PUBLIC HEARING

STATE OF CALIFORNIA

DEPARTMENT OF FOOD AND AGRICULTURE

DAIRY MARKETING BRANCH

DEPARTMENT OF FOOD AND AGRICULTURE

1220 N STREET

AUDITORIUM

SACRAMENTO, CALIFORNIA

TUESDAY, JANUARY 31, 2006

9:00 A.M.

TIFFANY C KRAFT, CSR, RPR
CERTIFIED SHORTHAND REPORTER
LICENSE NUMBER 12277

APPEARANCES

HEARING OFFICER

Mr. James P. Aynes, Staff Counsel

PANEL MEMBERS

Ms. Candace Gates, Research Manager I

Mr. Tom Gossard, Agriculture Economist

Mr. David Ikari, Chief, Dairy Marketing Branch

Mr. John Lee, Chief, Milk Pooling Branch

Mr. David Shippelhoute, Senior Agricultural Economist, Milk Pooling Branch

STAFF

Ms. Cheryl Gilbertson, Staff Analyst

ALSO PRESENT

Dr. James Gruebele, Land O'Lakes

Ms. Sharon Hale, Crystal Cream and Butter Company

Mr. Gary Korsmeier, California Dairies, Inc.

Mr. Hank Perkins, Security Milk Producers Association

Ms. Tiffany LaMendola, Western United Dairymen

Mr. Scott Magneson, California Dairy Campaign

Dr. William Schiek, Dairy Institute of California

Mr. Gary Stueve, Western Area Council of Dairy Farmers of America

Mr. Geoffrey Vanden Heuvel, Milk Producers Council

Mr. Andy Zylstra, Callifornia Dairy Campaign

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PROCEEDINGS

HEARING OFFICER AYNES: Good morning. This hearing will now come to order. The California Department of Food and Agriculture has called this public hearing in the Department's Auditorium, 1220 N Street, Sacramento, California, on this day, Tuesday, January 31st, 2006, beginning at 9:00 a.m.

My name is Jim Aynes. I'm the attorney for the California Department of Food and Ag, and I have been designated as the Hearing Officer for today's proceedings.

On October 4th, 2005, the Department received a petition from California Dairies, Incorporated, requesting a public hearing to consider amendments of the transportation allowance system and the Pooling Plan for the Market Milk and transportation credits of the Stabilization and Marketing Plans for Market Milk for the Northern and Southern California marketing areas. This hearing will consider the petitioner's proposal both to amend the Pool Plan in effect on January 31st, 2006, to amend transportation allowances for milk moving into the Bay Area receiving area, the Southern California receiving area, and the San Diego receiving area, and to amend the Stabilization Plan in effect on January 31st, 2006, to amend transportation credits for milk moving into Southern California Class 1 plants.

The Department has received four alternative proposals in response to the CDI petition. The proposals are from Hollandia Dairy, Security Milk Producers Association, Western United Dairymen, and Dairy Farmers of America.

During a pre-hearing workshop conducted on January 11, 2006, the Department provided an analysis on of alternative concepts and proposals. A copy of the analysis will be entered into the record of this hearing as exhibits.

Accordingly, the purpose of this hearing is to consider the amendments as proposed in the California Dairies, Incorporated's, petition, the alternative proposals offered by Hollandia Dairy, Security Milk Producers Association, Western United Dairymen, and Dairy Farmers of America.

Testimony and evidence pertinent to the call of the hearing will now be received. Anyone wishing to testify must sign the hearing roster located at the sign-in table. Oral testimony will be received under oath or affirmation.

As a courtesy to the Panel, the Department staff, and public, please speak directly to the issues presented by the petition and avoid personalizing any disagreements. Such conduct does not assist the Panel in its attempt to effectively address the sophisticated economic and regulatory issues presented in the petitions. For the record, testimony given at this hearing does not necessarily reflect the position of the Department regarding the proposed amendments.

Please note that only those individuals who have testified under oath during the conduct of the hearing may request a post-hearing briefing period to amplify, explain, or withdraw their testimony. Only those individuals who have successfully requested a post-hearing briefing period may file a post-hearing brief with the Department.

The Hearing Panel has been selected by the Department to hear testimony, receive evidence, question witnesses, and make recommendations to the Secretary. Please note that the questioning of witnesses by anyone other than members of the Panel is not permitted.

The Panel is composed of members of the Department's Dairy Marketing and Milk Pooling Branches and include: David Ikari, Chief Dairy Marketing Branch; John Lee, Chief, Milk Pooling Branch; Candace Gates, Research Manager to Dairy Marketing Branch; Thomas Gossard, Senior Agricultural Economist, Dairy Marketing Branch; and Donald Shippelhoute, Senior Agricultural Economist, Milk Pooling Branch.

I am not a member of the Panel, and I will not be taking part in any decisions relative to the hearing.

The hearing recorder is Tiffany Kraft of the firm of Peters Shorthand Reporting Corporation located in Sacramento. Transcript of today's hearing will be available for review at the Marketing Branch Headquarters located in Sacramento at 560 J Street, Suite 150. Anyone desiring copies of the transcript of today's hearing must purchase them directly from Peters Shorthand Reporting Corporation.

At this time, Cheryl Gilbertson, Research Analyst with the Dairy Marketing Branch, will introduce the Department's exhibits.

STAFF ANALYST GILBERTSON: Mr. Hearing Officer, my name is Cheryl Gilbertson. I'm an Analyst with the Dairy Marketing Branch of the California Department of Food and Agriculture. My purpose here this morning is to introduce the Department's composite hearing exhibits numbered 1 through 43. Relative to these exhibits, previous issues of Exhibits 9 through 43 are also hereby entered by reference.

The exhibits entered here today have been available for review at the Office of the Dairy Marketing Branch since the close of business on January 18th, 2006. And a bridged copy of the exhibits is available for inspection at the back of the room. Multiple copies of Exhibits 4, 5, and 6 are also available at the back of the room.

I ask at this time the composite exhibits be received. I also request the opportunity to provide a post-hearing brief.

Mr. Hearing Officer, this concludes my testimony.

HEARING OFFICER AYNES: Okay. The Department's exhibits will be identified as Exhibit 1 through Exhibit 43.

(Thereupon the above-referenced documents were marked by the Hearing Officer as Exhibits 1 through 43.)

HEARING OFFICER AYNES: We'll swear you for testimony.

(Thereupon Ms. Cheryl Gilbertson was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

STAFF ANALYST GILBERTSON: I do.

HEARING OFFICER AYNES: Does the Panel have questions?

Hearing no questions from the Panel, does anyone in the audience have any questions regarding the content of the Department's exhibits? Please recognize the questions are limited to the purposes of clarification.

Cross-examining of Department staff is not permitted. Please identify yourself and your organization for the record before asking any questions.

Any questions?

Hearing none, we'll continue.

California Dairies, Incorporated, now has 60 minutes to make its presentation in support of its petition. Would you give your name and spell your last name for the record?

Would you give your name and spell your last name for the record, please?

MR. KORSMEIER: Yes. My name is Gary Korsmeier. That's spelled K-o-r-s-m-e-i-e-r.

(Thereupon Mr. Gary Korsmeier was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. KORSMEIER: Yes, sir.

HEARING OFFICER AYNES: And did you want to submit this document as an exhibit?

MR. KORSMEIER: Yes, sir.

HEARING OFFICER AYNES: That will be Exhibit Number 44.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 44.)

MR. KORSMEIER: Mr. Hearing Officer and members of the Panel, my name is Gary Korsmeier, President and Chief Executive Officer of California Dairies, Inc., a milk marketing cooperative representing approximately 700 members, and we market about 40 percent of the milk in the state of California. Our recommended changes to transportation allowance and credits today was approved by our Board of Directors on January 24, 2006.

We appreciate the granting by the Department of Food and Agriculture of our request dated October 3rd, 2005, for a public hearing to present justification for increases in milk movement incentives. All producers benefit by proper incentives to obtain a higher pay price by remaining more competitive with out-of state source milk.

Transportation allowances, which is the ranch to plant movement, and transportation credits, plant to plant movement, are important milk movement incentives to insure a more orderly marketing of milk to Class 1 markets. 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.

Transportation costs have increased dramatically since the last public hearing on this subject matter on

August 4th, 2004. The most apparent is the escalating diesel fuel costs. But increases have occurred in wages, insurance, and employee benefits, especially health care coverage. Our testimony today incorporates all of these costs up to and including the just received notification by Kings County Truck Lines of higher diesel fuel costs effective February 1, 2006.

Timing is everything as it relates to the hauling costs, and we amended our original petition on October 3rd, 2005, on December 21st, which today will be further amended to include current costs. The need to have cost-justified milk movement incentives has not changed however, and adjustments are needed to maintain adequate incentives.

Our testimony addresses the hauling costs of two fluid processors we supply in the Bay Area, Alameda County, and the numerous fluid processors in the Southern California area where the higher need is for milk movement incentives. We will be consistent with our past underlying objective that producers should be responsible for the local hauls, and transportation allowances and credits should compensate those producers or plants that service the needed Class 1 market from outside local areas. These incentives should be from the closest available production area, thereby discouraging milk movement from distant locations and minimizing the cost to the producer pool in California.

Since the last public hearing on transportation issues, there has been a significant change in how milk is provided to the Southern California markets. Today, virtually all milk is moved, outside of the local supply, from ranch to plant or through the transportation allowance incentive. We are the largest provider to Class 1 markets in Southern California. And changes have occurred in the past two years that have eliminated most of the need to move milk from plant to plant via the transportation credit incentive system from the South Valley to Southern California. We supply one fluid processor with standardized product from our local Artesia location using transportation credits that we are requesting adjustments today.

Our recommendations for changes only to the Pooling Plan for Market Milk are as follows: This is Section 921.2.

A. For plants located in the Bay Area receiving area which shall consist of the counties of Alameda, Contra Costa, Santa Clara, Santa Cruz, San Francisco, and San Mateo, if there's any change there from the current plan.

From zero through 99, we are requesting a 27 cent per hundredweight, which is an increase of 2 cents per hundredweight.

Over 99 miles through 199, 31, which is also 2 cents, as is the over 199 miles of 32 cents. There might be some here about this record testifying today of higher allowances over 99. We do not move milk more than 99 miles into the Bay Area. So we just used the same 2 cent increment increase on the zero through 99 miles.

For plants located in Southern California receiving area, which shall consist of the counties of Los Angeles, Orange, Riverside, and Ventura, for milk shipments from Santa Barbara -- and we should make a note of that, because after about two months ago, there are no producers left in Santa Barbara County. So we probably could exclude that county has milk shipments. But I maintained it in there, but wanted to note it.

San Diego, Imperial, Kern, Tulare, Kings, and Fresno County, shipments of all of those counties from zero through 89 miles is 11 cents which is a 1 cent increase.

And then I've separated a new category as far as mileage, which I will talk about here a minute more in my narrative, from zero to 89 -- over 99, excuse me, through 109, 32 cents; over 109 through 139, 53 cents; and over 139 miles would be 70 cents.

Number two, for milk shipments from all other areas from zero through 89, 11 cents, which is consistent with the other county shipment; and over 89 is at 32 cents, which is also consistent at over 89, but there's no further categories there.

For plants located in San Diego receiving area, which consists of the county of San Diego, again the same as I had done from the milk shipments from other others, zero through 89, 11; over 89, 32.

Justification and supporting documentation for the above changes are as follows. We supply the Bay Area from Marin, Sonoma, Merced, Stanislaus, and San Joaquin Counties and are requesting to increase the allowance to 27 cents, or 2 cent per hundredweight increase which represents our blended cost increase over the local haul.

The local hauling rate for Merced, Stanislaus, and San Joaquin is .2725 from Cal Milk Transport. I do not have an exhibit here for that particular rate. It's close to the Kings County rate of 27, which I do. And the delivery to the Bay Area is .5575, which is listed on Exhibit A. It's hauling rates from Kings County. If you would go to that, you will see on that Exhibit A that there's down by the bottom there is all milk picked up in those counties delivered to San Leandro, which is where the two plants are that we supply in the Bay Area, 55 and three-quarters cents.

If you would take our principle recommendation to take off the local haul of the .2725, you end up with 28-and-a-half cents. So you might ask why we're not requesting 28-and-a-half and only requesting 27. The rate was at 25, and I thought that the 2 cents was an incremental increase, so we didn't ask for anything more. But the actual rate from those counties' net of the local haul is higher than the 27 cents that I'm requesting.

Back again now on page 3 to hauling rates, King County Truck Line. Again, as I stated earlier, we rarely move milk more than 99 miles to the Bay Area, but have increased the higher mileage brackets the same amount of the 2 cents that we did with the lower bracket.

In regards to Southern California receiving area, we are recommending changes in the mileage brackets that will give the incentive to our members to move milk to the Los Angeles Area Class 1 plants, instead of closer to manufacturing plants. The results of the August 4, 2004, public hearing split the mileage bracket of 90 to 139 miles to 90 to 120 and 121 to 139 miles, which was a disincentive for many of our members to move milk to the higher usages.

If our recommendation of the mileage brackets of 90 to 109 and 109 to 139 are not granted as the result of this hearing, we would prefer to revert back to the 90 to the 139 bracket prior to the 2004. But, again, we are requesting the new brackets of 90 to 109 and 109 to 139 as on the previous page at those rates.

Milk shipments from other areas include San Bernardino County, which today enjoys higher transportation allowances over and above local hauling rates. And we are recommending this change so allowances are only compensating producers for costs in excess of the local rates similar to allowances throughout the state. And that is up on my number two up on the top of that page 3 which talks about shipments from all other areas and limits the allowance to 32 cents, instead of the 50-some-odd cents if you went into the over 139 bracket.

Our recommended rate changes are reflective of our true blended actual costs of supplying the deficit markets in Southern California as verified by Exhibit A. Others will testify today for a higher rate in the over 139 mile category, which we do not disagree, but have limited our request to 70 cents per hundredweight to cover the costs south of Tulare County and therefore have placed a disincentive to move milk from Tulare County to Southern California, which again is consistent with my past hearing testimonies.

We could, however, reach a point in the next few years that Kern County milk production will not be adequate to supply the deficit Southern California market. The continuing decline of milk produced in the Southern California marketing area will require more distant milk to move to the needed markets. We have experienced over a 40 percent decline in the last two-and-a-half years in Southern California, which is over three million pounds of milk a day.

And again off the written testimony, our projections this year are we're going to lose another 5- to 600,000 pounds of milk in 2006. About half of that milk is moving into the New Mexico area, and the other half will be moving inside the state of California up in the Kern/Tulare area.

In the alternate proposal of Dairy Farmers of America is a diesel fuel adjustor which we believe has a lot of merit. Even though we need to address wages, benefits, and insurance cost increases at future public hearings like this one, a fuel adjustor will be a more timely adjustment to either increase or decrease the transportation milk movement incentives. We have applied the DFA fuel adjuster to our fuel formulas within our milk hauling agreements. And even though our rates are adjusted whenever diesel fuel adjusts by 15 cents a gallon instead of 5 cents per gallon, which is in their proposal, their formula for change is accurate, and we would support an automatic fuel adjuster monthly as a result of this hearing. This would be more accurate and more timely compensate those who supply the deficit markets.

And I think how I would ask that to be applied would be that using our current rates which were effective as of February 1 in this request and then use the basis that they were talking about, which was the Department of Energy website, and whatever that is as of February 1, then use that as the base from our requested changes, that as a base, and move it forward based on whatever happens with that index. So instead of using DFA's recommended numbers and the fuel formula, we would prefer to use our numbers and use it as the base to go forward, whether it's 5 cents per gallon increment for an increase or 15. We think 15 has just as much merit and you have less movement or less changes occurring within the fuel adjuster.

In regards to transportation credits, we recommend the following changes only to the Stabilization Marketing Plans for Market Milk, and this is Section 300.2 of the Stabilization and Marketing Plan. And that would be for the designated supply counties of Los Angeles County, we're asking for 36 cents, and that's the category that we use to move milk into Riverside County from a Class 1 processor, and we're asking for a 2 cent increase from 34 to 36.

The other counties -- as far as Tulare County is concerned is 70 cents from those designated deficit counties listed, the other Tulare County to deficit counties in Riverside or San Diego Counties, which would be a higher rate than in Los Angeles. And then in Fresno and Kings at 72. And from Los Angeles, Orange or Ventura, and Fresno and Kings from Riverside or San Diego, 72 in the first case, 80 cents in the latter.

The above changes reflect increases in costs from plant-to-plant deliveries from the county listed. The 36 cents per hundredweight credit for Los Angeles County is not the total cost, which is actually 49 and three-quarters, which is also listed on Exhibit A as far as Kings County is concerned. So there's actually a disincentive or not 100 percent coverage of moving from Los Angeles County to Riverside County in this case. We were disappointed that there were no increases granted in the last hearing, and we believe the justification is warranted to increase this credit from this hearing.

The increases from Tulare, Fresno, and Kings Counties continue our past practice of a disincentive from those counties to Southern California. The Class 1 differential of 27 cents per hundredweight plus our requested credit of 70 cents from Tulare County still leaves a shortfall of 5 cents.

