UNITED STATES DEPARTMENT OF AGRICULTURE

Agricultural Marketing Service

(Dairy Programs)

Milk in the Central	)	Dkt AO 313-A48
Marketing Area	)	DA 04-06
7 C.F.R Part 1032	)	

POST-HEARING

MOTION TO REOPEN HEARING

OR REFER FOR INVESTIGATION

And

BRIEF ON DEPOOLING-REPOOLING PROPOSALS

This brief is submitted on behalf of Central Equity Milk Cooperative, Associated Milk Producers, Inc., Land O'Lakes, Inc., Foremost Farms USA, First District Association – cooperative associations who represent 2,400 dairy farmers producing over 360 million pounds of milk per month on Order 32 (Gulden, Tr. 777).

INTRODUCTION

As acknowledged by interested parties and in prior decisions of USDA, proposals to address milk price volatility and resultant depooling are of national interest, respond to conditions experienced in several markets, and would have national impact if adopted. Much of the "evidence" in this hearing on depooling proposals 2, and 6-8 relies upon extra-record evidence addressed at the August 2004 hearing in Minneapolis, and the domino effect of the Upper Midwest Hearing on other markets, from abusive practices by inter-market handlers, if amendments are adopted even for a short period solely for Order 30. E.g., Tr. Hollon, Tr. 440; Kinser, Tr. 647-49. If depooling is a problem that should be addressed by pooling standard amendments, it should be coordinated by a multi-market hearing and a uniform implementation date. We therefore renew our repeated requests for a multi-market hearing on these issues. This can be done simply by re-opening the record of the Central and Upper Midwest hearings at the time the Mideast Order hearing is convened next month.

However, since the close of the record, a matter of great concern to the integrity of the federal milk order hearing process has come to our attention. This also supports reopening the hearings, and independently investigating the circumstances that led USDA to call the hearings.

The recent round of hearings in Minneapolis, Kansas City, and Ohio (forthcoming), to tighten market access rules were called at the request of DFA who (along with others) complained of marketing disorder when handlers "depooled" milk in response to volatile cash cheese prices, and resulting volatile milk prices. DFA admitted, as it must, that depooling in federal milk orders is neither new nor recent. Tr. 336-37. What is new is the degree of volatility in dairy markets, causing volatility in milk prices, causing greater depooling consequences, as illustrated by what happened last March, April and May. It now appears that last year's cheese price and milk price volatility may have been engineered.

On December 30, 2004, a report in the Chicago Tribune (Dec. 30, 2004, attached) suggested that recent cheese and milk price volatility was artificially created by DFA's purchasing practices on the Chicago Mercantile Exchange designed to manipulate cheese and milk prices. Similarly, Steve Coomes, Sr. Editor (PizzaMarketpace.com), reported last year that DFA bought "every one of those 400-plus loads" that kept the CME cheese price high last spring, and bought another 412 loads in June. While Dr. Bob Cropp (U. of Wisc) and

others observe that market manipulation is possible only in the short term, because the market will eventually self-correct (Trib. article, p. 5), it is the short-term volatility and handlers' response to short-term volatility that encouraged USDA's Dairy Programs to call federal milk order hearings during the past year. If DFA's actions manipulated not only CME cheese prices, but also Dairy Program's willingness to convene a hearing in which market access for competitors could be further limited, this deserves independent and serious inquiry before undertaking the rush to judgment that DFA has requested.

DFA proposal No. 2, and Dean proposals 6-8 are designed to discourage depooling of milk when regulated prices are out of sync by restricting repooling of such milk in subsequent months. The questions of fact and policy raised by these proposals, as we see them, and answers, are:

1. Does depooling in response to price inversions cause competitive problems between producers or between handlers? Yes.
2. Is it necessary for USDA to interfere with market-oriented response to manufactured product prices to address these problems? No.
3. Does depooling increase dairy farm revenue? Yes.
4. Would the proposals, if adopted, reduce farm revenue? Yes.
5. Are there alternative, less burdensome, remedies that would reduce or eliminate price inversions? Yes, as described by several

witnesses and as previously identified by the Secretary in the 1999 National Milk Order Reform Decision.

6. Is depooling local phenomenon for which a remedy should be sought only in the Upper Midwest and Central Orders? No.

7. Will amendment to the Upper Midwest and Central Orders cause marketing disorder and disruption in other markets? Yes.

8. Do the proposals represent a major change in Federal Milk Order regulatory policy? Yes.

9. Has the Central Market experienced a supply shortfall to distributing plants as a result of depooling? No.

10. Does an "emergency" exist within the meaning of 5 U.S.C. §557(b)(2) and 7 C.F.R. §900.12(d), justifying omission of a recommended decision? No.

I. Summary of Facts and Regulatory History.

There is, we believe, little dispute concerning the salient economic and marketing facts underlying the depooling proposals.

1. For reasons of supply and inelastic consumer demand, milk used for Class I or fluid purposes commands a higher price than milk used for manufactured products. In an unregulated market, Class I handlers will out-bid milk manufacturers for milk supplies. The federal order program

incorporates this economic fact in classified prices. 64 Fed. Reg. 16026, 16102 (April 2, 1999).

