

Chapter 1--Introduction

Since the early years of this century, the National Cheese Exchange (NCE) or one of its predecessor markets has been looked to as the best indicator of the value of cheese in the U.S. This is so even though by any definition, the Exchange is a very thin market and a market with few buyers and sellers. The importance of the prices discovered on the NCE is magnified greatly because they are the basis for formula pricing 90 to 95 percent of the bulk cheese in the U.S. It is perhaps not surprising that a price discovered by so few but used by so many should be a frequent target of criticism and questions.

In early 1992, the University of Wisconsin-Madison and the Wisconsin Department of Agriculture, Trade and Consumer Protection (DATCP) agreed to collaborate in an analysis of cheese pricing and the National Cheese Exchange. This report is the result of that collaborative effort. The study sought to ascertain whether the NCE was an efficient market, that is, one that discovers prices for cheese that accurately reflect national supply and demand conditions. And if this were not the case, whether there exist possible unfair trade practices or methods of competition in the pricing of cheese.

To achieve this objective, the study examined the organization of the cheese industry, the characteristics of those companies actively involved in cheese manufacturing, cheese marketing and trading on the NCE, the overall trading activity on the Exchange from 1974 to 1993 and a detailed analysis of the trading of leading sellers and leading buyers during 1988-1993.

These analyses are based on various sources of information. Beginning in early 1992, DATCP sent Demands for Sworn Statements and Production of Documents to the National Cheese Exchange and to over 20 cheese manufacturers, marketers and traders that had been

active on the NCE in recent years. These Demands were based on DATCP's authority under ss. 93.14 to 93.16 and 100.20(6), Wisconsin Statutes, and were made pursuant to DATCP's preliminary investigation of possible unfair trade practices or methods of competition.

In addition to information obtained in response to these Demands, and in some cases follow-up Demands, we obtained from the USDA copies of the minutes of all trading activity during each trading session of the NCE from 1973 through 1993 as recorded by USDA market news reporters. Together with legal counsel of DATCP, we interviewed representatives of all but a few of the companies receiving Demands, as well as other persons affiliated with the cheese industry. From time to time, we consulted with dairy marketing specialists at the University of Wisconsin. Extensive use was also made of various relevant secondary sources.

The report was prepared pursuant to an agreement between the Wisconsin Department of Agriculture, Trade and Consumer Protection (DATCP) and the University of Wisconsin College of Agriculture and Life Sciences and College faculty members Professors Willard F. Mueller and Bruce W. Marion. It was agreed that in cooperation with DATCP, Professors Willard Mueller and Bruce Marion would prepare without cost to DATCP a study of cheese pricing and the NCE.

DATCP agreed, at its discretion, to provide the faculty members and certain support scientists with proprietary information obtained by DATCP. The faculty members agreed to protect the confidentiality of such information and not to release proprietary information without the department's written approval. The agreement also provided that the faculty members may publish any of their analyses provided they do not disclose proprietary information in violation of the agreement. The entire agreement appears in Appendix 1.A.

Organization of the Report

Chapter 2 provides an overview of the cheese subsector from the dairy farm to consumers. It indicates trends in consumption, the location and type of cheese manufactured, how milk and cheese prices are determined and the role of federal programs. The characteristics of cheese manufacturing, processing and marketing are described, along with the three major channels through which cheese is marketed. Estimates are provided of the concentration of sales in cheese manufacturing, processing and marketing. The business characteristics of major firms in the cheese subsector are described. This is the broadest and most descriptive chapter in the report and is essential reading to understand much of the rest of the report.

Chapter 3 examines various features of the National Cheese Exchange, including a brief history of predecessor exchanges dating from the 1860s; a description of the NCE's current organization and operating rules; a summary of agencies with regulatory authority over the NCE; and an overview of certain characteristics of the Exchange that create the potential for price volatility and market manipulation.

Chapter 4 examines the characteristics and motives of various companies as they may affect their interests in trading on the NCE and the spot markets. The analysis includes an examination of the business characteristics of leading traders, the reasons most cheese concerns trade in the spot market rather than on the NCE, and an examination of various documentary evidence relevant to these matters.

Chapter 5 analyzes the trading patterns of leading seller-traders and buyer-traders on the Exchange and the apparent impact the two groups of traders had on the level of NCE prices

during 1988-1993. We also make an econometric analysis of these traders' activity on NCE prices.

Chapter 6 is an in-depth analysis of Kraft's activity on the NCE during 1990-1992. It focuses on the nature and apparent impact of Kraft's trading activity on NCE prices during each period of a price cycle: the price decline, the price bottom, the price rise, and the price top. This analysis, based on trading activity and company documents, explores the apparent motives for Kraft's trading conduct and its consequences on NCE prices.

Chapter 7 provides a summary of the findings of the report, our conclusions regarding the matters studied, and some suggested private and public options that may improve the pricing process for cheese.

Acknowledgments

The authors wish to express their appreciation to the many persons who assisted in this undertaking. We received much cooperation and assistance from those companies served with Demands for information and documents, as well as the many persons we interviewed.

