A handout entitled "NOTICE" compiled by Concerned Dairymen was circulated throughout the audience and to the task force members. Mr. Burns stated that this material would be included in the official record.

Members then began discussing individual proposals.

REVIEW OF PROPOSALS ADDRESSING THE LINK BETWEEN THE NCE PRICE AND THE BFP

1. *Replace current Basic Formula Price (BFP) with the Coffee, Sugar and Cocoa Exchange (CSCE) futures price.

    - A recommendation to the USDA to replace the NCE with a formula-based CSCE futures market for fluid milk pricing.
    - The NASS price should be used in the calculation of the BFP as soon as it is available to allow the futures market on the CSCE to develop.
    - The CSCE is not considered as a price determining mechanism at the current time, but it has the potential of being a representation of the market price.
    - USDA could set standards requiring a certain level of open interest before the milk futures price would be substituted into the BFP.

    Members' comments:

    ⇒ A cost of production "protector" must be inserted in the milk price formula.

    ⇒ The current fluid milk futures contract on the CSCE and Chicago Mercantile Exchange (CME) are flawed because they do not price the BFP, but they price the grade A milk price which includes a substantial give up charge during certain parts of the year. However, the CSCE does intend to seek approval for trade of a cash settlement BFP contract which would be a excellent substitute for the current fluid milk contract in phasing in a futures price.

2. *Replace current BFP with a national survey of manufacturing milk prices, less performance premiums and over-order values.
    - Milk price should be based on what plants pay for milk. This would be a better method for the valuation of milk. USDA is trying to move away from using formulas at all. Essentially, federal milk marketing orders should be used to set classified prices for fluid milk.

3. Replace current BFP with a formula that weighs the NCE price, the futures price, contract and spot prices according to the volume of transactions each accounts for --- **Remove**

4. *Request USDA to use its NASS-reported, probability-based national average cheddar cheese price in any pricing formula that includes a cheese price to establish minimum Grade A milk prices under federal milk marketing orders.

- Until the USDA-NASS monthly cheese price series is available, request USDA to use the monthly average Wisconsin Assembly Point Price (WAPP) for cheddar blocks in calculating the BFP.

Members' comments:

⇒ The WAPP is limited at this point and it may not be an accurate discovery mechanism because it is a small survey and not designed to be used as a national price.

⇒ The WAPP is a report of the price range for all surveyed milk.

⇒ The cost of production should also be included in the figuring of the BFP.

⇒ The fact that government has moved away from its involvement in setting the price over the last five years has given us price volatility and allowed the cheese price to reach $1.695.

⇒ The reason for the futures market today is because without government supports over the last five years you've seen the market go up and down and that will continue due to the fact that the industry is in a transition.

*These proposals were tabled and voted on later in the meeting.

POSSIBLE ALTERNATIVE PRICE DISCOVERY MECHANISMS FOR CHEESE

1. Recommend to the CSCE and the Chicago Mercantile Exchange (CME) to establish a cash contract for cheese--**Keep**

- The principle is to establish an alternative market for the cash trading for cheese.

Members' comments

⇒ This would provide a direct linkage between the futures price and the cash markets which would, in many peoples minds, improve liquidity.

⇒ Cheese on the cash market of the CSCE or the CME would always be bought and sold so there wouldn't be any uncovered offers or bids used in setting prices.

⇒ The cash market could operate simultaneously with the futures market, five days a week, 9 a.m. to 2 p.m.

The members voted to keep this proposal, 16 to 2.

DISCUSSION OF MARKET INFORMATION RELATED

1. Recommend to USDA to expand weekly WAPP series to a statistically reliable regional series to include major manufacturing areas (Mandatory reporting, if needed for statistical reliability). -- **Keep**

- This is a broader sample covering more areas than the current WAPP.
- The NASS report as proposed by Mr. Glickman would be a monthly report.

The vote was unanimous to keep proposal.

2. Recommend to USDA to report on spot transactions for important cheese varieties, such as a "standard" Mozzarella that covers a significant amount of sales -- **Remove**

3. Recommend to USDA to report volume statistics on weekly spot transactions -- **Remove**

4. Recommend to USDA to examine ways to improve market news sampling procedures to ensure representative sample of the weekly spot market. -- **Remove**
    - This proposal is addressed in 1.

POSSIBLE ALTERNATIVE REFERENCE PRICE FOR CHEESE CONTRACTED SALES

1. An improved weekly spot price series for cheddar and other important varieties that is national, statistically reliable.

    The task force members decided this was covered in the Market Information Related section, number 1 above.

REVIEW OF PROPOSALS ADDRESSING THE LINK BETWEEN THE NCE PRICE AND THE BFP (Cont.)

The Task Force revisited the proposals which address the link between NCE and milk prices and agreed to the following recommendations with a unanimous vote.

The task force recommends that:

1. The US Department of Agriculture should not use the National Cheese Exchange price to determine the basic formula price (BFP) for manufacturing milk as it does currently.

2. The price of manufacturing milk under Federal Milk Marketing Orders should be based on supply and demand of milk.

    The USDA could accomplish this by:

3. First, substituting the NASS-reported national average cheese price for the NCE price in the BFP as soon as it is available and reliable; (mandatory reporting, if necessary for reliability)

    And then:

4. Phasing in the Coffee, Sugar and Cocoa Exchange's or the Chicago Mercantile Exchange's "BFP milk futures contract" for the BFP according to a schedule based on the accuracy of the CSCE or CME price reflecting national supply and demand conditions for manufacturing milk.

or:

Replacing the BFP with a national survey of manufacturing milk prices, less performance premiums and over-order values.

TWO ADDITIONAL PROPOSALS WHICH WERE DISCUSSED

- A proposal to substitute the current WAPP for the NCE price in the BFP calculation as soon as possible. -- **Remove**

The members voted to remove this proposal, 13 to 5.

- Use the most recent USDA cost of production figures adjusted for inflation as a significant part of the BFP formulation.
  - ⇒ 1994 cost of production average across the United States was $16.49.*
    *USDA - Economic Research Service
  - ⇒ This is a similar proposal to what was offered for the last farm bill (1996 FAIR Act) asking for higher price support or directing CCC to purchase products at a higher price.
  - ⇒ A suggestion was offered urging the task force to give Mr. Von Ruden time to formulate this proposal.

Task force member Von Ruden will come back with a specific proposal at the December 5 meeting.

REVISIT OF PRELIMINARY PROPOSALS PREVIOUSLY REMOVED FROM CONSIDERATION

1. Limit on daily price movement on NCE

- Limits on daily price movements are important in volatile markets and we have a lot of price volatility which has been demonstrated over the last six months on the NCE.
- The public interest in this market is very strong.
- Limits on price moves would be effective in allowing the industry time to reconsider what supply and demand factors are.

  Members' comment
  - ⇒ It is very important because it effects the pricing for the whole cheese industry.
  - ⇒ The NCE is still going to effect the pricing of cheese even if the BFP is no longer used to price milk.
  - ⇒ Any price limits will restrict trading by members that what to dispose of cheese.
  - ⇒ The NCE is an auction house where buyers of cheese and sellers of cheese meet to dispose of their surplus or purchase additional products to support their needs.
  - ⇒ If a company comes to the NCE and wants to sell its cheese they should be permitted to sell it for whatever price they can get for it.

⇒ Because manufacturers still use the NCE to price cheese, restrictions are needed.
⇒ Limits may slow trading, but would not restrict it.
⇒ Price movement restrictions would effect both increases and decreases.
⇒ Other cash markets do not have limitations on price movements.
⇒ The reason other cash markets do not have limits on price movements is because they are used as a clearing mechanisms for futures markets.
⇒ People can still trade outside the NCE if they want a higher or lower price.
⇒ Their are no price limits on the butter exchange.
⇒ The NCE board, in the past, has requested that the CFTC regulate the trading on the NCE. The CFTC turned the NCE down because there wasn't a cheese futures contract at that time.

The members voted to keep this proposal, 10 to 9 and asked for additional information be given at the December 5 task force meeting.

2. Request that the CFTC and FTC reevaluate its regulatory authority of the NCE -- **Keep**

The vote was unanimous to keep this proposal.

Bob Burns restated that comments would be accepted in writing. Meeting adjourned at 4:15 p.m. The next meeting will be on December 5, beginning at 10:00 a.m.

Approved_____ Date_____

State of Wisconsin
Tommy G. Thompson, Governor

Department of Agriculture, Trade and Consumer Protection
Alan T. Tracy, Secretary

2811 Agriculture Drive
Madison, Wisconsin 53704-6777

PO Box 8911
Madison, WI 53708-8911

DATE: November 15, 1996

TO: Governor Thompson

FROM: Alan Tracy, Secretary

SUBJECT: Update on the proposals discussed at the Task Force on Cheese Pricing Meeting

The Task Force on Cheese Pricing met yesterday, November 14, 1996. The meeting was well attended by dairy producers. I have attached a list of proposals developed at the meeting, as well as proposals from the October 17, 1996 meeting. This memo summarizes the proposals developed at that meeting.

Proposals addressing the link between the NCE and milk prices:

The Task Force considered the link between the National Cheese Exchange and milk prices. It agreed that the U.S. Department of Agriculture should not use the NCE price as a factor in the basic formula price for milk. Rather, the price of manufacturing milk should be based on supply and demand of the raw product.

A member of the Task Force advanced a new proposal, suggesting that USDA- Economic Research Service's cost of production figures, adjusted for inflation, be included in the BFP. The Task Force decided to table it until the next meeting to wait for more information.

Proposal relating to possible alternative price discovery mechanisms:

The Task Force felt that, to add liquidity to the futures market, the CSCE and the CME should establish cash contracts for cheese.

Proposals relating to improved market information:

The Task Force felt that the USDA should consider improving the weekly series available, the Wisconsin Assembly Point Price (WAPP) series, to provide a timely indicator of cheese prices for the industry. The expanded series could be used as an alternative reference price for contracted cheese sales.

Proposals relating to oversight and operating rules of the NCE:

The Task Force felt that any regulation on trading against interest should be deferred to either the Commodity Futures Trading Commission or the Federal Trade Commission, rather than addressed through DATCP rulemaking. It was proposed that these agencies be asked to re-evaluate their regulatory authority of the National Cheese Exchange.

The issue of whether or not the Task Force should recommend to the NCE that it implement limits on its daily price movements, was revisited and kept for further consideration.

The Task Force scheduled their next meeting for 10:00 a.m. on December 5, 1996.

PROPOSALS ADOPTED AT THE NOV. 14 CHEESE PRICING TASK FORCE MEETING

RELATED TO ADDRESSING THE LINK BETWEEN THE NCE AND MILK PRICES:

The task force recommends that:

The US Department of Agriculture should not use the National Cheese Exchange price to determine the basic formula price (BFP) for manufacturing milk as it does currently.

The price of manufacturing milk under Federal Milk Marketing Orders should be based on supply and demand of milk.

The USDA could accomplish this by:

First, substituting the NASS-reported national average cheese price for the NCE price in the BFP as soon as it is available and reliable; (mandatory reporting, if necessary for reliability)

And then:

Phasing in the Coffee, Sugar and Cocoa Exchange's or the Chicago Mercantile Exchange's "BFP milk futures contract" for the BFP according to a schedule based on the accuracy of the CSCE or CME price reflecting national supply and demand conditions for manufacturing milk.

or:

Replacing the BFP with a national survey of manufacturing milk prices, less performance premiums and over-order values.

RELATING TO IMPROVED MARKET INFORMATION :

- **Recommend to USDA to expand the weekly Wisconsin Assembly Point Price series to a statistically reliable and regional series to include major manufacturing areas. (Mandatory reporting, if needed for statistical reliability.)**

This series could then be available as a possible alternative reference price for cheese contracted sales.

RELATING TO OVERSIGHT AND OPERATING RULES OF THE NCE:

- **Ask the Commodity Futures Trading Commission and the Federal Trade Commission to re-evaluate its regulatory authority regarding the National Cheese Exchange**

- **Recommend to the NCE Board that they consider imposing a limit on the daily price movement of NCE prices**

RELATING TO POSSIBLE ALTERNATIVE PRICE DISCOVERY MECHANISMS FOR CHEESE:

- **Recommend to the Coffee, Sugar and Cocoa Exchange and the Chicago Mercantile Exchange to establish a cash contract for cheese**

PRELIMINARY PROPOSALS STILL ON THE TABLE

(Held over for the December 5 meeting)

NCE RELATED:

- **Inclusion of public member on NCE board**

- **Anonymous trading on the NCE**

  * ***Anonymity of buyers and sellers to the public***

  * ***Anonymity among buyers and sellers during the trading process***

  * ***If anonymity among buyers and sellers during trading, also limits on trading lot size***

- **Remote access to trading sessions**

  * ***NCE will have remote access in trading sessions in 1997***

  * ***Expanded concept beyond what the NCE is doing-- continuous, electronic trading***

- **Expanded trading sessions**

  * ***Proposals to increase frequency of trading sessions***

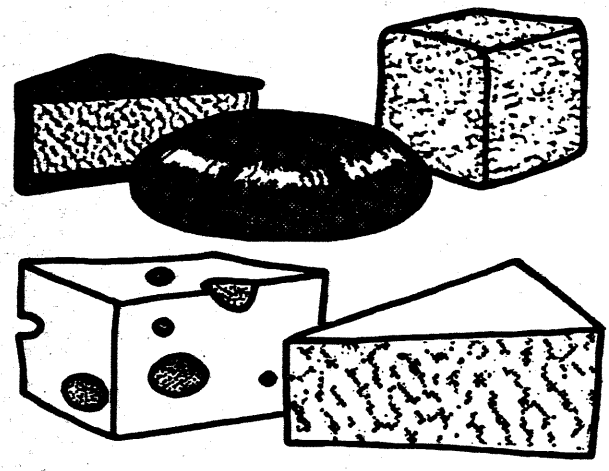
  * ***Proposals to move to continuous, electronic trading***

- **Examination of freight discounts**

Cheese Pricing

A Study of the National Cheese Exchange

Willard F. Mueller
Bruce W. Marion
Maqbool H. Sial
F. E. Geithman



Chapter 7--Summary, Conclusions, and Policy Initiatives

A. Introduction

Cheese is the most important manufactured dairy product in the U. S., commanding 85 percent of the milk from Wisconsin and 33 percent of all milk in the U.S. However, the price of cheese has even more effect on the nation's dairy farmers than these figures suggest. Cheese prices largely determine the manufactured grade milk price (previously the M-W price but now the Basic Formula Price), which is the main driver of farm milk prices throughout the country.

In 1992, sales of cheese manufacturers and marketers were about $16 billion. Bulk natural cheese generally goes from the cheese manufacturing plants to one of two types of converting operations: about three-fourths of natural cheese goes to cut and wrap operations which convert bulk cheese into the form, size and package desired by end-users; the remaining one-fourth goes to processing plants which grind, emulsify and blend natural cheese (usually with the aid of heat) to make processed cheese, cheese foods and cheese spreads.

Most cheese converters market finished natural or processed cheese products to one or more of three main types of customers: roughly 40 percent of all cheese is sold to retail food stores, 44 percent to foodservice, and the remaining 16 percent is sold to other food manufacturers (industrial accounts). Brands such as Kraft, Sargento and Borden are primarily important in cheese sold through food stores. Leading brands of cheese are sold at substantial premiums over private label or store brand cheese. Margins on cheese sold to foodservice and industrial accounts are similar to those on private label cheese.

We estimate that the largest four manufacturers of natural cheese accounted for about 29 percent of total pounds made in 1992. Most of the leading manufacturers are also involved in either cheese processing or the marketing of natural cheese. However, some of the leading processors/marketers make little or no natural cheese (i.e., Schreiber, Borden, Sargento). The largest four marketers of processed and natural cheese account for about 38 percent of the total *pounds* sold. The Census Bureau reported that in 1992 the four largest cheese companies made 42 percent of the *value* of all natural and processed cheese shipments. Thus, overall, both cheese manufacturing and cheese marketing are only moderately concentrated.

