

SURREBUTTAL TESTIMONY OF

CARL D. HERBEIN, CPA

Appearing on Behalf of the Area 1 Milk Dealer Association

Surrebuttal Testimony before Pennsylvania Milk Marketing Board

2013 Cost Replacement Hearing

January 8, 2014

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Area 1 – 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 1 Milk Dealers Association. I attach my Curriculum Vitae, as Surrebuttal Exhibit D1, which outlines my education, and experience in the dairy industry. This testimony and associated exhibits supersede rebuttal testimony and exhibits from December 20, 2013 to reflect updates as a result of further investigation and discussion with Board staff.

Background and Purpose of Hearing

Pursuant to Bulletin Number 1497, the Pennsylvania Milk Marketing Board is conducting a public hearing to receive evidence to establish minimum wholesale and resale prices in Milk Marketing Board Area 1. This hearing will include the annual update of annualized processing, packaging, and delivery costs; updated costs of containers, ingredients, and Class II products; updated labor, utility, and insurance costs based upon a comparison between cost per point for the second quarter of calendar years 2012 and 2013; skim and butterfat content of products regulated by the Board; adjustments for shrinkage, sale of bulk products, and cream processing costs; monthly adjustments to in store handling costs; and a reasonable rate of return to milk dealers and stores. In accordance with OGO A-937, evidence and testimony will be considered regarding the heating fuel adjuster in Area 1. In accordance with OGO A-939, evidence and testimony will be considered regarding the diesel fuel adjuster in Area 1.

Study Conducted

On behalf of the Area 1 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 March 2013 cost information as the new starting point for container updating. These March 2013 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 March 2013 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 1, 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.

Cross-Section

The Area 1 cross-section of dealers utilized includes Tuscan/Lehigh Dairies, L.P. – Lansdale, Milk Industry Management Corporation t/a Balford Farms, H.P. Hood LLC – Hatfield, and Wawa Dairy Farms. These companies process, package and deliver the majority of fluid milk products in Area 1 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 1 and this cross-section remains unchanged from the immediate prior hearing.

Surrebuttal Exhibits

Surrebuttal Exhibit D2 is prepared to present the ingredient costs as of March 2013, which should be inserted into the product formulas for pricing purposes and should replace the ingredient costs which are currently being used. These costs should then continue to be updated on a quarterly basis for flavored milk, flavored reduced fat milk and flavored non-fat milk. The Board should continue the updates on January 1st, April 1st, July 1st, and October 1st as is currently being done.

Surrebuttal Exhibit D2-A reflects the ingredient costs presented on Surrebuttal Exhibit D2 and demonstrates the increase or decrease when the cost replacement process occurs.

Surrebuttal Exhibit D2-B reflects a comparison of the current order butterfat tests by product category and compares those tests with the 2012 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 2012 tests reflected on this exhibit. It should also be noted that the butterfat content for the newly established product – nonfat flavored milk is now established based upon actual dealer manufacturing results.

Surrebuttal Exhibit D3 reflects the processing, packaging, and delivery cost per point for calendar year 2012. Please note that the points presented are for sales in the PMMB Area 1 made by the cross-section dealers. These costs should replace the existing costs from 2011, 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.

Surrebuttal Exhibit D3-A is prepared to show the effect of the cost replacement process by comparing the 2011 costs in the current order with the 2012 costs. Additionally, this exhibit reflects the 2013 cost increase adjustment and removes the 2012 cost increase adjustment to eliminate any possibility of duplication. It should also be noted that the bottling department points for 2012 are 165,081,902 for the cross-section dealers and this compares with 2011's bottling department points of 171,234,423. This comparison reflects a 3.6% decrease in bottling department points when comparing 2012 with 2011.

Surrebuttal Exhibit D4 is prepared to calculate the cost increases and decreases incurred in the second quarter of 2013 compared to the second quarter of 2012 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. Due to the timing of this Cost Replacement Hearing the second quarter was the most recent quarter available for auditing. Rebuttal Exhibit 4 which corresponded with Board staff's previous submission, showed an increase in 2013 points of 3.5% when compared to 2012. This increase was significantly different than any other area and significantly different than the annual comparison that I previously mentioned. This apparent anomaly required further investigation, which has now been completed in conjunction with Board staff. Surrebuttal Exhibit D4 now reflects the correct bottling department points for the Area 1 cross-section dealers for the second quarter in 2012 and 2013. By comparing the points we now show a reduction in points of 5.3%. The error that was discovered has been recognized by Board Staff as well and occurred at one of the cross-section dealers. Further documentation requested by Board staff supports this correction. This changed information in no way reflects a change in methodology and is the result of a proper application of required PMMB procedures.

Surrebuttal Exhibit D5 has been updated to reflect the October 2013 diesel fuel costs, which were used in issuing the minimum prices for December 2013. Additionally, this exhibit reflects the calculation of the average diesel fuel cost for calendar year 2012, which forms the basis for the annual adjustment and update. I recommend that this adjustment be continued on a monthly basis.

Surrebuttal Exhibit D6 has been updated to reflect August 2013 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 2012, which forms the basis for the annual adjustment and update. I recommend that this adjustment be continued on a monthly basis.

Surrebuttal Exhibit D7 updates the cost of shrinkage and cost and revenues from bulk cream and bulk milk. OGO A-951 (CRO 3) established a net cost of (.0005) per pound and the new net cost, based upon 2012, is .0002 per pound. Thus, there has been a net change of .0007 per pound.

Surrebuttal Exhibits D8 and D8-A has been updated to container costs utilized in the December 2013 resale price development. The shrinkage factor reflected on this exhibit is a statewide average and will be utilized

for all cost replacement hearings conducted this year. 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 shrinkage statistics for the 2013 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 1. 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 2013 as adjusted as a new starting point.

The Area 1 Milk Dealer Association requests and recommends that the blending concept be continued for all containers except half pints. The blending of container types, 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 0.0401 and it should continue to be adjusted monthly in accordance with OGO A-957.

Surrebuttal Exhibits D9-A and D9-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 December 2013. 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 1 dealers at 3.4%. 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 3.4% return is recommended.

Summary and Recommendation

The Area 1 Milk Dealers recommend that the Milk Marketing Board make the cost replacement adjustments, which are reflected in my testimony and exhibits. The Area 1 Milk Dealers recommend that the Milk Marketing Board continue the dealer profit margin at 3.4%. Thank you for your consideration of my analysis and opinions.