Commonwealth of Pennsylvania
Milk Marketing Board
2301 North Cameron Street
Harrisburg, PA 17110-9408

717/787-4194
Fax 717/783-6492

WEB SITE: http://www.mmb.pa.gov
E-mail: ra-pmmb@pa.gov

Official General
Order No. A-1010

Posted: December 2, 2020
Effective: January 1, 2021

COOPERATIVE PROCUREMENT COST

NOW, this 2nd day of December 2020, 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 January 1, 2021.

SECTION I
INCORPORATION

The attached Findings of Fact, Conclusions of Law, and Attachments are incorporated herein by this reference as though fully set forth in this order.

SECTION II

(a) In all milk marketing areas, effective 12:01 a.m. January 1, 2021, the price of Class I milk produced, processed, and sold in Pennsylvania by a cooperative to a dealer shall include $0.2416 per hundredweight cooperative procurement cost applicable to Pennsylvania produced, processed, and sold cooperative milk. The charge shall be reflected, as shown on Attachments 1 and 2, on the Board's monthly price announcements for minimum producer prices and for minimum resale prices.

(b) The milk dealer's minimum amount due to cooperatives shall include an obligation for the cooperative procurement cost.

(c) The cooperative procurement charge shall be included in the minimum wholesale and retail prices for all milk marketing areas in the same manner as the current over-order premium.

(d) Cooperatives shall itemize the cooperative procurement cost on invoices to dealers in the same manner as the over-order premium is itemized. Milk dealers shall report the payment of the cooperative procurement cost on their monthly reports (PMMB 62).

SECTION III
SEVERABILITY

If any section, provision, subsection, paragraph, or clause of this order is determined to be unconstitutional or otherwise contrary to law, the remainder of the order shall be given effect as though that section, provision, subsection, paragraph, or clause has not been included.

PENNSYLVANIA MILK MARKETING BOARD

Robert N. Barley, Chairman

James A. Van Blarcom, Member

Date: December 2, 2020

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FINDINGS OF FACT AND CONCLUSIONS OF LAW COOPERATIVE PROCUREMENT COSTS

FINDINGS OF FACT

Procedural History

1. On April 2, 2018, the Pennsylvania Milk Marketing Board ("Board") received a petition from the Pennsylvania Association of Dairy Cooperatives ("PADC") requesting a hearing to determine cooperative milk procurement costs and a method to incorporate those costs into minimum wholesale and retail prices.

2. The Board granted PADC's petition. On July 11, 2018, the Board issued Bulletin 1546, providing notice to those parties that have requested hearing notices be sent to them by the Board. Notice of the hearing was published at 48 Pennsylvania Bulletin 4371 on July 21, 2018. The purpose of the hearing, as provided in the hearing notices, was "to receive testimony and exhibits concerning cooperative milk procurement costs and a method to incorporate those costs in minimum resale milk prices."

3. On August 10, 2018, the Board issued a protective order to allow parties to present confidential testimony and exhibits in non-public sessions. On August 29, 2018, the Board enlarged the protective order to include confidential information regarding any entity. The Board held several *in camera* sessions and received testimony and exhibits that are redacted and sealed pursuant to the protective order.

4. The Board held hearings on November 5, 6, 7, and 8, 2018. The hearing continued on January 28. 29, and 30, 2019.

5. On January 31, 2019, the Board issued an order continuing the proceeding indefinitely to allow PADC to develop and submit evidence regarding how milk dealers would calculate their plant cooperative procurement cost obligation and how the cooperative procurement cost paid by milk dealers would be recovered in minimum resale prices. On May 24, 2019, PADC submitted the evidence requested and on June 28, 2019, the Board issued an order scheduling the hearing to continue on October 9, 2019. The October 9, 2019, hearing was then continued because the parties were discussing a potential compromise to resolve the hearing issues.

6. PADC and the Pennsylvania Association of Milk Dealers ("PAMD") filed a joint motion on October 22, 2019, requesting the Board adopt an interim compromise. On November 6, 2019, the Board held a hearing regarding the interim compromise. Based on the November 6, 2019, hearing and post-hearing briefs the Board adopted Official General Order ("OGO") A-1004 on December 4, 2019. OGO A-1004 became effective on January 1, 2020, and will expire on December 31, 2020. OGO A-1004 provided for an interim additional charge to be paid by Pennsylvania milk dealers to cooperatives for Pennsylvania produced, processed, and sold cooperative milk. OGO A-1004 also

provided a method for milk dealers to calculate their payment obligation for the charge and provided a method for milk dealers to recover the charge in minimum resale prices. On January 13, 2020, the Board issued Bulletin 1570 to provide additional detail, clarification, and examples regarding the calculation to be used by milk dealers to determine their payment obligation to cooperatives for the interim additional charge.

7. The hearing then continued on October 5, 6, and 7, 2020. The hearing concluded on October 7, 2020.

8. Over the course of the ten hearing days between November 2018 and October 2020, the Board heard testimony from numerous witnesses, many of them multiple times. Those witnesses are listed below with their areas of expertise if applicable.

