VOLUME VIII

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 and	)	DA-07-02
Orders	)	

National Public Hearing
Wednesday, April 11, 2007
9:20 o'clock a.m.
Radisson Hotel Circle Centre
31 West Ohio Street
Indianapolis, IN 46204

BEFORE:

JUDGE VICTOR W. PALMER
U.S. ADMINISTRATIVE LAW JUDGE
UNITED STATES DEPARTMENT OF AGRICULTURE

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I N D E X   O F   E X A M I N A T I O N

I N D E X   O F   E X H I B I T S

JUDGE PALMER: On the record, this is Wednesday, April 11th. Mr. Smith told me just before we started that they still have a problem with Janna McGee, and he's going to give us a report.

MR. SMITH: Thank you, Your Honor. I worked a good part of yesterday with Janna and she disappeared from the scene and sent me an e-mail at 9:00 saying that her son had been back in the hospital. So I don't need to go through her situation.

I'm trying to make a good faith effort to present something first thing this morning, with the way the hearing's going, trying to juggle both things.

What I would like to do, if it's all right, is to try to have something circulated by the end of today in anticipation of the remote possibility that she might be called on Friday.

As of Monday, she was fully planning to be here. I don't know whether she is planning to be here, but I'll let Your Honor know as soon as possible.

JUDGE PALMER: Make a continuing report. Sort of let you off the hook about 48 hours, 24 hours, just regarding her circumstances.

All right. I've got to have you stand now.

MARY KEOUGH LEDMAN,

having been duly sworn to tell the truth, the whole truth, and nothing but the truth relating to said matter was examined and testified as follows:

DIRECT EXAMINATION,

QUESTIONS BY MR. BENJAMIN YALE:

JUDGE PALMER: We have Ms. Ledman this morning. I received a copy of her statement. I've marked it as Exhibit 45.

(Exhibit 45 was marked for identification.)

MR. YALE: Benjamin F. Yale on behalf of Select Milk Producers, Dairy Producers of New Mexico, Continental Dairy Products, Zia Milk Producers and Lone Star Milk Producers.

Q Ms. Ledman, would you please give us your name and business address.

A My name is Mary Ledman. My business address is 1642 Old Barn Circle, Libertyville, Illinois.

Q And you are here today to testify on what issue?

A The prices used in the calculation of the class I, II, III and IV pricing formulas.

Q Are you prepared to testify on any other proposals that have been submitted?
A No, I'm not.
Q I think you have a statement here that you're going to read, and that would explain what your experience and training and education is --
A Yes, sir.
Q -- in this field. Very well. If you would then make your presentation and we'll ask some questions after.
A My name is Mary Keough Ledman. I reside at 1642 Old Barn Circle, Libertyville, Illinois 60048. I am an agricultural economist that provides consultation to the dairy industry. My previous public service includes employment with USDA's Federal Order 30, Glen Ellyn, Illinois office, and the Foreign Agricultural Service and the National Agricultural Statistical Service in Washington, D.C. My private sector experience includes: Manager of Dairy Economic and Kraft Foods and Director of Materials Planning for Stella Foods. For the past 12 years, I have been employed by Keough Ledman Associates, Incorporated as a dairy economist that provides monthly dairy product and milk price

forecasting, economic financial and policy analysis, dairy product and milk sourcing strategies, domestic and international market information, and expert witness testimony.

I appear here on behalf of New Mexico Milk Producers in support of using dairy product prices transacted at the Chicago Mercantile Exchange rather than surveyed dairy product prices as published by the National Agricultural Statistical Service, otherwise known as NASS, for the calculation of the monthly Class I, II, III, and IV prices.

A little bit of background. How and why did the NASS prices evolve? Several of us here remember the National Cheese Exchange, which in 1997, disconcluded trading, and at that time trading was then enacted at the Chicago Mercantile Exchange.

There was plenty of controversy later on around the National Cheese Exchange. It seemed like when the price of milk -- price of cheese went up, it was an act of God, and when it came down, somebody must have manipulated it.

That type of anecdote got changed in 2000. When the price of cheese in Chicago went up, it was an act of God, and when it came down, it was manipulated.

I don't buy into any of those scenarios. But there was plenty of controversy and the Secretary of Agriculture took a pretty conservative route when he needed to replace the National Cheese Exchange cheese price that was used in the basic formula computation. He went to a safe haven of a USDA survey price done by National Agriculture Statistical Service.

For the most part, what the NASS pricing does is reaffirm the Chicago Mercantile Exchange pricing. The use of NASS prices got expanded with the implementation of Federal Order Reform. Federal reform used product price formulas for all four classes and they expanded the NASS survey not just for cheese, but including butter, powder, nonfat dry milk powder and whey powder in those surveys.

The NASS prices validate the Chicago Mercantile Exchange prices for cheese and butter. However, the NASS nonfat dry milk price does not track to the current cash nonfat dry milk prices.

The U.S. nonfat dry milk market is unique, very unique, because there are so few sellers. One entity markets more than two-thirds of the nation's nonfat dry milk production, and that marketer tends to market the price of the powder on last week's NASS price. So there's a tremendous amount of circularity from that standpoint. There's also a disincentive to obtain higher-product prices and we've seen this twofold. First, energy surcharges that cooperatives instituted on the powder price to capture rising production costs rolled into or eventually just created a higher milk price. It's also a disincentive from the standpoint of extracting a higher premium for your cheese; that premium, whether it's due to quality or service, also rolls into the milk price. And assured with all producers, and not necessarily the producers of that individual plant or co-op that are doing the good job to attain that higher premium, that premium gets diluted across the whole marketplace.

Likewise, if there's a discount, if somebody has poor quality or oversupply and they discount their cheese, that discount dilutes the price across the whole market area and not just for the specific producers from that specific plant or company.

There is a disincentive to produce products that are in the survey. There's an unnecessary lag or timeliness; the NASS prices typically lag the Chicago Mercantile Exchange by two to three weeks. At times, this has caused a disconnect between the advanced prices for Class I and Class II skim versus the four- to five-week prices, the monthly prices, that are included in the Class III and IV prices.

At times, this causes a disconnect, causes some pooling actions that would not have occurred otherwise, and I think more importantly, we're not sending the market signals to the producers to either produce more milk or to produce less milk on a timely basis.

The NASS survey is limited to the known producers of this bulk product. I became very concerned about this when I visited a dairy plant this past January, which has an old dryer in it, and I suspect that there are several plants across the United States that may have an old dryer in their plant somewhere.

The plant manager was very proud that over the Christmas holiday and into the New Year that they were manufacturing nonfat dry milk and selling it at $1.40 a pound at that time. And I asked the plant manager, I said, "So how much of that is reported to NASS?" He said, "Absolutely none. They don't know I'm producing it and I'm not going to tell them."

That statement did not -- that statement bothered me about how cavalier the plant manager was knowing that NASS collects this data. I followed up with NASS and they indicated to me that to be in their nonfat dry milk survey, the plant needed to produce a million pounds of powder a year.

So here's the conundrum. Here's a plant that's producing powder in December and January, I do not know if it's continued and I have not followed up to see if it's produced powder in February, March, April; but nevertheless, very likely that NASS will not know that they produced the powder in January until the following year's dairy product survey of what that plant produced. By that time, the data is lost and it's not in the survey.

So I believe that there's an opportunity here for NASS and AMS to work very closely together because AMS has auditors in most of these plants, the auditors can visually see whether or not powder was produced. Once they recognize that a product has been produced in that plant that would fit into the NASS survey, an e-mail should be sent, some form of communication should happen between the two agencies so that NASS is aware that powder production in occurring in these plants, or any other product that would fit the NASS survey.

There is a growing difference between the NASS nonfat dry milk fat and the nonfat dry milk price reported by Dairy Market News, as well as the Chicago Mercantile Exchange nonfat dry milk price. NASS may have obtained mandatory reporting from dairy product prices in the 2002 Farm Bill, but it does not have audit authority; therefore, it is difficult for NASS to know if the product price as being reported adheres to the reporting instructions.

Figure 1 below illustrates the growing difference between the Western Mostly nonfat dry milk price. And again, clarification, that's the mid point of the Western Mostly nonfat dry milk price and reported NASS nonfat dry milk price.

The difference between Central States Mostly nonfat dry milk price and reported NASS nonfat dry milk price is even greater.

During Q1 2007, the monthly NASS nonfat dry milk price averaged $0.12 a pound less than the average Western Mostly price. That translates into $1.03 per hundredweight lower Class II and Class IV prices.

In addition, there could be -- in these months, it could have been possible with the different nonfat dry milk price that Class IV would actually have been the mover as well. So there could have been additional producer revenue left on the table here.

The Western Mostly price ranged from $1.1725 to $1.75 per pound for the week ending March 30th. The NASS price for that week was $1.2378 per pound.

Figure 1 shows the growing difference between the mid point of the Western Mostly price minus the reported NASS price for that week for the month, and that price difference was close to $0.17 in March.

I believe that the Chicago Mercantile Exchange is a preferred price discovery mechanism for the dairy industry. The Chicago Mercantile Exchange, otherwise known as the CME, is the public forum for both buyers and sellers to enter the marketplace. The CME has expanded its dairy complex of futures and dairy products since 1997; not only expanded the complex, but also expanded the trading times. At one time, we just traded butter once a week, Friday cheese market. We moved to three times a week, then eventually five times a week.

The CME prices provide more timely market signals because that's what the industry uses to price its products at the retail and wholesale pricing levels. It has commodity futures trading commission for oversight. As the dairy industry moves towards a more market-oriented pricing environment, it is even of greater importance to have timely and transparent pricing data for all market participants.

I would like to add that I read Mr. Dryer's testimony from yesterday, and I agreed with Mr. Dryer, that I like to envision a dairy industry that perhaps we can get to a point where the nearby futures actually indicate what the cash market is. And the only way that we're going to get there is if we take out regulated -- I should say we take out the NASS price in between. To me, that is a -- it hampers the transmission of prices from buyers and sellers, it just provides a lag in price transmission.

I think it does a good job of validating what people are really -- what customers -- buyers and sellers are really paying for a price -- or paying for products, but I don't see the need of using it in a regulated milk price.

BY MR. YALE:

Q I have a few follow-up questions on redirect.

I want to follow up on this issue, though, of developing of the markets and the use of the CME and the like.

Do you see the industry moving to a point where it's going to be relying upon a futures or cash on its nearby futures for the sell of milk?

Do you see that coming at some point in time? More readily use of markets, such as the CME, or tools such as the CME?

A Yes, we see the CME futures market being used even over the off-the-counter transactions, such as financial swaps, that set a price today for the next six months, twelve months, and these financial swaps whether they're calculated on block cheese price or a milk price, those futures markets today are dictating how those derivative prices are determined.

Q Do you see the industry relying more and more upon such a market reporting and shifting system, price shifting and risk shifting system, using a public exchange such as that?

A I believe they're already doing so.

Q All right. So the question comes, is this step of going to the CME as opposed to NASS a step in the direction where the industry is taking us as we speak today?

A I believe it's where the industry is already at, outside of nonfat dry milk pricing.

Q And because the industry is already there and the NASS isn't there, that is crediting problems within the pricing and the movement of milk today as a result of that?

A Correct.

Q And you've identified some of those in your testimony?

A Correct.
Q Now, I'm trying to go backwards here. You talked about the Green Bay Cheese Exchange.
Who operated the Green Bay Cheese Exchange? Was it the industry or was it an independent exchange that operated this?
A It was an independent exchange that operated it.
Q Did they market any other products?
A No.
Q Now with the CME, this is part of a much broader exchange?
A Yes.
Q Do you know how many commodities, by any chance, the CME --
A I don't.
Q But it's quite a few?
A Commodities, both agriculture and nonagriculture.
Q So you have nonindustry professionals that are participating in the management of this exchange?
A Yes.
Q And auditing and monitoring this?
A Yes.
Q Now, you had bullet points I was following, and

maybe you made the point in one of the statements, but I just want to go back on the second page you talk about one of the bullet points is the fact that NASS does not have the ability to audit.

What do you mean by "not having the ability to audit" and if they did, what should they be auditing that they're missing that is relevant to the pricing of milk?

A NASS obtains the pricing information on Wednesday of each week that they publish then on Friday that they basically compile and publish.

When I've asked them in particular on the nonfat dry milk price do they know whether or not export sales are included in that price, they say, "Well, we really don't know because we don't have audit authority." They, in a sense, pass the buck to say "Well, AMS has audit authority." And because of the hearing situation and ex parte, I've not been able to contact anybody at AMS to verify whether or not that they -- if they believe that they have audit authority.

But it's clear that NASS does not have audit authority. So even if they believe a price is suspect, they have no way of knowing. They clearly can see if a price has been omitted, the volume has been reported, they can see some very kind of gleaming omissions perhaps. And not that these are just accidental omissions. So they can follow up on that type of data discovery and price discovery, but when you try to find out whether or not there might be a misinterpretation on the reporting instructions, they don't have that ability.

Q Included in that would be the ability to audit to determine whether or not there are forward contracts included in their reporting?

A I think the basic statement is they don't have the ability to audit the invoice of either the buyer or seller to verify those transactions.

Q Now, you mentioned the term "transparency" in the last bullet point.

Could you explain the importance of "transparency" to an efficient marketplace?

A Transparency and the ability to see a published price and the volume associated with that price on a daily basis is important to the credibility and the acceptance of the pricing mechanism and price discovery. And we have that at the dairy

trading at the Chicago Mercantile Exchange.
Q Now there are comments that are made that the Chicago Mercantile Exchange is a thin market, and that that is sufficient reason not to rely upon it to use it for pricing.
A In the definition of a "thin market" with a few buyers and sellers, it could potentially fall into that category. But when you look at the vast amount of cheese and butter that's priced off of that market, it becomes a little more debatable whether or not it is a thin market because there is a vast amount of product, as we see as reported in the NASS prices, that is directly correlated to those Chicago Mercantile Exchange prices.
Q As part of your consulting business, do you daily and weekly track the CME prices as well as what NASS reports; is that correct?
A Yes.
Q And you try to establish a correlation between the two?
A Yes.
Q In the CME cheese and butter market, have you seen any significant divergences between the NASS and the CME prices that were reported?

A Not over time. For example, if you look at a six- to eight-week period or even the annual averages are very, very close. But there are month-to-month variations or the two- to three-week lag that does come into play.

But when you look at it for a longer period of time, they're very close.

Q But if you compare an only two- to three-week lag, you've seen situations where the CME was not being reflected in the NASS or vice-versa?

A When you adjust for the lag, they are reflected.

Q So the market is telling the industry -- or is telling through the NASS that that CME is the setting price profile?

A Correct.

MR. YALE: Your Honor, we will make her available for cross-examination.

We would move two things; one, that 45 be admitted as an exhibit, including figure 1 that is there, which, by the way, we're going to talk about that before we go. And then the other one is to move that she be accepted as an expert on dairy pricing.

JUDGE PALMER: We'll do both. We will receive 45 and she is an expert.

MR. YALE: I want to look at this figure 1 and get that explained into the report.

Q First of all, is this prepared by you?

A Yes, it is.

Q And how did you compute this?

A I began by computing the mid point of the Western Mostly Price as reported by USDA's Ag Marketing Services Dairy Market News; and from that, subtract the monthly average NASS price used in the Class III -- excuse me, the Class IV pricing formula.

So you can see when the NASS prices were implemented and the Federal Order Reform pricing formula in 2000, there was very little difference between the NASS price and the mid point of the Western Price. And if we think back to that time, there was significant quantity of nonfat dry milk powder exported, subsidized export under the D program, basically a support price of $0.80.

There were sales of powder to the government at $0.80 a pound; and that's really reflected until 2005, where we had some market movement. And further, really where it became an issue, we actually saw some market movement into 2005, and then in 2006. What I mean by "market movement" is prices above support price.

The fall of 2005 we saw prices of $0.95, mid-90 type prices, about $0.15 over the support price. In the spring of 2006, milk production was very plentiful, I think about up four to five percent versus the prior year during the first quarter. We had sales applied to the government, those sales went into the NASS price and you can see that the NASS price dropped and pretty precipitously from December of '05 to midyear, in which the NASS price was actually lower than the western price at times.

Now we've seen a situation where the western price has increased dramatically, but the NASS price has not.

Q Do you have an opinion whether or not if we were using -- during that period of time, were using CME price or market price as opposed to the NASS, whether there would have been an impact on the class prices under the Federal Order program in late 2006 and early 2007?

A Yes, I do. The CME nonfat dry milk price, which is not the price that I used here, but the mid point of the NASS, if memory serves me right, the CME nonfat dry milk price was as high as, I think, $1.65, might have even been at $1.75 in November, December. I believe today it's $1.45 for extra grade and maybe $1.65 for grade A. But nobody trades on that market today, and one of the reasons why is that the packaging spec is government bags. And with the commercial market of over $1.50 a pound and the government price of $0.80, nobody is going to put anything in government bags.

So the constraint on trading at the Chicago Mercantile Exchange right now is over a packaging issue, just a packaging issue.

The price here in the Western Mostly, the prices would have been higher, but the Western Mostly average was not as high as what the Chicago Mercantile Exchange price was in November and December.

But the answer is, if we used the mid point of the Western in the formula, it would have been higher, and recently, in the first quarter of this year, about $1.03 per hundredweight higher.

Q What would that impact have been on the rest of the classified pricing if that would have occurred?

A It would have raised the Class IV and II prices $1.03 here in the first quarter of this year, and potentially the Class IV could have been the mover and would have raised it as well.

But I don't have the magnitude of what the Class I would have been increased by.

MR. YALE: I have no other questions. Thank you.

JUDGE PALMER: Questions?

CROSS-EXAMINATION,

QUESTIONS BY MR. STEVEN J. ROSENBAUM:

Q Good morning. I recognize you're not an attorney; on the other hand, you did in your --

JUDGE PALMER: That helps her.

MR. ROSENBAUM: It helps her. In many cases it helps her.

Q However, in Exhibit 45 you do make the statement that NASS does not have audit authority with respect to the commodity prices that currently form the basis of the Federal Order pricing system, correct?

A Yes.

Q And then you --

UNIDENTIFIED SPEAKER: For the enhancement of the record, we have a new court reporter. Could Steve identify himself.

MR. ROSENBAUM: Good point. I'm Steve Rosenbaum, representing the International Dairy Association.

Thank you for having me do that.

Q Then Mary, you elaborate on that point somewhere in your testimony, your oral testimony as well, correct?

A Yes.

MR. ROSENBAUM: I think, Your Honor, I would like to have marked as Exhibit 46 a document which I will now distribute.

(Exhibit 46 was marked for identification.)

JUDGE PALMER: The document is actually a copy of the Code, 7 U.S. Code Chapter 38, what is it section 1637b. Mandatory reporting of dairy products.

Right away I'm going to ask that Ms. Ledman not be put through too much.

MR. ROSENBAUM: It will not be extensive, but she has made certain statements regarding NASS' authority.

I'll represent this is the current in effect version of that section of the code which anyone can verify.

JUDGE PALMER: The code will speak for itself. We'll use this just as helpful repetier, but any difference between the code itself is the code.

Q I'm not going to expect you to do this in great detail, but you do recognize that the start of this provision is the one that talks about the establishment of mandatory dairy product information reporting system?

A Yes.

Q And at the bottom under, what's number 3, it says "The Secretary shall take such actions as the Secretary considers necessary to verify the accuracy of the information submitted or reported under this subchapter."

Do you see that?

A Yes, I do.

Q And were you familiar with that provision until I showed it to you?

A Not that provision, but, Mr. Rosenbaum, I talked to NASS specifically. This is a quote from NASS that their own people doing -- calculating this data, they do not feel that they have audit authority and indicated that AMS does.

Q Do you know whether AMS is even, as we speak, in the process of promulgating a regulation to carry out these requirements?
A As I indicated in my testimony, due to ex parte in effect, I was not able to contact AMS or anybody in formulation to get their opinion as whether or not they have audit authority.
But clearly these prices by NASS' own admission are not being verified, and that's a problem.
Q I recognize actually we want -- don't get us wrong, we want them to be audited, too; but you suggested question as to whether there was, in fact, the authority to audit.
A And my statement, I should have been a little more clear perhaps, and said according to discussions with NASS.
Q Okay.
A It was NASS' own opinion.
Q From your perspective, it is AMS that imposes it as a mandatory -- let me start that again.
If it's AMS that provides the verification system through audits, that's fine by your perspective, I assume?
A In a perfect world, we would like to have the

agency actually doing the data collection and receiving the information firsthand to also do the auditing. To me, perhaps AMS should be doing it all or NASS should be doing it all. But when you start bringing in the cross agency task force to do something like this, we also get more delays and we'll find ourselves perhaps having revisions, but not on a timely basis.

Q These are both parts of USDA, aren't they?

A Correct.

Q Now, you have provided in figure 1 a chart that shows a difference between the NASS reported nonfat dry milk price and the Western Mostly price, correct?

A Yes.

Q I take it from your testimony that you have not perceived this kind of difference with respect to the CME versus, for example, the -- well, versus the other prices that are used to set minimum prices of Federal Order system and for which there is an CME price, correct?

A Correct.

Q This is unique to nonfat dry milk?

A It's unique to nonfat dry milk and the duration of it is unique.

Q Now, the nonfat dry milk market, the sellers there are cooperatives, correct?
A They are cooperatives primarily. Like two-thirds of the co-ops production, like a billion pounds of powder is all sold through Dairy America, a marketing agency, which has really turned into a cartel, if you will, that they set the price for their powder based upon last week's NASS.
So the NASS becomes the driver of their price.
Q But you would agree with me that it's cooperatives who are making that product and selling that product?
A Yes.
Q It's not proprietary handlers, correct?
A Correct.
Q If there's a misreporting to NASS that's going on, which I guess your testimony would infer, that's a misreporting by cooperatives, correct?
A Yes.
Q And by the way, you mentioned -- and this will be my last time to make you look at the statute probably -- you mentioned about plants of under a million pounds being exempt from reporting

requirements.

Do you recall talking about that?

A Yes.

Q And I just want to have you, and once again, it's in the middle of the page under D you see that it's discretionary with the Secretary whether or not to exempt plants under a million pounds, correct?

A I see that says "may exempt."

Q If there's a concern that that exemption is causing distortion in the reporting, I presume that the Secretary could remove that exemption or lower the exemption, as the case may be.

Do you see that?

A Yes.

Q Now, I want to read to you -- let me back up.

You're aware that the question whether or not the price formula should be driven by the NASS survey or by the CME is an issue that USDA has addressed a couple times in the past, correct?

A Yes.

Q This was an issue in Order Reform where there were some in the CME camp and some in the survey camp, correct?

A And seems like those camps have switched sides.
Q There may have been some switching. But USDA has been consistent. They, as part of Order Reform, made a decision to go with NASS surveys, correct?
A Correct.
Q Are you aware of the fact that that question was revisited as part of the hearing process that took place in 2000 after Order Reform was implemented January 1, 2000?
A Yes.
Q And once again, there were people who came to a hearing, just like this one, and suggested it switch to the CME; others who took the stand and argued why NASS should continue to be used, correct?
A Yes.
Q And USDA made a decision, then, to continue to use NASS and not switch to the CME, correct?
A Correct.
Q Now, I want to read you a sentence from the decision. This is the October 25, 2001 proposed rule, so this is a result to the 2000 hearings, 66 Federal Register 54072, where USDA states "The NASS prices reflect the CME prices with a

short lag, but are based on a much greater volume."

Now, you would agree with me -- let's just break that down. This statement "the NASS prices reflect the CME prices with a short lag," You would agree with me that that is an accurate statement except to the extent that it's proven recently to be inaccurate with respect to nonfat dry milk prices, as your figure 1 would suggest?

A That statement is accurate. I debate what a "short lag" is, two or three weeks; but nevertheless, regarding cheese and butter, that is correct. And even in 2000 and 2001, and you could make the statement to 2004, with very little market movement on nonfat, there was little reason to be concerned about the discrepancy between cash nonfat dry milk price and that reported by NASS.

We're not in 2004 anymore, and so the market conditions have changed significantly, and I believe that they're going to continue to change significantly going forward. I don't see us going backwards.

Q Well, there were different parts of your answer.

Would you agree with me that for cheese and

butter, the NASS prices reflect the CME prices with a short lag?
A With a lag, yes.
Q Would you --
JUDGE PALMER: With a "short lag."
Q Would you agree with the lag has not changed for those two commodities?
A The lag has not changed, but I don't think that lag adds anything for transparency.
Q And then the other thing USDA said in deciding to continue to use the NASS survey was that "the NASS prices are based on a much greater volume than the CME prices," correct?
Now, you may or may not view that as a valid criterion for decision making, but just from a factual perspective, you agree with me that the NASS survey picks up a much greater volume than the volume that's actually traded on the CME?
A I think we're comparing apples and oranges there. One's a reported price and the other is an exchange transacted price.
I think if we expanded the whole universe to include swiss cheese and mozzarella cheese, and all kinds of cheeses, they would all come

back and have some correlation to the Chicago Mercantile Exchange and we would have even a greater reporting universe. But at the end of the day, we're still not going to change the basic common denominator, which is the Chicago Mercantile Exchange program.

Q There are figures available, which I'm sure you've seen, as to the quantity of cheese and butter that's captured by the NASS survey, correct?

A Yes.

Q And there obviously are figures reported by CME as to the quantity of trades that take place on that market, correct?

A Yes, but compared to the billion pounds of butter being produced and nine billion pounds of cheese being produced annually, even which is what's captured at the NASS pales in comparison.

Q It may pale in comparison, but you can develop an analogy you couldn't see the CME volume trade from that perspective, correct; it's so much smaller, isn't it?

A The CME trade is small, but it sets the price for basically all of that nine billion pounds of cheese production.

MR. ROSENBAUM: I would like to mark another exhibit, Your Honor, which is Exhibit 47.

JUDGE PALMER: Do you want me to receive 46?

MR. ROSENBAUM: Your Honor, I would ask that it be received because it's convenient.

(Exhibit 47 was marked for identification.)

Q Exhibit 47 is an excerpt from the USDA Dairy Market Statistics 2005 Annual Summary, and I've pulled the tables that relate to trades on the CME for the butter and nonfat dry milk and cheddar cheese products by month and then by total for 2005; and then there's also an annual figure of 2004.

First off, let me just get you to confirm that there is no trading of dry whey on CME, correct?

A That is correct.

Q So even under your approach, there would continue to have to be a NASS survey as to dry whey prices, assuming the dry whey continues to be one of the commodities assessed in milk prices?

A One of two things would have to happen, whether

CME institutes -- brings together a cash contract, which could be a possibility. The other would be to follow suit what California has done in their cheese/milk price IV(b) price they use to mid point mostly for the western weight price in their milk price calculation.
Q Now, with respect to nonfat dry milk, there are shown here, correct me if I'm wrong, but zero trades for extra grade during the entire calendar year and five trades of grade A.
Am I reading that correctly?
A Yes, you are.
Q And then for cheddar cheese, with respect to 40-pound blocks, in the year 2005 there were as few as 14 trades -- total trades in a given month looking at January of 2005.
A Yes.
Q And with respect to barrels, there were as few as zero trades looking at July 2005, and there were a number of months which the total number of trades were fewer than 10, correct?
A Yes.
Q And these would be the -- under your proposal, this would be what we would be looking to, to set the minimum milk prices, correct? Not the

trades, the --

A Mr. Rosenbaum, this is what sets the NASS prices today. Nothing would change.

Q Well, the NASS prices are based upon thousands of actual transactions as --

A That have more than a 95 percent correlation to the Chicago Mercantile Exchange price.

