S. HRG. 105–131

ALTERNATIVES TO THE NATIONAL CHEESE EXCHANGE AS PART OF THE DAIRY PRICING SYSTEM

HEARING

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON APPROPRIATIONS

UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

SPECIAL HEARING

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ALTERNATIVES TO THE NATIONAL CHEESE EXCHANGE AS PART OF THE DAIRY PRICING SYSTEM

THURSDAY, MARCH 13, 1997

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURE, RURAL DEVELOPMENT, AND RELATED AGENCIES,
COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 2:38 p.m., in room SD–138, Dirksen Senate Office Building, Hon. Thad Cochran (chairman) presiding.

Present: Senators Cochran, Specter, Bumpers, Kohl, and Leahy.

Also present: Senator Santorum.

CONGRESSIONAL WITNESSES

OPENING REMARKS OF SENATOR COCHRAN

Senator COCHRAN. The subcommittee will please come to order. We are pleased today to convene a meeting of the Agriculture Appropriations Subcommittee for the purpose of reviewing the Department's plans for dairy pricing.

This hearing is being held at the request of the distinguished Senator from Pennsylvania, Senator Specter, who, during our hearing with the Secretary of Agriculture on the subject of the President's budget request, asked if we would schedule this special hearing to discuss the alternatives to the National Cheese Exchange as a part of the dairy pricing system.

I was happy to consent to that request, and today we are here keeping our commitment to hold a hearing on this subject. We appreciate very much Senators' attendance at the hearing, the Secretary of Agriculture's attendance, and that of others who we have asked to be here today to help us better understand the alternatives and the options available to the Government on this very important issue.

Let me point out, too, that we have problems in Mississippi and across the South with dairy pricing formula issues. While not specifically the subject of the hearing the milk marketing orders and seasonal base plans are an integral mechanism to encourage milk producers to even out their seasonal milk production over the year.

The authorization for these plans was not included in the Federal Agriculture Improvement and Reform [FAIR] Act, and we are concerned about that. We understand there are some witnesses who will be here to discuss this, and we hope the administration will work hard to address this problem as it endeavors to make needed changes to the dairy program.

At this point I am going to yield to my distinguished colleagues here on the committee for any opening statements they may have, and then we will proceed to hear from our first witness, Senator Feingold.

Senator Specter.

STATEMENT OF SENATOR SPECTER

Senator SPECTER. I thank you very much, Mr. Chairman, and thank you for convening this hearing as you have stated we would when we heard earlier from the Secretary of Agriculture on our regular appropriation hearing.

In my judgment, there is a real crisis in the milk industry today, with prices being so very low. The formula is determined with an input from cheese, and for every 10 cents the price of cheese goes up, the price of milk per hundredweight goes up by $1. There are some indications that the price of cheese which has been established is not the realistic fair market price. It is determined by the Wisconsin Cheese Exchange, and without getting into any of the details as to how that exchange functions, suffice it to say that it may not be the accurate market price in the country.

Secretary of Agriculture Glickman traveled to northeastern Pennsylvania a few weeks ago to meet with a large group of Pennsylvania farmers, about 500 gathered into a large field house that day to express real displeasure at what was happening with milk prices.

At that time, it was stated that the Secretary would review the situation to make a determination as to whether he would exercise the authority which he has unilaterally to establish a different price of cheese after due consideration of market factors which would, in turn, raise the price of milk.

Collaterally, the Department of Agriculture had been undertaking a rulemaking process, which takes considerable time, but the Secretary acknowledged that he had the authority to do it unilaterally and said he would take a look to see if market forces, the market price of cheese would warrant that kind of increase.

Since that meeting, the Secretary has been surveying the price of cheese across the country as he testified here, and the collateral proceeding on rulemaking has been going on.

We did discuss this matter to some extent when he was here before, but time did not permit the full discussion, which is why this meeting has been convened, so I am looking forward to hearing from Secretary Glickman and his associates as to what else has been done on the subject.

We also have the cheese purchasers here, very distinguished witnesses, Mr. Linwood Tipton, Mr. Ed Coughlin—I have consulted with Mr. Tipton in some detail on this question earlier, and we have a number of witnesses here who are dairy farmers, Arden Tewksbury, manager of the Progressive Agricultural Organization, and a very forceful advocate for milk farmers in his section of the State, for the full State and the country, and Mr. Ken Zurin, dairy farmer from Lancaster, PA. We have other farmers here as well.

So I think this promises to be a very worthwhile hearing, and I again thank you, Mr. Chairman.

Senator COCHRAN. Thank you, Senator Specter. Senator Kohl.

STATEMENT OF SENATOR KOHL

Senator KOHL. Mr. Chairman, we thank you for holding this hearing on the issue of alternatives to the National Cheese Exchange, and we thank all who have come to testify, especially those of you who have flown in from far away.

There has been a great deal of debate over the past 2 years about the National Cheese Exchange, about the flaws of that market and about the inappropriate influence it has had on farmers' milk checks and on cheese prices nationally.

To his credit, Secretary Glickman recently announced that he was seeking public comment on the proposal to delink the USDA calculation of the basic formula price on the National Cheese Exchange, and I think there is wide agreement that the delinking should take place, but the purpose of this hearing is not to rehash the debate about the shortcomings of the National Cheese Exchange, which unfortunately has been an acrimonious debate. The purpose of this debate is to look forward to try to reach common ground, and to focus on where we go from here.

As we will hear in testimony today, plans are underway to create a new market for cheese to be an alternative to the National Cheese Exchange. One of the things I would like to explore in this hearing is how to avoid merely repeating the flaws of the National Cheese Exchange.

Before we start, there are a couple of points that I believe need to be clarified. First, a more credible price discovery mechanism for dairy is an important prerequisite for the larger dairy pricing reforms that are taking place now at the USDA, but it is not a panacea for the low milk price problems that farmers have been experiencing. That is a separate debate and an important debate, and one that I have discussed with Secretary Glickman in the past, but it is not the subject of this hearing.

Second, we all want to find an alternative to the cheese exchange as quickly as possible, but I believe we need to be careful not to insist that USDA link its pricing system to any new market until that new market becomes viable, and has proven its credibility. We need to act as quickly as possible, but we should not make matters worse.

So we welcome everybody here today, and we look forward to your testimony.

Senator COCHRAN. Thank you, Senator Kohl. Senator Feingold, you may proceed.

STATEMENT OF HON. RUSS FEINGOLD, U.S. SENATOR FROM WISCONSIN

Senator FEINGOLD. Thank you very, very much, Mr. Chairman. I want to thank Senator Specter for his leadership and attention to this issue, and particularly thank Senator Kohl. He and I are partners on this issue, and agree I think in almost every respect on the dire need to find a different way to address this issue of cheese and milk pricing.

Mr. Chairman, thank you for holding this hearing and giving me an opportunity to testify on a very important matter to dairy farmers in Wisconsin and throughout the Nation, the National Cheese Exchange. I will submit a longer statement for inclusion in the hearing record if the chairman will permit.

Senator COCHRAN. Without objection, it will be included in the record.

Senator FEINGOLD. Thank you, Mr. Chairman.

The question of whether traders on the National Cheese Exchange have actually used this market to manipulate milk and cheese prices has been the subject of a lot of debate, but the more important issue at hand here, as Senator Kohl has indicated, is the resolution of problems that the exchange has created. To do that, we have to understand what the problems are.

