppose that.
Q. Okay. And the NASS is weighted average price of nonfat dry milk sold?
A. Right.
Q. You are proposing that the cost, at least for the purposes of the California study, use something that is greater than a weighted average?
A. For nonfat dry milk, yes. I believe that one of the reasons the department used the medium cost was to try to more reflect the powder plants that are in the non-California area, and the Federal Order area. I think it may have something to do with balancing roles. But I think it had more of a balancing role in

past make allowance determinations than it did now. I think that was their logic in doing so.

I would say, Ben, if the department wanted to use the weighted average for the entire group, for example, and they were then not to weight the national production that they have been doing, but weight the survey production that I used in my table, I probably wouldn't have a problem with them using the weighted average for the group.

If you look on my replacement Table 5-A. you will notice something that was very disturbing to me. On Table 1, the nonfat dry milk, NFDM, the weighted average cost goes to .1510, that is $.1510 per pound; and that is actually less than the current one and less than the one that would occur if you updated with just California that USDA showed in their analysis.

So it is not with great joy that I use that number. It probably would have been higher, had I used the weighted average of the whole group. However, I felt that I needed to be consistent with what USDA used.

Q. Okay. So let's talk about those two uses that you say they went with. One is that it more accurately reflects plants that are in the Federal Order program as opposed to those that are in California?

A. I think that was the intent, yes, sir.

Q. All right. Then why not just rely upon the average cost of plants within the Federal Order program and ignore what is in California?

A. Well. I think there is some concern that you need to have the largest possible survey available. The strengths of the California surveys are that they are actual audited numbers that people have confidence in.

With all due respect to the Cornell numbers, that is a brand new survey, unaudited. So I think the California gives a lot more credibility to it, and the department in the past has consistently decided to use California.

I will tell you that we would have preferred not to use California in the past. But we have changed our position now that we have heard the department's arguments.

Q. But let's take this one step further. They use the California -- so have you done any analysis to compare the cost of operating a plant in California versus operating a powder plant in any of the other locations in the Federal Order program?

A. Other than what California reports in their studies and what we have for the Ling study and for the Cornell study. California was less than the Ling study, but more than the Cornell study.

Q. The department rejected the Ling study.

A. In their initial interim decision, yes. We still support using the Ling and in our comments, we have asked the department to reconsider that. But initially in the interim. yes.

Q. Your next point that you made was because there is a balancing function with powder in the Federal Orders; is that right?

A. There certainly is in our order, yes.

Q. How much of this make allowance in the tentative final decision that we are now under is based upon an adjustment for the balancing factor?

A. Well, it appears a lot less than there was in the past, because if you look at the huge size of the plants in the Cornell study and, in fact. I believe if you look at the same in the size in California, there is now a piece of it. but it is a much smaller piece, particularly in the Cornell study. The Cornell plants are very. very large compared to the average size powder plant and certainly much larger than our powder plant in West Springfield, Massachusetts. So there is less of a component.

The only reason I can think of they used a medium. I believe they said in a past decision. there was an attempt to look at something to do on balancing, and trying to reflect more of a reflection of average size in the Federal Order.

Q. But the balancing is for the marketing area; is that correct?

A. Yes.

Q. And do you balance milk for any of the Texas plants?

A. No.

Q. Have you sought, under market service payment provision of the act to have market service payments attributable to your cost of balancing the New England order?

A. Yes, we have. Northeast order.

Q. Is that pending or --

A. No. That was rejected.

MR. YALE: One moment, please.

JUDGE PALMER: Sure.

(Pause.)

BY MR. YALE:

Q. If you would, turn to page 27.

A. Of the California?

Q. Of the California, Exhibit Number 9.

A. Okay.

Q. There is another simplified flow chart. Can you take a moment to take a look at that there on page 27. Then I have some questions.

(Witness complies with the request.)

A. Okay.

Q. All right. Does this appear to, in a simplified version, represent what happens in a butter/powder plant?

A. Yes.

Q. Now, the products of a -- as it shows here. of a butter/powder plant, include -- obviously we have powder, right, the nonfat dry milk that is sold. By the way, what moisture level is powder sold at? Is it sold absolutely dry, or is there some moisture in it?

A. No, there is a moisture level. I don't recall the exact amount.

Q. About 3 percent?
A. Well, it is 2 or 3 percent, but I am not sure offhand.
Q. Okay. And it sells powder, it also sells butter, right?
A. Yes.
Q. Those are the primary sales, right? And the powder plant that is there long-term that NASS thinks that the sales are reportable, would report just the powder and would report the butter; is that correct?
A. I believe so.
Q. Now, also at a butter/powder plant, they sell condensed, do they not, they produce condensed?
A. At our plant, they do, yes.
Q. Now, is condensed price based upon -- what pricing is that under the Federal Order?
A. It depends on what that product will eventually be used for. A lot of times condensed milk will be used for a Class II product, or it can be used for a Class III product, condensed milk could go into a cheese vat. So there are a lot of different uses for condensed milk.

Q. But condensed is not reported to NASS; is that right?
A. I don't believe so.
Q. And it wasn't a trick question.
A. I have never heard of it being reported.
Q. And the condensed can be a replacement for nonfat dry milk for some uses; is that right?
A. Yes, yes.
Q. In fact, we had a hearing a couple of months ago, I guess it was in Pittsburgh, that discussed the possibility that the condensed as a substitution for condensed and powder, right?
A. I believe that was mentioned.
Q. Now, is condensed sold at any kind of premium over the nonfat dry or the solids nonfat within it?
A. It depends on the time of the year. It depends on the demand.
For example, it may be less than the going rate. For example, in the flush time, if you have more milk coming in and you can't dry it all, so you just try to -- condensed, you can do more volume through. So you just try to find someone who will buy the condensed, because you have to do something with the milk product.

Other times of the year, you could get a small premium level, at least that is what I am told by our marketing people. It depends on the supply and demand is really what it comes down to.

Q. You don't know, then, specifically what your blended value of your condensed is?

A. No. I don't. I don't have that with me.

Q. Now, when the product is separated in the first step here, the powder is separated -- the skim milk is separated from the butterfat. right, that is the first step in a butter/powder plant?

A. Yes.

Q. And what is left over could be sold just as cream; is that correct?

A. Yes.

Q. And is cream ordinarily sold at a premium?

A. It can be. Once again, it depends on the circumstances.

In our plant, we don't normally sell cream. because we make butter.

Q. Okay. Now, in the process of churning the cream, there are two outputs that come out. The most common, obviously, is the butter, because that is what you are churning the butter for. right?

A. Yes.

Q. And you also produce, as an outflow, you produce buttermilk; is that right?

A. Yes.

Q. And do you sell buttermilk?

A. We sell buttermilk powder on occasion. But once again, it depends on the volume in the plant.

If the plant is running full, and we need the dryers to make the nonfat dry milk, okay, we might have to move buttermilk as a liquid product; and usually we do that at a lower price just to dispose of it, because we don't have the capacity in the plant to handle all the volumes that are there. So, once again, it depends on supply and demand.

Q. The cost to produce the buttermilk, though. is reported, when you reported your costs for your plant, was it not, of a butter/powder plant?

A. I believe it was, and then we reported the cost of solids involved, yes. We usually get a lower price for buttermilk. But I will be honest with you, sometimes that depends on supply and demand for powder and buttermilk.

Q. Sure. It is a commodity?

A. Right.

Q. The cost of producing the buttermilk is incorporated in the cost of operating a butter/powder plant, is that a fair statement?

A. I believe so.

Q. And is the value of the buttermilk incorporated into the Class IV formula?

A. I think it is reflected in that we have to -- the Class IV formula includes the protein and -- well, it includes the nonfat solids that are included in the butterfat. I think the buttermilk is included.

We pay for all the components that come into the plant. Whether those components become nonfat dry milk or buttermilk, they are still being paid for.

Q. But in the computation of the values at plants for the proxy value for Class IV, the value of the buttermilk is not included in that formula, is it?

A. No. I believe -- my understanding is that the components are being priced as if they were

nonfat dry milk. I don't believe that we get anything free out of this, in terms of the pricing. I would have to go back and look at the details of it.
Q. Now. I would like you to take another look at this -- let's look at this Exhibit 10 that Mr. Vetne provided. And if you would, look at the butter manufacturing costs, since we are talking about butter right now, or buttermilk.
A. Okay.
Q. In addition to the high cost and low cost group, they also report a range of cost, do they not?
A. They report a range of costs for particular categories of cost.
Q. Right. And if you were to sum up the minimum costs in that range, it is just a little over 10 cents a pound, is it not?
A. Yes. But I think you have to — I imagine they do this the same way that Dr. Ling did it. in that they really looked at the high and low for the whole plant cost population.
So if you had, you know -- a plant may have a lowest packaging costs of the group, but it may not have the lowest other ingredient costs

of the group. So there may not be a plant that represents all the lowest costs or a plant that represents all the highest costs.

I don't think you can sum it up and really tell you much. It really just tells you what the range is for the specific categories.

But you would have to look at what the low cost and high group costs to actually get a total cost.

Q. Look at the bullet point above the breakdown, the last bullet point. And what percentage of the butter was processed at less than the weighted average?

A. According to bullet point, it says, "Approximately 64 percent of the butter was processed at a cost less than the current manufacturing cost allowance for butter."

Q. I misstated that question. But you are right. that is what it says.

A. Less than .156 cents per pound.

Q. Right. Do we know based on this how much butter is produced at -- we can say then that half the butter, though, is produced at less than the 14.08 cents; is that right?

A. No.

Q. We can't say that?
A. Once again, we spoke about this before. I mean, you could have a plant that is making a huge amount of butter at a very small cost, which would then weight -- you could have a third of the butter, for example, at 10 cents a pound, and two-thirds at 16 cents a pound, and the weighted average would be 14 cents. That is what I am saying. I don't mean to be argumentative, but it could be that way.
Q. You answered the point I am getting at. We don't know how much butter is produced at a particular -- at 50 percent of the butter. We don't know where 50 percent of that butter is priced, do we?
A. No, not from the table, no.
Q. And a very large volume could be produced at prices lower than the make allowances that we have in the Federal system, right?
A. That is true, and I believe that probably that is reflective in the Cornell data. That was one of our problems.
Q. Do you compete for sales of butter with plants from California?
A. On a regular basis, I would say probably

not California. Midwest, yes. But we could with California. Butter is generally a national market. I hear our marketing people complain more about the Upper Midwest people than the California people.

Q. Members of your coalition?

A. No, members of my cooperative --

Q. No. I am talking about complaining about members of your coalition?

A. No, they are the good guys.

(Laughter.)

Q. I just wanted to make sure that was clear. There was that ambiguity there.

A. No. There is a very healthy level of competition for butter, and we compete like everybody else.

But I think we occasionally will buy butter from the West Coast. So there is movement of butter all ways.

But because butter is also something that a lot of stores want to be able -- they need butter on a very short notice; it is sometimes difficult to get that butter from California on short notice. It is easier to get it from a short distance, like the Upper Midwest.

Q. Now, part of the reason, as we go back to the hearing that we held earlier, the make allowance hearing, you gave testimony that in short said that you needed to have these reduced prices, because it was hurting your member producers, because their plants were losing money, does that sound like a fair --

A. We needed to have higher make allowances.

Q. Right.

A. Which could affect the price and reduce it. Because, yes, our plants were in a loss position. that's correct.

Q. Have you done -- now, do you sell -- let's put it another way.

Do your members' milk, is it exclusively marketed to your plants?

A. Our member milk?

Q. Yes.

A. No. Less than half of our milk goes to our own plants.

Q. But the proposal that you make that is going to reduce -- or that was accepted by the department in the final decision and is still an issue in this hearing with all the other factors, accepting the fact that you needed

higher make allowances for your plants, that also reflects the prices of the product or the milk that you sell to other plants; is that right? It is not just your plants that the price is getting changed, it is for all the milk that you sell on behalf of your members?
A. Oh, yes, yes.
Q. Okay. Now, approximately how many pounds of milk does Agri-Mark market annually?
A. Roughly about 2 1/2 billion pounds.
Q. Now, there have been some estimates of approximately a 20 cent impact on the prices for milk as a result of the tentative final decision. Have you heard those?
A. Yes.
Q. Okay. And, in fact, one of the baseline decisions or comparisons to baseline, Dr. McDowell and them came very close to that number; is that right?
A. I believe so.
Q. So on 2.5 billion pounds, how much -- on all of your producers' milk, how much would that affect them?
A. I have to do the math.
Q. Make sure you get the decimal in the right

place.

A. I believe that represents 25 million hundredweights, and at 20 cents a hundredweight. it would represent about $5 million.

Q. And the relief that you get at your plants -- now, you have got cheese and powder plants, right? So the impact was disparate. I mean, the powder did not have quite the improvement in make allowances for you as you saw it as the cheese plants?

A. That's right.

Q. So for the plants and the mix of the product that you sell -- or not you sell, your plants acquired from your members, approximately how much did that tentative final decision improve that situation, at the plant level?

A. Probably somewhere around $3 to $4 million.

Q. Okay. So on all of your sales to the producers, they lost $5 million, and they got back approximately 3 to 4 million in changes in the profitability of their plant?

A. Okay, but there is a lot more to that situation than just that transfer of money, Ben.

Q. All right.

A. Our concerns are this: Not only are our plants losing money, there are other manufacturing plants that are losing money who may leave the area. And when that happens, it is going to affect over-order premiums, it is going to affect the availability of market outlets for milk.

Our plants, for example, if we are losing $5 million -- or $4 million, excuse me, and our members are turning around and saying. "Well. how can I avoid that $4 million loss? I just don't have to ship to Agri-Mark anymore, and I can avoid that loss and get that higher --" and if they did not make the change, excuse me, if they did not make the change, they could avoid that loss by not shipping to Agri-Mark anymore.

And we would not have the ability to keep our plants. We would have to close plants because if we don't have the equity in the membership and the milk to do that, then there would be less of a market for the product. It would certainly affect our producers by far more than a million to $2 million across the amount of money involved.

That represents on our volume somewhere around 5 cents. 5 to 7 cents. We are looking at this as the ability to not only keep our plants being able to cover their costs, but plants in the Northeast to cover their costs, to provide markets for our members' milk, opportunities to get over-order premiums.

So there is a lot more to it than that. You just can't have a make allowance that doesn't cover costs and expect plants to be there or expect members to gain money through the Federal Order system but lose it through their operations and yet stay with the cooperative. That is one of the issues that we face. So it is not just a sum of the math numbers, as you put it.

Q. Now, in that analysis that you just gave. you indicated that there is over-order premiums in the market?

A. Yes, there are.

Q. Then why didn't you reduce the over-order premium structure to absorb the costs?

A. Well, because most of the over-order premiums that are out there are for the Class I market. We can get those, because we don't have -- we try to keep the milk supplies tight by putting it through the manufacturing plants.

The over-order premiums are not in the manufacturing plants to any great extent. because of this make allowance issue. The over-order premiums we get from Class I processors.

We could have taken that money from those processors and used those against their losses instead of giving them to our members, and then our members would not have been competitive with other producers in the marketplace and it would have been a further incentive for them to leave the cooperative.

Plus, if we were to do that and our members became a supply of cheaper milk in the marketplace, then others that were paying the Class I premiums, like Class I processors, might decide at that point that they could get a cheaper supply directly, and that would erode the Class I premium.

So it is sort of a price dance that you are doing out there, that you are trying to keep milk supplies as tight as you can to keep the premiums up.

Our members interpreted the losses at our operations differently from the prices that they have received. For example, we pay quality premiums to our members.

A lot of that is funded through Class I over-order premiums. Members feel they earn those premiums because of the higher quality milk. So it would be a serious concern if we were to lower those.

We are regularly informing our members of our losses, why those losses occur, why we operate the plants, and they have accepted those as the reasons for losing, at least on a short-term basis.

Sorry for the more complex answer. But there is a lot to it.

Q. No, we understand that. So let me back up though. Part of those over-order premiums of Class I market is to cover your costs of balancing those Class I markets, is it not?

A. A relatively small amount. We try to push as high a premiums as we can. Some of it is to cover that, though. And we do have different marketing fees, depending on how much services they want.

But we also have a very straightforward over-order premium that is a competitive producer premium.

Q. Do you have level deliveries or even delivery credits, or premiums for not receiving --

A. It is not so much a premium on the producer. Usually premium is straightforward. Okay. It is difficult to explain. There is a breakdown for it.

There are service charges. And at the level deliveries, you would have a much lower service charge than somebody who wants spot deliveries or uneven deliveries during the week.

On an over-order premium charge that exists, usually that is a producer based one and pretty much everybody who buys Class I milk will pay that amount, in addition to a service charge.

Q. But the service charges that you talk about for the uneven, for the spot loads and stuff is because if they receive spot loads, that means that you have erratic need for your balancing plants, powder, sometimes you have too much. sometimes you have too little, and there is a cost associated with that, right?

A. Right.

Q. And you are collecting that in part, you say?
A. It covers part of the cost of market balancing. Not all of it, because, first of all, you want to make that sale, particularly because it is a Class I sale, and a Class I sale benefits the market and the producer price most of all. So as a farmer organization, we want to do that.
Plus, you also have to meet standards under the Federal Order as a percentage of your milk shipped as Class I.
Q. Now, you mentioned that if plants don't get enough return, then they are not going to be able to stay in business; is that right?
A. That's true.
Q. That is true for any business, isn't it?
A. That is true.
Q. And that also applies to the farms, does it not?
A. Absolutely.
Q. Do you know what the farm -- it costs your producers to produce the milk that your plant is buying?
A. Far more than they are getting right now

under the pricing system.
Q. How long can they sustain that?
A. Well, that is why we work on various programs, such as the CWT program, we helped developed the MILC program. Others are trying to get that additional money. So. I mean, there are serious issues with that.
But trying to get the money out of plants is, in our mind, is penny wise and dollar foolish in the long run, because if you don't have the plants there, you are going to have far more costs later on.
So it is a balancing act. We believe that the problems of price that farmers have right now are certainly not a make allowance issue. We believe that it is caused by the tremendous growth of huge factory-like farms in New Mexico and Texas, Ben, who are lowering the amount of milk or raising the amount of milk production in the country and supply and demand dictates that the national price is lower. So we think that is the driver that is affecting our profitability of our farms more than anything else.
Q. Shouldn't the same driver apply to plants

as it applies to farms?
A. Not in the regulated market that we have that you have minimum pricing that you have to pay. If you have minimum pricing, either you cannot pay less, if you are a proprietary plant. or if you are a co-op plant, members don't expect you to pay less. They are going to be very cognizant of it and looking for other opportunities where they do not pay less.
Q. Is the production in your region declining, level or increasing?
A. Right now, it is declining.
Q. How long has that decline been going on?
A. It is sporadic. Right now, it has been going on about a year. But as a region as a whole, it has been going on about a year. New York goes up and down, Pennsylvania goes up and down, even Vermont to some extent goes up and down. But the rest of the five states that we operate in in New England are pretty much going down on a steady basis.
Q. So as I understand your premise again. about it being penny wise and pound foolish, if there are plants, there will be farms, right, that the farms will have a market for their

milk; is that right?
A. The farms have a market for their milk. right, if there are nearby plants, correct.
Q. If there are no farms, will there be plants?
A. No. You need a balance of the two. In the long run, you have to have generated enough money in the marketplace for farms to cover their costs and make a reasonable level of profit or at least a reasonable level that will give them the incentive to stay, and the same thing for plants. Once again, often it is a balancing act to make sure you have both. because you need both, Ben.
Q. Now, you made a comment about minimum prices and the like. And I want to give you a hypothetical that deals with that issue.
I want you to assume two plants in the same market of equal size, sufficient to surplus milk, I mean, the milk is readily available to meet the plants.
And currently you have a plant that is producing milk at about 14 1/2 -- or producing cheese at 14 1/2 cents per pound. Okay. That is plant A.

Plant B is producing it at 18.5 cents. so you have an average. I am going back to the old --

A. That is fine.

Q. -- to 16.5 cents per pound. Okay.

Already, the plant at 14.5 has a competitive advantage, does it not, over the 18.5?

A. Given your scenario, yes.

Q. All right. Now, and it can use that competitive advantage in what ways?

A. Well, it can use that additional funds to pay farmers more money and procure more milk, if it so chooses, or it can create more profit for its bottom line.

Q. Or it could sell cheese at a cheaper price to other customers?

A. Or it could sell cheese at a cheaper price

Q. Expanded markets

A. Expanded markets.

Q. And leaving that scenario and that situation, how long -- assuming there is enough capital for that plant to grow, isn't it true that in a period of time that that would overtake the 18.5 cent plant unless it changed its operation?

A. Well, not necessarily. Some of it depends on where -- you are making an assumption that you have two plants in the same market, and they are almost basically at the same location. And if that were the case, I would agree.

But I think a lot of what we are looking at through this order decision is the 14 1/2 cent plant -- I am sorry, the 14 1/2 cent per pound plant is located in another market, such as New Mexico, and the 18 1/2 cent per pound is located in a market such as New York, and the milk from New York is not going to flow to that 14 1/2 cent plant without great cost.

So that is the different scenario. I would agree if both plants are located right next to one another and they have different cost structures, that the 14 1/2 cent plant will likely expand and eventually the 18 1/2 cent plant will leave.

Q. Okay.

JUDGE PALMER: I think Mr. Wellington has testified long enough for this session of the morning. So why don't we take a break for about ten minutes. I think it is about time to take a break.

MR. YALE: Oh, all right.

(Thereupon, a recess was taken.)

JUDGE PALMER: The recess has ended, and. Mr. Yale, you were questioning Mr. Wellington. Proceed.

BY MR. YALE:

Q. I want to go back, we were talking about this hypothetical of an 18.5 cent plant and a 14.5 with an average, for the purposes of this. that the cost was 16.5 and that was the make allowance that was allowed and that set the minimum prices these plants paid. Do you recall that?

A. Yes. I recall that.

Q. Okay. And you made a comment that that doesn't work, because that is assuming they are all in the same market, but really, you have got a market up here, and you have got markets, I think you used the word New Mexico, it is a wonderful place. You have been there?

A. It is a wonderful place.

Q. Great place to dairy. So let's assume for a moment that you have got a plant in New Mexico or West Texas and this is the scenario.

Okay. Do you know how much it costs to move cheese per pound from New Mexico to New York?

A. I am told that if you move it in bulk on a regular basis, you can move cheese, large distances at relatively low cost, probably under a nickel a pound. But I don't know the exact amount. We don't normally move bulk cheese. But on occasion, we move bulk butter.

And that could be somewhere under 10 cents a pound, it might be close to 5, but I am not sure. It is much cheaper than I thought it was when people first started talking about it a number of years ago.

