— HEARING PANEL REPORT —

JANUARY 31, 2006 PUBLIC HEARING

ADDRESSING MILK MOVEMENT ISSUES CONTAINED IN THE
MILK POOLING PLAN FOR MARKET MILK AND THE
STABILIZATION AND MARKETING PLANS
FOR NORTHERN AND SOUTHERN CALIFORNIA

This report of the Hearing Panel (Panel) regarding proposed amendments to the Milk Pooling Plan for Market Milk (Pool Plan) and to the Stabilization and Marketing Plans for Northern California and Southern California (Stab Plans) is based on the January 31, 2006, hearing record. The record includes the Departmental exhibits, written statements and comments received from interested parties, written and oral testimony received, and written post hearing briefs.

During the hearing process, testimony and evidence was presented that referenced interstate commerce issues. The Panel has purposely avoided consideration of and basing its decisions on interstate commerce issues. The Panel believes that the interstate commerce issues will be best handled by the competitive market place. While some quotes mention this issue, their intention was to give the reader a sense of the discussion and not to indicate that it influenced the Panel's final recommendations.

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INTRODUCTION AND WITNESSES

The Department of Food and Agriculture (Department) held a public hearing on Tuesday, January 31, 2006, in Sacramento. The hearing considered amendments to milk movement incentives, namely, transportation allowances and transportation credits, as provided in the Milk Stabilization and Marketing Plans for Market Milk (Stab Plans) and the Pooling Plan for Market Milk (Pool Plan). The Department called the hearing after receiving a petition from California Dairies, Inc (CDI). After the notice was issued, alternative proposals were received from Hollandia Dairy (Hollandia), Security Milk Producers Association (Security), Western United Dairymen (WUD) and Dairy Farmers of America (DFA) prior to the deadline for submission of alternative proposals.

Hearing Witnesses:

A total of ten witnesses/organizations testified including the Department's witness.

1. *Cheryl Gilbertson — Department witness
2. *Gary Korsmeier— CDI
3. *Hank Perkins — Security
4. *Tiffany LaMendola — WUD
5. *Gary Stueve — DFA
6. Geoffrey Vanden Heuvel — Milk Producers Council (MPC)
7. *Kevin Albernathy — California Dairy Campaign (CDC)
8. *William Schiek — Dairy Institute of California (Institute)
9. Sharon Hale — Crystal Cream and Butter (Crystal)
10. *James Gruebele, Land O'Lakes (LOL)

An "*" indicates witness/organization who submitted a post hearing brief. No witness testified on behalf of Hollandia Dairy's alternative proposal. In addition, written submissions were received from one organization who did not give oral testimony:

11. James Dolan — Driftwood Dairy (Driftwood)

GENERAL ANALYSIS AND DISCUSSION OF ISSUES AND PROPOSALS FOR MILK MOVEMENT INCENTIVES

Background: Milk Pooling

In every federal milk marketing order, revenues from farm milk sales are pooled to establish a uniform blend price for all producers who pool their milk within the order. The blend price is modified for each individual producer by location differentials.

Similarly, most revenues from California farm milk sales to California processors are combined into a central pool. Unlike federal orders, California has two pool blend prices rather than a single pool blend price. Under the Pool Plan, the producer is paid based upon his or her allocated quota, base, and overbase at prices that reflect the pool-wide usage of all classes. The monthly quota and base amounts are computed for each producer to the extent these amounts are produced. The maximum monthly quota amount is determined by the current quota allocation, and the maximum monthly base is determined by the difference between production base and quota. Any production that exceeds these two figures constitutes overbase production.

Revenue from processors is distributed to dairy farmers via quota, base, and overbase prices. Since the Milk Pooling Branch's inception in 1969 until 1993, the quota price was primarily impacted by Class 1, 2, and 3 farm prices, while the overbase price was primarily impacted by the Class 4a and 4b farm prices. This was changed by statute enacted in 1993 and made permanent in 1994. Beginning in January 1994, a fixed differential was established so that the quota price is always $1.70 per hundredweight (cwt.) greater than the base and overbase prices. Historically from 1969 through 1993, the difference between the announced quota and overbase farm prices ranged from $1.06 to $2.26 per cwt. on an annual average basis. Currently, revenue above that needed to maintain the $1.70 differential is shared equally among quota, base, and overbase production. The announced quota price is adjusted based on farm location by regional quota adjusters (RQAs). Prices paid to an individual producer depend upon his or her farm location and blend of quota, base, and overbase holdings.

Not all revenue from milk sales is pooled. Grade B milk is not pooled, nor is it regulated by minimum prices. In California, plants not making any Class 1 or 2 products (manufacturing plants) can opt out of the pool. However, they generally will not if they are receiving any milk from producers owning quota. Over 65 percent of producers own some quota; over 35 percent of producers have at least one third of their milk production covered by quota. Exempt producer-handlers (a.k.a. producer-distributors) do not account to the pool for all of their Class 1 production. Option exempt producer-handlers do not account to the pool for their Class 1 production that is covered by the exempt quota they own.

Background: Milk Movement

In August 1999, the Department published a paper entitled "*Options to Facilitate Orderly Movement of Milk to California's Fluid Markets*" (January 2006 revised version) (Hearing Exhibit #6e). During 2000 using this paper as a starting point, the Department held a series of four industry workshops that attempted to review fully all aspects of milk movement incentives. A primary objective of the workshops was to try to reach a consensus on potential changes to the structure and scope of the milk movement incentive program. The workshops concluded without industry consensus; rather, the participants urged the Department to consider reviewing the unresolved issues at two public hearings that were held June 28 and July 2, 2001. Subsequent hearings were held June 4, 2003 and August 4, 2004. These hearings resulted in modifications to the existing milk movement system and not its replacement with a new system (Hearing Exhibit #43).

Transportation Allowances: What they are and how they work — When the Pool Plan was instituted in 1969, location differentials were established to provide producers with economic signals to move milk to designated counties. Location differentials were added to or deducted from quota payments to producers and were determined by the location of the plant that first received the milk. When milk was moved to designated counties, favorable location differentials offset the added cost of transporting milk.

As California milk production began to increase, overbase milk became an increasingly larger share of the total milk production. As a result, location differentials based solely on quota milk were no longer an efficient means of ensuring that adequate milk supplies would be made available to Class 1 plants. Consequently, location differentials were discontinued and a system of "transportation allowances" and RQAs were used as a means of ensuring the Class 1 plants were served.

Transportation allowances partially incentivize those producers who are supplying milk to higher valued usage. These allowances apply to all market (Grade A) milk moving from dairy farms to plants in qualifying areas that process more than 50 percent of the milk received into Class 1, Class 2, and/or Class 3 products. In addition, cooperative organizations receive transportation allowances on shipments to their plants if the plant is located in a deficit area and if the plant supplies 40 percent of its receipts for Class 1 usage.

Transportation Credits: What they are and how they work — In 1981, transportation credits were introduced to reduce the cost of plant–to–plant shipments. At one time, milk marketing areas in California were more numerous, and differences in cwt. prices among the milk marketing areas were sufficient to cover the cost of moving milk from one processing plant to another. However, with marketing area consolidation, these price differences were no longer capable of covering the cost of interplant shipments.
Transportation credits offset some of the cost of hauling milk assigned to Class 1 usage from plants in designated supply counties to plants in designated deficit counties. Handlers located in designated supply counties may deduct a specified transportation credit from applicable minimum prices for bulk market milk, bulk market skim milk and condensed skim milk shipped to a plant located in a designated deficit county. Shipments of market cream are not currently covered by transportation credits.

Call Provisions: What they are and how they work — Milk movement requirements, commonly referred to as “call provisions”, were instituted in 1979. They function by bestowing a ranking system for quota milk use when milk supplies are insufficient to meet the demand for fluid milk. Basically, call provisions require that manufacturing plants participating in the pool (i.e., plants receiving milk entitled to the quota price) must make a portion of the milk received available to plants processing Class 1 dairy products upon request. Because call provisions allow fluid plants to request milk from manufacturing plants, the impact of producer shipment decisions are mitigated. In other words, it does not matter to which plant a producer ships milk; call provisions give qualifying Class 1 plants the ability to obtain milk from manufacturing plants when it is needed.

Regional Quota Adjusters: What they are and how they work — While RQAs do not provide any direct incentive to move milk to Class 1 plants, they relate to a basic principle of location economics. Most Class 1 plants are located in or near the major population centers for economic reasons. Under normal conditions, Class 1 plants attract the nearest milk supply over more distant rural milk production areas. As a consequence, milk produced in close proximity to processing plants has more value.

RQAs, which with transportation allowances replaced location differentials, follow this economic principle. RQAs are deducted from the quota payments to producers and are determined by the geographical location of the producer's dairy. RQAs apply to the cwt. equivalent of quota milk produced. Presently, these rates range from $.05/cwt. for dairy farms located in North Coast counties to $.27/cwt. for dairy farms located in Fresno, Kings, and Tulare counties. There are no RQAs assigned to dairy farms located in the southernmost part of the state.

More complete discussions of transportation allowances, transportation credits, RQAs and call provisions can be found in the Departmental publication, "*Options to Facilitate Orderly Movement of Milk to California's Fluid Markets*" (Hearing Exhibit #6e).

SUMMARY OF PROPOSALS

(As presented at the Pre-Hearing Workshop)

- The proposed changes to transportation allowance rates, mileage brackets and county eligibility are summarized on Table 1.
- The proposed changes to transportation credit rates and county eligibility are summarized on Table 2.
- In addition there was a proposal by DFA to index transportation allowance rates based on the price of diesel fuel: specifically, the weekly price for diesel fuel in California as published by the U.S. Department of Energy.

Table 1: Transportation Allowances, Ranch-to-Plant

as Presented at the Prehearing Workshop, with Panel Recommendation

(Dollars Per Hundredweight)

		Constructive Miles	Current since Oct 2004	CDI Proposal	Hollandia Proposal	Security Proposal	DFA Proposal	Panel Rec	BRACKETS
Bay Area Receiving Area	1/	0 to 99	$0.25	$0.27	$0.25	$0.25	$0.26	**0.26**	
		99 to 199	0.29	0.31	0.29	0.29	0.31	**0.31**	
		199 +	0.30	0.32	0.30	0.30	0.32	**0.32**	
North Bay Receiving Area	2/	0 to 44	0.18	0.18	0.18	0.18	0.19	**0.19**	
		44 to 99	0.25	0.25	0.25	0.25	0.26	**0.26**	
		99 +	0.29	0.29	0.29	0.29	0.31	**0.31**	
Sacramento Receiving Area		0 to 59	0.13	0.13	0.13	0.13	0.14	**0.14**	
		59 +	0.16	0.16	0.16	0.16	0.17	**0.17**	
Shasta Receiving Area	3/	0 to 29	0.13	0.13	0.13	0.13	0.13		
		29 to 49	0.16	0.16	0.16	0.16	0.16		
		49 +	0.19	0.19	0.19	0.19	0.19		
San Diego Receiving Area		0 to 89	0.10	0.11	0.10	0.10	0.10	**NC**	
		89 to 139	0.43	0.31	0.43	0.43	0.43	**NC**	
		139 +	0.58	0.31	0.72	0.58	0.58	**0.65**	**BRACKETS**
Southern California Receiving Area	4/	0 to 89	0.10		0.10		0.11	**NC**	No change
	5/	89 to 120	0.29		0.29		0.31	**0.20**	89-122
Add San Bernardino County		120 to 139	0.48		0.48		0.51	**0.52**	122-139
		139 +	0.62		0.62		0.66	**0.65**	No change
Southern California Receiving Area	5/	0 to 89		0.11		0.12			
from seven designated counties	6/	89 to 109		0.31		0.32			
		109 to 139		0.52		0.53			
		139 +		0.68		0.76			
from all other counties		0 to 89		0.11		0.12			
		89 to 109		0.31		0.32			
		109 to 139		0.31		0.53			
		139 +		0.31		0.76			

1/ Alameda, Contra Costa, San Francisco, San Mateo, Santa Clara, and Santa Cruz Counties.
2/ Marin, Solano and Sonoma counties.
3/ Transportation Allowances for the Shasta Receiving Area have not been used since mid 1996.
4/ Los Angeles, Orange, Riverside and Ventura Counties.
5/ Security proposes to add San Bernardino county to the Southern California receiving area.
6/ Fresno, Kern, Kings, Imperial, San Diego, Santa Barbara and Tulare Counties.