<u>For Pennsylvania Association of Dairy Cooperatives</u>

- Troye Cooper – raw milk marketing, procurement from producers, and sales to handlers
- John Stoner – financial analysis and cost accounting
- Matthew Hartland – financial analysis and cost accounting
- Sharad Mathur – raw milk marketing and procurement from producers
- Elvin Hollon – agricultural economics, milk marketing regulation, and federal milk marketing orders
- Kurt Williams
- Dean Ellinwood
- Kai Knutson

<u>For Pennsylvania Association of Milk Dealers</u>

- Dave Stonesifer – cost accounting and dairy cost accounting
- Gino Tosi – dairy economics, milk marketing and milk price regulation
- Cheryl Caruso
- Chuck Turner, Jr.
- Betsy Albright
- Ron Mong – cost accounting and milk cost accounting

<u>For Dean Foods Company ("Dean")</u>

- Rob Blaufuss – agricultural economics, milk procurement and milk marketing
- Brian Kornfeind

<u>For Milk Marketing Board Staff ("Staff")</u>

- Clifford Ackman – milk statistics
- Gary Gojsovich – milk industry cost accounting and regulation
- Steven Zalman – milk industry cost accounting and regulation

For Pennsylvania Department of Agriculture ("PDA")

- Deputy Secretary Gregory Hostetter
- David DeSantis – milk industry cost accounting and regulation of the milk market in Pennsylvania

The Board truly appreciates the time and effort expended by all of the witnesses who provided testimony and evidence to us during this hearing. We understand the time commitment preparing and attending a multi-day hearing spread over two years, not only by the witnesses who attended all or several sessions but also by those witnesses who attended a single session. Also in evidence is testimony from a prior proceeding regarding cooperative procurement costs. All of the witnesses and evidence from the prior hearing admitted in this hearing provided us information that factored into our decisions on the issues presented and we carefully and thoroughly considered, reviewed, and weighed all of the testimony and evidence as we deliberated the issues and drafted this order. The findings and conclusions below are based on the totality of the evidence and our thorough review and weighing of all the evidence, without in all cases providing detailed summaries of each witness's testimony. The Board has several issues to decide, each of which is now addressed below.

Does the Milk Marketing Law provide authority for the relief requested by PADC?

9. Section 801 of the Milk Marketing Law ("Law;" 31 P.S. sec. 700j-801) requires the Board to "base all prices upon all conditions affecting the milk industry in each milk marketing area, . . . [including] a reasonable return on aggregate milk sales by milk dealers . . . ." The definition of "Milk Dealer" in Section 103 of the Law (31 P.S. sec. 700j-103) provides "[i]f a cooperative distributes . . . milk . . . to other milk dealers . . . or acts as an agent for its members, it shall be deemed to be a milk dealer . . . as to that part of its business, and shall be governed by the provisions of this act applicable thereto."

The Board establishes minimum wholesale prices based on milk dealer costs pursuant to section 801's mandate to provide milk dealers a reasonable return on aggregate milk sales. The Board does not currently, though, establish a minimum price based on cooperative costs to provide cooperatives a reasonable return based on aggregate milk sales.

However, section 103 defines cooperatives as "milk dealers" when cooperatives distribute milk to other milk dealers. Therefore, because section 801 requires the Board to establish prices that will provide a reasonable return to milk dealers and to "base all prices upon all conditions affecting the milk industry" we conclude that, when considering "all conditions affecting the milk industry," the Law provides authority to establish a price for cooperatives acting as milk dealers in pursuit of the mandate to provide a reasonable return to dealers.

Among the conditions affecting the milk industry is the role cooperatives play. We heard testimony from several witnesses who described cooperative functions in Pennsylvania's milk industry. Summaries of some of that credible and persuasive testimony are below. In particular Sharad Mathur provided credible and persuasive evidence regarding the evolution of the cooperative role in the dairy industry in the Northeast based on his more than 40 years' experience in raw milk procurement for both fluid milk processing plants and cooperatives. The Board concludes that the vital role played by cooperatives in Pennsylvania's dairy industry is "a condition affecting the milk industry" that should be recognized in Board-established prices.

Section 809 of the Law (31 P.S. sec. 809) describes, *inter alia*, cooperatives' relationships with their members regarding blending and paying proceeds of milk sales to the members and provides that cooperative milk sales to milk dealers must be made based on Board-established prices. We do not find authority in section 809 to conclude that cooperatives acting as milk dealers are entitled to a minimum price based on their costs. We conclude that the requirement that sales by cooperatives to other milk dealers be at or above Board-established minimum prices means that cooperatives must receive the minimum producer price. The requirement that sales by cooperatives to other milk dealers be at or above Board-established minimum prices is not the same as requiring a Board-established minimum price calculated to recover cooperatives' milk procurement costs.

Section 807 of the Law (31 P.S. sec. 807) provides that it is a violation "for any milk dealer . . . to provide manufacturing, processing, bottling, or delivery services for another dealer for a price less than the costs of the service provided." Section 807 does not address milk procurement services. Therefore, we conclude that this part of Section 807 does not provide authority to establish minimum prices based on cooperative milk procurement costs.

However, section 807 also provides that "[n]o method or device shall be lawful whereby milk is bought or received . . . or sold . . . or delivered . . . at a price less than the minimum price applicable to the particular transaction . . . or by a combined price for such milk, together with another . . . service which is less . . . than the aggregate of the price of the milk and the price or value of such . . . service . . . ." Section 807, then, requires that cooperatives receive the minimum price for the milk they sell (ie, the minimum producer price) plus the value of any service they provide in conjunction with selling the milk.

The Board concludes that Sections 103, 801, and 807 read together provide the Board authority to grant the PADC request to recognize and require payment of cooperative procurement costs through the minimum resale price provisions in the Milk Marketing Law.

Recovery in Board-established minimum wholesale prices of the amount dealers pay to cooperatives is discussed in more detail below, where we provide for "full" recovery by dealers. We note here that full recovery as provided for below essentially allows dealers to recover the cooperative procurement cost obligation in close to real time.

