

STAFF TESTIMONY BEFORE THE PENNSYLVANIA MILK MARKETING BOARD
COST REPLACEMENT HEARING – MILK MARKETING AREA 2
January 8, 2014

Staff Exhibit 1

Good Morning. My name is Clifford Ackman. As the Statistical Analyst for the Pennsylvania Milk Marketing Board, I collected the information for and produced Staff Exhibit 1, dealing with the cross-section of milk dealers in the East Central Milk Marketing Area (Area 2). I have listed these milk dealers in footnote 3 along with the percentage of sales by those dealers compared to all dealers selling into Area 2. As a representative sample of the entire area, these dealers were used to compile the data for the remaining Exhibits.

This cross-section of dealers' 2012 information contains the same companies as presented in last year's Area 2 cost replacement hearing information. This year, the cross-section data represents seventy-three percent of the Area's market.

This Exhibit offers the cross-section of dealers as presenting a significant portion of all sales into the marketplace. It demonstrates the comparability of Class 1 controlled product sales by all dealers (the top section of the Exhibit) and the cross-section dealers (in the lower half of the Exhibit). The sales of cross-section dealer products compares favorably with the sales of all dealers in the marketplace falling within statistically acceptable limits.

I also studied the size and types of deliveries of the cross-section dealers along with the types of customers served by them. As a group, the cross-section dealers serve a variety of customers: schools, restaurants, convenience stores, supermarkets, etc. which is comparable to all dealer sales into Marketing Area 2. I also found that the cross-section dealers employ all types of delivery systems (tractor-trailers and smaller, straight body trucks) which are common to this Area as well.

Based on the amount and type of milk sold by these cross-section dealers, the types of customers and the delivery techniques employed by these listed dealers, I find this cross-section to be representative of all dealers doing business in Area 2.

Staff Surrebuttal Exhibit 2

Good morning. My name is David DeSantis. I am employed by the Pennsylvania Milk Marketing Board as the Chief of Enforcement & Accounting. This morning I will be discussing Staff Surrebuttal Exhibits 2 through 11 for Area 2.

Staff Surrebuttal Exhibit 2 provides information regarding the average weighted cost for processing, packaging and delivering milk for the cross-section of milk dealers referred to by Cliff Ackman in Staff Exhibit 1. We have segregated costs in this Exhibit into the major cost centers that identify the processes milk undergoes, as it arrives at

the plant from the farm, and is transformed into the consumer packages you see in the grocery store.

For each of the cost centers listed in Staff Surrebuttal Exhibit 2, we have matched the expenses associated with the cost center with the volume of milk or other products that flowed through that cost center. The volumetric term in these exhibits is stated in points. A point equals one quart or quart equivalent.

The first cost center, Receiving, Lab & Field Work, accounts for the cost borne by the dairy to operate the Receiving area, tests milk coming into the plant from the farm, and provides field services to the dairy farmers supplying the dairy. After the dairy receives the milk, it will standardize and pasteurize the milk. Pasteurization is a process that kills harmful micro-organisms that may otherwise be in the milk and Standardization refines the milk into the various milk products like whole milk, 2% milk, non-fat or skim milk, and the flavored milks like chocolate or strawberry. Now the milk is ready for the next cost center, Bottling. Here the dairy fills gallon, half-gallon, quart and other containers with the milk products that have just been pasteurized and standardized and places those containers in cases for transport. Dairies usually have a conveyer system that carries the cases into the next department or cost center, the Cold Room. In the Cold Room, the dairy organizes the milk by their customers' orders for loading into the trucks. This brings us to the Delivery cost center. The Delivery cost center, as the name implies, aggregates all the costs and points associated with transporting the milk from the dairy to their customers. Lastly, the Selling cost center accounts for the selling function of the dairy. Here we find salespersons' costs, advertising, promotion costs and other selling type costs and related points in this cost center. This Exhibit brings all processing costs forward to year 2012 levels.

All of the aforementioned cost centers contain costs from service centers. Service centers provide services for two or more of the cost centers mentioned. For example, the Administrative service center provides management and other services that benefit every one of the cost centers listed. Therefore, we distribute costs from the Administrative service center to all of the cost centers. Similarly, the Garage service center may provide maintenance and repair services that benefit both the Delivery cost center and the Selling cost center.

Staff recommends that the Board replace the costs in the current Order with those costs enumerated in Staff Surrebuttal Exhibit 2.

