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VOLUME V
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
Friday, March 2, 2007
9 24 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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1 JUDGE PALMER: Mr. Yonkers, you
2 are still under oath, sir.

3 THE WITNESS: Thank you. Your
4 Honor.

5 JUDGE PALMER: Mr. Yonkers, yes.
6 sir. Mr. Beshore.

7 CROSS-EXAMINATION

8 BY MR. BESHORE:

9 Q. Marvin Beshore. Good morning. Dr. Yonkers

10 A. Good morning.

11 Q. I want to talk about your make allowance
12 issues first, **if** I might, and focus on the
13 cheese make allowance.

14 Although your testimony yesterday
15 reiterated verbatim a number of your positions
16 on your exceptions to the tentative final
17 decision, your proposed make allowances here are
18 a bit different from that in some respects.
19 correct?

20 A. Different in that they incorporate the most
21 recently available CDFA data.

22 Q. And they also eliminate the energy
23 adjuster, which you have advocated in your
24 exceptions?

25 A. I did advocate that in the exceptions and I

1 did not use that here.

2 Q. Well, you oppose it here

3 A. I oppose an ongoing monthly energy
4 adjuster.

5 4. Right.

6 A. The energy adjustment that had been
7 calculated by Dr. Stephenson and used to update
8 the data. I was a little unsure how to apply
9 that when we had another year's worth, an
10 updated CDFR data. And I apologize, I didn't
11 look at that that closely, but because we had
12 another year, there was less of an adjustment
13 necessary, and we decided to eliminate that
14 rather than to include it in this hearing

15 Q. Well, your position -- but you are opposing
16 the National Milk Producers Federation energy
17 adjuster proposal?

18 A. Proposal 17, that's correct.

19 Q. Although your position on exceptions is
20 that the same indices which are proposed to be
21 used in the National Milk proposal, that they
22 should be adopted in the tentative final -- or
23 should be adopted to revise the tentative final
24 decision, correct, same indices you advocated
25 there?

1 A. testimony and the exceptions filed there
2 was that in doing, in changing -- updating the
3 make allowances as a result of the hearing.
4 that, yes, you should be updating the cost of
5 processing data to make it updated to current
6 energy costs.

7 I have no difficulty separating that from
8 an ongoing monthly energy adjuster into the
9 future

10 Q. Well, but your make allowances that you are
11 advocating in this hearing are based on 2005
12 plant costs, for the most part?

13 A. That's correct.

14 Q. Okay. But we have in the record 2006
15 energy data, correct?

16 A. I don't know that we have 2006 energy
17 costs.

18 Q. Well, we have those data on the PPIs?

19 A. Well, we have graphs of the PPIs. I am
20 sorry, I don't recall Roger's testimony that
21 clearly to note that all the months are in
22 there.

23 Q. Well, the PPIs are published numbers?

24 A. Yes, they are.

25 Q. So the PPI indices that you advocated on

1 your exceptions are available on this record.

2 correct?

3 A. Yes.

4 Q. And they are available for time periods

5 post the plant cost data, just as with the

6 tentative final decision, correct?

7 A. I believe so.

8 Q. Okay. Does **it** make any difference that the

9 PPI for natural gas declined during the period

10 from 2005 to 2006?

11 A. Not in our reasons for not including **it** in

12 this hearing.

13 Q. That had nothing to do with it?

14 A. **It** had absolutely nothing to do with it. I

15 had not even looked at what those were. Marvin.

16 Q. Let's talk about some other elements of

17 your cheese make allowance proposal. Now, the

18 proposal that you have advanced in this hearing

19 was not the subject of -- the make allowances

20 that you have advanced was not the subject of

21 any of Dr. McDowell's analyses, correct?

22 A. No.

23 Q. So we don't know what its effect is when

24 run through his model, versus the baseline?

25 A. No. But **if it** were adopted as a result of

1 this hearing, they would run it in their
2 economic analysis for the decision.

3 Q. After it was done?

4 A. For the recommended decision. We are not
5 recommending that this be done on an expedited
6 or emergency basis, so there would be time to
7 file comments on the recommended decision.

8 Q. With respect to cheese, your
9 recommendations now are to add about -- well. in
10 excess of 3 cents per pound to the cheese make
11 allowance, versus what was run under Scenario A.
12 Proposal 1, correct?

13 A. I don't recall what make allowance was used
14 that Howard used in USDA's analysis. Did he use
15 the updated CDFA data or did he just use the
16 make allowance in the tentative decision? I
17 don't recall, Marvin, I really don't.

18 Q. My notes from his Exhibit 7 indicate that
19 the cheese make allowance that was used in
20 Scenario A was .1711.

21 Assuming that's correct, your proposal
22 today to go to .2017 is an increase of 3 cents
23 per pound in cheese?

24 A. Yes.

25 Q. Just in rough and round calculations, sort

1 of the rule of thumb, 10 cents -- 10 pounds of
2 cheese per hundredweight, that is 30 cents or so
3 in the Class III price, correct?

4 A. In the static analysis. But one of the
5 advantages of the USDA's model is it considers
6 the dynamics in the marketplace and how that
7 affects supply and demand conditions

8 Q. But in a static analysis, you are looking
9 at reducing the Class III price 30 cents or so
10 from the static value of Scenario A, correct?

11 A. I have not run that analysis.

12 Q. In addition, you have got an increase of
13 what, a penny a pound or so in whey versus
14 Scenario A?

15 A. Once again, I don't have that in front of
16 me. I don't know what he used for Scenario A.

17 Q. Okay.

18 A. Ours is 20.69 cents.

19 Q. And if Scenario A was ,1956, that is a
20 penny or so?

21 A. Yes.

22 Q. And that is what, 6 pounds of whey or so
23 per --

24 A. 5.9, yes.

25 Q. So that is another 6 cents, static

1 analysis, correct, Class III?

2 A. Correct.

3 Q. Now, your proposal, I forget the number
4 that would change the price series for the Class
5 III price, eliminate the barrel adjustment.

6 A. That's correct.

7 Q. That has another negative 16-plus cents on
8 the Class III price?

9 A. Once again, I have not -- I did not run
10 that analysis.

11 Q. You don't know what the --

12 A. I did not run that analysis.

13 Q. You didn't analyze what effect that would
14 have on the price when you were -- you and your
15 members were evaluating whether that was a good
16 idea or not?

17 A. Yes. When we were considering whether it
18 was a good idea, we did that in 2005. And I
19 don't recall that analysis at that time. And I
20 have not updated it since then, Marvin, so I
21 just don't have that.

22 Q. Well, assume with me the record shows that
23 that is a little over 16 cents negative on the
24 Class III price.

25 A. I will take your assumption that it is 16

1 cents.

2 Q. Now, we are over a 50-cent negative on
3 Class III under your proposals?

4 A. Roughly.

5 4. And that is -- oh, by the way, how much
6 would the whey cream proposal that IDFA is
7 advocating affect the Class III price?

8 A. I have not analyzed that.

9 4. Are you going to for this hearing?

10 A. I had not planned to introduce that into
11 the hearing record. Once again, USDA, if it
12 adopts the proposal, will analyze that as part
13 of its impact analysis.

14 Q. What data will it use?

15 A. You are talking about what data on the
16 difference in value between --

17 Q. Yeah, how much --

18 A. That is going to be introduced by other
19 witnesses who will follow me.

20 Q. Can you tell us how much it will reduce the
21 Class III price on a static basis?

22 A. I said I have not done that analysis.

23 Q. Do you know what the testimony will be from
24 your members with respect to that subject?

25 A. I know what has -- some of the testimony

1 that has already come in from other witnesses
2 here, and I know what Mike McCully is going to
3 testify to, and that is a difference in the
4 price of whey butter versus Grade AA butter is
5 about 10 cents.

6 4. Assuming that difference were incorporated
7 into the Class III formula in some way, how much
8 would that reduce the price?

9 A. I have not analyzed that, Marvin.

10 Q. Okay. Is Mr. McCully planning to quantify
11 that?

12 A. I don't believe so. We will have another
13 witness who will be testifying at the reconvened
14 hearing to talk about the methodology and how to
15 use that data for USDA.

16 Q. Okay. And --

17 A. In detail, how to use that data.

18 Q. That would then quantify the negative
19 impact on Class III?

20 A. Well, it will quantify the change that we
21 are proposing to the formulas. I don't know
22 that there will be an analysis of its impact on
23 Class III. Once again, that is something that
24 USDA will do if it elects to adopt the proposal
25 As of now, we have not done that analysis.

1 Marvin.

2 Q. Okay. Moving to the pricing of, product
3 price series proposals for cheese, again.
4 barrels versus blocks or CME versus NASS, those
5 issues.

6 I understand from your direct testimony you
7 have no -- IDFA has no position on Proposal 13.
8 that is a DFA and Northwest Dairymen proposal?

9 A. To eliminate barrels?

10 Q. Yes.

11 A. Yes, we have members who have strong
12 opinions on both sides. They will be submitting
13 individual testimony from their companies'
14 perspective on that.

15 Q. From both sides?

16 A. I don't know that. They have the
17 opportunity to do so. The only ones I know are
18 only on one side of that.

19 Q. And that side is?

20 A. In keeping the barrels in the NASS survey
21 that is used in the wholesale product price data
22 in the product price formulas.

23 Q. One of the comments you made in your direct
24 testimony, and this relates to what prices are
25 used, was that you are sympathetic with the

1 issues relating to the lag and between the NASS
2 and CME prices?

3 A. That's correct.

4 Q. But you are not -- you will oppose the
5 Agri-Mark proposal with respect to adjustments
6 to that?

7 A. To use a formal adjustment, yes.

8 We actually believe, and have believed for
9 years, that the NASS survey could be improved in
10 its timeliness by requiring electronic
11 reporting, make reporting mandatory.

12 As a matter of fact, we have worked twice
13 to pass legislative language in bills to do
14 that. USDA has not published a rule on that

15 We believe if that were done, we could
16 improve the timeliness of the NASS. We think
17 that ought to be done before we complicate the
18 formula for establishing the price that is going
19 to be used in the product price formulas.

20 Q. So it is your view NASS has the authority
21 to collect all those prices right now? That is
22 mandatory by law, is it not, by statute?

23 A. I do not believe that. Mandatory that the
24 data be reported to NASS? I don't believe that
25 is the case. I believe NASS's opinion is that

1 that is voluntary now. I believe USDA -- I have
2 been told USDA is working on a proposed rule to
3 make reporting mandatory.

4 Q. Do you know whether NASS has the capability
5 to do the electronic collection of data which
6 you have advocated?

7 A. They collect data daily, or have in the
8 past collected data daily on livestock markets
9 that was required by Congress, I believe, in the
10 2002 Farm Bill, and they have been doing that
11 several years. So they have that capability.

12 Q. In the electronic manner that you have
13 advocated, is that how they collect that?

14 A. Yes, yes.

15 Q. And is **it** your view that NASS or AMS has
16 the authority to collect that data on a
17 mandatory basis now?

18 A. You are asking me a **legal** question, and **it**
19 is my understanding that, as a result of this
20 hearing, if USDA decides that that is going to
21 be done as part of the regulated pricing system
22 then **it** is their job to convince NASS, if NASS
23 is the arm that is going to collect that data.
24 to actually enforce what their regulation is
25 So. yes. I believe they do.

1 Now, NASS has separate authority for
2 collecting data and confidentiality of data, and
3 I don't think this would in any way affect that.
4 That is one of the nice things about having NASS
5 collect the data is their broad confidentiality
6 that they have to protect individual data
7 sources, and I like it that way.

8 Q. Moving to some of the yield factor issues.
9 if I can. If I understood your statement, you
10 are not taking any position with respect to the
11 proposal by Dairy Farmers of New Mexico to
12 change one of the yield factors from 1.20 to
13 1.211?

14 A. Yes. that's correct.

15 Q. So you do not oppose that?

16 A. That's correct.

17 Q. Does that reflect an acknowledgment on
18 IDFA's part that there is an error in the math
19 as has been contended by Dairy Farmers of New
20 Mexico and others?

21 A. I can tell you the position of our
22 committee that looked at this was that we take
23 no position on it

24 Q. Okay. Now, why do you take no position?
25 On one of the other proposals, you said there

1 were people on both sides, you had members on
2 both sides, on the DFA Northwest Dairymen
3 proposal. On this proposal, why is there no
4 position?

5 A. We had a significant amount of discussion
6 on that other proposal you mentioned. There was
7 not any discussion on this one. There was just
8 the consensus that we not oppose it and not
9 support it, that we have no position on it.

10 Q But no consensus with respect to the
11 rationale?

12 A. Marvin, there was no discussion on that.
13 It was agreed that we were going to be neutral
14 on it.

15 Q. Okay. Now, you have advocated that losses
16 inside manufacturing plants be factored into the
17 formulas in a manner that would reduce the price
18 that dairy farmers receive, otherwise receive.
19 correct?

20 A. Reduce the yields, and therefore, reduce --
21 yes.

22 Q. Right, okay. Now, what causes plant
23 operators to have off-grade products in their
24 production?

25 A. I don't know

1 Q. Well, do dairy farmers have anything to do
2 with that?

3 A. No, dairy farmers don't have anything to do
4 with that -- well, unless it is related to the
5 quality of their milk. But I don't know that.
6 Marvin.

7 Q. Assuming it is related to the quality of
8 the production process or the manner in which it
9 is managed, is there any reason why dairy
10 farmers should absorb the risk of those
11 managerial -- that managerial supervision within
12 the plant?

13 A. I don't know that that is the only thing
14 that it is related to in the plants that I have
15 been in on, there is always cheese that does
16 not -- that spills off on the floor, there is
17 always components that are lost in the
18 processing because it remains in the lines when
19 the lines are cleaned.

20 Those are artifacts of the system for
21 processing. They are not necessarily related to
22 management. There is a level that is going to
23 occur, regardless

24 I don't believe I am advocating that poor
25 plant management be a reason for lowering -- for

1 changing the yield factors in this case.

2 Q. But you are advocating that product that is
3 produced that doesn't meet marketable quality
4 standards be factored into the formula as a
5 negative, as a reduction in plant
6 responsibility, plant accountability for price
7 correct?

8 A. I think the average of that in the industry
9 is very important to be considered by USDA in
10 its decisions to put in yield factors and
11 enforce minimum pricing.

12 Q. Are any of your members -- do you expect
13 any to be presenting testimony of the nature
14 that Mr. Galarneau presented with respect to his
15 actual plant operations and yields?

16 A. I honestly don't know the answer to that
17 question, because we hadn't fully considered
18 that until Mr. Galarneau's testimony this week
19 Marvin. And we believe it is an artifact of the
20 processing system that is natural. It is not
21 necessarily related to only management ability
22 that even the best management in the country is
23 not going to collect everything, whether it is
24 findings that are on the floor, or whether it is
25 off-grade production. And we will be talking

1 with our members in the coming weeks to see if
2 anyone is going to testify to that at the
3 reconvened hearing.