B. Cheese Pricing and the NCE

The commercial cheese industry in the United States began in the 1840s and by 1870 boasted over 1300 cheese factories, located predominantly in Wisconsin and New York State. Initially cheese factories conducted business individually with dealers. But by the 1870s, so-called "dairy boards" were established, where factory representatives and cheese dealers met and engaged in organized trading. These dairy boards and their successors evolved into the current National Cheese Exchange located in Green Bay, Wisconsin.

The National Cheese Exchange, often referred to herein as the NCE or the Exchange, is a centralized cash auction market trading 40-pound blocks (640-pound blocks were added in 1994) or 500-pound barrels of cheddar cheese in carlots of 40,000 pounds. In recent years the NCE has had 30 to 40 members consisting of cheese manufacturers, marketers, brokers and customers. Trading typically occurs from 10:00 a.m. to 10:30 a.m. each Friday.

During 1988 to 1993 just 0.2 percent of all bulk cheese was traded on the NCE. About 90-95 percent of bulk cheese sales involved direct supply arrangements using written or verbal "committed supply" agreements, often one year in duration. Another 5 to 10 percent involved spot market transactions.

Although only a tiny share of all bulk cheese transactions occurs on the NCE, it serves as the primary price discovery mechanism for bulk cheese transactions. Virtually all long-term bulk cheese contracts (not merely cheddar cheese) use so-called *formula price contracts*, which spell out various terms of trade as well as an agreed upon price premium over the closing weekly NCE opinion or price. Spot sales also are priced "off the NCE"; however, premiums are negotiated for each transaction and may vary somewhat from week to week. On committed supply agreements, prenegotiated premiums often apply for extended periods so that transaction prices move in lock-step with NCE prices.

NCE prices are also used in formula pricing some cheese sold wholesale to retailers and foodservice companies, especially private label and weak cheese brands. Historically, this practice tended to "couple" the wholesale price of cheese with the NCE price. Since about 1985, the extent and closeness of such coupling has declined, as some companies adopt wholesale list prices that change infrequently or modify the terms of formula price contracts.

C. Potential Problems of Thin Markets

Because such a small share of total bulk cheese transactions occur on the NCE, it is what market analysts call a "thin" market. Formula pricing and thin markets often go together. As firms adopt formula pricing--i.e., trading off a price established by someone else--the residual market declines in volume. Thin markets like the NCE are primarily a potential problem where they serve as a widely used reference price and hence become highly leveraged. The incentive to influence the NCE would be very different if it were used to price 5 percent of bulk cheese sales rather than the estimated 90 to 95 percent. As it is, during 1988-1993, the price on 0.2 percent of all cheese produced was used in setting the price on 90 to 95 percent. That simple fact creates a great incentive for attempting to influence the NCE.

Economists have identified several possible adverse consequences of thin markets including manipulation of price, incorrect price signals causing misallocation of resources, and increased price volatility due to market illiquidity. Thinly traded markets do not necessarily perform poorly if there is sufficient volume "waiting in the wings" and if no single firm (or group of cooperating firms) is large enough to influence price to its (their) advantage. The critical issue lies in having a sufficient volume of potential traders who will participate in price determination should price depart from the competitive level. Supply and demand in the thin central market may not accurately represent aggregate supply and demand conditions, especially if only a few firms trade in the central market, but virtually all firms use prices generated there in formula price arrangements. Even if a non-trader believes that the central market price is inaccurate, he may continue to use formula pricing since doing so reduces his transaction costs. Thus, for a given product the competitive structure of a thin central market may differ significantly from that of the aggregate market. The cheese industry illustrates this principle since the NCE is far more concentrated than either the buying or selling side of the aggregate market. The nature of competition in a central market is affected when some of its traders enjoy *strategic competitive advantages* over other actual and potential traders. As shown below, such advantages may cause the thinly traded central market to become a submarket within the larger aggregate market, with prices for both set in the central market.

The various stages of the cheese subsector fit the economic definition of moderately concentrated oligopolies. In sharp contrast, NCE trading is highly concentrated in both buying and selling, and it has a dominant seller-trader--Kraft General Foods, Inc., owned by Philip Morris Companies Inc. During 1988-1993, Kraft made 74 percent of all NCE sales and the next largest seller a mere 6 percent, with the top four seller-traders together accounting for 88 percent. During this period, the leading buyer-trader made 35 percent of all NCE purchases while the top four buyer-traders together came in at 81 percent. The degree of concentration was even greater in barrel trading, which accounted for 68 percent of all NCE sales and often appeared to drive block prices. During 1988-1993, Kraft made 83 percent of all barrel sales, a substantial percentage increase over the 1980-1987 period, when Kraft made only 25 percent of all barrel sales.

D. NCE Functions and Trader Motivations

Essential to understanding the trading conduct on the NCE is the proper identification of its functions: (a) to provide a cash market where members may buy and sell cheese and (b) to establish a "market opinion" price for bulk cheese, based on the day's last sale, highest bid, or lowest offer. There are, however, conflicting beliefs as to the primary reason traders use the Exchange. One view is that leading traders use the Exchange primarily as an alternative outlet or source of cheese; the second view is that they trade primarily to influence NCE prices, which are used in formula pricing bulk cheese bought and sold elsewhere.

If traders use the NCE primarily as an alternative outlet or source of supply, their trading patterns on the Exchange should be similar to those in any *bona fide* cash agricultural auction market: (a) traders that manufacture and sell most of their bulk cheese off the NCE should be mainly sellers on the NCE and (b) traders that normally buy most of their bulk cheese from others off the NCE for processing and marketing purposes should be mainly buyers on the NCE. On the other hand, if firms trade primarily to influence NCE prices, their trading conduct may often be the reverse of that expected in *bona fide* cash agricultural auction markets.

We tested these conflicting hypotheses by examining trading patterns over the 1980-1993 period. During 1980-1987, cheese companies that sold bulk cheese off the NCE were predominantly sellers on the NCE, while cheese marketers that bought bulk cheese off the NCE were predominantly buyers on the NCE--as expected in a bona fide cash auction market. This trading pattern was reversed during 1988-1993, when some leading marketers became predominantly sellers and several leading manufacturers became predominantly buyers.

The most significant reversal was that of Kraft, the largest buyer of bulk cheese off the NCE. During the seven years, 1980-1986, Kraft bought 411 loads on the NCE while selling only 175 loads. However, beginning in August 1986, Kraft became *exclusively a*

seller-trader on the NCE.[1] Also, beginning in 1988, three leading agricultural cooperative cheese manufacturers reversed their role, from being mainly sellers to being mainly buyers on the NCE. The cooperatives reversed their trading conduct more than one year after Kraft had become the leading seller-trader, suggesting that their reversals were a response to that of Kraft.

The shift in trading patterns occurred at the same time that the NCE became more important in the cheese price discovery process. During 1980-1987, cheese prices were strongly influenced by the government price support program. There was little opportunity for firms trading on the NCE to have much influence. As support prices declined, cheese prices became more market driven. The volatility and range of cheese prices increased sharply during 1988-1993. In this environment, cheese companies had both greater opportunity and greater incentive to influence prices.

In sum, the trading patterns of leading cheese manufacturers and marketers during 1980-1987 is consistent with the hypothesis that leading traders use the NCE as an alternative outlet or source of cheese. Trading conduct during 1988-1993, however, is consistent with the hypothesis that some leading traders are motivated primarily by a desire to influence NCE prices.

E. Business Characteristics of Leading Traders

Differences in the business characteristics of leading traders help explain why some were primarily buyers and others primarily sellers on the NCE during 1988-1993. Essentially, some traders benefit from higher NCE prices and some from lower NCE prices, other things being the same. To understand this concept, one must determine how an individual company's input costs and selling prices are related to NCE prices.

We examined the business characteristics of the nine leading traders on the NCE, who together accounted for 94 percent of all purchases and 94 percent of all sales during 1988-1993. Five of these traders--Kraft, Borden, Alpine Lace, Beatrice, and Schreiber--are primarily cheese marketers; three are agricultural cooperatives and major manufacturers of cheese: Mid-America, Land O' Lakes, and AMPI; and one is a broker: Dairystate Brands.

As cheese marketers, Kraft, Borden, Alpine Lace, Beatrice and Schreiber have certain characteristics in common. They all buy bulk cheese from manufacturers at NCE-based formula prices. NCE prices also largely determine the cost of milk used in making cheese and thus are the dominant influence over the cost of cheese-making in supplier plants.

There are, however, significant differences among these five cheese marketers. Kraft, Borden, and Alpine Lace all sell cheese under their own brand names. Kraft sells about 75 percent of its finished cheese products to retailers under highly differentiated Kraft brands that command significant price premiums over lesser brands. Borden, the second largest marketer of branded processed cheese to retailers, sells nearly all of its cheese under the Borden brand, which also commands a substantial price premium over private label and weaker brands, but a lower premium than Kraft brands.

Beginning in 1985, Kraft quit linking wholesale cheese prices to NCE prices and instead sold its brands at wholesale list prices, which frequently remain unchanged for many months. Since then there has been little correlation between NCE prices and the wholesale prices of either Kraft brands or those brands that often follow Kraft's prices. Although Kraft cannot set list prices entirely independently of other cheese brands, the relative strength of its brands gives it a significant degree of discretion in pricing. Like Kraft, Borden and Alpine Lace also sell finished product to retailers at list prices not coupled to NCE price.

Raw material inputs for processed cheese and finished natural cheese are predominantly bulk natural cheese and other dairy products. These inputs account for roughly 75 to 85 percent of the cost of finished cheese products. Profit margins for these three companies come mostly from the difference between the cost of cheese they buy or make and the wholesale price of finished product they sell. Since the bulk cheese they buy is priced off the NCE, and since the cost of bulk cheese constitutes such a large part of total manufacturing costs, Kraft, Borden and Alpine Lace all have a strong financial interest in lower NCE prices, all else remaining the same. There is also documentary evidence that implies Kraft believed it could influence NCE prices.

Beatrice and Schreiber differ somewhat from the other three marketers in that neither has strong consumer brands for its finished cheese products. Beatrice sells its products predominantly as private label brands and weak company brands to foodservice

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[1] From August 1986 through 1993, Kraft sold 2,043 loads and bought 22 loads. The 22 loads of blocks were evidently purchased for the purpose of influencing the price spread between blocks and barrels on the NCE, not because Kraft needed blocks at the time. Also, on two occasions Kraft bid to buy barrels; neither bid was filled. However, these bids evidently were made to *signal* its approval of an increasing price trend, not because Kraft needed more barrels. See Chapter 5, Section E. Thus, the above buyer-type actions were actually ancillary to Kraft's seller-trading activity, not the actions of a bona-fide buyer-trader.

companies, food retailers and industrial users. Schreiber, which is predominantly a processor and marketer of processed cheese products, makes a substantial majority of its sales to foodservice customers, particularly fast food chains. Most of its remaining sales are to food retailers, largely as private label or store brands and weak Schreiber brands. Therefore, both Beatrice and Schreiber sell to their customers at wholesale prices that are either formula-priced off the NCE or that compete with products of other sellers that formula-price.

Since Beatrice and Schreiber apparently sell their products at essentially NCE-based formula prices rather than at a list price, both their buying and selling prices are expected to generally follow the NCE. Thus, their ultimate interest in the level of NCE prices is likely to differ from that of Kraft, Borden, and Alpine Lace. Even though a marketer may buy a good share of its bulk cheese,[2] the fact that it buys bulk cheese and sells processed cheese and cheese foods at NCE-based formula prices means it may profit from higher NCE prices. Since bulk cheese costs may represent 70 percent or less of the total cost for making *processed* cheese products, an increase in NCE price will increase the wholesale price of the finished products by more than the cost of making these cheeses, all else being the same.

Beatrice and Schreiber also may have other motives for NCE trading. Both were primarily buyers on the Exchange during both 1980-1987 and 1988-1993. Thus, their trading pattern has been consistent with that expected of a cheese marketer who looks to the Exchange as a supplemental source of supply. The NCE is often the lowest cost source of bulk cheese. Thus, both Beatrice and Schreiber have an incentive to buy when NCE prices are below those in the spot market. But the amount they can purchase is limited by how much their bulk cheese needs exceed the amount they get from committed suppliers. Both may also have purchased on the NCE in an effort to prevent decreases in the value of their inventories. However, both also appear to sometimes participate in bidding up prices in rising markets for the apparent purpose of raising NCE prices rather than expecting to buy, since none of their bids are filled. On balance, however, the potential benefit of higher NCE prices to either company seems modest compared to the potential benefits marketers with strong brands may derive from lower NCE prices.

The three leading agricultural cooperative buyer-traders have two reasons for preferring higher NCE prices. First, the farmer-members of cooperatives benefit directly from higher prices for milk used in making cheese. Second, insofar as cooperatives sell some cheese under private label or weak brands of processed cheese, they have the same interests as Beatrice and Schreiber in higher NCE prices, although the potential benefits from this source are modest.

Since Dairystate is a broker, its interest in NCE prices presumably reflects those of its customers. Insofar as its customers are mostly small cheese manufacturers, it should be primarily a seller on the NCE, as it was during both 1980-1987 and 1988-1993. We are not satisfied, however, that we understand the motivation for much of Dairystate's NCE trading, particularly its activity in prolonged rising or declining price trends when there is little or no real prospect of consummating a transaction.

In sum, the business characteristics of traders determine whether, other things being the same, they benefit from lower NCE prices or higher NCE prices. Based on our analysis of the business characteristics of leading traders, we hypothesize that the leading cheese traders fall into three categories: (a) traders benefitting from lower prices: Kraft, Borden and Alpine Lace; (b) traders benefitting somewhat from higher prices: Beatrice, Mid-Am, Schreiber, Land O' Lakes, and AMPI; (c) a trader with a neutral interest: Dairystate Brands. Thus, if traders use the NCE primarily to influence prices, their interests in the level of NCE prices explain why traders in category (a) are predominantly seller-traders and those in category (b) are predominantly buyer-traders.

F. Spot Trading as an Alternative to the NCE

Analysis of the "spot market" provides further evidence concerning the motives of leading traders on the NCE. Whereas the NCE centralizes trading at one location for about 30 minutes each Friday, the spot market is comprised of direct transactions at negotiated prices among cheese companies for the purpose of handling short-term shortages or surpluses. (As used here, the term "spot market" refers only to those spot sales made off the NCE, although the NCE is also a spot market.) During 1988-1993, 5 to 10 percent of *all* manufactured cheese (all types and ages) was sold in the spot market, whereas about 0.2 percent was sold on the NCE. The fact that spot sales substantially exceed NCE sales (even for the types sold on the NCE) raises a question as to whether the NCE is needed as an alternative source of supply and a place to dispose of surplus. Some of those believing this function of the NCE to be essential evidently view it as a market of last resort, a place to which buyers or sellers turn because other

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[2] Beatrice makes between 50 and 75 percent of its total cheese sales needs, although it buys practically all of the barrel cheddar used in making processed cheese. During 1988-1993, Schreiber bought the bulk of its cheese requirements (from committed suppliers, from the spot market, and the NCE).

alternatives are unavailable. This rationale for Exchange trading is most plausible for small cheese manufacturers with limited knowledge of market alternatives. However, even small cheese companies rely predominantly on the spot market in disposing of surplus cheese. And brokers selling for small companies use the spot market far more than the Exchange.

Limited knowledge of market alternatives is an implausible reason for large companies to trade on the Exchange. Such companies have quite extensive knowledge of market alternatives and frequent communication with prospective buyers and sellers.

