

**BEFORE THE PENNSYLVANIA MILK MARKETING BOARD**  
**DIESEL FUEL ADD-ON TO THE OVER - ORDER PREMIUM HEARING**  
**ALL MILK MARKETING AREAS**

August 30, 2017

Rebuttal Testimony of John D. Rutherford, Jr.

Presented on behalf of the Pennsylvania Association of Dairy Cooperatives:

Dairy Farmers of America, Inc., Dairy Marketing Services, LLC,  
Lanco Dairy Farms Co-op, Inc., Land O'Lakes, Inc., and  
Maryland & Virginia Milk Producers' Cooperative Association, Inc.

My name is John Rutherford. I am Director of Economics at Dairy Farmers of America-Northeast Council. Thank you for the opportunity to provide testimony this morning. My testimony is on behalf of the Pennsylvania Association of Dairy Cooperatives (PADC) whose members are: Dairy Farmers of America, Inc.; Dairy Marketing Services, LLC; Lanco Dairy Farms Co-op, Inc.; Maryland & Virginia Milk Producers' Cooperative Association, Inc.; and Land O' Lakes, Inc., ("PADC"). Together the PADC cooperatives represent more than one-half of the Commonwealth's dairy farmers.

This testimony is in rebuttal to the proposal from PAMD ("Dealers") regarding the diesel fuel add-on to the over order premium. This hearing was noticed in Pennsylvania Milk Marketing Board Bulletin No. 1534 and proposes to amend Official General Order A-988 which currently sets the diesel fuel add-on at a rate of \$0.25 cents per cwt. The Dealers seek several changes which would reduce the fuel add-on to the over order premium. One change is to lower the top of the base 10-cent bracket for the fuel-add-on from a fuel price of \$4.1629/gallon down to \$2.8629/gallon. The Dealers propose to reduce the rate paid at this price level from \$0.25/cwt. to \$0.00/cwt. After allowing for a 1-cent change for the next 10-cent price bracket (\$2.8630 to \$2.9629), they resume the current change in the adjuster to add 2 cents for each incremental 10-cent bracket.

The PADC cooperatives feel these changes are too drastic given all the impacts at the farm of higher fuel costs. This rebuttal proposes what we believe is a more reasonable adjustment of the fuel add-on.

## **Higher fuel costs impact more items than direct diesel cost**

The change in milk production costs related to changes in fuel costs is greater than just the cost of fuel going into a tractor. Both the costs of hauling milk and cull animals off the farm, as well as the costs of bringing bulk feed and fertilizers to the farm, increase. The cost of fertilizer is also highly correlated to the price of fuel. In addition, the cost of energy (electricity or diesel) for cooling milk and other utilities on the farm will increase.

## **Estimating the total farm impact of fuel costs**

I researched the USDA-ERS milk cost of production (COP) estimates to review the full impact of fuel price changes on dairy farms. This data comes from surveys of actual producer cash costs and also makes assumptions about the value of some non-cash costs such as unpaid labor, capital recovery of machinery and equipment, and the opportunity cost of land (as a rental rate). Because the basis is a producer survey, the reported revenues and operating expenses are very representative of actual producer receipts and cash expenses.

Within the USDA-ERS data, there are some cost categories which align nicely with our question about fuel impacts on dairy farms in Pennsylvania; and there are other categories which are not as purely related to fuel costs. The “Fuel, lube, and electricity” (FLE) cost is an obvious match. Milk hauling, on the other hand, is embedded in “Custom services”. Similarly, the added cost of hauling in bulk feed is included in the “Purchased Feed” expense. The costs of raising feeds on the farm are embedded in the “Homegrown harvested feed”.

Fuel-related costs that are included in the feed cost shown can be approximated using the cost estimates for corn and soybean production. There is not a COP for hay or alfalfa, so I admit this is omitted. However, given the multi-year nature of most grass/hay stands, I expect a COP

for a hay crop to have a greater percentage of its cost related to fuel, thus making my ultimate estimate even greater. To reach an estimate of the portion of feed cost that is attributable to fuel, I will take fuel-related costs from these COP reports and calculate a percentage of the cost that is fuel related, then multiply this percentage times the feed cost.

There is not a Pennsylvania-specific COP estimate for corn or soybeans, so I will go to the closest regional information. PADC Exhibit 2 shows the ERS resource regions and most of Pennsylvania is part of the “Northern Crescent”.

The expenses that are directly fuel-related include “Fuel, lube, and electricity”, “Fertilizer”, and “Custom Operations”. All of the FLE cost applies. The fertilizer cost is highly correlated with fuel prices, but to be conservative I used only a 10% factor. Custom operation is basically the cost of the machine, the operator, and fuel, so I took 10% of the custom operations expense, again to be conservative. In calculating the percentage of purchased feed, I first inflated the price of the corn or soybeans by 25% as a mark-up for the seller to have a profit in selling the feed. This further reduces the impact of the fuel cost in the purchased feed. Two final calculations were to blend the costs from corn and soybeans by a ratio of 75:25 for homegrown and 25:75 for purchased feeds, reflecting that more of the homegrown feed cost on a dairy farm is related to corn than beans while soybeans are a greater portion of purchased feed cost.

