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II. BACKGROUND

A. The Dairy Industry

Cheese is manufactured from milk in hundreds of cheese manufacturing plants located across the country. Once manufactured, cheese usually is sold in bulk to a variety of potential outlets. Potential buyers include companies which cut and package cheese for retail distribution, companies which manufacture process cheese products, food manufacturers that use cheese as an ingredient in their own products, and wholesale and food service cheese distributors. A cheese manufacturer also can sell cheese to the federal government under various programs.

The contractual arrangements for the sale of cheese vary. Kraft's practice, in order to control for the desired high quality of Kraft cheese, is to obtain cheese under long-term arrangements with particular manufacturers. Under these arrangements, the cheese manufacturers typically agree to supply Kraft with the entire output of a plant. Cheese also is sold in bulk in spot transactions and can be sold on the NCE.

Recent years have witnessed significant changes in the dairy industry. Prior to 1988, government price support levels for cheese generally were set above "market clearing levels," *i.e.* a level reflecting industry supply and actual demand. As a result, farmers often overproduced milk and cheese manufacturers overproduced cheese. The resulting surpluses did not adversely affect dairy farmers or cheese producers because the surpluses were absorbed by the government at the support price.

As the government gradually lowered price support levels in the 1980s, market prices for cheese eventually rose above the price support levels. At that point, market supply and demand began to determine price. Not surprisingly, as Figure 1 suggests, market prices became more volatile as a result. Figure 1 illustrates price movements in recent years along with the primary market forces that in each instance caused a change in the directional trend of market prices. As can be seen, cheese prices not only reflect industry conditions and international forces, but also the vagaries of the weather and the state of the economy.

To a dairy farmer accustomed to government stabilized prices, these sudden fluctuations may have seemed dramatic. But cheese price volatility during the period covered by the Report was not unusual compared to other agricultural commodities. Figure 2 compares cheese price volatility to that of other commodities, showing that cheese prices have experienced relatively moderate volatility in comparison.

B. How the National Cheese Exchange Works.

The NCE is a cash market. The NCE's members constitute a diverse group of buyers and sellers, representing all segments of the industry. Members include both small and large companies, farmer cooperatives, and brokers. All interests in the cheese industry are represented on the Exchange.

The NCE trades for about one-half hour every Friday morning. Trading ends when the NCE presiding officer determines that the market has come to rest for the day. Sellers of cheese on the NCE must make delivery of carloads of cheese within a week after every trading session and buyers must make payment promptly thereafter.

Under NCE rules, the cheese sold on the Exchange is "current" cheddar cheese, consisting of 4 to 30 day old 40-pound blocks and barrels, along with 10 to 40 day old 640-pound blocks. Barrel cheese is used almost exclusively to make processed cheese products, while blocks are primarily used for cut, sliced, and shredded cheeses along with processed cheese products. The cheese is sold in approximately 40,000 pound carloads. The NCE sets specific tolerances for the moisture content, grade, packaging, origin, and delivery location for the cheese traded.

Like trades on futures exchanges, trading on the NCE is conducted in an "open outcry," trading pit-style environment. Buyers and sellers verbally call out their bids and offers. These bids and offers are then recorded by Exchange staff and by a representative from the Department of Agriculture, who attends every trading session. When a seller "fills a bid" or a buyer "covers an offer" a transaction is considered to be executed under Exchange rules.

As a matter of custom and practice, all bids are first made at the last price at which a NCE trade was executed. As a matter of market logic, only when *no* other member has chosen to sell at that price would a bidder increase its bid above the current price. Again, custom dictates that a bidder do so only in one-quarter cent increments. Likewise, when a member offers to sell, it offers first at the current price. Only when no other member agrees to buy at that price can a member offer to sell at a lower price, again moving only in one-quarter cent increments. If a higher bid or lower offer goes unfilled or uncovered, the member may continue to bid or offer at quarter cent increments (higher for bids and lower for offers) until another member is attracted to the proposed transaction and either fills the bid or covers the offer.

Since the NCE itself does not publish quotes, the referenced closing NCE opinion is the one published by the U.S. Department of Agriculture (USDA) and reported in *The Cheese Reporter*. By custom, the methodology used by the USDA is that an unfilled bid or an uncovered offer is the closing opinion if, respectively, an uncovered offer at the price below the last sale exists or if an unfilled bid exists at a price above the last sale. Otherwise, the price of the last sale is used. The rationale for this methodology is straightforward. An uncovered offer is an offer to sell at too high a price; if the offer had not been too high, another trader would have purchased the cheese at that price. If there is an uncovered offer below the last price at which a trade was consummated on the Exchange, that means market prices must have fallen since the last trade and the market price must be at least as low as the uncovered offer. In this circumstance, the uncovered offer best approximates the market price for cheese traded on the NCE. A similar logic applies on the reverse side to unfilled bids.

In recent years, as Figure 3 shows, trading on the NCE has tripled. As a result, Kraft, which the Report cites as the major seller on the NCE, has seen its share of sales on the NCE fall to nearly 30 percent on an annual basis. Notably, Kraft's share of sales has not fallen because it has traded less. Kraft's annual sales have ranged roughly between 200 and 400 carloads throughout this period. Instead, Kraft's share of sales has fallen because others have sold more, demonstrating their desire to participate on and their confidence in the NCE.[2]

The NCE is not the only place cheese is bought and sold; indeed, the vast majority of cheese sales take place off-the-NCE. Two other kinds of transactions are most common: (1) long-term agreements and (2) off-Exchange spot sales. In long-term agreements, a cheese manufacturer agrees to supply cheese under long-term arrangements with particular buyers. Under these agreements, price often is determined by reference to the closing NCE opinion. This practice of referencing the

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2. On this point, Professors Mueller and Marion acknowledge the relative drop in Kraft's trading and then draw a negative inference:

> Since our study did not go beyond 1993, we hesitate to speculate concerning the significance of Kraft's decreased share of trading activity beginning in 1994, and its complete cessation of trading during October 1995 through March 15, 1996. However, based on studies of other industries, it is not uncommon for a business to change its practices during and after it is being investigated.

Memorandum from Willard F. Mueller and Bruce W. Marion to Dairy Industry and Other Interested Parties, at 7 (March 27, 1996). Here are the facts. The investigation began in February 1992. Since the investigation began, Kraft's annual volume of trading has remained about at the same level (actually increasing slightly). In 1995, Kraft sold 356 carloads of cheese on the NCE. In other words, Kraft hardly ceased trading once the investigation began. Kraft did not sell a carload of cheese from August 1995 until recently, but that is because the cheese market has been tight recently, and Kraft has not had any excess cheese to sell.

NCE as a basis for pricing long-term agreements is further evidence of industry confidence in the NCE. Although the Professors attempt to call into question the NCE, no alternative reference price has been offered by anyone to replace the price discovered on the NCE.[3]

Cheese sales also occur in spot transactions. Although both spot transactions and trades on the NCE constitute discrete transactions, there are important differences between them. *First*, the "spot market" is not a centralized market. Rather, it consists of companies sometimes calling each other on the telephone to discuss buying and selling cheese; any resulting transaction is considered a spot transaction.[4] *Second*, in spot transactions, as with long-term agreements, a buyer can specify many parameters affecting the origins and delivery arrangements for the cheese acquired.

III. THE NATIONAL CHEESE EXCHANGE WORKS

In early 1992, the Wisconsin Department of Agriculture, Trade and Consumer Protection initiated an investigation of trading on the National Cheese Exchange. The agency delegated the investigation to two professors at the University of Wisconsin School of Agriculture, Professors William Mueller and Bruce Marion. Throughout the entire investigation, which lasted nearly four years, Kraft cooperated fully. Kraft submitted approximately 24,000 pages of business records in

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3. Professors Marion and Mueller assert that the fact that the NCE opinion is widely used by the industry as a reference price does not mean that the NCE price accurately reflects supply and demand, because companies may still reference the NCE even though it is manipulated. *Id.* at 2. This bald assertion is unsupported by any evidence from any industry source. The Professors provide no explanation for why NCE participants would not complain about and cure any manipulation. The Professors also argue that no other reference price is "available." *Id.* But the futures market and Wisconsin Assembly Point prices are available. If the industry participants did not have confidence in the NCE opinion as a reference price, they could more actively utilize these alternatives.

4. The term "spot market" also is a misnomer in the sense that it suggests the spot market is a separate economic market for trading cheese. Sales on the spot market are economically related to sales on the NCE and under long-term arrangements. All these "markets" are simply different avenues under which cheese is bought and sold.

response to a series of document requests, including six supplemental requests for information. Kraft personnel also spent countless hours gathering and providing information in response to questions posed along with answering questions in interviews and telephone conferences.

Beginning more than a year-and-half ago, Kraft asked repeatedly for an opportunity to hear the Professors' claims so that Kraft could respond to them. It is difficult to understand why the Professors would want to issue a "report" without hearing a full presentation of all sides of the case. But, despite these repeated requests for the Professors to identify any specific claim of wrongdoing of any type, Kraft did *not* learn of *any* allegations against it until the public release of the Report on March 18 of this year.

The Report itself presents *no* basis for any further investigation. The Report does not actually allege anything improper occurred on the NCE, but rather refers to what "appears to be" or what "may have" happened. Notably, the Report ultimately concludes that it cannot "determine whether the *apparent* trading against interest on the NCE meets the standards of legal proof required for a finding of price manipulation under the Federal or Wisconsin antitrust and unfair competition standards."[5] Such tentative guesswork offers no meaningful foundation for the broad policy conclusions proposed in the Report.

Indeed, any allegation of manipulation against Kraft must address the following fact: *Seventy percent of Kraft's sales from 1988 to 1992 were agreements to sell cheese at the price bid by another member.*[6] Kraft was not "establishing" or "moving" prices. Rather it was selling cheese for what another NCE member already thought -- and already stated -- it was worth before Kraft had acted. This is *not* market manipulation.

5. Report, at VII-36 (emphasis added).

6. This number was derived from reviewing the summary of trading activities published by the U.S. Department of Agriculture.

A. The Cheese Industry Is Competitive.

To manipulate a market, a party must have market power. Cheese manufacturing, however, is not a concentrated market. As the Professors admit, the top four firms hold only a 29 percent share of the cheese manufacturing market.[7] Nor is the cheese industry concentrated on the buying side of the market, as each of the different outlets for cheese includes many buyers. All the evidence suggests that competition reigns in the cheese industry.