Rather than recognize and require payment of cooperative procurement costs as we do in this order, we could recognize and require payment of individual cooperative procurement costs when each cooperative sells milk to a dealer. However, we conclude that taking into account "all conditions affecting the milk industry" requires that a cooperative procurement cost be part of Board-established prices. Requiring individual cooperative procurement costs be paid when cooperative sell milk to dealers would lead to delays in recovery of the cost by dealers that are required to pay the cooperative procurement cost. We conclude that requiring a cross section average cooperative procurement cost and full recovery is necessary to both fulfill the Law's requirement that cooperatives be paid the value of the procurement services they provide while at the same time minimizing potential negative impacts on dealers paying the cooperative procurement cost. The potential impacts of the recovery methods recommended during the hearing are discussed in detail below. However, based on the evidence and recovery methods proposed during the hearing, we conclude that the financial situation faced by Pennsylvania milk dealers described in the credible and persuasive testimony of Mr. Stonesifer and Mr. Mong is a "condition affecting the milk industry" that requires the quickest complete recovery by milk dealers of the mandated procurement cost.

Of the options we were presented, the method that would best provide timely complete recovery is through recovering the cooperative procurement cost in the same manner as the Board-mandated over-order premium. We recognize that in some circumstances this will result in some milk dealers recovering more cooperative procurement cost through minimum wholesale prices than they were required to pay. This is not the outcome we prefer. The Board would prefer a method that better match the amount paid by dealers to cooperatives to the amount recovered by dealers through minimum wholesale prices, but we were not presented with such an option. We conclude that providing recovery for the cooperative procurement cost through wholesale prices in the same manner as the over-order premium is recovered best takes into account all conditions currently affecting the milk industry.

<u>Should the Board recognize cooperative procurement costs in Board-established minimum prices?</u>

10. Gino Tosi is retired from the United States Department of Agriculture, Agricultural Marketing Service, Dairy Programs. Over 20 years of his work was in the Dairy Programs Order Formulation and Enforcement Branch. He opined that a "'cooperative only'" premium" is unnecessary and would be bad policy. Mr. Tosi testified that federal milk marketing order pricing already reflects the marketing and balancing costs for which the cooperatives sought compensation. He also testified that it would be bad policy in that payment for the requested cooperative procurement cost would favor the cooperative business model over all other alternative business models.

Mr. Tosi testified that marketing costs represented one of the three components of federal Class I differentials. He testified that USDA expressly explained that the marketing costs included such things as seasonal and daily reserve balancing of milk supplies, transportation to more distant processing plants, shrinkage, administrative costs, and opportunity charges at manufacturing milk plants that service Class I milk demands. Mr. Tosi opined, therefore, that the costs PADC sought to have included in what he termed a “cooperative-only premium” are already addressed in the Class I differential. Mr. Tosi also testified about cooperatives charging fees to recoup marketing and balancing costs, that the “cooperative-only premium” would discriminate against other entities that provide balancing functions that would not collect the “fees,” and that government should ensure that the prices it establishes are applied uniformly.

Elvin Hollon is Vice President for Fluid Marketing and Economic Analysis for Dairy Farmers of America (“DFA”). Mr. Hollon testified that federal milk market order pricing does not address the cost reimbursement requested in PADC’s proposal. Mr. Hollon explained that the cost centers representing the cooperative procurement cost proposal were based on their direct relationship to procuring milk for fluid buyers. He also testified that the cost centers did not include balancing costs or any costs associated with operating a manufacturing/balancing plant. In short, the costs presented by PADC were isolated to procuring milk for sale to buyers, including Class I buyers.

Mr. Hollon also explained that the marketing cost component of the federal Class I differential Mr. Tosi described is ultimately distributed equally to all producers through the marketwide blend price. In contrast minimum Board-established prices provide for milk dealer recovery of procurement costs from independent producers but do not provide any recovery of procurement costs for cooperatives supplying producer milk to dealers.

We find the testimony of Mr. Tosi and Mr. Hollon to be credible. We find more persuasive Mr. Hollon’s testimony that federal order Class I differentials do not address the cooperative procurement cost proposed by PADC. We also find persuasive Mr. Hollon’s testimony regarding the difference between payment of the Class I differentials through the marketwide blend price as opposed to procurement costs paid through Board-established minimum prices.

11. Several witnesses testified regarding the characteristics of cooperative milk procurement and selling that milk to processors. That extensive testimony is briefly summarized below.

Troye Cooper, Director of Operations, Milk Marketing, and Member Services for Maryland and Virginia Milk Producers Cooperative Association, Inc. (“Maryland and Virginia”), testified extensively over several of the hearing days. He testified that in 2016 Pennsylvania cooperative farms and independent farms supplied an almost equal volume of milk to Pennsylvania cross-section dealers (“cross section dealers” are generally the largest processors in Pennsylvania and are members of one or more of the six Milk Marketing Area cross sections used to develop minimum wholesale prices). Mr. Cooper testified that cooperatives assemble and supply milk from their members to dealers for Pennsylvania Class I use and that the costs of providing that service to milk dealers are borne by the cooperative. Pennsylvania Class I dealers with an independent supply, on the other hand, incur the costs for assembling and procuring the independent milk for their plants; in the Pennsylvania resale pricing system, those assembly and procurement costs for independent processors are ultimately incorporated in minimum wholesale and retail prices. Because the cost of procuring independent milk is incorporated in Board-established minimum resale prices, milk dealers recover that cost based on the cross section average cost in minimum wholesale prices. Currently, there is no mandated pricing mechanism that provides for cooperatives to recover their costs procuring milk.

Board regulations (7 Pa. Code sec. 149.46) establish and define cooperative cost centers ("section 149.46 costs"). Those cost centers are

- Field Services
- Laboratory
- Producer payroll
- Sales invoicing
- Dispatch, logistics and hauling
- Calibration services
- Producer relations
- Customer relations
- General and administrative (this is not a cost center, these costs are allocated across the other listed cost centers per generally accepted accounting principles)

Mr. Cooper provided details on these cost centers and their relationship to assembling and procuring milk. He explained why these functions are essential to the procurement service cooperatives provide. Mr. Cooper also explained that the costs do not represent balancing costs. He testified that the costs presented in the procurement cost analysis done by Mr. Stoner and Mr. Hartland ("RKL study") are only costs associated with assembling and selling milk to dealers.

