**COOPERATIVE MILK PROCUREMENT COSTS HEARING**

**OCTOBER 9, 2019**

**BOARD STAFF TESTIMONY OF STEVEN ZALMAN**

My name is Steven Zalman. I am the Director of Enforcement and Accounting for the Pennsylvania Milk Marketing Board. This hearing addresses the implementation of the cooperative procurement premium (CPP). The first part of my testimony will address how Board Staff can enforce, calculate, and incorporate a CPP into resale prices. The second part of my testimony will address other implementation hurdles and the position of Board Staff.

First, I would like to address why I refer to the CPP as a premium. We refer to any money paid to producers above federal minimums as a premium. The Over Order Premium (OOP) and the Over Price Premium (OPP) add to the price of milk that producers are paid above the federal minimum. Regardless of how it is calculated, or incorporated into resale prices, the CPP would be a mandated PA premium increasing the minimum price for coop milk. So, the OOP, OPP, and now the CPP are all premiums paid above federal minimums, establishing a PA minimum price, and are recoverable through minimum resale pricing. The CPP is accurately named as a premium.

## A. Obligation Computation

The CPP obligation can be calculated like the OOP obligation. In Board Staff Implementation Rebuttal Exhibit 1 we show an example of both premiums with sample data. The top box shows the obligation calculation for the CPP. The bottom box shows the obligation calculation for the OOP. As you can see, the only difference between the two formulas is when calculating the CPP we use PA produced coop pounds in the numerator of the equation (PA Produced Coop Pounds/Total Pounds – non-class 1 diversions), and when calculating the OOP, we use the total PA produced pounds in the numerator of the same equation. Currently, the OOP obligation is added to the cooperative invoice to the dealer and the Board auditors confirm the minimum dealer obligation due the coop. The CPP would be handled the same way. The coop would add the CPP to their invoice to the dealer, and Board auditors would confirm the minimum dealer obligation to the coop has been met.

We went through each cross-section dealer's audited monthly submissions for the year 2017 and calculated the CPP obligation for each month using the proposed computation method shown in the top box of Exhibit 1. The total CPP obligation for 2017 would have amounted to $1,242,589, using $.29 cwt as the CPP.

## B. Incorporation into wholesale and retail prices (Cost Recovery)

The Pennsylvania Association of Dairy Cooperatives (PADC) offers two methods to incorporate the CPP into resale prices, incorporation directly into dealer costs and by area purchase percentages. Board Staff analyzed these two methods by running simulations with the actual data from the 2017 cost replacement hearings. Neither of these two methods resulted in dealers receiving full recovery of the CPP paid. I will address these methods and propose an alternative method that does result in full recovery for all dealers. For the three methods, cost recovery was calculated in the same way, which is shown on Board Staff Implementation Rebuttal Exhibit 2.

**1. Incorporation directly into Dealer costs:**

Using the same spreadsheets used for the 2017 cost replacement hearings, the CPP obligations were added to the costs in the Receiving, Lab, and Fieldwork cost center for each dealer in an area's cross section. Our conclusions are as follows:

- 22.22 % (2 of 9) of cross-section dealers paying the premium received full recovery.
- 77.78 % (7 of 9) cross-section dealers paying the premium would not receive full recovery.
- In 2017, the PA cross-section dealers would have paid $1,242,589 in CPP's and recovered $820,569 in aggregate.

**2. Incorporation by area purchase percentage:**

The second method that PADC proposed was incorporation by area purchase percentage. PADC's method takes the percentage of coop milk purchased in the previous year per area and multiplies the result by the CPP to get the amount to be included in the milk costs before packaging. We analyzed this method by taking the percentage of PA coop milk bought in each area in 2016 and applied it to the milk cost before packaging in the 2017 cost replacement spreadsheets. Board Staff Implementation Rebuttal Exhibit 3 shows the price per pound used for each area. We inserted the additional price per pound in the milk costs before packaging and new wholesale and retail prices were calculated for each area. Our conclusions are as follows:

- 55.56 % (5 of 9) of cross-section dealers paying the premium received full recovery.
- 44.44 % (4 of 9) of the cross-section dealers paying the premium would not receive full recovery.
- In 2017, the cross-section dealers would have paid $1,242,589 in CPP's, and recovered $1,859,657 in aggregate.

**3. Board Staff Recommended Approach:**

Although PADC suggested the two previous methods of incorporating the CPP into resale prices, they also state that they are indifferent to the precise methodology, so Board Staff suggests the CPP be incorporated into resale prices like we do the OOP. The entire CPP would be included in milk costs before packaging. The OOP is included in our Producer Price Sheets and our Resale Price Sheets. Like the OOP, the CPP needs to be reflected in our Producer Price Sheets as it raises PA minimum producer prices for milk purchased from coops. The new Producer Price Sheet is shown in Board Staff Implementation Rebuttal Exhibit 4. The CPP also needs to be reflected on our Resale Price Sheets for recovery of the premium paid by dealers. The new Resale Price Sheet is shown in Board Staff Implementation Rebuttal Exhibit 5. We analyzed this method by using the new Resale Price Sheet. Our conclusions are as follows:

- 100 % of the cross-section dealers paying the premium received full recovery.
- In 2017, the cross-section dealers would have paid $1,242,589 in CPP premiums and recovered $4,413,531 in aggregate.

