

REBUTTAL TESTIMONY OF

RON MONG, CPA

Appearing on Behalf of the Area 5 Milk Dealers

Rebuttal Testimony before Pennsylvania Milk Marketing Board

Cost Replacement Hearing Based on 2018 Annual Reports

NOVEMBER 6, 2019

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Area 5 – Cost Replacement Hearing

I am Ronald W. Mong, Senior Manager at Herbein + Company, Inc. and my address is 2763 Century Blvd., Reading, PA 19610. I wish to present Rebuttal Testimony on behalf of the Area 5 Milk Dealers. I attach my Curriculum Vitae, as Rebuttal Exhibit D1, which outlines my education, and experience in the dairy industry.

Study Conducted

On behalf of the Area 5 Milk Dealers, I have reviewed the audit files and proposed adjustments prepared by the Pennsylvania Milk Marketing Board audit staff, have conducted fieldwork at each of the dealers in the cross-section and have prepared exhibits which present my findings.

Cost Replacement Process

This hearing will accomplish the annual cost replacement process in which the Pennsylvania Milk Marketing Board substitutes new cost information for the prior information, which is then utilized in developing its wholesale and resale prices. This hearing will include a container cost update utilizing April 2019 cost information as the new starting point for container updating. Once the cost replacement data is adopted, the April 2019 container costs will be updated monthly based upon cost information submitted by the cross-section dealers and reviewed by Board staff. This hearing will also include ingredient cost updating utilizing March 2018 cost information. Ingredient costs will then be updated on a quarterly basis for flavored milk, flavored reduced fat milk and flavored non-fat milk. These updates occur on January 1st, April 1st, July 1st, and October 1st of each year. All exhibits are prepared utilizing a weighted average based on the controlled sales in the area relative to its total sales of such products. All exhibits have been adjusted for inter-plant transfers. An inter-plant transfer is a transaction where a product is manufactured in one plant and transferred to an affiliate plant that

then sells the product to the ultimate consumer such that these exhibits have been prepared reflecting the sales to the ultimate consumer in the applicable area. This weighting and averaging method has been consistently applied from year to year.

Cross-Section

The Area 5 cross-section of dealers utilized includes Dean Dairy Products Company, LLC (Sharpsville, PA), Schneider's Dairy Inc., Turner Dairy Farms Inc., United Dairy Inc. (Martins Ferry, OH), United Dairy Inc. (Uniontown, PA) and Galliker Dairy Co. (Johnstown, PA). This is the same cross-section used in the last hearing. The cross-section companies process, package and deliver most of the controlled milk products in Area 5 (79.2%). This group of companies includes organizations that deliver to supermarkets, convenience stores, schools, institutions, and small retail outlets. In my opinion this cross-section of dealers is representative of the dealers selling controlled milk products in Area 5.

Rebuttal Exhibits

Rebuttal Exhibit D2 reflects the processing, packaging, and delivery cost per point for calendar year 2018. Please note that the points presented are for sales in the PMMB Area 5 made by the cross-section dealers. These costs should replace the existing costs from 2017, which are currently being utilized by the Board in establishing prices. These costs are calculated in accordance with PMMB rules and regulations and have been consistently applied from the previous year. Our calculation of the processing, packaging, and delivery costs agrees with the amounts that will be presented by Board Staff on Staff Surrebuttal Exhibit 2.

Rebuttal Exhibit D2-A is prepared to reflect the effect of the cost replacement process by comparing the 2017 processing, packaging, and delivery costs in the current order with the 2018 processing, packaging, and delivery costs. Additionally, this exhibit reflects the 2019 cost increase adjustment from Exhibit D7 and removes the 2018 cost increase adjustment. Including the cost update

adjustments, the increase in the cross-section dealer costs from the prior cost replacement hearing is \$0.0178 per quart equivalent (point), or 7.12 cents per gallon.

Exhibit D2 shows the number of points (quart equivalents) that are associated with each cost center. For example, the bottling department points for 2018 are 186,056,048 for the cross-section dealers. For 2017 the bottling cost center points were 181,433,412, an increase of about 5 million points, or 2.6 percent. Two cross-section plants had significant increases in bottling points. Three plants had significant decreases in bottling volume.

Rebuttal Exhibit D3 and D3-A have been updated to container costs utilized in the February 2019 resale price development. The container shrinkage factor reflected on this exhibit is a statewide average and will be utilized for all areas. This study was conducted for the period January to March 2009 and it is my opinion that it is reasonable to continue using this study's container shrinkage statistics for these Cost Replacement Hearings. There are no controlled milk products sold in Area 5 in paper half gallons or in 10-ounce containers. The container sizes indicated with footnote (4) should continue to be updated monthly when minimum prices are announced using April 2019 as the new starting point.

Our container cost calculations agree with those calculated by Board Staff and will be presented in their Staff Surrebuttal Exhibit 3.