Q. Okay. Now, if taking the scenario, and let's put the plant in West Texas, the 14 1/2 cent plant and let's make this change, and their cost for their milk has now been reduced by 2 cents a pound, because they pay only minimum price.

Would you not agree that they have the ability now to move cheese much further from their plant at a competitive price than they did before, because they got that extra 2 cents?

A. Yes.

Q. So here comes the point that I want to ask. Bob, if you have a thought on this. And that is that if you provide lower and lower cost milk to the newer, larger, more efficient plants to the west, are you not speeding up the process that you were talking about in which not only is the processing but the production going to move out of the Northeast?

A. There is a strong possibility of that. I don't think it all will occur, but it will move in that direction, yes.

Q. And we talked a little bit ago about cheese, and there was that theoretical minimum plant, and you said that you can't necessarily sum it up because somebody may have cheaper labor, but not cheaper packaging, and I accept that, and I think the department accepts that, because that is probably the way they listed it

But there are some large plants in California that are very efficient, are there not?

A. My understanding is yes

Q. And one of those is announced to build a plant in West Texas, in the process of doing that, is it not?

A. I have heard some news to that regard. But I don't know anything about it.
Q. Okay. So by lowering this price, do we not create a greater incentive for that to occur in those regions?
A. Okay. By lowering --
Q. -- the cost for the milk under the minimum pricing.
A. Well, that may -- it may be the case; but at the same time if you don't do it, you are going to have plants leave faster in other areas. So I am not saying it doesn't happen. Ben. But it doesn't happen in a vacuum. There are other things.
If you don't do it, there are other things that occur that could be as equally onerous to producers, at least the producers that I represent.
Q. Let's go back to this example again. though, where the plants are in the same place. If there is a plant that is at 18 1/2 cents and the make allowance is 6.5 and it is 4 1/2 cents. 14 1/2 cents for the other plant --
A. Oh, 16 1/2 make allowance, right?
Q. Make allowance, right. If you raise the

make allowance, you don't change the competitive relationship between the plants; is that correct?

A I would have to think about that If you raise the make allowance -- let's follow through on this. If you are raising the make allowance. you are lowering the Class III price, everything else being equal, to all the plants

Q. Right.

A. And you would allow the higher cost plant to cover more of their costs and the lower cost plant to either sell more product at a lower price or pay producers more, or turn more profit to the bottom line So that is what happens. Repeat your question.

Q. Okay. But does it -- does that situation you just described increase in favor of the lower cost plant, if you raise the make allowance?

A. Well, does it do more than it did before? Yes, I would say it does. Yes.

Q. While we just mentioned a minute ago minimum prices, I want to talk about that for a second.

You indicated that you sell milk and you sell it at over-order premiums and you have service charges and those things. How do you price that milk? Do you price it at the class. Federal Order class price, plus or minus a number?

A. Generally, yes.

Q. Is that a fairly common way in which milk is priced in your area?

A. As far as I know, yes.

Q. That the Federal Order price is used as the reference price for moving that commodity of milk?

A. On producer milk, yes.

Q. Yes. And then also in terms of these minimum prices, cheese plants -- first of all. as a co-op, you have an opportunity to pay your producers less than the minimum prices, right?

A. We have that opportunity; but there are very serious issues if we avail themselves of that opportunity.

Q. I am not saying it is a good thing. But you have the opportunity?

A. Yes, yes.

Q. It is also true the proprietary plants can purchase milk at less than class prices, can they not? Cheese plants, but bottling plants. but things that only make cheese.

A. Well, there is a question as to that. I am not sure exactly how the order has interpreted that. My understanding is that that has occurred in the past.

But I don't believe, to my knowledge, we haven't done that, sold it with milk. Although -- in the Northeast, I don't believe we have done that.

Could we have done it during a time of extreme surplus when our balancing plant is full on Memorial Day and we have to move milk to Wisconsin? That probably could happen.

But perhaps it was a non-Federal Order plant we moved it to. I don't know.

Q. I want to go back a moment to California, and you were talking about wanting to use those prices. I think you would agree with this statement, that the California dairy pricing and pooling program is more comprehensive than it is in the Federal?

A. What do you mean by "comprehensive"?

Q. First of all, that it covers all plants that purchase what we call Grade A, they call market grade milk, where in the Federal Order program, plants, manufacturing plants, can choose to be in or be out.

A. That is true.

Q. And it also provides for -- you talk about cost of production of plants. They also do a cost -- or cost of manufacturing. They also do audited studies of cost of producing the milk. do they not?

A. I believe I have seen some of those costs. But I don't know if they do them on a regular basis. I have no knowledge of those.

Q. And do you know what the percent of sales that California plants make outside of the State of California?

A. No.

Q. Are you aware that it is nearly half?

A. No. I am aware that they make substantial sales outside the state, but I don't know the degree.

Q. Now, I think at this point, I want to turn to your Proposal 2.

A. Okay.

Q. I am not saying I won't go back, but right now. I think that we will move into Proposal 2.

Some of these are clarification questions, just understanding the nature of the proposal. Your proposal only looks at the make allowances; is that correct?

A. Yes.

Q. And it does not look at the yields?

A. No, it does not propose update of the yields automatically.

Q. And it does not -- at the plant itself. there is no requirement to check to compare what the product at those plants is actually sold for, we rely entirely on the NASS for the value of the finished product?

A. Yes, that is true.

Q. All right. So the study of the make allowances would not look at any income from products that are not reported as part of the NASS? Any income that a plant makes that sells a commodity or a product that is not one of the four commodities, that price for that product will not be captured; is that correct?

A. Yes. That is the way the Cornell study has done it this initial time, and I believe that is what we were proposing, the same method.

Q. Now, if you recall the Cornell study, and

it may have been changed since then, but at the point it was presented by Dr. Stephenson, that at that point, nobody had really peer reviewed his study; is that right? Do you recall that?
A. I don't recall that.
Q. Do you recall whether he identified if anybody had analyzed it with him to check his math and his methodology or anything?
A. That I don't recall.
Q. And, obviously, that was not -- we don't know all the plants to know whether he got good plants, bad plants, you know, he did a random draw and that is all we know; is that right?
A. He didn't disclose which plants were there. We had some issues with the number of plants and the like.
Q. Right. And he didn't -- and even to the department, it hasn't been disclosed?
A. I don't know if he disclosed it to the department.
Q. Now, are you suggesting a higher number of plants be surveyed?
A. I would leave that up to the department to determine. But I think it would be valuable to have a higher number of plants, yes. I think we

would have the ability to do it if we could make use of the experienced marketing administrative staff out there.

Keep in mind that Mark Stephenson was very limited in his time and efforts, being a university professor with a lot of responsibilities. So I would hope we could survey more plants.

Q. Now, as I understand the question that was made from Mr. Vetne that you were proposing that you establish a formula and that there would never be another Federal Order hearing regarding the changes, unless it was a change in the formula; is that right?

A. I would hope there would be no -- that we could just use the same methodology for the survey on a regular basis, like you use the NASS methodology, and then if you needed to change the methodology, that you would then go to a hearing to make any changes in the methodology.

Q. Now, the methodology, though, that you are proposing is not exactly the one that Dr. Stephenson used; is that right?

A. No, it is. I want to use his methodology that he put together.

Q. Including his plant selection?
A. Well, he had a plant selection that I know he worked with USDA on. That is a good question, Ben. I don't mean to hesitate on my response.
But we did have some concern, for example. that he chose, out of 20 plants, five large plants on cheese. So I would much prefer that they had done a random sample and just had chosen enough plants that you would have a sufficient number of large plants and not have to stratify it by the large.
But we would be willing to go with the exact procedure, if that is what USDA felt they should do. I would leave that decision up to USDA.
Q. So you would allow the Secretary to devise a methodology --
A. Select the samples.
Q. -- select the samples and take this methodology, and there would be no opportunity for any participants in the dairy industry to give it any scrutiny before it is put into place?
A. Well. I would suggest, since this is more

of a longer term approach, that this might be something that could be offered in a tentative decision, not even going into effect, but getting comments from the industry once the Secretary decided to do this.

Q. You mean a recommended decision?

A. I am sorry, a recommended decision.

Q. Now, in the event that -- or is there a level of participation of plants within the Federal Order program that the need for California would no longer be necessary?

A. Yes. I believe that if you could audit all the plants and actually have auditing, such as California does, you wouldn't need to have California, because you would now have an audited structure and you would basically be auditing the population, much the same way California does.

Short of that, I guess, once again. I would leave it up to the USDA to make the decision, if they felt comfortable enough that they had a sufficient survey size, to leave California out.

Although, there may be arguments and reasons that they have relative to the NASS survey, since NASS covers California, they may want to leave California in there for that reason.

Q. There is a cost associated, obviously, with this type of a study, right?

A. Yes.

Q. Who is going to pay that cost?

A. I believe that that should come out of the Market Administrator's offices, because the function of this is to determine make allowance to get the class prices. Whether the individual Market Administrators incur the cost of the plants associated with their marketing area or whether they have an aggregate cost to do the entire study and then prorate that according to volumes. I would leave that up to USDA and the Market Administrators to discuss.

Q. Now, as it stands now, these prices would, in fact, directly impact the I and II prices. because they would be part of the advanced pricing system; is that right?

A. That's true.

Q. Now, you are aware, and I think you participated, there was a hearing about two months ago in Pittsburgh regarding a completely different formula that would price I and II separately from the III and IV. Do you recall that?

A. Yes.

Q. All right. And at that point, what happens with this NASS survey wouldn't necessarily impact what was going on in the Class I and II; is that right? Or not NASS survey, the Cornell methodology applied to the make allowances for III and IV?

A. Well, it would still affect the mover involved. It would still --

Q. Does it?

A. Yeah, I believe it does, because it does move with it.

Q. Does it move with the make allowances, or does it move on a separate relationship to cheese and powder prices?

A. I have got to pull back my memory on that particular piece. But I believe it does move with it. It would move with the make allowances.

Q. So it is your understanding that whatever happens in this hearing, it changes the make allowances, the yields, the methodology to determine --

A. I believe so, Ben, but I would have to go and review that. I don't want to misstate. My mind is focused on the make allowances here.

Q. So let me ask you this question then: If this only affected III and IV and did not affect I and II, you find out that they moved separately, is it appropriate to have Class I handlers pay for the cost of this survey?

A. Yes.

Q. Okay. Now, when the department makes these -- let's say on an annual basis would do the survey and make the changes, would you anticipate that the department would issue any opportunity for public comment that it could respond to, or would it be an automatic thing like the NASS?

A. My initial proposal would be that it would be an automatic thing like the NASS. If USDA felt they needed some public comment or the like, that is, of course, their decision on that.

Ben. I am trying to avoid some of what we have been through on this, in that when the make allowances change, that we don't have to spend several years and a lot of complicated

procedures to try to get a change --
Q. I understand that.
A. That is the intent of it.
Q. I am just trying to understand it, because, as you say, these things can be complicated.
Now, when they do this initial -- when they make an announcement on make allowance, would they be required to do an economic analysis such as we just saw yesterday and discussed with Dr. Cessna and Dr. McDowell?
A. That would be up to the USDA to do that. I don't know if they would or not.
In a way, I want this to be structured almost like the NASS. And they don't do a NASS every time. The NASS changes every month.
Q. Now, these cost studies can have a lag of a year or two, right, from the time it is actually applied, right?
A. Yes.
Q. In fact, we saw that, we were looking at something reported in late 2006, that really goes back to costs in 2005, right?
A. Yes.
Q. I think in light of energy and ethanol from the farm side and everything else. I think we

would all agree there has been a significant change in the cost structure, both to produce milk and to process milk that has occurred in those two years; is that right?

A. That's correct.

Q. If this were applicable at this point, the 2005 cost would not -- would be applicable for 2008 -- no. 2000 -- yeah, 2005 costs more or less would be -- I guess it would be 2007. It would be two years behind?

A. I think that would probably be the case. yes.

Q. Now, in the event that this occurs and it determines that the high costs that were attributable, for example, 2005, use this hypothetical. Let's move ahead, so we don't try to confuse it.

Let's say in 2010, they announce the prices. it is going to be in effect for 2011. but really there was a study for 2009, correct?

A. Okay.

Q. But let's say that 2009 had extraordinarily high costs on the plant side of the costs.

A. Yes.

Q. Which would mean higher make allowances and lower minimum prices to producers.

A. That's right.

Q. But at the same time, that as we begin to enter the year 2011, producers are facing an extraordinary cost maybe due to an extreme drought or some other huge issue that is having a monumental impact on their costs, would the department have the discretion to decide not to make the make allowances at that time, or would they have to go through a hearing to make changes in order to recognize the impact at the farm level?

A. Well, I believe that the make allowance issue really addressed to what are the true minimum costs of making the product, and that it is not going to relate directly to what the producers are receiving.

There are times when they are receiving a higher price, sometimes a lower price. So I would say that it becomes it automatically. There will be a case, for example, with those higher costs in 2009, that where the producers would have benefited by not having a reduction in their price, because of a higher make allowance that the handlers actually incurred.

So, yes, there may be a two-year lag, and. unfortunately, that may hit producers at different times relative to their income. Nobody wants to see that. But hopefully, there will also be benefit on the reverse side of the lag structure, when costs decline, and yet the make allowances stay lower than it would.

Q. But getting back to my question, does your proposal provide this department the discretion to decide whether or not to make the make allowances as reported by their study?

A. No. Like I said, I would prefer that the structure be very similar to, like, the NASS. and the department doesn't have a choice in whether to invoke new NASS prices every month. They are automatically put into the formula.

Q. Do you recommend that this proposal be instituted without a recommended decision?

A. No, this one, I believe -- no. I believe there should be a recommended decision. I believe there should be a lot of forethought. input from the industry on this.

But this is not an emergency situation in regards to Proposal Number 2. This is a long-term solution that the industry needs to be well aware of and be comfortable with.

So I would definitely think they would need a recommended decision on this, comments and the like. Things that we have done more often in the past than we have done recently.

Q. You are trying to think outside of the box for the future, as opposed to addressing an immediate --

A. Correct, correct.

Q. I want to go back to another topic that we briefly addressed.

As it turns out now, you would agree that the -- we have a weighted average price for the NASS survey for products sold, but we do not have a weighted average price, per se, that is being used for the costs for the make allowances. Would you agree to that?

A. Well, I think we do as of the interim decision. That was a weighted average.

Q. You believe that is a weighted average?

A. Yes.

Q. And do we have a weighted average regarding their yields?

A. I think the yields were based on formula yields. But I don't believe they were based on actual data that you created a weighted average from. My understanding, that is not a weighted average.

Q. Do you believe that the department should consider whether or not producers can sustain lower minimum prices in making this decision or not?

A. That is a difficult question, because we are always concerned about producer prices being a cooperative. But we also feel we have to balance out the need to maintain markets and have markets available for producers, and also reflect those producers who have invested in value added products and have their own plants.

So I would prefer that when we look at whether producers have the ability or whether it is going to affect their income, that they can address those on the Class I and II sides as they tried to do at the hearing in December.

But on the manufacturing allowance, I believe that should really be based on a true -- or as best representation of the manufacturing costs as can be determined.

Q. Okay. I want to change subjects. I am going to talk a moment about the NASS. Would you agree that the NASS has circularity in its pricing structure as it currently is used?

A. It has circularity with the CME. Is that what you are referring to?

Q. With the CME?

A. I don't understand, by "circularity" --

Q. Does it have circularity in terms of the fact that plants are unable to recover their costs from the marketplace because of the NASS?

A. No, I don't believe so.

Q. You don't believe that -- you believe that plants currently, if they have higher costs, can move those on to customers and not have to pay producers that extra cost?

A. No, they can't do that. But I don't know if it would be interpreted as circularity.

Q. I am going to read a quote that you gave at the make allowance hearing, just about a year ago. January 24th, page 1496, it looks like. of the transcript.

It says, "One of the reasons -- so there was a cost involvement and there was a marketing structure built around it. We are trying to accommodate that now and that's very difficult." You've been talking about butter.

JUDGE PALMER: Slow down.

BY MR. YALE:

Q. "So there was cost involved in that, and there was a marketing structure built around that, and we are trying to accommodate that now. and that is very difficult. One of the reasons it is difficult because we have a circular structure that was also noted, that when you increase the price of butter, and, in fact, we have tried to do that to accommodate these higher costs involved, that increase in the price of butter will get built back, for the most part back into the NASS survey and it will just increase our butterfat cost." Do you recall making this statement?

A. Oh, yes, okay, yes.

Q. And you agree to that?

A. Oh, yes, yes.

Q. Does that apply to the other commodities?

A. Yes. I am sorry, you were interpreting about circularity, I was not sure exactly what you meant.

Q. It may have been a circular question.

(Laughter.)

A. Yes. In the sense that when you try to increase your cost, for example, on powder is the one that I often use, you can only do it basically if your competition is doing it. And if your competition does it along with you, then USDA comes by, surveys what the price is and that new higher price now gets factored into the NASS. So to the extent that that is circular, yes. I apologize for my misunderstanding.

Q. And I think at your prepared statement that was given at that hearing, you said, "Industry is not subject to Government price regulations. Increased costs may be passed on and recovered by buyers."

A. You try to -- once again, I am not sure if I said that. I don't recall. But if it is in my statement, it is. And I believe that that is always what everyone tries to do.

Whether you can do it or not depends on the competitive situation. It is often tougher. though, Ben, when you have a benchmark price that buyers can refer to.

Q. And then you talk about powder and you gave an example. I want to quote this thing. It says, "In 2005 international demand for nonfat dry milk powder was rising, as were the costs of energy to make the product. Dairy America. Federation of cooperatives, including Agri-Mark. that jointly market about 80 percent of the U.S. nonfat dry milk production, was able to adjust its selling price and accounted for the increase as an energy surcharge."

A. Yes.

Q. "Their hope was to exclude this energy surcharge from the NASS price survey. The NASS did not allow a separate surcharge and instead raised the NASS survey price. That higher price was subsequently used in the Class IV price calculation and raised the milk price paid by Federal Order nonfat dry milk manufacturers accordingly. And despite the higher energy costs, manufacturers received no additional money to cover these costs." Do you recall?

A. Yes. I do.

Q. So is not the problem here that makes the need to change the make allowances as much the fact that you as a processor cannot pass your costs onto the consumer or a customer?

A. Yes.

Q. Okay. Now, when a dairy farmer, one of your members, has an additional or a reduced income due to the fact of higher -- right now. let me back up.

The way this works, as I understand it. is -- and let's just use the powder. You have a high energy cost to make the powder. Okay. You try to pass that on to the customer, the NASS captures it back and takes it and then adds it back into your cost of your milk so that the net is no increase to you, right, in your sales price, effectively, or your margin.

And by raising the make allowance, however. you are able to do that because, instead of passing it on to the customer, you just reduce the cost of your milk, right?

A. Well, that is true. But you are actually talking about a specific instance where the market was tightening and the prices were rising and the attempt was made to pass it onto the customers. There are times where the market prices are declining because of supply and demand, and costs are rising because of energy or other factors, and then, you know, it is not rising prices you can try to pass along.

So it depends on the circumstances. You would try to pass it along, if you can. There are circumstances where you can't pass it along. And, you know, there are higher costs that have to be incurred by somebody.

Q. Okay. And that is my point. That is where I am leading up to, is that the higher cost is now, instead of being passed up the chain, as they say to the consumer, it gets passed down to your supplier of your milk?

A. Well, the higher cost needs to be in the chain. And whether it can be passed up or down depends on the market circumstances.

So I mean, I think the way the order has structured their pricing, it should reflect the true cost of making the product.

If you do that, and then at the same time the market allows us to increase the price of a product and to the extent that that covers that additional manufacturing cost, then that is a good thing for everybody.

But when you're trying to just relate the two, boy, one is based on supply and demand. whether you can move your price, and one is based on the cost of making the product. And they don't always -- in fact, they rarely move in sequence.

Q. I understand that. But by going with the make allowance, though, if you have the scenario to push it on, you can, but if you can't, you do it through your cost and your make allowance and you would take it in reduced price to the producer, right?
A. Well, no, we don't do it through our make allowance. We can only do the make allowance through what the Federal Order system allows us to do.
Q. In this particular proceeding, the one that is also going on now, the make allowance is going up, at least the prior one, hopefully we changed that in this one, but the make allowance is going up, so the producers receive less money to offset those costs, right?
A. No -- I mean, yes, all else being equal. But keep in mind, one of the things that you said in the beginning was, if you can pass it along to your customer and raise -- and get it from your customer, well, as this make allowance is changing, okay, we are passing along additional prices to our customer.
Nonfat dry milk prices have risen substantially, as an example. Dry whey prices

are up dramatically.
Q. As a result of the make allowances?
A. No, as a result of trying to pass along -- as trying to raise the price. I am saying, raising the price to your customers and covering your costs, okay, are two different things. You sort of related the two, and I am saying they are not related.
Q. Let's unrelate them for a second.
A. Sure.
Q. If you want to adjust your costs and you cannot get it out of the chain and you have to do it by reducing the price of your milk, that is the producer that pays that, right?
A. The producer is getting -- he is not paying it. He is getting the value for the milk that is represented by the value of what is making the product, and what the product sells for. I mean, that -- so the producer is not getting -- you know, the producer price may go up or down. just like it does when cheese or butter moves.
But on the make allowance side, the way that the end product pricing is worked through the order, is that the producers get the value of their milk after you take -- after you

consider the selling price and then you subtract the make allowance.

0. So, in other words, the producers just really get whatever the milk is worth and they have their costs and their role in this has no impact on what the value of the milk is?

A. I mean, basically, the price of their milk is determined by supply and demand.

I mean, that is why we see, for example. that supply is starting to tighten right now, and you are seeing cheese prices go up, as I noted whey and nonfat dry milk prices go up. I am anticipating right now that the average milk price in 2007 to be somewhere between $2.50 and $3 a hundredweight above 2006 milk prices, and that is supply and demand working.

Q. And the same supply and demand should also apply to plants based upon their efficiency. right, the inefficient plant should not be protected under the system, that they should rely upon the price of the commodity based upon supply and demand as well, right?

A. Well, supply and demand has to impact what they get for the cheese or butter or what have you. In terms of the plant itself, if a plant is going to be allowed -- if you have a set of costs that the plant is getting, and let's say. for example, it is set at a higher level than another plant, say, there is a low cost plant out there, wherever that may be, you know, that plant can, like we have been talking about, do other things with that additional money that is out there.

But if you have minimum pricing, and it is at a level for that higher cost plant, that higher cost plant, if they follow the minimum pricing and it can't cover their costs, they are going to be out of business. There is no alternative to that.

A lower cost plant can competitively bid for more milk because of that, so, you know. they can competitively sell their product for less, if they so choose to do, or they can turn a profit and perhaps want to do more investment.

