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BEFORE THE
UNITED STATES DEPARTMENT OF AGRICULTURE

In Re	:	
MILK IN THE PACIFIC NORTHWEST AND ARIZONA-LAS VEGAS MARKETING AREAS	: :	DOCKET NOS. AO-368-A32 AO-271-A37 DA-03-04
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TESTIMONY OF ALEXIS KOESTER IN OPPOSITION TO PROPOSALS NUMBERED 1 AND 2

November 19, 2003
Seattle, Washington

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My name is Alexis Koester, and I am the President of Smith Brothers Farms. Smith Brothers is a family owned small business based in Kent, Washington. Kent is located halfway between Seattle and Tacoma, and our milk and dairy products are distributed almost exclusively within the Puget Sound region. We currently produce more than three million pounds of milk per month and our business would suffer if Proposal 1 or Proposal 2 were to be adopted. In addition, we currently ship surplus milk to processors in Alaska, and the adoption of either Proposal, even without a production cap would adversely affect our ability to balance our milk supply. I am testifying in opposition to Proposals 1 and 2 in their entirety.

Since 1960, we have operated as a producer handler in Order 124 without creating disruptive marketing conditions, and there is no evidence that disruptive marketing conditions are now occurring. We have carefully operated our business under guidelines that the Department has left virtually unchanged and Congress has consistently protected. We do not purchase milk from any source. All the milk we process comes from our own herd.

Benjamin Smith, my grandfather, established Smith Brothers in 1920. We have been serving our customers for four generations, and the Smith family has always been integrally involved in the operation of the business. Currently, six members of the Smith family make their living by working in the operation of the dairy. Four of the five voting stockholders are women.

In addition to my family members who are involved with the dairy, we employ 110 people in our production and processing operations whose families depend upon our continued existence. We also contract with approximately 60 independent distributors who service our customers through home delivery of our dairy products. Approximately one-third of our employees are hispanic. Their livelihood also depends on our continued existence.

Over the years, dramatic changes in the dairy industry have been seen. We have been able to survive by providing niche services to our customers in areas that are unserved or underserved by other distributors in the marketing area. Our markets are those which have largely been abandoned by regulated processors. Our largest market, for example, is home delivery of milk products. While the once familiar milkman has all but vanished from the American landscape, we still sell approximately 70% of our products through home route distribution through independent distributors. In 1980, home deliveries accounted for only 33% percent of our sales, but we have been able to increase our presence in this niche market, while others have all but abandoned it. Over thirty thousand Seattle area families depend on Smith Brothers to supply their dairy products directly to their homes. We fully expect that home delivery will continue to be our primary outlet into the future, but our future, even in that market, is dependent upon our ability to grow as may be necessary to meet the demands of our unique market.

Our product list includes fluid milk, buttermilk, chocolate milk, eggnog, whip cream, half-and-half and sour cream. We also serve our customers by providing delivery of staple food items such as coffees, eggs, and juices. In addition to our home delivery routes, we also serve coffee shops, restaurants, schools, and small businesses by providing many of the same products for their unique needs. Unlike the milk bottled and sold by the proponents of this rule change, we do not sell our product through large retail outlets or chains. We have chosen to compete in a different arena.

In addition to serving unique customers, we have been able to compete by differentiating our products. One quality of our milk is that Smith Brothers guarantees it to be BST free, which is a feature that many of our customers find important. By controlling the quality of our bottled milk starting with raw milk production, we can deliver great tasting products more consistently. This is another feature of Smith Brothers Farms milk that our customers appreciate.

We operate as a producer-handler in full compliance with the current federal regulations, and we have built our operation to ensure our continued compliance with the rules. Over the years, we have been presented with numerous challenges to our status as a producer-handler. Most recently, the USDA received comments from the industry during the course of federal order reform that suggested the curtailment or elimination of the producer-handler exemption. The Secretary properly concluded that:

> It has been a long-standing policy to exempt from full regulation many of those entities that operate as both a producer and a handler. … A primary basis for exempting producer-handlers from the pricing and pooling provisions of a milk order is that these entities are customarily small businesses that operate in a self-sufficient manner. Also, during the history of producer-handler exemption from full regulation there has been no demonstration that such entities have an advantage as either producers or handlers so long as they are responsible for balancing their fluid milk needs and cannot transfer balancing costs, including the cost of disposing of reserve milk supplies, to other market participants.

64 Fed. Reg. 16135 (April 2, 1999).

The Secretary also discussed the small changes that were made to producer-handler regulations for the sole purpose of standardizing the consolidated orders. Importantly, the Secretary noted that, "no changes have been made that would intentionally regulate a producer-handler that is currently exempt from regulation under current operating procedures." *Id.* The Secretary also took note of Congress's unwavering support of the producer-handler exemption.

Smith Brothers is now faced with another challenge to our continued existence. Despite no significant change in marketing conditions since order reform, and without any evidence of disorderly marketing having been presented at this hearing, the proponents again seek to shut our doors.