Sharad Mathur testified regarding cooperative milk procurement. Mr. Mathur's testimony that he provided in a separate 2014 hearing regarding cooperative procurement costs was entered into evidence for this hearing. Mr. Mathur was the Chief Operating Officer of Dairy Marketing Services when he gave the 2014 testimony. He has since retired but continues to work part time on special projects. Earlier in his career Mr. Mathur worked for independent processors and so has experience procuring independent milk and cooperative milk. Mr. Mathur testified that all the cooperative cost centers are part of the assembly and procurement of milk to be sold to dealers. He also testified that many of the costs incurred by cooperatives are for services required by dealers, including Farmers Assuring Responsible Management ("FARM") surveys and certain laboratory tests.

Kurt Williams is the General Manager and Executive Vice President of Lanco Dairy Farmers Cooperative ("Lanco"). Dean Ellinwood is Director of Operations for DFA for the Northeast Area. Kai Knutson is the Milk Supply Manager for Land O' Lakes Eastern Region. Based on their knowledge of each of their cooperatives, Mr. Williams, Mr. Ellinwood, and Mr. Knutson each testified that the cost centers found in the Board regulations and analyzed in the RKL study represent functions necessary to assemble and supply milk to dealers. They testified that their cooperatives could not market milk from farm to plant without incurring the costs in the RKL study.

Gregory Hostetter is the Pennsylvania Department of Agriculture Deputy Secretary for Animal Health and Food Safety. He testified that PDA supported the request to implement a mandatory cooperative procurement cost and to provide for recovery of that cost through Board-established minimum resale prices.

12. Several witnesses testified in opposition to what they often characterized as a "cooperative-only premium." That extensive testimony is briefly summarized below.

Rob Blaufuss testified as the Director of Dairy Procurement and Risk Management for Dean. He testified that adding the procurement cost would decrease the competitiveness of dealers that process and sell Pennsylvania milk. Mr. Blaufuss testified that sales could be won or lost over fractions of a penny and that the price increase caused by the cooperative procurement cost could lead to lost business. He also testified that out-of-state Class I plants owned by two members of PADC would gain a competitive advantage over Pennsylvania plants required to pay the cooperative procurement cost.

Mr. Blaufuss testified that cooperatives and dealers have different cost structures. He also testified that cooperatives can pay their members blended proceeds generated by the entirety of a cooperative's operations and milk payments.

Mr. Blaufuss also testified that he was concerned that the Board would impose a "regulated premium" on plants buying cooperative-supplied milk without providing for full recovery of that mandate.

Brian Kornfeind testified as the Vice President of Customer Brands and Strategy for Dean. Mr. Kornfeind's role included reviewing customer brand and private label proposals. He testified that the additional cooperative procurement cost would have the potential to threaten business in Pennsylvania. Mr. Kornfeind explained in detail how paying the cooperative procurement cost would make Dean uncompetitive.

During the course of this two year hearing, DFA acquired the four Pennsylvania Dean plants. To the extent Dean-specific competitive information can be extended and applied to other dealers and the testimony provided by other dealers, we considered the Dean-specific testimony regarding competitive impacts.

Mr. Stonesifer testified that the costs presented in the RKL study were more expansive than the costs fluid milk plants incur to procure independent milk. He opined that it was wrong to give cooperatives the same treatment as fluid milk plants under the Board pricing system when cooperatives and fluid milk plants are so different in terms of the costs incurred, the mechanisms available for cost recovery, the ability to pay dairy farmers, and the purpose and scope of the costs incurred. Mr. Stonesifer explained those differences between cooperatives and fluid milk plants in detail for the section 149.46 costs.

Mr. Stonesifer testified that the RKL study included expense items that in his opinion were inappropriate when accumulating milk procurement costs. As noted below, those expense items were explained by Mr. Hartland. Mr. Stonesifer was also concerned that the prior cost study and the RKL cost study arrived at similar procurement costs despite the current cross section not including a cooperative included in the prior cross section and the prior cost study including fewer cost centers. The RKL study, in other words, had a significant shift in the cross-section cooperatives and included new, and in one case expanded, cost centers. Mr. Hartland explained that one cooperative was removed from the cross section, but one was added for the RKL study. Additionally, Mr. Ackman found that 90.1% of the cooperative milk purchased by Class I plants in Pennsylvania was purchased from the RKL study cross section cooperatives .

Mr. Hartland addressed Mr. Stonesifer's cost center and accounting concerns. He explained that the cost centers in the RKL study (as detailed in 7 Pa. Code sec. 149.46) were part of the prior study, but had not been broken out as separate cost centers at that time. He also testified that the cooperative annual financial report (PMMB 60C) included total contract hauling costs, net of hauling reimbursement. Mr. Hartland further explained each of the expense items Mr. Stonesifer considered inappropriate: advertising captured costs related to membership-based advertising necessary to attract and maintain a member base to meet milk supply demands; the case expense line was used to record meeting expenses including member conferences and trade shows – those are costs associated with maintaining the member base and were recorded on the case expense line because when the RKL study was done the reporting forms, which were based on long-in-use dealer reporting forms, had not been completely refined and adapted to cooperative reporting; travel and entertainment represented a travel allocation for field staff or accounting managers working on producer payroll or sales/invoicing functions; the miscellaneous line item costs included outside testing, information technology services, membership and subscription fees, meeting expenses, and other outside services, all of which were appropriate procurement-related costs; the plant closing costs line was used to record corporate allocations for costs related to information technology, human resources, and government – once again, those appropriate procurement-related costs were recorded on an existing line because the forms had not been completely refined. In summary, in some cases the cooperatives were unsure which line to use for certain costs but the primary focus was that costs did get recorded in the relevant cost centers. Based on Mr. Hartland's testimony we find that costs were recorded correctly and appropriately and in the relevant cost centers.