I don't think there is an economist that will testify here today, or during the course of this hearing, that will not tell you that the lead indicator of the NASS price is the CME. And the only reason why the industry, both producers and processors, accept the NASS price is due to its high correlation with the Chicago Mercantile Exchange price.

Q Just to finish. In terms of butter sales, you have as few as 52 sales taking place in January 2005.

Do you see that?

A Yes.

Q Now, so in terms of actual commodities traded on the CME volume, you would agree with me that it's a tiny fraction of the product produced?

A You know what, reviewing the butter numbers on sales on butter, not having a calculator in front of me, but I think that there may be some months there on butter where the sales on the CME actually are greater than reported sales on NASS.

I think they'll be fairly close when we've got some months with over 200 carloads of 40,000-pound -- I see Mr. Hollon with his calculator there.

Can you do me the honors, 224 multiplied by 40,000.

Q Why don't you do 52 at the same time if we're going to go down that road, since that's the low amount.

UNIDENTIFIED SPEAKER: 8.9. So there would be a couple months where it may be close.

JUDGE PALMER: We don't want testimony out of the audience.

A 8.9 million, right?

JUDGE PALMER: Let the record show -- because this gets confusing -- someone in the audience gave her the number 8.9. She accepts it and she can use it, and that's it.

I don't want any other testimony from the audience.

Q By the way, you said there was a 95 percent

correlation between CME and NASS?
A Yes.
Q What does that mean "95 percent correlation"? Statistically, what does that mean?
A That 95 percent of the variation --
Q How much variability can there be off of the --
A Less than 5 percent is not attributed to the CME price.
Q Can you provide a range based on that information as to what is the range of numbers off the CME that the NASS can be and still be within 95 percent?
A No, I can't; not off the top of my head.
Q What I'm trying to get at is, do you know how different the prices could be between NASS and CME in any one month and still be within 95 percent correlation?
A I don't have that work in front of me, no.
Q Now, one of the issues you talk about is the lag, the two-week lag or so, correct?
A When I -- I use a three-week lag, a three-week equation when I'm predicting the NASS, weekly NASS cheese and butter prices off of the CME price.
Q Have you seen Bob Wellington's effort to see how

many weeks' lag picks up the difference between CME and NASS?

A No, I just use it for trading Class III futures for my personal use.

Q Are there some commodities -- are you familiar with livestock and meat, as well as dairy?

A I'm familiar, but -- I'll just say "I'm familiar."

Q Do you know whether the reporting of those are on a daily basis?

A Yes, I'm aware of the daily transaction prices reported into, I think, AMS. Their market livestock information system is very extensive and maybe could serve as some prototype for what the dairy industry potentially could get to some day.

Q Right. I mean, would the lag issue be addressed? Would the lag problem be reduced if there were more prompt reporting requirements as opposed to respective dairy commodities?

A Yes.

MR. ROSENBAUM: That's all I have. Thanks.

JUDGE PALMER: I've got some questions that are basic type things that go along with this here and I guess confused.

The lowest price these days is Class IV, is it not, in minimum pricing? We don't have a Class V?

A That's correct. But the lowest -- Class IV is only the lowest price because the combination of the butter and nonfat dry milk price used in the formula multiplied by the yields and subtract the make allowances results in a lower calculated price than the Class III.

But there are times where the Class IV, and I would suggest with using a different pricing mechanism, Class IV would be higher than Class III. Just because of the order I, II, III, IV does not necessarily mean that IV will always be less.

JUDGE PALMER: Well, we'll start with IV thinking of that as the building block, I gather. And what products are typically in Class IV?

I know they vary sometimes.

A It's real simple.

JUDGE PALMER: Good.

A And it's not -- years ago we had Class III was the building block, Class III plus $0.30 plus Class II.

We don't have that anymore. It's real simple. We have four products, butter and nonfat dry milk.

JUDGE PALMER: Is Class IV.

A Yes.

JUDGE PALMER: Butter and dry milk?

A Class III is cheese.

JUDGE PALMER: Now wait a minute. Butter and what was the other, dry --

A Nonfat dry milk powder.

JUDGE PALMER: Nonfat dry milk powder.

I'm doing this in case there's a review. I really am. In case this goes up to a court some judge goes, what the heck are they talking about, I thought, let's put it in one spot so maybe there's something here that could be an aid, and also for me.

So we have butter and nonfat dry milk powder as Class IV.

A Correct.

JUDGE PALMER: Class III is what?

A Just to be clear, milk that is converted into butter and nonfat dry milk is priced at Class IV.

JUDGE PALMER: Yeah.

A Milk that is converted into cheese is Class III. The product prices that go --

JUDGE PALMER: Milk converted into cheese. What's Class II?

A For the record, to calculate that Class III price, you need the cheese price, the whey price --

JUDGE PALMER: I'm going to go back to that.

A Okay.

JUDGE PALMER: Just give me the classes and then we'll go back.

A Class II are soft products, like yogurt and ice cream.

JUDGE PALMER: This is pretty much close enough for me.

Then class I is --

A You drink. The way I explain this is Class I you drink, Class II you spoon, Class III you cut, and Class IV you can store forever.

JUDGE PALMER: Now, how does -- in looking at Class IV, how is the NASS pricing set in Class IV? What do you do with the NASS price?

What is that? Does it serve a variety of things, I gather includes butter, nonfat dry milk, cheddar cheese.

Do you use all of it? Do you use a combination. Do you use an average or are you more specific?

A More specific. Specifically use the four or five weeks of data published by the 5th of the month for butter and nonfat dry milk powder in the Class IV formula.

JUDGE PALMER: You just use it for those two, just for the ones that are in the Class IV, butter and nonfat dry milk.

A Correct. The Class IV price plus $0.70 becomes the Class II price.

JUDGE PALMER: Becomes II?

A Becomes II. The Class IV plus $0.70 becomes the Class II price.

JUDGE PALMER: What happens to Class I?

A Class I is determined from the higher of either the Class III price or the Class IV price, using just two weeks of data.

JUDGE PALMER: That's why I'm asking this. I don't think this would be particularly intuitive.

A I don't think it's intuitive for a lot of us.

JUDGE PALMER: The Class III price you look at what?

A The block and barrel cheese prices that's reported by NASS, the whey price and the butter price.

JUDGE PALMER: Now is whey priced at Class III? You told me before that we have -- gee I forgot what we have. I saw cheese.

A Cheese. Cheese -- you know, "Little Ms. Muffet sat on a tuffet eating her curds and whey." We've got the cheese part of it and whey part of it. And the combined value of cheese, which includes butterfat and whey becomes the Class III product.

JUDGE PALMER: Anybody buys milk and cheese, extensively, anything left over for whey still be paying Class III price, the whole amount of milk.

A What happens is Class III, the milk price doesn't determine the whey price. It's the components that make up the -- it's when you take 100 pounds of milk and to convert it into cheese, what's the value of each of those components.

When I make a pound of cheese, I also have whey left over.

JUDGE PALMER: Wait a minute. Now, if I bought milk to make cheese, and I have a byproduct of whey, I don't get any change in price do I because some of the milk didn't actually make blocks of cheese, but made whey? I still pay the Class III price for all the milk that went into my cheese. So whey is really included in that.

A Whey is included in the Class III milk price, yes.

JUDGE PALMER: And the same thing -- what happened in Class II you say is the Class IV price plus $0.70.

I'm trying to figure out what yogurt sells for, ice cream sells for, just use that arbitrary $0.70.

A Correct.

JUDGE PALMER: Now what you're proposing is to use the -- what did you call it?

A Chicago Mercantile Exchange.

JUDGE PALMER: And how would that work for Class IV? What products would it be?

It wouldn't be just everything we sold in the United States or anything, it would be the products that went for butter and nonfat dry

milk as reported on the exchange?
A Correct. There would be no change in what products are used to calculate the class prices. We would just use a different publicly announced price.
JUDGE PALMER: The same applied in III; III would be the price of cheese?
A Correct.
JUDGE PALMER: II would still be whatever IV was calculated at plus $0.70?
A Yes.
JUDGE PALMER: And Class I would be the higher that you report?
A Yes.
JUDGE PALMER: If I've fouled up anything asking you these questions you want to straighten me out. Is there anything else class prices so somebody who would look at this who doesn't have your expertise would understand again what's happening?
A I think we've covered it.
JUDGE PALMER: Okay, I'll stop.
MR. ROSENBAUM: Your Honor, I think I need to move Exhibit 47 in evidence.
JUDGE PALMER: 47 is received.

Who else has questions?

MR. BESHORE: Marvin Beshore representing Dairylea Cooperative and Dairy Farmers of America.

CROSS-EXAMINATION,

QUESTIONS BY MR. MARVIN BESHORE:

Q Good morning, Mary.

A Good morning, Mr. Beshore.

Q Do I understand correctly that you're not advocating use of the CME for powder because of the inadequacy of contract?

A I believe that if the industry was given notice that NASS would be discontinued, that the industry would then find a replacement. And I think CME is the place to go to because it is the publicly traded market.

There is a problem, as I indicated, that the current spec is packaging in government bags. I believe that the industry can come to terms with the commercially-acceptable packaging and change that so it becomes a viable market. As it stands today, there's zero tradings because of that packaging requirement.

Q So CME, hypothetically in the future, if the trading terms, the products specifications would

changed, it could potentially be a market that could be used for powder?
A Correct.
Q But not under its present terms?
A Correct.
Q Now, with respect to some of the other commodities, then, just a couple of questions.
In the NASS pricing you've indicated some of the problems there and you noted circularity. There's been some comments about that, more comments about that proposal intended to address that issue.
Why is circularity a problem with NASS prices?
A It almost becomes why is circularity not a problem with the NASS prices.
Q Okay.
A And this is primarily an issue on the nonfat, but it also -- circularity comes from two areas; one is that if I try to raise my price on my cheese price, for example, because I have superior quality or service, that higher price gets into a survey and it raises my milk costs. So there's that type of circularity.
On the nonfat dry milk powder where rising

energy costs prompted nonfat dry milk manufacturers to implement fuel surcharge or energy surcharge, that became incorporated in the price. So they really never recouped that surcharge, it just enhanced the milk price.

Q So is it fair to say that the circularity issues with the NASS tend to put a damper on that price in your view as an economist?

A When we're talking about the fuel surcharge, it would have actually increased the class price. So those types of surcharges actually enhance the class milk price.

Q Okay. But one of your comments was -- and maybe this is not circularity, per se -- but you indicated, this is Exhibit 45, that the challenge with the NASS is that there's a disincentive to obtain or report higher product prices.

A That's correct. Because by reporting higher product prices, I'm just increasing my milk cost.

Q How does that work? We had a couple cheese manufacturers testify yesterday that their plant operations or the company operations a portion of their cheese production is reported to NASS, perhaps 20 percent, in one circumstance, 40 in another.

How does that disincentive play into the operations of a company in that situation when they've got 60 percent of the products are non-NASS, 20 or 40 percent are NASS?

Can you talk about that a little?

A Part of this would be what of their production fits the criteria for NASS. And I don't know the individual scenarios for those plants, but if I'm making a product that does not fit the product specification, or a product that we use internally. Say we make 40-pound blocks, I sell 20 percent of it on the open market, 80 percent of it I have contracted to our own cut and wrap facility, that's considered an internal sale. So that would not be in the NASS survey.

Maybe somebody who puts omega 3 or some foo-foo powder and it no longer fits the description and they may sell it at a $0.5 premium over the NASS; or it could be the old "oops vat," and it is not fit for human consumption and sells at a $0.20 discount. So there could be a variety of reasons why that's not included.

But there's -- just to be clear here, if I'm making a high-quality product and I'm getting a $0.2 to $0.3 premium on that, I want to share that $0.2 to $0.3 premium with my own producers shipping to the plant. I don't want to share that in the marketplace.

So there's a disincentive to report quality product.

Q So with the non-NASS products, the non-NASS portion of the company's production you have the appropriated incentive, correct, or an incentive to get the premium and the NASS product you don't have the same incentive?

A Yes.

Q The NASS prices, while there's a correlation with the CME, are lower than the CME, correct?

A Historically, I believe that -- I don't have all the annual years in front of me, but the NASS prices tend to be lower because they tend to be FOB plant prices, and there's a greater percentage of bulk dairy product being produced in the west, which has an FOB price, which is a discount -- a transportation discount from the Chicago market.

Q So NASS prices, by definition, are FOB plants,

correct?
A Correct.
Q And since they're lower than the NASS because of the FOB pricing and the weighting towards the western part of the country's production, weighting towards the western part of the country, is that perhaps one reason why the industry may wish to stay with NASS prices versus CME prices for Federal Order pricing?
A My personal opinion is that the industry -- my personal opinion is no. I think the industry is concerned about controversy of the National Cheese Exchange and the controversy that moved to the Chicago Mercantile Exchange.
It is my opinion that the Chicago Mercantile Exchange has been investigated, whether it be Justice Department, GAO, CFTC's, and I think it's weathered the storm. I think we're a lot more mature today in our use of the CME market than what we were in 2000.
So I think there are several companies that don't necessarily want the CME to come under that limelight and fire, and so they're comfortable with the NASS.
I don't believe that any of them are -- for

the half-cent to penny difference between the NASS and CME, I don't think that's a driving force.

Q If you're using the CME, would you use the block price? Is that your suggestion?

A For simplicity, I think the block price is the way to go. And my testimony is just limited to price here.

But when we incorporate the barrel and we're talking about different yields and we're talking about different make allowances, I think it's pretty clear that this industry bases the vast majority of the nine billion pounds of cheese off the block market. So I'm comfortable with using just the block market.

Q Can you elaborate on that, to the extent you can? What in your knowledge -- in your experience, what's the basis for your testimony that the great majority of the nine million [sic] pounds is based off the block market and not any other market -- CME block market?

A CME block, the nine billion pounds.

Q Billion pounds.

A Billion pounds. The barrel market prices barrel cheese; it does not serve as a pricing mechanism for Hispanic cheese or mozzarella cheese or pizza cheese. It does serve a function with pricing barrel cheese and barrel alone; whereas, the 40-pound block encompasses virtually every variety of cheese.

Q And in your personal knowledge, those additional varieties of cheeses are priced off the block market?

A The vast majority are priced off the block market. There are some of those cheeses that are attempting to price off of a Class III price and backing into kind of a theoretical cheese price; but it's my opinion that most of the cheeses are off of the block market.

Q Now, one of the -- of course, the producer for the manufacturers of those cheeses that are being priced and sold off the block market, one of the things that the NASS price does for them that the CME block market would not, is include barrel prices in their noted costs, correct?

A Yes.

Q And those prices, historically, are somewhat less than block prices?

A That has not been the case this year.

Q I didn't ask about this year. I said historically those prices have been somewhat less than the block prices, correct?
A From 2000 and 2005, yes.
Q And the spread has narrowed and there's been recently an inversion, if you will, in that price relationship?
A That's correct. But in the pricing formula, the addition of the $0.3 to the barrel price could actually be even greater price enhancement.
Q If you're using the CME block market, as you've suggested, what's your -- do you have a comment to if a barrel processor would object to that?
A I have none.
Q Just a question or two about a couple other points.
The manufacturer that is producing powder being sold on the spot market not reporting to the NASS, is that a situation where under present price relationships you could almost have a processor not reporting Class IV prices whose return was, you know, in excess of Class III, in excess of Class II, maybe even Class I in some area?
A I would call it a windfall profit.

Q Your figure 1 --
A And I would just like to interject. That was at $1.40; today's market is $1.80. We're talking four or five bucks a hundredweight. Big numbers.
Q So mandatory reporting and auditing would be useful?
A I think it's imperative with regulated pricing.
Q The table, figure 1, on Exhibit 45, your difference there is based on what, the mid point of the Western Mostly?
A Correct. If memory serves me here, I'm thinking the mid point was -- well, now the mid point of the Western Mostly is close to $1.55, $1.58, and the NASS price is close to $1.25. So it's increased now in April or the latter part of March to $0.30.
Q So this table goes through what, March?
A March.
Q Figure 1. The mostly range, I'm looking at fair market use for volume 74, report 14 on page 5. This is for week of April 2 through 6.
The Western Mostly range is reported as $1.24 to $1.80.
A Right, and the NASS price for that week will be

reported this Friday. The last bullet that I have went back a week on the Dairy Market News to the prior week's issue, and so that corresponds with the NASS -- this was the NASS price reported on April 5th for the last week of March.
Q The $1.25?
A The $1.2378.
Q $1.2378, okay.
A Because we had two official reports for the Class III and IV prices for March.
Q Yeah, we don't have to get into that.
A Okay. But this is using the report from April 5th.
Q Okay.
A Just for clarification.
Q Just in terms of your comparison here, what it shows -- or doesn't show, we know nothing about the volumes in the Mostly sales, correct?
A Correct.
Q You don't know whether there were in fact any trades at the mid point, correct -- I mean any sales at the mid point?
A Correct.
Q And you don't have any idea what the volume

disbursement of sales within that $1.24 to $1.80 range, correct?
A The Mostly is simply Dairy Market News folks who have been doing this job for several years calling the same people every week and saying "How much are you selling powder for?" It is not weighted. It's not verified either. But it is what the industry uses to place product that does not have -- that is not traded at the Chicago Mercantile Exchange, such as the dry whey price. People buy whey, sell it mid point at the Mostly.
When I was with Stella Foods buying 20 million pounds of nonfat a year back in 1993, '94, mid point at the Mostly was how all those contracts were written. The nonfat marketing has changed since then.
Q In any event, the volumes of powder, as far as that's concerned, that NASS reports or that were reported to NASS are very substantial volumes and a very substantial proportion of the total powder production in the country; is it not?
A Yes.
Q And that's a difference between the dynamics of powder marketing in terms of NASS -- powder

market in terms of the NASS reports versus other reported transactions?

A What's troubling, there is a lot of powder that is reported to NASS. Sometimes I think the focus on NASS has been on volume, not necessarily on price. And I say that because when I talk to people who report NASS prices, one in particular shared with me that the whole confusion, perhaps, on forward pricing it says specifically in the NASS instructions not to include a price that's been determined 30 days in advance.

And what they were -- what they claimed they were told at one time is that just for easy math, say that you sold 1.2 million pounds of powder at a fixed price, well, they -- NASS didn't want 1.2 million reported in the first month, they wanted it as an exited plant and they could use that fixed price for each of those monthly increments.

My interpretation of the NASS rules is that that fixed price sale would be in effect the first month, but in the second month that price would have been set more than 30 days in advance.

This is the difference between the California weighted average price and the NASS price. The California weighted average price specifically includes forward contracts, and over half the powder in this country is made in California; and I think that's where some of the confusion or perception with the NASS prices versus the instructions for NASS prices are coming into conflict.

Q So in any event, if the Western Mostly was -- mid point Western Mostly was used to price Class IV in the Federal Order system, a very large majority of the production in Federal Order system, which is reflected in the NASS price, would really be at a huge -- have a huge price problem; would it not?

A I think if we got rid of NASS prices tomorrow, you would see a dramatic change in how Dairy America prices nonfat to its customers.

Q Things can always change in our future, but if that was the -- if the Western Mostly was used today for -- and it priced those transactions that are reflected in the NASS series, it would be a huge problem for the powder producers, would it not, financially? I mean, they would

be selling it at several dollars under the minimum class price.
A Dairy America today is reporting a cash price of $1.85 a pound. We don't know how much they're selling at $1.85, but their producers are getting the equivalent of $1.25 in the Class IV or IV(a) price for that powder.
Somebody's making some money here.
Q Are you questioning the NASS average prices involved here in powder?
A Absolutely.
Q You don't think they're accurate?
A I think that there's a disconnect in the pricing on NASS, why NASS is so low compared to the cash market.
Q Well, it's a spot market, isn't it? The cash market is just a spot market?
A Dairy America practices is using last week's NASS on a portion of their sales to price this week's NASS.
If we want to talk about a thin market, we basically have two suppliers of price data to NASS; one is the cartel that represents nine cooperatives and 24 manufacturing plants, and they're sending in one price. And then you have

the other that's not a part of that. Meanwhile, if I picked up the phone to try to buy a load of nonfat dry milk today, I would be told the price of $1.85.

I would like to suggest that if the NASS cheese price was $0.10 or $0.20 less than the Chicago Mercantile Exchange, we'd have a congressional inquiry.

I'm a little baffled as to why that has not happened on nonfat.

Q You do not have personal eye-on knowledge of the Dairy America reports to NASS; is that not true, Mary?

A That's correct.

Q So any comments that you're making about Dairy America and its reports to NASS are based on secondary or tertiary or other information; isn't that correct?

A Yes.

MR. BESHORE: I don't have any other questions. Thank you.

JUDGE PALMER: Questions? Mr. Vetne.

MR. VETNE: Good morning. I'm John Vetne, representing Agri-Mark, et al.

CROSS-EXAMINATION,

QUESTIONS BY MR. JOHN H. VETNE:

Q I don't know where to start here. Let's start with the exhibit that was just -- do you still have a copy of 47 in front of you?

A This one?

Q Yeah. On page 2 of Exhibit 47, for example, looking at January of 2005 butter. It shows sales and the number is 52.

A Yes.

Q Does this tell us whether there are -- well, what does 52 represent? Is that transactions or carlots or what?

A That's 52 transactions, which are carlots, I believe between 40,000 and 44,000 pounds.

Q Does it tell us whether there's one seller and buyer in a transaction involving 52 cars or 52 sellers and buyers involved in 52 carlot transactions?

A Well, for every transaction there's a buyer and a seller.

Q Right. If somebody wants to buy 52 carlots of butter, how would this be reported here, one buyer?

A Correct. This is the transaction -- there's 52

transactions, but there's 104 participants.
Q If there were one buyer buying 52 carlots, and one seller of those 52 carlots, is this how it would be reported as shown on Exhibit 47?
A If there's just one seller -- we have no idea if those 52 loads came from 10 different buyers -- or excuse me, 10 different sellers or just one seller.
Q That's my question. So these are carlots, not necessarily transactions? By "transaction" I mean discrete buyers and sellers.
A I guess the -- your terminology is a little different than what I would use, but there's 52 transactions, and I have no idea whether there were 52 different buyers or sellers or just one buyer and seller for all 52.
Q Okay. With respect to each of these commodities, butter and cheese, where there is a number under sales that is simply a carlot, numbers of carlots that traded?
A Correct.
Q There are other data here, bids and offers. There are times when what is used as the CME price, for example, for 40-pound blocks of cheddar cheese, where there is a pricing or

price change in which there have been no sales on the CME, correct?

A Yes.

Q And that happens, let's see, under bids. If a buyer needs cheese and yesterday's cheese price was $1.25 a pound and a buyer comes to the CME says "I need a couple carlots. I'm willing to pay $1.27 a pound." And even though nobody comes to the plate with two carlots, that $1.27 becomes the CME price for that day; is that correct?

A Correct, it's raised in $0.40 increments.

Q And similarly, if a seller comes to the CME and yesterday's price was $1.25 and that seller has some cheese that they want to get rid of, says "I have this cheese I'm willing to sell it for $1.23. Yesterday's price was $1.25."

Even if no buyer steps up to the plate and says "I'll take it off your hands for $1.23." That $1.23 becomes the CME price for block of cheese for that day?

A Correct.

JUDGE PALMER: I don't know if this was asked before, but just looking at the butter one for January we have sales 52, bids 29, offers 7.

Did we ascertain whether or not the 29 bids are included within the 52 sales or if they're additional to the sales?

Do you know that, Ms. Ledman?

A I think they're additional, but I would verify that information.

JUDGE PALMER: I just didn't know how to read it. All right. I'm sorry. Go ahead.

Q In your testimony, let's see, you used, as close as I can get to quoting your testimony, you said "the lead indicator of NASS price is the CME." And later on you said "There's a 95 percent correlation between the CME and NASS prices."

A In some of the consulting work that I've done over the year, that 95 percent number is what I calculated.

Q Okay. And the lead indicator related to a particular percentage; is that correct?

A Yes.

Q It's just a pattern that you observed and incorporated?

A Correct.

Q You did not, when you made those statements, isolate it to any particular product, you appeared to be capturing every product that's

sold on the CME.
A No, those statements -- let me clarify, thank you. The 95 percent correlation is regarding the cheese market, the CME cheese market to the NASS cheese market. The lead indicator incorporates both the CME as the lead indicator for both the NASS cheese and butter markets.
Q All right. So neither one of those characterizations, then, would apply to nonfat dry milk?
A Correct, and I state that in my testimony, I believe.
Q And the percent correlation for butter, do you have one?
A Not off the top of my head, no.
Q And as far as lead indicator, NASS to CME -- well, CME to NASS, there is none for whey?
A Correct. But I will say that I think Dairy Market News is the NASS nonfat dry milk -- excuse me, the NASS whey price is tracking the changes in the Dairy Market News reported whey price fairly well; and I've been rather impressed with this, especially given the rapid change in that market since last September.

Q There's no proposal here to use Dairy Market News prices for purposes of translating to a regulated price, is there?

A My preference would be for all of these prices to be transacted at the Chicago Mercantile Exchange.

Q Which your preference includes a nonfat dry milk, which you indicate is not highly correlated to the CME and CME is not a lead indicator?

A The nonfat dry milk is really the unique commodity because we have one supplier of data to USDA that has two-thirds of the market; and I believe that is a cartel-driven price not a market-driven price.

It's not an open-exchange price, it is set by one major seller every week. And I fail to see that as a market-driven price with both buyers and sellers.

Q The CME price reported per pound block of cheese essentially drives or sets the price for almost all of the nine billion pounds of cheese produced each year, correct?

A Yes.

Q And would you agree with me that because of the substantial volume of cheese that is priced at or off the block price, that that is a good indicator for the value of milk used to produce cheese?

A Yes.

Q Your preference for powder would be a price that does not represent the substantial volume of milk used to produce powder. You have a different foundation theory for powder that does not apply to butter or cheese.

A Correct, because we don't have a cartel setting the cheese price, we have an open-market price.

Q And you acknowledge and, nevertheless, espouse, a regulated price for milk used to produce nonfat dry milk that does not represent prices actually paid for most dry milk?

A I think that there's been a growing difference between the price of nonfat reported to USDA and that reported by USDA's own agency Dairy Market News to the point where there have been weeks where the price reported by Dairy Market News, and let's -- just theoretically, let's just say that Dairy Market News is reporting the price of $1.20 to $1.50 and the NASS price comes in at $1.15. And so the NASS price doesn't even -- is less than the reported range by USDA's Dairy Market News.

I think that should throw a red flag saying is there something not right here? And that's what I want to bring across today.

Q Before you gave a response, I asked a question.

Do you have a yes or no answer to that question?

A Could you please repeat the question.

Q See if I can paraphrase what I asked.

You espouse the use of a regulated price for Class IV that is not representative of most transactions for nonfat dry milk, correct?

A No.

Q You believe that a regulated price that you envision for nonfat dry milk does represent most nonfat dry milk bought and sold in the United States?

A It is my opinion that a nonfat dry milk price determined in an open market, such as the Chicago Mercantile Exchange with buyers and sellers, whether those be bids or offers, is more transparent and is a market-driven price; whereas, I believe the current price being reported to NASS is over -- is weighted by a cartel price, which is more of a marketing strategy and a market-driven price rather than one that buyers and sellers come together to transact.

Q Your answer addressed transparency. My question addressed volume.

First of all, do you not believe that the prices of what you call the cartel are actual prices offered and paid?

A Like NASS, I, myself, have not had the opportunity to offer those prices.

I'm not -- I question as a result of conversations that I've had with folks associated with Dairy America, what exactly is being reported.

Q By what is "being reported," are you referring to volume reported or prices reported?

