

**Prepared Testimony of
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On behalf of
Northwest Dairy Association**

Federal Milk Market Order Hearing
Docket Nos. AO 368 A32 and AO 271 A37
September 23, 2003, Phoenix, AZ
Continued on November 17, 2003, Seattle, WA

My name is William C. Van Dam. I am testifying today on behalf of Northwest Dairy Association which is usually referred to as "NDA". In addition, Tillamook County Creamery Association, Farmers Cooperative Creamery and Northwest Independent Milk Producers have authorized NDA and me to express their support for our Proposal No. 1.

Background Information About NDA: NDA is a cooperative association, which acts as a handler in the Pacific Northwest Federal Order market (Order 124). NDA markets milk on behalf of 603 producers whose milk has traditionally been associated with the Pacific Northwest Order. Therefore, the provisions being considered at this hearing are of vital interest to NDA.

NDA is the parent company of WestFarm Foods, which operates three Class I bottling plants in Order 124. These plants are in Seattle, WA; Portland, OR; and Medford, OR. NDA also operates four milk manufacturing plants within Order 124. These plants, all in Washington, are at Chehalis, Issaquah, Lynden and Sunnyside.

NDA has no direct connection with the Arizona-Las Vegas Market Order (Order 131) and does not market the milk of any producers located in that area. NDA does however, experience two factors in common with Order 131 that create a bond between the two areas. First: both Order 131 and 124 border on different parts of the largest dairy state in this country – California. California has its own statewide order and therefore is not subject to regulation by Federal Orders. The interface with the statewide order is both interesting and potentially troublesome to NDA (as was shown by Arizona witnesses at the Phoenix phase of this hearing). Second: Order 131 appears to be the order with the highest volume of Producer Handler milk in the Federal Order System and Order 124 is the second highest. It is this second factor that caused NDA to request a joint hearing on this issue for Orders 124 and 131.

Proposals No. 1 and No. 3: Regulation of Producer Handlers with over 3 million pounds of Class I sales per month.

General statement: NDA cannot conceive of a valid argument that justifies the exemption from pooling of a Producer who is among the largest three percent of all producers in the entire market area. The exemption from Classified Pricing of any

Handler who operates a bottling plant that is as large and efficient as the plants of regulated handlers is equally unjustifiable. The fact that the cows and the plant are owned by the same entity does not make the current exemption fair to regulated handlers or the pooled producers. NDA has repeatedly and consistently voiced concern that the Producer Handler exemption for larger operations posed a threat to orderly markets and provided select competitors in the market with advantages that cannot be defended or sustained. These comments cannot have been missed by Producer Handlers and we certainly feel they have been adequately forewarned of our concern and the potential for changes in the rules.

The concept and exemption of Producer Handlers has a history as long as that of Federal Orders. The present exemption may have been appropriate for the circumstances that pertained at the time the concepts of Classified Pricing and Pooling were introduced 7 decades ago. Dairies were much smaller then and producers who bottled their own milk numbered in the hundreds (and probably in the thousands), home delivery was the standard, and stores were smaller and not organized into "chains". In the 1930's it was judged politically impossible to implement these new concepts if all producers who bottled their own milk were included. At that time there was no such thing as a Producer Handler who had a significant portion of any sizeable market, and they were not the primary cause of the ruinous competition that was disrupting the marketplace. They were however numerous and as a group they did not see any advantage to being in a pool. Therefore as a practical and as a political matter, they had to be exempted to get the early orders up and running. The exemption is an accident of history that has survived to this day in spite of the substantially changed circumstances of milk marketing in the Federal Order markets.

Revision to Proposal No. 1: NDA is the proponent of Proposal 1, which pertains to the Pacific Northwest (Order 124) market. There are some changes to language that we would like to offer at this time, consistent with revisions being proposed for the Order 131 market.

The revised proposal follows. Wording noted with a ~~strikethrough~~, indicates language we wish to delete from our original submission. Wording noted by **bold text and underline** indicates language we wish to insert into our original submission.

Revised Proposal No. 1: Amend the Producer-handler definition of the Pacific Northwest milk marketing order by revising § 1124.10 to read as follows:

§ 1124.10 Producer-handler.

Producer-handler means a person who operates a dairy farm(s) and a distributing plant(s) from which there is route ~~distribution within the marketing area during the month not~~ **disposition in the marketing area and the total route dispositions and transfers in the form of packaged fluid milk products to other**

distributing plants during the month does not exceed 3 million pounds and who the market administrator has designated a producer handler after determining that all of the requirements of this section have been met meets all of the requirements of this section.

(a) Requirements for designation. Designation of any person as a producer-handler by the market administrator shall be contingent upon meeting **all** the conditions set forth in paragraphs (a)(1) through (5) **(6)** of this section. Following the cancellation of a previous producer-handler designation, a person seeking to have their producer-handler designation reinstated must demonstrate that these conditions have been met for the preceding month.

(1) The care and management of the dairy animals and the other resources and facilities designated in paragraph (b)(1) of this section necessary to produce all Class I milk handled (excluding receipts from handlers fully regulated under any Federal order) are under the complete and exclusive control, ownership and management of the producer-handler and are operated as the producer-handler's own enterprise and its own **sole** risk.