Mr. Stonesifer testified that customer bids can be won and lost over a penny or less a gallon and that the cooperative procurement cost would impact dealers, especially those who sell to large food service and retail customers who have the option to buy packaged milk from out-of-state dealers.

Mr. Mong agreed with Mr. Stonesifer regarding how cooperative procurement differs from independent procurement. Like Mr. Stonesifer, Mr. Mong testified that he had not performed any inquiry or examination of the cooperatives' reported costs and thus did not know if the accounting was correct. Most importantly, Mr. Mong wondered whether all offsetting revenues had been correctly applied against cost center totals, as generally accepted accounting principles require the offsetting of costs with related revenues. According to Mr. Mong, based on the documents reviewed by Mr. Stonesifer and Carl Herbein, there was still no basis to conclude that the offset had been handled correctly.

Mr. Hartland testified that each of the cross-section cooperative financial statements had been audited by a reputable CPA firm and that he was comfortable relying on that information. He also testified that he worked with each cooperative to trace reported cost data submitted on Forms 60C back to each cooperative's general ledger detail, which is the same detail supporting their audited financial statements. Mr. Hartland testified that there was a significant amount of income offsetting some of the costs included in the PADC cross section. Mr. Hartland was confident that the accounting was correct, that expenses were categorized in the correct cost centers, and that all relevant income had been appropriately offset against related expenses. The Board finds Mr. Hartland's testimony to be credible and persuasive.

Mr. Mong testified that following the implementation of the OGO A-1004 interim additional charge dealers continued to pay premiums and handling charges above the interim additional charge. The Board finds that this should be given little weight for this decision. First, the interim additional charge was a compromise $0.20 per hundredweight, which is less than the cooperatives have requested. Second, while a handling charge sounds like it may be a charge for milk procurement services, a premium could be paid for any number of things based on the market for milk. We discuss this in more detail below as it impacts potential future considerations.

Chuck Turner is the President of Turner Dairy Farms ("Turner") in Penn Hills, Pennsylvania. Mr. Turner testified that Turner paid every dollar of premium it collects to dairy farmers and that the premium dollars are very important to the viability of those dairy farmers. Mr. Turner testified that fluid milk processors have been losing sales volume at what he characterized as an alarming rate – between two and four percent annually since 2010. Mr. Turner testified that cooperative services are not free, but that the Board should let the market determine the value of those services. Turner has an independent milk supply.

Betsy Albright is the Chief Financial Officer for Harrisburg Dairies ("Harrisburg"). Harrisburg is supplied by 32 independent dairy farms and also buys milk from cooperatives to fill the gap between what the independent dairy farms produce and what its market demands. Ms. Albright testified that Harrisburg opposed "guaranteeing [cooperatives] handling fees" because Harrisburg already paid for the services the cooperatives are providing and that cooperatives could negotiate for increased handling fees if necessary to match the level of service provided. Ms. Albright testified that cooperatives' businesses were not the same as Harrisburg's in paying farmers; it was her understanding that cooperatives were able to pay their farmers less than milk dealers could pay farmers. Ms. Albright also expected that if a cooperative procurement cost were mandated, Harrisburg would pay more for cooperative milk.

Cheryl Caruso is the Milk Accounting Director for Clover Farms Dairy ("Clover") in Reading, Pennsylvania. Clover buys milk from 158 independent producers and two cooperatives. Ms. Caruso testified that historically Clover has paid for the level of service it receives from cooperatives in the form of a handling charge and other negotiated premiums. Ms. Caruso testified that her understanding was that the cooperatives proposed the mandated cooperative procurement cost because they have costs for servicing the Class I market that they cannot always fully recover. Ms. Caruso testified she could not understand that, as cooperatives have sources of revenue available from serving the Class I market. She explained that Clover provides cooperatives with a valuable outlet for their milk and that by shipping to Clover the cooperatives are able to qualify more milk for pooling on Federal Order 1.

The Board recognizes that cooperatives and dealers have different requirements regarding paying dairy farmers. Those differences, including the concept of cooperative reblending, are not relevant to our decision. We are recognizing and requiring payment of the cooperative procurement cost because it is a cost for a service provided by the cooperatives when they sell milk to dealers. When that procurement service is provided in combination with the sale of milk to dealers, Section 807 of the Law requires cooperatives to be paid the value of the procurement service and requires dealers to pay the value of the procurement service.

Similarly, the Board recognizes that cooperatives and dealers have different operations and different cost structures. We also recognize that cooperatives and dealers assemble and procure milk differently. These differences are not relevant to our decision. We are recognizing and requiring payment of the cooperative procurement cost because it is a cost for a service provided by the cooperatives when they sell milk to dealers. To reiterate, we conclude section 807 of the Law requires cooperatives to be paid the value of the procurement service and requires dealers to pay the value of the procurement service.

As noted above, we gave little weight to the fact that dealers continued to pay premiums and handling charges to cooperatives following the adoption of OGO A-1004. The Board does find, however, that it is important to monitor dealer payments to cooperatives to ensure that the cooperative procurement cost works as we intend it to work. We believe that the presence of additional payments to cooperatives beyond the cooperative procurement cost may be an important consideration in the future.

