

REBUTTAL TESTIMONY OF

RON MONG, CPA

Appearing on Behalf of the Area 3 Milk Dealers

Rebuttal Testimony before Pennsylvania Milk Marketing Board

Cost Replacement Hearing Based on 2019 Annual Reports

March 3, 2021

Submitted: February 19, 2021

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Area 3 – 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 3 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 3 Milk Dealers, I have reviewed the audit files and proposed adjustments prepared by the Pennsylvania Milk Marketing Board audit staff, have reviewed the financial information of each of the dealers in the cross-section and have prepared exhibits which present my findings. We did not visit the cross-section dealers in accordance with COVID recommendations and our Firm's travel policy, but we were able to obtain the documentation we typically require to appropriately review the financial results reported by the cross-section dealers.

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 2020 cost information as the new starting point for container updating. Once the cost replacement data is adopted, the April 2020 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 April 2020 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 each dealer's percentage of controlled sales in the area relative to its total sales of such products. This weighting and averaging method has been consistently applied from year to year.

Cross-Section

The Area 3 cross-section of dealers utilized includes Clover Farms Dairy Co., Dan Ed Corp. T/A Guers Dairy, DFA Dairy Brands Fluid, LLC – Lansdale, DFA Dairy Brands Fluid, LLC – Lebanon, DFA Dairy Brands Fluid, LLC – Schuylkill Haven, Monroe County Milk Producers Coop Assoc. dba Pocono Mountain Dairies, Turkey Hill LP dba Turkey Hill Dairy, and Valley Farms Dairy LLC. This is the same cross-section that was used in the prior hearing. The three plants that are listed as DFA Dairy Brands Fluid, LLC were part of Dean Foods in 2019 and operating as debtor-in-possession following a bankruptcy filing on November 12, 2019. For simplicity our references to those plants refer to their current ownership since May 1, 2020. The cross-section companies process, package and deliver most of the controlled milk products in Area 3. 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 eight dealers is representative of the dealers selling controlled milk products in Area 3.

Rebuttal Exhibits

Rebuttal Exhibit D2 reflects the processing, packaging, and delivery cost per point for calendar year 2019. Please note that the points presented are for sales in the PMMB Area 3 made by the cross-section dealers. These costs should replace the existing costs from 2018, 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 is \$0.2812 per point, which agrees with the amount expected to 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 2018 processing, packaging, and delivery costs in the current order with the 2019 processing, packaging, and delivery costs. Additionally, this exhibit reflects the 2020 cost increase adjustment from Exhibit D7 and removes the 2019 cost increase adjustment. Including the cost update adjustments, the increase in the cross-section dealer costs from the prior cost replacement hearing is \$0.0188 per quart equivalent (point), or about 7 ½ 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 2019 are 137,947,000 for the cross-section. This is a decrease of about 3,707,000 bottling points from 2018, which is about 2.6 percent.

Rebuttal Exhibit D3 and D3-A have been updated to container costs utilized in the December 2020 minimum resale price calculation. 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 3 in paper half gallons, paper quarts, paper pints, 12-ounce containers, or 10-ounce containers. The container sizes indicated with footnote (5) on Rebuttal Exhibit D3 and footnote (2) on Exhibit D3-A should continue to be updated monthly when minimum prices are announced using April 2020 as the new starting point.

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

Rebuttal Exhibit D4 is prepared to present the ingredient costs per pound of finished product as of April 2020 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 December 2020 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 pounds times the ingredient cost of \$0.0401 per pound, which is \$0.0802 per quart.

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

Rebuttal Exhibit D5 updates the cost of milk shrinkage and the costs and revenues from bulk cream and bulk milk transactions.

The current order establishes a net revenue of \$0.0010 per pound and the new net cost, based on 2019 transactions is \$0.0034 per pound. There has been a net change of \$0.0044 per pound. That means overall these three groups of transactions resulted in a cost increase of about 3 3/4 cents per gallon.

Our calculation of milk shrinkage costs and the costs and revenues of bulk milk and bulk cream transactions agree with those calculated by Board Staff and expected to 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 2019 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 2019 tests reflected on this exhibit.

Our calculations of butterfat content by product type agree 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, 2020 with the six (6) month period ending June 30, 2019 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 materially from year to year. The weighted points for the first six (6) months of 2020 are 72,936,302, which is 1% less than the weighted points for the first six (6) months of 2019. Two of the eight cross-section members had significant business increases in 2020 compared to 2019. Three cross-section dealers had a significant volume decrease. In 2020 the three cost categories used in this calculation increased \$330,000 or 2.7% compared to 2019. This cost increase is due to labor and fringe benefit increases.

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 October 2020 diesel fuel costs, which were used in calculating the minimum prices for December 2020. Additionally, this exhibit reflects the calculation of the average diesel fuel cost for calendar year 2019, which becomes the new starting point for the monthly adjustments. I recommend that this adjustment be continued monthly. The

average diesel fuel cost for 2019 for the cross-section dealers is \$0.0127 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 December 2020 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 2019, 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 agree with those calculated 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 and agrees with Staff Exhibit 10.

Exhibit D10 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 \$881,135 of costs out of the gallon package (a deduction of \$0.0863 each) and add \$851,463 of costs to the paper half pint (an addition of \$0.0163 each). The net effect of the plusses and minuses is revenue to the dealers of \$2,129. This isn't zero because of rounding

Exhibit D10 also shows the container efficiency adjustments in the current order. The container quantities sold by the cross-section dealers in 2019 would result in additional revenues of \$128,917 if the proposed container efficiency adjustments are not adopted.

I recommend that the container efficiency adjustments be updated in this cost replacement hearing.

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 December 2020. The buildup of the announced December 2020 wholesale price is compared to the December 2020 wholesale price if the proposed cost replacement is implemented. 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 3 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 3 dealers at 3.4%. The rate of return serves as an important factor in the ability of Pennsylvania's fluid milk processors to maintain

and invest in their operations. Maintaining the current rate of return is also important for consistency and stability during an uncertain and difficult time for the dairy industry.

Summary and Recommendation

The Area 3 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.