Testimony of Daniel R. Morrison

My name is Daniel R. Morrison. I am a partner at The Aperio Group, LLC, whose offices are located in Downers Grove, Illinois. The Aperio Group is a consulting business specializing in dairy cost management systems for large grocery retailers. Aperio's proprietary "Efficient Processor Cost" technology provides clients with critical information from which to negotiate a dairy supply contract. Prior to forming The Aperio Group this year, I was employed by Dean Foods Company at their corporate headquarters in Franklin Park, Illinois for nine years. My positions at Dean Foods included Vice President of Finance and Administration of the Dean Foods Dairy Group and Vice President and Corporate Controller of Dean Foods Company. At Dean Foods, as a member of the senior management team, my responsibilities included accounting, financial reporting, acquisitions, cost accounting and strategic planning. Prior to Dean Foods I held senior level positions in industry and Big 4 public accounting. I am a CPA and hold a BS in Accounting from Illinois State University and an MBA from Northwestern University.

I have been engaged by Smith Brothers Farms, Edaleen Dairy, Mallorie's Dairy, and Sarah Farms to provide financial information regarding efficient dairy processing plant size and costs. My analysis of the testimony previously presented at this hearing suggests that Carl Herbein's testimony that producer handlers processing more than 3,000,000 pounds of milk per month can effectively compete as processors against larger processing facilities is inaccurate. Additionally, the analysis done by Mr. Herbein on warehouse store sales reaches a conclusion unsupported by market realities.

My expertise is in the area of dairy plant costs, not in federal milk marketing orders. My testimony is intended only to address the methods, data, and conclusions of Carl Herbein.

The Competitive Landscape

All three players in the fluid milk supply chain – dairy farmers, dairy processors and retailers have been consolidating at a rapid pace over the last ten years. This consolidation is driven by the same issues that face all industries –the need to continuously reduce operating cost and the need to expand geographic coverage to better service the customer. Cost reductions in the fluid milk processing industry are largely achieved through scale. Operating scale does matter in fluid milk processing plants. Larger production plants do deliver substantially lower processing costs, and national retailers with their

continued consolidation are demanding more from their suppliers and are getting it.

Considering this, I find it curious that the issue at this hearing is the alleged disruption PH's are causing in the fluid milk marketplace. Larger fluid processors today have enormous advantages over PH's in terms of scale, geographic coverage and product breadth. The large national and regional fluid processors offer customized dairy programs to their customers with incentives and efficiencies a PH could never offer.

For instance, the multiple plant networks many fluid processors have allows them to provide regional and/or national service to key customers. This is a substantial benefit to the retailers allowing them to streamline the number of dairy suppliers they deal with and accordingly reduce the cost of their purchasing operations. The multiple plant networks also provides many other benefits to the retailers including the added insurance of production backup in the event of a single plant supply disruption, and access to additional production capacity during periods of unusually high sales volume such as promotional periods or seasonal surges in volume. These are huge issues to retailers and play an important part in their supplier decision making process.

The large processors also offer scale based services that smaller processors find more challenging to offer including technology driven programs such as automated order entry, scan pay and EDI invoicing and payment systems. These systems not only drastically reduce the cost of doing business for the retailer but also lock in customers by raising the cost and complexity of changing suppliers.

All of these issues add up to large fluid processors having substantial non-plant cost advantages over PH's today. If fluid processors do have a threat today perhaps it lies in the area of captive dairies. Many of the largest national chains, such as Kroger and Safeway, operate their own dairies and for good reason. Milk is the largest private label category in the grocery store and retailers have been able to successfully develop their own brands in the milk category. Captive plants typically have substantial cost advantages to full line fluid plants and consequently can be a strong economic alternative to independent supply for a retailer. Captive plants can be scaled precisely to a retailers volume requirements and thereby achieve the full benefit of production leverage which independents seldom achieve do to the breadth of their product line and fluctuating volume.

Plant Volume & Costs

Testimony has been given at this hearing on plant volume and costs per gallon by Mr. Herbein. This testimony was used to draw conclusions about plant scale needed to achieve competitive costs for fluid milk processors. No rational economist or cost accountant would argue against the fact that as volume at a plant increases to approach the theoretical capacities of the plant, economies of scale are achieved and the unit cost of processing milk decreases accordingly. That is, I agree with Mr. Herbein to the extent that processing costs are inversely related to plant volumes. However, in my professional judgment and opinion, Mr. Herbein's conclusions in these areas do not at all reflect the reality of today's fluid milk marketplace. For example, Mr. Herbein states:

"At the 2,000,000 pound per month size a producer handler can be fully competitive with regulated pool plants on a cost of processing and packaging basis. At this point the competitive interaction between these handlers in the marketplace will be determined by their respective cost of raw milk".

