

Testimony of Michael Newell

May 2009 Federal Milk Marketing Order Hearing

Cincinnati, OH

Docket N. AO-14-A78, et al.

Good morning. My name is Michael Newell and I am currently employed by HP Hood LLC as their Director of Business Development for the western United States. From 1987 until May of 2007 I worked in a variety of positions at Crystal Cream & Butter Co., my family's milk processing business which was located in Sacramento, CA. Relevant to today's testimony are the positions I held as a Sales and Marketing Analyst from 1991 until 1997, Vice President of Marketing from 1997 until 2003, and Company President from February 2003 through October of 2007. In May of 2007 Crystal's dairy assets were sold to HP Hood and on November 1, 2007 HP Hood sold the Crystal brand and the conventional milk business to Foster Farms Dairy in Modesto, CA. At that time I transitioned to my present position at HP Hood. The purpose of my testimony is to give a first-hand perspective on the soft cap Producer-Distributor (PD) exemptions that Dr. Schiek discussed in his testimony and their impact on the competitive landscape in the Northern California milk market.

Overview of Crystal Cream & Butter Co.

Crystal Cream & Butter Company was founded in Sacramento in 1901. The Hansen family owned the business from 1921 until its sale in 2007. Crystal based its business on core principles of quality, service, integrity and competitive pricing. Crystal built an extremely strong brand name in the Sacramento Valley by consistently advertising on radio, television, and print media from the late 1950s through the early 2000s. Another key to Crystal's success was its high quality milk supply was almost entirely purchased directly from independent dairy farmers. Being located in the capitol city, Crystal was also extremely active in California dairy associations and participated regularly in California Department of Food and Agriculture milk pricing and pooling hearings.

Between 1990 and ^{2006 JSC}~~1996~~ Crystal's annual milk purchases ranged from 45 million to 60 million gallons. During this period Crystal had between 400 and 500 employees. For most of its business life Crystal was a full line manufacturer producing fluid milk, cultured products, ice

cream, butter, and nonfat dried milk. Until 1996, all of these products were produced at Crystal's downtown plant in Sacramento. In 1996 Crystal opened a state-of-the-art bottling facility on Belvedere Avenue in Sacramento which also incorporated ESL pasteurization capabilities. Fluid milk accounted for approximately 65% of Crystal \$140 to \$180 million of annual sales.

Crystal served the full gamut of customers - schools, restaurants, independent distributors, convenience store, other processors, and grocery stores. Grocery stores were the largest segment of Crystal's business. Crystal's primary distribution area ranged from Modesto (75 miles to the south of Sacramento) to Redding (150 miles to the north) and from the San Francisco Bay Area (75 miles to the west) and Lake Tahoe (100 miles to the east).

Northern California Marketplace

In the early 1990s the vast majority of the fluid milk sold in Northern California was provided by three captive dairy processors and five significant, family-owned independent processors. For the most part, the captive processors sold milk to the stores owned by their corporate parents. They, in general, did not compete with the independent processors and for that reason will not be a focus of this overview.

The independent processors were located in Petaluma, Emeryville (Berkeley), Modesto, Fresno, and Sacramento. I would estimate that in 1990 the processors based in Emeryville and Modesto were of comparable size to Crystal and the processors in Fresno and Petaluma were less than half that size.

In the early 1990s competition between the five independents was probably best defined as "orderly". The independent processors were dominant in their own "hometowns" and although each competed to some degree, distribution distance really seemed to be a limiting factor – i.e. – you competed with your neighbor but not your neighbor's neighbor. At that time a customer's price was dictated by published bracketed price lists and services levels. Based on the competitor's price lists that I recall seeing, the prices on the published price lists of the independent processors were fairly similar, so customers tended to base their purchasing decision on quality, service, support, and brand in addition to price. Looking back I think that price lists were similar because the independent processors' costs were fairly comparable.

Impact of P-D Exemption on Competition

Around 1993, we began to see an elevated level of competition with the processors located in Modesto and Fresno. At first this competition manifested itself in seemingly disconnected actions like more aggressive pricing on a school bid, offering full service to a customer at what previously had been a drop ship price, or the creation of a new price bracket for high volume accounts. Then we learned about an undisclosed provision of the 1993 Quota Reform Bill that had removed the cap from the P-D exemption and that this had allowed the independent processors in Fresno and Modesto to significantly decrease their milk cost by increasing their exempt quota holdings. Prior to this time we had a vague knowledge of their dairy operations and that a small portion of their milk had been exempted from the pool since its establishment in 1969.