And a similar comparison from Fresno County is over a 30 cent shortfall, which we believe is proper. The shortfall of the 5 cents is also on Exhibit A, which indicates that the transportation north of MacFarland and south in Tulare County to Los Angeles is $1.02. So the $1.02 less the 97 cents is the 5 cent shortfall.

The alternate proposals by Hollandia Dairy of an increase in transportation credits from Los Angeles County to San Diego County is one we can support. We can verify their actual costs from an independent third-party hauler is 60 cents a hundredweight since we are involved in that transaction. We are not supportive, however, of their expansion of transportation credits for over 139 miles, because there is adequate milk in Riverside and San Diego County to supply their requirements.

I first put in there "abundance," but I talked earlier about how short Southern California was, so I didn't think it would be proper to put "abundance" in there. But there is an abundance amount of milk for that particular processor in San Diego County.

We would like to thank you for the opportunity to submit our recommended changes and would like to request a post-hearing file period to answer or clarify any questions regarding this hearing.

And before I end on that, I note on Exhibit A, which is the next page, we have the hauling rates that we were notified last week that are effective February 1, tomorrow, as far as to the different areas from Kern County. There's listed down there is from Bakersfield to Los Angeles area is 79 and a quarter. If you would take that 79 and a quarter using our principle of reducing by the local haul of 27, you get 52 and a quarter cents. And our request is for 53.

We have some hauling in other areas around Bakersfield, and so we blended that to how we got the 53. But that calculation comes very close, and that is the category where most of the milk is being moved from Kern County into Southern California on the transportation allowance system.

So with that, Mr. Hearing Officer, thank you for allowing me to testify. I'll be willing to answer any questions anybody might have.

HEARING OFFICER AYNES: Thank you. Your request for a post-hearing brief period is granted.

Are there questions from the Panel?

PANEL MEMBER GOSSARD: Mr. Korsmeier, on Exhibit A, how often does Kings County send you notification of adjustments in hauling rates?

MR. KORSMEIER: Mr. Gossard, I indicated earlier about the fuel adjuster whenever the diesel fuel formula within their formula calculation moves 15 cents either up or down, we will get an adjustment.

In addition, in March of every year there is a wage package increase that deals with the employee benefits and wages. And so we every year get one effective March 1, which again is 30 days since we know we're going to get some further increases than what we have right now, but we don't know what they are and couldn't incorporate them today. We get one March 1st of every year, and then we get one any time the fuel moves by more than 15 cents during a given month.

PANEL MEMBER GOSSARD: Okay. Thank you.

On page 3 of your testimony, the paragraph that starts off with the number two, you're talking about changing the mileage brackets for the 90 to 139 range. And you said that the current split causes some disincentives, but that your proposal would eliminate it. Could you elaborate a little how specifically is a disincentive effecting your members and how would that change the disincentive by changing those brackets?

MR. KORSMEIER: Sure. The bracket prior to the, you know, 2004 hearing was 90 to 139 miles. We have producers in that 100 to 109 bracket that were receiving, you know, higher credit of 50-some-odd cents a hundredweight, which compensated them to move milk into the Class 1 market. It's primarily coming out of the San Diego County area.

But by reducing the -- by changing the brackets to a 90 to 120 and you reduce the allowance from 50-some-odd cents down to 30-some-odd cents, that ended up with a 20-cent-plus disincentive for those San Diego producers and some of our upper San Bernardino County producers to, you know, move milk into the Class 1 market. And actually San Bernardino County would be under the other category anyway. So it's primarily the San Diego producers that are falling into the 100 to 109 bracket. And they are encouraged, at least today, from financial return to go to a local cheese plant instead of coming to the Class 1 market.

PANEL MEMBER GOSSARD: Thank you.

I have some other questions, but did any of the other Panel members want to have any questions in addition? Okay.

On page 4, when you're addressing the transportation credits, you currently haul milk from the northern San Joaquin Valley into the Bay Area. Why did you not ask for an adjustment in that transportation credit?

MR. KORSMEIER: Because we primarily service that market from ranch to plant. And I think, Mr. Gossard, you know, the requested changes we're making are the areas that we're involved in. And as I've indicated on here, we're not requesting any other changes of what currently is in the Pooling Plan or Stabilization Plan other than the ones we're indicating. So if it's -- if a change is not indicated, then we're recommending to maintain what's currently there.

PANEL MEMBER GOSSARD: Finally, I'm back on page 3, there was one follow-up question I did have on the bracket issue. You said, "if our recommendation of mileage brackets are not granted as a result of this hearing, we would prefer to revert back to a single bracket that was in place prior to 2004." At what rate?

MR. KORSMEIER: That would be at the rate of the 53 cents.

PANEL MEMBER GOSSARD: Thank you very much. No further questions.

HEARING OFFICER AYNES: Are there any further Panel questions?

PANEL MEMBER SHIPPELHOUTE: Mr. Korsmeier, on page 2 regarding the receiving area for Southern California, your proposal gives preferential treatment for milk coming from certain counties. One of those that you have in here is Santa Barbara County. And you indicate there are no longer any dairies in Santa Barbara County and therefore that could be struck.

MR. KORSMEIER: That is correct.

PANEL MEMBER SHIPPELHOUTE: If there are dairies still in Santa Barbara, would you suggest or recommend leaving that county in there?

MR. KORSMEIER: Yes, I would. But I think I have direct knowledge that there are not any -- there are none, excuse me. There are none. But yes, if you can find one, then we should keep it in there.

PANEL MEMBER SHIPPELHOUTE: I can do that.

MR. KORSMEIER: Okay.

HEARING OFFICER AYNES: Further Panel questions?

PANEL MEMBER IKARI: Just a couple of questions.

Mr. Korsmeier, I think in your response to Mr. Gossard, you indicated 15 cents per month. Is it accumulated, or does it have to occur in the month?

MR. KORSMEIER: It could be accumulated over a period of time, Mr. Ikari. Whenever it moves by 15 cents, then the next month it is adjusted. So we could go -- we would like to be in a position where we could go five or six months before there's a 15 cent increase, but that's not what we've experienced the last year. But it's an accumulation. Once you reach that accumulation of 15 cents up or down, then you would adjust it the next subsequent month.

PANEL MEMBER IKARI: Okay. I'm curious if we can explore your comment at the bottom of page 1 where you talk about producer should be responsible for local hauls. And I'm mindful of the Department exhibits where transportation allowances cost the pool the most money. I'm also mindful of the exhibit where there appears to be a lot of milk in Southern California that is not going to Class 1. Are you supportive of the minimizing the cost to serve the Class 1?

MR. KORSMEIER: As a general principle, yes, Mr. Ikari. I think we're looking at Southern California that, you know, it is a deficit market. It's been declared a deficit market for years. There are some existing non-Class 1 plants there that have been supplied by that market, and we've always looked at that as a total market, you know, responsibility to supply and certainly understand and appreciate the -- I think the thrust of your question about local milk should go into Southern California, and there would not be maybe as much of a need coming out of Kern County.

But our position -- and our Board's been supportive of that. And it's been certainly a part of their cost that they believe that that market as it presently stands should continue to be supplied as it has been in the past. And as milk moves out, that milk should be covered by transportation allowances out of the Kern County area primarily. And, you know, they look at that like other producers look, and rightfully so, that's an additional cost to them. But we believe those current markets that are other Class 1s should still be supplied. And it's part of the overall need for plant capacity in the state of California, if nothing else. We'd like to keep those plants operational.

PANEL MEMBER IKARI: So I take it from your testimony then that CDI would not support increases in the transportation allowances in the Southern California area, even a penny or two pennies, as a means to encourage more of the local milk to move to the fluid usage.

MR. KORSMEIER: By decreasing?

PANEL MEMBER IKARI: No, increase the transportation allowance in Southern California.

MR. KORSMEIER: Oh, local increase in Southern California.

PANEL MEMBER IKARI: Right. And thereby perhaps reducing the need for further distant milk and hopefully reducing the total cost to the pool.

MR. KORSMEIER: I just think your example of 1 or 2 cents is, you know, certainly not going to be sufficient to change that disincentive. But our Board, yes, could get comfortable in recommending a higher allowance for the Southern California producers to supply that local market. We could be in support of that. But, again, at the level of 1 or 2 cents you're talking about, I don't believe that will change the balance any, you know, as far as the supply.

PANEL MEMBER IKARI: What do you think it would take?

MR. KORSMEIER: I think it would be more than any of us would be comfortable in increasing, simply because of the fact that there are existing markets there that need to be serviced. And it is to the benefits of all producers those markets are serviced.

So, I mean, you'd be talking, you know, 20-plus cents probably. And none of us could get comfortable with that number as far as increasing in Southern California. Because then you're totally offsetting the cost of the local haul. And that's not something that -- you know, that's not a principle that we're supportive of. And because if we increased to the level I think we would have to increase, your local Chino producers or Southern California producers would virtually a zero haul.

And even with that, I don't think for certainly a short period of time that that's going to change the milk movement because of the requirement of those plants --

other plants in Southern California would be too much.

PANEL MEMBER IKARI: Thank you. I have no further questions.

HEARING OFFICER AYNES: Are there any further Panel questions?

PANEL MEMBER SHIPPELHOUTE: Just a follow up on Dave's questioning.

Are you aware of anybody that would be proposing to increase those rates high enough to try to encourage that local milk into the Class 1 plants?

MR. KORSMEIER: No, Mr. Shippelhoute, I'm not aware of it. I might find out before the day's over, but I'm not aware of it now.

HEARING OFFICER AYNES: Are there any further Panel questions?

Thank you for your testimony.

MR. KORSMEIER: Thank you.

HEARING OFFICER AYNES: Representatives of Hollandia Dairy, Security Milk Producers Association, Western United Dairymen, and Dairy Farmers of America will now receive 30 minutes each to present their alternative petitions. Testimony shall be received in the following order: Hollandia Dairy, Security Milk Producers Association, Western United Dairymen, and Dairy Farmers of America.

Would the representative of Hollandia Dairy please come forward?

PANEL MEMBER IKARI: Does not appear that anybody is here.

HEARING OFFICER AYNES: Does not appear that anybody is here to represent Hollandia Dairy. So we will move on to Security Milk Producers Association. Would the representative of Security Milk Producers Association please come forward? Would you give your name for the record and spell your last name, please?

MR. PERKINS: Good morning. My name is Hank Perkins, P-e-r-k-i-n-s.

(Thereupon Mr. Hank Perkins was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. PERKINS: I do.

HEARING OFFICER AYNES: And do you wish to submit this document as an exhibit?

MR. PERKINS: Yes, sir.

HEARING OFFICER AYNES: And your document will be identified as Exhibit Number 45.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 45.)

HEARING OFFICER AYNES: You may begin your testimony.

MR. PERKINS: Mr. Hearing Officer and members of the Panel, my name is Hank Perkins, and I represent Security Milk Producers Association, a cooperative of dairymen serving the Southern California Class 1 market. The Board of Directors of Security Milk Producers Association has approved this testimony at their January 18th, 2006, meeting. We would like to thank the Department for calling this hearing to address the milk movement incentives within the Pooling Plan for the market milk.

Our first proposed change is to add San Bernardino County to the Southern California receiving area. Security Milk Producers Association currently supplies one fluid milk processor in San Bernardino County. As we all know, the Southern California milk supply has been disappearing at an increasing pace. The latest hauling data compiled by the Dairy Marketing Branch shows a decline of 30 percent in Chino and Corona and San Bernardino area from April 2004 to August 2005. Currently, the plant is supplied with local milk. But as available supplies dwindle, transportation allowances need to be extended to plants in San Bernardino County to ensure them a stable supply of Class 1 milk. This is based on historical shipments of local milk into San

Bernardino County. The cost to the pool would be approximately $2,000 per month to implement this change.

We are also proposing an increase in the transportation allowance for the Southern California receiving area. It was only 18 months ago that we were here representing testimony regarding increased hauling costs. Since that time, fuel costs have risen dramatically. The Department of Energy diesel fuel graph shows a 43 percent increase in diesel fuel prices from April '04 to December '05. At the previous hearing, SMPA requested the allowance for the over 139 mile bracket to be increased to 74 and three-quarters hundredweight. Today, we request the allowance for this bracket to be raised to 76 cents.

In the same time period, SMPA has seen its transportation costs from Tulare County to the Los Angeles basin increase by more than 5 cents per hundredweight. As of the end of December, our haul rate from Tulare to Los Angeles was a-dollar-six, including fuel surcharge. Copies of invoices from our independent milk haulers showing rates and surcharges are attached to our written statement. Using a local haul rate of 30 cents leaves us with a shortfall of 76 cents hundredweight when diesel fuel prices peeked in October. Our effective haul rate was 1.19, giving us an 89 cent shortfall.

According to information provided by the Milk Pooling Branch, nearly three-quarters of the milk produced in Kern County from December '04 through November '05 has moved into the Southern California market area. Also, it has become increasingly difficult to obtain dairy permits in Kern County. With the need for more milk in the Los Angeles basin and most of the available supply in Kern moving south, milk will need to move to Tulare area to satisfy the Class 1 market in Southern California.

In regards to the other mileage brackets, SMPA supports the request of CDI for increases. The rates suggested by CDI accurately reflect actual hauling costs from those areas. We feel the changes requested by CDI are justified due to the escalating fuel costs.

Per the Department's analysis of proposals, our requested adjustments result in a cost to the pool of approximately 250,000 per month. We recognize this is a significant amount, but feel it is justified to cover increased freight costs to bring fluid milk into the Southern California marketplaces. We realize fuel prices fluctuate through the year making it difficult to project hauling costs and determine appropriate allowances. While diesel prices have fallen considerably since the October '05 peak, they are once again on the rise. It is apparent that high fuel prices have become a reality, and they must be addressed.

The specific language of our requested changes to the Pooling Plan for Market Milk is as follows: Section 921.2(e) for plants located in Southern California receiving area which shall consist of counties of Los Angeles, Orange, Riverside, San Bernardino, and Ventura, from zero to 89, 12 cents per hundredweight; over 89 through 109, 32 per hundredweight; 109 through 139, 53 per hundredweight; and over 139, 76 per hundredweight.

And we would like to make a note that we would support a fuel adjuster of some sort if there was to -- if the Panel came up with something.

On behalf of Security Milk Producers Association, thank you for the opportunity to present our testimony today. We would like the option to submit a post-hearing brief for clarity of our position if necessary.

HEARING OFFICER AYNES: Your request for a post-hearing brief period is granted.

Are there questions of the Panel?

PANEL MEMBER SHIPPELHOUTE: Mr. Perkins, you indicate that you would support a fuel adjuster similar to what CDI testified to and what DFA has in their proposal.

MR. PERKINS: That's correct.

PANEL MEMBER SHIPPELHOUTE: In the DFA proposal, those rates would change every time there was a 5 cent change in diesel fuel prices. If I understand CDI's testimony correctly, they would look at that change in the area of 15 cents. Do you have any sense of where you folks might be comfortable with, what you would recommend?

MR. PERKINS: Our current fuel surcharge changes on a 5 cent rate at this time. But whatever the Panel would come up with that you feel it would be justified for the industry we would be comfortable with at this time.

PANEL MEMBER SHIPPELHOUTE: Thank you.

HEARING OFFICER AYNES: Are there further questions of the Panel?

PANEL MEMBER IKARI: Mr. Perkins, I tried to go through the document really quick. But is there a documentation for your request for the 76 cents that shows the blended costs of your haul?

MR. PERKINS: It's located on the back of our testimony. There's three rate hauling on the back, invoices that show the accurate hauling costs. Our current rate is 90 cents a hundredweight. And at an 18 percent fuel surcharge we're being charged currently, that shows it there.

PANEL MEMBER IKARI: Okay. One of the -- I note the difference between the rate you've asked for and the rate CDI asked for in that bracket. Could the cost that you're being incurred reflect a smaller volume, or how do you explain the difference in the cost?

MR. PERKINS: Well, we take our fuel surcharge rate that we have with our current hauling rate, and our rate is what it is. And it's been that way. It's been higher than the others for a while. But I'm not real sure. Maybe the volume of milk they move may be the reason their rate's a little lower.

PANEL MEMBER IKARI: Okay. Thank you.

HEARING OFFICER AYNES: Further Panel questions?

Hearing none, thank you for your testimony.

Testimony shall now be received from Western United Dairymen. Will the representative please come forward and provide us with your name and the spelling of your last name?

MS. LA MENDOLA: Good morning. My name is Tiffany LaMendola, L-a-m-e-n-d-o-l-a.

(Thereupon Ms. Tiffany LaMendota was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MS. LA MENDOLA: I do.

HEARING OFFICER AYNES: Do you wish to submit this document as an exhibit?

MS. LA MENDOLA: Please.

HEARING OFFICER AYNES: Your document is identified as Exhibit Number 46.

(Thereupon the above-referenced document
was marked by the Hearing Officer as
Exhibit 46.)

MS. LA MENDOLA: Mr. Hearing Officer and members of the Hearing Panel, my name is Tiffany LaMendola. I'm the Director of Economic Analysis for Western United Dairymen. Our association is the largest dairy producer trade association in California representing approximately 1,100 of the state's dairy families. We are a grassroots organization headquartered in Modesto, California. An elected Board of Directors governs our policy. The WUD Dairy Programs Committee met December 8th, 2005, to analyze the CDI petition, discuss transportation issues, and to make recommendations to the Board of Directors. The Board of Directors met December 16, 2005, and January 20th, 2006, to approve the position I will present here today.