Staff Surrebuttal Exhibit 3

Staff Surrebuttal Exhibit 3 provides information on the cost of containers for the cross-section dealers. Again, we have units sold by the cross-section dealers weighted by the sales weighting method described above. For costs, we have an opportunity to be more current as compared to the costs in Staff Surrebuttal Exhibit 2. We have taken the invoiced costs paid by the cross-section dealers for plastic containers, paper containers and resin in April of 2013 to arrive at a weighted cost per unit. The costs for plastic containers are broken down into purchased containers and blow molded

containers for the Gallon and Half Gallon. As was done in previous hearings where container costs were addressed, we are using controlled container sales volumes for the previous year. We are, therefore, pairing current costs with the weighted units sold in the previous year to arrive at the most current weighted cost per unit available. Where the market has both paper and plastic containers, like the half-gallon container, we have provided a combined paper/plastic price. After we established a cost for each container type in Column E, we are updating those April costs to the costs observed in our most current container surveys in Column F. At this point we are applying a factor for container shrinkage in Column G. This is the same adjustment we established in the last cost replacement hearing. The last column H simply adds the shrinkage factor to the updated container cost in Column F.

Staff recommends that the Board replace the base container costs with those found in Column C and the weighted units with those found in Column D and continue to update these costs using the audited surveys submitted by the cross-section dealers. Staff further recommends that the Board continue the practice of providing separate plastic and paper half-pint prices through a plastic add-on.

Staff recommends that the Board replace the current container costs with the costs found in the Staff Surrebuttal Exhibit 3.

Staff Surrebuttal Exhibit 4

Staff Surrebuttal Exhibit 4 provides information on the cost of ingredients added to the various milk products like the chocolate powder and sugar in chocolate milk. This Exhibit pairs Year 2012 sales activity with April 2013 costs to get a very current weighted cost for the ingredients in each of the milk products.

The National School Lunch Program has recently been changed to permit schools to only serve lowfat or 1% milk (unflavored) and nonfat milk (including flavored). Due to the recency of this change, a full year of reliable data was not available as dealers shifted production from reduced fat flavored milk to nonfat flavored milk. To establish ingredient costs and butterfat content for these products, we used the six-month period from July 2012 to December 2012 instead of the full year normally used.

Staff recommends replacing the current ingredient costs with those found in Staff Surrebuttal Exhibit 4.

Staff Surrebuttal Exhibit 5

In the normal course of processing milk at a dairy, the dairy incurs costs and receives revenues from the act of processing the milk. For example, all dairies lose a small amount of milk as some milk is left in the lines and tanks as it moves through the plant. We call this normal loss shrinkage. Here we are accounting for the costs associated with shrinkage. In addition, dairies typically sell off excess bulk milk and cream they are unable to use in their own plants. In selling off the excess milk and cream, the dairy may have made a profit or a loss on the transaction. Staff Surrebuttal

Exhibit 5 details the cost of shrinkage and the profits or losses and processing costs associated with selling excess milk and cream.

Staff recommends that the Board use the costs and profits in Staff Surrebuttal Exhibit 5 to replace those that are in the existing Order.

Staff Surrebuttal Exhibit 6

Staff Surrebuttal Exhibit 6 summarizes the components of the milk cost prior to the milk going into the bottle. We are using the most current announced milk prices available prior to the submission date for the Exhibits. The current fat and skim prices for Class I products are in the top numeric panel of the Exhibit. In the lower numeric panel labeled Class I, we show the actual pounds of the Class I products (Columns A and B) sold by the cross-section dealers in this Milk Marketing Area. We have labeled the columns A through K and provided mathematical descriptors indicating how we arrive at the cost per pound for each of the products in the table.

This is the same methodology used in previous resale price hearings. Staff recommends that the Board continue to use this methodology for establishing the before bottling costs for the controlled milk products listed. Staff also recommends that the Board use the pounds from columns A & B, along with the ingredient and bulk costs in columns I & J, to replace those in the existing Order.

Staff Surrebuttal Exhibit 7

In Staff Surrebuttal Exhibit 7, we are obtaining the most current costs available for three significant cost categories; labor, utilities, and insurance costs. To bring these costs forward, we are comparing the costs and related plant volume in the second quarter of 2012, with the costs and plant volume in the second quarter of 2013. We feel that bottling points are a good measure of the plants' overall volume or activity. In columns, A and B, we list the second quarter costs for 2013 and 2012 for each of the cost categories. In the next two columns, we list the bottling points for 2013 and 2012 for the second quarter. By dividing the costs by the points in columns E and F, we can compare the cost increase or decrease per point in column G.

Staff recommends replacing the quarter-to-quarter cost in the current Order with the bottom line cost in Staff Surrebuttal Exhibit 7.