The Professors attempt to sidestep this conclusion by looking at trading of cheese on the NCE as though it were isolated from the influences of supply and demand in the cheese and dairy industries. That assumption is the premise for the Professor's conclusion that trading on the NCE was "very highly concentrated" which, in turn, is the basis for many of the Report's erroneous conclusions.[8] The NCE cannot be analyzed in isolation.

The members of the NCE are the *same* buyers and sellers of cheese that operate in the cheese industry as a whole. They are the same companies that regularly trade with each other *off* the NCE, sometimes pursuant to long-term agreements and sometimes in spot transactions. *No* industry participant has been excluded from membership or trading on the Exchange. Rather, all the principal participants in the cheese industry are free to trade on the NCE, and most do. In fact, about 85 percent of the cheese industry's manufacturing capacity is represented on the NCE. It defies economic logic and common sense to analyze the interactions of these same industry members on the NCE in isolation from their interactions in the industry as a whole, especially given the link in prices between *on* and *off* the NCE transactions.

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7. Report, at II-29.

8. Report, at III-26.

The Professors rationalize viewing the NCE as an isolated market because they claim it is "shielded by substantial entry barriers."[9] Those "barriers" are pure fiction; there are no "entry barriers." Any industry participant can trade on the NCE. Membership is open to any company that pays a small fee ($600 per year) and can deliver or take delivery of a carload of cheese. Moreover, massive amounts of cheese are available to buy and sell on the NCE should any member decide to do so.[10] As suggested by the threefold increase in trading in recent years, the NCE is an easy market to enter and exit.

Moreover, even if there were somehow "substantial entry barriers" to trading on the NCE, that would not justify treating the NCE as an isolated market. Under standard antitrust principles, a market is not defined as a separate product market as long as buyers would react to a price increase by substituting supply from another source.[11] In this instance, should prices rise on the NCE relative to the spot market, buyers would immediately try to obtain cheese supplies at lower prices off the Exchange. The converse is true from the seller's perspective should prices on the NCE fall below market prices. Entry barriers are irrelevant in this analysis. Even a patented product (*i.e.*, a product with a legally protected barrier to entry) would not constitute a separate market as long as buyers

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9. Report, at VII-32.

10. The Professors nevertheless state that entry barriers exist because Kraft has "strategic competitive advantages," citing "contestable markets" theory as the economic basis for the conclusion. *Id.* (citing William Baumol, John Panzar, and Robert Willig, Contestable Markets and the Theory of Industry Structure (1982)). The source of entry barriers under contestable markets theory, however, is investment in nonsalvageable costs. Industry participants need not invest in such costs to participate on the NCE.

11. DOJ and FTC Horizontal Merger Guidelines, § 1.11 (1992) ("If the alternatives were, in the aggregate, sufficiently attractive at their existing terms of sale, an attempt to raise prices would result in a reduction of sales large enough that the price increase would not prove profitable, and the tentatively identified product group would prove to be too narrow.").

can substitute other products. The existence of supply and demand side substitutability makes any claim that the NCE is a separate market inconsistent with antitrust principles and economic logic.

Even assuming the NCE is an isolated market, the Professors wrongly assert that there was "exceptionally high seller and buyer concentration during 1988-1993."[12] The Professors measure concentration by the Herfindahl-Hirschman Index[13] based on *actual* NCE trades.[14] The proper way, however, to measure concentration in this "market" would be on the basis of the various members' *capacity* to trade.[15] Each member is equally able to trade the lots traded on the NCE, so the "appropriate" Herfindahl-Hirschman Index for the NCE is about 500 since the 35-40 members are roughly equally divided between buyers and sellers. This is a very low level of concentration; anything less than an HHI of 1000 is considered a "safe harbor," raising no market power concerns. The fact that Kraft's share of the market has fallen since the late 1980s and early 1990s, due solely to increased activity by other traders, underscores the importance of focusing on capacity, not actual sales. Concentration is only appropriately measured by capacity to trade and should not change simply because others choose not to trade.

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12. Report, at III-29.

13. The Herfindahl-Hirschman Index ("HHI") is the aid used by the Justice Department and the FTC to measure market concentration. *See* DOJ and FTC Horizontal Merger Guidelines, § 1.5 (1992). The HHI is calculated by summing the squares of the individual shares of all the market participants. For example, a market consisting of four firms with market shares of 30 percent, 30 percent, 20 percent, and 20 percent has an HHI of 2600 ($30^2 + 30^2 + 20^2 + 20^2 = 2600$). The HHI ranges from 10,000 (in a case of pure monopoly) to a number approaching zero (in a case of atomistic competition). *Id.* n.17.

14. Report, at III-27 and III-28.

15. The Merger Guidelines state that "[p]hysical capacity or reserves generally will be used if it is these measures that most effectively distinguish firms." DOJ and FTC Horizontal Merger Guidelines, § 1.41 (1992). The Guidelines then note that "[w]here all firms have, on a forward-looking basis, an equal likelihood of securing sales, the Agency will assign firms equal shares." *Id.* n.15.

B. NCE Traders Are Sophisticated Businesses With Substantial Resources.

The Professors characterize Kraft as the principal participant on the "seller/trader" side of the NCE during the relevant period.[16] Kraft, along with Borden and Alpine Lace, all marketers of branded cheese, accounted together for 82 percent of all the cheese sold on the NCE between 1988 and 1993.[17] Five other firms -- ConAgra/Beatrice and Schreiber (large private labelers of cheese) and AMPI, Mid-America and Land O'Lakes (all large dairy cooperatives) -- serve as the principal "buyer/traders" on the Exchange.

These five "buyer/trader" firms accounted for 89 percent of all cheese purchased on the Exchange in this time period.[18] Each of these firms has annual revenues in excess of $1 billion. Each typically trades -- buys or sells -- off the Exchange many times the total amount of cheese traded on the NCE at all times. All are large firms with enough business sophistication to recognize and act in their own self-interest and, as the Report recognizes, their interests are generally different than Kraft's.

The Professors claim, however, that *even if* other traders believed they were injured by Kraft's conduct on the NCE, they "often seemed to defer to Kraft's actions, perhaps because they feared the consequences of not doing so."[19] The Professor's suggestion of "fear" is sheer speculation, again devoid of any attempt at evidentiary foundation. The Professors assert that these sophisticated, financially resourceful businesses passively accept Kraft's conduct because they

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16. Report, at V-4.

17. *Id.* Kraft accounted for 74 percent of the total during this period. *Id.* But, as discussed earlier, Kraft's share has recently fallen to nearly 30 percent.

18. *Id.*

19. Report, at VI-54.

believe that Kraft has "superior knowledge of overall industry conditions."[20] But, other than understanding its own inventory situation, Kraft relies on public information for knowledge of industry conditions and, therefore, could not have "superior knowledge." Kraft surely does not have more information than the dairy cooperatives and cheese manufacturers about the availability of milk and cheese at any point in time. Similarly, information on the state of demand in the end-use markets for cheese (like retail sales in supermarkets) is available generally from trade publications and market research firms like Nielsen and Information Resources Inc.

However, if the assertion that "Kraft knows better" is true, it clearly contradicts the inference that Kraft's NCE trading injures competition. On the contrary, by trading on the Exchange, Kraft reveals its "superior" information to its suppliers and its rivals. Simply by observing Kraft's trades, other traders obtain some of Kraft's "superior" information and can take this information into account in their own decision making. Therefore, by trading on the NCE, Kraft contributes to the quantity and quality of information underlying the resulting price.[21] Thus, under the Professors' own argument, Kraft's trades on the NCE are a good thing, enhancing competition and price discovery.

The Professors also assert that traders contemplating buying cheese at the low prices allegedly offered by Kraft on the NCE "may believe such a strategy involves greater risk than going along with Kraft."[22] This makes no sense. If Kraft did what the Professors allege and offered cheese on the NCE at an artificially low price, a buyer would have everything to gain and nothing to lose by purchasing the bargain cheese. *First*, it would acquire cheese at an artificially low price which

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20. *Id.*

21. This point was made in a seminal article in the economics literature. *See* Sanford J. Grossman and Joseph E. Stiglitz, "On the Impossibility of Informationally Efficient Markets," 70 Amer. Econ. Rev. 393-407 (June 1980).

22. Report, at VII-26 and 27.

it could then resell for a profit. *Second*, by the Professors' own logic, "buyer/traders" would lose money off-the-Exchange if prices were artificially lowered on the NCE, therefore giving them every incentive to purchase such low-priced cheese on the NCE. Buying cheese at artificially low prices in these alleged circumstances would be a "win-win" proposition for a "buyer/trader." While the Professors would have you believe these companies are mindless, timid puppets afraid to act in their best interest, in fact they are sophisticated companies more than able to recognize bargain cheese if it becomes available.

C. The NCE Accurately Reflects Industry Supply and Demand.

No universally accepted economic definition exists of a "thin" market. The Professors state that they use the term "thin market" to mean one in which a small proportion of "trading relative to the total transactions that are priced off the market" occur.[23] In this sense, the term "thin market" is purely descriptive, "implying nothing regarding a market's pricing or operational efficiency."[24] However, the Professors then equate this with a very different definition of a "thin" market: "A market is thin if the reservation supply and demand values of only a small proportion of all traders are represented in the market."[25]

These two definitions are *very* different, because the first implies only a small volume of trading, while the second implies that those trades that do occur ***are not representative*** of industry supply and demand. The latter definition assumes that only a small percentage of total trades occur in the market, because only a small percentage *is available to be traded* there; in economics this

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23. Report, at III-10.

24. *Id.*

25. *Id.* n.23 (citing Ronald Raikes, Thin Markets: Some Causes, Consequences, and Remedies *in* Marvin I. Hayenga (ed.), Pricing Problems in the Food Industry (With Emphasis on Thin Markets), University of Wisconsin Monograph 7, at 132 (February 1979)).

means the market is "illiquid." Illiquid markets are of concern to economists because their illiquidity makes them less able to deal with unexpected shifts in supply or demand. Thus, the price that arises from transactions in an illiquid market may not accurately reflect the underlying conditions of industry supply and demand.

