REDACTED SUBJECT TO PROTECTIVE ORDER DATED AUGUST 10, 2018

REBUTTAL TESTIMONY OF

RONALD W. MONG, CPA

Appearing on Behalf of the Pennsylvania Association of Milk Dealers

Testimony before the Pennsylvania Milk Marketing Board

Cooperative Milk Procurement Costs

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Cooperative Milk Procurement Costs

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 Testimony on behalf of the Pennsylvania Association of Milk Dealers. I attach my Curriculum Vitae, as Mong Procurement Rebuttal Exhibit D1, which outlines my education, and experience in the dairy industry.

Cooperative Milk Procurement Costs are High

PADC has entered Exhibits showing that their costs of procurement based on weighted average Class I pounds were $0.3451/Cwt. for 2018, and $0.3297/Cwt. for 2017. In the last hearing their Exhibits showed procurement costs of $0.2845/Cwt. These amounts represent an increase of $0.045/Cwt. from 2016 to 2017 (16%) and an additional $0.015/Cwt. from 2017 to 2018 (5%). The total increase for the two-year period is $0.06/Cwt. (21%). During this same period from 2016 to 2018 the average of the processors' cost center costs in the six PMMB areas increased from $0.2715/point to $0.2955/point. This $0.024/point increase is 9%. The cooperatives' procurement costs increased at double the rate of the processors' cost centers.

An important factor in the difference in increases is that the processors have constant competition from others in the marketplace – unlike cooperatives they cannot create a marketing agency in common. They continually strive to limit cost increases. The minimum wholesale prices are set by PMMB using the average cost center costs of the cross section. The PMMB minimum wholesale becomes the selling price for most of the dealers' sales. Every dealer works to get their costs below the cross-section average. The cooperatives, on the other hand, do not have similar competitive pressure to reduce their reported procurement costs. They are asking to have their costs passed to the processors without limit. Essentially this is a blank check.

What market forces would stop their costs from increasing every year? None. Are these costs limited by competition like the dealers' costs in the cost replacement process? No.

In the prior hearing, Dave Stonesifer explained in detail how the costs that PADC is reporting as procurement costs are not the same as the costs that a processor incurs in procuring independent milk. He explained these differences in detail in his testimony. I agree with his testimony. Of all the costs that the cooperatives are seeking, there are only two that could be argued are realistically similar to those incurred by milk dealers and those would be field services and producer payroll, although they remain different in scope and magnitude because the cooperative enterprise is different than the Pennsylvania Class I fluid milk plant as explained by Mr. Stonesifer. Since the reason the cooperatives petitioned for this hearing was that Pennsylvania fluid milk plants with independent supplies incur the same costs as cooperatives incur in getting milk to the Class I plant, but independent plants recover those costs through the wholesale price build up and cooperatives must secure compensation from the marketplace, the Board should carefully consider what costs legitimately mirror the costs of Pennsylvania's fluid milk plants.

We did not update the processor's costs of procuring independent milk for 2017 and 2018 as I deemed it unnecessary to the point. I stand by the point that Dave Stonesifer was making with the analysis. See PAMD Exhibit D3, Submitted September 20, 2018.

The Board staff has not audited the cooperative procurement costs in the PADC Exhibit. Chairman Barley's memo to Interested Parties on March 5, 2020 said, "Due to workload priorities Board staff will not be able to audit any new cost submissions parties contemplate filing."

We have not performed any inquiry or examination of the cooperatives' reported costs. We don't know if the accounting is correct. Are any expenses assigned to the wrong cost centers? Have labor costs been properly allocated? Most importantly, have all offsetting revenues been correctly applied against the cost center totals?

There are three examples of revenues offsetting costs in the wholesale price build up that I wish to highlight, however there are several more and these types of offsets must be mandated if the Board makes the unwise decision to adopt a cooperative-only procurement mandate.

1) Several cross-section processors perform milk hauling for their independent producers. The hauling fees collected from the producers are properly deducted from the reported milk hauling expenses. This is found in the Receiving, Lab and Field Work cost center.
2) Several cross-section processors receive revenue from trailer rental and from back hauling. These revenues are correctly deducted from the expense reported in the Delivery cost center.
3) Processors that sell bulk milk in excess of their needs deduct the revenue from those sales in computing net gain or loss on bulk milk transactions.