First of all, to suggest that at only 3 million pounds a month a PH can be fully competitive with a regulated pool plant is an assumption not founded in the facts of today's marketplace and is not even close to reality. One only needs to look at the standard productive capacity of fluid milk filling equipment today to realize how off base this "conclusion" is. For example, standard gallon bottle fillers purchased today are rated at a line speed of up to 100 gallons a minute. The following example illustrates the theoretical productive capacity of a single gallon line assuming a run rate of 80 gallons a minute and 100 hour weekly processing time (both reasonable industry benchmarks):

Gallons per Minute	80
Gallons per Hour	4800
Gallons per Week (100 Hours)	480,000
Pounds per Week (8.6 lbs/gal)	4,128,000
Pounds per Month (x4)	16,512,000

In this illustration, a single gallon line alone could process over 16 million pound a month. When you add in half gallons and other products a plant would likely produce you quickly see that minimum

volumes of 20+ million pounds per month are necessary to effectively utilize the productive capacity of a plant and thereby have competitive costs. To suggest that a fluid processor could somehow run a dairy plant at what amounts to 10% of its theoretical capacity and achieve a competitive cost is not reasonable.

This fact was confirmed years ago in the February, 1997 Cornell Study of Fluid Milk Plant Productivity. Cornell selected 35 respected dairy processing plants from throughout the United States. The plants were a mix of independent, co-op and captive fluid processing plants. All aspects of fluid milk processing costs were surveyed and a detailed report was issued. From a plant volume standpoint, the average plant in the study was running at 75% of capacity and averaging 27 million pound a month. Indeed, the smallest plant in this study was processing 12 million pounds a month and the largest was in excess of 50 million pounds. To suggest that a PH could somehow be cost competitive with this set of processors while only running 3 million pounds a month is simply not realistic.

The Cornell study was also informative with regard to plant costs. In the survey, plant costs ranged from a low of 12 cents a gallon to a high of 28 cents a gallon. Fully one-third of plants had costs below 18 cents a gallon and 65% of the plants fell within the 15-25 cent range.

The information provided in the Cornell Study, in my experience and professional judgment, continues to be reflective of what productive processors can achieve today – gallon processing cost in the 15 to 25 cent a gallon range.

The plant costs used in the Herbein testimony ranged from 34 to 88 cents a gallon and are not reflective of anything that could remotely be considered a competitive cost. If a producer handler were bottling milk at that type of cost in the marketplace, not only would they be competitively disadvantaged relative to the market, the long-term viability of the plant would be questioned. In my professional opinion and experience, a plant that inefficient, if operated by a large regulated handler would be shut down or folded into a larger efficient plant that could handle the capacity.

If we accept the distinct probability that the cost data upon which Mr. Herbein based his analysis is overinflated, then the conclusions that are drawn from the data must also be called into question. The determination that the economies of scale occurring at the processing plant level off at three million pounds is not borne out by reality.

As a result, the conclusions drawn in the Herbein analysis suggesting that producer handlers were selling below cost or selling at a level that regulated handlers could not match is simply incorrect. Using the exact model offered by Mr. Herbein, I input recent warehouse prices observed in the Portland and Seattle markets and compared. This analysis is comparable to Mr. Herbein's Exhibit 25, Table E.

As did Mr. Herbein, I backed out a profit for the warehouse store and removed the processing costs identified by Mr. Herbein. This yielded a raw milk cost which was converted to a per hundredweight cost. The per hundredweight cost was compared to the appropriate Class I and Order uniform price which was calculated by the Market Administrator's office and supplied by Mr. Yale's office.

These tables, which utilize the methodology and cost data of Mr. Herbein reveal the same alleged servicing of the warehouse store at below Class I price. However, these observations were based in milk supplied by regulated handlers. No producer handler supplied any of the milk utilized in this price survey. In fact, none of the dairies offering this testimony supply warehouse stores in Order 124. The information supplied to me by my clients indicates that this milk is supplied by regulated handlers, not producer handlers. Since the regulated handler is supplying milk in a manner similar to the Arizona producer handler, the only conclusions that can be drawn are that either (1) the warehouse store is selling milk as a loss leader or (2) Mr. Herbein's underlying data and methodology is suspect.