4 Q. Now, in his data, if you start with actual
5 pounds, he started with farm weights and tests.
6 if you recall his testimony, correct?

7 A. I don't recall exactly, but I don't --
8 okay.

9 Q. I asked him a question, "What was your
10 starting point," and he said, "Farm weights and
11 tests."

12 A. Great.

13 Q. Assume with me that's correct. If you
14 start with farm weights and tests at the
15 beginning of the process, and you end with
16 actual pounds of finished product -- I mean, of
17 production --

18 A. Yes.

19 Q. -- haven't you -- and your yield factor is
20 then related to those, you know, the beginning
21 point and the end, that is how you calculate
22 your yield factor, have you not factored in all
23 of the items of shrinkage, plant loss, whatever
24 it might be, from beginning to end?

25 A. It is my understanding that is not how the

1 current pricing system calculates its yield
2 factor.

3 Q. That wasn't my question

4 A. Oh, if they did?

5 Q. If you take data such as his, you begin
6 with your gross volume of raw material, farm
7 weights and tests --

8 A. At the farm. Okay

9 Q. And you end with the product that comes
10 out, you know, the back end of the plant. I
11 mean, the production --

12 A. Yes, right.

13 Q. Okay. Have you not inherently factored in
14 everything in between?

15 A. If you could do that, yes.

16 Q. Okay.

17 A. I believe so. Well, of course, you are
18 going to have -- you are not only -- for
19 instance. in a cheddar plant, you are not only
20 going to have cheddar and dry whey and whey
21 butter. There is going to be the off-grade
22 stuff that comes out. And the same thing in a
23 butter powder plant. You are going to have
24 buttermilk and so --

25 Q. He showed that, did he not?

1 A. Yes, he did. Well, he showed it for his
2 cheese. I don't recall if he did it for butter
3 powder.

4 Q. I think it was all butter powder.

5 A. Oh, was it?

6 Q. Yeah.

7 A. Okay.

8 Q. In any event, with that type of information
9 set, you have got -- everything is factored in?

10 A. I believe so.

11 Q. With respect to the issue of whey cream, in
12 your view, first of all, there is no published
13 data on volumes of whey cream, prices of whey
14 cream; am I correct?

15 A. That's correct. And the data on even sweet
16 cream is anecdotal and reported in great ranges
17 And there is not volume data, it is only price
18 data in some parts of the country.

19 Q. In your view, why is there no data with
20 respect to the whey cream markets?

21 A. There are a lot of things that USDA doesn't
22 report data on. I don't know why there isn't.

23 Q. And whey butter, I mean, there used to be
24 data on whey butter published by Dairy Market
25 News or Grade B butter?

1 A. Grade B butter. That is when it traded on
2 the Merc. I don't know how long they did it
3 after it stopped trading or even if they did it
4 at all. I just don't recall.

5 Q. And trading was eliminated because there
6 just wasn't enough volume to --

7 A. They also eliminated Grade A butter trading
8 at the time, yes.

9 Q. question was, the data series was
10 eliminated -- or trading was eliminated because
11 of lack of volume, correct?

12 A. I believe so. I mean, the CME obviously
13 makes money on the trades, and low volume trades
14 doesn't make that much money for the activities
15 that they have to put into maintaining that
16 market.

17 Q. Isn't it your understanding that much of
18 the whey cream in the cheese making process is
19 out back into the vat and used in the cheese
20 making process?

21 A. It is not my -- I don't have an
22 understanding of whether it is most or less
23 than. I can tell you that some of our members
24 have told me they do that. I have been in
25 several of our members' plants and in none of

1 them have they done it. So there are a number
2 of large plants I have been in where they do not
3 do that. And there will be members testifying
4 on that.

5 Q. Do you know, can you tell us any members of
6 IDFA who make whey butter?

7 A. I don't know that information.

8 Q. Do you know if there are any?

9 A. I don't know if there are any. Well
10 Agri-Mark makes it. They are an IDFA member. I
11 know because I am testifying to it. But I don't
12 know. Marvin.

13 Q. Can you tell us any IDFA members who market
14 whey cream?

15 A. There are several members who market whey
16 cream and plan to testify on that.

17 Q. And do you know where they market it, to
18 what uses?

19 A. No. I don't think I have had that
20 discussion with them. The few that I have
21 talked to have marketed to a churn company that
22 makes butter. But I don't know what they
23 actually do with it. I haven't had that
24 discussion.

25 Q. Do you have any information, Bob, with

1 respect to the price formulas that your members
2 use in selling their cheddar cheese? Not
3 prices, per se, but, you know, price formulas

4 A. As a matter of fact, on advice of counsel,
5 I don't discuss terms of trade that our members
6 have with their customers or their suppliers
7 either one, for antitrust reasons

8 Q. I wasn't asking for price levels or prices.

9 A. Well, that's terms of trade, when you get
10 into what formulas they are using to purchase
11 milk, and no, we don't talk about that.

12 Q. Well, your testimony said that, with
13 respect to the CME pricing question, I mean, you
14 testified that apparently their terms of trade
15 or price levels, you said they can't pass on
16 their increased costs with CME plus, didn't you
17 testify to that?

18 A. That was my understanding of general level
19 of markets, is that you can't do that, because
20 your customers have opportunities to go to the
21 CME or elsewhere for that product.

22 Q. So that was only -- the only basis for that
23 testimony was just general knowledge that the
24 CME is there as an option for that product?

25 A. Yes, it was. And I know that at least one

1 of our members is considering testifying at the
2 reconvened hearing on that topic. And I believe
3 others may also, after hearing about the
4 interest in that this week.

5 Q. Do you not know from general knowledge, not
6 from your members, that cheddar cheese, it is
7 known and accepted that cheddar cheese is sold
8 on prices off the CME, CME plus or minus?

9 A. I have seen that reported in trade news
10 reports often, yes.

11 Q. Do you have any reason to doubt that?

12 A. No.

13 Q. You have raised a concern with respect to
14 one of the proposals, I am not sure which one,
15 the proposal to eliminate barrels from the
16 series. I believe, that it would negatively
17 impact the risk management options that the
18 industry has.

19 A. Not to eliminate barrels, to do the energy
20 adjuster.

21 We have no position on eliminating barrels.

22 Q. It was -- I stand corrected, it was with
23 respect to the energy adjuster. Is that your
24 only -- that was your only, in your direct
25 testimony, as I reviewed it, and heard it, that

1 was your only basic objection to the energy
2 adjuster?

3 A. It was in my direct.

4 Q. Okay.

5 A. That's correct.

6 Q. And is that your members' only objection to
7 the energy adjuster, the apparent contention
8 that it would somehow affect risk management
9 ability?

10 A. I also have concerns about the time frame
11 in which that would be done.

12 I did testify about some issues I have on a
13 similar thing USDA does with respect to farm
14 costs of production, where they do a survey
15 every four to eight years, and then they use
16 general levels of indexes to update; and USDA's,
17 ERS's Web site notes that, you know, by the time
18 they do a new survey, the use of those indexes
19 have not been incorporated in firm level
20 decisions that have adjusted input use due to
21 changes in relative prices.

22 So I do have concerns that the longer you
23 do that, the more opportunity to have that make
24 allowance be not reflective of what is actually
25 going on, and I believe that that should be

1 adjusted at hearings, not automatically

2 It is similar to our opposition to, I
3 believe it was Proposal 2 that called for
4 automatic updates

5 Q. Well, energy prices are, by far, the most
6 volatile input factor in cost of processing
7 dairy products, are they not?

8 A. Well, I haven't looked at all costs of
9 impact. Maybe my members can. But obviously
10 energy impacts costs of transportation, costs
11 of -- and perhaps, you know, that is not
12 reflected as an energy cost. It can affect
13 packaging, it can affect plastics that are used
14 in the system. So you are right, energy is the
15 underlying factor, but it may not show up in the
16 individual cost items.

17 But over time, if prices are radically
18 different, firms adjust their relative input
19 uses to reflect changes in those relative input
20 costs in the industry.

21 Having a comprehensive make allowance
22 survey will incorporate that. And that is why
23 we are in favor of USDA conducting an annual
24 survey that would incorporate those factors

25 Q. Well, with respect to, you know, just fuel

1 and electricity, natural gas and electricity.
2 which are the two main, if you look at the
3 California data, or even Stephenson data, they
4 are the two main energy cost factors.

5 A. I am not disagreeing with that. Marvin.

6 Q. Okay. What is the change likely to be, the
7 change in the ratio of using electricity versus
8 natural gas among -- in the industry, is that --

9 A. Well, that is not the only thing that
10 changes. The other thing that changes is plant
11 volumes change from year to year. It could be
12 based on milk supply, it could be based on
13 demand, it could even be based on higher energy
14 cost and making products that have lower energy
15 input usage, all of which will change the
16 average cost of processing in the plant.

17 That would be picked up in an annual survey
18 of all those costs.

19 Q. These are direct variable costs. I mean.
20 the cost of natural gas per pound of powder is
21 not going to change much with the volume in the
22 plant, is it?

23 A. Well, it depends what else you are using
24 the natural gas for in the plant, Marvin.

25 If it is only used for the dryer, when the

1 dryer is operating with their startup and
2 shutdown and if you are processing a lower
3 volume, the cost per unit -- or a higher volume.
4 the cost per unit would be lower.

5 I believe the best way to monitor the
6 changes in make allowances due to changes in
7 various cost factors is to do a comprehensive
8 study of it, and not use indices.

9 For example, if we, you know, had that
10 comprehensive survey every year, I am not sure
11 we need to do the within-year energy updaters.
12 But if we didn't have that survey every year.
13 and, you know, we were back, like in this case
14 seven years or six years after the make
15 allowances, for six, seven years, I would have
16 real concerns about using indices on only one
17 part and ignoring price changes that are going
18 on in other parts. Because, you know, labor
19 costs change. It is not that they don't change
20 they do change, and benefit costs associated
21 with those change.

22 So there are other factors that change
23 there, and it is IDFA's opinion that that would
24 be better captured in monitoring the total cost
25 of processing

1 Q. But for now, and the total cost of
2 processing that you are advocating that USDA
3 adopt in this hearing is going to lock in the
4 natural gas price, for instance, at the highest
5 price it has been for whatever -- probably ever
6 at the late 2005 prices, correct?

7 A. The data that CDFA used was for calendar
8 year 2005 is my understanding, so that would
9 reflect costs for during that entire year.

10 Dr. Stephenson indicated that the majority but
11 not all was between July of 2005 and June of
12 2006, some of which came after, some of which
13 came before.

14 Q. July of 2005 and June of 2006, are you sure
15 about that? Wasn't it July of 2004 and June of
16 2005 in Stephenson's stuff?

17 A. Perhaps it was. So that wouldn't even
18 incorporate the high costs in late 2005.

19 Q. But CDFA does?

20 A. But also, for that portion, particularly
21 the fourth quarter, that is one of the four
22 quarters that are included in that CDFA data

23 Q. Well, the whole year of 2005 is high?

24 A. Well, it is high because of the fourth
25 quarter, yes. I mean, earlier in the year.

1 there was a drastic runup, and in the second
2 half of the year peaking in the fourth quarter.

3 Q. And when we use that data, we are going to
4 look that in, even though those prices of
5 natural gas have declined since that time?

6 A. And I certainly hope USDA adopts the
7 portion of Proposal 2 that requires annual
8 updated allowances and hopefully will get data
9 for the following year and the following year.
10 and if the change is significant enough, and if
11 someone wants to petition for a hearing. I am
12 hopeful that is exactly what that data will
13 provide to us, so we can look at how that spike
14 impacted the overall cost of processing.

15 MR. BESHORE: Thank you.

16 JUDGE PALMER: Mr. Vetne.

17 CROSS-EXAMINATION

18 BY MR. VETNE:

19 Q. John Vetne here for Agri-Mark and others.
20 Good morning, Bob.

21 A. Good morning, John.

22 Q. In your testimony in opposition to Proposal
23 2, you indicate that the principal problem and
24 perhaps the only problem you have with that is
25 that make allowances would be adjusted

1 automatically without hearing?

2 A. That's correct.

3 Q. With respect to that reason for opposition
4 would it satisfy your needs as an IDFA economist
5 if the update would follow a notice and comment
6 similar to that used in the fruit and vegetable
7 program, after the basic parts of the order have
8 been established, so that USDA would publish the
9 survey results and invite notice and make
10 notice, and invite comments on applying that for
11 the future, without coming to a place like
12 Strongsville and allow for, among other things
13 advocates to comment that there is a factual
14 component here that is in serious dispute and we
15 really need to go to hearing on that part, but
16 without such assertion of a factual dispute, the
17 comments and the policy implications would be
18 sufficient? Do you see a problem with that?

19 A. We have discussed this, the whole concept
20 of notice and comment. And actually, there is
21 I think, a general level, a consensus of support
22 for nonsubstantive changes for orders to be done
23 through notice and comment. However, we haven't
24 identified all of those issues that we feel
25 would be reflective of that.

1 Certainly a substantive change is changing.
2 for instance, from the BFP to product price
3 formulas. But once product price formulas are
4 adopted, I see no reason why factors like
5 updating make allowances, using exactly the same
6 data that was used to establish the make
7 allowances at the last hearing, couldn't be done
8 through something like a notice and comment
9 procedure. I personally would be supportive of
10 that.

11 Q. All right. You were asked some questions
12 yesterday by Mr. Yale concerning neighboring
13 hypothetical plants, one having a manufacturing
14 cost of 14 cents per pound to make cheese and a
15 neighbor having a manufacturing cost. I think it
16 was of 20 cents.

17 Do you recall that series of questions?

18 A. Actually, I still have that on my notes
19 from yesterday, yes.

20 Q. Okay. And I think the scenario with which
21 you agreed was that whether the manufacturing
22 allowance stays at 16.5 or is raised to 20
23 cents, the plant that can produce cheese for 14
24 cents a pound is going to expand, or maybe
25 create a new plant and it is going to capture a

1 greater share of the market, correct?

2 A. They certainly would have an incentive to
3 do so. And I would expect if they didn't do it
4 someone else would see what is going on in the
5 market and become a new entrant into the market
6 following their model, yes.

7 Q. And eventually the plants that are able to
8 continue to produce at 14 cents would dominate
9 that market?

10 A. Absolutely. And my testimony tried to lay
11 out that that is exactly what used to happen.
12 It just happened only in the Upper Midwest in
13 the M&W price series marketing area for Grade B
14 milk.

15 But plants that had more money would be
16 competing in the marketplace and using that to
17 lure milk to its plant or using it to make
18 investments that expanded or even invested in
19 new plant and equipment for the plants. And I
20 would expect the same thing would happen here.

