TESTIMONY OF

RONALD W. MONG, CPA

Appearing on Behalf of the Pennsylvania Association of Milk Dealers

Testimony before the Pennsylvania Milk Marketing Board

Over-Price Premium Hearing To Account For

Cooperative-Owned Fluid Milk Plant Purchases Of Member Milk

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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 Rebuttal Exhibit D1, which outlines my education, and experience in the dairy industry.

Study Conducted

On behalf of the Pennsylvania Association of Milk Dealers, I have reviewed the monthly over-price premium files prepared by the Pennsylvania Milk Marketing Board staff. I have studied the most recent twenty-four months from August 2018 through July 2020 to evaluate the impact of a significant increase in cooperative ownership of fluid milk plants in the over price premium cross sections and wish to present my findings here.

Over-Price Premium

The calculation of the Over-Price Premium is detailed in OGO A-925 which became effective on March 25, 2004.

The Over-Price Premium represents dollars paid by cross-section dealers to their cooperative suppliers and independent dairy farmers above the PMMB minimum amount due. It is intended to accurately reflect amounts paid above a fluid milk plant's regulatorily required minimum payment, commonly referred to as the minimum amount due or minimum due so that these costs can be appropriately built into the wholesale minimum prices enforced by the Milk Marketing Board.

The PMMB minimum amount due is an important concept in the Pennsylvania milk regulatory system. Each month the PMMB field staff determines that each licensed processor has paid to their milk suppliers at least the minimum due for that month in order to enforce Pennsylvania's minimum prices to producers. The minimum due is calculated by the plant's usage in each of the four price Classes times the corresponding PMMB announced price for that Class. This subtotal is adjusted for payments made to or received from a Federal Order Settlement Fund. The process of auditing the minimum due to independent farmers or dairy cooperatives is a critically important monthly task of the PMMB staff. It gives assurance to the raw milk suppliers that they were paid for the correct pounds at the proper prices as required by law.

In many cases a dairy processor pays their cooperative supplier or independent farmers more than the minimum amount due. The payments above the minimum due are called over-price premiums and when aggregated to arrive at the cross section average, they establish PMMB's Over-Price Premium (OPP) that is built in the wholesale minimum prices. These additional payments are analyzed while the PMMB auditor is examining the plant's calculation of the minimum due. OGO A – 925 describes in detail how these payments above the minimum amount due are accumulated by PMMB Area and correctly included in the minimum resale prices. This system for including over-price premiums in minimum resale prices has operated appropriately for many years.

In Pennsylvania the minimum wholesale prices set by the PMMB tend to set the market price in the wholesale market. Therefore, it is critical to the survival of fluid milk processors that all costs incurred by the plants are reflected in the wholesale prices. It is important that the Over-Price Premium accurately reflect over-price premiums actually paid above the minimum due and not diluted by milk volumes that, by definition, do not have an over-price premium.

The simple average of the Over-Price Premiums for the most recent twenty-four months is shown in the first column of Exhibit D2. The amounts vary from Area to Area based on market circumstances.

Current Market Changes

On May 1, 2020 Dairy Farmers of America (DFA) acquired four large Pennsylvania fluid milk plants from Dean Foods. Dean Foods had entered bankruptcy in November 2019. In addition to these Pennsylvania plants DFA acquired through the bankruptcy process other plants in other states. DFA is operating these plants under the name “Dairy Brands”.

The acquisition is expected to result in an inappropriate dilution of the Over-Price Premium. When a cooperative-owned and -operated plant acquires milk from its own members there is no minimum due calculation because the PMMB minimum prices do not apply to a cooperative purchasing member milk. As a result, the Over-Price Premium is diluted by Class I sales from plants that have no minimum due to producers when they procure member milk.

Because there is no PMMB minimum due for raw milk purchases if the plant is supplied by member milk, there can be no Over-Price Premium by definition. Please understand, it is not zero. An Over-Price Premium simply does not exist. This is analogous to out-of-state milk. Since there is no minimum due obligation on out-of-state milk, an over price premium does not exist, and such milk is carved out of the current OPP calculation, so neither the pounds nor the dollars (which are zero) inappropriately dilute the OPP. Similarly, since the individual plant’s over price premium will not exist with respect to the purchase of member milk by a cooperative-owned plant, the purchases of member milk by a cooperative-owned plant must be excluded from the Over-Price Premium so the Over-Price Premium can do its job of reflecting the average of premiums paid above the minimum due.

In addition to the four plants recently purchased by DFA there is also a cooperative-owned and -operated plant in PMMB Area 3. DFA has only been operating the four large Pennsylvania fluid milk plants for two months. Rather than attempt to calculate an actual impact analysis based on their transition period, I made pro forma calculations as if all of the cooperative-owned plants in the current cross sections only purchased their member milk and thus had no minimum due and therefore no over-price premium dollars to contribute to the cross section over the most recent twenty-four months. These plants certainly could have a mix of supplier sources, but I did not believe it was necessary to study the mix for purposes of my impact analysis which I believe reflects a realistic picture of the potential impact.

In the second column of Exhibit D2., the sales pounds were left in the calculation but there were no over-price premium dollars. The biggest changes in OPP if these plants have no over-price premium dollars are in Area 1 (reduced by $0.07 per Cwt.) and Area 5 (reduced by $0.06 per cwt.) These are also the two PMMB Areas with the largest sales volume.

Since a cross-section that includes cooperative-owned and -operated plants that have no minimum due or OPP on member milk dilutes the cost recovery to the remaining plants in the cross-section that do have a minimum due, proprietary plants might be less able to pay amounts above the minimum due when the cost recovery in the PMMB price-setting calculation is flawed.

Recommended Solution

Instead of automatically excluding cooperative-owned plants from the Over-Price Premium cross sections, I recommend that the Board amend the existing order to so the volume of member milk purchased by a cooperative-owned plant is carved out of the cross section. That would allow the over-price premiums such plants might pay on independent milk or other cooperative milk to still be included in the cross sections.

The third column on Exhibit D2 shows the potential impact of this proposal by showing what the Over-Price Premium would have been over the 24-month period if member milk (assumed to be

100%) purchased by the cooperative-owned plants in the cross sections were carved out same as out-of-state milk.

Cross-Section Plants Partially Supplied by Member Milk

Exhibit D3 shows a hypothetical example calculation of how the OPP would work if a cooperative-owned and -operated plant is only partially supplied by member milk.

In this example a hypothetical processor receives 10 million pounds of raw milk, 7 million of it from non-member Pennsylvania farms. The plant paid their Pennsylvania-sourced independent milk $7000 more than the minimum due. The calculation in column A shows this results in an OPP of $0.10 per cwt.

In the column labeled B this same hypothetical cooperative-owned dairy procures 5 million pounds of member milk. There can be no Over-Price Premium on these 5 million pounds. The remaining 2 million pounds is from independent producers. The plant pays $2000 in OPP on these 2 million pounds. Using the current OPP order that did not account for cooperative-owned fluid plants in Pennsylvania, all the PA source milk would be used as the divisor, even though there can be no OPP on the member milk. This dilutes the Over-Price Premium to $0.0286 per cwt.

The column labeled C shows the updated method that accounts for cooperative ownership of fluid milk plants in Pennsylvania. The 5 million pounds supplied by cooperative members is excluded from the divisor. This exclusion is needed because there can be no Over-Price Premium on member milk. The Pennsylvania raw milk receipts in the calculation is reduced by the pounds of PA member milk.

Summary and Recommendation

On behalf of the Pennsylvania Association of Milk Dealers, 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.