Table 2: Transportation Credits, Plant-to-Plant
as Presented at the Prehearing Workshop, with Panel Recommendations
(Dollars Per Hundredweight)

SUPPLY COUNTIES	DEFICIT COUNTIES		CURRENT SINCE Aug 2003	CDI PROPOSAL	HOLLANDIA PROPOSAL	WUD PROPOSAL 1/	PANEL REC
Los Angeles	Orange, Riverside,	Differential	0.00	0.00	0.00	0.00	0.00
	and Ventura	Credit	0.34	0.36	0.34	0.34	0.26
Add San Bernardino County		**Total**	**$0.34**	**$0.36**	**$0.34**	**$0.34**	0.26
	San Diego	Differential	0.00	0.00	0.00	0.00	0.00
		Credit	0.34	0.36	0.60	0.34	0.26
		Total	**$0.34**	**$0.36**	**$0.60**	**$0.34**	0.26
Tulare	Los Angeles, Orange,	Differential	0.27	0.27	0.27	0.27	0.27
	and Ventura	Credit	0.60	0.68	0.60	0.60	0.69
		Total	**$0.87**	**$0.95**	**$0.87**	**$0.87**	0.96
	Riverside,	Differential	0.27	0.27	0.27	0.27	0.27
	and San Diego	Credit	0.68	0.76	0.68	0.68	0.77
Add San Bernardino County		**Total**	**$0.95**	**$1.03**	**$0.95**	**$0.95**	1.04
Kings and	Los Angeles, Orange,	Differential	0.27	0.27	0.27	0.27	0.27
Fresno	and Ventura	Credit	0.63	0.70	0.63	0.63	0.72
		Total	**$0.90**	**$0.97**	**$0.90**	**$0.90**	0.99
	Riverside,	Differential	0.27	0.27	0.27	0.27	0.27
	and San Diego	Credit	0.71	0.78	0.71	0.71	0.80
Add San Bernardino County		**Total**	**$0.98**	**$1.05**	**$0.98**	**$0.98**	1.07
Sonoma	Alameda, San Francisco	Differential	0.00	0.00	0.00	0.00	
	and Santa Clara	Credit	0.27	0.27	0.27	0.27	
		Total	**$0.27**	**$0.27**	**$0.27**	**$0.27**	no change
Merced and Stanislaus (part)	Alameda, San Francisco	Differential	0.00	0.00	0.00	0.00	
	and Santa Clara	Credit	0.38	0.38	0.38	0.38	
		Total	**$0.38**	**$0.38**	**$0.38**	**$0.38**	no change

1/ WUD does not propose any rate changes, only the elimination of condensed skim as an eligible product.

IMPACT OF PROPOSALS

Transportation Allowances: The analysis of the transportation allowances proposals used historical milk movement that occurred monthly during December 2004 through November 2005. The Department generated the data in Table 1 using different filters as proposed in the petition and alternate proposals, including changes in mileage brackets and changing the allowance rates:

- The petition by CDI to change brackets and rates would have increased costs to the pool by $183,790 per month.
- The proposal by Security to change brackets and increase rates would have increased costs to the pool by $249,521 per month.
- The proposal by DFA to increase rates would have increased costs to the pool by $111,197.

Table 3: Monthly Increase in Transportation Allowance Costs
Current System Compared to CDI, Hollandia, Security and DFA Proposals
Proposed less Current of $1,871,162

	CDI	**Hollandia ***	**Security**	**DFA**
Northern California	$17,936			$19,811
Southern California	$165,854	$0	$249,521	$91,386
TOTAL	**$183,790**	**$0**	**$249,521**	**$111,197**

* The Hollandia proposed rate increase for San Diego County involves such a small volume of milk that the cost increase is insignificant.

Transportation Credits: The analysis of the transportation credits proposals was based on historic milk movements: the 12 months from November 2004 to October 2005. The data in Table 2 was generated using different filters as proposed in the alternative proposals. These filters included changing transportation credit rates, and eliminating condensed skim as an eligible product:

- CDI's proposal to increase rates for milk moving into and within Southern California would have cost the pool an additional $6,908 per month.
- Hollandia's proposal to increase rates form Los Angeles to San Diego would have cost the pool an additional $3,220 per month.
- WUD's proposal to eliminate eligibility for condensed skim would have saved the pool $18,666 per month.

Table 4: Monthly Increase *(Decrease)* in Transportation Credits Costs
Current System Compared to CDI, Hollandia and WUD Proposals
Proposed less Current of $116,405

	CDI	Hollandia	WUD
Whole, 2-10, 1-11	$3,513	$0	$0
Skim	$2,402	$3,220	$0
Condensed Skim	$993	$0	($18,666)
TOTAL	**$6,908**	**$3,220**	**($18,666)**

GENERAL DISCUSSION

In making recommendations on any proposed changes to the transportation allowances and credits (commonly referenced as the milk movement incentive system), it is necessary to understand the following economic and marketing factors that warrant the continuation of the milk movement system.

Prior to the establishment of milk pooling:

- A dairy producer's income was directly related to the actual processing plant that the producer sent their milk. If the plant had a high Class 1 usage, then the producer's income reflected the higher Class 1 price. If the receiving plant made Class 4 products, then the producer's income reflected the Class 4 prices. This situation helped create an imbalance in bargaining power between producers and Class 1 plants that resulted in inequities and unfairness. To help resolve those problems, the dairy industry adopted a system to pool statewide dairy farm revenues.
  - ". . . some dairymen now in business never experienced the pre-pooling climate. This has led to a situation in which the need for a statewide pooling system that distributes milk sales revenues equitably among producers is not as evident to some." – testimony of WUD.

After the establishment of milk pooling:

- A dairy farm's revenues do not increase when the farm ships their milk to the highest usage (Class 1, 2, 3) plants.
- The cost of hauling milk from the farm to the processing plant becomes a governing factor for determining the destination of the farm milk shipments.
- Since manufacturing plants are typically operated in rural locations in closer proximity to dairy farms, dairy farms can normally minimize their hauling costs by shipping to these plants.
  - "When the pooling system was implemented in California, contractual arrangements between producers and processors were eliminated, and incentives to ship to fluid processing plants, were removed. Producers made the commitment to assure supplies to the Class 1 market in exchange for the benefit of all producers sharing in the revenues from the higher value Class 1 sales." - testimony of WUD.
  - "Milk producers are responsible under the California regulated system to absorb the transportation costs to provide milk to the deficit Class 1 marketing areas throughout the state." - testimony of CDI.
- A transportation allowance is established at a rate that would make the farmer indifferent between shipping their milk to a nearby local manufacturing plant or to a more distant fluid plant in the urban market. Transportation allowances are paid to dairy farms that ship their farm milk to higher usage plants.
  - "Contrary to the belief of some, transportation allowances are paid to producers, not plants supplying the Class 1 market. The added cost incurred to ship to a fluid plant is somewhat offset by the allowance and is returned to the producer either through their cooperative or directly in the milk statement if they're an independent shipper. The revenues from the sale of those producers' milk to the Class 1 markets are shared equally by all producers through the pool." – testimony of WUD.
- Similarly, transportation credits are paid to organizations (generally cooperatives) that supply milk from their manufacturing plants to the higher usage plants in the metropolitan market.
- The total cost of the transportation allowance and credit system is borne by the pool.

- All producers that share in pool revenues benefit from higher revenues of Class 1, 2, 3. – even if their farm milk sales are not shipped to the higher usage plants.
  - o "According to the Department figures, Class 1 alone returns nearly ten times the cost of the transportation system to the pool." – testimony of WUD.
  - o "All producers benefit by proper incentives to obtain a higher pay price by remaining more competitive with out-of-state source milk." - testimony of CDI.
- Despite sizable quantities of milk production in some metropolitan markets where the production is needed to supply the fluid milk processing plants, significant quantities of the local milk supply is not made available to the fluid milk plants.
- Many producers are paid premiums outside the pool revenues by manufacturing plants. The availability of these premiums provide additional economic incentives to farms to ship their milk supply to manufacturing plants instead of fluid plants.
- As the dairy farms relocate away from metropolitan markets, the annual cost of the milk transportation allowance and credit system will continue to increase over time.

Table 5: Annual Cost of
Milk Movement Incentives
(Million Dollars)

	1984	1994	2004*
Credits	$1.1	$2.1	$2.9
Allowances	$3.3	$4.1	$17.3
TOTAL	**$4.4**	**$6.2**	**$20.3**

* In 2004, 78 percent of the total cost was for Southern California.

In making recommendations, the Panel's approach to and analysis for setting rates for transportation allowances and credits has changed over time:

1. Rates for allowances should be the hauling costs, less any adjustments. From 1983 through 1996 in setting the transportation allowance rates, the Panel primarily considered:
   a. The cost to haul milk from rural ranches to urban plants (distant haul),
   b. Less the cost to haul milk within the rural area (local haul), and
   c. Less a modest shortfall.

2. Rates for credits should be the hauling costs, less any adjustments. From 1983 through 1996 in setting the transportation credit rates, the Panel primarily considered:
   a. The cost to haul tailored milk from country plants to urban Class 1 plants,
   b. Less any differential between the rural plants' Class 1 price and the urban plants' Class 1 price, and
   c. Less a modest shortfall.

3. The rates for allowances and credits should result in comparable costs. Starting with the June-July 2001 hearing, the Panel began to place more consideration on:
   a. The cost to the pool of the transportation credits for shipping tailored milk via plant-to-plant shipments, and
   b. The cost to the pool for comparable transportation allowances for ranch-to-plant shipments.

   The relative costs did not have to be equal, only comparable.

4. When a plant has a combination of allowances and credits, the cost of the combination should be comparable to the cost of the credits only for competing plants. As a result of this January 2006 hearing, the Panel believes it is necessary to place greater consideration on:
   a. The cost to the pool of the transportation credits for shipping tailored milk via plant-to-plant shipments, and
   b. The cost to the pool for comparable transportation allowances for ranch-to-plant shipments <u>plus the cost of the transportation credits for milk moved plant-to-plant within Southern California</u>.

   Again, the relative costs do not have to be equal, only comparable.

Policy dilemma in setting appropriate transportation allowances and credits:

- Ranch milk arriving at qualifying plants is eligible for transportation allowances;
- Plant milk arriving at qualifying plants is eligible for transportation credits;
- It is inefficient for the milk movement system to provide transportation allowances for ranch-to-plant shipments when the intermediate usage is condensed skim; and
- In Southern California, plant milk arriving at qualifying plants in Orange, Riverside, San Bernardino, San Diego and Ventura counties is eligible for transportation credits from Los Angeles County plants that themselves have received ranch milk eligible for transportation allowances.