(2) The plant operation designated in paragraph (b)(2) of this section at which the producer-handler processes and packages, and from which it distributes, its own milk production is under the complete and exclusive control, ownership and management of the producer-handler and is operated

(3) ~~The plant operation designated in paragraph (b)(2) of this section at which the producer-handler processes and packages, and from which it~~ **The producer-handler neither receives at its designated milk production resources and facilities, nor receives, handles, processes, or** distributes at or through any of its designated milk handling, processing, or distributing resources and facilities other source milk products for reconstitution into fluid milk products or fluid milk derived from any source other than:

(i) Its designated milk production resources and facilities (own farm production);

(ii) Pool handlers and plants regulated under any Federal order within the limitation specified in paragraph (c)(2) of this section; or

(iii) Nonfat milk solids which are used to fortify fluid milk products.

(4) The producer-handler is neither directly nor indirectly associated with the business control or management of, nor has a financial interest in, another handler's operation; nor is any other handler so associated with the producer-handler's operation.

(5) No milk produced by the herd(s) or on the farm(s) that supply milk to the producer-handler's plant operation is:

(i) Subject to inclusion and participation in a marketwide equalization pool under a milk classification and pricing program under the authority of a State government maintaining marketwide pooling of returns, or

(ii) Marketed in any part as ~~Class I milk to the non-pool distributing plant of any other handler~~ **to a non-pool distributing plant.**

(6) The producer-handler does not distribute fluid milk products to a wholesale customer who is served by a plant described in § 1131.7(a), (b), or (e), or a handler described in § 1000.8(c) that supplied the same product in the same-sized package with a similar label to a wholesale customer during the month.

(b) Designation of resources and facilities. Designation of a person as a producer-handler shall include the determination of what shall constitute **the person's** milk production, handling, processing, and distribution resources and facilities, all of which shall be considered an integrated operation, ~~under the sole and exclusive ownership of the producer-handler.~~

(1) Milk production resources and facilities shall include all resources and facilities (milking herd(s), buildings housing such herd(s), and the land on which such buildings are located) used for the production of milk ~~which are solely owned, operated, and~~ which the producer-handler has designated as a source of milk supply for the producer-handler's plant operation. ~~However, for purposes of this paragraph,~~

~~any such milk production resources and facilities which do not constitute an actual or potential source of milk supply for the producer-handler's operation shall not be considered a part of the producer-handler's milk production resources and facilities.~~

(2) Milk handling, processing, and distribution resources and facilities shall include all resources and facilities (including store outlets) used for handling, processing, and distributing fluid milk products which are solely or partially owned by, and directly or indirectly operated or controlled by the producer-handler or in which the producer-handler in any way has an interest, including any contractual arrangement, or over which the producer-handler directly or indirectly exercises any degree of management or control.

(3) All designations shall remain in effect until canceled pursuant to paragraph (c) of this section.

(c) Cancellation. The designation as a producer-handler shall be canceled upon determination by the market administrator that any of the requirements of paragraph (a)(1) through ~~(5)~~ **(6)** of this section are not ~~continuing to be met~~, or under any of the conditions described in paragraphs (c)(1), (2) or (3) of this section. Cancellation of a producer-handler's status pursuant to this paragraph shall be effective on the first day of the month ~~following the month in which the requirements were not met or the conditions for cancellation occurred~~ **conditions were not met**.

(1) Milk from the milk production resources and facilities of the producer-handler, designated in paragraph (b)(1) of this section, is delivered in the name of another person as producer milk to another handler.

(2) The producer-handler handles fluid milk products derived from sources other than the milk production facilities and resources designated in paragraph (b)(1) of this section, except that it may receive at its plant, or acquire for route disposition, fluid milk products from fully regulated plants and handlers under any Federal order if such receipts do not exceed 150,000 pounds monthly. This limitation shall not apply if the producer-handler's own-farm production is less than 150,000 pounds during the month.

(3) Milk from the milk production resources and facilities of the producer-handler is subject to inclusion and participation in a marketwide equalization pool

under a milk classification and pricing plan operating under the authority of a State government.

(d) Public announcement. The market administrator shall publicly announce:

(1) The name, plant location(s), and farm location(s) of persons designated as producer-handlers;

(2) The names of those persons whose designations have been cancelled; and

(3) The effective dates of producer-handler status or loss of producer-handler status for each. ~~Such announcements shall be controlling with respect to the accounting at plants of other handlers for fluid milk products received from any producer-handler.~~

(e) Burden of establishing and maintaining producer-handler status. The burden rests upon the handler who is designated as a producer-handler to establish through records required pursuant to §1000.27 that the requirements set forth in paragraph (a) of this section have been ~~and are continuing to be~~ met, and that the conditions set forth in paragraph (c) of this section for cancellation of the designation do not exist.

These changes were developed in coordination with representatives of United Dairymen of Arizona and Dairy Farmers of America. In his prepared testimony, DFA's witness explains the intent behind this proposal, in the form of a revised Proposal No. 3 for Order 131. We agree with those comments. We feel that consistency between the two orders is appropriate, although perhaps not essential.

Our testimony today will be directed toward the situation as it exists in Order 124, but it is the example of what is happening in Order 131 that most clearly illustrates what could happen in any order.

My Exhibit: I have prepared an Exhibit which contains a series of tables. It is attached to the copies of my prepared testimony which are available for participants in this hearing. We request that my Exhibit be marked at this time and I will then describe each Table in the exhibit as I go through my testimony.

