BEFORE THE PENNSYLVANIA MILK MARKETING BOARD

COOPERATIVE MILK PROCUREMENT COSTS HEARING

October 9, 2018

Testimony of

John S. Stoner, CPA, CVA and Matthew I. Hartland, CPA/ABV

Testimony of John Stoner

My name is John S. Stoner and my business address is 1800 Fruitville Pike, Lancaster, Pennsylvania, 17604. I am a partner in the Business Consulting Services Group of RKL LLP, which is an accounting and professional services firm with headquarters in Lancaster, Pennsylvania. I have over 30 years of experience in public accounting. In addition to being a Certified Public Accountant, I am a Certified Valuation Analyst with a practice concentration in providing business valuation, operational consulting, and litigation support services. I also have over 30 years of experience in conducting and supervising financial audits and cost accounting assignments. My educational and professional background are summarized in PADC Exh 11.

I am testifying today on behalf of the Pennsylvania Association of Dairy Cooperatives, or the “PADC”, whose members include Dairy Farmers of America, Inc., Dairy Marketing Services, LLC, Lanco Dairy Farms Co-op, Inc., Land O’ Lakes, Inc., and Maryland & Virginia Milk Producers Cooperative Association, Inc. PADC is requesting that the Pennsylvania Milk Marketing Board, or the “PMMB”, consider testimony and exhibits concerning cooperative milk procurement costs and a method to incorporate those costs in minimum wholesale and retail milk prices.

GNEMMA Milk Procurement Cost Study

RKL was previously engaged by the Greater Northeast Milk Marketing Agency, or “GNEMMA”, to conduct a Milk Procurement Cost Study (“Cost Study”). The focus of that study was to measure the milk procurement costs incurred by cooperatives during the year 2012 in supplying milk to PA Class 1 Dealers. The purpose of that cost study was to provide evidence in support of the GNEMMA request that the Pennsylvania Milk Marketing Board require payment to cooperatives for their milk procurement costs for PA Class 1 milk. The Cost Study was based on 2012 financial data obtained from six GNEMMA member organizations that accounted for approximately 66% of the 10.4 billion pounds of milk produced in Pennsylvania during 2012.
For each of the six member organizations included in the Cost Study, RKL obtained their year-end audited financial statements, prepared in accordance with generally accepted accounting principles (GAAP), and also obtained internally prepared financial reports generated from their accounting systems. These financial reports, as well as, the underlying general ledger “chart of accounts” provided the data necessary to extract the relevant milk procurement costs from their overall financial statements.

RKL held meetings and conference calls with representatives of each participating cooperative. The purpose of those meetings was to review and discuss their respective business operations and specifically how the milk procurement costs are presented in the financial reports and underlying accounting systems. Personnel responsible for milk accounting for each organization submitting data were included in this process. RKL obtained milk procurement costs from the six participating cooperatives in the following cost categories:

Direct Costs:

- Field staff / membership
- Lab work
- Dispatch / scheduling / truck route supervision
- Processing payroll payments to producers
- Balancing (defined as additional hauling expense to meet daily demand fluctuations)

Indirect / Overhead Costs:

- General and administrative allocation to milk procurement
- Corporate overhead allocation to milk procurement

Once the data gathering, review, evaluation, and analysis of the relevant costs was completed, we then began to construct our milk procurement cost “build-up” for each separate reporting entity. Our objective was to calculate the average milk procurement cost per hundredweight for PA Class 1 milk.
Although we believe that certain procurement costs for Class 1 milk (fieldmen, inspection, and laboratory costs) are higher than other Classes of milk products, we did not attempt to allocate those costs disproportionately in determining the average cost per hundredweight. We used a uniform distribution of the overall milk procurement costs incurred by the total number of pounds of milk sold in the region. Our method of cost distribution for individual entity cost build-up is illustrated on PADC Exh 14.

After completing the individual cost build-up for each separate entity, we had to determine the best approach to construct the composite cost build-up for the entire group. Since our objective was to measure the milk procurement costs incurred by cooperative organizations in connection with their operations related to the procurement of Pennsylvania Class I milk, we decided to allocate the individual entity cost build-up data in proportion to each entity’s PA pound activity. Simply illustrated, if one entity marketed 30% of the PA milk production examined in our study, its individual procurement cost build-up figures would be weighted 30% in constructing the composite average. Using this methodology, the composite procurement cost build-up was established with an emphasis on determining the average procurement costs incurred by cooperatives conducting business in Pennsylvania. The result of the 2012 RKL Cost Study was a cost per-hundredweight of $0.2783.