Based on the above, the Panel has reached the general conclusions that:

- California producers have the responsibility to ensure that the higher valued usages are supplied. The cost of the transportation allowance and credit system is the producers' obligation to finance this responsibility. In return, all producers that participate in the pool revenues get the opportunity to share in the blended revenues of the higher priced class usage.
- California manufacturing plants that satisfy the California pool qualification requirements and thereby enable the producers that ship farm milk to their plants to participate in the pool revenues also have the responsibility to make milk supplies available to the higher value usages when needed.
- Costs for diesel fuel have increased significantly over the past few years. As a result, the cost for hauling milk to fluid plants in metropolitan markets has increased since the last public hearing on this subject matter on August 4, 2004.
- With the exception of one producer organization, most hearing witnesses generally accepted and supported the following principles for setting milk movement incentives:
  1. Producers who serve the fluid market should be reimbursed for the added costs of serving the higher valued usage.
  2. The closest milk supply to the market should be the first to be used.
  3. The system should attempt to minimize costs to the pool.
- Dairy processors added two additional considerations:
  4. When setting allowances and credits, equity among competing Class 1 plants in attracting milk supplies must be considered.
  5. Equally important, encouraging or promoting monopoly power on supplying producer organizations - preserving fair competition among competing milk suppliers.
- These five criteria are reasonable and sound principles for establishing appropriate transportation allowance and credit rates.
- Producers should be responsible for the local hauls.

- With the exception of one witness, all witnesses supported cost justified adjustments to transportation allowances and credits.
- Transportation allowances and credits must be adequate to encourage farm milk to move to the higher usage plants. Inadequate rates will endanger the adequacy of the milk supplied to plants which process Class 1, 2, and 3 products. Should this negative impact occur, California dairy farmers would ultimately bear the burden in the form of lower pool blend prices.
- California's transportation allowance and credit system plays a part in determining the volume of California milk (relative to other sources) that will supply California's total Class 1 needs. Failure to make cost justified adjustments to the allowances and credits can translate into significant financial loss to California producers.

DISCUSSION AND RECOMMENDATIONS FOR FUEL INDEXING

Since their inception in the early 1980s, the Department has established transportation allowance and credit rates as fixed values that change through the hearing process. Over the last 24 years prior to this current hearing, the Department has held nine hearings which have resulted in some change to the allowance and credit systems. Historically, hearings held every two to three years have been sufficient to conform the allowance and credit systems to changing economic conditions.

At this hearing, DFA proposed indexing transportation allowance rates based on the price of diesel fuel, specifically, the weekly price for diesel fuel in California as published by the U.S. Department of Energy. While several witnesses supported this concept, many added their concerns. CDI viewed fuel cost as only a part of the several cost factors in moving milk. Due to volatility, the Alliance stated that fuel price is the only factor that should be indexed and that other factors can be addressed through the hearing process.

Institute and Crystal stated that additional information and discussion was needed. Specific mention was made that fuel indexing would not lessen hearing frequency: "Because the index adjusts transportation allowances based on the change in diesel prices relative to the prices that existed when the transportation allowances were set, the so-called base case, and because structural conditions in the market do change, it is necessary to update the transportation allowance by holding hearings on a somewhat regular basis annually or every 18 months so the base case can be updated . . .Thus, while the index will be a useful method for ensuring that the transportation allowances and credits stay current, it will not put an end to the need for hearings such as this one." - testimony of Institute. Additionally, hearing frequency would not likely decrease because DFA's proposal addressed transportation allowance rates, but not transportation credit rates.

MPC and WUD were opposed to an automatic index, citing the need to "acquire data on milk movement and associated costs to make informed decisions related to specific rates and specific mileage brackets, supply counties, deficit counties, needed shortfalls, etc." - testimony of WUD. The Institute echoed the need for more study: ". . . we would like to see how well the index's projected rates track with actual hauling rates before supporting any particular indexing proposal. Also, we would have a greater confidence level if the base case rates were established during a period of relatively stable diesel prices. . . . Establishing a base case with August 2005 data might have the effect of locking in some hauling rate relationships that were not reflective of the real underlying cost relationships." - testimony of Institute.

An indexing proposal using diesel fuel prices had been made at the milk movement hearing held in July 1994; the Department found that "there may be merit to a formula based on fluctuations in fuel costs. While several witnesses expressed support for such a formula in concept, there was a consensus that further study by the industry was needed prior to its adoption. The Department concurs." (Statement of Determination and Order of the Secretary, Hearing Held July 19, 1994.)

Stakeholders did not pursue fuel indexing after the 1994 hearing, and the issue lay dormant until DFA made its proposal at this current hearing. The delay in addressing this issue may be a reflection of the history of energy prices relative to all consumer prices. The following table compares annualized rates of changes in crude oil prices and the Consumer Price Index (CPI) for the 1990s and 2000s to date; it is only recently that crude oil prices have been increasing faster than the CPI:

	1990s	2000s
Oil	1.8%	15.8%
CPI	2.8%	2.9%

The Panel's analysis of DFA's proposal showed an anomaly; the effect of diesel prices on hauling costs did not depend on the distance of the haul. At $2.20 and $2.70 per gallon, DFA's proposal implies that energy makes up, respectively, 30 percent and 35 percent of hauling costs for both the shortest mileage bracket (0 to 44 miles) and the largest bracket (over 199 miles).

The Panel performed a second analysis to estimate the percent of total costs that energy represents of hauling costs, an analysis with energy having a larger share of cost with increased distance. This analysis combined the weighted average regression of plant-to-plant milk movement (page 20, hearing exhibit 6b) with some assumptions about tanker trucks capacity and fuel efficiency:

- Hauling rate = $0.306 fixed plus $0.00385 per mile
- Typical tanker load = 6,132 gallons
- Typical tanker fuel efficiency = 7 mpg

With these assumptions, the Panel estimated that for a diesel price of $2.20 per gallon, energy's share of total hauling cost ranged from 0 percent at zero miles, 10 percent at 120 miles, and 12 percent at 250 miles. For a diesel price of $2.70 per gallon, energy's share of total hauling cost ranged from 0 percent at zero miles, 12 percent at 120 miles, and 15 percent at 250 miles. These percentages are different from those obtained using DFA's proposal.

While appropriate for hauling contracts that are rebased every year, it appears that DFA's specific proposal may not be a suitable method of indexing transportation allowance rates. Given however that energy prices are increasing at a much faster rate than historically, the concept of fuel indexing should be given future consideration. Prior to serious consideration, the Panel would like to see further study on how well the projected transportation allowance rates using the proposed index tracks against the actual hauling rates in the various mileage brackets over some time period.

Panel Recommendation: Do not adopt the proposed fuel indexing at this time.

DISCUSSION AND RECOMMENDATIONS FOR TRANSPORTATION ALLOWANCES FOR NORTHERN CALIFORNIA

Background

Transportation allowances for milk supplied to North Bay, Bay Area, and Sacramento deficit areas presented little controversy among witnesses testifying at this hearing. The majority of witnesses support the notion that transportation allowances should make producers indifferent between shipping milk to a distant Class 1, 2 or 3 processing plant versus a closer manufacturing plant.

Witnesses that proposed changes to specific rates focused their testimony to areas in which they supplied milk. These proposals appeared to be reasonable relative to recent increases in hauling rates, and were fairly consistent among witnesses.

Analysis

CDI proposed increasing the rate in the Bay Area receiving area $0.02/cwt. in all mileage brackets, while leaving North Bay and Sacramento unchanged. Had the rates proposed been in place for the 12 months of December 2004 through November 2005, they would have resulted in a monthly average increased cost to the pool of $17,936. However changing the rates in one of the Northern California receiving areas, without changing the others may cause issues between handlers competing for the same milk. See discussion below.

DFA presented a two part proposal. The first part of their proposal was to change the rates in all three active Northern California receiving areas. The second part of their proposal was to use an indexing concept for all allowances to raise and lower the transportation allowance rates in both Northern and Southern California. This concept could have resulted in either higher or lower allowance rates across California. As previously discussed, the Panel does not recommend adopting the indexing proposal at this time.

DFA's proposed rate increased included a $0.03/cwt. increases for all milk moving into the Bay Area receiving area, a $0.02/cwt. increase for milk moving under 44 miles into North Bay plants, a $0.03/cwt. increase for milk moving over 44 miles into the North Bay, a $0.01/cwt. increase for milk moving less than 60 miles into Sacramento, and a $0.02/cwt. increase for milk traveling over 59 miles into Sacramento plants. Had those rates been in place during the 12 months of December 2004 through November 2005, they would have resulted in a monthly average increase cost to the pool of $42,409.

In their initial alternative proposal, DFA had proposed smaller increases in the rates for Northern California. The rates initially proposed were available to interested persons to review and consider prior to their testimony. Therefore, the panel interpreted testimony relative to DFA's proposed rates as pertaining to those rates. Those proposed rates would have increased all Northern California transportation allowance rates $0.01/cwt. except for milk moving over 99 miles into the North Bay receiving area, which would have increased $0.02/cwt. Had those rates been in place during the 12 months of December 2004 through November 2005, they would have resulted in a monthly average increase cost to the pool of $20,030. These are the rates the panel recommends adopting.

The testimony of both the Institute and Crystal caution the Department that changes in transportation allowance rates can have the unintended consequence of disadvantaging plants operating within the same marketing area, potentially causing milk to shift from supplying one deficit area to another. The Department corrected such a situation in a prior milk movement hearing by adding Sonoma and Marin to the North Bay receiving area. When setting the rates for the newly expanded North Bay area, Sacramento, and the Bay Area receiving areas, the Department was careful to not encourage such shifts.

Panel Recommendation:

For the Bay Area Receiving Area:
1. +$0.01 from $0.25 to $0.26/cwt. for 0 to 99 miles
2. +$0.02 from $0.29 to $0.31/cwt. for over 99 to 199 miles
3. +$0.02 from $0.30 to $0.32/cwt. for over 199 miles

For the North Bay Receiving Area:
1. +$0.01 from $0.18 to $0.19/cwt. for 0 to 44 miles
2. +$0.01 from $0.25 to $0.26/cwt. for over 44 to 99 miles
3. +$0.02 from $0.29 to $0.31/cwt. for over 99 miles

For the Sacramento Receiving Area:
1. +$0.01 from $0.13 to $0.14/cwt. for 0 to 59 miles
2. +$0.01 from $0.16 to $0.17/cwt. for over 59 miles

Had those rates been in place during the 12 months of December 2004 through November 2005, they would have resulted in a monthly average increased deduction from the pool of $19,812.

DISCUSSION AND RECOMMENDATIONS FOR TRANSPORTATION ALLOWANCES FOR SOUTHERN CALIFORNIA

Transportation Allowances for Southern California

Background

The Southern California receiving area milk supply is changing dramatically. The Chino milk supply is diminishing rapidly due to urbanization, affecting availability of local ranch milk for Southern California processors. Some Chino producers have and will continue to move to the San Joaquin Valley, Kern County and northward, others have looked to Imperial County, and still others to outside of California. In most instances the distances that milk will need to travel to plants will be greater.

Many of the Class 1 plants are located in urban Los Angeles and Orange counties while manufacturing plants are located in more rural areas closer to dairies. Hauling costs to move milk have escalated greatly in the past 12 months due to higher energy prices caused by low supply, high demand and geopolitical issues (see Hearing Exhibit #6b, pages 4 and 10). Due to these dynamics, the need and means to attract milk to fluid plants will increase.

Proposals and Analysis

As a result of facing higher transportation costs and changes in locations of producer milk, dairy processors in California have requested adjustments to the transportation allowance rates for producer milk delivered to Southern California plants (see Table 1). All of the witnesses had their individual proposals; other than CDC however, most concurred that transportation allowance rates need to be adjusted to meet the rising cost of hauling. In addition, the majority of witnesses favored the application of the concepts previously discussed in the General Discussion section.