All the talk about equal treatment, fairness among producers, and unfair competition is simply not borne out by the facts. In reality, this hearing is an attempt by the largest players in the dairy industry to relegate Smith Brothers Farms to the low end of the marketplace. The adoption of a cap on producer-handler production—even one that would exempt our farm today—would limit our future growth at a time when farm sizes are increasing, cooperatives are consolidating, and independent processors are vanishing.

Elvin Hollon's testimony reveals the goal of the proponents. It is to freeze producer-handlers out of any real chance to compete with DFA and Dean Foods for warehouse and superstore sales, the fastest growing segment of dairy sales. This is anticompetitive, and would only vest more power in a small number of entities that already exert far too much control in this industry.

The proposals, if adopted, would force Smith Brothers Farms to change the way we operate our business, and we would incur increased costs. Depending on market conditions, our ability to continue our operation may be threatened. The loss of nearly one million dollars per year is particularly troubling to Smith Brothers Farms financial well-being because of the debt load that we are currently carrying. This was the result of a new farm which we built two years ago and which is located 150 miles from our plant. I want to stress that the decision to build a new farm was not the result of herd expansion. Our herd size did not increase with the move. That move was necessitated by environmental and population concerns because of our proximity to the Seattle area. In addition to our capital costs, we faced increased transportation costs with this move.

The impact of the various proposals would force Smith Brothers to incur additional costs in the form of Class I settlement fund contributions, despite the fact that we purchase no milk. Even if the AMAA were to permit such action, the proponents own testimony established no basis for this dramatic change in policy. In the proponents' testimony, they have submitted a table showing the number of producer-handlers in Oregon and Washington, which shows route distribution for the years 1975, 1980, 1985, 1990, 1995 and 2000. *See* Exhibit 7, Table 4. This exhibit plainly demonstrates that the number of producer-handlers declined during that period from seventy-three to eleven. Although route distribution has climbed over the full twenty-five year period, route distribution by producer-handlers has **fallen** by nearly six percent since the year 2000. *See* Exhibit 20.

The reduction in the number of producer-handlers reflects the consolidation in the industry, but also reflects the reality that being a producer-handler involves a substantial amount of risk that the typical dairy farmer does not bear. The unfair advantage claimed by the proponents is a fallacy. The proponents have repeatedly testified about the allegedly unfair and unjustifiable advantage enjoyed by producer-handlers and have suggested that we can outprice competitors at will. This is patently false, and it is not supported by facts. Common sense and simple economics tell us that if there are large and easy profits to be made by operating as a producer-handler, there will be a rush to seize that opportunity. That has not happened. If being a producer-handler was the fast-track to wealth that the proponents claim, then why aren't there more of us?

Changes in marketing conditions since 2000 have not been favorable to producer-handlers. Table 11 of the Market Administrator's statistical information for Order 124 Class I In-Area Sales establishes that the percentage of those sales attributable to producer-handlers has actually decreased. Using that data, we calculated a simple ratio of Class I sales by producer-handlers in Order 124 to all Class I sales in the Order. In 2000, producer-handler sales accounted for 10.43% of Class I sales in the Order. For all of 2002, the percentage had decreased to 10.08%, and in the first six months of 2003, the percentage is only 9.8%. *See* Exhibit 1; Table 2.

Further analysis of the same Market Administrator's data indicates a decline in the presence of producer-handlers as Class I suppliers to the marketplace. Our Table 3 compares, for each of the first six months of this year, the year over year changed in producer-handler Class I route distribution. Between 2001 and 2002, there was an average decrease of 4% and the first six months of 2003 were at only 94.35% of the sales for 2000. *See* Exhibit 20.

For the reasons cited by the Secretary in support of her last decision on this topic, the Department should not adopt these proposals. Payment into the producer settlement fund by producer-handlers is not authorized by statute, and even if it were, it contradicts Congress's often repeated intent that the producer-handler exemption be preserved and would also constitute a change in the long-standing policy of the Department.

The proponents seek to close our business despite the fact that Smith Brothers does bear all of its balancing costs, is entirely self-sufficient, and is a small business as a dairy products manufacturer that employs less than 500 employees. Any growth of our production in recent years has been due to increased efficiencies, not additions to our herd. In fact, we are milking about the same number of cows today that we were milking 20 years ago. Smith Brothers Farms is not engaged in "unabated growth" as has been suggested. Accordingly, we have not added substantial amounts of milk to the Pacific Northwest Order.

The proponents suggest that our operation threatens their ability to market milk in the Order and that Smith Brothers Farms is somehow a threat to their business. These claims are made despite the fact all of the proponents and most, if not all, of the others testifying in support of the regulations are significantly larger that our operation. In fact, with the possible exception of other producer-handlers, our processing facility is smaller than most of those within Order 124. The businesses that compete with Smith Brothers Farms for the small percentage of our sales outside of home delivery are all able to compete effectively against us. Testimony was given about sales we lost to a Vitamilk distributor. The loss of this sale was not due to undue greed on the part of Smith Brothers Farms. Aside from the fact that we do not control the bids entered by our distributors, I can recount numerous sales contracts that we did not win. In many cases, we find that we are outbid for contracts by some of the competitors here today. We do not have an unfair price advantage over regulated handlers. If we did, we would never lose a sale on price, but we do lose sales based on price. Instead of leveling the playing field, as the proponents suggest, the adoption of these proposals would place us at a distinct price disadvantage.

