



Commonwealth of Pennsylvania

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Official General
Order No. A-937

Posted: May 3, 2006
Effective: June 1, 2006

AN ORDER REGARDING INGREDIENT COSTS AND ESTABLISHING HEATING FUEL ADD-ONS TO MINIMUM WHOLESALE PRICES AND ESTABLISHING A METHODOLOGY TO ADJUST THE HEATING FUEL ADD-ONS

NOW, this 3rd day of May 2006, the Commonwealth of Pennsylvania, Milk Marketing Board (Board), adopts and issues this official general order pursuant to the authority conferred by the Milk Marketing Law, 31 P.S. §§ 700j-101 – 700j-1204. This order will become effective at 12:01 a.m. on June 1, 2006.

SECTION I

The attached findings of fact and conclusions of law are incorporated herein by this reference as though fully set forth in this order.

SECTION II

(a) Minimum wholesale and retail prices for flavored milk, flavored reduced fat milk, and egg nog shall be adjusted in each Milk Marketing Area to reflect the ingredient costs found in Finding of Fact 5.

(b) In each Milk Marketing Area the wholesale and retail prices of fluid milk products shall be adjusted monthly using the methodology set forth in Findings of Fact 16 and 17, effective June 1, 2006. The adjustment shall continue until the next cost replacement hearings in each area, at which time it will be evaluated and necessary adjustments made.

PENNSYLVANIA MILK MARKETING BOARD

Boyd E. Wolff, Chairman

Luke F. Brubaker, Member

Barbara A. Grumbine, Consumer Member

Date: May 3, 2006

FINDINGS OF FACT AND CONCLUSIONS OF LAW

INGREDIENT COSTS AND HEATING COSTS

March 1, 2006

FINDINGS OF FACT

1. On March 1, 2006, the Pennsylvania Milk Marketing Board (Board) convened a hearing for all milk marketing areas to receive testimony and evidence to consider the effects on minimum wholesale and retail prices of increases in ingredient costs and increases in natural gas and fuel oil costs.
2. Notice of the hearing was published at 36 *Pennsylvania Bulletin* 364 on January 20, 2006, and was mailed to those who have requested notice of Board hearings by means of Bulletin No. 1393 dated January 10, 2006.
3. At the conclusion of the hearing, a briefing schedule was established, with briefs due March 23, 2006, and reply briefs due March 30, 2006.

Ingredient Costs

4. Carl Herbein testified for the Pennsylvania Association of Milk Dealers (Dealers) as an expert in milk cost accounting. Mr. Herbein calculated the effect of increased sweetener costs on ingredient costs for flavored milk, flavored reduced fat milk, and egg nog, as of January 2006. Mr. Herbein recommended that the ingredient costs he arrived at replace the ingredient costs in the current orders for each Milk Marketing Area because of the “extreme increase in cost that has occurred since our last round of cost replacement hearings.”
5. Mr. Herbein testified that ingredient costs for January 2006 were as follows:

a. Milk Marketing Area 1

Flavored Milk	\$0.0367/pound
Flavored Reduced Fat Milk	\$0.0319/pound
Egg Nog	\$0.0835/pound

b. Milk Marketing Area 2

Flavored Milk	\$0.0225/pound
Flavored Reduced Fat Milk	\$0.0204/pound
Egg Nog	\$0.1399/pound

c. Milk Marketing Area 3

Flavored Milk	\$0.0182/pound
Flavored Reduced Fat Milk	\$0.0250/pound
Egg Nog	\$0.1486/pound

d. Milk Marketing Area 4

Flavored Milk	\$0.0248/pound
Flavored Reduced Fat Milk	\$0.0303/pound
Egg Nog	\$0.1429/pound

e. Milk Marketing Area 5

Flavored Milk	\$0.0223/pound
Flavored Reduced Fat Milk	\$0.0255/pound
Egg Nog	\$0.1287/pound

f. Milk Marketing Area 6

Flavored Milk	\$0.0227/pound
Flavored Reduced Fat Milk	\$0.0240/pound
Egg Nog	\$0.1286/pound