San Bernardino County

Security proposed that San Bernardino County be included in the Southern California receiving area. The reasons for their proposal included:

- Dwindling milk supply in the local area, with dairies leaving the Chino Agricultural Preserve area.
- The need to attract milk from greater distances and at higher transportation rates to replace diminishing sources of milk.
- Plant with Class 1 utilization with supply needs in San Bernardino.

Department data reflects a 30 percent decrease in milk production from the Riverside and San Bernardino county milk production areas from April 2004 through August 2005. There was no opposition to include San Bernardino County. With the reduction in the availability of local milk, the proposal to include San Bernardino in the Southern California receiving area is appropriate.

Panel Recommendation: Add San Bernardino County to the Southern California receiving area.

Rates for Southern California Receiving Area

CDI proposed increases rates for all four mileage brackets:
1. +$0.01 from $0.10 to $0.11/cwt. for 0 to 89 miles
2. +$0.03 from $0.29 to $0.32/cwt. for over 89 to 109 miles
3. +$0.05 from $0.48 to $0.53/cwt. for over 109 to 139 miles
4. +$0.08 from $0.62 to $0.70/cwt. for over 139 miles

DFA and Security had similar proposals, except:
- DFA wanted a $0.04 smaller increase in the fourth bracket to $0.66/cwt.;
- Security wanted a $0.01 larger increase in the first bracket to $0.12/cwt.; and
- Security wanted a $0.06 larger increase in the fourth bracket to $0.76/cwt.

The three proposals would have increased the annual cost to the pool by:
- $1,984,296 for CDI
- $1,096,632 for DFA
- $2,994,252 for Security

CDI testified that the Southern California receiving area will require more distant milk to move to needed markets. They have seen a 40 percent production decline in the last two and one half years in Southern California from CDI's own producers, or 3 million pounds per day. This is in addition to the higher transportation rates that are being incurred. (see Table 1)

Currently the highest rate for transportation allowances for the Southern California receiving area of 139+ miles is $0.62/cwt. The CDI proposal calls for an increase to $0.70/cwt., but limits this to producer milk only originating from Fresno, Kern, Kings, Imperial, San Diego, Santa Barbara, and Tulare counties. Institute agrees that ranch milk from Kings, Tulare, and Fresno will be needed in increasing quantities to meet the demands of the Class 1 fluid plants. At the same time, the CDI proposal limits the maximum transportation allowance rate for ranch milk originating from all other counties to $.31/cwt.

The Panel believes that putting a ceiling on transportation allowances of $0.31/cwt. for all other counties would limit the availability of ranch milk from other counties. Milk supplies north of the seven designated counties may be needed to serve the needs of the Class 1 fluid market in Southern California.

Local or Close-in Milk (0-39 miles)

WUD stated that in the Southern California receiving area, there is much local milk going to manufacturing plants that should be used for fluid milk purposes. Several witnesses addressed the issue of how much of an incentive would be needed to move the milk from the manufacturing plants to the fluid plants instead:

- CDI felt that even an additional $0.20/cwt. would not change the long term milk commitments and supply requirements of manufacturing plants;
- WUD agreed that an additional $0.20/cwt. would not be effective, would over-compensate producers in some cases, and would increase the cost to the pool; and
- Institute calculated that manufacturing plants may be willing to pay up to $0.59/cwt. to attract and keep their producers.

The latest hauling rates survey (see Hearing Exhibit #6b, page 4) indicated that the local milk hauling rate in the Chino area is $0.349/cwt. and the cost of the haul to Los Angeles area plants is $0.385/cwt. The current transportation allowance rate for 0-89 miles is $0.10/cwt. With the difference between the local haul rate and the rate to Los Angeles being only $.036/cwt., the $0.10/cwt. transportation allowance rate provides adequate compensation to move milk to Class 1 fluid plants.

The panel concludes that there is no need to change the rate of $0.10/cwt. for the 0-89 mileage bracket.

Barstow and San Diego <u>Supply</u> Area

Another concern testified to at the hearing was that the current brackets and mileage did not address the actual costs of supplying the deficit markets in Southern California, specifically the Barstow and San Diego supply area. Testimony by CDI and LOL indicated that producer milk shipped from the Barstow area to fluid plants in Southern California receiving area were over-subsidized by the current transportation allowance rates. The Department analysis indicated that the distant less local hauling costs were in some instances actually less than the transportation allowance provided.

The panel determined that changing the 89-120 mileage bracket and rate for ranch milk moving out of the Barstow and San Diego supply area would assist in addressing the issue. The analysis indicated that only adjusting the mileage bracket from 89-120 miles to 89-122 miles was insufficient and that the $0.29/cwt. allowance rate needed to be lowered to $0.20/cwt. The Panel also tried to minimize the affect on producers delivering milk from Kern County.

Analysis of Mileage Bracket Adjustment:

For the following discussion please also see the chart, Eligible Milk Earning Transportation Allowances Kern, Tulare & North; Barstow; Chino & East; San Diego Areas, on Attachment A-3.

With 122 miles as the break between the 2nd and 3rd mileage brackets:

- The 1st mileage bracket (0-89 miles) has most of the Chino area milk with a minimum of Barstow area milk;

- The 2nd mileage bracket (89-122 miles) has most of the Barstow area and San Diego County milk with a minimum of Kern County milk, Rates were changed from $0.29 to $0.20/cwt.; and

- The 3rd and 4th mileage brackets (122-139 miles; 139+ miles) have most of the Kern County milk with a minimum of Barstow area and San Diego County milk.

Panel Recommendation: Change the mileage brackets as follows:
1. 0 to 89 miles, no change
2. over 89 to 120 miles becomes over 89 to 122 miles
3. over 120 to 139 miles becomes over 122 to 139 miles
4. over 139 miles, no change

The Further Distant Milk, 3rd and 4th Mileage Bracket (120-139 miles; 139+miles):

Testimony was received addressing the issue of ranch milk delivered to the Southern California receiving area from Kern, Tulare, Fresno Counties, and beyond. In all instances the need to increase allowances to assist in moving milk was related to higher transportation costs. Copies of billings by trucking companies indicated not only higher rates but also fuel surcharges. The latest Departmental hauling rate survey confirmed that hauling rates have increased in transporting milk (Hearing Exhibit #6b, page 4).

The hauling rates for Kern County ranch milk were:
- $0.297/cwt. for the local hauls;
- $0.805/cwt. to Los Angeles County; and
- $0.889/cwt. to Riverside and San Bernardino counties.

The panel recommends that there be no short fall for Kern County milk. Thus, for the over 122 to 139 mileage bracket the rate should be $0.52/cwt.

The hauling rates for Tulare and Kings County ranch milk were:

- $0.294/cwt. for the local hauls;
- $0.997/cwt. to Los Angeles County; and
- $1.034/cwt. to Riverside and San Bernardino counties.

The panel recommends that in determining the transportation allowance for the 4th mileage bracket (139+ miles), the rate be the weighted average of:

- The distant less local haul <u>with no shortfall</u> in Kern County, and
- The distant less local haul <u>with a shortfall</u> in Tulare County.
- The weights used in the weighted average are the amounts of Kern County milk and Tulare County milk in the 4th mileage bracket.

Thus, for the over 139 mileage bracket the rate should be $0.65/cwt.

Panel Recommendation for the Southern California receiving area:

1. No change in the $0.10/cwt. rate for 0 to 89 miles
2. -$0.09 from $0.29 to $0.20/cwt. for over 89 to 122 miles
3. +$0.04 from $0.48 to $0.52/cwt. for over 122 to 139 miles
4. +$0.03 from $0.62 to $0.65/cwt. for over 139 miles

The panel's recommendation increases the cost to the pool by $678,596 per year.

<u>San Diego Receiving Area</u>

CDI proposed rate changes for all three mileage brackets:

1. +$0.01 from $0.10 to $0.11/cwt. for 0 to 89 miles
2. -$0.11 from $0.43 to $0.32/cwt. for over 89 to 139 miles
3. -$0.26 from $0.58 to $0.32/cwt. for over 139 miles

Hollandia had a significantly different proposal:

- No change to rates in the first two brackets; and
- A $0.14 increase in the third bracket to $0.72/cwt.

The two proposals would have changed the annual cost to the pool by:

- $5,952 for CDI
- Hollandia's proposal – there was insufficient milk receiving allowances in this bracket, to make a significant change in cost.

Hollandia proposed to increase the transportation allowance rate for ranch milk moved over 139 miles. They indicated there was insufficient local ranch milk available to obtain and separate for their skim milk needs, in its place they have purchased skim milk. An increase in transportation credits was needed to offset increasing hauling costs to acquire this skim milk.

CDI testified that not much milk travels over 89 miles to the San Diego receiving area; transportation allowance rate for milk traveling over 89 miles should be limited to $.31/cwt.

WUD also agreed that this increase is not necessary since there is sufficient milk available from Riverside and San Diego counties (89 miles or less) to serve this area and that an increase in rates is not necessary.

Department's analysis of the availability of milk and its utilization in the San Diego receiving area for the last twelve months indicated that with the urbanization of the San Diego receiving area the amount of local ranch milk available to serve local needs is diminishing and a sufficient milk supply will not be available. The Department concluded the amount of ranch production in the San Diego receiving area from the period October 2004 through October 2005 dropped by 26 percent. The producer milk availability problem has become similar to those of Class 1 fluid handlers located in the Southern California receiving area. As dairies leave the Southern California area, there will be a growing need for milk supplies further away from the San Diego area. The most recent hauling costs survey indicates that the local haul rate is $0.37/cwt. Milk from the San Jacinto to San Diego was surveyed at $0.43/cwt. While the Panel does not have hauling rate data for ranch milk coming into the San Diego receiving area in the 139+ mileage bracket, the potential need to serve this market from this distance is evident. In addition, the San Diego receiving area is in competition for milk supplies with the Southern California receiving area; the adoption of $0.65 cwt. for the 139+ bracket is merited.

Panel Recommendation for the San Diego receiving area:

1. No change in the $0.10/cwt. rate for 0 to 89 miles
2. No change in the $0.43/cwt. rate for over 89 to 139 miles
3. +$0.07 from $0.58 to $0.65/cwt. for over 139 miles

The panel's recommendation would increase the cost to the Pool by $54 per year.

DISCUSSION AND RECOMMENDATIONS FOR TRANSPORTATION CREDITS FOR FLUID MILK AND CONDENSED SKIM

Background

Farm milk contains more fat than fluid processors need or desire. Fluid milk processors that receive their milk supply directly from dairy farms must incur additional costs to separate and handle the excess cream. The cream can be either processed into manufactured products (butter, ice cream, etc.) or sold to other dairy processors.

Some fluid plants only process fluid milk products four to five days a week; thus, there is the practical, logistical issue of handling the excess milk supply on those days that fluid products are not processed. To cope with these issues, the fluid processors must either make significant investments in equipment and facilities (often at an economic loss) or make arrangements for someone else, usually a cooperative, to take their excess milk (always at an additional cost).

Tailoring farm milk to remove the surplus fat and balancing the farm milk supply are services that largely benefit the fluid milk processor and are not functions performed at the dairy farm. Producer cooperatives that own and operate dairy manufacturing facilities can provide these services to their customers, but these services normally are provided at some added cost for the added value it provides. Removing excess cream by tailoring the farm milk supply and balancing the fluid plant's daily needs are services whose costs should be paid for by processing plants; they are not considered in the calculation of transportation credit rates. Consideration instead is given to hauling rates when setting transportation credit rates (and transportation allowance rates). In addition, consideration is given to the relative cost to the pool of the allowance and credit systems.