A Both, prices and the volume associated with those prices.

Do they really adhere to the NASS definition?

Q What "NASS definition" are you referring to?

A Primarily the one not to include forward contracts with prices not set 30 days in advance.

Q Okay.
A Because these prices are included in the California price.
Q We'll get to that. Do you believe that the actual purchase and sale of powder by Dairy America, not necessarily reported transactions, but all volume sold, and the price for that volume would be substantially reflected in a spot market price?
First of all, "a spot market price" is essentially what you advocate using, correct?
A Yes.
Q Okay. And do you believe that that spot market price would reflect majority of transactions, actual transactions, purchase and sell of product?
A Yes.
Q Including the non-spot market contracted?
A I believe if we had viable -- if we were able to delink the NASS prices to the Class IV price, that we would have a viable spot market non-spot price virtually overnight.
Q Okay. Your opinion, then, is if you adopted the way you suggest, that in the futures there would be a correlation between actual transaction

prices and the spot market prices?

A Yes.

Q Your testimony is not that spot market prices, as observed now or in the past, correlate with most transactions?

A I think the spot market prices that I've observed, particularly since the fall of last year, should give rise to the industry whether or not the current NASS prices are reflective of the market.

Q Your observation is that the spot market prices do not correlate with actual prices paid by buyers and sellers for most transactions as surveyed by NASS?

A I believe I've stated here in my testimony that there's a growing disconnect between the NASS nonfat dry milk price and the spot market price; and as a result of that growing difference, I am testifying today that I think this issue needs further investigation and that a spot market, if we could get to the point where we are on cheese where the CME leads the cheese and butter market, I believe the only way we can get there on nonfat dry milk is for us to have the airing of this issue today regarding the growing difference between the NASS number and the spot market.

Q You refer to "needs investigation." Is it your opinion that USDA should act in this pricing policy on an assumption and then investigate to see if the assumption is true or investigate to see what the facts are and then, if needed, take regulatory action in terms of pricing?

A I believe that the agencies within USDA should work together to have some sort of audit function of all prices; if we're going to continue to use NASS, to have all of those prices, have some sort of audit function, which, as Mr. Rosenbaum has pointed out with the language here, the Secretary has ability to do.

To my knowledge, in speaking with USDA folks on this issue, they have not verified any of these prices.

Q The Secretary may, as a result of this hearing, adopt some changes in present formulas. You're testifying as to some of those proposals, especially the ones dealing with the use of CME?

A Yes.

Q You testified that there are some observations that you've seen that suggest a problem with

prices reported to NASS, correct?
A Yes.
Q You advocate, as a result of your observations, that there should be an investigation, yes?
A Your use of the word "investigation" may be different than my use of the word "investigation." Research, look into, audit. Not "investigation" as a witch hunt.
I'm looking for auditing and verification which exist in the language today; nothing more, nothing less.
Q And you don't know what the results of that investigation would be, obviously, but you think, as you use it, that investigation ought to take place?
A Yes.
Q And you advocate that the prices -- the formulas be changed prior to that investigation rather than having that data investigated to see what the facts are?
A I think you and I both know that this -- nothing changes overnight in this industry that we work in, and I'm here today discussing an issue that it seems other people have been unwilling to do so because of political reasons.

And so I believe that we have to have, first, the awareness that there is an issue here or could be an issue before changes are put into a recommended decision.

Q So let me see if I understand. Part of your testimony here, because you have USDA personnel as a captive audience, part of the purpose of your testimony is to suggest that USDA ought to do something that may be beyond the four corners of proposals, but something ought to be done because there's a problem.

A I'm here supporting CME pricing being used in the formula first. Number two, recognizing that there's not a CME price for really nonfat dry milk at this time, or whey. How do we get there?

That type -- to get there, you need to have an open forum to discuss these issues. And, yes, I'm here to suggest that the CME could trade these items as well.

Q Okay. Now with respect to whey, whey is -- whey powder is a product that is surveyed by NASS?

A Yes.

Q Whey powder is a product that is not traded on the CME?

A Correct.
Q And is it traded on any other similar market, such as coffee, tea, and sugar, cocoa exchange?
A No.
Q By the way, what happened to the coffee, sugar, tea, cocoa exchange milk commodity?
A I think that's outside the scope of this hearing.
Q Okay. The point is that some of those commodities were -- at one point there was a plan to trade those commodities on the coffee exchange and they are no longer?
A They've been absorbed at the Chicago Mercantile Exchange, which at one point both of those exchanges were competing; and simply put, the Chicago Mercantile Exchange won out.
Q All right. And I guess this goes to some questions Marvin Beshore asked.
When the Dairy Market News reports a Mostly range, I think it used the range $1.24 to $1.80 for powder, the numbers reported in that range include no information on whether the $1.24 represented 95 percent of trades or 5 percent of trades.
A As I answered Mr. Beshore, those prices are not

weighted by volume.

Q Do you know whether that range information could possibly come from a single buyer -- I mean single seller, if a call was made, "Well, this week we sold some powder at $1.24 and some powder at $1.80."

Do you know whether that range could come from a single telephone call?

A Well, if Dairy America was reporting, which I'm sure they get the phone calls, they would report such a range.

Q So your understanding of the kind of data collected by Dairy Market News is that the range information can come from a single seller or multiple sellers for any of those commodities that are reported by dairy marketers?

A That is correct. But I'm not suggesting that Dairy Market News just speaks to one entity by any means.

Q And you're not suggesting that Dairy America is the only recipient of a phone call?

A Absolutely.

Q There are multiple recipients of phone calls for whatever appears in the Dairy Market News?

A Correct.

Q Have you talked to Dairy Market News about this process?
A Yes, I have.
Q They're not subject to that ex parte thing, are they?
A No, they're not.
Q Although they are part of the dairy division -- dairy programs, AMS?
A As far as I know they're not.
Q California, in an impressing way, is using whey in whatever formula they have. Do they have their own survey or do they rely on Dairy Market News?
A They rely on Dairy Market News mid point of the Western.
Q Do you know whether they cross check or correlate or confirm reasonableness of that number within their own state?
A I do not.
Q California does not, however, use a Dairy Market News Mostly Western for nonfat dry milk?
A That's correct.
Q They actually survey and weigh transactions in California where plurality of powder is produced and sold?

A Correct.
Q You referred at one point to the concept of the use of the CME would provide better signals to producers to produce more milk.
A Or less milk.
Q Or less milk. The signal that you're referring to is what?
It's not a trick question.
A The price.
Q The price. And the signal to produce more milk would be a price moving in what direction?
A Up.
Q The signal to produce less milk is the price moving?
A Down.
Q And producers respond to signals by producing more or less based on their own individual and then regional considerations, correct?
A Correct.
Q There may be price levels at which a signal to produce more milk is transmitted to New Mexico based on whatever cost they have, while simultaneously that signal to produced is transmitted to New England by producers to produce less milk?

A Well, you have picked kind of an opposite range when we look at cost production at the farm level, perhaps. With rising feed costs and greater percentage of New Mexico producers not raising their own feed, I'm not sure if that's going to hold true.

But to have a New Mexico producer, the signal to produce more milk in New Mexico would be a rising cheese market. In a New England state where historically the cost of production has been higher, that rising price is still more than what the producer was getting the previous month.

So I'm not sure it would necessarily tell them to produce less milk.

Q Well, let's limit the source of Federal Order Reform from the time of the Cornell Price Surface Dairy Simulator.

Ten years since, New Mexico's production has doubled. Southeast production has gone up maybe 30, 40 percent. Those productions, it appears, has appeared in NASS data of which the official notice was taken last time.

Those production observations are in response to pricing up on both sides?

A Yes.
Q You said something about "financial swap." Could you describe what those are?
A A financial swap is a financial tool. There's no physical product traded. Let me just give an example that there's a cheesecake manufacturer who buys creamed cheese as one of their major ingredients for their cheesecake, and one of the key components in that creamed cheese price is butter. Cheesecake manufacturer doesn't buy any butter at all, but it's still a major component in his raw material cost.

So in a way to protect themselves from the volatility of the butter price, they enter into a financial swap. Let's just use the price hypothetically of $1.40 a pound and a volume of a million pounds of butter a month. The cheesecake manufacturers, the buyer of the swap, they want to buy butter at $1.40 a pound. The seller of the swap is a manufacturer of butter, and that manufacturer of butter says $1.40 a pound, sure, I'll enter into that transaction. Any month in which the butter price is less than $1.40 a pound, say $1.35, the cheesecake company wire transfers within seven days of the announcement by Dairy Market News of the average butter price for the month, the CME butter price, that nickel a pound to the seller of the swap.

Q In four million pounds?

A Four million pounds.

Q Regardless of how much the creamed cheese user actually bought?

A Correct. It's a financial tool. There's no physical product. And I've worked on these --

Q And the other part of the transaction, if the butter price is a $1.45?

A Then the cheesecake company wire transfers the nickel a pound back to the processor of the butter.

Q And if it's the other way around?

A If the market is $1.45 a pound?

Q They want to make a --

A Exactly -- sorry, the processor wire transfers the money to the cheesecake company.

Q These kinds of transactions don't necessarily need to be between sellers and buyers or accommodators that produce the products, instead of butter maker; it could be a dairy farmer, for that matter?

A Correct.
Q Who want some sort of assurance of the value of butterfat?
A Yes.
Q Or it could be a cooperative or could be a bank, for that matter?
A I've not done one with a bank, but in theory, yes.
Q It works something like a forward contract?
A Yes; it is a forward contract.
Q It's a forward contract that does not involve -- is not related to actual, physical receipt of the commodity being contracted?
A Correct.
Q It is a forward contract of the risk of volatility with respect to that between the buyer and seller, a risk?
A Correct.
Q Do you know whether Dairy Market News publishes any description of the methodology it uses to collect price information and report it, such as the Western Mostly or Central Mostly ranges?
A I can't say that I've seen a glossary of information or not. They may have.
Q Procedural?

A I would have to call them and ask for them to e-mail me if they had it.

Q The answer is you don't know. I mean, my question was, do you know.

Oh, you referred to the "oops vat" which might be sold for a $0.20 discount, and then you went on to say that "not fit for human consumption."

Now if the cheese price is $1.30 and there's a carload of cheese or block of cheese, whatever it is, that's not fit for human consumption, is there somebody that would buy it for $1.10?

A It could go into dog food, the undergrades. Some of them, whether or not they're not fit for human consumption could be debatable. Some of them do go to animal feed and it may be a $0.40 discount.

My point is, that's not -- I think that the line of questioning was why wouldn't a company -- why would a company only report 20 percent of their sales to NASS.

Q Yes.

A And the answer to that is the remaining 80 percent do not -- does not fit the NASS criteria for a variety of reasons.

Q So your reference to "oops" and "not fit into criteria," has nothing to do with the consumability of a product or the salability of a product, it's something that doesn't meet certain specifications which may mean the standard of identity, or anything else?

A Correct.

Q Okay. I didn't want to leave this record with the implication that anything that is "oops" is unfit for human consumption, because that would be a gross exaggeration, wouldn't it?

A That is correct. I apologize for that.

Q Is there any source of a survey for buttermilk powder prices?

A Dairy Market News.

Q Dairy Market News. It's not surveyed by NASS, is it?

A In the dairy products report, NASS has, at times, had a whey price, I think a buttermilk powder price. I don't know if they still do it or publish that in the dairy products production monthly report. They would have a manufacturer shipments, manufacturer stocks; nevertheless, there have been these prices reported by the

NASS, but what's used in the industry are the buttermilk powder prices as reported by Dairy Market News.

Q NASS has, at some point, reported either in the monthly or annual dairy product publication, but do you know whether that was done in the same way as the NASS surveys for pricing purposes? Do you know how that was done, was it weighted, yadda, yadda, yadda?

A No, and nobody uses it in Congress within the industry.

Q So Dairy Market News has some information on buttermilk powder prices, and it is, like the others, a range, and it is, like the others, something of which we know nothing about how, within that range, products are weighted; whether it comes from a single buyer or multiple buyers. You know they make some calls and then they provide a range.

A Yes, and it's used by the industry.

MR. YALE: Your Honor, can I interject for an informational issue.

It's about 11:35. I need to talk to my witness, see what his availability is; but I understand that Mr. Beeman is not going to be available, and we haven't had a break, there' a lunch coming. We're not close to being done, so if we can have a short break and sort that out.

MR. BESHORE: Let me just -- Mr. Beeman is a dairy farmer from Pennsylvania who is here, is going to have to leave sometime shortly after 1:00 to get his plane back.

JUDGE PALMER: All right. Let's defer. Let's take you off the stand, put Mr. Beeman on for a moment and take his testimony.

MR. YALE: Barry wants to leave before lunch, too.

THE WITNESS: I have family obligations myself, guys, and I've got a five-hour drive back to Chicago.

I mean, how much more time do you think you'll be with me?

JUDGE PALMER: Tell you what. Let's do the two minutes. I've got a feeling it will be great to bring you back.

MR. ROWER: Your Honor, might I suggest that we consider with the cross-examination of witnesses that we don't repeat testimony and that the questions asked once, it's in the record. I know the attorneys and everybody here want to represent their clients and we certainly want that to be part of the record. But repetitious testimony, or testimony that repeats itself, does not help. The record should reflect what the questions are and what the answers are. But if we ask them six or seven times, I think we're in the area where we don't need to do that, Your Honor.

JUDGE PALMER: You're absolutely right.

MR. ROWER: In order to move the hearing along in an efficient way, I think it's important to do that.

JUDGE PALMER: I don't know if that's happening. Let's go on.

BY MR. VETNE:

Q Ms. Ledman, you're here at the request of Dairy Farmers of New Mexico?

A Yes.

Q And are you being compensated for being here by Dairy Farmers of New Mexico?

A Yes.

Q And is the position that you have advocated here one that you have advocated for a long time, even before being contacted by Dairy Farmers New Mexico, or is it one that you have developed

since being contacted by Dairy Farmers New Mexico?
A It's one I've had for a long time.
Q And Mr. Yale indicated that you're not here to testify about anything else.
So if I ask you a question concerning the policy or substantive merits of Dairy Farmers of New Mexico of the proposals, you would decline to answer; am I correct?
A Yes.
Q And under your arrangements with Dairy Farmer of New Mexico, are you free to take a conflicting position with respect to those other components of the Dairy Farmers of New Mexico wishes, if you were asked to participate in a brief regarding those components?
A I have no intentions to do so.
Q That wasn't my question. Are you free under those arrangements?
A Yes, I would be free.
Q Thank you.
JUDGE PALMER: Any other questions? Does anybody here have any questions for her? I think she's covered everything.
MR. YALE: Just a quick -- I'm going down

the list real quick. I may not if you can just give me two seconds.

JUDGE PALMER: Come up to the podium.

REDIRECT EXAMINATION,

QUESTIONS BY MR. BENJAMIN YALE:

Q I just want to make -- and this is not trying to be repetitious, just one line of questions.

We talk about, and there were a lot of questions about the thinness of the market and there were statements about the smallness of the number of trades in the CME.

I want to take the situation where if you are a buyer of cheese and the CME is reporting a cash price of $1.25, you're calling your sellers that sell you cheese and they're wanting $1.35, what are you going to do?

A I'm going to go to Chicago Mercantile Exchange and bid for cheese.

Q So the Mercantile who reports a small amount, it is a relief valve, so to speak, of the market to adjust itself depending on what's actually going on in the background; is that right?

A Correct.

Q So it's not necessarily that it covers all the trades overtly, but in fact, it is covering all

the trades all the time?
A Correct.
Q The same as the other way, if you were selling it and you want to sell it and all the buyers are saying it's $1.20 and the CME says it's $1.30, you're going to go to the CME, right?
A Correct.
Q And either the CME is going to come down to you or you're going to go up to it, right?
A Correct.
Q So it's that relief valve.
The other question had to do, I do want to get this in, and maybe we can do the math later. I want to point it out.
There was a question about the CME in a higher price than the NASS survey -- I think I'll withdraw. I'll do that later. I don't think I need her to do it.
MR. YALE: I don't have any other questions.
JUDGE PALMER: Any other questions? Mr. Beshore.

RECROSS-EXAMINATION,

QUESTIONS BY MR. MARVIN BESHORE:

Q Mary, I didn't ask you about butter, I don't

think, and I just have one question about that.
Is the butter volume reported by NASS, representative of the butter trade in your view?
A I have not done essentially what we did here ad hoc and look at the weekly volume at the CME and compared it to the weekly price volume reported by NASS, so I can't give you that correlation. But when I'm forecasting NASS prices, I start with the CME butter price with the two- to three-week equation.
So what I do in forecasting prices, I base NASS off of CME.
Q There's a linkage there, in your view?
A Yes.
Q But are the volumes on butter reasonably representative of the trade in your observation?
A When we see those volumes very seasonably from, I think, as much as four million pounds a week to times where, you know, in the summer where it could be less than a million pounds a week.
I really -- I can't answer it more than that, I guess.
Q But the NASS butter prices follow the CME in your view?
A Yes.

Q In your observation?
A Yes.
Q And the CME butter price, prices most of the butter that's sold -- produced and sold in the country?
A That is correct.

MR. BESHORE: Thank you.

JUDGE PALMER: Does that do it? Thank you very much. Let's bring the gentleman up. I think we have time.

Is everybody able to handle this? Are you okay over there?

THE REPORTER: I'm fine.

BILL BEEMAN,

having been duly sworn to tell the truth, the whole truth, and nothing but the truth relating to said matter was examined and testified as follows:

DIRECT EXAMINATION,

QUESTIONS BY MR. MARVIN BESHORE:

JUDGE PALMER: This has been marked as Exhibit 48.

(Exhibit 48 was marked for identification.)

Q Mr. Beeman, could you just state your name and address.

A My name is Bill Beeman. My address is RR 2 Box 131 Kingsley, Pennsylvania.

Q And do you have a statement to present that's been marked as Exhibit 48?

A Yes, I do.

Q Would you proceed with that, please?

A Thank you.

Q Good morning. My name is Bill Beeman. I'm a dairy farmer from Kingsley, Pennsylvania in Susquehanna County. I am a member of Dairylea Cooperative, Inc. and serve as First Vice-President and Secretary. Dairylea is a dairy farmer owned cooperative with 2,400 members. It is the largest dairy cooperative in the Northeast U.S. and fifth largest in the U.S. This year Dairylea turns 100 years old.

My wife and I operate an 80-cow dairy with a rolling herd average of 20,000 pounds. Like most dairy farmers, we work hard every single day to be more efficient in producing milk. We look at opportunities to use different methods and technologies to produce more milk per cow, milk more cows and take unnecessary costs out of our operation.

I think the operation of our farm is much the same as any business. That is, become more efficient without technologies that fit our size and scope of operation and make sense for our farm, and shed costs as we can without hurting our bottom line. From time to time our input prices escalate so quickly and so significantly that we are not able to mitigate these costs. This, too, is something that eventually impacts most, if not all, businesses. Over the last 48 months our farm has been dealing with higher labor and insurance costs and energy-related costs such as fuel, hauling, fertilizer, chemicals and electricity. Since September, we have been dealing with significant cost escalation in feed prices emanating from federally subsidized incentives to increase corn-based ethanol production. The cost of production on my farm has increased $4.28 per hundredweight over the last four years. I would think that this is a similar increase on most farms of my size. All farms throughout the U.S. have experienced some form of cost of production increase of significant nature for their particular operation.

Cost of production impacts due to higher feed costs is a popular topic these days. Purchased feed costs on my farm have increased 55 percent from $200 to $310 per ton since last August. This alone has added $1.82 per hundredweight to our farm's cost production. We have struggled with these higher input prices. It doesn't make sense for us to feed less to mitigate this cost because the higher feed costs still result in purchased feed costs being significantly less than the milk price. Thus, feeding less and reducing milk production would result in losing revenue to cover our overhead costs. In the current environment, all feed stuffs are more expensive and there is a very limited ability to change the feed ration in an attempt to mitigate a portion of the feed-related cost of production increase. So the cost of production increase due to higher feed prices cuts right to our bottom line and lowers our net income, which recently has meant that we lose even more money.

When dairy farmers have a cost of

production increase after attempts to mitigate our costs, our only other course of action is to get more money out of the marketplace. Ed Gallagher, Dairylea's Vice-President of Economics and Risk Management, would tell me that if production cost increases occur long enough, they will eventually get bid up into the milk price as some farmers go out of business and others cut their production. He may be correct, but the problem is that if there is a price correction, it takes a number of months for it to occur. So our only other alternative, after mitigating costs to the limited extent that we can, is to seek higher negotiated milk prices. In my case, this means through Dairylea and its marketing arm, Dairy Marketing Services. This means that DMS has to go to its customers and pass our higher costs along to the marketplace.

An important point I want to leave with you is that dairy farmers do not have the option of having a federal agency require our input suppliers to sell us inputs at a lower price because our costs have increased. The single largest input purchase on our farm is livestock feed. There's no regulatory structure that requires feed dealers to sell dairy farmers their livestock feed at a lower price because the dairy farmer's cost of production has increased $4 per hundredweight. Instead, we have to go to the marketplace to get the extra money.

Ed has told me that he has attended a number of meetings with manufacturers, processors, USDA personnel and university economists, and has been told that dairy farmers and their cooperatives need to be more efficient and get more money out of the marketplace on their own to resolve our cost issues. Dairylea believes that it's time to level the playing field.

Under the current system, manufacturers can pass their higher production costs back down to dairy farmers via make allowance changes - this system no longer works. Dairy farmers have their own production costs to deal with; we should not be burdened by taking on the costs of manufacturing plants, too. It is time for manufacturing plants to be asked to pass their higher production costs to the marketplace instead of back down to farmers.

Dairylea Cooperative's Board of Directors unanimously passed a resolution on March 9, 2006 requiring management to create milk pricing systems and customs that result in dairy product manufacturing costs being passed to the marketplace instead of back down to dairy farmers (see Exhibit 1).

Dairylea would prefer that the marketplace determine the make allowance. The old Minnesota-Wisconsin price series resulted in the marketplace determining the make allowance. At this time, Dairylea does not have a proposal to offer that would allow the marketplace to determine the make allowance, although Ed tells me he is exploring different options. Instead, Dairylea is here today to work within the confines of the existing system to make a "tweak" that would eliminate the need to have additional make allowance changes.

The tweak is a Dairylea proposal to incorporate a cost of production add-on to be used with products included in the NASS pricing survey, as a way to end the circularity embedded in the Federal Order pricing system. Ed

Gallagher will testify about the specifics of our proposal and the problems with pricing circularity.

Ending the pricing circularity will allow all manufacturing plants to pass their production costs on to the marketplace without impacting the raw milk price. This change is necessary to create a Federal Order program that no longer will need to utilize make allowance changes.

Dairylea is a proud member of the National Milk Producers Federation. I am a delegate and Dairylea's President, Clyde Rutherford, serves on its executive committee. Notwithstanding prior testimony, Dairylea supports the National Milk proposal to modestly adjust make allowances for changes in energy costs. It opposes other proposals that seek to increase make allowances.

Dairylea urges Secretary Johanns to implement our proposal to help strengthen and modernize the Federal Order program.

Thank you for allowing me to testify today.

BY MR. BESHORE:

Q Mr. Beeman, I have just a few other questions and then I'll make you available for cross-examination. In addition to the sales of milk, is one of the sources of revenue on the dairy farm the sale of bull calves?

A Yes, it is.

Q Can you tell us in the last two years or so how that income stream has been affected on your farm?

A Up until about 18 months ago, a 100-pound bull calf, which would go back to the barn, bring anywhere from $200 to $250 at sale.

My last bull calf that I sent to the marketplace within the last two weeks was a 112-pound calf, and it netted me $131. Calves that are under 100 pounds that normally go to the marketplace would bring, in the past, $0.60 to $0.80 a pound, are down to the $0.30 to $0.40 pound range now, and I received one as low as $0.20.

Q $0.20 per pound?

A $0.20 per pound on an 80-pound calf.

Q So on that calf, what did you net?

A My net $0.20 per pound would have been $16 with a gross, take out the trucking and cost of sale, we netted just over $7 for that calf.

Q With a herd of 80 milking cows, how many bull

calves do you sell a year?
A Over the years it would average about 50 percent; some years more, some years less. Over the years, about 50 percent.
Q So 40 or so?
A Right.
Q Your testimony, which has been marked as Exhibit 48, in it you refer to Exhibit 1, which is attached to Exhibit 48, and it is a Dairylea board resolution.
A Yes.
Q I wondered if you could tell us a little bit about how this resolution came to pass, and let me just ask you, is this resolution, which has been marked as Exhibit 1, something that was prepared by your staff and presented to the board to rubber stamp or adopt the staff's initiative and recommendation?
A Not exactly, no.
Q How did this come to occur?
A At our March 9th, 2006 board meeting, Ed Gallagher was reporting to us on his recent trip to the Federal Order hearing on make allowances, and the discussion entailed got ensued as to what we could do to pass prices at our interest

to the marketplace and how we could do it.

We were not satisfied with the fact that when you have a make allowance hearing and the manufactured price increases get passed back to us; we wanted to do something about that. So we had a lengthy discussion about that and this resolution was the byproduct of that, and it directed our management team, particularly Ed Gallagher, to work on a system that would help us, dairy farmers. And this proposal that he is prepared to bring to this hearing this week is a result of that.

Q The Dairylea board of directors are all dairy farmers?

A Yes, they are.

Q And elected by membership?

A Yes, they are.

Q The resolution says at the top "Dairy Cooperative, Inc." and "DFA Northeast Area Council."

Was this adopted by both of those boards?

A Yes, it was.

Q Do they meet together on some occasions?

A We do on most occasions.

Q They meet together and the DFA Northeast Area

Council is also composed of dairy farmers?
A Yes, they are.
Q That are elected amongst the membership of the northeast region.
A That's correct.
Q And both of those bodies directed that the staff, your hired staff, go back and attempt to address this problem in a different manner than it had been addressed previously?
A That's correct.
Q You then adopted this resolution and told Mr. Gallagher and company to prepare a proposal which is going to be presented at this hearing?
A Correct.
MR. BESHORE: Thank you. I would move for the admission of Exhibit 48 and Mr. Beeman is available.
JUDGE PALMER: Any objection to 48 being received? Received.
Questions for Mr. Beeman. Yes, Mr. Yale.

CROSS-EXAMINATION,

QUESTIONS BY MR. BENJAMIN YALE:

Q Good morning, Mr. Beeman. Ben Yale with Select Milk Producers, Continental Dairy Products, Lone Start, Zia and Dairy Producers of New Mexico. I want to thank you for coming as a farmer to talk.

I'm sure where you're from it's no different than any other, there's a certain amount of coffee-shop talk amongst farmers.

Is that a fair statement?

A Fair statement, yes.

Q And as a dairy farmer, you have those discussions with other dairy farmers?

A That's correct.

Q You also have these conversations at the board meetings with other members of Dairylea and I guess DFA and some of those farmer members, right?

A We do talk, yeah.

Q And recently as you have discussions, has anybody sat back and said "Man, this is the greatest it's ever been, I don't know why you're complaining."

A Not that I know of, sir.

Q Has anybody even suggested it's okay, they can get through; it's fine, this is what they have to do and it's fine?

A No, sir.

Q And this sense of frustration and financial stress goes beyond whether you're a co-op member or not, or how big or small you are in the business.

A That is correct.

Q By the way, I want to thank those members for taking that time to make that clear to push this chain up. I think that's an important system that we need to think about.

At pages two to three of your testimony you indicated that Mr. Gallagher had told you that, well, the prices will come back because eventually they'll be enough less milk that there will be a shortage of milk and the plants will bid the milk up and the price will come back up, right?

