BEFORE THE PENNSYLVANIA MILK MARKETING BOARD

OVER-PRICE PREMIUM HEARING, 2nd PART

June 4, 2014

Testimony by John S. Stoner, CPA,

Presented on behalf of the Greater Northeast Milk Marketing Agency:
Dairy Farmers of America, Inc., Dairy Marketing Services, LLC, Land O'Lakes, Inc.,
Maryland and Virginia Milk Producers Cooperative Association, Inc. and
Upstate-Niagara Cooperative, Inc.

EXPERT QUALIFICATIONS

Good morning, I am John S. Stoner, CPA, CVA, Partner with Reinsel Kuntz Lesher, LLP ("RKL"), a regional accounting and consulting firm with four offices located in Central Pennsylvania and employing over 300 people. I have over 31 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 am currently Partner-in-charge of the Business Consulting Services Group in RKL's Lancaster office. I also have 31 years of experience in conducting and supervising financial audits and cost accounting assignments. My Curriculum Vitae, which outlines my education and work experience, is included as Exhibit 1.

DESCRIPTION OF ASSIGNMENT

I have been engaged by The Greater Northeast Milk Marketing Agency ("GNEMMA") to conduct a Milk Procurement Cost Study. The focus of the study is to measure the milk procurement costs incurred by cooperatives in supplying milk to PA Class I Dealers. The purpose of the cost study is to provide evidence in support of the GNEMMA request that the Pennsylvania Milk Marketing Board require payment to cooperatives for their milk procurement, assembly, and balancing costs for PA Class I milk. I am here today to present the results of this Cost Study on behalf of GNEMMA.

PREPARATION FOR ASSIGNMENT

I had no previous experience working with clients in the dairy industry or a specific knowledge of milk accounting with one exception. I have performed a forensic accounting analysis in connection with feuding neighbor farmers over an ownership dispute of dairy cow herds. That analysis focused on the projected lost revenues associated with an alleged theft of cows over a ten-year period. The revenue analysis included dairy industry specific assumptions and averages including a) cow gestation period; b) number of offspring; c) cow milk production; d) useful production life; e) feed and veterinary costs; f) cow disposal value; and g) fluctuations in milk pricing over the 10-year period.

As a Certified Valuation Analyst, it is common to receive requests to perform business valuation services for companies that operate in very unique industries, niche markets, or market segments in which the Valuator has no prior knowledge or experience. This lack of industry experience does not preclude the Valuator from taking on the assignment but does require additional upfront research and self-study to obtain a general understanding of the industry in which the company operates. The prerequisites for accepting these types of assignments are technical skills and work experience to understand accounting, cost accounting principles and business processes, and the

ability to perform financial analysis to interpret financial information. It is with this understanding that I have accepted the Milk Procurement Cost Study assignment.

In preparation for the GNEMMA Milk Procurement Cost Study, my research and self-study included the following:

- Obtained agricultural and dairy industry information from a variety of websites and reference materials;
- Discussed dairy farm and cooperative functions, business activities and revenues and expenses incurred with representatives of the GNEMMA member organizations participating in the cost study;
- Reviewed agricultural industry accounting guidance provided by the American Institute of Certified Public Accountants;
- Met with PMMB staff to obtain an overview of PA Milk Marketing Law, the PMMB's role in establishing the regulated pricing for PA milk products, and discuss the various PMMB Orders establishing the methodology for calculating both the Over-price and Over-order premiums;
- Obtained examples of the Milk Dealer's Financial Statements (PMMB-60) and Milk Dealer's Monthly Reports (PMMB-62) during the meeting with PMMB staff and received a walk-through of these documents and supporting schedules by Mr. David DeSantis;
- Reviewed PMMB's website to further review resources provided.

After performing the preparation work mentioned above over a period of six weeks, I felt prepared to begin the data-gathering phase of the Milk Procurement Cost Study.