The Professors suggest that the NCE is "thin" because the majority of cheese manufactured is "committed supply" under long-term arrangements, leaving only a limited amount of cheese to trade in what they characterize as a "residual market."[26] Their logic is that this "residual market" is easily shocked by shifts in supply and demand and, therefore, is an unreliable pricing mechanism. This argument assumes the NCE (and the spot market) is not connected with the overall cheese market. But just because cheese is sold under a long-term supply arrangement does not mean that the buyer, after acquiring the cheese, cannot make it available for sale on the NCE. Indeed, as the Report elaborates at great length, sales of cheese on the NCE often consist of cheese originally acquired under a long-term supply arrangement. Conversely, just because a manufacturer commits to supply cheese under a long-term arrangement does not mean it cannot acquire cheese on the NCE if it is priced attractively. Industry supply and demand is linked across all the avenues of buying and selling cheese, including the spot market, long-term supply arrangements, and the NCE.

Furthermore, as the Professors concede, a market like the NCE, in which only a small fraction of total product is traded, will *not* perform poorly if there is sufficient volume "waiting in the wings."[27] The Report's own estimates clearly establish that there is a large volume of cheese "waiting in the wings" of the NCE. The Professors' estimates show that massive quantities of uncommitted cheese are traded in spot transactions off-the-NCE. Indeed, the Report estimates that

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26. Report, at III-13.

27. Report, at III-13 (citing Marvin L. Hayenga, Summary 11-12 *in* Pricing Problems in the Food Industry (With Emphasis on Thin Markets) (Marvin L. Hayenga ed. 1979)).

trades on the NCE amount to less than one-tenth of the bulk cheese "waiting in the wings" and sold in spot transactions during 1988-1993.[28] The large quantity of cheese *available* to be traded on the NCE facilitates the exchange's ability to provide price discovery that accurately reflects underlying industry forces of supply and demand.

D. The *True* Significance Of NCE Trading Volumes.

The relatively small volume of trading on the NCE actually confirms the reliability of NCE prices as a reference point. If any company had tried to manipulate prices on the NCE, trading volumes would have been much higher.

A simple example illustrates this point. Assume that adverse weather conditions unexpectedly reduce the amount of milk available to be converted into cheese. Cheese suppliers will have less cheese available to supply processors than was anticipated.[29] This unexpected reduction in the supply of cheese will create pressures for price to rise, as processors seek more cheese than is forthcoming under their supply agreements in order to fill the unchanged demand for cheese.

Now assume, as the Professors allege occurred on some occasions,[30] that Kraft decided to offer a sufficient amount of cheese on the NCE to keep price unchanged. Kraft would be offering cheese at a bargain price both to other cheese processors frantically searching for cheese and to cheese suppliers anxious to increase the amount they can provide. Indeed, in order to keep the price unchanged, Kraft would have to be willing to supply excess cheese on the NCE at a bargain price until the *entire excess demand* of the rest of the industry was filled.

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28. Report, at III-13.

29. Kraft's agreements with most of its cheese suppliers, like many in the industry, do not specify a certain quantity to be supplied. Instead, they commit Kraft to take an entire plant's output. In the face of adverse weather, that output will be lower than anticipated.

30. *See, e.g.*, Report, at VI-8 through VI-14 (alleging that Kraft's "persistent and largely solitary selling" in 1991 kept "prices virtually unchanged" over several weeks).

What would be the implications of such a strategy? *First*, enormous quantities of cheese would flow on the NCE, as all other traders capitalized on Kraft's attempts to hold down the price of cheese. And *second*, in the face of reduced supplies from its own suppliers, Kraft would have to further drastically reduce the amount of cheese it had available to meet its own demand.[31] Such conduct would defy business logic and surely would be reflected in Kraft's documents *if* it were occurring. It was *not*, as the record evidence demonstrates unequivocally.

E. Kraft's NCE Trading Made Good Business Sense.

1. Kraft's "Switch" From Net Buyer to Net Seller.

From 1984 to 1986, Kraft sold little cheese on the NCE.[32] Kraft did not need to sell cheese on the NCE in order to manage its supplies, because the government absorbed all excess cheese at the government support price. Then, as it does today, Kraft assured itself a steady supply of quality cheese through long-term relationships for the output of its suppliers. Then, unlike today, it could simply divert any excess cheese to the government, either by selling it to the government itself or by directing its suppliers to sell some of the cheese they had committed to supply to Kraft to the government instead.

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31. This description understates the problem Kraft would face in this scenario. As consumers bid up the retail price of cheese in the face of the reduced supply, Kraft's rivals' excess demand at current prices would increase, forcing Kraft to cut back its own purchases and sales of cheese even more.

32. Contrary to the Report's assertion that Kraft's natural interest as a buyer on the NCE was reflected in its NCE trades prior to 1987, Kraft was a net buyer on the Exchange only in the four years 1983 to 1986, a period of very significant industry-wide supply reductions due to the government's Milk Diversion Program and Dairy Termination Program. In the three-year period 1980 to 1982, Kraft was a net seller on the NCE just as it has been since 1987.

By the late 1980s, the government had reduced dairy price supports to such an extent that the market price of cheese exceeded the support price.[33] Without the government's price support net, dairy farmers and cheese manufacturers no longer routinely produced milk and cheese vastly in excess of industry demand. Thus, Kraft found itself facing the possibility of -- at times -- running short of cheese. The cost to Kraft of running short of cheese and not having enough product to fill consumer demand far outweighed its cost of selling any surplus cheese should consumer demand forecasts prove overly optimistic or supply forecasts prove too low.

Therefore, Kraft chose to increase its committed supply of current manufacturing cheese in response to the change in the supply environment, in order to assure that it would not run short of cheese. For example, in years when Kraft became concerned about an adequate supply of cheese in the fall (generally a period of low production but high demand), Kraft would commit to take the output of additional plants early in the year, when supply is abundant. As a result, in some years, Kraft found itself with excess cheese in the months when supply was abundant, but demand was low, and during these times it would frequently sell cheese in spot transactions and on the NCE.

The Professors dispute this explanation. They mistakenly argue that, because Kraft's inventories of *total* raw material cheese were lower from 1988 to 1992 than they had been previously, Kraft did not increase its inventories in response to the change in price support levels.[34] The Professors are mixing apples with oranges, so to speak. In fact, Kraft's available supplies of *current* manufacturing cheddar, the type of cheese sold on the NCE, increased by almost 20 percent in 1990-1991 over the 1986-1987 level. Kraft's *total* cheese inventory did decline, but the decline

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33. For a six-month period in late 1990 to early 1991, market prices did fall to support prices because of strong milk and cheese production combined with the recession in the general economy, which moderated consumption.

34. *See* Report, at V-39.

occurred solely in *aged* cheese varieties, which represent the bulk of Kraft's total cheese inventories and are not sold on the NCE. Inventories of these types of cheese decreased in 1988-1992 principally because Kraft developed proprietary methods to reduce its inventories of aged cheese.

It is in Kraft's business interest to be a net seller on the NCE, not a net buyer as the Professors assert. Kraft's selling on the NCE reflects its sensible production, procurement and inventory management practices. These are designed to support Kraft's broad business strategy of maintaining sufficient supplies to ensure that it is always able to meet consumer demand for Kraft's cheese products.

2. Kraft's Sales of Excess Cheese

During the period covered by the Report, when Kraft found that it had or expected to have excess cheese, it took various actions to reduce its inventory position. Kraft asked its suppliers to reduce cheese production or find other outlets for some of the cheese they had committed to sell to Kraft. Kraft also sold excess cheese in spot transactions to other industry participants, to the government bid and support programs, or on the NCE. In 1991, for example, when it became clear that demand for Kraft's cheese products was lower than had been projected, Kraft found itself with substantial quantities of excess cheese. To address that excess inventory, Kraft sold both on and off the Exchange while also reducing its receipts from its suppliers.

The Professors mistakenly conclude that Kraft sold on the NCE when it was short of cheese, not long.[35] Kraft provided voluminous documents in the investigation regarding its inventory position. When it provided these documents in 1992, in a sworn written response to a Demand For Sworn Statements and Production of Documents, Kraft identified the documents that were utilized

35. *See, e.g.*, Report, at VI-14 ("[T]he available evidence does not support the hypothesis that Kraft's heavy selling on the NCE during February-March 1990 was dictated by excess Kraft or industry inventories.").

by its personnel in making decisions on pricing, sales, and purchases of bulk commodity cheese. These documents verify that Kraft sold on the NCE when it had surplus cheese. The Professors ignore these documents, focusing instead on Kraft's monthly status updates, which are brief summary postings that state, *after-the-fact*, that Kraft's surplus cheese was under control, precisely *because* Kraft had been able to sell its surplus cheese in spot sales or on the NCE. The Professors' "no surplus" conclusion is based on a complete misreading of the documentary record.[36]

F. Kraft Did Not "Trade Against Interest."

The Professors assert that -- *on average* -- Kraft lost money on the sales it made on the NCE but made money on sales it made in the spot market.[37] From this fact, the Professors assert that "[t]here is evidence that Kraft chose to sell cheese on the Exchange at a loss when it could have more profitably made the sale elsewhere."[38] The Professors characterize "[s]uch conduct" as constituting "*trading against interest*, the practice of purposely not selling at a profit-maximizing price."[39]

Contrary to the Professors' assertions, the facts show that Kraft never traded against interest. The Professors' argument is premised on the idea that manipulation can be inferred from whether

36. The Professors' conclusion also arises from what appears to be a deliberate misuse of Kraft's inventory data. In 1991, when Kraft had excess cheese because it had substantially miscalculated demand, it sold heavily both on and off the NCE. Kraft's documents, however, show that its actual inventories of cheese throughout much of 1991 were below its *planned* inventories. On the basis of these documents, the Report appears to conclude that Kraft was short of cheese in 1991 and, therefore, that its sales on the NCE were not consistent with its inventory and business plans. However, "planned inventories" greatly exceeded the inventory levels actually needed to support declining sales through most of 1991, as evidenced by Kraft's declining internal usage and its large off-the-Exchange sales -- sales that were many times larger than its sales on the NCE.

37. Report, at VI-56.

38. *Id.*

39. *Id.* (emphasis in original).

Kraft made more money on its spot transactions than it did from sales on the NCE. But whether or not Kraft profited more from its spot sales than sales on the NCE is the wrong question. As discussed below, spot sales usually result in a higher price, not just for Kraft but for all sellers in the industry. Given that, it is not surprising that, on average, Kraft earns more from spot transactions than it does from sales on the NCE.