Staff Surrebuttal Exhibit 8

To account for the volatility of fuel prices on an on-going basis, we have adopted the methodology found in Staff Surrebuttal Exhibit 8. Here we relate the cost of fuel for the previous year for all dealers and the points for the same period. Line 1 shows the weighted cost for diesel fuel for the cross-section dealers for 2012. Line 2 is the 2012 average On-Highway diesel price per gallon as posted by the Energy Information Administration (EIA). Line 3 is the current EIA On-Highway diesel price. Line 4

represents the percentage of change in the diesel price from year 2012 to the current price. Using the percentage of change on line 4, line 5 shows the current presumed diesel cost for the cross-section dealers. By subtracting line 1 from line 5 we find the changed diesel cost on line 6. By dividing the changed diesel cost on line 6 by the weighted delivery points of the cross-section dealers, we find the changed cost per point on line 8.

Staff recommends that the Board continue to include this adjustment in the cost replacement process. Staff also recommends that the Board replace the 2011 points and costs with the 2012 points and costs found in Staff Surrebuttal Exhibit 8.

Staff Surrebuttal Exhibit 9

Pursuant to the portion of Official General Order A-937 regarding heating fuel add-ons, staff has calculated the current heating fuel add-on using the same methodology used in Staff Surrebuttal Exhibit 8 using Standardization and Pasteurization points and the Pennsylvania Natural Gas Industrial price as posted by the Energy Information Administration. Staff recommends that the Board continue to include this adjustment in the cost replacement process. Staff also recommends that the Board replace the 2011 points and costs with the 2012 points and costs found in Staff Surrebuttal Exhibit 9.

Staff Surrebuttal Exhibit 10

Staff Surrebuttal Exhibit 10 summarizes the information from all previous Exhibits and relies on data from the base Order regarding Class I milk to arrive at a proposed wholesale price. In this Exhibit, we also compare the proposed wholesale price with the current wholesale price so the Board can see the effect of the changes in costs on the wholesale price of milk.

Column A provides the milk cost from Staff Surrebuttal Exhibit 6. Staff Surrebuttal Exhibit 6 provides a milk cost in terms of a cost per pound. We must multiply the milk cost per pound by the number of pounds per container. For example, there are 2.15 pounds of milk in every quart of standard milk. By multiplying the cost per pound for standard milk on Staff Surrebuttal Exhibit 6 by 2.15, you have the quart price for standard milk found in Column A of this exhibit.

Column B lists the container costs from Staff Surrebuttal Exhibit 3.

Column C combines the quarter-to-quarter adjustment from Staff Surrebuttal Exhibit 7 with the diesel and heating fuel adjustments from Staff Surrebuttal Exhibits 8 and 9. It also includes an adjustment per O.G.O. A-972 for the 'Discount Effect'.

Column D is the container efficiency adjustment from the price order. This adjustment accounts for the relative efficiency of filling large containers as opposed to filling and handling smaller containers. You can put milk in a gallon container more quickly and handle gallon containers more efficiently than you can 16 half pints.

Column E lists the processing costs from Staff Surrebuttal Exhibit 2.

Column F is the sum of columns A through E.

Column G is profit. This percentage profit reflects the profit in the current Order.

Column H is the average price with profit. If all wholesale customers in the Milk Marketing Area received exactly the same amount of milk and the same level of service for every delivery, we could stop here.

Column I removes the average delivery. By removing the average delivery, we arrive at a cost for processing the milk and bringing it to the dock. All milk regardless of its ultimate destination will have the same cost at this point.

Column J adds back the cost of a relatively small high-cost delivery. By adding back the high-cost delivery, we have a price from which we may subtract discounts. In this way, we can match the cost of the delivery with price. For a large efficient delivery to a supermarket, we can subtract a large discount reflecting a low into store price. For smaller less efficient deliveries, we subtract a smaller discount reflecting the higher cost of the smaller delivery.

Column K is the sum of Columns H, I and J and is our proposed wholesale price.

Column L is the wholesale price under the current cost replacement order.

Column M is the difference between the proposed wholesale price and the current wholesale price.

Staff Surrebuttal Exhibit 11

Staff Surrebuttal Exhibit 11 provides a methodology for arriving at the retail or out-of-store price for milk.

Column A is the proposed wholesale price from Staff Surrebuttal Exhibit 10.

Column B is the deepest discount from the current general price order.

Column C is the average in-store handling cost from the current general order. This in-store handling cost has been updated monthly by the Consumer Price Index. Staff recommends that the Board continue to employ this form of cost update for the retail price

Column D reflects the retail profit in the current Order.

Column E is the sum of columns A through D and is the proposed retail or out-of-store price.

Column F is the most recently announced retail price.

Column G is the difference between the proposed retail price and the current retail price.