

SURREBUTTAL TESTIMONY OF

CARL D. HERBEIN, CPA

Appearing on Behalf of the Area 2 Milk Dealer Association

Surrebuttal Testimony before Pennsylvania Milk Marketing Board

2016 Cost Replacement Hearing

July 5, 2017

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Area 2 – Cost Replacement Hearing

I am Carl D. Herbein, CPA, President and CEO of Herbein + Company, Inc. and my address is 2763 Century Blvd., Reading, PA 19610. I wish to present Surrebuttal Testimony on behalf of the Area 2 Milk Dealers Association. I attach my Curriculum Vitae, as Surrebuttal Exhibit D1, which outlines my education and experience in the dairy industry.

Study Conducted

On behalf of the Area 2 Dealers Association, I have reviewed the audit files and proposed adjustments prepared by the Pennsylvania Milk Marketing Board audit staff, have conducted fieldwork at each of the dealers in the cross-section and have prepared exhibits which present my findings.

Cost Replacement Process

This hearing will accomplish the annual cost replacement process in which the Pennsylvania Milk Marketing Board substitutes new cost information for the prior information, which is then utilized in developing its wholesale and resale prices. This hearing will include a container cost update utilizing April 2016 cost information as the new starting point for container updating. These April 2016 container costs are updated on a monthly basis based upon cost information submitted by the cross-section dealers and reviewed by Board staff. This hearing will also include ingredient cost updating utilizing April 2016 cost information. Ingredient costs are updated on a quarterly basis for flavored milk, flavored reduced fat milk and flavored non-fat milk. These updates occur on January 1st, April 1st, July 1st, and October 1st of each year. All exhibits are prepared utilizing a weighted average based on the controlled sales in the area. All exhibits have been adjusted for inter-plant transfers. An inter-plant transfer is a transaction where a product is manufactured in one plant and transferred to an affiliate plant that then sells the product to the ultimate consumer. These exhibits have been prepared reflecting the sales to the ultimate consumer in the applicable area. This weighting and averaging method has been consistently applied from year to year.

The only differences between Staff's exhibits and my exhibits are due to the substantive issue that was addressed in and will be resolved as part of the Area 4 hearing. That Area 4 decision will then be applied to the Area 2 exhibits and conclusions which will result in the new PMMB prices.

Cross-Section

The Area 2 cross-section of dealers utilized includes Clover Farms Dairy Company, Swiss Premium Dairy, Turkey Hill Dairy, Tuscan/Lehigh Dairies, Inc. (Schuylkill Haven, PA). These companies process, package and deliver the majority of fluid milk products in Area 2 and comprise a group of companies which include organizations that deliver to supermarkets, convenience stores, schools, institutions, and small retail outlets. In my opinion this cross-section of dealers continues to be representative of the dealers selling fluid milk in Area 2 and this cross-section remains unchanged from the immediate prior hearing.

Surrebuttal Exhibits

I am submitting revised exhibits on surrebuttal to reflect an allocation that was omitted in the rebuttal exhibits and changes that result from reconciliation of minor differences with Board Staff. Except for the substantive Area 4 issue that affects the amount of the allocation, the allocation that is included in the surrebuttal exhibits now applies the same method as Staff.

Surrebuttal Exhibit D2 reflects the processing, packaging, and delivery cost per point for calendar year 2015. Please note that the points presented are for sales in the PMMB Area 2 made by the cross-section dealers. These costs should replace the existing costs from 2014, which are currently being utilized by the Board in establishing prices. These costs are calculated in accordance with PMMB rules and regulations and have been consistently applied from the previous year.

It is my understanding that the rather insignificant differences between PMMB Staff's initial submission and my rebuttal exhibits will be reconciled with the filing of the surrebuttal exhibits by PMMB Staff.

Surrebuttal Exhibits D2-A through D10-B

Surrebuttal Exhibit D2-A is prepared to reflect the effect of the cost replacement process by comparing the 2014 costs in the current order with the 2015 costs. Additionally, this exhibit reflects the 2016 cost increase adjustment and removes the 2015 cost increase adjustment to eliminate any possibility of duplication. It should also be noted that the bottling department points for 2015 are 85,173,691 for the cross-section dealers and this compares with 2014's bottling department points of 82,037,823. This comparison reflects a 3.8% increase in bottling department points when comparing 2015 with 2014.