For instance, if the cooperatives wish to include a cost for any hauling, for example, the Saturday and Sunday they do not ship to a fluid plant, they must reduce those costs, like the milk dealers do, with the revenue that is generated from the alternative outlet. This correct accounting for revenues offsetting expenses has been used by the cross-section dealers and audited by Board Staff for many years. Generally accepted accounting principles (GAAP) require the offsetting of costs with related revenues. We and the Board should be able to determine if this has been handled correctly in the PADC cost build up. Based on the documents that Dave Stonesifer and Carl Herbein were able to review from the cooperatives previously, we still do not have any basis to conclude it has been handled correctly.

Board Staff audits of the PMMB-60s submitted by cross-section dealers have been valuable in verifying the financial information. Because I have been directly involved in preparing Exhibits for cost replacement hearings, I know that the Staff's work has corrected accounting, classification, and mathematical mistakes. The PADC financial data should be subjected to the same scrutiny and it is not sufficient in my opinion to adopt the concept only to discover that the cooperative enterprise is too opaque or complex or different to address the numerous issues raised by Dave Stonesifer and Carl Herbein previously.

Full Recovery is Required

If the Board adopts a mandatory cooperative procurement charge the full amount should be included in the resale prices. The method for inclusion in the prices should be the same as the current Over Order Premium (in August 2020 $1.00/Cwt.) and the current Interim Compromise Charge ($0.20/Cwt.) which was implemented in OGO A-1004 on January 1, 2020.

I have reviewed the various methods for recovering the cooperative-only procurement charge. The only method that allows processors with a substantial cooperative milk supply to recover their costs is to include the full amount of the procurement charge in the resale price build up.

If processors must pay a mandated charge for cooperative procurement the only fair and equitable method is to directly, without dilution, include those mandatory costs in the wholesale prices. If these plants don't get full recovery of these costs it is very unfair. Processors can't maintain the statutory rate of return if the wholesale prices don't reflect the full costs of the cooperative procurement charge.

The Primary Reason for the Diluted Recovery Proposal is Not Supported by Historical Data

PADC opines that the current method used for the Interim Compromise Charge results in a so-called "over-recovery" but offers no data or even a definition of "over-recovery". History has shown us that one cannot simply analyze the amount of mandate required versus the recovery that is built into the wholesale prices. That analysis can show whether there is an under-recovery on PA sales subject to a mandated charge, but it does not necessarily show if plants are using recovery in excess of the mandate to support raw milk purchases of that Pennsylvania plant. Historically, our studies have indicated Pennsylvania's fluid milk dealers have paid out all of the raw milk related cost recovery plus some.

Herbein + Company, on behalf of the Pennsylvania Association of Milk Dealers, conducted a study as part of a 2010 hearing to address the formula for calculating the over-order premium, which showed there was no evidence dealers recovered more than they paid for raw milk through the wholesale prices. See FOF No. 13, OGO A-968 Amended (July 13, 2011), Official Notice Requested.

On behalf of the Pennsylvania Association of Milk Dealers, I helped Dave Stonesifer prepare a surrebuttal exhibit for this hearing that was not offered due to the bifurcation of the hearing, which is Mong Procurement Rebuttal Exhibit D2. This analysis shows similar results as the 2009 study.

We requested and obtained the audited monthly PMMB 62 Forms for ten cross section milk dealers from the Pennsylvania Milk Marketing Board staff. This information was reviewed for an understanding of the conditions surrounding the premiums paid on raw milk and premiums recovered through PMMB minimum pricing by the members in the cross-section. We utilized the months of January, February and March 2018 as the time period for this study. At the time we prepared the exhibit, that quarter was the most recent quarter for which the Milk Marketing Board staff had completed all of their audits for each of the PMMB-62s for the dealers in the cross-section.

The cross-section was comprised of Clover Farms Dairy, Dean Foods Sharpsville, Dean Foods Meadowbrook, Galliker Dairy, Guers Dairy, Harrisburg Dairies, Rutter's Dairy, Schneider's Dairy, Swiss Premium and Turner Dairy Farms. This cross-section of dealers represents dealers purchasing milk from Pennsylvania producers and out of state independent milk, as well as dealers purchasing milk from cooperatives with Pennsylvania and out of state milk supply. It is my opinion that this cross-section is representative and reliable for this study.

This Exhibit shows that Pennsylvania dealers pay out more in total premiums to their producers than they collect in total premiums built into wholesale prices applicable to their PA controlled sales. The last column reflects premiums paid to producers that exceed the amount recovered through the Pennsylvania wholesale price.

Rather than milk plants experiencing an "over-recovery", there appear to be premiums paid to producers attributable to PA controlled sales that are not fully recovered and there are also premiums paid to producers attributable to non-controlled sales above amounts collected from Pennsylvania sales.

