

REBUTTAL TESTIMONY OF

CARL D. HERBEIN, CPA

Appearing on Behalf of the Area 2 Milk Dealer Association

Rebuttal Testimony before Pennsylvania Milk Marketing Board

2015 Cost Replacement Hearing

January 6, 2016

Rebuttal Testimony of Carl D. Herbein, CPA

Area 2 – 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 Rebuttal Testimony on behalf of the Area 2 Milk Dealers Association. I attach my Curriculum Vitae, as Rebuttal Exhibit D1, which outlines my education, and experience in the dairy industry.

Background and Purpose of Hearing

Pursuant to Bulletin Number 1518, the Pennsylvania Milk Marketing Board is conducting a public hearing to receive evidence to establish wholesale and resale prices in Milk Marketing Board Area 2. 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 first halves of calendar years 2014 and 2015; 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 2. In accordance with OGO A-939, evidence and testimony will be considered regarding the diesel fuel adjuster in Area 2.

Study Conducted

On behalf of the Area 2 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 2015 cost information as the new starting point for container updating. These March 2015 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 2015 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 1st, 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 2 cross-section of dealers utilized includes Clover Farms Dairy, Swiss Premium Dairy, Turkey Hill Dairy, and Tuscan/Lehigh Dairies, Inc. – Schuylkill Haven. These companies process, package and deliver the majority of fluid milk products in Area 2 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 2 and this cross-section remains unchanged from the immediate prior hearing.

Rebuttal Exhibits

Rebuttal Exhibit D2 reflects the processing, packaging, and delivery cost per point for calendar year 2014. Please note that the points presented are for sales in the PMMB Area 2 made by the cross-section dealers. These costs should replace the existing costs from 2013, 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

Rebuttal Exhibit D2-A is prepared to show the effect of the cost replacement process by comparing the 2013 costs in the current order with the 2014 costs. Additionally, this exhibit reflects the 2015 cost increase adjustment and removes the 2014 cost decrease adjustment to eliminate any possibility of duplication. It should also be noted that the bottling department points for 2014 are 82,037,823 for the cross-section dealers and this compares with 2013's bottling department points of 87,266,080. This comparison reflects a 6.4% decrease in bottling department points when comparing 2014 with 2013.

Rebuttal Exhibit D3 and D3-A have been updated to container costs utilized in the December 2015 resale price development. The shrinkage factor reflected on this exhibit is a statewide average and will be utilized for all areas. 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 2014 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 2. 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 March 2015 as adjusted as a new starting point.

The Area 2 Milk Dealer Association requests and recommends that the blending concept be continued for all containers that are represented by both plastic and paper with the exception of the half pint container. The blending of containers, 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 .0426 and it should continue to be adjusted monthly in accordance with OGO A-957.

Rebuttal Exhibit D4 is prepared to present the ingredient costs as of March 2015, 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.

Rebuttal Exhibit D4-A reflects the ingredient costs presented on Rebuttal Exhibit D4 and demonstrates the increase or decrease when the cost replacement process occurs.

Rebuttal Exhibit D5 updates the cost of shrinkage and cost and revenues from bulk cream and bulk milk. The current order establishes a net revenue of (.0020) per pound and the new net revenue, based on 2014 is (.0010) per pound. Thus, there has been a net change of .0010 per pound.

Rebuttal Exhibit D6 reflects a comparison of the current order butterfat tests by product category and compares those tests with the 2014 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 2014 test reflected on this exhibit.

Rebuttal Exhibit D7 is prepared to calculate the cost increases and decreases incurred during the six (6) month period ending June 30, 2015 with the six (6) month period ending June 30, 2014 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. This year the cost increase (decrease) analysis has been performed utilizing the first six (6) months of 2015 and comparing that with first six (6) months of 2014. It should also be noted that the weighted points for the six (6) month period of 2015 are .4% more than the weighted points for the first six (6) months of 2014.

Rebuttal Exhibit D8 has been updated to reflect the October 2015 diesel fuel costs, which were used in the issuing the minimum prices for December 2015. Additionally, this exhibit reflects the calculation of the average diesel fuel cost for calendar year 2014. Additionally, this exhibit reflects the calculation of the average

diesel fuel cost for the calendar year 2014, which forms the basis for the annual adjustment and update. I recommend that this adjustment be continued on a monthly basis.

Rebuttal Exhibit D9 has been updated to reflect the August 2015 natural gas costs and reflects OGO A937 effective June 1, 2006 concerning heating fuel costs. Additionally, this exhibit reflects the calculation of the average heating fuel cost for calendar year 2014, which forms the basis for the annual adjustment and update. I recommend that this adjustment be continued on a monthly basis.

Rebuttal Exhibits D10-A and D10-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 2014. 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 2 dealers at 3.5%. 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 3.5% return is recommended.

Summary and Recommendation

The Area 2 Milk Dealers recommend that the Milk Marketing Board make the cost replacement adjustments, which are reflected in my testimony and exhibits. Thank you for your consideration of my analysis and opinions.