PADC Exhibit 3 shows the annual average cost of diesel fuel from 2012- 2016. This table also includes the totaled estimated on-farm fuel costs for the years when the price declined- from 2014 to 2016. For a decrease in fuel cost of \$1.551 (\$3.991 - \$2.440), we have a change in production costs of \$0.846 (\$2.959 - \$2.113). This is a relationship of less than 2:1, which means that full application of a fuel adjuster would change the milk price more than \$0.05 per

cwt. for every \$0.10 bracket of diesel fuel prices. Please understand that the point of this exercise is not to argue that the adjuster for each \$0.10 fuel cost bracket should be \$0.05 per cwt. or to prove that the total fuel add-on should be in excess of \$2.00 per cwt. Instead, the point is that the cost of fuel inputs is a significant influence in the over-all costs of producing milk, well beyond the existing or proposed fuel adjuster. At this point in time, PADC is requesting only a fraction of these costs be included in the fuel add-on.

**The base range should be \$2.60 to \$2.699 per gallon of diesel fuel**

The US Energy Information Administration reports that for the month ended July 31, 2017, the Central Atlantic average on-highway diesel price was \$2.682/gallon. This brings the recent 12-month rolling average to \$2.6588/gallon. See PADC Exhibit 4. My comments below will reflect the PADC view that the \$0.10 fuel price bracket of \$2.60 - \$2.699 should be the base price range.

**The base add-on should be \$0.10/cwt. per the surrounding areas**

The methodology for setting a fuel add-on changed with OGO-A-983. With that Order, the Board changed the base point for the fuel add-on from a number more directly related to farm production costs to one comparing the fuel surcharge in states neighboring Pennsylvania. This change brought the fuel add-on down from approximately \$0.80/cwt. to \$0.25/cwt. The current rate charged to plants in Ohio and New Jersey ranges from \$0.085/cwt. to \$0.17/cwt. PADC suggests adopting a base of \$0.10/cwt. at the current price of fuel.

### **This is fair**

Setting a base price for the fuel add-on at \$0.10 per cwt. as a partial recoup of the impact of higher energy costs for farmers is fair. The Dealers have fuel costs (both delivery cost and plant operations-related) in their cost replacement formulas which total \$0.49/cwt. for Area 1 where the diesel base is \$0.44/cwt. and the plant costs base is \$0.05/cwt. For the other five Marketing Areas the total embedded base fuel cost ranges from \$0.36 to \$0.86 per cwt.

### **Source of the \$0.02 change**

The change in the fuel add-on for each change in a \$0.10 diesel cost bracket was set to be \$0.03 back in the 2004 hearing, as reflected in OGO-A-927. At that time, Mr. Schad provided compelling evidence that the impact on farms of a \$0.10 movement in the diesel fuel price equated to a \$0.03 change in costs. By the time of the 2013 hearing this relationship had changed. In cross examination from PAMD counsel, Mr. Schad commented that further review of the fuel situation at the farm led him to conclude the on-farm portion of costs should, in reality, be \$0.01/cwt. for every \$0.10 bracket of diesel fuel costs, or cut roughly in half. Combining this \$0.01 change in on-farm cost to the undisputed \$0.01 change in milk hauling cost per \$0.10 bracket meant the new fuel adjuster change became \$0.02/cwt.

### **The \$0.02 is not full compensation**

As stated earlier, higher fuel costs cause a much greater impact on the total cost of producing milk than PADC is advocating. At this time, PADC is not requesting that the fuel add-on fully cover the impact on COP. For purposes of this hearing, PADC can agree with \$0.02/cwt. change per \$0.10 bracket of fuel cost change, as PAMD has already proposed. This

acknowledges that producer costs do vary with diesel fuel prices, while remaining a modest recovery of these costs. Making the change automatic with movements in the reference price of diesel fuel will keep the fuel add-on more current with actual costs at the farm.