Q. At what point do you determine -- let me back up.

Based upon the way the formulas are set now, in particular for the commodities, the margin that the plants have is fairly fixed in the system, right? You have the NASS tells you how much you are selling -- what the product is worth, you take out your make and that tells you what you have to pay for your milk?

A. Right.

Q. The plants basically have to operate within that make, is that a fair statement?

A. For those set commodities, yes.

Q. And you just said that those that have a higher cost are not going to be able to stay in business, and they are going to go out of business; is that right?

A. Right.

Q. At what point do we determine where the make should no longer cover a plant of higher cost?

A. Well, that is where I am proposing that, in my proposal I have, saying that you look at where 80 percent of the milk is covered. We had to give an estimate of that. Not at the weighted average of it, saying half the plants can't cover their costs or half the milk or whatever. As, again, we know the weighted average does not always have to be half.

Q. You are proposing 80 percent?

A. I am proposing that, saying that, yeah.

there is 20 percent of the milk that would not be able to cover their costs. Not every plant should have to cover their costs. We are not proposing a hundred percent of the plants cover their costs.

But we looked at 80 percent, because my understanding is that California looks at up to about 80 percent when they determine what their final manufacturing allowances they will allow in the state.

And, in addition, when Mark Stephenson looked at his population sample, he came up with a number that represented 82 percent of the milk, I believe, and 33 percent of the plants.

So we felt 80 percent would allow a large volume of milk to cover their costs, because those plants have to be there. But it still only represents less than 33 percent of the plants. So I don't think it is overly burdensome.

You still have a lot of plants out there that won't be able to recover their costs, but they have to work on efficiency of their plants. as we all do.

MR. YALE: I have no other

questions at this point.

JUDGE PALMER: Very well. Other questions? Yes, Mr. Rosenbaum.

CROSS-EXAMINATION

BY MR. ROSENBAUM:

Q. Good morning, Mr. Wellington.

A. Good morning.

Q. I wondered if you could pull out Exhibit 10, which is the updated California study of manufacturing costs that Mr. Vetne distributed during the course of your examination.

And if you would turn with me to the page. I think it is the third page, although they are not numbered, the page that covers cheese manufacturing costs. Do you see that?

A. Yes.

Q. Now, this set of data is the most current data in existence with respect to what it costs to make cheese, is that correct, in terms of the time period being covered?

A. I believe so.

Q. This is actually -- this is more recent data than Dr. Stephenson had available to him?

A. Yes.

Q. And the Federal Order make allowance under the tentative decision for cheese is 16.82 cents, correct?

A. Yes.

Q. And it is sort of a stunning bullet point, which is the last bullet point, you know. I will quote it, which says, "For this study period. approximately 0 percent of the cheese was processed at a cost less than the current manufacturing cost allowance for cheese. 17.8 cents per pound." Do you see that?

A. Yes, I do.

Q. And that, of course, 17.8 cents per pound being referenced there, that is the California make for cheese, correct?

A. Yes.

Q. The study period referenced here is January through December 2005?

A. Correct.

JUDGE PALMER: Did I hear -- I didn't hear an objection, did I? I heard a murmur from somewhere.

MR. ROSENBAUM: I think it was a telephone call or something.

BY MR. ROSENBAUM:

Q. Now, what that would suggest is that even

at a make allowance almost exactly one penny higher than the Federal Order make allowance. there wasn't a single plant in California that could produce a single pound of cheese at less than that make allowance, correct?
A. Yes.
Q. And this survey covered seven separate cheese, cheddar cheese plants in California. right?
A. That is what the statement says.
Q. Including a low-cost group and a high-cost group, right?
A. Yes.
Q. And as you interpret this page, every single plant had a cost of manufacturing that was higher than 17.8 cents per pound. correct?
A. Due to that footnote, what that footnote says, yes, that is true.
Q. I mean. wouldn't that indicate that to the extent that the California plants are representative of what costs are being incurred nationwide to make cheese, the current Federal make allowance of 16.82 cents is woefully inadequate?
A. Absolutely

Q. Even if you raised it by a penny, you still would not have a make allowance high enough to cover any cheese made in California, correct?
A. That's correct.
Q. Much less a question of what the weighted average cost of manufacturing is, correct?
A. Yes.
Q. And, in fact, the weighted average cost of manufacturing is shown here as being 19.14 cents per pound, correct?
A. Yes.
Q. That is almost 2 1/2 cents per pound higher than the current Federal Order make allowance for cheese, correct?
A. Yes.
Q. So to the extent that the weighted average in California would be looked at as an indicator as to what the make allowance should be for the Federal Order system, it is obvious that the current Federal Order make allowance is woefully inadequate, correct?
A. I would agree.
Q. Now, another point one can derive from this is the size of the increase in cost between 2004 and 2005, correct?

A. Yes.
Q. And what it shows is in that one year alone, the weighted average cost of making cheese rose from 17.69 cents in 2004 to 19.14 cents in 2005, correct?
A. Yes.
Q. And that is stated as being a 1.45 cent increase in the last column, correct?
A. Correct.
Q. Now, I am going to ask you to do something that maybe is not entirely fair. But I don't think this will be too hard. I just want to get some percentages in front of us. If I could hand you a calculator, as I calculated it, that 1.54 increase --
A. I think 1.45.
Q. I stand corrected. The 1.45 cent increase over a preexisting cost of 17.69 is an 8.2 percent cost increase during that one-year period, if you could just confirm that my math is right on that.
A. What percentage did you say?
Q. I got 8.2 percent.
A. Let me just double-check here. Ah, yes, 8.2 percent.

Q. Now, if manufacturing plants, such as your own -- well. let me just back up and say, are cost increases of that magnitude the kind of thing that Agri-Mark itself also experienced under that time frame, roughly speaking?

A. Yes.

Q. Now, if approximate -- it was your employer. Agri-Mark, that first requested the hearings that resulted in the make allowance hearings that took place in 2006, correct?

A. Yes.

Q. And am I correct that you first asked for a hearing in roughly September of 2005, does that sound about right to you?

A. Well. I first met with the department. actually, in March of 2005 to discuss having a hearing.

And then I requested a hearing officially in September 2005.

Q. Okay. And the -- it is finally now in February 2007 that any change actually is being made in the Federal Order system as a result of your request for emergency hearing; is that right?

A. That's correct.

Q. So it has taken about 17 months to actually effectuate any change, based upon the date you asked for the hearing and when the actual change is now coming into effect, more or less as we speak?
A. Yes.
Q. Now, given that kind of time lag, what does that tell you, and what would you tell the department ought to be their sort of mind-set when it comes to setting make allowances, you know, namely, the fact that plants can easily be put in situations where costs are rising rapidly and yet it takes the Federal Order system a substantial amount of time to react to that? How does that affect, in your mind, how they should go about setting the make allowances to begin with?
A. Well, that is where I would like them to have the automatic procedure in place, so they can have a procedure being conducted on an ongoing basis; and then I grant that it will take some period of time to analyze the survey collect the information and analyze it.
But if you could do it that way, you could probably have a lag of hopefully only about a

year, as opposed to far more than a year.

Keep something in mind, Steve, that although we do have new make allowances that were put into effect, they were essentially based on 2004 data. I went to the department in 2005 because of these costs that we were starting to see being incurred. So we knew there was a huge problem that we were just starting to face.

But we are still now, in 2007, just implementing costs based mostly on 2004.

Q. Now, another way one might approach it is simply, if you will, to err on the high side of the make allowance when you are setting it in the first place, to account for the fact that over time costs may rise, and yet the system cannot adjust quickly enough to account for that?

A. Because of interim pricing, the department could do that. But as a producer co-op representing farmers and the fact that this does influence a variety of classes and other things. we prefer that they try to get the most accurate number they can and not necessarily err on the high side.

I can tell you our operations people may feel differently because of the struggles they face. As a co-op, we try to get the most accurate number.

Q. That only works if you can adjust quickly with respect to the make allowances as costs adjust in the real world?

A. That is true, or if you have an ongoing effect. no. you are going to change this every year. You might be a year behind, you might incur losses. If you know that at least the following year you can at least start to cover those losses, that puts you in a better position, particularly with your owners; if you are not making as much money, or if you happen to be losing money, if you know that there is some relief on the horizon, even if that relief is a year away, I guess that is okay. I would prefer to have everything ongoing, like the NASS does, but I don't think that is realistic.

Q. Just another question in terms of the math here. The weighted average cost in California for 2005 of 19.14 cents, I calculate that to be 2.32 cents more than the current Federal make allowance of 16.82. So if you could just confirm that math?

A. That's correct.

Q. Okay. And then if you could just confirm this calculation, that that 2.32 cents is 13 - let me rephrase that.

Given that the California weighted average cost for 2005 is 2.32 cents more than the current Federal make allowance for cheese, then that means that the percentage by which the current Federal Order price -- strike that.

That means that the percentage by which the current Federal make allowance is less than the weighted average cost of manufacturing in California, I get 13.7 percent, that is to say, 2.32 cents divided by 16.82 cents.

A. I must be doing something wrong on your calculator.

Q. Okay.

A. What number did you get, Steve?

Q. I get 13.8 percent.

A. Yes, .1379, .138.

Q. That, just to clarify, because my question got a little convoluted there. Let me start the question over again.

The percentage by which the current Federal

Order price -- let me do it the other way around. I will start the question again.

The weighted average cost of manufacturing in California for cheese is 13.8 percent more than the current Federal Order make allowance for cheese; is that right?

A. Yes, that's correct.

Q. And you have testified that under the regime, the finished product pricing regime. under which we have lived since 2000, a regulated plant can never keep more than the make allowance, because it must take the price it receives for the finished product and pay everything other than the make allowance over to the farmer in terms of a minimum regulated price, correct?

A. For that product that they sell at the NASS price. yes.

Q. Okay. And, accordingly, if there are Federal Order regulated cheese plants out there whose cost equals the weighted average cost in California, they are, with respect to the NASS surveyed products, suffering losses of 13.8 percent of their total cost of make, correct?

A. I would believe so.

Q. And these are the considerations you are bringing to bear, in part, for some of your proposals, correct?

A. Yes.

Q. Now, you were asked some questions with respect to the Range of Costs column, and I believe your testimony was to the effect that you thought that the individual rows, like Processing Labor, Processing Non-Labor -- I am still on the third page of Exhibit 10 -- that those would not likely be describing any individual plant, but rather the lowest or highest, as the case may be, cost incurred for any plant, correct?

A. That is my understanding.

Q. So that the processing labor, a minimum of .0378 cents might be from one plant, and the processing non-labor minimum cost of .0570 might be from a different plant, right?

A. Yes.

Q. In fact, if one were to add up those minimums, assume with me that if one were to do that, the result would be something less than 17.8 cents, okay?

A. Okay.

Q. The fact that this report shows that there is no plant that is manufacturing at less than 17.8 cents would be confirmation that the individual line entries must be, if you will, best of class for each individual entry as opposed to any one particular plant?

A. I think you could interpret it that way.

Q. You were asked several questions with respect to Exhibit 9, which is the California Manufacturing Cost Annual 2005 report.

JUDGE PALMER: I am going to take a quick recess. I mean quick, because I don't want us to wander off forever. But I want to take a recess for a few minutes. When I come back. we start.

(Thereupon, a recess was taken.)

JUDGE PALMER: All right. Back on the record.

BY MR. ROSENBAUM:

Q. I was about to ask you a question about Exhibit 9.

A. Yes.

Q. Maybe you can turn to page 10 of Exhibit 9. You were asked some questions by Mr. Yale regarding what the numbers on that table might

imply regarding yields; is that right?
A. Yes.
Q. Now, you don't have a facility in California yourself, I take it?
A. No. I don't.
Q. Now, assume with me that these various tests in California are performed after various fortifications may have been added to the vat. such as nonfat dry milk or condensed skim, or ultra filtered milk.
If that was the case, would it be possible to derive any conclusions regarding yields from this table?
A. I think it probably would not be. At our plants, we don't fortify because we make cheddar cheese. We don't do the same type of technology that they use. I gather what you are saying is true. That you probably could not back into it. unless you knew the solids you were adding.
Q. And to the extent that there is no data in this report as to those sorts of things, it would be impossible to derive that information?
A. If there is no such data, I don't know.
Q. You would agree with me, if there is no such data in the report, and, in fact, if these

various fortified milk products had been added. it would be impossible to derive any true information as to yields?

A. Yes, I believe that would be the case.

Q. Okay. Now, I believe you testified that in a circumstance where there is a given make allowance and there is a more efficient plant whose costs of manufacturing are below the make allowance, that plant has various opportunities available to it, one of which would be to pay extra money, something beyond the minimum price to secure more milk, correct?

A. Correct.

Q. In that circumstance, the less efficient plant might be called upon to meet that competitive price, correct?

A That's correct

Q This gets to the question whether or not the make allowance is, in fact, a guaranteed amount that a plant can hang onto Is it? Well, my point is, are there circumstances in which a plant, in fact, has to pay more than the minimum milk price and, accordingly, does not end up with the entire make allowance?

A. Oh, yes, definitely, definitely.

Q. Okay. I mean, these are minimum milk prices we are setting, correct?
A. Right. And even in the case, for example. in our area, we tried to maintain some small level of premium with Class III manufacturers. although that was eroding very rapidly, and it was a very difficult negotiation, because they had all the problems we had, but you try to maintain something, because you are trying to procure milk supply.
Q. Now, on the question of how do you use the California survey data and the -- how to use the Federal data that Dr. Stephenson most recently compiled, I am really going to your proposal, some of the issues related in your Proposal 1, you have suggested that the California data and the, what I will call the Federal Order area data, should be weighted, based upon the pounds of product made by the surveyed plants, correct?
A. Correct.
Q. As opposed to what USDA did, which was to project the surveyed data to the total pounds of production in California, with respect to the California data and then outside California, with respect to the non-California data.

correct?
A. Correct.
Q. Okay. Now, there is a separate issue that came up in the last hearing with respect to how one should take the data that Dr. Stephenson produced and utilize it, correct, with respect to cheese in particular?
A. Yes.
Q. Namely, he performed his survey on a stratified basis, correct?
A. Yes.
Q. And then he -- he testified, as you will recall, that one should then derive a population weighted average cost, correct?
A. Yes.
Q. Which USDA did not do, correct?
A. Correct.
Q. Now, is it your view that in fact, a population weighted average cost should be used?
A. Yes.
Q. You are not stepping away from that position?
A. No. And, in fact, if you use that populated weighted average cost, I would have no problem with the procedure that USDA used, which

was to apply it against all the milk outside of California.

Q. And that is really the issue I am trying to get at.

A. Yes.

Q. Which is, if you use the populated weighted average cost, which Agri-Mark has advocated in your comments on the tentative decision. correct?

A. Yes.

Q. That would address this problem?

A. Yes, that certainly would. It was -- just to elaborate a bit further, that is one of the reasons, for example, we particularly had a problem with butter, because there were only four plants. And then USDA took those -- that averaged cost, which had serious statistical problems, and applied it across all the butter production outside of California.

That clearly should not have been the case. because it was a very small sample of plants. So in that case, if you use the sample and weight it by the sample, then at least it is reflective of the smaller sample size.

But without a doubt, I would much rather use the Cornell population weighted sample that he came up with and use that across the method that USDA did, using the entire production outside of California.

Q. With respect to cheese, we're talking about cheese?

A. Yes, cheese; and I would eventually like to do the same type of procedure for all the products.

Q. Well, to orient ourselves, it was with respect to cheese that Dr. Stephenson performed a stratified sample, correct?

A. Yes.

Q. He did not do that for the other products. correct?

A. Right. The department could do that now for cheese. They could not do it for the other products. Eventually, if we had, under Proposal 2, I would like them to do that for all the products.

Q. And if USDA were to accept your comments. as well as my organization's comments on the tentative decision, and switch over to a system that does use a population weighted average for cheese, then that would address the question of how one projects the survey data to the population as a whole?

A. Yes.

Q. And would properly address that?

A. Yes.

Q. Okay. Now, on the question of the annual survey, this is Proposal Number 2 that you testified about, I guess an issue is how much open-ended discretion one would intend to provide USDA to change the make allowance without going to a hearing. You would perceive that to be one of the issues, I take it?

A. Yes.

Q. As an example, whether or not one would use a -- or a stratified sample, or not, is that something you would want to leave up entirely to the discretion of USDA year to year, or would you want that kind of choice to be something that had been worked on in advance?

A. I think it needs to be worked on in advance. I think we ought to have rules for that.

If initially they wanted to follow the Cornell rules on that, that can be dangerous, because we are not sure -- we are not sure of how much -- how many facilities are available to conduct this survey. If it is all Market Administrators, you can have a much larger survey, and perhaps you don't even need to stratify it at that point. But I would not know the answer to that. I think it should be defined before it is put in the order if that's the case.

Q. You would want a pretty well defined system of how they were conducting the survey, before you would want that to be --

A. Yes.

Q. -- automatically implemented; is that fair?

A. Yes.

MR. ROSENBAUM: That is all I have.

JUDGE PALMER: I think it is -- I presume -- is there anybody else that wants to question the witness? And you are going to be a while, aren't you? It wouldn't be ten minutes' worth?

MR. BESHORE: It might be.

JUDGE PALMER: Okay. We will give you a crack at the bat.

THE WITNESS: I don't know if I like that term.

MR. BESHORE: As long as I am wielding the bat.

JUDGE PALMER: Yeah, a mixed metaphor there. I don't know where I was deriving it from.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Marvin Beshore for DFA and Dairylea. Bob. I want to look first at the cheese manufacturing cost page of Exhibit 10. It is the fourth page in my Exhibit 10, that Steve Rosenbaum was asking you some questions about. If you look at the change in cost from prior year to current year, the three columns to the right, it is quite striking, is it not, that the changes in cost were 13.1 -- or .0131 out of .0145 and the difference from prior year to current year was in the processing non-labor line

A. Yes.

Q. Do you see that?

A. Yes.

Q. And if you look at the bottom of that page that identifies the components of processing non-labor, included there are costs such as utilities and it goes on. But utilities is

included in that, correct?
A. Yes.
Q. And that would include, or is it your understanding that that would include costs of electricity, energy, energy costs?
A. Yes.
Q. And that has been one of the -- the really major drivers of cost inflation in the manufacturing sector, has it not?
A. Yes.
Q. Now, one of the alternatives in this hearing for updating make allowances is the National Milk Producers Federation Proposal Number 17, which would implement a monthly energy adjuster. You are familiar with that proposal, right?
A. Yes.
Q. Now, if that proposal -- and it is based off of published price indexes for cost of energy, correct?
A. Yes.
Q. If that were in place, would it not be correct that, you know, these year-to-year changes on the basis of Exhibit 10, cheese manufacturing costs, very substantial portions

of those changes in costs in this time sequence would be captured on a monthly basis?

A. Yes.

Q. And by the same token, if there were to be declines in energy costs, because we know there is volatility in those marketplaces, the monthly adjuster would reduce the make allowance by those amounts as indicated by the indexes. correct?

A. Yes.

Q. And return that money back to the producer price, if you would?

A. Yes.

Q. Okay. So is it -- wouldn't that be, you know, one very good way to keep make allowances current with costs?

A. Relative to energy, yes. I am trying to look at the entire cost structure, because there are levels of -- labor can change, chemicals. other things. That is why my proposal is to try to update the entire survey.

Agri-Mark and, I believe, our members of our coalition co-ops, support the National Milk proposal. And I think you could even make it work with Proposal 2, within Proposal 2, if you wanted.

And, in fact, in Proposal 2, we call for a regular update and we say annually. But it might be biannually or something. And within it, we try to look at the energy.

Q. And I appreciate that. In terms of. I guess, wouldn't it be fair to say that in terms of the substantial short-term, relatively quicker increases in manufacturing costs in the energy sector, outstrips everything else in terms of the steepness and quickness of price changes?

A. It does. But as an industry, we are very -- do a poor job anticipating other problems. Such as back in the late '70s, we had a severe price inflation. I mean, if that were to happen again, we would have everything going crazy. So I am trying to develop something in there that could address that issue a little more quickly, if it were to occur.

Q. Okay. Now, California, if I am correct. the California Department of Food and Agriculture, while it publishes the annual studies and cost studies which we have here in Exhibit 9 and 10, does not automatically change its make allowances with that data, is that your understanding?

A. That is my understanding.

Q. Okay. And they have a hearing when they determine to call it and consider the updated cost information with respect to their make allowances?

A. That is true.

Q. Okay. Let's just talk a little bit more about cheese. And I wonder, the cheese in the Federal Order system with respect to the make allowance issue and the circularity issue, there is quite a difference in the cheese situation. versus powder, for instance, in terms of quantity of the product priced under the Federal Order system that is incorporated into the NASS series. Would you agree with that?

A. I believe that is the case. I would have to look at the numbers.

Q. The numbers are and will be in the record in terms of the NASS volume numbers and Federal Order volumes.

A. Right.

Q. But certainly powder is a much less differentiated market than the cheese market?

A. Yes, much so.
Q. And a much higher percentage or a higher percentage of the powder that is produced in the country goes into the NASS survey then of all cheese produced?
A. Yes.
Q. In fact, in the Federal Order system, do you know what portion of the cheese, of Class III usage, is even cheddar cheese, versus other kinds of cheese?
A. I don't know that offhand. I know it is not even the majority of the Northeast is cheddar. The majority is mozzarella. Italian cheese.
Q. And Italian cheese is not in the NASS?
A. Correct.
Q. And within cheddar, some portion of it, I don't know what the percentage is, but some portion of it is blocks and barrels, but there are other cheddar varieties produced?
A. Yes.
Q. And of the blocks and barrels produced. only some portion of that is actually in the NASS survey?
A. Yes, right.

Q. So given the fact in the cheese market, the Federal Order system, that, you know, only some portion, which I don't know the percentage of it, precise percentage is not important for this question, but only some portion of the cheese production is actually challenged with the NASS circularity issue, but Class III prices, all of it. How do you interrelate that fact with your request that 80 percent of the production be covered?

A. Well, I would disagree with you. Marv, in that there is only a small percentage that is impacted by that circularity.

All the prices that we have are based off of that same price level that NASS comes off of. So, you know --

Q. When you say "all prices," what --

A. For cheese, for example. All our cheese prices, okay, are relative to -- normally it is a CME. When we run a regression and we relate the CME to the NASS, it is like 98 percent. So it is basically the NASS price. So everything moves with that same price relationship.

Q. As a matter of practice?

A. As a matter of practice. So even though we might have a cheese, for example, that we don't include in the NASS, it could be a commodity cheese that could have been with the NASS, but we don't make it on a regular basis, but we have the same problem with that cheese. It can even be a branded cheese item that we sell relative to the NASS.