2. Revenue sharing among producers in a market-wide pool was designed to allow producers to share in Class I revenue and avoid cutthroat competition for sales to fluid milk plants. As recently summarized by a federal appeals court panel in Chicago:

> "…the history of the milk-marketing regime evidences primary concern with producer competition to make sales to the fluid milk market, not the manufacturing market. See Zuber, 396 U.S. at 180-81 (discussing AMAA purpose "to remove ruinous and self-defeating competition" among producers for sales in the fluid milk market); see also Block v. Cmty. Nutrition Inst., 467 U.S. 340, 343 (1984) (discussing pooling requirements as means "[t]o discourage destabilizing competition among producers for the more desirable fluid milk sales"); United States v. Rock Royal Coop., Inc., 307 U.S. 533, 572 (1939) (characterizing system of compensating payments under the settlement fund as "reasonably adapted" device "designed... to foster, protect and encourage interstate commerce by smoothing out the difficulties of the surplus and cut-throat competition which burdened" the fluid milk market).

Lamers Dairy Incorporated v. United States Department of Agriculture, 379 F.3d 466 (7th Cir. 2004)(text at fn. 9-10).

3. The Secretary of Agriculture in the *Lamers* litigation more succinctly explained that Congress intended by revenue pooling "to share a portion of revenue from *fluid milk* sales with all farmers in the pool." Lamers Dairy v. U.S. Dept. of Agriculture, 7th Cir. Nos. Nos. 03-2308 & 03-2661, Secretary's Brief at 30 (November 2003), reproduced at http://www.ca7.uscourts.gov (emphasis supplied). Continuing, the Secretary emphasized: "the statute is principally intended to prevent destabilizing competition among farmers for sales to the fluid market, and it achieves this objective by establishing a mechanism to ensure that *revenues from the fluid milk market* are pooled and equitably shared among all the market's producers." *Id.* At 33, emphasis supplied.

4. USDA's 1999 Milk Order Reform Decision reaffirmed that the purpose of market wide pooling was to redistribute Class I revenue:

> It is the Class I pricing structure that provides additional revenue above the basic value for milk to producers. Because of this, Class I pricing is often viewed as the cornerstone of the milk order program's pricing policy. This is so because the Class I fluid use of milk commands the highest-valued use in the marketplace and is the preferred outlet for milk by producers. It is also this use of milk that has the greatest effect

on determining the location value of all milk and in determining the differences in blend prices that are received by producers.

64 Fed. Reg. 16026, 16101-102 (April 2, 1999).

5. The order regulations continue to provide "pooling standards …to provide the criteria for identifying those who are reasonably associated with the market for *sharing in the Class I proceeds*." 68 Fed. Reg. 37674, 37684 (June 24, 2003)(Final Decision, Upper Midwest Milk Marketing Order).

6. It is axiomatic that when Class I prices are *not higher* than competitive values of milk used to manufacture dairy products, as happens on occasion, there are no pooled Class I proceeds to share. Fluid milk suppliers in such event may retain the full and exclusive benefit of higher competitive premiums generated due to price inversion.

7. Until the late 1960's, federal order Class I prices were announced on the 5th day of the month to which they applied, and manufacturing prices were announced the same day for the previous month. *American Dairy of Evansville v. Bergland,* 627 F.2d 1252 (DC Cir. 1980)(text of dissenting opinion by Wilkey at fn. 3-9). Thereafter, the Class I price announcement was moved forward by one month, and made on the 5th day of the month for the following month to improve the fluid milk "handlers' ability to respond to

class I price fluctuations." *Id.* Advance pricing of Class I milk, now announced on the 23rd of each month, continues for the primary benefit of and at the request of fluid milk processors. 64 Fed. Reg. at 16102; 69 Fed. Reg. 19292, 19300 (April 12, 2004)(summarizing concurring views of DFA).

8. In the Federal Milk Order Reform Decision, USDA acknowledged that "since 1988, the volatility in the manufactured dairy product market has caused problems with the advance pricing of Class I milk." *Id.* Since at least 1989, handlers have depooled milk used in manufactured products when market prices have been out of sync with (higher than) federal order blend prices at the plant. Depooling is a national phenomenon, as it was prior to Federal Milk Order reform. Gulden, Tr. 777-98; Ex. 42.

9. The cause of price inversion is advance pricing of Class I milk: "Class price inversion occurs when a markets's [sic] regulated price for milk used in manufacturing exceeds the Class I (fluid) milk price in a given month, and causes serious competitive inequities among dairy farmers and regulated handlers. Advanced pricing of Class I milk actually causes this situation when manufactured product prices are increasing rapidly." *Lamers Dairy,* supra (quoting National Federal Milk Order reform Decision, 64 Fed. Reg. 16026, 16102 (Apr. 2, 1999)).