APPROACH USED TO GATHERING THE DATA

Identification of Contributing Participants to the Cost Study

The initial step was to identify which GNEMMA member operational units would be providing financial and milk production data for the Cost Study. We received separate data from the following entities:

- Land O' Lakes, Inc.
- Dairy Farmers of America, Inc. – Mid East Council
- Dairy Marketing Services, LLC – Mid East
- Dairy Farmers of America, Inc. – North East Council
- Dairylea Cooperative Inc.
- Maryland and Virginia Milk Producers Cooperative Association, Inc.

RKL signed a confidentiality agreement with all parties restricting the use of the proprietary data obtained. Our use of the separate entity data is limited to the inclusion of information for the sole purpose of computing and presenting composite milk procurement costs on the basis of hundredweight (cwt).

Method of Information Gathering

We submitted an Information Request to each participant that outlined the information we initially wanted to receive and inspect in connection with the Milk Procurement Cost Study. This request was designed to obtain an understanding of the following for each participating entity:

- Overall financial statement results for fiscal years 2011 and 2012 for the regional cooperative operations that include Pennsylvania;
- General ledger "chart of account" design information that provides an understanding of how the individual general ledger accounts are numbered and the groupings used to prepare the overall financial statements;
- The general ledger trial balance totals as of December 31, 2011 and December 31, 2012;
- Guidance on which accounts are associated with cooperative operations in Pennsylvania, if not apparent from the information requested above;
- General ledger account transactional detail for 2012 year only for expense accounts directly, partially, or indirectly associated with Pennsylvania milk procurement activities;
- Additional information that may be helpful in identifying, analyzing, and measuring costs associated with PA Class I milk procurement in the following categories:

    - Direct costs:
        a) Field staff / membership
        b) Lab work
        c) Dispatch / scheduling / truck route supervision
        d) Processing payroll payments to producers
        e) Balancing (defined as additional hauling expense to meet daily demand fluctuations)

    - Indirect / overhead costs:
        a) General and administrative allocation to milk procurement
        b) Corporate overhead allocation to milk procurement

- Copy of Milk Dealer's Monthly Report (PMMB-62) for all months for 2011 and 2012;
- Copy of Milk Dealer's Financial Statement (PMMB-60) for 2011 and 2012.

The requested information was uploaded electronically to RKL's secure file exchange website.

Review, Evaluation, and Analysis of the Information Received

Each set of information received from the various participating entities needed to be reviewed carefully since the entities have differences in organizational structure, operational design, size and extent of operations, financial reporting format, and concentration of PA vs. non-PA business activities. However, it was also clear from the data reviewed that each cooperative entity has been incurring similar types of milk procurement costs in the normal course of business. It is also important to note that the financial information provided to RKL came from financial statements and underlying accounting systems that report financial results in accordance with generally accepted accounting principles ("GAAP"). Each entity undergoes an annual financial statement audit by an independent CPA firm that issues an opinion that the overall entity financial statements were prepared in accordance with GAAP. RKL verified that the financial data used in preparing this Cost Study was consistent with and included in the overall financial data subject to the GAAP based financial statement audit.

After reviewing the data, separate meetings were held with representatives of each participating cooperative. The purpose of these meetings was to review and discuss their respective business operations and walk-through the financial data collected and specifically review how the milk procurement costs are presented in the financial statements and accounting system. Personnel responsible for milk accounting for each organization submitting data were conference-called into these work sessions. Once the data gathering, review, evaluation, and analysis of the information was completed, we then began to construct our Milk Procurement Cost "build-up" for each separate reporting entity.

MILK PROCUREMENT COST BUILD-UP

Approach, Assumptions Made, and Method of Cost Distribution for Individual Entity Cost Build-up

The purpose of our Cost Study was to measure the estimated milk procurement costs for PA Class I milk. In other words, the task consisted of performing a cost accounting analysis of milk procurement costs. The financial data of the GNEMMA members contained in our analysis cover regional operations that include their Pennsylvania activities but also non-PA operations. Pennsylvania-only financial results and cost centers are not maintained for these regional operating enterprises. As a result, we needed to consider whether the costs incurred by the cooperative entities studied would likely have materially disproportionate milk procurement related costs in Pennsylvania as compared to the other surrounding states included in their regional financial statements. We did not perform extensive research or analysis on this question but based on the nature of the costs involved in milk procurement, we concluded that a

uniform distribution of the overall costs incurred by the total number of pounds of milk sold in the region is a reasonable approach. We do believe that the fieldmen cost, inspection, and laboratory costs are higher related to Class I milk, as compared to the other Classes of milk products (for example preliminary incubation (PI) counts), but we did not attempt to allocate those costs disproportionately in connection with our Class I milk procurement cost study.