Surrebuttal Exhibit D3 and D3-A have been updated to container costs utilized in the May 2017 resale price development. The container shrinkage factor reflected on this exhibit is a statewide average and will be utilized for all areas. This study was conducted for the period January to March 2009 and it is my opinion that it is reasonable to continue using this study's container shrinkage statistics for the 2016 Cost Replacement Hearings. The cross-section of dealers utilized for each area and for each container is representative of the dealers selling fluid milk in Area 2. It is important to note that these container costs have been updated on a monthly basis and that process of monthly updating should be continued utilizing April 2017 as adjusted as a new starting point.

The Area 2 Milk Dealer Association requests and recommends that the blending concept be continued for all containers that are represented by both plastic and paper with the exception of the half pint container. The blending of containers, including blow-molded and purchased plastic containers should be continued for each container utilized in this area. The wholesale and resale prices for the control product sold in half pint containers should be determined utilizing the paper container cost for paper and by applying a plastic add-on for half pint containers that are "ridged plastic in nature." The plastic add-on must be updated and the new reset should be \$0.0386 and it should continue to be adjusted monthly in accordance with OGO A-957.

Surrebuttal Exhibit D4 is prepared to present the ingredient costs as of March 2016, which should be inserted into the product formulas for pricing purposes and should replace the ingredient costs which are currently being used.

Surrebuttal Exhibit D4-A reflects the ingredient costs presented on Surrebuttal D4 and demonstrates the increase or decrease when the cost replacement process occurs.

Surrebuttal Exhibit D5 updates the cost of shrinkage and cost and revenues from bulk cream and bulk milk. The current order establishes a net revenue of (.0010) per pound and the new net revenue, based on 2015 is (.0025) per pound. Thus, there has been a new net change of (.0015) per pound.

Surrebuttal Exhibit D6 reflects a comparison of the current order butterfat tests by product category and compares those tests with the 2015 actual butterfat tests. This exhibit also reflects the increase or decrease in butterfat content. A decrease in butterfat content will result in less cost of milk in the wholesale and resale prices, which will result from this process and an increase in butterfat content will result in more cost of milk in the

wholesale and resale prices, which will result from this process. I recommend that the Board replace the current butterfat by product with the 2015 tests reflected on this exhibit.

Surrebuttal Exhibit D7 is prepared to calculate the cost increases and decreases incurred during the six (6) month period ending June 30, 2016 with the six (6) month period ending June 30, 2015 for labor and fringe benefits, utilities, and insurance. This calculation is performed by comparing labor and fringe benefits, utilities, and insurance on a per point basis. This adjustment allows for an updating of significant costs, which change rapidly. This year the cost increase (decrease) analysis has been performed utilizing the first six (6) months of 2016 and comparing that with the first six (6) months for 2015. It should also be noted that the weighted points for the six (6) month period of 2016 are 4.2% lower than the weighted points for the first six (6) months of 2015.

Surrebuttal Exhibit D8 has been updated to reflect the March 2017 diesel fuel costs, which were used in issuing the minimum prices for May 2017. Additionally, this exhibit reflects the calculation of the average diesel fuel cost for calendar year 2015, which forms the basis for the annual adjustment and update. I recommend that this adjustment be continued on a monthly basis.

Surrebuttal Exhibit D9 has been updated to reflect January 2017 natural gas costs and reflects OGO A-937 effective June 1, 2006 concerning heating fuel costs. Additionally, this exhibit reflects the calculation of the average heating fuel cost for calendar year 2015, which forms the basis for the annual adjustment and update. I recommend that this adjustment be continued on a monthly basis.

Surrebuttal Exhibit D10-A and D10-B are prepared to reflect the wholesale minimum price for a gallon of reduced fat milk and a half pint of flavored non-fat milk for May 2017. These exhibits also cross-reference the exhibits that support the individual line items.

Class II Controlled Products

The annual cost replacement process many times includes an updating of Class II product costs. We are not presenting such data at this time. We ask that the Board continue with the current methodology. The dealers have considered and will continue to review other approaches but do not presently see a basis for modifying the status quo.

Rate of Return

I recommend that the Board maintain the rate of return for the Area 2 dealers at 3.5%. This rate of return will provide the ability for the dealers to reinvest in their facilities and create new products. In order to continue to foster the incentive and ability of these companies to continue to invest in product and plants that are able to compete for Pennsylvania and out-of-state volume the continuation of the 3.5% return is recommended.

Summary and Recommendation

The Area 2 Milk Dealers recommend that the Milk Marketing Board make the cost replacement adjustments, which are reflected in my testimony and exhibits. Thank you for your consideration of my analysis and opinions.