Commonwealth of Pennsylvania
Milk Marketing Board
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Official General Order No. A-948

Posted: November 7, 2007
Effective: December 1, 2007

TEMPORARY ADJUSTMENTS TO RESALE PRICES
INTERACTION BETWEEN PERCENTAGE DISCOUNTS AND HIGH MILK PRICES

NOW, this 7th day of November 2007, 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 December 1, 2007.

SECTION I

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

SECTION II

(a) Adjustments shall be made to resale prices in each area based on Finding of Fact 9;

(b) The adjustments shall be made based on the methodology outlined in Finding of Fact 10 and the attached worksheets;

(c) The adjustments shall continue until the average wholesale prices for 2% gallons of milk without the small delivery and small container adjustments return to the base period prices shown in Finding of Fact 4, or until November 30, 2008, whichever occurs earlier.

PENNSYLVANIA MILK MARKETING BOARD

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Boyd E. Wolff, Chairman

Luke F. Brubaker, Member

Barbara A. Grumbine, Consumer Member

Date: November 7, 2007

FINDINGS OF FACT AND CONCLUSIONS OF LAW
TEMPORARY ADJUSTMENTS TO RESALE PRICES
SEPTEMBER 5, 2007

FINDINGS OF FACT

1. On September 5, 2007, the Pennsylvania Milk Marketing Board (Board) convened a hearing for all milk marketing areas to receive testimony and evidence concerning temporary adjustments to resale prices due to the interaction between high milk prices and percentage discounts.

2. Notice of the hearing was published at 37 Pennsylvania Bulletin 4154 on July 28, 2007, and was mailed to those who have requested mailed notice of Board hearings by means of Bulletin No. 1414, dated July 18, 2007.

3. Carl Herbein testified for the Pennsylvania Association of Milk Dealers ("Dealers") as an expert in cost accounting and milk cost accounting. Mr. Herbein noted that the Pennsylvania dairy industry is experiencing unprecedented increased in raw milk costs, which is resulting in significant increases to in-to and out-of-store controlled milk prices. The Board's official general orders allow milk dealers to provide percentage discounts which are governed by the volume of milk delivered and/or by limited dealer service arrangements. Mr. Herbein testified that many retail customers utilized the allowable discounts such that percentage discounts affect a significant portion of milk sales. He further testified that with the current significant increase in wholesale milk prices dealers are faced with granting discounts that are causing significant margin erosion. Mr. Herbein provided a simple example to demonstrate the margin erosion: assuming a store customer earns a 10% discount, when the wholesale price of milk is $3.00 per gallon, the customer's discount is $0.30, but if the wholesale price of milk is $4.00 per gallon, that same customer's discount is $0.40. In this case, the dealer's revenue is reduced by $0.10 per gallon while performing the same functions.

4. To analyze the effects of the percentage discounts, Mr. Herbein conducted an analysis of each of the six milk marketing areas using the same cross section of dealers used for the most recent cost replacement hearing in each area (with two exceptions – Balford Farms in Area 1 and United Dairy and Schneider's Dairy in Area 5, all of which Mr. Herbein was unable to procure data from due to scheduling issues). Mr. Herbein opined that the cross sections were representative of the marketing conditions in each milk marketing area. The analysis utilized the prices for a 2% gallon of milk, which is representative of all other price-controlled products with respect to discounts and the effect on handler margin.

   Mr. Herbein study used a base period of January 2006 through March 2007. Mr. Herbein explained that he used this base period because the most recently completed cost replacement hearings at the time of his testimony utilized calendar year 2005 as the base for operating costs and margins granted. In addition, the 15 month period beginning January 1, 2006, through March 31, 2007, was a period of relatively stable milk price levels and the relationship between milk costs and discount levels functioned in an appropriate manner. Mr. Herbein testified that beginning in April 2007, the relationship between milk costs and discount levels was no longer working as it was designed to and dealer margins have been severely eroded since then.

Mr. Herbein calculated the average wholesale price for 2% gallons during the base period without the small delivery and small container discounts because the Board uses this price in determining the amount of margin to be added into the wholesale price. Mr. Herbein arrived at the following base prices for a gallon of 2% milk:

Area 1	$2.7292
Area 2	$2.2980
Area 3	$2.4355
Area 4	$2.4198
Area 5	$2.4292
Area 6	$2.3702

5. Mr. Herbein's study quantified sales information by type of discount granted for October 2006. Mr. Herbein did not include sales made pursuant to a tolling arrangement. By comparing the various discounts available at the August 2007 wholesale price for 2% gallons to the discounts available at the base period price, Mr. Herbein determined the amount of lost revenue suffered by milk dealers due to the price increases for August 2007. Mr. Herbein's study demonstrated for each of the six milk marketing areas the dealers' margin erosion caused by the lost revenue.