Approach, Assumptions Made, and Method of Cost Distribution for Cross Section (Composite) Cost Build-up

After completing the individual cost build-up for each separate entity, it was necessary 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.

Balancing

In discussing milk-procurement activities with GNEMMA representatives and also through our independent research on the subject, we were introduced to the concept of "balancing". The business challenge in the dairy industry that requires "balancing" is a result of the fundamental relationship between supply and demand. Cows generally produce milk at a consistent rate regardless of the day of the week. Unfortunately, milk processing and consumption patterns do not mirror the supply of milk production. Milk production does have a seasonal fluctuation, higher in the spring and lower in the fall, which is another variable in the "managing supply vs. demand" equation. Making this business challenge more difficult to address is the fact that milk cannot be stockpiled and stored, as is the case with raw materials in many other industries, in response to the imbalance between supply and demand. The business activity to address this problem is commonly referred to as "balancing".

Dairy cooperatives play an essential role in managing the "balancing function". Dairy cooperatives have developed the infrastructure to provide the milk procurement and distribution systems required to effectively and efficiently support the dairy industry. Assembling milk from the farm, routing raw milk where it is needed, and managing milk supplies above fluid requirements are all parts of the "balancing system".

In connection with this Cost Study, many of the operational costs incurred by the GNEMMA representatives associated with the "balancing system" are included in the general and administrative cost component as presented on Exhibit 8. However, the

additional transportation costs incurred to transport the redirected milk on a routine basis to the balancing plants have not been captured since hauling costs have been excluded from our milk procurement cost build-up. In our Cost Study, we have focused on the daily PA Class I plant balancing activity and have not attempted to quantify the additional transportation cost associated with the seasonal fluctuation of milk production.

We requested information from each GNEMMA entity studied to review milk volumes ordered and delivered to PA Class I processing plants vs. the volumes required to be redirected and transported to the balancing plants on a regular daily basis. We then calculated the additional hauling costs incurred to transport the redirected milk loads to the balancing plants, based on the average actual transportation cost incurred by each entity in supplying individual Class I plants. The approach we used to measure the additional "balancing cost" defined for the purpose of our Cost Study as "extra hauling costs to transport redirected milk to balancing plants" is present in Exhibits 7 – 7f. We believe the additional hauling cost related to the balancing function is only a portion of the overall costs incurred by the co-operative organizations in performing this important function. However, we limited our analysis to only this element of balancing cost.

In connection with the construction of the GNEMMA Cross Section (Composite) Cost Build-up, we converted the cost associated with the balancing function, limited to the extra hauling expense, to a cost per hundredweight using a weighting methodology which allocated the extra hauling expense to the total pounds actually delivered to the Class I plants being balanced.

WALKTHROUGH AND EXPLANATION OF EXHIBITS

Now that I have provided a general description of the approach used to gather and analyze the data and construct the composite milk procurement cost build-up, I would like to walk you through the Exhibits prepared in connection with our Cost Study. These Exhibits will provide a further understanding and illustration of the specific costs incurred by the cooperative organizations in connection with their PA Class I milk procurement and the magnitude of average cost measured on a per hundredweight (cwt) basis.

Exhibit 1 is my Curriculum Vitae that provides a summary of my professional certifications, educational background, and work experience. I would like to bring to your attention a unique project that I conducted on behalf of the Commonwealth of Pennsylvania. In 2006, I was engaged by the Pennsylvania Attorney General's Office as an accounting expert to perform a cost study. The focus of the cost study was to review, evaluate, and measure the costs incurred by the State in administering its Unclaimed Property Program and estimate the costs associated with the handling of a specific item of property. My expert report and testimony was used in connection with a legal dispute that ended in a favorable decision for the Commonwealth. My report and methodology held up to scrutiny in the District Court, as well as the US Court of Appeals for the Third

Circuit (No. 07-3880). This is just an example of how I have been able to apply my accounting and financial analysis skill sets to analyze costs in a credible manner.