Producer Handlers of Order 124: Exhibit ____, Table 1 is a set of data comparing the numbers of producers and volume of milk produced by both Producer Handlers and the normal pooled producer. The volume data for all producers is that gathered and reported by NASS. The data related to producer numbers comes from county statistics reported by the Market Administrator's office, as does the data related to production and number of Producer Handlers. The data was taken from these sources to eliminate any impact of depooling and market boundaries.

The table is largely self explanatory and I will expound on just a few points. First the similarities. In the 13 years represented in this Table there was a total increase of production of 21% by pooled producers and 22% by Producer Handlers. The number of producers decreased at very similar rates: the pooled producer count decreased by 49% while that of Producer Handlers decreased 53%. It would appear that the overall economic pressures impacted both groups in similar ways.

Second the differences. The most obvious difference between the pooled producer and the producer handler is in average size of operation. The average pooled producer markets approximately 833,000 pounds of milk a month while the average Producer Handler produces 2,627,000 pounds of milk a month. The average Producer Handler is more than 3 times bigger than the average pooled producer and their dairy farms are among the largest in the entire PNW market area. Additionally the trend line for the past 7 years (1995 to 2002) is that the average Producer Handler is growing in size faster than the average pooled handler.

Small business. With the above background, then, I would like to point out that the public policy considerations to support small businesses overwhelmingly argue for ensuring that the Producer Handler exemption does not injure the 933 pooled producers who are, as far as we know, mostly within the definition of "small business".

It may be that the potentially regulated Producer Handlers also are within the definition of "small business". However, we point out that many of the smaller regulated plants fit this definition also.

The Producer Handler Advantage: NDA concurs with the procedure used in prior hearings that analyze the Producer Handler advantage by looking at the difference between the Class I price and the Blend price. A regulated handler *does* pay the Class I price. If a Producer Handler were to do an economic analysis to accurately measure the success of the plant and distribution part of his operation, he would value the milk used in his plant at the classified prices in the Order, because that reflects the milk cost of his regulated competitors. Even if this calculation resulted in a loss it would show management how their plant measured up to the competition. If the Producer Handler were operating his business with the concept of maximizing his income this would be a number of great interest.

In exactly the same manner the dairy farm portion of the operation should measure its success against the blend price in the market. The blend price is real and it is available to the Producer Handler should he close or sell his plant, or otherwise become subject to regulation. The manager of the dairy farm will (or should, anyway) insist that he gets at least that price in calculating his own performance.

I should add that many years ago, I worked a while for a Producer Handler and my analyses used the approach just outlined.

These two values of milk, one to the plant and one to the farm, are obviously different. Assuming the Producer Handler uses some form of enterprise accounting this difference in value would be a third source of income (or profit) – one that exists solely because of the Producer Handler exemption in the Order. The other two profit centers are the Dairy Farm and the Milk Processing and Distribution. Of the three I can assure you that only one of them, the PH exemption, is likely to always be profitable.

Exhibit ____, Table 2 calculates the difference between the two milk values each year from Jan 2000 through Oct 2003 with the assumption that 100% of a Producer Handler's milk is sold as Class I. The average difference for the 46 months included in this time period is \$1.79 per cwt (15.4 cents per gallon) of milk. The blend price used in this Table is the actual reported price. The variation in the spread from year to year is related to:

- a. very significant differences in Class III and Class IV prices which because of "higher of" Class I pricing will tend to push the Class I price higher while at the same time the lower priced of Class III or Class IV milk will reduce the blend price, and
- b. depooling opportunities, when taken, will always reduce the volume of the higher priced of Class III or Class IV pooled, which in turn will lower the blend price.

Exhibit ____, Table 2A is the same calculation except in this case we have adjusted the Class I usage to the 85.5% achieved by Producer Handlers in the Pacific Northwest Order in the three full years 2000 through 2003. The 85.5% number is from Exhibit ____, Table 3, which adds to the reported route distribution sales by Producer Handlers, the sales of "surplus bulk milk" used as Class I to unregulated areas (Alaska) as reported in the Market Administrator's Exhibit 7, Table 6 which was prepared at our request. For the purposes of this table we balanced the pool for the Producer Handler with 14.5% of their milk assigned a value equal to the *lower of* Class III or Class IV. This was done in spite of the fact that the same MA Exhibit which reports on the usage of Producer Handler surplus milk shows that approximately half the surplus was either used in his plant as Class II or was moved to plants that reported its usage as Class II. The intent of Table 2A is to show the worst possible likely Producer Handler blend price. Even this worst case scenario leaves a Producer Handler advantage of \$1.33 per cwt (11.4 cents per gallon).

I and others who have experience in selling packaged milk to wholesale accounts know that even 11cents is an incredible advantage. This is a business where competition causes business to change hands for fractions of a cent per gallon. The 11.4 cent worst case cost advantage held by the Producer Handler is many times bigger than the price difference that separates traditional regulated competitors. There simply is no possible way for the regulated handler to compete with the prices that the Producer Handler could (and often does) offer. This advantage is far bigger than needed to acquire new business. By this I mean that a Producer Handler does not need to use even a significant portion of his advantage to get new business. He

just needs to be a bit lower than the competition. The balance of the advantage remains as margin (profit if you will) that goes to the Producer Handler.