Most cheese companies prefer the spot market because it has substantial advantages over NCE trading, including the following:

-- Spot traders are able to establish more precise delivery, age and quality specifications than are NCE traders.
-- Spot transactions may occur any time during the business week rather than during the typical NCE trading period of about 30 minutes each Friday.
-- NCE sales are F.O.B. within 200 miles of Green Bay. Plants located some distance from Green Bay may often avoid the freight charges associated with NCE transactions by trading in the spot market.
-- Spot traders need not pay the 0.25 cent per pound charge assessed to both the buyer and seller on NCE trades.
-- Spot market trading provides an opportunity to trade at prices not immediately known to competitors. In competitive markets, firms departing from the prevailing price generally do not wish to communicate this information to others.
-- The thinness of the market and its widespread use in formula pricing discourage large cheese manufacturers and marketers from using the Exchange *as an alternative outlet or source of supply* because doing so may adversely affect the price they pay or receive for contract purchases. Hence, the logical buyers and sellers in competitive cash auction markets are discouraged from using the NCE as bona fide buyers or sellers. Spot trades do not create this conflict because the prices of committed supply agreements are not linked directly to spot prices.

Given this list of spot market advantages, it is not surprising that NCE prices generally have been lower than spot market prices for comparable cheese. The lower prices can make the NCE an attractive, though less reliable, source of supply for buyers who need more cheese than they receive from committed suppliers. Of course, lower prices on the NCE do not explain why a large company would prefer to sell there. Indeed, it is difficult to identify any reasons why a large company would prefer to sell on the NCE rather than in the spot market, other than to influence the market price.

Kraft's publicly stated reasons for selling on the NCE are that (a) it always builds a surplus into its annual plan, and (b) it must take the entire output of its committed suppliers. But while Kraft always plans for some surplus--and occasionally has unplanned surpluses or shortages--these reasons explain neither its large sales on the NCE nor its exclusive seller-trader status from August 1986 through 1993. Analysis of Kraft's operations reveals that it can--and usually does--manage surpluses in one of three other ways: by reducing the amounts taken from committed suppliers (so-called "deprocurement"), by selling in the spot market, and by selling to the CCC when the option is available. For example, when in 1990-1991 Kraft faced the largest unplanned surplus in recent years, it sold a relatively minor part of the total surplus on the NCE. Most, if not all, cheese sold on the NCE could have been placed in inventory or sold more profitably to the CCC and in the spot market. Instead, Kraft chose to sell on the NCE at prices below the CCC support level. After prices rose above the support level in 1991, Kraft sold on the NCE for the apparent purpose of moderating an upward price trend.

On barrel and block sales for the entire 1987-1992 period, Kraft calculated that it *lost* an average of 2.40 cents per pound on NCE sales, *gained* an average 2.65 cents per pound on spot sales, and *gained* an average of 0.19 cents per pound on CCC sales. Thus, there was a net differential of about 5 cents per pound between the loss from NCE sales and the gains from spot sales. (The comparisons include only sales of 40-pound cheddar blocks and 500-pound cheddar barrels, the cheese types sold on the NCE in 1988-1993.) To sell on the Exchange at a loss when other more profitable outlets are available constitutes trading against interest; i.e., it is irrational business conduct unless Kraft expected to influence NCE prices to its benefit. The profit-loss calculus to justify selling at such a loss is straightforward. Although Kraft lost about $1.5 million on NCE sales during 1987-1992, every 1 cent per pound reduction in NCE prices lowered Kraft's raw material procurement costs by over $10 million *annually*.

When considering whether or not the NCE as presently functioning is necessary as an alternative outlet, it is important to recall that a fragmented but geographically centralized cheese industry gave birth to the NCE and its predecessors in 1918. Since then manufacturing has become increasingly consolidated, with the number of cheese plants falling from about 4,000 in the early 1900s to 508 by 1987. Only 216 companies had annual sales over $100,000, the 50

largest of which made 82 percent of all natural and processed cheese shipments. Moreover, in 1920, two years after the predecessor of the NCE was established, Wisconsin accounted for 64 percent of the value of all cheese shipments; by 1994, Wisconsin's share of U.S. cheese production (in pounds) had declined to 30 percent. Over the period, cheese production in the Western Region grew from about 6 percent to nearly 25 percent.

This geographic decentralization of manufacturing and decline in firm numbers, together with improved communications and transportation, has made obsolete a central cash auction market where buyers and sellers physically meet. Other food and nonfood manufacturing industries have demonstrated that they can effectively manage unexpected shortages and surpluses without central cash markets, instead depending entirely on adjustments in supply, trades in spot markets, and inventory adjustments. Viewing the NCE in the context of the evolving cheese industry raises questions as to whether the NCE, as it currently functions, has become an anachronism.

G. Trading Activity of Leading Traders, 1988-1993

During 1988-1993, there was a cyclical pattern to cheese prices each year, caused by seasonal variation in overall supply and demand conditions. Prices typically were lowest in February and March, the beginning of the flush production; prices typically rose thereafter until they peaked in late summer or fall.

Overall supply and demand conditions determine the broad contour of prices over each price cycle. But given the high inelasticity of short-run supply and demand, there often is a range of prices that will clear the market at each point on the cycle. This gives traders with market power a range within which they may influence the price established each week on the NCE. Such traders might not always seek the *lowest or the highest* price possible each trading session; rather, they might choose to periodically influence prices over a price cycle when they believe doing so would aid in achieving their profit goals.

Leading traders on the NCE may be divided into two groups based on their differing financial interests in the level of NCE prices, other things being the same. Kraft, Borden and Alpine Lace apparently benefit from lower NCE prices, whereas Beatrice, Mid-Am, Schreiber, Land O' Lakes and AMPI apparently benefit from higher NCE prices, other things remaining the same. During 1988-1993, leading traders in the first group were predominantly seller-traders on the NCE, selling 1806 loads and buying 57 loads. Those in the second group were predominantly buyer-traders, buying 1947 loads and selling 93 loads. The two groups made 91 percent of all purchases and 86 percent of all sales. The leading seller-trader was Kraft, which made 74 percent of all sales, and the leading buyer-trader was Beatrice, which made 35 percent of all purchases.

Over each price cycle, the seller-traders, led by Kraft, usually traded most actively at price tops, price bottoms, and intermittently when prices were rising. At price bottoms, Kraft sometimes appeared to fill as many bids as required to keep prices at or near the seasonal low. Between a price bottom and the next price top, buyer-traders appeared to bid up the market, often with few consummated sales. During periods of rising prices, the seller-traders, led by Kraft, appeared to signal implicit approval of rising prices by not participating in trading, occasionally signaling explicit approval of rising prices by joining buyers in submitting bids, and signaling disapproval of rising prices by actively selling into a rising market, thereby moderating upward price trends. When seller-traders ceased selling, the upward price trend usually continued. At price tops Kraft often initially filled bids with the effect of slowing or stopping the upward trend. Thereafter, Kraft led in filling bids and in offering to sell as the market topped and began to subside. Once a downward price trend was established, Kraft frequently continued making offers to sell--often joined by Borden and Alpine Lace and sometimes by other traders. Generally, little actual selling was required to maintain a downward price trend, since with prices falling everyone in the marketing chain generally withheld purchasing, thereby delaying inventory accumulation until prices hit bottom. The apparent effect of seller-trader activity, led by Kraft, often was to shape the pattern of NCE prices over a price cycle.

The trading conduct of the two smaller seller-traders, Borden and Alpine Lace, differed from Kraft's in an important respect: whereas Borden made 30 percent of all offers to sell barrels during 1988-1993, it made only 4 percent of all barrel sales. Likewise, Alpine Lace made 30 percent of all offers to sell blocks but made only 5 percent of all block sales. The apparent explanation for these disparities in the pattern of offers and sales is that when buyer-traders began buying heavily, Borden and Alpine Lace generally became inactive, leaving Kraft to assume the losses that usually accompanied heavy selling. Thus, Kraft clearly dominated selling activity on the NCE.

Leading seller-traders were confronted by a small group of buyer-traders, led by Beatrice in barrels and Mid-Am in blocks. The buyer-traders were most active at price bottoms and during upward price trends. At price bottoms they exerted upward pressure on the market by covering offers (usually Kraft's) or making bids (usually filled by Kraft). Whenever Kraft stopped filling bids at a price bottom, buyer-traders actively bid

up prices, usually with few or no sales, sometimes for many successive weeks. The buyer-traders appeared to be a less cohesive group than the seller-traders, since at times some buyer-traders sold when others were buying.

Overall trading patterns imply that the seller-trader activity exerted a downward influence on price, and the buyer-trader activity exerted an upward influence on price. For example, during the days Kraft and the other leading seller-traders were active on the NCE, prices *increased* during only 8 percent of the sessions, whereas they *decreased* during 43 percent of the sessions and *remained unchanged* during 22 percent of the sessions. And in 27 percent of the sessions their selling activity *moderated upward price trends*. The same general pattern existed in block trading as in barrels.

The apparent influence of buyer-trader activity was the mirror image of leading seller-trader influence, but less pronounced in its effect. During the days leading buyer-traders were active, barrel prices *increased* on 45 percent of the days, *decreased* during 30 percent of the days, and *remained unchanged* on 25 percent of the days.

H. Kraft Trading Activity 1990-1992

An in-depth analysis of Kraft's trading activity during 1990-1992 provides insights into the apparent motives and consequences of Kraft's conduct, especially during cyclical price bottoms. For example, after a large price decline during January and the first week of February 1990, prices remained virtually unchanged for two months. The low prices apparently did not fully reflect market fundamentals but rather Kraft's persistent heavy selling on the NCE. Neither Kraft nor the industry had excess inventory at the time. Indeed, the market was quite tight with many cheese companies seeking supplemental supplies in the spot market. Market supplies would have been even tighter had not some companies apparently delayed building inventories because they feared prices might fall even lower. Whereas Kraft incurred losses on its NCE sales during this period, the evidence indicates that it often could have made profitable sales in the spot market.

The evidence does not support the idea that Kraft's large NCE sales during February-March 1990 were motivated primarily by a need to dispose of surplus cheese on the NCE. Kraft documents reveal that its top purchasing officials did not believe a surplus existed or loomed on the horizon. Insofar as Kraft had any short-term supply imbalances, these could have been managed by increasing inventory modestly or by making more spot sales, the predominant methods used by Kraft and other large firms in handling surpluses in periods when price supports were not operative.

Although NCE barrel prices fell 30.5 cents per pound between the January high and the February and March lows, Kraft lowered its average net wholesale processed cheese prices by only 5 cents per pound during the same period. As a result, Kraft's gross profit margins on cheese reached record highs during February and March 1990.

This and other evidence presented in this analysis support the hypothesis that Kraft's trading activity was motivated primarily by a desire to influence NCE prices, not to dispose of surplus cheese. During 1990-1992, Kraft managed its surplus problem predominantly by reducing procurement of bulk cheese, selling in the spot market, and selling to the CCC when available. Kraft's overall NCE sales were *unprofitable*, whereas its spot and CCC sales were *profitable*. There is evidence that Kraft chose to sell cheese on the Exchange at a loss when it could have more profitably made the sales elsewhere. Such conduct constitutes *trading against interest*, the practice of purposely not selling at the profit-maximizing price. In the context of NCE trading, this implies the seller anticipates the unprofitable NCE sales will enhance company profits by lowering prices paid for bulk cheese purchased under NCE-based formula price contracts.

I. Econometric Analysis

In addition to the analyses of trader motives, overall trading patterns, and the in-depth analysis of Kraft's conduct, we made several econometric analyses of NCE prices. The analyses sought to estimate quantitatively the relationship between NCE prices and various independent variables. Two alternative estimating techniques were used in examining the relevant relationships.

The analyses tested the hypothesis that during 1988 through 1993, trading by Kraft and the other leading seller-traders had a negative influence on NCE prices, and that trading by leading buyer-traders had a positive influence on prices. The analyses found a statistically significant *negative* relationship between NCE prices and leading seller-trader activity. The analyses found a very modest *positive*, but *not statistically significant*, relationship between NCE prices and the activity of leading buyer-traders.

The analysis implies that when at least one of the three leading seller-traders, dominated by Kraft, was active each week of a month, the average block and barrel price for the month was 4 to 5 cents per pound lower than if none of these traders had been active during the month. (These estimates are expressed in 1993 dollars.) So, if these traders were active during half of the weeks in a year, block prices would have averaged 2 to 2½ cents less for the entire year.

A separate analysis was made estimating Wisconsin Assembly Point (WAP) prices rather than NCE prices. This was done to determine whether the findings regarding NCE prices were representative of the actual transaction prices for the 90-95 percent of bulk cheese sold under committed supply agreements using NCE-based formula prices. These formulas typically include a premium over the relevant NCE price, with the size of the premium varying somewhat with changes in overall market conditions. Hence, NCE prices do not reflect precisely the actual transaction prices paid under committed supply agreements.

To determine whether this potential shortcoming of NCE prices significantly affected the relevance of our results, we substituted in our estimating equations average WAP prices, which are the prices paid on spot transactions at Wisconsin assembly points. WAP prices generally are higher than NCE prices with the size of the premium influenced by market conditions. Our results using WAP prices are very similar to those using NCE prices. These results indicate that NCE prices are representative of the NCE-based formula prices for bulk cheese sold under committed supply agreements.

In sum, these analyses provide quantitative support for the hypothesis that the leading seller-traders --dominated by Kraft--were successful in reducing NCE prices when they participated in trading. In doing so they lowered the price of bulk cheese sold by cheese manufacturers at NCE-based formula prices. The trading activity of leading buyer-traders, however, had no statistically significant influence on prices.

J. Conclusions

The National Cheese Exchange and its predecessors have been subject to periodic criticisms and questions since their inception. It is easy to understand why. This tiny market in Green Bay, Wisconsin, operates for about 30 minutes each week with trades averaging 0.2 percent of total cheese volume during 1988-1993; yet the NCE price is used to formula-price virtually all bulk cheese transactions. This enormous leverage and the concentrated nature of trading raises questions as to whether the NCE may be subject to manipulation for the benefit of some traders.

During the 1970s and through the mid-1980s, cheese prices were determined largely by government price supports for cheese; prices on the NCE seldom moved far from the CCC price. Thus, there was less opportunity and incentive for firms to manipulate the NCE. As price supports and CCC stocks declined, the role of the NCE in cheese pricing changed. Cheese prices became increasingly market driven, price volatility increased sharply, and in this environment the potential pay-off from *managing* NCE prices increased.

During 1988-1993, the NCE apparently did not perform the functions expected of a *bona fide* cash auction market serving primarily as a supplemental outlet or supply. In *bona fide* cash agricultural auction markets, price determination is the *result* of trading, not the *purpose* of it. However, the evidence presented in this report provides considerable support for the hypothesis that during 1988 to 1993, leading seller-traders and, to a lesser extent, buyer-traders, engaged in trading primarily to influence NCE prices.

There is evidence that in recent years Kraft has been the market leader on the NCE. Whereas Kraft is the leading *buyer* of bulk cheese off the NCE, beginning in August 1986 Kraft became exclusively a *seller-trader* on the NCE. During 1988-1993 it made 74 percent of all barrel and block *sales* on the Exchange. In the important barrel market segment, which accounted for 68 percent of NCE sales, Kraft made 83 percent of all sales. Together with two other leading seller-traders, Kraft accounted for 88 percent of all barrel sales and 70 percent of all block sales.

Analysis of trading conduct during 1988-1993 indicates that Kraft's trading activity appeared to fashion the pattern of NCE prices over each price cycle. Kraft's sales on the Exchange were usually at a loss, whereas when it sold either in the spot market or to the CCC it generally made a profit (or incurred a smaller loss than on the NCE).

While Kraft was the dominant seller-trader on the NCE, it frequently was joined by Borden and Alpine Lace. These three seller-traders were frequently confronted by five leading buyer-traders, Beatrice, Mid-Am, Schreiber, Land O' Lakes and AMPI. The buyer-traders--especially Beatrice and Mid-Am--often appeared to challenge Kraft's conduct at cyclical price bottoms and price tops, and to take turns bidding up prices during rising price trends. Insofar as cooperation occurred among buyers or among sellers, this may merely have reflected a shared interest in the level of prices; we found no evidence of collusive conduct among traders. The buyer-traders were a less cohesive group than the seller-traders, with some buying while others were selling.