Q. NASS-plus.

A. NASS-plus. So whatever that relationship. and how that changes, you know, we have to then look at that consideration. So I am just saying, it is not just that small percentage of the NASS, it moves everything relative. And the make allowance applies to all that milk in the Federal Order, that cheese makers are making.

You know, there is not an extra ability to try to grab more money out of the marketplace, even for those other varieties, because they all move relative to that basic price.

Q. As a matter of practice?

A. As a matter of practice.

Q. Or custom in the industry?

A. Yes.

Q. But there is no locked-in circularity issue with this non-NASS products?

A. No, but it is a general business practice and it is what generally happens.

Q. Of course there are -- strike that.

Would you agree that when the Secretary is looking, the department is looking at the various issues in this hearing, make allowances. yield factors, formula factors, et cetera, that he ought to devote the same degree of scrutiny to what is the proper yield factor or formula factor as he does to what's a proper make allowance, that they are all important and should be given --

A. When he is looking at those, yes. I don't believe that the yield factor, for example, will change as often as the make allowance will change, because the make allowance has all the various costs that change. Energy will change on a regular basis. Our packaging might cost -- change every month or two. So there are a lot of cost things that change.

Yield really doesn't -- as long as yield factors in the components of the milk, yield will probably only change when there is a big change in technology or something that affects the making of the product.

It is not a day-to-day cost structure that can change. That is what I am saying, there are different timetables to these. When the Secretary is considering yield, absolutely, he should give due diligence to that.

Q. Technology, for instance, in something such as the ability to recover butterfat in the cheese making process or utilize it in the cheese making process is something that ought to be looked at?

A. And I believe it will be.

Q. Okay. Now, are you or is your group planning to ask Dr. Stephenson to testify at the next session of this hearing or someone from Cornell?

A. It would have to be Dr. Stephenson, because Dr. Stephenson is the primary person that worked on it. There were some inquiries about Dr. Stephenson to attend this hearing and testify. But I believe he is having hip surgery this week.

JUDGE PALMER: He won't be available for the next one either, having had it.

MR. BESHORE: We don't know for

certain when the next hearing is.

BY MR. BESHORE:

Q. My question is --

A. We would like very much for him to be here, we will request for him to be here.

Q. Now, just one other area with respect to the proposed update or your Proposal 2 and how that would work.

Is it your thought that NASS would be responsible for the plant cost survey data, or AMS?

A. I believe AMS was my original view.

Q. Okay. And under the Federal Order program?

A. Well, my thoughts were that Market Administrator's office would collect the data. because they have experienced people to do so and they are in the plant for other purposes.

Might it be in conjunction with NASS? Perhaps. I know they collect similar type data. So I guess I would view both agencies working together on this.

Q. I ask that in the context of the fact that there may presently be Federal regulation in the Upper Midwest, which has a lot of the cheese production capacity in the country. But at some point in time, if it is possible that there would not be Federal regulation, Federal Order regulation in the Upper Midwest, but it is not. I guess -- the Federal Order system is not co-extensive with all the cheese manufacturing capacity, even in the country outside of California, whereas, NASS survey capability extends to all of that capacity. How do you see those interrelating or meeting that challenge?

A. Well, and I am looking at viewing, taking a survey of all the plants outside of California for this particular piece, and so they don't have to be within Federal Orders or near Federal Orders.

I just felt that, based upon my experience with Federal Orders, I have great respect for their auditing staff. So I felt that, here is a group that could do this at a minimal cost. There will be some cost, and since it relates back to Federal Order issues, it is a way to the Federal Orders to pay that. So I don't have to worry about the department wondering where they are going to get the money to do this. So I was trying to connect the two.

If the department finds that there is a

better way to do that or it should be done through NASS. I don't have an issue with that. They are the experts on this, not I.

Q. Do you have a view on whether AMS has the authority under the order program to collect data and audit data from those plants that are not, you know, in the system or even necessarily receiving milk from Federal Order plants?

A. That is a good point. I don't know that. I think probably we will have to take a look at that, and we have got a 2007 farm bill and maybe we need to make some adjustments in that.

MR. BESHORE: Okay. Thanks, Bob.

JUDGE PALMER: I think we are going to recess for lunch. I don't know if we have more questions or not. I will find that out. Yes, we do have more questions. So we are going to be back here at 1:00, and you will be back on the stand. So have a good lunch.

THE WITNESS: I will be here.

(Thereupon, a luncheon recess was taken at 12:05 p.m., with the proceedings to be continued at 1:00 p.m.)

AFTERNOON SESSION

1:15 p.m.

JUDGE PALMER: All right. Who wishes to examine Mr. Wellington? Over here. Mr. Schad.

CROSS-EXAMINATION

BY MR. SCHAD:

Q. Good afternoon, Bob. Dennis Schad. representing Land O'Lakes. And if you answer him, Bob, I won't have to.

JUDGE PALMER: I didn't get that either. but that's all right.

THE WITNESS: Unfortunately, I did get it.

MR. SCHAD: Maybe later.

BY MR. SCHAD:

Q. Bob, there were quite a few questions directed to you by Mr. Yale and also Mr. Beshore relative to products that are sold by cheese plants, butter plants, powder plants, that are not included in the NASS survey. Do you remember those questions?

A. I remember questions of that nature, yes.

Q. Okay. Are you of the opinion that the costs of producing those products, were they captured in either the Cornell or the Ling surveys?

A. Most of those products, no.

Q. So if you were selling Cabot cheese in a retail function, none of the aging costs, none of the packaging, none of the marketing costs would be captured in the make allowances; is that correct?

A. That's correct.

Q. And are you of the opinion that the make allowance cost surveys only capture the cost of producing products, commodities, the commodity products in those NASS defined sizes?

A. Yes, that is my understanding.

Q. Okay. Thank you. Another question. It goes to the idea of the annual survey.

When the annual survey will be done relevant to your Proposals 1 and 2, do you expect that this survey will capture the costs of manufacture for the commodity products?

A. The total cost or the -- I think it is hopefully going to capture the same limited costs for those NASS products.

Q. Yes, I agree. And the next question is really the lead one. It will also capture the

volumes that each one of those plants produced during that period of time, if it is a new Cornell survey on 2006 for a cheese plant. it would capture the cost of producing NASS cheese, as well as the number of pounds produced. is that correct?
A Right Because most of the auditing is done to get the total cost divided by the production. That is how you get the per pound cost.
Q. Right, per pound cost.
A. Right.
Q. That per pound cost would also capture any productivity gains at that plant; is that correct?
A. I believe so, yes.
Q. Right. If the total costs stay basically the same, and the number of pounds that go through the plant and the end product increased. you would see --
A. -- the average cost per pound would go down, right.
Q. Right. And the inverse would also be true?
A. True.
Q. There were quite a few questions basically

from Mr. Yale that basically asked you to consider the producer cost of production in the make allowances. And you answered them that you didn't believe that that was a part of this proceeding; is that correct?

A. That's correct.

Q. Okay. Are you of the opinion that the USDA recognizes the Federal Order system as a price support program?

A. No, I don't believe they look at it as a price support program.

Q. So enhancement of producer prices for any reason would not be under the normal operating procedures of the Federal Order system; is that correct?

A. Well, for the most part. But I believe they -- one of the things they are charged with is to look at feed and other things. We did look at that issue in regard to the Class I prices, so there is some relationship going on there.

Q. Okay.

A. But on Class III and IV, it is a market clearing price, and if you enhance income there, you are just going to put the manufacturers out of business and they won't be able to clear the market.

Q. Thank you very much. Good answer.

There was a question that was brought up in the same context. If there was a drought, for instance, where the department was going to release the prices based on the survey of Proposals 1 and 2, and the question was, should the department hold up or change or take into consideration the drought before putting out the make allowances, do you recall your answer to that question?

A. Yes. I said that the department should not do that. But I would also follow up on that that if there was a drought situation, chances are there is going to be less milk production as a result of that, which is going to change the supply and demand dynamics, the supply dynamics that would affect the price. Hopefully you wouldn't have a price response going back to farmers.

In addition, if the drought is on a local basis, and there is less milk, you still have the plants, all varieties of plants, by varieties. I mean Class I, II, III, IV plants.

they are going to be competing for that smaller supply of milk.

Q. So you would expect the -- is it true that you would expect less milk going to the Class III and IV plants because of a drought and the scarcity that you would assume would come from the drought?

A. Yes. If milk supply is down, the plants that get that lower amount of milk first, at least in the Northeast, are the Class IV plants, then the Class III plants, and then Class I and Class II plants generally get all the milk they need.

Q. If a plant wanted to keep running, you would expect those Class III and IV plants to increase whatever order premiums they would be paying?

A. I would say to the extent they could.

Q. And looking at it from the other direction. if, indeed, plants were getting less milk, those Class III and IV plants were getting less milk because of the drought situation, would you expect a cost per hundredweight to increase?

A. Yes, if --

Q. I am sorry, cost per pound of product?

A. Right, cost per pound of product. It would be because you have a certain amount of fixed costs and if you are putting less milk through. you are not covering those fixed costs, so the fixed costs per pound of product would go up.
Q. Thank you much. And the last question, it is probably a technical question. I noticed that you did not testify relative to Proposal 3. Proposal 3, if you remember, is from the Dairy Farmers of New Mexico, and there, the proposal was set the make allowances based only on the Cornell prices, except for the whey price for going forward.
Do you have -- will you testify later relative to Proposal 3?
A. No. I don't believe I will. But I did respond to a question, I believe, by Mr. Yale, saying that we originally had a position where we didn't want to include California. But then as we saw the department's reasoning for including California and all the other factors that were out there, we decided that probably at this point in time, it would be better to include California, and they were also included in the manner -- well, include California and

also include the Cornell study in a different manner than was used by the department.

So our position would be opposition to Proposal 3.

JUDGE PALMER: Any more questions? All right, sir, if you state your name on the record.

DR. CRYAN: My name is Roger Cryan, C-r-y-a-n.

JUDGE PALMER: You are entering your appearance?

DR. CRYAN: I am entering my appearance, I am with the National Milk Producers Federation.

JUDGE PALMER: You have some questions?

DR. CRYAN: I have some questions.

CROSS-EXAMINATION

BY MR. CRYAN:

Q. Bob, I would like to look at Exhibit Number 10, and I would point out that to begin with on the -- the pages are not numbered. But on the page for butter costs, the increase in butter cost from 2004 to 2005 was relatively small.

But the processing non-labor component of that was a tenth of a cent out of four tenths of a cent.

A. That's correct.

Q. Twenty-five percent. On the page for nonfat powder manufacturing costs, the processing non-labor element of that was .89 of a cent out of 1.16 cents, which by my calculation is 77 percent.

A. That looks about right.

Q. For the cheese, as we discussed, the processing non-labor was 1.31 cents out of 1.45 cents, which I calculate to be 90 percent.

A. Yes, that looks about correct.

Q. For skim whey powder, processing non-labor was up 2.47 cents, compared to total of 1.78 cents, which is actually 139 percent of the increase.

What was the significant event of 2004 and 2005 with respect to costs?

A. Well, basically it was energy costs going up, primarily oil related costs, but it also went over into propane, electricity and others.

Q. Is it your experience as a cooperative manager, that over the long term, energy prices tend to go up and to go down?

A. Yes.

Q. Even if the trend is up over the long term. they can go up and down substantially above and below the trend?

A. Yes, they are much more volatile than we would like to see them be.

Q. And do they tend to be more volatile, that is, do they tend to have -- do they tend to go up above trend and below trend more than other costs that you deal with as a processor, aside from milk prices, of course?

A. Yes, yes.

DR. CRYAN: That is all I have. Thank you very much.

JUDGE PALMER: Thank you. Other questions? All right. Mr. Vetne.

REDIRECT EXAMINATION

BY MR. VETNE:

Q. John Vetne. Mr. Wellington, if you look at Exhibit 5-A, the correction for Exhibit 5, do you have that in front of you?

A. Yes.

Q. In the text that you read, there is a reference to 17.8 cents per pound for cheese.

and in the table to the right, on the right-hand column under "Cheese," there is 17.9 cents.

A. The correct number on the table, Table 1, would be 17.8 cents, or really .1780.

Q. $.1780?

A. Yes.

Q. And that is a correction to the table?

A. Yes.

Q. Thank you. Do you have Exhibit 9 in front of you? The charts and graphical data?

A. Yes.

Q. Could you turn to page 11, please, the flow chart for cheese?

A. Yes.

Q. Okay. At the top left-hand corner of that page on the flow chart, there is an illustration for incoming raw ingredients, which includes milk fortification ingredients. Do you see that?

A. Yes.

Q. I think you addressed this in response to questions on page 10. But with respect to Agri-Mark, does Agri-Mark, as a matter of practice, fortify incoming milk before it goes into the vat?

A. No, we do not.
Q. Okay. And you indicated that fortification that might take place, that might be represented by that, would include condensed milk, nonfat dry milk, perhaps RO milk --
A. Correct.
Q. -- that kind of thing. And during the period of the year in which fat is relatively low, one might even add cream to maximize the fat/protein ratio of incoming milk?
A. That could happen in the middle of the summer, for example, when butterfat tested very low.
Q. But none of those things are done by Agri-Mark; is that correct?
A. As I mentioned, the cream in the middle of the summer, I don't believe we do that. But it could happen if there were extremely low tests on the product. Normally we standardize and take some cream out.
I imagine we could put fresh cream back in. but I am not aware of us doing that.
Q. You standardize and take cream out for the purpose of yield efficiency to improve the protein to fat ratio?

A. Yes. Occasionally, we will do that. For the most part, we have a wide variation in using producer milk, so we don't do that on a regular basis to come to an exact ratio.

Q. And with respect to that observation on fortification of raw product, you indicated in response to prior questions that that would help explain the higher yield shown on page 10, the prior page of the Exhibit 9?

A. Yes.

Q. Okay. And that yield is also something you don't experience?

A. Oh, yes. Those yields are much higher than we would get.

Q. And with fortification, of course, comes an extra cost to produce that extra yield, correct?

A. The ingredients, yes.

Q. If one were to do that. Do you have an opinion on whether if, for plants that do fortify, if the fortification did not take place, whether the per pound cost to make the product would be greater, lesser or the same?

A. I imagine it would be greater. But since I don't fortify, I don't know that for a fact.

Q. Later on in the document, I didn't make note of the page, there is a flow chart for nonfat dry milk and butter.

A. That might be on page 19 for butter -- it is for both.

Q. Nonfat dry milk and butter, page 19. Exhibit 9. If you look down at the bottom. which is a continuation of the flow chart for butter, there is a reference to buttermilk. which comes out of the churn. Do you see that?

A. Yes.

Q. That buttermilk is not the same thing as buttermilk one finds on the grocery store shelf; am I correct?

A. No, it is not exactly the same.

Q. The buttermilk that one finds from the grocery store shelf is made from skim milk. basically, right?

A. I believe so. But, once again, we don't make the product.

Q. Okay. And the buttermilk is a byproduct of the churning; is that right?

A. Yes.

Q. And it is a skim product, the fat is captured in the butter; is that correct?

A. Yes. I mean, there is some small residual amount of butterfat in it. We try to capture all the butterfat we can.

Q. And the buttermilk byproduct, that skim product is dried and converted to powder, similar to nonfat dry milk, correct?

A. Yes. It usually has higher moisture, it has other criteria that are different. I don't know the detailed criteria. It is not exactly like nonfat dry milk.

Q. It has somewhat less solids and somewhat more moisture than skim milk that simply has been separated?

A. That is true. I believe there are some acid differences and some other things.

Q. It costs, therefore, a little bit more to convert to powder than skim milk?

A. Per pound of solids it does, because there are fewer solids in it. The total amount. I am not sure if there is a difference on that or not.

Q. And the price received for buttermilk powder, compared to nonfat dry milk, is there a difference?

A. Yes, we usually get less for buttermilk powder.

Q. And you indicated that under the current formula, you account for all of your skim solids as though it were converted to nonfat dry milk?

A. Yes.

Q. So to the extent that some of those skim solids end up as buttermilk, you are actually paying more for the product under minimum pricing than you would get from the market, even if you were getting from the market the full -- capturing the full recovery and make costs for nonfat dry milk?

A. Yes.

Q. You indicated in response to some cross-examination that your hope is that a periodic survey by USDA will include information about the plant population and volume produced by plants similar to that discussed by Dr. Stephenson for cheese plants last September?

A. Correct.

Q. And that would, I take it, rely on getting some information from NASS, which does gather production data for individual plants?

A. Yes, I believe he -- well, I am not sure if he got the information from NASS. I know he got it from a different source. But I know NASS would probably be the best source.

Q. Okay. With respect to Proposal 2, periodic survey and adjusting, automatically adjusting the make allowance, based on survey methodology that is established, it may have been in response to a question or it may have been your answer to a question, reference was made to some opportunity to comment. Do you recall that?

A. Yes. To have a recommended decision. not -- a decision not on an emergency basis, and a recommended decision so people could comment on it.

Q. On the methodology resulting from this hearing?

A. Yes.

Q. After a methodology is adopted, if one is adopted, and a survey is done, do you suggest that there should be an opportunity for comment on the survey results?

A. Not in my proposal. My proposal would put it in automatically, to avoid some of the time delays.

Q. Okay.

A. I recognize that a lot of people would probably like to do that and USDA may decide a different procedure than what I am recommending. But I am recommending right now that they just put it into effect.

Q. All right. Are you aware that there are some procedures provided under the Federal Orders that allow for changes without going to a hearing like this one that result simply from a release and informal comment in a short period of time, such as modification of pooling requirements where there is either a deficit or glut of milk?

A. I know our Market Administrator in the Northeast has some authority to do that. I don't know -- I guess that might be a cumulative authority among all Market Administrators.

Q. Yes.

A. I would imagine that that could possibly be.

Q. So that is one of the possibilities, sort of compromise that USOA might adopt, to incorporate that kind of informal comment, short period of time in their methodology?

A. That is true. My intent is not to avoid comments or have additional information. My intent is to try to speed up the process to get changes done on a timely basis.

Q. Okay. Do you have Exhibit 10 in front of you? That is the California '05 Manufacturing Cost Survey released November 29, 2006.

A. Yes. I have that.

Q. Look at the cheese page.

A. Yes.

Q. If you look under the grouping of plants. the low-cost group, which shows an average cost for that low-cost group of three plants of 18.79 cents or $.1879, are you with me so far?

A. I follow you.

Q. If you look up in the last bullet point. indicating, as Mr. Rosenbaum pointed out, that none of the cheese plants were able to process milk at 17.8 cents, can you make an inference from that concerning the variability of costs among the lowest cost plants?

A. Well. it would be at least from $.178 per pound, to -- I am not sure what the high level would be. But it likely would probably not be too high, because where the high group cost is out at 19.6 and the current weighted average at 19.14. I can't judge what the high -- exchange would be.

Q. It looks like, though, doesn't it, there is not very much variability?

A. I would say that is probably the case. But once again, I don't know.

MR. VETNE: Your Honor, at this point. I would like to have two exhibits marked. and they could be officially noticed. But -- first of all, I don't think Exhibit 10 has been received.

JUDGE PALMER: No, it hasn't, nor has 9.

MR. VETNE: I will ask for 10. Mr. Yale can ask for 9.

JUDGE PALMER: Have you asked for 9? They are both received.

(Thereupon, Exhibits 9 and 10 were received into evidence.)

JUDGE PALMER: At this point, we are up to 11. What do you have?

MR. VETNE: This is a notice of a final decision from the State of California adopting the make allowances to which reference is made in Exhibit 10.

JUDGE PALMER: Any objection to that?

MR. BESHORE: Is that 11?

JUDGE PALMER: That will be 11.

MR. STEVENS: So this is an exhibit?

JUDGE PALMER: It is easy to handle as an exhibit.

(Thereupon, Exhibit 11 was marked for purposes of identification.)

JUDGE PALMER: Let me read it for you. It says, "California Department of Food and Agriculture, dated July 24, 2006." It is a decision, it is a decision by them, a decision dated July 24th, 2006. Do you have another one?

MR. VETNE: That is a notice of the decision --

JUDGE PALMER: Just a notice. I am sorry.

MR. VETNE: -- by the administrating official, David Ikari. The decision was made by the Secretary of Agriculture.

That document indicates that, as well as the decision -- I will request official notice of that. That document indicates at the end that the decision was stayed for a period of time so they could do an environmental quality survey.

The next exhibit is dated October 20. 2006, which is a notice from A.J. Yates, the Undersecretary of Agriculture for CDFA, that the stay has expired and the make allowances will become effective November 1, 2006.

JUDGE PALMER: We will mark that one as 12.

(Thereupon, Exhibit 12 was marked for purposes of identification.)

MR. VETNE: These are official documents of the California Department of Food and Agriculture, which I printed off their Web site last night, and I would ask that they be received.

JUDGE PALMER: All right. They are received.

MR. VETNE: Okay.

(Thereupon, Exhibits 11 and 12 were received into evidence.)

BY MR. VETNE:

Q. Now, Mr. Wellington, we just received and took notice of the July of 2006 decision that adopted a make allowance for cheese of $.178, which became effective on November 1, 2006. and the manufacturing cost survey was released 29 days later.

So the make allowance was already out of date in the first month it was adopted, correct?

A. Yes.

Q. Exhibit 10 reveals that it wouldn't cover any plants.

A. Yes.

Q. And that fairly rapid out-of-datedness, if I can coin a word, as you discussed with earlier examiners, was primarily a product of rapidly escalating energy costs during that year?

A. Well, yes. That and the audit process. I guess, takes nearly a year to process.

Q. It is that kind of delay between cost incurment and reflection of costs in a make allowance that you hope to mitigate by your Proposal Number 2?

A. Yes, it is.

MR. VETNE: Thank you. That is all I have. Thank you.

JUDGE PALMER: Questions over at the table over here to the right? You need a moment or two to think about it?

MR. SCHAEFER: Henry Schaefer. USDA.

CROSS-EXAMINATION

BY MR. SCHAEFER:

Q. On your Table 5-A and which was Table 1 -- or Exhibit 5-A, which is Table 1 in your Exhibit 5, you list a series of make allowances, and I believe you indicated that those were not the make allowances that you were proposing be adopted as a result of this hearing, but rather were an example of the calculations to show how you believe the calculation should be carried out; is that correct?

A. That's correct.

Q. If that is the case, what make allowances do you propose be adopted as a result of this hearing?

A. Basically the make allowances that we put in our comment period for the last hearing that involve the -- it would be the Cornell study and the California study for cheese and whey and the Ling study for butter and powder. I know we are not talking about the Ling study. But that is my comments.

From there, I would say that you would then update those studies using the new California study that was not in that hearing record that is in this hearing record.