Our current system. When the pooling system was implemented in California, contractual arrangements between producers and processors were eliminated, and incentives to ship to a fluid plant likely a longer distance was 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.

Thirty-seven years have passed since the implementation of the pooling system. Many things have changed, and 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.

Many producers look at their own hauling and fuel costs and wonder why they should also be required to fund transportation incentives. Transportation costs to dairymen increased in step with those of the processing plants, yet there's no way for many producers to recoup the added expenses. This is a hard concern to address. Those producers in support of funding the transportation incentive system would likely offer the following points.

First, 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. Allowances on ranch to plant shipments constitute the largest share, about 94 percent, to the cost to the pool from the transportation system. The use of transportation credits on plant to plant shipments has declined rapidly.

2. The transportation system is not perfect. However, it serves the function of helping to maintain California's Class 1 markets and returning those dollars to the pool. Even though Class 1 utilization in the state has declined, it is still in a producer's best interest, at least financially, to protect the Class 1 market. According to the Department figures, Class 1 alone returns nearly ten times the cost of the transportation system to the pool.

Third, producers who service the Class 1 market should be rewarded. Without incentives to ship to more distant fluid plants, supplies available to the Class 1 market would likely dwindle. Processors would be forced the pay larger over-order premiums to attract the milk and would likely opt to obtain milk from out-of-state sources or relocate out of California. The rational manager will do whatever costs his plants the least amount of money.

Though there is support and rationale to maintain the current transportation system, upon review of the materials released by the Department in preparation for this hearing, our Board of Directors raised several concerns. It is apparent there are flaws in the current milk movement system that need to be addressed. However, it is also apparent that there are no easy solutions.

Dynamic changes continue to evolve within the state. While this hearing does not deal with major changes, it is becoming clear that at some point this industry may need to seriously consider how we can adapt the system to meet current and impending challenges. For instance, evidence shows that Southern California milk supply continues to decline. The cost of the transportation incentive program has surpassed $2 million in recent months, a cost far in excess of what anyone would like to see. As availability of milk in Southern California deteriorates, how will we continue to address the need to supply the Class 1 market yet minimize cost to the pool?

At the same time that the California milk supplies are declining and more milk is being shipped to greater distances, there's a great deal of local milk use for non-fluid purposes, such as cheese. This is troubling as the cost to move milk further distances continues to escalate. We ask the Department to consider what can be done to attract more local milk to the Southern California fluid market while also reducing costs to the pool.

These are just a few concerns. Issues like this are numerous. We will touch on a few additional problems in the remainder of our testimony. Though we do not pretend to know all the solutions to these problems, we encourage the Department to be cognizant of them as they recommend changes.

Basic criteria. Our Committee and Board both agree with and continue to support guidelines set forth by the Department during the last hearing with respect to setting transportation incentives.

First, producers who serve the Class 1 market ought to be rewarded.

2. The closest milk to the market ought to move first.

3. A regulated system ought to attempt to minimize costs to the pool.

We strongly encourage the Department to stay committed to these basic tenets in their review of the proposals at hand and in their recommendation to the Secretary.

In addition to the basic tenets outlined above, our Board was able to come to agreement that a common sense approach should be used in setting transportation allowances. That is, to the greatest extent possible, allowances should be based on data from the Department. This is the most reliable data available to the industry as a whole. However, we are a bit constrained due to the fact that the hauling rate data for August 2005 is outdated at this point and not representative of the changes requested by the petitioner. Therefore, we must also take the current climate into consideration when looking at the requests put forth.

We agree with the basic guiding principles that have historically been used -- through transportation allowances, shippers should be made indifferent when choosing to ship milk locally or to the more distant and presumably a higher usage plan. We also agree with the Department that a shortfall should continue to exist in the structure of any area receiving a transportation allowance to encourage the closest milk to move first.

Western United's alternative proposal. Western United Dairymen's alternative proposal calls for the elimination of transportation credits for condensed skim. Our Board has numerous reasons for supporting this amendment.

First, the movement of condensed skim into Southern California has undergone a major change in the last year. Using Department data, appropriate credit rates, and differentials, one can estimate the pounds of condensed skim moved between various regions. While a great deal of condensed skim was once supplied to Southern

California by the south San Joaquin Valley, this is no longer the case. In fact, there has been a large increase in the pounds of condensed skim eligible for credits from within Southern California. Data indicates that is now the case that nearly all the condensed skim demanded from Southern California is supplied from within that region. It should be noted this change occurred even with the condensed skim credit available to move the product to south San Joaquin Valley.

The Department released Figure 8 at the pre-hearing workshop. It compares the cost to the pool of moving condensed skim via transportation credits to moving a comparable amount of ranch milk via transportation allowances to Southern California. At first blush, this figure seems to make the argument that credits for condensed skim should not be eliminated because it is less costly to the pool to move condensed skim via credits than moving a greater amount of ranch milk via allowances.

However, while we do not question the accuracy of this figure, we do feel it is a bit misleading. Recall the current supply situation for condensed skim in Southern California. It is not being supplied by the south San Joaquin Valley. Rather, it is being supplied from within Southern California. The ranch milk is already being moved there and then subsequently manufactured into condensed skim.

Our proposal does not change the competitive situation all ready in place. Our proposal does not result in a shift of condensed skim being supplied by, say, Tulare, to being supplied from within Southern California. Even with credits available, not to mention the differential, to plants in the southern San Joaquin Valley, that change has already taken place. Figure 8 depicts an option that is not currently available and an option that has proven unsustainable for reasons we're not privy to.

So given the current dynamics, how do we follow the basic tenets outlined above, namely minimizing costs to the pool? Clearly, eliminating the credit for condensed skim is an easy answer. Given that producers are already funding the transportation of ranch milk to Southern California, they should not also be required to fund the transportation of a manufactured product plant to plant in Southern California. In fact, data from the Department indicates there is currently some milk that receives a transportation allowance and then a transportation credit, namely on the condensed skim supplied from Los Angeles. This "double-dipping" is far beyond the original intent of the transportation incentive system developed in California, increases costs to the pool, and was even a concern of the Department in the last Hearing Panel report. There is no justification for producers to cover this additional cost.

The Hearing Panel report from the June 4, 2003, transportation hearing supported the addition of a credit on condensed skim. The Panel writes,

"There's one specific concern that the Panel has regarding its proposed credits for condensed skim. It may be possible for a plant to receive an allowance for incoming milk and then a credit for the condensed skim that leaves the plant. The Panel discussed prorating the allowance against the credit. However, it decided to monitor the situation as it unfolds."

We urge the Panel to heed their own charge and fix the situation that has unfolded by recommending to the Secretary WUD's alternative proposal.

In addition, and to address the condensed skim supplied to the Bay Area that are eligible for credits, it must be recognized that producers already fund a fortification allowance on condensed skim used for fortification purposes. In fact, the receiving plant that purchases condensed skim for fortification receives a credit from the pool of 9.87 cents per pound solid nonfat. According to the October 2005 pool report, 5.45 million pounds of solid nonfat were eligible for the condensed allowance.

Using the Department's estimation of the 31.6 solid nonfat test in condensed skim solid nonfat pounds equate to about 17.3 million pounds of condensed skim. Over twelve months, this adds up to over 207 million pounds of condensed skim used for fortification purposes. Given that during the period November 2004 through October 2005, 50.7 million pounds of condensed skim were eligible for transportation credits, compared to the 207 million used for fortification statewide, one can assume that a great deal of that product also received a condensed fortification allowance.

Producers should not be responsible for moving a manufactured product plant to plant that is already greatly subsidized through fortification allowances. The goal of assuring supply to the Class 1 market is sufficiently provided through transportation allowances and transportation credits on milk.

We urge the Department to eliminate the transportation credit for condensed skim. Its existence, even coupled with the differential, could not maintain what the Department has shown as less costly plant to plant movement of condensed skim. Obviously, the availability of the credit has done nothing but increase costs to the pool, allowing the same milk to receive transportation allowances and credits, and the same products to receive transportation credits and fortification allowances.

Given the current dynamics in the industry, if the Department wants to follow their basic tenant of reducing cost to the pool, then credits on condensed skim will be eliminated. Clearly, the tangible savings offset any potential costs to the pool.

CDI's petition. We support the transportation allowance increases requested by CDI. To the best of our knowledge, the requested increases are cost justified and necessary to maintain an adequate supply of milk to Class 1 markets. Unfortunately, we do not have access to hauling rates or milk movement data other than what is provided by the Department. As we have witnessed over the past year, the elements of hauling costs are in constant flux. Given the constant changes and given the latest hauling cost figures released by the Department are dated August '05, we must rely on the figures provided by CDI to glean a better understanding of current conditions. We appreciate the fact that CDI adjusted their original petition to reflect declines in diesel prices.

We are supportive of CDI's recommended changes to the Southern California supply counties and brackets that aim to deal with certain areas being overcompensated for their hauling costs through transportation allowances. Under no circumstances should producers make money off the transportation allowances. This is not the purpose of the transportation allowances and it unnecessarily increases costs to the pool.

We also agree with CDI's proposal for the furthest out brackets in the San Diego receiving area. According to the Department, nearly all the milk moved within transportation allowances is less than 100 miles from the qualifying plant. If data warrants the small increase in the local allowance, then it should be adjusted. However, there is no reason for larger rates for further out brackets if the milk from those areas is not needed to sufficiently supply the one processing plant located in San Diego County.

Though we are testifying in support of CDI's transportation allowance proposals, there is one concern of our Board that should be noted. CDI informed participants at the workshop they are now being forced to move a greater amount of milk from areas beyond Kern County to fulfill needs in Southern California. This explains the reason for the requested larger increase in the 139-plus mileage bracket. Data from the Department supports the fact that a great deal of milk is being shipped long distance to Southern California. However, the same data shows, as mentioned above, that a great deal of local Southern California milk is not being utilized as Class 1.

Rather than being forced to increase the allowance in the furthest out bracket in order to attract sufficient amounts of ranch milk to Southern California, we would rather see some of Southern California milk that is currently being supplied to other classes be used for fluid purposes. We cannot propose a means to accomplish this goal. Did the addition of a closer in bracket in Southern California from the 2003 transportation hearing improve the situation by attracting more local milk? We don't have appropriate data to tell. Perhaps the competitive situation from milk in Southern California created by non-fluid plants precludes this shift from occurring. We can't say. However, we urge the Department to analyze this situation carefully. Doing so would ensure the basic tenets outlined above are followed.

Increase in transportation credits for milk and condensed skim. We do not support CDI's request for an increase in transportation credits for condensed skim due to the fact we do not support any transportation credits on condensed skim. Our reasoning was fully outlined above.

With respect to transportation credits on milk, excluding condensed skim, our Board supports cost justified increases to transportation credit in so much that the resulting credits do not cost the pool more money and moving the equivalent amount of milk via transportation allowances.

At the last transportation hearing in 2004, it was recognized by the Panel at that prior hearing and against recommendations of the Panel, transportation credits were increased. The increase threw off the level playing field, providing a greater net draw from the pool for milk moving plant to plant than for the same amount of milk moving ranch to plant. Data presented by the Department in Figure 7 indicates that given the current rates and differentials, it is still more cost effective to move milk via allowances rather than credits. Given any potential increases in allowance or credits, we urge the Department to maintain a level playing field.

A few additional points are worth noting. According to the Department, historically, "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." We know the tailored milk moved plant to plant via transportation credits likely demand premiums in the marketplace. Given the Department decides to make no adjustments in the current credit rates, this premium, which is not pooled, can be used by processors towards the costs of hauling the tailored product plant to plant.

Finally, we urge the Department to address the fact that ranch milk moving into Los Angeles receiving area and then subsequently out of Los Angeles as tailored milk is charging the pool both an allowance and credit. Producers should not be required to fund this. According to Department figures, in the instances where this occurs, the pool loses more money than if the milk had originally moved plant to plant from the Southern San Joaquin Valley. Again, we have no specific recommendations to solve this problem. However, we hope the Department takes this situation into consideration in their deliberations.

Hollandia's alternative proposal. We do not supported Hollandia's alternative proposal. The increase in the allowance rate for the furthest out bracket in San Diego receiving area goes against the basic tenets support by our Board. The increase proposed by Hollandia far exceeds the allowance requested by CDI. Furthermore, Department data indicate that very little milk is currently being moved to the San Diego receiving area from over 139 miles. Our Board assumes that the increase requested by Hollandia would result in either overcompensation on the small amount of milk that is moved this distance or encourage more milk to move from the furthest out bracket. We cannot support either outcome.

Similarly, we cannot support their proposed increase in transportation credit from Los Angeles to San Diego from the current 34 cents to the proposed 60 cents. The proposed increase does not appear to be cost justified and greatly exceeds the level of 36 cents proposed by CDI.

Security's alternative proposal. We do not support Security's alternative proposal. The requested substantial increase in transportation allowances for the furthest out bracket supplying Southern California goes against the basic principle by encouraging the closest milk to move first. The requested increases are larger than those proposed by CDI and run the risk of costing the pool unnecessary dollars. A shortfall larger than that proposed by Security in this bracket should be maintained.

Other than the fact that there is only one fluid milk processing plant in San Bernardino County, we do not know enough about the milk supply situation for that plant to comment on the addition of that county to the Southern California receiving area. The added cost to the pool should only be borne if conditions warrant it. We ask the Department to carefully analyze this request.

DFA alternative proposal. We do not support DFA's alternative proposal for automatic adjustments in the allowance rates based on fluctuations in diesel fuel prices. We have a number of concerns surrounding this proposal.

First, fuel is only one component in the total hauling cost. It is easy to assume that fuel is the largest contributor to changes in hauling rates. However, data from the Department would argue differently. The Department's regression analysis in Figure 10 identifies an interesting point that should be considered when analyzing the DFA proposal. According to Department analysis, in August 2005, the weighted regression analysis suggested that fixed rate was now about 31 cents, up 9 cents per hundredweight of product, while the variable rate was 39 cents, up 2 cents per hundredweight -- hundred miles per hundredweight product. It would not be responsible to automatically adjust allowances based on diesel fuel fluctuations given there are other cost components that are more volatile.

The Department outlined similar concerns in their analysis on a proposed index to make allowance in 2001 citing that changes should not be made based only on one cost factor when other factors could be moving in the opposite direction. According to the Department, using only one component of cost makes no sense if another component of cost is moving in the opposite direction. In addressing a proposal for indexing put forth in 2001, they say,

"The specificity of the proposal also causes some concern. The proposal singles out a line item from the data, and makes price adjustments based on the line item's relationship with a baseline figure. If the proposal were accepted, it would then be logical to propose a similar amendment for other costs that increase by more than the baseline."

CDI was clear at the workshop that their proposed adjustments to the transportation allowances included other cost elements beyond diesel fuel prices. However, in looking at the Department's analysis of the two proposals, we see that the DFA proposal results in allowance rates similar and at times hire than those proposed by CDI. However, CDI's proposal takes into consideration multiple cost components, while the DFA proposal deals only with diesel fuel. Given this, it can be assumed that the fuel adjuster proposed by DFA may be inflated. At the very least, it raises concerns over determining an appropriate adjuster.

We pose a few questions to the Department. Would an automatic adjustment based solely on fluctuations in published diesel prices take into consideration any long-term contracts or risk management exercise that the processing plant may have taken part in to reduce their costs? Would we ever see a sustained drop in diesel prices, or will prices continue on a long-term upward trend? Does an automatic adjustment discourage competition for lower hauling rates?

It seems to us that the Department considers many factors at each transportation hearing. In particular, how will the Department continue to maintain a level playing field between the cost of shipping milk via transportation credits and allowances? Depending on the answer to these questions, we very well could end up in the situation where extra hearings are called just to deal with inappropriate adjustments to allowances that were a result of an automatic adjuster.

As a producer group not directly involved with the marketing of milk, we rely on data from the Department and testimony provided by processors to glean an understanding of fluctuations in hauling costs and milk movement patterns. Transportation hearings give the industry an opportunity to share their knowledge. Given the implementation of an automatic adjuster, how can producers monitor the accuracy of the resulting rates? It is only through the hearing process that we can acquire data on milk movement and associated costs to make informed decisions relating to specific rates for specific mileage brackets, supply counties, deficit counties, needed shortfalls, et cetera. The list goes on and on.

Finally, DFA offered the suggestion at the workshop that hearings could be called to make adjustments to allowances due to fluctuations and other cost components. Given the time and effort expended by the Department and industry for a hearing, we argue that we should continue to monitor all cost factors at once. DFA was unable to provide a firm recommendation on how often automatic adjustments should be made. We very well could end up having the same or even additional hearings under this scenario. Given that the hearing process in California is expeditious, we recommend staying with the current setup of evaluating transportation allowances. To quote the 2001 hearing Panel once again,

"The Department has on a historical basis demonstrated it can make needed adjustments in allowances in a timely manner when sufficient data is provided."

We thank you for the opportunity to testify and request the option to submit a post-hearing brief.

HEARING OFFICER AYNES: Your request to submit a post-hearing brief is granted.

Are there questions of the Panel?

