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February 3, 2017

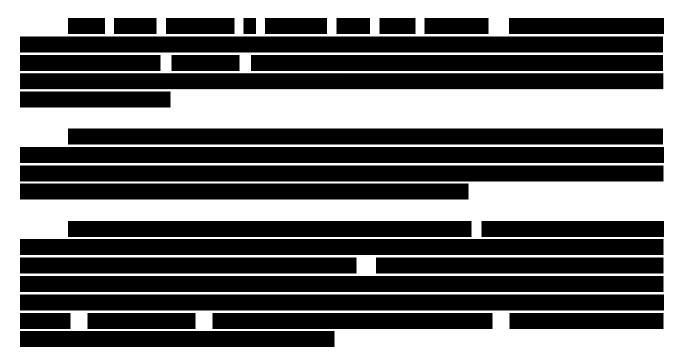
Luke Brubaker, Chairman c/o Doug Eberly, Chief Counsel Pennsylvania Milk Marketing Board 2301 North Cameron Street Harrisburg PA 17110

Re: Cost Replacement Hearing – Area 4

Dear Chairman Brubaker and Members of the Board:

The Board sets milk prices which allow dealers to recover their costs with a profit. If the Board allows dealers to recover charges imposed within the company, when the money is not leaving the company, the result will be wholesale and retail milk prices bloated by dealers' internal transactions.

The issue is whether an intercompany charge should be an allowable expense for price setting calculations. Tr. 1:72.





Calling it by the sophisticated name of "transfer pricing" does not mean they should be reimbursed for these charges. "Transfer pricing" simply means setting prices for the transfer of goods and services between related entities. When a company engages in transactions like these, the transfer pricing rules must be followed to avoid penalties, of course, but that does not somehow change the fact that the money stays within the chooses to require some of its plants to pay royalties, they are welcome to do so. But they are not welcome to charge the consumers of Pennsylvania for it.

Intercompany royalty charges are not mentioned in the Board laws, regulations, or orders. Therefore general principles must be interpreted and applied.

Milk Marketing Law. The courts have said, "The intent of the Milk Marketing Law is clear. The Board must consider the interest of '(1) the producers of milk, (2) the transporters, processors and sellers of dairy products, and (3) the consuming public.' City of Pittsburgh v. Milk Marketing Board, 1 Pa. Commw. 300, 307-08, 275 A.2d 115, 120 (1971). 'The problem before the [Board] in price fixing, is to provide a fair return to producer and dealer, and to maintain a just consumers' price.' Colteryahn Sanitary Dairy v. Milk Control Commission of Pennsylvania, 332 Pa. 15, 27, 1 A.2d 775, 781 (1938)." Babac v. Pennsylvania Milk Marketing Board, 618 A. 2d 1050, 1052 (Pa. Commw. 1992) (emphasis added).

Section 801 of the Law states that Board prices shall provide "a reasonable return on aggregate milk sales by milk dealers or handlers and stores selling milk. A reasonable return shall mean not less than a two and one-half percent (2½%) nor more than a three and one-half percent (3½%) rate of return based on net sales of price-controlled products determined in accordance with generally accepted accounting principles."

GAAP is a collection of rules and standards for financial *reporting*. Tr. 1:75. GAAP does not dictate which of the reported costs are to be included in Board prices. Section 801 means that

dealers should report in accordance with GAAP. But it does *not* mean that all the costs that are allowable or reportable or recognized under GAAP must be included in the Board's prices.

<u>Board discretion</u>. The Board has broad discretion about setting prices. For example, Section 801 says prices are to include a reasonable return on milk dealer aggregate sales, which are net sales of price-controlled products determined in accordance with GAAP plus a return factor. "Net sales" is defined by GAAP as sales less discounts and deductions.

Obviously, for GAAP purposes, sales means actual sales.

However, the Board decided to set prices without taking into consideration actual sales. In 1991, the Board was challenged in court about that method of calculating prices. The Board's method was held to be consistent with the statute: "projecting costs and adding a reasonable return in order to determine what a reasonable return from aggregate milk sales *would be...* [T]his court's conclusion is that the board did not abuse its discretion by not requiring evidence of actual income from aggregate sales." *Babac v. Pennsylvania Milk Marketing Board*, 593 A. 2d 1337, 1339 (Pa. Commw. 1991) (emphasis added).

The Board only used costs and the rate-of-return factor – *not* actual sales – to set prices, even though the statutory price formula is based on "aggregate milk sales" and "net sales of price-controlled products determined in accordance with generally accepted accounting principles." This case shows that the Board's discretion is very broad. But that discretion need not be exercised in this case because GAAP *supports* elimination of intercompany charges.

<u>GAAP</u>. As testified, according to GAAP, intercompany transactions are *disclosed* on an individual plant's financial statement, but they are *eliminated* on the financial statement for the entire company.

Each plant submits a PMMB-60 and keeps separate records. 7 Pa. Code § 149.6. It is appropriate under GAAP to disclose intercompany transactions on those reports. Without the GAAP requirement to disclose intercompany transactions on the plant financial statement, someone looking at the statement might think the sales are all third party sales and get a skewed impression of the plant's financial position. But on the financial statement for the entire company, the intercompany transactions are eliminated.

"Intercompany transactions are eliminated in preparing a consolidated financial statement because the statement represents the financial position and operating results of a single business enterprise. We follow that GAAP principle by adjusting intercompany charges to actual cost. It is appropriate for the plant to report them on the plant's statement, but that does not require us to include them in the price of milk, when the big picture shows us that they are simply intercompany transactions." Board Staff Surr. pp. 1-2.