The Area 5 Milk Dealers request and recommend that the blending concept be continued for all containers that are represented by both plastic and paper except for the half pint container. The blending of containers, including blow-molded and purchased plastic containers should be continued for each container sold in this area. The wholesale and resale prices announced for controlled products sold in half pint containers should continue to be calculated utilizing the paper container cost. The minimum price of plastic half pints should continue to be calculated by adding the calculated

difference between the cost a plastic half pint and a paper half pint. The plastic – paper differential used in announcing October 2019 minimum prices was \$0.0464. This differential should continue to be adjusted monthly.

Rebuttal Exhibit D4 is prepared to present the ingredient costs per pound of finished product as of April 2019 for inclusion in the product formulas used in the monthly price announcements. Rebuttal Exhibit D4-A reflects the ingredient costs presented on Rebuttal D4 and shows the increase or decrease from the ingredient costs used in calculating the October 2019 minimum prices.

The ingredient costs are shown on D4 in cents per pound of finished product. The PMMB minimum price calculations multiply these ingredient costs per pound times the milk weight of each container size. For example, a quart of flavored milk weighs 2.0 pounds. The PMMB price formulas would calculate the ingredient costs of a quart of flavored milk by multiplying the quart weight of 2.0 times the ingredient cost of \$0.0383, which is \$0.0766 per quart.

Our ingredient cost calculations agree with those calculated by Board Staff and presented in their Staff Exhibit 4.

Rebuttal Exhibit D5 updates the cost of milk shrinkage and the costs and revenues from bulk cream and bulk milk transactions. Milk shrinkage in a dairy plant is the cost of milk that is purchased from dairy farmers or dairy cooperatives but which is lost in the manufacturing process.. The cross-section dairy plants have two types of bulk milk transactions. The first type of transaction is when raw milk not needed by the plant goes directly from the farm to another dairy plant. The plant buying the unneeded milk typically manufactures cheese or nonfat dry milk. The plant buying the milk can negotiate a price that is less than the price a fully-regulated fluid milk plant must pay for that milk, so depending on market circumstances, this transaction (a diversion) can result in losses.. The second type of transaction is when milk is received, standardized, and pasteurized, and then shipped to a food

manufacturing plant. The purchasing plant could make candy, baked goods, puddings, soups, or many other varieties of food products. These transactions are called transfers. In Exhibit D5 both types of transactions are combined on the bulk milk row. Bulk cream sales occur at fluid milk plants because the butterfat test of the incoming raw milk is about 3.8% butterfat, and the average butterfat test of the packaged products sold is closer to 2.0% butterfat.

The PMMB monthly price calculations correctly account for the costs of milk shrinkage and the costs and revenues for the sales of bulk cream and bulk milk.

The current order establishes a net cost of \$0.0001 per pound and the new net revenue, based on 2018 transactions is also \$0.0001 per pound. That means on the whole these three transactions resulted in no net change.

Our calculation of milk shrinkage costs and the costs and revenues of bulk milk and bulk cream transactions agree exactly with those calculated by Board Staff and will be presented in their Staff Surrebuttal Exhibit 5.

Rebuttal Exhibit D6 reflects a comparison of the current order butterfat tests by product type and compares those tests with the 2018 actual butterfat tests. This exhibit also reflects the increase or decrease in butterfat content. Because the butterfat component of milk has a higher cost than the skim component, a decrease in butterfat content will result in a decrease in the cost of milk in the wholesale and resale prices. An increase in butterfat content will increase the cost of milk in finished products. I recommend that the Board replace the current butterfat by product with the 2018 tests reflected on this exhibit.

Our calculations of butterfat content by product type agree exactly with those calculated by Board Staff and presented in their Staff Exhibit 6.

Rebuttal Exhibit D7 is prepared to calculate the cost increases and decreases incurred during the six (6) month period ending June 30, 2019 with the six (6) month period ending June 30, 2018 for three important cost categories in a dairy plant. These three costs are: labor and fringe benefits, utilities, and insurance. This adjustment allows for an updating of significant costs, which can change significantly from year to year. We calculated the weighted points for the first six (6) months of 2019 are 14.7% more than the weighted points for the first six (6) months of 2018. The three cost categories used in this calculation increased 11.0% during that same period.

Our calculation of the cost increases for labor, insurance and utility agree with those calculated by Board Staff and presented in their Staff Exhibit 7.

Rebuttal Exhibit D8 has been updated to reflect the August 2019 diesel fuel costs, which were used in calculating the minimum prices for October 2019. Additionally, this exhibit reflects the calculation of the average diesel fuel cost for calendar year 2018, which becomes the new starting point for the monthly adjustments. I recommend that this adjustment be continued monthly. The average diesel fuel cost for 2018 for the cross-section dealers is \$0.0151 per point. This amount varies in each area based on distances traveled, delivery sizes, and fleet fuel efficiency.

Rebuttal Exhibit D9 has been updated to reflect June 2019 natural gas costs and reflects OGO A-937 effective June 1, 2006 concerning heating fuel costs. Additionally, this exhibit reflects the calculation of the average heating fuel cost for calendar year 2018, which becomes the new starting point for the monthly adjustments. I recommend that this adjustment be continued monthly.