PANEL MEMBER SHIPPELHOUTE: Tiffany, on page 2 of your testimony, the bottom paragraph, you indicate producers who service the Class 1 market should be rewarded. What did you have in mind when you were making that statement?

MS. LA MENDOLA: I think that just goes along with the basic tenets that we outlined that the Department has historically followed and basically shows support from the allowance system in place. You're providing the allowances to those producers who currently serve the Class 1 market.

PANEL MEMBER SHIPPELHOUTE: Later in your testimony, page 6, the top paragraph, you indicate under no circumstance should producers make money off the transportation allowances. I'm trying to balance those two statements. It seems to me that a reward for the producers most commonly would be a financial reward.

MS. LA MENDOLA: Oh, I see what you're saying. I think in this case we're saying an allowance should be provided to help cover the costs of hauling to the fluid plant to provide an incentive. But we don't think that that allowance should in any way exceed their actual hauling costs. And that seems to be at least what we're being told is the case for some producers in that certain area. They're actually making money off doing it. I don't think -- we're not arguing that they should make money. We're just saying an incentive should be provided if they choose to do that.

PANEL MEMBER SHIPPELHOUTE: Thank you.

HEARING OFFICER AYNES: Yes.

PANEL MEMBER LEE: In a prior testimony by Gary Korsmeier, he was asked by Dave Ikari about his views on increasing transportation allowance for the local haul for producers to Class 1 plants. What is your position on that?

MS. LA MENDOLA: We really didn't -- our Board did not take a position on that. Other than the small increases that were included in CDI's petition, I think there was a one cent increase in the local haul. Because it wasn't an alternative proposal or included in the petition, we did not take a position on that. So I can't really say.

PANEL MEMBER GOSSARD: Ms. LaMendola, on page 4 and again on page 7, you addressed the issue of double-dipping. And to some extent you say eliminating the condensed skim transportation credit will deal with this. But in reality wouldn't the best way to eliminate the double-dipping is to eliminate the transportation credit for plants in Los Angeles County?

MS. LA MENDOLA: I guess, you know, that would be one way to address it. I think I also suggested that we don't have a proposal to deal with that. I think -- I don't know what the Department meant in their quote as far as prorating the allowance against the credits. You know, I would have liked to have known more about that. But it wasn't discussed at the workshop. And so I guess I can't really find out anything about that until after the hearing. I don't have a solution to it, other than it seems to be costing the pool unnecessary money twice.

PANEL MEMBER GOSSARD: And on top of page 6 you're addressing the San Diego proposal of CDI, noting that there is an adequate milk supply at the moment. But with the decline of milk production in Southern California, how long is that moment going to last?

MS. LA MENDOLA: I wish I knew. I think your guess is probably as good as mine. I mean, right now there's basically no milk moving from that for this out bracket, so I'd like to think it would last a while. But I don't really have a good feeling for that down there. Someone else probably would.

PANEL MEMBER GOSSARD: My final question deals with page 7, the Security Milk Producers proposal. You say you did not support their proposal, but you seem to be stressing the rate increase, the 139-plus bracket. Is it that part of the proposal that you find objectionable? Or is there problems with their other rate proposals at the closer end brackets?

MS. LA MENDOLA: That was the one that was most troubling to our Board, just because it was so much larger than that requested by CDI. And that really goes against those basic tenets. The closer ones are larger than CDI's as well, and it is CDI's proposal that we are in support of.

PANEL MEMBER GOSSARD: Thank you.

PANEL MEMBER IKARI: I just have a couple of questions. I'll call you Tiffany.

MS. LA MENDOLA: You're not going to try my last name?

(Laughter)

PANEL MEMBER IKARI: Off the record.

Tiffany, you mentioned in your testimony the Department should consider what can be done to attract local milk -- more local milk to the Southern California fluid market. And then later on page 6 you talk about providing the Department with discretion to propose means to accomplish this goal. You raise a couple of questions about, did the closer bracket in Southern California improve the situation of attracting local milk. But you're really very general in terms of that and rely totally on the Department's discretion. And I wonder if you can be a little more specific as to the types of changes the Western United would support or the Department should consider.

MS. LA MENDOLA: Yeah. I mean, I wish I could. It just wasn't something that our Board took a position on, other than we're concerned about it. And the way to solve it is obviously hard, or it probably would have been done by now. I really can't sit here and give you a specific way, because there is no certain way that our Board can support it.

PANEL MEMBER IKARI: Perhaps you can consider that in a post-hearing brief. But the dilemma for the Department is in making a decision that we're basically legitimating a decision, one of the purposes of the hearing process is to expose concepts and proposals and get input. And doing it totally independently just by Department discretion is a sensitive issue, one in which we would take great caution in doing. And so any information and guidance that you could provide in terms of maybe the rate or increasing the rate or whatever, maybe further brackets, whatever you can think of certainly would help. Thank you.

HEARING OFFICER AYNES: Are there further Panel questions?

PANEL MEMBER LEE: Yes. Regarding the proposal to completely eliminate transportation credits for condensed skim, would your group be interested in having a partial credit, whereas longer distance condensed skim would still receive transportation credit?

MS. LA MENDOLA: I think at this point they've taken the position to completely eliminate credits for condensed skim, regardless of where it travels to or how long a distance.

PANEL MEMBER LEE: Thank you.

HEARING OFFICER AYNES: Are there any further Panel questions?

PANEL MEMBER SHIPPELHOUTE: Tiffany, on page 2 of your testimony, bottom of the page, paragraph two, you point out the Class 1 alone returns nearly ten times the cost of transportation system to the pool. How did you calculate that?

MS. LA MENDOLA: I had contacted the Department a while back and asked what the returns to the pool from the Class 1 revenues were. And I'm just comparing that to the per hundredweight cost of the transportation system. It's not quite ten times. But if you add in the Class II and III revenues, it would be.

PANEL MEMBER SHIPPELHOUTE: Do you know if that was calculating the difference between the Class 1 price and the lower 4a, 4b, how was that done?

MS. LA MENDOLA: I believe that's how they did it. They assumed the milk would go into 4a rather than into Class 1 if I recall. So that was 50 cents a hundredweight versus the cost of the transportation system earning around 6 cents a hundredweight.

PANEL MEMBER SHIPPELHOUTE: On page 3 in your basic criteria, number 3, regulated system ought to attempt to minimize the cost to the pool. Would you agree that the additional revenues that you mentioned in 2 are a result of the regulated system?

MS. LA MENDOLA: I'm sorry. The revenues I mentioned -- oh, back here?

PANEL MEMBER SHIPPELHOUTE: Yes.

MS. LA MENDOLA: Are a result of the regulated system?

PANEL MEMBER SHIPPELHOUTE: Correct.

MS. LA MENDOLA: Yeah. I think we're supporting that notion.

PANEL MEMBER SHIPPELHOUTE: Okay. Thank you. No other questions.

HEARING OFFICER AYNES: Are there any further Panel members?

PANEL MEMBER IKARI: One additional question.

There was two concepts. One was the 5 cent that Security -- DFA proposed, and Gary Korsmeier testified at 15 cents. Would you favor one over the other?

MS. LA MENDOLA: I don't think we're in favor of either one. And the 15 cents, unfortunately, because we have no opportunity to analyze that for the workshop or prior to this hearing. You know, that's hard to comment on. But our Board was opposed to the basic policy idea of an automatic adjuster.

PANEL MEMBER IKARI: I understand you're opposed to the concept, but wouldn't a 15 cent adjuster move it more slowly, adjust you know the allowance?

MS. LA MENDOLA: It could. I guess it depends on how frequently you do it. Again, we didn't see any data on it. If you're looking at it every month or every quarter, I don't know how often, you know, the proposal would be to adjust it. I think there's just a lot of holes there that we don't really understand how it would be implemented.

PANEL MEMBER IKARI: Thank you.

MS. LA MENDOLA: I'd have to know all that detail to really answer that question.

HEARING OFFICER AYNES: Are there any further Panel questions?

Thank you for your testimony.

Now we will receive the testimony from Dairy Farmers of America. Would the representative please come forward? Would you state your name and spell your last name for the record?

MR. STUEVE: Gary Stueve, S-t-u-e-v-e.

(Thereupon Mr. Gary Stueve was sworn,
by the Hearing Officer, to tell the truth,
the whole truth and nothing but the truth.)

MR. STUEVE: I do.

HEARING OFFICER AYNES: And do you wish this document to be entered as an exhibit?

MR. STUEVE: Yes.

HEARING OFFICER AYNES: This will be Exhibit Number 47.

(Thereupon the above-referenced document
was marked by the Hearing Officer as
Exhibit 47.)

HEARING OFFICER AYNES: You may begin your testimony.

MR. STUEVE: Mr. Hearing Officer and members of the Hearing Panel, thank you for the opportunity to testify here today. My name is Gary Stueve and I'm Vice President of Fluid Milk Operations for the Western Area Council of Dairy Farmers of America. And I'm here today with the approval of our Board in a meeting held on

January 17th.

We currently market the milk of 300 member producers in California as well as the milk from nearly 100 non-members. We market nearly one-forth of our milk to non-Class 4 plants with the majority of the remaining volume going to Class 4b cheese plants. Because nearly one-forth of our milk enters non-Class 4 plants and potentially qualifies for transportation allowances, we have submitted an alternative proposal dealing specifically with transportation allowances. Our testimony deals only with necessary adjustments due to changes in diesel fuel prices. I will not be testifying on other milk movement incentives at this time. I appreciate the opportunity today to provide comments as well as an explanation of our alternative proposal.

I would like to preface my testimony by stating our position is twofold. First, we have submitted changes to the milk pooling plan as they relate to transportation allowances for four specific receiving areas. Second, we are separately proposing the addition of a fuel adjuster formula to the pooling plan that would allow for automatic fuel-related adjustments to transportation allowances for all current receiving areas. I would also like to point out that we have made slight adjustments to both of these proposals versus what we provided in our original proposal.

I would like to thank the Department for the analysis of our proposal that became available yesterday afternoon. As I mentioned, we have made some slight adjustments, but nothing drastically that changes our proposal.

We have provided in our exhibit the changes we feel are necessary and justified for four specific receiving areas. Situations exist, from a Transportation perspective, whereby there is less incentive to move milk to Class 1 markets. In Tulare, for example, the net, net haul after transportation allowances for delivery to Los Angeles is approximately 42 cents. Local deliveries in the Tulare area are approximately 29 cents. Although historically shortfalls have been maintained, the increases in fuel surcharges have created shortfalls that are too large. Fuel-related freight cost increases from Kern and Tulare Counties to Los Angeles from the North Valley to the Bay Area have risen from 9 to 15 cents per hundredweight since August 2004, while local rates have risen only 2 to 3 cents. We have included copies of some of our fuel surcharge programs that show the increases due to fuel changes since the last hearing in August 2004.

Secondly, and as indicated in the second part of our alternative proposal, it has become obvious to us throughout this latest hearing process that the volatile up and down movement in fuel prices necessitates the need for a formula-driven fuel adjuster to be used to derive the dollar amount used in transportation allowances. We are advocating the use of a fuel adjuster program similar to the fuel surcharge programs used by the freight companies but modified for use in the pooling plan. In developing a model for a fuel adjuster, we had three objectives: It needed to be accurate; it needed to be as simple as possible; and needed to be trackable.

Like most milk marketers, we have several fuel surcharge formulas in use by our milk haulers. The fuel adjuster model we proposed in our alternative proposal is based in part on one of the fuel adjuster programs we have in place with some of our milk haulers. It has been in place for many years and has served our haulers and us well. This program applies a per hundredweight charge to the freight rate for each 5 cent per gallon movement in the cost of diesel fuel. This per hundredweight charge is then applied to the different freight rates in each specific mileage bracket.

Because the pooling plan utilizes many different mileage brackets, in formulating our model we modified this existing program so that it utilized a percentage change for every 5 cent change in fuel costs, rather than a hundredweight change. Using this information, we calculated a factor of .8 percent change in transportation allowances for each 5 cent movement in fuel cost. By converting it to a percent basis, it can be applied to multiple mileage brackets. The base fuel cost in our model is 2 dollars and 11-and-a-half cents. This is the fuel cost as listed on the Department of Energy website for the week of August 3, 2004, the week of the last transportation hearing. The current transportation allowance would serve as the base rate or the beginning rate for transportation allowances.

On Monday, October 3rd, 2005, the very day that CDI petitioned the state for a hearing, the fuel price listed on the DOE website was $3.26. On December 12, ten weeks later, the price had dropped to 2.46, a drop of 80 cents per gallon. The following week, the week we submitted our alternative proposal, fuel had risen to 2.52. It has continued to rise and at this point is 2.73.

In December and January had fuel continued to decline to the $2.11 level, there may not, strictly from a fuel perspective, have been a reason to conduct a hearing today since $2.11 was the cost of fuel on August 4th, 2004, the date of the last transportation hearing. I think it's safe to say fuel costs and the resultant need to conduct hearings related to fuel costs have been a moving target.

By linking fuel costs used in the fuel adjuster to the DOE website, the industry and public would have easy and ready access to a reliable source of information. Because we experience movements in fuel surcharges each month, it would be our suggestion that adjustments for transportation allowances for all receiving areas be made monthly using the average fuel costs from the prior two months.

We have supplied in our exhibit a revised fuel adjuster schedule using the .8 percent factor. After careful evaluation, we determined this to be more accurate and cost inclusive than the .7 percent we originally proposed.

We also corrected a minor error, the base fuel is listed incorrectly. We had incorrectly listed it the week prior to the hearing in August 2004 instead of the week of the hearing. We have attached and provided to the Panel several backup documents, and I would like to briefly explain what we've provided.

Document Number 1 in the upper right-hand corner, this is the proposal that we're making the first part of our alternative proposal for the changes to the four specific receiving areas, the Bay Area, Sacramento, North Bay, and Southern California. We actually constructed this using our fuel adjuster formula, and we used $2.75 fuel when we put this together. And I think this illustrates a moving target. When we put this together two or three weeks ago, fuel was quite a bit less, and it's continued to move up. At this point, an adjuster using 2.75 is rather modest.

Document Number 2, this is our fuel adjuster formula. This is what it would be for the month of January, the current month. And if you notice in the box for current fuel, we've got 2586. That's the average fuel on the DOE website for the prior two months, so for November and December. And the resultant transportation allowances are in the second column. This also uses the .8 percent factor.

Document Number 3 merely shows how we arrived at the 2586. This is again the average for November and December.

Document Number 4 merely shows what it would be moving forward under this plan, and for February we would use December-January fuel. You see we have a drop of about a penny a gallon on average. That in itself would probably not be enough to trigger any change in transportation allowances.

Document Number 5, I just included this for informational purposes. This is our fuel adjuster, the same factors, the same beginning base fuel. But I put in the peak of 3.26 that occurred that first week of October. And gives an idea to the Panel of what those costs would have translated to to the transportation allowances.

The next three documents, 6, 7, and 8, this is the actual fuel surcharge program that we have in place with four of our haulers. And it's the one I alluded to earlier that we used as a guide in putting together our adjuster. This particular fuel surcharge program adjusts based on every 5 cent change in fuel, and it calculates a per hundredweight charge.

I would like to point out that the fuel costs at the top for this particular fuel surcharge is not from the DOE website. It's from an independent source. But the arrows that I've drawn in below do indicate what the resultant fuel surcharge was. And in this first page, document 6, is January '06, the current month.

Document Number 7 is November '05 when our fuel under this program peaked at just a little bit over $3 a gallon. You see what the fuel surcharges were.

And then Document 8 is August '04, the date of the last transportation hearing to compare the change in rates.

Documents 9 and 10 is a fuel surcharge calculator. This is a fuel surcharge program we have in place with only one of our haulers. But it is worth mentioning they haul about 35 loads a day for us, so we felt it was worthwhile to include it. I actually on the bottom of Document 10 included another box where I calculated what the actual fuel surcharge was using an average fleet rate for those mileage brackets with fuel at 2.11 as it was in August of '04 and at 3.26 where it was in October. This particular hauler using this program actually calculates their fleet rate weekly. So they don't bill us necessarily every week. But they calculate it weekly so that we see all the peaks and we see the drops. It goes up quicker, but it also comes down quicker.

Document Number 11 is another hauler we've got, again being used by single hauler. They haul 30, 40 loads for us. Rather simple, take DOE current fuel minus the base fuel divide by eight and come up with a percentage that they apply.

Documents 12 and 13 is another fuel surcharge program in place by one of our haulers. This is a rather limited use. It's used basically for one longer distance haul. Basically shows about a 1 percent -- or is a 1 percent change for every nickle in fuel.

I would like to thank you for the opportunity to testify today. I do request the opportunity to submit a post-hearing brief, and I would be happy to try to answer any questions the Panel may have.

HEARING OFFICER AYNES: Your request to submit a post-hearing brief is granted.

Are there questions from the Panel?

PANEL MEMBER GATES: Mr. Stueve, on page 2, you talk about where you picked up the 5 cents per gallon of movement for that one for several haulers or certain amount of milk that you have there. Could you tell me how much milk is representative of your total by the 5 cent -- you know, by those haulers?

MR. STUEVE: Okay. This ties back Documents 6, 7, and 8. This basically is that fuel program. And this probably is about 60 percent of our California milk.

PANEL MEMBER GATES: Thank you.