Based upon the letters submitted to the Department, we believe that the real purpose of this hearing is to prevent or dissuade a new large Oregon dairy farm from becoming a producer-handler and competing with Dean Foods and DFA for that part of the market now serviced by predominantly large players. The proponents of the changes, all large cooperatives or the large handlers they serve, have heard rumors about this farm, and they are fearful about losing revenue to the Boardman Dairy, should it obtain PD status. Of course this is pure speculation at this time. By eliminating producer-handler status as a viable option, the proponents would succeed in that effort, and Smith Brothers Farms would be a casualty of their protectionist actions.

However, the current market conditions do not support a change in the Order. The imposition of a cap, even one high enough to exempt Smith Brothers Farms would restrict our future growth, what ever that may be. Meanwhile, other farmers, other cooperatives, and other handlers retain the ability to expand without restriction. Furthermore, the imposition of any cap based on what marketing conditions might occur in the future is unjustified and speculative. Of course, a cap that is lower than our current production would force us to examine whether to continue as a producer, whether to continue as a handler, or whether it will be feasible to continue operations, at all.

Quite simply, this proposal would dramatically injure or terminate our business—all because the proponents fear the unknown effects of a possible new competitor. As the Secretary has noted in previous decisions, there is no demonstration or evidence that Smith Brothers Farms, or any other producer-handler, hold an unfair advantage as a producer or a processor. In fact, the evidence establishes that in exchange for partial regulation, we bear costs usually borne by other market participants.

The proponents also testified that producer-handlers do not play by the same rules as other market participants. That is untrue; we all play by the same rules. All producers and processors are subject to the same marketing orders. If we purchase milk, we would pay into the pool and draw from it, just as do other processors and producers who buy and sell raw milk. Similarly, there are no barriers that prevent a handler from buying a dairy herd or that prevent a dairy farmer from opening a bottling facility.

Producer-handler status places limits on the types of customers that we can effectively serve. First, we can only serve those customers who require less milk than we produce. Unlike a pool handler, we cannot simply purchase more milk to fill the large or growing needs of a customer. We cannot serve customers whose demand for milk is irregular. Our profitability depends on our ability to effectively control our surpluses and its disposition. When a customer has needs that exceed our farm capacity or would upset our ability to balance, we are faced with the choice of losing our producer-handler status or our customer. Our limited ability to service large accounts demonstrates yet another reason why we are not direct competitors of the Krogers, Safeways, and Dean Foods of the world. This proposal would, however, effectively bar us from ever servicing these processors.

The proponents have suggested that payments from producer-handlers into the producer settlement fund are necessary because Smith Brothers, and other like situated producer-handlers, enjoys an unfair advantage because we can acquire our Class I milk for the blend price. This is not accurate. Smith Brothers does not, as is suggested, enjoy an advantage equal to the difference between the Class I price and the blend price. Our milk is acquired at whatever our cost of production is. Our costs of production often exceeds the Order 124 blend price and, in times of weak prices, exceeds the Class I price. Likewise, a producer-handler has its own blend of uses, because not all of our milk is used in Class I products.

This blend, which Mr. Hollon identified in his testimony, must also take into account the unique and significant balancing costs of producer-handlers. We sell surplus milk for less than Class price. Typically, we are paid the Class III price less $1.50 per hundredweight. In addition to the costs of balancing, producer-handlers have expenses in transportation that other producers do not bear. Producer-handlers bear huge amounts of risk in the event that there are problems at their processing facility. A stoppage in production can mean the loss of raw milk that cannot be replaced by a purchase from another farm. Likewise, problems on the farm such as herd health issues are not only a loss to a producer, but can mean the loss of milk to the plant that cannot be replaced. The result can be lost customers. Managing the timing of deliveries to the plant is also critical, or we must incur additional cleaning costs and difficult scheduling.

These demands, in addition to increasing our operating costs, effectively self-regulate the size of producer-handlers. At the farm level, we are required to carefully maintain the level of our herd. Fluctuations pose the risk of causing large pool plant purchases, which would require us to lose our status or, alternatively, have large surpluses which must be disposed of, often at substantial loss.

These balancing demands are unique to producer-handlers and have required us to find novel solutions to remain competitive. One of our solutions has been to ship milk to Matanuska Maid Dairy in Alaska. There are expenses associated with that which other producers do not experience and are not accounted for by the proponents' incomplete suggestions. Despite these costs, we are proud that we have found another underserviced market that both balances our supply and provides a wholesome supply of milk to Alaska.

In summary, there was no disruption in the marketplace found during order reform. There have been no changes in the marketing conditions in the marketing area since order reform. There are no facts supporting a finding of disruptive marketing. The proposals should not be adopted.