10. In early years of the Federal Milk Order Program, producers relied on price regulation to respond to changed conditions. In recent decades,

producers have adjusted to changes by greater reliance on negotiated market prices in excess of minimum federal order prices. "Cooperatives have relied more on over-order charges in recent years as a way of fine-tuning order prices promptly to changed conditions and supplementing the minimum prices established under the orders." AMS, USDA, The Federal Milk Marketing Order Program Marketing Bulletin No. 27 (Rev. 1981, Updated 1989) at 35. Over-order price adjustments have also been the marketplace response to depooling.

11. When milk is depooled due to price inversion or other out-of-sync relationship between regulated prices and market prices, producers delivering milk to manufacturers receive more revenue than they would if pooled. Class I handlers must frequently pay more in over-order premiums to compete for milk supplies with market value of milk used in cheese, butter or powder. *Lamers Dairy, supra.* .

12. The Secretary of Agriculture has, in fact, similarly observed that…

> "…the administrative exemption from these [pooling] requirements that may be accorded cheese processors during the occasional "inversion" of class prices *merely permits additional competition among handlers for the available milk supply*. It does not in anyway detract from the

statute's central purpose of preventing ruinous competition among dairy farmers for the *fluid* milk market.[1]

13. If the depool proposals are adopted, net farm income will decline as manufacturing class milk will pay into the pool, diluting these revenues, and Class I handlers will be relieved of bidding for milk based on milk's current value. Class I buyers would simultaneously have been relieved of paying additional premiums to compete against the current value of milk.

14. It has been USDA's position "that the different treatment of Class I and Class III handlers is rationally based because of the purposes of regulation and the differing marketing conditions faced by fluid milk and cheese producers." As a matter of regulatory policy and law, the 7th Circuit has confirmed that "the Secretary reasonably can require that milk used to produce fluid products be pooled while exempting other handlers from obligatory pooling. Indeed, the AMAA is premised on obligatory pooling of Class I milk, so that all producers may partake of its economic benefits." *Lamers Dairy, supra.*

15. It was USDA's view in the course of federal order reform that depooling due to price inversion and volatility is a national problem causing disorder, and should be addressed with a national remedy directed at the regulatory *cause* of price inversion rather than handlers' marketplace response

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[1] Lamers Dairy v. U.S. Dept. of Agriculture, 7th Cir. Nos. Nos. 03-2308 & 03-2661, Brief of the Secretary of Agriculture at 17 (November 2003), reproduced at http://www.ca7.uscourts.gov (emphasis supplied in part).

to price inversion. "Since volatility in the manufactured product markets is expected to continue, the Class I price mover developed as part of this Federal milk order reform process should address this disorderly marketing situation." 64 Fed. Reg. at 16102 – 03. The national remedy was a shorter lag between the Class I price announcement and the following marketing month (64 Fed. Reg. at 16103):

> The advanced pricing procedure provided in this final decision results in a Class I price that is based on a more recent manufacturing use price, thus reducing (but not eliminating) the time lag that contributes to class price inversion.... .... [R]educing the time period for which Class I pricing is advanced should reduce the potential [of price inversions] considerably, allowing Class I handlers to compete more effectively with manufacturing plants for fluid milk.

16. The shorter lag time between the Class I price announcement and the marketing month was facilitated in the Milk Order Reform process by use of NASS survey reports of prices paid to dairy manufacturers for dairy products, from which milk values could be imputed and computed. When NASS survey was adopted in 1999 as the Class I price mover, USDA believed the incidence of price inversions would be reduced by basing the "*prospectively determined*

Class I prices on the most recent market statistics available." Secretary's Brief in *Lamers Dairy v. USDA, supra*, at 26.

17. The national remedy in 1999 did not cure the problem, as the Secretary projected and as is evident in this proceeding. The reform remedy, however, left room for additional rule amendments to further close the pricing lag, or to eliminate it altogether.

18. The existing (post-reform) lag between the advance Class I price announcement on the 23rd of each month and marketplace reality, as reflected in milk product prices at the end of the following month, is six weeks. Gulden, Tr. 721. The most recent reliable and current market data available, however, is no longer produced by NASS surveys, but by dairy product and futures trading on the Chicago Mercantile Exchange, as the Secretary presaged in the Federal Milk Order Reform Decision. 64 Fed. Reg. 16103. There is an additional lag of two to three weeks between current marketplace activity, as reported by the CME, and price survey results as compiled and reported by NASS.

19. These pricing lags exacerbate the price inversion/depooling problem, and provide a ready place to continue a market-oriented reform process. Simply switching from NASS survey to CME prices, without affecting the timing of Class I price announcements would bring Class I prices three weeks closer to marketplace reality. CME trading has matured, proven reliable, and

been accepted by the dairy industry in a half-decade of trading since the FMMO Reform Decision. .