Q. So we would use what you have in your comments on the hearing of last year --

A. Correct.

Q. -- updated with the new California data --

A. Correct.

Q. -- for 2005?

A. Yes.

MR. YALE: Your Honor. I want to enter an objection. This is the problem that we pointed out during this hearing. We have pending a make allowances and we are testifying on an open hearing, in which the -- not on an open hearing, a hearing that has been closed and we are in a comment period.

And where are we at? Is this testimony going to be used for the next decision off of this hearing, or is it going to be used on the hearing that we closed in September?

JUDGE PALMER: Well, I tell you. the question is by a member of the Dairy Division who will be assisting in the writing of these decisions. And if the decisions are wrong, I guess you will file a 15-A. So I am going to leave the -- objection is overruled and let him ask the question. Go ahead.

MR. SCHAEFER: Okay.

BY MR. SCHAEFER:

Q. Moving on, you discussed the population of plants that you would possibly draw a survey from. What population of plants are you looking at that that survey might be drawn from?

A. Well, I was considering the same type of survey that Professor Stephenson looked at. So from my point of view, it could be all the plants outside of California, I would draw the survey from there.

Q. Would that include, when you say "all plants." is that all plants, literally all plants, or plants that would only produce products that would be represented in the NASS survey?

A. Plants that produce products that are represented in that survey. Thank you.

Q. If a population was not audited or, in your case, you requesting the potential for auditing it, if the population could not be audited, what criteria would you use to select the survey plants?

A I would probably use a random sample of these plants In terms of stratifying the sample, I would hope that wouldn't be necessary, because it could be a large enough sample I know that was a problem with Dr Stephenson's work, because he was doing all the work himself

And so, because he felt for cheese, for example. he could only do 20 plants, that he then stratified that and chose five large plants and what have you

So I would hope that it could just be a random sample of plants, and it would include a large enough number to give the department the assurance that it was covering both very large plants and other types of plants

Q I believe one of the earlier attorneys asked about the cost of conducting these surveys, and you had indicated that the Market Administrator might be able to do them

If the Market Administrator does not do them, because you also indicated that it could be done directly out of AMS, where would the funding for that come from?

A Well. I was hopeful that the funding would come from the Market Administrators, but if not. I guess it would have to come from the general funds of AMS.

Q. And if it came -- if the Market Administrators conducted the surveys. then would that directly mean an increase in the administrative assessment?

A. It likely would, yes.

Q. In Proposal 2, when you talk about the -- you have got two criteria there, and you talk about manufacturing plants and you also mention producer milk, and producer milk implies pooled milk, would the criteria in there include milk received at nonpooled plants, milk received at nonpool plants?

A. As long as it was priced under the order. if it was producer milk received at nonpooled plants.

Q. Okay. With regard to your two criteria there for selecting a higher of, you have got 80 percent for the first criteria, and the 80 percent would apply to the milk volume used in the Class III and IV manufacturing plants, and I would assume that in this case the manufacturing plant population is all Federal Order manufacturing plants, or is it the total population of plants?

A. That is a good question. I would say Federal Order, plants that receive producer milk under Federal Orders.

Q. Along that line there, how did you derive your 80 percent figure?

A. We looked at what California uses, which I believe is 50 to 80 percent, they try to meet a range within that to determine their final number when they come up with a decision. So I was basing part of that on California; and then part of it was when you looked at the population sample that Dr. Stephenson calculated, he came up with the population sample weighted average. or weighted average sample, I guess is a better way to put it, that would cover 82 percent of the milk and 33 percent of the plants.

So I felt that 80 percent was close enough to his number, within the California range, and it would cover somewhere in the vicinity of around 33 percent of the plants, maybe a little less. So I thought that was a reasonable number to propose.

Q. In the second part of that criteria, we have a -- let me paraphrase this a little bit. because when I read this, I wasn't sure I was getting it So, as I understand the second part of this proposal, that you are suggesting that the make allowance be set at a point where 25 percent of the producer milk in a particular order, and you have laid out the criteria for those orders at 4 billion pounds annually at III and IV, that a make allowance be set at a value that would cover 25 percent of that milk for a particular order

And then that make allowance would be applied across all orders, is that correct?

A Well, it would cover plants, such that the cumulative volume of those plants receiving producer milk in that order would sum up to at least 25 percent of the total milk And the intent was that once you determined that, you would calculate it for each one of the orders. and whatever was the higher make allowance, or compared to the 80 percent, would be the underlying make allowance

The intent of this, Henry, is to make sure that there is at least some plants that are covering their costs in every order that has significant -- I won't say "significant" -- has substantial amount of manufacturing volume.

The 25 percent was a relatively arbitrary number, so was the 4 billion. I tried to look at the breakdown of the different amount of manufacturing milk that the orders had, and there seemed to be sort of a common break between -- around 4 billion. That is reflected in Table 2, and there was no order that had between 3 and 4 billion, for example. So I said 4 billion sounds reasonable.

Twenty-five percent is a reasonable number. because that would equate to 1 billion pounds. Plus my intent here is not to have this incredible make allowance to cover the cost of some plant that operates, you know, three or four months a year in the Southeast. I am not trying to do that.

I just want to make sure that there is sufficient volume of milk in each manufacturing order; and it relates to Dr. Stephenson's comments that under the weighted average make allowance that he had, not the population sample, but the weighted average make allowance, it was unlikely that any plant in the Northeast would be able to recover their costs. In much the same manner that it was noted in California that under the current make allowance they have zero percent of their plants cover their costs.

So I was trying to give some kind of safeguard on a regional basis.

Q. Mr. Yale had a number of questions regarding the cost, high-cost plants' and low-cost plants' average make allowance and how those plants related to each other competitively, and where the money that the low cost plant would realize could be used if a make allowance was set at some other level than the lowest. Let's put it that way.

And I guess -- my question along that line is, what price spread or what spread in the make allowance would you anticipate between what we would set and what a group of low cost plants would have for make allowance would put you at such a competitive disadvantage that it would -- as you mentioned, it would force you out of business at some point in time?

A. Well, it is not the spread between what you set and what the low cost is, it is really -- it is what it is between what you set and what our costs are that would put us out of business, if we ended up having to pay -- account for a make allowance that was smaller than what we have. and so we ended up incurring losses over time. That is what would drive us out.

I guess maybe I didn't follow the question. Henry.

Q. I guess what I was getting at is, in the discussion with Mr. Yale, you indicated that with the low-cost plants having the higher make allowance, that they would have additional monies to use to pay producers to reinvest into their plants to use on their bottom line and so forth, that that eventually would cause you some competitive issues. And so how -- and I can understand your answer to the first -- to what I said before, I understand that entirely.

But as those plants became more and more competitive. even if you could, even if the make allowance was set high enough that you would cover your costs, at what point do those lower cost plants make you so uncompetitive that you no longer can continue?

A. I don't have an answer for that, because I don't know

But I would say that if that was the case and the plant was located next door to our plant, then I could understand that, that perhaps our plant shouldn't be there, if another plant next door had it.

The problem that I see is that the plant that has lower costs is located a thousand or more miles away. So, you know, that is not going to make us uncompetitive. Producer Milk in the Northeast is not going to relocate to Clovis, New Mexico to find a home. So that will not create the same level of problem for us.

Like I said, if there is a plant that has that dramatically lower cost right near our plant, then that happens in the marketplace. I understand that.

MR. SCHAEFER: Thank you, Bob.

JUDGE PALMER: Anything else? Yes. Mr. Vetne?

MR. VETNE: Just one follow-up.

REDIRECT EXAMINATION

BY MR. VETNE:

Q. With respect to that issue that Mr. Schaefer talked about, the plants that receive Federal Order milk, the resulting Class

III or IV price is only a minimum price, it is not the price?
A. Correct.
Q. And it is a price for which you account to the pool?
A. (Witness nodding head up and down.)
Q. And in turn, goes producers?
A. Yes.
Q. One thing that happens when -- that may happen if a plant is uniquely enjoying a make allowance that is greater than its costs, is that the producers will try to bargain for that extra income the plant is receiving in the form of premiums, correct?
A. That could happen, but that is not how the process works.
Q. That is not how the competition works?
A. Well, I wouldn't say that a producer group would say. "You got these extra premiums, we want them." Okay?
Q. Um-hum.
A. I think what happens is the plant would say, "Hmm, I am making a good amount of profit on this product. I ought to make more product, okay, which I could then continue to make profit

on." So then they go on and they try to go out and get more milk, they bid up the price in order to secure milk from somebody else. Okay.

So producers, that may raise a whole level of premiums in the surrounding area, not just their own level of premiums. That is sort of how the process works. The end result is the same.

Q. The end result is the same, that some of that make allowance money ends up in producer checks, and in addition to that, for plants such as Southwest Cheese, which is owned by producers in part, the profits go to producers.

So it can get to producers in two ways, one in their monthly milk check and one in the profit division at the end of the accounting period?

A. To the extent they own it or part of it. profits or losses would fall to them, yes.

MR. VETNE: Thanks.

JUDGE PALMER: Any other questions? Mr. Yale?

RECROSS-EXAMINATION

BY MR. YALE:

Q. I want to follow up on the premium question of John's and I think it had something to do with the question Henry asked.

Doesn't there come a point when the spread in the make allowances are such that the more efficient plants are so -- given such an advantage with the higher make allowances and lower milk price, that they can more than offset whatever you will gain as a plant by having the higher make allowance, by going out and forcing you to pay more for the milk, because they are offering premiums or discounting your product in the marketplace to maintain market share or combinations of the two?

A. I can't say it wouldn't happen, Ben. because I don't know. I guess I could say that is a possibility.

I mean, that is a long-term problem for a plant. If the make allowances are too low, it is an immediate problem, because you are accumulating losses.

So I mean, this may be caught between a rock and a hard place, but, once again. I think in my mind, a lot of these differences are so geographic in nature that it would not create the same level of problem.

Q. You talk about rock and a hard place and you talk about regionality. So let's talk about the rock and the hard place. Doesn't it reach a point where the economics of concentration and modernization and all these other things that are going on in this global marketplace, that those plants that are geared towards a regional application, that need the higher cost, are not going to be able to do it through modifications of minimum prices and survive in that type of environment?

A. There is that possibility, particularly if we don't have adequate make allowances. And if that happens, that creates a problem for producers, because they don't have a market for their milk. It creates a whole array of problems, which we are trying to avoid.

Q. Now, if you have a situation where plants are profitable at making cheddar cheese, for example, and I think you mentioned that they are thinking, "If I am making a profit. I would like to make more profit by making more cheese"?

A. Correct.

Q. Don't we have a situation with too lucrative of make allowances that we will generate higher production of cheddar cheese. lower commodity prices and lower producer prices?

A. Well, so much money brings forth so much milk. So if you are going to -- if that milk is going to be attracted to those cheese plants. perhaps what happens is less milk will be attracted to either cheese plants in other areas or from butter/powder plants or other things.

I don't know if it is going to necessarily drive down prices in the long run. It may in the short run. But that is already happening. When large plants go out west and they put a tremendous amount of cheddar cheese on the market, you see the cheddar cheese price being depressed -- this last two months is a perfect example.

I mean, if you looked at where my peers thought cheese prices would be, we thought that they would start to rise faster than they did. And I think a part of it may be that there was a lot of cheddar cheese on the market. So that can happen, but I don't think it is the make allowance issue that is driving it. I think it is the increase in milk production in areas like

New Mexico and Texas and Colorado and California that are driving it.

Q. You mentioned, I think, on another question, that the spread in the make allowance is unimportant unless the plants are next door. But yet you just mentioned on another question on the issue of next door, unless the plant was next door, that the spread wasn't going to have an impact, or nearly as much an impact on you. right?

A. Right, yes.

Q. There was a location value?

A. Yes, absolutely.

Q. But now you just mentioned your problem is the expansion of producers in cheese plants in the Southwest.

A. No. Because what that is doing is it is increasing the total amount of milk production --

Q. Okay.

A. -- total amount of cheese, and it is the supply and the demand of the product that is ending up in affecting the national price. We are not talking about a competitive price between plants. We are talking about the national price for milk and the national price for cheese and other commodities.

Q. And that doesn't have an impact on your competitive relationship in your markets?

A. It has -- I can't say it has none, because I would have to think about that. But I would say it doesn't have as large of one as these other factors. It may not have any. I am not sure.

It certainly has an impact on the fact that if milk prices are lower because of this occurrence, that farmers will likely produce less milk or go out of business, which then will affect our competitive relationship.

Q. This brings up another point. And I am not trying to put words in your mouth. But the only reasons that it suggests that we are going to get more money for producers is if some producers are unable to produce the same amount of milk, either a drought or they go out of business, they have fewer cows or produce less milk.

And then when they do that, their neighbors get to make more money on the milk that they are able to have. I mean, is that the model that we are supposed to be working off of?

A. No. I would prefer that we work off of a model that we increase demand for products, and so we continue to expand supply and we can increase demand.

For example, the demand for protein solids. milk protein solids internationally is skyrocketing. So we have a huge increase in demand for nonfat dry milk powder, for whey powders. I would prefer that to be the model that we use, as opposed to having producers go out of business or produce less milk.

But that does occur. Certain producers have some advantages in other regions of the country. I mean, I could go into water subsidies and others. That is not going to serve a purpose here.

But I would prefer it to be demand driven. not supply driven.

JUDGE PALMER: Let me ask this: The protein products, you mentioned a couple of them, what were they again?

THE WITNESS: Nonfat dry milk.

JUDGE PALMER: What is that used for by the manufacturer?

THE WITNESS: It can be used as an ingredient in an array of products, such as bakery products, ice cream, it could supplement to make cheese, yogurts.

JUDGE PALMER: What is the advantage of it in terms of health? You said there was some health advantage or there is some marketing value?

THE WITNESS: I just said there is a demand for it internationally.

JUDGE PALMER: Why is there a demand for it? What is there about that?

THE WITNESS: Well, because income levels are rising, particularly in countries like China. And so, as it does, they increase the quality of their diet. And when they do that, they demand more dairy products as a high end of that.

For example, China is considering the possibility of perhaps putting in a school lunch program where they give milk to, I don't know, a billion youngsters. The chances are, they won't be using fresh fluid milk, they will do something like making a milk drink using nonfat dry milk powder.

JUDGE PALMER: And America would be exporting to them?

THE WITNESS: I would hope so.

JUDGE PALMER: You do hope so.

THE WITNESS: We would certainly want to do that. I know, for example, we sell nonfat dry milk powder to Cuba. And Cuba has a program where I believe it is at least a pint of milk that every child gets. They take the nonfat dry milk powder, they mix it with another oil -- I think it might be coconut oil, but I'm not sure -- and the children get that.

So what we are seeing is that countries like China and other Pacific Rim countries in particular, the income levels going up, people are consuming more products, they are eating out more, restaurants, McDonald's are expanding, and they use a lot of dairy products.

JUDGE PALMER: Well. I take it the dairy industry is probably lobbying to try to get some Congressional help in the getting products sold overseas, is that it?

THE WITNESS: Oh, absolutely. There are different ways that we are doing it, Your Honor. There is a dairy export program.

and then even the producers have a program called CWT Co-Ops working together, and one part of that is actually buy out herds of cows, and the second piece is to subsidize -- probably that is not the right word, but to help products move overseas, so we can move more of our products If the price of the product in our country is only a few cents more than the price overseas, this program pays that difference, so we can move that product overseas

JUDGE PALMER How does a marketing order program fit in with that? I mean, I'm asking a real question here, how does a marketing order program fit in with that, with all these weight make allowances and all the rest of it?

THE WITNESS Well, it certainly helps, for example, as we look at -- let's say we look at the make allowance for whey powder. which is under consideration here The current make allowance on that is 1941, I believe, and we are now seeing that whey powder, because of international demand, has jumped from, my gosh. two, three years ago it was 20 cents a pound, and now it is probably 60 cents a pound

So that is 40 cents a pound above the cost of making it. There is almost 6 pounds of the equivalent of whey powder in a hundredweight of milk. So 40 cents times 6 is $2.40. And that comes out of the Class III price.

JUDGE PALMER: How do you use whey powder? Whey powder is used how?

THE WITNESS: Whey powder is also used as an ingredient and can be used in a variety of different products also overseas. It is usually added to different products to increase their nutritional value. Whey also has a lot of lactose, which is milk sugar, so it could be the palatability of the product.

If you were to go into a supermarket here. I am more familiar with them here, you could look in hot dogs, baby food, you name it, you will see whey powder there as an ingredient. because it is a relatively low cost addition that adds a lot of taste, nutrition and other factors.

JUDGE PALMER: Now, whey powder or whey was pretty much -- I don't want to use the wrong word, but you didn't have a market for whey at one time?

THE WITNESS: At one point, whey was the byproduct of cheese making.

JUDGE PALMER: Right.

THE WITNESS: Where, you know, basically. 20. 30 years ago. some people might have just poured it down the drain.

JUDGE PALMER: In fact, they poured it into some coal mines, I think it was. had a fire someplace, put out the fire and then it ate the beams and the whole town collapsed. Wasn't that one of the --

(Laughter.)

THE WITNESS: I don't recall that, but that might be a good use. Maybe we should do that with some of our surplus milk.

But, yes, that was the case, and in fact, there are still some areas where you land spread. We still land spread some of the permate, the lactose, we try to get all the protein out. But there is still some land spreading being done with the product.

JUDGE PALMER: How did you convert whey from a product that was a byproduct that nobody wanted to one that is now giving a high profitability to the dairy industry, what happened there?

THE WITNESS: Well. I think there was a lot of food technology changes that saw the ingredients as a very high protein, source of protein, source of lactose, and whey powder was really cheap.

I think it was the price more than anything, because at one point, it was less than 20 cents a pound. And nonfat dry milk. for example, at one point, under the Federal Order was over a dollar -- I'm sorry, under the price support program, was over a dollar a pound. still over 80 cents. So whey was a cheap way of getting a lot of the nutrients.

JUDGE PALMER: Who financed the research?

THE WITNESS: I think a lot of it was done to give farmers a 15-cent deduction for milk promotion.

JUDGE PALMER: Is that still on?

THE WITNESS: Yes, that is still on.

JUDGE PALMER: I asked enough.

MR. YALE: That is fine.

JUDGE PALMER: Little extra

information.

MR. YALE: Gave me a chance to narrow down my questions.

BY MR. YALE:

Q. Dr. Wellington, I want you to, if you would. I think that Exhibit 9, I want to go back to this, because there are some points that I think have been misread out of this.

A. Is that the California report?

Q. Yes, it is. And then also Exhibit 10, you might even have both of them at the same time.

A. I have them in front of me.

Q. And Exhibit 9, at page 9, bullet point 7 indicated -- this was for the year 2004, I realize we are running a year behind. but 2004. that 62 percent of the cheese was processed at less than the make allowance of a dollar -- or 1.71?

A. That is what it says in footnote 7, yes.

Q. We don't know how much less, right?

A. That's correct.

Q. So at that point, those at least indicated a profit over the make allowance -- or they had the potential to make it for less than the make allowance and be profitable?

A. The processing cost less than -- that would be true.

Q. Now, it was noted that in the bullet point on page, I guess it is the third page of Exhibit 10, indicated that $1.78. that none are above that, right?

A. Correct.

Q. Okay. Now, I want to go back, if you would, back on Exhibit 9 and look at paragraph 8 and what is the --

MR. BESHORE: What page?

BY MR. YALE:

Q. Page 9, Exhibit 9, page 9, I'm sorry, paragraph 8, the first sentence, read that.

A. "The weighted average yield was 11.53 pounds of cheese per hundredweight of milk."

Q. It does not say anything about fat or fortification or anything else, does it?

A. It goes on to mention the moisture content.

Q. It talks about vat tests, but it doesn't talk about -- it talks about cheese per hundredweight of milk, and it doesn't modify that as fortified milk or UF milk or powdered milk or RO milk?

A. But I don't know what that means. I know

it says per hundredweight of milk going in. You could be putting in a hundredweight of producer milk into there and then you could be adding three bags of powder to it. I am saying, I don't know that, Ben, from reading this.
Q. Now, are you familiar with the Van Slyke formula?
A. Only moderately so. Probably less than that. Ben.
Q. Then I am not going to put you on it. I will be courteous. Do you know whether or not it is possible to solve the butterfat recovery without knowing the amount of protein that goes into the mix?
A. I think you need a relationship of protein to butterfat.
Q. Under the Van Slyke formula?
A. I am not sure, Ben. That is something I am not sure of.
Q. Let's look over here again. First of all. it costs money to get higher yields out of a cheese plant, right? Whatever it is, whether you use other ingredients or whatever, you need equipment, right?
A. Sure.

Q. And you need the skilled workforce?
A. Yes.
Q. A great cheese maker?
A. Yes.
Q. A very good one anyhow, someone that knows what they are doing. You and I -- maybe you could -- we couldn't just sit at the kitchen table and yield that today, no matter how many books we read?
A. My granddaughter thinks I can, but nobody else does.
Q. Well. I think you could make it, but I don't know that you could -- we could make 11 pounds, all right?
A. Yes.
Q. It takes modern equipment. All of those things go in that, right?
A. Yes.
Q. And those are incorporated into the cost. right, the make allowances? We have heard gobs of costs, between the Cornell and the others. somewhere along that investment, it is in there. right, in those costs, depreciation?
A. You listed a lot of pieces in there. Would I say that's the costs of labor from a good

cheese maker, yes. Probably the cost of the vats and other things, yes. The fortified product you add, no.

Q. Okay. I am going to go with that for the moment, all right? But if we know what the -- based on these costs, what the butterfat yield is, or butterfat recovery -- let me back up.

Do you believe that the department should intentionally reduce the yield for these formulas based on the make allowances if it has knowledge that the yield is higher than what is currently used?

A. I think that the department should use a yield that represents reality and representative of cheese making.

Q. Okay. And if that -- do you have any evidence that the yield for butterfat recovery is different than -- higher or lower than 94 percent?

A. Oh, I know it is under 94 percent. I have people who are looking at it right now, and when we reconvene at some time in April. I may have a witness who will talk about all our experience with that.

Q. But you are not going to talk about that?

A. No, not at all.

Q. Okay. And you would agree, would you not. that producers paying -- being paid for milk at a yield higher than 9.6-plus pounds for hundredweight of milk, save 10 or 10.5 at these make allowances, it is a better return for them than what they currently have at a lower yield, everything being the same. Let me restate the question. That was a terrible question. I'm going to withdraw it and start again.

Assume for the moment that we are only going to change the yield, because the testimony shows that for the 6.82 cents that the department has determined the make allowance is, based upon what CDFA shows and RCBS and Cornell, the yield should be higher in other testimony. that that higher yield ought to be incorporated into the Class III price to return more value to the producer for the milk used in making cheese; is that correct?

A. Well, I have to go back and look at why the department decided on the current yield factors.

I don't recall them, or why they did that. I know the Van Slyke formula has not changed in a hundred years or something. So I am not sure what their reasoning was behind that. I am sure the department had very good reasoning, and I would want to review that before I answered your question.