Dan McBride of NDA (among others) will testify concerning competitive milk pricing by Producer Handlers. Quite often the price quoted to customers by Producer Handlers is much lower than what is needed to meet the competition. To the extent this reflects the advantage Producer Handlers enjoy from not being regulated, we contend that this is an arbitrary “wasting” of an economic benefit designed by Congress to be available to all dairy producers in the marketwide pool.

It is disturbing to see that some of the quotes we have seen are for prices as much as 45 cents less per gallon than the prices quoted by regulated handlers, when Federal Order prices are high. That is considerably more than the advantage available to the Producer Handler. If this is indeed happening the Producer Handler is netting less than the Blend price that would be paid to a pooled producer. This flies in the face of normal pricing and marketing logic.

One explanation for such low pricing may be that the Producer Handler is buying a long term customer through fixed price contracts that do not increase at times (like the present) when the Class I price mover is high. This really is not a satisfactory answer because every Producer Handler knows what the current Classified pricing umbrella is. It may also be that there are so many Producer Handlers in Order 124 that they are competing among themselves for the limited business available. We conclude that this pricing is an excellent example of the kind of price competition that occurs in the absence of regulation, and which gave rise to the concept of “disorderly” markets. Indeed, this hearing record has already demonstrated enough disorderliness that the Secretary should act to put a stop to it.

The dollars available to the Producer Handler, whether kept or “wasted”, exist because of milk pricing laws designed to improve the income of all producers. The Agricultural Marketing Agreement Act (AMAA) calls for these funds to be “distributed equally” among all producers, rather than squandered in competitive excess. It is very difficult to reconcile the existing unequal distribution of Class I premium income with the language and clear intent of the Order program’s enabling legislation.

Balancing costs: One of the primary justifications given for the current exemption is that the Producer Handler must bear the full costs of balancing his milk supply without burdening the pooled producers. Federal Order theory, then, permits the exemption as long as the Producer Handler does not shift a balancing burden to the regulated producers and plants in the pool. The reasoning is that since the Producer Handler does not share his Class I proceeds with other producers, then in all fairness he should not then be allowed to shift to those producers any of the cost of balancing his own milk supply.

NDA contends, and the evidence submitted shows, that the way Producer Handlers market today, most do – and almost always will – use the pool to balance their milk

supply. This goes beyond the obvious fact that by selling to distributors or to stores that carry milk from regulated handlers, the regulated market is there to fulfill any shortage they may have.

Another very important point in understanding this issue is to consider the incentive that exists for the Producer Handler to avoid selling any surplus milk to a manufacturing plant. It is fairly standard procedure for a manufacturing plant that is willing to purchase surplus milk to pay the seller the lowest of Class III or Class IV. If manufacturing plants are full they will often pay even less than the lowest Class price. This gap can be as big as \$3 per cwt.

Producer Handlers become very innovative in avoiding this cost – for that is what they judge it to be – a cost. We know that it is common for Producer Handlers to sell surplus milk to regulated handlers, thus displacing pooled milk and pushing the balancing burden back onto the pool. There is no evidence whatsoever that any Producer Handler considers it an obligation to make sure he has paid the full costs related to sale of his surplus milk.

We define surplus milk for a Producer Handler as that milk above his own bottling needs. To understand this number we asked the MA's office for a report that shows the disposition of Producer Handler surplus milk since Jan 2000. The result is Table 6 in the MA's Exhibit No. 7. To avoid the impact of restricted data on the report I calculated percentages based only on the full year 2001 and the YTD for 2003. The resulting disposition of Producer Handler surplus milk was:

- 27% Class I (sales to other bottlers)
- 52% Class II (use in ice cream or sold to Class II plants)
- 21% Class III and IV combined

To the extent a Producer Handler's milk is sold anywhere but a manufacturing plant, it will *always replace* a sale that would otherwise have been made by a pooled producer (or his cooperative). Even though the Producer Handler's sale to a bottling plant would be "down allocated" to Class IV or III, it backs pooled milk out of that plant into the pool balancing plants – contradicting the principle that "a Producer Handler balances his own supply".

Current rules allow the sale of surplus Producer Handler milk to regulated handlers, even though the rest of the pool balances that sale. Unfortunately that issue is not directly before this hearing.

I also want to point out that the down allocation rules do not fully protect the pooled producers. If the bottler buys enough from a Producer Handler that some is allocated to Class II, this removes Class II differential dollars from the "marketwide" pool. And if some is allocated to Class I, the pool receives only the difference between Class I and the blend price, not the full class I differential.

As Dan McBride will testify from his experience, some Producer Handlers sell their surplus to an unregulated bottling plant in Alaska that also buys from NDA. By selling to Class I or II bulk milk uses in Alaska, the Producer Handler has also taken away from the pooled producers (who would otherwise be supplying that market) the entire value of the Class I or II differential. And, again, the burden of handling his surplus has been shifted to the pooled producers, violating one of the primary assumptions justifying the Producer Handler exemption.

Loss of Class I sales to the pool: Classified pricing was introduced into the law to protect dairy producers from the effects of unstable (and mostly low) milk prices caused by milk handlers fighting for market share with low prices. Older observers may remember what were dubbed "milk wars". Classified pricing did stabilize the prices but caused a second "war" over who would get to serve the markets with the highest valued Class I milk. To correct the abuses that occurred, the pooling and equal distribution of the premium generated was added to the marketing plans. And except for an occasional hiccup the concepts have worked well to achieve the stated objectives.