A Sure.

Q I'm not suggesting anything, but you've been in the dairy industry a few years, right?

A Yes, I have, 27 years.

Q Huh?

A Twenty-seven years.

Q And you started farming at 10, I take it?

A Thank you.

Q When it said that the number that the -- or that the milk goes out, what has been your experience over the years that contributed in large part to the reduction of the supply of milk that allowed supply and demand to get back in line again to bring up prices?

A It depends; sometimes it's the climate, the weather.

Q Okay.

A Sometimes it's low prices.

Q What if it's low prices that causes it; how does that work into the equation? How does that physically happen that you have low prices and then eventually you have low milk and because we have low milk you get high prices?

A Low prices are a result of high prices.

Q I understand.

A If you have low prices, farmers will be fed up and sell out or they will start cutting cost, cutting the grain, I mean, how they feed their cows, which will lower production, which in turn will lower the overall production throughout the nation and prices will eventually rebound.

Q So there's really two ways that the farmers have control over it; one of which is they use management tools to be less efficient than they were before to get less milk out of their cattle

and maybe have fewer cattle, right?
A Right.
Q But the other one is for farmers to actually stop milking, right?
A Stop -- sell cows.
Q Or go out of business altogether?
A Right.
Q So when we hear about this idea of producers producing less milk, there's also a very personal farmer interest that's occurring someplace in the country where some family has decided, as you said, they're fed up and they're getting out, right?
A Yes.
Q And have you ever experienced any neighbors or others that have gone through that process?
A Several.
Q And that's a difficult time, right?
A Yes.
Q I have no other questions.
JUDGE PALMER: Any other questions? Mr. Rosenbaum.

CROSS-EXAMINATION,

QUESTIONS BY MR. STEVEN ROSENBAUM:

MR. ROSENBAUM: Steve Rosenbaum,

International Dairy Foods Association.
Q Mr. Beeman, you are -- you, as a cooperative, are free to sell your milk as high priced as you're able to extract in the marketplace, correct?
A Yes.
Q If a buyer comes to you and says the make allowance has changed, the minimum price is now lower and, therefore, we're going to lower how much we pay you, you're free to say "We're not interested," correct?
A Correct, yes.
Q And have you observed the migration of cheese manufacturing over the years away from the area in which your cooperative is located and toward the left?
A Yes.
Q Is that of concern to your cooperative?
A Yes, it is.
Q You would not want to have a proposal adopted that would result in increased incentives for cheese manufacturing to move to California or cheese, for example, unregulated areas in Idaho; is that correct?
A No, I would not. If such a resolution were

presented, no, I would not.

Q I'm sorry, I didn't hear you.

A If such a resolution was presented, no, I would not.

Q The mechanism that you propose in your proposal, and I recognize you're going to have more detail presented through Mr. Gallagher, I'll have questions for him, too.

A Yes.

Q But you do recognize that this mechanism would not effect the pricing regimes that exist in the California system or in unregulated areas; is that correct?

A Correct.

Q And the effect -- if there's a disparate effect of your proposal or federally-regulated cheese manufacturers versus that were regulated by state of California, or those that aren't regulated at all, that would be a concern to you, I take it?

A If it affected the way we do business, yes.

MR. ROSENBAUM: That's all I have. Thank you.

JUDGE PALMER: Any questions? Yes, Mr. Smith.

CROSS-EXAMINATION,

QUESTIONS BY MR. DANIEL SMITH:

Q Good morning, Mr. Beeman. My name is Dan Smith. I represent the Maine Dairy Industry Association. I hope you get home today. I hear the weather is not in our favor going home.

I would like to follow up a little bit on your description of how producers respond to low prices by perhaps cutting the feed ratio.

Could you explain that a little bit more and speak to your personal experience on that.

A Personally, I try my best not to cut my feed costs because I know without my production I have to have a production to cover my costs as best that I can, but sometimes the cost of production -- the cost of production and feed costs are the highest costs and so some farmers attempt to cut back, scale back as to what they're willing to feed their cows, as far as the grain, maybe feed more forages and less grain; and that, invariably, usually amounts in having less production per cow.

Q You're a board member of Dairylea?

A Yes, I am.

Q How many producers are in Dairylea's membership at current?

A I believe the producing number is around 1,400.

Q Around 1,400. And as a board member, can you speak to your experience as to what percentage of that membership might respond to a person who is typically lower priced by cutting feed costs?

A No.

Q In your 27 years in the industry, have you found reason in response to lower costs to cut your feed ratio?

A Maybe on one occasion.

Q One occasion. Are you familiar with the adage in our neck of the woods when milk prices are up, farmers respond by producing more milk, and when milk prices are down, farmers respond by producing more milk?

A Yeah.

Q In relevant comparison to responding to the lower price by increasing production, what would be your ballpark of the 1,400 members -- you can guess on this one since we're using a rule of thumb -- of the 1,400, how many would respond by producing more milk and how many would respond by cutting their feed?

A I guess it might be split evenly.

Q Split pretty well?
A Yes.
Q On your farm you indicated that the cost of production has gone up in the $4 range?
A Yes.
Q How have you responded to that to maintain your operation in terms of your labor and maintenance and your equity?
A In the last couple years, it has eaten into my equity. We have probably waited longer than we would normally wait to replace some equipment. We repair equipment a little more extensively before we impact to replace it; but that is getting to the point where steel is steel and steel is expensive and any repairs with steel is expensive.

So it's a very delicate balance as to whether you want to continue to repair old equipment or invest in new. But we're to the point now where we will be reinvesting in some new equipment, we have no choice.
Q Which means more equity investment?
A Yes.
Q Without, obviously, exposing more than you wish, but where do you see yourself in the next five

years if this pricing scenario continues that we've seen in the last five years?

A If we continue the way we are right now in pricing, with the highs and the lows and the lows getting lower and seem to be -- not necessarily the lower, but stay longer with the input costs the way they are at the present time, there will be many farmers, in my situation, and very likely myself included, will be out of business.

Q So lowering the feed input won't solve the problem?

A No, it will not.

Q Thank you.

JUDGE PALMER: Any questions? Give your name to the reporter, please.

CROSS-EXAMINATION,

QUESTIONS BY MS. HEATHER PICHELMAN:

Q Good afternoon. My name is Heather Pichelman I'm with the USDA Office of the Genral Counsel.

First of all, I just want to thank you on behalf of the Secretary for traveling here today from Pennsylvania and testifying for us.

Your testimony is extremely important for the record, and I want to thank you for coming here today.

Actions under the Federal Milk Order program are subject to the Regulatory Flexibility Act. The act speaks to ensure that the regulatory and information collection requirements are tailored to size and nature of small businesses. The act defines a dairy farm as a small business if it has an annual gross revenue of less than $750,000.

Based on that, would you consider yourself -- and no need to give me numbers, but would you consider yourself a small business?

A Yes, I would.

Q Based on that, as a small business, how do you see the Milk Order working for you or against you, and specifically with these proposals? I know you already testified in support of Proposal 20, but do you have anything else to tell the Secretary about these proposals or anything that you would like him to know?

A We need a business environment that is more stable than it has been in the recent past. We need a Department of Agriculture that will respond, if possible, a little quicker than it has in the recent past.

Now, having been a farmer for 27 years, and knowing that the product that I produce has a very short shelf life, and therefore, it is very volatile, and knowing that when you produce more than the market will bear, your prices will normally go down. We know that, we have learned to live with that; but we need to find a way, if we can, to keep these prices from dropping as low as they have versus staying periods of time. Basically, making a little leveler playing field.

I think a chart was presented here yesterday showing the old M&W report, you know, when milk prices stayed relatively stable; they were up in the fall and down in the spring. They were pretty predictable. That's not been since; they have done away with that. It hurts us, small farmers, and even your large farmers, whose cost production is considerably less than ours at this point in time; it's hurting them too, it has.

MS. PICHELMAN: Thank you. Thank you, again, for being here today.

JUDGE PALMER: Any other questions?

Thank you, sir. As Counsel just said,

thank you for being here today.

We're now going to recess until 1:00 p.m.

(A recess was taken.)

JUDGE PALMER: All right. We're a little late so let's try to keep moving.

I was just told that Mr. Smith -- and I'm doing it again, I'm not talking into the mike, which we're all doing and the reporter is having trouble getting our voices, so please use the microphones. We all think we project wonderfully, but sometimes we don't; so try to use the microphones.

I was just told by Mr. Smith that he would like to call Mr. Whitcomb now, and I understand that Mr. Rosenbaum has agreed to that, so we'll change the order a little bit, so he is now distributing papers.

Let's go off the record for a minute. It looks like it's going to take a while.

(A discussion was held off the record.)

JUDGE PALMER: Do we have everything now for Mr. Whitcomb? This will be Exhibit 49. We're marking that for identification as Exhibit 49.

(Exhibit 49 was marked for identification.)

UNIDENTIFIED SPEAKER: The attachment is 50.

(Exhibit 50 was marked for identification.)

JUDGE PALMER: I'll tell you what, I'll work without. It will be No. 50 marked for identification. The statement is 49 and the attachment is 50.

All right, Mr. Whitcomb come on up on the stand.

WALT WHITCOMB,

having been duly sworn to tell the truth, the whole truth, and nothing but the truth relating to said matter was examined and testified as follows:

DIRECT EXAMINATION,

QUESTIONS BY MR. DANIEL SMITH:

Q Good afternoon, Walt. The Judge has marked your statement as Exhibit 49, and your Exhibit is 50.
The statement that has been marked as Exhibit 49 is substantially similar to the statement that we distributed to the attorneys in this hearing on Friday; is that correct?
A That is correct, with some corrections for grammar and some other things that I will note

as we travel through. What we think of as "minor changes."

Q Thank you. If you can proceed with your statement?

A Thank you. Good afternoon. My name is Walt Whitcomb. I am a third-generation dairy farmer. My daughters, studying dairy science at Cornell, may be the fourth. My family's farm is located in the town of Waldo, Maine, which is near Belfast, a coastal town about 45 miles east of the capital, Augusta. Our farming operation includes 175 Registered Jerseys and Guernsey cattle milking, an equal number of young stock. We have 275 acres, grazing another 100 acres and manage 175 acres of timberland.

I'm a board member of the Maine Dairy Industry Association, which in parentheses, (MDIA), which represents all dairy farmers in the state of Maine, and I am testifying on behalf of the association in support of our proposal.

I'm testifying with two purposes in mind. First, and primarily, I wish to convey my firsthand experience on our farm with the impact of the current Class II -- Class III and Class

IV pricing series on our financial condition. Our family farm has been a steadfast small business, under the 750,000 threshold, in our rural community for nearly a century, but we feel we cannot rely on federal minimum prices as a basis to remain in operation. Although we as Jersey and Guernsey dairy farmers have benefitted as much as anyone from component pricing, persistently inadequate prices coupled with the unpredictable price swings are placing an ever-increasing burden on my bottom line. It is only by resorting to a variety of alternative sources of income, including a substantial state subsidy and increased equity finances for operating expenses, that I'm able to stay in business. Without change to this pricing scenario, my farm faces the dire consequences of draining our equity to continue operating. As you well know, equity is a farmer's retirement account. And we ask ourselves the question, do we empty it to keep farming it, or do we quit with a few assets? A logical conclusion should be to retire sooner than would be necessary in order to avoid dissipating too much of my equity stake. And I ask myself frequently, should I encourage my children to be another generation at Springdale Jerseys?

Secondly, as a board member of the Maine Dairy Industry Association, I will describe the impact of the current federal pricing structure across our membership. More than 70 -- and the next number is a correction from my previously distributed text. Based on our research, we've been able to conclude that 70 percent of the dairy farms in Maine do fit the small business threshold, as defined in the notice for this hearing, which is myself included, and we further found that the average revenue per Maine farm is $440,000, the source noted in the footnote below. The Maine experience demonstrates that the current federal price regulation is endangering dairy farmers across my state, and from what we're able to note, throughout New England, and perhaps across the country. So this part of my presentation will include a brief explanation of our state's two programs that are serving as a short-term cushion for shortfall in federal price regulation and its impact on my farm and throughout our state. In particular, I'll describe the operation of the Maine Dairy Stabilization Program, which is providing price support payments to Maine dairy farmer.

In the end, my testimony about this regulatory program, and about my farm, are intended to urge the department to rethink the justification for the current pricing series and to consider the need for a substantial correction as we have proposed. The farm community is left with the impression that the department favors the dramatic price swings as a necessary reflection of the market, and that rock bottom prices are the correct level because there continues to be enough milk in the system. Unfortunately, the experience on my farm in my statement clearly illustrates that the real reason there's enough milk in the system. And that is, we as farmers, along in our case with our state, are subsidizing the production of milk by mortgaging our future to stay in business.

This national survival of the fittest strategy is wearing us all out. Absent a better system returning the value of the products to the producer, in the not-too-distant future, certainly in certain regions of the country there will not be enough milk in the system.

We intend for our proposal to begin to correct this problem. Our proposal would ensure that the procurement price for milk used for manufacturing purposes, once again captures that measure of the value of the raw product we produce sufficient to ensure stability of supply. Given that our product is creating real value in the market, according to the proper function of the federal pricing series, we would gain at least that intrinsic measure of the value. This will restore balance to the regulatory system and eliminate the need for us to continue to subsidize milk production in the marketplace.

For my testimony, I'm drawing on the shared experience of three generations of our northeast dairy farm family dating back to the 1916. And we fully agree that a pivotal partner in that experience, obviously, has been the Federal Milk Marketing laws, as they have been enacted through the years, including, in our case, operating in concert with our longstanding, in-state regulatory commission, the Maine Milk

Commission.

We in Maine have traditionally operated under a dual state and Federal Order system, our actual pay prices have been determined by our own state regulatory program. At the same time, we've always understood that the state pricing program and market conditions in Maine are reflected in substantial part by the New England/Northeast Federal Order. This has been particularly true following the reformation and the consolidation prompted by the '96 Farm Bill, as most milk produced in Maine is now regulated under Federal Order One.

From our perspective, the historical purpose of federal milk marketing laws has been to provide a stable marketing environment for processors and producers operating in a common market. In our own case, this is the so-called Boston market. We understand the law as being intended to establish a regulated minimum producer prices sufficient to assure an adequate, stable, long-term supply of milk for common marketplace.

We've never understood federal minimum pricing as intended to displace pricing operations of the marketplace. Rather, we've understood its primary function as intended to provide workable minimum blended producer prices that avoid disorderly competition between fluid and manufacturing customers serving the market.

One additional regulatory point. Our state law retains a vestige of federal law in that we -- federal law that has mostly receded from view, and that is parity pricing. The Maine Milk Commission, which is our state regulatory entity, has maintained the long-ago parity principle of maintaining a link between the consumer and producer price. Under the Maine Milk Commission, over-order producer prices still reflect consumer prices. And it is this heritage that prompted our association, meaning MDIA, to approach the state legislature with our new additional program that now makes up for part of the inability of the federal prices to establish workable minimum producer prices.

My testimony will relate to the operation of my farm from 2004 to the present. And I have picked 2004 as a starting point because producers that year received the highest prices ever, and soon thereafter, experienced a tremendous dip in the pay price. It was fairly easy looking at my profit and loss statements to draw the contrast. This combined up and down experience is a good working example of the impact on the farm of the operation of new pricing series implemented following the '96 Farm Bill.

For the purpose of illustration, I'll use the department's reported mailbox prices for 2004 through 2006 for the Northeast Federal Order, along with the department's published costs of production for the same years for our neighbors in Vermont, which is the closes NASS survey. These tables are contained in what I believe is Exhibit 50. For greater accuracy, I will incorporate some of my own actual costs and refer to a cost production study that's conducted as part of the Maine Milk Commission's work. The pages of the production study that I referenced are also contained in that same exhibit, Exhibit 50, we simply didn't have enough copies of the whole study to distribute.

As further background, I will first tell you a little bit about my farming operation. My grandparents started the farm in 1916, the references in the deed that it actually started a century before, but somebody actually sold it off. Like most New England farms, it was a multipurpose farm. The farm had animals besides cows; my grandfather and grandmother sold gravel, cut wood, worked out with their team of horses, sold butter and vegetables in town, and we did for many years after my grandparents were dead.

Without being too nostalgic, farming for the first half of the twentieth century provided a way of life that was not largely dependent on money to be sustainable. The farming operation was labor intensive and not so reliant on machinery and all the accompanying operating expenses. My grandfather could tell you the names of his horses for 50 years afterwards, but he didn't know names of tractors. Family members, for the most part, were the labor force, further minimizing the need for cash money or to support production.

Short-term debt related mostly to spring planting and perhaps for chattel, and it could be expected that this debt would largely be repaid each harvest. The only onerous money requirement was the long-term debt for the real estate and buldings.

Perhaps to better cover the odds of betting solely on farm income to service the real estate debt, my grandparents, as did my parents, earned some off-farm income to support their farm income. Still, the basis of the family's income was farming; dairying was the essence of the farming operation, other than selling the calves and cows, and they sold first butter, that went on the boat to Boston, then cream, and then with refrigeration, we got into the fluid milk business.

Technological change, accelerating in the '50s, significantly altered this working equation on our farm and all around us. The bulk tank and other improvements in hygiene, greater reliance on soil inputs and equipment, along with other demands of modernizing farm, required capital investments and increased short- and long-term debt service demands of dairy farming.

With an increased demand for capital, often to meet the regulatory needs to improve milk quality, the old story about bringing milk cows on skids because the inspectors wanted to move so many times, decision making on the farm became more and more dependent on the price of milk. Farmers who chose to remain in production had to find a return from the milk price sufficient to cover their increased capital costs for improvements in their dairying operation. This greater reliance on milk price as a source of income for the farm made dairying more of a specialization.

In our own case, my mother and father enjoyed their registered cattle and were able to respond to this greater need for specialization by developing our dairy farm to include cattle sales as well as the milking. This combination over the years allowed the farm to grow, modestly, pay our bills and provide some funding for the five of us children to go on to college. Until the recent era of nutrient management, the basic capital debt for land and equipment was largely retired.

As we have now transitioned generations, the farm's stability and profitability has continued to be largely the result of selling milk to our in-state fluid market and sales of heifers and cows. This increased specialization has proved for us to be a workable response to the changes in the dairy marketplace over the life of our farm. And until really only recently this business plan has allowed me to continue operating the farm taking on only limited long-term debt, and that's primarily to match the demands of NRCS funding to build manure-handling facilities.

While I'm proud of our ability to evolve with change and still stay connected to the roots of our farm, I am gravely concerned about our future. Simply put, even with ongoing and increasing intervention by the state of Maine, my milk check will not suffice to keep me in operation.

Of most concern, we have this year had to take out an additional mortgage on the farm to cover my operating expense, and as the previous speaker said, it was to pay the grain bill. This past year's rapidly climbing fuel and fertilizer prices, followed by the same trend in concentrate cost stand in sharp contrast to the low milk price of the year.

Looking to the future, the use of equity financing to cover operating expenses is simply not a sustainable cause. We have made capital investments in the farm to improve efficiency and make it attractive for our children, as did my parents and my grandparents before me, and I've understood that the equity we hold in our farm property represents our retirement, as well as our investment in our children's future. Under current circumstances, although our daughters are interested in coming back to the farm after school, I worry that this may not be a realistic option for any of us.

I do not believe that the farming operation will be sustainable over time in a manner that will allow my daughters to service their debt and enable us to recover any equity. Rather, without change in the pricing situation, I believe we will more likely end like so many of our neighbors, forced to cease operation before we dissipate further our equity interest in the farm property. There is no retirement for dairy farmers who have indebted all their equity just to stay farming.

The issue of my farm's profitability and the current threat to its sustainability is a relatively straightforward computation of the discrepancy between my cost of production and my pay price. This is, of course, no great mystery to anyone here who has followed the costs and prices over the last two years, but I thought it would be a useful exercise to work through for the purposes of this hearing.

I will now refer to the USDA's figures in Exhibit 50 to illustrate this point and I've also discussed them.

According to the USDA's cost of production figures on the first three pages of the exhibit, and these are the total cost production that come out of our neighboring Vermont farms in 2004, and it showed that to be $23 per hundredweight, $24 going into 2005, and then they go up dramatically $28 at the end of last year and beginning of this year. I quibble a little bit with those figures because they're not drawn the way my profit and lost statement is drawn, but I find most of the cost inputs to be relatively comparable with the costs on my farm, and I believe this calculation would be a good starting point for my testimony on cost production.

I did feel that I needed to factor in two adjustments to bring the cost of production down actually closer to the figure that I use when making decisions for my farm. When I looked at the line for labor and multiplied this figure per hundredweight to achieve the total cost of my farm, I reduced the allocation for family and hired labor from $8 per hundredweight to $5 per hundredweight; this better reflects my actual pay figures for my profit and loss for both my employees and for ourselves. Secondly, and I treaded on quicksand to do this, but I thought that actual numbers in my profit and loss show a total fee cost of about $1 per hundredweight less on our farm than the NASS figures. And one of the conclusions I had was that we do a lot of packing, so that perhaps lowered that cost, at least over the last two years, although as we get toward the end of last year, the cost went up dramatically on feed.

So in sum, I reduced USDA's figure by $4, and worked from a cost of production calculation of $19 per hundredweight for 2004, $20 for 2005, and around $24 for last year and leading into this year.

On the pay side, according to the figures on the fourth, fifth and sixth pages of the exhibit, USDA reported a 2004 mailbox price for the northeast order of $16.29 for -- $15.39 for '05, and then $13.22 for '06. As noted at the outset, the price of '04 was the highest ever that we received, and the price soon thereafter dipped dramatically to just over $12 by the summer of '06, recovering somewhat at the end of the year. While individual pay prices of course vary greatly, I find these are a good benchmark to use for assessing my farm income, and that of my neighbors.

It may be seen that even in the best years, the mailbox price was not enough to cover my adjusted cost of production. Using my figure of $19 for the cost of production, that year the pay price was almost $3 short. In '06 and leading into this year, the story was much worse. Using my cost of production figure of $24, the pay price was at least $10 per hundredweight short.

Here is the translation of these figures to actual dollars of overall farm income on a medium-sized Maine farm, having approximately

150 cows and shipping over three million pounds of milk.

These numbers are obviously rounded in several ways, you still make a -- but they are still quite representative of our farm. We have a few more animals, but the mailbox revenue figures and cost figures, including the substantial increase, are the same, while our revenue declined, and are still representative of circumstances on my farm. The situation on our farm is a little less dire in the past than it might be otherwise because we sell animals and we do have the high component prices, but the mailbox prices are representative of our operation, and for the operations of the neighboring farms.

The questions for anyone, of course, and particularly for the department in this hearing while considering whether the pricing series needs change, is how do we manage to continue in operation, given the dramatic disparity between our costs and pay prices? As part of this inquiry, the department should also be considering whether we will continue to do so in the long term, as it assesses whether the current pricing series will continue to provide an adequate supply of milk for our Federal Order.

As indicated at the outset, there are two basic answers as to how I managed to stay in operation. First, the State of Maine now operates two programs that have boosted my pay price to a sustainable level. I receive both a pooled, over-order price payment through operation of the Maine Milk Commission and then an additional subsidy payment from the state general fund. In combination, these payments have boosted my pay price enough to approach a break-even operation of our farm.

Yet in this past year, with the dramatic decline in federal minimum prices coupled with a dramatic increase in feed, energy and utility costs, even these income supplements were not sufficient to cover the $10 spread between mailbox price and the cost of production that I discussed just a minute ago. Like so many farmers across the country, as I look back through my actual expenditures, I was forced to trim back or eliminate any improvements to the buildings, maintenance and repair, cut back on equipment maintenance, which, of course, is self-defeating in the long run, cut back on labor, non-family labor, and reduce my family's draw from the farm. And as I have said, of most concern to me in the long-run, is that I have increased my mortgage just to provide operating funds.

Looking down the road, this second series of steps that I've taken is not sustainable in the long-run. There are only so many shortcuts, and only for so long, that a well-run operation can take before becoming a marginal operation. It is bad life planning, to say nothing of business planning, to mortgage one's future livelihood for current operating expenses.

Nor can I rely for the long-term on continuation of the combined market regulation and subsidy support from the state. Over-order price regulation can be sustainable for the long term, but if it is not asked -- but if it is not being asked to make up too much of a shortfall between Federal Order minimums and my cost of production, as long as it is not being asked to make up too much of the difference. If that is our current circumstance, the federal minimums are simply too short, currently, and a single state over-order program cannot be relied upon to make up the difference without throwing large amounts of placement into disarray.

Back home we think it is nothing less than remarkable that the State of Maine and its political process has been willing to provide a direct subsidy payment to keep its farmers in operation. We think this political resolve remains, but for the long term it would be simply too much to ask the taxpayers to continue subsidizing our operation because of what we feel are regulatory shortcomings which should be made up at the federal level and the market's inability to otherwise provide us with fair return on our product.

If federal minimum prices are not somehow adjusted to provide more sustainable prices, my own numbers put our farm in jeopardy. I seriously think I could be forced out of business.

My experience, of course, is not unique in Maine, and for this reason MDIA sought to participate in this hearing and to offer our proposal. I will now turn to the larger perspective of our association.

I'll begin with a little background about dairying in Maine. Historically, Maine dairy farmers have provided essentially all of the state's fluid market needs. Built around providing in-state, high-valued fluid demands, ours has been a long-time, stable and self-supporting industry.

Dairying is the largest sector of Maine's diverse agricultural economy. The dairy industry generates $570 million annually to the state's economy. Maine's dairy farmers, processors and ag business obviously contribute millions per year in state and local taxes, including a major portion of property tax revenues to support some rural communities. The industry provides jobs, 4,000 Maine jobs, and earnings of $150 billion each year; of course, this is very small dairies.

The State of Maine, from consumers to processors to retailers to farmers, thus, has a tremendous interest in ensuring stability of this industry.

Between November 2001, the last time milk prices sank to unprecedented lows in May of

2003, Maine lost 12 percent of its farms. In June 2003, the state responded by making of emergency disaster relief support payments totaling $3 million to the farmers. The governor at that time established a task force to find ways to stabilize the dairy industry -- he established it and the dairy farmers paid for it -- and prevent further loss of farms, milk production, economic activity associated with the dairy industry.

The governor's task force made 17 recommendations for stabilizing the dairy industry, ranging from proposal of a formal assessment of the industry's economic value to making state constitutional changes in taxation. The task force found, though, that the core issue was a federal system's failure to provide adequate minimum price.

In an attempt to address this core problem, the state acted to pass a state price support program, which is called the Maine Dairy Stabilization Program. The program provides a safety net payment of the difference between the federal law blend price and the short-run break-even cost of producing milk in Maine, as a cost determined by production study conducted by the Maine Milk Commission, which we previously referenced.

Adoption of the Dairy Stabilization Program included the unprecedented step of providing money from the state's general fund. The state's fiscal year in 2006, $4.7 million were paid to farmers and is projected to pay $12.5 million by the end of '07. Current monthly payments have run as high as $1.2 million a month since last July.

Today, Maine has 250 remaining dairy farms, and that's actually a correction. At the Milk Hearing we had Monday, the Commission told us we had 352 remaining dairy farmers. And as an ongoing concern that state action cannot be relied upon over the long term to cushion the financial distress of the state's dairy farmers in order to maintain our supply in our industry. As I indicated at the outset, the experience of my farm is representative of the experience across our 350-farm membership, meaning that the state's farm, collectively, would be in profound financial distress absent the operation of our two state programs.