The proper question is *not* whether Kraft profited more from spot sales than sales on the NCE, but whether Kraft ever forewent a higher price off-Exchange to sell on the NCE. To answer this question, one cannot look at *average* profits, but must determine whether Kraft on a transaction-by-transaction basis ever turned down an opportunity to sell cheese at a higher price off-Exchange in order to sell cheese on the NCE. The Report never identifies such a transaction, and, therefore, presents *no* evidence that Kraft ever "traded against interest."

The Professors' basic flaw is that they fail to recognize that there are not always buyers willing to pay a higher price or "premium" in a spot transaction for Kraft's excess cheese. Buyers are willing to pay a premium if they need cheese in the near term or wish to customize the transaction so as to ensure they will receive cheese of the desired quality and with the desired delivery arrangements. When Kraft can find such buyers, it will sell cheese off the Exchange at a premium. If Kraft cannot find such buyers (or cannot find enough buyers with sufficient demand to purchase all of Kraft's excess cheese), no premium will attach to Kraft's excess cheese and the most economical place to sell the remaining cheese is on the NCE.

Overall, the Professors' argument is paradoxical. Under their logic that Kraft always could obtain a better price *off* the NCE, it would be equally true that buyers always could obtain a better price *on* the Exchange. Therefore, under the Professors' own argument, buyers would reject Kraft's offers to sell cheese in spot transactions and wait to buy the same cheese on the NCE at a lower price. This is not what occurred. The facts are that buyers are sometimes willing, for the reasons explained, to pay a premium for Kraft cheese.

1. **Why Spot and NCE Prices Are Different.**

Spot prices usually trade at premium to NCE prices. The reason for the difference in price are: (1) differences in the known quality or other characteristics of the cheese offered in the different transactions and (2) differences in the amount or distribution of costs borne by the buyer and by Kraft.

When Kraft sells cheese in a spot transaction, buyers are willing to pay a price premium in order to obtain these advantages:

- **Known quality.** A buyer in a spot transaction will know whether the cheese is suitable for its specific requirements (*e.g.*, cheese suitable for slicing). The buyer also can specify the exact age desired and will know the track record of the manufacturing plant at which the cheese was produced.
- **Known logistics.** A buyer in a spot transaction can arrange an exact delivery date and specify the delivery arrangements.

The cheese sold on the NCE, on the other hand, is subject to more flexible specifications and is, in essence, a "commodity." These factors will naturally result in off-NCE transactions commanding a premium over NCE opinion prices. Similar economics exist in futures markets, where it is not unusual for cash prices to exceed futures prices during delivery months, in part because futures contracts allow different grades of the commodity to be delivered and, therefore, the precise quality is not known.[40]

40. Thomas A. Hieronymus, Economics of Futures Trading 153 (1971).

Differences in the amount and distribution of costs between buyer and seller also tend to create a difference between on- and off-NCE prices. In many cases, the higher price for cheese sold off-the-Exchange reflects the fact that sellers pay for certain costs directly, while on the NCE the buyers pay. Given that, sellers will naturally ask for a higher price in a spot transaction. For example, the distribution of container costs between buyer and seller often differs between off-Exchange and on-Exchange sales. For all of Kraft's off-Exchange sales of barrel cheese in fiber containers and many of its off-Exchange sales of barrel cheese in steel containers, the container-related cost averaged one cent per pound. This cost is reflected in the delivered price for Kraft's sales off the Exchange. On the NCE, this cost is borne by the buyer. The Professors do not take this into account.

In other cases, the quoted NCE opinion price does not reflect the true price a seller receives for its cheese. For example, Kraft's sales of 40 pound block cheese on the NCE received a moisture premium that averaged one cent per pound during the period analyzed by the Report. This premium was received over and above the stated NCE price for the transaction. Again, the Professors made no attempt to incorporate this premium in their price comparisons.

2. <u>Why Companies Sell on the NCE.</u>

Failing to recognize the importance of the source of the price premium, the Professors simplistically conclude that "[i]t is difficult to identify reasons why large companies would rather sell on the NCE than in the spot market, other than to influence the market price."[41] Such a statement ignores the specific realities in the marketplace that sometimes eliminate Kraft's ability to secure premiums, or even buyers, for off-Exchange sales and, therefore, makes it more economical to trade on the NCE. Despite Kraft's preference for a premium, when Kraft's

41. Report, at IV-35.

off-Exchange buyers have no interest in immediate spot cheese procurement, or only are interested in fewer carloads of cheese than Kraft has to sell, Kraft will not be able to sell all its cheese off-Exchange at a premium. Likewise, when Kraft's surplus cheese does not fit the parameters desired by spot-market buyers, there is no reason it should command a premium in an off-Exchange sale. Additionally, Kraft's perception of its inventory position, particularly its very short term inventory position, in the context of its own and overall industry demand, fluctuates during the week, so that Kraft may not believe it is able to meet requests for cheese early in the week and yet have a surplus on Friday morning, particularly if NCE activity reveals a changing market. Finally, finding a buyer off-the-Exchange willing to pay a premium is not costless, as Kraft must spend time and resources searching for such a buyer. Centralized sales on the NCE reduce the cost of identifying parties willing to buy Kraft's surplus cheese. Therefore, if Kraft is unaware of a buyer willing to pay a premium, sales on the NCE will maximize Kraft's profits by lowing the costs of disposing of excess cheese.

In these instances and for these reasons, Kraft will sell on the NCE. This is not "trading against interest" at all, but perfectly rational behavior, designed to maximize the profits Kraft earns from selling its cheese.

This reality -- that at various times Kraft turns to the NCE as the most profitable place to sell cheese -- is dismissed by the Professors on the grounds that it "appears specious."[42] The basis for this assertion is that Kraft could simply "find a buyer by persistently lowering the offer price in the spot market."[43] That statement demonstrates a lack of understanding as to the nature of the "spot market." It is not (like the NCE) an open bidding market with all members of the industry available

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42. *Id.*

43. Report, at IV-35 and 36.

and ready to initiate trades or respond to Kraft's offers. Rather, Kraft's spot market consists of telephone calls to or from a small group of major "buyer traders" that recognize and pay for the premiums sometimes commanded by Kraft's cheese. When these firms -- as is typical in a falling market -- have sufficient cheese for their own immediate needs, they have no motive to buy Kraft's cheese at anything over the expected NCE opinion.

The single specific instance which the Professors point to as evidence that Kraft "could have sold in the spot market" when it sold on the NCE is a flat misconstruction of the facts.[44] On the Monday preceding the April 3, 1992, trading session, Kraft was selling heavily in the spot market -- 16 carloads of *aged* cheese at significant premiums over the preceding week's NCE closing prices. While Kraft did not also sell to other firms that were expressing interest in buying cheese from Kraft at the time, there is no evidence to show those firms were willing to pay anywhere near the same premium. Indeed, Kraft's decision to wait and sell cheese at the NCE session proved prudent. Prices surged upwards. Kraft's sales on the NCE were at prices between 2½ and 3¼ cents higher than the previous week's closing NCE opinion.

The Professors also argue that Kraft's sales to the Commodity Credit Corporation (CCC) were more profitable than sales on the NCE and, therefore, that Kraft's decision not to sell to the CCC at times was "trading against interest."[45] This argument ignores the commonly understood relationship between sales to the CCC and sales elsewhere. Sales to the CCC involve transaction costs of about 2 cents per pound. Thus, market prices for cheese usually must fall below the government price support level before sales to the CCC become viable. Hence, selling at a slightly lower price on the NCE is not trading against interest.

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44. Report, at IV-45.

45. *See, e.g.*, Report at VI-56.

The Professors do not -- and cannot -- point to a single instance where, after taking into account spot demands and pricing, Kraft's dynamic inventory position, and Kraft's view of likely market developments, Kraft was not justified in making an NCE trade. The Professors' charge that Kraft "traded against interest" is devoid of any factual support.

G. The Professors' Econometric Analysis is Wrong.

The Report contains an econometric analysis purporting to show that Kraft and other "seller/traders" were "successful in reducing NCE prices when they participated in trading."[46] The inference is that the NCE "was not an effectively competitive price discovery mechanism"[47] and that Kraft's trading artificially depressed the price of cheese traded on the NCE. The Professors' econometric analysis is incorrect, because it fails to separately analyze the effect of Kraft's sales and *uncovered offers* on NCE prices. This distinction is critical, because as a matter of economic logic and common sense, *uncovered offers* cannot artificially depress prices below true value. This is because an uncovered offer, by definition, carries a price that is *too high*, *i.e.*, a price no buyer on the NCE is willing to pay. If the NCE closing opinion is set by an uncovered offer, the NCE price could *not* have been manipulated.

Figure 4 presents the Report's estimates of the econometric effect of Kraft's activity on NCE price (column 1); a re-estimation of the Report's model using "ordinary least squares" estimation procedure (column 2);[48] and a simple modification of column 2 that distinguishes between Kraft's

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46. Report, at VII-21.

47. Report, at VII-31.

48. Using ordinary least squares greatly reduces the cost and complexity of the estimation procedure but has no substantive consequence for the conclusions in this case, since simple inspection shows that the coefficient of interest -- the coefficient on Kraft's "activity" -- is comparable in size and statistical significance to the coefficient yielded by the more complicated Tobit and maximum likelihood procedures used in the Report.

sales and its uncovered offers (column 3).[49] Column 3 of Figure 4 reveals that Kraft's *sales* on the Exchange had no negative impact on price; rather, the entire negative impact Kraft had on price is attributable to *uncovered offers*. For example, Column 3 shows that the coefficient of Kraft's sales on the NCE block price is only -0.13, which means that in months when Kraft sold in *every week*, price was lower on average by *one-tenth of a cent*, a tiny impact. Moreover, the effect of Kraft's sales on price is statistically insignificant, as shown by the fact that the t-statistic of the coefficient -- a common metric of statistical significance presented by the number in parentheses below the coefficient -- is smaller in absolute value than 2.[50]

By contrast, the coefficient on Kraft's uncovered offers is both much larger than the coefficient on Kraft's sales and it is statistically significant. (The t-statistic in parentheses is -2.62.) In months when Kraft left an uncovered offer in *every week of the month*, the NCE price of block cheese was lower by 3.97 cents, on average. But if only Kraft's uncovered offers affect price, Kraft cannot be manipulating prices lower because, again, uncovered offers are offers at too high a price.