20. A rational (but disruptive) economic response to repooling limits on depooled milk has been demonstrated very recently. Milk depooled from the Northeast Order last spring was associated with the Mideast milk pool because of repooling limitations in the Northeast Order. This activity was undertaken at expense of Northeast producers when the milk was depooled, and at the expense of Mideast producers when it was repooled. Kinser, Tr. 647-49. Though other markets in which DFA and other proponents operate have been affected by depooling and price inversion, proposals for other markets have been slow in coming. Several witnesses who favored a piecemeal approach to depooling conditioned their support on the assumption that similar remedies would be adopted nationally, in a series of hearings. These assumptions are naïve. As long as economic self-interest is served for national or regional milk suppliers by foreclosing repooling in some markets, but leaving the door open to their own repooled milk in others, a coordinated and national remedy is unlikely unless the Secretary takes the initiative. In the Mideast Market, for example, DFA took a public position opposing a price inversion remedy for the Mideast Market for many of the same reasons we oppose DFA's contrary position in this one. 69 Fed. Reg. 19291, 19300 (April 12, 2004).[2]

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[2] The April 2004 final Mideast Order Decision, at 19300, describes DFA's stated position in opposition to depooling limitations: "The DFA witness is of the opinion that penalizing supply plants, often cooperative

21. Although price inversion and depooling have been a feature of Federal Milk Order Markets since at least 1989, proponents ask for "emergency" relief. This request is in apparent response to the extraordinary increase in Class III prices last spring. That cow is already through the barn door. Proponents' apparent argument for emergency action is that the events of last spring are likely to occur in the near future. There is no evidence supporting this contention. The Secretary's recent denial of any remedy for price inversion/depooling in the Mideast Market, let alone an emergency remedy, argues persuasively against emergency procedures to avoid any moderate price inversion/depooling that is likely to take place pending fully informed rulemaking.

22. Last spring's Class III price spike followed a period of low milk prices to which producers slowly responded by reducing milk cow numbers. From a peak of 9.166 million milk cows in June 2002 (in response to earlier high milk prices), the number of milk cows declined nationally for nearly two years, bottoming at 8.987 million cows in March 2004. NASS, USDA, *Milk Production* (October 2003 and 2004).

23. Since March, milking cow numbers have steadily increased, with 9.038 million cows as of September 2004. *Id.* This increase in milk cows, in

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owned, may cause financial damage to be borne by the manufacturing sectors of the market. Additionally, DFA does not endorse the notion that producers should incur any penalty because of price outcomes which, they conclude, are the result of the order program providing for the advance pricing of Class I and II milk that serves the interest of handlers."

predictable (but delayed) response to higher milk prices, is expected to continue. USDA's Economic Research Service projects that "milk production is expected to expand during the second half of 2004, but large increases are not projected until next year." ERS, USDA, Livestock, Dairy and Poultry Outlook, (Sept 04 LDP-M-123)(www.ers.usda.gov).

24. There is therefore no substantial evidence to suggest that a Class III price spike, of the kind experienced last spring at the end of a long period of declining production and cow numbers, will reoccur before the Secretary has the opportunity to issue a recommended decision (if any) and receive comments and exceptions.

25. Although proponents speculate about Class I supply in periods of price inversion, experience over 15 years of depooling, including depooling last spring, has not produced any concrete evidence that supplies for fluid use are being withheld so that producers may take undue advantage of depooling opportunity. The DFA witness eventually admitted that he was not aware of any one failing to meet a commitment to supply milk to a distributing plant even when incentives to withhold milk were greatest:

> "Q Reluctance is not the same as not shipping. Was there any contracted for milk where there's a long-term commitment that was not supplied, to your knowledge, by anybody during the month with a negative PPD?

A. I don't think there was."

Hollon, Tr. 453. In short, Central Market milk suppliers have responsibly fulfilled their regulatory, public interest, and contract obligations to keep distributors supplied with adequate milk. There is no evidence to the contrary.

25. Finally, it is clear that the DFA-proposed solution will impose heavy burdens on its competitors that will not be borne by DFA. With many distributing plant customers, and a large pooling base, DFA may repool by shifting supplies among its customers without regard to a 125% limit.

II. ARGUMENT

The proposals to require Class III or IV milk to pool and make compensating payments to the producer settlement fund in times of price inversion, subject to disqualification from sharing in Class I revenues if milk is depooled, tests the edges of Congressional authority in the AMAA. Congress clearly intended that a portion of higher Class I revenues be shared with all producers.

> Congress, however, was not similarly concerned with pooling the revenues that could be derived by farmers competing for sales to the cheese market. Thus, the fact that cheese processors are permitted to "de-pool" their milk and to avoid an obligation to share revenues through the producer settlement fund does not give rise to a species of competitive harm that was of concern to

> Congress. This may well subject milk bottlers to more competition for the milk supply, and thus drive up the prices they must pay to dairy farmers. But Congress did not enact the statute to protect *handlers* from the risks of such competition.

Brief of the Secretary of Agriculture in *Lamers Dairy v. USDA*, *supra*, at 33. As to the complaints of milk processors that depooling unfairly requires payment of higher competitive premiums to dairy farmers, USDA further observed: "Congress has not indicated that it even regards the competitive position of milk bottlers as a 'problem' warranting a legislative response." *Id.* at 29.

While Central Equity and its sister cooperatives perceive no acute problem in marketplace conditions by the fact that processors sometimes pay higher premiums to dairy farmers, particularly when the cause of the problem is advance pricing advocated by the processors (69 Fed. Reg. at 19300), we agree that price inversion and depooling are issues that may reasonably be addressed in rulemaking amendment as they were addressed in the Federal Milk Order Reform Decision – on a national basis.