21 The market used to do that, and that is why
22 it is so critical for USDA not to put them out
23 of business because of the regulated pricing
24 structure, to leave room for the market to work

25 Because in some areas of the country, you

1 can't plop down a cheese plant that can take.
2 you know, millions of pounds of milk a day.
3 There is not that available milk supply to put
4 into that plant, based on its structure.

5 But at the same time, if plants in regions
6 that tend to have higher costs of processing
7 because they are smaller plants, it is older
8 technology, a variety of reasons, they can't go
9 out of business overnight, because that milk has
10 nowhere to go.

11 Over time, it will either attract that
12 newer, more efficient plant capacity in there.
13 or milk will be pulled away to other regions of
14 the country where that capacity exists.

15 But that ought to be done through the
16 market, not strictly based on the regulatory
17 minimum prices.

18 Q. And with respect to that scenario that we
19 just discussed and that you discussed with Ben
20 to the extent that there are plants that have
21 that kind of variation, whether neighboring or
22 across the country, if USDA conducted an annual
23 manufacturing cost survey, the survey would
24 reflect the increasing proportion of milk
25 produced at the lower cost, and therefore.

1 capture more of that lower cost into its survey
2 results?

3 A. Absolutely. Because that would be a
4 greater volume of cheese running through those
5 more efficient plants and, therefore, that would
6 make up a greater share of, in this case, the
7 make allowances, the cost of processing data
8 going into the make allowance calculation.

9 Q. In response to one of my recent questions.
10 you talked about what used to happen in the
11 Upper Midwest when we had M&W series. Let me
12 follow up on that a little bit.

13 Prior to 2000, when the M&W or the BFP were
14 in place, there were instances, as there have
15 been in recent years, in which some cost input,
16 such as energy, spiked or declined. Would you
17 agree with that?

18 A. I haven't looked at the data, but I find it
19 difficult to believe that there weren't
20 instances where prices went up and prices went
21 down for input costs like energy

22 Q. Do you recall a time prior to 1990, when we
23 all used to stand in lines, or sit in our cars
24 in lines to get gas?

25 A. That is a long time ago, like the mid '70s

1 but, yes, I do remember that.

2 4. And during those times, Upper Midwest
3 plants that were included in the M&W and BFP
4 surveys had the opportunity to recapture some of
5 their costs lost when costs spiked, recapture
6 some of those costs when the situation turned
7 around?

8 A. The opportunity, yes, depended on the
9 competition for milk in their market. But, yes.
10 the opportunity existed, because there was not a
11 fixed margin allotted to them under the product
12 price formula.

13 Q. So, for example, if costs all of a sudden
14 increased, the plants might or might not,
15 depending upon competition, lower pay prices to
16 producers in response to those higher costs?

17 A. Correct.

18 Q. And if they could not, because of
19 competition, lower prices to producers at that
20 point, they might reflect it in prices at a
21 later point, capturing their losses for one
22 period with extra gains in another period?

23 A. Well, it could also be reflected by the
24 least efficient plants stopping production and,
25 therefore, having a change in the market on the

1 other side, too, or less competition for milk
2 with fewer number of buyers available for milk.
3 So there are a lot of factors that play into
4 that. But, sure.

5 Q. You have been here throughout the hearing?

6 A. Yes.

7 Q. You have heard testimony concerning
8 producer costs?

9 A. Yes.

10 Q. And how producers were able, during 2004
11 and 2005, to pay off their debt and make
12 improvements and cover some of their losses from
13 prior years?

14 A. Or to prepare for future low price years,
15 because milk prices, high prices tend to correct
16 themselves and low prices do also at the farm
17 level.

18 Q. Okay. question to you is, isn't that
19 kind of dynamic from year to year, more profit.
20 less profit, plant the nest egg, draw from the
21 nest egg, the same kind of dynamic in which the
22 M&W price functioned?

23 A. Well, any business that is in business for
24 the long run doesn't look at one year or one run
25 or one quarter. It looks at a longer time frame

1 in how it is covering its costs, and what it can
2 do in the short run has a lot of factors. It
3 can involve nothing on the production side, it
4 can involve the financing side, or the return
5 that they are getting adjustments, in
6 anticipation that they will make that up at a
7 later date when the conditions are different

8 Q. Is the answer "yes," a similar dynamic?

9 A. Yes.

10 Q. And the fixing of a manufacturing allowance
11 in regulation in concrete, now, has interfered
12 with the operation of that dynamic in the
13 marketplace?

14 A. Yes.

15 Q. And that is why you testify that it is
16 dangerous to err on the low side?

17 A. Yes, because it will bring part of that
18 marketplace dynamic back.

19 Q. You were asked some questions yesterday
20 about the opportunity of manufacturers, for
21 example, to hedge the cost of energy. Do you
22 recall that?

23 A. I don't believe I was asked any questions
24 on that, hedging energy costs. Dr. Cryan was
25 asked some questions on that.

1 4. Dr. Cryan was asked some questions.

2 A. No, maybe somebody else. I was not asked
3 those questions. I don't recall.

4 Q. You weren't asked questions about IDFA
5 policy in encouraging the liquidity of the
6 markets?

7 A. The markets, yes, on the dairy contract
8 price.

9 Q. Okay.

10 A. And on energy, yes.

11 Q. Well, those hedging opportunities for dairy
12 products are available to dairy manufacturers
13 also?

14 A. Yes.

15 Q. To the extent that they relate to hedging
16 against class prices and manufacturing
17 allowances, those hedging opportunities also
18 come with a cost. correct?

19 A. A transactions cost, yes. And also there
20 are limits. It is a little different for
21 processors than it is for farmers, because of
22 the sheer volume of the milk and the product
23 that they are processing. And in some cases
24 there are trading limits and that is one reason
25 why we have policy to encourage liquidity in the

1 markets and raise the trading volume, so that
2 those limits are not as severe on any one
3 player.

4 Q. Mr. Beshore asked you some questions, or
5 asked you one question -- let me see if I have
6 got it right. If you measure the components of
7 incoming milk and go to the end and measure the
8 volume of marketable product that is sold, and
9 apply the value of that marketable product to
10 the incoming milk, you have accounted for all
11 the losses that occurred in between?

12 A. I don't recall value as part of it. I
13 thought it was just the components and the milk
14 weights, volume. But, yes, you would have
15 accounted for it entirely on that basis. I
16 believe.

17 Q. It would apply to value also, wouldn't it?
18 If you account for the dollars that come from
19 the finished product sold and apply that to the
20 components and incoming milk, you have accounted
21 for everything in between the stream?

22 A. I believe so.

23 Q. Okay. So, for example, in protein, we had
24 some testimony yesterday that there are
25 approximately 3 pounds of protein in a

1 hundredweight of milk?

2 A. Of 3.5 milk, yes.

3 Q. You would agree with that. So if at the
4 end of the day, when a manufacturer receives
5 incoming milk at 3.0 protein and sells cheese
6 which in the aggregate from that hundredweight
7 of milk contains 2.9 pounds of protein, rather
8 than 3, if you take the value of that 2.9 pounds
9 of protein and spread it over the 3 pounds of
10 incoming milk, you have accounted for the losses
11 in between?

12 A. I believe so

13 Q. But in that instance, you have not
14 accounted for the lower value of inevitable
15 downgrade, if you apply the surveyed price to a
16 hundred percent of the cheese?

17 A. You would have to apply the actual value on
18 the products to do that. And if some of it was
19 of lower value, that would be part of going into
20 that total value calculation, I agree with that.

21 Q. Look for the total value of all the product
22 produced, and apply it to the total components
23 of all incoming milk?

24 A. Yes.

25 Q. Otherwise, you risk overstating the value

1 and understating the make allowance?

2 A. Well, certainly overstating the value of
3 that milk at the farm bulk tank. I don't
4 believe the price or the value of the outputs is
5 in any way part of that make allowance cost of
6 processing calculation. The yield, the volume
7 yield would be.

8 Q. The volume yield, but we start with the
9 price and try to translate the price received to
10 the price you have to pay?

11 A. Yes, but it is not part of determining
12 that.

13 Q. It would be an adjustment in the price
14 factor?

15 A. Now you are losing me. Maybe I need to go
16 back to the --

17 Q. Let's go back then. If --

18 A. I was with you until you included the make
19 allowance, and I am not sure where that factors
20 in.

21 Q. All right. Let's go to the finished
22 product then. In order to determine a pay price
23 to dairy farmers, you need -- for product price
24 purposes, you need to know the value of the
25 finished product by some method?

1 A. Yes.

2 4. And what we now have is a NASS survey
3 method for all of those products, correct?

4 A. Yes.

5 Q. If 99.5 percent of cheddar cheese, for
6 example, produced by a typical plant is sold at
7 NASS prices, and .5 percent of cheese in the
8 typical plant is sold at a downgrade price, you
9 have attributed more revenue to the plant than
10 you should?

11 A. If you priced it at a hundred percent of
12 the NASS price, that's correct.

13 Q. Okay. So somewhere in the translation of
14 revenue received to prices required to be paid,
15 an adjustment should be made for the fact that
16 some cheese is sold at a lower revenue?

17 A. Now I understand your question, and, yes, I
18 would agree with that.

19 Q. And that can be made anywhere along the
20 formula line?

21 A. It could be made anywhere. USDA has, up
22 until now. I believe, tried to make that in the
23 yield factors, and our testimony is consistent
24 with that.

25 But I suppose you could make it in the make

1 allowance. One way of doing it would be.
2 instead of looking at the total volume, only
3 look at the volume that was not off-grade, that
4 would be another way of doing it. So you would
5 be dividing total costs by a lower market -- I
6 would have to think about that.

7 Q. You could adjust it at the assumed price
8 received, that is, in the survey price, you
9 could adjust it in the yield or you could adjust
10 it in the make allowance?

11 A. Yes, you could.

12 Q. At some place along the way?

13 A. Yes.

14 JUDGE PALMER: All right. Fine
15 Mr. Schaefer.

16 CROSS-EXAMINATION

17 BY MR. SCHAEFER:

18 Q. In previous hearings, we have had some
19 discussion on the dry whey make allowance, and
20 the proponents at that time indicated that the
21 dry whey value was 2 112 cents greater than the
22 nonfat dry milk as far as the make allowance
23 It cost 2 112 cents more to produce dry whey
24 than nonfat dry.

25 In your Table 1, you indicate --

1 California, CDFA, has a 28 1/2 cent make
2 allowance and an 18.72 make allowance. How
3 would you reconcile the difference, that 10-cent
4 difference?

5 A. Well, we didn't have the data on total cost
6 of processing whey. The 2 1/2 cents you are
7 referring was testimony in May of 2000, based on
8 data prior to that. I don't even remember the
9 exact time period that it is.

10 But we didn't have any other data to use at
11 that time. And as I recall that testimony, it
12 was looking at, from an engineering standpoint
13 the differences because of the lower solids
14 content in whey, so there is more drying
15 involved, the fact that there was a two-stage
16 process to crystallize lactose.

17 It was only looking at incremental costs,
18 it was not looking at whey plants. This is
19 looking at whey plants. You are so far off from
20 apples and oranges here, this is actually
21 looking at what whey plants' cost of processing
22 is.

23 Q. I guess when I referred to 2 1/2 cents.
24 that was also testified to a year ago in January
25 at the hearing in Alexandria.

1 But I guess then, what you are really
2 saying is that was basically some sort of
3 estimation process and that the actual plants
4 have shown significantly different costs than
5 that, and I guess, do you have any idea what.
6 besides some sort of estimation process and an
7 actual cost, where those cost differences could
8 be derived from?

9 A. It could be in the volume of the plants. I
10 don't know, because I haven't -- you know, I
11 don't run whey plants. I don't know the
12 difference.

13 But that could be plant volumes. As I
14 recall, also from the last year's hearing, since
15 you bring it up, there were a number of plants
16 that have to move whey long distances, whereas
17 in most cases, you are not moving milk from one
18 facility where it is a byproduct of something
19 like cheese making to a nonfat dry facility.
20 where it is being dried. But in whey, there
21 were costs of moving that were testified to. So
22 that would add there also

23 Q. You indicated support of a portion of
24 Proposal 2 that would conduct an annual survey
25 or I think you mentioned maybe biannual or

1 annual or some other regular survey.

2 A. I did mention biannual.

3 Q. But a regular survey. And one of the
4 things you mentioned when you discussed that was
5 that you particularly liked the CDFA data and
6 the retention of the CDFA data. because it was
7 audited and covered the entire population -- not
8 the entire, but a very large percentage of the
9 population of plants in California

10 A. That's correct.

11 Q. The question then is, are you suggesting
12 then that USDA, if Proposal 2 goes -- that
13 portion of Proposal 2 which you are supporting
14 would go into a decision, that the USDA should
15 survey the population of plants and, of course,
16 have it be conducted and audited similar to the
17 California or CDFA procedure?

18 A. I believe in cross yesterday. I indicated
19 that, unless USDA did that, I would still have
20 more confidence in using audited data from CDFA
21 in weighting with the non-California survey in
22 order to determine make allowances. It is kind
23 of a check factor that goes in there. because it
24 is audited data and it does represent almost the
25 population. It is just a survey.

1 It is an enumeration. I ~~am~~ not necessarily
2 recommending that to USDA. I ~~am~~ looking forward
3 to seeing how USDA, if they adopt that proposal.
4 what the regulation looks like, what the rule
5 looks like on that, and then commenting on that
6 Q. I guess along that line then, other people
7 have testified to a survey versus the
8 population. Do you have any opinion as to which
9 you would be supportive of?

10 A. I don't think I could know that without the
11 costs involved. There are a lot of factors that
12 would go into that. I think surveys are very
13 valuable pieces of information. In this case,
14 you are surveying something that is now going to
15 be used in regulated minimum pricing. It is
16 nice to have audited data when you do that, to
17 ensure, entirely ensure its accuracy.

18 We do have that from CDFA. And I believe
19 that, at least initially, that is enough of a
20 check to have in the system against what is
21 going on in the rest of the country

22 If your survey data starts to look wildly
23 different than what is going on at CDFA, perhaps
24 even spot audits would address that. But we
25 really haven't discussed anything beyond a

1 limited survey at this point at IDFA.

2 Q. You talked a little bit in response to some
3 questions by Mr. Beshore, who brought up an
4 example that was presented by Mr. Yale the day
5 before. on 16 cents, and a make allowance of 16
6 cents and plant costs of 14 cents.

7 I thought I would look at that for just a
8 minute. I am going to change the example just a
9 little bit to fit the examples that you put into
10 your testimony.

11 And the question goes along with if you
12 have got a cheese price, which you used in your
13 examples of \$1.40 and a 20-cent make allowance.
14 you concluded that the firm, the processor,
15 would pay \$1.20 to its producers, basically with
16 the locked in make allowance of 20 cents.