### **Allow fuel add-on in short term to rise and fall - similar to Dealers**

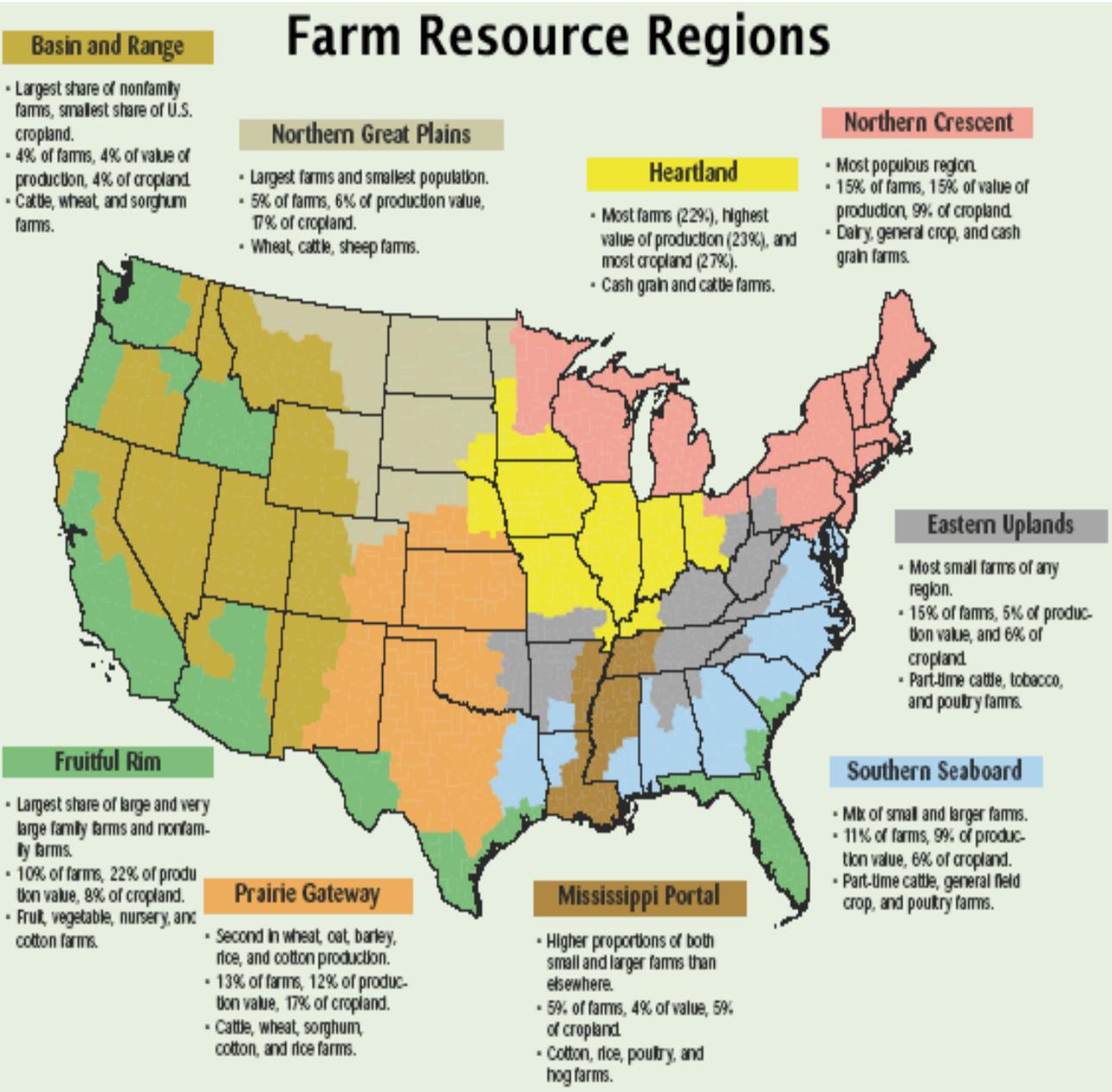
PADC does not believe the fuel add-on should be allowed to be negative. Fuel-related costs will remain even if the price of fuel were to fall below five of the \$0.10 brackets -- in other words if the price of fuel drops \$0.50. Therefore, PADC requests the fuel add-on be snubbed at zero. For any diesel fuel price below \$2.20 (when using a base fuel price range of \$2.60-\$2.699/gallon), the fuel add-on will be zero. In the Dealers' cost replacement process, adjustments due to changes in fuel costs are applied to an amount of cost from a base year. While it is true that movements in the fuel cost will yield negative adjustments to that base amount, unless fuel becomes free (*i.e.* - \$0 cost), some degree of cost recovery always remains.

### **Summary of proposal**

In summary, the PADC agrees with the Dealers that the fuel add-on to the over-order premium should be readjusted and that \$0.10 movements in the reference price should equate to \$0.02/cwt. movements in the fuel add-on. The latter was determined by the Board to be correct just a few years ago. However, we disagree that we need a third determination of a fuel add-on base. The present order compares the fuel surcharge in neighboring states as the basis for setting the current base. This would reset the current base to \$0.10 at the prevailing base fuel price range of \$2.60-\$2.699. The remainder of our proposed fuel add-on is shown in PADC Exhibit 5.

Thank you for your consideration of our testimony.