The Department's entertainment of proposals by DFA et al. and Dean to limit consideration of depooling issues to a single-market hearings in the Upper Midwest, followed by Central and Mideast hearings, where it is so

apparent that the issues transcend one market and that a single market remedy would shift disorder to others, is a unexplained departure from long-standing agency policy. Although now more than ten years old, the agency's brochure, *The Federal Milk Marketing Order Program* (Marketing Bulletin No. 27), explained:

> The net effect of changes in the milk order program over the past 40 years has been a shift from market orders geared to local conditions to a system of orders geared to regional and national conditions. Wider use of regional and national hearing has been made to adopt these changes.

Similarly, the publication *Questions and Answers on Federal Milk Marketing Orders* (AMS — 559) at 12 affirms:

> [A] change in one order -- particularly a change in price -- affects supply-demand balance in other markets unless related changes are made in the other orders. Many of today's marketing problems must be viewed in the perspective of the national milk supply and the total demand for milk in the country.

The wisdom, economic necessity and regulatory imperative that milk marketing issues of multi-market importance be addressed in a multi-market hearing is reinforced by guidance of the 1962 *Report to the Secretary of Agriculture by the Federal Milk Order Study Committee* (known as the "Nourse Report"), considered by the Secretary to express the philosophical and economic foundation for Federal Milk Orders during the past four decades. *See In re Borden, Inc., et al.,* 46 Agric. Dec. 1315, 1408, 1411-19 (1987). Concluding its discussion on the principles of "orderly marketing," The Nourse Report (at 9-10) cautions that orderly marketing "includes a recognition that the outlook of the Secretary of Agriculture and his aides should not be parochial but industrywide in its scope." This powerful statement has application to current industry conditions and policies. It means that orderliness is to be viewed in the context of both the short run and the long-run effects of milk order provisions. It also means that decisions should consider the effects on the whole industry and avoid short-run expediency.

Concluding its discussions on p. 101, with almost prescient reference to this proceeding and current tensions between fluid and manufacturing users of milk, the Nourse Report emphasizes the Secretary's responsibilities as a steward of the dairy industry:

> We believe that the Secretary must exercise care to avoid short-run partisan positions in the interests of fluid milk producers as

> may run counter to other dairy interests of the general economy, or the long-run interests of the fluid milk producer himself. The growing interrelationships between the market milk and manufacturing milk segments now mandated extreme care to avoid arbitrary decisions in the market milk sector which may work hardship on the manufacturing sector. Moreover, modern marketing conditions bring handler problems more and more often to the core of orderly marketing issues. The Secretary is empowered and entrusted to develop a system of orders, integrated as to their relations with each other and to all the uses into which milk goes, not merely as to their internal housekeeping. He is cabinet minister to the nation's agriculture, with equal obligation to all farmers.

With these principals in mind, the Secretary has in the past had the courage and integrity to declare "*mea culpa*" and to terminate local or regional market hearings when it became clear that the issues were of broader interest or the proposed remedies would have serious extra-territorial consequence. *See,* 52 Fed. Reg. 15951 (May 1, 1987)(terminating consideration of marketwide service proposals for southeast markets because, if adopted, "inter-market milk movements throughout this broad area …would result in producers in the

[markets subject to the hearing notice] bearing the burden of balancing milk supplies for [other markets]….”). In a Texas Order proceeding, the Secretary terminated consideration of a proposal to reduce Class III prices in part because the problem addressed involved “the sale and processing of milk over a broad region that extends well beyond the Texas marketing area.” 49 Fed. Reg. 20825, 20828 (May 17, 1984):

> Furthermore, consideration of the long term manufacturing efficiency issue has implications to the level of Class III pricing throughout the Federal order system and the national market for manufactured dairy products. Thus, it is preferable that the issue not be addressed on the basis of a record that is limited to … one market.”

Id., at 20830.

The Secretary should follow the wise example of her predecessors and either terminate the proceeding, with an invitation to submit multi-market or national proposals on the depooling/price inversion issues,[3] or reopen the hearing to include other markets in the Notice of Hearing.

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[3] The Secretary’s Notice of Hearing for the Upper Midwest and Central markets has preempted and foreclosed the ability of handlers and producers in other markets to engage in frank dialogue with USDA officials on the merits of proposals to address depooling/price inversion problems. From June 16, 2004, forward, all USDA personnel with whom such discussions might otherwise take place are precluded from *ex parte* discussion or communication. 69 Fed. Reg. 34963, 34966 (June 23, 2004). The inequitable and unfortunate result is that only the DFA Group and other proponents of Upper Midwest amendments, who had such discussions with USDA personnel (Hollon, Tr. 283 – 85), will enjoy the benefit and instruction of pre-hearing dialogue with agency officials on the merits of such proposals.