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49. To measure Kraft's NCE "activity," the Professors use the proportion of weeks during the month that Kraft sold or offered cheese, independent of the amount or kind of cheese Kraft sold or offered. Therefore, the interpretation of the coefficients in Column 1 of Figure 4, which simply repeat the coefficients in the Table 5.5 of the Report, is that in those months when Kraft either offered or sold cheese in *every week of the month*, the average NCE price was 2.6 cents lower than it would have been had Kraft offered or sold no cheese. In those months when Kraft offered or sold cheese in only one-half the available weeks -- two out of four weeks, for example -- the average price was 1.3 cents lower than it would have been had Kraft offered or sold no cheese.

50. "Statistical significance" is a technical term for whether or not an observed result is likely to have occurred just by chance. For example, if you flip a fair coin, you know you have a 50-50 chance of having it land "heads-up." But if it lands "tails-up" instead, you would not conclude that the coin was not fair, or that it always would land tails-up. When a result is deemed to be statistically significant, it is because it is very unlikely that it occurred simply by chance, like having a coin land tails-up. Therefore, it provides a measure of confidence in whether or not the effect observed is real or simply coincidence.

By not distinguishing between sales and uncovered offers, the Professors present a completely misleading econometric analysis.

The econometric analysis in the Report has another key failing in addition to not distinguishing between the effects of sales and of uncovered offers: it fails to take into account -- "hold constant" in econometric terms -- the trading activities by all others on the NCE. But clearly the activities of all traders also affect the NCE price. And if Kraft is selling or offering cheese at the same time as others, then the estimated effect of Kraft's NCE activities will, in part, reflect the trading by others. In other words, there are important "left-out" variables in the econometric model used by the Professors that bias the estimated effect of Kraft's activities on price.

Figure 5 presents the results of an expanded model, which corrects these errors. This is the model the Professors could and *should* have used. It incorporates *total* activity on the Exchange -- sales, uncovered offers and unfilled bids, by *all* traders, including Kraft. The econometric analysis presented in Figure 5 differs from that presented in the Report in two other important ways. *First*, the data underlying the Report's analysis are *monthly* averages of weekly prices and trades. But averaging typically reduces the variability of the underlying data, suppressing important information, and may therefore lead to reduced statistical precision. Since the NCE is a weekly exchange, it makes sense to analyze the data on a weekly basis. The analysis presented in Figure 5 is of weekly price and trading data. *Second*, the Professors' analysis measures the incidence of trading as the proportion of weeks that a trader was active, without regard to the *quantity* of cheese at issue. This choice again suppresses important information: When excess demand is greater, as measured by the quantity of cheese sought, price should be correspondingly higher. Similarly, when the quantity of excess supply is higher, as measured by the quantity of cheese offered, price should be correspondingly lower. In Figure 5, the independent variables that measure trading activity on the NCE -- sales, offers, and bids -- reflect the quantity of cheese at issue.

Figure 5 shows that changes in the NCE price were principally explained neither by Kraft's sales on the NCE, nor even by Kraft's uncovered offers, but by the activity of *all* participants on the NCE. In particular, Figure 5 shows that sales were not the only activities affecting NCE price, or even the most important. NCE prices were mainly affected by uncovered offers and unfilled bids. Figure 5 shows, as expected, that the coefficient on unfilled bids by all traders -- a measure of total excess demand -- is positive, *i.e.*, for each additional carload of block cheese for which there was an unfilled bid at the end of the day, price rose by about one-tenth of a cent (column 2). Figure 5 also shows, as expected, that the coefficient on uncovered offers by all traders -- a measure of excess supply -- is negative, *i.e.*, for each additional carload of block cheese for which there was an uncovered offer at the end of the day, price fell by about one-tenth of a cent.

Figure 5 shows clearly that *Kraft's* NCE activity -- *whether sales or uncovered offers* -- had no greater impact on the NCE price than the trading activity of the other members on the NCE. Indeed, if anything, Kraft's trades have a weaker impact than trades by others. The coefficient on Kraft's sales is positive and statistically significant, and suggests that when Kraft sold, price did *not* fall; when others sold, price did fall.

This empirical evidence directly contradicts the Professors' assertions about Kraft's activity on the NCE. As Kraft's expanded econometric analysis shows, Kraft's NCE activities had no differential impact on NCE prices. Indeed, Kraft's sales and offers were less likely to result in a decline in price than the sales and offers of others.

Another comparison supports this econometric analysis. Figure 6 compares weekly changes in NCE barrel price for weeks when Kraft sold cheese to weeks in which only other traders sold cheese on the NCE. Although Figure 6 is not based on Kraft's econometric analysis, it is consistent with the results. Prices are greatly affected when others sell on the NCE, but generally unaffected when Kraft sells. Again, Kraft did not have any differential impact on NCE prices.

IV. KRAFT HAS BEEN AND REMAINS OPEN TO CHANGE

A. Potential Improvements to the NCE.

Long before the Report was published, Kraft has been active in supporting improvements to and refinements in Exchange trading and alternatives thereto. The NCE, for instance, currently is planning to introduce electronic trading sometime later this year. Kraft was an early supporter of this development. Under current plans, traders will have access over electronic screens to the information on the board at the NCE. Traders can make bids or offers, or fill bids or cover offers electronically from their location off-site. At the same time, the current "open outcry" bidding also would be available to traders. Electronic trading should facilitate access to the NCE by industry participants not physically located in the Upper Midwest.

Kraft also believes that increased frequency of trading on the NCE warrants consideration. The scope of trading on the NCE also could be expanded. Kraft supported the introduction of 640-pound block trading and believes it is worthwhile for the NCE to consider other styles of cheese (besides cheddar cheese). This may not, however, be as easy as it might seem, because non-cheddar cheeses are more differentiated than cheddar cheese and, therefore, may prove more of a challenge to standardize.

Anonymous trading also has been discussed. It has been widely reported that the media and political pressures that sometimes attach to trading on the NCE may deter some traders from participating more actively on the NCE. Given that anonymous trading may further increase trading volumes, Kraft has no objections to this idea. Kraft sees no need to keep its trading anonymous, but Kraft has no objection to proposals to making all trading on the NCE anonymous.

Kraft will review with an open mind any ideas put forward during these hearings or elsewhere to improve participation and trading on the NCE. If there is an idea that will genuinely improve trading on the NCE, Kraft will support it and believes the industry itself will adopt it.

B. Potential Alternative Benchmarks For Cheese Pricing.

Currently, the cheese industry uses the NCE as the reference price for most off-Exchange agreements. The NCE has served well as a source of price discovery and Kraft sees no need, at this time, to replace the NCE opinion as the benchmark for off-Exchange cheese trading. If a better price discovery mechanism evolves, Kraft and the cheese industry will use it. Until then, efforts most productively should focus on enhancing NCE's services, rather than replacing it.

Nonetheless, Kraft is interested in any ideas for improving price discovery in the cheese industry. Two alternatives have been discussed. *First*, a greater reliance could be placed on spot transactions. This may be difficult, but not infeasible. Relying on spot transactions is common for many commodities for which there is no centralized exchange. Kraft questions, however, whether even the most refined spot market reference price could match the cost-effective price discovery on a centralized market such as the NCE. The ultimate test would be whether industry participants are willing to accept spot transactions as being as reliable as the NCE.

To make spot transactions a more viable alternative, revisions would have to be made to the Wisconsin Assembly Point price index. One change might be to collect information on a national rather than regional basis. Another change would be to standardize the transactions reported, so as to increase the transparency of the prices reported. Mechanisms to provide better verification of the reported standardized transactions also would help.

The *second* possible alternative consists of the futures contract trading on the Coffee, Sugar, and Cocoa Exchange. Kraft supported the creation of a futures market. As market prices have moved above government price support levels, cheese prices have become more volatile, giving industry participants a greater incentive to use futures markets to manage price volatility.

To this point, however, the liquidity on the futures markets has not been sufficient to justify referencing the futures markets in off-NCE transactions. In other words, the degree of industry participation on the futures market does not match that on the NCE, and greater industry participation is probably necessary to make the futures market a liquid, viable alternative. Someday this might occur.