The above characterization of trading conduct on the NCE implies that prices were established within the context of bilateral oligopoly, with Kraft acting as the dominant price leader, with two followers, confronted by five leading buyer-traders. Economic theory teaches that what actually happens under bilateral oligopoly depends upon the relative market power of the conflicting parties, including which party exercises price leadership. When power is evenly divided, the resulting prices *may* approximate competitive ones. If one side enjoys greater power than the other, the resulting prices will benefit the holders of greatest power. The study

examined this issue by analyzing the conduct and performance of leading traders.

The analysis indicates that there was an imbalance in market power between buyer-traders and seller-traders, with the balance favoring Kraft and its followers. Kraft is the largest cheese company, the largest buyer of cheese off the NCE, and the leading seller on the NCE, especially in barrel cheddar cheese. We estimate that Kraft used 35 to 40 percent of all barrel cheese made in the United States in 1992,[3] practically all of which was purchased under committed supply agreements at NCE-based formula prices. Kraft, in turn, uses this barrel cheese in processed cheese and cheese spreads, where Kraft accounts for about 60 percent of *retail* sales.

Kraft's large size in the cheese industry and dominance in NCE trading give it several *strategic competitive advantages* over traders and potential traders.[4] One competitive advantage derives directly from Kraft's position as the largest buyer of cheese off the NCE[5]. Each year Kraft builds some surplus into the amount of cheese it agrees to buy from committed suppliers.[6] In addition, it typically has first call on any excess cheese produced by committed suppliers, thereby controlling whether the cheese is sold in the spot market or on the NCE. Thus, Kraft has various methods of managing its surplus, which gives it the option of selling as much of the surplus on the NCE as best serves its interest.

Buyer-traders apparently do not have similar flexibility. Cheese marketers like Beatrice and Schreiber may plan each year to buy some cheese in the spot market and on the NCE. But the amount they can buy on the NCE may vary greatly from week to week. It is, therefore, risky for such marketers to plan on the NCE as a significant supply source. Since most marketers obtain 90-95 percent of their cheese under committed supply arrangements, this limits the extent to which they can buy cheese on the NCE.[7] Likewise, when selling on the NCE, Kraft often deals directly with

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[3] A 1989 Kraft document states that Kraft utilizes [... to ...] percent of the cheese produced in the U.S. Kraft General Foods, Inc., *Cheese Procurement Strategy*, Operations, December 6, 1989, KGF 2948, 2977. In November 1990, Kraft's cheese procurement director estimated that Kraft accounted for [...] percent of total U.S. cheese production. Kraft General Foods, Inc., Wayne Hangartner, "Jerome Cheese Company," November 8, 1990, KGF 3218, 3228. Information has been redacted from the report at this time pursuant to an agreement with Kraft General Foods, Inc., that there will be a subsequent judicial resolution of a good-faith dispute over the trade secret status of the information.

[4] A firm enjoys a strategic competitive advantage if it can employ strategies not available to other actual and potential market participants. Alexis Jacquemin, *The New Industrial Organization*, The MIT Press, 1987, 107-129; Michael E. Porter, *Competitive Advantage*, The Free Press, New York, 1985; T. Schelling, *The Strategy of Conflict*, Harvard University Press, 1960.

[5] In an interview, Richard B. Mayer, Chairman-CEO of Kraft General Foods, Inc., reportedly said size "yields a lot of areas of *competitive advantage*" including "*incredible purchasing power*. Those types of advantages are very, very real." Emphasis added. J. Liesse and J. Dagnoli, "Goliath KGF Loses Steam After Merger," *Advertising Age*, January 27, 1992, p. 17.

(fn. 5 cont.)
Kraft included among the implications of being the largest cheese buyer the ability to get better information than others about overall market conditions. Kraft General Foods, *Cheese Procurement Strategy*, Operations, December 6, 1989, KGF 2948, 2990. It included among the strategies to maximize profits: developing superior information systems; establishing inventory strategic reserves; and influencing industry conditions to support Kraft business strategy. *Id.* 2993.

[6] Kraft buys virtually all its barrel cheese needs from committed or spot suppliers. Kraft also can obtain additional barrel or block cheese from some of its committed supplier plants that can convert from making block to barrels. Such plants are referred to as "balancing" plants. If need be, these plants can supply additional barrels or blocks for trading purposes, thus contributing to Kraft's supply flexibility.

[7] Of course, one option would be for a trader to buy at a low price on the NCE and sell at a higher price in the spot market. We have no evidence that this occurs frequently, although brokers may occasionally do so. Perhaps the reason for this is that buyer-traders believe the potential rewards are smaller than the potential risks. This is especially true at market tops and in declining markets, when a speculative buyer-trader may end up selling at a lower price in the spot market than he paid on the NCE.

At market bottoms, such speculative trading may be discouraged because continued heavy seller-trader activity may ultimately drive prices down even lower. Finally, other seller-traders that benefit from lower prices would not be inclined to *buy* on the NCE if doing so threatened to *increase* prices or slow decreases.

cooperative cheese manufacturers that sell much of their bulk cheese (as committed suppliers or in the spot market) to Kraft and other cheese marketers. Although cooperatives often plan to buy some cheese in the spot market, their needs at a specific time may be quite limited. Since they must ultimately sell any cheese purchased that exceeds their needs, they face the same problem as the proverbial coal mines of Newcastle. Moreover, during 1988-1993, the leading cooperatives did not appear to coordinate their buying efforts on the Exchange. Land O' Lakes was an active seller-trader on a number of occasions. AMPI, the largest cheese cooperative, was the least active of the five leading buyer-traders, and on one occasion sold heavily (while other buyer-traders were buying) on the Exchange, causing an historic drop in prices. Thus, the leading buyer-traders at times appeared to trade at cross purposes, an action which suggests that they constituted a less cohesive group than the seller-traders.

Kraft enjoys another strategic advantage over buyer-traders because of the asymmetry in market information among traders.[8] Kraft believes that its greater overall size and larger committed supplier base compared to other traders give it superior information regarding the size of industry inventories and overall supply/demand conditions. Other traders acknowledge that Kraft is the best informed trader, commanding the respect of both sellers and buyers. Because of Kraft's superior market knowledge, other traders hesitate to oppose Kraft's view of market conditions as implied by its trading conduct, especially during the turning points at the bottoms and tops of price cycles. When Kraft is active in a down market, traders with coincident interests often join in offering cheese; but traders with conflicting interests may remain on the sidelines because they suspect Kraft knows better than they such relevant facts as the size of industry inventories and shifts in aggregate supply and demand. A trader contemplating activity contrary to that of Kraft may believe such a strategy involves greater risk than going along with Kraft. Such conduct may also be encouraged by the fact that all leading buyer-traders have much slimmer profit margins than Kraft. The deference shown Kraft because of its superior market knowledge is a classic example of strategic advantage conferred by asymmetrical market knowledge.

Finally, Kraft gains competitive advantage because it buys so much cheese off the Exchange directly from actual and potential Exchange traders, a fact which may explain why important suppliers of Kraft have elected not to participate in trading. Only one (AMPI) of Kraft's leading suppliers during 1991-1992 traded on the Exchange in those years. This suggests that Kraft's leading suppliers were reluctant or unable to challenge Kraft on the NCE even though their interest in NCE price levels differed from Kraft's. No such constraints are placed on buyer-traders for whom Kraft is not a large customer off the NCE. Beatrice, Schreiber, Mid-Am and Land O' Lakes, the leading buyer-traders on the NCE, are not committed suppliers of Kraft, and they sell relatively little of their total bulk cheese output to Kraft. On the other hand, AMPI, an agricultural cooperative, the country's largest cheese manufacturer and a large committed supplier of Kraft, made far fewer purchases on the NCE than did Mid-Am, the nation's second largest cheese cooperative. AMPI's behavior is consistent with the expectation that firms selling relatively large amounts of cheese to Kraft off the Exchange are not likely (or able) to challenge Kraft's conduct on the NCE. Likewise, any trader that has a continuing business relationship with Kraft may cooperate with it on the NCE despite the fact that NCE prices seemingly have a neutral impact on the trader's profitability.

These various strategic competitive advantages are the source of Kraft's ability to exercise price leadership on the NCE. As Michael E. Porter observed, "industry leadership is *not a cause but an effect of competitive advantage.*"[9] No other trader on or off the Exchange enjoys these advantages, all of which derive

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[8] The literature of strategic behavior includes asymmetry of information among rivals as an important factor conferring strategic advantage to a firm. David Encaoua, Paul Geroski and Alexis Jacquemin, "Strategic Competition and the Persistence of Dominant Firms," in Joseph Stiglitz and G. Frank Matthewson (ed.), *New Development in the Analysis of Market Structure* (1986), p. 55. Economic theory also suggests that asymmetric information facilitates cartel behavior. J.S. Feinstein, M.F. Block, and F.C. Nold, "Asymmetric Information and Collusive Behavior in Auction Markets," 74 *American Economic Review* (June 1985), 441-460. In a recent decision, the British Office of Fair Trading concluded that "asymmetries in information" constituted a significant barrier to entry. M.A. Utton, *Market Dominance and Antitrust Policy*, 1995, p. 130. See note 5 above regarding Kraft's superior market information.

[9] Michael Porter, *Competitive Advantage*, (The Free Press-Macmillan Inc.), 1985, p. 26. Emphasis in the original. David Encaoua, Paul Geroski, Alexis Jacquemin. "Strategic Competition and the Resistance of Dominant Firms: A Survey," in Joseph Stiglitz and G. Frank Mathewson, *New Development in the Analysis of Market Structure*, MIT Press, (1983) 79, 55-56.

from Kraft's large overall size and unique organizational structure. In this context, Kraft holds the balance of power. Of course, there may be times when supplies are so tight that Kraft is unable to depress prices on the NCE. Indeed, it may not be in Kraft's interest to do so at times, lest price be inadequate to bring forth a sufficient supply. But this only indicates, of course, that there are constraints on Kraft's ability to influence prices, a condition true even for a monopolist.

Kraft's potential influence over industrywide prices would be greatly diminished if it only *bought* from committed and spot suppliers and *sold* any surpluses in the spot market, since then its influence over price would be limited primarily to its buying power in the aggregate cheese market. Since Kraft's cheese requirements account for a quite modest share of total cheese production (approximately 15 to 20 percent),[10] it would have little unilateral control over price.

Thus, the existence of the NCE and the industrywide practice of NCE-based formula pricing greatly enhances or facilitates the use of the power conferred by Kraft's various strategic advantages.[11] Since potential traders do not enjoy these advantages, they cannot effectively *contest* the pricing decisions made on the NCE. This establishes the NCE as an incontestable submarket within the aggregate cheese market. And because cheese in the aggregate market is priced "off the NCE," the ability to influence NCE prices confers influence over industrywide prices.

The documentary evidence indicates that sellers with strong brands not coupled to NCE prices benefit from lower NCE prices, other things being equal. Kraft's conduct on the Exchange, as well as documentary evidence, implies that it believed it could influence NCE prices, and that at times it sold at a loss to accomplish this result. Selling on the NCE at a loss when it could have sold profitably (or at a smaller loss) elsewhere constitutes irrational business conduct unless Kraft expected to benefit from lower prices paid to committed suppliers. That is to say, rational businessmen would not needlessly squander resources in Exchange selling unless they believed doing so enhanced overall profits.

Kraft's former director of procurement rationalized Kraft's behavior on the NCE by explaining that when Kraft has a surplus it first offers cheese to potential spot buyers. When it exhausts this demand, it sells the remainder on the NCE at a loss, if necessary. He acknowledged that in this scenario the NCE might be viewed as a *market of last resort*. If correct, this would be a serious indictment of the thin NCE market as an appropriate basis for formula pricing practically all sales of bulk cheese.

Kraft's use of the NCE as a market of last resort is also irrational conduct for a seller seeking to maximize profits on surplus sales. Economic theory teaches and business experience verifies that sellers in imperfectly competitive markets avoid publicizing prices of distress sales to avoid "spoiling" the market for other sales. This logic implies that a rational seller would make distress sales in the spot market, not the NCE where prices become public immediately. It is rational, however, to treat the NCE as a *market of last resort* if doing so reduces the price at which a *seller* on the Exchange *buys* large amounts of bulk cheese off the Exchange at NCE-based formula prices.

Finally, our econometric analysis provides further support for the hypothesis that during 1988-1993 Kraft and other seller-traders had a significant negative impact on NCE prices. The implication is that at times Kraft enjoyed significant savings in procuring bulk

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(fn. 9 cont.)
Steven C. Salop, "Strategic Entry Deterrence," *American Economic Review*, 69 (May 1979), 335-338. Michael E. Porter, *Competitive Advantage*, The Free Press, New York, 1985. Steven C. Salop (ed.), *Strategy, Predation and Antitrust Analysis*, Federal Trade Commission, Washington, D.C., September 1990.

[10] In a public document Kraft reports that in 1992 it accounted for about 20 percent of all cheese in the U.S., and 40-45 percent of all cheese sold through supermarkets. Dede Thompson Bartlett, Vice President and Secretary, Phillip Morris Companies Inc., to the Reverend Seamus P. Finn, O.M.I., February 24, 1992, enclosures, Kraft General Foods, Inc., "Share of the U.S. Dairy Industry," and "Facts about Kraft's Cheese Business."

[11] The NCE, as presently structured, may be viewed as an institution that enhances or *facilitates* the use of unilateral or collective market power. The legal-economic literature on facilitating practices usually discusses them in the context of practices that promote cooperation among competitors and market dominance. The critical point is that the facilitating practice enhances the use of unilateral or collective market power. See Scherer and Ross, *op cit*, 235-274; Donald S. Clark, "Price Fixing Without Collusion," 1983, *Wisconsin Law Review*, 887; Kevin J. Arquit, "The Boundaries of Horizontal Restraints: Facilitating Practices and Invitations to Collude," Federal Trade Commission, Washington, D.C., August 11, 1992; Randall C. Marks, "Can Conspiracy Theory Solve the Oligopoly Problem?" 1986, *Maryland Law Review*, 387.

cheese because it bought the cheese at NCE-based formula prices. The econometric analysis found that leading buyer-traders had no statistically significant impact on prices. But based on our non-econometric analysis of buyer-trader motives and conduct, we are inclined to believe they did have a modest countervailing influence. At a minimum, had they made no effort to countervail Kraft's leadership, NCE prices might have been lower at times. Thus, we do not imply that there are no constraints on Kraft's influence, but rather that during 1988-1993, the balance of power tilted in Kraft's favor and that at times it benefitted from this advantage.

Farmers have an important financial interest in higher NCE prices, but their cooperatives cannot be indifferent to the effect higher prices may have on milk output. In the absence of control over the supply of milk for manufacturing and without government support programs, the highest price cooperatives may achieve is the competitive equilibrium price. They do, of course, have a strong incentive to prevent NCE prices from going below this price, which may occur if NCE prices are manipulated.

In sum, our analysis of business motives, trading conduct on the NCE, an in-depth analysis of Kraft's conduct on and off the NCE, and a quantitative analysis of NCE prices indicate that the National Cheese Exchange was not an effectively competitive price discovery mechanism during 1988-1993. As currently organized, the Exchange appears to facilitate market manipulation. The main beneficiaries of this situation appear to be Kraft General Foods, Inc., and other seller-traders with coincident interests. The evidence supports the hypothesis that during 1988-1993 Kraft (a) had a financial *motive* for influencing NCE prices, (b) had the *power* to influence prices, and (c) had at times exercised this power for its benefit. We emphasize, however, that we found no evidence of collusion among cheese companies.

This raises the question, did Kraft possess *unilateral* power over prices in NCE trading? To possess unilateral power, a firm must hold a substantial market share in an economic market with significant entry barriers that protect the firm from potential competitors.