6. David DeSantis testified on behalf of Board Staff as an expert in milk marketing and milk accounting. Mr. DeSantis also calculated the effect of increased sweetener costs on ingredient costs. Mr. DeSantis arrived at the same ingredient costs for each of the areas as Mr. Herbein. Mr. DeSantis concurred with Mr. Herbein's recommendation that the ingredient costs listed above replace the ingredient costs in the current orders.
7. Board Staff and Dealers used the same cross section of milk dealers in each area to calculate ingredient costs. Each cross section was identical to that used in the most recent cost replacement hearings in each area. We find that the cross sections used are representative of dealers doing business in each of the areas for the same reasons we found them representative in the respective cost replacement hearings.
8. The Board finds that sweetener cost increases have resulted in the increased ingredient costs found in Finding of Fact 5. We further find that these increases are significant and have a material impact on milk dealer costs. Therefore, the Board finds that the ingredient costs found in Finding of Fact 5 will replace the ingredient costs in the current respective orders.

Natural Gas and Heating Costs

9. Mr. Herbein also testified regarding increased natural gas and heating costs incurred by milk dealers in each of the Milk Marketing Areas. The cross sections Mr. Herbein used to analyze the increased heating costs in each of the areas were the same as those used in

the most recent cost replacement hearings for the respective areas, with two exceptions: Balford Farms and Pocono Mountain Dairy were not included in the cross sections because they do not process milk and did not have the increased expenses. Mr. Herbein testified that the Board should address the increased expenses because they were “significant,” given milk dealers’ “very thin margins.”

10. Mr. Herbein recommended a cost replacement approach to address the milk dealers’ increased natural gas and heating costs. He calculated a natural gas/fuel oil cost per point for 2004 based on each cross section’s standardization and pasteurization points. Mr. Herbein calculated the 2004 cost per point because 2004 cost data are the basis for the current pricing orders in each area. He then calculated a natural gas/fuel oil cost per point for January 2006 based on each cross section’s 2004 standardization and pasteurization points. Mr. Herbein recommended that the difference between the January 2006 and year 2004 costs per point, adjusted to eliminate the effect of the quarter-to-quarter adjustment in the current order caused by natural gas and fuel oil only, be added to the minimum wholesale and retail prices. Mr. Herbein recommended that the additional natural gas and fuel oil costs should be included in resale prices until the next cost replacement hearing in each area, when the costs would be adjusted to whatever they actually were at that time.
11. Mr. Herbein testified that he did not think an index system was appropriate. He testified that further study would be necessary to determine how an index would compare to actual costs; he believed that using an index deviated from a generally accepted accounting principles cost-based system. Mr. Herbein also testified that “there are many factors in the indexes that have nothing to do with the regulated milk dealers in Pennsylvania.” Mr. Herbein testified that the index used to adjust prices based on diesel fuel costs was acceptable because it was trued up to actual costs each year.
12. Mr. DeSantis recommended an indexing system to account for changes in milk dealers’ natural gas and fuel oil costs. He testified that generally prices are going to rise and fall in the market together, regardless of location. Mr. DeSantis also noted that the use of the index would adjust prices based on the percentage difference between current costs and a base cost. Mr. DeSantis testified that about 90 percent of the heating fuel in milk plants in Pennsylvania is natural gas, so an index should be based on changes in natural gas prices. He also testified that it would be appropriate to use a Pennsylvania-specific natural gas cost in the index. Mr. DeSantis further testified that most of the energy used is used in standardization and pasteurization, so it was most appropriate to use those points when adjusting prices.
13. Mr. DeSantis testified that it would be a “mistake” to use the cost replacement approach recommended by Mr. Herbein. Mr. DeSantis testified that the static adjustment based on a peak month’s price would not be reflective of milk dealers’ costs into the future. Mr. DeSantis also testified that making monthly adjustments based on an index would be the best way to incorporate current costs into resale prices.
14. Carl Myers testified for Dealers as an expert in natural gas costs and pricing. Mr. Myers testified that it was more appropriate to use natural gas price information than crude oil