<u>What are the cooperative procurement costs?</u>

13. Mr. Ackman testified as an expert in milk statistics. He opined that the cooperative cross section used by Mr. Stoner, Mr. Hartland, and Mr. Zalman was representative of cooperatives selling milk to Pennsylvania Class I milk dealers. That cross section

included DFA Division 46, DFA Division 47, Maryland and Virginia, Lanco, and Dairy Marketing Services. Mr. Ackman testified that 90.1% of the cooperative milk purchased by Pennsylvania Class I plants in 2016 was supplied by the cross section cooperatives. He testified that the plants which received the cross section member milk were located in all areas of Pennsylvania and sold packaged milk of all volumes in all areas of Pennsylvania. The Board finds that the cooperative cross section is representative of cooperatives doing business in Pennsylvania and supplying milk to Pennsylvania Class I processors.

14. Mr. Stoner, Mr. Hartland, and Mr. Zalman presented cooperative procurement cost evidence based on calendar year 2016 reporting done pursuant to 7 Pa. Code sec. 149.43 and 7 Pa. Code sec. 149.46. Mr. Stoner expressed confidence that the analysis for 2016 was reliable. Both Mr. Stoner and Mr. Hartland testified that the analysis was done based on information and accounting methodology in accordance with generally accepted accounting principles. Mr. Stoner opined that the analysis was accurate within a reasonable degree of professional certainty. Later in the hearing, Mr. Hartland presented cooperative procurement cost evidence based on calendar years 2017 and 2018. No other party presented cooperative procurement cost evidence based on calendar year 2017 or 2018 and the Board did not consider the 2017 and 2018 information for this order.

Mr. Hartland presented the 2016 cooperative procurement cost center costs using two weighting methodologies – one based on each of the cooperative cross section member's deliveries to Pennsylvania Class I plants and one based on each cross section member's PMMB Class I pounds.

Mr. Zalman independently analyzed the information in the RKL study. Mr. Zalman's analysis showed that the total pounds used in the RKL study for the Dispatch, Logistics, and Hauling cost center should be adjusted. Mr. Hartland agreed with the adjustment. Mr. Zalman also offered a different weighting methodology because the Class I volumes used by Mr. Hartland for the RKL study are not reported to the Board by each of the cooperatives separately. Since that information is not readily available, either of the methods presented by Mr. Hartland would require additional reporting and administrative overhead. Mr. Zalman recommended using all pounds when weighting each cross section member's contribution to cooperative procurement costs.

Mr. Stonesifer opined that the two weighting methods used in the RKL study were flawed and overstated costs. Mr. Stonesifer testified that the sales weighting method used to weight dealer costs during cost replacement hearings would help mitigate the inflated cross section costs. Sales weighting is based on the percentage of dealer sales into an area and is not based on dealers' respective percentage of cross section members. Mr. Stonesifer did not apply the sales weighting method to the cooperative costs.

Mr. Stoner testified that any of the weighting methodologies used by Mr. Zalman and by Mr. Hartland in the RKL study was reasonable and appropriate and in accordance with generally accepted accounting principles. He also testified that the sales weighting method recommended by Mr. Stonesifer was reasonable. Mr. Hartland testified that he applied the sales weighting method after reading Mr. Stonesifer's testimony and that it resulted in approximately the same average cost. Mr. Stoner testified that the specific weighting technique had minimal impact on the cross section cost per hundredweight.

The Board finds that the calendar year 2016 procurement cost evidence presented by Mr. Stoner, Mr. Hartland, and Mr. Zalman is accurate and was derived in accordance with generally accepted accounting principles. In so finding, we find credible and persuasive Mr. Stoner's testimony regarding the analysis and development of the evidence and find testimony to the contrary to be not persuasive. We also find credible and persuasive Mr. Stoner's and Mr. Hartland's responses to the various potential issues raised by Mr. Stonesifer which are addressed above. The Board also finds credible and persuasive Mr. Hartland's testimony that none of the costs or revenues from cooperative operations not related to milk procurement are, or should be, included in the RKL study.

The totality of the evidence and testimony demonstrates to the Board that the RKL study and Mr. Zalman's study were conducted appropriately and according to generally accepted accounting principles. The testimony regarding the nuts and bolts accounting and study methods and procedures provided by Mr. Stoner and Mr. Hartland is practically indistinguishable from testimony we have heard in the past from Board Staff and accountants presenting dealer cost information in the cost replacement hearing context.

The Board finds that the cross section weighting methodology recommended by Mr. Zalman should be used. Mr. Stoner testified that it would be appropriate to use that weighting methodology. In addition, it would not require additional or different reporting.

The Board finds that procurement costs based on calendar year 2016 information should be used. Calendar year 2016 information is the only evidence presented that was verified by Board Staff. The Board further finds that the cooperative procurement costs presented by Mr. Zalman based on calendar year 2016 information should be used for this order, as those costs were based on the weighting method that we find appropriate to use. Those costs are

Cost Center		**$/hundredweight**
Field Services		0.08337
Laboratory		0.04325
Producer Payroll		0.01479
Sales Invoicing		0.00742
Dispatch, Logistics, Hauling		0.08024
Calibration Services		0.00354
Producer Relations		0.02619
Customer Relations		0.00894
Total		0.2678

15. Based on the totality of the evidence, the Board finds that the section 149.46 cost center functions are performed by cooperatives to assemble and procure milk to sell to dealers. However, the Board finds that the Producer Relations cost center should not be included in the cooperative procurement cost. A cooperative's producer members own the cooperative. This is, therefore, essentially owners relating to themselves and we find that it would not be appropriate to include the Producer Relations cost center. Removing the Customer Relations cost center results in a cooperative procurement cost of $0.2416 per hundredweight.

Obligation – the amount of the cooperative procurement cost paid by dealers to cooperatives

16. Official General Order A-1004 and Board Bulletin 1570 provide a method to calculate the dealer obligation for paying the interim additional charge to cooperatives. Dealers are required to calculate the interim additional charge obligation using the same methodology used to calculate their over-order premium obligation.