Column 1 represents the total pounds of milk received. Column 2 represents the portion of Column 1 that is received from Pennsylvania producers. Column 3 represents the Over-Order Premium dollars paid to Pennsylvania producers. The total minimum obligation due to the producers is reflected in Column 4 and the actual amount paid to producers in Column 5. Column 6 represents the payments made above the minimum due (Column 5 minus Column 4). The amount that producers are paid above the federal and state basic requirements (including the Pennsylvania mandated Over Order Premium) is shown in Column 7 (Column 3 plus Column 6). The first seven columns mentioned here all relate to the purchase side of the milk transaction cycle and demonstrate dealer costs relative to premiums paid.

Beginning with Column 8, we examine the sales side of the premiums to reflect the premiums that are collected through PA's wholesale minimum prices. Column 8 reflects the pounds of Pennsylvania Class I sales (i.e., PA produced, processed and sold) for the cross-section dealers in all areas of Pennsylvania. Column 9 is a calculation which is takes the Class I sales (per cwt.) from Column 8 times the Over Order Premium for the respective months (see the footnote A on the exhibit). This Over Order Premium amount includes the monthly fuel adjuster.

The result in Column 9 is the amount of Over Order Premium revenue generated by the cross-section in the wholesale minimum prices however, it is important to note that this does not reflect any level of wholesale discounts in the marketplace. Discounts would serve to lessen the amount of OOP recovery for the dealers in this calculation but it would not reduce the amount of over-order premium paid to producers.

Column 10 is a calculation that shows the amount of Over Order Premium dollars collected by the dealers, less the amount of Over Order Premium dollars paid to the producers (Column 9 minus Column 3). Again this Column 10 would show a smaller positive number if discounts were factored in.

Column 11 shows the difference between the total over payment from Column 6, less any excess Over Order Premiums collected from Column 10. The result of $976,615 represents excess premiums paid by the dealers to producers and clearly illustrates the dealers paid to their producers significantly more than the recovery they received in the wholesale minimum prices. Again, it is important to note that this number would be affected by the inclusion of any PMMB allowable wholesale discounts in the marketplace.

The Over Price Premium component of the monthly milk prices factors some of the excess producer premiums paid for Pennsylvania milk above the Over Order Premiums. In practical terms, excess premiums paid in January are reported to the Board Staff on the January PMMB Form 62, which is then audited and becomes part of the pricing calculation three months later in April. The same process would have for February premiums (part of the May price announcement) and March premiums (part of the June price announcement). We reviewed the calculations of the actual Over Price Premium dollars that became part of the monthly price announcements as noted above and reflected this in Column 12. This represents Over Price Premiums recovered in future minimum prices.

Column 13 is a calculation that illustrates the net premiums paid to producers at the end of this quarter for the cross-section, net of any premiums received by the processors through the recovery mechanism provided for in the wholesale minimum price calculations for Over Order premiums and Over Price premiums. All of this illustrates that the raw milk supply in Pennsylvania is sourced from both in state and out of state producers, and that the dealers are paying their producers more than they recover from the wholesale price build up. As a result, PADC's concern with an "over-recovery" does not have historical precedent. As I said, just because an amount appears to be an "over-recovery" doesn't mean that the dealer doesn't pay those amounts, or more, to their raw milk suppliers.

Blending Directly into Dealer Costs

PADC has recommended a cost-recovery method for the cooperative procurement charge. They would have the processor record the monthly payment of cooperative procurement charge as an expense in the Receiving, Lab and Field Work cost center. PADC advocates recovering these mandatory charges through the cost replacement process. Blending these mandatory charges into the cost centers is incorrect and inadequate. It will result in two levels dilution as shown in Mong Procurement Rebuttal Exhibit D3.

1) Processors buy milk and use it in all four price Classes, not just Class I. The points calculation used to determine the cost per point in the Receiving, Lab and Field Work cost center includes all the milk received and used at the plant. If a processor buys all its milk from Pennsylvania cooperative members and uses two-thirds in Class I and the other one-third in the three other Classes the proposed mandatory procurement charge would be based on Class I but the cost that would be reflected in the cost build up would be spread over all milk points and result in inappropriate dilution. The dealer would only receive a portion of the costs in the cost replacement process. See Mong Procurement Rebuttal Exhibit D3. The proposed mandatory cost is based on Class I but the recovery in prices is diluted by the non-Class I points. In other words, the denominator is too big.
2) There is also a second level of dilution as shown on Exhibit D3 as well. This dilution comes from the fact that when the plant level costs are aggregated in the cross section, the weighting of the other plants' cooperative supply, if lower, will further reduce the recovery. This is because the level of cooperative supply is different at each plant in the cross section. The cooperative fully supplied plant will have costs that are diluted by the other plants in the cross section that don't have those costs. Unlike costs that are controllable because they are not mandated, it is entirely unacceptable for these mandated costs to be not fully recoverable.
3) Further, recovering proposed mandatory cooperative procurement costs through the Receiving, Lab, and Field Work cost center takes up to two years. Many processors would have to tap into their lines of credit to pay the charge until the cost recovery begins two years later. This creates financial difficulty if the processor is already at their borrowing limits in their line of credit. The lag would go something like this:

