

**REDACTED SUBJECT TO PROTECTIVE ORDER DATED JULY 15, 2020**

SURREBUTTAL TESTIMONY OF

RONALD W. MONG, CPA

Appearing on Behalf of the Pennsylvania Association of Milk Dealers

Surrebuttal testimony before the Pennsylvania Milk Marketing Board

Over-Price Premium Hearing To Account For

Cooperative-Owned Fluid Milk Plant Purchases Of Member Milk

August 5, 2020

Submitted: July 31, 2020

**Surrebuttal Testimony of Ronald W. Mong, CPA**

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**Response to PMMB Staff Rebuttal Testimony**

PMMB Staff has provided Rebuttal Testimony and Exhibits in this hearing. This is my response to that testimony and exhibits on behalf of PAMD.

**Purpose of Our Hypothetical Examples**

The purchase of the four Dean Foods plants by Dairy Farmers of America (DFA) was final on May 1, 2020. As of today, the impacts of the ownership change have yet to be seen. In fact, the changes will take time to evolve.

One of the critical and most basic aspects of operating a fluid milk plant is the source of raw milk. My industry experience is that when cooperatives acquire processing plants one of the primary reasons is to obtain or maintain an outlet for member milk. The hypothetical examples provided in our Exhibits are intended to show the Board what could happen if all four plants were supplied 100% with member milk. **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] **[END CONFIDENTIAL ATTORNEY EYES ONLY**

**MATERIAL]** Therefore, we are asking that the calculation method be corrected now, **[BEGIN**

**CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] **[END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]**

**Board Staff Exhibit**

The Staff Exhibit uses sales data from only two months, February and March 2020. The Over Price Premiums in these two months were calculated from dollars paid in November and December 2019. Dean Foods entered bankruptcy on November 12, 2019. The sale of the plants to DFA took place on May 1, 2020. These two post-bankruptcy months are not necessarily representative. Also, Gov. Tom Wolf ordered all non-life sustaining businesses to close on March 19. The business disruptions caused by COVID-19 had repercussions across Pennsylvania. The dairy industry was not immune to these impacts and those impacts quite likely would have affected the sale volume used in the Staff's OPP calculation. Because of the Dean Foods bankruptcy and the COVID-19 crisis in my opinion February and March 2020 are not the correct months to calculate the impact of our proposed change and it is far better to look at a larger time period given these circumstances.

The Staff exhibit and Staff's concern in the testimony that PAMD's proposal will increase the OPP is a distraction that misses the point – when circumstances change, there are times when the Board has to make adjustments to ensure that things continue to be handled correctly. We can't just say we don't like the result. **[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** [REDACTED]

[REDACTED]

**[END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** I would also like to note that my Exhibit D2 also showed this same result in our initial submission.

The OPP calculation has been correct in the past because the OPP dollars and pounds have been included whether the dollars paid were high or low. The results were mathematically correct every month. Whatever was being paid in the market was included. When dollars paid out increased, the OPP increased. When market changes brought the amounts paid above the minimum down, the OPP decreased. All plants were fairly treated based on their sales in each Area. The situation changed in May 2020 when four large Pennsylvania fluid plants were acquired by DFA and had the potential to be supplied with member milk.

We calculated the 30-month simple average of the Over Price Premium paid by each plant used in the monthly resale price calculation. These OPP were paid during the period December 2017 through May 2020. They were used in calculating minimum resale prices from March 2018 through August 2020. There is a three-month lag between the month that OPP dollars are paid and when they are used in the minimum resale price calculation. This allows time for PMMB Staff to review the amounts actually paid.

**[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

**[END CONFIDENTIAL ATTORNEY**

**EYES ONLY MATERIAL]**

If Dairy Brands is charged a premium, due to the non-arm's length nature of the transaction, including that there is no minimum due calculation for such a transaction, there is no assurance the premium is representative of premiums incurred for Class I cooperative milk or to verify that premiums that may be invoiced do not otherwise get reimbursed to the plant, let alone that they are paid. I and my Herbein colleagues have extensive experience with dairy cooperative accounting. I can confidently say that the dairy cooperative business model is to compensate members based on the entire enterprise. This includes monthly payments for the milk and an annual return to members based on the cooperative enterprise's profit. As a result, if premiums are invoiced to the plant, they reduce the profitability of the plant but increase the pool of funds available to pay members. In accounting terminology these premiums are not "arms-length." Any Class I premiums invoiced to the plant would not necessarily be specific to the Class I market. Generally accepted accounting principles (GAAP) require the elimination of related-party transactions. The PMMB system does not recognize premiums for cooperative owned plants buying member milk because there is no minimum due calculation which is the basis for calculating an over price premium. Board Staff correctly excludes premium dollars when cooperative-owned plants buy member milk

**[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY**

**MATERIAL]**

**[END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]** Because there cannot be premium dollars in this type of vertically integrated fluid milk plant we are asking that the Class I sales pounds be excluded as well so not to misrepresent the level of market premiums.

[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL] [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] [END CONFIDENTIAL

**ATTORNEY EYES ONLY MATERIAL]** PAMD’s request to remove sales pounds from a cooperative-owned plant’s OPP calculation is because when the plants are supplied with member milk there can be no OPP. If the sales pounds from plants that can never have any OPP dollars are included in the calculation the impact of the plants that are paying OPP is diluted. The correct math is to eliminate the Class I sales pounds from cooperative-owned plants to the extent they are supplied with member milk.

When Pennsylvania Class I sales pounds are included in the OPP calculation from plants that can’t have any OPP dollars the resulting answer is not representative of OPP paid by plants that are not cooperatives supplied by member milk. If the calculation is incorrectly low there are two results. First, plants that pay OPP dollars incur costs that are not recovered in the minimum resale prices. Second, plants have an incentive to not pay more than the minimum due because these payments are not recovered in the minimum resale prices.

When the minimum resale prices don’t include all costs plants won’t achieve the statutory rate of return provided in the law.

### August Over Price Premium

On Thursday, July 23, PMMB announced the minimum resale prices for August. The Over Price Premiums in this price announcement were based on amounts paid in May. [BEGIN CONFIDENTIAL

**ATTORNEY EYES ONLY MATERIAL]** [REDACTED]

[REDACTED]

[REDACTED] [END CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]

[BEGIN CONFIDENTIAL ATTORNEY EYES ONLY MATERIAL]

[REDACTED]

[END CONFIDENTIAL ATTORNEY

EYES ONLY MATERIAL]

### **Summary and Recommendation**

My conclusion remains the same as in my original testimony. I recommend that the Milk Marketing Board carve out member milk purchased by a cooperative-owned fluid milk plant from the OPP determination. If a cooperative-owned plant is 100% member supplied, that plant would effectively be excluded from the cross section. If a cooperative-owned plant is only partially supplied by member milk, then their milk purchases and the over-price premiums associated with third party suppliers could appropriately be included in the cross section to the extent that they are supplied with non-member (independent) milk or milk from other cooperatives.

Thank you for your consideration of my analysis and recommendation.