Both Mr. Cooper and Mr. Zalman testified that the obligation should be calculated using the methodology adopted in OGO A-1004 and further explained in Board Bulletin 1570. There was no testimony to the contrary, either before OGO A-1004 was adopted or during the hearings held after OGO A-1004 was adopted. The post-OGO A-1004 hearings were held for the express purpose of considering the dealer obligation and dealer recovery.

Based on the testimony of Mr. Cooper and Mr. Zalman the Board finds that the dealer obligation to pay the cooperative procurement cost should continue to be calculated using the same methodology as used to calculate dealers' over-order premium obligation. This is the only method recommended during the hearing, it was adopted for the interim compromise order, has been in effect since January 1, 2020, and no evidence of another methodology has been offered.

Recovery of the cooperative procurement cost obligation in Board-established minimum wholesale prices and price sheet format

17. Official General Order A-1004 requires that the interim additional charge be included in the minimum wholesale and retail prices for all milk marketing areas in the same manner as the current over-order premium (OGO A-1004 Section II(c)). Mr. Cooper and Mr. DeSantis recommended a different method for dealer recovery of the cooperative procurement cost obligation. Mr. Stonesifer and Mr. Mong recommended maintaining "full" recovery. As explained below, the Board finds that the cooperative procurement cost obligation should be fully recovered as provided for in OGO A-1004.

As noted previously, the Board establishes minimum wholesale prices based on processing dealer costs pursuant to section 801's mandate to provide milk dealers a reasonable return on aggregate milk sales. It is important to distinguish two types of costs recovered through minimum wholesale prices: "plant" costs and mandated costs.

For purposes of this discussion, plant costs are those costs incurred by individual processing dealer plants and reported to the Board through the annual Milk Dealer Financial Statement (PMMB 60). Very broadly speaking, cross section dealers report their financial information annually and Board Staff audits that financial information. The audited financial information is used in each of the six Milk Marketing Areas to calculate the average cross section costs that are then used to build up minimum wholesale prices. These costs include standardization, pasteurization, bottling, and cold room, for instance (this is not an exhaustive list).

Board-established minimum wholesale prices provide for an average cost recovery of plant costs, because the cross-section average costs are used to establish each Area's minimum wholesale prices. If a plant's bottling cost, for instance, is higher than the cross section average, that plant won't recover its full bottling cost if it sells at the minimum wholesale price. Importantly, though, in this example the bottling cost is controllable by the plant – it can take steps to become more efficient and lower its bottling cost to or below the average (the plant could invest in a new piece of equipment, adjust the products it's bottling, or take other steps). And no plant's bottling cost is mandated by the Board.

Mandated costs are those costs processing dealers are required to pay, primarily the Board-mandated Class I over-order premium established via Board official general order (processing dealers also pay a $0.20 per hundredweight processor assessment under the Federal Fluid Milk Promotion Order.) The mandated over-order premium cost, while unique to each processor as explained below, is recovered in full in minimum wholesale prices, rather than as a cross section average cost.

The over-order premium obligation to all Pennsylvania producers is based on each plant's Class I utilization – the amount of Class I milk produced, processed, and sold in Pennsylvania by each individual plant. Since each plant has a unique Class I utilization each plant, then, has a unique over-order premium obligation. Similarly, the cooperative procurement cost obligation to Pennsylvania cooperatives is based on each plant's cooperative Class I utilization – the amount of cooperative Class I milk produced, processed, and sold in Pennsylvania by each individual plant. Each cooperative-supplied plant will have a unique cooperative procurement cost obligation.

The complete over-order premium cost, whether incurred or not, is incorporated into minimum wholesale prices. In simple terms, for over-order premium purposes a plant with 100% Pennsylvania Class I utilization has an obligation to its producers to pay the entire over-order premium and a plant with 50% Pennsylvania Class I utilization has an obligation to its producers to pay them 50% of the over-order premium. While it is true that a plant's over-order premium cost is controllable and can be lowered by decreasing the plant's Pennsylvania Class I utilization, primarily by buying less in-state milk and buying more out-of-state milk, since it is a Board-mandated cost the entire over-order premium amount is recovered through Board-established minimum wholesale prices.

With that background, we considered the cooperative procurement cost recovery options presented by the parties. Mr. Cooper recommended blending the obligation directly into dealer costs. The obligation would then be recovered by dealers in minimum wholesale prices in the manner that such plant costs as pasteurization, standardization, bottling, and cold room are recovered. These plant costs are updated annually through cost-replacement hearings.

Mr. DeSantis testified that when a cooperative sells milk to a dealer, there are actually two separate sales – the sale of the milk and the sale of the services associated with the milk sale. Mr. DeSantis characterized the sale of cooperative procurement services as a dealer-to-dealer transaction that must be regulated by the Board as prescribed by the Law in the same manner the Board regulates other dealer-to-dealer transactions. Mr. DeSantis opined that incorporating the obligation into the other costs on the PMMB 60 would be the simplest way to incorporate the obligation into minimum resale prices.

Plant costs that are recovered through the cost replacement process are reported on a calendar-year basis to the Board by May 1 of the following year. The annual financial statements (Form PMMB 60) are audited by Board Staff. The Board holds a hearing for each milk marketing area to consider these plant costs and to issue new price orders incorporating the costs. The Board's goal is to hold those hearings in the fall of the year following the year in which the costs are incurred, however that goal is not always attained. For instance, cost replacement hearings based on PMMB 60s for the 2019 calendar year will not be held until February and March 2021, with those 2019 costs finally serving as the basis for Board-established minimum prices beginning March and April 2021. The bottom line is when dealers recover costs through the cost replacement process there is considerable lag.