17 If the particular processor had a make
18 allowance of 15 cents and you put it into this
19 example, then, of course, if you sell the cheese
20 at \$1.40, the fixed price make allowance is 20
21 cents, or the fixed make allowance is 20 cents.
22 and he still pays \$1.20 for the milk. but it
23 only costs him 15 cents. So you have an extra
24 nickel there.

25 How do you foresee that plant utilizing

1 that extra nickel?

2 A. Well, he pays that \$1.20 in regulated
3 minimum. He could use some of that to procure
4 more milk to run his plant more. He could use
5 that to invest in a second plant, because he is
6 more efficient; and if it is a cooperative
7 plant, it would be returned through its members
8 through the revolving capital retains.

9 4. And certainly with the competitiveness that
10 this plant would have against other plants, he
11 would have a competitive advantage; and if he
12 increased production, expanded production or new
13 entrants even came into the industry, that would
14 be to the long-term detriment of plants with
15 significantly higher costs?

16 A. I would agree with that statement.

17 MR. SCHAEFER: Okay. Thank you
18 very much, Bob.

19 JUDGE PALMER: Mr. Rosenbaum.

20 CROSS-EXAMINATION

21 BY MR. ROSENBAUM:

22 Q. Dr. Yonkers, a couple of clarifying issues
23 In response to some questions, I think from
24 perhaps Mr. Vetne, you were asked about how the
25 current formulas account for various factors.

1 whether **it** is in the yield factor, whether **it** is
2 in the make allowance, et cetera. Do you recall
3 that?

4 A. I recall that.

5 Q. I think you made the statement that with
6 respect to what I would call off-spec product,
7 that that would be an issue that, under the
8 current approach to things, would be dealt with
9 in the yield factor; is that right?

10 A. **It** is not dealt with in the yield factor.
11 But USDA has considered differences in values
12 related to outputs, things like the difference
13 in value of dry buttermilk versus nonfat dry
14 milk that come out of butter, by adjusting the
15 yield factor. Therefore, I believe that is
16 probably the way **it** should be done now.

17 Q. But you are not suggesting that particular
18 issue is currently captured by the --

19 A. No, not currently captured.

20 Q. You are advocating that **it** be captured,
21 correct?

22 A. That **it** be considered, yes.

23 MR. ROSENBAUM: That is all I have.

24 JUDGE PALMER: Mr. Beshore.

25

1 CROSS-EXAMINATION

2 BY MR. BESHORE:

3 Q. Just a couple other points, Bob. On the
4 price lag, CME/NASS price lag issue, you
5 indicated that your members are sympathetic to
6 that issue, I think.

7 A. Yes, I did.

8 Q. Can you elaborate on why? I mean, what
9 problems does that cause presently in the
10 system?

11 A. I think some of our members would prefer
12 that on a weekly or daily basis, that their
13 output price matched their input cost. One of
14 the problems is not knowing your input cost
15 until after the fact, because prices for Class
16 III are not announced until on or before the 5th
17 of the following month. It is an issue and they
18 would like the prices to be as current as
19 possible when they are manufacturing. I think
20 that is what is driving it.

21 Now, they have to balance that against the
22 fact that the CME price is related to a Chicago
23 price; and Mr. McCully in his testimony will
24 talk about how there are numerous transactions,
25 if the CME reports a price of \$1.30. the actual

1 price that changes hands is below \$1.30 and he
2 is going to testify to that. So that has
3 different issues related to accurately
4 representing the actual transactions price.

5 Our members like the fact that NASS does
6 that. They just wish it were not published on
7 Friday for the week ending the following
8 Saturday. They wish it could be done in a more
9 rapid manner, to process that data, to get that
10 data in and process it.

11 Q. But the basic issue relates to matching
12 selling price with product cost?

13 A. They would like to do that, yes.

14 Q. You made the comment that I wanted to ask
15 you about before, and I forgot to.

16 On page 9 of your testimony, that the
17 recent vote in the Upper Midwest order, which
18 you understand nearly resulted in termination of
19 that order, was a direct result of the
20 considerations you have outlined with respect to
21 make allowances

22 None of your members vote, or -- what is
23 the source of that information, I guess is my
24 question?

25 A. News reports. But we do have several

1 members who are cooperatives in the Upper
2 Midwest who informed me that they had voted
3 against the recent tentative decision.

4 Q. And for the reasons that you have stated
5 here?

6 A. That the make allowances were not
7 sufficient, that the product price formulas were
8 not sufficient to allow them to cover all their
9 costs of processing, and as a result, their
10 members were forced to take a lower return on
11 their milk than others in the market that did
12 not have investments in manufacturing
13 facilities.

14 Q. In other words, it is your understanding
15 that your members thought -- in the Upper
16 Midwest thought the class prices in the system
17 have been too high?

18 A. The word they use is "broken."

19 Q. One final question. This is kind of on the
20 topic I started with yesterday.

21 You are advocating the use and really
22 touting the CDFA data, which is based on the
23 cost of producing blocks only, correct, and
24 adjusted to reflect the cost of blocks only, in
25 a state pricing system which uses only blocks to

1 price for the, you know, for the product cost.
2 correct?

3 A. Correct

4 Q. Okay. You are advocating that in the --
5 that be applied to the Federal system, where.
6 you know, the proposal that IDFA has and its
7 testimony advocates continued use of the barrel
8 volumes. Can you reconcile those things?

9 A. Well, first of all, we did not take a
10 position on the proposal to eliminate barrels.
11 We have proposals to --

12 Q. I understand that.

13 A. -- to change that adjustment.

14 Q. But your proposal would eliminate any
15 barrel adjustment?

16 A. That's correct. Oh, yes. I would prefer
17 that -- and we did ask CDFA, and I believe I
18 answered this yesterday, we would like to know
19 what those adjustments are; and they were unable
20 to -- or declined to run that calculation and
21 really couldn't even tell us how much it meant
22 in their make allowances.

23 The best thing would be to actually know
24 what that information is and adjust that. I
25 would like that.

1 Q. Well, is there any question in your mind
2 that it is an upward adjustment in their
3 announced make allowances?

4 A. I don't know that answer, and we will have
5 a representative from Davisco will be testifying
6 to their difference in costs between those two.
7 and it is so tight that I ~~am~~ not positive there
8 is a difference anymore, or which way it goes.

9 Q. Well, is there -- are you saying that you
10 think the CDFA cost data for blocks, if it was
11 not adjusted for blocks only, might actually be
12 higher?

13 A. They were unable to tell me what direction
14 or what that adjustment is. So I ~~am~~ not going
15 to presume what it is, based on the data that I
16 have seen from a witness we will have at the
17 reconvened hearing.

18 Q. Have you seen data from any other
19 companies? Have you heard anything in this
20 hearing record or past hearing records that it
21 costs more to produce barrels than blocks?

22 A. I have never seen actual cost data on
23 blocks versus barrels, perhaps with the
24 exception of the most recent rural business
25 cooperative service that was testified to last

1 year at the make allowance hearing, but there
2 was no adjustment for differences and other
3 variables like plant size or other things that
4 were going on there. So I have never seen any
5 actual plant data on what **it** costs at any of
6 these hearings on blocks and barrels.

7 I have heard people say **it** is 3 cents. But
8 they have not submitted any actual cost data to
9 demonstrate that.

10 Q. But in the prior round of hearings, when
11 the 3 cents was generated, the testimony
12 enumerated various cost factors?

13 JUDGE PALMER: Let's not get too
14 much into another hearing. He basically said he
15 doesn't know. but he heard 3 cents.

16 BY MR. BESHORE:

17 Q. And that came from the 2001, 2000 --

18 A. May of 2000 testimony.

19 Q. May 2000 testimony. Okay. Thank you.

20 JUDGE PALMER: Are we complete
21 with this witness? One more?

22 MR. ROSENBAUM: I just want to
23 follow up.

24 JUDGE PALMER: I would like to
25 break as soon as we complete the witness, and I

1 would like to make **it** a short break.

2 CROSS-EXAMINATION

3 BY MR. ROSENBAUM:

4 Q. So briefly on this CDFA issue. First of
5 all, you have stated that there will be a
6 witness providing direct testimony that there is
7 no difference between blocks and barrels, the 3
8 cents is not true, correct?

9 A. Yes.

10 Q. And then on the last page of your
11 testimony, am I correct that on a weighted
12 basis, that CDFA cheese data only represents, if
13 you will, a 22 percent input into the cheese
14 make allowance: is that correct?

15 A. Of the weighting, yes, that's correct.

16 Q. And the remaining 78 percent comes from the
17 Cornell study, correct?

18 A. That's correct.

19 Q. And that study included both blocks and
20 barrels, correct?

21 A. That's correct.

22 Q. So to the extent that there is a difference
23 between the cost of blocks versus barrels. that
24 is captured in that portion of the make
25 allowance data?

1 A. The data that went into determining the
2 make allowance, that's correct.

3 MR. ROSENBAUM: That is all I have.
4 Thanks.

5 JUDGE PALMER: Are we okay to let
6 the witness go? Thank you very much, sir.

7 We are going to take a short recess,
8 and by that I mean, you know, come right back.

9 (Thereupon, a recess was taken.)

10 MICHAEL McCULLY

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

13 (Thereupon, Exhibit 26 was marked for
14 purposes of identification.)

15 JUDGE PALMER: Back on the record.
16 I just administered the oath to Mr. McCully.
17 And he has handed me his statement and we have
18 marked **it**, the reporter has marked **it** as Exhibit
19 26. Yes. sir. Mr. Rosenbaum.

20 MR. ROSENBAUM: Mr. McCully, you
21 have a prepared statement that has been marked
22 as Exhibit 26, if you could read that for us.
23 please.

24

25

1 STATEMENT FOR THE RECORD AND
2 DIRECT EXAMINATION BY MR. ROSENBAUM
3 MR. McCULLY: Thank you. My name
4 is Mike McCully, Associate Director of Dairy
5 Procurement at Kraft Foods. I am testifying on
6 their behalf. I have worked for Kraft over 10
7 years and currently have responsibility for U.S
8 milk procurement, U.S. and global dairy market
9 analysis and price forecasting and U.S. dairy
10 commodity risk management. Kraft is a member of
11 the International Dairy Foods Association, and
12 this testimony supports IDFA's position and
13 proposals.

14 Kraft is both a manufacturer and
15 purchaser of dairy products used in our retail
16 and food service businesses. Kraft has
17 manufacturing facilities and buys milk in the
18 following states: New York (Lowville, Campbell
19 and Walton); Pennsylvania (Lehigh Valley);
20 Wisconsin (Beaver Dam); Missouri (Springfield);
21 Arkansas (Bentonville); and California (Tulare
22 and Visalia).

23 Kraft also has other facilities that
24 receive dairy commodities, for example, cheese,
25 cream and NFDM, for the production of products.

1 such as process cheese, natural cuts and shreds.
2 frozen pizzas and macaroni and cheese. For
3 these facilities, we procure cheese from
4 California, Idaho, New Mexico, Colorado, South
5 Dakota. Iowa. Wisconsin, Minnesota. Illinois.
6 Michigan, New York and Vermont, as well as
7 import cheese from New Zealand and Australia.

8 Kraft has closed or sold many
9 manufacturing plants over the last 25 years, and
10 relies increasingly on dairy products we
11 purchase from others.

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

16 Pricing Class III Fat. Fat pricing
17 issues in this hearing include how much milk is
18 lost in shrinkage between the farm and the plant
19 and how to value that fat not recovered in
20 cheese, but which comes out in the whey. I will
21 address each of these.

22 Farm-to-Plant Milk Loss. Like all
23 plants, we also experience loss of fat between
24 the farm-gate and our cheese vat or from
25 farm-gate through someone else's separator to

1 our vat in the form of cream.

2 All this milk must be accounted for
3 at the Class III price, not just the milk that
4 ends up in the vat. Therefore, any yield or fat
5 recovery expressly or implicitly included in the
6 formula must account fully for shrinkage between
7 the farm and the vat, so that the yield or fat
8 recovery is not artificially or arbitrarily
9 inflated.

10 The Valuing of Whey Cream. The
11 current price formulas set the minimum milk
12 price by starting with the price obtained by
13 processors for their finished products. The
14 current formula assumes butter made from whey
15 cream has the same price or value in the
16 marketplace as Grade AA butter, but this is not
17 supported by data.

18 It is also incorrect to assume that
19 whey cream should be valued highly, because it
20 can just be added back into every cheese vat.
21 In fact, Kraft does not allow the addition of
22 whey cream for most of the cheddar cheese that
23 we buy.

24 BY MR. ROSENBAUM:

25 Q. Mr. McCully, let me just interrupt you

1 there, because there has been some focus on this
2 issue of whether or not whey cream can be simply
3 added back to the cheese vat.

4 Can you give us in percentage terms how
5 much of the Kraft cheese **it** is permitted to
6 allow the whey cream -- **it** is permitted to add
7 the whey cream back into the cheese vat?

8 A. **It** is a small number. There is roughly
9 only between 10 to 15 percent of the total
10 cheese that we buy that we allow whey cream to
11 be added back in.

12 So the majority, over 85 percent of the
13 cheese that we buy, we do not allow whey cream
14 to be added into the vat

15 Q. Thank you, please continue.

16 JUDGE PALMER: Would you give us
17 the reason why you don't?

18 THE WITNESS: Probably the main
19 reason is quality, quality issues

20 On page 3, the fat that is not
21 recovered in cheese, but is sold instead in whey
22 cream or whey butter does not command a market
23 price equal to fat and AA butter. Whey cream
24 and butter are equivalent to Grade B butter,
25 since whey cream cannot be used to produce Grade

1 AA butter. Back when all three grades of butter
2 traded at the Chicago Mercantile Exchange. Grade
3 B butter was about 7 cents less than AA butter
4 during the seven-year period from 1991 to 1997,
5 but the spread widened to about 10 cents in the
6 last two years of B market trading in 1997 to
7 '98.

8 While the CME Grade B market no
9 longer exists, Grade B butter is still bought
10 and sold.

11 Kraft's experience in selling whey
12 cream suggests this 10-cent discount to the AA
13 market still exists. One of our butterfat
14 suppliers from California also sells Grade B
15 butter for a 10-cent discount to the AA market.

16 In addition to the lower valued whey
17 cream, there is also fat in the whey stream that
18 ends up in whey powder and other whey products.
19 According to USDEC specifications, sweet whey
20 powder contains 1.0 to 1.5 percent fat. In
21 summary, the fat in whey is of lower value than
22 Grade AA butter, and the Secretary should revise
23 the current formulas to account for that lower
24 value, based on all of the evidence presented at
25 the hearing on the amount of that lower value

1 Continued Use of NASS Prices. Kraft
2 supports the continued use of the NASS survey
3 prices in the milk price formulas. Even though
4 this represents prices for only one-third of all
5 cheese produced in the country, it represents
6 significantly more volume than the CME market
7 and is national in scope.

