

Testimony for Federal Order Hearing Commencing May 4, 2009

JT Wilcox

I was employed by Wilcox Farms Inc. and later, by Wilcox Dairy Farms LLC from 1985 until 2008 when ^{Certain} ~~the~~ assets of Wilcox Dairy Farms were sold. Before 1985, I was intimately _{JTW} involved in the family business as a high school and college age employee and trainee.

From 1985 until 2008, I filled a variety of management and staff positions including:

- Manager of an 800-cow dairy production operation that was integrated with a milk plant, first as a producer handler and later as a supplier of a regulated fluid plant held under the same ownership as the herd.
- Manager of a regulated fluid milk plant producing approximately 10 to 15 million pounds per month
- Project manager responsible for business plan and construction of a 200,000 bird integrated laying operation incorporating feed processing, layer operation, egg processing and distribution
- Project manager responsible for business plan and construction of a new regulated milk plant near Spokane, Washington designed for streamlined and efficient processing of relatively low volumes of milk for a small market
- Director of Inland Northwest for Wilcox Dairy Farms LLC responsible for plant operations, distribution and local sales and marketing with a new regulated fluid processing plant producing between 2.5 to 7.5 million lbs. per month

- Corporate Director of Operations for Wilcox Dairy Farms LLC responsible for plant operations with three regulated fluid plants processing between 30 and 60 million lbs. per month and distribution in a five state area
- CFO of Wilcox Dairy Farms LLC responsible for accounting, finance and human resources

I also served on a variety of industry boards including terms as:

- Commissioner on the Washington Egg Commission
- Commissioner on the Washington Dairy Products Commission
- President of the Washington State Holstein Association
- President of the Washington Poultry Industry Association
- Chairman of the National Fluid Milk Processor Promotion Board

Wilcox Farms Inc. is a 100-year-old family agribusiness located near Roy, Washington. The company's primary products have been liquid and shell eggs and milk. In 1960, the company entered the dairy cattle business as a producer for a local dairy cooperative.

In 1974, the company held discussions with a large regional grocery chain regarding a proposal that Wilcox Farms build a milk processing plant, become a producer handler and supply this chain with their fluid milk needs. The grocer was aware of the advantages of the producer handler exemption and was able to use their alternative supplier to balance supply with demand. As a result, Wilcox Farms built a fluid milk processing plant and operated as a producer handler until approximately 1987.

In 1987, Wilcox Farms was serving several rapidly growing grocery chains. The growth occurred in steady increments rather than one large quantum leap. In the case of one of the grocers, Wilcox was gradually replacing an incumbent supplier. In the case of another grocer, Wilcox was simply growing with that grocer's rapidly increasing corporate volume. For several quarters, Wilcox maintained their status as a producer handler, but eventually, in order to meet the demand of its customers, Wilcox management elected to become a fully regulated handler.

In 1998, Wilcox Dairy Farms LLC was formed as a separate company with Dairy Farmers of America holding a minority position in ownership and Wilcox Farms contributing some of their dairy assets. In the years following, Wilcox Dairy Farms LLC grew to be one of the largest dairies serving the Pacific Northwest.

In the early to mid 2000's, Wilcox Dairy Farms LLC found that the increasing concentration of grocery chains created a situation where only a few large grocery retailers, cooperative grocery warehouses and food service chains purchased the majority of the packaged fluid milk products sold in the marketing area. Milk suppliers based their capital and cost structures on the status quo volumes. The result of this situation was that Wilcox felt the need to respond to downward pressure on milk processing margins in order to maintain critical volume. Wilcox felt that the consequences of losing a large customer would bring into question the viability of the company. After several years of losses due to shrinking margins, the decision was made to sell certain assets of Wilcox Dairy Farms LLC and close the business.

The market for milk through grocery and food service outlets has become increasingly concentrated. Most of the volume is purchased by large regional and national chains or by warehouse operators that serve chain and independent outlets. Most milk processors serve one or more of these customers and many of these grocers, food service operators or food warehouses purchase their dairy needs from several suppliers, even in the same region.

Milk is considered one of the critical grocery items. It is an extremely serious issue if a store or restaurant is out of fluid milk products and it is equally serious for most of them that their fluid milk products are competitively priced. It is very common for gallons of milk to be a featured promotional item on weekly grocery advertisements.