Q. All right. I want to now, if you would. turn to, I think it is the second page -- I am not sure, I lose track of the pages. It looks like it might be the third page in my Exhibit 10, it says, "Nonfat Powder Manufacturing Costs."

A. I have it in front of me.

Q. Then if you would, at the same time, look at page 26 of Exhibit 9.

A. I have that in front of me.

Q. Let's look at Exhibit 9, page 26, paragraph 6. What percentage at that point was producing nonfat dry milk at less than 1.52?

A. According to the report, it says about 63 percent of nonfat powder was processed at a cost less than the manufacturing cost allowance.

Q. Not wanting to read, go through our weighted average thing, we don't know what that 63 percent, what price that would be at, do we?

A. No.

Q. We don't know whether it is a penny or 4

cents, right? You might take your total minimums and kind of get a bottom?
A. There is a low cost factor there. But I wouldn't offhand know.
Q. Okay. Let's look over here at the Exhibit 10. And the last bullet point indicates that 74 percent is less than $1.60. So they have raised it .08 cents and they have bought even more nonfat dry milk?
A. I think you mean .16.
Q. .16, right. So you would have to agree that the make allowances that California is proposing -- or not proposing, is using, is encompassing more than the average, weighted average production in that market?
A. If you want to remind me what the current make allowance is in California?
Q. I think it says here in that one exhibit we just got from --
A. I know, that is what I am looking for.
Q. .16.
A. Yes. .160. Well, okay. Could you repeat the question? Now I have it all in front of me.
Q. With the nonfat dry milk, it says 74 percent was processed at a cost less than that.

My question is, is that we don't know what it is, but we can with some certainty say that the weighted average cost for nonfat dry milk in California is less than $1.60, can we not?
A. Well, this says the weighted average cost was .1659.
Q. The average cost, 70 percent, 4 percent of that is less than $1.60?
A. Right, because once again, keep in mind that the weighted average is not necessarily an average. There are probably some huge plants out there and I would just, wow, w-o-w, put that in there, low cost group, you have three plants. Ben, and you have a cost of 15 -- I am sorry, $.153 per pound, and the volume in the group is 350 million pounds of milk for those three plants.
So I think what is happening here is that you have some really low cost huge plants. So the -- but the weighted average even with those huge plants is still $.1659 per pound. So I am not sure we can draw the conclusion you keep saying.
I would say, though, that -- I mean, here is an example, where 74 percent of the plants

can cover their costs at 16 cents, according to the nonfat dry milk powder table in Exhibit 10; and that is why, one of the reasons I am asking for 80 percent on ours, because here is a case where 74 percent can do it.

Q. Let me follow that up then with a final line of questions.

A. Okay.

Q. You indicated that some plants are able to obtain a higher price even for their commodity than what shows up in the NASS, right? They sell it for a higher price than the weighted average NASS price?

A. Yes, I think NASS would show that.

Q. If those plants are within a region that that also corresponds fairly closely to the higher cost plants, should not the department be looking at their profitability, that is, what they are selling their cheese for, less than what their make allowance is, as opposed to an average selling price much lower than what they are selling at, and make allowance that evidently is lower than what they are making it at, rather than weigh that in and bring down the whole pricing structure?

A. Well, I mean, I think the department has already factored in, when they come up with the NASS price, those are already -- those higher price levels above the NASS are one of the reasons why the NASS price comes out where it is, because they bring the whole average of NASS up. If you only looked at the low cost plants, the NASS would be dragged back down again. I think all producers benefit by having that higher NASS and having those in there.
Q. But what we don't have is the correspondence plant for plant, pound for pound as the cost to make those commodities, that is missing in all this equation, right?
A. Well, that is what we are trying to get at.
Q. We are trying to get at it. But they have that in California, we don't have that. And you are indicating that the numbers -- you are not satisfied that the numbers are accurate that we have that we accurately reflect the make allowances, right, outside of California?
A. Well. I think we have the ability to do a better job using what we propose, instead of going into that. But as it is right now, it is certainly too low for my operations and those in

the Northeast.

Q. And you don't know whether that would go up or down, depending on what the department does? If you were to do a much more comprehensive survey, you don't know whether that would change that up or down for you?

A. Well, I know what it is for me. But I don't know what it would be for others.

MR. YALE: Very good. Thank you.

JUDGE PALMER: All right. Any more questions for this gentleman, who has been here almost all day? He has been here all day.

MR. STEVENS: Your Honor, I just want to make sure that the record reflects that all the exhibits that Mr. Wellington introduced. or that were introduced through his testimony, have been marked for identification and have been admitted into evidence.

JUDGE PALMER: We have received them all. We have received everything from Exhibit 1 through Exhibit 12. They are all noted as received.

MR. STEVENS: Thank you, Your Honor.

JUDGE PALMER: You have another question. Mr. Beshore?

MR. BESHORE: Marvin Beshore, just a couple of questions, Bob.

RECROSS-EXAMINATION

BY MR. BESHORE:

Q. Do you buy bulk cream at your butter/powder plant?

A. On occasion.

Q. And it is not uncommon for butter/powder plants to buy cream to process for butter?

A. I imagine that someone like Land O'Lakes buys them much more than we do.

Q. I was not limiting it to you. Butter, that is a common ingredient or a common --

A. Yes.

JUDGE PALMER: He is entitled to take advantage of you guys occasionally.

(Laughter.)

MR. BESHORE: That is fair enough. As long as he is taking advantage of one of his partners in the activity here.

BY MR. BESHORE:

Q. So these flow charts that were in Exhibit 9 that have been used and referred to to depict activities of manufacturing plants, the ones -- the identical ones on page 19 and 27 of Exhibit 9, it does not show bulk cream as a potential input at butter/powder plants, but just as you can have additional -- or nonfarm milk solids go into a cheese plant, bulk cream being -- skimmed milk is a common ingredient that would be an input to a butter/powder facility?

A. That is true. And you could also have condensed milk brought in. We don't normally have that, we are a seller of condensed, not a buyer.

If there were a glut in the marketplace and people needed to move -- for example, you might have a case where another butter/powder plant by a co-op has a problem, it is a fire or something, and they need to get rid of product. they can condense, but they can't dry. So we will receive condensed and dry from the condensed.

Q. Okay. In all the questioning about regional differences in costs of manufacturing. are you proposing that there be regional differences in make allowances?

A. No, no.

Q. Just one other question. You have been asked about the fact that your cheese plants. for instance, do not report their sales in the NASS price series, because you sell in other channels.

A. Correct.

Q. Essentially. In those other channels, do you know, can you tell us whether the sales prices tend to be based on multiples of the cheese market price, CME price, for instance?

A. There is some relation to the CME price. I wouldn't say a multiple, like whole number multiples. But there is some relationship to the CME price.

Usually, we would try to get CME-plus, but sometimes we actually get CME-minus. There are times in the springtime where we have a flush of milk and we don't want to be holding excess inventories of cheese. So we move commodity cheese and we want to get rid of it, so we have to sell it at a lower price than the CME.

Q. But in any event, it is priced off of those benchmark cheese prices?

A. Yes. Basically everybody in the industry needs to know, feels they need to know what the fair price is. So they always refer to the CME. for right or wrong, as to what is the ongoing price, and then it seems that the negotiation is always around that price level.

MR. BESHORE: Okay. Thank you.

JUDGE PALMER: All right, sir. I think you are excused. Do you want to take a short recess?

Mr. Schad, you are coming back. You will be coming back to be cross-examined. Let's do a little off the record discussion.

(Thereupon, a recess was taken.)

JUDGE PALMER: Mr. Schad is back on the stand. Who would like to question? He is available for cross-examination. If you really can't think of a question, you don't have to -- you don't really have to question him.

I am losing names here. I am losing everything here. Mr. Wellington basically went over much of the same material. So I don't know how many questions you would have for Mr. Schad. but maybe you do. Does anybody have questions for Mr. Schad?

MR. MILTNER: Your Honor, I think Mr. Yale does.

JUDGE PALMER: Mr. Yale does. All right. We will wait for Mr. Yale for a moment. Mr. Yale, would you like to question Mr. Schad?

MR. YALE: Yes.

JUDGE PALMER: All right, sir.

MR. YALE: Why didn't anybody else have any questions?

JUDGE PALMER: I don't know.

MR. VETNE: I might. Your Honor.

JUDGE PALMER: You have a question?

MR. VETNE: No, I don't have a question, but an insert on page 3 of your testimony, you refer to CDFA release of manufacturing costs, Exhibit blank. That Exhibit number may now be filled in as Exhibit 10.

MR. SCHAD: That's correct.

JUDGE PALMER: And that was on Exhibit -- what was your exhibit number. 6?

MR. SCHAD: My testimony is Exhibit 6.

JUDGE PALMER: I am going to leave mine alone. Exhibit 6, and that was on page what?

MR. SCHAD: Three.

JUDGE PALMER: Oh, I see it. That should say Exhibit 10?

MR. SCHAD: That's correct.

JUDGE PALMER: I marked that one copy anyway. All right, sir.

MR. MILTNER: Your Honor, we have a point. I wonder if we could have a courtesy of the court here, I guess. There is a producer in the back of the room from Michigan who is going to be here for today and he is heading back and he has indicated that he would like to make a brief statement and put some testimony on. I wonder if we begin with Mr. Schad, if we might find ourselves at the end of the day and Mr. Topping not have a chance to testify.

JUDGE PALMER: What is his name?

MR. MILTNER: Gary Topping.

JUDGE PALMER: Topping. All right. We will try to get him in before the day ends.

MR. VETNE: Let's do it now.

MR. MILTNER: Is it okay if we put him on now?

JUDGE PALMER: All right. Let's put him on now. You can step down. Mr. Schad.

MR. SCHAD: Thank you.

GARY G. TOPPING

having been first sworn by the judge. was examined and testified under oath as follows:

DIRECT EXAMINATION

BY MR. MILTNER:

Q. Mr. Topping, you are a dairy farmer up in Michigan?

A. Yes, I am a dairy farmer, third generation. I am a third generation dairy farmer and have three boys that would like to come home.

Q. You are not here appearing as a witness for Dairy Producers of New Mexico or any of the clients that I represent. But we met earlier today and we offered to help get you on the stand so you can make a statement.

So I am going to let you offer your comments and we will go from there. Okay?

A. I appreciate that. This is my first time to one of these, and I find it very interesting. and really came to just voice my opinion to how the co-ops are representing us as dairy farmers.

I find it very ironic that they are looking to increase profitability without representing the people that they are supposed to represent first.

And, for example, we are going to see a 25 percent -- or 25 cent deduction for next month's milk, versus we are going to see 86 cent increase instead of $1.11 so I thought I should come down and make my voice be heard and be on the record and be somewhat opposed to the increase in the make allowances before we as producers see any response to the pricing for our cost of production.

I would also like to talk about the NASS discovery. There is numerous in the Federal rule regarding the price discovery of the make allowances -- excuse me, not the make allowances, but the NASS pricing, which is to exclude forward pricing, and I do not think that that is occurring.

And we as dairy farmers are not seeing the true price of nonfat dry milk powder today. And that is pretty much everything I have to say.

JUDGE PALMER: Do we have some questions? Anyone have any questions? Yes, Mr. Yale, do you want to ask a question, sir?

CROSS-EXAMINATION

BY MR. YALE:

Q. Mr. Topping, maybe you said it and I missed it, did you indicate -- where is your farm?

A. My farm is located in Stockbridge. Michigan.

Q. Where is that located?

A. Right between Lansing and Ann Arbor. Michigan.

Q. Okay. And you are a member of a co-op?

A. Yes, I am a member of Michigan Milk Producers.

Q. Are you an officer or director or anything?

A. I am an officer of my local and serve on the ballot for market adviser.

Q. Now, what is your understanding of what these proposals are doing?

A. Well, the way I understand it, the manufacturers of these dairy products are unprofitable, and they are asking for an increase in the cost of their production, so that they can cover their cost of manufacturing cheese, nonfat dry milk powder, butter and whey products.

Q. Now, you mentioned something about forward contracting on the NASS. What are you referencing?

A. Well, if you go back to the -- when we first decided to change the pricing formulas, there was a lot of talk about supply and demand. and if you look at the Federal rule on the gathering of the NASS data, it says on every ingredient, whether it is butter, nonfat dry milk powder, whey and cheese, that forward pricing was to be excluded.

And I don't understand how the NASS price is today on nonfat dry milk powder $1.09 and the spot market on Dairy America's web page is $1.45. And the Chicago America exchange is $1.52. If those prices were reflected in my milk check, I would see a substantial increase in my milk -- in my pay price.

Q. And are you saying then that this NASS survey that those prices, the reason they have not climbed, is that those prices were negotiated on long-term contracts?

A. That's correct.

Q. Do you have any basis for that?

A. Well, you can look in last Friday's Dairy News that the USDA puts out, and there is an article in there, it says at the very bottom. "This is substantially reduced due to long-term contracts."

Q. Okay. And this is the Dairy Market News?

A. Yes.

Q. That comes out every Friday?

A. That's right.

Q. And that has a reference to the fact that there is long-term contracts and you believe that is working into the NASS formula?

A. Absolutely.

Q. All right. Let's change subjects a minute. Am I safe to say that you came down here not because you are flush with money and you wanted to have processors make more. I mean, is it really the other way around, that the economics at the farm level have changed?

A. Well, I find it very interesting that we are talking about cost of production on the manufacturing level, and the USDA has cost of production for dairy farmers, and we don't worry about dairy farmers, but we are going to worry about the manufacturers today.

Q. Okay. Are you -- there are other dairy farmers in the area where you work or you farm?

A. Yes, absolutely. And one of the reasons why I feel that we should be very involved is that there is going to be a buyout that has to be introduced by Saturday, and I know of numerous farms around me that are going to submit a bid.

Q. Now, in your position with as -- some position with MMPA, do you have contact with other dairy farmers to talk about the situation in your neighborhood?

A. Yes. I have been working on this since last summer when the nonfat dry milk powder price was $1.65 and we were in the 90 cent range, and I made it a mission of mine to get it corrected.

Q. You mentioned this buyout? What buyout are we talking about?

A. We are talking about the CWT buyout.

Q. By that, the producers are going to get out of the business by selling their cows?

A. Well, they are going to submit a bid and if they are accepted, they will be out of the dairy business.

Q. Now, at the farm level, when your income comes down and your costs are too high for the

income, how does a farmer survive if they are not making money on a month-to-month basis?
A. Well, I think so many people look at it. that going back in the earlier years, we were a lot more diversified. We were corn raisers, we were alfalfa sellers.
Today, if we are in the dairy business, we are in the dairy business. Our only way to improve income is to produce more milk.
I didn't -- for myself last year, I produced 400 some thousand more pounds of milk with the same number of animals, worked really hard, put more hours in, and showed $105.000 less income.
Q. Now, does it take cash and money to add to your management style to get that additional production?
A. Well, absolutely. Cow comfort is a big thing, and with my sons coming home and helping a lot more, we are doing more ourselves and better able to manage our cows.
Q. How are you able to survive if the operating costs exceed the monthly income? I mean, you said you expanded your herd. Where does the money come from?

A. I didn't expand; I actually produced more milk.
Q. Right. Where do you come up with the money to do those things?
A. If you --
Q. How do you get through --
A. In other words, when you are in a negative cash flow, you go to the bank and borrow money.
Q. You borrow money against what?
A. My assets.
Q. Which is your farm?
A. My farm, my cows, my real -- I mean, my machinery, whatever.
Q. You are not there, but have any of your neighbors reached the point that that is no longer an alternative?
A. I think that it is a situation with some that the land values in Michigan have kept a lot of dairy farmers in business because of our real estate values.
But in the last year Michigan land values and our economy has gone extremely bad. 53.000 houses are for sale or foreclosed on in the State of Michigan right today, and we are going to see a substantial decrease in land values.

property values; and I think that a lot of dairy farmers are going to be in trouble because their land values aren't going to be what they were three years ago.

Q. So they are living off of borrowed money. rather than income, is that what you are saying?

A. Yes, I am.

Q. Now, you weren't here, but there was a statistical study that was presented by USDA and you may have read it, it was on the Web site.

But it talked about, based on different scenarios, the number of cows may go up or down. but there is reduced income, at some point there is less cows. How does it translate that reduced income ends up being fewer cows that are being milked in the national dairy herd, do you have an opinion as to that?

A. Well, I would have to say that when it gets to a certain point that you need to get cash flow, you are going to sell animals. I see in our area right today, if you go to Rosebush. which is an area of Sale Barn, people are not selling their cows to get income. They are selling their young animals and their heifers and their breeding age animals to pay bills.

Q. So then the reduced income and the negative cash flow also results to the point where they begin to sell off their herd and future herd; is that correct?
A. That's correct.
Q. Now they borrow against their farm and now they are borrowing against their future; is that right?
A. That's right.
Q. And then does **it** reach a point, have you seen some of your neighbors that they can no longer have anything to borrow against, that they have to terminate their operation?
A. Well, the last -- with the opportunity, there have been three buyouts, and those have bailed most of those farmers out.
Q. And that is farmers helping other farmers, right?
A. That's correct. In other words, we originally started to put a nickel a hundred in and now **it** is ten cents a hundred.
Q. Now, has there been a change in the operating expenses at the farm, a significant change in the operating expenses at the farm in the last year?

A. To give you some idea, they were talking about fuel expense. In 2004, my farm's fuel expense was $35,000. Last year, my fuel expense was $70,000.

So you talk about increase, utility costs and fuel expense, we are seeing it too.

Q. Now, do you pay for the hauling of your milk to the plant?

A. Yes. I do. I pay 49 cents.

Q. Did that go up during that period of time?

A. I had -- my hauler came to me and negotiated an increase, yes.

Q. So is that included in that 35 to 70.000. that change in --

A. No.

Q. So you have that cost as well?

A. That's right.

Q. Now, there is a proposal that is here that says -- that so much says that if the energy costs go up, the plants get to increase their make allowances, which in turn reduces the class prices, which is the money that you receive.

Are you saying that if the energy prices go up at the plants, it is also going up at the farm?

A. Absolutely.
Q. Would that work for you, to have your energy costs go up and then your income from your milk go down to cover those operating costs?
A. That is why I am here today.
Q. Okay. And you would be opposed to that?
A. I am opposed to the one-sided scenario of this picture.
Q. Okay.
MR. YALE: I have no other questions. Thank you, Your Honor.
JUDGE PALMER: Any questions? Mr. Schad.

CROSS-EXAMINATION

BY MR. SCHAD:
Q. Good afternoon, Mr. Topping. You took my chair.
A. I am sorry.
Q. Just a couple of questions, and if I understand, you said the current NASS pound price was 1.09?
A. That's correct.
Q. I think you said 1.45 was the Dairy America price; is that correct?

A. That's correct. That is the price of the spot market. If you go to Dairy America's price -- or Web page, it lists the NASS price. the fuel surcharge, which is zero at the current time. It then lists the buttermilk price, and then it lists the spot on nonfat dry milk powder price.

Q. You also said, I believe, that the CME price was 1.54?

A. The CME price, I believe, was 1.52.

Q. All right. My question would be -- I haven't looked at the NASS in the last couple of weeks. Do you look at the NASS price reports that are developed and printed and circulated every week?

A. Yes, yes, I do.

Q. Do you ever take notice to the number of pounds that are listed for powder sales?

A. Yes. I have been watching them. And I have noticed that they have increased dramatically.

However, I also know that last fall, or last December, I called Dairy America, asked for two loads of nonfat dry milk powder, and they stated to me that they couldn't help me out because there was no product available.

Q. Is your co-op a member of Dairy America?
A. No, it is not.
Q. Could you tell me, well, as an idea. I have looked at the NASS reports in the last couple of months. And I think the number of pounds -- would you agree with me that the number of pounds represented by sales are somewhere between 12 and 24 million pounds?
A. Yes. I would.
Q. On a weekly basis?
A. Yes. It wasn't that prior to the end of the year. It was somewhat lower.
Q. Sure. As an organization that sells powder, people go home at Christmas, they don't buy powder.
Could you tell me how many loads of powder were sold across the CME during that same week?
A. I know that it is a very minute amount. However. I also know that the Dairy America made a big agreement with Fonterra to send nonfat dry milk overseas.
Q. Would you believe me if I told you during the year 2005 across the CME there was a grand total of five powder sales?
A. Yes, and I believe that if you wish to not

feel that that is an appropriate price to use. maybe we should just do away with the NASS pricing that is -- the way it currently is done. and let's do it correctly, and you would see the price fluctuate up and down a lot more than it does today, because NASS price is pricing itself.

Q. Do you have any evidence for that assertion?

A. Well, if you go back to look at the Federal Register, Western Dairy Producers stated exactly what was going to happen, that it would price itself, and that is exactly what is happening today.

If you feel that you make a contract and price it off the NASS, and next week you price it off the NASS that went up 2 cents and the spot market is 40 cents higher and you feel that those prices are appropriate at the NASS. I would beg to differ.

Q. Well, how many loads were sold at the spot market prices?

A. As far as on the CME, I don't know. But I know there is a lot of nonfat dry milk powder sold on the spot market that is never reported to the NASS and is never sold through the CME. Would you agree to that?

Q. No.

MR. SCHAD: Thank you very much.

JUDGE PALMER: You said you tried to buy some powder. I am a little -- I don't understand. As a farmer, why would you be buying powder?

THE WITNESS: Well, I wanted to know what the market was.

JUDGE PALMER: You bought it to sample the price?

THE WITNESS: No, what I did, I called up. I said I am a buyer -- or I would like to buy two loads of nonfat dry milk powder. And I was told there was no product available.

JUDGE PALMER: Okay. I get you. Yes. Mr. Beshore.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Good afternoon, Mr. Topping, my name is Marvin Beshore. And I represent two cooperatives in this hearing, Dairy Farmers of America and Dairylea Cooperative.

Have you reviewed the entire hearing notice, including the supplemental notice?
A. Have I been watching what -- well. I became involved --
JUDGE PALMER: You know, sir. I am going to try to help you a little bit. He wanted to know if you read all this material that was in the Federal Register.
THE WITNESS: No, I have not.
BY MR. BESHORE:
Q. Let me suggest to you there is a proposal in the hearing which has been put forward by one of the cooperatives I represent, Dairylea, it is number 20, it came out -- you get mailings, I assume, from either Michigan Milk or the hearing administrator with the notice and all.
This came out in the second hearing notice, supplemental notice, and it proposes to change the way in which the NASS price is announced or calculated, in a way, for commodities by encouraging or providing a mechanism to encourage sellers to push to add prices in the marketplace without reducing the announced NASS price. I am simplifying something.
But the thought behind it, which came from

the farmer directors, I am told, of Dairylea. the thought behind it was that the Federal Order system ought to get out of pushing the cost back to the farms, but encourage processors to add on to their prices and push costs forward in the system. Okay?