Finally, many of the problems discussed previously with regard to transportation allowances are applicable to transportation credits:

- All interested parties must rely on information released by the few organizations involved with milk shipments
- CDFA haul data has lengthy lag time
- Energy costs are in constant flux
- Southern California specific –
  - o Dairies leaving Southern California
  - o Dynamic changes and ever increasing fundamental problems
  - o Institutional patterns of milk movement
  - o Local milk used in manufacturing plants that is unavailable for higher usage
  - o More milk and more distant milk needed
  - o Trucks bring excess fat and water in the form of ranch milk from the Southern San Joaquin Valley, then haul the fat back in the form of cream after the water is evaporated off

Proposals

All proposals for transportation credits addressed issues in Southern California. There were no proposals to change the transportation credits in Northern California. (See Table 2)

<u>Transportation Credits for Condensed Skim</u>

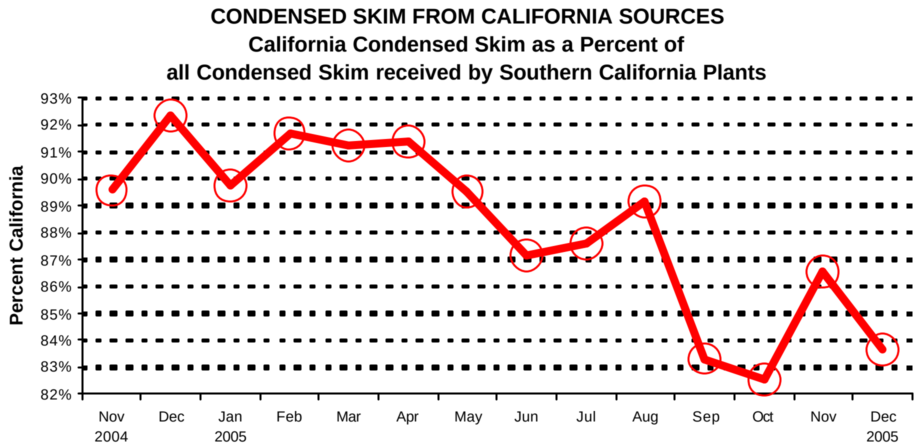
WUD, with MPC's support, proposed the elimination of credits for condensed skim. This proposal was not supported by the Institute and was opposed by LOL. At the milk movement hearing held in August 2004, the Department denied a similar proposal to eliminate the credits for condensed skim. For the 12 months ending October 2005, the proposal would have reduced annual pool costs about $225,000.

The Department established credits for condensed skim shipped plant-to-plant on a statewide basis after the milk movement hearing held in June 2003. The establishment of the credit for condensed skim:

1. Gives the Class 1 processors additional options for securing their milk supplies - LOL stated that the elimination of transportation credits for condensed skim would result in a single supplier in Southern California: if true, would not be in the public interest;
2. Facilitates the effective movement of condensed skim used for Class 1 fortification;
3. Assists California's fluid processors in meeting California's fluid milk standards; and
4. Allows California condensed skim to remain a competitive source of solids-not-fat (snf) for fortification.

Using 2005 annual data, a post-hearing analysis by the Panel determined that elimination of credits for condensed skim would have resulted in a savings of $0.011 to $0.026/lb-snf for every pound of SNF in the condensed skim receiving transportation credits.[1] Again using 2005 annual data, decreased sales of condensed skim would have resulted in a loss of $0.342/lb-snf for every pound of SNF in the condensed skim sales lost.[2]

The Panel also found that since the adoption of credits for condensed skim in 2003, while there were periods of increases and decreases from the end of 2004 to the end of 2005, the period did not mark a significant increase in the sales of condensed skim eligible for transportation credits. For this same time period, however, California condensed skim declined from 90.9 percent to 84.0 percent of the total condensed skim arriving at Southern California plants (see following figure).



Given all of the above, particularly the potential loss of pool revenue, the Panel is concerned about any proposal that would affect the competitiveness of California condensed skim.

Panel Recommendation: Make no changes to the eligibility of condensed skim for transportation credits.

Transportation Credits to and Within Southern California

CDI proposed increases in the transportation credit rates for eligible milk shipped from the Southern San Joaquin Valley of $0.07 and $0.08/cwt. These proposals were supported by LOL and opposed by CDC. For the 12 months ending October 2005, the proposal would have increased annual pool costs about $20,000.

CDI also proposed a $0.02/cwt. increase in the credit rate for all eligible milk shipped from Los Angeles County. Again, this proposal was supported by LOL and opposed by CDC. For the 12 months ending October 2005, the proposal would have increased annual pool costs about $60,000. Eligible plants located in Los Angeles County are entitled to transportation allowances for incoming ranch milk, and since 2001, these same plants have also been entitled to transportation credits for bulk product sent to Class 1 plants in Southern California, except those in Los Angeles County itself. WUD expressed concern that receiving both transportation allowances and credits may result in over compensation (a.k.a., “double dipping”).

In making recommendations, the Panel's approach to and analysis for setting rates for transportation credits (and allowances) has changed over time (Departmental exhibit #6b, page 7):

1. Rates for allowances and credits should be the hauling costs, less any adjustments (Class 1 differentials, local hauls, shortfalls). From 1983 through 1996 in setting the transportation credit rates, the Panel primarily considered:[3]
   a. The cost to haul tailored milk from Southern San Joaquin Valley plants to Southern California Class 1 plants,
   b. Less the differential between the Class 1 prices in Southern California and Southern San Joaquin Valley, and
   c. Less a modest shortfall ranging from one to seven cents.
2. The rates for allowances and credits should result in comparable costs. Starting with the June-July 2001 hearing, the Panel began to place more consideration on:
   a. The cost to the pool of the transportation credits for shipping tailored milk via plant-to-plant shipments, and
   b. The cost to the pool for comparable transportation allowances for ranch-to-plant shipments.

   The relative costs did not have to be equal, only comparable.
3. When a plant has a combination of allowances and credits, the cost of the combination should be comparable to the cost of the credits only for competing plants. As a result of this January 2006 hearing, the Panel believes it is necessary to place greater consideration on:
   a. The cost to the pool of the transportation credits for shipping tailored milk via plant-to-plant shipments, and
   b. The cost to the pool for comparable transportation allowances for ranch-to-plant shipments <u>plus the cost of the transportation credits for milk moved plant-to-plant within Southern California</u>.

   Again the relative costs do not have to be equal, only comparable.

In Southern California, meeting all three criteria presents a problem:

- Ranch milk arriving at qualifying plants is eligible for transportation allowances;
- Plant milk arriving at qualifying plants is eligible for transportation credits from the Southern San Joaquin Valley;
- Plant milk arriving at qualifying plants in Orange, Riverside, San Bernardino,[4] San Diego and Ventura Counties is eligible for transportation credits from Los Angeles County plants that themselves have received ranch milk eligible for transportation allowances; and
- It is inefficient for the milk movement system to provide transportation allowances for ranch-to-plant shipments when the intermediate usage is condensed skim (discussed in a separate section after the recommendation for fluid milk).

Thus, if the cost of credits from Southern San Joaquin Valley plants to Orange County plants is comparable to the cost of allowances from Southern San Joaquin Valley ranches to Orange County plants, then it is likely that the cost of credits from Southern San Joaquin Valley plants to Orange County plants is much less than the cost of allowances from Southern San Joaquin Valley ranches to Los Angeles plants plus the cost of the credits on to Orange County plants.

For Fluid Milk (Whole, 2-10, 1-11, Skim): The combination of transportation allowances[5] and credits within Southern California exceeded the cost of transportation credits only from the Southern San Joaquin Valley (hearing exhibit 6d, page 10). However, as at the last three milk movement hearings, transportation allowances from the Southern San Joaquin Valley were comparable to the cost of transportation credits from the Southern San Joaquin Valley (hearing exhibit 6d, page 10). Thus while plants in the Southern San Joaquin Valley might be competitive while serving plants in Los Angeles County, the plants would probably not be competitive when serving plants in Orange, San Bernardino,[4] San Diego, Riverside and Ventura Counties.

To address the relative competitiveness for both Valley and Southern California plants:

1. Transportation credit rates in the valley would need to be increased;
2. Rates in Southern California would need to be decrease; or
3. A combination of the two would need to be implemented.

The Panel chose a balanced approach of comparable changes to both systems with a -$0.08/cwt. reduction in Southern California and a +$0.09/cwt. increase in the Southern San Joaquin Valley.

Panel Recommendation:

- Lower the credit rate within Southern California by -$0.08, from $0.34 to $0.26/cwt.
- Increase the credit rate from Tulare to Los Angeles, Orange and Ventura by +$0.09, from $0.60 to $0.69/cwt.
- Increase the credit rate from Tulare to Riverside, San Bernardino[4] and San Diego by +$0.09, from $0.68 to $0.77/cwt.
- Increase the credit rate from Fresno and Kern to Los Angeles, Orange and Ventura by +$0.09, from $0.63 to $0.72/cwt.
- Increase the credit rate from Fresno and Kern to Riverside, San Bernardino[4] and San Diego by +$0.09, from $0.71 to $0.80/cwt.

The cost to the pool of these recommendations depends on whether any institutional relationships change. With no changes in the relationships, total costs would decrease $200,000 per year. With changes in the relationships, the cost of transportation credits would increase and the cost of transportation allowances would decrease; net costs might either increase or decrease.

For Condensed Skim: For condensed skim the combination of transportation allowances and credits within Southern California far exceeded the transportation credits only from the Southern San Joaquin Valley (hearing exhibit 6d, page 11). The problem, however, is not due to the combination of transportation allowances and credits. The transportation allowances alone are the problem. Additionally, there is little economic reason to ship the fluid carrier to Southern California only to discard most of it in making condensed skim, especially when some of the finished cream is hauled back to the Southern San Joaquin Valley. Lowering the allowances to address this condensed skim issue would, however, result in disruption of milk used for fluid products (whole, 2-10, 1-11, skim).

The Panel identified a possible solution: change the transportation allowance and/or credit rates from dollars per cwt. to dollars per pound of snf. This solution was not addressed in the hearing record, however, most witnesses supported the concept that transportation allowances and credits should be set at the least cost to move the required milk. Converting rates from a $/cwt. basis to a $/lb-snf basis could, unfortunately, result in other, unintended consequences that may be obvious to interested parties but not to the Panel. The Panel believes that prior to making any hearing consideration on this conversion, it would be far better to thoroughly evaluate this approach via public forums or workshops. This would give interested stakeholders a chance to present both reasonable objections and better alternatives.

Panel Recommendation: Stakeholders, together with the Department, should review the concept of replacing $/cwt. basis to a $/lb.-snf basis.

Modification of Counties Eligible for Transportation Credits

San Diego: CDI and Hollandia proposed to give San Diego County a separate credit for eligible milk shipped from Los Angeles plants and increase the rate from $0.34/cwt. to $0.60/cwt. The Institute supported this proposal if it was cost justified; WUD and CDC opposed this proposal. A similar proposal was rejected by the Department at the August 2004 milk movement hearing. For the 12 months ending October 2005, the proposed rate change would have increased annual pool costs about $40,000.

CDI proposed a transportation credit rate of $0.36/cwt. from Los Angels County to Orange County and an additional $0.26/cwt. for a rate of $0.60/cwt. from Los Angeles County to San Diego County. CDI proposed a transportation credit rate of $0.70/cwt. from Tulare County to Orange County and an additional $0.08 for a rate of $0.78/cwt. from Tulare County to San Diego County. The Panel does not understand why the additional cost of moving milk beyond Orange County to San Diego County was $0.08/cwt. in one case and $0.26/cwt. in another case.