Many economists, dairy farmers, and market observers agree that the exchange is a badly flawed market. It has low trading volume, few active traders, brief trading periods, infrequent trading sessions, and tends to be highly volatile, overreacting to market conditions. Those characteristics make it very easy for one single trade to affect the opinion price of the exchange, but that is not the fundamental problem.

While the flawed nature of the cheese exchange gives traders the ability to manipulate prices, it is the role of the exchange in setting milk prices that appears to provide them with the incentive to do so. The combination, then, of these two factors is the crux of the problem.

To solve the problem, we must address both the flaws of the market and its influence over milk prices. The National Cheese Exchange has a strong and indirect influence on milk prices paid to farmers throughout the Nation. USDA sets the basic formula price for milk, which under Federal milk marketing orders is based on two components: First, a survey of prices paid to producers by 160 milk manufacturing plants, and second, an adjustment factor linking the National Cheese Exchange prices to the BFP.

Recent efforts to address the cheese exchange problem by breaking the direct link between the Cheese Exchange and the basic formula price, as Senator Kohl has indicated, only addresses part of the problem. While USDA should delink the BFP from the exchange and fortunately Secretary Glickman has taken the first steps toward doing that, doing so will not eliminate the influence of the Cheese Exchange on farmer milk prices.

The more fundamental problem is the role the exchange plays in setting milk prices for the first half of USDA's BFP formula, that plant survey component that I have mentioned. As the exchange is the only existing source for consistent price information on cheese, most cheese sellers surveyed by USDA link their forward contract prices for cheese to the price of the National Cheese Exchange, so this indirect linkage caused by the role the exchange plays as the price benchmark for the industry is actually the more pervasive and difficult problem to solve here. It will not be solved until new and reliable sources of price information which cannot be manipulated by one large buyer or seller are developed, maintained, and utilized.

Mr. Chairman, I caution members of this committee and the Department of Agriculture not to consider the creation of any single National Cheese Exchange replacement or any one particular alternative source of price information as the sole solution to this problem. Relying on a single alternative to the exchange accomplishes nothing if the alternative market is merely in effect the recreation of the National Cheese Exchange by a different name.

I think, and I believe Senator Kohl agrees, if I may say so, the problem is better approached from several different angles at once. As he has said, first eliminating the formal link between the BFP and the NCE.

Second, creating and encouraging many different sources of price discovery, including increasing USDA cheese price reporting for off-exchange transactions, increasing trading volume on cheese and milk future markets, and creating alternative and potentially competing cash markets for cheese.

But there is then a third approach that has to be taken to make this all work, and that is regulating and overseeing at the Federal and State level any cash market that directly or indirectly affects milk prices regulated under Federal Milk Marketing Orders.

To this end, I have introduced legislation, the Milk Price Discovery Improvement Act, S. 258, which would require USDA to implement many of these solutions. I am very pleased that Secretary Glickman has agreed to implement some of these initiatives, such as price reporting for off-exchange cheese transactions independent of a congressional mandate.

The Secretary has also opened up a comment period to begin the process of delinking the cheese exchange from the basic formula price for milk. But I caution both the Secretary and members of this committee not to prematurely substitute an alternative market price for the cheese exchange in the BFP until that market is found to be free from manipulation.

So these options, changing the calculation of the BFP, creating new cash markets, improving USDA cheese price reporting, and increasing regulation and oversight, are not exclusive of one another. They can and should be implemented simultaneously.

So to conclude, Senator Kohl and I, as well as others in the Wisconsin congressional delegation, have been working very hard on this issue of the National Cheese Exchange for many years, and particularly in the last year. We welcome the interest and participation of this committee and other Senators in ensuring that dairy farmers are no longer held hostage to a market which cannot be relied upon to return a fair and competitive price to farmers.

And again, thank you very, very much, Mr. Chairman, for permitting me to testify and for holding this hearing.

PREPARED STATEMENT

Senator COCHRAN. Thank you, Senator, for your statement and your contribution to this hearing. Your complete statement will be made part of the record.

[The statement follows:]

PREPARED STATEMENT OF SENATOR RUSS FEINGOLD

Mr. Chairman and Members of the Agriculture Appropriations Subcommittee, thank you for holding today's hearing and for this opportunity to testify on the problems created by the National Cheese Exchange and the lack of reliable pricing information in the dairy industry.

As many Committee members are aware, the National Cheese Exchange controversy has recently received national attention due to the recent dramatic and unprecedented plunge in milk prices which followed sharp drops in cheese prices at the Exchange.

What some members of this Committee may not know, is that the controversy surrounding the Cheese Exchange, located in Green Bay, Wisconsin has been raging in my state for several years. I have been working with my colleague, the senior Senator from Wisconsin [Mr. Kohl], for many years to resolve some of these problems.

Wisconsin farmers have alleged, and a March 1996 study by the University of Wisconsin and the Wisconsin Department of Agriculture, Trade and Consumer Protection (DATCP) concluded, that cheese prices on the National Cheese Exchange are vulnerable to manipulation for the benefit of traders on the Exchange and frequently to the detriment of dairy farmers. Contrary to popular belief, concern about the National Cheese Exchange has persisted in Wisconsin regardless of the milk price level. Senator Kohl and I were working on the National Cheese Exchange issue on behalf of dairy farmers when milk prices were at their peak last year.

Following release of the UW/DATCP report, Senator Kohl and I asked federal antitrust authorities to look into those allegations. The fundamental conclusion of the Department of Justice and the Federal Trade Commission is that the type of manipulation that is alleged to have occurred at the National Cheese Exchange is not a violation of federal antitrust law. That is obviously a difficult answer for dairy producers to hear. Farmers correctly conclude that just because such manipulation may be legal, doesn't mean the problems that might lead to manipulation shouldn't be corrected.

In order to determine how to solve those problems, it is important that members understand what this whole controversy is about, and what it is not about.

Many economists, dairy farmers and market observers agree that the Exchange is a badly flawed market. It has low trading volume, few active traders, brief trading periods, infrequent trading sessions, and tends to be highly volatile overreacting to market conditions. Those characteristics make it very easy for one single trade to affect the opinion price of the Exchange. But that is not the fundamental problem.

While the flawed nature of the Cheese Exchange gives traders the ability to manipulate prices, it is the role of the Exchange in setting milk prices that appears to provide them with the incentive to do so. The combination of these two factors—the ability and the incentive to manipulate—is the crux of the problem.

Fundamentally, the resolution of the problem of the National Cheese Exchange lies in ensuring dairy farmers that the price they receive for milk they produce cannot be manipulated by those with the power and incentive to do so. To solve the problem, we must address both the flaws of the market and its influence over milk prices.

The Exchange affects milk prices because of the way the federal government sets milk prices under Federal Milk Marketing Orders. The Basic Formula Price is calculated each month by USDA and is used to set the base price for milk for all farmers regulated by Federal Orders. The BFP has two components. The first is a survey of actual prices paid to producers by roughly 160 manufacturing plants receiving grade B milk—which is unregulated by the Federal government. The second component is an adjustment factor based in large part on the price at the National Cheese Exchange.