If there is that type of proposal in the hearing here, would you tend to see that as a positive approach for the problems that you have articulated?

A. Well, are you saying -- I don't understand maybe the question. But are you saying -- I don't understand why the co-ops today or manufacturers of nonfat dry milk powder aren't chasing $1.45 or $1.52 spot market. Is that what you are asking me?

Q. No. I am talking not just about powder, but about all the cheese pricing, butter pricing, all the pricing in the Federal Orders that determine what, you know, what you get for your milk. Okay. They are all based off of NASS.

A. That's correct.

Q. NASS calculations of selling prices.

A. Yes, and this -- what I am so concerned about is that no one ever would have thought that the Class IV nonfat dry milk powder price would have reflected the skim price and would have been higher than the cheese price. And I don't understand why we, we as dairy farmers. shouldn't look to that and become more intelligent about the pricing of milk and understand why we aren't seeing some of these better pricings.

Does that make any sense? I didn't answer your question very well, but I don't know what you are really wanting out of me.

Q. Well, are you looking at pricing mechanisms for anything other than nonfat dry milk?

A. Well, that is the one that is so far out of proportion. And there has got to be a reason for it. And the reason for it is that Dairy America, which is -- I am throwing out 80 percent of probably the product, or is marketing 80 percent of the product, if they have most of that product under contract, then NASS can't move, or move very little, because there is no cash market, product hardly available to move the NASS.

Q. And it is your view that NASS is not, in essence, determining the right price there. because they are factoring in long-term contracts, which are not supposed to be factored in the price?

A. That's correct. In the Federal Rule, if you look, it states "exclude forward pricing" on every one of those -- every one of those commodities.

Q. Do you have thoughts on how the make allowance system should work for cheese pricing in the Federal Order?

A. You know, as I said before, I do not have a problem with an increase in make allowance for manufacturers. However, I do have a problem where we don't experience the higher prices on the commodity prices to reflect those prices.

If today nonfat dry milk powder showed a 30 cent increase, we wouldn't have seen a decrease in our pay price.

Q. Because --

A. Even though with the increase in make allowance.

Q. Because the Class IV price would have become the mover --

A. That's correct

Q. -- for your Class I prices?
A. That's right.
Q. And, of course, it moves Class II prices?
A. That's right.

MR. BESHORE: Okay. Thank you.

JUDGE PALMER: Mr. Stevens.

CROSS-EXAMINATION

BY MR. STEVENS:

Q. Good afternoon, Mr. Topping. I want to thank you for coming.
A. Well, I am a little nervous.
Q. Well, that is all right.

JUDGE PALMER: You don't look it. You look fine.

BY MR. STEVENS:

Q. You are very articulate, and I know the Secretary wants to hear what the farmer has to say. That is what we are here for. I think, for all of us. to hear what you have to say, and for you to educate the Secretary as best you can, so the department can make a decision based on your input as well as everybody else's. I know in the department, I speak for everyone. they appreciate you taking the time to come down here and participate

Having said that, the hearing notice establishes a basis, a definition of small business. You are a dairy farmer from Michigan. I believe.

Could you put in the record, or illuminate for the Secretary's benefit, the size of your farm and where it is, and the volume of your production, if you would care to, whatever you care to put in the record.

A. I know you stated that -- I think the small, you consider anything over 500.000 pounds.

Q. Yes, the definition is in the notice of hearing, and basically gross revenue less than $750,000. You would be -- that is the definitional section.

A. I would be considered larger than that. Would you like to know how much?

Q. Well, you don't -- only if you care to put it on the record. It is up to you.

A. Last year I shipped 6.8 million pounds of milk.

Q. All right.

A. And my gross milk sales was, oh, $900,000.

Q. So you are close, you are certainly very

close. And you have friends, I am sure, who are in the dairy business --
A. Absolutely.
Q. -- who are small businesspeople?
A. Absolutely.
Q. And that is something that the Secretary wants to know about. He wants to know about how do these proposals affect small businesses. What do small businesses want to tell the Secretary of Agriculture about how these regulations either benefit you -- these proposed changes in the regulations either benefit you or don't benefit you? And quantify that as best you can.
A. My facility is quite old, and if I was to remain in the dairy business long-term and remodel my facility, I could not continue to do that on the number of animals. So that. therefore, forces me to increase my size even more.
I am looking at alternatives as far as becoming more efficient, doing things more myself and with my boys, it is going to be their decision.
I think that the large herds that we are

seeing, I think we see the large herds in the areas that we are seeing them in today, because last spring me and -- my wife and myself went to see what our competition was. And they are relocating there, because there are no people. They are trying to get away from the environmental issues.

JUDGE PALMER: You are talking about Texas?

THE WITNESS: That's correct. Texas, New Mexico.

BY MR. STEVENS:

Q. Idaho?

A. Absolutely. It is an environmental thing. I think we are going to see more and more of it And I am concerned about the dairy industry in more populated areas.

My county is probably one of the fastest. was one of the fastest growing in the state for some time.

Q. And as far as these proposals are concerned, the ones that are here to be heard, any insight that you can offer to the department?

A. I don't know how we can -- it seems like anytime you look at the cost of production, as far as what Ohio's cost of production. Michigan's cost of production, if we were to get to those numbers, we see such substantial increase in production that we just crucify ourselves as far as price.

The more pounds we produce, the less price we get. And I don't know how we are going to solve that problem.

Q. Is there anything else you care to offer up to shed light on these small business implications?

A. It is just extremely hard to be profitable anymore.

Q. So it is an uphill battle?

A. Absolutely.

Q. And continues to be, and you are looking for some relief?

A. Absolutely.

Q. Well, again, thank you for coming and taking the time out of your life. Good luck to you, sir. Thank you.

JUDGE PALMER: We have two gentlemen that want to ask questions. Go ahead

CROSS-EXAMINATION

BY MR. SMITH:

Q. Good afternoon, Mr. Topping, I am Dan Smith, I represent the Maine Dairy Industry Association. I would like to follow up on some questions from Mr. Stevens, as well as Mr. Yale. about your farm.

Do you have a rule of thumb number for cost of production that you use? You referred to Ohio's cost of production. In Michigan for your farm, do you have a number in mind?

A. Well, when you look at USDA's cost of production, my cost of production, when you look at the operating costs, are very close. When you look at the other costs, I am less than that.

Q. So --

A. You want a number?

Q. Yes. You don't have to be specific.

A. I am saying it seems to me when -- of course, my fuel costs, my energy costs, all of those costs have gone up substantially. When I receive 14.50, it seems like I can pay my bills. When I start receiving less than that, it starts getting harder and harder and I can't.

And you can operate on your depreciation for about so long, and then you have got to do something different.

Q. So you indicated to Mr. Yale that one of the things you do different is go to the bank?

A. Absolutely.

Q. And, you know, you don't have to give specific numbers. But is there some amount over the last couple of years as milk prices have gone down, relative to your production, that you could give us some insight of how much you have had to borrow against that 14.50?

A. In 2002, I lost my father. And it was probably the worst year of my life. And 2003 was an extreme struggle. 2004, of course. we had good milk prices. We ended up catching up on accounts payable, caught up on things, our feed bills, you know, cost of feed was a little higher in 2004.

And 2005 comes along, and we were able to replace some equipment, fix a lot of things up. and then comes 2006, and we start going backwards again.

It just seems extremely up and down cycles; and I don't know how long we can take it

mentally, having the highs and the lows like we have been having.
Q. Have you had labor on the farm besides your family?
A. Yes. yes. My one son graduated in 2004. and my other son is a senior at Michigan State now.
Q. And do you have -- so with the number of cows you must be milking, you must have people other than yourself?
A. That's right.
Q. Have you cut back on your labor over the last couple of years and taken on more hours for yourself?
A. We try to do more and more ourselves. Of course, my sons come home and work more hours anytime they can. And I have had to do away with one employee since -- for 2006.
Q. One employee out of how many employees have you had over the last couple of years on average?
A. Out of five.
Q. One out of five. So you cut back one out of five as one strategy?
A. Yes.

Q. Have you had any off-farm income, does your wife work, is that part of the mix?
A. Yes. I keep telling my wife if it gets any worse, I am going to have to get more wives for more off-farm income.
(Laughter.)
Q. Again, I don't want to get into what your wife does for her salary. Ballpark?
A. Well, my wife is township clerk, she works at the hospital and she does the books on the farm and the books on the feed company also.
Q. Is your farm a corporation or how -
A. No. It is a partnership.
Q. Do you pay yourself some kind of a wage to the farm, salary, partnership fee, draw?
A. Well, I take a draw.
Q. You do take a draw?
A. I take a draw and then usually, like, the last three months, I haven't taken any, and my wife starts getting after me.
Q. That was my next question. So you cut back on the draw then?
A. Absolutely.
Q. Are there -- do you get corn payments on your farm? I don't know what you have for feed.

A. Yes, I received corn subsidies. However. I received some payments this year that I got in advance that the corn price is going to be high. and I am going to have to pay them back come next fall. So I am not looking forward to those.

Q. Have you done any expansions on the farm. using other NRCS funds -- or not other, but NRCS funds?

A. No. As far as like putting in animal waste facilities or those things? No.

Q. So you haven't relied on other sources of income from the Government?

A. No.

Q. Okay. Thanks.

JUDGE PALMER: Yes, sir.

CROSS-EXAMINATION

BY MR. GALARNEAU:

Q. Hi. my name is Clayton Galarneau, and I work for Michigan Milk Producers.

Mr. Topping --

JUDGE PALMER: Would that be your dairy co-op?

MR. GALARNEAU: Yes.

JUDGE PALMER: Oh, okay.

BY MR. GALARNEAU:

Q. How long have you been an MMPA member?

A. I have been a member since I graduated high school and I was elected Vice-President as soon as I got out of high school, and actually. I wasn't a member when they elected me. So they were right there pretty quick to get me on the membership list.

Q. Very good.

A. So I have been a member since 1973.

Q. Thank you. And does your co-op guarantee a home for all of your milk?

A. Yes, it does.

Q. Are you familiar with your co-op's mission statement?

A. Yes, I am.

Q. Would you like to repeat that?

A. No.

(Laughter.)

BY MR. GALARNEAU:

Q. How about if I help you. "To market our members' milk to the greatest advantage possible." Does that sound right?

A. That sure does.

Q. That is all I have, thank you.

A. One question I would like to put on the record. To market my milk, the best available way possible, correct?
Q. That's correct.
A. The best available way possible is also to return the best available price to me who pays your salary.
Q. And I would like the opportunity to explain that to you in greater detail. But probably not here. Thank you.
A. No problem.
JUDGE PALMER: All right. You may have some other fellows out in the hallway that will be explaining to you about co-ops. Anything further?
There doesn't appear to be anything. Thank you, sir. Thank you for coming in. We enjoyed your testimony and appreciate it.
THE WITNESS: Thank you for your time.
JUDGE PALMER: Mr. Schad. I would take a break, but I think we ought to move on and get Mr. Schad done, if we can.
All right. You are still under oath, sir. Anybody have any questions for Mr. Schad?

I think somebody started. Mr. Yale?

CROSS-EXAMINATION

BY MR. YALE:

Q. Mr. Schad, Land O'Lakes operates powder and cheese plants, do they not?

A. That's correct.

Q. Where are their powder plants?

A. There is a powder plant at Carlisle. Pennsylvania. And there is -- and also in California, but that is not a subject of this hearing.

Q. Okay. So you just have the one plant within the Federal marketing area, powder plant?

A. Yes, sir.

Q. What about cheese plants?

A. We have three in the Federal marketing. that would be Kiel, Denmark --

Q. All in Minnesota?

A. -- and Melrose.

Q. Kiel, and the state is?

A. Wisconsin.

Q. And Denmark?

A. Also Wisconsin.

Q. And Melrose?

A. Minnesota.

Q. Okay. And those right now are in the Upper Midwest milk marketing area?
A. Yes, sir.
Q. Now, when you -- wait a minute. Is it a fair statement to say that Land O'Lakes wants to get a situation that it can fairly compete, that its plants are profitable and it is fair to producers without being taken advantage of by other producers in the marketing area, is that kind of where you want to go? How would you say what your goal is with those proposals and your positions?
A. We would want our farmers to have a return on their invested capital in dairy plants.
Q. In dairy plants. What about at their farms?
A. Of course.
Q. Okay. So the goal is to put more money into the producer's pocket. Either through higher sales of the milk or returns on their plants or because they have the plants, they are able to get higher sales on their milk within the market, it is all part of a master marketing plan?
I mean, how would you -- you are not

following that question, and maybe it was a terrible question. So let's start again.

If your plants -- is the only way that you see delivering higher income to your producers by operating profitable plants, or is that only part of an overall strategy of Land O'Lakes?

A. We operate plants. We have a value added business as well. And we also market our members' milk to third-party sales.

Q. Okay.

A. All three of those provide our members with a hopefully competitive milk price on a monthly basis, as well as a return on their investment --

Q. Okay.

A. -- as patronage.

Q. As patronage, right. Now, there has been some discussion by Dr. Wellington regarding --

A. Before we go there, he was qualified as an expert, not a Ph.D.

Q. He is not a Ph.D. I was so impressed. I awarded him one. He has got a Yale degree, he's got a doctorate.

(Laughter.)

A. Actually, it was Rutgers, I believe.

Q. Was it Rutgers? Well, then I take it back.
Bob made testimony regarding proposals to gather information for an annual survey and to provide make allowances; is that correct?
A. Yes. Proposals 1 and 2.
Q. Now, do you have a position as to what information the department should have readily available to make a decision in terms of what a make allowance yields or whatever ought to be?
A. Well, let's break apart the question. The first question is relative to make allowances.
Q. Right.
A. I see that as an issue of manufacturing costs. So I would expect -- and my testimony speaks to it -- that I would expect the department to proactively go out and gather manufacturing costs for -- from those plants that produce the NASS commodities, and relative to yields. I would expect that the department addressed that question in 2000 and came out with a final decision in 2003.
I also see that they are addressing it at this hearing as well.
Q. Now, in a determination of the profitability of a plant -- because we are using

a proxy plant to determine the value of your manufactured milk, right? We take the NASS and an average yield and an average of some kind of make allowance to determine what the value of manufactured milk is.

A. Okay. I would agree, and I said in my testimony that the class price is the residual of the NASS minus the cost of manufacturing as a weighted average and also times a yield factor. I agree.

Q. And the NASS captures virtually all of the commodity butter, powder, cheese and dry whey within the system, is that a fair statement?

A. Based on what NASS collects. I mean, NASS doesn't collect, for instance, intercompany sales, and just given the definition of what the NASS is.

Q. It has its limits?

A. Yes, sir.

Q. Now, but having all of that information is an important aspect to arrive at a fair make allowance yield and prices that are minimum prices under order; is that correct?

A. I agree with you so far as to say that the class price is as I spoke.

Q. Okay. So the NASS addresses -- I am not going to get into the issue between CME and the NASS. We will do that later. But right now. for the moment, the NASS at least surveys all of this, gives a fairly accurate information in terms of what those prices are, right?

A. Yes, sir.

Q. Is there more information that ought to be made available in the NASS reporting, other than what is in there today? I mean, it just has basically the average, and it doesn't have the range or quartiles or anything else like that in terms of -- do you see any other information that is necessary to make a decision?

A. No. I do not.

Q. There has been a discussion on the make allowances by Bob, okay, that he is looking for a higher than average, weighted average in terms of cost of -- or allowance for make at the plants. More than just the weighted average, he wants something to cover 80 percent of the production or a certain percentage of the plants, right?

A I heard him testify to that effect. Yes, sir

Q. Now, in your testimony, you have concerns about the snubber?
A. I have concerns about Proposal 2, Part B, I believe, which is a recognition of regional costs, and the calculation of a make allowance average, yes, I have concerns about that, sir.
Q. And why would you have concerns about that?
A. I -- Land O'Lakes is very comfortable with a national price, and that I feel that -- Land O'Lakes feels that a recognition of regional costs would take us down a road which would lead us to a recognition of regional sales prices instead of averages; and I think we would lose much more than we would gain if we moved away from using a national sales price and a weighted average national cost of production.
Q. That is because in some ways, you are really speaking about two different things. The regional manufacturing costs and the national sales price don't totally link up in terms of what is going on; is that correct?
A. We see an inconsistency there, yes.
Q. And isn't it also true that the way this would work is that the lower -- I always have trouble with the higher and the lower.

The plants with the marketing area with the plants with the higher manufacturing costs would tend to dictate what the prices would be in the rest of the country under that proposal?

A. I am not sure I come to that conclusion. but I would say there would be a recognition of regional costs.

Q. Okay. And is there a risk in having the regional cost that if you have a region with much more efficient production, that it might start to create some disorderly marketing and the fact that they might have the wherewithal to be able to expand their market share by having the higher make allowances?

A. I am not sure that -- in 25 years. I have never used the word "disorderly marketing conditions" in a Federal Order hearing, and I am not going to as a response to your question.

Q. I won't ask you the definition of "disorderly" then.

A. However, I could see that there could be -- if you are going to define a make allowance based on a regional cost, I could see a disconnect with areas that would have lower prices, yes. And that is why we are opposed to that part of Proposal 2.

We are clear, we are, Land O'Lakes is opposed to that.

Q. Yes, I am clear to that. So are we. But I just wanted to deal with that. Now, part of this -- another part and confined to that, not just at the order level and the snubbing, is the idea of having, even on a national basis, that X percent of plants or X percent of production would be covered by the manufacturing allowance.

A. Was there a question there?

Q. Yes. I mean, are you aware of that, is that part of the proposal?

A. That is -- part of my testimony reflects the fact that California says that they set make allowances to cover somewhere between 50 and 80 percent. I cite that in my testimony.

Q. What percentage should we be citing it at?

A. Somewhere between 50 and 80 percent. I would want the department to have that ability to look at the marketplace and make those decisions, based on population percentages.

Q. Was that populations of plants?

A. And the answer is, no, population of volume. And maybe to answer a question you didn't ask, why 50 to 80 percent range, maybe the department would see that one class of milk has costs that would have to do with balancing.

So maybe another department might recognize that by making sure that a higher percentage of the milk under the Federal Orders is covered by that, as opposed to another product that may not have that balancing function in the marketplace.

JUDGE PALMER: Off the record.

(Thereupon, a discussion was held off the record.)

BY MR. YALE:

Q. So let's come back to this point with the -- that is information that -- the department is going to need information regarding that balancing function, is that correct, or is this something that they are supposed to obtain outside of the marketing hearing, at least these hearing processes, how are they going to determine what value there is to the balancing of these plants?

A. As they look at the numbers, they can see that there would be a range, a range of costs. and through their investigation, their auditing, they can see that -- they may find out that that range of cost for a particular product has to do with balancing.

Q. So you talk about you want a national price. Should the cost of balancing also be nationalized?

A. Yes. If I want a national price. I am going to have that, that recognition.

Q. So you do not recommend the department cover those costs through a market service payment provision within the individual orders, as opposed to changing the make allowances?

A. What I recommend has little to do with what the department does.

Q. I understand that. I don't know if it has little to do. You have an influence.

A. I testified in a hearing in the Northeast for market service payments and it was turned down. So I have to expect that the next hearing would have the same result.

Q. So -- all right.

A. And the department has said at points that Class IV is a market clearing price. They have also recognized that the groupings that they use in the California and especially in the 2000 hearing had to -- they chose the grouping that set the make allowance, based on a recognition of balancing.

So there are things that the department can do by looking at the information to make accommodations for balancing, if they chose to.

Q. So now we are at a point where we have knowledge of the values on a weekly basis of the commodities that are defined in the NASS. We have some knowledge of some cost at some plants that nobody seems to be satisfied that they are completely accurate.

A. We are defining the conditions today?

Q. Conditions today.

A. Or conditions that I am asking for?

Q. The conditions today.

A. Yes, sir.

Q. You are not totally satisfied that we have identified the costs of manufacturing products outside of California, are you?

A. No, sir. I did write exceptions and comments to the temporary decision.

Q. And your position is that they were too low, right?

A. Yes, sir.

Q. And there are those who disagree, they thought they were too high, right? I mean, you have to agree, there were some people who disagreed, took the other position, right? I will withdraw it It is a trick question

The point is, is that I think there is some agreement that there needs to be a higher level of information available to the participants in the program, so that we know what those numbers are and we can develop a better confidence that whatever arises out of that, that we can feel comfortable with that, is that correct?

A Yes. I agree with that, sir

Q So that comes then to -- first of all, while we are still on it, I want to talk about the market service payment issue, that that appears to be an awful wide discretionary window for the department to decide whether or not to adjust If we were to get the knowledge of the NASS or the product values, however we discover that, and we are satisfied with the make allowances, you are still wanting to give the department discretion to move those numbers around to arrive at some number that isn't necessarily mathematically precise, from the first to the second?

A. Yes, sir.

Q. Okay. And what would you tell the department in terms of how would you -- what criteria would they use to determine, first of all, whether they should make an adjustment and then, number two, how much of an adjustment to make?

A. And which adjustment are we talking about?

Q. I am talking about, we have discovered the price of the product.

A. Yes, sir.

Q. We now have -- we are satisfied with the manufacturing costs. Okay. And you are still saying that they should be able to make some adjustment for -- primarily for balancing.

A. I am saying that the department should have discretion to move within a set of percentages that would cover a volume of milk and that they would be able to give rationales to why they chose a volume of milk that they felt needed to be covered by their make allowances.

Q. So you see that -- the only real criteria that is objective, that somebody could say they qualified or not, is somewhere between 50 and 80 percent?

A. That was my testimony.

Q. And any other criteria, there are no criteria. It is whatever the department decides is relevant at that point?

A. Yes.

Q. Now, let's go to another issue, and that is, you talked about the yields and you said there was a hearing in 2000. Do you believe that there is currently an open knowledge that is available to all participants, sufficient knowledge to know what the average yields are at the various plants that make the commodities that are used in the NASS survey?

A. If your question is, is there tabulated somewhere some listing of yields at different plants, based on some level of standardized milk, I know of none.