C. Can Commercial Cheese Market Information Be Better Assimilated and Reported in a More Timely and Accurate Manner?

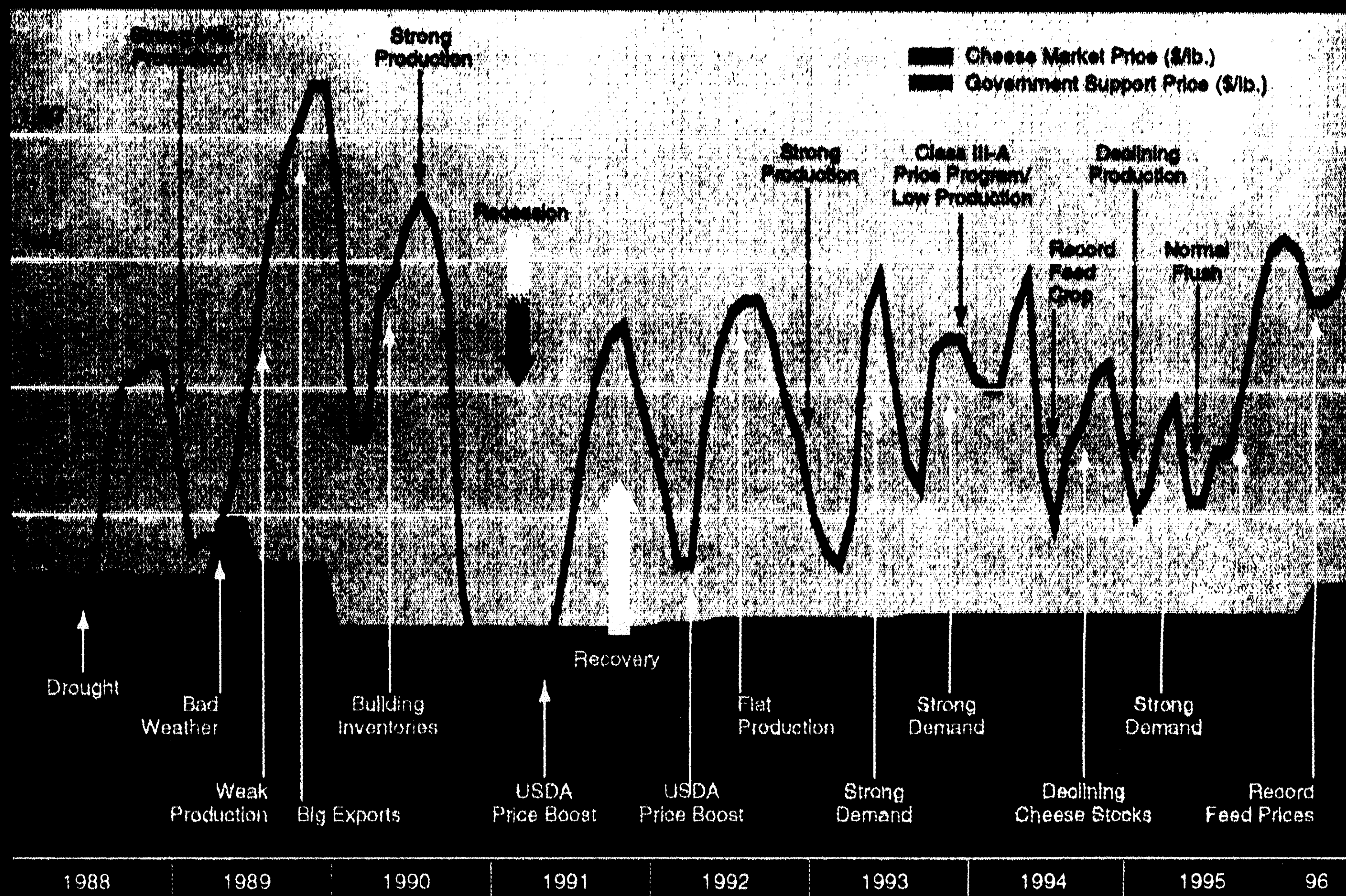
Like other industry participants, Kraft would welcome better and more timely market information and would support any efforts by the U.S. Department of Agriculture to enhance its data collection. Although Department of Agriculture information is now useful for some forecasting purposes, Kraft finds the information often too stale and uncertain in accuracy to use on a more dynamic basis for pricing and inventory management. Kraft would be interested in hearing ideas to improve the usefulness of this system.

V. CONCLUSION

The Professors' Report is dead wrong, both inaccurate and misleading. It is long on speculation and ignores the real facts about the dairy and cheese industries. The reality is that the NCE works, as demonstrated by its substantially increasing use and the industry's reliance upon the NCE as the reference point for pricing millions of dollars of cheese transactions. Kraft's trading on the NCE has made good business sense, once analyzed in light of its inventory philosophy, the status of its inventory at the time, and then prevailing supply and demand conditions. Under any proper econometric analysis, Kraft's trading on the NCE had no adverse effect on NCE prices.

Even though Kraft believes that the NCE is "not broke," Kraft has been and remains open to any suggestions that might benefit the dairy industry. Kraft recognizes that its success is dependent upon a healthy and competitive dairy industry.

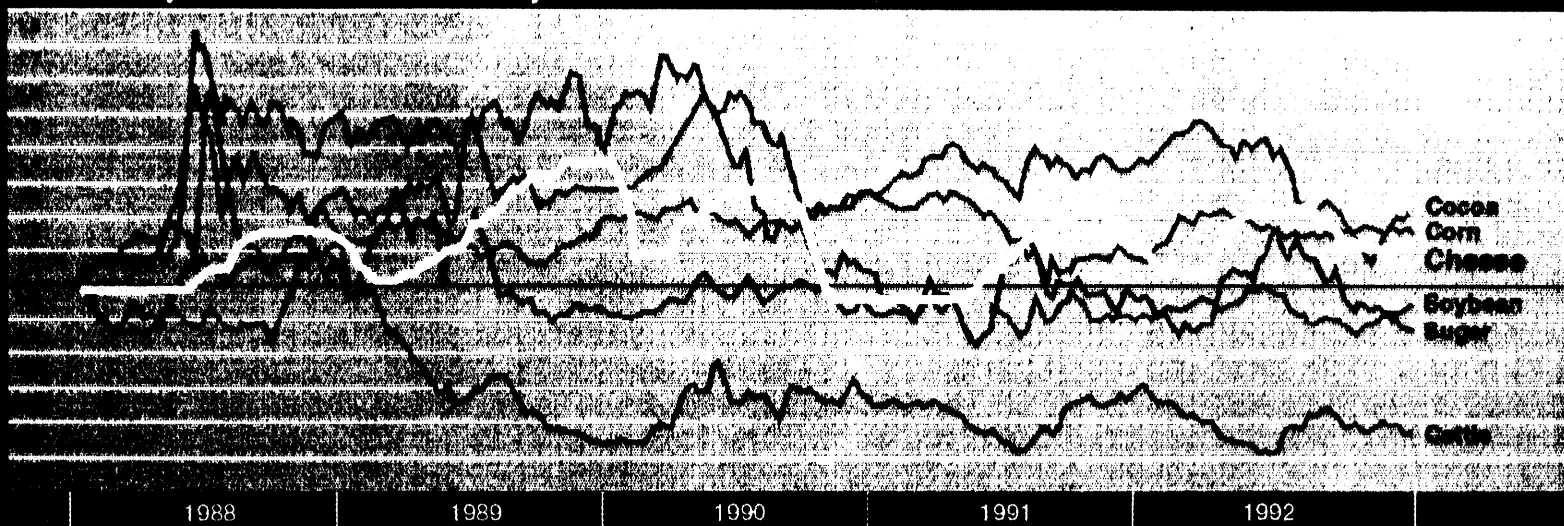
Supply and Demand Drive Cheese Prices
Market Forces Explain the Price Volatility



All Commodity Prices Are Volatile

Cheese Prices Compared to Other Agricultural Commodities

Commodity Prices Indexed at January 1988

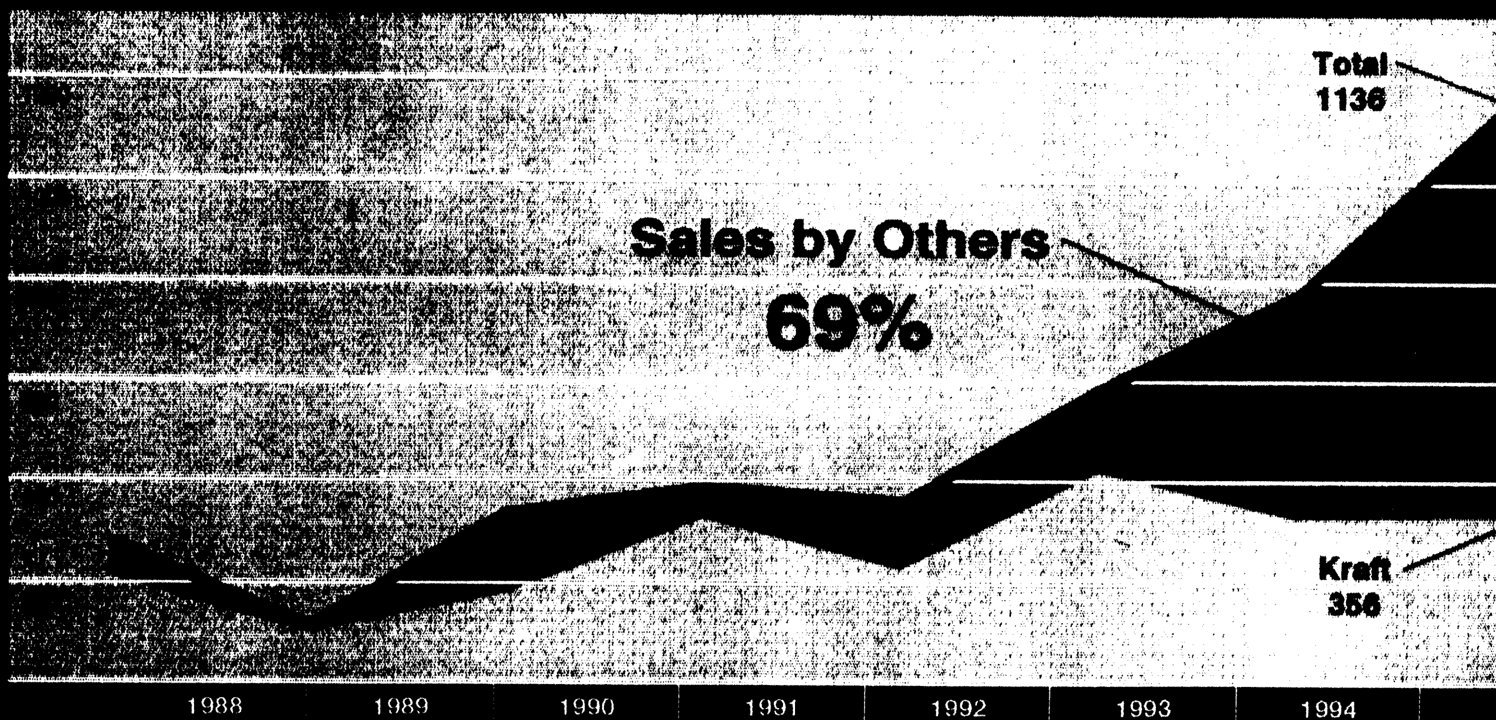


Average Volatility of Selected Agricultural Commodities

Kraft's Share of NCE Sales Has Dramatically Declined

Volume Sales on the NCE, 1988 –1995

NCE Sales By Carloads



Estimated Effect of Kraft's NCE "Activity" on NCE Price

	(1) Report Estimate[1]	(2) OLS Re-Estimate	(3) Modification
Barrel Price			
<u>Kraft Activity</u>			
Total	-2.615 (2.17)	-2.333 (-1.87)	
Sales	--	--	0.027 (0.01)
Uncovered Offers	--	--	-3.974 (-2.31)
Block Price			
<u>Kraft Activity</u>			
Total	-2.146 (2.03)	-2.405 (-2.26)	
Sales	--		-0.130 (-0.11)
Uncovered Offers	--	--	-3.881 (-2.62)