Kraft's average share of NCE sales during 1988-1993 was 74 percent, which is well above the range that economists generally consider sufficient to confer unilateral power in a market with high entry barriers.[12]

NCE trading constitutes a separate economic market shielded by substantial entry barriers. These barriers exist because practically all bulk cheese prices in the aggregate cheese market are priced off NCE prices and because actual and potential traders in the aggregate market cannot replicate, at the same cost, the strategic competitive advantages Kraft enjoys in NCE trading. Therefore, both the actual and potential traders on the NCE apparently cannot successfully *contest* the prices established there, even when they depart significantly from competitive levels.[13]

Thus, during 1988-1993, Kraft enjoyed the two necessary conditions of unilateral power, a large market share in a market with significant entry barriers.

Because these conclusions are based on an analysis of the six-year period, 1988-1993, they may reflect factors *unique* to these years and, therefore, may be an imperfect predictor of the future performance of NCE pricing. There is evidence that beginning in 1990 Kraft engaged in especially aggressive short-run profit maximization, as it substantially increased gross profits for cheese by widening the spread between wholesale net selling prices and bulk cheese procurement costs. During this period Kraft appears to have used the competitive advantages it enjoys in NCE trading to periodically depress bulk cheese prices, perhaps by a greater amount than is sustainable in the future. If so, this does not diminish the apparent consequences of Kraft's conduct during the years studied, nor does it gainsay the need to enhance the NCE's competitive performance. Even short-run price manipulation subverts the market to the detriment of consumers and farmers as well as some industry participants.

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[12] Economists typically assume firms with market shares exceeding 40-50 percent may possess unilateral market power. George J. Stigler, *The Organization of Industry*, 1968, 228, uses 40 percent in identifying such firms. P.A. Geroski, "Do Dominant Firms Decline," in Donald Hand and John Vichers (eds.), *The Economics of Market Dominance*, 1987, states that "A market share of 40 percent is the conventionally accepted cut-off point" in identifying dominance.

During 1988-1993, Kraft's annual share of NCE sales ranged from 56 percent to 91 percent. Kraft's share apparently varied, in part, depending upon the volume of sales required to achieve its objectives. Each year it very probably could have sold larger amounts on the NCE had this been required to achieve its objectives.

[13] The theory of contestable markets holds that a firm with a large market share has power over price if entry and exit in a market are made difficult because of significant advantages enjoyed by the dominant incumbent firms. John C. Panzar and Robert D. Willig, *Contestable Markets and the Theory of Industry Structure*, 1982. Also, see text at notes 30-31, Chapter 3, for reasons NCE prices may not be representative of aggregate demand and supply conditions.

K. Public and Private Initiatives to Improve Price Discovery

There are several possible solutions to the problems with price discovery on the NCE. Included in the following discussion are policies and procedures which could be implemented in conjunction with the NCE, as well as suggestions for possible alternatives to the Exchange as a central cash auction market.

In considering alternatives to the Exchange, we are mindful that despite its deficiencies as a price discovery mechanism, the Exchange is widely used by industry participants as a reference price in formula pricing. This function is highly prized by many because it greatly reduces transaction costs. It is, therefore, imperative that any alternative to the Exchange continue to provide this function.

The Problem of Trading Against Interest

As discussed earlier, an anomalous trading pattern has emerged on the NCE in which the leading *sellers* on the NCE are predominantly *buyers* of bulk cheese off the NCE; the leading *buyers* on the NCE are either large agricultural cooperative cheese manufacturers that *sell* bulk cheese off the NCE or large cheese marketers that sell private label brands or weak company brands. This trading pattern appears to be motivated by efforts to influence prices, not to use the Exchange as a residual market.

This behavior may involve what legal-economic analysts characterize as "trading against interest," a phenomenon in which big buyers (sellers) of a product may sell (buy) some of it in one market in a way that depresses (increases) the price in another market where the companies buy (sell) practically all their supplies. Such conduct always raises a question of potential market manipulation.

While both leading buyers and sellers on the NCE may have periodically attempted to trade against interest in recent years, leading seller-traders, dominated by Kraft, appear to have been the main beneficiaries of the practice. Indeed, the conduct of leading buyer-traders during 1988-1993 may have been largely a response to Kraft's seller-trader activity beginning in August 1986. The apparent purpose and effect of Kraft's conduct on the NCE have certain parallels to a classic market price manipulation case involving trading against interest. In *Socony*, the major oil companies used the spot market price of gasoline to formula-price gasoline they sold to jobbers. By purchasing a small amount of gasoline in the spot market, the major oil companies were able to raise spot prices, thereby raising prices to jobbers and consumers throughout the Midwest.[14] The Supreme Court concluded in part:

> [T]he fact that sales on the spot markets were still governed by some competition is of no consequence. For it is indisputable that competition was restricted through the removal by respondents of a part of the supply which but for the buying programs would have been a factor in determining the going prices on those markets.[15]

Whereas the oil companies manipulated the spot market in order to benefit their selling prices, Kraft sold on the NCE with the apparent purpose and effect of lowering the price it paid for cheese purchased from committed suppliers under NCE-based formula prices.

Unlike the major oil companies, who achieved their purpose by *agreement* among oligopolists, Kraft's conduct seems to involve primarily a *unilateral* action, followed by some cooperating marketers with interests similar to Kraft's. *Unilateral* conduct involving selling against interest also *may* violate public policy when practiced by a dominant trader. For example, in a consent decree the National Cranberry Association, the dominant cranberry marketer, is among other things restrained from, "Purchasing cranberries from others and reselling or otherwise disposing of them to artificially raise, depress or stabilize market price levels of fresh or processed cranberries."[16]

Various public and private initiatives may aid in eliminating the market failure problems caused by trading against interest. To be effective, the policies must address the factors that make such trading possible and that give competitive advantage to some traders. Below we discuss possible approaches to the problem.

Prohibiting Trading Against Interest

The courts have approved decrees banning trading against interest where the purpose and effect have been to manipulate prices.[17] We do not presume here to 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 statutes.

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[14] *United States v. Socony*, 310 U.S. 150 (1940).

[15] *Ibid.*

[16] *United States v. Nat. Cranberry Ass'n*, 1957 TC par. 68, 850 (D. Mass 1957).

[17] For example, *Socony* and *National Cranberry Assn.*

The NCE By-Laws have been applied to prohibit trading against interest, although they have been applied only narrowly. In one instance a trader who covered an outstanding offer at a higher price than the last covered offer was reprimanded by the Directors of the Exchange because the trade "was not consistent with the *natural self interest* of buyers to attempt to purchase at the existing or a lower market price."[18] Yet, Exchange president Richard Gould and the NCE Board of Directors have expressed the view that the NCE cannot be manipulated by the "unilateral" action of an individual trader.[19]

Trading Limits

A cash auction market may adopt rules limiting the amount of purchases or sales made by a single party. For example, the United States Treasury Department has such a rule in the sale of United States securities: "The maximum award that will be made to any bidder is 35 percent of the public offering...."[20] This rule was deemed necessary despite the fact that there are about 35 "primary" treasury security dealers, as well as other bidders for a particular security being sold. Moreover, the new security competes with similar securities already available in the market; for example, a new two-year treasury security has competition from already issued securities of similar duration.

This approach may not be practical on the NCE. It clearly could not be applied to trading for individual days. Nor may it be practical if applied to longer periods, since a trader would never know beforehand how much total trading would occur over the relevant period.

Alternative Basis for Formula Pricing Cheese

One alternative for preventing any trader from affecting price by trading against interest is to change the rules of the NCE, or enforce more aggressively the existing rules. Another alternative is to develop some price basis other than the NCE that can be used for formula pricing bulk cheese. From time to time, some members have advocated alternatives. Indeed, apparently some Kraft officials are not wedded to the NCE and have said that Kraft supports the review of alternatives to the NCE, and expects to participate in any alternative.[21] In our view, however, the required

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[18] Minutes for a Special Meeting of the Board of Directors of National Cheese Exchange held on August 31, 1990, 3. Emphasis added. Exchange President Gould wrote this trader that "your company's *trading activity was clearly against its economic best interests* and could easily be interpreted as an intentional attempt to manipulate the market price of 40 pound block." Emphasis added. R.J. Gould to Robert Burns, President, Beatrice Foods, September 21, 1990. For a discussion of this and a similar incident see text at notes 108-111, Chapter 4. The Board viewed this conduct as "detrimental to the interests and welfare of the Exchange." Minutes of a Special Meeting of the Board of Directors of the National Cheese Exchange, August 31, 1990, p. 4. The Board's authority for prohibiting such conduct is Article III Section 4(a) of the NCE By-Laws, which authorizes the Board to suspend a member for "any conduct considered detrimental to the interests or welfare of the Corporation. Suspension in each case shall be for such period of time as may be designated by the Board of Directors not exceeding six months." National Cheese Exchange By-Laws, Article III, Section 4(a), which was amended August 23, 1988, "increasing permissible suspension from two months to six months."

The Exchange president has responsibility for monitoring trading activity for collusion. "Interview of Richard J. Gould," Rosemary Derrio to Matt Frank, Assistant Attorney General of the Wisconsin Department of Justice, March 4, 1988, p. 3.

[19] See Chapter 4, note 100 and text at note 103.

[20] *Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds*, Department of the Treasury Circular, Public Debt Series No. 1-93, Section 35622.

May 20, 1992, Saloman, Inc. and Salomon Brothers, Inc., entered into a consent settlement agreement with the Securities and Exchange Commission for allegedly violating the Treasury Department 35 percent rule. Among other matters agreed to in the settlement, Saloman was required to pay $190 million to the United States and $100 million for compensatory damages to injured parties. *Securities and Exchange Commission v. Saloman Inc. And Saloman Brothers Inc.*, Complaint and Permanent Injunction and other Relief, May 20, 1992.

[21] Kraft General Foods, Inc., *Milk Prices, Cheese Prices and the National Cheese Exchange*, author not identified, April 14, 1992, KGF 16948, 16956. A cover page to the document indicates it was forwarded from Wayne Hangartner, Kraft's Director of Cheese Procurement and Inventories, to others in his department, and is identified as "Copy of Presentation to the Dairy Farm Specialists" on 4/14/92. A similar sentiment is expressed in Kraft General Foods, Inc., *National Cheese Exchange (NCE)*, author not identified and undated, KGF 16913, 16917.

industry participation and assistance which would be required to make any fundamental changes may not be forthcoming until some State or Federal authority determines whether trading against interest has occurred and has adversely influenced prices on the Exchange.

In considering alternative bases for formula pricing, it is important to keep in mind that existing problems with the NCE are due to a combination of factors: the Exchange is a *highly concentrated, thin market*, that is highly leveraged in its effect through *formula pricing;* and Kraft enjoys a *strategic competitive advantage* over other actual and potential traders on the Exchange. So long as these conditions exist, the NCE serves to *facilitate* non-competitive behavior. Any alternative basis for formula pricing, to be an improvement, must eliminate or reduce the distorting influence of these problems.

Trading on the NCE is much more concentrated than is cheese manufacturing, cheese converting or cheese marketing. If the industry were to adopt a different price discovery mechanism that encouraged/allowed participation of more members representative of the aggregate market, a more competitive market would evolve. Such a market might be much less concentrated and might reduce the strategic competitive advantages Kraft enjoys in NCE trading, especially if the other initiatives discussed below were adopted.

Price Report for Direct Spot Transactions

Price reports of decentralized spot transactions are used in several commodities as a reference price for formula pricing (see Appendix 7.A, which reviews thin market/formula pricing problems in other agricultural commodities). This system is clearly feasible in the case of cheese. At the present time, Wisconsin Assembly Point prices are reported weekly. However, the accuracy of these reports is not highly regarded by industry members. To replace the NCE as a basis for formula pricing, the spot market price report would need to be substantially improved.[22]

Such a price report could still encounter thin market problems since the spot market for bulk cheese represents only 5 to 10 percent of total cheese volume, and during tight supply conditions perhaps much less than that. We have not been able to determine the size of the spot market for cheddar cheese which meets NCE standards. We do know, however, that it is significantly larger than the current volume sold on the NCE. Even the largest traders typically trade much more off the NCE than on it, and numerous cheese companies never trade on the Exchange. A report covering spot sales nationally would enlarge the total volume of direct transactions, greatly expand the reporting base and better reflect aggregate market conditions. (The current WAP price report covers only sales in Wisconsin.) Such an enlarged spot price reporting program would better reflect the overall structure of cheese manufacturing and cheese marketing, which is relatively unconcentrated and, therefore, less subject to manipulation. Thus, we believe that thin market problems would be fewer and less influential than those of the NCE.

In order to avoid a thin price reporting problem like those encountered in beef (see Appendix 7.A), it would be essential that the spot market price report be accurate and based on a significant portion of spot transactions. Thus, a mandatory reporting program similar to those used for some products in California may be required.[23]

While price reports of spot transactions of bulk cheese appear feasible at the present time, it is well to keep in mind that there are other ways of developing an acceptable reference price. Another alternative is for market news to "simulate or formulate prices for thin markets based upon prices of related products that are traded in less thin or more price-representative markets."[24] For example, live broiler prices can be formulated from ready-to-eat broiler prices. And, carcass beef prices can be formulated from boxed beef prices. Thus, if the spot market for bulk cheese should also become too thin over time for reliable price discovery, there may be other ways of developing an acceptable reference price.

Electronic Marketing Systems

Spot market trading might be facilitated by the adoption of an electronic market system. Electronic markets have been tried with mixed success in several agricultural commodities. Although several of the

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(fn. 21 cont.)
On another occasion Phillip Morris Vice President and Secretary stated that Kraft supports "the review of alternatives [to the NCE] and expects to participate in any alternative that may be developed." Dede Thompson Bartlett, *op. cit.*, p. 2. See note 10 above, this chapter.

[22] One cheese company has used the WAP price in setting the premiums paid one of its suppliers in Wisconsin.

[23] See text at note 31 this chapter.

[24] D.R. Henderson, "Price Reporting in Thin Markets," in Hayenga, p. 120.

markets did not succeed, experience has shown that such markets generally reduced marketing costs, increased prices to sellers and lowered costs to buyers, improved pricing efficiency and increased competition.[25] The problems of adapting to an electronic market in cheese may be less difficult than in most other products where such markets are used or have been tried.

An electronic market system might increase spot trading in several ways. It could aid spot traders in identifying the nearest potential suppliers or buyers. Trading volume could also be increased if the electronic market permitted trading in cheeses not meeting the current NCE age and quality requirements; in addition, the frequency of trading could be increased to daily or three times a week.

To succeed, an electronic system must be cost effective. In the 1980s, several electronic markets closed because of high fixed costs and low trading volume; however, enormous strides have been made in computer and communication technologies since then. With current technology, an electronic market for cheese might be less costly than the NCE, when all costs are considered. The market could be supported by all industry participants as is done in some California market reporting programs.

Higher prices to commodity sellers in electronic markets appear to stem in part from increased competition between buyers and in part from reduced transaction costs. Studies of computerized auctions of slaughter lambs, [26] feeder cattle,[27] and hogs[28] found they increased prices to producers.

Part of the benefit of electronic trading is its anonymity, according to empirical analyses of these markets.[29] In oligopolistic markets, traders are more likely to compete on price if their rivals do not know the parties involved and the terms of each transaction. This is in sharp contrast to NCE conditions where each trader's action is immediately known to others. In markets of few sellers, such transparency of trading tends to *facilitate* market manipulation, not competition.

An efficient electronic spot market would not, alone, solve problems arising from persistent and systematic "trading against interest" by a firm with competitive strategic advantages over other actual and potential traders. But this practice would be more difficult if much of the current spot trading were shifted to an electronic market and if other steps were taken to reduce the competitive advantage of some traders, e.g., eliminating advantages deriving from the asymmetrical market knowledge of traders.

The above are merely suggested options in creating an electronic market system that may facilitate and enlarge spot trading. Industry users and others experienced in electronic markets can best determine the adjustments necessary for success in cheese.

