BEFORE THE PENNSYLVANIA MILK MARKETING BOARD

COOPERATIVE PROCUREMENT COSTS HEARING

All Milk Marketing Areas

October 5, 2020

Surrebuttal Testimony of David DeSantis

Presented on behalf of the Commonwealth of Pennsylvania

Department of Agriculture

Submitted September 11, 2020

Dear Chairman Barley and Members of the Board:

Good morning. I'm Dave DeSantis, testifying on surrebuttal on behalf of the Pennsylvania Department of Agriculture. After my original submission of testimony, I have had a chance to review the submissions of Board Staff and the Pennsylvania Association of Milk Dealers. In so far as these may have touched on areas that my initial testimony targeted, I would like to offer clarifications and amplifications to ensure the Board plainly understands the position of the Department of Agriculture.

First and foremost, it is the Department's firm belief, and mine, that the subject of this hearing, the sale of the services connected with the procurement of milk by the cooperatives on behalf of the processing dealers, is a dealer-to-dealer transaction and must be regulated by this Board as prescribed by law the same way it regulates all other dealer-to-dealer transactions. Based on previous submissions, Board Staff has suggested that charges for these services be labeled as a "premium." Now knowing that this is simply another cost category, we believe that Board Staff will agree that incorporating this dealer-to-dealer cost into the other costs on the Milk Dealer financial statements will be the simplest, and most transparent way (given the hearing structure of this Board) to incorporate this specific cost into the resale price structure of the Milk Marketing Board.

With respect to the dealers' testimony, there are several issues I would like to address. Firstly, the dealers claim that the coops "are asking to have their costs passed to the processors without limit. Essentially a blank check." This statement assumes that there is no price competition for the service of procuring milk. It also assumes that the costs associated with procuring milk are not real or could be otherwise inflated at will. I contend that both of these assumptions are simply not true.

When considering cost competition for milk procurement, there is in fact, very real competition. Every cooperative has a fiduciary obligation to its members to ensure that all marketing costs, especially the highly significant cost of procurement, are as low as practicable. Thus, the cooperatives themselves, in competition for producers must strive for the lowest costs possible. Each individual member bears those costs, not some nebulous corporation called the coop. The cooperative structure of members voting on the leadership which directs the marketing decisions and resulting costs and efficiencies, which includes procurement costs, must be as low as possible under this democratic structure. If a cooperative wishes to survive and maintain its members, it must strive for the lowest costs possible in all areas, including the procurement of milk.

Also consider the competition between cooperatives. Like the processing dealers, if a cooperative acting as a dealer selling procurement services can bring their costs below the average procurement cost, they will, just like the processors who have lower processing costs, be more profitable.

And then there's the ultimate competitor for the milk procurement market, the processing dealers themselves. If the Board-regulated price for procurement services from cooperative rises too high, these processing dealers can begin recruiting producers and purchasing milk from their own independent supply. If the procurement costs regulated by this Board are ever more than what a processing dealer can pay, by marshaling their own supply, creating a field staff to monitor and support their independent producers, ramping up testing, maintaining their own producer payroll, maintaining the additional reporting requirements from state and federal agencies, then they can switch to an independent supply. This is not an idle observation. In my experience, most producers would jump at the chance to ship directly to a viable processor.

There is one other very significant aspect of the dealers' assertion that the cooperatives' costs might be "passed on to the processors without limit" that I need to address. All costs, by the cooperatives, processors, retailers or even milk haulers, are subject to audit by this Board's staff. I firmly believe that, without any equivocation, if Mr. Gojosivich raises his hand to state that the costs that his team has examined and audited are correct, you can take it to the bank. That's not to say that mistakes and oversights don't occur, they do. But this Board can dependably rely on the evidence presented by this Board's staff is as reliable as humanly possible. Where mistakes are made, corrections and adjustments soon follow.

With these competitive pressures, and with the best milk accounting and auditing staff on the planet, this Board can rest assured, this is no blank check.

As a point of clarification, I would like to comment on Mr. Mong's assertion on page 8, paragraph 2 of his Rebuttal Testimony, "Discounts would serve to lessen the amount of OOP recovery for the dealers in this calculation but would not reduce the amount of over-order premium paid to producers."

Simply stated, delivery discounts simply reflect the reduced costs for efficient deliveries, not the cost for purchasing or procuring milk. The best example to give is in the dock discount. When the Board sets a dock discount, (when the purchaser picks milk up at the dealer's dock) no delivery costs are included but all the milk costs including premiums and associated procurement costs are right there in that dock-discounted price. The Board-mandated discounted minimum price for a dock discount or any other volume based, or stop charged based, only reflects the decreased cost (plus profit) for that delivery format. The dealers are fully compensated for all their costs in Pennsylvania's resale price structure and any additional procurement costs mandated by this Board would also be returned to our dealers plus profit.

To address the dealers' concerns regarding dilution of the cost across other classes of milk (page 10, paragraph 1 of Ron Mong's Rebuttal Testimony), I offer this observation. Paying a Board-mandated procurement charge to the cooperatives is no different than paying for procurement for an independent producer supply. The cost for procurement for an independent supply of milk destined for Class 3 utilization or Class 1 utilization outside the state is the same as for milk produced, processed, and sold as Class 1 within Pennsylvania. This Board should make no distinction as to the source or destination of the procurement service demanded by our dealers. It is the dealer-to-dealer sale of procurement services that must be regulated regardless of ultimate utilization of that milk. Think of it this way. When we see selling costs on a processor's financial statement, we don't segregate those costs into efforts to sell Class 1 Pennsylvania milk from all other sales. All of the costs for selling all milk are distributed across all milk sales regardless of class or area of use.

One cost that is not reflected in the procurement cost requested by the cooperatives is the cost of balancing. Balancing from the perspective of a processing dealer with an independent supply of milk is the cost incurred when that dealer acquires more milk from their independent producers than their customers want. They then need to redirect that milk. When there is an oversupply of milk there is a cost, not only for the producer, but for the purchasing dealer (or cooperative) to channel that milk to a manufacturer who may take on the burden of creating and then storing a more shelf-stable manufactured product, like cheese or milk powder, that may have a depressed price due to oversupply. With an independent supply of milk, our processors must take on the task of finding a home for all the independent producer milk they contracted to buy. This may entail logistical efforts to find a home for that milk along with the financial costs of taking a lower price for the milk the dealer is selling than they may be paying their dedicated independent supply. There is no such headache when purchasing from a cooperative, nor is that additional cost calculated into the procurement cost that is the subject of this hearing. Clearly there is competitive pressure to make the cost for procurement as low as possible.

When the Board regulates these dealer-to-dealer procurement costs, Pennsylvania processors will be relieved from paying for procurement costs for milk that was never destined for their plants. If they had an independent supply, these dealers would pay for procurement for all the milk they are obligated to purchase. In this sense, requiring dealers to only pay procurement costs for milk that goes into their plants is quite reasonable.

I respectfully ask the Board to consider the merits of the Department's position on this proposal.

Thank you.