

SUPPLEMENTAL TESTIMONY OF

RON MONG, CPA

Appearing on Behalf of the Area 2 Milk Dealers

Testimony before Pennsylvania Milk Marketing Board

Cost Replacement Hearing Based on 2017 Annual Reports

May 1, 2019

**Testimony of Ron Mong, CPA**

**Area 2 – Cost Replacement Hearing**

I am Ronald W. Mong, Senior Manager at Herbein + Company, Inc. and my address is 2763 Century Blvd., Reading, PA 19610. I wish to present additional Testimony on behalf of the Area 2 Milk Dealers. My Testimony will discuss the dealers selected for the Area 2 cross-section used in the cost replacement hearing held on April 3, 2019.

**Board Questions**

At an Area 2 conference held on April 24, 2018 the Board asked several specific questions about the cross-section of dealers used in the cost replacement hearing. On behalf of the Area 2 Milk Dealers, I have reviewed the questions and this Testimony presents my answers to those questions. I have also prepared exhibits, which present my findings.

**Cross-Section Questions**

- 1) Whose idea was it to change the Area 2 cross-section?
- 2) What was the process of communication between Board Staff and Herbein + Company?

**[BEGIN ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER**

[REDACTED]

[REDACTED]

**[END**

**ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]**The wholesale prices in Area 2 are the lowest of any PMMB Area. Exhibit D13 shows the minimum wholesale price of a 2% reduced fat gallon in April of each year from 2009 through 2019. During the most recent five years Area 2 averaged \$0.27 per gallon lower than the simple average of the other five PMMB Areas. During this period Area 2 was lower than the next lowest PMMB Area by an average of \$0.15 per gallon. Area 2 has the types of customers and product mix like other PMMB Areas, and is similar to Areas 2 and 3, so the significantly lower wholesale prices over time started to not make sense.

**[BEGIN ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]** [REDACTED]

[REDACTED] **[END ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]** asked for our analysis of the significant variance between Area 2 and the other Areas in Pennsylvania. We determined that the processing and packaging costs in Area 2 were comparable to the other Areas, but that delivery costs in Area 2 were much lower than other Areas. Our study determined deliveries to small format customers were under-represented in the cross-section used in previous the cost replacement hearings. The Area 2 market had changed over the years.

In our studies of deliveries of controlled products, we classify customers into one of three categories:

Small format – deliveries to convenience stores, schools, dollar stores, drug stores, restaurants, coffee shops, delis, and “mom and pop” stores. Based on volume these deliveries would qualify for the lowest discount levels (3.5% for 200-quart weekly average or 6.5% for 500-quart weekly average) or would not qualify for any allowable discount (less than 200-quart weekly average). These deliveries are almost always made by straight truck. They involve more stops and generally reflect a higher per unit cost of delivery.

Large format – deliveries to supermarkets, warehouse club stores, “big box” stores, and large institutional customers. Because these deliveries are large they usually qualify for the largest allowable discount (11.5% for 1000-quart weekly average). Tractor-trailers typically deliver these customers. They involve fewer stops and generally reflect lower per unit delivery costs.

Tractor-trailer – full trailer loads to distributors and other dealers. If the customer holds a PMMB license these deliveries qualify for a 23% discount.

Exhibit 14 is our analysis of delivery sizes in Areas 2, 3 and 4. We have combined large format deliveries and tractor-trailer deliveries as their delivery costs are similar. We will discuss this Exhibit in detail later in our Testimony.

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL  
REDACTED PURSUANT TO PROTECTIVE ORDER DATED APRIL 19, 2019**

Once we understood that small format deliveries were underrepresented in the Area 2 cross-section we reviewed the 2017 sales data for all the dairies used in cross-sections. In November 2018 we suggested to Board Staff that Pocono Mountain, Balford Farms, and Valley Farms should be considered for addition in the next cost replacement hearing. **[BEGIN ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]** [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

**[END ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]**

After hearing our concern and suggestion, Board Staff took the time to study all six cross-sections. Because Board Staff has access to sales volume information from all participants in each Area they are uniquely able to make this analysis. Herbein + Company only has access to sales data from cross-section members. Board Staff delivered their study of the cross-section members to us in December 2018. The Staff recommended changes in five of the six PMMB Areas.

Area 1 – Add Swiss Premium

Area 2 – Add Balford Farms, Pocono Mountain, Valley Farms, and Wawa

Area 3 – Add Lehigh – Lansdale

Area 4 – No changes

Area 5 – Add Galliker, remove Meadow Brook (closed). Consider Marburger for future cost replacement hearings.