It is this second factor, the direct linkage between the National Cheese Exchange and the Basic Formula Price that has garnered a lot of attention. Many have suggested that if we break this link, and we should, that the influence of the Cheese Exchange on milk prices will be eliminated. I, and many others, including the Senator from Pennsylvania [Mr. Specter], have proposed to do that and as you may know, Secretary Glickman has taken the first steps toward breaking that link by opening up a comment period on the issue.

However, breaking that direct link will only solve part of the problem. The more fundamental problem is the role the Exchange plays in setting milk prices for the first half of USDA's BFP formula—the plant survey component.

The plants that are surveyed by USDA pay farmers milk prices based on the price they receive for the cheese they manufacture. That price is determined by the prices at the National Cheese Exchange. Since the Exchange is the only existing source for consistent price information on cheese, most cheese sellers surveyed by USDA, and indeed most cheese sellers and buyers nationally, link their forward contract prices for cheese to the price at the National Cheese Exchange. This indirect linkage caused by role of the Exchange as the only source of price discovery is the more pervasive and difficult problem to solve.

Solving this problem requires that new and reliable sources of price information that cannot be manipulated by one large buyer or seller are developed, maintained and utilized by the dairy industry. I caution members of this Committee and the Department of Agriculture not to consider any single National Cheese Exchange replacement or any one particular source of price information as the sole solution to this problem. Many options are needed and the more price information, the more fair the marketplace will be for dairy farmers.

Since the release of the University of Wisconsin/DATCP report, I have proposed tackling this problem from every possible angle including:

—Creation of voluntary internal reform of practices at the National Cheese Exchange to increase trading volume and reduce both price volatility and the influence of individual traders on overall price levels. Reforms could include limitations on daily price movements, movement toward electronic trading, and a prohibition of certain trading practices.

—Increased price reporting by USDA for off-Exchange bulk cheese transactions to reduce the role of the Exchange as the only source of price information thereby hopefully reducing the indirect influence of the Cheese Exchange on milk prices;

—Elimination of the direct link of the National Cheese Exchange to USDA's Basic Formula Price;

—Creation of a new cash market or markets that do not share the flaws of the National Cheese Exchange;

—Increased federal efforts in improving milk price discovery generally, such as encouraging greater trading on futures market and exploring the creation electronic markets; and,

—Increased federal and state regulation and oversight of any cash market, including the National Cheese Exchange, that fundamentally influences milk prices paid to producers.

These options are not exclusive of each other. And in fact, if they were all implemented, we might be well on our way to solving the fundamental problem of the lack of price discovery in cheese and dairy markets. In fact, relying on one option alone will not resolve these problems.

I have introduced legislation to implement several of these options. My bill, the Milk Price Discovery Improvement Act (S. 258) requires USDA to begin consistent weekly reporting of cheese prices for off-Exchange transactions, requires USDA to eliminate the direct link between the milk prices and the National Cheese Exchange or its replacement market, requires increased USDA oversight of any cash markets that affect milk prices under Federal Milk Marketing Orders, and requires USDA to explore additional ways of improving price discovery such as encouraging increased trading volume in futures market.

I am extremely pleased that Secretary Glickman has taken steps to implement a number of the provisions in my bill without a Congressional mandate.

In fact, this week marks the first week of USDA's weekly reporting of cheese prices for off-Exchange transactions—something I first proposed in June 1996 as part of Senator Daschle's Cattle Industry Improvement Act and which I later urged Secretary Glickman to implement using existing administrative authority.

The success of this new price series as a reliable source of price discovery depends upon the cooperation of cheese manufacturers and processors reporting prices, as well as upon the integrity of those reported prices. It will take the agency some time to determine whether or not this has been achieved. However, it is an excellent start toward improving price discovery. If the Department believes that accurate and statistically reliable price collection can only be achieved through mandatory data collection, I urge the Secretary to notify Congress as soon as they make that determination.

Secretary Glickman has also taken the first step toward delinking the price of the Exchange from the Basic Formula Price by taking public comments on whether that link should be broken. An additional question facing the Department is whether or not they should find an alternative price to replace the role of the Exchange in the BFP. I urge the Department not to rush to judgment on a new indicator of cheese price value in this formula. If necessary, the Department should consider in the short run, not replacing the adjustment component of the BFP.

Senator Kohl and I have also been working to encourage the development of new cash cheese markets that would have sufficient protections against intentional manipulation of prices and which might garner greater federal oversight. Specifically we have talked with the Coffee, Sugar and Cocoa Exchange to understand how they might structure a sound and efficient cash market for cheese.

I understand that the cheese processing industry has also aggressively sought new markets by soliciting bids from major commodity exchanges for the creation of a new cheese trading mechanism. It has been suggested that the Exchange may cease operation in Wisconsin on May 1st due to the scrutiny it has been under and because of potential increased regulation by the State of Wisconsin. Efforts by private industry to establish an alternative market are apparently in response to that likely outcome.

I caution members of this Committee and the USDA to avoid the temptation to prematurely substitute prices from a new market for the Cheese Exchange in the BFP before it can be shown that the market is reliable and free from manipulation. We must not attempt to solve the problem of the National Cheese Exchange's influence on milk prices by merely creating a new problem. If the Cheese Exchange is merely recreated under a different name, we will have accomplished nothing.

It continues to be absolutely critical that any market mechanism that can so severely impact regulated milk prices, directly or indirectly, is overseen and regulated by those federal and state entities with the expertise to do so. My legislation gives USDA authority to prohibit anticompetitive activities on cash markets that affect milk prices. This authority is similar to that which the agency has over livestock auction markets under the Packers and Stockyards Act. So long as regulated prices are affected by private markets, USDA has a fundamental responsibility to exercise oversight. I have also cosponsored legislation offered by the senior Senator from Wisconsin which increases the Commodity Futures Trading Commission role in overseeing certain cash markets.

Ultimately, we must address the fundamental problems of the lack of adequate price discovery in the dairy industry by continuing to approach this problem from every angle possible. USDA can and should break the direct link between the National Cheese Exchange and milk prices. Congress can and should increase regulation and oversight of markets that indirectly affect milk prices under Federal Orders to ensure that farmers' prices are not being manipulated. But neither the Congress nor the Federal government can prohibit the dairy industry from relying on poor pricing mechanisms. We must continue to work to create more and better price information to provide more pricing options for the industry and to ensure dairy farmers that their milk prices cannot be manipulated.

Senator Kohl and I, as well as others in the Wisconsin Congressional delegation have been working very hard on these problems for some time. We welcome the interest and the participation of this Committee and other Senators in ensuring that dairy farmers are no longer held hostage to a market which cannot be relied on to return a fair price to farmers.

FEINGOLD TESTIFIES ON NATIONAL CHEESE EXCHANGE IN FIRST SENATE HEARING ON ISSUE

WASHINGTON, D.C.—U.S. Senator Russ Feingold testified before the U.S. Senate Appropriations Subcommittee on Agriculture today on the need for a meaningful solution to the problems posed by the National Cheese Exchange (NCE). This is the first U.S. Senate hearing focused on the role of the NCE.

Senator Feingold used the opportunity to inform his colleagues about the problems the Cheese Exchange imposes on farmers in Wisconsin, and nationally, and to caution them against the pit-fall of an easy fix that simply delinks the NCE from USDA's milk price formula. Feingold advocated a more comprehensive approach addressing the pervasive influence the Exchange has on milk prices.