PANEL MEMBER GOSSARD: I had a question on Attachment 6. You mentioned that the figure for January '06, the 2.4198 per gallon was not a DOE figure. Now, in your programs, are your adjustments based on DOE figures?

MR. STUEVE: Yes.

PANEL MEMBER GOSSARD: Okay.

MR. STUEVE: Because it's public information. And generally speaking, the figure that we have here that's not DOE is at a different level. But generally the tracking the movement up or down is roughly the same as the DOE.

PANEL MEMBER GOSSARD: Now, is there a possibility that any of your haulers could have contracted for fuel and their fuel costs would be significantly different than what you're suggesting with the suggestion?

MR. STUEVE: Yeah. I would imagine it is possible. We would not have knowledge of that, of the specifics of that.

And, again, I think our primary concern is that movement up or down in fuel and not necessarily where the fuel is at. I understand your point, if they over contracted, they may not have some of those up or downs, but we would not have a direct knowledge of that.

PANEL MEMBER GOSSARD: So your contracts are written such that it's based on the DOE going up and down, and what they charge you is based on that, the adjustments?

MR. STUEVE: Yeah. This particular program here is the only one that's not. Every other fuel surcharge that we have from a hauler is based on DOE.

PANEL MEMBER GOSSARD: But you said this 6, 7, and 8, that's about 60 percent of your milk, though?

MR. STUEVE: Yeah, off the top of my head, 50 to 60 percent, yes.

PANEL MEMBER GOSSARD: Thank you very much.

PANEL MEMBER LEE: I have a question, Mr. Stueve. Western United had spoken about your proposal in their prior testimony and their concerns over an automatic adjustment. Do you have any comments related to any of those comments?

MR. STUEVE: Only that I think maybe I can elaborate on a comment that I made at the workshop, and that's that this is fuel related only. And we would propose that this would be handled very similar to the way we deal with our haulers. And they deal with us with fuel as a separate issue rather than anything else. I mean, anyone that procures transportation services knows their hauler will come to them sometimes about insurance and workmens' comp and non-fuel issues, too.

So my only comment would be this deals with fuel and would still leave you the opportunity -- because the current transportation allowances would be your base rate, it would still leave you the opportunity to come and make adjustments to those for any other reason. And it wouldn't necessarily result in an additional hearing, because, basically, I mean we got this worked out accurately. For the most part it takes fuel off the table. And now you're dealing with on the transportation allowance side just non-fuel issues, if we've done the fuel part correctly.

PANEL MEMBER LEE: But you also did mention about long-term contracts. Could you speak to something to that effect on long-term contracts on fuel and how would that affect your proposal?

MR. STUEVE: Well, it wouldn't necessarily, unless we were privy to those long term. Those fuel contracts are the business of our haulers, and we don't have any interest in those or any knowledge of them.

I only suggest that it's possible that they do enter into long-term fuel agreements. But we wouldn't have any direct knowledge of what that is or how they work.

PANEL MEMBER LEE: Thank you.

PANEL MEMBER IKARI: Mr. Korsmeier talked about 15 cents, so we have two numbers that have been testified to. You've asked for a post-hearing brief. I request that you -- whatever objective information that you could provide relative to 5/15 cents, why is one number better than the other -- obviously there's different viewpoints. But what objective data can we look at to make a decision on?

MR. STUEVE: Okay. I can elaborate that in post-hearing. I can tell you that the basis for us putting this together was based on that largest fuel surcharge program that we have in place now, the one that's 50 to 60 percent. And that's based on a nickle. But I can elaborate in our post-hearing brief.

PANEL MEMBER IKARI: Thank you.

HEARING OFFICER AYNES: Are there further Panel members?

PANEL MEMBER GATES: Just one more.

Could you elaborate on why you chose the two-month average, or did you look at any other?

MR. STUEVE: Again, the initial thought came from this program that we have that is our largest fuel surcharge program, and it tends to work real well. This program pre-dates me by a lot of years in terms of my affiliation with DFA. And everything I've been able to determine, it's been a very successful program. And it uses the prior two months and flattens out the ups and downs. As you can see, we peeked our fuel at just a shade over $3 and when fuel actually was in excess of 3.25.

PANEL MEMBER GATES: Thank you.

HEARING OFFICER AYNES: Are there any further Panel questions?

Thank you for your testimony.

After a break, we'll be continuing with public testimony. We're going to go off the record for five minutes, and we will reconvene here in five minutes.

(Thereupon a recess was taken.)

HEARING OFFICER AYNES: This hearing will come to order. We are reconvening.

Members of the public may now testify with each speaker provided with 20 minutes, followed by questions from the Panel. To ensure the accuracy of today's hearing record, I request that each witness state your name and spell your last name, swear or affirm to tell the truth and nothing but the truth, identify the organization that you represent, state the number of members of your organization, and state the process by which the organization finalized your testimony today.

The first on the public testimony will be Geoffrey Vanden Heuvel. Please state your name and spell your last name for the record.

MR. VANDEN HEUVEL: Geoffrey Vanden Heuvel. First name, G-o-e-f-f-r-e-y, V-a-n-d-e-n, H-e-u-v, as in Victor, e-l.

(Thereupon Mr. Geoffrey Vanden Heuvel was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. VANDEN HEUVEL: Yes.

HEARING OFFICER AYNES: And are you representing an organization?

MR. VANDEN HEUVEL: I am.

HEARING OFFICER AYNES: What organization is that?

MR. VANDEN HEUVEL: Milk Producers Council.

HEARING OFFICER AYNES: And what's the number of members of your organization?

MR. VANDEN HEUVEL: Approximately 100.

HEARING OFFICER AYNES: And by what process did the organization finalize your testimony today?

MR. VANDEN HEUVEL: The Board of Directors at the January 2006 established positions which this testimony represents.

HEARING OFFICER AYNES: Did you wish to submit this document as an exhibit?

MR. VANDEN HEUVEL: Yes.

HEARING OFFICER AYNES: This will be Exhibit Number 48.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 48.)

HEARING OFFICER AYNES: You may begin your testimony.

MR. VANDEN HEUVEL: Thank you, Mr. Hearing Officer and members of the Panel. I'm Geoffrey Vanden Heuvel. I'm a dairy producer with operations in San Bernardino and Riverside Counties. As I stated previously, I'm testifying on behalf of Milk Producers Council.

Milk Producers Council does not oppose the cost justified rate adjustments to the transportation allowances proposed by the petitioner. We do not in theory oppose cost justified adjustments to transportation credit rates, but we reiterate our long held position that transportation credits which subsidize plant to plant movement of milk should not cost the producer pool any more than subsidizing a similar amount of ranch to plant milk movement to transportation allowances.

Milk Producers Council agrees with Western United that the transportation credit should not apply to condensed skim. Condensed skim is a value-add product and not milk, and therefore should not qualify for a credit out of the pool.

We do not have the expertise to agree or disagree with the petitioner's request to adjust the mileage brackets for Southern California receiving area. But we do not think that the Department should go back to designating supply counties for transportation allowances. Distance from the market should be the criteria for establishing transportation allowances.

Finally, we oppose the automatic fuel cost adjuster for the transportation subsidy system. While we know that fuel prices can fluctuate significantly, we do not think that the Department should completely remove the risk inherent in the milk transportation business by putting the producer funded subsidy on auto pilot. Fuel surcharges are more appropriately negotiated between buyers and sellers. This latest round of fuel cost increases combined with a significant reduction in the Southern California milk supply should be a wake-up call to the industry that new business arrangements will need to be negotiated which will provide additional funds from the market to pay for the movement of milk to the Southern California Class 1 Market. The current transportation subsidy system will not be sufficient over the long term to assure an adequate supply of milk for that Southern California market.

Let me just add and reiterate here that it's not inconceivable -- I mean, diesel fuel hit 3.26 or 3.25, I think was the testimony, a gallon. It's a very volatile situation in the Middle East as we know. You put this fuel surcharge in where it automatically adjusts, and diesel fuel goes to $5 or higher, and that's not out of the realm of possible. And the pace of moving production out of Southern California is increasing. And what this really points out -- and I'll say as a producer, it's a little disturbing to hear the testimony that's happened already from those advocating a fuel adjuster. There ought to be a fuel adjuster, but it ought to be negotiated between the sellers of milk and the buyers of milk trying to get a fuel adjuster.

I think producers have acknowledged that we have an obligation to pay for transportation to the market. But that was in a context which is rapidly changing. And Class 1 differential is a pretty static number, and we're going to get to a point where just about all that value of that increase in Class 1 price is going to go to freight the milk to the market. When you look at the transportation credit comparing with the area differential, we're well over a dollar a hundredweight.

And I think we've got to re-evaluate this. That's not the subject of this hearing. But you will signal, the Department will, what direction you would like the industry to go in the future. I think putting an automatic fuel adjuster in the transportation subsidy system is the wrong direction to go, and it will take the pressure off of those who market the milk, the co-ops, take the pressure off of them to actually negotiate a fuel surcharge with the buyers of milk who ultimately should bear the costs. We have to be able to push these transportation costs through the marketing chain and not roll them back on producers.

So I also would like to add in Mr. Ikari's questioning of Mr. Korsmeier and also some of the other witnesses as to whether the transportation allowance should be increased or it could be increased in Southern California to attract more of that local milk. I think that Milk Producers Council advocated for many years that the transportation allowance should cover the Southern California producers. For many years, the Southern California producers were excluded from being able to be eligible for transportation allowances as opposed to, say, the Sacramento producers who were eligible for many years.

And I think you've seen that with the implementation of the transportation allowance for Southern California producers, there was an incentive for the co-ops who represented those Southern California producers to actually go back after Class 1 businesses in Southern California, at least that seems to be the result. We've had a very favorable turn of events in the last couple of years in terms of, you know, the Southern California production seeking Class 1 markets and trying to serve them.

So, you know, money moves milk. And more money moves more milk. And that's pretty much of a truism. And so there is a number out there. And I don't agree with Gary that it would take 20 cents additional to move

Southern California milk to the Class 1 market. Milk will move for significantly less amounts of money than that.

Now, obviously, other buyers in Southern California, non-Class 1 buyers, would be unhappy to see the transportation allowance go up, because they would have to match it or get more competitive to get milk. But if the Department's intention is to try to increase the incentive to get Southern California milk to move to the Class 1 market, I would say a 5 cent adjustment would definitely get some folks' attention, and 10 would get a lot. So there would be a lot of pressure by the Southern California producers that remain to be looking at those Class 1 markets if that transportation allowance were increased.

So whether that's a good policy decision or not I'm not commenting on at the moment. But I might after consultation with my colleagues think about that in a post-hearing brief, which I would like permission to submit.

But my own opinion is that increasing that allowance in Southern California 5 to 10 cents would definitely create an incentive to be more aggressive in going after that Class 1 market.

So thank you for the opportunity to share our views, and I'd be happy to answer any questions.

HEARING OFFICER AYNES: You requested to submit a post-hearing brief?

MR. VANDEN HEUVEL: Yes, I did.

HEARING OFFICER AYNES: That request is granted.

Are there questions from the Panel?

PANEL MEMBER GOSSARD: Mr. Vanden Heuvel, two questions. Actually, they're somewhat related.

You mentioned at the end of the testimony the significant reduction in the Southern California milk supply and the need to look at an alternative system over time. How much time do we have? How much longer do you envision that milk supply in Southern California increasing at its current rate until it's all gone? Or how much time do we have to look at a new system?

MR. VANDEN HEUVEL: We've got a while. You know, I mean, I think we've got a couple of years. And, you know, it depends -- the development is happening relatively fast. I think just about every dairy in Chino is sold. You know, there's been a business arrangement that has been entered into where there's a buyer and a seller. But there's a lot of these properties that are in fairly long escrows, three- to five-year escrows. And just watching this, you know, living in it every day, you know, the things really tend to slip.

And the developers are very sensitive to the overall economy. And as interest rates go up, the last thing they want are new houses they can't sell. So they're very sensitive to that.

So we've had quite a rash in the last 24 months. And I think those show up in your numbers, and the pace will continue. But I don't know that it necessarily will accelerate. I think it will stay fairly steady as these things roll out. So I think we do have a little bit of time.

We also have a very large cheese plant there in Corona and what their future is and what their decision is is going to have an impact. If you're looking at supply in Class 1 milk market in Southern California, what the Corona cheese plant does is a factor that you can't ignore. So, you know, those owners seem to desire to keeping it going, at least in a near term, and we're greatful that they do do that, because we need that plant to stay open and functioning at the moment. So I would say it's something we need to start thinking about. But it's not -- I don't think it's imminent that is something that's going to happen in the next 24 months.

PANEL MEMBER GOSSARD: And to follow up, has Milk Producers Council given any thought to what sort of alternatives there might be to the current allowance and credit system to get milk to Southern California?

MR. VANDEN HEUVEL: Well, one is in regards to the fuel -- and I refer to it in my comments -- it's critical that if we're going to have extraordinary fuel costs to transport milk, there needs to be a mechanism where those come out of the buyers and that we don't roll back -- we don't roll back on producers after a certain amount of baseline. There's still support for the transportation subsidy system as it currently exists.

As we move out, you know, I think there isn't a clear answer. And it may become more clear as it evolves through time. But because it depends on, you know, independent decisions of other plants, too. We really don't know what people may decide to site Class 1 plants in the future. So I don't think the picture is clear, is why I say we need to be thinking about it. But I don't have an answer for you.

PANEL MEMBER GOSSARD: Thank you very much.

HEARING OFFICER AYNES: Are there further Panel questions?

PANEL MEMBER IKARI: Geoff, would the concept of placing a cap or limit on how much the fuel adjuster could increase, would that modify your reservation about the fuel adjuster? You mentioned $5 gas or $5 fuel. Suppose that within a period of time, say twelve months or six months, or you pick the time period that it could increase by X amount and then, you know, if it went beyond that, this would require a need for a hearing to look at the whole transportation allowance and credit issue.

MR. VANDEN HEUVEL: You know, I guess looking at the kind of the real world results, if the fuel adjustments are staying in a fairly narrow range, you know, what's the point? When you really need the fuel adjuster is when it's really high. And my point is it's time for our co-ops to negotiate in their contracts with the buyers the fuel adjuster. And if you guys do it and they can fund it out of the transportation subsidy system out of the pool, why should they do that? Obviously, the buyers are going to resist it.

But the greatest argument to the buyer for why we need to have that is because we may be looking at those kinds of numbers potentially, and we'll need a way to cover those costs. And covering them out of the producers pool is not the way -- in the producers -- if that were to happen, we'd be facing the same problem. So I think you've really got to make a policy decision. And I really don't think that a good -- there's an argument for a fuel adjuster. But I don't think it's a -- I don't think it's -- in our opinion, it does not rise to the level of justifying doing it. And if you put a cap in it, then you kind of defeated the ultimate purpose of it, which is that the pool picks up these fuel adjustments. And if they're in a fairly narrow range, then there's no reason why we can't deal with them on a regular basis in terms of we have a transportation hearing generally every 18 months or so. And to get the modest -- you know, the general cost drifts, we can take care of it that way. And if there's going to be greater fuel impacts than that, then they ought to be coming out of the other end and not out of the producer pool.

PANEL MEMBER IKARI: Finally, in your testimony you indicate distance from the market should be the criteria for establishing transportation allowances. Don't you support that the Department should consider cost of the haul and impact on the pool and try to minimize the cost to the pool?

MR. VANDEN HEUVEL: Yeah. I think the Department has to consider all those things. The Department did make a fundamental policy change a number of years ago, which I thought was positive, which was to get away from picking winners and losers and go to a more equitable way of establishing these rates.

And, you know, I think you may remember Milk Producers Council at one point had an alternative proposal where we suggested identical rates for the whole state, and all Class 1 would be eligible. And, you know, we didn't bring that proposal forward for this hearing.

You know, the Department clearly struck a balance between recognizing uniqueness situations in particular with regards to receiving areas and the milk that supplies those receiving areas, and yet still recognizing that, you know, anybody could -- if this plant in this particular area really is a deficit plant and needs milk to be brought to it, is it fair? The Department apparently determined it wasn't fair to say, well, we want this milk to come from a particular county or that county, but we won't reward another county in a similar area.

And I think Imperial County which has been trying to develop a dairy industry there for some time has in the past, you know, really argued that they were discriminated against by that policy direction. And I think it is important to note that kind of imbedded in CDI's proposal -- which while we support their rate adjustments if they're justified by the costs, we do not support their breaking out of these counties and going back. We understand why they're doing it, but we don't support that.

And it is important to note while CDI did include Imperial in their Southern California receiving area and the San Diego receiving valley, and I believe there's only one plant there so it may not be a big deal, but they did reduce the rate and changed it, which would impact Imperial. And potentially Imperial could be a supply county to a San Diego plant. So there is some imbedded policy change in the CDI proposal that the Department will need to consider. And I think I've expressed our views on that matter.

PANEL MEMBER IKARI: Thank you.

HEARING OFFICER AYNES: Are there any other Panel questions?

Thank you for your testimony. We have four more people who have signed up to testify. So hopefully we can keep moving and complete this hearing without having a break for lunch.

Let's continue. Next witness would be Andy Zylstra.

Would you state your name and spell your last name for the record.