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL  
REDACTED PURSUANT TO PROTECTIVE ORDER DATED APRIL 19, 2019**

Area 6 – Add Lehigh – Schuylkill Haven, remove Meadow Brook (closed)

We studied in detail the appropriateness of the Board Staff's recommended cross-section changes. We also discussed the proposed changes with the existing cross-section members in each Area with changes. We needed the dealers' perspective on changes in the market and the changes in customers purchasing milk.

We concluded that all the cross-section changes recommended by Board Staff were appropriate. In each of the five areas with cross-section changes the new cross-section was more representative of the market in that Area than the one it replaced.

**3) Were there any dealer-specific issues discussed between Board Staff and Herbein + Company when considering the cross-section changes?**

No, after our analysis of the recommendation and deliberation with the existing cross-section members we communicated to Board staff our agreement with the cross-section changes they proposed.

There was no attempt to include additional small delivery focused dealers and no attempt to exclude large delivery focused dealers.

**4) Was last year's Area 2 cross-section representative?**

On the one hand it was representative in that it had a mix of delivery sizes and because it covered the majority of sales in the Area. On the other hand, it understated the representation of small delivery volume in the area.

The four dealers used in the cost replacement hearing that resulted in OGO A-953 (CRO 9), effective April 1, 2018, did not include enough representation of dealers serving small format customers. This is illustrated in our Exhibit D13.

**5) Does the Area 2 cross-section meet the tests in the Commonwealth Court decision "School District of Philadelphia v. Pennsylvania Milk Marketing Board", decided October 18, 1996?**

**a. Geographically diverse?**

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL  
REDACTED PURSUANT TO PROTECTIVE ORDER DATED APRIL 19, 2019**

Clover Farms Dairy Co.	Reading, PA (Berks)
Dean Dairy Holdings LLC dba Swiss Premium Dairy	Lebanon, PA (Lebanon)
Milk Industry Management Corp. T/A Balford Farms	Allentown, PA (Lehigh)
Monroe Co. Milk Producers Coop Assn. dba Pocono Mountain Dairies	Allentown, PA (Lehigh)
Turkey Hill LP dba Turkey Hill Dairy	Conestoga, PA (Lancaster)
Tuscan/Lehigh Dairies, Inc.	Schuylkill Haven, PA (Schuylkill)
Valley Farms Dairy LLC	Williamsport, PA (Lycoming)
Wawa Beverage Company	Media, PA (Delaware)

This is a geographically diverse group of dealers. Seven different counties in Pennsylvania are represented. Three members are located within Area 2 and five are located outside Area 2. Area 2 covers 3 counties

**b. Cross-section coverage?**

Staff Exhibit 1 states that the cross-section dealers supply 79.8% of the reported milk sales to this area. This is higher than the 62.2% in the 1996 Commonwealth Court decision.

**c. Container sizes representative of containers sold by dealers in area?**

We studied the sales by container size in Area 2 using the dealer sales data used to calculate the container costs. We concluded that the sales by dealers in the cross-section are representative of sales in the Area. As we said in our Testimony on April 3: "There are no controlled milk products sold in Area 2 in paper half gallons, 12-ounce containers, or 10-ounce containers." The Area 2 cross-section includes half pints in both paper cartons and plastic containers. The cross-section includes one dealer that manufactures gallon containers, with the other processors purchasing empty containers from various vendors.

**d. Sales to customer types representative of area?**

We prepared Exhibit 14 to show the volume of controlled sales to small format customers compared to sales to large format and tractor-trailer customers. With a cross section of essentially 80%

coverage, we have a pretty good idea of the volume of small format sales in the area. In addition, based on almost 40 years of experience in the Pennsylvania dairy industry, it is my opinion that Area 2 is similar to Areas 3 and 4, and so the fact that the Area 2 cross section reflects a small delivery and large format break down that is in between the break down for Areas 3 and 4 reinforces my conclusion that the cross section reflects sales to customer types representative of the area. In my opinion it was important to update the cross section to reflect changes in the marketplace over the last several years to ensure that the cross-section adequately represents all customer types in Area 2.

**Evaluation of Staff Recommended Cross-Section Changes in Area 2**

Our review of the cross-section changes proposed by Board Staff resulted in observations about each of the four dealers that were added.

**[BEGIN ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]**

[REDACTED]

[REDACTED]

**[END ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]**

The four dealers added to the cross-section increase the coverage from 63.2% to 79.8%, an increase of 16.6 percentage points.

**Supplemental Exhibits**

**Exhibit D12 - Area 2 Wholesale Prices Compared to Other PMMB Areas**

This Exhibit shows the PMMB minimum wholesale price for a gallon of 2% reduced fat milk for the month of April from 2009 through 2019. This shows the history of minimum prices in Area 2 to the other five PMMB Areas. The gallon 2% reduced fat milk was selected as it is often the highest volume item sold at a fluid milk plant. April was selected because in most years the new prices from the cost replacement process are in place by April. This Exhibit illustrates how different Area 2 pricing has become over the past several years and the reason why Herbein + Company was engaged to analyze if there were issues with Area 2.