a. Payment begins January 2021

b. Calendar year ends December 31, 2021

c. PMMB-60 filed on or before May 1, 2022. This annual financial statement would include twelve months of the mandatory procurement charge.

d. Cost replacement hearings held in Fall 2022 using the costs submitted in the 2021 PMMB-60s.

e. Resale prices calculated using the costs in the new OGOs would be announced for January 2023. This would be the first time the processor recovers any of the mandatory procurement charge even though the payments would have been made for 24 months.

Processors can't fund this procurement charge for two years before the costs are included in the resale price calculation.

The PADC testimony advocates a proposal that condemns cooperative-supplied plants to permanent margin reduction. In addition to margin reduction due to inadequate cost recovery it delays that recovery for up to two years. Adopting this severe plan at a time when plants cannot withstand it is bad policy. Industry chaos in both sales and in the supply chain due to COVID-19 is the worst possible time to implement new mandatory cost that will not be properly built into wholesale minimum prices.

Additional Cooperative Charges

I wanted to determine if the implementation of the $0.20 Interim Compromise Charge in January 2020 eliminated other cooperative charges. In other words, are the cooperatives in the same situation as are Pennsylvania's fluid milk plants where in the case of packaged fluid milk, the wholesale minimums generally determine the maximums in the wholesale sale of packaged milk? No. I reviewed the Over Price Premium records for the cross-section plants that have a cooperative supply beginning with the resale price build up in April 2020. Because of the time lag between premium payment and inclusion in the OPP, January 2020 payments above minimum were used to calculate April's OPP. February payments were used for May's OPP. I determined that cooperative supplied plants continued to pay premiums and handling charges on top of the Interim Compromise Charge which was implemented January 1, 2020. This is yet another way in which cooperatives are not the same as Pennsylvania's fluid milk plants. Cooperatives can recover the cost of their services by charging premiums on top of the Over Order Premium and even the Interim Charge.

Cooperative Control of Balancing Plants

One method for a processor to avoid a mandatory cooperative charge would be to convert from a cooperative milk supply to an independent (nonmember) milk supply. Seeking out-of-state milk is another option for those with proximity to out-of-state sources. Pennsylvania has independent milk available in most regions. This would be a cost savings because, according to Stonesifer PAMD Exhibit D3, Submitted September 20, 2018, the cost of procuring independent milk is about \$0.1051/Cwt., which is significantly less than the proposed cooperative charge of about \$0.28/CWT (the calculation for the same time period) or \$0.35/Cwt.

However, this is unworkable for some processors because of cooperative ownership of dairy manufacturing plants. Cooperative-owned plants can and do pay below Class prices on milk that they balance for processors supplied by independent milk. If there is no non-cooperative outlet for milk disposal then the processor is trapped into at least a partial cooperative supply so the cooperative will do business with them.

In western Pennsylvania there are proprietary cheese manufacturing plants available to balance an independent milk supply. The fluid plants also help these manufacturers to qualify for the Federal

Order pool. The availability of non-cooperative balancing makes independent milk supply a viable option in western Pennsylvania. The option is not as readily available in central and eastern Pennsylvania.

Therefore, the Board should not take lightly this decision. Absent full recovery, there are plants that may not have the options necessary to withstand the dilution that PADC is proposing.