Our calculation of the cost increases for the diesel fuel adjustment and the heating fuels adjustment ed by Board Staff and presented in their Staff Exhibits 8 & 9.

Container Efficiency Adjustment

An important part of the calculation of PMMB's minimum resale prices is the container efficiency adjustment. These adjustments are in place to allocate the fluid milk processors' costs appropriately to the various sizes of containers sold. The impact of the container efficiency adjustment is to deduct costs from the two larger packages, gallons and half gallons, and to add costs to the smaller containers. Our calculation of updated container efficiency adjustments is shown at Exhibit D10.

The container efficiency adjustment was implemented to be revenue neutral, meaning the container efficiency adjustment did not add costs and did not generate new revenue. The adjustments as originally calculated added a dollar of costs to the smaller containers for every dollar deducted from the larger containers. When correctly calculated the container efficiency adjustments will not be a revenue-generation tool, but instead will serve as a cost allocation tool. The plusses should equal the minuses so that the total of plusses and minuses foots to zero.

The container efficiency adjustment has two components:

- 1) Bottling costs allocation – based on filling speeds at each processing plant
- 2) Cold room and delivery costs allocation – based on number of units packed in a plastic milk case.

Bottling Cost Center

The bottling cost center costs shown on Exhibit D2 are \$0.0476 per point. This is an average of all sizes packaged at all the cross-section plants. Our calculation starts with this average cost. The goal of the calculation, which we achieved, is to adjust the average bottling cost center costs for the individual container sizes so that in total the average cost per point remained \$0.0476.

Cold Room and Delivery Cost Centers

The cold room cost center costs shown on Exhibit D2 are \$0.0481 per point and delivery cost center costs per point are \$0.1629 per point. An allocation of the costs in these in two cost centers is needed because dairy h container packages are not sold individually but in plastic milk cases. The dairy employees handle these cases and not the individual units. Each plastic case holds a different number of points for each container size.

We calculated the number of milk cases each plant used to handle the containers it sold in 2018. We allocated the total cold room and delivery costs to each size based on the number of milk cases used for that size. As we did in the bottling cost center allocation, we made certain we only allocated the actual costs at that plant. No additional costs were added or deducted. The cold room and delivery costs pluses and minuses were equal. The adjustments were revenue neutral.

Exhibit D10

Exhibit D11 shows the results of our container efficiency update calculations. The actual quantity of each size container is shown in the first column. These quantities are multiplied by our calculated container efficiency adjustments to determine the impact on cross-section dealer revenue. For example, the updated adjustments would allocate \$1,607,267 out of the gallon package and add \$1,180,910 to the paper half pint. The net effect of the plusses and minuses is revenue to the dealers of \$2,675. This isn't zero because we are only calculating the container efficiency adjustments to four decimal places, but in the world of accounting this kind of small difference due to rounding is reasonable.

I recommend that the container efficiency adjustments be updated in this cost replacement hearing. In addition, I recommend that adjusting these important factors becomes part of every year's cost replacement hearing so that revenue neutrality can be maintained from year-to-year.

Summary

Rebuttal Exhibit D11-A and D11-B are prepared to reflect the wholesale minimum price for a gallon of reduced fat milk and a half pint of flavored non-fat milk for October 2019. These exhibits also cross-reference the exhibits that support the individual line items.

Class II Controlled Products

The annual cost replacement process could include an updating of Class II product costs. Class II controlled products include half & half, light cream, sour cream, and heavy cream. We are not presenting any recommendation to change the method used for Class II pricing. We ask that the Board continue with the existing methodology. The Area 5 milk dealers have considered and will continue to review other approaches but do not see a need for modifying the status quo.

Rate of Return

I recommend that the Board maintain the rate of return for the Area 5 dealers at 3.5%. Milk dealers in Area 5 and across the Commonwealth are facing a serious battle for profitability as fluid milk demand continues to decline year-over-year.

I reviewed the Statements of Operations for the year ended 12/31/2018 for the six cross-section dealers. These are submitted by the dealers on Exhibit B of the PMMB-60 Milk Dealer's Financial Statement. The 2018 weighted average rate of return for the Area 5 cross-section dealers was -1.0%. This is well below the statutory range of 2.5% to 3.5%. Two of the plants had operating losses in 2018. The rate of return at the most profitable plant in the cross-section was below 2.5%. The Board may be wondering how the rate of return can be that low if the statutory rate of return is set at 3.5%. There are many reasons, including the fact that cost replacement lags the period when the operating costs were incurred. In the end, however, given this dismal profit and loss situation, it is essential that the Board continue the 3.5% rate of return.

Summary and Recommendation

The Area 5 Milk Dealers recommend that the Milk Marketing Board make the cost replacement adjustments, which are reflected in my testimony and exhibits. Thank you for your consideration of my analysis and opinions.