Q. Okay. So -- let me kind of go -- well, the point is, we do not have any -- in the way -- we don't have anything even as good as Mark Stephenson's report on the make allowance, so we don't even have that on the yields, for somebody to sit back and say they studied X number of plants, different sizes, and this is what we have been able to determine, based upon their

yields and seasonality, this is what they can produce in terms of -- we don't know that, do we?
A. Seasonality and the things that they put into the vat.
Q. Right, right.
A. Okay.
Q. Now, the NASS cheddar is a standardized product, is it not?
A. My understanding would be it is, but I don't know that for certain. I think the fact that it is -- it has different moisture levels and it is standardized to a moisture level, if that is the answer to your question, that it is a standard product --
Q. You know, I am talking about standard of identity. Does it have a standard of identity, what can go into -- you don't know?
A. I don't have an answer.
Q. So what do you believe the make for cheese. for example, ought to be, right now, or what are you proposing? I am not going to challenge you. I just want a number, because I don't want to --
A. I can't give you a number.
Q. It is 16.82 right now, right. I think under

the Temporary Final Decision, I think it is 16.82. right? Let's assume that for the moment.
A. We will stipulate that.
Q. Okay. Let's assume after you do a study, that you are satisfied with it, everybody seems to be fairly satisfied with it, although we may not like the numbers, but sometimes the truth is inconvenient, we accept that, that that is the number and it comes out it says it is 16.82.
Right now, the implied yield -- do you know what the implied yield is in the make allowances today for cheese?
A. No, I don't.
Q. If I told you it is approximately .966, you don't know whether that is right or wrong?
A. I do not know that.
Q. For the moment, let's say that that is what it is. But a study shows that this make allowance that we've just announced, that the yield ought to be 10.2, do you have an objection to the department changing the formula to compute the protein value and the Class III value, based upon that higher yield?
A. With the assumption that it is standard milk and it is not milk that has been fortified

in any way, shape or form.

Q. I understand that.

A. Yeah, I would go with the numbers. I think that -- sometimes I feel like I am the only one left who really believes that it is the process that is the most important, rather than the end result.

Q. We may have more in common than you think. Now. Land O'Lakes has quite a few farmers. I believe you are the second largest, third largest co-op?

A. I think it is third. DFA would be largest. CDI and then Land O'Lakes.

Q. And within the Federal Order system, you probably would be about the second?

A. Yes, I would think -- yes, definitely.

Q. When you do these proposals and stuff, do you do any analysis in terms of actual farm income and the profitability at the farm to determine whether you are delivering a price that is sustainable by your members, so that they can, on a long-term basis, stay in business and provide the milk to your plants?

A. Again, you know, Land O'Lakes pays a competitive price to its membership. And between its plants and its value added business. it wants a return on investment, a return on our members' investment.

Q. The answer really is, no, you don't determine whether they are getting enough, you are just going to give them the best that you can, and that is it, right?

A. That is all that is in the bank book.

Q. Now, you indicate Land O'Lakes has member farms, members who are farmers. Does Land O'Lakes itself own any farms or operate any farms itself?

A. It probably does. I guess we have the Answer Farm, which is the Purina Research Facility in St. Louis. So, yes, we own --

Q. But in terms of a production farm?

A. No.

Q. Bob answered a lot of questions, so --

A. That is why I asked him questions too.

Q. You might want to confer a Doctorate on him yourself.

Does Land O'Lakes offer any program of risk protection to its farmers, such as using the CME or the Class III futures or Class IV futures?

A. Yes, we have a program where our members.

if they choose to participate, they are offered a forward -- a variety of forward contracted prices.

Q. Does the -- among that variety, does it include the use of the futures of the Class III and Class IV offered by the CME?

A. Yes. I am not sure about the IV, but the III. In addition, we will have customers who will buy our products, who want to fix a price. and we, as a service to both customers and members, we play broker in between.

Q. Sure. Now, does Land O'Lakes have a position as regards the value of the Class III futures market to the dairy industry, in terms of is that an important component now from the -- I mean, do they support the use of a futures market, other than just using it? I mean, do you support the growth and use of the futures market as a part of the risk sharing program?

A. Yes, sir.

Q. We have right now, based on the make allowance that has got a tentative final decision, which means a final one can come out, we have a Class I and II hearing that we are

awaiting a decision, which can be a recommended or tentative final or a final, final. we don't know. And then this hearing can result in one or two or three decisions as well, right? I mean --
A. One or two or three decisions?
Q. One or two recommended decisions that become regulations that we have to --
A. I don't think anyone is asking for an emergency hearing. So I think you will get a recommended and a final. So it will only be one set of prices.
Q. But that doesn't mean even after the recommended that the final is a tentative one, looking for further comments. They have done that before, have they not? You don't have an opinion on that. The point is, we are looking at three or four potential decisions impacting prices over the next --
A. Yes, if you look at the aggregate of the hearings, I would agree with you.
Q. Right. Within the next six months or a year, with the speed with which they are able to put them out?
A. With the speed with which they are able to

put them out.

Q. And they are doing that lately. You are not satisfied with the speed, but they are getting out quicker than they have. I have to give them that.

The point I am getting at is, doesn't the risk of having three or four decisions potentially coming out there have an impact on people trying to establish how they want to offset their risk on the futures market, because they do impact the futures market?

A. Yes. I agree it has an impact on the futures market. I would also -- futures markets are all about finding a way to set a price and to take the risk out of the market. I mean, is regulatory risk all that much different than weather risk? I mean --

Q. I understand. But regulatory, it increases the amount of regulatory risk, with all these pending right now?

A. Yes, there is more regulatory risk now because of the department having hearings that set class prices.

Q. Now, let me go on to another subject. Are you aware of the methodology in which most of the milk -- I think you mentioned that Land O'Lakes sells milk to other plants, not just to its buyers that it sells, but sells your members' milk to other buyers, right?

A. That's correct.

Q. Is the method within the market, the Federal Order marketing area, because we exclude California -- do you use the minimum class prices as a reference price for the sales of that milk?

A. Yes.

Q. Fairly exclusively?

A. I don't know about the sales in the Upper Midwest, but the sales that I have executed in the Northeast is always the applicable Federal Order price.

Q. Plus or minus, depending on what the market bears?

A. Yes, sir.

Q. Right. And that is a pretty common practice?

A. As far as I know, yes, sir.

Q. And that is part of a risk allocation, so that you know that your risk is no different than your competitors' risk or others', right?

Isn't that part of the use of it?

A. I have to pay the dairy farmer that price that month.

Q. It protects you from that risk?

A. Yes.

MR. YALE: Very well. I have no other questions.

JUDGE PALMER: Anybody else? Mr. Beshore.

CROSS-EXAMINATION

BY MR. BESHORE:

Q. Marvin Beshore. I have just one clarification question. Ben asked about the component of prices in the NASS series, whether -- what transactions go into NASS prices. Okay. And I think you referred to intercompany transactions not going into the NASS price.

A. That's correct.

Q. Okay. I think what you mean the transcript to reflect, is that intracompany prices?

A. I am very sorry. Thank you for clearing that up.

Q. I-n-t-r-a company prices?

A. Yes, sir

Q. Intercompany prices or transactions are reflected in the NASS, that is between different companies?

A. That is my head nodding and making a sound for being so stupid.

Q. No, not stupid. I just want it to be correct on the record there.

A. Thank you.

JUDGE PALMER: Thank you Questions? Mr. Schaefer?

CROSS-EXAMINATION

BY MR. SCHAEFER:

Q. Good afternoon, Dennis.

A. Hello. How are you today?

Q. Good. You had a table in here that you are showing a calculation of weighted average cost using 2002 methodology.

A. Yes. sir. it is page 5.

Q. Correct, on page 5. I think I will ask you the same question I asked Mr. Wellington. Are these -- is this just an example of a calculation method you would like to see the department use, or is this a reflection of what make allowances you would like to see come out of this hearing?

A. I would give you the same answer as Mr. Wellington.

Q. Okay. Thank you.

JUDGE PALMER: Any other questions?

MR. SCHAEFER: I have one.

JUDGE PALMER: I am sorry. I wasn't trying to make you finish, it looked like you had.

BY MR. SCHAEFER:

Q. On page 6, you talk about Mr. Wellington's Proposal Number 2 and a little bit about the survey and who would collect the data from the survey And I guess in your discussion there in a couple of places, you mention, first of all. the Director of the AMS would collect that data In the second place you mean the Secretary Mr Wellington had indicated, I believe, a preference really for the Market Administrator personnel.

Who would you have collect the data from a survey, if a survey was implemented?

A. The reason I made a distinction with the Director of the AMS, is that I was afraid that the proposal language as I read it for 2, would have the Market Administrators choose the sample out of their markets, rather than having a national sample

So if I can clear it up, I would expect that the AMS, the Director of the AMS to be the one who would develop which plants should be in the sample, start with the population of all plants, and if that is not possible, to bring it down to a level that the department is comfortable with

But I agree that the Market Administrator auditing staff would be the best folks to go in and to do the -- on the groundwork

Q When you talk about the population of plants, are you referring to the literal population of all manufacturing plants, or do you have a specific criteria?

A Again, we are looking for the plants -- well, first of all, it would be plants located outside of California I think there should also be a qualification that the plant receive pooled Federal Order milk, at least one hundredweight of pooled Federal Order milk, so that we have the largest sample possible, and that we would be looking for the plants that manufacture those products that are included in the NASS survey.

Q. And if the -- whoever decides whether there should be a survey or not, do you have any specific criteria on how the plants in that survey should be chosen out of that population?

A. Again, we are assuming that the Secretary or Director chooses not to do the population of plants.

I would wish that they would do a random sample of the plants. But to get to a level that you are going to have a significant volume of the NASS production of that product in your sample, so the department may determine that, as Professor Stephenson talked about, there are a lot of very small plants that he excluded from his survey. However, you could get to some level that the department is comfortable with the volume of product produced in the NASS survey as represented by those plants.

MR. SCHAEFER: Thank you. Dennis. That is all I have got.

JUDGE PALMER: Mr. Vetne.

REDIRECT EXAMINATION

BY MR. VETNE:

Q. John Vetne. Dennis, on that subject. recent cross by Mr. Schaefer, as I understand it, correct me if I am wrong, you want the Administrator or Deputy Administrator for Dairy Programs to set the rules, give instructions, but it is okay for the Market Administrator personnel to carry out those instructions?

A. Yes, sir.

Q. As long as it is done in the same way, consistent way from market to market?

A. Yes, sir.

Q. And that function could conceivably also -- again, correct me if I am wrong -- conceivably also be contracted out to somebody like Cornell, using market assessment funds?

A. Yes, sir.

Q. In response to question on using the largest sample possible, is there a reason why one would exclude, for example, Idaho cheese plants, non-California plants that might not receive Federal Order milk?

A. I made my qualification so broad that I hoped there would be one hundredweight of

Federal Order milk go to all the plants that would impact the survey. But if there was a plant in Idaho that did not have it, I would say that you would have to exclude it, did not receive that one hundredweight.

Q. Earlier in responding to questions from Ben Yale, you were discussing the policy objective of the proposal of covering a certain volume of milk. 50 percent to 80 percent is what California uses.

And Mr. Wellington also talked about covering some portion of plants as another reference.

And I wrote down that in response to one of those questions, you would hope that the Secretary, in looking at those issues, would explain why the agency chose a volume percentage or plant percentage of milk to be covered as part of their decision process.

A. That's correct. If I didn't say it, that was my intent.

Q. The Federal Order Reform decision and the decision following the 2000 hearing which became final in a decision released November of 2002 and effective 2003, that decision explained that the make allowances chosen were intended to cover most of plants receiving Federal Order milk. I humbly interpret "most" to mean more than half.

In all of the policy alternatives that you have suggested, including the proposal for emergency hearing last year and in this one, it seems to me you are ending up at a more conservative place, it is acceptable for less than half, or not most of plants to be covered?

A. As an answer to your last question. I would expect the Secretary to make a decision that would cover a number of plants or a percentage of plants that he feels comfortable with.

I believe if we look at the Cornell and the Stephenson conclusions, he talked about one third of the plants being covered and, if I am correct. and 82 percent of the volume of milk.

Q. At an allowance of something in excess of 20 cents per hundredweight for cheese?

A. That's correct.

Q. And we end up with an allowance of just under 17 cents, which would be substantially less than a third of the plants?

A. Right. Which I would expect the Secretary.

when he gave such a decision, to give a rationale.

MR. VETNE: Okay. Thank you.

JUDGE PALMER: I don't see any hands raised. Does that mean we can conclude with this witness? I think we can. Thank you very much, sir. Let's go off the record for a second.

(Thereupon, a discussion was held off the record.)

CLAYTON L. GALARNEAU, JR.

having been first sworn by the judge, was examined and testified under oath as follows:

JUDGE PALMER: All right. I think we are about ready. All right, Mr. Galarneau and Mr. Vetne, if you would please proceed.

MR. VETNE: Okay.

DIRECT EXAMINATION

BY MR. VETNE:

Q. Proponents of 1 and 2 call the third witness, Clayton Galarneau, Michigan Milk. Mr. Galarneau, you have been sworn in?

A. Yes.

JUDGE PALMER: We have a statement that we are going to mark for identification as

Exhibit 13.

(Thereupon, Exhibit 13 was marked for purposes of identification.)

BY MR. VETNE:

Q. Mr. Galarneau, you indicate your affiliation and some of your experience in your statement?

A. I do.

Q. You have testified at Federal Order hearings before?

A. Yes, I have.

Q. And you provide economic and regulatory analysis for Michigan Milk?

A. Several times.

MR. VETNE: Okay. And. Mr. Galarneau, like the prior witnesses, is being offered as an expert for his opinion testimony.

JUDGE PALMER: All right. Is there any need to voir dire Mr. Galarneau? Does everybody agree he is an expert? Go ahead.

MR. VETNE: Proceed.

STATEMENT FOR THE RECORD OF

CLAYTON L. GALARNEAU, JR.

THE WITNESS: As you mentioned.

my name is Clayton Galarneau. I am the Director of Manufactured Product Sales and Operations for Michigan Milk Producers Association, otherwise known as MMPA. I have been with MMPA for 21 years, and I am currently responsible for the operations of two manufacturing plants located in Michigan. MMPA members supply over 3.5 billion pounds of milk per year from about 1600 farms located in Michigan, Wisconsin. Indiana and Ohio.

Approximately one third of the milk marketed by MMPA is processed within our own two facilities. MMPA's manufacturing plants produce a variety of bulk dairy products, including cream, condensed skim milk, Grade A nonfat dry milk and Grade AA bulk butter. These plants provide a key role in assisting with the balancing of milk requirements in the greater Michigan. Indiana and Ohio milk shed.

We support the proposal presented by Agri-Mark advocating the adjustments of the Class III and IV make allowances based on the most current data available. We recommend including the CDFA data through 2005 as noted in the Preliminary Economic Analyses prepared by the USDA. We also support Agri-Mark's proposal. which seeks to amend the Class III and IV product formulas annually, using an annual survey of cheese, whey, butter and nonfat costs. We support the Market Administrator performing the annual survey in using a representative random sample of the manufacturers of cheese, whey. butter and powder.

We support the proposal presented by National Milk Producers Federation to include a mechanism for adjusting the energy portion of the make allowance formula on a monthly basis for changes in natural gas and electricity.

The experiences of the last two years of widely fluctuating fuel and electricity prices have proven the necessity of a monthly adjuster to the energy portion of the make allowance used in the price formulas for Class III and IV milk. Energy represents a significant portion of the cost of producing butter, powder, cheese and whey. We have provided evidence at the national hearing held in January of 2006, which documented the tremendous financial impact that the increase in energy costs had on our operations for 2005 and the first quarter of 2006.

As energy costs increase. manufacturers need to be able to recover the increased costs by adjusting the make allowance, and if energy costs decrease, farmers should also benefit from the reduction to the make allowance to generate a higher milk price.

BY MR. VETNE:

Q. Mr. Galarneau, does -- where I stopped you. does that end your narrative discussing Proposals 1 and 2 in support?

A. Yes, it does.

Q. Your testimony from here on is anticipatory in response to other proposals for which the proponent's testimony has not yet been delivered?

A. That's correct.

Q. Okay. You prefer to provide that now?

A. If there is no objection.

JUDGE PALMER: Any problem? He is on the stand. I guess otherwise he would have to come back.

BY MR. VETNE:

Q. Go ahead, sir.

A. All right. Thank you. We oppose proposal number 7 submitted by Dairy Producers of New Mexico which seeks to eliminate farm-to-plant shrink from the product pricing formulas. MMPA and competitors in Michigan, Wisconsin, Indiana and Ohio markets pay dairy farmers the Federal Order blend prices based on farm weights and tests. MMPA processing plants are billed for the milk based on farm weights and tests.

Unfortunately, not all the milk picked up at the farm is received by the plants. Invariably, some portion of the milk clings to the walls of the transport vessels, pipes and hoses, and the plant receives slightly less than the purchased quantity. This farm-to-plant shrink needs to be allowed for in the yield factor for Class III and IV products. Our organization regularly monitors farm-to-plant shrink, and the losses typically average about .3 percent by weight. Attachment A, which I would like to make the next exhibit, which would be --

JUDGE PALMER: It is attached?

THE WITNESS: Fourteen?

JUDGE PALMER: Well, no, why don't we just make it part of your statement.

MR. VETNE: It is all part of Exhibit 13.

JUDGE PALMER: It's all part of the exhibit.

THE WITNESS: Okay. Thank you. Attachment A summarizes several months of MMPA's experience in tracking farm-to-plant losses. The results summarized in Attachment A are very typical of the last several years of experience.

We oppose proposals submitted by Dairy Producers of New Mexico which seek to change Class IV nonfat dry milk and butter yield factors. MMPA's two manufacturing plants have considerable experience in the production of nonfat dry milk and butter, and we find the current yield factors provide a reasonable method of determining the appropriate milk value for Class IV products.

Attachment B summarizes the mass balance of Class IV products produced from 100 pounds of milk testing 3.5 percent butterfat and having 8.685 percent solids nonfat. The current Class IV price formula uses a yield factor of 1.2 pounds of butter per pound of butterfat. The formula assumes 4.2 pounds of butter for 100 pounds of milk containing 3.5 percent butterfat.

Similarly, the formula assumes 8.59815 pounds of nonfat dry milk using the yield factor of .99 pounds of powder per pound of solids nonfat. The model is valued using the average NASS butter price for 2006 of $1.2193 and the average NASS powder price of 2006 of $.8874, generating a milk price of 11.06 per hundredweight.

In contrast to the model presented in Attachment B, the model shown in Attachment C attempts to explain the typical output that MMPA experiences from 100 pounds of milk containing 3.5 butterfat and 8.685 -- that is where I need to make sure you identify that correction there -- solids nonfat.

MMPA typically experiences a butter yield of 4.11 pounds per 100 pounds of 3.5 percent butterfat milk and 8.42 pounds of nonfat dry milk. In addition to the butter and powder produced, MMPA would typically expect about .38 pounds of buttermilk powder from each 100 pounds of milk.

Attachment C multiplies MMPA's yields typical for butter, powder and buttermilk by the average NASS prices The model shows MMPA's typical yield generates a milk value of $11 11 per hundredweight Although this appears to be greater than the value generated in the current Class IV formula by 5 cents per hundredweight. several factors combine to eliminate the perceived 5 cent advantage

Unfortunately, in the production process of butter, powder and buttermilk. off-grade products are produced Our experience in butter production indicates about 1 3 percent of total production will need to be sold as off-grade products

This product typically will have to be sold for about a 30 to 40 percent discount from prevailing NASS prices The powder and buttermilk production typically produces about 1 2 percent of production that must be sold as off-grade, and they are generally discounted by about 30 to 40 percent as well The bottom of Attachment C summarizes the lost value attributed to off-grade products, and this example is 5 cents per hundredweight

Although MMPA's butter and nonfat production typically generates yields slightly different from the factors used in the current Class IV price formula, the current formula does provide a more simplified calculation for generating milk values as a close proxy to a more complicated alternative. MMPA recommends that the yield factors used in Class IV price formula remain as currently stated.

We urge the department to revise the make allowances as recommended above and provide an emergency decision as expeditiously as possible.

These comments are submitted on behalf of Milk Michigan Producers, which is a member owned and operated dairy cooperative serving nearly 2400 dairy farmer members in Michigan, Indiana and Wisconsin.

Thank you for considering my comments, and I would like to have this entered into the record.

JUDGE PALMER: Are there any objections to receiving the statement? I presume there is none. It is received as an Exhibit 13.

(Thereupon, Exhibit 13 was received into evidence.)

JUDGE PALMER: And is there anything else, Mr. Vetne, on direct?

MR. VETNE: Yes, just a couple of things, if we have time.

BY MR. VETNE:

Q. Mr. Galarneau, on page 2 of your statement. you didn't read into the record some mathematical formulas as part of your reading. However, you do intend for those to remain as part of the statement that you provided in the exhibit?

A. Yes.

Q. With respect to your buttermilk production. I addressed some earlier questions to Mr. Wellington.

First of all, is it your observation that the prices you received for buttermilk powder are less than the prices you received for nonfat dry milk powder?

A. Generally.

Q. And do you also, like Mr. Wellington, like Agri-Mark, have to remove more moisture from the skim buttermilk than you would normally do from skim milk to make nonfat dry milk?

A. Yes, we do. That is indicated on my

Attachment C, when I look at the average yields for buttermilk at 2.5 percent butter -- I am sorry, 2.5 percent moisture, versus our nonfat average yield of 3.3 percent moisture.

Q. And yet you are paying for those solids that go into buttermilk powder under the current formula as though it were going into NFDM?

A. That's correct, and that is what I hoped that my two schedules would explain.

Q. On your farm-to-plant shrink or loss of .3 percent by weight, within that .3 percent, is the ratio of fat to skim the same as it is in producer milk, or is more of that fat than skim proportionately?

A. Yes. Typically, we lose more fat than skim in that farm-to-plant shrink. The fat has more clinging properties and is more likely to cling onto the walls of the tanks.

Q. Okay. That is all I have. Thank you.

Oh, one more thing. The off-grade products that you sell, as well as buttermilk powder. those aren't included in any prices reported to NASS, are they?

A. No.

MR. VETNE: Thank you.

JUDGE PALMER: I think that concludes it for today. We will return here tomorrow at 9:00.

(Thereupon, the proceedings were adjourned at 4:54 o'clock p.m.)

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C E R T I F I C A T E

STATE OF OHIO,)
) SS:
SUMMIT COUNTY,)

I, Binnie Purser Martino, a Registered diplomate Reporter, Certified Realtime Reporter and Notary Public within and for the State of Ohio, duly commissioned and qualified, do hereby certify that these proceedings were taken by me and reduced to Stenotypy, afterwards prepared and produced by means of Computer-Aided Transcription and that the foregoing is a true and correct transcription of the proceedings so taken as aforesaid.

I do further certify that these proceedings were taken at the time and place in the foregoing caption specified.

I do further certify that I am not a relative, employee of or attorney for any party or counsel, or otherwise financially interested in this action.

I do further certify that I am not, nor is the court reporting firm with which I am affiliated, under a contract as defined in Civil Rule 28(D).

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my seal of office at Akron. Ohio on this 6th day of March, 2007.

Binnie Purser Martino, RDR, CRR

My commission expires June 26, 2009.

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