I would like to refer to two additional figures in Exhibit 50 to document this profile of the current collective economic health of the state's dairy farmers. As you can see, beginning on page 7 of this exhibit, the Maine Milk Commission publishes these figures. Three sets of figures reflect the long- and short-run net returns in '05 for a 55-cow operation, and 163-cow operation, and a 305-cow operation, which is roughly our definition of a small, medium and large farmer in our state.

I'll explain a little bit about these figures before I present my analysis. If you're looking at the exhibit, in the upper left-hand corner each of the three sheets, you'll see an "annual revenue." Under that heading you'll see "milk receipts." This figure includes all payments received by Maine farmers, including MILC payments, over-order prices from the commission, and the direct subsidy payments from the Stabilization Program. For purposes of this testimony, to make everything roughly similar, I've substituted USDA Department's mailbox price computation for '05 for the "milk receipts" figure on the Maine Milk Commission and then recomputed the total revenue under the "annual revenue" heading. Using the figures in each case for the "total operating expense" the "total overhead expense" and the "annual depreciation and interest expense," all appearing on this right side of those figures and all the same developed from the Maine. I recalculated then, using federal prices, the long- and short-run returns shown under the "annual cost" in the lower right-hand corners of the pages.

This paragraph explains what I did. The box underneath shows the calculations. Then just in a quick summary, a farm with 55 cows using the federal revenue, shows a short-run loss of $32,000, and then we add back in depreciation, which eventually you have to do, a long-term loss $95,000. A medium-sized farm, again a loss in the short-term of $25,000, and then a long-term loss of $280,000, and then Maine's larger farm actually says that they generated $25,000 profit in the short-run, but have a long-run loss as well of $355,000. These are actual figures drawn from those studies.

According to these figures, in each

instance, all of the farm groupings were at best marginal in short term and in severe distress for the long term. In effect, as with my farm, only when the capital costs of "annual depreciation and the interest expense" can somehow be factored out that, farms are able to continue to operate in the short term.

Across the state of Maine, without state support, farmers are in effect being asked to subsidize the production of milk by factoring out their long-term capital requirements. The regulated marketplace is simply not returning what is necessary to cover this substantial portion of our expenses. Somehow farmers are expected to continue to operate and produce milk for the market and as you heard from other farmers testifying here, I don't think our numbers are different than what they would generate.

As a final note on the figures in front of us, the University of Maine economist who prepares the cost of production studies under contract for the Milk Commission, the study referenced in this data by Dr. Timothy Dalton, has also compared Maine costs of production with those of producers across the rest of the northeast and across the upper midwest, which we'll call the northern crescent. According to his assessment, Maine costs of production are a little bit higher than the rest of the region. The specific areas of the costs seem to be a little higher in fuel and utilities, our electric rates are extremely high, repair costs are higher, we call it farming at the end of the pipeline, and our property taxes are high.

We do reference in the final page of my exhibit that particular statement from Dr. Dalton. Nonetheless, I'm confident that the analysis I have presented about the relationship between inadequate pricing and long-term producer finances and the supply of the milk is applicable for this broad and encompassing region of the nation's milk supply, and it helps explain our situation in Maine.

MDIA has become a party to this hearing with the belief that the association's state-wide producer perspective of the adverse impact of the current federal pricing policy provides important testimony in support of the need to make a comprehensive change to the Class

III and Class IV pricing series. We believe our proposal is a critical first step towards that comprehensive change. We believe our proposal will begin to restore the pricing series' capability to provide sufficient return on the value we are creating in the market so as to ensure that we can sustain our operations, and thereby provide a stable supply of milk for the marketplace over the long term.

I will rely on our expert, hopefully experts, to describe that proposal in detail. On behalf of the association, I do, however, challenge the Department, when assessing our proposal, to consider the basic rationale for the current pricing series. We believe the price must be sufficient because we want to challenge the statement that the price must be sufficient now because there's enough milk in the system.

Our belief is that the assessment can only be true in the shortest of terms. The impact of requiring farmers for too long to carry the burden of inadequate prices is now readily apparent in the southern part of this country, the basic, local supply of milk for that milkshed is vastly disappearing. The cost is beginning to bear in the northeast milkshed, where I'm from, we are now beginning to see the supply for our orders diminish these last few years.

MDIA's mission and my purpose for being at this hearing is to issue another warning to those who oversee the milk regulatory structure. As the farm population ages (and I suddenly felt older as I was typing some of this and my first grandchild coming); as dairy farmers abandon their debt-ridden farms, and as younger family members choose a more financially secure livelihood, called into question is the basic premise "there will always be enough milk."

Perhaps there will be, but allowing the current economic climate to continue certainly guarantees that milk production will not be a function of small family business like mine, that have been welcome for a century as an integral part of our rural communities.

Thank you for your consideration of our proposal and for receiving my testimony, and I am available for questions, should there be any.

I apologize for reading fast.

JUDGE PALMER: Mr. Smith.
MR. SMITH: Thank you.
BY MR. SMITH:
Q Mr. Whitcomb, a few questions to clarify your statement somewhat.
Start with the exhibit. You indicated on pages six through seven of your statement that you were relying on the USDA mailbox prices.
If we can just walk through where the figures that you're relying on are found in those statements.
A Under the exhibit the first three pages of the exhibit are published NASS data. We felt that that was a more -- a wider perspective and used as strictly Maine prices. The first line, of course, is the Northeast Order, which is the one that I'm speaking to directly. We don't do NASS data specifically for our state, but Maine Milk Commission has numbers readily available.
Q The $16.29 figure you referenced for the year as the average price on the far side of the row; is that correct?
A Under 2004, the average would be top right-hand corner.
Q It's the same three references for '05; it's the

average for the year, and '06 was the average for the year?

A Correct.

Q The mailbox prices are not reported by year, number one -- first question. So how did you come to the figures that you came to as average figures?

Did you do a simple computation of the 12 figures or did you see some trends that, as you indicated, there was an increase in the price spiking up towards the end of the year?

A Well, if you follow down through that.

Q I think I said "mailbox," I meant the "cost of production" figures, pages four through six, sorry for that confusion.

A Okay. The second point is we used the various cost of production as an average.

Can you kind of repeat the question then?

Q Yeah. These figures are not reported with an average for the year, but you used some type of average for each of the years in your statement, which didn't seem to be just a straight -- which isn't just a straight average of the year, so just trying to get into the record the calculation that you've made.

A We factored out some things that didn't seem to be exactly applicable to my operation in trying to arrive at a similar price.

When I derive my own figures from my own profit and loss, there were a couple of things that were slightly different, so the attempt was to make the comparisons as complete and honest as we could between final profit and loss, Maine Milk Commission figures and NASS figures.

Certainly, the argument can be made that there were some areas that didn't exactly correlate, but the bigger picture is to create a trend, and I don't think we argue with the trend on any of these.

Q On that point, I understand that you reduced the total fee cost line, which is about just under halfway down under the "operating cost" by about a dollar, "total feed cost" reduced by a dollar and under the "allocated overhead" you've reduced the combined hired labor and opportunity cost by $3; is that correct?

A Yes. And again, that's just simply comparing when you total this price on hundredweight basis for the total cost for each year, they seemed to be a little out of line with my cost; that's why

I referenced the fact that I reduced those, and there's an attempt, again -- you know, we could have offered the testimony simply using the NASS numbers and had an even greater disparity between the cost of production and my cost and the pay price, which we chose to attempt to be a little more, I think, honest in reflecting what we think the operation conditions are on our farm compared to using the NASS numbers.

Q And the last set of figures are contained in the publication from the University of Maine that the cover page is included as the next page in Exhibit 50 entitled "The Cost of Producing Milk in Maine: Results from the 2005 Dairy Cost of Production Survey," authored by Dr. Dalton and Lisa Bragg.

Could you just briefly explain how the Maine Milk Commission came to issue this -- hire the University of Maine and then issue this publication?

A The Maine Milk Commission has a longstanding -- I assume it's a contractual arrangement with the university to deduce costs in its compilation of minimum processor prices, as well as minimum producer prices; that's a function of our state commission which I guess doesn't exist in most states.

After a number of years of lobbying, we did get the commission to go through a detailed analysis of cost of production for the farmers. It had been doing that on a routine basis for the processors. Farmers have always been a little bit upset, the processors even include the cost of their garbage cans in the cost of production so they have them reflected in what their guaranteed margins are.

So this cost of production study, which I only reference three or four pages, but it's a complete booklet, I just didn't have enough copies available to distribute perhaps the experiment station to make them if anyone chose to reach them. They even have a website. This went into a detailed cost production analysis where surveys were sent out to every existing dairy farmer in the state. It was a voluntary response. It was about a 13-day survey. Frankly, I didn't make mine out, I didn't respond, but a large number of families did.

Statistically, Dr. Dalton felt he got a representative example of all three different size farms and developed a detailed cost of production which they update on an annual basis now. And then if you compare the numbers he developed with NASS numbers from Vermont and then the numbers he, you know, was able to find across the northern crescent, they were not significantly out of line, used some different factors. I noted in my testimony some of the areas that our costs seemed to be a little higher than our state.

Q The next part of the exhibit referencing your statement on page 11 is perhaps a little more complicated. If you can just walk through that. You indicated that you replaced in the "annual revenue" figure in the top left-hand corner the "milk receipts" figure, and recomputed the "total revenue" to make up your table at the bottom of page 11.

And if the revenue figure on the bottom of page 11 is $126,000 for the 55-cow farm, which is the first of these three tables, and the actual number on the table is $159,891. As I understood your testimony, what you did was take the under number of cows, the annual milk shipment, which is per hundredweight of

8,195.5 hundredweight multiplied that by the mailbox price, reported in the USDA figures of $15.39, and that product was replaced for the milk receipt figure and then you're adding back in livestock and other revenue, and then that was the $126,000 that you reported in the table; is that correct?

A That is correct. The difference that you see in those figures is the impact of our state subsidy system, frankly.

Q So that the subsidy would be the difference between $159,000 and change and $126,000 reported in the table?

A For the 55-cow operation. Then we continued using that same page as statistics drawn from this cost of production study, we put in the operating expense and the overhead expense, and then were able to derive the short-run loss, in that case, if you applied simply USDA mailbox prices and then added in the actual interest in depreciation expense of the study and showed the long-term loss.

Q Then based on that, you recomputed the short-run and long-run return in your table and you went -- just summarize the table. If you could read into the record, read the headings "revenue, operating expense," and read each of the lines for each of the three.

A Sure. Under "55 cows" under "revenue" we are using the NASS number -- substituting the NASS number for the price on the actual amount of milk ship for a 55-cow operation we received revenue of $136,000.

Q $126,000?

A Oh, 126, excuse me. "Operating expense," which came out of the study, was the actual operating expense of $123,000. The "overhead expense" is $26,000, which developed a short-run return loss of $23,000. And if you factor in, as we should, "depreciation and interest expense," it would be another $72,000 expense, and so our long-term loss for the 55-cow operation would be $95,000.

For 163-cow operation, which in our state is considered a middle-sized operation, again, on the next page of the technical data takes the pounds of milk that that farm would generate using the NASS mailbox price, you get $512,000 revenue. Your "operating expense" is determined by the milk commission study $464,000. Your "overhead expense" is $73,000, which returns a short-run loss of $25,000, add on $183,000, "depreciation/interest expense" and so your long-term loss is $208,000 for the middle-sized operation.

The larger operation in our state is called a 304-cow operation with "total revenue" using the NASS mailbox price and the total pounds they generate of $1,008,000, "Operating Expense" is $836,000, "overhead expense" is $145,000, and they actually show a short-run return profit of $25,000. But when you add in "interest and depreciation expense" of $380,000, they, too, have a long-run loss, which is $355,000.

Q So in summary, at least with a midsized farm of 163 cows, according to the Maine Dairy Industry Association, where you include all of the additional payments, milk payments out of the federal government, the overrun premiums, Maine Milk Commission and the state dairy support program, Stabilization Program, payments, those are all computed under the long-run return showing -- for the short-run, we'll start there, with those payments, that size farm showed a short-term return of $133,000 and change, and under your computation, that same farm showed a

loss of $25,000.
A Correct.
Q And 158,000 odd dollars, these are those payments that put that farm in the black?
A That's what the figures show, yes.
Q But even with that substantial payment, that farm is still running. Okay.
While we're on the statement page, just a correction for the record, on page 10 at the bottom in your statement said "today Maine has 250 remaining dairy farmers."
A That was incorrect.
Q It's 350?
A It's 352.
Q Oh, it's 352. Two more than -- that's very unique. I would say in these areas, that there's actually more than rather than less?
A There was a legislative hearing on Monday where the association went to the legislature to actually try to get funding for the depreciation and interest expense to be added to the Stabilization Program; that was the number of farms that was submitted as testimony by the milk commission.
Q If you could, you did not read the table on page

seven into the record. If you could just do that to complete your statement. Bottom of page seven if you could go through the rows and figures.

JUDGE PALMER: Exhibit 49?

MR. STEVENS: You have a copy of the statement. The reporter has a copy of 50?

THE REPORTER: Yes, I do.

MR. STEVENS: It's in the statement.

JUDGE PALMER: Which page?

MR. SMITH: Bottom of page seven, if you could incorporate the substance of the table into the statement.

Year	Revenue	Cost	Net Income
2004	$500,000	$570,000	($70,000)
2005	$460,000	$600,000	($140,000)
2006	$400,000	$720,000	($320,000)

Q Last two questions, number one, on page three at the top of your statement, the second sentence, two sentences, "Our proposal would ensure that the procurement price for milk used for manufacturing purposes, once again captures that measure of the value of the raw product we produce sufficient to ensure stability of supply. Given that our product is creating real value in the market, according to the proper function of the federal pricing series, we should gain at least that intrinsic measure of value."

You indicated you wanted to clarify what you had meant by "intrinsic measure of value."

A Well, I think it gets to the substance of what we're attempting to propose here, and we -- the farmers' frustration obviously is seeing the value of the product, or a smoother product which is what we're exposed to in our environment, in our state, principally northeast, or the manufacturing product.

The product price at the retail level seems not to have the fluctuation that we see at the raw price level or producer price, and we just feel that if we're going to ensure a stable supply, we have to have a stable price based on the value of that product in the marketplace.

The premise of allowing it to go up and down, somehow suggesting that corrects the supplied situation, creates just an untenable situation for those of us who are producers, particularly given the current climate that we're in, which we thought a year ago our problem was the fuel prices were going to be the death nil, then pale in comparison to the cost of the grain prices as the year went along.

So, frankly, I don't know how they survive in other states. We explained why we survive, but patience of the taxpayers in our state may not last forever.

Q Lastly, you indicated to me on the break that you wanted to provide your comment on Mr. Beeman's indication that farmers would respond to lower prices by producing less milk.

A Well, I understand that that's a philosophy from the position that we are in in our market, and I think given the condition of the dairy farmers across the nation, I just don't think that that necessarily applies.

The reason that our state got into business of trying to create the program we did was because they were very concerned about maintaining a structure that would allow dairy farming to continue. We were very concerned about losing the whole supply chain.

The numbers would diminish to the point of not having feed supplies and milk commission suppliers, and all the other infrastructures you need for dairy operators.

So if we don't have, you know, physical location that you allow in other states for those kinds of infrastructures needs. So our experience from our view is that we have limited abilities to expand in a northeast area, and particularly when the focus of this hearing is on small producers, we just think there has to be a focus on keeping small businessmen alive, away from allowing the market to go -- or the price of our own product to fluctuate so widely, which some testify large members can survive with; had comments that they're not surviving any better than we are, but there needs to be a mechanism, and that's what we're attempting to talk about here to level the prices.

The prices being received in the marketplace gets more of it back to the farmers.

MR. SMITH: One last mechanical point.

Your Honor, the three footnotes on page 2, 10, and 12 of the statement could also be incorporated into the text.

	Revenue	Operating Expense	Overhead Expense	Short-run Return	Dep/Interest Expense	Long-run Return
55 Cows	$126,000	$123,000	$26,000	($23,000)	$ 72,000	($ 95,000)
163 Cows	$ 512,000	$464,000	$ 73,000	($25,000)	$183,000	($208,000)
304 Cows	$1,008,000	$838,000	$145,000	$25,000	$380,000	($355,000)

L Bragg and T Dalton, Maine Cost of Production Study, see footnote 1 at page 27

JUDGE PALMER: I'm going to give you a sticky, page seven to be copied. Go over and stick it on the ones that you want her to copy. The page numbers aren't exactly where they should be. Also put a couple of the stickies on the government's. Take the whole thing, we'll give you a second or two.

MR. SMITH: How about at the break.

JUDGE PALMER: You want to do it at the break.

MR. SMITH: You need your sticky's back?

JUDGE PALMER: The government's here to serve.

Do you have questions for the witness?

[1] L Bragg, T Dalton, The cost of Producing Milk in Maine *Results from the 2005 Dairy Cost of Production Survey*, Maine Agricultural and Forest Experiment Station, The University of Maine, Technical Bulletin 193, Page 21, September 2006 (See Exhibit)

Mr. Vetne.

CROSS-EXAMINATION,

QUESTIONS BY MR. JOHN H. VETNE:

Q Good afternoon, Mr. Whitcomb. My name is John Vetne. I'm an attorney with an office in New Hampshire, I camp up in Maine. I represent Agri-Mark and Associated Milk Producers. So you're welcome. I do buy milk in Maine, and I do pay the tax.

By the way, the subsidy from the state's general fund is the outgoing money. The incoming money is the tax on packaged milk sold in Maine that goes into the general fund; is that correct?

A If you force us to say that, technically, you're correct. There is supposed to be a disconnect between any matter of taxation in our state and any payment that farmers make -- or any special interest.

Q Let's put it this way: The total amount of taxes on packaged milk sold in the state of Maine, more or less equal the subsidy going out to dairy farmers?

A Actually, it didn't this last year, and that was because of some consonation that was being addressed even Monday in the State House.

They created a program that followed the price and did not create a revenue screen, we'll call it, to match that. So that's causing the Congress to worry.

Q My part, I'll pay another penny when I buy milk in Maine.

JUDGE PALMER: You have an interest.

Q I'm looking at the top of page three of your testimony, top paragraph there, third sentence. "Given that our product is creating real value in the market."

By "our product" are you referring to your farm and other farms in Maine that you represent?

A Correct.

Q And the "real value in the market" that you're referring to, are you referring to the use of your milk in full use?

A Sure. We actually have a small amount of milk that ends up as processed in in-state cheese.

Q That was my next question. There is a small in-state user of milk --

A Very small, small enough so they can specifically ask for milk from a Jersey/Guernsey

farm to be one of the major suppliers.
Q A simple farm. When you refer to a portion of your subsidy coming from the Maine Milk Commission in a "pooled, over-order price," is that the regulated difference between a federal Class I price and the state Class I price?
A Are you referring to a specific spot?
Q I'm sorry, page eight middle.
A Page eight? You said page eight?
Q Yeah, page eight middle. You said, "I receive a pooled, over-order price through operation of the Maine Milk Commission."
Maine has Class I prices regulated that are higher than federal Class I prices at the same locations?
A Well, actually, we've been successful in appealing to the commission for a couple of over-order payments, a fuel adjustment cost that they've added in addition to the published blend price; and then there's been another cost factor as well.
Q These are added to the regulated prices charged to the fluid milk plants that purchase milk from Maine producers?
A I believe so. Yes, yes; they're the ones that

complain vividly at the hearings.

Q Okay. Are you a member of a cooperative?

A I am not personally.

Q You sell your milk to Oakhurst?

A Correct. Some members, yeah. People who sell to this market have a choice of being in a cooperative or not. Agri-Mark members generally sell to other sources.

Q Oakhurst is the primary buyer of nonmember milk from Maine?

A I assume. We have three fluid processing plants and I think they're the principal one.

Q And all three of those plants are now regulated -- fully regulated under the Federal Order system?

A I believe so. And enough of the milk is distributed out of state so they fall into the federal regulations, that's correct.

Q Am I correct in concluding that the bottom line of your testimony, your position is that somewhere in the federal pricing system more revenue needs to be produced in the regulated price coming back to Maine dairy farmers?

A Not just Maine dairy farmers, but that's who I'm speaking for.

Q And for that purpose, it's true, isn't it, that it doesn't matter whether it comes on the Class III price or the Class IV price or the Class I price, as long as that additional revenue flows from some regulated source?
A That I would, I guess, venture to saying yes to that question. I mean, my personal experience is on the fluid market, but that is less than half the milk in the country, as I understand it.
Q That's about two-thirds of the milk in Maine or a little more?
A More than that.
Q A little more. This goes back not too many years. At one point Maine had a fairly large, for Maine purposes, cottage cheese manufacturing plant not too far from your farm, correct?
A That would be right, correct.
Q And that operation closed because it wasn't economical to continue to produce cottage cheese in Maine?
A I mean, I don't know the specific reasons. Some felt that cottage cheese consumption was down. It was not a popular item anyway.
Q A plant could produce other things also. It was

a plant owned by other Agri-Mark, leased to Hood.
A At that time. And they had significant challenges.
Q What is the size of the remaining cheese plant in Maine?
A I think --
Q If you know?
A I don't know. It's a small operation and they acquire their milk from the Oakhurst operation, so we received our check from Oakhurst; and I think they're charged rather handily for what they receive.
Q Oakhurst diverts your milk to this operation?
A We don't deal with them independently.
Q All right. On top of page 12 of your statement you're referring to some of these reported production cost surveys. And you use the term "all of the farm groupings." You're referring there to the large, medium and small groupings?
A The groupings that we had used in our Maine study, correct.
Q Now, are you familiar with a production cost survey and report prepared by the Farm Credit Banks in the northeast?

A Not in detail, no.
Q Not in detail.
A I mean, I've seen references to it and I may have actually seen it, but I can't quote from it.
Q As a foundation for my question, let me tell you, that report shows cost of production by cost groupings, not just size groupings. So you can get some idea of the range of cost amongst farms.
Does any of the information from Maine, that you're aware of, show what the cost range is from low-cost producer to high-cost producer?
A In terms of differentiating between the so-called more profitable farmers and less profitable within a range?
Q Yeah, either all the farms. For example, some farms might produce nonfat dry milk for $14 hundredweight and another for $24 within the same size group.
Are you aware of what the range would be within the producers that respond to the production cost survey?
A I am not. And I honestly don't know if it's included in -- I think there's some reference to

the ranges in this cost of production survey. I'm not personally familiar with it. I don't know if I can thumb through and find it for you.

Certainly, if you get an average, some above and some below.

Q Yeah. I just wondered if you had some idea what the number might be.

A I don't.

Q But the end that's collected is ultimately used for legislative policy and subsidy of dairy farms in the state of Maine?

A Farm Credit numbers?

Q This is state survey.

A State survey. That is right. That's right. That's the legal document that's submitted to the Maine Milk Commission for their legal proceedings.

Farm Credit is a party to all of this; in fact, they've been very helpful in the whole legislative process.

Q You said participation in the survey is "voluntary;" everybody gets a survey form, but not everybody participates?

A The initial ones were -- and I wanted to bring that to the attention of this proceedings because it would cast a doubt in some people's minds as to whether somebody was more ambitious than others in terms of completing it. I wasn't one of the ambitious ones.

As we verify those facts against NASS data and other data, they seem to be in the range.

Q But is the Maine survey still voluntary?

A I believe so. I believe so. And I just hesitate to say yes or no exactly because I haven't been a party to those discussions at the Maine Milk Commission.

Q To the extent that it's voluntary, it certainly has been in the past, would you agree with me that there's less incentive for a low cost producer to participate in the survey?

A Well --

Q It would tend to reduce the number upon which the state subsidy is based?

A Oh, I wouldn't see someone thinking it through that far. If I don't put my bad numbers in it will go higher. It may be an inference that some people -- ambitious or something.

Q You would agree with me that a producer that has a low-cost production, if that producer includes his or her costs in the survey, it would tend to

bring the average down?
A It could. I don't know that they knew that that was the end result when the survey was done.
Q A low number added in any average tends to bring it down; not just a matter of it could, it would, correct?
A Correct.
Q And there's a great incentive for high-cost producers to submit their number?
A I mean, the survey was done before any legislation had taken place, so no one knew that that's -- it was kind of blind in a positive way because nobody knew what the end result was going to be.
Q Is it going to be an annual thing, the survey?
A There's actually an update that has been done. They used the producer survey, as well as the old data supplied by feed suppliers and utility data and so forth.
They don't rely on the farmers to tell them how much the cost of electricity is. They use actual numbers from the utilities. So some of the real cost data comes from sources other than farmers.
If you read through the study, there's a

lot of the other details, the optimism of the farmers and how many of them think they're going to be in business in five years and those kinds of things. It's even as much a part of this as the actual numbers.

So the study isn't highly based on voluntary response.

Q In your own experience, in your experience and your knowledge of other producers in Maine, during times of high feed prices, such as are current, is there more grazing?

A Well, the extension service encourages us.

Q Who encourages you to?

A Extension service, cooperative extension service.

We're kind of anomaly in terms of being a farm of our size that grazes. A lot of situations obviously don't lend themselves to having 150 cows out on pasture. Frankly, it's a pain in the neck; but, it's a traditional way of doing it on our farm and does lower some of the costs.

We have a very significant percentage of our operation, almost 20 percent of our operation are organic and mandated to graze, that's the rules.

So if that's the response you wanted.

JUDGE PALMER: Would that increase the labor cost if somebody has to move the cows out to the grazing pasture and bring them in?

A Correct. Offset some by less feed obviously.

JUDGE PALMER: Right.

A I read about it in trade publications, but I can't imagine people grazing 200-, 300-, 400-cow herds. I need to visit those folks, I guess, to see how it's done.

MR. VETNE: Thank you very much.

JUDGE PALMER: I apologize for not speaking into the microphone.

More questions? Mr. Yale.

CROSS-EXAMINATION,

QUESTIONS BY MR. BENJAMIN F. YALE:

Q I just have a few questions. You know, one of the things of interest is that USDA has its own model of collecting data, managing it and referencing it in categories and size input products, input components; then you go to California and they have their own way, and now we see what Maine does.

One of the things I find interesting is

this 55-, 163- and 304-cow operation. Can you describe what a typical 304-cow operation is?
A Simply took total number of 350 farms, or probably more than 350 when they did this survey, and found a way to categorize all of them into groups. And so they derived at that number being a third of them were this size and that was the medium number, and third another size that was the medium number. Our largest operation in the state, no need to laugh at other states, it's a 1,400-cow operation, so that's the top. I've got a neighbor that milks 14.
So they run in between.
Q So is that a weighted means at 55? In other words, they took the bottom third of all the farms and then found the mean average number of cows?
A I don't know.
Q But basically they ranked all of the farms, and the bottom third they put it in and called that the 55-cow?
A Right.
Q Middle third they called the 163, and the top they called 304?

A Yeah, just an attempt to categorize. When it became legislation, I wasn't involved at that stage. They created a three-tiered system, and so the state subsidy is based on size. The bottom tier gets a higher subsidy than the middle and top tier gets less. There's not a cutoff like MILC. It's called a tear, T-E-A-R -- no.

Q I figured for you guys it was the tier that was followed by a tear.

Now the 304-cow, what's the smallest 304-cow dairy; do you know?

A I do not know. We're at 175 and we're in the middle, so it's above that.

Q Now this 1,400-cow dairy, do they market their milk like for a co-op?

A I believe it's -- they don't sell to the local in-state processor. They may be a member of Agri-Mark.

Q Now the milk -- you know, Maine's a very large state. It's one of the larger New England states, but after two hours going through six states you get to that one. But where is the milkshed in Maine?

A Central -- the population stops essentially at

Bangor anyway, which is halfway up the state. The northern part of the state is the potato growing region; there's always discussion about putting dairy up there because there's thousands of unused acreage and a lot of grain crops.