Exhibit 2 is an illustration of the approximate percentage of milk produced by Pennsylvania farms represented in the GNEMMA cross section studied as compared to the total Pennsylvania milk production. The purpose of this exhibit is to demonstrate the significant coverage of milk procurement activity in Pennsylvania handled by the GNEMMA members reviewed. Approximately 66% of the 10.4 billion pounds of milk produced in Pennsylvania during 2012 are represented in this Cost Study.

Exhibit 3 is a representative listing of the cost categories that were evaluated in connection with this Cost Study. We reviewed financial data from each of the identified entities that comprise the GNEMMA cross section. Each organization maintains an accounting system that provides the level of transactional details and specific expense categories that are designed to account for their overall business operations. As is typical in most industry segments, different organizations account for similar costs in different ways. Differences in buckets of costs (some very detailed and others broader) and differences in expense category descriptions and terminology were encountered while conducting this Cost Study.

In addition, the specific cost categories reviewed have varying degrees of correlation to the milk procurement function. Some of the cost categories are directly related (such as field services and laboratory and quality testing) while others are indirectly related (general and administrative functions). We identified certain cost categories within the overall expenses reviewed that were excluded from our measurement of milk procurement costs since they were not associated, either directly or indirectly, with milk procurement related activities. We obtained an understanding, through the review of documents provided and discussions with entity representatives, how each organization distributes their indirect costs including corporate level costs and general and administrative expenses to their operational divisions and departments, including milk procurement.

Exhibit 4 is a glossary of terms that provides definitions and other clarifying information on how specific terms are being used in connection with our Cost Study.

Exhibit 5 is an illustration of the mathematical formula used to translate the individual reporting entity's procurement cost data into the uniform measurement unit of cost per hundredweight (cwt). This computation was done separately for each of the six reporting entities. Since the cost data reviewed cover regional operations, we distributed the costs uniformly based on the total number of pounds sold through the regional operations.

As an example, if one of the reporting entities incurred $3,000,000 of total milk procurement costs and were responsible for providing 1,000,000,000 pounds of milk, their average cost for milk procurement would be $0.003 per pound ($3,000,000 divided by 1,000,000,000 = $0.003. To convert this number to the per hundredweight

measurement, the $0.003 is multiplied by 100 ($0.003 x 100) to arrive at $0.300 cost per cwt.

Exhibit 6 is a hypothetical example illustrating the weighting methodology used to construct the cross section (composite) cost build-up. We started with the individual entity procurement cost build-up amounts per hundredweight as explained with Exhibit 5. I want to be very clear that the information presented here on Exhibit 6 is purely hypothetical and does not portray any of the individual entity data actually studied. Since there are only a few accountants in the room today, I want to make sure the weighting methodology used to compute the cross section (composite) cost build-up is understood. In this example, reporting entity A has $0.27 per cwt procurement cost build-up based on the review of its underlying cost data. For this example, we have assumed that reporting entity A supplied 10% of the PA pounds provided by the Cross Section. Therefore, reporting entity A's $0.27 per cwt cost would contribute $0.027 ($0.27 x 10%) in the construction of the weighted average Cross Section (composite) cost. Reporting entity D supplied 30% of the PA milk from the Cross Section so its $0.30 per cwt individual cost would contribute $0.09 cents ($0.30 x 30%) into the Cross Section (composite) cost. Completing the Cross Section calculation for the other entities (B, C, E, and F) using this methodology results in a total hypothetical Cross Section cost build-up of $0.30 per cwt.

Exhibits 7 – 7f provides information on the methodology we used to measure the additional transportation cost incurred by the GNEMMA Cross Section associated with the Balancing function. As previously stated in my testimony, Balancing is required to address the disparity between the daily milk supply and the fluid requirements of individual Class I plants. The milk supply required to be balanced is redirected and transported to the closest available balancing plant. In some instances, the redirection to the balancing plant results in a transportation cost reduction. We have considered both transportation cost increases and decreases in estimating the net impact on transporting the redirected milk.