   Since the wholesale prices for a 2% gallon of milk will change each month, the lost revenue and related margin erosion suffered by the dealers will change each month. Mr. Herbein provided a methodology that will allow for the margin erosion to be mitigated by providing for a monthly adjustment to minimum wholesale and retail prices. Mr. Herbein recommended that the Board adopt such an adjustment to restore milk dealer margins to at least the statutorily mandated minimum of 2.5%. Mr. Herbein also recommended that the adjustments continue until the wholesale prices for 2% gallons return to the base period price, or for a period of one year, whichever occurs earlier.

6. Mr. Herbein also testified that in addition to the cross section data he presented, he also reviewed the files of a number of well-managed Pennsylvania dealers, some of whom were represented in the cross sections and some of whom were not. Mr. Herbein testified that these particular dealers were traditionally very successful and that he found actual in-the-red losses being experienced by some of them. Mr. Herbein further testified that the timing of those losses was tied to the spike in raw milk prices and the discount issue had significantly, although not exclusively, contributed to the losses. Mr. Herbein testified that even for those dealers not suffering in-the-red losses, maintaining the profit margin set by the Board during the cost replacement process was essential to maintaining healthy milk processing facilities.

7. The Board's own analysis of Mr. Herbein's presentation and our resale pricing methodology indicates that the interaction between high milk prices and the percentage discounts has resulted in lost revenue and margin erosion for the dealers.

In addition to dealers providing discounts to their customers who earn them, the discounts also play a role in establishing minimum retail prices. Generally the largest dealer-to-store discount is subtracted from the minimum wholesale price before the in-store handling cost and retail profit are added to arrive at the minimum retail price. Therefore, as milk prices rise, the dealers lose some revenue due to the percentage discounts, but retailers do not receive a "benefit" equal to the lost revenue (this can be seen by comparing Surrebuttal Exhibits D and H for each of the milk marketing areas). The higher percentage discounts also provide some "benefit" to consumers in the form of a lower beginning price for the retail price build-up than would otherwise be the case with a smaller discount amount.

The Board finds that an adjustment to minimum wholesale and retail prices is appropriate to address the interaction between high milk prices and percentage discounts, based on the effects the percentage discounts have on dealer revenue and margin and minimum wholesale and retail prices.

8. We also analyzed Mr. Herbein's exhibits to determine the portion of sales subject to percentage discounts in each of the milk marketing areas.

To arrive at the following percentages, we used Surrebuttal Exhibits B and D for each milk marketing area. We divided the total annualized gallons sold subject to a discount shown on Surrebuttal Exhibit B by the MARS annualized selling gallons of surveyed dealers from Surrrebuttal Exhibit D. We found that the following percentages of sales were made subject to a discount:

Area 1	33%
Area 2	75%
Area 3	79%
Area 4	11%
Area 5	76%
Area 6	85%

9. Based on the percentages shown in Finding of Fact 8, the Board finds the following:

a. In Area 1, an adjustment should be made to bring the dealer margin to 2.5% because a significant portion of the dealer sales are not made subject to a percentage discount;

b. In Area 2, an adjustment should be made to bring the dealer margin to 3.0% because a significant portion of the dealer sales are made subject to a percentage discount;

c. In Area 3, an adjustment should be made to bring the dealer margin to 3.0% because a significant portion of the dealer sales are made subject to a percentage discount;

d. In Area 4, no adjustment should be made due to the relatively small portion of dealer sales that are made subject to a percentage discount;

e. In Area 5, an adjustment should be made to bring the dealer margin to 3.0% because a significant portion of the dealer sales are made subject to a percentage discount;

f. In Area 6, an adjustment should be made to bring the dealer margin to 3.0% because a significant portion of the dealer sales are made subject to a percentage discount;

10. The Board finds that adjustments to minimum wholesale and retail prices should be made pursuant to the methodology outlined by Mr. Herbein in the Surrebuttal Exhibits and his testimony. We also find that the adjustments should be made on a proportionate basis across all Class I products.

We have analyzed Mr. Herbein's testimony and the Surrebuttal Exhibits and, using appropriate rounding, have developed the attached worksheets to be used to make the monthly adjustments in each area. As recommended by Mr. Herbein in his testimony, the previous month's 2% gallon price is used to calculate the current month's adjustment.

CONCLUSIONS OF LAW

1. The September 5, 2007, hearing 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 this order, the Board 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

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Boyd E. Wolff, Chairman

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Luke F. Brubaker, Member

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Barbara A. Grumbine, Consumer Member

Date: November 7, 2007

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