In a national hearing USDA may want to consider use of CME reported prices as a mover of Class I prices to address the national price inversion problem, as the next logical step in the reform process, as an alternative to piecemeal control of marketplace response in the Upper Midwest and Central markets to price inversion. A national inquiry into this national problem may also consider whether any advance pricing for the benefit of Class I handlers continues to be justified today. In the course of 35 years of Class I price announcements before the marketing month, the quantity and quality of market information available to handlers has improved immensely, as has the economic sophistication of handlers who have survived to this point. Handlers now have previously unavailable forecasting tools such as daily reports from the CME providing current cash prices, industry opinion of future prices of dairy products and milk values in CME futures markets. Handlers also have a number of risk management tools, through CME trading and other sources, to help mitigate the effects of volatility and to stabilize handler costs. Is it not appropriate in these circumstances to consider whether Class I handlers have also matured sufficiently to compete for milk based on current market value in the same manner as milk product manufacturers?

The Federal Milk Order Reform Decision of 1999 suggested that the time for Class I handlers to assume more responsibility to estimate market prices, and to be weaned from reliance on a regulatory crutch, was not far off:

> [A]s more NASS product price survey observations become available, basis differences from earlier traded/issued product price surveys such as those from the Chicago Mercantile Exchange or Dairy Market News will be more predictable and, therefore, should provide for more accurate predictions of future price levels. In addition, futures markets have been established for the four dairy products in the NASS price surveys. While trading to date in these contracts has not been large, interest in these markets may increase as the industry learns to use them as effective hedges to the component values determined under this final decision. These markets also will assist handlers in estimating the Class I price.

64 Fed. Reg. at 16103. A hearing in which reasonable alternative remedies to the supposed problems are not disregarded or artificially constrained is a fundamental requirement of "reasoned decision making." *Motor Vehicle Manufacturers Association v. State Farm Mutual,* 463 U.S. 28, 48 (1983). Even limited to the Central Market hearing, the issues and remedies as unnecessarily narrowed by the Secretary's Notice of Hearing, fail the *Motor Vehicle* test. A national hearing to bring Class I and Class III/IV prices into greater symmetry, if a remedy is needed, is now in order.

CONCLUSION

For the foregoing reasons, as detailed in hearing testimony, cross-examination of witnesses, testimony, and officially-noticed data, the dairy farmers represented byCentral Equity, et al., respectfully request the Secretary to reject all DFA and Dean proposals and proposals limiting depooling. If any issue merits further rulemaking consideration, the Secretary should issue a new invitation to submit proposals for hearings on multiple markets or all markets as well as investigate the circumstances under which volatile cheese prices were created.

Respectfully submitted,

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TRIBUNE SPECIAL REPORT

Dairy insider has clout in setting prices

With timed trades through Chicago's Merc, Dairy Farmers of America's Gary Hanman has found a way to support cheese prices, earning farmers an extra $1.3 billion this year.

By Andrew Martin
Tribune national correspondent

December 30, 2004

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Tucked at the back of the chaotic trading floor of the Chicago Mercantile Exchange, behind the flashing electronic signs that show the prices of pork belly futures and foreign currencies, traders with telephones pressed to their ears call out bids that are then scribbled on a white board labeled "Spot Cheese" in magic marker.

You can thank them for setting the price of a gallon of milk.

The obscure cheese exchange opens with the blare of a siren each trading day at 10:45 a.m. and closes about 15 minutes later. Some days there are no trades. But the low-tech methods and limited trading don't reflect the huge influence of the exchange. The dairy industry uses the quotes for the price of cheese on the exchange to set raw milk prices, in much the same way the financial industry uses benchmarks like the prime rate to set interest rates for everything from home equity loans to credit cards.

The trouble is, the cheese exchange is a secretive operation that is essentially unregulated and heavily influenced by a key industry insider who has a huge stake in how much dairy farmers are paid for the milk, which in turn affects how much consumers pay for a gallon at their local store.

For that insider--Gary Hanman, chief executive officer of Dairy Farmers of America, the nation's largest dairy cooperative--the higher the price the better.

A barrel-chested, red-haired 70-year-old who is known for his country charm and trademark red suspenders, Hanman is responsible for finding markets for about a third of the nation's raw milk and for keeping the dairy farmers who make up his membership happy by paying them a high price.

Traditionally, dairy cooperatives have haggled with milk plants or cheese manufacturers over the price of

milk. Hanman has figured out another way to boost his members' profits, and that is by increasing the price of cheese at the Chicago Mercantile Exchange.

It's a strategy that has made the dairy group the dominant buyer of cheese at the Mercantile Exchange, conducting more than half of all purchases, according to several sources who track the exchange, where trades are confidential.

Here's how it works: The cooperative buys hundreds of truckloads of cheddar cheese at the Merc each year, timing its purchases for maximum influence on the cheese price. If Hanman can boost the cheddar cheese price at the Merc, dairy farmers are paid more for their raw milk.

And if raw milk is more expensive for milk production plants, they pass along those higher costs to grocery stores. Ultimately, those costs are included in the price of a gallon of milk or a package of cheese.

Hanman refused to discuss his strategy, saying through a spokeswoman that such information was proprietary. But in an October speech to dairy farmers in New York, he was expansive.