Board Staff favors this method because we are treating the CPP consistent with the OOP, and it results in 100% recovery of the CPP paid by dealers. Board Staff Implementation Rebuttal Exhibit 6 summarizes the results for each of the methods.

## C. Pennsylvania Producer Impact

Board Staff has had the benefit of the evidence presented at the first part of this hearing, which was in addition to the pre-submissions. Several aspects of the hearing had an impact on our position.

Cooperatives can pay their members whatever they want. If the CPP is granted, like the OOP, the coops will distribute it as they desire. For example, there is nothing to prevent them from investing in plants outside of Pennsylvania or distributing it to producers in any manner they choose. Statements made from PADC witnesses have indicated the PA producer might not receive any significant benefit at all. As a result, we feel compelled to express an opinion and take a position about the proposed CPP.

Investing in plants is a well-established part of the cooperative business model. Elvin Hollon testified that DFA members already have investments in 42 wholly owned processing plants that produce fluid milk, cultured and frozen dairy products, cheese, butter and milk powders. [1] [redacted]

Kai Knutson testified that Land O' Lakes members get 2 cents per hundredweight from a 75 cent OOP. [3] That amounts to 2.67%. Using the same ratio would mean that PA producers would receive an additional $0.0077 cwt on their milk check from a mandated 29 cent CPP.

Troye Cooper even acknowledges, that if farmers would see an increase in their milk checks, "to be quite honest with you, it'd be thoroughly negligible. They'd have to go to the fourth decimal, likely." [4]

Board Staff does not support a premium that is only paid to coops, when PA farmers may not benefit at all, and admittedly if they do it would be negligible, and could be used to finance plants outside of PA, or for other purposes they choose.

## D. Consumer Impact

PADC is telling the Board that Pennsylvania consumers would welcome this extra cost onto the price of their milk, without producing any evidence to support that claim. PADC wants the Pennsylvania Milk Marketing Board to mandate a premium payable to only cooperatives when PA independent producers will not benefit at all, and PA cooperative producers will benefit very little, if at all. But according to PADC, PA consumers, "would and do want it that way". One can almost admire the chutzpah it takes to say that PA consumers want what you want, when you have no evidence to support the claim.

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[1] November 8, 2018 Tr. 1142.

[2] January 30, 2019 Tr. 227 (*in camera*)

[3] January 30, 2019 Tr. 388, 405.

[4] January 30, 2019 Tr. 125.

## E. Wholesale and Retail Price Impact

Board Staff agrees with the calculation pertaining to the change in wholesale and retail prices using blending by area purchase percentage in PADC Exhibit 28. We have already presented Exhibit 5 which shows the complete resale price sheet for July 2019 using the Board's recommended method, as it would look if published. For the Producer Price Sheet there would be two options. There could be separate Producer Price Sheets for coops and independents. Exhibit 4 is a Producer Price Sheet for both coop milk and independent milk. So that we may have only one Producer Price Sheet, Board Staff prefers the Producer Price Sheet shown in Exhibit 4.

## F. PMMB Staffing and Computer Systems Impact

If this premium is implemented it would place additional burdens on Board Staff. Staff has not been trained in auditing coop records and would need additional training. Refining the coop audit process will be very time consuming and would draw critical employees away from other areas. Even with the proposed fee increase the PMMB is still operating at a deficit, so hiring an additional employee for this purpose would not be a viable option. I estimate that auditing, hearing preparation, and working with the coops refining the process would require 30% of a full time person's time.

The Milk Accounting and Regulatory System (MARS) and the monthly dealer reports (PMMB - 62e) would need programming to account for the addition of the CPP. Currently MARS produces a dealer obligation summary report (schedule 8.4) that summarizes by line item the amount due for each producer. To add an additional line item for the CPP and make the other programming changes in MARS to account for the CPP would require the hiring of an outside contractor. The cost of the contractor would be approximately $16,000 per month. There may be additional programming requirements, such as the addition of database fields that may require major unforeseen programming changes. The time required to make these changes are unknown. PMMB 62e programming is done internally so no outside expense will be incurred.

## G. Conclusions

During the first part of this hearing I testified that the Board should delay making a decision and include the CPP in the mix of other possibilities that were presented at the hearings held in 2018 in response to a Pennsylvania Department of Agriculture petition. Because of the testimony that we have heard and further discussions on the premium, Board Staff opposes a coop premium. To our knowledge a coop only premium has never been implemented elsewhere, and we have not heard any testimony to the contrary. There may be unintended consequences that have not been thought about. It places additional financial burdens on the PA consumer to support non-PA producers, with only fractions of a cent even possibly reaching PA producers. The CPP would be a mandated premium that accommodates the cooperatives, while excluding PA independent producers. We have not studied, and no evidence has been presented how PA producers, PA consumers, or the public at large, would view the PMMB mandating more than $1,242,589 in a coop only premium when there would be no guarantee it would be paid to PA producers. Their sentiment and perceptions should be a consideration in deciding whether the CPP should be implemented.