price information to calculate an adjustment to resale prices caused by increased heating costs. Mr. Myers also testified that it was not appropriate to use an index of any kind to approximate milk dealers' costs for the energy they consume. Mr. Myers testified that an index was not appropriate because there are differences in pricing depending on location, there are differences in pricing depending on the quantity of natural gas consumed, and there are differences in natural gas costs depending on how the gas is purchased and the types and extent of risk management techniques employed. Mr. Myers recommended that actual invoice costs be used to adjust resale prices based on milk dealers' costs.

15. The Board finds that changes in milk dealers' natural gas and fuel oil costs should be recognized in resale prices on as current a basis as possible. We believe that adjusting costs on a current basis promotes a more orderly market. Therefore, the Board finds that milk dealers' natural gas and fuel oil costs shall be adjusted monthly in each Milk Marketing Area based on an index using Pennsylvania natural gas costs. We find that a natural gas index will most accurately reflect changes in dealers' natural gas and fuel oil costs based on Mr. DeSantis's testimony that natural gas comprises approximately 90% of the heating fuels in milk dealers' plants. We further find that the index system shall continue at least until the next cost replacement hearings in each of the Milk Marketing Areas, at which time we will consider testimony and evidence regarding the continuation of the adjustment or changes that should be made in the adjustment.
16. The methodology used to index dealers' heating fuel costs in each area shall be based on the various Heating Costs Adjustment exhibits offered by Board Staff, with some modifications. First, natural gas prices will be used, rather than crude oil prices. All natural gas prices shall be Pennsylvania-specific and will be those published by the United States Department of Energy, Energy Information Administration, and found on its website at <http://tonto.eia.doe.gov/dnav/ng/hist/n3035pa3m.htm> and http://tonto.eia.doe.gov/dnav/ng/xls/ng_pri_sum_dcu_SPA_m.xls. Second, the adjustment shall be based on standardization and pasteurization points, rather than bottling points; the Board finds persuasive and credible the testimony of Mr. Herbein and Mr. DeSantis that most of the energy used in the milk dealers' plants is in standardization and pasteurization. Third, the cost update shall be based on an average of three months' Pennsylvania natural gas costs; the Board finds that averaging three months of costs, rather than merely using one month, will provide milk dealers with a mechanism to recapture the increased costs they experienced at the end of 2005.
17. The table below demonstrates, using Milk Marketing Area 4 as an example, how the index system will operate and how the adjustment to resale prices will be calculated. The Heating Cost Increase (Decrease) per Standardization and Pasteurization Point shall be included each month in the wholesale and retail price build-ups. The average natural gas price for 2004 in the Board Staff's formula shall be the simple average of the 12 months of data for 2004 published by the Energy Information Administration at the website currently titled "Pennsylvania Natural Gas Industrial Price (Dollars per Thousand Cubic Feet)" at <http://tonto.eia.doe.gov/dnav/ng/hist/n3035pa3m.htm>. Similarly, the average natural gas price for the second quarter of 2005 in the Board Staff's formula shall be the simple average of prices for April 2005, May 2005, and June 2005, found at the same website (<http://tonto.eia.doe.gov/dnav/ng/hist/n3035pa3m.htm>). For June 2006 resale

prices, which will be announced on May 19, 2006, the simple average of October 2005, November 2005, and December 2005 Pennsylvania Natural Gas Industrial Prices, as published by the Energy Information Administration, will be used to calculate the Pennsylvania Average Natural Gas Industrial Price in line 6 of the calculation shown below. For each succeeding monthly resale price announcement, the three month average will roll forward one month – for July 2006 resale prices, November 2005, December 2005, and January 2006 Pennsylvania Average Natural Gas Industrial prices shall be averaged for line 6; for August 2006 resale prices, December 2005, January 2006, and February 2006 prices will be averaged; and so on.