The Panel reviewed the public information on plant-to-plant hauling rates (hearing exhibit #6b, page 5) and the confidential information used to construct this public exhibit. As at the August 2004 milk movement hearing, the hauling rates from Los Angeles to San Diego County are no greater than some of the rates from Los Angeles to Orange, Riverside and Ventura counties. Finally, given the panel's concern about the combined economic impact of providing both transportation allowances and transportation credits on milk originating in the Southern San Joaquin Valley, the panel seriously questioned the appropriateness of expanding the transportation credit for San Diego shipments.

Based on the Panel's review of the available data and the prior discussions, the Panel did not feel that there was sufficient basis to justify the establishment of transportation credits into San Diego market.

Panel Recommendation: Make no change to San Diego transportation credit rates relative to the rates for the other eligible Southern California counties

San Bernardino: Security proposed making San Bernardino County eligible for transportation allowances. Previously in this report, the Panel has recommended that this proposal be adopted. This then raises the issue of whether San Bernardino County should also be eligible for transportation credits.

No specific proposal or testimony was made regarding making San Bernardino County eligible for transportation credits. The issues regarding eligibility for allowances were addressed, however, and are applicable to the issue of eligibility for credits as well. The supply of milk in Southern California is dwindling rapidly; San Bernardino's production declined 14 percent from October 2004 to October 2005. The time is fast approaching when eligible plants in San Bernardino County will likely need both the allowance and credit systems. For the 12 months ending October 2005, no eligible milk was received by any San Bernardino plants; thus, the proposal would have had no impact on annual pool costs. This would change if San Bernardino plants began to receive eligible products.

Panel Recommendation: Make San Bernardino County eligible for transportation credits from Fresno, Kings, Los Angeles and Tulare counties.

This Hearing Panel Report has been prepared and submitted by:

Original signed by:

David K. Ikari, Chief
Dairy Marketing Branch

Original signed by:

John Lee, Chief
Milk Pooling Branch

Original signed by:

Thomas W. Gossard
Senior Agricultural Economist
Dairy Marketing Branch

Original signed by:

Donald Shippelhoute
Senior Agricultural Economist
Milk Pooling Branch

Original signed by:

Candace Gates
Research Manager II
Dairy Marketing Branch

ATTACHMENT A–1

SUMMARY OF HEARING PANEL RECOMMENDATIONS WITH SUPPORTIVE AND OPPOSING ARGUMENTS

Fuel Indexing

Panel Recommendation: Do not adopt the proposed fuel indexing at this time.

Supportive Arguments:

- Contrary to the assertion that fuel indexing will lessen the need to hold transportation allowance hearings, it will be necessary to hold regular transportation hearings to update the base.
- The Panel's analysis of the impact differs from the testimony of proponents. This raised questions about how well the adjusted rates would track with the actual hauling costs.
- The proposal would only index transportation allowance rates and not transportation credit rates.

Opposing Arguments:

- Volatile up and down movement in fuel prices necessitates the need for a formula driven fuel adjuster that will automatically adjust transportation allowance rates.
- Failure to make timely adjustments in the transportation allowance rates will penalize producers who generally must ship their milk longer distances to serve the higher valued usage plants as compared to those producers who minimize their hauling costs by shipping to the local manufacturing plants.
- If most producers perceive that they are better off shipping their milk to the local manufacturing plants, then both California fluid milk sales and California pool revenues may be negatively impacted.
- Slow response to a real problem.

Transportation Allowances for Three Receiving Areas in Northern California

Panel Recommendation:

For the Bay Area Receiving Area:

1. +$0.01 from $0.25 to $0.26/cwt. for 0 to 99 miles
2. +$0.02 from $0.29 to $0.31/cwt. for over 99 to 199 miles
3. +$0.02 from $0.30 to $0.32/cwt. for over 199 miles

For the North Bay Receiving Area:

1. +$0.01 from $0.18 to $0.19/cwt. for 0 to 44 miles
2. +$0.01 from $0.25 to $0.26/cwt. for over 44 to 99 miles
3. +$0.02 from $0.29 to $0.31/cwt. for over 99 miles

For the Sacramento Receiving Area:
1. +$0.01 from $0.13 to $0.14/cwt. for 0 to 59 miles
2. +$0.01 from $0.16 to $0.17/cwt. for over 59 miles

Supportive Arguments:
- The increased hauling costs justified a slight increase in the allowance rates in the order of $0.01 to $0.02/cwt.
- The broad consensus of witnesses (most producer organizations, competitive cooperatives, and regional processing organizations) was in support of the proposal as being cost justified and within the five generally accepted criteria for adjusting transportation allowance rate.

Opposing Arguments:
- Any increase in transportation allowance rates will reduce the pool revenues available to some producers.
- Producers are facing higher production costs.
- Producers are facing lower milk prices.

Transportation Allowances for the Southern California Receiving Area

Panel Recommendation: Add San Bernardino County to the Southern California receiving area.

Supportive Arguments:
- Declining milk production in Southern California will not be available to serve the fluid needs of San Bernardino County.
- Transportation allowances and credits will be needed to encourage milk production in more distant areas (outside Southern California) to be shipped into the county.
- No witnesses opposed the inclusion of San Bernardino County.

Opposing Arguments:
- Inclusion of San Bernardino County will increase the total cost of the transportation allowance system to the pool.
- San Bernardino fluid plants have not had a problem obtaining an adequate milk supply.

Panel Recommendation: Change the four mileage brackets as follows:
1. 0 to 89 miles, no change
2. over 89 to 120 miles becomes over 89 to 122 miles
3. over 120 to 139 miles becomes over 122 to 139 miles
4. over 139 miles, no change

Supportive Arguments:
- With 122 miles as the break between the 2nd and 3rd mileage brackets:
  - The 1st mileage bracket has most of the Chino area milk with a minimum of Barstow area milk;
  - The 2nd mileage bracket has most of the Barstow area and San Diego County milk with a minimum of Kern County milk; and

- The 3rd and 4th mileage brackets have most of the Kern County milk with a minimum of Barstow area and San Diego County milk.
- See also Attachment A-3.

- Transportation allowances are uniform throughout the Northern California receiving areas and Southern California conditions are no different.
- Limiting the transportation allowance rate to $0.31/cwt. for all other counties:
  - Limits the ability of Southern California's fluid plants to attract milk supplies north of the Fresno production area; and
  - Limits competition among cooperatives supplying milk to Southern California.
- The problem of over-compensating the Barstow shipments can be more simply addressed by adjusting the mileage brackets.
- Contractual arrangements with hauling companies result in flat average rates over large areas making it difficult to set appropriate brackets.

Opposing Arguments:
- The Barstow situation does not fit the present model in Southern California. Southern California conditions differ from those in Northern California.
- The over 139 mileage bracket that applies to Fresno and Tulare counties could be applied to the counties north of Fresno while still excluding Barstow.
- The establishment of the maximum $0.31/cwt. rate would have better addressed the over-compensation in Barstow.

<u>Panel Recommendation</u>:
1. No change for $0.10/cwt. rate for 0 to 89 miles
2. -$0.09 from $0.29 to $0.20/cwt. for over 89 to 122 miles
3. +$0.04 from $0.48 to $0.52/cwt. for over 122 to 139 miles
4. +$0.03 from $0.62 to $0.65/cwt. for over 139 miles

Supportive Arguments:
- The hauling costs have increased with higher fuel prices.
- In the 1st mileage bracket:
  - The present transportation allowance rate is more than adequate to cover the difference between the local and distant haul for the Chino area; and
  - Raising the allowance rate will not result in attracting milk to fluid plants from cheese plants.
- In the 2nd mileage bracket, reducing the rate addresses over-compensation in the Barstow area and San Diego County.
- In the 3rd mileage bracket, the rate is the distant less local haul with no shortfall for Kern County.
- In the 4th mileage bracket, the rate is the weighted average of:
  - The distant less local haul <u>with no shortfall</u> in Kern County, and
  - The distant less local haul <u>with a shortfall</u> in Tulare County.
  - The weights used in the weighted average are the amounts of Kern County milk and Tulare County milk in the 4th mileage bracket.
- See also Attachment A-3.

Opposing Arguments:
- For the 1st mileage bracket:

- an increase is consistent with the increases in the three Northern California receiving areas; and
- The hauling costs have increased with higher fuel prices.

- For the 4th mileage bracket, the rate is too low given the increasing need to attract more milk from north of Kern County.
- Raises the net cost to the pool (the increases in the 3rd and 4th mileage brackets more than offset the decrease in the 2nd mileage bracket).

Transportation Allowances for the San Diego Receiving Area

<u>Panel Recommendation</u>:

1. No change for $0.10/cwt.rate for 0 to 89 miles
2. No change for $0.43/cwt. rate for over 89 to 139 miles
3. +$0.07 from $0.58 to $0.65/cwt. for over 139 miles

Supportive Arguments:

- In the 1st mileage bracket, the present transportation allowance rate is more than adequate to cover the difference between the local haul and the haul to the fluid plants for San Diego County milk. Raising the allowance rates unnecessarily raises the transportation cost to the pool.
- Declining milk production, both in San Diego County and in Southern California generally, will not be available to serve the local fluid needs of San Diego County. In the 3rd mileage bracket, raising the rate puts the San Diego receiving area on a more competitive basis with the Southern California receiving area.

Opposing Arguments:

- For the 1st mileage bracket:
  - an increase is consistent with the increases in the three Northern California receiving areas; and
  - The hauling costs have increased with higher fuel prices.
- For the 3rd mileage bracket, raises the cost to the pool.

Transportation Credits

<u>Panel Recommendation</u>: Make no changes to the eligibility of condensed skim for transportation credits.

Supportive Arguments:

- Provides the fluid processors with additional options for securing needed milk supplies.
- Elimination of eligibility for credits would have resulted in a savings of $0.011 to $0.026/lb-snf for every pound of SNF in the condensed skim receiving transportation credits. While a decreased sale of condensed skim would have resulted in a loss of $0.342/lb-snf for every pound of SNF in the condensed skim sales lost.
- From the end of 2004 to the end of 2005, California condensed skim has declined from 91% to 84% of the total condensed skim arriving at Southern California plants.
- Encourages condensed skim to flow from the Southern San Joaquin Valley into Southern California and will lessen some of the economic incentives for serving condensed skim from Southern California sources.

Opposing Arguments:

- Nearly all the condensed skim eligible for transportation credits for Southern California is supplied within the area.
- Producers already fund the ranch-to-plant transportation cost from the Southern San Joaquin Valley to Southern California and do not believe it is appropriate to fund the transportation cost within Southern California.
- Elimination of condensed skim eligibility will reduce the cost to the pool.

Panel Recommendation: Make no change to San Diego transportation credit rates relative to the rates for the other eligible Southern California counties.

Supportive Arguments:

- Hauling rates to San Diego plants are no larger than hauling rates of comparable distances to other Southern California plants.
- There is an inconsistence in the testimony as to what is the additional cost of moving tailored product beyond Orange County to San Diego County.

Opposing Arguments:

- San Diego plants are at a greater distance from tailoring plants than other plants in Southern California.

Panel Recommendation: Make San Bernardino County eligible for transportation credits from Fresno, Kings, Los Angeles and Tulare counties.

Supportive Arguments:

- Declining milk production in Southern California will not be available to serve the fluid needs of San Bernardino County.
- Transportation allowances and credits will be needed to encourage milk production in more distant areas (outside Southern California) to be shipped into the county.