Recovery Through the OPP Is Also Unacceptable

It is not an acceptable solution to provide for recovery of the cooperative-only procurement charge in the Over Price Premium. I analyzed the dilution impact on plants with cooperative supplies and the resulting losses are serious given the long-term lack of profitability among fluid milk plants in Pennsylvania as shown in Mong Procurement Rebuttal Exhibit D5, which updates Stonesifer PAMD Surrebuttal Exhibit D2, entered into evidence on January 28, 2019. The fragility of many of Pennsylvania's fluid milk plants will be compounded by the difficulties facing milk plants whose businesses has been adversely affected by the closing of schools and reduced food service sales as a result of the COVID-19 pandemic. Using 2019 sales data, **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** [redacted] **[END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** in that year if the 35-cent cooperative only premium had been in effect in 2019 and recovery was implemented through the Over Price Premium. In addition, other plants **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** [redacted]. **[END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** It is important to know that these losses are not once and done. Diluting the recovery of a mandated cooperative-only procurement charge will cause losses for these plants year-over-year. **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** [redacted]

[redacted] [END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL] Unfortunately, for some of Pennsylvania's fluid milk plants, shifting milk supply may not be an option.

There would be similar adverse results if PADC's method of putting the cost through receiving lab and field work would occur, although the magnitude of the dilution (and losses) for plants with a cooperative supply would be more substantial due to two levels of dilution that I've described. Importantly, these losses are not one-time losses. They are annual.

Some ideas simply cannot be implemented without creating serious damage and serious inequities. Mong Procurement Rebuttal Exhibit D4 reveals the serious inequities created among Pennsylvania's fluid milk dealers based on their source of milk supply. I have the feeling the Board would like to adopt something for the cooperatives, but this proposal simply cannot be the answer. It would hand a government-imposed advantage to plants with independent milk and a non-cooperative outlet for balancing, while it would condemn plants with cooperative milk and little access to non-cooperative balancing to year-over-year and unsustainable losses.

I urge the Board to be clear-eyed and recognize that this proposal is the medicine that will kill some patients. And, as the testimony before today indicates, cooperatives do not need this medicine. They have many resources and governmental advantages already to help them successfully maintain their business model.

I remind the Board of the testimony of Mr. Tosi, who explained that the FMMO Class I differentials were designed with the costs of marketing milk in mind.

The impatience in the room was palpable when Dave Stonesifer testified that reblending is a tool and advantage that cooperatives have that serve to offset PADC's alleged need to be treated just like Pennsylvania fluid milk plants. His points should not be discounted. Cooperatives are entirely different entities and they have far greater regulatory flexibility than fluid milk plants in operating their business and managing their costs and setting prices that they do not need to be treated the same, in any respect as fluid milk plants in Pennsylvania. If the cooperatives should be treated the same as Pennsylvania's fluid milk plants, then the fluid milk plants should be able to reblend and collectively bargain on price as permitted by the Capper Volstead Act. Since that won't happen, this proposal should not happen. I urge you not to rule out the powerful advantages that cooperatives have that make them very dissimilar from Pennsylvania's fluid milk plants.

Among other things, reblending allows cooperative-owned plants, to choose to pay or not pay Pennsylvania and some FMMO mandated charges on raw milk. In addition, serving fluid milk plants provides access to a lucrative market including pooling on federal orders which benefits the entire cooperative enterprise including the manufacturing facilities. The profitability of these manufacturing facilities in turn returns dollars to cooperative farmers. These opportunities are available through reblending.

Due to recent developments, we now have another example of how the advantages unique to cooperatives may play out. The **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** [redacted] **[END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** will not be required, like their competitor plants buying cooperative milk, to pay this procurement charge to the extent they purchase member milk. If they choose to pay the procurement charge, neither we nor PMMB will have any way of determining if it comes back to the plant in other ways through related party transactions designed to make **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** [redacted] **[END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** more competitive and more able to compete for packaged milk sales. This new possibility now increases PAMD's concern that based on milk supply sources, PADC's proposal will create winners and losers. It is a perverse result that this Board cannot possibly want to sanction that the cooperatives are championing a proposal that will greatly injure their most significant customers.

Summary and Recommendation

On behalf of the Pennsylvania Association of Milk Dealers, I recommend that the Milk Marketing Board not adopt a mandatory cooperative-only procurement charge. The cooperatives can and do charge their customers handling charges and premiums to recover the cost of serving fluid milk plants. However, fluid milk plants should not have to cover the entire cost of the marketing arm of the cooperative or to face higher costs due to the creep from the varied scope of the cooperative enterprises. The cooperatives are not like Pennsylvania fluid milk plants. They have advantages and tools Pennsylvania fluid milk plants do not have. Giving the additional tool of a cooperative-only premium will increase their market impact.

If the Board adopts a mandatory cooperative-only procurement charge, I urge the Board to recognize that the only rational path forward would be to provide for a full pass through in the resale price calculation. This is the only solution that maintains the financial stability of cooperative-supplied processors.

Thank you for your consideration of my analysis and recommendation.