"Wisconsin farmers know the crux of the problem is that the structure of the Cheese Exchange makes it easy for someone to manipulate prices and the role of the Exchange in setting milk prices creates an incentive to do so. That is why I have introduced a comprehensive bill which will not only delinks the Cheese Exchange from the Basic Formula Price, but also creates alternative sources for price information and increases USDA oversight over markets that influence milk prices," said Feingold, referring to S. 258, which was introduced on February 4, 1997.

The hearing is the latest in a series of developments in the dairy industry. Last Friday, the USDA released options for reform of milk marketing orders addressing inequities suffered by mid-west producers. Comments on these recommendations will be accepted until June 1. The final USDA proposal is due by the end of the year.

ALTERNATIVE PRICE FOR CHEESE FREE FROM MANIPULATION

Senator COCHRAN. Senator Kohl, this is a great opportunity for you to put a tough question to your colleague, if you want to take advantage of it.

Senator KOHL. Well, as Senator Feingold indicated, he and I are in basic agreement on the dimensions of this problem, and on some of the things that need to be done. I am not going to ask him again to say the extent to which he and I agree. He has said it three or four times. But I am delighted that he is here. I have enjoyed working with him, and he is very constructive in his suggestions, and he is most diligent in his effort to get this matter resolved.

Because what happens to dairy in Wisconsin is of great significance. The dairy industry is our biggest industry, and it is something about which we in Wisconsin are all very sensitive, very concerned, and I appreciate the opportunity to work with Senator Feingold, and I think we are going to get something done.

Senator COCHRAN. Thank you. Senator Specter.

Senator SPECTER. Secretary Glickman is here, so I will just ask two very brief questions. Senator Feingold, you say an alternative price should not be established for cheese unless we know the market is free from manipulation, but if we could establish an alternative price for cheese free from manipulation, would you see any reason for delaying doing that?

Senator FEINGOLD. No; if we can be assured that there might be an alternative market at the Coffee, Sugar, and Cocoa Exchange, or perhaps the Chicago Mercantile Exchange that cannot be easily manipulated. If we knew we had the power through the Federal regulators to prohibit anticompetitive practices at an alternative market, then I think that is something we want to move to. But we need to get those kinds of assurances, and the legislation has to be in place to empower the Federal Government to do that.

To just simply create it and merely reproduce the problems of the National Cheese Exchange that have occurred so far, I think, would be a mistake.

Senator SPECTER. How about a survey by the Secretary across the country establishing what the market is, which may be different from the Green Bay Cheese Exchange?

Senator FEINGOLD. I believe the Secretary is already moving in that direction. I asked him last fall to start gathering cheese price information for off-exchange transactions, and he started to do it on a monthly basis. I believe he has now moved to a weekly basis. I hope I am not speaking out of school on that, but I believe that is something that is beginning this week.

I feel the Secretary is very concerned and responsive to exactly what you have just said, the need to look at all the possible information that we have so that we do not continue to have our current problems, which is a cheese exchange that really is involved with 1 or 2 percent of the cheddar cheese in the country, and that does not really reflect the broad scope of cheese transactions in the country.

Senator SPECTER. Well, he has been working at that. The concern that I have and that my Pennsylvania farmers have is the delay which has occurred.

Mr. Tewksbury just commented to me that it has been 3 months since the first meeting with the Secretary, so we want to see if we can establish the alternative.

ESTABLISHING A PRICE FLOOR

Let me ask you one other subject matter very briefly, and that is, a number of Senators, as I understand it, led by Senator Breaux, wrote to Secretary Glickman asking him to establish a price floor of $13 per hundredweight, and I have written to the same effect on a temporary action because the farmers are in such dire straits. What would your sense of that be?

Senator FEINGOLD. Well, I think the Secretary is in the process of looking at a number of options with respect to milk prices. Basic milk pricing reform, which I think is broader than the scope of this hearing is something USDA is in the process of proposing. The Secretary just issued potentially six different alternative reform options that he is looking at with regard to the Milk Marketing Order system. Flooring the basic formula price is one issue that has come up.

I have indicated that I think he ought to look at all different options, including the possibility that you have just mentioned, but I really think this should be done in the process of the comment period, listening to dairy farmers. A lot of my farmers would tell you that $13 is not enough. That is not adequate. The figure that has been bandied about in Wisconsin is $14 or higher.

Senator SPECTER. Well, we can always listen to a counterproposal, but that is better than what we have now. Do your farmers have a sense of immediacy about getting something done now because of the crunch on rising prices and falling milk prices, the rising cost of production and falling milk prices?

Senator FEINGOLD. In the 14 years that I have been either a State senator or a U.S. Senator working on agricultural issues I have never seen a greater sense of immediacy, and that is why all of us and our Governor met with the Secretary of Agriculture recently with a number of our dairy farmers.

The decline that occurred in prices in November and December was a real jolt. Senator Kohl and I had raised issues about the cheese exchange last July in Madison. We indicated that if we did not do something about this, something like this might happen, and it did happen, and the reaction in Wisconsin to the sharp decline from about $15 per hundredweight down to a little over $11 per hundredweight in just a few weeks was a very jarring experience not just for our farmers but for everyone in the State.

So there is a feeling of tremendous urgency, and that is why I believe the Secretary should move as fast as he can to delink the Cheese Exchange from milk prices and assist in identifying alternative markets, and in passing legislation that will guarantee that we do not just end up with the same problems. We should have the Federal ability to regulate that which obviously needs to be regulated.

Senator SPECTER. Thank you very much, Senator Feingold.

Senator COCHRAN. Thank you, Senator. Thank you, Senator Feingold.

Senator FEINGOLD. Thank you, Mr. Chairman.

DEPARTMENT OF AGRICULTURE

STATEMENT OF HON. DAN GLICKMAN, SECRETARY OF AGRICULTURE

ACCOMPANIED BY:

MIKE DUNN, ASSISTANT SECRETARY, MARKETING AND REGULATORY PROGRAMS

KEITH COLLINS, CHIEF ECONOMIST

INTRODUCTION OF WITNESS

Senator COCHRAN. The Secretary of Agriculture has kindly agreed to appear at our hearing today. We want to welcome the Hon. Dan Glickman, Secretary of Agriculture. Just recently he was before the committee discussing the President's budget request for the next fiscal year, and it was during that testimony that Senator Specter requested that we have a special hearing of the committee on the subject of dairy pricing.

We are very happy that the Secretary could arrange his schedule to be with us today. Mr. Secretary, welcome to the committee. Thank you very much for your cooperation in this effort. You may proceed.

STATEMENT OF SECRETARY GLICKMAN

Secretary GLICKMAN. Thank you, Senator Cochran, Mr. Chairman, Senator Kohl, Senator Specter, Senator Santorum.

I bring with me today two folks who have been with me before on occasion, or at least separately before the committee, Keith Collins, who is our chief economist, and Mike Dunn, who is the Assistant Secretary for marketing and regulatory programs, and they have followed this subject very, very carefully over the years.

Now, first of all, I think this is an important hearing. It has obviously gotten a great deal of interest, and we have a great deal of interest in the Department about this hearing, and you have a good diversity of witnesses afterward.

I want to thank Senators Kohl and Leahy, Specter, Feingold, Santorum, Jeffords, and all the others, including yourself, Mr. Chairman, for your interest in this issue and the volatility of dairy prices.