1 Report, Table 5.5 at V-33.

Estimated Effect of Kraft's NCE Activities on NCE Price

Expanded Model

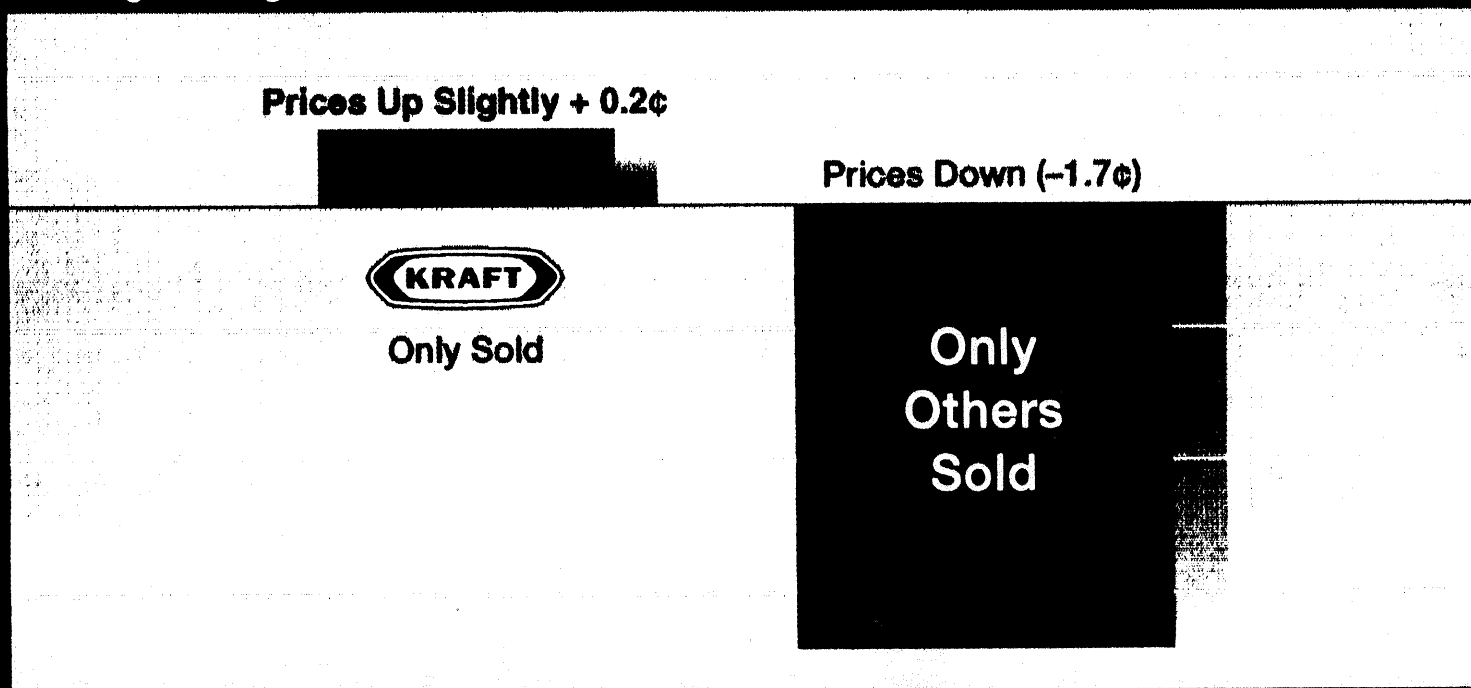
	Barrel Price	Block Price
<u>Kraft's Activities</u>		
Sales	0.074 (2.64)	0.064 (2.26)
Uncovered Offers	-0.067 (1.02)	-0.012 (-0.18)
<u>Total Activities</u>		
Sales	-0.051 (2.04)	-0.050 (-1.98)
Uncovered Offers	-0.087 (-2.23)	-0.130 (-3.30)
Unfilled Bids	0.101 (6.68)	0.081 (5.29)

Note: Weekly data, 1988 through 1993. Regression also includes monthly dummies and monthly demand and demand variables analyzed by the Report, Appendix 5.

Kraft's Trading Did Not Adversely Affect NCE Prices

Cheese Price Changes When Kraft Versus Others Sold

Average Changes in NCE Barrel Cheese Prices April 1988 – December 1992



Headline #3
[FN01W.051696.00008]
Phrase: NATIONAL CHEESE EXCHANGE

FEDERAL NEWS SERVICE TRANSCRIPTS [FN01W] via NewsNet
Thursday May 16, 1996
Update #: 10 Item #: 8

PREPARED STATEMENT OF JAMES W. LAUDERDALE VICE PRESIDENT MARKETING & SALES DAIRY FOODS GROUP

MID-AMERICA DAIRYMEN, INC.
BEFORE THE HOUSE AGRICULTURE COMMITTEE
LIVESTOCK, DAIRY AND POULTRY SUBCOMMITTEE
WEDNESDAY, MAY 15, 1996

Mr. Chairman and members of the Subcommittee, my name is James Lauderdale. I am Vice President of Marketing & Sales for the Dairy Foods Group of Mid-America Dairymen, Inc.

Today, Mid-America Dairymen's 18,000 members produce more than 18 billion pounds of milk. Five mergers in 1994 and 1995 nearly doubled the size of our cooperative in 12 months. Mid-America Dairymen now has members in 30 states, from coast to coast and border and border.

Mid-America Dairymen dairy products, produced in the cooperative's 37 manufacturing plants, are sold in every state and are exported internationally. Processing plants in the Mid-America Dairymen system produce a wide variety of dairy products, from butter, nonfat dry milk and cheese to in-can sterilized baby formula and adult nutrition products. Mid-America Dairymen also participates in several joint ventures that serve fluid milk and dairy product markets. Recently Mid-America Dairymen announced a strategic alliance with Avonmore

Foods of Ireland to form an international sales and marketing company to market Mid-America Dairymen products in global markets.

As the nation's largest dairy cooperative, and one of the nation's largest manufacturers and marketers of cheese, I welcome this opportunity to comment on the National Cheese Exchange, and its importance to us and our ability to meet our customers needs on a year round basis.

For the past several years Mid-America Dairymen has sold more cheese than we manufacture. Thus, we are a large buyer of cheese, both on the open market and through the National Cheese Exchange.

Several factors have led to Mid-America Dairymen's position, not only as a manufacturer, but as a buyer of cheese. As a major supplier of milk for fluid uses and manufacturer of a number of value added dairy products, we experience tremendous swings in the volume of milk available for cheese manufacturing during the course of a year. We, therefore, experience wide variations in the quantities of cheese available from our manufacturing facilities. To meet our commitments to supply our customers with product on a year round basis, we source product from the outside -- both on a committed basis and on a spot basis. We use the National Cheese Exchange as one source of spot loads of cheese.

As the dairy industry has begun to deregulate, dairy product markets have become more volatile. We have seen significant price swings in the price of milk, and in the price of dairy products -- cheese, butter, and nonfat dry milk -- as supply and demand conditions have changed.

The National Cheese Exchange is the major place in the country where buyers and sellers come together weekly to buy and sell cheese based on changes in their estimates of the supply and demand conditions in the market. A review of the membership of the National Cheese Exchange reveals it represents a very large percentage of the total cheese produced in this country, and a large percentage of the total cheese sold. Since buyers and sellers of cheese from around the country trade on the exchange, bids and offers not supported by supply and demand conditions are met by members of the Exchange willing to buy or sell. We feel the National Cheese Exchange prices move up and down based on changes in member assessments or estimates of fundamental changes in their supply and demand conditions which collectively reflects the supply demand conditions of the entire country.

Given the confidence that the industry has had in the pricing opinion established by the National Cheese Exchange, it has become a base for company selling prices, and the basic formula price. This does not mean it is a company's selling price, but the Exchange price or opinion is a starting point for developing the selling price. Clearly the market has viewed the Exchange price or opinion as a valid supply and demand indicator of what the price should be for cheese.

The study "Cheese Pricing, A Study of the National Cheese Exchange," by Willard F. Mueller, et. al., raises the question of the need for increased regulation of the exchange, and whether or not the exchange should be regulated by the State or Federal government. Given the fact that the National Cheese Exchange has become a national exchange, it is our opinion that its regulation should not fall under state regulation. The Exchange, located in Green Bay, Wisconsin, can continue to operate, or could be moved if the Board of Directors feels it would benefit the industry.If there is increased regulatory oversight, it is our feeling it should be with the Commodity Futures Trading Commission (CFTC).

It is our opinion that the National Cheese Exchange is the best market available to provide a pricing basis for commodity cheese. It reflects the assessment of the supply/demand situation for cheese by buyers and sellers on a nationwide basis.

With the recently signed Farm Bill eliminating supports on cheese and nonfat dry milk in four years, we anticipate increased volatility in our dairy markets in the future. World supply and demand conditions, and consumer wants, desires, and needs are going to contribute to more volatility in our markets than we have seen before. It is increasingly important, therefore, that producers and consumers continue to have confidence in our markets. We look forward to working with the Subcommittee to assure that is the case.

Thank you for this opportunity to express our position on the National Cheese Exchange.

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SUBMISSION BY NATIONAL CHEESE EXCHANGE, INC.

TO

HOUSE SUBCOMMITTEE
ON LIVESTOCK, DAIRY
AND POULTRY
Steve Gunderson, Chairman

HOUSE SUBCOMMITTEE
ON RISK MANAGEMENT
AND SPECIALTY CROPS
Tom Ewing, Chairman

Joint Public Hearings on May 15 and 16, 1996
Re: Study of the National Cheese Exchange, Inc.

Dated: May 9, 1996

Richard J. Gould, President
National Cheese Exchange, Inc.
130 East Walnut Street
Green Bay, WI 54301
Telephone: (414) 432-7768

PRELIMINARY REMARKS

As a result of a four and one-half year study of the National Cheese Exchange (NCE) prepared for the Wisconsin Department of Agriculture (Department) and authored principally by two economics professors, Willard F. Mueller and Bruce W. Marion, for the purpose of determining whether there existed possible unfair trade practices or methods of competition in the pricing of cheese, the Department has released a 265-page report authored by the professors hypothecating that Kraft, through domination of the industry and its buying and selling cheese at NCE trading sessions has manipulated prices of cheese for its own benefit and that NCE, as presently organized, appears to facilitate market manipulation. This response is addressed to the allegation that the NCE appears to facilitate market manipulation and should be replaced or changed "to enhance its competitive performance." We submit that this report has not established any market manipulation.