During the course of the hearing, Dairy Farmers of America ("DFA") bought four Pennsylvania milk processing plants from Dean Foods ("Dean"). Mr. Zalman calculated the obligation that would be owed by the cost replacement cross section dealers in 2017 had DFA owned the Dean plants in 2017. He then calculated the effect of providing for dealer recovery as a plant cost as recommended by Mr. Cooper and Mr. DeSantis. This analysis essentially demonstrates the effect of this recovery method going forward, since DFA now owns four Pennsylvania processing plants.

Mr. Zalman's analysis revealed

- six of the 19 cross section dealers would have a cooperative procurement cost obligation,
- incorporating the obligation into dealer costs as recommended by Mr. Cooper and Mr. DeSantis would result in none of the six dealers with an obligation recovering the full amount of the obligation in minimum wholesale prices,
- the remaining cross section dealers would have no obligation but would nonetheless "recover" an amount in minimum wholesale prices attributable to the cooperative procurement cost obligation.

Mr. Stonesifer testified that the cost of the "cooperative-only premium" should be fully recovered in the minimum wholesale price. He explained that the minimum wholesale cost build up is based on weighted averages so dealers with costs above the average will not achieve full cost recovery, which incentivizes them to become at least as efficient as the averages. In contrast, there is no mechanism for dealers paying the cooperative procurement cost to become more efficient; dealers would not be able to reduce a Board-mandated cooperative procurement cost because it is a mandate, unless they buy cooperative milk from out of state or use independent supplies. Mr. Stonesifer also testified that the vast majority of cross-section milk dealers, for the period 2009-2016, experienced a rate of return below the statutorily-required 2.5%. He testified that fluid milk plants are suffering and cannot sustain any level of additional losses forced upon them through the diluted recovery of a mandated cooperative procurement cost.

Mr. Mong testified that the if the Board adopts a cooperative procurement cost obligation, the only rational recovery method would be to provide for a full pass through in the minimum resale price calculations. Mr. Mong testified that the only method that allows processors with a cooperative milk supply to recover the cost of a cooperative procurement cost obligation is to include the full amount in minimum wholesale prices and that any other method results in dilution of the recovery. He testified that processors cannot maintain the rate of return required in the Law if minimum wholesale prices do not reflect the full cost of the obligation and opined that the only way to maintain financial stability of cooperative-supplied processors was to provide for full recovery.

The Board finds that the cooperative procurement cost should be recovered by building the entire cost into minimum wholesale prices. We are requiring dealers to incur the cooperative procurement cost obligation just as we require them to incur the over-order premium obligation, so the Board finds and concludes, of the options presented to us, that it is appropriate to provide for a similar recovery in Board-established minimum resale prices. As noted previously, though, this method will result in some dealers recovering more in minimum wholesale prices than they will be required to pay. We would prefer a method that better matches the amount paid to cooperatives by dealers to the amount recovered by dealers in minimum wholesale prices, but did not receive that type of proposal during the hearing.

In finding that full recovery is the better option of the ones presented, we find credible and persuasive Mr. Stonesifer's and Mr. Mong's testimony regarding the impact on dealer rate of return and financial stability if full recovery of the obligation is not provided. We also find credible and persuasive Mr. Zalman's analysis of the effect of incorporating recovery of the obligation into resale prices as a plant cost.

Having found that the cooperative procurement cost should be recovered in the same manner as the over-order premium, we must decide how that recovery should be indicated on monthly price sheets. The Board believes that the most efficient and transparent way is to adopt most of the price sheet recommendations made by Board Staff in conjunction with OGO A-1004, as presented in Attachments 1 and 2 to this order.

We did not adopt Staff's recommendations when we issued OGO A-1004 because that order memorialized a compromise entered into by the interested parties. Despite Staff's contrary recommendation, that compromise included the price sheet format adopted with OGO A-1004.

There being no agreement now on any particular price sheet format for this permanent order, the Board finds that the format recommended by Staff should be adopted with some modification. First, we have found that the cooperative procurement cost is a cost, not a premium, so any labels referring to "premium" in the original Staff recommendation should be changed. That being said, the cooperative procurement cost applies only to milk purchased from cooperatives and we find therefore that the most direct way to indicate the additional cost on the monthly producer price sheet is through the skim and butterfat values for milk purchased from cooperatives. Attachments 1 and 2 are provided as an example and will be adopted to include the cooperative procurement cost of $0.2416 per hundredweight established by this order.

18. The cooperative procurement cost is not a "cooperative-only premium." It is a cost incurred by cooperatives to assemble and supply milk to Pennsylvania dealers.

We have required in this order that the cooperative procurement cost obligation and recovery be treated in the same manner as the over-order premium. We have done this not because the cooperative procurement cost is a premium, but because this is the most efficient and transparent manner to treat the cost.

Establishing a uniform cost based on a cross section of cooperatives allows the Board to provide for full and near real-time recovery by dealers of their obligation to cooperatives. If the cooperative procurement cost were paid as a cooperative-specific cost by each dealer to each cooperative, those costs would be treated the same as other dealer plant costs. They would be reported annually via PMMB 60s and updated and recovered through the annual cost replacement hearing process. This would delay recovery, as noted above. It would also provide for an average recovery, which the Board believes would lead to added financial strain for dealers.

CONCLUSIONS OF LAW

1. The hearing was held pursuant to authority granted to the Board in section 801 of the Milk Marketing Law (Law), 31 P.S. § 700j-801.

2. The hearing was held following adequate notice, and all interested persons were given a reasonable opportunity to be heard.

3. In establishing the attached order, the Board has considered the entire record and has concluded that the adoption of this order is supported by a preponderance of the evidence, substantial competent evidence, and is reasonable and appropriate under section 801 of the Law, subject to any revisions or amendments the Board may make in the manner set forth in the Law.

PENNSYLVANIA MILK MARKETING BOARD

Robert N. Barley, Chairman

James A. Van Blarcom, Member

Date: December 2, 2020

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