I have an oral statement which I would like to read, and then there is a longer written statement which I would like to include in the record.

I would like to begin with a brief description of recent events in milk markets, then I would like to discuss how the Department uses the National Cheese Exchange prices in administering its Federal milk marketing order program, and then finally review—and I think this was the purpose Senator Specter asked originally for the hearing—review the actions we have taken to address concerns about National Cheese Exchange prices and what we might do in the future.

First of all, the current dairy situation. A series of unusual events combined to make 1996 a year dairy farmers will long remember and perhaps would like to forget.

Producers faced record high feed costs, high forage prices, low forage quality, and low cull cow and calf prices.

Milk prices were record high but were also extremely volatile last year. During late spring and summer, milk prices rose as milk production declined, and dairy product prices reached record high levels.

Suddenly, as milk production began to recover and commercial stocks of dairy products exceeded year earlier levels, dairy product prices plummeted, causing the basic formula price to drop by over $4 per hundredweight in just 3 months, September to December.

On January 7, I announced a series of actions to help stabilize farm milk prices, including (1) purchasing additional cheese for use in the domestic food assistance programs, (2) working to increase the flow of dairy products into our international food assistance programs, (3) stepping up activity under the dairy export incentive program, and (4) conducting a national survey of cheddar cheese prices in response to concerns about the accuracy of reported prices.

We also later on increased our purchases under the commodity supplemental food program, which is a program for seniors and low-income folks that we provide commodities for, and total cheese purchases this year by the Department are up considerably, about 40 percent. So there is an effort to try to deal with the problem on the demand side, and we believe these actions have been helpful and the price picture is improving.

Since December, the basic formula price increased by over $1 per hundredweight and is now very near last year's level. Our analysts expect the all-milk price to strengthen throughout the year and average $13.75 per hundredweight for all of 1997, despite the lower prices at the start of the year, so we will see, I think, without being overly Pollyannish about it, improved milk prices for the rest of the year both in terms of the various classes, and that will be reflected in the basic formula price. As I said, it is up about $1 since the low.

The use of National Cheese Exchange prices in Federal orders is obviously key to our concern and yours as well. Under Federal milk marketing orders, which regulate the marketing of about 70 percent of the milk produced in the United States, the minimum price a processor or handler must pay for milk varies with how the milk is used.

Milk used in manufacturing hard products such as cheese is referred to as class III. Generally, the class II price in each order equals the class III price plus about 30 cents a hundredweight, while the class I price equals the class III price plus a differential that varies by location, and this is the issue that Senator Kohl and others have raised so often. This differential has caused some people to believe that there is an unfairness in the pricing system and is something we are looking at right now.

Prior to May 1995, or less than 2 years ago, the Minnesota-Wisconsin price series—it is called the M–W price—was used to establish the minimum class III price under Federal orders. That is the milk price used for cheese and other hard products.

The M–W price depended on two factors: (1) the average price paid by about 170 plants for manufacturing grade or Grade B milk in Minnesota and Wisconsin during the previous month, and (2) an estimate of the change in the price from the previous month to the current month.

Over time, statisticians at USDA became increasingly concerned that not enough data was available to reliably estimate the change in price from the previous month, the second part of that calculation.

By early 1995, just 61 manufacturing plants, or about one-third of those that we expected to participate, were being used to estimate the price change from the previous month.

Following a national hearing and formal rulemaking, USDA replaced the M–W—Minnesota-Wisconsin price—with the BFP, or basic formula price, which we use now.

The BFP starts with the same base month, M–W price survey, but updates that survey using changes in wholesale dairy product prices. In updating the M–W price to the current month, the change in the price of cheese on the National Cheese Exchange receives about 90 percent weight, and the change in butter and nonfat dry milk prices receive about 10 percent weight, and Mr. Collins can explain why that is the way it is, but I think there is no question that the price of cheese on the cheese exchange has a considerable amount to do with what the basic formula price actually becomes.

The National Cheese Exchange is often described as a thin market. That is, the volume traded on the exchange is very small relative to total cheese sales. Thin markets generally raise questions about their ability to accurately reflect supply and demand conditions in a market, and the potential for manipulation.

This has led to concerns that the use of the National Cheese Exchange prices in determination of the basic formula prices could adversely and perhaps unintentionally affect producers through lower minimum prices under the orders, and through increased price volatility.

To determine whether the basic formula price, which has the NCE component, is accurately reflecting the volume of milk, we have tracked the BFP and the old M–W pricing system. Averaged over the 21-month period from May 1995 through January 1997, the BFP and the M–W price have been almost exactly equal. However, during the last quarter of 1996, the time of the great fall, a period of rapidly declining milk prices, the BFP, the basic formula price, averaged 32 cents per hundredweight lower than the M–W price, so there was some difference during that 3 months, as I said, about 32 cents per hundredweight.

This divergence does raise the question whether the BFP is overly sensitive to changes in the National Cheese Exchange prices. At this time, we are in the process of determining whether there exists an alternative to NCE prices for administering Federal milk marketing orders, and we are engaged in a dialog with the dairy industry to examine alternatives and develop additional markets for cheese.

The Department is seeking public comment until about 2 weeks from now on whether there exists an alternative to National Cheese Exchange prices in establishing the basic formula price. Based on the comments received and other information available, USDA will determine whether to replace National Cheese Exchange prices in establishing the BFP.

We are also reviewing the basic formula price as part of the 1996 farm bill's mandate to consolidate and reform orders, and as Senator Feingold said, just last week, I issued a series of options on how we might do that in terms of the pricing mechanism, and we anticipate releasing a report on the BFP shortly after the March 31 date.

On January 7, I announced that USDA would conduct a national survey of cheese prices. I am happy to announce that this week our National Agricultural Statistics Service has started a weekly survey of cheddar cheese prices, and I would tell you in all honesty that I think your involvement has helped move that thing along faster.

We are encouraging all cheese plants to participate in the survey, and are working with interested parties to ensure that the data collected are accurate, timely, reliable, and of value to the dairy industry. It is too early to determine if this is the appropriate candidate for pricing cheese, in the basic formula price as an NCE replacement. We are testing it to see if it is a good candidate.

This will depend on the level of participation. Right now, this is a voluntary-based effort, and we will see whether that volunteerism works to get the reporting that we need. If it does not, we may have to come back and ask you for the authority to require the participation, but right now we are seeing if the voluntary effort does work. We are encouraging all cheese plants to participate in the survey, and are working with interested parties to assure that the data collected are accurate.

Both the Chicago Mercantile Exchange and the Coffee, Sugar, and Cocoa Exchange are exploring the possibility of starting a cash market for cheddar cheese. We are committed to working with the exchanges and the dairy industry to further develop such markets to the benefit of producers and processors.

In conclusion, let me just say that we, along with you, have followed closely the concerns expressed originally by Senators Kohl and Feingold and more recently during my trip up to Pennsylvania with Senator Specter, concerns over NCE prices and their use in pricing under Federal milk marketing orders.

As I have said, our study has indicated that there is a slight but perceptible difference between the pricing mechanism under the BFP, which uses the cheese exchange, and the way we would have calculated it under the old M–W system. Basically they track each other, except the last 3 months of the year the BFP was somewhat lower, about 32 cents a hundredweight lower, on average.