8 Reliance on the CME prices alone
9 would measure from a thinner market and exclude
10 the substantial and growing volume of cheese
11 produced in the Western States, such as
12 California, Idaho and New Mexico. This point is
13 particularly important when realizing the cheese
14 market is national in scope and that this is
15 only reflected in the NASS price surveys.

16 Let's work through a simple example.
17 The CME price is based on the price of cheese
18 within a 300-mile radius of Green Bay,
19 Wisconsin. Any distance greater than 300 miles
20 is discounted by a freight differential.

21 If a cheese plant in Tulare,
22 California sells a load of cheese for \$1.35 at
23 the CME to a buyer in Chicago, the price would
24 be discounted by 4.27 cents per pound, which is
25 the freight differential for 2100 miles.

1 The cheese plant would report 1.3073
2 as the sales price to NASS, since that is their
3 net sales price, not the \$1.35 price that the
4 CME would report for that cheese.

5 Therefore, the NASS price is a
6 measure of the national market price for cheese.
7 while the CME only represents a locally adjusted
8 price for the Green Bay area. And I add, the
9 section on delivery points and freight
10 differentials from the CME rule book are
11 included as Appendix A.

12 We appreciate the fact that there are
13 issues with the NASS survey, such as the time
14 lag in reporting. However, instead of
15 eliminating the NASS survey, as some recommend,
16 we feel it would be more prudent to address the
17 root cause of the time lag.

18 One solution would be to require more
19 timely reporting of prices that would reduce or
20 eliminate the current lag impact.

21 As an example, livestock and meat
22 prices are reported by USDA AMS on a daily
23 basis. This information is available for all
24 market participants to use on a real-time basis
25 with no lags

1 Moving to daily price reporting is
2 not something new for dairy, since we
3 transitioned from weekly to daily cash markets
4 at the CME.

5 So instead of throwing the baby out
6 with the bath water, the industry would be
7 better served by improving the existing NASS
8 survey and developing a pricing system that is
9 transparent, easy to understand and transmits
10 market signals immediately.

11 Continued Use of Barrel Cheese
12 Prices. The USDA should continue to use both
13 block and barrel cheese prices in calculating
14 milk prices and reject proposals to eliminate
15 barrels from the formula.

16 The first reason is simple. There
17 are more barrels reported in the weekly NASS
18 price survey than blocks. Since 2000, the NASS
19 survey has been approximately 57 percent barrels
20 and 43 percent blocks. Some quick math confirms
21 these figures.

22 In 2005, U.S. cheddar cheese
23 production was 3.05 billion pounds. We estimate
24 approximately 20 percent, or 600 million pounds,
25 were for aging. Another 1.1 billion pounds were

1 in barrels. Of the remaining 1.3 billion
2 pounds, we estimate 45 percent was packaged in
3 640-pound blocks and 55 percent in 40-pound
4 blocks.

5 Comparing the volume of 40-pound
6 blocks to barrels results in about 60 percent
7 barrels and 40 percent blocks, so we feel the
8 NASS survey is reflective of the U.S. cheese
9 market for 4- to 30-day-old cheddar cheese.

10 Continuing the use of barrels in the
11 formula is consistent with past USDA decisions.
12 In the Federal Milk Marketing Order Reform in
13 March 1999, quote, "Many commenters insisted
14 that barrel cheddar cheese prices should be
15 included in a weighted average with block
16 cheddar prices since much more barrel cheese is
17 produced than block cheese." End quote.

18 And in their explanation of the new
19 product formulas, USDA stated, quote. "Including
20 both block and barrel cheese in the price
21 computation increases the sample size by about
22 150 percent, giving a better representation of
23 the cheese market." End quote.

24 The same logic used then still holds
25 true today; therefore, barrels should remain in

1 the price formula

2 Another reason to keep barrels in the
3 formula is that barrel and block cheese are
4 different commodities with different supply and
5 demand dynamics Block cheese is primarily used
6 in cutting or ready-to-eat applications
7 whereas, barrel cheese is primarily used in
8 process cheese applications

9 As the narrow and sometimes inverted
10 spread between blocks and barrels over the past
11 year have demonstrated, there are clearly
12 different supply and demand drivers for each
13 blocks and barrels If the goal of USDA is to
14 reflect the value of cheddar cheese, it is
15 imperative both blocks and barrels are included
16 in the price formula

17 Eliminate 3-Cent Barrel Adjustment

18 For the reasons detailed above, it is clear both
19 barrels and blocks should remain in the milk
20 price formulas But the current formula
21 contains a problem when adjusting the barrel
22 prices to a comparable block price

23 First, the barrel price is adjusted
24 to 38 percent moisture from the reported
25 moisture Then 3 cents is added to the barrel

1 price. Several proposals advocate reducing or
2 eliminating that 3-cent addition. We believe
3 the 3-cent addition should be eliminated.

4 The average block moisture is just
5 under 38 percent. We agree with the adjustment
6 of the barrel moisture to 38 percent to give an
7 apples to apples comparison. However, the
8 3-cent differential added to the barrel price to
9 account for manufacturing, packaging and testing
10 differences is not needed.

11 Following is an example to illustrate
12 this point. It starts with the 2006 average
13 producer tests for Federal Order milk with the
14 fat test of 3.69 percent and a protein test of
15 3.05 percent.

16 Using a 90 percent fat retention in
17 the current yield formula, the cheese yield is
18 10.07 for block and 9.53 for barrels. Using
19 \$1.40 market for block and a \$1.37 market for
20 barrel, this converts to \$1.40 block price and
21 \$1.471 barrel price adjusted to 38 percent
22 moisture.

23 To calculate the gross return, the
24 yield is multiplied by the moisture adjusted
25 prices. For block, this is 14.099 cents per

hundredweight and 14.023 cents for barrel.

2 On a cheese basis, this equates to
3 approximately ,0075 or three-quarters of a cent
4 per pound difference for blocks, well below the
5 3-cent adjustment currently used in the price
6 formula. The table in Appendix B provides two
7 additional examples with higher and lower market
8 prices. However, the result is the same. The
9 difference in the gross return between blocks
10 and barrels is well below the 3 cents currently
11 used in the formula.

12 In the Federal Order Reform decision
13 it was stated, "The three cents that is added to
14 the barrel cheese price is generally considered
15 to be the industry standard cost difference
16 between processing barrel cheese and processing
17 block cheese." End quote. It added that
18 comments noted the 3 cent difference was due to
19 the difference in packaging costs.

20 Over the past ten years, 40-pound
21 block manufacturing efficiency has improved, and
22 the advantage in barrel manufacturing efficiency
23 has narrowed. We believe the 3 cent adjustment
24 overstates the difference and does not reflect
25 the extra investment in additional steps needed

1 to package cheese in barrels. Depending on the
2 plant, these steps include recrumbling.
3 pressing, vacuum sealing and cooling. It is
4 clear the 3-cent adjustment is overstated.

5 Importantly, the Cornell
6 manufacturing cost survey, contains both block
7 and barrel cheese plants and are reflective of
8 costs for both container types. Therefore, the
9 price formula should continue to adjust the
10 barrel moisture to 38 percent, but the 3-cent
11 adjustment should be eliminated completely from
12 the formula.

13 Impacts on Futures Markets. A
14 number of proposals have the potential to
15 negatively impact the CME futures markets. The
16 elimination of barrels in the milk price
17 formulas would greatly reduce the volume of
18 cheese represented in the NASS survey used to
19 establish milk prices. This seems to be counter
20 to the goal of having the most accurate
21 representation of the value of the underlying
22 commodities in the price formulas used to settle
23 futures contracts

24 Additionally, the proposal to add an
25 energy adjuster would add basis risk to futures

1 prices. Specifically, adding an unknown energy
2 adjuster introduces an unpredictable element to
3 the price formula and would likely deter market
4 participants from using futures for hedging.
5 Given the volatility of milk prices and need for
6 risk management tools, any proposal that would
7 negatively impact these tools should be
8 rejected.

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

13 BY MR. ROSENBAUM:

14 Q. Mr. McCully, before we make you available
15 for cross-examination, if you could just turn to
16 Appendix B, which you referenced in your written
17 testimony. This is a document that you
18 prepared. I take it?

19 A. Correct.

20 Q. And this relates to the block versus barrel
21 issue. correct?

22 A. Correct.

23 Q. And the question whether USDA should
24 eliminate the 3-cent adjustment that now exists
25 in the formula?

1 A. Correct. This is some theoretical examples
2 using average fat tests, average protein tests
3 and fat retention and some other factors that
4 are used in the current formulas.

5 Q. Now, your example number 1 shows a
6 block/barrel spread, if you will, of \$.0075,
7 correct?

8 A. Correct

9 Q. Which is about three-quarters of a percent?

10 A. Three-quarters of a percent.

11 Q. And that is the example that you worked
12 through in your testimony, correct?

13 A. Yes. And then I used two other scenarios.
14 Example 2 and Example 3 are scenarios of a lower
15 market price and a higher market price.

16 Q. And with a higher market price, the spread
17 actually declines, correct?

18 A. Correct. about four-tenths of a cent

19 Q. And with a lower market price, the spread
20 increased to about a penny, correct?

21 A. Just over a penny, correct.

22 Q. Still substantially less than --

23 A. That's correct, well below 3 cents.

24 MR. ROSENBAUM: Your Honor, I would
25 ask that Exhibit 26 be admitted into evidence.

1 JUDGE PALMER: Tell me again what
2 Appendix A is.

3 THE WITNESS: Appendix A, there
4 are several pages here, this is directly out of
5 the CME, or Chicago Mercantile Exchange, rule
6 book. About a third of the way down, **it** is
7 Section 53S04.D., which is delivery points, and
8 this is from the rule book --

9 MR. ROSENBAUM: That is on the
10 second page?

11 THE WITNESS: On the first page.
12 that is on the first page of Appendix A. That
13 goes through and this is the rules then for
14 delivery points for cheese sold at the CME.

15 And the following pages are actually
16 then the interpretation, and actually, **it** is a
17 breakdown of the mileage chart and the freight
18 differentials for each of those mileage ranges.
19 ranging from 300 miles up to 2449 miles, and
20 then there are several examples of how to do the
21 calculations for the freight differentials.

22 JUDGE PALMER: Reference me back
23 in your statement to where you -- did you make
24 mention of **it** there in the statement?

25 THE WITNESS: Yes, that was in.

1 when I walked through -- on page 4, when I
2 walked through the example of the CME price and
3 a seller in Tulare selling to a cheese buyer in
4 Chicago, how that worked out. That's referenced
5 there in the middle of the page.

6 JUDGE PALMER: I see. Okay. Very
7 well, we will receive it.

8 (Thereupon, Exhibit 26 was received
9 into evidence.)

10 MR. ROSENBAUM: Mr. McCully is
11 available for cross-examination.

12 JUDGE PALMER: Very well
13 Questions.

14 CROSS-EXAMINATION

15 BY MR. YALE:

16 Q. Good morning, Mike.

17 A. Good morning.

18 Q. This discussion is on the record. A couple
19 of quick questions about Kraft. Does Kraft sell
20 any commodity cheddar that they report to NASS?

21 A. No.

22 Q. The cheese -- all of the cheddar which
23 Kraft manufactures is for its own internal use?

24 A. We are down to the point where we really
25 don't manufacture much cheddar cheese anymore

1 that would be applicable for NASS, or that would
2 even fit into the NASS survey. What little we
3 do, we use internally, it is not sold.

4 Q. Part of that is that Kraft has set some
5 quality standards that you really wouldn't
6 consider the cheese that you did make being a
7 commodity cheese, isn't that a true statement?

8 A. The only plant we have left in the Federal
9 Order system that makes cheddar cheese is made
10 with a proprietary process that is used for
11 processing. So that is not exactly a quality
12 issue, it is a proprietary technology issue.

13 Q. And you mentioned the idea that you don't
14 bring back the whey butter in part because of
15 quality?

16 A. Correct.

17 Q. And there are those who believe the only
18 way to get a good quality full fat cheese is not
19 to use the whey butter; is that correct?

20 A. Correct.

21 Q. I don't want to go into a lot of detail
22 here. But I think it is an important time to
23 bring this into the record.

24 The use of cheddar cheese has wide ranges,
25 even within cheese use, does it not? I mean, we

1 have shredded cheese, right?

2 A. Um-hum.

3 Q. And cubes, and all kinds -- slices --

4 A. Yes.

5 Q. Some is used to sell as a natural cheese

6 some of it is to be used as part of a cheese

7 product and some of it is just to add cheese

8 flavor to some other product, is it not?

9 A. Correct.

10 Q. And each of those have different standards

11 or qualities that are required to meet those

12 particular manufacturing or marketing goals.

13 right?

14 A. Typically, those would have different

15 specifications. In our world, they do.

16 Q. And similarly, as one begins to establish

17 standards of quality and specific marketing and

18 manufacturing standards that -- there is a cost

19 that is associated with that, right, to meet

20 those higher standards?

21 A. Give me an example of a cost that would --

22 Q. Well, if you were able to produce a cheese.

23 for example, that you could utilize more than 90

24 percent of your -- and use some of the whey

25 butter and stuff, you may possibly be able to

1 make it cheaper than those who try to do
2 the whole thing

3 A. In that example, that's correct.

4 Q. And those who try to develop a cheddar that
5 they want to age, as opposed to shred, they
6 probably put different quality standards and
7 controls?

8 A. Typically, yes, cheddar for aging, you
9 would do some things a little different than if
10 you were making current cheese for processing or
11 slicing.

12 Q. And as a result of that, ordinarily, one
13 tries to get that added cost out in the
14 marketplace, right?

15 A. You try to. It doesn't always happen.

16 Q. You indicated that it doesn't always
17 happen, but that is where the business decision
18 is made to develop that type of cheese and make
19 that investment, because you figure, with that
20 extra cost, hopefully, we will get that and then
21 some more from the market, over the plain
22 cheddar, right?

23 A. That would be the goal you would set out
24 with.

25 Q. I want to talk to you about the CME -- the

1 testimony that you made on the CME, and you
2 indicate that at the CME, that there is a
3 location value to those contracts; is that
4 right?

5 A. That's correct. The great Green Bay basing
6 point with a 300-mile radius. **I**t goes back to
7 the old days of the NCE.

8 Q. Right. And looking at this, you gave an
9 example. **I** believe, of Fresno and Tulare.

10 A. Tulare, Tulare to Chicago.

11 Q. Then the next table that you had at the
12 page -- this may have been off the CME. They
13 had a Fresno to --

14 A. Correct. **I** believe the CME has five
15 different examples, Eau Claire, Twin Falls.
16 Dallas. Fresno and Mankato.