What this does demonstrate affirmatively is that the regulated handlers in the Pacific Northwest can effectively compete for the business provided by warehouse stores, despite the presence of three larger producer handlers in the marketplace. As a corollary, it at least implies that status as a producer handler, and the corresponding Class I exemption, is not the determinative reason that Sarah Farms may have earned the business of any warehouse stores in Order 131, as suggested by Mr. Herbein.

Conclusion

The scale of processing plants in the fluid milk business continues to grow and smaller, less efficient plants continue to be sold, shut down or folded into larger more efficient plants. Captive operations, with their limited number of SKU's (normally just gallons and half-gallons with one or two labels) set the cost curve from which other processors

must compete. Considering this, in order to be a long-term player in the fluid processing business, plants must run efficiently and process sufficient volumes, to achieve a competitive cost. Establishing a maximum monthly processing limit of 3 million pounds for producer handlers would simply put them out of business by relegating them to operating plants that cannot capitalize on the economies of scale required to reduce per unit costs to competitive levels.

September 2003 (12 Milion Pound Plant)		Seattle
Average Retail (out of store prices)		4.29
Store Markup at	0.08	0.317778
Store Markup at	0.14	0.526842
Price paid to dairy supplier	0.14	0.08
	3.763158	3.972222
Dairy Supplier Costs		
Plant	0.796	0.796
Packaging	0.396	0.396
Distribution	0.296	0.296
Shrinkage	0.03	0.03
Milk PEP	0.034	0.034
TOTAL COST	1.552	1.552
VALUE OF RAW MILK	2.211158	2.420222
One Gallon Value	1.105579	1.210111
Convert to CWT	12.83577	14.04939
Analysis of Implied Return per CWT:		
Class I Cost - FO 124	15.81	15.81
FO 124- Uniform Price	12.54	12.54
Compare to Class I	-2.974228	-1.76061
Compare to Uniform Price	0.295772	1.50939

October 2003	(12 Milion Pound Plant)		Seattle
Average Retail (out of store prices)			4.29
Store Markup at		0.08	0.317778
Store Markup at		0.14	0.526842
Price paid to dairy supplier		0.14	0.08
		3.763158	3.972222
Dairy Supplier Costs			
	Plant	0.796	0.796
	Packaging	0.396	0.396
	Distribution	0.296	0.296
	Shrinkage	0.03	0.03
	Milk PEP	0.034	0.034
	TOTAL COST	1.552	1.552
	VALUE OF RAW MILK	2.211158	2.420222
	One Gallon Value	1.105579	1.210111
	Convert to CWT	12.83577	14.04939
Analysis of Implied Return per CWT:			
Class I Cost - FO 124		16.37	16.37
FO 124- Uniform Price		13.05	13.05
Compare to Class I		-3.534228	-2.32061
Compare to Uniform Price		-0.214228	0.99939

September 2003 (12 Milion Pound Plant)		Portland
Average Retail (out of store prices)		4.29
Store Markup at	0.08	0.317778
Store Markup at	0.14	0.526842
Price paid to dairy supplier	0.14	0.08
	3.763158	3.972222
Dairy Supplier Costs		
Plant	0.796	0.796
Packaging	0.396	0.396
Distribution	0.296	0.296
Shrinkage	0.03	0.03
Milk PEP	0.034	0.034
TOTAL COST	1.552	1.552
VALUE OF RAW MILK	2.211158	2.420222
One Gallon Value	1.105579	1.210111
Convert to CWT	12.83577	14.04939
Analysis of Implied Return per CWT:		
Class I Cost - FO 124	15.81	15.81
FO 124- Uniform Price	12.54	12.54
Compare to Class I	-2.974228	-1.76061
Compare to Uniform Price	0.295772	1.50939

C

October 2003	(12 Milion Pound Plant)		Portland
Average Retail (out of store prices)			4.45
Store Markup at		0.08	0.32963
Store Markup at		0.14	0.546491
Price paid to dairy supplier		0.14	0.08
		3.903509	4.12037
Dairy Supplier Costs			
	Plant	0.796	0.796
	Packaging	0.396	0.396
	Distribution	0.296	0.296
	Shrinkage	0.03	0.03
	Milk PEP	0.034	0.034
	TOTAL COST	1.552	1.552
	VALUE OF RAW MILK	2.351509	2.56837
	One Gallon Value	1.175754	1.284185
	Convert to CWT	13.65051	14.90939
Analysis of Implied Return per CWT:			
Class I Cost - FO 124		16.37	16.37
FO 124- Uniform Price		13.05	13.05
Compare to Class I		-2.719492	-1.46061
Compare to Uniform Price		0.600508	1.85939

D