Because of the size and scale of the grocery and food service chains, and because of the critical nature of fluid milk, buyers of this commodity have become extremely sophisticated and aggressive. To protect their companies, buying departments have developed very strong

quality and inspection programs, sophisticated sales data analysis, and because they deal with so many fluid milk processors, they have become very knowledgeable about costs and regulations dealing with fluid milk. Major chains often employ staff or consultants that are well versed in federal order regulations and some are former staff members of the USDA. It is possible that some large buyers of fluid milk are as well informed regarding dairy price regulations as some milk processors.

Large grocery and food service chains are very aware of the producer handler exemption. They are also aware of the historical disadvantages involved in that status. In the past, the need to “balance” production of milk, which can be relatively level in a modern, well-managed dairy herd, with milk demand, which varies during the week, seasonally, and in response to promotions, worked to diminish the milk cost advantage that the producer handler exemption provides to the producer handler. Now, however, as grocery and food service distribution centers have grown in size and management sophistication, it is possible to take care of the balancing more readily. It is much easier for the warehouse operator to balance a producer handler’s milk production with milk demand by using other, regulated processors. For instance, the operator of a large distribution center routinely receives milk from a variety of milk processors. Even chains which do not use their warehouse for milk distribution are capable of balancing a producer handler, as was done by several of Wilcox Dairy Farms chain customers. Because of the limited number of large buyers of milk, it is very likely that a regulated supplier could be found that would agree to vary his volume to accommodate the needs of the warehouse operator in balancing producer handlers.

Although it is easy to demonstrate how balancing a large producer handler can be done through the use, in a large warehouse, of multiple suppliers, it is also a reality. Because Wilcox Farms had a history as a producer handler, early in this decade, the suggestion was made by a large milk purchasing company that Wilcox Dairy Farms LLC convert to producer handler status. The origin of the suggestion was a sophisticated understanding of the producer handler exemption, the ability of the milk purchasing company to balance milk at the customer level and a desire to secure the advantage of lower cost milk for their own customers.

Although Wilcox Dairy Farms LLC had the expertise to do this, the offer was declined because of the specific circumstances faced by Wilcox Dairy Farms LLC. It was felt by Wilcox management that the producer handler exemption would be quickly eliminated through regulation if such a major disruption in the milk business occurred in the Pacific Northwest, and Wilcox was unwilling to take that risk. In the event, this was a wise choice since the exemption was limited in the PNW Federal Order in 2006. In addition, at that time, Wilcox was packaging the milk from approximately 15-20,000 cows. Unlike large dairy farms, which already have made the investment in infrastructure and cattle, that would all have been incremental investment for Wilcox Dairy Farms LLC. The capital for that farming infrastructure investment was beyond the reach of Wilcox Dairy Farms LLC in light of the risk that the exemption would be limited. It is interesting to note that at large size levels, the investment in cows and dairy farm infrastructure is far greater than processing infrastructure for the same capacity. It would be comparatively easier in terms of capital, for an existing dairy farmer with 10,000 cows to add a processing plant than for an equally sized processor to add the dairy cattle capacity. A recently reviewed University of Florida capital budget for a large dairy farm estimated capital ^{expenditures} ~~costs~~ at

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over \$4,000 per head. Wilcox Farms built a milk plant near Spokane with capacity for milk from around 5000 cows for less than \$7,000,000. The investment to double capacity would have likely been less than \$3,000,000. The capital required for a 10,000-cow herd would be about \$40,000,000 according to the University of Florida study.

In my opinion, it makes sense for large grocers or food service companies to seek out producer handlers. There are major advantages in doing this and the disadvantages are not difficult to mitigate in today's marketplace. The major obstacle in doing this is uncertainty regarding the longevity of the exemption. If it appeared very likely for the exemption to remain, then I would certainly be interested in consulting for a producer handler, and if asked, to invest my own resources in one because the prospects for success would be good given the exemption and other advantages listed below.

A producer handler, by its nature does not need any special exemptions. This is a business model with inherent efficiencies and it should and will survive based upon those efficiencies. This is especially true if the producer handler has a strong, contractual relationship with large milk buyers, as was the case when this possibility was proposed to Wilcox Dairy Farms.

- A dairy herd produces milk at a much more consistent rate than is seen in customer demand. If a large milk buyer was able to balance the production of a producer handler then the consistent weekly volume would result in a more efficient plant in both capital and operational terms.