17 Q. Tulare, Fresno, **I** mean, we're not
18 talking --

19 A. No. **i**t is just down 99.

20 Q. Just down the street. And **I** think your
21 testimony was, **I** think this example here, going
22 to Mankato, **i**t is as much as about 5 cents a
23 pound. The numbers expressed here are in
24 hundredweight, are they not, in the CME table?

25 A. Correct.

1 Q. It would be about 4 112 cents a pound; is
2 that right?

3 A. For the example for Fresno to Mankato?

4 Q. Yes.

5 A. 4.49 per hundredweight or, yeah. about 4.5
6 cents. about 4 112 cents.

7 Q. Now, conversely, and they don't have an
8 example here, but cheese -- other than they have
9 got some going from Mankato to the East
10 Atlantic, but manufacturing of cheese in the
11 East, for example, have a landed value higher
12 than that same cheese produced in the Upper
13 Midwest, right?

14 A. Correct.

15 Q. Particularly if the market is in the East?

16 A. Correct.

17 Q. By and large, that is where it is viewed
18 the market is, right, is in the East?

19 A. For the cheese produced in the East?

20 Q. No, for cheese primarily produced outside
21 I mean, you use some locally but --

22 A. Midwest and East. Not as much the Mountain
23 or the Western States. But more Midwest to the
24 East Coast.

25 Q. Are you aware of any statistic that

1 indicates how much cheese is produced in
2 California that is shipped out of the State of
3 California?

4 A. I have seen it. I can't recall it. It is
5 a large number.

6 Q. Now, are you aware of the fact that the
7 CDFA does actually -- when they do their audits
8 of plants, they actually look at what their
9 cheese is sold for?

10 A. We don't participate in the cheese survey.
11 But I believe that's correct.

12 Q. And they actually report a weighted average
13 cheese price as sold at the plant as compared to
14 CME?

15 A. It's California reported prices, their
16 products, yes.

17 Q. Right. And that, for example, for the
18 years 2004 through 2005, that there were times
19 when it was more than a nickel less than the
20 CME, sometimes as much as 10 or 15 cents and
21 sometimes as much as 10 or 12 cents above the
22 CME, are you aware of that?

23 A. I haven't seen the ranges. I believe the
24 transportation differential used in the CDFA
25 formulas is 4.5 cents. So I usually figure it

1 is around that neighborhood. And that is
2 probably. in years before, higher freight costs.

3 Q. Now, there are no cheese plants located in
4 California, right?

5 A. There are no cheese plants?

6 Q. I am saying, no cheese plants in the
7 Federal Order system located in California?

8 A. That would be a safe way to say it. Unless
9 they have done something in the last couple of
10 days to join the Federal Order system, that
11 would be correct.

12 Q. Or there was the big one that separated
13 them from the country, right?

14 (Laughter.)

15 Q. So all of the cheese plants that are
16 located within the Federal Order then. as one
17 remembers our geography, those plants are
18 located closer to the Green Bay pricing point
19 than California, by and large?

20 A. Correct. You are moving back to the East

21 Q. By and large. There are some exceptions?

22 A. Yes.

23 Q. The Northwest, I think --

24 A. Yes.

25 Q. So in the NASS pricing, according to your

1 testimony, I think that is generally understood.
2 is that the NASS price captures the California
3 basis into that pricing, right?

4 A. It is national in scope, so it would
5 capture, yes. California, Idaho, New Mexico
6 wherever it was reported, it would capture more
7 of a local price.

8 Q. And do you know what percentage of NASS
9 reported cheese is produced in California?

10 A. I don't know that off the top of my head
11 I can't remember -- I have to ask you a
12 question, whether the cheese is reported as West
13 Coast, I think it is West and Midwest, and if it
14 is just West, it is not broken down by state.
15 So I don't know the answer to that.

16 Q. Are you aware in computing the make
17 allowances for the tentative final decision in
18 the scenarios here, that the department
19 estimated that the NASS cheddar was about 22
20 percent in California and the rest in --

21 A. Just per the previous questions of
22 Dr. Yonkers. I would say that's correct.

23 Q. So 22 percent of the cheese that is in the
24 NASS is reported at locations in which producers
25 who are pooled under the Federal Order don't

1 even deliver their milk to, right?

2 A. Right.

3 Q. But the price that they would receive would
4 be based upon that location, in part by almost
5 one-fifth, right?

6 A. Correct. It is reflective of a national
7 market. I think if you went back 50 years, when
8 we didn't have a national marketplace for dairy
9 products or dairy commodities -- I can see the
10 direction you are going. But since we are in a
11 national marketplace, cheese produced in New
12 Mexico or Idaho has to compete with the cheese
13 in California. So that is why there is good
14 rationale for including all of that, because it
15 is a national marketplace.

16 Q. But the market itself -- it is a national
17 marketplace, I agree. But the market has
18 provided the location value for the cheese in
19 the different locations. It is not -- they
20 don't all pay the same price, right? They pay a
21 price that is based upon, in part, their
22 location and their own supply and demand at
23 their plant, right?

24 A. Correct.

25 Q. All right. So the question the department

1 is being asked is what is the value of milk
2 delivered to a cheese plant that is pooled into
3 the Federal Order, because we are going to
4 determine what that producer is going to pay,
5 right?

6 A Correct

7 Q All right The relevant factor is what
8 that plant is paying for its milk, and its cost
9 to produce that milk, that determines what
10 that -- what is available to profitably pay the
11 producers, right?

12 A Now. if I follow the logic then that we
13 would have a NASS survey only of commodities
14 produced and sold within the Federal Order
15 system, so you would exclude all of the
16 commodities, mainly cheese, produced in
17 California and Idaho and a lot of butter and a
18 lot of nonfat dry milk and whey produced in
19 California as well

20 So if that is the direction you are going.
21 if I understand, you are basically going in the
22 direction where you would want to have a NASS
23 survey of commodity prices just within the
24 Federal Order system?

25 Q I am not suggesting, but that might be a

1 solution and that might be a response. I am not
2 asking you whether to accept or reject that.

3 A. I would, as I walked through it, I wouldn't
4 agree with that, because it goes back to the
5 national marketplace argument.

6 Q. I understand. I want to go back, there
7 were some questions, I think, more of
8 Dr. Yonkers that talked about the basic formula
9 price and the Minnesota/Wisconsin series, right?

10 And in that period of time, what was
11 determined in that price was the location value
12 in Wisconsin and Minnesota, those plants
13 determined what the location value of their
14 cheese was by market factors in which location
15 was built into the price they sold their cheese.
16 right?

17 A. That was, I think -- I have to go back to
18 the history books. I don't have the knowledge
19 that you have. Not that I'm saying you are old.
20 but more experienced.

21 (Laughter.)

22 A. But if you go back in the history of the
23 MW, that is at that time, historically, where a
24 lot of the cheese was produced in that area.

25 And one of the reasons the MW went away, was

1 because of the growing influence of cheese
2 production in the West.

3 Q. By the way, Minnesota and Wisconsin were
4 states when I practiced.

5 (Laughter.)

6 Q. But **it** was -- I understand why they had to
7 get away, for a lot of reasons. But that value
8 was established on the value of the cheese at
9 the plants that purchased the milk, right?

10 A. Correct.

11 Q. Now, what you are showing with the CME
12 chart in this mileage, is that the market
13 recognizes that there is a location value for
14 cheese at the plants at which **it** is produced,
15 right?

16 A. Correct.

17 Q. All right. And the question -- or **it** is
18 not the question, but the point is, that as **it**
19 stands now. NASS, approximately one-fifth of its
20 price is based upon the location value of plants
21 that do not participate in the pricing of milk
22 for the Federal Order; is that right?

23 A. Correct. But are in the national
24 marketplace for cheese.

25 Q. They are in the national market. And I am

1 going to violate a fundamental rule of
2 cross-examination, I am going to ask a question
3 that I don't know the answer.

4 A. I am glad I am able to experience this.

5 Q. Well, a lot of times I thought I knew the
6 answer when I asked the question and you turn
7 out to be wrong.

8 On this CME, the rule book, page 4 of 10?

9 A. The first page of the appendix, correct

10 Q. Right. Under "Weight," it has this
11 comment, "Payment shall be made on the basis of
12 the exact net weight delivered, with cheese
13 delivered in steel barrels receiving a 3-cent
14 per pound discount." What is that referring to?

15 A. It is actually good to see the CME is very
16 up to date, because that rule, that 3-cent
17 discount, just went into effect in the last -- I
18 can't remember the exact date. But it has been
19 since the first of the year.

20 It is addressing the extra cost of
21 companies or people that buy barrel cheese on
22 the CME that incur extra costs handling steel
23 barrels.

24 Q. So it is related to the packaging of the
25 steel barrels, not the drums or the --

1 A. No, it is not fiber. It is just addressing
2 the steel drum.

3 MR. YALE: Okay. Very good

4 I have no other questions. Thank you.

5 JUDGE PALMER: Questions?

6 Mr. Beshore.

7 CROSS-EXAMINATION

8 BY MR. BESHORE:

9 Q. Mr. McCully, on the first page of your
10 testimony, you list Kraft facilities in the
11 Federal Order system. I wonder if you can tell
12 us, you know, just quickly what products are
13 produced at those facilities and whether they
14 are buying producer milk, starting with New
15 York. Lowville.

16 A. First I will address the producer milk
17 All the milk we buy is from cooperatives. We
18 don't buy any direct from the farm anymore.

19 Q. That point was specifically with respect to
20 the Lehigh Valley plant. Are you buying any
21 milk there?

22 A. You have asked me that question before.
23 previously. I will go through them. Lowville
24 is primarily cream cheese. Campbell is Italian
25 styles, mozzarella and string. Walton is

1 cultured products, cottage cheese and sour
2 cream. Lehigh Valley, it is a very small amount
3 of milk, used for coffee creamer type product.
4 it is Tassimo, which is a fairly new coffee
5 product of ours.

6 Beaver Dam is cream cheese, Springfield is
7 cream cheese, Bentonville is cheddar cheese and
8 Tulare -- now. we are outside the Federal Order
9 Tulare is primarily Parmesan, and Visalia, which
10 is about to be closed, is sour cream and cottage
11 cheese. It also had a butter powder churn, or
12 butter powder operation.

13 Q. So the only plant that produces the
14 products that we are talking about costs of in
15 the make allowances here is Bentonville?

16 A. Bentonville is a cheddar plant; however, it
17 would be cheddar for processing.

18 Q. Okay. It is not NASS commodity cheddar?

19 A. No, no.

20 Q. So all of Kraft's interest with respect to
21 the pricing of cheese, commodity cheddar cheese
22 is as a buyer?

23 A. Correct. It is more -- if we would have
24 had this, and you have been -- you know, 15
25 years ago, this list obviously was a lot longer

1 and we owned a number of commodity cheese
2 plants. Our strategy over the years has been to
3 move out of the commodity cheese production and
4 buy from suppliers. So our interest is more of
5 our supply base and the cheese that we purchase
6 4. Okay. And as a buyer, you are interested
7 in having the lowest possible cost for the
8 product that you purchase?

9 A. Our primary interest is having the cheese
10 plants be viable in producing cheese for us and
11 quality cheese in addition to cost. Obviously
12 that factors into it. But one of our primary
13 concerns is the overall health of our supply
14 base and we get concerned when we have suppliers
15 that are losing money or, as has happened over
16 the years, actually close.

17 Q. So as a buyer, your interests kind of go
18 hand in hand here with the plants you are buying
19 from. The lower you can get the cost of their
20 raw product, that is going to keep them in
21 business, and enable you to pay less for the
22 cheese you purchase from them, correct?

23 A. Over the years, that is just typical
24 efficiency in moving to larger plant sizes. As
25 we explained to Mr. Yale, as cheese production

1 is moved to the West, obviously larger scale
2 facilities are more efficient than some of the
3 smaller plants that used to dot the countryside

4 Q. When you talk on page 2 about farm-to-plant
5 milk loss, since you are not -- you know, you
6 are not making cheddar cheese except at
7 Bentonville, how are you accounting for these
8 things to Class III price, other than at
9 Bentonville? I suppose the mozzarella is Class
10 III.

11 A. Cream cheese. Most of the products that
12 went through there is string cheese, the
13 mozzarella, Italian styles, the cream cheese.
14 the cheese for -- the milk going to Bentonville
15 will all be Class III. That is primarily what
16 we have, some Class II, but mostly Class III.
17 Not the traditional cheddar cheese that is more
18 the focus of this.

19 Q. Are you contending that the formulas
20 presently require you to pay for milk volumes
21 that you are not processing?

22 A. Well. I do not have a lot of specifics. I
23 think there will be other folks that will be
24 talking about, with more details, since we have
25 moved away from buying directly from farms, we

1 don't have as much data or as close to that as
2 we used to be. But there is loss, just, say.
3 for the cream that we would buy, obviously there
4 would be some loss as we are buying cream as it
5 is going through someone else's separator.

6 4. Right. But when you are buying cream, that
7 price is not regulated?

8 A. You still have to account for the
9 components in the milk.

10 Q. But the price you pay for the cream is a
11 negotiated free market price --

12 A. That's correct.

13 Q. -- with your supplier.

14 With respect to the whey butter market, do
15 you manufacture any whey butter?

16 A. We don't manufacture whey butter. We do
17 generate whey cream, and we sell the whey cream
18 to churns that manufacture the whey butter.

19 Q. Okay. At your plants in the Federal Order
20 system, are you selling whey cream from those
21 plants?

22 A. Campbell, New York, would be the Federal
23 Order plant. And we sell that typically to a
24 churn in the Northeast.

25 Q. Okay. How many makers of whey butter are

1 there in the Northeast?

2 A. I honestly don't know the answer to that.

3 Q. Do you know if there is more than one?

4 A. I couldn't even -- I don't know. I
5 honestly don't know

6 Q. You have had one --

7 A. I know there is someone buying it in the
8 Northeast. I don't know if that is the only one
9 or one of many

10 Q. Do you even know who that is?

11 A. I do -- no, I don't, actually, I don't. I
12 am not involved with cream sales, so I am not
13 sure where it is going.

14 Q. Okay. Do you buy whey butter?

15 A. No. In the United States. I should
16 clarify that.

17 Q. So any -- do you know anything about the
18 prices of whey butter produced in the Federal
19 Order system?

20 A. To answer directly, no. But what I do
21 is -- what I refer to in here as far as our
22 sales of whey cream, both in Federal Orders and
23 I would assume that in California you would have
24 a similar market for the Grade B butter as the
25 rest of the country

1 Q. Okay. But any comments you made about your
2 sales of whey cream, you just told us you are
3 really not involved in that?

4 A. Not me personally. The numbers that I have
5 here in my testimony are actually from our -- I
6 asked our cream person, our cream buyer, and she
7 is the one that provided the data from this, for
8 this.