The following weighted heating costs and standardization and pasteurization points, as presented by Mr. Herbein, shall be used on line 1 and line 10, respectively, of the calculation.

a. Milk Marketing Area 1

Heating Costs	\$272,135
Standardization/Pasteurization Points	166,137,230

b. Milk Marketing Area 2

Heating Costs	\$186,238
Standardization/Pasteurization Points	90,135,461

c. Milk Marketing Area 3

Heating Costs	\$323,826
Standardization/Pasteurization Points	145,820,959

d. Milk Marketing Area 4

Heating Costs	\$537,587
Standardization/Pasteurization Points	251,684,166

e. Milk Marketing Area 5

Heating Costs	\$619,860
Standardization/Pasteurization Points	273,180,985

f. Milk Marketing Area 6

Heating Costs	\$206,720
Standardization/Pasteurization Points	98,242,644

MILK MARKETING AREA 4

Heating Costs Adjustment – March 2006

Update of Heating Costs from Year 2004 to 2nd Q 2005

1. Weighted Heating Costs - Year 2004		\$	537,587
2. Pennsylvania Average Natural Gas Price - Industrial - Year 2004 ⁽¹⁾	\$	8.82	
3. Pennsylvania Average Natural Gas Price - Industrial - 2nd Quarter 2005 ⁽¹⁾	\$	9.58	
4. Percent Increase In Natural Gas Cost ((Line 3 - Line 2) ÷ Line 2)			8.62%
5. Presumed Heating Costs - 2nd Q 2005 ((Line 1 X Line 4) + Line 1)		\$	<u>583,927</u>

Update of Heating Costs from 2nd Q 2005 to March 2006

6. Pennsylvania Average Natural Gas Price - Industrial - Oct., Nov., Dec. 2005 ⁽¹⁾	\$	14.24	
7. Percent Increase In Natural Gas Cost ((Line 6 - Line 3) ÷ Line 3)			48.64%
8. Presumed "Current" Heating Costs ((Line 5 X Line 7) + Line 5)		\$	<u>867,949</u>
9. Increase in Heating Costs from 2nd Q 2005 to "Current" (Line 8 - Line 5)		\$	284,022
10. Weighted Standardization and Pasteurization Points - Year 2004			<u>251,684,166</u>
11. Heating Costs Increase (Decrease) per Stand. & Past. Point (Line 9 ÷ Line 10)		\$	<u>0.0011</u>

Footnote:

1. Source: Pennsylvania Natural Gas Industrial Price per Energy Information Administration website.
web address = <http://tonto.eia.doe.gov/dnav/ng/hist/n3035pa3m.htm>

18. The Board finds that the index system adopted in this order accounts for concerns that Mr. Myers had regarding the use of indexes to adjust prices. In the formula developed by Board Staff it is not necessarily the natural gas price that is important, but rather the relative change in natural gas prices, and the Board finds, based on Mr. DeSantis's testimony, that the relative change is the same regardless of how an individual dealer's natural gas is priced.
19. The Board believes that the index system is preferable to the cost replacement approach recommended by Mr. Herbein. The index system provides for as current as possible adjustments to resale prices, based on changes in natural gas prices, rather than an on-going static adjustment based on one month that may not be typical of natural gas and fuel oil costs the rest of the year (indeed, Dealers requested the hearing based on the atypical nature of natural gas and fuel oil cost increases at the end of 2005). We also have no way of knowing with any degree of certainty where natural gas prices will go in the future and are concerned that use of a cost replacement approach based on costs incurred in a month when prices may have been atypically high could result in unnecessarily high resale prices.
20. The Board also finds that it is not advisable at this time to implement a monthly adjustment to resale prices based on actual current heating costs incurred by dealers. We base this finding on Mr. DeSantis's testimony that the multitude of billing methods seen at the dealers makes it impractical to calculate monthly adjustments based on those actual costs in an accurate manner.
21. Because of the delay in adopting this order caused by the necessity of considering a new proposal made at the first pre-order conference, the Board did make some modification to the order as originally drafted and circulated. The original order provided for using the most current three months Pennsylvania Natural Gas Industrial Prices. This order still provides for an index using three months of Pennsylvania Natural Gas Industrial Prices, but the three month rolling average is no longer the most current three months; the three month rolling average will still begin with the months of October 2005, November 2005, and December 2005. We made this modification so that milk dealers would be in the same position they would have been in had it not been for the delay in adopting this order. Continuing to use the three most current months prices would have caused at least October 2005, one of the higher natural gas price months, to not be included in the index.