MR. ZYLSTRA: My name is Andy Zylstra, Z-y-l-s-t-r-a.

(Thereupon Mr. Andy Zylstra was sworn,
by the Hearing Officer, to tell the truth,
the whole truth and nothing but the truth.)

MR. ZYLSTRA: I do.

HEARING OFFICER AYNES: What's the organization that you represent?

MR. ZYLSTRA: California Dairy Campaign, CDC.

HEARING OFFICER AYNES: What's the number of members of that organization?

MR. ZYLSTRA: Approximately 350.

HEARING OFFICER AYNES: And by what process did the organization finalize your testimony today?

MR. ZYLSTRA: At our Board of Directors meeting on December 22 of '05.

HEARING OFFICER AYNES: Did you wish to submit this document as an exhibit?

MR. ZYLSTRA: Yes.

HEARING OFFICER AYNES: Okay. Your document will be identified as Exhibit 49.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 49.)

HEARING OFFICER AYNES: You may start your testimony.

MR. ZYLSTRA: Thank you. Mr. Hearing Officer and members of the Panel, my name is Andy Zylstra. I'm a dairy producer from Turlock, California. I'm testifying today on behalf of the California Dairy Campaign, CDC, which represents more than 350 dairy producers throughout the state of California. CDC speaks today also on behalf of the farm and ranch members of the California Farmers

Union CFU. The testimony I'm presenting today is based on positions adopted by the CDC Board of Directors at our December 22nd, 2005, Board meeting.

The California Dairy Campaign opposes the petitioner's request to increase the transportation allowances. We believe that an increase now so soon after the previous one is not only unjustified, but leading the dairy industry in the wrong direction. Higher costs are not just plaguing processors, but hitting dairy farmers as well. In addition to significantly higher input costs, recent milk prices paid to producers will plummet 15 to 20 percent below the cost of production. This is not the time to reduce producer prices even further.

Increased energy prices in 2005 have taken a tole on everyone across the state, including dairy farmers. Processors are certainly not alone when it comes to higher input costs. Producers' costs have also continually increased over the last 5 years, reaching $14 per hundredweight in some areas.

The September 2005 CDFA production cost summary is the most recent data currently available to determine producer cost and it is conceivable that these costs will go up even more over the next few months. Some might claim that the higher milk prices during the last year offset the higher costs now being incurred by producers, but it is important to recognize that since March 2002 the average dairy has accumulated net income of negative $200,000 due to the fact that producer prices have been below break-even levels for considerable periods of time. See attachment, please.

Now just this month, despite producer and government programs, commodities used to set prices received by producers have reached a two-and-a-half year low. These low prices coupled with record high input costs are going to be devastating to the dairymen. CDC is opposed to the increase in the transportation allowance, because it will compound the growing problem of producer prices not covering our costs of production.

The best solution to cover processors' rising costs is for processors to raise the selling price of their product. The marketplace should pay for this cost of doing business. After all, the increase in fuel prices is the result of poor public energy policy, and dairymen should not have to pay for this failure.

When producers pay to subsidize processors' transportation costs, it eliminates any incentive for plants to efficiently transport milk. As dairy farms relocate throughout the state, plants should operate in areas that enable them to efficiently transport milk from producers to consumers. The processor is responsible for delivering milk from the producer to the consumer, and they are well paid to meet this responsibility. Producers do not have the profit opportunity enjoyed by processors and should not be forced to pay for the unwillingness of processors to cover their costs through the marketplace.

The California Dairy Campaign would like to thank the Department for the opportunity to present our views today. We would also like to request the opportunity to submit a post-hearing brief. Thank you. And if the Panel has any questions, my colleague and I would take this opportunity to answer them.

HEARING OFFICER AYNES: Your request to submit a post-hearing brief is granted.

Are there questions of the Panel?

PANEL MEMBER GOSSARD: On the second page of your testimony, you make the statement, "after all, the increase in fuel prices is the result of poor public energy policy." Could you elaborate on what energy policy you are addressing here in that statement?

MR. ZYLSTRA: I'll turn it over to my colleague, Scott Magnuson.

MR. MAGNESON: The higher price in energy could be related to not being self-sufficient in energy. It could be related to alternative energy sources not being thoroughly investigated. It could be the result of conservation through higher efficiency in cars and other means. So I think public policy has a lot to do with energy prices.

HEARING OFFICER AYNES: Excuse me. What was your name again, please?

MR. MAGNESON: Scott Magneson, M-a-g-n-e-s-o-n.

(Thereupon Mr. Scott Magneson was sworn, by the Hearing Officer, to tell the truth, the whole truth and nothing but the truth.)

MR. MAGNESON: I do.

PANEL MEMBER GOSSARD: My second question, I'm looking at the first page, the second paragraph. You say this is not the time to reduce producers' prices by increasing the allowances. But doesn't an increase in the allowance merely re-distribute money from some producers to other producers? Isn't it all still producer money? Isn't it all going to producers?

MR. MAGNESON: Why would -- I don't think that it's justified to charge everybody to move milk that goes into the allowance goes into one or two producer's hands.

PANEL MEMBER GOSSARD: Thank you.

PANEL MEMBER IKARI: I just have a question on the sources of the table, the accumulated income and monthly income. Where is this data obtained?

MR. MAGNESON: The cost of production, most of it's from CDFA. The cost of production index is where the costs were. The blend price is data that's derived from literature that you put out. The other data is an estimate of average producer hertz size and producer production numbers. So I think that the numbers are general. But the indications are that regardless of the exact numbers that we use, the indication is that there was a huge amount of debt that was incurred by the average dairyman in the state. And that even though these high prices over the last few years, that debt still hasn't been erased.

PANEL MEMBER IKARI: So the sheet that says accumulated income and monthly income, is a table that you developed?

MR. MAGNESON: Yes.

PANEL MEMBER IKARI: Based on the cost production and based on other things?

MR. MAGNESON: Yes.

PANEL MEMBER IKARI: Could you document what you did, what your methodology is to put that table together for that chart?

MR. MAGNESON: Yes.

PANEL MEMBER IKARI: Because without it, you don't understand where it came from. Thank you.

PANEL MEMBER SHIPPELHOUTE: Following up on that same line of questioning, I have similar questions on that same number and in part based on your answers.

Am I understanding you correctly that part of that negative 200,000 is an accumulated debt that was carried forward from the time period prior to March 2002?

MR. MAGNESON: Yes. Well, and if you'll see that that's when it went from the cumulated net income in March went from a positive to a negative at that time. And since that time, we've been -- because the prices were below cost of production, that debt's been accruing. Until the prices improve and the net incomes were in the positive, and that started to erase some of the accumulated loss.

PANEL MEMBER SHIPPELHOUTE: And on a policy question, you indicated you don't think it's fair for the transportation allowance to be paid by all for money that goes to a few. Is that an accurate or fair summarization of your comment?

MR. MAGNESON: Well, I think that we would like to see any transportation costs eventually be paid by the marketplace and not have to be paid by producers.

PANEL MEMBER SHIPPELHOUTE: That kind of begs the question in my mind -- and perhaps you can give me your response to this -- and that is, what about the additional Class 1 revenues that are paid into the pool that is being paid by that milk that's being supplied by a few? And by additional Class 1 revenues, I'm referencing moneys above say the Class 4a or 4b price the Class 1 bottlers are paying.

MR. MAGNESON: I mean, we support the pool, and we support cap, but the cost of moving that milk should be paid by the buyer. I mean --

PANEL MEMBER SHIPPELHOUTE: Well, there are those that would argue that the higher Class 1 price that the bottlers are paying is a payment for those transportation costs. And I'm looking for your comments on those arguments.

MR. MAGNESON: Well, I don't how to restate what I've said, that we believe that the transportation should be paid by -- any increase should be paid by the buyers and passesd on to marketing instead of coming out of producers' pockets.

PANEL MEMBER SHIPPELHOUTE: No further questions.

HEARING OFFICER AYNES: Any further Panel questions?

Thank you for your testimony.

MR. MAGNESON: Thank you.

MR. ZYLSTRA: Thank you.

HEARING OFFICER AYNES: William Schiek.

MR. SCHIEK: Very good.

(Laughter)

HEARING OFFICER AYNES: Would you state your name and spell your last name?

MR. SCHIEK: My name is William Schiek, S-c-h-i-e-k.

(Thereupon Mr. William Schiek was sworn,
by the Hearing Officer, to tell the truth,
the whole truth and nothing but the truth.)

MR. SCHIEK: I do.

HEARING OFFICER AYNES: What organization do you represent?

MR. SCHIEK: I represent the Dairy Institute of California.

HEARING OFFICER AYNES: And what is the number of members?

MR. SCHIEK: We represent approximately 40 dairy companies operating in California.

HEARING OFFICER AYNES: What was the process used by the organization to finalize your testimony?

MR. SCHIEK: It was approved by our Board -- unanimously by our Board of Directors.

HEARING OFFICER AYNES: And did you wish to submit this document as an exhibit?

MR. SCHIEK: I do.

HEARING OFFICER AYNES: Your document will be identified as Exhibit Number 50.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 50.)

HEARING OFFICER AYNES: You may proceed with your testimony.

MR. SCHIEK: All right. Thank you.

Mr. Hearing Officer and members of the Hearing Panel, since I've just already said who I am, I'm going to skip the first paragraph. So if you're following along, start with the second.

Dairy Institute appreciates the opportunity to testify today and to comment on the proposals by California Dairies, Dairy Farmers of America, Security Milk Producers, Hollandia Dairy, and Western United Dairymen, which are under consideration at this hearing. We commend the Secretary for his willingness to consider updating the regulatory framework in which our members operate to make it reflective of current market conditions.

At issue in this hearing are proposed changes to the milk movement incentives contained in the Pooling Plan and the Stabilization and Marketing Plan for Northern and Southern California. The broad purposes of milk movement programs have been identified as follows:

First, to assure adequate supply of milk to plants which provide Class 1 and Class 2 usage product to consumers.

Second, to assure that higher usage (Class 1, 2, and 3) have a priority in terms of milk movement incentives to producers.

And, three, to encourage the most efficient movement of milk to fluid usage plants.

The enactment of milk pooling in 1969 fundamentally altered the relationship between Class 1 processors and suppliers. Prior to pooling, the higher plant blend price that was paid by Class 1 plants provided a positive incentive to attract milk to the highest use. During the discussions leading up to the Gonsalves Milk Pooling Act, producer representatives, in exchange for processor support, made a commitment to ensure that Class 1 plants would be served. From the beginning, it was recognized that fluid plants by virtue of the higher minimum prices they pay should be able to procure necessary milk supplies without having to subsidize the haul cost to their plants.

The current system of transportation allowances and credits in California developed after a period where milk movement incentives were limited primarily to area differentials and location differentials on quota milk, a system which is somewhat similar to the location differentials employed at federal orders. Over time, the consolidation of marketing areas, growth in milk production, changing production and distribution patterns, and unique California geography necessitated new milk movement mechanisms.

The transportation credits and allowances both came into being in the early 1980s. The general principle behind transportation allowances was that they should compensate dairymen for the difference between the local haul to a manufacturing plant and the long haul to the more distant fluid milk plant in the metropolitan area. In the absence of such incentives, producers would have an incentive to ship their milk to a manufacturing plant and a disincentive to serve a fluid milk market. When the transportation allowance fully compensates producers for the difference between the local haul and local haul, they will be indifferent as to where they ship their milk.

With respect to transportation credits, the principle was 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 marketing area Class 1 differentials. Historically, the transportation credits and allowances have been set at levels that do not fully compensate handlers for their shipping comments. A shortfall in hauling compensation with respect to more distant milk was supported by Dairy Institute in the past based on the assumption it would encourage more efficient milk movements. The extent of the shortfall needed to encourage ordinary movement has been and continues to be a subject of debate. As I will discuss in more detail later, we believe application of the shortfall concept should be limited to the most distant milk supplies only.

We continue to believe that a milk movement incentive system is necessary in order to meet the statutory mandates and guidelines governing industry. In recent years, the industry has continued to evolve and has undergone considerable structural change. Consolidation of supplying cooperatives and fluid milk processors has changed milk production and distribution patterns. It is, therefore, appropriate to review the existing system of transportation allowances and credits to determine if changes are necessary. This usual review is made all the more critical when we consider the changes in milk supply structure which are taking place across the state but nowhere more impressively than in Southern California. A recent feature article in the Los Angeles Times has chronicled the changing scene in the Chino basin as dairies move out to be replaced by housing developments.

I included that article as Attachment 1 behind my testimony.

Quotes from various members of the dairy industry in Southern California foretell a rapid contraction of the Southern California milk supply. The implications are obvious. To supply the fluid processing plants in the L.A. basin, rapidly increasing quantities of milk are going to be trucked in from outside the area. While the growing milk supply in Kern County is an obvious choice to supply the market, it has become apparent that not all this milk is able to serve the Southern California fluid market. Milk has been moving to Southern California from Kings, Tulare, and Fresno Counties to meet the Class 1 demand, and it appears likely that increasing quantities from these areas will be needed in the future.

We believe it is consistent with the purposes of milk stabilization and with the commitments made by producer leadership at the inception of milk pooling that milk should be attracted to Class 1 plants at order prices. Unfortunately, some have held the incorrect view that the sole purpose of the Class 1 price differential is to enhance producer income, instead of recognizing that in part the differential was designed to ensure that Class 1 markets are served.

Another notion that has been troubling to Dairy

Institute's membership has been the belief expressed by some that over-order premiums should be relied upon as the primary means to attract milk for fluid purposes. We continue to maintain that the existing order prices paid by processors provide more than enough revenue to attract milk for Class 1 and mandatory Class 2 purposes, and that marketing and pooling plans should provide the milk movement incentive mechanisms which are adequate to ensure that those uses are served.

In general, Dairy Institute supports proposals that seek to make cost justified adjustments to transportation allowance and credits. Costs for diesel fuel have increased significantly over the past few years. In recent months, the price has become quite volatile. The aftermath of the Gulf Coast hurricanes sent diesel fuel prices soaring in the autumn 2005, but prices returned almost as dramatically by year-end. And Attachment 2 is a graph and table of diesel fuel prices.

Since the beginning of 2006, diesel fuel prices, following price movements in the crude oil market, have begun increasing again as international tensions surrounding Iran's nuclear program have given oil traders concerns about supply interruption.

One thing that appears to be clear is that the current transportation allowances and credits are not reflective of the new energy price realities. At the time when alternative proposals for this hearing were due, Dairy Institute elected not to submit a proposal because of inadequate information about hauling rates. CDFA data, while always useful, was viewed as being somewhat out of date because the reported rates were for August 2005.

By December 2005, when alternative proposals were due, diesel rates had changed substantially. Instead, we purpose to argue for the application of sound economic principles in setting the allowance and credit rates, basing them on the most recent rate and fuel cost information available to the Panel at the time of the hearing. The volatility of the diesel fuel prices make this task difficult. Currently, diesel prices appear to approximate those seen during early August 2005, and it may prove that the rate information provided by CDFA is currently more applicable than we believed earlier.

Notwithstanding the uncertainty in fuel prices and hauling rates, Dairy Institute believes that transportation allowances and credits must be adequate to encourage milk to move to higher use plants in deficit areas. Inadequate rates lead to California Class 1 processors being unable to compete favorably with manufacturing plants for milk supplies and put them at a competitive disadvantage with respect to out-of-state processors. In order to secure the local Class 1 market for California producers, transportation allowances and credits must be adequate to draw milk without transportation subsidization by the buyer or supplying cooperative.

Dairy Institute continues to support the principle that transportation allowance rates should be set equal to the difference between the cost of the local haul and the cost of the haul to the higher use plants in metropolitan markets. A slight shortfall should apply only to the most distant mileage brackets to encourage milk that is located closer to the market to move first.

With regard to milk moving into Southern California, there should be no shortfall on milk coming from as far away as Tulare and Kings County, because of the increasing volumes of milk that are necessary to supply the Southern California market from those areas. The transportation allowance system was meant to address the narrow problem of how to attract milk to fluid plants in metropolitan areas at order prices. However, when setting allowance and credit rates, equity among competing Class 1 plants in attracting milk supplies is something that needs to be considered. This is particularly true when the application of milk movement incentives confers advantages on some Class 1 plants over others. If these advantages would not have existed in the absence of milk movement incentives, then the incentive should be adjusted to both 1) redress the inequitable impacts and 2) ensure that fluid plants are adequately served. With the foregoing in mind, Dairy Institute's position is that fluid milk plants operating within a market should not be disadvantaged relative to each other in the procurement of nearby milk supplies.

Dairy Institute supports the principle that transportation credits should be set equal to the haul cost less any area differential. In the distant past, we have advocated that a shortfall should apply to the more distant milk to encourage more efficient milk movements. However, in recent years, we have advocated full compensation for all but the most distant milk to encourage competition in supplying the Class 1 market. Full compensation is especially important for shipments from the South Valley into the Southern California market as there is an historic pattern of plant-to-plant milk movements. Furthermore, the alternative supplies from Southern California and Kern County do not seem to be adequately available to meet Southern California's needs. Shortfalls in credit rates should only be employed for the most distant milk in Fresno or farther away, and not milk relatively closer in in Kern, Tulare, and Kings that regularly serves the Southern California Class 1 market.