Public and Private Actions to Improve Market Information

Accurate market information is an essential prerequisite of competitive markets. Asymmetry in market knowledge is one problem among traders on the NCE. Public information can be improved, however, particularly regarding inventory levels and prices off the NCE.

Many industry personnel interviewed in the course of this study expressed dissatisfaction with current information on commercial inventories, since they regard inventory information as critical in making price decisions. Although government data reflect trends, they do not accurately measure total inventory. Likewise, industry participants question the accuracy and usefulness of Wisconsin Assembly Point prices. This source of spot price information would be improved if it covered spot transactions in all major cheese manufacturing areas.

The Agricultural Marketing Service (AMS), USDA, should be encouraged to improve the quality of estimates and be provided the resources necessary to accomplish this. All the AMS dairy market news

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[25] Wayne D. Purcell and T. L. Sporleder, "Will Electronic Markets Continue to Develop?" *National Conference on Electronic Marketing of Livestock*, Chicago, October 4, 1990.

[26] James R. Russell and Wayne D. Purcell, "Costs of Operating a Computerized Trading System for Slaughter Lambs," *SJAE*, Vol. 15, No. 1, July 1983, pp. 123-127.

[27] Thomas L. Sporleder and Phil L. Colling, "Competition and Price Relationships for an Electronic Market," selected paper, 1986 annual meetings of the AAEA, Reno, Nevada, July 27-30, 1986.

[28] W. Timothy Rhodus, E. Dean Baldwin, and Dennis R. Henderson, "Pricing Accuracy and Efficiency in a Pilot Electronic Hog Market," *AJAE*, 71:4, November 1989, pp. 874-882.

[29] Shannon R. Hamm, Wayne D. Purcell, and Michael A. Hudson, "A Framework for Analyzing the Impact of Anonymous Bidding on Prices and Price Competition in Computerized Auction," *NCJAE*, 7:2, July 1985, pp. 109-117.

information programs rely on voluntary responses. We believe that it may be necessary to initiate mandatory reporting programs to obtain accurate information of inventories and prices. Such programs have been adopted for some commodities by the State of California and others.[30] For example, California's market reporting program in grapes is mandatory, its costs paid by grape processors and growers.[31] Similarly, the California State Market News Service has a mandatory program for reporting the price of nonfat dry milk. To insure accuracy, the records of NFDM plants are audited every two months. It is generally acknowledged that the NFDM prices reported for California are much more reliable than those reported for other regions of the country, which are based on weekly phone calls to a relatively few plants by Market News personnel.

Agricultural cooperatives also provide a promising vehicle for obtaining more accurate market information for their members. For example, in 1992, agricultural cooperatives in California and Washington established the Western Cooperative Milk Marketing Association, a marketing agency in common as permitted by the Capper-Volstead Act. This association reports to its members in aggregate form (separately for spot and contract sales) the weekly production, inventory and average prices of nonfat-dry milk and butter. Since these cooperatives represent about two-thirds of NFDM output in the country, this market information is extremely important. The association also sets a minimum price at which members agree to sell their butter and cheese.

A 1992 survey of Upper Midwest Cooperatives indicated that they believed information-sharing on cheddar and mozzarella cheese would have potential for improving their marketing efforts.[32] No action has been taken to date.

Cooperative information-exchange efforts have the potential to improve the efficiency of cheese pricing. As noted in our study, the current asymmetry in market information among traders appears to be one source of Kraft's competitive advantage on the NCE. We recommend that cooperative information-exchange efforts have open membership to qualified cooperatives. Such a system creates the greatest likelihood that such efforts will improve competitive performance in a market.

Futures Trading in Cheese

A futures contract for cheddar cheese was initiated in June 1993. An analysis by Fortenbery and Zapata examined the trading volume of the contract and the degree to which futures prices and NCE prices are interdependent.[33] Co-integration analysis, the technique used by Fortenbery and Zapata, measures the extent to which two markets have achieved a long-run equilibrium. They ask, "Have the cash and futures markets for cheddar cheese achieved the long-run equilibrium expected to exist between two markets pricing the same commodity and utilizing the same market information?"

Most studies of cash-futures relationships in agricultural markets have found that the two markets are closely related, with futures often leading cash markets in price discovery. In the case of cheddar cheese, Fortenbery and Zapata find no evidence that the futures market leads the cash market in price discovery, or vice versa. The two markets for cheddar cheese show substantial independence. And, for the two year period, June 1993-July 1995, the authors find that the cash (NCE) and futures markets for cheese still show no evidence of becoming co-integrated. Fortenbery and Zapata find these results unusual and raise the question of "whether there are institutional or market structure constraints which prohibit the cash and futures markets from behaving in an efficient pricing manner."

There is no indication as yet that the near-term futures contract price will be used instead of the NCE in formula pricing. Indeed, this could hardly be expected since the futures contract is still struggling to survive. Before the cheese futures contract will be considered as an alternative to the NCE for formula pricing, it must become a viable futures market. The dominant role played by the NCE may actually have hindered the early success of futures trading in cheese, as some traders felt "like observers of the few large players who have

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[30] See Henderson *op. cit.*, p. 122, regarding the legislative authority given the Secretary of Agriculture to mandate information on private trades for cotton.

[31] State of California, 1992 Food and Agricultural Code, Article 8, section 55601.6.

[32] Robert Cropp, *The Feasibility of Joint Activities Among Dairy Cooperatives in the Processing and Marketing of Cheese*, University of Wisconsin Center for Cooperatives, UW-Madison, University of Wisconsin Extension-Cooperative Extension.

[33] T. Randall Fortenbery and Hector O. Zapata, "An Evaluation of Price Linkages Between Futures and Cash Markets for Cheddar Cheese," Working Paper 107, Food System Research Group, University of Wisconsin-Madison, March 1995. The authors have updated this analysis through July 1995.

dictated recent price movement."[34] Also, the NCE is too thin a market to be used by futures traders that accept delivery on a contract. For example, when Pizza Hut accepted delivery of a futures contract, it offered three loads of blocks on the NCE. By the end of the trading session, Pizza Hut had reduced its offer 18 times without a sale. Block prices dropped 10.5 cents for the day.

If a viable futures market develops for cheese, it would provide opportunities to hedge risks of market participants, including farmers. It may also improve the price discovery process by increasing the number of market participants. But a futures market, alone, will not solve all market failure problems, particularly those which are structurally based. One need only recall that a thriving gasoline futures market has existed throughout the years since the creation of the OPEC oil cartel in 1973. Similarly, coffee and some other agricultural commodity futures markets have operated successfully in industries with state-run cartels. While such futures markets are useful in hedging risks, they have not brought effective competition to these industries. We emphasize this point lest some mistakenly conclude that all competitive problems in the cheese industry will be solved by a viable futures market.

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[34] CSCE Daily Dairy Market Report, September 9, 1993, Market commentary. This source reported, in part:

> Traders await with trepidation tomorrow's session at the NCE, as the last few weeks have produced large price increases...which resulted in major moves in the futures markets....the reality is that the NCE continues its hold on market participants. At least for the time being, this causes some traders to feel like observers of the few large players who have dictated recent price movement.

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11-22-96
TRACTOR-CADE
File

Wisconsin Farmers get another no-show from Governor Thompson

While our Governor was hunting on Friday Nov. 8th the dairy farmers received their 3rd drop in their milk price.

Just hours after our Governors task force gave the Green Light to the Green Bay Exchange the price of block cheese dropped 21½ cents. The following Friday another drop hit us and ironically on the morning 250 farmers stood outside the Governors office we received another drop that will mean an average farmer will have losses of about $2500.00 per month. How can they justify almost a $4.00 drop that can be a loss of around 75 million a month to our state.

This price drop will not benefit you consumers so don't think you will see any price reduction at your Holiday Season. The only people who will benefit are the processing industry who can buy our milk cheap and sell their retail products high to you consumers.

Our Governor knew the farmers were coming and once again he chose to give the people who produce Wisconsins most important industry NO RESPECT. Secretary Alan Tracy allowed ten of us to come in and discuss our crisis. As I listened to him I tried to understand why our Governor would be absent from such a devasting situation. On my way out I heard a man say "His so-called task force made as much sense as putting O.J. Simpson on his own jury."

I got the list on the task force from a release from Tommy Thompson himself. Also stating Wisconsin is the world's number one cheese maker, producing one-third of the world's cheese. Cheese prices directly affect the price received by Wisconsin's 27,000 dairy farmers for their milk.

Gary Anderson, dairy farmer, Cecil
Bob Burns, President, Beatrice Cheese
Marsha Glenn, Vice President, Kraft Foods
Bernard Golbach, President, Master's Gallery Foods, Plymouth
Richard Gould, President National Cheese Exchange, Green Bay
Will Hughes, Wisconsin Federation of Cooperatives, Madison
Ed Jesse, Associate Dean, UW Madison College of Agriculture & life Sciences
Larry Lemmenes, President & General Manager, Alto Dairy Cooperative, Waupun
Secretary William McCoshen Department of Development, Madison
O'Neil McDonald, Regional President, Supervalu Stores, Milwaukee
Jon Peterson, dairy farmer, Cashton
Jack Strum, President, A. Strum & Sons, Manawa
Bob Thelen, dairy farmer, LaFarge
Secretary Alan Tracy, Department of Ag. Trade & Consumer Protection, Madison
Wilfrid Turba, DATCP board member, Elkhart Lake
Deborah Van Dyk, Schrieber Foods, Green Bay
Bob Wagner, President, Weyauwega Milk Products, Weyauwega

I will let you decide how fair this task force investigation is.

Maybe hiding in the woods wasn't a bad idea after all.

Madeline Flogel
608-348-9954

Chairman:
Agriculture Committee

Member:
Environment & Utilities
Government Operations
Natural Resources
Rural Affairs

Al Ott

State Representative • 3rd Assembly District

To: Representatives Ainsworth, Hahn, Olsen, Otte, Skindrud, Ward and Zukowski + Sykora

From: Representative Al Ott

Date: November 22, 1996

Re: Appointment with Governor Thompson

Governor Thompson has responded to our November 1, 1996 request for a meeting to discuss the recent controversy surrounding the National Cheese Exchange. He is available to meet with us at 1:30pm on Thursday, December 12, 1996.

As you know, I have scheduled a briefing for the Assembly Agriculture Committee from 9:00am until Noon on December 12. I strongly encourage all of you to attend as it should prove to be a very informative session. I have attached a copy of the agenda for your information.

Please let me know as soon as possible if you cannot attend the briefing and/or the meeting with Governor Thompson afterward. As you know, our opportunities to meet with the Governor are rare. Please make every effort to attend the meeting so that we can share our constituents' and our own concerns about Wisconsin's dairy industry.

Office: P.O. Box 8953 • Madison, WI 53708 • (608) 266-5831 • Toll-Free: 1 (800) 362-9472
Home: P.O. Box 112 • Forest Junction, WI 54123-0112 • (414) 989-1240

Chairman:
Agriculture Committee

Member:
Environment & Utilities
Government Operations
Natural Resources
Rural Affairs

Al Ott

State Representative • 3rd Assembly District

To: All Legislators

From: Representative Al Ott, Chair
Assembly Agriculture Committee

Date: November 25, 1996

Re: Briefing on Dairy Issues

I would like to extend an invitation for you to attend a briefing on issues related to Wisconsin's dairy industry that I have scheduled for the Assembly Agriculture Committee. The briefing is being held on **Thursday, December 12, 1996 from 9:00am to Noon in Room 417 North of the State Capitol**. I have included a copy of the agenda on the reverse side of this memo for your information.

With the recent controversy surrounding the National Cheese Exchange and since many of us were home campaigning for several months, I thought a briefing would be beneficial to bring legislators up-to-date on several issues. I hope you are able to attend.

The briefing will feature invited speakers only. No public testimony will be heard although anyone is welcome to attend to listen. Any legislator in attendance is welcome to ask questions of the speakers.

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NOVEMBER 1996

NEWSLETTER OF THE COFFEE, SUGAR & COCOA EXCHANGE, INC.

ON THE MARKET

CSCE Files with CFTC to Trade BFP Milk Contracts

To provide a milk futures contract that better tracks the industry benchmark for milk pricing, the CSCE Board of Managers approved Basic Formula Price (BFP) milk futures and options contracts at its November 13, 1996, meeting. The new BFP milk futures contract is based on the BFP, which is a survey (index-type) of prices paid for milk by butter, cheese and nonfat dry milk plants in Minnesota and Wisconsin.

"The new contract developed from ongoing dialogue with various segments of the dairy industry who felt strongly that the Exchange would better satisfy hedging needs if it provided a market with a closer relationship with the Basic Formula Price for milk", said CSCE President James J. Bowe.

The BFP is announced monthly by the United States Department of Agriculture (USDA). As such, the BFP represents the minimum price for the Federal Milk Marketing Orders and is a benchmark that is widely used in most segments of the milk industry. The Exchange's BFP milk contract will be cash settled and calls for a contract size of 1,000 times the BFP (equivalent to 100,000 pounds of milk). Trading hours are 9:00 AM - 2:00 PM New York Time and the price quotation is in cents per hundredweight (see sidebar for contract specifications).

The CSCE will file for designation with the CFTC to list the new contract and plans to begin trading shortly after designation is received.

Other Dairy Markets

Marketing and publicity efforts for the Exchange's other dairy products continue, as CSCE representatives address industry gatherings, advertisements appear in trade publications as well as on agricultural radio programs, and articles run in industry journals. CSCE Marketing Manager Kevin McCormick conducted a milk hedging workshop on November 5 for 50 members and officials of Associated Milk Producers, Inc. (AMPI) in Bloomington, MN, and also met with several key representatives at Land O' Lakes.

The Exchange Marketing Department has available **qualified milk leads**, which will be distributed to Exchange members upon request. To receive the leads, or for more information on the CSCE's dairy products, contact Janet Troy, vice president/marketing & communications, at (212) 742-6107 or Kevin McCormick, marketing manager, at (212) 742-6103.

BFP Milk Futures Contract Specifications

Form of Contract: The seller under any BFP milk futures contract agrees to sell to the purchaser, and the purchaser agrees to purchase from the seller, 1,000 times the BFP (the equivalent of 100,000 pounds of milk).

The BFP: The BFP, which is calculated and announced by the USDA, is an estimate of the average price paid for Grade B (manufacturing) milk by plants in Minnesota and Wisconsin. The BFP is announced around the fifth day of the month following the month to which it applies.

Trading Hours: 9:00 AM to 2:00 PM New York time.

Delivery Months: Current calendar month, next two calendar months and each Feb, Apr, Jun, Aug, Oct and Dec occurring in the ensuing 12 months.

Price Quotation: Dollars and cents per hundredweight (cwt.)

Minimum Fluctuation: One cent per cwt., equivalent to $10.00 per contract.

President's Message

The Board of Managers is constantly reviewing the services and benefits provided to members, with a view towards optimizing the benefits of membership at the CSCE. In that regard, the Board has just appointed a special committee made up of myself and the four public members to assess the level of equity currently maintained by the Exchange to see if there is excess equity which should be made available to members. That analysis is just beginning and the Committee will present a report to the Board over the next months as plans are finalized for our building project and its financing. As always, the Board will keep the membership informed as progress occurs.

Recently, I was asked some questions about another member benefits program, specifically concerning the Long Range Planning Committee. Paul DeMarco, Sr. told me that he had been asked several questions by members regarding the requirements for participating, the planned start-up-date and the program's compensation structure. I thought this would be a good opportunity to briefly recap some of the highlights of the program.

Basically, the Long Range Planning Committee will start functioning in the year 2000. We plan to have at least one meeting annually of members who have had significant tenure at the Exchange and who have participated actively in either the day-to-day floor operations of the CSCE or served on committees or the Board of the Exchange or the Clearing Corporation (for details on the eligibility requirements, please contact me).