The bulk of the milk is generated probably within 60 miles of the capitol of Augusta. The Boston population moves into Maine and that moves north, so the production in southern Maine -- production moving north in our state as well.

Q So you say 60 miles to Augusta. What's the typical length of farm to market haul?

A We're 100 miles from our doorsteps to Oakhurst, and that's typical. The two major plants in the state are within a mile of each other. Portland, Maine, so all the milk goes there except for in Bangor, which is not used as much. So it's at least 100 miles for most of the milk.

Q Then from your farm to that milkshed that you were talking about that you're a part of, how far is that to Boston?

A It is 200 miles for us to Boston.

Q Okay. Now, I wanted to -- I know that Mr. Smith asked you these questions, but I was a little confused, and let me just share what I'm trying to find out.

First of all, you're aware that my clients have got some proposals that have the potential, depending on which of them and to the degree that they're adopted, to increase blend prices.

You're aware of that?

A Only on the fringe.

Q Now, one of the exhibits suggested $0.60 to $0.65 per hundredweight increase. Now that's an average nationwide. It may be more in the northeast. We didn't do that on the Northeast Order.

On a per hundredweight basis, how close does that come to meeting some of the requests that you have in this proposal?

A Well, I mean, I guess I can't really quantify that. I know it wouldn't be a substitute for what we're now receiving from the state to make up the difference between short-run break-even costs and the blend price.

At this point in time, I hesitate to speculate because I just don't have -- you know, I don't have that right at hand.

Q Well, let me ask it another way. One of the concerns that you talked about is that the -- you have this state program that you're concerned how many dollars in the end they're going to make available to you, so it may run out the support.

If our proposals were adopted at the range that I suggested, that would have an impact of reducing the need for a tax on Maine milk consumers -- well, however the income is generated from Maine revenue -- to meet those needs; is that true?

A Sure it is. Sure it is. I guess we were trying to get to the point that, from our perspective, we just think it ought to be -- money ought to be generated differently other than the tax.

Q Oh, that leads up to my next question. And I didn't quite catch the percentages, but the percentage -- do you know what the percentage of the milk that you produce in your state is consumed outside of your state?

A I don't know that. I mean, the historic figure was it was a 50/50; 50 percent went for out-of-state consumption in some manner because we have limited processing, cheese products and other products come back in.

As our in-state production has declined, population relatively stable, but that perhaps 50 percent export state now. I mean, so that's all I know about the numbers.

Q But the situation you have now is, is that, for example, on your farm, you produce the milk and I guess your state's in-state, correct?

A The major in-state processor also has markets, as no deference to Mr. Smith, contracts as far away as Burlington, Vermont.

Q So half of the milk, then, leaves the state and the consumers in those parts are only paying whatever a market price is that has been generated under the system, the rest of it somewhat a little under, where those in Maine the consumers are paying that price plus something else to assist you in your costs.

So let me put it this way: As I understand it, then, that all of the production in Maine receives a subsidy, but all of the subsidy comes from Maine, but not all of the marketing is done in Maine; is that right?

A That's absolutely correct. And we've had, in fact, some very bitter in-state pooling fights about how milk -- you know, where milk is marketed and who gets a cut of the pie; and it's now leveled as a playing field.

A lot of that in-state processing is the plants have closed in Boston and processing is done in Maine, so processing is done there. And, again, part of the rationale is that even when the farmer price was declining, the in-store price was not, so theoretically, the taxes, when we're taxing the margin, that would be kept by processing retailing interest and the convincing argument I gather that they were able to win the day with the legislature was that they weren't going to cost the consumer any more money, that much more.

Q I know you're hoping to have somebody else. I know you have some complexities that have occurred and I'm sorry for that.

A Yeah, I wasn't presenting myself as the expert.

Q I understand that. But in general the proposal that you're wanting to do is to come up with something on a national level that's in the market that generates the equivalent of the income that is being generated in Maine now?

A Sure. I mean, that is the reason we're in this process is to, again, make the statement and we see it in a popular found press all the time, as is if we were getting what the equivalent price in the marketplace is, we would be getting $43 a hundredweight, which is what the report says.

So we're simply -- you know, we understand that Maine's processes isn't going to work nationally; that's why we went to the committee to see if we can pull another add-on to the component pricing that would get us at least to break even as producers.

Q Now, there's another component besides -- as I understand.

JUDGE PALMER: Let me just interrupt. Off the record.

(A discussion was held off the record.)

Q The Maine dairy program is more than just farm price regulation. You also have regulation at the plants in terms of what they have to pay over and above the Federal Order program.

A Well, they're a guaranteed margin, as well as their producer minimum prices and processor minimum prices and retail minimum prices.

Q That's my next question. So they have a retail minimum pricing component?

A It's illegal to use milk as a loss lever in our state.

Q How does that work?

A Depends on who's responding to the question, I guess.

Q No, I mean, the mechanics. I mean, the point does it -- are they required -- the stores are required to pay or sell it for no less than the invoice that they receive from the plant?

A It's a legal audit. They're audited by the Maine Milk Commission and a fee assessed at all levels to pay for the auditors. I suppose it's no different than auditors on the federal pool.

Q And that's only on fluid milk?

A Right, right. We have no sense to really produce any other products.

Q At this point, you don't know the difference between the 60-some cents in the formulas and what else you would need to meet your --

A It took me a little longer to produce these numbers than just sit and think it through.

Q I understand. Now, just so I understand, then later on I can figure this thing through. But the table that you have on page 11, there is a -- I understand if I look at the tables that are on pages -- like table A1 "Cost of

Production for Small Farm." I can understand where you came up with the operating expense and the overhead expense.
A Correct.
Q And then the depreciation interest expense also comes from that.
A Correct.
Q The short-run and long-term returns are simple subtractions. It's the revenue one that I just want to make clear.
You're not using the revenue in the table A1, but instead are using --
A Using the price that I list in the previous testimony that whatever the pay price for that year for the mailbox price.
Q The mailbox price.
Did you add to that the MILC payments if there were any that year?
A We added all the add-ins in terms of other receipts.
We did not -- no.
Q So right now, this 126 which is your mailbox price, in addition to that, there is an MILC payment?
A Yeah; I would have to go back and double check.

I think I left the extra payments out. We left all the in-state stuff out, so we would be consistent.
Q Right. Then you mentioned this over-order price is under regulation by the Maine Milk Commission; is that something above and beyond this revenue payment that you receive?
A Right. This is a fuel adjustment cost and processors were in before the commission got a fuel adjustment cost added to some of their interest.
I mean, I wasn't a party to these hearings, so I don't have them committed to memory; but there were several other cost factors added in as the prices went up. You get to a certain point where the processing retail interest successfully argued if the fluid price is too high in Maine they'll go elsewhere.
Q Okay. So that's one of the reasons there's a difference between what you had and the one you reported over?
A Correct.
Q Now you indicated, which I guess was a surprise to you, might have been a surprise to all of us, you had two more dairies in Maine.

Do you know what size those two new dairies are.

A I can't tell you exactly. I mean, there is a very active organic interest. You know, there may have been -- there's plenty of vacant dairies so somebody may have come back on using a dairy.

I can't imagine somebody starting from scratch and starting one at this time. We had, as it said previously in the testimony, we had substantial erosion. I mean, the thing that we see in statistics for the first time in well over a year, our monthly output of milk actually didn't decline this past January. We actually saw a leveling off in our total production.

We would like to think it is attributed to stabilizing the old commerce.

MR. YALE: Well, thank you for the effort you put in this. I have no other questions.

JUDGE PALMER: Any more questions? Mr. Beshore.

CROSS-EXAMINATION,

QUESTIONS BY MR. MARVIN BESHORE:

Q Good afternoon, Mr. Whitcomb. I just have two questions perhaps.

On page six of your statement, Exhibit 49, you reference having had to take out -- incurred debt this year to cover "operating expenses."

And what I'm wondering is, have you ever done that before?

A You know, obviously we borrowed money to buy equipment or to make improvements. Actually have to borrow money to pay the grain bill and it occurred to Mr. Smith and I, actually as we were going through this at noon, that one of the reasons our feed cost may have shown a little bit less last year because we hadn't yet paid the grain bill.

If we had actually added in the big amount that we didn't pay that we were after the loan for, probably shouldn't have reduced our feed cost as I did when I did the computation.

Obviously, we're an operation that has borrowed money. We have a line of credit and we've had snags, but this sort of a massive -- it's a combination you would like to think it's your own circumstances, a terrible crop two years in a row, and some other projects that were way over budget, all those things. But as you talk to the neighbors and talk to the folks from other states and talk to the folks in Cleveland at the other hearings and so forth, it's somewhat universal, at least in terms of being put in the position.

Q How many years has your generation been dairying on your farm?

A Well, it's a gradual transition. Parents still partial owners and so forth. I've personally been there for 25 years.

Q And is this the most extraordinary cash crunch or need for borrowing money for operating expenses?

A Of this type, absolutely. I mean, we've been tight before, you make decisions that cost you money over time; but just to see this vacuum of, you know, no money to operate, you know, you save -- if you don't pay your grain bills, you pay your help.

I mean, everybody is doing the same.

Q So in your experience, it's the worse in those 25 years?

A Yes, absolutely.

Q In Maine you graze your cattle.

A Well, short season, yes.

Q That's what I was going to ask.

How many months can you actually have cattle out on the pasture?

A We had 18 inches of snow last Thursday, so it's a while yet. End of May through middle of October sometimes. In terms, I mean, if there's something for them to eat out there.

MR. BESHORE: Thank you very much.

JUDGE PALMER: Mr. Stevens.

CROSS-EXAMINATION,

QUESTIONS BY MR. GARRETT STEVENS:

Q Garrett Stevens, Office of General Counsel Department of Agriculture.

Mr. Whitcomb, thank you very much for coming. I know it's very important to the Secretary to hear from small business people, as you've described yourself, and you represent some other people who are small businesses up in Maine who are in the dairy business, and thank you for taking time out of your schedule to come down and participate.

Thank you very much.

A Thank you.

Q And it is important that the Secretary hear from you because you are a small business, and as the Regulatory Flexibility Act requires, we hear from small businesses. We tailor these regulations to small businesses, and we've all heard a lot of -- your testimony was very insightful and helpful, I'm sure it will be to the Secretary, and your answers to the questions on cross-examination also were very good in that regard.

And what I would like to do is just ask you that if you have anything else that you would like to add to the record at this point, in terms of what you want the Secretary to know about the effect of these proposals for or against you as a small business and your fellow dairy farmers up in Maine, this is an opportunity to inform the Secretary of those issues.

So, please, feel free to say whatever you would like for the record relative to these proposals.

A Well, thank you. I appreciate your interest and we certainly -- on behalf of the farmers in Maine, we appreciate the forum. We ventured into it very tentatively, taking turns as to who can get away from the farms to make these kinds of journeys.

The thing that strikes me, and I haven't been here for all the proceedings, obviously, I have to attempt to get home to milk cows, I heard you in Cleveland and, again, read the statutory requirement of this focused on small business. It seems to me that our whole process is driven by the big producers, and we're not.

There are a lot of great minds in this room who would love to figure out how not to have it that way. But it is your mandate and it is our desire to have this process as much as possible allow the small businesses to survive in the small communities. And in all due respect to the folks from Idaho, I can say that we can milk you all in the ground, that really the focus is I think the people that I'm here speaking for, that's the small guys.

So I just reiterate the fact that we appreciate your willingness to try to figure out a way that allows us in the small communities to find a way to keep us going; and if we can rework the whole competitive price thing, I'm the last person to be up here to complain about component pricing because it keeps me alive, but not everyone in Maine is a Jersey farmer, and we do need to figure out how to keep some neighbors going, too.

So I don't have any magic suggestions, but I like the fact that you let us take a little time to come up here, as a small businessperson, because that's what we are, in our situation probably be a long time before we're anything beyond that.

Q As you know, this is a program which the Congress passed for the benefit of producers and processors of milk, but it's for the milk industry, isn't it? It's to benefit the milk industry and all its parts. And with this legislation, particularly small business, to take into consideration them, so that's what it's for and you're doing that, and that's what the Secretary wants to hear for sure.

A Well, thank you.

Q Let me say on a personal note, I go to Maine every summer. It's a beautiful state and I know you know it's a beautiful state. And so on that point, I'm glad you're here from Maine.

A It's a little hard to find some of those rocky parts, but there is a vibrant industry there; and it's kind of interesting. I was not involved in the in-state political process, it's amazing.

I think there are locations in this country, and I think it's probably fairly widespread, where the citizens want to keep the farmers in place. And I know it's true for our neighbors and other states as well. Of course, the bad things that have happened create a sense that there's an uprising against the farmers and I speak for dairy farmers.

We've learned a lesson in our state that consumers are not the problem, and we can figure out how to share the bounty between the processing interest, the manufacturing interest, and producers, I think it can be a little more workable. Just the current situation, I mean, in our state we're thinking a third, a third and third of the farmers. It's not the third categories I have here. It's the third aren't going to make it, or might not make it, and a third that might make it, and a third that probably will make it.

I think you're in a very dire position of losing a tremendous number of dairy farmers in this planting season, and, you know, they kind of sent me -- I don't know, bought a plane ticket, sent me down here saying "You've got to make an attempt to do something so we can convince people that the industry is going to survive beyond our state program."

So that's our plea in this.

JUDGE PALMER: Sir, I want to take in evidence, I don't think we received 49 and 50. So we're going to receive those.

And we thank you for coming. You're excused, sir.

You want go over and get your stickies on her exhibit.

Why don't we take a recess. I guess the next witness will be your witness.

MR. ROSENBAUM: Yes, Your Honor.

(A recess was taken.)

(Exhibit 51 was marked for identification.)

(Exhibit 52 was marked for identification.)

JUDGE PALMER: On the record.

You handed me two exhibits. One is the statement of Mr. Jennings, which I've marked for identification as Exhibit 51. And the other one is a fairly large group of statistics or charts, and that will be 52.

JOHN JENNINGS,

having been duly sworn to tell the truth, the whole truth, and nothing but the truth relating to said matter was examined and testified as follows:

DIRECT EXAMINATION,

QUESTIONS BY MR. STEVEN J. ROSENBAUM:

Q Good afternoon, Mr. Jennings. How are you.

A Okay.

Q Mr. Jennings, we have marked Exhibit 51, which is your written testimony, correct?

A That's correct.

Q We'll get to Exhibit 52 in a minute during the course of your testimony.

Let me make one point of clarification before we read your testimony. You had provided in advance of the hearing, probably about a week and a half ago now, a version of your testimony, correct?

A That's correct.

Q And what we've handed out as Exhibit 51 is very similar to, but has a slight revision to a couple of the numbers, correct?

A That's correct. It was a clerical error when

accumulating the data; there was one that was omitted on January 12th, and the new testimony has that added in and the numbers adjusted.
Q Your testimony includes discussion of the loads of whey cream that you sell, correct?
A That's correct.
Q And that's what you're referencing to when the compilation was done initially, there was one load missed, so that data was left out, correct?
A That's correct.
Q Is it fair to say that the inclusion of that additional load has only a marginal impact on the calculations that had been your earlier testimony?
A That's correct.
Q Nonetheless, someone who wants to have right numbers needs to read Exhibit 51, not the earlier version.
A True.
Q Why don't you go ahead and read your testimony.
A This testimony is submitted on behalf of Great Lakes Cheese Company.

My name is John Jennings. I'm the plant manager of Great Lakes Cheese New York, Inc. Dairy Manufacturing Plant located at 23 Phelps

Street in Adams, New York. The facility is owned and operated by Great Lakes Cheese Company, headquartered in Hiram, Ohio. I have been serving as the plant manager of the Adams facility for the past 14 years. I am responsible for the overall operations of the facility and I report directly to the Vice-President of Manufacturing. I am directly involved in the entire process from purchasing of raw materials to sales of products. Prior to becoming the plant manager, I held a variety of production and supervisory positions in the Adams plant. I have worked at the plant for 31 years, starting in 1976, when it was owned and operated Dairylea Cooperative; Great Lakes purchased the plant from Dairylea in 1985.

The Adams facility converts whole milk into American style natural cheese (primarily cheddar). Along with the cheese products, sweet whole whey powder and whey cream are also produced as byproducts of the operation. The plant currently processes approximately 410 million pounds of milk annually. This equates to 41 million pounds of American style natural cheese, 23 million pounds of sweet whole whey powder, and approximately 1 million pounds of whey cream fat annually. All of these products are sold in bulk form used for further processing or as an ingredient.

My focus today is to provide information about the cheddar manufacturing and byproducts generated that might be helpful to USDA to make a sound decision from the hearing. I am not a dairy economist; I don't consider myself to have specialized expertise in the regulated milk pricing, however, I've been told a couple things about the current Class III formulas that concern me. Specifically, I've been told that existing formulas assume that no milk components are lost in manufacturing process, and that all the fat received at the plant that is not captured in the cheddar cheese has a value equal to the value of fat in grade AA butter. I disagree with both of these assumptions and will elaborate further on these issues.

Q Let me just interrupt you, Mr. Jennings, there so that we can help orient people following along.

International Dairy Foods Association has a proposal number 9, which would adjust the Class

III formula to reflect the lower value and reduce the butter fat recoverable as whey cream.

Is it fair to say that your testimony goes to that proposal?

A Yes.

Q Please continue.

A In-Plant Losses. For the sustainability of processors, it is imperative that the products accounted for in the regulated milk pricing system not exceed what can be produced from milk being priced. There are inherent component losses throughout the manufacturing process. These component losses may come in the form of, but not limited to, cheese, whey -- or milk, cheese, whey solids, and whey cream. Two significant contributors to component losses are the cleaning and sanitizing of equipment and the de-sludging of the whey separator equipment.

Typically, cheese operations will run up to 20 hours of process and will be down for approximately four hours to clean and sanitize. The start-up and shutdown process and the cleaning process lead to component losses. At the front end of the process, milk is lost at pasteurizer start-up and shut down. At start-up, the milk has to push water through the system and the milk/water mixture is run onto the floor and disposed of as waste material until it reaches approximately 90 percent milk concentration. At shutdown, the opposite occurs and water is used to chase the milk. Once the water dilutes the milk below 90 percent milk concentration, the balance of the milk/water mixture is run onto the floor and not disposed of as waste material. We have not quantified the volume of these losses, but they do exist throughout the industry.

Milk components that are clinging to the insides of the equipment are also lost (that is, disposed of as waste material) during the cleaning and sanitation cycle. That is the most significant component that clings to the stainless steel and is lost during the daily CIP (clean in place) cycle through the piping and equipment. However, whey solids also build up on the inside of the whey dryer and are lost when the equipment is cleaned every couple of weeks. Again, we have not quantified the volume of these losses.

An area of loss that we have quantified is the whey solids lost in the whey separation process, resulting in the de-sludging of the whey separators. After the whey is removed from the cheese vat, that is separated to recover as much of the whey fat as possible. This is because the fat in whey cream has a higher value than fat in dry whey products. All the whey generated is run through a separation process where the fat is removed by the means of a centrifuge-type machine. This is a continuous process, and during the operation the machine will de-sludge on a timed sequence.

De-sludging is basically backwashing the machine or flushing out the residual solids that build up in the machine during the separation process. The industry standard is to typically run a full de-sludge every hour and a partial de-sludge every 15 minutes. During the full de-sludge, approximately 20 gallons of product is discharged from the machine and during a partial, only about five gallons of product is discharged. Our operation runs approximately 19 1/2 hours per day, which equates to 390 gallons of product during the full de-sludge and 290 gallons of product during a partial de-sludge.

The whey solids level for the full de-sludge are 3 percent and for the partial de-sludge are 4 percent. When you convert the gallons to pounds and calculate the dry pounds of solids lost for both full and partial de-sludging, it equates to approximately 200 pounds of dry whey solids per day. The facility operates at full capacity for at least 355 days per year. The total whey solids lost annually is 71,000 pounds. That 71,000 pounds represent 0.3 percent of our incoming raw milk "other solids" purchased last year. Using the average of the whey Mostly Central market for 2006, $0.3348 per pound, the value of the solids lost would be $23,770. This information was compiled by measuring the de-sludge volumes and in-plant testing of the product discharge. The market value is the average value for 2006 "central states whey mostly" reported in the USDA/ANS Daily Market News.

Whey cream market value. The second focus point of my testimony is the market value of whey cream fat and the limited marketing options available for whey cream fat. The Adams facility produces approximately one million pounds of whey cream fat annually. Potential outlets for this product are very limited not only in the eastern region, but for the entire country as well. To my knowledge, there are only two processors purchasing whey cream in the east currently, Great Lakes Cheese of New York, Inc. is selling whey cream to a processor in Massachusetts, and it is sold FOB the Adams plant. The value that Great Lakes Cheese of New York, Inc. has received for the product basically has been the AA butter market price. During our 2006 fiscal year, Great Lakes Cheese of New York, Inc. received an average price of $1.24 or $0.25 per pound for the whey cream fat sold. The average CME AA butter price weighted by load sold each week was $1.2405. So our average multiplier over the course of the year was 1.16 percent of the CME grade AA butter market. Copies of the actual invoices will be submitted for the record at the hearing. Table 1 (attached to my testimony) provides a summary of cream sales by month with average invoice prices and billed amounts. Additionally, it shows the average Class III fat price for each month and the revenue shortfall from that minimum fat price. Table 1 shows that although we received an average price of $1.2425 on the fat pounds and whey cream sold during 2006, the average Class III minimum regulated fat price is $1.3248 per pounds on the fat that was sold. So we received $0.8.23 less per pound fat that we were charged under the regulated price system. I am informed that the Class III price formula was modified slightly in February of this year and now determines the value per pound of butter fat by subtracting 12.02 cents from grade AA butter price and multiplying that amount by 1.2. Based on that formula, the average value ascribed to the fat in the Class III price that we sold as whey cream in the January through December 2006 timeframe was slightly lower at 1.3185. But given that we in fact only received $1.2425 per pound of fat in the whey cream, we still would have incurred a loss on the fat component of the whey cream of 7.6 cents per pound fat. This 7.6 loss does not consider the loss on the protein and other solids that are carried in the skim portion of the whey cream. We are only paid on the fat component of the whey cream and do not get paid for the components that are carried in the skim.

Great Lakes Cheese Company, Inc. also owns and operates Empire Cheese, another dairy processing plant located in Cuba, New York. That facility produces Italian cheeses and also generates whey cream on a daily basis. Due to the fact that the product from this facility doesn't meet the requirement of the whey cream processors in the east, all of the whey cream is shipped and sold in the midwest. In this scenario, Empire Cheese is responsible for the freight costs to locations in either Wisconsin or Nebraska. In this case, the value that Empire receives for the whey cream coupled with the freight costs result in a significantly lower return than is achieved at the Adams plant.

I would just like to thank you for allowing me to testify here.

Q Why don't we take a look at table 1, which is the last page of your testimony, which has been marked Exhibit 51, so you can take us through it and make sure that everybody understands what it is you're showing.

You have in the first -- this relates to

your sales of whey cream during 2006, correct?
A That's correct.
Q And it shows, what, fiscal year 2006, but it's also calendar year 2006, correct?
A Right.
Q And you have a list of months in the left-hand column, and then a heading "Total Cream Pound Shipped." I assume that means just what it says, how many pounds of whey cream you shipped each of those months, correct?
A That's correct.
Q And then the "Total Fat Billed." What does that represent?
A That represents the percent of fat in those total pounds shipped, was the actual total fat billed.
Q So the first column is the total number of pounds in whey cream, and the second column is the total pounds of fat in that whey cream, correct?
A That's correct.
Q The third column is how much you would pay per pound of fat in that; is that right?
A That's correct.
Q So you're paid not based on the poundage of whey

cream, per se, but based upon the poundage of fat in that whey cream, correct?
A That's correct.
Q And then the next column is "Total Dollars Billed," correct?
A That's correct.
Q What this shows is that for the year as a whole, you were paid $1.2425 per pound of fat for the whey cream that you shipped, correct?
A Weighted average, that's correct.
Q And that is a weighted average?
A Correct.
Q So that you've taken in account sometimes there's much, sometimes much less; but you've accounted for all that?
A Correct.
Q And this is a price you received at your plant, correct?
A That's correct.
Q Then the "Total Dollars Billed" is simply the number of fat pounds which is the third column times the price per pound, correct?
A That's correct.
Q So that in January it's 79,650 pounds of fat in the whey cream times $1.3674 that you were paid

for a pound of fat for a total amount billed of $108,916, correct?
A That's correct.
Q And "Total Amount Billed" is what you got paid, right?
A Right.
Q Now, there's then a next heading going to the right on the column is called "Fat Revenue Shortfall from Regulated Class III Fat Price," correct.
A That's correct.
Q Basically, what you're capturing here is under the current Federal Order system, how much did the orders assume you're receiving for the fat in your whey cream when it comes to setting your minimum milk prices, correct?
A Correct.
Q And you've done that under two different scenarios. The first you called "At Actual Announced Class III fat," correct?
A That's correct.
Q And that's the formula that actually was in place in 2006 while all of this was taking place, correct?
A That's correct.

Q The next group is under something called "Restated to February 2007 Class III fat price formula," correct?
A That's correct.
Q And that reflects how much you would have been charged under the Federal Order system had the minimum pricing formulas that came into effect March 1, 2007, been in effect back in 2006, correct?
A That's correct.
Q So it's the middle set, the "actual announced Class III fat" that actually reflects what it was you were charged, so to speak; but the last set is, if you will, a more hypothetical set simply so that no one would think that you're overstating things by failing to account for the slight increase in the make allowance that came into effect in March 2007, correct?
A Correct.
Q And let's focus, then, first on the "actual announced Class III fat," the middle section of table 1. You've got "Class III Fat Price (Actual) set forth here. I take it that's as the name would suggest, what the Federal Order formula assumed you were getting paid for the

fat in your whey cream in setting minimum milk prices, correct?
A That is the Class III fat price.
Q That's the Class III fat price, exactly.
And then the next column to that "Revenue less Class III fat price" take, for example, January, it's a negative $0.1010, correct?
A Uh-huh.
Q Is that simply subtracting how much you actually got from the fat, would pay for the fat, which is shown for January 2006 at $1.3674 minus what the Class III formula was assuming you would pay for that fat $1.468?
A That's correct.
Q So this is, if you will, your shortfall; this is how much less you actually got paid for your fat compared to how much the formula assumed you were being paid for your fat, correct?
A That's correct.
Q And the last column in this middle section of table 1, for January $8,042 -- negative $8,042, correct?
A That's correct, yes.
Q And that's simply multiplying the number of fat pounds you sold times that revenue shortfall,

correct?
A That's correct.
Q So in this particular example, it would be 79,650 pounds of whey fat sold in January 2006 times the shortfall of $0.1010, gives you a revenue shortfall of $8,042, correct?
A That's correct.
Q Finally, you totaled that up per month and then for the entire year?
A Correct.
Q And then, on average, the Class III formula assumes that you were earning for the fat in your whey cream $0.0823 more than you actually are?
A That's correct.
Q Which is the number you gave in your testimony, correct?
A Correct.
Q And the dollar amount of that shortfall is $82,612?
A Yes.
Q And the last set of material on table 1 we talked about a minute ago, as your application of the exact same protocol, except using the new class price formulas, correct?