So this concerns us. It is some evidence that this is not the process that we would want to have certainly in the future, but we need to develop the evidence. We welcome any evidence that will help promote reform and contribute to opportunities for growth and stability for our Nation's dairy producers.

So I would say that completes my testimony, Mr. Chairman, and I have my two experts with me that will try to work together with you in trying to resolve this problem.

PREPARED STATEMENT

Senator COCHRAN. Thank you very much, Mr. Secretary. We appreciate very much your cooperation with our committee. Your complete statement will be made part of the record.

[The statement follows:]

PREPARED STATEMENT OF DAN GLICKMAN

Mr. Chairman and members of the Subcommittee, I welcome the opportunity to discuss the current dairy situation and related policy issues.

I would like to begin with background on the current situation in milk markets and the role of minimum pricing under Federal milk marketing orders. Then I will discuss how the U.S. Department of Agriculture (USDA) uses National Cheese Exchange (NCE) prices in administering its Federal milk marketing order program. Finally, I will review USDA's actions to date to address concerns about NCE prices.

THE CURRENT MARKET SITUATION FOR MILK

The all-milk price averaged a record $14.74 per cwt. in 1996, up $2 per cwt. from the previous year and exceeded the previous annual record by about $1 per cwt (figure 1). However, this average masks the unusual volatility in milk prices during 1996. During the first 3 quarters of 1996, milk prices averaged well above previous-year levels but declined sharply during the fourth quarter.

The Basic Formula Price (BFP), which USDA uses to establish minimum prices handlers must pay for milk according to use under Federal milk marketing orders, dropped from a record $15.37 per cwt. in September to $11.34 in December. In addition to this sharp decline in milk prices, dairy producers had to cope with record high feed costs, high forage prices, low forage quality and low cull cow and calf prices this past year.

The variability in farm-level milk prices in 1996 reflected movements in wholesale dairy product prices. During late spring and summer, wholesale dairy product prices surged to record highs, as milk production declined 2–3 percent some months from 1995 levels. However, as milk production began to recover and commercial stocks of dairy products greatly exceeded year-earlier levels by the fall, wholesale dairy product prices started to plummet. From early October to mid-December, the price of 40-pound blocks of cheddar cheese on the NCE fell 30 percent from its record high. The price of Grade A butter on the Chicago Mercantile Exchange (CME) dropped 56 percent from early October to mid-November.

On January 7, 1997, I announced that USDA would take a series of actions to help strengthen farm-level milk prices. Those actions included:

—purchasing an additional $5 million of cheese for use in domestic food assistance programs in addition to the accelerated school lunch purchases already underway;

—working with private voluntary groups to increase the flow of dairy products into international food assistance programs;

—reactivating the Dairy Export Incentive Program (DEIP) for butterfat, which had been idle since mid-1995, coupled with stepped-up DEIP sales for non-fat dry milk to stimulate exports of dairy products; and

—conducting a national survey of cheddar cheese prices in response to concerns about the accuracy of reported prices.

Since this announcement, both dairy product and farm-level milk prices have rebounded considerably. The wholesale price of butter is up 64 percent from its late 1996 low, and the wholesale price of cheddar cheese is up 12 percent from its low, despite continued large cheese inventories. These wholesale price increases have raised milk prices. Since December, the BFP has increased by $1.12 per cwt., reaching $12.46 in February. Compared with one year ago, the BFP for February is down $0.13 per cwt., and the preliminary all-milk price for February of $13.30 is down $0.50 per cwt.

In 1997, USDA expects milk production to increase less than 1 percent. Milk production per cow will increase while cow numbers will continue their long-term decline. USDA expects milk production to decline about 1 percent during the first quarter but increase about 1 percent the remainder of the year, reflecting improved pasture conditions and lower grain and forage prices.

The modest increase in milk production is expected to contribute to a steady improvement in milk prices over the course of the year, with the all-milk price averaging in the low-to-mid $13 per cwt. range during the first half of 1997 and slightly above $14 during the second half. For all of calendar 1997, the all-milk price is projected to average $13.75 per cwt., $0.83 above the 1990–95 average.

ROLE OF FEDERAL MILK MARKETING ORDERS IN PRICING MILK

Federal milk marketing orders regulate the marketing of only Grade A milk and in only certain areas of the country. Presently, there are 32 Federal milk marketing orders covering about 70 percent of the milk produced in the United States. Before an order can go into effect in a particular area, two-thirds of the dairy farmers voting in a referendum must approve it.

Under all Federal milk marketing orders, milk is classified according to its use which determines the minimum price a processor or handler must pay for milk. Milk used in fluid milk products is referred to as Class I and is assigned the highest minimum price. Milk used in soft dairy products, such as ice cream and yogurt, is classified as Class II; and milk used in hard, storable products, such as cheese, butter and nonfat dry milk, is classified as Class III and is assigned the lowest minimum price.

Minimum Class II and Class III prices are essentially uniform nationally, while minimum Class I prices under Federal orders vary geographically. This difference in pricing structure between Class I and the other classes of milk reflects the added cost of moving milk in fluid form from surplus to deficit areas. Generally, the Class II price in each order equals the Class III price plus $0.30 per cwt., while the Class I price equals the Class III price plus a differential that varies by location. Producers in each order receive a blend price for their milk—the weighted average of the prices and uses of all milk within the order.

THE USE OF NCE PRICES IN FEDERAL ORDERS

Prior to May 1995, the Minnesota-Wisconsin (M–W) price series was used to establish the minimum Class III price under Federal orders. The M–W price for a given month depended on two factors: (1) the average price paid by about 170 plants for manufacturing grade (Grade B) milk in Minnesota and Wisconsin for the previous or base month and (2) an estimate of the change in the price from the base month to the current month. The estimated price change from the base to the current month was based on a very small sample of plants that paid dairy producers twice a month. The prices paid producers for the first half of the month were the primary basis for the estimated change in the M–W price from the base month. By early 1995, USDA was using price information from just 61 manufacturing plants to estimate the price change from the base month to the current month.

Because of concerns expressed within the dairy industry about the representativeness and applicability of the M–W price series, USDA held a national hearing to consider a replacement for the M–W price series, and, based on the hearing record, replaced the M–W price with the BFP. The BFP starts with the same base month M–W survey price from Grade B manufacturing plants but updates that survey information to the current month using information on monthly changes in wholesale prices of butter, cheese and nonfat dry milk. In updating the M–W price to the current month, the change in the price of cheese from the base to the current month on the NCE receives about 90 percent weight and the change in butter and nonfat dry milk prices, as reflected in the prices of Grade AA butter on the CME and West Coast f.o.b. low/medium heat nonfat dry milk, respectively, receive about 10 percent. Those weights reflect product yields from 100 pounds of milk and the relative amount of milk used in the production of each product.

NCE prices are also used in 10 Federal orders with component pricing provisions. In those orders, cheese prices determine the value of protein in milk. The purpose of component pricing is to allocate receipts in each Federal order pool according to the composition of each producer's milk. Component pricing does not change total producer receipts in an order, only the distribution of receipts among producers in an order. The effect, for example, of lower cheese prices is to reduce protein prices to producers. However, component pricing formulas also include a residual value component which equals the BFP minus the value of fat and protein in producer milk. This means that an over-estimate of the protein value would lead a corresponding decrease in the residual value component, resulting in no change in the total value of producer milk that is pooled in the Federal order. Likewise, an under-estimate of the protein value would lead to a higher residual component.