The Exchange has already begun funding its future obligations for the Long Range Planning Committee; in 1995, $4,000,000 was set aside in a special account, and, in 1996, an additional deposit of $500,000 was made. The Exchange intends to set aside an additional $500,000 annually to fund future payments as more members become eligible to serve on the Committee. Members are eligible to participate on the Long Range Planning Committee for a period of ten years, for which they will be compensated at a rate of $20,000 annually for attending the meetings of the Committee and for providing their perspective on the Exchange's appropriate future course of action.

In discussing member benefits from the Exchange, it is worth noting the Member Trading Award Plan, which is nearing completion of its second full year. It is expected that by the end of 1996, the Exchange will have paid trading awards to members totalling $6.6 million. When combined with the money set aside for the Long Range Planning Committee, the CSCE has provided benefits to members totalling $11.1 million in the past two years.

If you have additional questions about the Exchange's benefits plans, or would like a copy of the program specifics, please give me a call.

Sincerely,

James J. Bowe
President

Board Notes

The following actions* were taken by the CSCE Board of Managers at its November 13, 1996 meeting:

• The Board appointed a Special Committee consisting of Carl Beck, Francoise Duboc, Joel Segall and Andrew Tucker, the public members of the Board, and James Bowe, President, to (1) determine whether the cash and other property of the Exchange exceed what is required for the conduct of the Exchange's corporate purposes, and if so the amount of the excess; (2) determine the most efficient method of distributing or otherwise making all or some part of such excess available to the members of the Exchange; and (3) report its findings and recommendations to the Board.

• The Board adopted amendments to Floor Trading Rule 3.06 to permit the transfer of open contracts between clearing members so long as there is no change in beneficial ownership of the contracts and to enumerate certain types of transfers between affiliated persons and entities that will not be deemed to involve a change in beneficial ownership. The amendments also grant the president the authority to permit transfers not otherwise covered by the Rule, on a case by case basis.

• The Board approved amendments to Rules 1.33 and 3.21 to provide for a program to educate members and clerks on issues of sexual harassment. Once effective, Exchange members with floor trading privileges and registered clerks will be required to attend this course.

• The Board approved an implementation plan for amendments to rules currently pending with the CFTC which will require that lessees be affiliated with a member firm as a condition to soliciting or executing customer orders and will impose fees on lessees in addition to the contract fees charged to members. Under the implementation plan the pending amendments will apply to lessees who enter into lease agreements on and after the date on which the amendments are made effective.

• The Board considered a request from CFCCNY, made by CFCCNY's Chairman, to restore to CFCCNY the powers that the former clearing corporation had previously held. The Board resolved to form a committee comprised of three members of the Exchange's Clearing & Margin Committee, appointed by the Exchange Chairman and three CFCCNY Board members to be appointed by the CFCCNY Chairman, to make recommendations to the Board on how to address the concerns expressed by the CFCCNY Board and the proposal made by Exchange staff not later than the February 1997 Board meeting.

• The President reported on the status of the building project, noting that the Letter of Intent with New York City and State was nearly complete and that progress on an interexchange agreement with NYCE was being made.

• The Chairman reported on the status of merger discussions with NYCE.

• The Board approved amendments to By-Law Resolution No. 5 to specify that of the floor member Board positions, at least one must be filled by a floor broker and one by a floor trader. The amendments also classify a floor member as a broker if 70% of the member's volume is executed for customers, and classify a floor member as a trader if 70% of the member's volume is executed for proprietary accounts, in each case measured on the basis of volume executed during the 12 calendar months prior to nomination.

CONTINUED...

COMMITTEE UPDATES

• The President reported that NYCE had declined the Exchange's proposal to provide it with clearing, trade input and other systems support in favor of a proposal from the Board of Trade Clearing Corporation.

• The Board adopted a resolution interpreting Floor Trading Rule 3.13(d). Rule 3.13(d) prohibits a member from simultaneously entering both buy and sell orders for the same commodity in the same delivery month unless such orders are for different principals. The interpretation provides that the Exchange member or member firm which first receives an order directly from a non-member and relays that order for execution or executes the order shall be deemed to be the member that entered the order within the meaning of Rule 3.13(d).

• The Board approved amendments to Clearing Rule 25.00 and Membership Rule 1.47 to clarify the eligibility requirements for clearing membership. The amendments specifically provide that in order to be eligible to be a clearing member an organization must have, in all cases, two full Exchange memberships that are available to satisfy claims against the organization and which are not subject to a lease agreement.

• The Board adopted Disciplinary Resolution No. 2 and approved amendments to Disciplinary Rule 26.25 to authorize the Exchange's trading ring supervisors, acting as agents for the Floor Committee, to issue summary sanctions against anyone who blocks a member's entry or exit from a trading ring.

• The Board adopted rules to provide for new cash settled milk futures and options contracts based on the USDA's Basic Formula Price (BFP). The BFP is a monthly USDA calculated survey price that

(continued on back cover)

Clearing & Margin Committee
Chairman: Charles Kolligian
Contact: Jorge Dorlhiac
(212) 742-6120
Date: October 15, 1996

Raised the spot add-on for the December 1996 Coffee "C" contract to $1,000 from $500. The $1,000 add-on will also apply to all straddle/arbitrage transactions involving the December 1996 contract. Reviewed applications for clearing privileges.

Date: October 28, 1996

Raised the spot add-on for the December 1996 Coffee "C" contract to $2,000 from $1,000. The $2,000 add-on will also apply to all straddle/arbitrage transactions involving the December 1996 contract.

Executive Floor Committee
Chairman : Paul Dapolito, III
Contact : Regina Rocker
(212) 742-6042
Date : October 16, 1996

Approved applications for floor trading privileges. Discussed imposition of summary action for price corrections and directed counsel to review the issue with the CFTC and to present recommendations for alternative procedures, if necessary, to enforce the print correction policy. Discussed Post Settlement Session criteria for futures.

Date: November 6, 1996

Approved applications for floor trading privileges. Tabled discussion on the criteria for post settlement sessions until next meeting. Directed that a release be issued regarding Flat Markets to clarify that Associated Brokers may make a flat market bid and offer at the same price and such action will not be deemed a trading violation. Recommended to the Board* to amend the rules to make it a decorum violation to block a member's entrance to or exit from the ring and authorize ring supervisors to issue summary fines for such violation. Received an update on the CFTC's review of the Exchange's print sequencing policy and procedures for issuing summary action for print corrections.

Membership Committee
Chairman: Alfred J. Mascia
Contact: Regina Rocker
(212) 742-6042
Date: October 24, 1996

Interviewed applicants for full and associate membership, reviewed requests to confer member firm privileges and lease agreements. Directed staff to draft an amendment to Membership Rule 1.03 specifying that no more than one sponsor may be an employer of an applicant or an employee of an affiliated firm and both sponsors must know the applicant for at least six months. Recommended to the Board* to amend Clearing Rule 25.00 which specifies the qualifications of clearing members. The amendment clarifies that in order to be eligible to be a clearing member of the Exchange, the organization must either (a) have full Exchange membership privileges conferred upon it by two full Exchange members who are in good standing or (b) have full Exchange membership privileges conferred upon it by one full Exchange member who is in good standing with the Exchange, who owns two full Exchange memberships, both of which may be sold and the proceeds applied to satisfy claims against the organization as prescribed under the Rules, and have at least one other person with decision-making authority over the affairs of the organization, satisfactory to the Exchange.

Finance Committee
Chairman: W.C. "Dub" Hay
Contact: Walter J. Hines
(212) 742-6201
Date: October 29, 1996

Received its semi-annual presentation by Oppenheimer Capital regarding its management of the Exchange's portfolio of investments. Net cash flow from operations to the portfolio including the long-range planning investments has been about $1,750,000 in the nine month period of 1996. Maturities have been kept short and with an increased allocation to cash, in view of market conditions and outlook.

Dairy Products Committee
Chairman: Fred Hensler
Contact: James J. Bowe
(212) 742-6123
Date: October 30, 1996

Reviewed how the current milk contract is not tracking the Basic Formula Price closely or consistently enough for the hedging needs of the dairy industry. Recommended to the Board* approval of a new milk contract based on the BFP which is announced monthly by the United Sates Department of Agriculture (USDA) (see cover story). Discussed a presentation by the Exchange to the USDA for an options pilot program for milk. Discussed the willingness of the Exchange to provide an alternative to the National Cheese Exchange (NCE) cash cheese market.

Warehouse & License Committee
Chairman: Dale Christensen
Contact: Richard M. Foster
(212) 742-6203
Date: November 1, 1996

Voted to fine two warehouses for unreported coffee deliveries. Directed staff to communicate to all licensed warehouses, owners and

(continued on back cover)

On Friday, October 18, 1996, the CSCE hosted the 10th annual seminar and tour for nine Knight-Bagehot Fellows, mid-career journalists participating in a Masters Degree program at Columbia University's Graduate School of Journalism. The Fellows met with Exchange staff, visited the trading floor and enjoyed a coffee grading demonstration.

Please Note

On October 1, 1996, a new discharge allowance of $12.45 per long term became effective for the Sugar No. 14 contract. This rate is effective for all deliveries between October 1, 1996 and September 30, 1997.

Members Mart

NEW MEMBERS
Name • Guarantor • Date of Admission
FULL
Robert Pressner • Gerald, Inc. • 10/10/96
Gregory Dadourian • Klein & Co. Futures, Inc. • 10/16/96
Lawrence B. Cheifetz • Spear, Leeds & Kellogg • 10/25/96
Martin Lockie • Klein & Co. Futures, Inc. • 10/25/96
Thomas Hurley • Geldermann, Inc. • 10/29/96
Simon van den Born • J. Aron & Co. • 10/31/96
Joseph G. Goehring • 10/31/96
Jonathan Kelly • Spear, Leeds & Kellogg • 10/31/96

ASSOCIATE
David Barrett, Jr. • Rand Financial Services, Inc. • 10/14/96
John P. McDonnell • Rosenthal Collins Group • 10/25/96
Sean M. Geraty • E.D.& F.Man International • 11/6/96

CHANGE OF GUARANTOR
Name • Guaranteed by • Effective Date
Jeffrey Ramundo • Pioneer Futures, Inc. • 10/09/96
Jeffrey Roseme • Pioneer Futures, Inc. • 10/09/96
Mark Thompson • E.D.& F.Man International • 10/09/96
Egidio Lepre • Klein & Co. Futures, Inc. • 10/18/96
John Corey • Geldermann, Inc. • 11/05/96
David Blumetti • Geldermann, Inc. • 11/11/96

Seat Market

A listing of seat sales for the period of October 10, 1996 through November 13, 1996.

Full Membership

10/15/96	$131,000
10/16/96	$145,000
11/6/96	$132,000
11/8/96	$131,000

Associate Member
No sales during this period.

September Volumes

Coffee Futures	196,696
Coffee Options	75,978
Sugar No. 11 Futures	264,290
Sugar Options	81,741
Sugar No. 14	15,506
Cocoa Futures	167,227
Cocoa Options	21,022

On the Market

A monthly newsletter published by the
Coffee, Sugar & Cocoa Exchange, Inc.
4 World Trade Center
New York, NY 10048

Editor: *Elise Wolter Sherman*
Design & Production: *Michelle M. Weimer*

Additional copies may be obtained by calling
1-800-HEDGE IT or (212) 742-6100
or FAX (212) 748-4321
http://www.csce.com

CSCE Important Dates

November

28-29 Thanksgiving Holiday; Exchange Closed

December

FTD = First Trading Day
LTD = Last Trading Day
FND = First Notice Day
LND = Last Notice Day
ND = Notice Day
SD = Spot Date

2 FTD Dec 97 Milk Futures
FTD Dec 97 NDM Futures
FTD Dec 97 Cheddar Futures
FTD Dec 97 Butter Futures
FTD May 98 Coffee Futures
FTD May 98 Sugar No. 14

2-5 National Milk Producers Federation 80th Annual Meeting; Anaheim, CA

4-6 FIA/SFE Asia Pacific Futures Forum - Sydney, Australia

6 LTD Dec 96 Milk Options
LTD Dec 96 NDM Options
LTD Dec 96 Cheddar Options
LTD Dec 96 Butter Options
LTD Jan 97 Cocoa Options
LTD Jan 97 Coffee Options

9 LTD Jan 97 Sugar No. 14
FTD Dec 97 Milk Options
FTD Dec 97 NDM Options
FTD Dec 97 Cheddar Options
FTD Dec 97 Butter Options

10 ND Jan 97 Sugar No. 14

12 LTD Dec 96 Cocoa Futures

13 LND Dec 96 Cocoa Futures
LTD Jan 97 Sugar Options

16 FTD Mar 98 Sugar Options

17 LTD Dec 96 Coffee Futures

18 LND Dec 96 Coffee Futures

19 LTD Dec 96 Milk Futures
LTD Dec 96 NDM Futures
LTD Dec 96 Cheddar Futures
LTD Dec 96 Butter Futures

20 ND Dec 96 Milk Futures
ND Dec 96 NDM Futures
ND Dec 96 Cheddar Futures
ND Dec 96 Butter Futures

24 Half Trading Day

25 Christmas Day; Exchange Closed

26 Christmas Holiday; Exchange Closed

31 Half Trading Day

CSCE Briefs

The International Exchanges Operations conference hosted by the Chicago Mercantile Exchange took place in Chicago on October 21-22. In conjunction with the conference, some CSCE members and staff toured the CBOT's new trading floor. They are, as pictured above (l to r): Jan-Willem van den Dorpel; CSCE Board Member/Building Advisory Committee Member, Kelly Cooper; Floor Facilities Committee Chairman, Kevin J. O'Keefe; Operation and Technology Committee Chairman; and Patrick Gambaro, Senior Vice President, Floor Operations & Systems.

• On October 24, 1996, Patrick Gambaro, CSCE Senior Vice President/Floor Operations & Systems, served on a panel at the Chicago-Kent College of Law Conference in Chicago, IL, to discuss Exchange and FCM issues.

• Mark your calendar for Friday, January 10, 1997, when the CSCE will host its Member Holiday Party at The Rainbow Room from 6:00 - 11:00 PM. Invitations will be mailed to members in early December.

• The CSCE hosted an exhibit booth at the Futures Industry Association Expo '96, held in Chicago, IL, from October 23 - 25, 1996. Elise Wolter Sherman, Director/Corporate Communications, represented the Exchange and distributed literature on the Exchange's products and services.

• During the week of October 28, the CSCE hosted a series of options education courses for members, lead by Sheldon Natenberg, known options expert. Mr. Natenberg conducted three different programs, including "Options for the Beginner", "Intermediate Options", and "Advanced Options"; approximately 150 members and non-members attended.

• On October 10, 1996, CSCE President, James J. Bowe, Jorge Dorlhiac, Vice President, Chief Economist, and Janet Troy, Vice President, Marketing & Communications, met USDA Risk Management Agency Administrator Kenneth D. Ackerman to discuss a possible Options Pilot Program for milk.

Board Notes
(continued from page 3)

determines minimum milk prices and is a widely accepted benchmark for most segments of the milk industry *(see cover story)*.

• The Board amended the Exchange's definition of the term "Rules" to conform with the CFTC's definition of that term.

• The Board approved amendments to Floor Trading Rule 3.21 to provide a procedure for the suspension and/or termination of a clerk's registration by the Executive Floor Committee if the clerk's continued registration is found to be contrary to the best interests of the Exchange.

• The Board approved an amendment to Clearing Rule 25.02 to provide for clearing member position limits for the Exchange's new butter contracts.

**All rule changes must be approved by the Commodity Futures Trading Commission before they become effective.*

Committee Updates
(continued from page 3)

submitters their responsibility to report deliveries in accordance with Exchange rules.

Date: November 7, 1996

Approved revisions to the Warehouse Inspection Report, Original Applicaiton for Warehouse Operator's License and coffee audit written procedures. Discussed warehouse inspection proposals and coffee and cocoa weighing procedures.