Summary of Events after the 2012 Cost Study

I provided testimony before the PMMB in support of the 2012 Milk Procurement Cost Study during the Over-Price Premium Hearing that comprised seven hearing days during the period November 13, 2014 – April 3, 2015.

On November 4, 2015, the PMMB adopted and issued General Order No. A-992. That order states that “the Board will develop a framework, set of regulations, and reporting mechanism for cooperatives, similar to that in place for milk dealers, that will allow us to accurately determine relevant cooperative costs”.

Submitted August 13, 2018
On November 10, 2015, RKL was engaged by the Pennsylvania Association of Dairy Cooperatives ("PADC") to provide assistance to their member organizations and coordinate efforts with the PMMB staff responsible for developing a framework, set of regulations and reporting mechanism for cooperatives, similar to that in place for milk dealers, that will allow the PMMB to accurately determine relevant cooperative costs. RKL has participated in the following activities in connection with this engagement:

1. Reviewed the financial information gathered from each participant in the GNEMMA cost study (based on 2012 financial data) to identify relevant cooperative cost centers.

2. Held conference calls with each PADC member organization to discuss their financial reporting, current organizational design and changes in operations since the GMENNA cost study, and to develop an approach to gather and accurately report their relevant milk procurement costs.

3. Provide assistance to cooperatives in analyzing their costs and helping them determine proper cost allocation methodology and support documentation for general and administrative and other indirect costs to provide an ability for the PMMB staff to review and independently verify the accuracy of the cooperative information submitted.

4. Met with PMMB staff, at their request, to discuss the objective of accurate and uniform reporting of relevant cooperative costs and to provide input regarding recommended cooperative cost centers for the PMMB Form 60C reporting.

5. Further meetings with PMMB staff, as requested, to discuss the proposed cost centers and new reporting format for cooperative cost centers.

6. Provide any other assistance, as requested, to support the PMMB staff's understanding of the cooperatives financial records and their independent audit function and verification of the relevant cooperative costs.
On February 18, 2016, the PMMB circulated a draft of proposed amendments to Section 149 of the Pennsylvania Milk Marketing Board regulations. The proposed changes include revisions to Section 149.43 (Dealer Cost Centers and Operating Accounts) and a new section of the regulations (Section 149.46 Cooperative Cost Centers). In addition to the proposed regulation changes, a draft cooperative reporting form, similar to the existing PMMB-60 form, was designed based on the cooperative cost centers outlined in Section 149.46.

After the framework, regulations and reporting formation (PMMB 60C) were presented in draft form, the next step in the process was to schedule site visits at each cooperative location for the organizations included in the coop cross-section. The purpose of the site visit was for PMMB staff to gain an understanding of the overall cooperative operations, accounting and financial reporting and to discuss with coop personnel how to capture the financial data needed to complete the PMMB Form 60C. 2015 Cooperative data was used for this initial walk-through of the cooperative milk procurement cost reporting process utilizing the newly designed PMMB Form 60C. An RKL representative was on-sight to participate in the process for each site visit. The cooperative information gathering, completion of the draft PMMB Form 60C, and the PMMB staff’s on-site review of the 2015 procurement cost data, served as a “dry run” of the accounting and reporting framework.

On March 23, 2016 I provided testimony in support of the draft amendments to Section 149 of the Pennsylvania Milk Marketing Board regulations. In that testimony I provided a status report on the progress made as of that date in the PMMB staff’s efforts in the development of a framework, set of regulations and reporting mechanism for cooperative milk procurement cost reporting. I stated with confidence that the PMMB staff were well on their way to developing the framework, regulations, and reporting mechanism necessary for cooperatives to accurately and consistently report their relevant costs.
The information and understanding of each cooperative’s operations and financial reporting obtained during the PMMB staff’s initial site visits would enable them to develop an effective “audit approach” to verify the accuracy and consistency of the information submitted.

I also stated with confidence that the PADC member organizations were well on their way to understanding the new PMMB reporting requirements, addressing their internal needs to redesign accounting systems and/or develop supplemental financial reporting and cost accounting techniques specific to the PMMB reporting requirements. I also indicated that RKL was well positioned to support both the PADC member organizations and the PMMB staff in their respective tasks and responsibilities in connection with this initiative.

A concern was raised during the Over-Price Premium Hearing regarding whether it was possible to design and implement a financial reporting system for cooperatives that would provide for the accurate and uniform collection of cooperative cost data that the PMMB could rely on. I testified on March 23, 2016 that not only was it possible, but that is was in the process of being implemented.

The final PMMB regulations under PA Code Section 149.43 and Section 149.46, which were enacted in March of 2018, are attached as PADC Exh 15, and I have included a blank copy of PMMB Form 60 as PADC Exh 7.A and PMMB Form 60C as PADC Exh 6.A. I would like the Board to note the comparability between these forms.