USDA CONCERNS REGARDING THE BFP AND NCE PRICES

Although USDA does not have any oversight authority, either under the Agricultural Marketing Agreement Act of 1937 or the Capper-Volstead Act, for trading activities on the NCE, we are very interested in NCE prices because of their use in Federal milk marketing orders and by the dairy industry to price cheese. The cheese industry relies on NCE prices for pricing cheese marketed in the United States. An estimated 90–95 percent of bulk cheese is sold on a committed basis with the price tied to NCE prices. In addition, when the USDA held formal hearings to consider a replacement for the M–W price series, the hearing record strongly supported using NCE prices in determining the value of bulk cheese. However, the NCE is a "thin" market, that is, the volume traded on the exchange is very small relative to total cheese sales. Thin markets generally raise questions about their ability to accurately reflect supply and demand conditions in a market and the potential for manipulation. This leads to concerns that the use of NCE prices in determination of the BFP could adversely, and unintentionally, affect producers through lower minimum prices under the orders and through increased price volatility.

To determine whether the BFP is the functional equivalent of the M–W price, we have tracked the base month M–W price and the BFP for the same month since May 1995 (figure 2). Over the 21-month period from May 1995 through January 1997, the BFP exceeded the base month M–W price in 11 months by an average of $0.13 per cwt. The BFP fell below the base month M–W price in 9 months by an average of $0.19 per cwt. The base month M–W price has averaged $12.79 and the BFP has averaged $12.78 per cwt., or just $0.01 per cwt. lower since May 1995. Thus, it would appear that use of NCE prices to update the base month price M–W has not resulted in any apparent long-term distortion in minimum Federal order prices to producers.

We are also concerned that NCE prices may be causing minimum order prices to become more volatile. The BFP has generally exceeded the base month M–W price during the spring and summer months but has been significantly below the base month M–W price during the last quarter of the year. During the last quarter of 1996—a period of rapidly declining milk prices—the BFP averaged $0.32 per cwt. below the base month M–W price. This divergence between the BFP and the base month M–W price during this period raises the question whether the BFP is overly sensitive to changes in NCE prices.

The use of NCE prices in the determination of the BFP emerged as a broad concern following publication of a University of Wisconsin study, which concluded that the NCE was not an effective competitive price discovery mechanism during 1988–93 and the NCE appears to facilitate manipulation of cheese prices. The study led to a Congressional hearing in May 1996 and the creation of a Task Force on Cheese Pricing by Wisconsin Governor Thompson. The Governor's Task Force recommended in January 1997 that USDA no longer use the NCE price in determining the BFP.

Subsequently, bills were introduced in Congress that would require the Commodity Futures Trading Commission (CFTC) to regulate the NCE or require USDA to eliminate its use of NCE price data in setting the BFP. The Senate passed a sense of the Senate resolution asking USDA to consider replacing the NCE price in the BFP as soon as possible.

More recently, CFTC approved a cash settled futures contract for fluid milk that uses the BFP as the settlement price. In so doing, the CFTC issued a report indicating that price manipulation or distortion on the NCE was not of sufficient concern to disapprove the new contract. At this point, we believe the best approach is to work in partnership with the dairy industry to develop a price series that the industry has confidence in and that will not disrupt the conduct of business among producers, processors and retailers.

USDA ACTIONS

At this time, we are trying to determine whether there exists an alternative to NCE prices for administering Federal milk marketing orders, and we are engaged in a dialogue with the dairy industry to examine alternatives and develop additional markets for cheese. On January 29, USDA announced that it would seek public comment on whether NCE price data should be used in the determination of the BFP. Comments must be postmarked by March 31, 1997. Based on the comments received and other information available, USDA will determine whether to replace NCE prices in establishing the BFP. If USDA determines that the NCE price is no longer functioning as intended, "price equivalency provisions" in Federal order regulations permit an alternative cheese price series to be substituted for the NCE price.

USDA would also like to provide additional data on cheese prices to augment NCE price information. USDA's National Agricultural Statistics Service (NASS) has initiated a national survey of weekly cheddar cheese prices. This voluntary survey begins this week. USDA is encouraging all cheese plants to participate in the survey and is working with interested parties to ensure that the data collected are accurate, reliable, timely and of value to the dairy industry. As with any new survey, a period of time will be needed to validate its accuracy and reliability before we can begin publishing the data and expect it to be accepted by the dairy industry.

A common criticism of existing cash and futures markets for milk and dairy products is their thinness or lack of volume. Currently, the Coffee, Sugar and Cocoa Exchange (CSCE) trades futures in cheddar cheese, nonfat dry milk, fluid milk and butter, and the CME trades futures in fluid milk and butter, all of which have limited volume. The CSCE recently announced a futures contract for fluid milk that is cash settled using the BFP. Both the CME and CSCE are exploring the possibility of starting a cash market for cheddar cheese. USDA is committed to working with the Exchanges and the dairy industry to further develop such markets to the benefit of producers and processors.

The announced action to seek public comment on the use of NCE price data in determination of the BFP is in addition to the longer term process currently underway in USDA to consolidate and reform Federal milk marketing orders by April 1999. USDA will continue to review the BFP as part of Congress' mandate in the 1996 Farm Bill to consolidate and reform orders. Last Friday, USDA released several reports addressing options for milk order reform, including long-term pricing issues. We anticipate releasing an additional report on the BFP in the very near term.

In conclusion, USDA has followed closely the concerns over NCE prices and their use in pricing under Federal milk marketing orders. We recognize the significant and valuable contribution of the nation's dairy farmers to U.S. agriculture and to the overall economy. Last year, the nation's dairy farmers accounted for over $22 billion in farm receipts and over 10 percent of total farm sales. Changing the Federal order pricing system could have broad and substantial consequences for producers and processors. That is why USDA is now in the process of a thorough evaluation of alternatives and positive reform measures for Federal milk marketing orders. We welcome any evidence that will help promote reform and contribute to opportunities for growth and stability for our nation's dairy producers.

Mr. Chairman, this completes my testimony and I'll be happy to answer any questions.