The discovery of this significant competitive advantage was of great concern. We began tracking this advantage on a monthly basis and it ranged between \$.20 per gallon and no difference. As Dr. Schiek has testified, on the average the advantage was \$0.11 per gallon on the portion of the milk they were able to exempt from the pool. In our mind, this was an incredible cost advantage that threw what had previously been a level playing field out of balance. As I'm sure has been noted at this hearing, customers often base their purchasing decisions on a fraction of a penny per gallon and when you have an advantage of a dime per gallon to use at your discretion, it becomes an enduring competitive advantage. We actively pursued legislative changes to correct this inequity via the Dairy Institute, but were unsuccessful beyond ceasing further expansion after March 1995.

This advantage was a truly disruptive development for the Northern California competitive landscape. In about 1996 a large box store chain from the Northwest initiated its expansion into California by opening a store in Redding, CA. Crystal had a large distribution plant in Redding that had previously been a bottling plant. Additionally Crystal served a large box store in Redding and virtually every independent grocery store in the area with the exception of Costco. Thus we felt we were in a great position to serve this new prospective customer. We gave the customer our very best pricing and the new entrant promptly selected the PD from Fresno as its supplier— from a distance of over 300 miles to the south due to superior pricing.

This was just the start of a trend that developed over the next ten years. Crystal was very successful at taking care of its existing business, but anytime new business was available it seemed to go to one of the two Producer Distributors. Despite having a new bottling facility we

found it extremely difficult to be price competitive for new business opportunities in the conventional milk market. The PD from Fresno put the P-D advantage to good use - building a first rate full service route system that covered virtually all of Northern California to serve the Target stores and several major convenience store chains. The PD in Modesto was selected as the supplier for the Wal-Mart stores in Northern California. I should note that Crystal had a working relationship with this PD and did serve the Wal-Mart stores in the Redding area on their behalf. During this period margins compressed and business growth was slowly declining for Crystal as independent stores went out of business and very few new customers were added.

The P-D advantage impacted the other two independent processors in different ways. The large independent processor that was located in Emeryville opened a new facility in 1999 and by 2000 had sold their business. I believe that increased competition and the declining prices and margins were a factor in that family's decision to sell. The new owner has lost its share of high volume business opportunities including the online bid for a chain that Dr Schiek referenced in his testimony. We actively participated in this process and could not come close to the price that was settled on. The independent processor in Petaluma took a different direction. They positioned their business to appeal to a natural, health-minded customer base conveniently located in close proximity to their plant, and have been able to grow their business quite successfully by marketing their conventional and organic products to this growing niche consumer segment on product benefits rather than price.

By mid-2006 the Hansen family had reached the conclusion that it was time to sell the business. Margins and prices were continuing to fall and sales were eroding. Certainly many factors beyond the P-D issue played a part in this decision like industry consolidation, market-wide excess bottling capacity, increasing business insurance costs, union labor issues, and family considerations. We did not have the cost advantage of the Producer Distributors, the resources of a national milk processor, nor were we focused on a specific consumer niche like the Petaluma milk processor. The attributes that had made us successful for so many years – quality, service, and brand were not valued as much as a lower price. The business was not fun anymore and it was time to move on which the family did in May of 2007. HP Hood has taken a much different approach with the Sacramento plant choosing to sell the Crystal brand name and the conventional milk business and focus instead on the segment of Extended Shelf Life dairy products.

Conclusions

Reflecting on the impact of the P-D exemption over the last 15 years, leads me to several conclusions. First of all, I have no ill feelings toward the two Northern California PDs. To the

contrary, they are both excellent operators and I admire their ability to see an opportunity and exploit it to their advantage. I find it highly ironic however, that the California milk pooling system that was put in place to stabilize the milk market for the benefit of all milk producers created this situation. The expansion of the P-D exemption essentially channeled money that had previously been paid to the producers via the pool to the Producer Distributors which used it to improve their cost competitiveness and grow their businesses, limiting other producers' access to the Class 1 market

I was asked to testify about my perception of impact of the California PD situation. My understanding is the federal order system is considering a petition that would create a hard cap that would effectively limit the size of an exempt Producer Handler to a relatively low volume level. I would encourage this. The goal of government controlled dairy pricing systems should provide for market stability for both producers and processors and should not create opportunities which stand to benefit one party at the expense of other parties.

That concludes my testimony, thank you for the opportunity to share Crystal's experience. I hope you find it helpful.