It has been over 2 ½ years since I provided a status report in the March 23, 2016 hearing. A tremendous amount of hard work and dedication has been spent on this important initiative, by the coops, PMMB staff, and RKL. The cooperatives have invested a significant amount of resources to provide the milk procurement cost data in the format requested by the PMMB. The PMMB staff has now had the opportunity to review the cooperatives financial records, completed PMMB-60C reports, and undergo their normal audit process, similar to what they do in verifying dealer PMMB-60 data.
Summary

RKL has been involved in this milk procurement cost analysis for five years. Initially we summarized our analysis without a form or regulations from the PMMB, but now the PMMB has put together the structure and regulations of the reporting, and the PMMB staff have performed their audit of 2016 data. As you will hear, the results of the 2016 cost study are very similar to RKL's initial 2012 cost study, which is not a coincidence in my opinion. I expect there will be further refinements on the part of both the cooperatives and the PMMB staff in the cost reporting process, and such refinement will come with time, as it has over the decades of cost reporting for the dealers. I would hope the Board would not expect a process at that level of establishment for the coops given that this process has only recently been implemented. Although this reporting process for the coops is still early-stage, I am confident the results of our analysis for 2016 are reliable. One indication of this is the relative consistency of outcomes between the 2012 cost analysis (prepared by RKL), the 2015 (dry run of Form 60-C information gathering) efforts, and the 2016 (PMMB staff audited) analysis. RKL stands by our work and results of our analysis.

I would like to thank the Board for allowing me the opportunity to present an overview of this process. In my opinion, the results of the 2016 PADC cross-section milk procurement cost analysis is based on information and accounting methodology in accordance with generally accepted accounting principles and is accurate within a reasonable degree of professional certainty. We request that the Board use this information to determine minimum wholesale and retail milk prices and not let the cooperative producers wait any longer.
Testimony of Matthew Hartland

My name is Matthew Hartland. My business address is 1800 Fruitville Pike, Lancaster, Pennsylvania, 17604. I am a manager in the Business Consulting Services Group of RKL LLP. I am a Certified Public Accountant and Accredited in Business Valuation and I have over twelve years of experience in public accounting. My experience is primarily concentrated in business valuation, financial analysis, financial modeling, general management consulting, and litigation support. My educational and professional background are summarized in PADC Exh 12.

Along with John Stoner, I am also testifying today on behalf of the PADC. Although I personally have not given prior testimony in these proceedings I have been involved in every prior engagement with GNEMMA and the PADC, and have had significant involvement in assisting the PMMB staff in developing the framework for reporting cooperative costs.

My testimony today is primarily focused on the milk procurement costs of PADC member coops for 2016. I have assisted the PADC member coops in measuring and reporting their respective milk procurement costs and I have assisted the PMMB staff during their audit process of PADC member cooperative milk procurement costs for 2016. I have summarized a cross section of these cooperative milk procurement costs and am here today to present the results of the cross section.

2016 Milk Procurement Costs

First I would like to give a little overview of the process involved in arriving at the cross section summary. Although reporting requirements for Cooperatives were not formally effective until March 2018, a final form of what is now Pa. Code Section 149.46 was available by February of 2017.
It was at that time that the PMMB staff sent a copy of the PMMB Form 60C with instructions (PADC Exh 6.B) to the following PADC Cooperatives requesting that they complete the form with their milk procurement costs for calendar year 2016:

- Northeast Region of Dairy Farmers of America, Inc. and Dairy Marketing Services, LLC,
- Mideast Region of Dairy Farmers of America, Inc. and Dairy Marketing Services, LLC,
- Maryland & Virginia Milk Producers Cooperative Association, Inc., and
- Lanco Dairy Farms Co-op, Inc.

Each of these cooperatives then began the process of independently compiling their milk procurement costs for the calendar year 2016. Each of these cooperatives are required to have annual financial statements prepared. The milk procurement costs compiled by each cooperative was derived from the financial information included in their annual financial statements, which they are required to have prepared annually in accordance with generally accepted accounting principles. This information was then used to complete the PMMB Form 60C in accordance with PMMB staff’s request and the regulations set forth in Section 149.46. RKL provided support to the Cooperatives in this process by providing feedback regarding any questions raised and performing a high-level review of reported costs for completeness prior to their submission to the PMMB staff for their auditing process.