The amount of dollars that do not make it to the PNW order pool because of the Producer Handler exemption are significant. The best measure of this is the line called the Producer Handler advantage shown on Exhibit ____, Table 2. If the volumes of Class I sales now in the hands of exempt Producer Handlers were put back into the pool along with the matching milk production, the net gain to the pool would be the Class I price less the blend price paid to the Producer Handler.

Exhibit ____, Table 4 shows the dollars taken from the PNW order pool by all Producer Handlers in the previous 3 full years. In calculating this number we have included the non pool sales of surplus Producer Handler milk as Class I. If the larger Producer Handlers were regulated then all sales to Alaska would once again be from regulated sources and would add to the Class I volumes in the PNW order.

The table shows in excess of \$4 million worth of premium dollars do not appear in the pool each year. Approximately 70% of this is taken from the pool because of the activities of those Producer Handlers who are larger than the proposed 3 million pound limit. The net impact on the pool blend price is approximately 4 cents per cwt.

NDA believes it is contrary to the stated purposes of the Agricultural Marketing Agreement Act to allow this amount of Class I premium dollars to be concentrated in the hands of so few producers (producer handlers) instead of being equally distributed to all producers through pooling.

Uniform handler prices. Fundamental milk pricing theory and the law hold high the concept of uniform handler prices. It simply cannot be argued that this exists when one type of competitor (the Producer Handler) has a competitively sized plant but is not subject to classified pricing. Paul Arbuthnot, formerly President of Sunshine

Dairy in Portland OR has previously testified how difficult (impossible really) , it can be to compete with a Producer Handler.

The threat to Federal Order milk pooling. Of far greater importance than the 4 cent reduction in pooling is the principle involved, and the potential upheaval in our industry if these Proposals are not adopted. A basic tenet of Federal Orders is the equal sharing of Class I proceeds. This concept is the very heart of Federal Orders. We are concerned that the presently unlimited Producer Handler exemption can and will be used to drain our pool of its Class I dollars. As the larger producers in our market begin to be aware of a pool dwindling gradually toward a blend of manufacturing milk only, they may follow the example of those who are Producer Handlers and will begin to bottle and distribute milk. They will be unregulated and will compete vigorously for "their" share of the market. Certainly this competition will cripple the competitive position of regulated handlers and in time will drive them out of the market place, or more likely force them to force the producers supplying them with milk to sell milk at less than Class I prices. . These are exactly the conditions that existed 70 some odd years ago that lead to the laws setting up Federal Orders.

The worry about the threat to the Federal Order system is not new. What is different, at this time, in both the Phoenix and Seattle markets, is that some have actually taken advantage of the exemption to a degree that so impacts the market that others will be tempted to follow. The result is a self financing juggernaut that can use its unregulated advantage to strip all the large volume accounts from the regulated handlers.

I know from my own discussions that the interest level among the larger producers is very high. I am aware of a large producer in Oregon who has openly discussed the possibility of becoming a Producer Handler. And I know from conversations with producers that others have at least considered the possibility.

The economic incentive is high for a producer, who may see a potential gain of \$1.73 per cwt. A high volume discount store will also drool over the opportunity to "share" some of this gain in order to price milk even lower at retail. The parties cut out of this game are the regulated handler and the pooled producer. But as they become less competitive, their best solution may be to try to "join them" if they can't "beat them".

And as this trend accelerates, the pooled Class I dollar amounts decline. And gradually, what the rest of the producers can gain from the Federal Order system diminishes.

The Arizona model can be repeated in any Federal Order. People watch and they learn. Unless the Producer Handler exemption loophole is plugged (or at least limited) now, the future of the Federal Order is very bleak indeed.

The case for a 3 million pound limit.

A Producer Handler is both a Producer and a Handler. In establishing the 3 million pound limit we considered the impact of the limit on each part of the operation.

Producer: In the Pacific Northwest market during May 2002 there were only 22 producers, out of a total of 933 producers, whose production volume exceeded 3 million pounds for the month. This number of 22 comes from "Analysis of Hauling Charges and Producer Milk By Location and Size-Range of Production, Pacific Northwest and Western Federal Orders", May 2002 Staff Paper 02-03 published November 2002 Page 13, Tables A-5 and A-6, Seattle Market Administrators office, by Chris Werner

These 22 producers represented only 2.4% of all producers. In May 2003, per Table 1 of the Market Administrator's Exhibit No 8, the 3 largest Producer Handlers have average Class I sales of 4.7 million pounds. By definition these 3 Producer Handlers will have production that at least equals and more likely exceeds their Class I sales. So the three large Producer Handlers will join the other 22 producers that produce in excess of 3 million pounds per month and will be among the largest 3% of all producers in the Pacific Northwest Order market.

Others will present evidence at this hearing of the cost advantages of the larger dairy farms. There is no point in repeating that evidence. The salient point is that there is absolutely no reasonable basis to continue to grant an exemption to Producers who already have economies of scale on their farms that only 3% of the other producers in the market can match.

Compared to a pooled producer of the same size, the Producer part of a Producer Handler operation has not one penny of extra costs "just because" the operation also happens to own and operate a plant. In fact, in many cases the Producer who is also a Handler has a significant cost advantage in that many, but not all, Producer Handlers have the dairy farm located on the same property as the plant and therefore have no raw milk hauling costs.