- Within a range, it is possible through management and feed to customize the butterfat content of a herd's milk. Doing so would provide a more nearly optimal component level resulting in better net returns
- Raw milk storage tanks can be minimized because the same tanks are used for plant and herd raw storage. Raw milk storage tanks are a major capital cost for both milk processors and dairy farmers and washing tanks is an operational cost for both. Wilcox Farms used common raw tanks for herd and processing when it was a producer handler.
- Wilcox Farms has operated three large-scale, vertically integrated laying hen operations. The egg industry, like some other agricultural industries involving livestock, has evolved into an industry that is dominated by vertically integrated enterprises, similar in nature to the exempt producer handler. The reason is that the operation is much more efficient when production is linked directly to processing. Eggs are a fresh, perishable product similar to milk. If the producer handler exemption was considered to be secure for the long term, it seems reasonable, based on other livestock based commodities and on my experience at Wilcox Farms, to expect that the vertically integrated producer handler would be the most efficient and dominant business model.

Of course, the producer handler exemption provides the greatest incentive, however, under the right circumstances the above efficiencies can serve to add to the advantage of the producer handler.

There is another way in which a small producer handler is used to reduce price and margins to the detriment of regulated fluid milk plants.

When Wilcox Farms began serving one of its first national grocery accounts, around 1985, it was still a producer handler. The grocer's milk buyer understood the production constraints and the advantages of the exemption and allowed Wilcox to begin serving his stores at the level of only four stores at a time. This was efficient for Wilcox because at that time Wilcox had surplus milk and because the volume of four stores fit well into full truckload deliveries.

Wilcox was under the impression that their price was lower than the incumbent's price. Wilcox was not aware what the incumbent was told regarding Wilcox pricing, however it is not uncommon in the dairy business for a supplier to be informed when a competitor's pricing is more favorable. In many post 1987 cases, Wilcox was told by its customer that its' (Wilcox) pricing was not competitive in an area. Sometimes the lower priced competitor was a producer handler. Normally, Wilcox, as the incumbent was asked to lower the price to meet a competitor's price, even when the competitor was able to serve only a small number of stores in a limited region, such as the four stores that Wilcox began serving around 1985. In some cases, Wilcox was allowed to respond only for that region. In others, Wilcox was asked to reduce its price in the entire service area.

It is very important for grocers and food service wholesalers that their fluid milk prices be seen as highly competitive. In general, when a milk buyer has an opportunity to buy milk at

a cheaper price than he is currently getting, the incumbent supplier is informed and has a chance to match the lower price. If the incumbent declines the opportunity to match prices then it is usually understood that his status as the incumbent supplier is at risk either in individual stores or in a region.

Although producer handlers have not become a major issue in some regions, it seems more likely that this is due to uncertainty regarding the longevity of the exemption rather than because there are insurmountable business obstacles to more companies taking advantage of the exemption. Over the last two decades a number of trends exist that would make it more likely for a producer handler to be viable than in the past.

- The size of dairy farms has grown rapidly. There are a number of dairy farming companies that already have enough cows to produce the milk needed to supply one of Wilcox Dairy Farms LLC plants.
- The advantages of linking production and processing of agricultural products have been well established in other livestock based commodities such as beef, chicken and eggs.
- If there were a level of certainty regarding the longevity of the producer handler exemption and a long-term contract, as was offered to Wilcox Farms in the past, a producer handler would be an attractive investment. Wilcox was offered investment resources as an inducement to change status. In my real estate auction work, my broker and I are in every day contact with investors with the cash resources to back this kind of enterprise and in my opinion, a solid

regulatory advantage, such as the producer handler exemption would provide a positive inducement to invest.

- Greatly increased concentration of grocery and food service chains, together with the consolidation of warehouses serving independent grocers and food service outlets provides more milk buyers with the size necessary to have multiple milk suppliers and provide balancing for a producer handler.
- Fierce price competition between very large grocers that often promote milk based on price, means that no milk buyer can afford to ignore any potential price advantage for his company or his retail customers. Buyers are much more sophisticated and aware of regulatory advantages and actively seek out dairies to be producer handlers.

Until now, uncertainty about how the USDA would react to a very large producer handler's entry into the market has, in my opinion, constrained companies from investing in this business on a large scale. Certainly, that was a major constraint for Wilcox Dairy Farms LLC. If this national hearing definitively rejects the opportunity to modify the exemption, then I have little doubt that major efforts will commence to create large fluid milk processors that operate as producer handlers. As mentioned above, I am confident enough in their success to seek consulting engagements or to invest in them myself.

Respectfully submitted

JT Wilcox

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