Upon receiving each cooperative’s completed Form 60C for 2016, the PMMB staff sent a request list to the cooperative and scheduled a time to go the cooperative to perform their auditing procedures. I was also present at each location to review supporting documentation of reported costs and to facilitate the Board staff’s auditing process. This involved assisting the cooperatives in understanding what the PMMB staff requested in their audit process as well as assisting the PMMB staff in understanding what the Cooperatives were providing in support of their 60C filings.
RKL’s recommendation throughout the PMMB staff’s audit process was that they request and review the same sort of documentation for audits of milk dealers and perform the same types of audit procedures that are typically done for milk dealers. Commonly requested information included support for payroll costs, overhead allocations, transactions with related parties, pounds reported by cost center, and cost center allocation methodology. The PMMB staff also requested support for specific costs and cost center information for each respective cooperative.

Once the PMMB staff had completed their auditing process of each cooperative’s milk procurement costs, RKL reviewed the PMMB staff’s summary and supporting documentation and provided feedback as necessary.

2016 Milk Procurement Cost Cross Section

RKL and the PMMB staff independently summarized the results of each cooperative’s reported milk procurement costs into a cross section. RKL’s summary is attached as PADC Exh 16. The first page of this exhibit shows the nine cost centers promulgated in the milk marketing regulations section 149.46 and a weighted average, cost per-hundredweight for each cost center. Each cooperative’s reported milk procurement costs for 2016 were calculated on a per-hundredweight basis. We would like to note that we did receive confirmation from Cliff Ackman, Statistical Analyst for the PMMB, that the cross section used in our analysis, comprised of the cooperatives previously mentioned, is a valid cross section in his opinion for PMMB use. The second and third pages of PADC Exh 16 reflect additional detailed information of a confidential nature which is aggregated into the cross-section summary on page 1. Page two of PADC Exh 16 is described below. Page three of PADC Exh 16 is a summary of each cooperative’s PMMB 60C in the cross section on a combined basis. The combined line item costs on this page are before the allocation of the general and administrative cost center, which is allocated on line 48 at the level of each individual cooperative and summarized on line 48 of this page. I will address additional questions about this information pursuant to the protective order for this hearing.
The General and Administrative cost center, which is cost center number nine, shows no cost per-hundredweight on page one of PADC Exh 16 since all costs in that cost center are allocated to the other eight cost centers. The allocation methodology for this process is the same for each cooperative and involves measuring the proportion of costs for each cost centers with the total costs of all the cost centers, excluding the general and administrative cost center that is being allocated. As an example, if the field services cost center for one cooperative accounted for 25% of the total costs for that cooperative, excluding the general and administrative costs, then 25% of the general and administrative costs would be allocated to field services.

We have presented two weighting methodologies for purposes of determining the weighted average cost for each cost center. The first weighting methodology is based on each cooperative’s deliveries to PA Class 1 plants and the second is based on each cooperatives PMMB Class 1 pounds. If one cooperative delivered 25% of the total deliveries to Pennsylvania class 1 plants in the cross section, that cooperative’s cost per-hundredweight would be weighted 25% in the cross section. Likewise, if one cooperative has 25% of the total PMMB Class 1 pounds in the cross section, that cooperative’s cost per-hundredweight would be weighted 25% in the cross section. A summary of the actual weighting applied to each cooperative in the cross section is presented on page two of PADC Exh 16. We have given consideration to other weighting methodologies but do not see any significant change in the resulting total weighted average cost per-hundredweight.

The result of the cross section is a weighted average cost per-hundredweight of $0.2894 based on the weighting of deliveries to PA Class 1 plants and $0.2845 based on the weighting of PMMB Class 1 pounds. We note that these amounts are very close to the originally submitted cost per-hundredweight of $0.2783. It is our understanding that the PMMB staff have arrived at a similar, if not identical figure.
Summary

RKL has now gone through the process of compiling milk procurement costs for several years of data. We have also invested time in assisting the PMMB staff in developing a reporting framework and mechanism that is in line with the current dealer reporting process. More recently, RKL has assisted PADC members in the reporting of 2016 milk procurement costs and we have assisted the PMMB staff during their audit of those costs. Based on my experience and judgement, I believe the resulting weighted average cost per-hundredweight for the cooperative cross section that I am reporting to you today is accurate and supported by reliable information that was prepared in accordance with generally accepted accounting principles. Based on this cross section, the weighted average cost per-hundredweight incurred by Pennsylvania dairy cooperatives in procuring milk to Pennsylvania Class 1 plants is $0.2894 or $0.2845, depending on weighting methodology.

I would like to thank the Pennsylvania Milk Marketing Board for the opportunity to present our testimony and exhibits in support of our findings. Now that the Board staff has had the opportunity to review and audit the cooperative PMMB 60C cost information using a process similar to that used to verify dealer costs as reported on the PMMB 60 Forms, we respectfully request that the Board recognize these costs and incorporate them in minimum wholesale and retail milk prices.