Opposing Arguments:

- Inclusion of San Bernardino County may in the future increase the total cost of the transportation credit system to the pool.
- San Bernardino fluid plants have not had a problem obtaining an adequate milk supply.
- No witnesses supported the inclusion of San Bernardino County.

Panel Recommendation:

- Lower the credit rate within Southern California by -$0.08, from $0.34 to $0.26/cwt.
- Increase the credit rate from Tulare to Los Angeles, Orange and Ventura by +$0.09, from $0.60 to $0.69/cwt.
- Increase the credit rate from Tulare to Riverside, San Bernardino and San Diego by +$0.09, from $0.68 to $0.77/cwt.
- Increase the credit rate from Fresno and Kern to Los Angeles, Orange and Ventura by +$0.09, from $0.63 to $0.72/cwt.

- Increase the credit rate from Fresno and Kern to Riverside, San Bernardino and San Diego by +$0.09, from $0.71 to $0.80/cwt.

Supportive Arguments:

- Balance the competitive situation of supplying tailored products between supply plants in the Southern San Joaquin Valley and supply plants in Los Angeles County.

Opposing Arguments:

- There were no specific requests for rate reductions.
- A net $0.17/cwt. change may be disruptive to current contractual relationships.

Panel Recommendation: Stakeholders, together with the Department, should review the concept of replacing $/cwt. basis to a $/lb.-snf basis.

Supportive Arguments:

- Most condensed skim produced in Southern California and the Bay Area is over-compensated.
- Plant-to-plant movement of condensed skim from the San Joaquin Valley to Southern California and the Bay Area would be more efficient as the excess water does not need to be hauled.

Opposing Arguments:

- Slow response to a real problem.

CALIFORNIA DAIRIES, INC. – Gary Korsmeier

- Addresses the hauling cost to two fluid processors supplied in the Bay Area and numerous fluid processors in the Southern California area. Incentives should be from the closest available production area thereby discouraging milk movement from distant locations and minimize the cost to the pool.
- Milk producers are responsible under the California regulated system to absorb the transportation costs to provide milk to deficit Class 1 marketing areas; should be responsible for local hauls and transportation allowances and credits should compensate those producers or plants that service the needed Class 1 market outside the local areas.
- Since the last hearing on transportation issues, there has been a significant change in how milk is provided to the Southern California markets. Virtually all milk is moved, outside of local supply, from ranch to plant or through the transportation allowance incentive.

<u>Transportation Allowances:</u>

- Increase the transportation allowances for plants located in the following receiving areas:

<u>Bay Area</u> (Alameda, Contra Costa, Santa Clara, Santa Cruz, San Francisco, and San Mateo):

0-99 miles	$0.27/cwt.
99-199 miles	$0.31/cwt.
Over 199 miles	$0.32/cwt.

The increase represents the blended cost increase over local hauling rates.

*****<u>Southern California Area</u> (Los Angeles, Orange, Riverside, Ventura):

Milk shipments from Santa Barbara, San Diego, Imperial, Kern, Tulare, Kings, and Fresno counties only:

0-89 miles	$0.11/cwt.
89-109 miles	$0.32/cwt.
109-139 miles	$0.53/cwt.
Over 139 miles	$0.70/cwt.

Milk shipments from all other counties:

0-89 miles	$0.11/cwt.
Over 89 miles	$0.32/cwt.

*****<u>San Diego Area</u> (San Diego County):

0-89 miles	$0.11/cwt.
Over 89 miles	$0.32/cwt.

*****Also proposes adjustments in the mileage brackets in order to give the incentive for members to move milk to the Los Angeles area Class 1 plants instead of to closer manufacturing plants.

- If recommendation of mileage bracket changes is not granted as a result of this hearing, would prefer to revert back to the 90-139 bracket in effect prior to the 2004 hearing.
- Recommended rate changes are reflective of true blended actual costs of supplying the deficit markets in Southern California.
- The continuing decline of milk produced in the Southern California marketing area will require more distant milk to move to the needed markets. A 40 percent decline in the last 2-1/2 years in Southern California, or 3 million pounds per day.
- Supports DFA's diesel fuel adjuster. Fuel adjuster will be a more timely adjustment to either increase or decrease the transportation milk movement incentives. DFA's formula for change is accurate.

<u>Transportation Credits:</u>

Make the following changes to transportation credits:

- Increase to $0.36/cwt. for shipments <u>from Los Angeles</u> County to: Orange, Riverside, San Diego, Ventura counties.
- Increase to $0.70/cwt. for shipments <u>from Tulare County</u> to: Los Angeles, Orange, Ventura counties.
- Increase to $0.78/cwt. for shipments <u>from Tulare County</u> to: Riverside, San Diego counties.
- Increase to $0.72/cwt. for shipments <u>from Fresno and Kings counties</u> to: Los Angeles, Orange, Ventura counties.
- Increase to $0.80/cwt. for shipments <u>from Fresno and Kings counties</u> to: Riverside, San Diego counties.
- The above changes reflect increases in costs for plant-to-plant deliveries from the counties listed. The $.36/cwt. credit for Los Angeles County is not the total cost, which is $.4975/cwt.
- The increases from Tulare, Fresno and Kings Counties continue past policy of a disincentive from these counties to Southern California. Plant-to-plant milk only moves from those counties on an emergency basis. A disincentive should remain but not total elimination of those counties receiving credits.
- Supports Hollandia alternate proposal to increase the transportation credits from Los Angeles County to San Diego County.
- Does not support Hollandia alternative proposal to expand the transportation allowances for over 139 miles because there is adequate milk in Riverside and San Diego counties (less than 89 miles) to supply their requirements.

SECURITY MILK PRODUCERS (SECURITY) – Hank Perkins

<u>Adding San Bernardino County to the Southern California Receiving Area</u>

- Security supplies on fluid milk processor in San Bernardino County.
- Dairy Marketing Branch's hauling data reflects a 30 percent decrease in the Chino, Corona, and San Bernardino from April 2004 to August 2005.
- Plant is being supplied with local milk, but as available milk supplies dwindle, transportation allowances need to be extended to plants in San Bernardino County.
- Based on historical shipments of local milk to San Bernardino County, the cost to the pool will be approximately $2000 per month.

Transportation Allowance Adjustments

- Only 18 months ago that Security presented testimony regarding increased hauling costs.
- Department of Energy data reflects a $0.43/cwt. increase in diesel fuel prices from April 2004 to December 2005.
- At previous hearing Security requested a $0.75/cwt. rate, at this hearing Security is requesting a $0.76/cwt. rate.
- In same time period, Security has seen its transportation costs from Tulare County to Los Angeles basin increase by more than $0.05/cwt.
- At the end of December, Security 's haul rate from Tulare to Los Angeles was $1.06/cwt. including fuel surcharges.
- Copies of invoice from independent milk haulers document Security's local haul rate of $0.30/cwt.
- Using local haul rate of $0.30/cwt. leaves Security with shortfall of $0.76/cwt.
- When diesel fuel prices peaked in October, Security effective haul rate was $1.19/cwt., giving them an $0.89/cwt. shortfall.
- Pooling data reflects that nearly three-quarters of the milk produced in Kern County from December 2004 through November 2005 has moved into the Southern California marketing area.
- While Security requested adjustments would result in a cost to the pool of approximately $250,000 per month, it justified to cover increased freight costs.

California Dairy Inc Proposal

- Security supports the CDI request for increases. The rates accurately reflect actual hauling costs from those areas.

WESTERN UNITED DAIRYMEN – Tiffany LaMendola

- Allowances on ranch-to-plant shipments constitute the largest share (94 percent) of cost to the Pool from transportation system.
- Class 1 returns nearly ten times the cost of the transportation system to the Pool.
- Milk supplies are declining in Southern California – more milk is getting shipped to greater distances and a great deal of local milk is used for non-fluid purposes, such as cheese.

Condensed Skim/Transportation Credits

- Propose to eliminate transportation credits for condensed skim.
- There has been a large increase in pounds of condensed skim eligible for credits within Southern California.
- Nearly all of condensed skim demanded by Southern California is supplied within that region.
- Proposal to eliminate credits does not change competitive situation already in place in Southern California.
- Some milk receiving a transportation allowance and then a transportation credit on condensed skim from Los Angeles – double-dipping.
- Hearing Panel in 2004 had a concern and discussed prorating the allowance against the credit to alleviate double-dipping.
- Condensed skim that is fortified already receives a fortification allowance of. Plants receive $0.0987 per pound of SNF on purchase of condensed skim for fortification.

- Producers should not be responsible for moving a manufactured product plant-to-plant that is already subsidized through fortification allowances.

Transportation Allowances

- Support CDI transportation allowance proposed rate adjustments.
- Support CDI bracket changes.
- Do not think necessary to change rates for further out brackets if milk from those areas is not needed to sufficiently supply the one processing plant in San Diego.
- Concerned that there is a great deal of milk in Southern California not being utilized as Class 1.
- Would rather see some of Southern California milk currently supplying other classes than Class 1 be utilized for fluid purposes.
- Do not support CDI proposal to increase transportation credit for condensed skim.
- CDFA data indicates that it is more cost effective to move milk via allowances than credits.
- Ranch milk moving into Los Angeles receiving area and then out of Los Angeles as tailored milk charging pool both allowance and credit.

Hollandia Proposal

- Do not support Hollandia proposal.
- Proposed increase exceeds allowance requested by CDI.
- Very little milk is moved over 139 miles.
- Do not support their transportation credit increase from Los Angeles to San Diego.

Security Milk Producers Proposal

- Do not support Security Milk Producer proposal.
- Requested increase in allowance for furthest out bracket goes against encouraging the closest milk to move first.

DAIRY FARMERS OF AMERICA – Gary M. Stueve

- Increases in fuel surcharges have created shortfalls for those transporting milk
- Suggesting transportation allowance rate increases for four designated areas
- Since August 2004, local fuel-related freight costs have increased $0.02-0.03 – fuel-related freight costs from Kern and Tulare counties to Los Angeles and from the North Valley to Bay Area have risen $0.09-0.15.
- Fuel adjuster will apply a .8 percent change in transportation allowance for each $0.05 movement in the cost of diesel fuel. Will be applied to different freight rates in each mileage bracket.
- The base fuel rate will be the Department of Energy fuel cost listed on their website.
- Suggest that adjustments for allowances be made monthly using the average fuel costs from the prior two months.

Dairy Farmers America Proposal

- Do not support DFA proposal for automatic adjustments in allowance rates based on diesel fuel prices.
- Fuel prices are not the only component in total hauling costs.

- The Department previously noted that a proposed index make allowance would not be made because changes should not be made on only one cost factor when other factors could be moving in the opposite direction.
- If price adjuster is accepted, then logical to propose a similar amendment for other costs that increase by more than the baseline.
- Does an adjustment factor discourage competition for lower hauling rates?
- No firm timeline on how often these adjustments would be made was offered.
- CDFA has stated in the past that it can make needed adjustments in the allowances on a timely manner when sufficient data is provided.

MILK PRODUCERS COUNCIL - Geoffrey Vanden Heuvel

- Supports cost justified rate adjustments to transportation allowances.
- Transportation credits for plant-to-plant movement of milk should not cost the pool anymore than ranch-to-plant movement.
- Agrees with WUD that the transportation credit should not apply to condensed skim milk.
- Should not go back to designating supply counties for the transportation allowance; distance from market should be the criteria.
- Opposes automatic fuel cost adjuster. Fuel surcharges are more appropriately negotiated between buyers and sellers.
- Current transportation subsidy system will not be sufficient over the long term to assure an adequate supply of milk for Southern California market.