Farms producing more than 3 million pounds per month are typically very efficient. It makes no sense to give them a regulatory advantage that is not available to smaller farms.

Handler: The "right size" at which to include the Handler part of a Producer Handler operation in the pool is not as clear as the Producer side. The plants of Producer Handlers, even those over the proposed limit, are not bigger than 97% of the regulated plants in the market. The choice of 3 million pounds for the limit has an intuitive and political side to it. The political side is that the 3 million pound number first circulated among the proponents because Congress chose to exempt plants smaller than that from the 20 cent/cwt assessment for the processor funded promotion program. We understood the goal was not to burden smaller plants with that 20 cent assessment, and that 3,000,000 was the size below which Congress felt the burden would be unfair or excessive.

More importantly, after careful review of available data, we find that the 3 million lbs threshold has solid economic support for purposes of both that Congressional assessment and the issues in this hearing. As noted earlier, NDA's subsidiary, WestFarm Foods (WFF), operates three Class I bottling plants in Order 124. This provides a wealth of actual detailed data from which to draw comparisons of size versus operating costs. Only one of those plants runs at volumes close to the 3 million pound level and Mr. Dan McBride, in following testimony, will share the details of the study of that plant. The points of this study that are most important to our discussion are:

1. The numbers generated within WFF are quite similar to those presented by Mr. Carl Herbein at the extremes (that is for the smallest and for the largest plants). The WFF data clearly support a cost trend line that shows costs decrease as plant size increases.
2. The difference between data groups is that the WFF study indicates that costs decrease more quickly than is indicated in the Herbein Exhibit.
3. Our data shows that somewhere past 2.5 million pounds of volume, costs per unit begin to drop dramatically.

The cost decrease per gallon of product from a 2.5 million pound per month plant to one that does 3 million per month is approximately 10 cents per gallon. This data shows that at about 3 million lbs the cost savings at the plant offset the Producer Handler advantage of 11.4 cents shown on Table 2A of my exhibit. In our view, the purpose of the 3 million pound limit is to establish a size beyond which it is no longer reasonable to exempt a Producer Handler. The 3 current Producer Handlers that exceed the 3 million pound limit average 4.7 million pounds of Class I sales. As shown in the MA's Exhibit 8, Table 2, the average size of these operations already exceeds the average size of the smallest third (6 plants) of the regulated plants in Order 124 by more than 750,000 pounds per month. There is no reason to exempt these plants based on their "small" size.

To illustrate this point further we have used the limited "market information" available to us, to estimate the bottling volumes of the smallest 20 bottling plants in the Pacific Northwest Order and rank their estimated volumes from smallest to largest:

| <u>Plant</u> | <u>Estimated Lbs/Mo</u> | <u>Regulatory Status</u> |
|-------------------------|-------------------------|--------------------------|
| Noris Farms | Under 500,000 | Producer Handler |
| Norman Brook ** | 500,000 | Producer Handler |
| Valley of the Rogue | 500,000 | Regulated Pool Plant |
| Faith Dairy | 1,000,000 | Producer Handler |
| Eberhard Dairy | 1,500,000 | Regulated Pool Plant |
| Lochmead Dairy | 1,500,000 | Producer Handler |
| Country Charm Dairy | 1,500,000 | Producer Handler |
| Country Morning Dairy** | 2,000,000 | Producer Handler |
| <i>Mallories Dairy</i> | <i>4,000,000</i> | <i>Producer Handler</i> |
| WFF-Medford | 4,000,000 | Regulated Handler |

| | | |
|----------------------|------------------|-------------------------|
| Andersen Dairy | 5,000,000 | Regulated Handler |
| Sunshine Dairy | 5,000,000 | Regulated Handler |
| Umpqua Dairy | 5,000,000 | Regulated Handler |
| Wilcox-Cheney | 5,000,000 | Regulated Handler |
| <i>Edalean Dairy</i> | <i>6,000,000</i> | <i>Producer Handler</i> |
| Vitamilk Dairy ** | 7,000,000 | Regulated Handler |
| Wilcox/Curly's | 7,000,000 | Regulated Handler |
| <i>Smith Bros.</i> | <i>7,500,000</i> | <i>Producer Handler</i> |
| Alpenrose | 8,000,000 | Regulated Handler |
| WFF – Portland | 8,000,000 | Regulated Handler |

** Note, Vitamilk went out of business in August, and Norman Brook went out of business in September. Country Morning had a fire in October, and its future is uncertain. All three are on the Market Administrator's exhibits.

I emphasize these are only rough estimates. The MA's office has available to it the accurate information needed to rank the plants in the Pacific Northwest Order and we urge them to verify these numbers for the Order Formulation Branch, if that is permitted. For our purposes at this hearing, however, these estimates are sufficient to demonstrate the point that Producer Handlers are not necessarily the smallest handlers.

We concluded from our ranking that the two largest of the Producer Handlers plants are larger (and presumably for that reason more efficient in bottling) than eight fully regulated plants (nine if Vitamilk is included). The smallest of the Producer Handlers that would be regulated by our proposal No. 1, Mallories Dairy, would be larger than two fully regulated plants and about the same size as the WestFarm Foods plant at Medford, which is also owned by producers (cooperatively).