**Exhibit D13 – Analysis of Delivery Sizes**

This Exhibit shows my calculation of the pounds of controlled sales to two different categories of customers: large format/tractor-trailer and small format. For 2017 the percentage of small format deliveries represented by the cross-section dealers in Areas 2, 3 and 4 ranged from 31% to 39%. The Area 2 cross-section for 2016 had only 22% small format deliveries. This analysis reinforces my opinion that small format delivery costs were underrepresented in the 2016 cross section.

I based my calculation of delivery types for each dealer on inquiries of management, sales records, and fleet information.

Area 3 and Area 4 were selected because they are adjoining to Area 2 and in my opinion similar in terms of customer types purchasing milk.

Area 3 has the highest percentage of small format customers, 39%, in this comparison and has the highest delivery costs per point of \$0.1226. Area 4 has the lowest percentage of small format customers, 31%, and had lower delivery costs per point of \$0.1037.

**Exhibit D14 – Cross Section 2017 Compared to Cross Section 2012**

This Exhibit shows how the Area 2 sales pounds of the cross-section dealers changed in the five years between 2012 and 2017.

In 2012 there were five dealers in the cross-section and their controlled sales totaled 140 million pounds. These sales represented 67.2% of the Area 2 2012 sales of 208 million pounds.

HP Hood (Hatfield) was sold in October 2014 to Balford Farms. The Hatfield plant discontinued processing and packaging milk at that time. **[BEGIN ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]** [REDACTED]

**[END ATTORNEY EYES ONLY MATERIAL SUBJECT TO PROTECTIVE ORDER]**The cross-sections for the cost replacement hearings based on financial data from 2014, 2015 and 2016 did not include the HP Hood (Hatfield) data. The sales and financial data of Balford Farms was not used in Area 2 until this cost replacement hearing based on 2017 financial results.

**CONTAINS CONFIDENTIAL-ATTORNEY EYES ONLY MATERIAL  
REDACTED PURSUANT TO PROTECTIVE ORDER DATED APRIL 19, 2019**

If the 2017 Area 2 cost replacement hearing had used only the four dealers used in the prior hearing the percent coverage would have been 63.2%. While 63.2% is typically viewed as good coverage, it is also important to ensure that the cross section includes dealers with a range of delivery types. And even though the cross section last year included small deliveries, a good portion came from plants with a focus on large deliveries, meaning that their delivery costs are already weighted toward lower large delivery costs. In my opinion it was important to increase the percentage of small deliveries reflected.

Adding the four new dealers to Area 2 brought the cross-section percent coverage to 79.8%.

**Exhibit D15 – Analysis of Delivery Costs**

This Exhibit shows how the Area 2 delivery costs, delivery points, and cost per point for each dealer in the 2016 and 2017 cross-sections. The dealers that deliver primarily to large format/tractor-trailer customers have delivery costs per point less than \$0.10. Dealers that deliver primarily to small format customers have delivery costs per point higher than \$0.12.

The four dealers that were in both the 2016 and 2017 cross-sections had similar combined weighted average costs per point in both years – about \$0.08. This shows the focus of the 2016 cross-section dealers on large format/tractor-trailer customers.

The four dealers added to the 2017 cross-section have higher delivery costs per point because of their service to the small format customers. The inclusion of these dealers brings the weighted average delivery costs to about \$0.12 per point. As shown on Exhibit D13, this is like the weighted average delivery costs in Area 3 and Area 4, which are adjoining geographically to Area 2.

**Discounts**

Customers in Area 2 and all PMMB Areas are allowed discounts deducted from the minimum wholesale prices published each month. These discounts are based on the weekly average delivery size and other factors. The discounts reflect the fact that it costs more to make a delivery of a few cases to a number of customers than it costs to drop a trailer or a large delivery to fewer customers. The discounts are intended to reflect the cost savings the dealer experiences when a customer meets the volume requirements and pass those delivery

savings along to the customer. However, if the discount is applied to a minimum price that is overwhelmingly reflective of dealers focused on large deliveries, then the discounted price is understated.

The discounts in Area 2 were established when the cross-section was more representative of small format and large format deliveries. When the cross-section doesn't include enough small format customers the discounts overstate the savings that a dealer experiences when they make a large format delivery.

#### **Summary and Recommendation**

The Area 2 Milk Dealers recommend that the Milk Marketing Board use the cross-section used for our April 3 testimony and exhibits. This is also the cross-section used by Board Staff in their testimony and exhibits.

Thank you for your consideration of my analysis and opinions.