

SUPPLEMENTAL SURREBUTTAL TESTIMONY OF

CARL D. HERBEIN, CPA

Appearing on Behalf of the Area 3 Milk Dealer Association

Supplemental Surrebuttal Testimony before Pennsylvania Milk Marketing Board

2013 Cost Replacement Hearing

March 5, 2014

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Area 3 – Cost Replacement Hearing

I am Carl D. Herbein, CPA, President and CEO of Herbein + Company, Inc. and my address is 2763 Century Blvd., Reading, PA 19610. I wish to present Supplemental Surrebuttal Testimony on behalf of the Area 3 Milk Dealers Association. I submitted testimony and related exhibits on January 3, 2014 and this testimony will explain the purpose of this supplemental submission and provide one additional exhibit and will replace Exhibits D4, D4A, D9A and D9B which were originally submitted on January 3, 2014.

Background and Purpose of Hearing and Supplemental Surrebuttal Submission

Pursuant to Bulletin 1499, the Pennsylvania Milk Marketing Board is conducting a public hearing to receive evidence to establish minimum wholesale and resale prices in the Milk Marketing Board Area 3. This hearing will include the update of annualized processing, packaging and delivery costs, updated costs for containers, ingredients and Class II products; updated labor utility and insurance costs based upon a comparison between cost per point for the second quarter of calendar year 2012 and 2013; skim and butterfat products regulated by the Board; adjustment for shrinkage, sale of bulk products, and cream processing costs; monthly adjustment to in-store handling costs; and a reasonable rate of return to milk dealers and stores. In accordance with OGO A-962 (CRO-3), evidence and testimony will be considered regarding the heating fuel adjustor in Area 3. In accordance with OGO A-962 (CRO-3), evidence and testimony will be considered regarding the diesel fuel adjustor in Area 3.

The Cost Replacement Hearing for Area 3 was conducted on January 8, 2014 and during the deliberations following the hearing the Pennsylvania Milk Marketing Board decided that more information was necessary before the Cost Replacement Order could be issued and they requested a quarter-to-quarter comparison for the fourth quarter of calendar years 2012 and 2013. I attach Supplemental Surrebuttal Exhibit D4 and D4-A which reflects the fourth quarter of 2013 and 2012 comparison. Supplemental Surrebuttal Exhibit D4-A also reflects the second quarter of 2013 comparison with the second quarter of 2012. Of significance in the comparison of the

second quarter and fourth quarter is the significant change in the cost adjustment and the bottling cost center points.

Exhibits D9-A and D9-B, which were previously submitted have been updated to include the fourth quarter to fourth quarter update in case the Board decides to use the fourth quarter instead of the second quarter.

It is my opinion that the Board should not use the fourth quarter because it sets a bad precedent. The Board's own hearing call instructed the interested parties to use the second quarter data. And this was reasonable because the second quarter is the quarter that is more often used for updates. Notably, the quarter to quarter was conceived, as I recall, in order to help dealers address cost spikes that usually occurred in the second quarter – at the time, the cost spikes pertained largely to labor contract renewals. This made it so that dealers were not overly burdened by increased costs during the time between cost replacement hearings. Area 3 had such a cost spike, although this time it had to do with volume loss. Even though the loss appears to have been temporary, the costs, the operational adjustments, and the setback from that volume loss should not be brushed under the rug as if it did not happen.

It is my opinion that the Board must consider all factors when making these cost replacement adjustments and there are factors in addition to the fourth quarter comparison that I wish to present for the Board's consideration. I attach Supplemental Surrebuttal Exhibit D10, which is a statewide exhibit that I previously presented to the Board in connection with the discount hearing last Fall. This exhibit is very important to be considered while the Board reviews the Area 3 cost replacement adjustment. Please note that the operating income level from 2010 to 2012 has been reduced significantly. The profit level continues to be below the statutory limit of 2.5% and the profit reduction for the processing dealers has been reduced \$.0097 per point from 2011 to 2012 and was also reduced by \$.0119 per point from 2010 to 2011. This total profit reduction of \$.0126 is significant and the Area 3 cross-section dealers of Clover Farms Dairy Company, Guers Dairy, Pocono Mountain Dairies, Schneider – Valley Farms, Inc., Swiss Premium Dairy, Inc., Turkey Hill, LP, and Tuscan/Lehigh Dairies, LP – Schuylkill Haven are representative of this statewide presentation. Outside of the competition-related volume fluctuations that were experienced, the dealers in Area 3 have been significantly affected by reduced milk volume due to consumer demand and increasing costs as reflected in the exhibits (D-3A) that I previously submitted.

Over the years, we have had both increases in expenses and some decreases in expenses as measured by the quarter-to-quarter update, which were appropriate for including in the process. The vast majority of these quarter-to-quarter comparisons have utilized the second quarter to second quarter comparison due to the calendar year requirement for the basic PMMB 60 report, which provides the foundation for the cost replacement adjustment. Any deviations from this second quarter to second quarter comparison must be very carefully analyzed by the Board so as to not distort the cost adjustment. The Area 3 milk dealers have been suffering economically as Supplemental Surrebuttal Exhibit D10 shows and the second quarter to second quarter adjustment, would help dealers to address genuine costs that were incurred for those that lost volume temporarily and it will help those struggling from demand driven losses with costs that will not be recovered until the next cost replacement hearing. The use of second quarter to second quarter for Area 3 would have provided \$.0119 per point of the \$.0216 per point profitability deterioration, which has occurred over the last few years. The Area 3 milk dealers suggest that the Pennsylvania Milk Marketing Board consider the overall level of profitability (lack thereof) in making this important cost replacement adjustment.

Finally, I want the Board to understand how this process affects dealers. After the exhibits are completed, and submitted we explain to the dealers how cost replacement will affect prices. Those dealers use that information in planning for the next year. They decide if they can keep or lay off staff or if they can follow through on a particular investment for example. This is true because these hearings have always been objective. The numbers speak for themselves. I represent to the Board that there are companies that are operating on a razor's edge and decisions were made in January based on the numbers that we and staff submitted. I believe it is a mistake to second-guess the objective data under these circumstances. There are real consequences for businesses and we are facing risky times for our milk dealers. I cannot emphasize this enough.

Thank you for your consideration of my analysis, opinions, and suggestions.