There is no reason to exempt the Producer Handler plants based on their size or their being a "small business". To demonstrate that hypothetically, note if the largest company in the Northwest, Microsoft, were to buy one of the Producer Handler operations, it would still be a Producer Handler and exempt from regulation. Alternatively, when a tiny bottler like Valley of the Rogue does business, without its own cows, it is fully regulated. This is not about "small business", it is about competitive equity and the statutory principle of uniform pricing. Small regulated plants deserve a "level playing field".

NDA suggests that in determining the appropriate threshold for regulation, the fundamental policy that should govern USDA's thinking is the requirement of uniformity in pricing, found in 7 USC Section 608c(5)A, which reads in pertinent part:

"Such **prices shall be uniform as to all handlers**, subject only to adjustments for

(1) volume, market, and production differentials customarily applied by the handlers subject to such order,

- (2) the grade or quality of the milk purchased, and
- (3) the locations at which delivery of such milk, or any use classification thereof, is made to such handlers.”

That price regulation of producer handlers is within the Secretary’s authority is clear from Section 608c(5)C, which reads:

(C) In order to accomplish the purposes set forth in paragraphs (A) and (B) of this subsection, providing a method for making adjustments in payments, as among handlers (including producers who are also handlers), to the end that the total sums paid by each handler shall equal the value of the milk purchased by him at the prices fixed in accordance with paragraph (A) of this subsection.

In our view, the uniform pricing goal in Section A should be accomplished as suggested under Section C – the smaller handlers properly receive an exemption (which clearly is an adjustment of sorts) based on volume, to the end that the total sums paid by each handler approximate the class values.

Specifically, NDA believes that the evidence in this hearing will show that Producer Handlers below 3 million pounds have inefficiencies in processing that raise their overall costs to the point where they in reality have no cost advantage over a regulated plant (even with the 20 cent promotion assessment that also gets added when a plant exceeds 3,000,000 pounds/month). On the other hand Producer Handlers with greater volumes have processing costs that are similar to regulated plants so there is no justification for avoiding uniform pricing in their case. The marketing activities of a Producer Handler does not begin having disorderly impact on the market place until the dock costs of the Producer Handler are lower than those of the regulated handler. The evidence shows that this occurs when the Producer Handler’s volume crosses the 3 million per month of bottling volume.

To summarize our argument, we suggest that the volume of producer handlers is the relevant consideration for exemption (or regulation). And in determining the volume level, the key consideration should be to ensure, insofar as possible, uniformity in milk costs between the Producer Handler plants and regulated plants after consideration of such additional volume-related costs as higher processing costs, the 20 cent/cwt promotion assessment, or anything else. We submit that a Producer Handler whose volume exceeds 3,000,000 pounds per month can compete effectively on the “level playing field”, even though fully regulated.

Another point worth noting is that the three largest Producer Handlers represent about 70% of the total Class I sales of the 9 Producer Handlers. Adoption of the size limit would reduce the portion of the market’s total Class I sales held by exempt Producer Handlers to about 3% – which we can accept as a not disruptive volume of Class I sales. Thus the proposed level of regulation accomplishes another primary purpose of the milk order program, that of preventing disorderly markets.

Disorderly Markets. The current unlimited exemption of Producer Handlers has led to disorderly market conditions. The goal of preventing disorderly markets is one of the key concepts of the Federal Order system, along with uniformity of pricing as discussed above.

Federal Orders have prevented disorderly markets in part through adoption of “marketwide pooling”. During the early years of Federal Orders, other approaches were tried, including individual handler pools. That approach was discarded, because it led to competition among producers to compete for access to the more favorable handler pools. I note that the analysis I used above, to derive a Producer Handler’s regulatory advantage based on utilization, is essentially an analysis of a handler pool with only one producer. For all the reasons that individual handler pools created disorderly markets when they involved many producers, the same result can occur when the handler pool contains only one large producer instead of many small producers.

Disorderly marketing among producers can occur in either the market for raw milk or the market for bottled milk. NDA producers own three bottling plants in the Pacific Northwest market, as noted above, and they compete with individual producers who do business as Producer Handlers. When they compete in the wholesale market, we have the classic situation of competition among producers for the Class I market, albeit a competition in the form of bottled versus bulk milk. Even though it is cooperative producers who own a plant, competing with individual Producer Handlers who own their plant, it is still competition among producers for the Class I market. It’s a similar disorderly marketing situation, which needs to be remedied in the same way as was competition between handler pools – that is, by regulations which put all producers into a marketwide pool to create a “level playing field”. The traditional approach to disorderly marketing of bulk milk has been to bring producers (and we propose that this should include Producer Handlers) into a marketwide pool. At the same time, this addresses the problem of non-uniform pricing among handlers which the exemption for Producer Handlers creates for regulated bottling plant operators.

In the example I have used, I described disorderly marketing among producers by citing competition between a Producer Handler and a producer-owned (cooperatively operated) bottling plant. Taking this a step further, however, when those disorderly markets occur there is little difference between the negative impact on a pooled producer who ships to a proprietary plant, compared to the negative impact on a producer who ships to a cooperatively owned plant (other than the amount of investment that may be at risk).

This can be seen by the recent closure of Vitamilk Dairy in Seattle, which we believe was at least in part the result of competition from large Producer Handler plants in Washington State. The producers who shipped to that proprietary plant lost their market, and may enjoy less favorable market opportunities in the future.