A Correct.
Q And it's a what if -- what would have happened had the formulas came into effect on March 1, 2007 been in effect back in 2006, correct?
A Correct.
Q And what you've shown me is that there's a marginal improvement in your situation, in that your losses would have been reduced from $82,612 to $76,351; is that right?
A That's correct, yes.
Q And on the per pound of fat basis, the effect would have been a loss of $0.0760 per pound of fat had the March 1, 2007 formulas been in effect during 2006, correct?
A Correct.
Q Now, let's look at Exhibit 52, if we could, please.
By the way, I take it that it's implicit, but to make it explicit Great Lakes does not process its whey cream, correct?
A No, we do not.
Q And 100 percent of the whey cream from your Adams plant is sold to Agri-Mark, correct?
A Correct.
Q Now Exhibit 52 is really backup for Exhibit 51,

correct?
A Exactly, yes.
Q And what is included is every single invoice that you sent to Agri-Mark with respect to the whey cream you sold them during 2006, correct?
A That's correct.
Q And let's just take an example, if we could. If you could turn to the second page of Exhibit 52, this is an invoice for your shipment to Agri-Mark of whey cream, correct?
A That's correct, yes.
Q And the shipment of whey cream, if you look in the description column, was 22,400 pounds of whey cream, correct?
A That's correct.
Q And it contained 43 -- let me start that again.
Which was 43.39 per fat, correct?
A Correct.
Q Resulting in 9,719.36 pounds of fat, correct?
A Correct.
Q And you said you were paid on the fat in the whey cream, correct?
A Correct, yes.
Q And in this particular invoice, you were paid $1.35 per pound?

A That's correct.
Q That's under the "Unit Price" heading, correct?
A Uh-huh.
Q So the total payment for this particular shipment was $13,121.14, correct?
A Correct.
Q And when you put together -- and this is one -- this particular shipment, I'm looking for the date, is January 11th, 2006, correct?
A It's actually --
JUDGE PALMER: This is page two?
MR. ROSENBAUM: Yeah, page two.
JUDGE PALMER: You said page three before.
MR. ROSENBAUM: I'm sorry. Page two. I stand corrected.
Q Page two an order date of January 11th, 2006?
A Yes, actually the ship date was 1/2.
Q Just tell me where that appears. I'm not seeing that.
A I don't think it does appear on the invoice, but on the cover sheet it lists the date shipped down there.
JUDGE PALMER: First page.
Q Okay. Actually, there's a column I now see called "Your P.O. Number" on the second page,

which says 010206; do you see that?

On the second page of Exhibit 52.

A Okay.

Q "Your P.O. Number."

A That's actually the ship date.

Q That's actually the ship date?

A Yes.

Q And then what you've done, let's go to the first page of Exhibit 52, what you show on this is for the first three months of 2006, January, February, and March, you collected each of those months all the shipments that took place during that month, correct?

A Correct.

Q And then for January you compiled that information together in the top third of the first page of Exhibit 52; is that right?

A That's correct.

Q Then 178,690 pounds shipped becomes the information that's on the last page of your Exhibit 51, which shows the same amount with respect to the pounds of whey cream shipped, the total pounds of fat billed, and the total amount billed, correct?

A Yes.

Q And the first page of Exhibit 52 has information for January, February, March; and then behind that are the invoices that cover that time period, correct?
A Correct, yes.
Q And then following that, then, are similar three summary pages for April, May, and June, correct?
A Correct, yes.
Q Appears about a quarter of the way through the collection followed by the invoices for April, May, and June, correct?
A Correct, yes.
Q And the same appears with respect to all the remaining months?
A Correct.

MR. ROSENBAUM: Your Honor, at this point I would ask that Exhibits 51 and 52 be admitted.

JUDGE PALMER: They're received.

MR. ROSENBAUM: And the witness is available for cross-examination.

JUDGE PALMER: Questions? Mr. Beshore.

CROSS-EXAMINATION,

QUESTIONS BY MR. MARVIN BESHORE:

Q Good afternoon, Mr. Jennings.
A Good afternoon.

Q I want to ask a couple of questions about table 1 and the data which is really very interesting and very helpful, and I appreciate your willingness to share this level of data with the hearing record because, you know, we don't get -- we don't have that level of data from all participants. But, of course, there's more data that reflects your total operations, and then maybe I will explore some of that as well.
Do you know -- you buy approximately 410 million pounds of producer milk.
A Yes.
Q Is that an annual figure for 2006?
A It's 413 million probably, somewhere around in there.
Q Do you acquire and put into your cheese production any other ingredients besides producer milk; that is any fortification ingredient, powder, cream?
A The only thing we would add to -- we would make a reduced fat cheddar. Very, very small volumes of cream solids.
Q Do you add any additional butterfat?
A No.
Q Do you know what the average butterfat test of

your milk coming into the facility was in 2006?
A Not offhand. I mean, I would guess about 3.6. I don't know that to be exact.
Q Do you know whether it would be something close to the market average?
A I would guess.
Q So if we use that number, if we just make the assumption you were getting market average test milk and took that times your 413 million pounds of producer milk, we would know approximately your gross volume of butterfat, correct?
A Correct.
Q Since you don't buy any additional cream, that would be the gross pounds of butterfat coming into your plant?
A Correct.
Q Now, do I understand that all of your whey cream is disposed of as reflected in your testimony in Exhibit 52, table 1 Exhibit 52?
A Sold, not disposed of.
Q Sold, I'm sorry. Yes, sold.
A Yes.
Q So the balance of the butterfat that you purchased versus what was sold as whey cream, went into the cheese?

A Correct.
Q So if we just did a little bit of math with your receipts and the percentage of butterfat and then took out the pounds of butterfat disposed of as whey cream, we would know approximately the proportion of the butterfat that you received that was retained in the cheese?
A Less the potential loss.
Q Less any potential loss.
A Yes.
Q Now, do you know, as the -- what's your position?
A Plant manager.
Q As plant manager, do you know approximately what percentage of the butterfat is retained in your cheese?
A Well, we have OST enclosed single shaft horizontal vats, and we probably retain about 91 to 91 1/2 percent.
Q If the arithmetic showed that it was even higher than that, would you have any reason to dispute that?
A I guess I wouldn't believe it, just based on our calculations that's what it is. I don't know how it would come up higher.

Q Well, if you had, for -- I'll just use 3.7, which is market average, I used a little less than that to estimate your gross butterfat, I was using 410 not 413, but on 3.69 butterfat, that's 15,129,000 pounds of butterfat for the year.
A Okay.
Q Does that sound about right? And you sold just over a million pounds of fat for whey cream.
A Uh-huh.
Q That's 6.6 percent or so of your gross butterfat, which would leave 93 plus percent in your production, correct?
A That could be. Again, I guess you would have to consider potential loss, too.
Q I understand.
A I guess that's where I would say the difference is.
Q You think you are using one to two plus percent of your butterfat on your production process?
A Could be.
Q More than -- okay one to two?
A Again, I don't know what you're using for a fat value is accurate for our milk supply without going back and looking at our milk supply

calculation in our milk invoices.
Q Your invoices show that whey cream sales records show the pounds shipped are less than 10 proposed lots?
A Uh-huh.
Q How does this work? Does Agri-Mark send a tanker around?
A The way it is on cream is supposed to be shipped out. Your tank is supposed to be emptied every 72 hours. In order to comply with those types of things, we use a tanker that actually picks up whey cream up at Shadigee, or Shadigee town operation comes down and picks up another half of that tanker, and then they haul both of them over to West Springfield.
Q How far is West Springfield from Adams?
A Five and a half hours, I would say.
Q How far is Shadigee from Adams?
A Probably three hours, I would guess.
Q You made the statement on the first page of your testimony that "I have been told that the existing formula assumes that no milk components are lost in the manufacturing process."
Who told you that?
A Well, that was some discussion I had with Sue

Taylor.

Q So that's Ms. Taylor's statement to you?

A Right.

Q Now, you make whey powder?

A That's correct.

Q Whey powder, okay. And at your plant you don't have -- were you here yesterday at all?

A Well, late yesterday afternoon.

Q There have been some cheese manufacturers that have testified to issues with the whey price because it's based on the powder market, and if they're not making powder, their product may return a different value than the powder value.

Did you hear any of that discussion?

A No.

Q In any event, you process all your whey into powder?

A That's correct.

Q Do you have other potential buyers for whey cream other than Agri-Mark?

A To my knowledge, there's only one other potential in New York state. I don't know the other players out beyond New York state.

Q Has Agri-Mark purchase all the whey cream from your plant as long as you've been associated

with it?
A No, used to go to another location in New York state for a period of time.
Q What is the other location?
A Eagle Meadows Creamery, which is in Pennsylvania.
Q Do you know the $76,000 figure that is on table 1, which you calculated as a difference in the Class III butterfat value versus your value received from Agri-Mark, how much is that per pound of cheese in your production; do you know?
A How much is?
Q If you allocated that over your cheese production, 41 million pounds you said.
A I don't have that number.
Q Do you report any of your cheese production to NASS price surveys?
A Only with respect to cold storage reporting.
Q You don't do any reporting weekly?
A It's basically the cheese is produced for aged longhorn product.
Q Does Great Lakes at any other locations make cheddar cheese?
A No.
Q Cuba, what cheese is produced there?

A Mozzarella and provolone.
Q Does Great Lakes have more than those two plants?
A For manufacturing?
Q For manufacturing cheese.
A Well, they have a processed cheese plant in La Crosse, Wisconsin.

MR. BESHORE: That's all I have right now. Thank you, Mr. Jennings.

JUDGE PALMER: More questions? Mr. Vetne.

CROSS-EXAMINATION,

QUESTIONS BY MR. JOHN H. VETNE:

Q Mr. Jennings, I'm John Vetne. I represent Agri-Mark and other cooperatives.

You indicate that you do not report any cheese to NASS, that's because it's transferred internally for aging or is it sold for aging?
A It's both. I mean, primarily aging in-house.
Q Is some of it used for slicing, shredding, that kind of thing also, in-house?
A Yes.
Q And the process for making the cheese and the cheese that comes off the -- out of the vat is the same whether it's aged or sliced or shredded?

A The end target might be -- well, for aging it's the same. If you were making a current product, it would be slightly different.
Q I want to go through some of these locations that you discussed a little bit with Mr. Beshore.
First of all, do you acquire your milk at Adams from farmers or from cooperative associations?
A Cooperative associations.
Q And when you purchase that milk, do you purchase it at the cooperative's farm weighted test or your plant receiving test?
A The farm weighted test.
Q To the extent that there's a loss in that process, that also does not show?
A Does not show.
Q And you process and sell sweet whey powder at that plant?
A That's correct.
Q And sweet whey powder contains also trace amounts of butter?
A Small amounts, yes.
Q Do you do something with a byproduct called salt whey in your plant?

A Basically all our salt whey is reintroduced through the whey cream. We don't have "salt whey stream" outside of the process.
Q So the fat in the salt whey is separated and put into the whey cream; is that right?
A That's correct.
Q In the process of cheese making, do you also use components in the form of cheese finds?
A They are recovered through our finds recovery system.
Q But they're not reshaped into a block or barrel or anything else, they're sold at deep discount?
A That's correct. I mean, there are losses in the equipment in the operation where cheese is ejected from equipment and then breakage of pieces falling to the floor, that type thing; those are losses, as well.
Q Have you observed that the recovery of fat in the low-fat cheeses that you produce is less than the fat recovery in the whole fat cheese?
A From the milk standpoint?
Q Yes, have you looked at that, whether there's a difference of fat recovery?
A No, I have not. We really don't generate and produce a lot of low fat, just now coming up

with that.

Q Do you receive seasonably different volumes that vary from month to month, season to season?

A Basically, there is a designated milk supply that goes in the Adams facility through our relationship with co-ops, and we seasonably go up and down. We absorb the season fluctuation. So it's really geared toward we can typically run capacity in May's time versus November, and wherever it falls down in the fall and tailors off is what we end up. So we are absorbing seasonal fluctuations.

Q Have you absorbed different fat recovery depending upon the season of the year?

A I would say -- not fat recovery, I would say reduction in fat.

Q Fat recovery depends in part on the Casein fat ratio in producer milk; isn't that correct?

A That's part, yes.

Q Is there a variance in the Casein fat ratio producer milk by season or by supplier?

A I mean, it varies some, yes.

Q The data in Exhibit 52 shows a whey cream containing a range of approximately 43 percent to 49 percent butterfat.

Would you comment on the reasons for that kind of range and why that might be?

A Well, I mean, it's just a variation in the process.

Could be operator tentativeness to the machine. There isn't any specific reason that we do this. We don't have the automation that probably you could put on sometimes and have to adjust your operation or your separation equipment to maintain a certain level. We don't have that degree of sophistication.

It's basically an operator operating it and monitoring and making adjustments as he sees fit.

Q That's a delivered amount?

A No, that's FOB.

Q FOB. You indicated that Empire shipped its whey cream elsewhere.

Is its process similar to yours?

A No, it isn't, actually. To a degree it is and then once you get past a certain piece of equipment, it goes into what they call a "cooker phase" where the cheese has gone into a --

Q Does Empire operate its own whey grind facility or whey processing facility?

A Yes, they do.

MR. VETNE: That's all I have now. Thank you.

JUDGE PALMER: Other questions?

MR. VETNE: Sorry, Mr. Beshore, I remember there was one.

Q Do you have some portion, however small, of cheese that comes out of the vat that is not up to specifications that you want, a grade or something, that you use for other purposes?

A Only in the case of where we may have a culture slow down or something like that. On a daily basis, no.

Q And on those occasions where it happens, do you find a way to use it in-house?

A That would go to our process cheese plant.

MR. VETNE: Okay. Thank you.

JUDGE PALMER: Mr. Yale.

CROSS-EXAMINATION,

QUESTIONS BY MR. BENJAMIN F. YALE:

Q Good afternoon. Ben Yale on behalf of Select Milk, Dairy Producers of New Mexico and others.

I want to echo Mr. Beshore's appreciation data, data, data. It's a difficult subject and I appreciate the data.

I have a couple questions. More as the notes came together with the other questions I tried to cross them out so it may be a little random. I'm not trying to trick you or anything.

You mentioned you have these prices in here. I noticed in your testimony talking about the whey cream that you sell, that it was a function of the CME price, but it was like a very low multiple, like just barely one times; is that right?

A Correct.

Q Now, is that a short-term or long-term negotiated price? I mean, how does that -- how's that price arrived at?

A It's a yearly-negotiated formula.

Q Okay. And it's always just a function of whatever the CME AA price is?

A That's the main driver of it. That's our starting point.

Q Do you know what this whey cream is used for?

A I asked the question here a while back and I think it's a food service application, food service combination.

Q Now, this is a private negotiation, but is there an industry sheet or something periodically or whatever that sets out and says the whey butter value is this multiple of CME AA?

A I don't believe there is.

Q Now, we've had -- it's getting late in the day so I'm starting to lose track of counting, but we've had several people testify, such as yourself, that they have whey cream and they sell it, and there's been different multiples.

By the way, is this an FOB, the plant?

A FOB Adams plant.

Q FOB Adams plant, okay. There's been different multiples, I think one of them was as much as 1.17, if I recall correctly.

Let's assume for the moment that the department says "we want to value whey cream," that is the amount that's not used in the cheese. How would the department and the public that participates in this program who are not making that particular whey, how would they know what is the value of whey cream?

A Well, I think, again, it would have to be the value of fat that you receive and would have to be representative of that fat that you paid for and what is left over.

Unfortunately, the problem on the whey cream side is that it's not a big demand product. It's not something that most operations want to deal with or have potential markets for. I mean, that's the downside.

Q There's a lot of cheese plants that found some internal use for it in something, right?

A There are some that reincorporate their whey cream into their cheese operation again and we do not do that.

Q You couldn't do that with an aged cheese, right?

A No.

Q And because it's a fairly -- I mean, your fat to protein is much higher; you try to have a lot more fat in yours with aging?

A Not necessarily, just we don't want to reincorporate it back into the system because of potential culture issues I might run into already been exposed to cultures and problems.

Again, our vats are very efficient, in the neighborhood of 53 1/2 and 54 percent.

Q All right. But it comes back, I think your premise is, is that we want to pay for the use what we put the product for, right?

A Right.

Q Now, in the purchase of this milk, do you pay anything in excess of the Class III price for that milk?
A No, we have over-order premiums, I guess, in the area as well.
Q And in those negotiations with whoever you buy your milk from, do you have discussions with them regarding the fact that you're not getting the full value for the -- in your view, the full value of the butterfat that you're paying for?
A We have not to date.
Q And to be consistent, as you have over the years with an aged longhorn, it's pretty high-quality cheese, right?
A That's correct.
Q And those aren't sold in blocks, more or less sold in loaves?
A No, sold in 700-pound blocks and 40-pound blocks.
Q Okay. Coming back to my question, first of all, I mean, you are able to sell the butterfat for something. It's not as much as you would make if you put it in the cheese, right?
A Correct.
Q But it has a value. The question we come back

to, how would you value that publicly? I mean, how would we know what whey is worth?

Do you have any suggestions how we would know that? I mean, you've given us information. Nobody else has really given us really the kind of detail that you have.

A I really don't have a good feel for that idea.

Q Now, you gave us information for 2006 and you said there are annual contracts.

Are those calendar years or is it just some other year?

A No, it's calendar year.

Q Calendar year. So are you operating under a different basis this time?

A Actually, it's been the same multiplier for several years now, hasn't changed.

Q There's some consistency?

A One thing is consistent.

Q One thing is consistent, okay.

Now, one of your theories is, I think, that what you're saying is that you should pay for the milk or the components that you use and the way you use it.

Do you know -- I think you said by testimony something like you have a 91, 91 1/2

percent butterfat recovery, something along those lines?
A Yeah.
Q And do you know how the butterfat that your plant receives is actually effectively priced?
A I mean, it's basically priced by the Class III pricing formula.
Q You don't know whether there's a built-in situation where you pay some additional money for protein to cover the extra value of the fat that is used in cheese?
A No.
Q You're not aware of that?
A No.
Q Now, on your second page there you make a comment where you equate the amount of other solids that's lost in this sludge, as you were going through the various processes.
First of all, do you participate in any kind of joint program where your operations are sent in and there's some central process where it combines a number of similar size plants so that you can kind of look at yours against other plants to see how you're doing on losses as compared to others, or costs compared to others?

A We did recently participate in a Cornell University study, which I haven't got the report back yet, just kind of getting wrapped up with Mark Stevenson.
Q Is that on the cost of producing?
A Cost side, yes.
Q But you haven't done anything in terms of losses?
A No.
Q And you don't do that on an ongoing basis, do you?
A No.
Q So, do you know -- and I'm sure you're doing a good job -- do you have any way of knowing whether yours is better than others, worse than others?
A We don't compare them to anybody's, so I don't know.
Q Now, you've indicated in your testimony that you -- those other solids that aren't in the sludge, I mean, the bulk of it you sell to a whey powder?
A Right.
Q Now, do you try to standardize that whey powder in any particular protein, whey protein?

Do you know what the range of the component is?
A It's 12 percent protein, 67 percent lactose, somewhere around there.
Q And do you know approximately how much -- I mean, have you ever looked at the yield in terms of how much milk that comes in, what percentage of that ends up in the whey powder yield?
A We've not done a calculation like that, no.
Q Just kind of getting rid of what's left and whatever it is it is?
A Right, uh-huh.
Q While we're talking about yields, I have a question.
You say that you get approximately 410 million pounds of milk annually, and I think you clarified it might have been 413 or something like that, and you make 41 million pounds of American style natural cheese. So you get approximately 10 pounds of cheese out of 100 pounds of milk that's delivered?
A Uh-huh. On an average, it's just something less than that.
Q Now, your plant in Cuba, you said you did the Italian style cheeses, is that an acid whey that

comes off of that?
A No.
Q That's a sweet whey?
A Yeah.
Q And do they remove the cream before they -- a lot of the cream before they ship it to the plant?
A No, they standardize up.
Q Standardize up?
A Bring skim solids in.
Q Bring skim solids in. Do you know what their fat content is on the average on their cheeses?
A No.
Q I wanted to go back just for some more information. You talk about whole sweet whey powder. It's whole simply because you didn't take the butterfat out, or just that there is some butterfat there so, therefore, you're able to call it whole?
A I don't know have the definition, all I know it's called whole sweet whey.
Q Frankly, I haven't been able to find any real definition of whey powder either.
A I think it just falls under the typical range of these components that make up the whole sweet

whey.

Q We don't necessarily compare that to whole milk powder, which has a relatively high powder fat?

A No, I don't think so.

MR. YALE: I don't have any more questions.

JUDGE PALMER: You don't have any more questions? Mr. Smith.

CROSS-EXAMINATION,

QUESTIONS BY MR. DANIEL SMITH:

Q Good afternoon.

A Good afternoon.

Q You indicated that you prepare your milk from cooperative associations?

A Yes.

Q And that you're paying premiums at this time?

A That's correct.

Q Looking at the 2004 to 2006 period, prices went up, prices came down. How did the premium structure that you have, how was it affected by those price swings?

A Well, I mean, again, in any area where you're dealing with premiums, it's based on supply and demand. That's what drives a lot of the issues here.

Q Your premiums you distinguish between quality

and quantity premiums and a procurement premium above that?
A We have quality premiums, yeah.
Q And is that the full measure of the premium?
A No.
Q So the procurement amount is in there in addition to that.
Is that the amount that moves in response to a supply and demand?
A In some cases it's been both.
Q You heard Mr. Whitcomb testify about his concern of the potential loss of a lot of farms through this spring planting.
Has that come up in your discussion with your suppliers?
A No; not to date it hasn't, no.
Q Do you envision in your business planning -- does your business planning include a concern about the milk supply in the near future?
A I think to a degree it does. I mean, in the last several years now there's been no milk discussion that we haven't had that someone hasn't brought up the fact that we're losing more farmers every day.

It's typically the smaller ones that are kind of -- whatever their issues are, they're leaving the business. But what we've been kind of told is that in most cases when we lose some of the smaller ones, the bigger guys get a little bigger. I mean some of those cows are not necessarily leaving the areas, just being shuffled around. So at this point in time there's not been indications that we're in a crisis situation yet.

Q You don't hear confirmation of a crisis situation?

A Not at this point. Again, we haven't had discussions in our co-op and milk price certainly in the last five, six, seven months. If something changed in that period of time, that would be another discussion.

Q It hasn't come up in a premium discussion?

A No.

Q Are you familiar with the market order statistics, the volume of milk for the whole market where the statistics are shown in terms of the milk supply?

A I don't follow that, no. I mean, to the T where I could talk about it.

Q Going downstream, were you here when Mr. Dryer testified yesterday?
A Some of it, just in the middle of his testimony.
Q When he was talking about how the price to his customer established being on hold essentially to the block price on exchange.
Would you agree with his assessment that processors tend to work as a group in terms of the pricing at this point, and that there's problems --
A I don't know if they work as a group.
Q I don't mean in concert.
A I think that is one of the tools that people use as a base to start with.
Q And his testimony is pretty strong that if processors deviate from that "dismal failure" is the term he used.
Do you have a sense of that in the industry?
A I think that's going to have definite impact if you deviate to any degree, I mean, from that, but that's the pricing mechanism everybody is using, you want to go off that, that is going to have an impact on you.
Q The customers of your cheddar cheese are

generally -- who do you sell your cheese to, supermarkets?

A A variety of customers.

Q Is it competition with processors from California, Midwest primarily?

A It's all the above, really.

Q All the above?

A A lot of business. You look at our business, we're a private label, and primarily private label packaging company. What we manufacture is a very small amount of what we purchase. As the manufacture division of Great Lakes, we are competing with those suppliers that they're purchasing their cheese from.

Q What I'm getting at is what I asked Mr. Dryer, whether there's any distinction being made in the market between processors regulated under California pricing series, specifically, that you see the impact of that and also in addition more recently with deregulation in the Idaho area?

A I really don't feel comfortable commenting on that. I'm not on the procurement side of my business; they would see those differences.

JUDGE PALMER: He basically came as plant manager to give his testimony as such.

MR. SMITH: I understand. I was taking every opportunity I can with a good witness to see how far I could get, so thank you.

JUDGE PALMER: Any other questions? Give your name again. I don't think the reporter has it.

MR. SCHAEFER: Henry Schaefer. USDA AMS Dairy Programs.

CROSS-EXAMINATION,

QUESTIONS BY MR. HENRY SCHAEFER:

Q Two questions. One is on your price that you receive from Agri-Mark, I notice that you have a number of prices that are the same. Is that because the contract is based on the CME for a weekly average?

For instance, in January there you've got \$1.35 for two days, and then \$1.4202 for two days.

A No, that might be just the case of the week that the butter market didn't change and the butter price is not the CME butter prices.

Q You're dealing a multiplier on a daily basis?

A Yes.

Q And then on your information there on your losses and your de-sludging, you show a $0.3 percent loss versus your incoming milk, your incoming raw milk and your other or solids.

That 71,000 pounds that you indicate, is that made up only of what the order calls other solids lactose and ash, or is there also some protein and some fat included in that de-sludging solids that come out?

A It could be a combination of that because it's basically separating waste solids. So whatever is in whey, six percent solids is what is there.

MR. SCHAEFER: Thank you very much.

JUDGE PALMER: Other questions?

Mr. Beshore.

RECROSS-EXAMINATION,

QUESTIONS BY MR. MARVIN BESHORE:

Q Mr. Jennings, what's your view on why there are only two buyers of whey cream in your region; there are certainly a number of cheese plants.

A I think it's directly related to their ability to market that type of product. The markets are limited, and so that's what's driving it.

Q Would it have anything -- do you think there is any relationship with the volumes of whey cream available?

JUDGE PALMER: In what sense?

Q If there's more available, would there be potentially more people processing it?

A I don't think there's a lot of marketing behind this product. I don't know that it's been proven. I don't know how I would answer that because, you know, my understanding of this product is it is a little different than sweet whey butter -- sweet butter, so you would have to market it, I guess, to see if there's actually growth -- potential growth for it.

I don't know if just having more whey cream would change that scenario.

Q One other question with respect to your -- the price you pay for your butterfat under the present formulas.

The present formula, as I understand it, tell me if I'm wrong, assumes that 90 percent of butterfat is used in your cheese?

A Uh-huh.

Q So that the cheese price for butterfat is just on 90 percent of your butterfat, correct?

A Correct.

Q That's your understanding, okay.

Now, if you actually are able to be

sufficiently efficient in your production system that you incorporate it in two percent, three percent, whatever, some amount greater than 90 percent of the butterfat in cheese, what's your obligation to pay for that butterfat?

A We don't have an obligation at this point in time.

Q So that's essentially free yield?

A Well, again, in our product, our moistures are lower than probably typical maybe because of longhorn quality. So our yields are probably less in general than what would be -- the standard identity for cheddar is 39 percent moisture or under. Our typical moisture range is 37 1/2 is our target. So we're losing up some yield to that because of the specs we have to leave for our longhorn product.

Q I think you've correctly indicated you don't have any obligation for that under the formula at present?

A No.

Q If you're looking at the total pricing formula here for your butterfat, wouldn't you need to take into account an offset for that value

versus what you've shown in your whey cream value?
A That's a possibility.
Q And one way to estimate that offset might be you look at what the formula says for how many pounds of cheese come with a pound of butterfat, 1.582, or whatever it is, and use that as a way to get at some possible offset value?
A There's probably some number you can use, I don't know what that is.
Q You haven't attempted to make that calculation?
A No.

MR. BESHORE: Thank you very much.

JUDGE PALMER: Any questions? Mr. Vetne.