# Farm Resource Regions



## Average Fuel and Total Dairy Related Impacts: 2012-2016

	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
Central Atlantic Diesel annual average	\$ 4.102	\$ 4.011	\$ 3.991	\$ 2.925	\$ 2.440
Total of On-farm and Milk Haul costs			\$ 2.959	\$ 2.405	\$ 2.113

<b>Date</b>	<b>Monthly (*)</b>	<b>12-mo Avg</b>
Aug-2016	2.442	
Sep-2016	2.492	
Oct-2016	2.554	
Nov-2016	2.562	
Dec-2016	2.647	
Jan-2017	2.789	
Feb-2017	2.768	
Mar-2017	2.751	
Apr-2017	2.767	
May-2017	2.749	
Jun-2017	2.702	
Jul-17	2.682	2.6588

(\*)Central Atlantic (PADD 1B) No 2 Diesel Ultra Low Sulfur (0-15 ppm) Retail Prices (Dollars per Gallon)

## Proposed Fuel Add-on by Fuel Price

Diesel Fuel Price per Gallon

<u>low</u>	<u>high</u>	<u>base</u>	<u>change</u> <u>per cwt.</u>	<u>net add-on</u>
\$ -	\$ 2.199	\$ 0.10	\$ (0.10)	\$ -
\$ 2.200	\$ 2.300	\$ 0.10	\$ (0.08)	\$ 0.02
\$ 2.300	\$ 2.400	\$ 0.10	\$ (0.06)	\$ 0.04
\$ 2.400	\$ 2.500	\$ 0.10	\$ (0.04)	\$ 0.06
\$ 2.500	\$ 2.600	\$ 0.10	\$ (0.02)	\$ 0.08
\$ 2.600	\$ 2.700	\$ 0.10	\$ -	\$ 0.10
\$ 2.700	\$ 2.800	\$ 0.10	\$ 0.02	\$ 0.12
\$ 2.800	\$ 2.900	\$ 0.10	\$ 0.04	\$ 0.14
\$ 2.900	\$ 3.000	\$ 0.10	\$ 0.06	\$ 0.16
\$ 3.000	\$ 3.100	\$ 0.10	\$ 0.08	\$ 0.18
\$ 3.100	\$ 3.200	\$ 0.10	\$ 0.10	\$ 0.20
\$ 3.200	\$ 3.300	\$ 0.10	\$ 0.12	\$ 0.22
\$ 3.300	\$ 3.400	\$ 0.10	\$ 0.14	\$ 0.24
\$ 3.400	\$ 3.500	\$ 0.10	\$ 0.16	\$ 0.26
\$ 3.500	\$ 3.600	\$ 0.10	\$ 0.18	\$ 0.28
\$ 3.600	\$ 3.700	\$ 0.10	\$ 0.20	\$ 0.30
\$ 3.700	\$ 3.800	\$ 0.10	\$ 0.22	\$ 0.32
\$ 3.800	\$ 3.900	\$ 0.10	\$ 0.24	\$ 0.34
\$ 3.900	\$ 4.000	\$ 0.10	\$ 0.26	\$ 0.36
\$ 4.000	\$ 4.100	\$ 0.10	\$ 0.28	\$ 0.38
\$ 4.100	\$ 4.200	\$ 0.10	\$ 0.30	\$ 0.40
\$ 4.200	\$ 4.300	\$ 0.10	\$ 0.32	\$ 0.42
\$ 4.300	\$ 4.400	\$ 0.10	\$ 0.34	\$ 0.44
\$ 4.400	\$ 4.500	\$ 0.10	\$ 0.36	\$ 0.46
\$ 4.500	\$ 4.600	\$ 0.10	\$ 0.38	\$ 0.48

## CERTIFICATE OF SERVICE

I, Marvin Beshore, Esquire, certify that on August 10, 2017, I served true and correct copies of the foregoing to the following interested parties, all of whom accept service by email:

John H. Howard, Esquire  
*Pennsylvania Department of Agriculture*  
johoward@pa.gov

Matthew Espenshade  
*Pennsylvania State Grange*  
in.the.shade@comcast.net

Andrew L. Saylor, Esquire  
*PA Milk Marketing Board*  
asaylor@pa.gov

Arden Tewksbury  
*Progressive Agriculture Organization*  
progressiveagricultureorg@gmail.com

Wendy Yoviene, Esquire  
*Pennsylvania Association of Milk Dealers*  
wyoviene@ober.com

Thomas J. Price, CPA  
*PA Food Merchants Association*  
tjprice@herbein.com

Carl D. Herbein, CPA  
*Pennsylvania Association of Milk Dealers*  
cdherbein@herbein.com

Allen Warshaw, Esquire  
*PA Food Merchants Association*  
allen.warshaw@gmail.com

John J. Bell, Esquire  
*Pennsylvania Farm Bureau*  
jjbell@pfb.com

Respectfully submitted,



Marvin Beshore, Esquire