I make the latter statement because those producers now have the choice of shipping to NDA or to DFA, and from what we understand based on our discussions with these producers, they will have a greater hauling cost with either cooperative, and they will have no opportunity with either cooperative to market under a “free farmed” label program that returned a bonus to them.

In our view, their demise was the result of several factors. One was competition from Producer Handlers, which the management of Vitamilk Dairy has discussed with me and with NDA personnel many times over the years, and testified to earlier in this hearing. There were other factors as well, including consolidation of the grocery chains which limited market opportunities for them. But when that consolidation occurred, they and WestFarm Foods both focused on the remaining market, much of which is handled by independent distributors.

In both our case and Vitamilk’s, the distributors typically buy cheap gallons from the larger Producer Handler plants, to sell along with a full line of products from the regulated plants from whom they also buy products. Dan McBride’s testimony will further document how that occurs.

NDA respectfully submits that this is evidence that the Producer Handler exemption creates “competitive harm” by undercutting the regulated plants. We also respectfully submit that this harm is the direct consequence of a competitive environment which is “disorderly”, as exempt Producer Handlers cut price in order to take and maintain that business. We respectfully submit that this “disorderly price competition” pits one group of producers (exempt Producer Handlers) against another group (those in the pool). Finally, we respectfully submit that this fact pattern is as clear a case of disorderly market conditions as any fact pattern previously found in any prior decisions by the Secretary that remedied disorderly markets, and that the solution is to bring the larger Producer Handlers into the marketwide pool.

Proposal 2: Same size package with similar label limitation.

NDA supports the wording and concept of Proposal 2.

The limitation proposed, however, speaks to just one of a variety of ways that a Producer Handler can take advantage of regulated handlers to, in effect, balance its milk supply. The Producer Handler in the situation addressed by this rule simply bottles gallons of milk in its own label until the milk supply was used up. If the amount delivered was not enough volume for the store (and it was surely planned that demand would exceed supply) the store’s other milk supplier, a regulated plant, would deliver enough gallons in a “similarly labeled” package to fill the store’s needs. In this way the Producer Handler could always clear 100% of his milk at “near Class I prices” in a single package size while the regulated handler would then deliver all the other milk products plus have some sales of gallons.

The “store” mentioned in the previous paragraph could just as well be a distributor who buys from multiple sources. Mr. Dan McBride of the NDA staff will, in testimony following mine, describe exactly how this is occurring. A critical point that a regulator must consider is that a Producer Handler is not limited to finding traditional full product line customers but can effectively market to a limited portion of sales to a customer. The portion invariably will be the largest volume most easily bottled package – the gallon.

The overall problem is not solved by this Proposal. The same trick can be accomplished nearly as effectively by using different labels. And it will be an endless task to keep the rules coming fast enough to keep up with the variations that could occur. Outright prohibition of the sales of “gallons only” is the logical conclusion of such a rule, but that would be such an infringement on normal business affairs that it would quickly be judged a regulatory overreach. Indeed, as a business strategy a regulated handler may decide to specialize in the high volume gallon trade. In the scope of business competition this is a legitimate market ploy that only touches the regulatory realm when done by an exempt party who by doing so enriches himself at the expense of regulated handlers and all pool participants.

Along this same line of thought USDA is urged to contemplate the economic incentive that exists for the creation of additional “gallons only” Producer Handlers. Producers continue to grow in size, as do stores. The investment required to build and equip a simple “gallons only” plant is not large compared to the existing investment already in place by either the dairyman or the store. When the Return On Investment of this contemplated investment is calculated for a large dairyman the investment pays a handsome dividend even if the Producer Handler had to give up a portion of the potential advantage.

It is clear from past decisions of USDA that they see their role as one of reacting to actual events instead of to potential events. But at this time there are two instances where the available loopholes are being used in ways that make a mockery of milk price regulation. The first, of course, is Sarah Farms in Arizona, and its remarkable growth.

The second instance is not a Producer Handler exemption as we normally understand the term. USDA is urged to consider the actual event of a new plant operating in Yuma, AZ. that has been built to take advantage of a “loophole exemption” from classified pricing and pooling *In that case, the loophole is in the inability of the state of California to regulate, under its state order, milk processed outside the state but sold into California.* The exemption that this plant found is for all intents and purposes exactly the same as the exemption available to a Producer Handler. The economics are powerful. The model has been established. It is probably not a coincidence that the owner of this new plant is in fact the largest Producer Handler in America.

In the view of NDA the best and most rational course is to end the exemption for those whose size makes them a threat to render moot the concepts at the heart of milk regulation –classified pricing and pooling.

Proposal No. 4: Double Dipping. NDA urges the implementation of the concept recently incorporated into several other orders (Order 30, 33, 124, and 135) which effectively prevents the simultaneous pooling of milk in the California statewide pool and in a Federal Order. The change should be adopted consistently across all orders. The language proposed for this hearing meets this suggestion and its adoption is encouraged. In order to save time at this hearing and to avoid repetition of testimony given a previous hearing, NDA requests that Official Notice be taken of the testimony and findings (recommended and final decisions) of the previous Federal Order hearings related to this subject.

Proposal No. 5: Conforming amendments. NDA, as always, supports the need to make necessary adjustments to the Marketing Agreements.

This concludes my prepared testimony. Dan McBride will offer additional testimony on behalf of NDA.