DISCUSSION

The burden is on a party petitioning the Board to (1) demonstrate that there is a problem or issue that the Board should address and (2) to put forth a reasonable solution to the problem that the Board can implement.

In this matter, the Pennsylvania Association of Milk Dealers petitioned the Board to hold a hearing to address increased sweetener costs and increased heating fuel costs. The Milk Dealers demonstrated to us that increased sweetener costs were indeed an issue that should be addressed. The Milk Dealers also provided us with a suggested solution to the

issue of increased sweetener costs that we considered reasonable and that we found should be implemented to correct the problem.

The Milk Dealers also demonstrated to us that increased heating fuel costs were an issue that should be addressed. However, the solution suggested by the Milk Dealers at the hearing and in its briefs was not one that the Board found to be reasonable and we decided not to implement it, for the reasons set forth in the Findings of Fact. Instead, we spent quite a bit of time and effort crafting a solution to the issue that we found to be reasonable and that we found should be implemented to address the issue of increased heating fuel costs.

The Board believes that the time to demonstrate to us that a problem exists and to offer reasonable solutions to that problem is during the hearing and through briefs. We do not think the pre-order conference is the appropriate venue to offer substantive proposals. The purpose of hearings and briefs is to offer and fully examine substantive solutions to issues that an interested party has identified. The purpose of pre-order conferences is to correct technical errors in the Order, such as errors in mathematical calculations or in transferring numbers from exhibits to Findings of Fact, and to clarify Findings of Fact that may be confusing or could be written more clearly.

To consider implementing substantive proposals offered during pre-order conferences risks rendering hearings, briefs, and the Board's deliberative process meaningless. There are at least two possible undesirable outcomes. Parties will begin to feel that they can come to hearings and "ask for the moon." The Board will then spend valuable time and resources designing a reasonable solution to the issue. Parties will then come to the pre-order conference and suggest some type of "compromise" solution between their original, unreasonable solution, and the solution the Board has already designed precisely because we found it to be reasonable. The other possible undesirable outcome is that parties may begin to feel that they can come to hearings essentially unprepared. Once again, the Board will spend time and resources crafting a solution, only to have it questioned at the pre-order conference by a party that did not do the initial preparation necessary to present a reasonable solution in the first place at the hearing.

The Board is not saying that either of these undesirable outcomes occurred in this matter. Rather, we find this to be a concern and intend to maintain the relevance of our hearings and the briefing process and to maintain the integrity of our deliberative process.

We have decided, therefore, to adopt our original order in this matter, with a slight modification so that the Milk Dealers are in the same position they would have been in had we adopted this order when originally scheduled and to allow the inclusion of the months with the highest natural gas costs in the index system.

CONCLUSIONS OF LAW

1. The March 1, 2006, hearing regarding the effect of increased sweetener costs and increased natural gas and fuel oil costs was held pursuant to the authority granted to the Board in sections 801 and 803 of the Milk Marketing Law (Law), 31 P.S. §§ 700j-801 and 700j-803.
2. The hearing was held following adequate notice and all interested parties were given a reasonable opportunity to be heard.
3. In adopting the attached order, the Board has considered the entire record and concludes that the order is supported by a preponderance of credible evidence and is reasonable and appropriate under sections 801 and 803 of the Law.
4. The attached order may be amended pursuant to the procedures set out in section 801 of the Law.

PENNSYLVANIA MILK MARKETING BOARD

Boyd E. Wolff, Chairman

Luke F. Brubaker, Member

Barbara A. Grumbine, Consumer Member

Dated: May 3, 2006

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