NCE has safely withstood critical examination in the past and this report, considering the time and resources put into it, in our view, again falls far short of finding anything for which NCE can be criticized. The conclusion that NCE appears to facilitate market manipulation lacks any specific factual support. If in fact NCE does make it easier for a member to engage in market manipulation, we are unaware as to how it could be done. NCE does provide the physical facilities for trading; that is, the Exchange quarters, chalkboard, utilities and personnel. NCE has nothing to do with its members' trading activity decisions.

THE EXCHANGE

NCE is a non-stock, non-profit corporation which provides the physical facilities for those who have cheese to sell to dispose of it and for those who have need for cheese to acquire it, all pursuant to its rules for trading. That is its only function.

Becoming a member of NCE is not difficult. Membership is limited to individuals or organizations of good reputation, financial responsibility and credit who can satisfy the members that he or it is suitable to assume responsibilities and privileges of membership. We presently have 34 members consisting of agricultural co-ops, cheese manufacturers, cheese marketers, dealers and brokers. In the past, we have had supermarket chains as members as well as a pizza franchiser. Our members represent about 90% of the cheese industry (Report p. III-7). NCE is supported by annual dues of $600 per member and clearing charges, consisting of $100 for each car of cheese sold on NCE, one-half of which is paid by the buyer and the other one-half by the seller. Those who use the facilities more frequently thereby contribute more to its support.

NCE staff consists of its president who administers the affairs of the NCE and a board clerk who posts the transactions on a chalkboard during trading sessions and keeps its financial and other records. Neither person has any connection with the cheese industry.

Trading is done by the open outcry method. Buyers verbally bid for cheese and sellers verbally offer cheese. They state their bids and offers by style of cheese, number of cars and price. Only cheddar cheese of the styles known as forty-pound block, barrels and 640's are traded. The bid or offer is posted on a chalkboard. Until a bid is filled by a seller or an offer covered by a buyer, the trader may raise his bid or lower his offer in increments of a quarter of a cent. Upon a bid being filled or an offer covered, the sale is posted on the chalkboard.

Trading sessions are held every Friday and last for a minimum of thirty minutes. If trading is active, the presiding officer extends the session until trading has come to rest. Usually, thirty to forty minutes is adequate for our members to complete their transactions.

Contrary to a statement by the authors of the report (p. VII-5), it is not a function of NCE to establish a "market opinion" price for bulk cheese. NCE does not issue quotations or other reports of trading activity. An employee of the USDA keeps a record of all transactions. An opinion as to the closing price of each style traded is published every Friday by a privately owned publication, The Cheese Reporter.

Observers are free to put whatever emphasis they care to on NCE transactions. No one is required to accept NCE transactions as a pricing mechanism. NCE has come to be used as a pricing mechanism because of its industry reputation for accurately reflecting the price of cheese. When a buyer-trader and a seller-trader enter into a contractual relationship referred to as formula pricing based upon NCE transactions, the contract is one that is entered into voluntarily by the parties. No one is forced to accept NCE prices as a part of the contract. NCE has no knowledge of the terms or conditions of these arrangements.

The unit of trading at NCE trading sessions is a semi-load of cheese weighing between 40,000 and 43,000 pounds. Transactions at NCE result in the commodity actually changing hands. At today's prices, this amounts to approximately $60,000 per load. This is quite different from other commodity markets used by speculators for trading in futures where requirements of only five to ten percent of contract value are common and where, we understand, less than three percent of the contracts traded result in the commodity actually changing hands because of sales cancelling purchases. NCE provides the framework for pure competition. There can be no worthwhile substitute for selling and paying cash based on competitive bidding and selling by knowledgeable, responsible people who know that they have to pay for in full and deliver promptly (seven days maximum) that for which they bid for or offer.

We submit that the NCE is one of the most efficient price discovery mechanisms that exists in any commodity today.

ANONYMITY OF TRADERS

We do consider it advisable to amend our rules to permit traders to remain anonymous and we are pleased to note that the professors' report does state that keeping traders anonymous would be a positive move on the part of NCE. (p. VII-42). Trading at the NCE is publicly reported fully and widely. Each bid, offer or sale is recorded by the USDA by the minute and second for future review if necessary. The names of the members involved in each transaction are also recorded. We would prefer that the traders remain anonymous because of the our awareness that trading is very likely being restricted by concern for economic reprisals against traders who offer or sell cheese at a price lower than a previous transaction. Agricultural co-ops are frequently subject to criticism by patrons when circumstances require the co-op to offer or sell cheese at a price lower than a previous transaction. In 1993, NCE scheduled a meeting of its Rules Committee to consider the matter. Within days, the media reported on this in a flury of negative stories and headlines repeating the words "deals" and "secrecy" in lieu of reporting the proposal rationally, interpreting it as an attempt by the NCE to keep secret all NCE transactions between buyers and sellers. Senator Feingold objected to such a change and wrote to the NCE referring to this as "cloaking transactions" and referring to trading as "secret transactions." Not making known to the public the names of buyers and sellers on NCE does not imply "secret deals" or keeping NCE transactions secret. The negative publicity, however, discouraged us from pursuing this change. It is safe to assume that at least some of those opposed to anonymity are those who engage in unfairly accusing traders of lowering cheese prices in an attempt to interfere with the traders' business relationships. With anonymity, those competitors and others who charge traders with dominating or lowering the market fear that they will no longer be able to exercise this economic pressure.

REGULATION OF THE EXCHANGE BY

THE COMMODITY FUTURES TRADING COMMISSION (CFTC)

NCE has always been concerned about possible price manipulation because we are aware of the fact that NCE has become a so-called price discovery mechanism.

In the early 1970's, NCE requested that it come under the jurisdiction of the CFTC. At that time, we were advised that because NCE did not deal in futures, NCE transactions were not within CFTC's regulatory power. We are now informed that since the CFTC has designated the Coffee, Sugar and Cocoa Exchange as a contract market for futures trading in cheddar cheese the CFTC now has the authority to bring an administrative action against any person if it has reason to believe that a party is manipulating or attempting to manipulate the price at which cheese is traded on NCE.

Our rules for trading are designed to ensure good faith trading and to prevent collusion and price manipulation. We will welcome any suggestions from the CFTC at any time as to how these rules can be improved. We feel that we have an obligation to see that our rules encourage and do not restrict trading. The goal of NCE is a free and open market where the law of supply and demand can work and where true prices are expressed.

We submit, however, that the professors' report is not a sufficient basis for making changes in the NCE trading rules which, in the view of a vast majority of the cheese industry, are working well.

THE REPORT

This report emphasizes that no evidence of collusion among NCE traders was found. The authors further state that they do not presume to determine whether Kraft's alleged conduct met the standards of legal proof required for a finding of price manipulation under the federal or Wisconsin antitrust and unfair competition statutes. However, the Department, without making any finding of its own, has hyped this report as though there have been substantial revelations with respect to improper trading practices when, in fact, there are none. Despite the inability of the authors to express an opinion that Kraft violated any law against price manipulation, the Department, in a press release, has stated that this report "raises serious concerns" about NCE and that it finds a need to "replace the Exchange or enhance its competitive performance." There is no factual basis for these purely subjective conclusions. This language plays on the lack of understanding of the public as to what is fact and what is opinion. Unfortunately, no matter what is now published in defense of NCE, its reputation has been impaired based upon the mere opinion of these professors.

One of the most troubling aspects of this report is that while the authors' hypothesize that Kraft manipulated NCE prices to the detriment of suppliers from whom it was buying cheese, there is a total absence of evidence of any complaint made by any supplier that it was taken advantage of. Certainly, no such complaint was ever made to NCE. The suppliers who have been theoretically damaged by the hypothesized price manipulation were present at, observed and participated in every trading session during which this alleged price manipulation took place.

Apparently recognizing this obvious lack of a grievance or claim of damage, the authors of this report have attributed this silence to assertions that Kraft dominates the industry to the extent that these stellar concerns were fearful of Kraft.

This report recognizes that, during the period covered, certain traders (Kraft, Borden and Alpine Lace), designated as "seller-traders," benefited by lower prices and exerted a downward influence on NCE prices and that other traders (Beatrice, Mid-Am, Schreiber, Land O' Lakes and AMPI), designated as "buyer-traders," benefited by higher prices and exerted an upward influence on NCE prices.

The authors claim that Kraft, because of its "market power" and "competitive advantages," had the unilateral power to manipulate prices lower on NCE and thus, because of formula pricing, to pay less to its suppliers off NCE, the so-called buyer-traders, and thereby substantially increase its profits. Because of these "competitive advantages" and "market power," the authors contend, the so-called buyer-traders such as Land O' Lakes, AMPI, Mid-Am and Beatrice would not challenge pricing decisions made by Kraft on the NCE.

AMPI, Land O' Lakes and Mid-America Dairymen, Inc. are the three largest dairy cooperatives in the United States. Beatrice is an independent operating company of ConAgra, Inc., with sales of $23.5 billion. These four buyer-traders alone are major participants in the cheese industry, all having many facilities and large inventories of cheese, the values of which are affected by NCE transactions. Most significantly, the three cooperatives also have a major interest in maintaining high cheese prices because of their farmer-members to whom their managers are responsible and who benefit directly from higher prices for milk used in making cheese.

It is a denial of reality to assert, as the authors have, that Mid-Am, AMPI, Land O' Lakes and Beatrice would hesitate to oppose Kraft's views of market conditions or contest pricing decisions made by Kraft on the NCE. This report contains no factual data to support a claim that Kraft and its followers had superior market power to the buyer-traders. Nor is it realistic to conclude that if Mid-Am, AMPI, Land O' Lakes or Beatrice suspected Kraft of price manipulation, they would nevertheless remain silent and accept lower prices paid for their cheese.

To accept the hypothesis that Kraft could unilaterally manipulate the price of cheese downward without complaint from the buyer-traders is ludicrous. In the absence of facts to the contrary, the correct and logical interpretation is that the buyer-traders, all of whom were present at and participated in every trading session during which Kraft sold cheese, concluded that the prices at which Kraft was selling its cheese reflected its then true market value. To come to any other conclusion one would have to assume that these buyer-sellers were all intimidated by Kraft, lacked knowledge of market conditions, and had incompetent management, none of which assumptions would be warranted. Market