9 Q. So your cream buyer provided the data
10 regarding the selling price for the whey cream?

11 A. Correct.

12 Q. Okay. With respect to barrels and blocks.
13 if I read -- I am on page 5 of your statement.
14 If I follow the data that you have presented
15 here in the first full paragraph -- the only
16 full paragraph on that page, regarding current
17 production, currently there are more blocks
18 produced than barrels?

19 A. If you define blocks as -- if you include
20 640s and 40s and what primarily goes into aging
21 is blocks as well, if you include all that.
22 there would be more blocks produced in total
23 than barrels.

24 Q. Okay.

25 A. If you do an apples to apples comparison as

1 far as what that cheese is, 4- to 30-day-old
2 cheddar cheese, then actually, I went through
3 this example, as well as what is reflected in
4 the NASS survey, there is more 4- to 30-day-old
5 cheddar cheese packaged in barrels than in 40
6 pound blocks.

7 Q. Reported to NASS, reported to NASS?

8 A. Correct.

9 Q. Okay. But your data shows -- set aside the
10 aging volumes.

11 Your data says that there is 1.3 billion
12 pounds going into 640s and 40-pound blocks.
13 versus 1.1 billion in barrels?

14 A. That's correct. These are our estimates.
15 So that is close.

16 Q. I understand. That is quite a difference
17 from the situation, apparent situation reported
18 in the Order Reform decision of March 1999 that
19 you quoted, which says there is much more barrel
20 cheese that's produced than block cheese?

21 A. To qualify that, that wasn't my quote. I
22 didn't say that. But that was the quote in the
23 Order Reform in '99 that other people said that
24 So, obviously, they could use their own numbers
25 or do their own analysis.

1 But this is from our experience obviously
2 with the NASS and being one of the larger buyers
3 of cheese in the country. Through our
4 experience, this has been an estimated breakdown
5 of barrel. 500-pound barrel, 40-pound block and
6 640-pound block production.

7 Q. I guess what I am observing from the data
8 in your testimony is that the cheese market, the
9 production of blocks has certainly been
10 increasing in comparison to the production of
11 barrels.

12 A. Recently the production capacity that has
13 come on line is 40-pound block or 640s.

14 Q. For instance, the very large new plants in
15 the Southwest are block plants?

16 A. Yes, Southwest cheese is all block. That
17 is one of the things I talked about, there is
18 extra investment. It is easier, if you are
19 going to put up or build a new cheese plant, it
20 is cheaper and easier to build just a straight
21 40-pound block plant and not add additional
22 steps for packaging in barrels.

23 Q. But the block is also the bigger market?

24 A. And it has been, yes. And there has been
25 more growth in the natural business, natural

1 cheese business recently.

2 Q. Okay. With respect to the data regarding
3 cost of blocks and barrels. this is all
4 information that you are providing from sources
5 other than Kraft?

6 A. Which -- give me, or help me out. Which
7 example are you talking about now?

8 Q. Well, any. Is there any information here
9 that is Kraft-specific? I mean, it seems to be
10 comments that you are making as a witness on
11 behalf of Kraft, but comments you are making on
12 data provided by other sources.

13 A. I guess I still don't follow, which example
14 are you looking at? Which thing are you looking
15 at exactly?

16 Q. I am looking starting on page 6, "Eliminate
17 3-Cent Barrels."

18 A. On page 6, those are numbers, that is not
19 proprietary Kraft information specific to any
20 supply. This is a theoretical example -- what I
21 walked through here was average vat and protein
22 tests from 2006, and applying some standard
23 yield numbers to come up with the gross return
24 that I estimated there as an example in I think
25 the Appendix 2.

1 Q. Were the -- in Appendix 2, the formula that
2 you applied to those -- in the assumptions, was
3 that the current Federal Order yield formula?

4 A. The 90 percent fat retention is what is
5 currently used.

6 4. Right.

7 A. And the .822 is also used in the current
8 formula. The rest of it. this is what is used
9 for the current formula. So there is nothing --
10 I am first to admit, I am not a Van Slyke expert
11 or anything like that. So this is --

12 Q. I join you.

13 A. I don't talk about all the casing and all
14 this other stuff. This is the current formula.

15 Q. The current Federal formula, as you
16 understand it?

17 A. Yes.

18 Q. So you just took the milk fat percent and
19 protein percent as reported in Federal milk
20 order statistics?

21 A. Exactly. And this example of 3.69 and 3.05
22 are the average for 2006 in the Federal orders

23 Q. And you applied the Federal Order yield
24 formula to that?

25 A. Correct.

1 Q. Aren't the factors in the Federal Order
2 yield formula based on 3.5?

3 A. Actually, yes. And if you do this at
4 3.5 -- actually, I did that, I did a printout of
5 that page. but if you do this at 3.5. the
6 numbers are still the same.

7 Q. Okay. The math and everything is exactly
8 the same?

9 A. Correct.

10 Q. Doesn't 3.69 milk generate more cheddar
11 than 3.5 milk?

12 A. But we are just looking at the block and -
13 some of the numbers obviously do change is the
14 difference. The main thing I am looking at is
15 the difference. The difference remains the
16 same.

17 Q. The difference is the same?

18 A. Yes. Obviously cheese yield and some of
19 the numbers within the block and the barrel are
20 changed, but the difference, the bottom line
21 does not.

22 MR. BESHORE: Thank you.

23 THE WITNESS: You are welcome.

24 JUDGE PALMER: Mr. Vetne?

25

1 CROSS-EXAMINATION

2 BY MR. VETNE:

3 Q. Good morning, Mr. McCully.

4 A. Good morning.

5 Q. Early in examination by Mr. Yale, you
6 acknowledged unequivocally that there is no milk
7 going to California cheese plants that is
8 Federal Order milk.

9 Let me ask you if you are aware that, for
10 many, many years, there have been some
11 California producers shown in Federal Order pool
12 reports?

13 A. Correct.

14 Q. And when that producer of milk is not used
15 for some fluid use in Federal Order plant: would
16 it not automatically be diverted to a California
17 plant?

18 A. Repeat the question, please.

19 Q. When milk from California producers who are
20 pooled in a Federal Order is not needed at a
21 Federal Order distributing plant, would it not
22 ordinarily be diverted to a California cheese
23 plant?

24 A. Cheese or butter powder, yeah.

25 Q. So you are aware that there is some Federal

1 Order milk that is received and processed at
2 California manufacturing plants?

3 A. Correct. Like I said, I was just thinking
4 of the actual plant within California is
5 obviously not in the Federal Order system. So I
6 wasn't thinking all the way through it.

7 Q. But some milk is?

8 A. Yes.

9 4. And in response to a question by Mr. Yale.
10 I think he asked you if the objective here is to
11 determine the value of milk used in manufactured
12 products at Federal -- at cheese plants pooled
13 under the Federal Order, to which you responded
14 yes?

15 A. Correct.

16 Q. Are you aware that a great number of cheese
17 plants within the Federal Order geographic
18 system are not pool plants?

19 A. There are a number of nonpool plants.
20 correct.

21 Q. And you are not limiting, by your answer
22 you did not intend to limit your pricing
23 objective to those that are pool plants versus
24 those that are not?

25 A. That's correct

1 Q. In fact, your plant in Bentonville.

2 Arkansas is not a pool plant?

3 A. That's correct.

4 Q. You responded to a question, agreed that
5 the price you pay for cream is not a regulated
6 price. However, for those who sell you cream or
7 somewhere down the supply chain, there is

8 somebody that is accounting to a regulated pool

9 A. Absolutely.

10 Q. For all the components or quantity of that
11 milk?

12 A. Correct. You would have to track to the
13 end use, that's correct.

14 Q. Okay. On page 3, you use -- you refer to
15 the term USDEC. What is that?

16 A. U.S. Dairy Export Council, or USDEC.

17 Q. Is that a Government agency?

18 A. Not a Government agency, no.

19 Q. You referred to one of your butterfat
20 suppliers from California that sells Grade B
21 butter. Is that Grade B butter because it was
22 produced from whey or is it Grade B butter for
23 other reasons?

24 A. It is produced from whey cream.

25 Q. From whey cream. And you also referred to

1 a discount for Grade B butter. Let me ask you
2 this: Does your sale of whey -- fat in whey
3 cream correspond with the discount, discounted
4 value of Grade B butter?

5 A. Over the year -- or during the year, the
6 range will be plus or minus a little from 10
7 cents, but on average, it is about the 10 cents,
8 as far as what our discount is on our cream
9 sale.

10 Q. When you sell whey cream to a processor or
11 to a churn from your cheese plants, you incur a
12 transportation cost from your cheese plant for
13 that byproduct?

14 A. Correct.

15 Q. To your knowledge, is that transportation
16 cost currently included in Federal make
17 allowances?

18 A. I don't believe it is.

19 Q. And finally, on page 7, top of the page
20 there are some numbers in the paragraph ending
21 at the top of the page. \$14.099, in your
22 testimony, as you read it, you used the words
23 "cents" after that, 14.099 cents. That is
24 \$14.099 in that case and in the other cases?

25 A. That's correct. I misspoke.

1 MR. VETNE: Thank you.

2 JUDGE PALMER: Any more questions?

3 Dr. Cryan.

4 CROSS-EXAMINATION

5 BY MR. CRYAN:

6 Q. Thank you, Your Honor. I am Roger Cryan
7 with the National Milk Producers Federation.

8 Hello. Mr. McCully.

9 A. Good morning, Roger.

10 Q. Mr. McCully, would you agree that energy
11 costs are the most volatile element of dairy
12 processing costs, other than milk prices
13 themselves?

14 A. Other than milk prices?

15 Q. Yes.

16 A. That would be correct. As far as
17 volatility, that would be correct.

18 Q. Do Kraft plants use any sort of energy
19 futures to manage their energy price risks?

20 A. We use both, well, natural gas and oil
21 futures for hedging our energy, overall energy
22 needs across plants, transportation.
23 distribution centers. So it is -- in aggregate
24 terms, we do. And I am not always -- it is not
25 always the best, but we do it.

1 Q. When a make allowance decision is announced
2 by the USDA, can a Kraft plant necessarily lock
3 in energy costs corresponding to the make
4 allowance, energy costs for the life of that?

5 A. No. We manage our energy at a macro
6 corporate level and not by plant. So there is
7 no way for an individual plant or the dairy
8 plants or the milk receiving plants to say that
9 they want to do something. It is not managed
10 that way.

11 Q. But if the -- if an administrative make
12 allowance is established based on, for example,
13 energy costs in 2004, the day that announcement
14 is made, is it possible for you to lock in 2004
15 energy costs for the life of the make allowance?

16 A. First of all, I don't know what the life of
17 the make allowance is. Secondly, again, we
18 don't manage it on a plant-by-plant or a group
19 of plants basis.

20 It is hard enough for people to understand
21 energy markets the way it is, and to try to
22 explain Federal Order pricing and energy
23 adjuster, that it would be nearly impossible to
24 try to incorporate that into your energy
25 hedging.

1 4. Okay. I understand that. On page 8 of
2 your statement, you discuss -- indirectly, you
3 discuss Proposal 17 on an energy adjuster, you
4 say, "Additionally, the proposal to add an
5 energy adjuster would add basis risk to futures
6 prices."

7 Could you explain how and to whom -- for
8 whom such an energy adjuster would add a basis
9 risk?

10 A. First of all, I guess before I answer the
11 question directly, philosophically, another
12 reason that we oppose an energy adjuster is that
13 we have got a system that is terribly complex to
14 begin with, and adding another adjuster, another
15 complexity onto it, in our opinion, in my
16 opinion, is just fundamentally the wrong
17 direction.

18 But with that said, to answer your
19 questions, the components -- we can talk about
20 whether you are hedging milk or cross hedging
21 cheese with Class III milk futures; and I guess
22 specifically, for anyone cross hedging their
23 cheese purchases with the Class III milk
24 futures, their interest is in the cheese price,
25 which typically is the biggest component and the

1 most volatile component of the Class III milk
2 price.

3 Obviously anyone who has been following
4 that lately, knows that the whey price has added
5 a large amount of volatility and basis risk to
6 that Class III futures price, and they are going
7 to hedge, and an energy adjuster would do the
8 same thing; obviously not probably to the
9 magnitude of the whey price movement recently
10 but it would be another moving piece that would
11 add basis risk or would decrease the correlation
12 between the cheese price and the milk price.

13 So it would affect anyone who was hedging
14 cheese with milk futures. It could affect or
15 would affect some of the local traders or
16 speculators that participate in the futures
17 market.

18 They have told me, you know, very directly
19 that this -- anything that would cause more
20 volatility or give them less ability to be able
21 to predict or estimate what price their milk
22 price would be, is problematic for them, and our
23 concern then boils down to if there are issues
24 like that that would decrease the trading volume
25 or liquidity of milk futures is negative for the

1 industry.

2 Q. Would that increase basis risk for plants
3 that are buying milk?

4 A. If they are buying -- well, first of all,
5 there are probably not a lot of plants hedging
6 with Class III milk futures, because they are
7 basically a margin business. Their output --
8 what they are getting for their output is based
9 on their input.

10 I didn't say that right. What they are
11 paying for their input, their milk is based on
12 their sales price, their output. So there is
13 really not a lot of reason for them to use milk
14 futures, because it is basically a pass-through

15 The risk is more for people that, say for
16 us, with retail businesses, for food service
17 businesses, that are doing hedging than for
18 either milk purchases or cheese purchases.

19 Q. You said it is a pass-through. It is a
20 pass-through of milk prices, plus processing
21 costs pass through to commodity prices?

22 A. Correct. I believe you said that correctly

23 DR. CRYAN: Thank you.

24 JUDGE PALMER: Questions?

25 Anybody? Mr. Rosenbaum, do you have anything

1 further?

2 MR. ROSENBAUM: One moment. No.
3 nothing.

4 JUDGE PALMER: Fine. Thank you
5 very much, sir. And I believe that is our final
6 witness of this session.

7 MS. PICHELMAN: I would like to
8 move that the McCully testimony, Exhibit 26. be
9 received into evidence.

10 JUDGE PALMER: Yes. it is
11 received. Let's go off the record a little bit.

12 (Thereupon, Exhibit 26 was received
13 into evidence.)

14 (Thereupon, a discussion was held off
15 the record.)

16 MS. PICHELMAN: I have some
17 information regarding our --

18 (Thereupon, a discussion was held off
19 the record.)

20 JUDGE PALMER: On the record
21 again. Yes? What is your full name again?

22 MS. PICHELMAN: Heather Pichelman
23 with the USDA Office of General Counsel. We
24 have some information regarding the next
25 session. I guess, where we reconvene. In

1 Indianapolis, **it** will be on Monday. April 9th.
2 beginning at 1:00 p.m., and the hotel where **it**
3 will be located is the Radisson Hotel, City
4 Center, Indianapolis. The address, 31 West Ohio
5 Street in Indianapolis. The number there.
6 317-635-2000.