"The Chicago Mercantile Exchange is the tide that moves all boats, up and down," Hanman said. "As that market moves--since that market is the basis on which all people sell cheese--if you can have a positive influence on that market, you can have a positive influence on price."

By supporting the price of cheese last spring and again in August and September, Hanman argued that his group increased dairy farmers' milk checks by an estimated $1.3 billion.

The strategy has had a clear effect: Dairy farmers have been paid higher prices for their milk, at least in the short term, and consumers have been stuck with the bill.

That's because the cheese exchange is what is called a "thin market"--it handles a relatively small number of transactions, but those transactions help set the price for a much larger universe of cheese and milk sales across the nation.

"If you are a large cooperative and you are holding up the price of cheese, it has huge implications for our economy because it affects the retail price of milk," said Kenneth Bailey, a dairy economist at Penn State University. "There's a direct impact [between] what happens at the Chicago Mercantile Exchange and what a family pays for a gallon of milk."

System's integrity questioned

Ed Jesse, a dairy economist at the University of Wisconsin-Madison, said the dairy group's actions raise questions about the integrity of the system for pricing dairy products because it appears to be governed by factors other than supply and demand. When that happens, he said, someone ends up "getting ripped off," whether it's consumers, farmers or cheesemakers.

"It's a situation that smells," Jesse said.

Whether the dairy group's strategy is legal, though, is a matter of debate. That's partly because the market is so obscure it falls into a gray area of the law.

The Commodity Futures Trading Commission, which regulates futures for everything from fertilizer to live cattle, does not oversee the cheese exchange because it's a cash market, meaning it acts much like a live auction where actual products are bought and sold.

No other federal agency regulates the cheese exchange either. Instead, it's left entirely to the Merc's oversight, which includes a staff of 120 that monitors millions of trades each day.

Merc officials declined to answer questions about Dairy Farmers of America activities at the cheese exchange.

"CME believes strongly in the integrity of all of its markets, including the spot dairy market," the Merc said in a prepared statement in response to Tribune inquiries. "The exchange devotes significant resources, through our market regulation department, to maintaining this integrity and closely monitors all of our markets."

Dairy Farmer of America officials contacted for this story declined to comment.

The Tribune reported in August that the dairy group is being investigated by the Justice Department and several state attorneys general because of allegations that the group is trying to monopolize the nation's raw milk market by forcing dairy farmers and competing cooperatives to join it. The cooperative represents about 23,000 farmers.

In previous interviews, group officials have said they are cooperating with the investigation and denied wrongdoing.

Although less than 1 percent of the cheese manufactured in the United States is traded at the cheese exchange, it determines the price for most of the other cheese--and raw milk--sold in the U.S. Yet by tradition, simply because a way is needed to set the price of cheese and milk nationwide, buyers and sellers look to the exchange for prices.

"There's no place else to look, no other central market," said Jesse, the Wisconsin economist. "By general agreement, the industry has agreed to use the CME as the barometer for prices."

That can be a recipe for trouble.

"It's an extremely questionable method for setting the price of milk because it is a thin market, and thin markets are notorious for their vulnerability to manipulation," said Peter Carstensen, a law professor at the University of Wisconsin-Madison.

At his speech before dairy farmers in October, a tape of which was obtained by the Tribune, Hanman laid out the cooperative's strategy for pumping up the cheese price in Chicago.

At the end of each fiscal year, Dairy Farmers of America executives meet to discuss how much cheese they

think they will sell the following year through the group's subsidiary, Borden Cheese, he said.

By design, Hanman said, the cooperative doesn't make as much cheese as it needs for the year, so it can buy the remainder at the Merc.

"This year, our plan was to be 400 loads of cheese [in] deficit and to buy some of that cheese on the CME [the Merc]," he said.

So when the market for block cheddar cheese started to drop from a record high of $2.20 a pound in April, Hanman's group stepped in at $2 and tried to hold the price there, he said. When that failed, the cooperative tried again and held the price at $1.80 from May 21 to June 22.

"Each day, we were the main buyer of cheese on the CME trying to make a statement . . . that we thought $1.80 was about the right price for 40-pound blocks of cheddar cheese," Hanman said. "On one day, the 7th of June, we, DFA, bought 52 loads of cheese on that market that day, a record."

The group returned to the market in August when it needed another 100 or so truckloads of cheese, Hanman said, holding the price at about $1.55 a pound through the beginning of October.

By keeping the prices from falling further in both May and August, Hanman said, Dairy Farmers of America added $1.3 billion to dairy farmers' milk checks, $278 million of which went to his group's members.

"Our ability to be in the cheese business, to be a market-maker, and yet to fulfill our needs in the marketplace is what led to that price enhancement," he said.

Similarly, a Feb. 26, 1999, memo by the group's chief financial officer, Gerald Bos, outlined the cooperative's financial situation from the month before and described how it propped up the cheese price at the Merc.

"We also supported the market on the CME through January 13 by buying 7.4 million pounds of cheese at an average price of $1.85 [per pound]," Bos wrote. Because the cheese was worth far less than they paid, Bos said, the cooperative lost $3.6 million.

