

REBUTTAL TESTIMONY OF

Jed Davis

Appearing on Behalf of the Area 4 Milk Dealers

Rebuttal Testimony before Pennsylvania Milk Marketing Board

Cost Replacement Hearing Based on 2021 Annual Reports

March 15, 2023

Rebuttal Testimony of Jed Davis

Area 4 – Cost Replacement Hearing

I am Jed Davis, Senior Consultant at Herbein + Company, Inc. and my business address is 2763 Century Blvd., Reading, PA 19610. I attach my Curriculum Vitae, as Rebuttal Exhibit D1, which outlines my education, and experience in the dairy industry.

On behalf of the Area 4 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.

Cross-Section

The Area 4 cross-section of dealers utilized in our exhibits is the same as Staff's and includes DFA Dairy Brands Fluid, LLC - Lebanon, DFA Dairy Brands Fluid, LLC – Schuylkill Haven, Galliker Dairy (Johnstown), Harrisburg Dairies Inc., Rutter Brothers Dairy, Inc., and Turkey Hill LP. The cross-section changed from the previous year based on the board staff's recommendation. The cross-section companies process, package and deliver most of the controlled milk products in Area 4. This group of companies includes organizations that deliver to supermarkets, convenience stores, schools, institutions, and small retail outlets.

Rebuttal Exhibits

Rebuttal Exhibit D2 reflects the processing, packaging, and delivery cost per point for calendar year 2021. Please note that the points presented in the exhibit are for sales in the PMMB Area 4 made by the cross-section dealers. These costs should replace the existing costs from 2020, which are currently being utilized by the Board in establishing prices. Our calculation of the processing, packaging, and delivery costs is \$0.2892 per point.

Exhibit D2 shows the number of points (quart equivalents) that are associated with each cost center. For example, the bottling department points for 2021 are 238,181,102 for the area 4 cross-section. Compared to the prior year, this amount is a decrease of 63,909,981 bottling points from 2020 which represents a 26.8 percent decrease in points.

Rebuttal Exhibit D2-A is prepared to reflect the effect of the cost replacement process by comparing the 2020 processing, packaging, and delivery costs in the current order with the 2021 processing, packaging, and delivery costs. For 2021, these costs were up \$0.0274 per point. Additionally, this exhibit reflects the 2022 cost adjustment from Exhibit D7 and removes the 2021 cost adjustment. Including the cost update adjustments, the increase in the cross-section dealer costs from the prior cost replacement hearing is \$0.0331 per quart equivalent (point).

Rebuttal Exhibit D3 and D3-A have been updated to container costs utilized in the February 2023 minimum resale price calculation. The container shrinkage factor reflected on this exhibit is a statewide average and is utilized for all areas. There are no controlled milk products sold in Area 4 in paper half gallons, paper quarts, 12-ounce containers, or 10-ounce containers. The container sizes indicated with footnote number (5) on Rebuttal Exhibit D3 and footnote number (2) on Exhibit D3-A should continue to be updated monthly when minimum prices are announced using April 2022 as the new starting point.

Rebuttal Exhibit D4 is prepared to present the ingredient costs per pound of finished product as of April 2022 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 February 2023 minimum prices.

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 cost of \$0.0007 per pound and the

new net cost, based on 2021 transactions, is \$0.0011 per pound. There has been a net change of \$0.0004 per pound.

Rebuttal Exhibit D6 reflects a comparison of the current order butterfat tests by product type and compares those tests with the 2021 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 2021 tests reflected on this exhibit.

Rebuttal Exhibit D7 is prepared to calculate the cost increases and decreases incurred during the six (6) month period ending June 30, 2022 with the six (6) month period ending June 30, 2021 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 2022 are 119,443,101, which is 2.0% more than the weighted points for the first six (6) months of 2021. This results in a decrease in costs on a per point basis of (\$ 0.0030) per point.

Rebuttal Exhibit D8 has been updated to reflect the December 2022 diesel fuel costs, which were used in calculating the minimum prices for February 2023. Additionally, this exhibit reflects the calculation of the average diesel fuel cost for calendar year 2021, which becomes the new starting point for the monthly adjustments. I recommend that this adjustment be continued monthly. The average diesel fuel cost for 2021 for the cross-section dealers is \$0.0129 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 October 2022 natural gas costs pursuant to OGO A-937. Additionally, this exhibit reflects the calculation of the average heating fuel cost for calendar year 2021, which becomes the new starting point for the monthly adjustments. I recommend that this adjustment be continued monthly.

Container Efficiency Adjustment

Our calculation of updated container efficiency adjustments is shown on Exhibit D10. This exhibit shows the results of our container efficiency update calculations. The actual quantity of each size container sold 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 \$1,311,718 of costs out of the gallon package and add \$852,966 of costs to the paper half pint. The net effect of the plusses and minuses is a cost to the dealers of \$(760). This isn't zero because of rounding. 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 2021. These exhibits also cross-reference the exhibits that support the individual line items.

Class II Controlled Products

The current process for updating Class II pricing monthly should be continued.

Rate of Return

I recommend that the Board maintain the rate of return for the Area 4 dealers at 3.5%. 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 4 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.