** Board Recommendation - See Board Notes*

COFFEE, SUGAR & COCOA EXCHANGE, INC.
4 WORLD TRADE CENTER
NEW YORK, NY 10048

TOMMY G. THOMPSON

Governor
State of Wisconsin

Ag. file

December 3, 1996

The Honorable Al Ott
Wisconsin State Assembly
P.O. Box 8953
Madison, WI 53708

Dear Representative Ott:

Thank you for taking the time to share with me your thoughts with me regarding the Task Force on Cheese Pricing.

I have enclosed some of the correspondence I have sent to the Task Force in the recent days. Most significantly, I asked the Task Force to consider recommending to the United States Department of Agriculture that the National Cheese Exchange not be used in the Basic Formula Price for milk. This recommendation was adopted at the November 14, 1996, meeting.

As you know, the Task Force's deadline is January 1, 1997. I will continue to follow this process closely. Thank you, again, for your letter.

Sincerely,

TOMMY G. THOMPSON
Governor

TGT/cas

g:\ag\11357

Room 115 East, State Capitol, P.O. Box 7863, Madison, Wisconsin 53707 • (608) 266-1212 • FAX (608) 267-8983

TASK FORCE ON CHEESE PRICING

SUMMARY OF ACTION

THURSDAY, DECEMBER 5, 1996

1. Meeting called to order.

2. Opening comments from Bob Burns.

3. Bill Oemichen reviewed the possible future changes to the Federal Order System.

4. Comments for the floor.

5. Discussion and evaluation of proposals from the previous meetings. The proposals were removed from consideration or forwarded in a report to the Governor.

6. Meeting Adjourned.

Task Force Members in Attendance:

Robert Burns, Chair
Gary Anderson
Marsha Glenn
Bernard Goldbach
Richard Gould
Jim Holte
Will Hughes
Gerald Jaeger
Ed Jesse
Larry Lemmenes
Jon Peterson
Jack Sturm
Thomas Taylor for Bill McCoshen
Bob Thelen
Alan Tracy
Wilfred Turba
Deborah Van Dyk
Darin Von Ruden
Bob Wagner

MINUTES

TASK FORCE ON CHEESE PRICING

THURSDAY, DECEMBER 5, 1996

CALL TO ORDER

The fifth meeting of the Task Force on Cheese Pricing was called to order by Chair Robert Burns at 10:08 a.m. The meeting was held in the Mendota Room No. 4 of the Dane County Exhibition Hall.

OPENING COMMENTS

Bill Oemichen, Administrator with the Wisconsin Department of Agriculture, Trade and Consumer Protection, reviewed recent announcements from the USDA regarding proposed changes to the Federal Order System.

- Dan Glickman, Secretary, US Department of Agriculture, is proposing that the current 32 order system be consolidated to 10 regional orders.
- Mr. Glickman has set an initial response date for public comment on the proposed Federal Order System of February 10, 1997. Within five days of that date Mr. Glickman will make an initial report on what the new basic formula price (BFP) will be.
- Producers will probably be asked to vote on the new federal order proposals sometime between September 1,1998 and October 1, 1998 with the new orders being effective January 1, 1999.

PUBLIC COMMENT

Bob Burns opened the meeting up for question and/or comment from the audience.

1. The recommendations from the USDA regarding the reform of the Federal Order System is a long term solution. What is being done to help the farmers today?

   Members' comments:

   ⇒ USDA has been asked to do some advance purchases for the school lunch program.

   ⇒ A proposal has been circulated around for USDA to do some emergency action on pricing.

   ⇒ There has been discussions that cooperatives should collectively start doing something.

2. Is there any way the task force can implement something that says production costs have to be a factor in a price support program? Can we declare a state of emergency in this state?

   Members' comments:

⇒ We need something to stimulate the demand and right now we do not have any short term solution for this problem.

⇒ At the last task force meeting a recommendation was proposed and will be taken up today which deals with the inclusion of the cost of production as a factor in the calculation of the BFP.

3. Where is the surplus that drove down the price?

4. Has the Task Force addressed the report authored by Bruce Marion, Willard Mueller, with the University of Wisconsin-Madison, and Maqbool Sial, with the Wisconsin Department of Agriculture, Trade and Consumer Protection (WDATCP)?

   Members' comments:

   ⇒ This is a policy advisory group, not an enforcement body and not an investigatory body. The report was forwarded to the Federal Trade Commission (FTC), US Department of Justice and the Commodity Futures Trading Commission (CFTC) and none of them have apparently taken any action.

5. Why was trading against interest declined for consideration?

   Members' comments:

   ⇒ The only thing on the table that directly addressed trading against interest was a rule drafted by the WDATCP. The task force generally agreed that passing that rule would only move the exchange out of state and have no other direct accomplishment.

6. Why don't we price cheese at the retail level?

7. Is the vote scheduled for between September 1, 1998 and October 1, 1998 regarding the Federal Order System one which each individual farmer will be able to participate in or will the vote be through the coops?

8. Joint effort marketing is something that should begin to be used. The only people taking advantage of state statue 560.29 is the tourism industry.

9. We need a state of emergency declared by the Governor.

A task force member addressed the audience and explained that agriculture is the task force's number one concern and priority.

Bob Burns brought the meeting to order. The minutes from the fourth meeting on November 14, 1996 were approved. A subcommittee was formed to take the task force's recommendations and put them into a proper written form. The subcommittee's member will be Gary Anderson (Chair), Ed Jesse, Marsha Glenn, Bob Wagner and Gerald Jaeger.

Members then began discussing individual proposals.

REVIEW OF PROPOSALS ADDRESSING THE LINK BETWEEN THE NCE AND MILK PRICES:

The Task Force revisited the proposals which address the link between NCE and milk prices and agreed to the following recommendations with a unanimous vote.

The task force recommends that:

1. The US Department of Agriculture should not use the National Cheese Exchange price to determine the basic formula price (BFP) for manufacturing milk.

2. The price of manufacturing milk under Federal Milk Marketing Orders should be based on supply and demand of milk.

   The USDA could accomplish this by:

3. First, substituting the NASS-reported national average cheese price for the NCE price in the BFP as soon as the NASS price is available and reliable; (mandatory reporting, if necessary for reliability)

   And then:

4. Substituting the Coffee, Sugar and Cocoa Exchange's or the Chicago Mercantile Exchange's "BFP milk futures contract" for the BFP. A schedule could be developed that increases the weight assigned to the milk futures price proportional to the volume of milk futures contracts traded.

   or:

   Replacing the BFP with a national survey of manufacturing milk prices, less performance premiums and over-order values.

REVIEW OF ADDITIONAL PROPOSALS ADDRESSING THE LINK BETWEEN THE NCE AND MILK PRICES:

1. Replace the BFP with a value generated by an economic formula that equally weights monthly changes in cost of production as measured by a Dairy Parity index calculated by USDA; consumer purchasing power as measured by an index of U.S. per capita disposal personal income, and a milk-equivalent production weighted index of cheddar cheese, nonfat dry milk, and butter prices.

   - This would be a straight forward economic formula price. The idea behind an economic formula is to try to replicate supply and demand factors in a formula by taking proxies for those supply and demand factors.

- The advantage of this as a substitute is that it moves 2/3 of the BFP away from the NCE.
- It is a more stable price which moves directly with changes in milk production costs.
- One disadvantage is that this is not a market clearing price.

Members' comments:

⇒ Is the cost of production figure used a regional or national cost? This is a national price reflecting changes in cost of production.

⇒ Whose production costs do you use? This is again not the absolute cost of production, rather it is the changes in cost of production.

⇒ The market clearing problems are also of concern.

⇒ The starting point for the calculation was the average MW price for a period from 1990 through 1992.

⇒ Does this formula move away from the 96 Farm Bill's efforts of less government price supports?

⇒ The weighting of the various parts of this formula were determined by using the relative proportion of milk moving into those three products.

⇒ This will hurt the dairy industry because with a guaranteed price there will be an overproduction problem. Should we be also considering a supply management plan.

⇒ It is possible that the net price that would replace the BFP could go higher or lower than what we experienced in 1990 to 1992.

⇒ Risk and volatility in dairy prices are something that contributes to our profitability over the long run.

⇒ If we try to go to Washington with a recommendation that is not based on market supply and demand, we will have a hard time getting any reception.

The members voted to reject this proposal, 10 to 8.

2. Move toward the deregulation of pricing within the federal milk marketing order system and eliminate the BFP.
   - The idea here is that a farmer would have offers to pick and choose from when shipping milk. This moves away from formula pricing of milk and direct government involvement in setting the price levels.

   Members' comments:

   ⇒ Without the government mandating price or the protection of price equality, could you have some small farmers not being offered a fair price.

   ⇒ A competitively determined price is the most desirable for everybody.

   The vote was unanimous to keep this proposal.

3. Use a 3 month rolling average of cash price instead of an immediate cash price in the formulation of the base price for producer milk.
   - The 3 month rolling average will eliminate the drastic drops in milk prices.

   Members' comments:

⇒ This is not a consistent market process to determine the price of milk, it is only moving the price on the basis of a three month average.

The members voted to reject this proposal, 11 to 6.

4. Encourage the holder of supply, farmers, their cooperatives and others, to work at marketing, distribution and advertising to maintain, expand and meet consumer demand for milk and milk products.
   - It is important to have the coops do a better job of marketing.

   Members' comments:
   ⇒ It is important that this statement be broadened to include dairy plants also.

   The member voted to keep this recommendation, 14 to 3, and that it be included in the body of the report.

5. Weighting the product prices used in the BFP formula to reflect national production of cheddar cheese, nonfat dry milk and butter.
   - This would be folded into the section 1 above, Review of Proposals Addressing the Link Between the NCE and Milk Prices, under number 3.

   Members' comments:
   ⇒ This should be national in scope.
   ⇒ How do the cash markets for butter and nonfat dry milk compare to the Green Bay cheese exchange?
   ⇒ The Chicago Mercantile Exchange is a national market for butter and the volatility on that market is enormous. There is no national market for nonfat dry milk.
   ⇒ This would be a short term fix only.

   The member voted to keep this proposal, 12 to 4.

DISCUSSION RELATING TO IMPROVING MARKET INFORMATION:

1. Recommend that USDA expand the weekly Wisconsin Assembly Point Price to a statistically reliable and regional series that would include major manufacturing areas. (Mandatory reporting, if needed for statistical reliability.)

   This proposal was passed at the November 14 meeting, no further discussion was offered.

REVIEW OF PROPOSALS RELATING TO OVERSIGHT AND OPERATING RULES OF THE NCE:

1. Recommend that the Commodity Futures Trading Commission and the Federal Trade Commission reevaluate their regulatory authorities regarding the NCE.

   This proposal was passed at the November 14 meeting, no further discussion was offered.

2. Recommend to the NCE Board that they consider imposing a limit on the daily price movement of NCE prices.

   This proposal was passed at the November 14 meeting, no further discussion was offered.

REVIEW OF ADDITIONAL PROPOSALS STILL ON THE TABLE:

1. Recommend to the NCE board that they include a public member or members on the NCE board.

   Members' comments:

   ⇒ The NCE is a private corporation with a board of directors who are elected by its members according to their bylaws.

   ⇒ The members of the board of directors are elected from a pool that includes members of the NCE.

   ⇒ The board meets 6-8 times a year.

   ⇒ A public member would add trust giving the perception that someone was on the board looking out for the producer and consumers best interest.

   ⇒ There are no prohibitions against having a nonmember on the board of directors of the NCE.

   The members voted to keep this proposal, 11 to 7.

DISCUSSION OF ALTERNATIVE PROPOSALS ON ANONYMOUS TRADING ON THE NCE:

1. Recommend that the identities of buyers and sellers be anonymous during trading.

   Members' comments:

   ⇒ The NCE is in favor of anonymity to the extent that it is possible.

   ⇒ The intent is to insure that during the trading process individual traders are not influenced in the trading decisions.

   ⇒ The purpose is to try and expand trading in the NCE.

   The vote was unanimous to keep this proposal.

2. Recommend that the NCE limit individual trading lot sizes.

   - The present unit of trading is a car load of cheese which consists of between 40,000-43,000 pounds of cheese. This is at a cost of between $60,000-$70,000 per car.
   - The reason for the large unit is to insure that people are trading for legitimate purposes and not for speculation.
   - There have been no complaints from anybody in the industry about the trading unit size of a car load.

     Members' comments:

     ⇒ The intent of this was to limit the trading lot size.

     ⇒ The size of the company may determine the lot size offered.

⇒ History would support the fact that size of the company does not determine lot sizes.

⇒ If a person offers 10 car lots of cheese, another person does not have to take all 10, he can take just 1 or 2 cars.

⇒ Members cannot offer 2 different lots of cheese unless they offer them at different prices.

The vote was to reject this proposal, 16 to 2.

DISCUSSION OF PROPOSALS TO BROADEN PARTICIPATION AND ACCESS TO TRADING:

1. Expand the frequency of trading sessions on the NCE.
   - There has never been any requests to meet more than once a week.
   - This would involve more expense for our members.

   Members' comments:

   ⇒ It would cause a large expense for all member.

   ⇒ It may be that after the NCE implements electronic trading, the time for them to consider the frequency of trading is after they have seen electronic trading work for a while.

   The vote was unanimous to reject this proposal.
2. Implement continuous, electronic trading for bulk cheese transactions. (Note: The NCE will implement remote access to current weekly trading sessions in 1997.)
   - Someone would have to constantly monitor a continuous system.
   - There has not been any demand for this.
   - We are not a price discovery mechanism and have no interest in being a price discovery mechanism.

   Members' comments:

   ⇒ The NCE may not want to be a price discovery mechanism but it is.

   ⇒ If electronic trading were available, there would be more participation in the market.

   ⇒ A suggestion was made to revise the recommendation to be "Recommend to the NCE Board that they consider implementing more frequent electronic trading sessions for bulk cheese transactions, once remote electronic access is in place. (Note: The NCE will implement remote access to current weekly trading sessions in 1997.)"

   The vote was unanimous to keep this revised proposal.

There was a meeting held of the report subcommittee following the Task Force Meeting. An agreement was made to hold a subcommittee meeting on December 17, 1996 at the Wisconsin Department of Agriculture, Trade and Consumer Protection. The meeting was later changed to December 19, 1996 at 1:00 p.m. at the department in room 172.

Meeting adjourned at 2:19 p.m.

Approved_____ Date_____

State of Wisconsin
Tommy G. Thompson, Governor

Department of Agriculture, Trade and Consumer Protection
Alan T. Tracy, Secretary

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OFFICE OF POLICY & PROGRAM ANALYSIS
FAX COVER SHEET

DATE: 12/6/96

TO: Kim / Rep. Ott's Office

FROM: Ann Roth

SUBJECT: Cheese / Milk Pricing

PHONE: (608) 224-5043

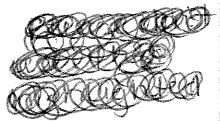
FAX: (608) 224-5034 or (608) 224-5045

NUMBER OF PAGES INCLUDING COVER SHEET: 2

If any pages need to be resent, please call the sender at the number listed above. If we do not hear from you, we will assume this transmittal has been completely received. Thank you.

MESSAGE: Per our phone conversation.

1. **Recommend that the US Department of Agriculture should no longer use the National Cheese Exchange price to determine the basic formula price (BFP) for manufacturing milk. The price of manufacturing milk under Federal Milk Marketing Orders should be based on supply of and demand for milk used in the manufacture of dairy products.**



Discussion Points:

- The NCE price was never intended to be an indicator of national supply of and demand for milk. There are available alternative measures that have the potential to be more reliable indicators of market supply of and demand for milk.

- The current BFP is highly influenced by the NCE price in two ways: the Minnesota-Wisconsin price series (M-W price) used in the BFP is highly correlated to the NCE price; and approximately ninety percent of the weighted price adjustment factor used in the BFP is based on the NCE price.

- Yet the NCE price results from trading that represents less than two percent of all bulk cheddar cheese transacted nationally. In the short term, the U.S. Department of Agriculture should include a cheese price in the BFP that more broadly represents cheese market transactions. In the long term, the price of milk should reflect the market for milk for all its manufacturing uses, not solely cheese.