Comments on the specific proposals. Dairy Institute supports cost justified allowances and credits. CDI's proposals for transportation allowances appear to be cost justified based upon the time frame when their proposal was submitted, that is December 21st, 2005. And I note they were updated today to become even more current. However, we would point out that since that time, diesel fuel prices have increased, and I think they've already addressed that.

We also note that CDI's proposal appears to call for a shortfall in the most distant mileage brackets for Southern California receiving area. Again, as we said earlier, given the changing nature of the milk supply in Southern California, we believe there should be no shortfall in allowance rates, except for milk originating beyond Kings and Tulare Counties.

CDI's call for an adjustment in the mileage brackets for Southern California's receiving area cannot be disputed by Dairy Institute, and representatives of cooperatives operating in the region who are involved in arranging for ranch-to-plant shipments are in the best position to determine the appropriate brackets.

We agree with CDI that splitting the Southern California supply areas is warranted given the negative hauling rate that is currently being experienced by producers in the Barstow area of San Bernardino County.

With regard to CDI's proposed rates for San Diego, such changes would be acceptable only if they do not result in plants in San Diego having to subsidize the haul to their plant.

With regard to Northern California, we note that CDI's proposed allowance rates into the Bay Area are basically in agreement with those proposed by DFA. Such changes appear to be cost justified and are supported by Dairy Institute.

CDI's transportation credit proposal would employ a shortfall of about 12 cents per hundredweight with respect to plant-to-plant movements into Los Angeles, and about 5 cents per hundredweight for milk going to Riverside.

Other proposed changes to transportation credits appear to be cost justified. We would argue that since milk moves regularly from more than 139 miles in Tulare County to serve the Class 1 market in Southern California, shortfalls should be negligible, especially since milk supplies in Southern California continue to wane.

Dairy Institute generally supports DFA's proposal to increase transportation allowances in the Bay Area, Sacramento, and North Bay receiving areas. Of particular note is DFA's proposal to automatically update transportation allowances based on an index of diesel fuel prices. Dairy Institute is supportive of this in concept.

Given the incredible price volatility we have been experiencing, indexing may be the only means to ensure that fluid plants will be adequately served. We point out, however, that when utilizing indexing, it is essential that the base scenario is correct. We would agree with Mr. Korsmeier's notion that you start by updating the base scenario before you begin to apply the index. For example, it might be necessary to update the transportation allowances and mileage brackets via a hearing first and then apply the index from that point in time going forward.

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 or so so the base case can be updated. Otherwise, the allowances suggested by the index will become increasingly divorced from the actual rates being charged by haulers. 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.

While we are supportive of the indexing concept, 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. In August 2005, diesel prices were increasing rapidly. About every week they were going up I believe on the order of 15 to 20 cents a gallon. It was almost a vertical line going up on the graph. And it is not clear that in all cases hauling rates were going up in lockstep with diesel prices. Thus, the observed hauling rates might not have reflected the entire price increase in all cases. 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.

Dairy Institute supports the allowance rate changes proposed by Security to the extent that they are cost justified and conform to the general principles we have outlined earlier in our testimony. We note that the proposed allowance rate for the over 139 miles mileage bracket appears to overcompensate producers for the difference between the local haul and the Southern California haul by 2 to 3 cents per hundredweight per CDFA data. Again, that data may not reflect the reality today. But looking at the August data, that appears to be the case.

With regard to Security's proposal to include San Bernardino County in the Southern California receiving area, Dairy Institute is supportive in light of the declining local milk supply, as long as there are eligible plants located in the deficit area of the county, particularly within the Inland Empire region.

We do not have the necessary data to evaluate whether Hollandia's request for changes to transportation allowance and credits is cost justified. To the extent they are cost justified and in accordance with the other principles we have outlined, we would be supportive. However, the proposed changes for the San Diego receiving area put forth by CDI would suggest that Hollandia's proposals are not cost justified.

Western United has proposed the elimination of the transportation credit on condensed skim. It is unclear from the CDFA analysis presented at the pre-hearing workshop that the Western United proposal will result in a net reduction in total cost of the transportation allowance and credit system to the pool. As more and more milk must be drawn from the south valley to meet Southern California's needs, it seems possible that maintaining the transportation credits for condensed skim could reduce the future costs to the pool. Dairy Institute does not support the elimination of transportation credits on condensed skim at this time.

Dairy Institute supports the continuation of the call provisions. Under these provisions, handlers are given an incentive to voluntarily supply milk for fluid uses when the call provisions are implemented. The existence of the call provisions promotes supply handlers building business relationships with fluid customers to voluntarily release market milk such that both seller and buyer can better plan such milk shipments. Without the call provisions, supply handlers would have less of an incentive to build such ongoing relationships, which would exacerbate disorderly and chaotic milk movements in emergency short supply situations.

Dairy markets are unpredictable, and the call provisions are a necessary standby mechanism should they be rapidly and unexpectedly needed. Unanticipated weather conditions, rapidly changing manufactured product prices, and cost price squeezes have caused sudden changes in milk production patterns in the past, and the call provisions have helped maintain milk supply availability. The call provisions are the only means within the marketing and pooling system to make quota milk available for priority uses.

Thank you for the opportunity to testify. I would like to request the opportunity to file a post-hearing brief. And I am willing to answer any questions you have.

HEARING OFFICER AYNES: Your request to submit a post-hearing brief is granted.

Are there questions of the Panel?

PANEL MEMBER GOSSARD: Dr. Schiek, on page 4 of your testimony, the middle paragraph on transportation allowances, you end, "with the foregoing in mind, Dairy Institute's position is that fluid milk plants operating within a market should not be disadvantaged relative to each other in the procurement of nearby milk supplies."

Do your members feel that there is some disadvantage among members in securing supply under the current system? Were you addressing a specific example or general?

MR. SCHIEK: It's more of a general principle. If you make changes, the idea is that you should keep this principle in mind.

We had a situation that we were concerned about at the last hearing where in the North Bay Area there were some proposed changes basically to include Sonoma and Marin and the North Bay into a new receiving area or create a new receiving area. And our concern was that proposed changes in Solano and in sort of the Sonoma/Marin area might result in those areas being able to procure milk in, say, the northern San Joaquin Valley more easily with a greater incentive than processors located in Sacramento. So the idea was you've got three areas competing for essentially the same milk supply. And the notion is you don't set up a credit or allowance system that disadvantages one of those areas relative to the others in the procurement of that supply.

So we just think that's a principle that we'd like to see the Department keep in mind and adhere to in setting allowance rates and mileage brackets and all those.

PANEL MEMBER GOSSARD: But at this point none of your members in those three areas have had a concern based on what was implemented with those changes at the last hearing?

MR. SCHIEK: Right. We're not hearing any concerns at this time.

PANEL MEMBER GOSSARD: My second question is on page 6, first full paragraph, "we would have a greater confidence level if the base case rates were established during a period of relatively stable diesel prices." Is there any chance that we would find -- you had earlier said that you would prefer to start with a current time period rather than going back to the prior period, as DFA did. But can we find a case in a more current time period with stable diesel prices?

MR. SCHIEK: You know, that's a good question. But I'll point out this, that, you know, if you had done it, say, in the month of December, during that month while prices were going up a little bit from 2.46 to around 2.52, that's a relatively modest change within the month. August was unique. I don't know. You've got Figure 1 it's Attachment 2 of my testimony which has the graph of diesel prices. And you look at about the middle of 2005 there's a section I've kind of circled it here where there's basically a vertical line upward. That's August.

And my point -- if I can expound on it a little bit. My point is that when you've got diesel prices increasing so rapidly on a week by week basis and then you go out and do a hauling cost rate survey and publish the results -- and I'm not trying to be critical of the survey method or anything. I'm saying the reality is is that not every hauler may be up to date on their adjustments, for a variety of reasons. They might be slow in making their adjustments, although that's less likely to be true these days. But they may have bought their fuel earlier and just, you know, they're going to be delayed by a couple of weeks in making their adjustment. So you've got that price skyrocketing up, and it may just take a little while for the rates to adjust to where they fully reflect that price level. So it's just a difficult -- and it's difficult to hit a moving target. And in that particular month, that's an extreme case of where the price was moving very rapidly.

PANEL MEMBER GOSSARD: Thank you very much. No further questions.

HEARING OFFICER AYNES: Other further Panel questions?

PANEL MEMBER IKARI: Well, I'll ask a question. Dr. Schiek, you probably were in the audience when Geoffrey Vanden Heuvel mentioned 5 cents -- 5 to 10 cents. But the concept that I've asked some questions about is raising the local rates in Southern California. If you're not prepared to indicate today, I would like you to put that in your post-hearing brief. What about the concept of raising local rates in Southern California to attract the local supplies?

MR. SCHIEK: I can certainly give that some thought, but I do have some thoughts. I tended to agree with the testimony of Mr. Korsmeier on this issue. And let me explain a little bit why.

Right now, we have a situation in Southern California where we have a lot of fluid milk higher use plants, Class 1/Class 2. We also have a large cheese plant down there. The issue is will 5 cents pull milk away from that cheese plant and send it to a fluid milk plant? And I just don't see it. Because I mean, cheese plant operators are rational. And they're going to look at what is their alternative costs. I mean, they like to keep their plants running at near capacity to achieve efficiency. So they're going to want to replace that milk if it's pulled away to a fluid plant. And their alternative is going to be bringing that milk in from outside the area, which is going to cost more than 5 cents.

So I tend to agree with Mr. Korsmeier, that it would take a lot of money to begin to draw milk out of that plant. And I'm not, you know, trying to say the plant is good or bad or anything like that. But I think the reality is that it would take a lot of money to draw supplies there that are locked into that plant out of that plant.

If an individual producer has the discretion to choose where he's going to go, yeah, he might make a choice to go the fluid plant. But I think what would happen very quickly is if the operator of that plant wants to keep that plant full, he's going to match that 5 cents. It's going to take a lot of money before he's willing to say, okay, I'm going to let that go. That's how I would view it based on the economics. But I'll give that some more thought.

PANEL MEMBER IKARI: What about the economics as producers leave, and assuming that the cheese plant stays there, aren't they going to be willing to provide higher and higher premiums in order to keep their plants full? So we're going to have to pull more milk from greater distances to serve the Class 1 market.

MR. SCHIEK: Yeah. I think that's exactly what's going to happen until such time as the supply gets so tight that the plant operators decide they've got to do something else, either close the plant down and move it, move the equipment, and put a plant somewhere else.

But in the short run, it would seem to me there is a certain segment of the Southern California milk supply that is simply not going to be available to the Class 1 market. And I don't know -- like I said, I agree with Mr. Korsmeier. I don't think there's much you can do that would free that milk up in terms of policy decision making with transportation allowances. It would be -- the dollars we're talking about would be more than we'd be willing to do.

PANEL MEMBER IKARI: Western United also talked about or testified about other alternatives the Department might consider. Without having more specifics, as you prepare your post-hearing brief, if you have any ideas on things that the Department could consider, please include that in your post-hearing brief.

MR. SCHIEK: Alternatives to transportation allowance and credits to move milk, is that what you're --

PANEL MEMBER IKARI: They testified the Department in reviewing the testimony of this hearing and reaching decisions, we should consider -- and they weren't very specific. But we should consider methods or alternatives or actions that would encourage more of that local milk. So I'm just -- whatever ideas and concepts you have I would be interested in seeing in your post-hearing brief.

MR. SCHIEK: Okay.

PANEL MEMBER SHIPPELHOUTE: Mr. Schiek, I think you've been very clear in your testimony. And as I read back through and review your written transcripts, you're very clear that your position on the use of transportation allowances in a policy role is that they should make producers indifferent as to where they ship their milk; is that correct?

MR. SCHIEK: I would say yeah, with the exception of perhaps the milk that's most distant away. In other words, in the past you may have seen a sort of progressive shortfall. Like in the first mileage bracket, maybe there's no shortfall. In the second, there's a penny or two. In the third, there's a greater shortfall.

Again, given that so much of the Southern California milk supply is tied up and not available to the fluid market, in my view, I think what we're saying is you're going to have to bring milk in from as far away as King and Tulare certainly. And so I'm thinking it's when you get out beyond that that you should start applying the shortfall concept.

PANEL MEMBER SHIPPELHOUTE: You've been asked to comment in your post-hearing brief relative to a 5 cent or 10 cent rate that might encourage local milk in Southern California to supply that. I'm just wondering if perhaps when testifying to that, perhaps you can reiterate your position on the policy of transportation allowances, whether they should be a policy tool to make producers indifferent or perhaps work in a manner that others had suggested here today.

MR. SCHIEK: I can do that.

And I guess what I also would point out is that, unfortunately, in some occasions to get milk to move, it would take more than just indifference on the hauling costs. I think let's -- and I probably need to give some thought as to whether from a policy standpoint. We have to talk about that.

But the reality is is that getting milk -- and this is essentially the situation in Southern California. If you look at the hauling rates, it looks like from the August 2005 data it looks like something around 4 to 5 cents total would be adequate to make a producer in Chino indifferent on shipping to the local plant or shipping to Los Angeles. Just on the rate structure.

But, again, if the plants are willing to pay to hang onto that milk, you've got to pay more to get it to move away. And that's a problem. And I don't know that the transportation allowance system is necessarily designed to address that issue. But we need to be aware of that, that sometimes it takes even more than sort of hauling costs parody to make that milk move.

HEARING OFFICER AYNES: Are there any further questions of the Panel?

Thank you for your testimony.

Sharon Hale. Would you state your name and spell your last name?

MS. HALE: Sharon Hale, H-a-l-e.

(Thereupon Ms. Sharon Hale was sworn,
by the Hearing Officer, to tell the truth,
the whole truth and nothing but the truth.)

MS. HALE: Yes, I do.

HEARING OFFICER AYNES: And what organization do you represent?

MS. HALE: Crystal Cream and Butter Company.

HEARING OFFICER AYNES: And does that organization have members?

MS. HALE: No. We're a proprietary company.

HEARING OFFICER AYNES: What was the process of the organization to finalize your testimony?

MS. HALE: The draft was approved by the President of the company.

HEARING OFFICER AYNES: Do you wish to submit this document as an exhibit?

MS. HALE: Yes, I do.

HEARING OFFICER AYNES: Your document is identified as Exhibit Number 51.

(Thereupon the above-referenced document
was marked by the Hearing Officer as
Exhibit 51.)

MS. HALE: Thank you.

HEARING OFFICER AYNES: You may start your testimony.

MS. HALE: Mr. Hearing Officer and members of the Panel, my name is Sharon Hale. I'm Vice President of Dairy Policy and Procurement for Crystal Cream and Butter Company. Our administrative offices are located at 1013 D Street, Sacramento, California. We currently operate two production facilities in Sacramento and purchase the majority of our milk from independent dairy farmers located in sounding counties. Supplemental milk is sourced from cooperatives as needed to satisfy fluctuating market demands.

Our company is a member of the Dairy Institute of California and supports the testimony presented earlier by Dr. Schiek. We believe the basic elements of the policy presented by Dr. Schiek are critical to an effective milk movement incentive plan within this state and urge the Department to give serious consideration to these principles in the development of a finding from this hearing. My testimony on behalf of Crystal will focus on proposed adjustments in the transportation allowance system for ranch-to-plant shipments of milk in Northern California.

Milk supplied to Crystal by the independent dairies with which we have contracts is hauled by a single trucking firm. The hauling agreement, which was re-negotiated mid-2005 and fully operative by July of

2005, contains two separate hauling rates which correspond to the constructive mileage brackets included in the current transportation allowance system for milk delivered to the plant in the Sacramento receiving area. In addition, the agreement includes stop charge and fuel adjustment provisions.

CDFA's exhibit entitled, "Hauling Rates - Ranch to Plant Comparison: January 2000 to August 2005" indicates the hauling rate for milk located in Sacramento and San Joaquin Counties which moved to a local destination increased .095 per hundredweight from April 2004 to August 2005. Records for Crystal's independent producers show an increase of .068 per hundredweight for the same period of time. The difference between our rates and those reported by the state is due to the differences between two rates in April 2004. At that time Crystal was receiving some supplemental milk from a cooperative along with organic milk supplied under a co-packing arrangement. Some of this milk may have come from Sacramento and San Joaquin Counties and been hauled at a lower rate, thus dropping the average a bit. The difference between the two is not a major concern to us. The significance is that both sets of numbers reflect a sizable increase in hauling rates during this period.

What we do not understand is the precipitous rate decrease reported on the same Departmental exhibit for milk located in the northern San Joaquin Valley and moving to a destination in Sacramento. The state's data indicates haul rates decreased .068 per hundredweight from April 2004 to August 2005. Our independent dairies in the over 59 mile bracket experienced a .065 per hundredweight increase during the same period. At first we thought the reported decrease might be associated with organic milk. The load size and frequency of deliveries have grown steadily as the demand for organic milk has increased. There would be some logic behind a haul rate reduction due to these efficiencies, but the raw milk pound reported for August 2005 is not consistent with the volumes we generally associate with organic milk.