Exhibit 7 is an illustration of the mathematical formula used to measure the additional hauling cost associated with the balancing function. The mechanics of the computation we used are based on the following factors:

- What are the normal daily order/delivery requirements for PA Class I plants?
- How many loads are needed to meet the highest daily requirement each week to particular PA Class 1 plants?
- How many loads are redirected to balancing plants each week?
- What is the transportation cost differential between regular destinations and balancing plant destinations?
- What is the weekly additional net transportation cost associated with the overall balancing function?
- What is the annual additional transportation costs associated with balancing?

- How many pounds of milk are supplied to PA Class I plants?

In order to evaluate the balancing activity performed by the GNEMMA co-operatives, we directed the marketing and accounting personnel for each entity to perform the following analysis for our review:

- Identify the PA Class I plants that they routinely supply
- For each plant selected, review the order/delivery volumes for the second week of each month during 2012
- Using the highest daily load count for each week reviewed as the peak fluid requirement for each separate plant determine the number of loads redirected each week. This is defined as the number of daily loads under the peak requirement for all other days during the week. These milk volumes must be balanced and transported elsewhere.
- Determine the hauling cost differential between delivery to the PA Class I plant and the balancing plant
- Quantify the weekly additional hauling cost to perform the balancing function (number of redirected loads times hauling cost differential)
- Convert the weekly additional hauling cost to a monthly amount
- Compare the monthly additional hauling cost to the volume of milk delivered to the Class I plant to determine the average cost per hundredweight.
- Using the above methodology, the annual balancing cost associated with each PA Class I plant reviewed was calculated.
- Exhibits 7b – 7f present the actual ordering pattern for 5 of the specific plants reviewed. The red portion of each graph reflects the percentage of the daily milk supply redirected to the balancing plant.
- Exhibit 7a illustrates the weighting technique used to incorporate the balancing component into our GNEMMA Cross Section (Composite).

Exhibit 8 presents the actual GNEMMA Cross Section Class 1 Milk Procurement Cost per hundredweight as calculated by Reinsel Kuntz Lesher, LLP based on our review of the 2012 data provided by the participants of our Cost Study. This exhibit provides the result of our Cost Study. The cost per hundredweight that we have calculated is $0.2783. As previously described in my testimony, we obtained financial data from 6 GNEMMA operational units that market approximately 66% of the milk produced on PA farms in 2012. For each of the 6 entities, we analyzed the 2012 data, examined the underlying accounting records, interviewed the responsible accounting and milk marketing personnel, traced the financial data to inclusion in GAAP prepared audited financial statements, and sorted and summarized the cost categories that are associated with the milk procurement function. We then obtained milk volume statistics for each entity, both for overall 2012 regional operations as well as milk volumes provided to Pennsylvania Class I plants. Using the milk volume statistics obtained, we

converted each separate entity actual procurement cost to the standard industry measurement of cost per hundredweight. We then constructed the GNEMMA Cross Section average using a weighting methodology based on the Pennsylvania volumes provided by each entity. The detailed accounting information used in our Cost Study has been compiled for each separate entity and has been marked and submitted in camera and is authorized for use by only those parties subject to the Protective Order.

Exhibits 9 00001 - 00094 are submitted *in-camera* to preserve the confidentiality of the separate entity data provided to RKL in connection with our Cost Study. We believe this information is necessary to understand the source of cost data relied upon in conducting our Cost Study as well as the primary computations we made in determining the individual entity cost build-ups that were used to construct the Cross Section procurement cost amount per hundredweight. The use of all of the materials contained in Exhibits 9 00001 - 00094 is restricted to the terms and conditions outlined in the Protective Order.

CONCLUSION

In my professional opinion, on the basis of my study, the GNEMMA cross-section cost composite which I have calculated is the cost per cwt incurred by Pennsylvania dairy farmer cooperatives in supplying milk to PA Class I plants for processing and consumption by PA consumers.