7 JUDGE PALMER: Give that phone
8 number again.

9 MS. PICHELMAN: Sure. 317-635-2000.

10 JUDGE PALMER: Very good. Let's
11 go off the record a little bit.

12 MR. VETNE: I do have something
13 for the record.

14 JUDGE PALMER: Mr. Vetne, yes.

15 MR. VETNE: First of all. Your
16 Honor, earlier this week I distributed a copy of
17 direct testimony in the form of a declaration of
18 Tim Greenway. Mr. Greenway is likely to be
19 available at the next session, but I wanted to
20 note that, because if **it** is not -- if I don't
21 make mention of **it** or **it** is not marked. **it** would
22 technically constitute an ex parte communication
23 outside the record.

24 **It** may be helpful simply to mark that
25 as an exhibit, at this point, and subject to

1 cross-examination at the next session, or simply
2 to note that **it** is there.

3 JUDGE PALMER: I tell you what. I
4 don't think we need to mark **it** and confuse
5 ourselves. I will give you a ruling. I don't
6 regard **it** as an inappropriate ex parte
7 communication.

8 MR. VETNE: All right. Thank
9 you.

10 Secondly, I have some official notice
11 requests, which I think would be useful to get
12 them in at this time.

13 I will give them to you. They are
14 from CDFA, in addition to what has been
15 received.

16 JUDGE PALMER: C --

17 MR. VETNE: CDFA, California
18 Department of Food and Agriculture.

19 JUDGE PALMER: CDFA.

20 MR. VETNE: The Web site is
21 www.cdfa.ca.gov/dairy. In the "Hearings and
22 Outcomes" subpage of that hearing matrix. Class
23 IV-A and IV-B hearing of June 1, 2006, from that
24 the panel report dated 7/21/06, the final
25 results. statement of determination of 7/21/06

1 which was a determination by the Secretary of
2 Agriculture adopting the panel report.

3 And additionally, under dairy
4 publications on that Web site --

5 JUDGE PALMER: Under which?

6 MR. VETNE: Dairy publications
7 on that Web site, at the bottom of the page,
8 there is a report entitled "Estimated Impact
9 Analysis of 2005 Utility and Labor Rates on
10 Butter, Nonfat Dry Milk, Whey Powder and Cheese
11 Manufacturing Costs," which is an illustration
12 of CDFA's indexing of 2004 costs to 2005
13 changes.

14 From Dairy Programs AMS, I ask
15 official notice of the November 2002 economic
16 analysis on final Class III and IV make
17 allowance decision, and similarly, the November
18 2006 final economic analysis of the tentative
19 final decision, which I don't think has been
20 noticed at this point.

21 From Economic Research Service, which
22 is www.ers.usda.gov, I ask official notice of
23 the annual -- no, of the Monthly Livestock,
24 Dairy and Poultry Outlook Report for 2006
25 through 2007 date of briefing.

1 And from USDA NASS, at the Web site
2 is www.nass.usda.gov, three publications, one is
3 Dairy Products Annual Publication through April
4 2007, that is publication for -- sorry, through
5 2007, starting in 2000, which is an April
6 release each year. And then it usually comes
7 out in April, but just in case it is not, the
8 monthly publications of the same document for
9 '06 and '07 to date of briefing.

10 Okay. An annual publication called
11 "Agricultural Prices," which is ordinarily
12 released in July of each year for prior year
13 data, again from 2000 to the last publication
14 and then monthly for '06 and '07.

15 Also from NASS, a publication called
16 "Crop Production, Annual Summary," which is
17 released in January, the most recent one was
18 released in January for the prior year. 2000 to
19 2006 and then monthly through '07 date of
20 briefing.

21 And from the Office of Chief
22 Economist of USDA, the baseline reports that we
23 have been referring to for 2000 through 2007.
24 Those were released in February, and the URL for
25 that is www.usda.gov/oce.

1 And then, finally, remaining an
2 historical baseline data accessible through a
3 link from the Office of Chief Economist site on
4 the ERS Web site, and it contains an explanation
5 of the baseline, how it works, and prior issues
6 of the baseline. And that is accessible through
7 www.ers.usda.gov/briefing/baseline.

8 That concludes my request of official
9 notice at this time.

10 JUDGE PALMER: Anybody have any
11 problem with that? It sounds to me like they
12 are all Government publications, so we will take
13 official notice of them. They all appear to be
14 relevant for the matter of the hearing. We will
15 take official notice of each of the publications
16 that you have stated.

17 MR. VETNE: Okay. Then one
18 final request here, at the beginning of the
19 hearing. I brought up an issue and I am renewing
20 it now.

21 That is, the prior record that
22 brought us here, the record from the 2006 make
23 allowance hearing, which of the Class III and IV
24 price formula, addressed only make allowances
25 not yields, not surveys

1 Today's hearing addresses all three.
2 make allowances, yields and surveys.

3 I have a question of what I need to
4 do at the next session or sessions, depending
5 upon that record, since that forms the
6 foundation for much of the testimony. There has
7 been a lot of reference to testimony from that
8 hearing.

9 I would like that record. Your Honor
10 incorporated in its entirety, that is, the
11 exhibits and testimony from that record, into
12 this record.

13 The question of that kind of
14 incorporation evidentiary-wise is relevance.
15 Clearly, the testimony from that hearing on make
16 allowances is relevant to the make allowance
17 component of this hearing.

18 Another evidentiary question is for
19 evidence, if this were a court proceeding would
20 be one of hearsay. If you overcome the
21 relevance question, you get to hearsay. There
22 is a hearsay exception rule for prior recorded
23 testimony in court proceedings, the measures of
24 which include the availability of the witness to
25 reproduce everything he said before and be

1 subject to cross-examination.

2 If the witness is not available.
3 whether the witness, whether the testimony
4 produced was subject to robust examination or
5 opportunity for cross-examination by persons
6 having interest similar to those at the
7 subsequent hearing. All of those conditions are
8 met, and I think it would improve the efficiency
9 of the next session to know before we leave
10 today whether that record will be incorporated
11 in this record.

12 Otherwise, I have a list of about 20
13 witnesses and 40 exhibits from that. to do it on
14 an individual basis, and I think that would be
15 less efficient. Thank you.

16 JUDGE PALMER: Mr. Beshore, you
17 have comments?

18 MR. BESHORE: Yes. We object to
19 the incorporation wholesale of the record from
20 the prior proceeding.

21 The Secretary, very intentionally.
22 has established two separate hearings. This is
23 a new hearing, a new record. That was a prior
24 proceeding, a separate record. To grant the
25 motion would be to undo here what the Secretary

1 has done in establishing these dockets. And I
2 don't think it is appropriate.

3 With respect to the evidentiary
4 issues, of course, the availability and that
5 sort of thing. I would just say, there are
6 different issues in this hearing than there were
7 in that one. The examination, while there may
8 be some co-extensive, they are not identical.
9 And the examination, the testimony would have
10 been different. And I object.

11 JUDGE PALMER: I am going to
12 sustain your objection. I think it would just
13 confuse all the work we are doing here.
14 Everybody is concentrating upon the proposals
15 here and bringing forward their evidence and
16 trying to shape it.

17 I could well see using material,
18 perhaps from testimony at a prior hearing, to
19 cross-examine a witness, if you wanted to bring
20 a transcript reference in. But to just bring
21 the whole thing in wholesale, and then the fact
22 that the Secretary has, oh, I don't know, is --
23 at any rate, I am not going to keep talking
24 But I am going to sustain the objection and not
25 do that.

1 MR. VETNE: Okay. As I
2 understand **it**, Your Honor, the sustaining of the
3 objection is not based on any analysis of the
4 Rules of Evidence or the application of prior
5 recorded testimony from a separate hearing and a
6 different docket in similar circumstances in
7 Federal Court.

8 But in any event, the Administrative
9 Law Judge has the opportunity, under the rules
10 to certify a question like this to the
11 Secretary. That may be done between here and
12 the next hearing session, and I request that the
13 Administrative Law Judge so certify.

14 JUDGE PALMER: I am not going to
15 do that either. I think **it** is my job to do it.
16 I have done it. I think you have a ruling.
17 Obviously you have an exception to the ruling
18 that can be pursued. But I am not going to
19 certify it. All right. Let's -- yes, sir?

20 MR. MILTNER: Your Honor, I have
21 a separate issue to address.

22 JUDGE PALMER: Yes.

23 MR. MILTNER: I think **it** was
24 Exhibit 19, **it** was introduced with Mr. Wolfe,
25 and there were some Web sites -- there were some

1 USDA data that was provided. And we needed Web
2 sites to refer to those.

3 JUDGE PALMER: Oh, yes. Do you
4 want to read those in?

5 MR. MILTNER: Yes, the cost of
6 production information is from the Economic
7 Research Service, and the Web site is
8 [www.ers.usda.gov/browse/animalproducts/
9 dairy.htm](http://www.ers.usda.gov/browse/animalproducts/dairy.htm).

10 The documents relating to mailbox
11 prices are from Dairy Market News, and they are
12 reported once a month in Dairy Market News.
13 Those particular documents were compiled in a
14 spreadsheet available from the Mideast Market
15 Administrator's Office at www.fmmaclev.com.

16 JUDGE PALMER: Very well.
17 Anything else of that sort? Mr. Vetne.

18 MR. VETNE: A separate issue
19 but a procedural request. I have one request
20 and one inquiry of the department.

21 The request is, if the economic
22 analysis staff of the Dairy Programs can do an
23 analysis of the DairyLea proposal in a way
24 similar to the others, to do that or let us know
25 that **it** can't be done.

1 And the other question is, will the
2 testimony and exhibits from this segment of the
3 hearing be posted at some time in the near
4 future, so that we may review **it** before the next
5 session?

6 JUDGE PALMER: Think about that
7 for a while. I am not going to ask you to
8 answer that at this second. We will do that
9 before we leave.

10 MR. BESHORE: Just to make a
11 similar request with respect to an ERS, or the
12 economic staff analysis of proposals in the
13 hearing, if **it** were possible, we would like to
14 request that the IDFA positions as reflected in
15 Dr. Yonkers' testimony, which were not analyzed
16 by Dr. McDowell, be analyzed, if that is
17 possible, in the same manner that the other
18 proposals have been for the next session.

19 JUDGE PALMER: Let's go off the
20 record for a minute.

21 (Thereupon, a discussion was held off
22 the record.)

23 JUDGE PALMER: So that all and
24 everyone understands what is going to happen at
25 the next hearing, which is going to begin at

1 1 00 p m on April 9, 2007 in Indianapolis at
2 the place that has been stated a moment ago.
3 that hotel, in advance of that hearing, we are
4 going to try to do something to make sure that
5 we do finish that week

6 And one of the things we are going to
7 do, we are stating now that the order of
8 testimony will follow the proposals in the
9 notice, at least in respect to the direct, so
10 that we will first take the direct testimony on
11 the proposals in order, subject to change, for
12 the convenience of parties But that is going
13 to be the rule of thumb, if you will

14 And we will also have at the hearing
15 a sign-up sheet for all to sign who wish to
16 testify in opposition to any of those
17 proponents, and we will try to accommodate those
18 people principally -- well, I won't say just in
19 order of signing up, because there may be some
20 problems But we will get a sign-up sheet and I
21 will review it that day and we will see if we
22 can set up some appropriate times for them to
23 testify

24 There will then be a -- so we will
25 take the direct testimony, then we will take

1 testimony in opposition.

2 (Thereupon, a discussion was held off
3 the record.)

4 JUDGE PALMER: Again, this is a
5 rule of thumb. We will take all of the
6 proposals, testimony by people in favor of the
7 proposals first, and then we will take people
8 who are opponents of any or all of those
9 proposals.

10 However, it is understood that some
11 of the people giving direct testimony in favor
12 of some proposals may go on to testify in
13 opposition to other proposals.

14 We will then take time to allow for
15 rebuttal, and we will then have Government and
16 other witnesses of that sort come back as well

17 Statements. All of the people who
18 intend to submit statements of the sort that we
19 are receiving as exhibits shall provide them to
20 the Department of Agriculture on or before March
21 29th.

22 (Thereupon, a discussion was held off
23 the record.)

24 JUDGE PALMER: They will send them
25 to amsdairycomments.usda --

1 MS. PICHELMAN: At usda.gov.

2 JUDGE PALMER: Let's strike that.

3 I will do **it** again, amsdairycomments@usda.gov.

4 And they will provide them by March 29th. Now,
5 nothing here means that people can't still come
6 to the hearing and give a statement, but we are
7 trying to encourage them to get their longer
8 written type statements in before the hearing
9 so that they can be reviewed.

10 The statements will then be made
11 available on the Web site, as soon as possible
12 after March 29th.

13 Let me stop again.

14 (Thereupon, a discussion was held off
15 the record.)

16 JUDGE PALMER: Howsoever, in
17 respect to opposition testimony, statements of
18 that sort, **it** is understood that many of these
19 statements will not have been prepared in
20 advance of the hearing. And they will still be
21 received at the hearing, even though they were
22 not sent in by March 29th.

23 All right. I will see everybody. I
24 guess, then in Indianapolis. Have a good, safe
25 trip. Mr. Beshore?

1 MR. BESHORE: Do you want to make
2 any advance notifications to us in terms of what
3 type -- how long we are going to go daily at
4 Indianapolis in order to try to get the job done
5 and how long we are going to go on Friday of
6 that week? We are going to be challenged.

7 JUDGE PALMER: Yeah, I understand.
8 We are going to start at 1:00 p.m.. and we are
9 going to finish on Friday at 12 noon. But we
10 might do some evening sessions, but I really
11 would try to do it nine to five each of those
12 days.

13 But, if necessary, we may go into
14 some evening sessions. I think everybody has to
15 get home too. And travel is such that I think
16 we need Friday afternoon for that.

17 MS. PICHELMAN: Your Honor, the
18 testimony from this hearing and exhibits should
19 hopefully be available within approximately ten
20 business days. There was a request for that.

21 Also, the request for additional
22 economic analysis was noted. Maybe it can be
23 done. But it surely is noted and will be passed
24 on to those who would do it.

25 JUDGE PALMER: You have taken that

1 request and you will get back to them by -- how
2 do you get back to them? Do you give them a
3 call on the phone or put **it** on the Web site?

4 MR. ROWER: Oh, the result
5 could be posted.

6 JUDGE PALMER: ~~We~~ will post that
7 too.

8 MR. CARMAN: If we get one.

9 MS. PICHELMAN: The request was
10 noted and will be passed on to those who would
11 do it. Thank you.

12 JUDGE PALMER: Anything further?
13 ~~We~~ will see you in Indianapolis.

14 (Thereupon, the proceedings were
15 adjourned at 12:17 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 14th day of March, 2007.

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 Binnie Purser Martino, RDR. CRR

commission expires June 26, 2009.

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