CALIFORNIA DAIRY CAMPAIGN – Andy Zylstra

- Opposes petition to increase to transportation allowances.
- Dairy producers as well as processors have experienced energy cost increases.
- Processors should raise the selling price of products to cover costs.
- Plants should operate in areas that enable them to efficiently transport milk from producer to consumer

DAIRY INSTITUTE OF CALIFORNIA – Dr. William Schiek

<u>Background</u>

- During establishment of pooling program, producers made commitment to ensure that Class 1 plants would be served.
- By virtue of the higher minimum prices that fluid plants pay, Class 1 plants should be able to secure necessary milk supplies without having to subsidize the haul cost to their plants.
- Absent the transportation allowances, producers would have an incentive to ship their milk to a local manufacturing plant, and a disincentive to serve the fluid milk market.
- Transportation allowance compensates producers for the difference between the local haul to the manufacturing plant and the long haul to the fluid plant, so producer will be indifferent as tow where they ship their milk.
- The transportation credit was set on principle to compensate the milk supplier for the cost of shipping milk from the supplying plant to the deficit-area plant, after accounting for any difference in the marketing area Class 1 differentials.
- The need and importance of the transportation allowance and credit system will grow as milk production moves to locations further away from the urban fluid processing plants.

Dairy Institute's Position

- Supports proposals that seek to make cost-justified adjustments to the transportation allowance and credits.
- Current transportation allowances are not reflective of the new energy cost realities.
- Because diesel fuel rates fluctuate, the transportation allowance and credits should be established based on sound economic principles and on the most recent rates and fuel cost information available to the Hearing Panel.

Transportation Allowances

- Set equal to the difference between the cost of the local haul and the cost of the haul to higher-use plants in metropolitan markets.
- Slight shortfall should apply only to the most distant mileages brackets to encourage milk that is closer to the market to move first.
  - o Exception – no shortfall in the allowance for milk shipments to Southern California from Tulare and Kings Counties. Increasing volumes from those areas that are necessary to supply the fluid plants in Southern California.
- Fluid plants operating within a market should not be disadvantaged relative to each other in the procurement of nearby milk supplies.

Transportation Credits

- Set equal to the haul less any area differentials.
- Advocate full compensation for all but the most distant milk to encourage competition in supplying the Class 1 market.
  - o Full compensation important for shipments from the south valley into Southern California, where there is an historic pattern of plant-to-plant milk movement.
  - o Alternative supplies from Southern California and Kern County do not seem to be adequately available to meet Southern California needs.
  - o Shortfall in credits into Southern California should only be employed for the distant milk (Fresno), and not in relatively closer areas of (Kern, Tulare, and Kings).

CRYSTAL CREAM & BUTTER - Sharon Hale

- Supports Dairy Institutes petition and testimony.
- CDFA's 'Hauling Rates-Ranch to Plant Comparison: Jan 2000 to Aug 2005' reflects the hauling rate for milk located in Sacramento and San Joaquin counties increased $.059/cwt. while Crystal's producer records show an increase of $.068/cwt for that time period. Even though there is a difference, the significance is that there is a sizeable increase in hauling rates during this period.
- CDFA exhibits for milk located in the Northern San Joaquin Valley and moving to Sacramento reflect a haul rate decrease of $.068, while Crystal's independent dairies in the 'over 59 mile' bracket experienced a $.065/cwt. increase during that time period.
- Supports DFA's proposed increase to the transportation allowance for milk moving to the Sacramento receiving area from over 59 miles by $.01/cwt. Milk in the Northern San Joaquin Valley moving locally increased $.022 /cwt. during the same period, thus increasing the incentive by $.043/cwt. to ship to a plant in that area instead of moving to a plant located in the Sacramento deficit area.
- California milk movement incentive system will not entice all milk to move. In the Sacramento area, milk moves away from the deficit market toward cheese manufacturing facilities because those facilities provide additional incentives for milk with specific

compositional characteristics, so it is more lucrative to move that milk to the cheese facility than the deficit fluid market.

- Urbanization of the Sacramento region continues to reduce the supply of milk to Crystal with two long-time dairies going out of business and the prospect of that trend continuing.
- DFA's proposal to increase transportation allowances for both mileage brackets associated with the Sacramento receiving area is warranted based on the diminishing overall supply of milk and the attractiveness of alternative usages.
- See value to automatic fuel surcharge formula, but do not have a clear understanding of how such formulas might function, nor have conducted sufficient analysis to be able to support the adoption of a fuel surcharge formula at this time. Recommend a formula of this type be fully developed and explored by the industry in preparation for consideration at a future hearing.

LAND O'LAKES, INC. – James W. Gruebele

<u>Transportation Credits</u>

- Supports adjustment in credits moving milk from South Valley into Southern California Class 1 plants.
- Supports CDI proposal.

<u>Condensed Skim</u>

- Supports including condensed skim in transportation credit system.
- More costly to supply whole milk using transportation allowance than to move milk in condensed skim using transportation credits – Figure 8 of CDFA workshop.
- Elimination of transportation credits on condensed skim would exacerbate problem of "other source" competition.
- LOL could not compete in sale of condensed skim shipments from Tulare to Southern California markets without transportation credits.
- Every pound of solids imported from out-of-state sources creates more pounds of solids from California sources that are used for lower class usage – negative impact on pool.
- If transportation credits are removed from condensed skim, that would leave only 1 plant in California to supply condensed skim to Southern California.

<u>Transportation Allowances</u>

- Milk movement issues:
    - encourage local milk to move first
    - transportation allowances should be based on difference between local and long distance haul to Class 1 markets
    - do not overcompensate producers serving Class 1 markets
    - make cost justified changes to transportation allowances
- LOL supports CDI changes to correct over-compensation in high desert.
- Supports CDI proposal to change mileage brackets from 89-109, 109-139.
- Supports CDI new rates for the 89-109 and 109-139 brackets – corrects over-compensation for producers in the high desert supplying Class 1 milk into deficit areas.
- Believes CDI proposal would make California milk more competitive with out-of-state sources of milk and provide producer equity.
- Oppose Hollandia proposal to increase allowances in San Diego area.

<u>Justification for Proposals</u>

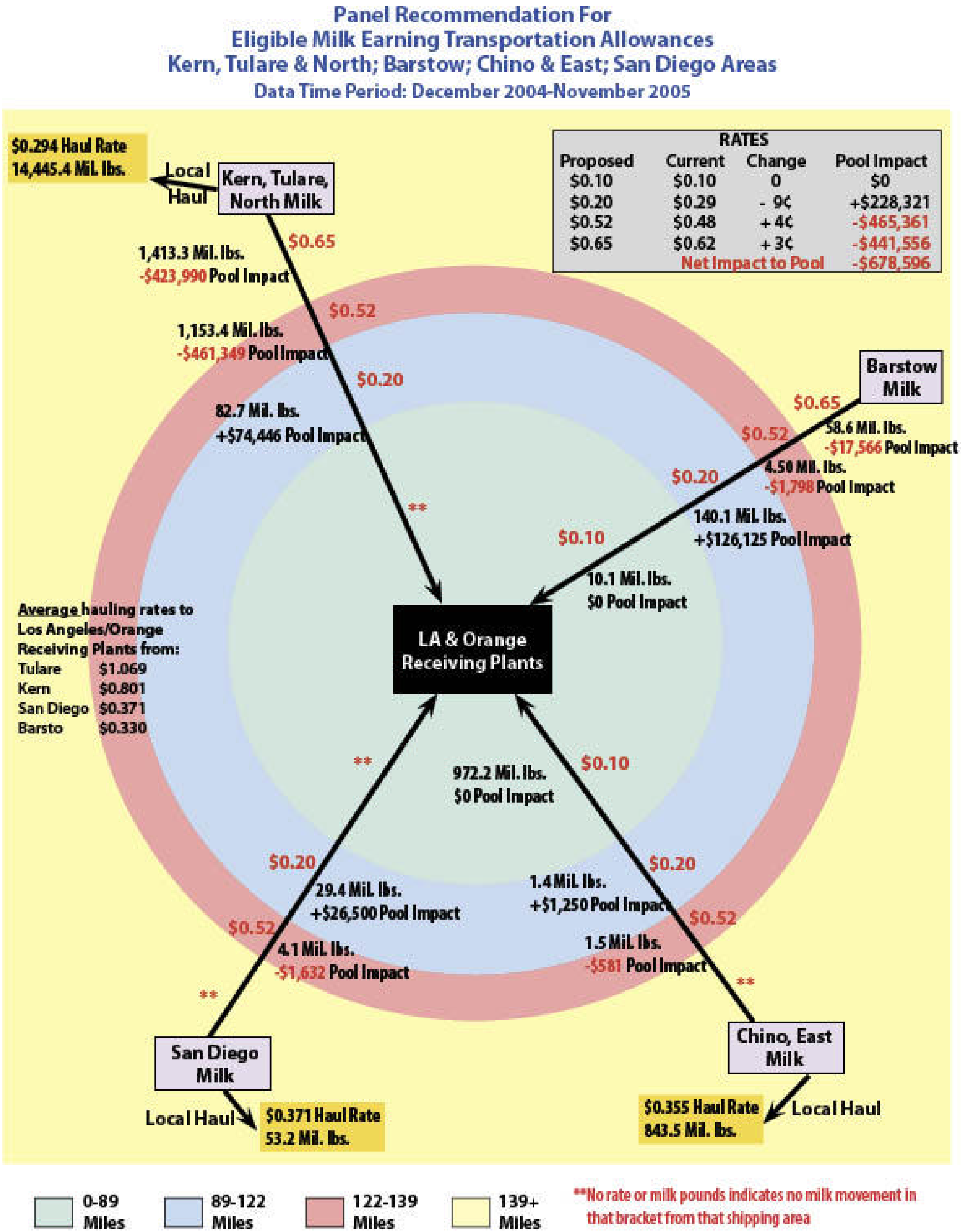
- Packaged milk from out-of-state is negatively affecting Pool revenue. Southern California cannot be competitive with out-of-state packaged milk.
- LOL believes transportation allowance from Barstow area should be reduced.
- Producers in Class 1 markets should be no worse off supplying a Class 1 market than shipping milk to manufacturing facility.
- Priority should be to make California milk more competitive with out-of-state sources.

DRIFTWOOD DAIRY – James E. Dolan

- Request that the transportation credit be increased to $.7925/cwt. <u>from Tulare County to Los Angeles</u>. This will help eliminate current shortfall.
- Studies show plant-to-plant movement of milk from South Valley to Southern California is just as efficient if not more so than ranch to plant from South Valley to Southern California.
- Historically, the Department had always adjusted transportation credits close enough to allow plants to compete. That did not happen after the last hearing.
- Increasing transportation credits to eliminate disincentives to move South Valley to Southern California will help insure an adequate and timely supply for the Southern California fluid market.

HOLLANDIA DAIRY – Submitted an alternative proposal, but did not testify at the hearing.

Attachment A-3



END NOTES

1 Uses current transportation credit rates of $0.34/cwt. within Southern California and $0.60/cwt. from Tulare to Southern California plus a $0.22/cwt. Class 1 differential for condensed skim.

2 Uses 2005 annual average prices for Southern California Class 1 and Class 4a.

3 During this same time period, in setting rates for transportation allowances, the Panel considered:
a. The cost to haul the milk from the Southern San Joaquin Valley plant to Southern California Class 1 plants (distant haul),
b. Less the cost to haul the milk within the Southern San Joaquin Valley (local haul), and
c. Less a modest shortfall.

4 Assumes acceptance of Panel recommendations to make San Bernardino County eligible for transportation allowances and credits.

5 In this analysis, the new rates recommended by the Panel were used.