RECROSS-EXAMINATION,

QUESTIONS BY MR. JOHN H. VETNE:

Q One follow-up to Mr. Beshore's question. You said you purchased milk from cooperatives?
A Correct.
Q When you purchase milk from cooperatives, you pay a negotiated price that includes some premium over the regulated formula?
A That's correct.
Q To the extent your yield is better than the average yield of cheese plants or anything else,

gives you some additional revenue yourselves for one to bargain with you to share in that?
A From the milk seller you mean?
Q Yes, the milk seller.
A No.
Q They try to get additional premiums from you above the regulated price?
A They do, but not on the premise that we're better yields than somebody else.
Q Do you pay on the basis of any component premium or quantity premiums and that kind of thing?
A No.
Q Just straight components?
A Yes.
Q Quality premium?
A Uh-huh.
Q You pay that?
A Yes.
Q Yes. Thank you. Oh, yeah, and you have an obligation to pay the contract price, not just the federal price?
A Right.
Q There is that obligation?
A Yeah.
JUDGE PALMER: Mr. Rosenbaum.

MR. ROSENBAUM: Nothing further.

JUDGE PALMER: All right, sir. Thank you very much.

Let's go off the record for a moment unless we want to stay on the record.

MR. ROSENBAUM: No.

JUDGE PALMER: Let's go off the record.

(A discussion was held off the record.)

EDWARD W. GALLAGHER,

having been duly sworn to tell the truth, the whole truth, and nothing but the truth relating to said matter was examined and testified as follows:

DIRECT EXAMINATION,

QUESTIONS BY MR. MARVIN BESHORE:

(Exhibit 53 was marked for identification.)

Q Mr. Gallagher, your statement contains your business address and a statement of professional background.

MR. BESHORE: Before he reads that, I would just like to say that Mr. Gallagher is being offered as an expert in agricultural economics and marketing, and I would like to have him read his statement with that request that he be so recognized.

JUDGE PALMER: Let him start and see.

A My name is Edward Gallagher. I'm Vice-President of Economics and Risk Management for Dairylea Cooperative, Inc. My business address is 5001 Brittonfield Parkway, Syracuse, New York.

I've been employed by Dairylea for the past 11 years, and previous to that, I was employed by the Office of the Market Administrator, New York-New Jersey Marketing Area. I served in a variety of capacities during my 12 years at the Market Administrator's office, including the last five years as its Chief of Market Analysis, Research and Information. I have a Bachelor of Science degree from Cornell University and a Masters of Science from The Ohio State University. Both degrees were in agricultural economics. I was raised on a dairy farm in Central New York. I have an extensive dairy economics, milk marketing and Federal Order background. I have testified at numerous milk marketing regulatory hearings at both the federal and state levels.

Dairylea Cooperative request that the United States Department of Agriculture amend --

JUDGE PALMER: Let me stop you right there. Does anyone want some voir dire in his expertise?

I'll accept him as an expert.

A Dairylea Cooperative request that the United States Department of Agriculture amend Federal Orders in a manner that assist dairy product manufacturers in passing their production costs on to the wholesale and retail dairy product markets (i.e., the marketplace). The Dairylea proposal, which requests the implementation of a cost add-on process as it relates to the National Agricultural Statistical Service, N-A-S-S, NASS, product price survey will eliminate the pricing circularity embedded in the NASS Product Price Survey; create a mechanism for all dairy product manufacturers to use to assist them in passing on higher production costs, regardless of whether a manufacturer's product is included in the NASS survey; allow for regular updates to facilitate manufacturers in passing along their production cost increases in a more timely basis; reduce and perhaps eliminate the need for future make allowance changes which have had a divisive effect on dairy industry relationships; appease diary farmers' negative sentiment that Federal Orders operate in a manner that facilitate manufacturers to pass their higher production costs down to producers; and provide a positive step forward in preparing the U.S. dairy product manufacturing industry for the inevitability of the real business world faced by diary farmers and other businesses that do not have federal assistance in mitigating higher production costs by lowering prices received by suppliers.

This proposal is fashioned after a real world effort by milk powder manufacturers to pass along higher energy related production costs to their wholesale and retail accounts. In 2004 and 2005, Dairy America implemented energy surcharges when selling powder. The Dairy America selling price was increased by a cost add-on to the powder sales price. Their customers accepted the cost add-on and paid the powder price plus the add-on. Exhibit 1 is an actual Dairy America invoice from December 2005. The line "December Surcharge" identifies a price per pound of $0.0293. This value was charged to the customer to cover the higher energy costs of producing the nonfat dry milk powder. During the product price survey process, NASS, at the request of USDA's Dairy Division, picked up the full sales price as the NASS price, the powder price of $0.9883 plus the add-on of $0.0293. Dairy America sells 75 percent of the U.S. powder production and almost two-thirds of U.S. powder production is included in the NASS survey. Dairy America's use of the energy surcharge effectively raised the milk price for its members and prevented them from capturing additional income to offset higher production costs; this is the circularity that Dairylea attempts to correct with this proposal.

I'm at the first full paragraph on page two. The Dairylea proposal creates a regulated maximum cost add-on. The Dairy America members, or any manufacturer with product included in the NASS survey, could use the cost add-on to pass on their higher production costs without increasing the regulated price of the raw milk they use. The result would be to effectively end, or at least significantly mitigate, the NASS survey/Federal Order class price circularity problem.

Make allowances have become controversial to many dairy farmers. The Dairylea members view the make allowance as a cost of production credit to manufacturers, financed through lower regulated milk prices. Like dairy product manufacturers, dairy farmers also face higher production costs. They, too, have incurred higher energy, fuel, labor, interest charges and other input costs. Recently, dairy farmers have also incurred substantially higher feed costs. However, dairy farmers do not receive a regulated cost of production credit to offset these higher costs. For instance, the federal government does not provide a cost of production credit that forces dairy input suppliers to sell their products to farmers at a lower cost. There's not a federal mechanism for dairy farmers to push their higher production costs back to feed dealers by forcing them to sell feed at a lower price. Instead, farmers are often encouraged to be more cost efficient or asked to negotiate higher prices in the marketplace to cover their higher production costs.

The Dairylea members and other dairy

farmers are wondering why the pricing system does not work the same way for manufacturers as it does for them. Presently, as make allowances are increased, farmers are asked to pay their own milk production cost increases, as well as taking on the burden of a portion of manufacturers' production cost increases. Footnote 1, between 2002 and 2005, USDA reports that the average operating plus hired labor cost for producing milk increased by $1.68 per hundredweight, an increase of 15.3 percent. These costs likely increased further during 2006. With aggressive federal and state level incentives to increase bio-fuel production, additional cost escalation will occur during 2007. Data contained in Exhibit 2 is taken from USDA's web address at www.ers.usda.gov/Data/CostsAndReturns/data/recent/Milk/R-USMilk.xls.

Dairy product manufacturers operate businesses. Businesses get to choose how to mitigate rising costs through a number of management practices, including increasing their sales price. For the vast majority of dairy products that are processed or manufactured, the option of increasing their sales price as a means of mitigating or eliminating production cost increases is a relevant option. However, if the business manufactures a product that is included in the NASS Price Survey, that option, partially, and, in theory completely, is unavailable. That is because the cost of production increased sales price will be picked up in the NASS Price Survey and ultimately will increase the price of raw milk which was used to manufacture the dairy product. This prevents the manufacturer of NASS Price Surveyed product from pricing their way out of a situation of rapidly rising costs of production, as a part of its business strategy.

In his testimony at the January 2006 Federal Order make allowance hearing, Dr. Robert Yonkers described the challenge of the circularity issue in the following way.

JUDGE PALMER: You know what we're going to do, I think we'll just assume everybody can read that statement and not have you read that. That's his testimony.

They can refer back to that during questioning.

A This circularity issue perpetuates the need to make regulated changes to milk prices by adjusting make allowances, under the broad assumption that costs will rise over time. An alternative approach is needed, one that brings a larger measure of market orientation to the regulated pricing structure. And one that brings better balance to the financial stakes surrounding make allowance changes.

The Dairylea members request the implementation of an alternative process that results in production costs being passed up through the system instead of back down to them. The alternative approach allows manufacturers to pass cost of production increases through the system and into the marketplace instead of passing these costs back down to farmers.

It would allow NASS price survey participants to utilize a cost of production surcharge when selling their product, without the surcharge being included in the NASS price; the cost of production surcharge would be determined in a hearing and be fixed until changed by USDA; a NASS survey participant could pass along cost increases greater than the surcharge amount, but the NASS pricing survey would only credit them up to the maximum amount of the established cost of production surcharge; the plant utilizing the surcharge would have to show it was a negotiated add-on; and to facilitate manufacturers in passing their costs on relative to products excluded from the NASS price survey, the Market Administrators would publish the cost surcharge in their Class III price announcement each month.

Some of the dairy industry's best economic thinkers would say that implementation of the Dairylea proposal is unnecessary. They might comment that adjusting make allowances gets you to the same place, even if circularity exists. The theory goes that a make allowance change would eventually result in the manufacturers higher production costs being shared by both producers and marketplace via lower milk prices and higher marketplace prices. They would recognize that the initial impacts of a make allowance change would not result in an equal sharing of burden between producers and marketplace. In fact, they would say that initially 100 percent of the cost falls into lower producer prices. Over time, as production is impacted by lower prices, dairy product prices rise, along with producer prices, and in the end some equilibrium level is met where both producers and the marketplace are sharing the higher manufacturing costs.

USDA's economic analysis for the most recent make allowance hearing can be pointed to as empirical evidence that this process is expected to occur.

Do you want me to read the footnotes?

JUDGE PALMER: I don't think you need to read the footnotes. You have your source material in footnotes. You don't have to read those.

A Thank you. It has been widely reported that the most recent make allowance change reduces Class III prices by $0.25 per hundredweight, immediately. The USDA analysis predicts that during 2007, the impact on Class III prices would be minus $0.19 per hundredweight, suggesting that some form of supply response occurs during the first year that transfers some of the cost to the marketplace. The USDA analysis shows that by 2015, the negative impact to producer prices would be reduced to $0.08 per hundredweight. This suggests that, in the long run, the dairy farmer cost of the Class III make allowance change, as it relates to Class III values, would be $0.08 and the marketplace cost would absorb $0.17.

By continuing to use USDA's analysis, it calculates that the first year's impact on milk revenues would be a reduction of $190 to $195 million, depending on whether the measurement in change is the All-Milk Price or is the change in total Federal Order cash receipts.

Dairylea does not dispute the theory that underpins the thought process that reaches the above conclusions. In fact, we agree that the federally-regulated dairy pricing world, inclusive of circularity and make allowances, works this way. However, it works this way because people have chosen to have it work this way. There's nothing that says it has to work this way.

Dairylea believes it can and should work differently. Dairylea believes that the first year revenue effect should be entirely absorbed by marketplace --

JUDGE PALMER: Stop for a glass of water.

A Dairylea believes it can and should work differently. Dairylea believes that the first year of revenue effect should be entirely absorbed by the marketplace and that over time producer prices and revenue should decline as markets adjust to higher wholesale prices, the exact opposite progression as occurs with the current make allowance change. Dairylea believes that the elimination of the circularity issue is a necessity in pushing the first year effect off the back of dairy farmers and squarely onto the backs of those in the marketplace. Doing so would save producers millions of dollars. USDA estimated that the current process cost producers approximately $190 million during 2007. By changing the system to push costs up, a larger amount, and perhaps all of the $190 million would have been absorbed by the marketplace and not producers. Over time, the end results would have been the same in price value, meaning the long-run share of the cost absorption by dairy farmers would have likely been the same, but producers would have been financially better off getting to that equilibrium point.

All of us know that a dollar is worth more today than a year from now. Many of us are likely familiar with net present value analysis. Using USDA's analysis for the impact on producer revenue from 2007 to 2015 as a result of the make allowance changes and using an eight percent discount rate, the net present value of the change to producer revenue is minus $819 to minus $826 million. Since the valuation -- since the value of the production asset is determined by the future earnings potential of the asset, the net present value analysis shows that the collective production assets of the U.S. dairy farming sector were devalued by $819 to $826 million due to the increase in the make allowance. Dairylea believes that a large portion of the $819 plus million net present value loss would have been avoided if the process worked in the reverse order, whereby the costs would be initially pushed to the marketplace. In theory, dairy producers would eventually see lower revenue as demand slowed as a result of higher marketplace prices and ultimately lowering prices to producers. However, the net decline in producer revenue would be less than the amount occurring due to the present system of adjusting make allowances.

I would like to read this footnote.

JUDGE PALMER: All right, go ahead.

A The discussion of manufacturing costs is slicing a couple of pennies per pound pretty thinly. In reality, the marginal cost impact is so small that passing on one or two cents a pound of additional cost may not be a recognized factor in the marketplace and demand may not be impacted in any measurable way, meaning higher production costs could be passed out without hurting manufacturers or lowering milk prices.

Dairylea recognizes that there is a fuzzy and gray timeframe as to when and how manufacturers' costs of production get pushed up through the marketplace or down to producers. Some could argue that during the time period that manufacturers wait for a make allowance increase, it is in fact pushing costs off in both directions. If so, this would suggest that no make allowance change is needed. Others could argue that manufacturers push costs entirely back to producers via lower over-order premiums, again, suggesting that no make allowance change is needed. Still others could argue that manufacturers are absorbing these costs, which if so, is a problem that needs to be addressed.

However, the solution to this problem should not be one where producers' assets are devalued by over $819 plus million. Instead, people need to change the pricing culture and practices of the dairy industry. We recognize that in today's Federal Order milk pricing regulatory environment, the leadership of USDA and Dairy Division is needed for this to occur. Dairy producers need your leadership in getting this done. The dairy manufacturing sector needs regulatory assistance in passing their higher production costs onto the marketplace. Dairylea has the full faith in the industry that this can be accomplished.

This is the essence of the Dairylea proposal. It creates a mechanism for dairy manufacturers to use to help them pass their costs on to the marketplace. It will lead to a change in how people think and act and a process that has the potential to save producers millions of dollars.

The easiest way to eliminate the circularity issue would be to utilize Chicago Mercantile Exchange (CME) cash traded prices in the Federal Order pricing formulas, in lieu of the NASS pricing surveys. Not only would pricing circularity be eliminated, but the issues affecting manufacturers due to the timing lag between NASS and the CME would be corrected. Unfortunately, at present, the CME only has viable cash markets for cheese and butter, but not whey and nonfat powder. A complete elimination of the circularity issue could not be achieved by replacing CME prices with NASS prices, although an improvement could be made by utilizing cheese and butter prices from the CME instead of NASS survey prices.

Agri-Mark has proposed a method of adjusting NASS prices in an attempt to re-create them as more current CME cash prices. The NASS surveying process reports prices that are two weeks old so Federal Order manufacturing prices are always two weeks behind the cash market changes of CME. This is troubling to manufacturers since they sell their product at the current CME price, but pay for raw milk based on the lagged NASS prices. In a declining market, manufacturers have a higher likelihood of operating at a loss since the base CME sales prices will be less than the NASS price that determines raw milk costs.

The key element here is that manufacturers sell their product based on the cash CME price. Over the last seven years the U.S. dairy products manufacturing industry has had the chance to vote on the price discovery mechanism to use that forms the basis of their weekly pricing. Their choices have been the current CME cash exchange or the lagged NASS survey. The dairy industry has overwhelmingly chosen the CME cash exchange.

An important element in using a pricing series is its transmission of information from day to day, week to week and month to month. From a longer run historical perspective, these short-term price changes are, for the most part, transmitted in the same manner by both series. This is would be expected since the NASS survey picks up information on spot wholesale prices which are based on the CME cash price.

A disorderly marketing condition exists due to the use of the NASS pricing survey due to its lag and the impact on short-term manufacturing losses. This can be corrected without impacting price transmission, since the industry uses CME prices to price their product. Knowing that the CME cash prices reflect day-to-day supply and demand changes and NASS pricing tracks CME pricing, it would be appropriate to utilize CME prices in place of NASS wherever possible.

One of Dairylea's goals is to eliminate the pricing circularity as it affects Federal Order Class III and IV prices. Dairylea supports using CME cheese and butter prices as a replacement for NASS cheese and butter prices.

In the absence of this change, or in addition to this change, the Dairylea proposal will help eliminate the pricing circularity. From our perspective, it is a perfect compliment to using CME cheese and butter prices in that it will end the circularity embedded in whey and nonfat powder prices, which will still use the NASS pricing survey.

USDA would determine the maximum cost

add-on and publish them on a monthly basis in their Federal Order Class III and IV price announcements. USDA would hold periodic Class III and IV dairy products cost of production hearings, perhaps once per year.

I would like to read this footnote, too. Dairylea would submit that this process could occur without hearing and that USDA could use the formulation as prescribed in the November 22nd, 2006 Tentative Decision and accompanying documentation. At the point that both the California Department of Food and Agriculture and the Cornell Program on Dairy Markets and Policy manufacturing cost of production data are updated, the USDA can use the methodology to automatically recalculate the cost-of-production add-on and begin to report the new add-on.

At each hearing it would review the make allowance calculations for cheese, whey, nonfat dry milk and butter as prescribed in the Tentative Final Decision published November 22nd, 2006. It would make a determination as to the cost per pound change in the make allowance values. The positive difference would become the maximum allowable cost add-on that could be excluded from NASS survey pricing for each surveyed product, cheese, whey powder, butter and nonfat dry milk.

An illustration of the calculation of the maximum allowable cost add-on can be shown by modifying the table in Exhibit 5. It is this formulation that Dairylea proposes that USDA use to determine the maximum allowable cost add-on for each product. Exhibit 6 is USDA's calculation of the make allowances if the updated California data is used. This will be utilize to show the calculation of the maximum allowable cost add-on. Exhibit 7 is Dairylea's modified version of Exhibit 6. Exhibit 7 calculates the maximum allowable cost add-on using the updated California data. Comparing Exhibit 6 to Exhibit 7, notes that the line "Scenario make allowance" in Exhibit 6 has been changed to "Target Make Allowance" in Exhibit 7 and that additional lines of information have been added in Exhibit 7 that are not in Exhibit 6. Exhibit 7, using the cheese calculation as a reference, the cost add-on calculation utilizes the target make allowance of $0.1711 per pound and subtracts the existing make allowance now used under the Federal Order program, $0.1682 per pound. This results in a value of $0.0029 per pound, which is called the cost of production change. The cheese cost of production change becomes the maximum allowable cheese cost add-on under the Dairylea proposal.

Dairylea supports the National Milk Producers Federation's proposal to adjust make allowances by an energy index. The Dairylea proposal works in a complimentary fashion to the National Milk proposal. Both can be implemented. In determining the cost add-on pursuant to the Dairylea proposal, the energy cost change reflected by the National Milk proposed calculation would be subtracted.

A brief example will show how the two proposals complement one another. Exhibit 8 identifies USDA's projected calculations of the NMPF energy index. Using projections for 2007, the NMPF proposal would increase make allowances in the following manner.

Do you want me to read that table?

JUDGE PALMER: No.

MR. STEVENS: No, just put that in.

USDA's Estimated Make Allowance Changes From the Application of the NMPF Proposal, 2007

Product	$/lb
Cheese	$0.0023
Butter	$0.0015
NFDM	$0.0062
Dry Whey	$0.0056

A The changes due to the NMPF proposal would be subtracted from the changes identified in Exhibit 7. This NMPF adjusted calculation is shown in Exhibit 9. As can be seen, Exhibit 9 uses the same format as Exhibit 7 but has added additional lines for the adjustment from the NMPF energy index. For the calculation of the cheese cost add-on, the $0.0023 increase in the make allowance due to energy costs is backed out of the cost of production change. The cost of production change was $0.0029 per pound. Subtracting the $0.0023 energy cost of production increase from this number results in a value of $0.0006 per pound. The $0.0006 per pound would become the month's maximum cost add-on. This means that if a NASS survey participant reported in their NASS survey that they sold their cheddar cheese for $1.40 per pound plus a $0.006 cost add-on, the NASS survey would only incorporate the $1.40 into the calculation of the Class III price.

The Dairylea proposal does not suggest a negative cost add-on. As can be seen for dry whey and butter, the NMPF energy adjustment is greater than the calculated cost of production change. In these cases, the maximum cost add-on would be zero.

It is hoped that all manufacturers could use the cost add-ons in pricing dairy products to their customers. For instance, a cheddar manufacturer whose product was not included in the NASS survey could use the published cost add-on as a means of passing its increased cost of producing cheddar cheese on to its customers. Similarly, a mozzarella manufacturer may be able to do the same thing.

Presently, USDA publishes the Fluid Milk Promotion Order's $0.20 assessment on Class I milk on a monthly basis when announcing Federal

Order Class I prices. This process has assisted Class I handlers passing on this cost to its customers. Different yet but related, the Pennsylvania Milk Marketing Board has implemented a fuel adjuster to be added to Class I over-order prices under jurisdiction. The Pennsylvania Milk Marketing Board uses the Federal Department of Energy's Energy Information Administration's (EIA) publication of regional diesel fuel prices to assist in calculating the fuel surcharge that is passed on to dealers and the marketplace. Federal Order 5 and 7 also utilize EIA information in their transportation credit programs and publish calculated information to assist the industry in determining transportation credit reimbursement. As previously indicated, Dairy America successfully implemented a cost add-on a few years ago. The point here is that federal agencies have been assisting private entities in passing along cost factors, both by providing a mechanism to communicate the costs to the industry and by providing the information to determine the cost add-on.

Public Law 106-532 requires USDA to conduct mandatory pricing surveys of Class III and IV manufacturers that produce at least one million pounds of product each year. It is from this law that the NASS Dairy Product Price survey was developed. It requires the Secretary to take any necessary actions to verify the accuracy of the information submitted. It provides a mechanism for a federal court to enforce the law and assess a civil penalty of as much as $10,000 per occurrence for, among other things, inaccurate reporting.

Manufacturing plants would submit a modified Dairy Products Pricing Survey each week. See Exhibit 12 for copies of the existing surveys for cheese, whey, butter and nonfat dry milk. Plants would continue to report the total dollar sales and/or dollars per pound as they presently do. These values would be inclusive of the cost add-on. The existing survey could easily be modified to identify the cost per pounds and pounds of product total dollars, of the regulated cost add-on that was included in any of the plant's sales. As additional information, the plant would provide copies of invoices as evidence that the cost add-on was a separately charged item and that the cost add-on does not exceed the maximum allowable value as determined by USDA for any of the product that is priced with a cost add-on. In order for the plant to receive the cost add-on credit against their sales, it would have to show on the invoices that the add-on was a separately negotiated factor, as evidenced by it being clearly indicated as such on the invoice, and that it did not exceed the maximum allowable amount. For product that is properly documented as a cost add-on, the total dollar value of the add-on on the product that was priced with the add-on will be subtracted from the total dollars of sales included in the report, to determine the plant's NASS survey price and its contribution to the weekly price calculation.

Periodically, Federal Order auditors will conduct audits to assure that the submitted information is correct. I am not aware whether this is happening now, but Congress has given the Secretary the authority to verify the accuracy of the information.

If upon audit it is found that a survey participant has incorrectly claimed the cost add-on, USDA will add the value back into the next weekly calculation of its product price survey. If the audit finds that the survey participant incorrectly claimed the cost add-on over a number of weeks, the values can be added to the price survey on a weekly basis by adding the total dollars of the inappropriately claimed cost add-on and dividing by the number of weeks involved.

To facilitate correct reporting, USDA should conduct a series of visits to the plants providing the information, in advance of the implementation of the cost add-on program. Additionally, during the first month of implementation, auditors should visit the plants of those submitting information for an audit and review of procedures. Certainly, a systematic approach of visiting the plants or plant groups that are the largest contributors, in pounds of product included in the pricing surveys, should be visited first.

The Dairylea proposal is included as Exhibit 13. It would amend section 1000.50 of all orders by adding a section (r) requiring the exclusion of the maximum cost of production add-on surcharges from inclusion in the NASS survey prices used to calculate the class prices. It would also amend section 1000.53(a) of all orders by adding a section (12) requiring the publication of the maximum cost of production surcharges.

It is Dairylea's intent that the process used to exclude the maximum cost of production add-on from the NASS survey follow our testimony presented herein or as adjusted in our post-hearing brief.

Thank you for the consideration of this proposal that is important to the members of Dairylea Cooperative.

BY MR. BESHORE:

Q Now, Mr. Gallagher, you have just read substantially the text of pages 1 through 11 of the document that's been marked for identification as Exhibit 53, correct?

A Correct.

Q Now, portions of that text, however, certain of the footnotes, you did not read, but you nevertheless intend the text of those footnotes to be considered part of your testimony as if you had read it?

A I do.

Q And the same with respect to quoted material that you did not read or tabular material in the text which you did, such as at page nine, which you did not attempt to recite from your testimony?

A That is correct.

Q There are 13 exhibits attached behind pages 1 to 11 of text into 53, correct?

A That is correct.

Q Some of them you referenced and described in your testimony, but in some cases they were referred to and not necessarily described.

I wonder if you would just take a minute and go through them 1 to 13, and to the extent they're not self-explanatory, indicate for the record -- explain for the record what each exhibit is.

A Exhibit 1 is an invoice from Dairy America that identifies the December surcharge, their energy cost add-on for that particular month.

Q Now, and this is one of the -- an invoice, an actual invoice that involved what's been a much discussed attempt to have a surcharge which resulted in it being handed back in and a

circularity problem that's been discussed?
A That's correct.
Q Go on to number 2.
A Exhibit 2 is "USDA Cost of Production Data for the United States for 2000 through 2005."
Q And Exhibit 3.
A Exhibit 3 is "USDA's Estimated Make Allowance Change Impact from November 2006" that's page 6 and page 15 of that particular document.
Q Okay.
A Exhibit 4 is a table I created that is net the present value impact calculation. It uses USDA data from Exhibit 3A and 3B from November 2006.
Q Those are the exhibits in that hearing?
A Correct. That is the USDA analysis as a result of their decision.
Q Okay.
A Exhibit 5 is USDA's calculation of proposed make allowance for November 2006, page two of that document.
Exhibit 6 is USDA's calculation of make allowances for scenario A presented at this hearing. It was in their document that they published in February 2007, it's page eight of that document.

Exhibit 7 is a modification that I made that's calculating the maximum cost add-on and it's a modification of Exhibit 6.

Q The document just before this, your Exhibit 6?

A Right. Uses scenario A as proposed with this scenario.

Exhibit 8 is index energy cost and effective make allowances for scenario J per USDA's calculation from their February 2007 analysis of some of the hearing proposals, page 24 and page 25 of that document.

Exhibit 9 is the modified version of calculating the energy maximum cost add-on reflected in the NMPF adjusters, so that would be a modification of Exhibit 7.

Exhibit 10 is a USDA Class I price announcement for the Appalachian Order released on March 23rd, 2007, their class pricing.

Q And that shows the process or assessment which you discussed?

A Correct. And it also shows the EIA average diesel fuel price used in the calculation for market service payments.

Q Okay.

A Exhibit 11 is the "US Public Law 106-532" known as the "Dairy Product Mandatory Reporting" clause.

Q Subtitle C is called "Dairy Product"?

A Subtitle C "Dairy Product Mandatory Report."

Q All right.

A Exhibit 12 are copies of the four NASS surveys that were provided to me. Probably were provided to me in the fall of 2006.

Q The survey?

A Right.

Q The forms which the plants are requested to use to report their information to NASS?

A For their dairy product price survey.

Q Exhibit 13 is the Dairylea proposal, which I believe was published in the supplemental hearing notes.

MR. BESHORE: Your Honor, if 53 has not been received. We move so.

JUDGE PALMER: We will receive 53.

And now he's going to come back tomorrow for cross.

Q There's an additional document that we marked as a separate exhibit, which we will provide at that time.

JUDGE PALMER: We're going to do that

tomorrow, all right.

Now let's go off the record for a moment.

(A discussion was held off the record.)

(Thereupon, the hearing was adjourned at 5:25 p.m.)