We are indebted to the various DATCP personnel with whom we collaborated in obtaining information for the report. Especially helpful were legal counsels Reid Klopp and Sherry Steffel, bureau director Robert Park prior to his retirement in July 1994, William Hughes until he left in July 1994, and Ann Roth.

Several university researchers were very helpful in our initial inquiry of cheese pricing, including our former graduate student in Agricultural Economics, Allan Krause, and undergraduate Gary Clough. Laura Hengehold worked as a full-time researcher during the second year of the project.

We were extremely fortunate in having knowledgeable and unselfish colleagues ever ready to share with us their special expertise. We are particularly indebted to Professors Peter Helmberger, Jean Paul Chavas, and Reuben Buse for their productive consultations on econometric matters. Likewise, we are indebted to Professors Edward Jesse and Robert Cropp for instructing us in the more arcane aspects of dairy marketing.

Finally, we extend our unqualified appreciation to Ardella Crawford, who typed our many drafts and whose editing of the manuscript extirpated the more egregious malapropisms.

The authors are proud to join the many past and present faculty members of the Department of Agricultural Economics who have studied cheese marketing. These include such distinguished economists as Henry C. Taylor, the first chair of the department, George S. Wehrwein, Benjamin H. Hibbard, Asher Hobson, Rudolph K. Froker, Hugh Cook, Truman Graf, Edward Jesse and Robert Cropp.

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Appendix 1.A

AGREEMENT

STATE OF WISCONSIN DEPARTMENT OF AGRICULTURE, TRADE
AND CONSUMER PROTECTION

UNIVERSITY OF WISCONSIN

The State of Wisconsin Department of Agriculture, Trade and Consumer Protection ("department"), the University of Wisconsin College of Agricultural and Life Sciences ("college"), and college faculty members Prof. Willard F. Mueller and Prof. Bruce Marion ("faculty members") hereby agree as follows:

WHEREAS, the department is currently engaged in a study and analysis of market practices related to the purchase and sale of cheese, including transactions on the National Cheese Exchange; and

WHEREAS, college faculty members Prof. Willard Mueller and Prof. Bruce Marion ("faculty members"), and support staff scientists working for those faculty members, are also currently engaged in a study and analysis of market practices related to the purchase and sale of cheese, including transactions on the National Cheese Exchange; and

WHEREAS, the above studies and analyses are important to the State of Wisconsin, and to the state's dairy economy, and constitute an important and legitimate function of both the department and the college; and

WHEREAS, the interests of the department and the college will be mutually served by collaboration in the pursuit of the above studies and analyses; and

WHEREAS, the department is authorized by law to obtain proprietary information from private firms, including possible trade secrets, which may be necessary to complete the above studies and analyses; and

WHEREAS, the department is obliged to preserve the confidentiality of trade secrets under s. 134.90, Stats.; and is responsible for deciding whether other proprietary information received by the department may be released to the public;

NOW, THEREFORE, the following parties, in consideration of mutual benefits derived, agree as follow:

1. In cooperation with the department, college faculty members Prof. Willard Mueller and Prof. Bruce Marion ("faculty members") agree to perform a study and analysis of market practices related to the purchase and sale of cheese, including transactions on the National Cheese Exchange, and to make the results of that study and analysis available to the department. The college agrees that the faculty members may perform this

study and analysis in their capacity as faculty members of the college.

2. For purposes of the above study, the department will, in its discretion, provide the faculty members with proprietary information obtained by the department. The faculty members will protect the confidentiality of all proprietary information received from the department, and will establish reasonable security measures to protect the confidentiality of that information. The faculty members will not release proprietary information without the department's prior written approval.

3. Solely for purposes of the above study and analysis, the faculty members may give their support staff scientists access to proprietary information received from the department, provided that the support staff scientists are individually identified to the department in advance, and provided that the support staff scientists agree to protect the confidentiality of the information. The faculty members are responsible for ensuring that their support staff scientists protect the confidentiality of any proprietary information provided to them.

4. No faculty member or support staff scientist who receives proprietary information under this agreement will use that information in any way that could result in the receipt of anything of value for himself or herself, for his or her immediate family, or for any other person or organization, unless the department has made that information available to the public.

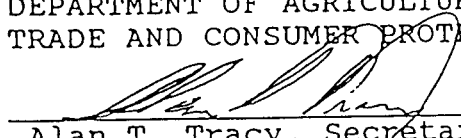
5. This agreement does not prohibit a faculty member or support staff scientist from publishing any study or analysis, provided that the publication does not disclose proprietary information in violation of this agreement.

6. This agreement does not prohibit the release or publication of proprietary information with the prior written approval of the department.

Signed this 24th day of February, 1992.

STATE OF WISCONSIN
DEPARTMENT OF AGRICULTURE,
TRADE AND CONSUMER PROTECTION

By


Alan T. Tracy, Secretary

Signed this 10 day of February, 1992.

By Willard F. Mueller
Prof. Willard F. Mueller
Principal Investigator

Signed this 10 day of February, 1992.

By Bruce W. Marion
Prof. Bruce Marion
Principal Investigator

Signed this 14th day of February, 1992.

UNIVERSITY OF WISCONSIN

By Robert W. Erickson
Robert W. Erickson
Director, Research Administration
-- Financial