"I want to point out that we need to remember that by supporting the market we held the [average price farmers received for raw milk] to $16.27 [per hundred pounds of milk]," he wrote. "We estimated that if [DFA] had not supported the market the drop in the [average price to farmers] would have been to $12.94. This should save our members about $96 million."

While many factors influence the price of milk at grocery stores, including the profit margins of the retailers, the price jumped in two of three recent instances in which the group supported the price of cheese at the Merc. In a third, the price held steady instead of dropping as expected.

For instance, after DFA bought 7.4 million pounds of cheese in late 1998 and early 1999, the average price of a gallon of whole milk in Chicago jumped from $3.09 in December 1998 to $3.39 in January, $3.49 in February and $3.42 in March, according to the U.S. Agriculture Department.

Similarly, after the dairy group held the price of cheese at $1.80 per pound in May and June of this year, the retail price of milk in Chicago increased from $3.49 a gallon in May to $3.92 in June and $4.02 in July, USDA statistics show.

Finally, when the group supported the price of cheese at about $1.55 through August and September, the price of a gallon of milk in Chicago held steady at $3.62 from September through November. While the cooperative's actions didn't increase the price, they appear to have kept the price of milk from continuing to slide lower. Some question whether Hanman overstates his group's influence on the cheese exchange in an effort to woo new members and impress existing ones.

"I think Gary's comments about raising the prices, they're certainly self-serving," said Bruce Marion, a retired University of Wisconsin dairy economist, "His business is in part to convince farmer members that they are out there battling for them."

Marion is one of the authors of a report in the mid-1990s that alleged price manipulation at a cheese exchange in Green Bay, which was closed in 1997.

Market does readjust

Others point out that even if the dairy group can manipulate the cheese market for several weeks or a month, the market eventually corrects itself by plunging lower after the group stops buying cheese.

"It may be manipulated in the short run, but no one has enough money to do it for very long," said Bob Cropp, a dairy economist at the University of Wisconsin-Madison.

Experts differ on whether the strategy is illegal market manipulation or simply taking advantage of a vulnerable system for pricing dairy products. The disagreement stems in part from the fact that the cheese exchange is unregulated and so obscure that few people understand how it works.

The Commodity Exchange Act prohibits manipulation of "any commodity in interstate commerce," and the Sherman Antitrust Act forbids anyone from trying to monopolize trade. The Merc's rules say it is a "major offense" to "engage in, or attempt to engage in, the manipulation of Exchange futures or options contracts or cornering or squeezing the underlying cash market."

Major offenses can result in expulsion from the exchange and up to $1 million in fines.

The Merc also describes it as a "minor offense," punishable by suspension and up to $100,000 in fines, "to engage in uncommercial conduct."

Carstensen, the Wisconsin law professor who has researched competitive issues in the dairy industry, said the cooperative's actions at a minimum raise questions.

"They are not in there as genuine traders," Carstensen said. "They are not in this market for the purpose of actually buying butter or cheese or selling butter and cheese. But they are in there to influence the price because of some off-market transactions."

He said that while the group's actions might meet the legal definition of market manipulation, they fall outside the usual scope of the federal agency that enforces the law, the Commodity Futures Trading Commission. That panel typically only investigates cash markets if they are affecting futures markets in a negative way.

Some critics have suggested that the group's dominance in the cash market for cheese may in fact be giving it an advantage in the futures market. But trades are secret, and neither the Merc nor the Commodity Futures Trading Commission would comment on the group's activities in the futures market.

Others argued that the cooperative is not doing anything illegal, because anyone with enough money is entitled to buy as much cheese as he or she wants at the Mercantile Exchange.

"Any single company is free under the antitrust laws to bid the exchange price up or down as they please," said James Robert Nolin, a Los Angeles attorney who specializes in antitrust law. He said the legal problems under antitrust law start when one company, or cooperative, conspires with another to move the market.

The questions over pricing in the dairy business, some experts contend, will likely continue as long as the price of milk is linked to markets like the Chicago cheese exchange.

"It's still a market that lacks the characteristics of a really competitive market," said Marion, the retired dairy economist. "You still have a very thin market with some dominant players that are trying to jiggle the market one way or the other."

Mary Ledman, a dairy industry analyst, said the cheese exchange doesn't function properly because only the buyers and sellers of fresh cheddar cheese participate, even though all types of cheese and dairy products across the country rely on the cheese exchange for pricing information.

Makers of mozzarella cheese, for instance, don't participate since only cheddar is traded. And many dairy cooperatives don't trade because they can only buy cheese; selling would be perceived by dairy farmers as an attempt to drive down the price and consequently, their milk checks.

Meanwhile, some of the biggest buyers of cheese, including fast-food restaurants and grocery chains, have found a way to avoid the Merc by establishing long-term cheese contracts. But they are a small percentage of the marketplace for cheese. The vast majority of buyers and sellers continue to look to the Merc to determine their prices.

The reason, said Jerry Dryer, the editor of the trade publication Food & Dairy Market Analyst, is that "nobody has come up with a better plan."

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