Given the extreme difference between the state's reported hauling rates from northern San Joaquin Valley to Sacramento and those of our independent dairies located in the over 59 miles bracket, we do not feel comfortable using the state's rate to determine the appropriate transportation allowances for milk moving to Sacramento. However, we feel our own data provides adequate justification to support the alternative proposal by Dairy Farmers of America to increase the transportation allowance for milk moving to the Sacramento receiving area from over 59 miles by 1 cent per hundredweight. Milk in the northern San Joaquin Valley moving locally increased .22 per hundredweight during the same time period, thus increasing the incentive by .043 per hundredweight to ship to a plant in that area instead of moving to a plant located in the Sacramento deficit area.

Ranch to plant hauling rates from Sacramento and San Joaquin County to the Northern San Joaquin Valley did follow a logical pattern when they increased .061 per hundredweight from April 2004 to August 2005. Mirroring the increase in the Sacramento and San Joaquin local haul for the same time period, one could question the necessity of increasing the transportation allowance for milk movement into Sacramento from locations in the zero to 50 miles bracket. We believe there are other factors that must be considered which support a uniform increase for both mileage brackets in the Sacramento receiving area.

One of the long-standing principles of milk movement is to move the closest milk first, thus minimizing the cost of the program, but still attracting sufficient milk to supply the needs of the deficit markets. But I believe we all realize California's milk movement incentive system will not entice all milk to move. In the Sacramento area, milk moves away from the deficit markets towards cheese manufacturing facilities located in the northern San Joaquin Valley because those facilities provide additional compensation for milk with specific compensational characteristics. Simply, certain milk is better suited for making cheese, and the economic rewards for that milk are far more attractive than those associated with supplying the deficit market. Similarly, some dairymen have business philosophies that when exercised directs their milk out of the area as well.

CDFA's exhibit entitled, "Analysis of Transportation Allowance Proposals" distributed at the January 11 workshop quantifies this reality in Table 7. 169.7 million pounds of milk in Sacramento County qualified for transportation allowances, while the larger portion of the county's milk, some 194.3 million pounds, was classified as non-qualifying. Unknown to us is the actual destination for the qualifying milk, but it's likely not all of that amount listed actually moves into the Sacramento deficit area. And certainly none of the non-qualifying milk supplied the Sacramento market. This situation only compounds the ongoing loss of milk production which is occurring in Crystal's historic milk supply area.

The Dairy Information Bulletin reports that milk production in Sacramento County for the period of January through November was down 1.7 percent in 2005 from the same time period in 2004. This compares to San Joaquin

County and the Northern California counties for the same period of plus 2.0 percent and plus 3.9 percent respectively. As we have testified in the past, urbanization continues to eat away at the dairies located closest to Sacramento, and these numbers provide supporting evidence of that statement.

Since the 2004 hearing, two long-time dairies supplying milk to Crystal and located fairly close to the city have gone out of business. We've been told of others who are thought to have already sold their property for development, but we have no firsthand knowledge of these transactions at this point. But in a simple drive around the area, the advance of houses towards existing dairies can easily be seen. We are confident in saying the supply of milk closest to Sacramento will continue to diminish.

In our opinion, 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. Equally as important is the need to maintain a balance between the deficit areas in Northern California.

Currently, transportation allowances are paid for milk moving into the Bay Area, the North Bay, and Sacramento receiving areas. Conceivably, milk could be shifted from one deficit area to another if the allowances provide sufficient incentive to do so. We believe the Department understood this possibility as they determined the August 4, 2004, hearing and as a result made multiple adjustments to avoid putting one area at a disadvantage to another. We view the proposal by DFA as recognizing the same potential consequence and avoids the creation of advantages for one qualifying plant over another by proposing changes throughout the region.

If for some reason the Department decides transportation allowances should be something more than the package proposed by DFA, we definitely recommend the balance between qualifying plants in all deficit areas be given serious consideration.

In our testimony, we have repeatedly referenced DFA's proposed amendments to existing transportation allowances. However, we want to be certain the Panel understands it's our intent to extend our comments to the other proposals dealing with transportation allowances in Northern California. With no direct experience in hauling milk into the Bay Area, we did not feel qualified to comment directly about the increases contained in CDI's proposal, but urge the Department to consider the competitive impact of their proposal on the other deficit receiving areas as well.

Before closing, we want to mention the second portion of DFA's alternative proposal which deals with adding an automatic fuel surcharge formula to the Milk Pooling Plan. We certainly see value in a more rapid incorporation of hauling rate fluctuations stemming from fuel escalator clauses imbedded in hauling contracts, but as yet did not have a clear understanding of how such a formula might function, nor have we seen sufficient analysis to contrast its positive attributes against any potential undesirable qualities. We're not comfortable supporting the adoption of the fuel surcharge formula at this time, but recommend a formula of this type be fully developed and explored by the industry in preparation for consideration at a future milk movement hearing.

That concludes my testimony. I appreciate being able to express Crystal's views at this hearing and request an opportunity to file a post-hearing brief.

HEARING OFFICER AYNES: Your request to submit a post-hearing brief is granted.

Are there questions from the Panel?

Thank you for your testimony.

MS. HALE: Thank you.

HEARING OFFICER AYNES: Jim Gruebele. Would you state your name and spell you last name?

MR. GRUEBELE: My name is James Gruebele, G-r-u-e-b-e-l-e.

(Thereupon Mr. James Gruebele was sworn,
by the Hearing Officer, to tell the truth,
the whole truth and nothing but the truth.)

MR. GRUEBELE: I do.

HEARING OFFICER AYNES: And what organization do you represent?

MR. GRUEBELE: Land O' Lakes.

HEARING OFFICER AYNES: And that's not a member organization? That's a company?

MR. GRUEBELE: No. This is a member organization.

HEARING OFFICER AYNES: Oh, it is. Okay. How many member organizations?

MR. GRUEBELE: 274 producers.

HEARING OFFICER AYNES: By what process did the organization finalize your testimony?

MR. GRUEBELE: Approved by the Board of Directors of management.

HEARING OFFICER AYNES: Do you wish to submit this document as an exhibit?

MR. GRUEBELE: Yes.

HEARING OFFICER AYNES: Your document is identified as Exhibit Number 52.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 52.)

HEARING OFFICER AYNES: You may testify.

MR. GRUEBELE: We've taken care of the first paragraph. Let's move on the transportation credit.

Land O' Lakes supports an adjustment in the transportation credit based upon cost justified changes in freight costs in moving milk from the South Valley into Southern California Class 1 milk plants. However, Land O' Lakes supports the continued use of a shortfall in moving milk on a plant-to-plant basis. This is based on the principle that closest in milk should be used first.

Land O' Lakes is presently serving a customer in Southern California market. Land O' Lakes supports the proposal presented by California Dairy Industries. CDI's proposal reflects changes in the freight costs in moving product from the South Valley into Southern California market; but there is a shortfall.

Condensed Skim. Land O' Lakes continues to support the inclusion of condensed skim in the transportation credit program. Land O' Lakes opposes the proposal by Western United Dairymen to eliminate coverage for condensed skim. CDFA prepared Figure 8 in section called, Analysis of Proposals for Transportation Credits" for the pre-hearing workshop that compares pool cost comparison of transportation allowances and credits for condensed skim. See attachment. The pool cost of delivering 10,000 pounds of condensed skim to Southern California when the milk originated in southern San Joaquin Valley is compared to the transportation credits from Tulare County to plants with 100 percent, 90 percent, and 80 percent utilization. It shows the transportation allowances for shipping whole milk is at least 2.5 times as high than it is for providing for a transportation credit for condensed skim from Tulare County. What this means is it is simply more costly to supply milk using transportation allowances than it is to moved milk in the form of condensed skim utilizing the transportation credit.

In earlier testimony at a Milk Incentive Movement Hearing, Land O' Lakes in that testimony discussed the competitive problem of other source condensed skim. It is clear that other source condensed skim is very competitive relative to California condensed skim sources. Elimination of the transportation credit for condensed skim would simply exacerbate that problem. In fact, Land O' Lakes could not compete in the sale of condensed skim to our customers without a transportation credit for condensed skim shipments from Tulare to Southern California markets.

It turns out there are plants located in states that are not regulated under the federal order market. California condensed skim is competing against unregulated plants that are able to supply condensed skim to California Class 1 plants.

Every pound of solids imported from out-of-state sources means that the additional pounds of solids from California sources are used for lower class uses, and that has a negative impact on the California pool.

As I indicated in the post-hearing brief in 2004, the Department policy has been to treat out-of-state producers in a non-discriminatory manner when it comes to condensed skim. The accounting for condensed skim received by Class 1 processing plants for fortification is the same whether the condensed skim comes from processing plants in state or from out-of-state sources. The California Class 1 plant is credited with a fortification allowance and credited with a Class 2 price, and there is an up-charge from Class 2 to Class 1 if that is the final usage of the product.

Of course, if the condensed skim is from unregulated out-of-state sources, there is no guarantee that the acquiring plant paid a Class 2 price for that product. The cost advantage for the other source condensed skim could be very significant.

Furthermore, the importation of milk has been increasing from out-of-state sources. In 2004, the total amount of milk imported amounted to 2.344 billion pounds, and in 2003 is 1.188 billion pounds. It is my understanding that Table 4b in the DIB includes not only bulk milk ranch to plant from out-of-state sources, but also some plant to plant milk including condensed skim and perhaps some organic milk. The volume of milk exported actually declined from 2003 to 2004. The imports for 2005 are running close to import totals for 2004. See the source that I used.

Another very important factor is if the transportation credit on condensed skim were eliminated, that would leave only one firm in California to supply the condensed skim in Southern California. The Class 1 processors do not feel comfortable with a sole supplier of milk products. This is one of the reasons that Southern California Class 1 processors sought out-of-state sources of condensed skim several years ago. In fact, the particular firm in question has unique advantage. When milk is shipped to this supply plant in Southern California, the milk movement is covered under the transportation allowance program. When this supply plant moves the same milk on a plant to plant basis to some Southern California Class 1 milk plants, that milk movement is compensated under the transportation credit program as well.

Transportation allowance proposal. The principles that LOL thinks should be supplied to milk movement issues are as follows:

1. Encourage local milk to move first.

2. Transportation allowances should be based on the difference between local and long distance haul to Class 1 milk markets.

3. Do not overcompensate producers serving Class 1 milk markets.

4. Make cost justified changes to transportation allowances.

Land O' Lakes fully supports CDI changes to correct the overcompensation problem in the high desert. First for milk shipments from the South Valley to Southern California, CDI identified milk shipments from Santa Barbara, San Diego, Imperial, Kern, Tulare, Kings, and Fresno Counties and changed the mileage brackets from over 89 miles to 109 and over 109 to 139. Currently, the mileage brackets are from 89 to 120 miles and over 120 miles through 139 miles.

Secondly, CDI identified transportation allowances for milk shipments from all other areas. And for the category from zero to 89 miles, they recommend a transportation allowance of 11 cents per hundredweight, and that was at the post-hearing brief. I did not include any changes they might have made today. But we support whatever changes they made. In over 89 miles, they proposed a transportation allowance of 31 cents per hundredweight. This provision in the CDI proposal is there to correct the overcompensation problem for producers in the high desert that are supplying Class 1 milk into deficit markets.

Under the current program, producers who are located between 89 and 120 miles from the deficit market receive a transportation allowance of 48 cents per hundredweight. Under CDI's proposal, producers in that mileage bracket over 89 miles would receive a transportation allowance of 31 cents per hundredweight.

When comparing the local haul to the long distance haul, CDI proposal provides for adequate compensation under the CDI proposal, and results in a more even-handed result than the current program. There are producers in the high desert that ship milk from more than 139 miles to a deficit market. Under the current program, such producers receive a transportation allowance of 62 cents per hundredweight. It turns out the haul rate to the deficit market for those producers -- and this information I received I hope is current -- are currently receiving 55 cents per hundredweight. The rate is 55 cents per hundredweight I should say. The transportation allowance is a pure subsidy in this case. It compensates for more than the haul.

One glove does not fit all. The current program does not result in equal treatment among producers serving the Class 1 market. The CDI proposal goes a long way to correct this problem. We believe the CDI proposal would make California more competitive with out-of-state sources of milk and provide more producer equity.

We oppose the Hollandia proposal to increase the transportation allowance from 58 cents to 72 cents per hundredweight for plants in the San Diego market. Industry sources indicate there are adequate amounts of milk available from closer-in sources and therefore there is no need to change the current transportation allowance from 58 cents per hundredweight from over 139 miles for the San Diego area.

Justification for proposals. As everyone knows, an out-of-state unregulated producer distributor is selling packaged milk in California and therefore taking some Class 1 outlets away from in-state Class 1 milk processors. This is a very serious problem for California Class 1 plants that are required to pay the Southern California Class 1 price for milk used for fluid purposes.

This lowers pool prices in California.

In addition, we all know about the court case with respect to other sources of bulk milk. This milk is no longer being pooled. I would like you to note that the Figure 4 should be changed to Figure 5. If you would make that note, that would be helpful. Figure 5 of the background materials specific to milk movement incentive shows that the California annual bulk milk imports continues to grow. And while it represents only 4 percent of California's total milk supply, it represents 15 percent of the fluid milk markets. See attachment.

This is of great concern. The imports of bulk milk have been an important factor contributing to the decline in the percent of California milk used for Class 1 purposes. These data of course do not include the impact of packaged milk sales into California from out-of-state sources. Figure 5 also shows that 81 percent of the fluid milk sources are California sourced milk and it is pooled. Another 4 percent is sourced from exempt milk that is producer distributor milk, and 15 percent is bulk milk from out-of-state sources for 2005.

It is essential to adjust the transportation allowances in California when the hauling rates warrant such changes. Plants in deficit markets need the producer milk, and in fact the needs are greater today than in the past because of the continued exodus of producers from the Southern California milk shed. Again, California needs to be competitive with out-of-state sources of milk. And so needed adjustments should be made so producers in the relevant supply areas are no worse off supplying Class 1 plants than supplying milk to manufacturing facilities. It is important to encourage milk to move for Class 1 purposes. From a producer equity issue, LOL believes the transportation allowance from Barstow area should be reduced.

Conclusion. The California producers have a responsibility to ensure that Class 1 needs of the milk processors are met. And in California, this includes the provision to pay for the milk movement incentive programs. Pooled manufacturing plants also have a responsibility to make milk available for Class 1 purposes when needed. All pool manufacturing plants in California have that responsibility.

California producers face significant competition from out-of-state sources. This is a major challenge. Adjustments to the transportation credit and allowance program may be only a small part of the solution to the out-of-state milk problem. The cost for not making cost justified adjustments to the milk movement incentive could be very large. We must remember that out-of-state producers have an incentive to move milk into California because of the difference between the California Class 1 and the blend prices in whatever market such producers might be located. The advantage for out-of-state bulk milk could be much larger if the milk is sourced from unregulated markets.

The amount of out-of-state milk has been growing. We need to do everything we can to make California milk more competitive with out-of-state sources. Making the needed cost justified adjustments to the transportation credit and allowance programs can help to do this.

This concludes my testimony. And I wish to have the opportunity to submit a post-hearing brief.

HEARING OFFICER AYNES: Your request to submit a post-hearing brief is granted.

Are there questions of the Panel?

Hearing none, thank you for your testimony.

MR. GRUEBELE: Thank you.

HEARING OFFICER AYNES: Is there anyone else who wishes to testify?

Do we have more documents?

STAFF ANALYST GILBERTSON: We do. I'd like to submit into the record a letter received from Driftwood Dairy signed by James Dolan.

HEARING OFFICER AYNES: State your name.

STAFF ANALYST GILBERTSON: My name is Cheryl Gilbertson with Dairy Marketing Branch.

HEARING OFFICER AYNES: And we have the one document to be submitted, and that would be Exhibit 53.

(Thereupon the above-referenced document was marked by the Hearing Officer as Exhibit 53.)

HEARING OFFICER AYNES: Is there anyone else who wishes to testify, any other documents?

Having received no additional requests to give testimony, this hearing is closed, with the exception of those witnesses who have requested and received the opportunity to file a post-hearing brief.

The Department will respond to petitions as required by applicable statutes and regulations. The request for a post-hearing briefing period by the witness is granted. The witnesses shall be provided the opportunity to submit a brief amplifying, explaining, or withdrawing their testimony.

In order for the brief to be considered, the Department must receive the brief by 4:00 p.m., Tuesday, February 27th, 2006. The brief may be sent or delivered to the Department's Dairy Marking Branch located at 560 J Street, Suite 150, Sacramento, California, 95814. The brief may be faxed to the Branch at 916-341-6697 or sent by e-mail to dairy@cdfa.ca.gov.

This hearing is closed.

(Thereupon the Department of Food and Agriculture Market Milk Hearing adjourned at 12:39 p.m.)

CERTIFICATE OF REPORTER

I, TIFFANY C. KRAFT, a Certified Shorthand Reporter of the State of California, and Registered Professional Reporter, do hereby certify:

That I am a disinterested person herein; that the foregoing hearing was reported in shorthand by me, Tiffany C. Kraft, a Certified Shorthand Reporter of the State of California, and thereafter transcribed into typewriting.

I further certify that I am not of counsel or attorney for any of the parties to said hearing nor in any way interested in the outcome of said hearing.

IN WITNESS WHEREOF, I have hereunto set my hand this 8th day of February, 2006.

TIFFANY C. KRAFT, CSR, RPR
Certified Shorthand Reporter
License No. 12277