<u>Board Regulations</u>. Board regulations also support elimination of intercompany charges. Intercompany charges for hauling and rent are specifically disregarded in the regulations and are not acceptable costs. 7 Pa. Code §§ 149.25 and 149.43(b)(30). "Board Staff interprets these regulations to be a statement of the general principle that all intercompany charges (royalty included) need to be adjusted to actual expenses." Board Staff Surr. p.1. Intercompany container charges are also adjusted to actual expenses in accordance with that principle. Tr. 1:76, 134.

Gary Gojsovich described the process. "For other related company transactions, we look at what's been charged and that's usually reported in the – they may send it to us, but then we disallow it. But then we go back and look at what the actual expense is ... And we'll allow that." Tr. 1:114.

The hauling and rent regulations were adopted in 1978. 8 Pa.B. 2672. The GAAP reporting requirement was added to the Milk Marketing Law in 1984. Act 243 of 1984. The GAAP reporting requirement was added to the statute after the regulations were adopted. A statute overrides contradictory regulations. But there is no indication that anyone has ever suggested these regulations contradict the law. Related party transactions involving rent, delivery charges, and containers have been adjusted to actual costs over the years and that has been accepted by the dealers. Tr. 1:76.

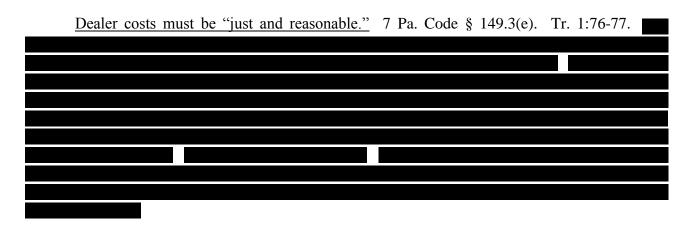
Other Board regulations also support Board Staff's position. Board regulations define "costs" as "the amount of money actually incurred for property or services." 7 Pa. Code § 149.2. Dean contends that these charges are an actual expense incurred by the processing plants, but it is necessary to look beyond the plant gates to the true context of these transactions. The royalty charge is a related party transaction. The royalty charge is not considered an actual "cost" for price-setting purposes. Tr. 1:75-76, 125. Board Staff's longstanding practice is to disallow what related

entities within a company charge each other, and allow the actual expenses. Tr. 1:76, 90, 111, 115.

The royalty charge is calculated without taking into consideration any actual expenses. Tr. 1:73.

Board prices are based on actual expenses, not

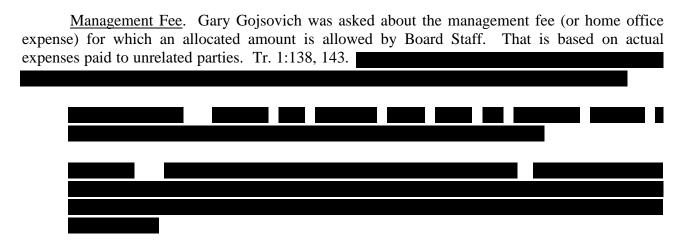
market value.



These charges are not just and reasonable because milk prices should not be inflated by intercompany charges that a company pays to itself. They can be disclosed on the PMMB-60 but then are disallowed, and actual third-party costs are used for pricing purposes. Board Staff would do the same with royalty charges if actual costs were identified. Tr. 1:76, 90. Expenses paid to unrelated parties are allowed. Tr. 1:105, 140-141.

Intercompany charges might comply with what is considered "reasonable" under transfer pricing requirements, but the Milk Marketing Law and regulations require more – "a *just* consumers' price."

<u>Board regulation 149.21</u> provides that intercompany *sales* of packaged products are reported by the dealers at fair market value. This regulation does not contradict the principle of disregarding intercompany transactions for price-setting purposes, because it has nothing to do with costs and has no impact on the price buildup. Tr. 1:142.



It is true that this royalty charge has been included in milk prices for quite a few years. But the Board has never been asked to make a decision about this issue. Tr. 1:73. Consistency would mean that the longstanding practice of disregarding intercompany transactions – dating back

- SUBJECT TO PROTECTIVE ORDER DATED OCTOBER 18, 2016

at least to the 1978 regulations – should be followed. Accepting the royalties was an anomaly which, now that it has been presented to the Board, should be abandoned.¹

Allowing the dealers to recover these self-imposed internal charges would irretrievably throw open the barn door to milk price increases. Allowing intercompany charges presents a greater threat to the dairy industry in Pennsylvania than disallowing them. This current cost could turn out to be the tip of an iceberg. This royalty charge is already expensive for Pennsylvania consumers – 5.76 cents per gallon

The royalty rate was described as conservative and could have been even higher. The nickel per gallon could be closer to a dime per gallon in the future. Board Staff Surr. p.2. And that is just for this one dealer.

There is nothing to prevent other dealers from setting up similar arrangements. Board Staff Surr. p.2.

A decision allowing the royalty charges could become a precedent with far-reaching impact. How could other types of intercompany charges be disallowed, if royalties are allowed?

Board Staff respectfully asks the Board to disallow the royalty charge and reaffirm the principle that intercompany transactions are disallowed for price-setting purposes.

Respectfully submitted,

Andy Saylor

Staff Attorney