Figure 1: ALL-MILK PRICE AND M-W(BFP) MILK PRICE

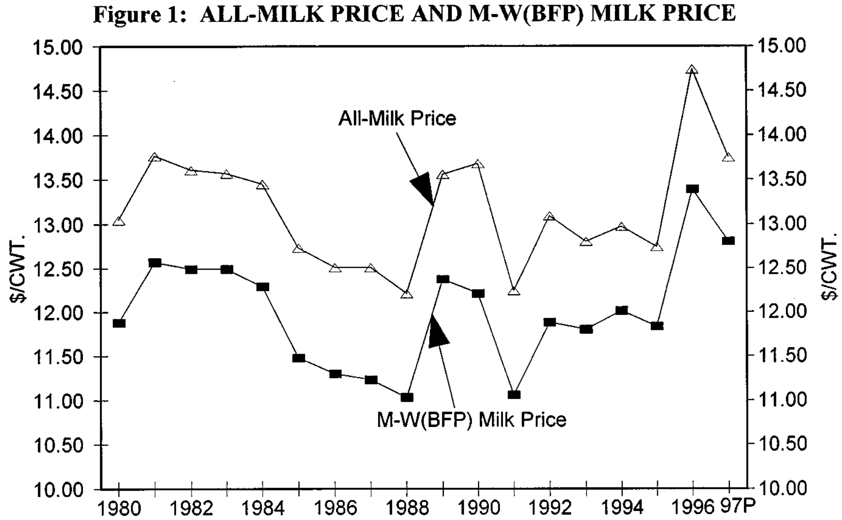
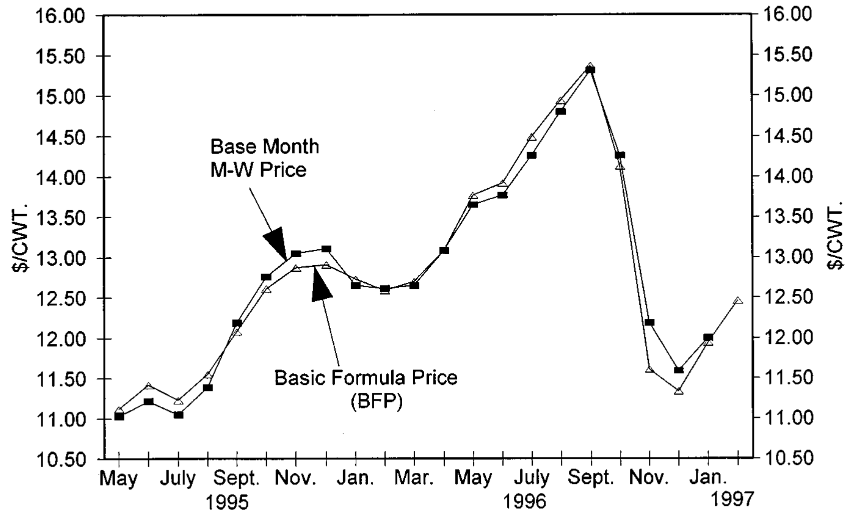


Figure 2: BFP AND BASE MONTH M-W PRICE



SEASONAL-BASE PLANS

Senator COCHRAN. In my opening statement, I mentioned that it is very important in the South that we understand the importance of milk marketing order seasonal-base plans as an integral part of the mechanism to encourage milk producers to average their seasonal milk production over the year.

There is nothing in this plan, is there, that would have these as mutually exclusive ways of establishing prices, particularly in view of the fact that we have had experience with this program which previously has been authorized? We understand that the plans were not included in the FAIR Act, but there is some testimony that we will receive today on this subject, and we hope you will carefully consider those views and will address them in your testimony today.

Secretary GLICKMAN. We will. Perhaps Mr. Dunn may want to comment, but we have supported efforts to make some legislative changes on the seasonal basis issue.

Senator COCHRAN. You may proceed.

Mr. DUNN. Mr. Chairman, we are, in fact, in favor of seasonal-based pricing.

Senator BUMPERS. Would you pull the microphone closer?

Mr. DUNN. We are, in fact, in favor of the seasonal-based pricing, Mr. Chairman, and we did push for it in the FAIR Act. Time simply ran out on us, and we will work very closely with Congress to ensure that we get that back in.

Senator COCHRAN. Thank you very much.

Senator SPECTER. We do have other Senators who want to question witnesses, so we will start off with a 10-minute time limit, and then we can come back to Senators who want to question witnesses further if that is satisfactory. Is there any problem with that?

[No response.]

Senator COCHRAN. Senator Specter.

Senator SPECTER. Thank you very much, Mr. Chairman.

Mr. Secretary, again I thank you for going to northeastern Pennsylvania and for the special attention you are paying to this issue.

When you say that you have started the weekly survey of cheese prices, when do you expect that you would have responses from that survey so that you might establish a different cost of cheese from the Green Bay Exchange price which, in turn, might raise the price per hundredweight of milk?

Secretary GLICKMAN. I will ask Mr. Collins to respond.

Mr. COLLINS. Senator Specter, we are receiving questionnaires this week. The first collection date will be the price for the first week of March, the week that ended this past weekend. The questionnaires have been coming in Tuesday and Wednesday and today.

Senator SPECTER. So you have already had some come in?

Mr. COLLINS. Yes, we have.

Senator SPECTER. What are the initial results?

Mr. COLLINS. I have not looked at the questionnaires. They are being compiled by our statisticians, so I do not know what they show, but I can tell you what we did.

Senator SPECTER. Well, I only have 10 minutes. I want to know what they show. When do you think you will have an idea as to what the results are so we might expect a change in the price of milk?

Mr. COLLINS. I do not think you can expect anything for a couple of months. We do not start any data collection effort like that, a national data collection effort, based on a probability sample and then report those results immediately. We go through several weeks of testing, so it is going to be a while before we make anything public.

Senator SPECTER. Well, several weeks will be different than several months. What I would like to know, Mr. Secretary, is when is the earliest we might expect to know what those results are so we can see if there will be a change in price?

Secretary GLICKMAN. I am going to give you a nonscientific rule of thumb here. I would say in about 6 weeks we will know whether the questionnaires are producing the volume of information necessary to determine whether we are getting the data that we need to make that judgment, so the problem, Senator Specter, is that if we do not get the full participation from people in the industry the survey is not going to produce the value that we need to have it produce to change the price, so that is why we have to do the outreach and work it and get people, some of whom are here in this room, to come forth and give us the information.

Senator SPECTER. So if you do not receive it on a voluntary basis, then you are going to need legislation to compel people to give you the answer?

Secretary GLICKMAN. I would say the answer to that is yes. I do not think we have the legal authority to compel.

Senator SPECTER. Well, then, would it be helpful to you if we initiated that legislative process as a fallback position so that we do not have to start it—I know the answer to that is yes. We will start the legislative process going so that we have it as a fallback.

Mr. Secretary, on the question of, I note a difference between the BFP, basic price formula, and the M–W, the Minnesota-Wisconsin.

You say there already has been a noticeable difference of 32 cents per hundredweight. Does that indicate to you that the existing pricing mechanism is, in fact, efficient?

Secretary GLICKMAN. I am trying to look at the chart here.

Senator SPECTER. I thought that is what you had suggested in your testimony.

Secretary GLICKMAN. The interesting thing is, if you look at the charts, 32 cents is a somewhat significant difference. If you track it over the last 2 years the prices almost track each other identically.

There was a period in November and December 1995 and January 1996, when the M–W price exceeded the BFP, and then there was a period in 1996 when the BFP exceeded the M–W price by a few cents, but certainly during the fall of 1996 the reverse occurred.

I am not sure why this happened, but I bring it to your attention that there is a 32-cents-a-hundredweight difference, and that is why, among other reasons, we are trying to go through this comment period to see whether there is a better way to price milk than this, whether to go back to the M–W pricing system or use our own statistical surveys to get it done.

Senator SPECTER. Mr. Secretary, what concerns me is the time delay. I can understand the need to establish a market on cheese different from the Green Bay, and you have an indication that it may be at least 32 cents per hundredweight low.

I am speculating or wondering about some action to establish a floor price at $13.50 per hundredweight now. We have a couple of Pennsylvania milk farmers who are here today that I chatted with just a few minutes ago. Mr. Arden Tewksbury pointed out to me that it has been some 3 months since he met with you with a group of some 20 farmers, and the price of milk has gone down and the costs of production have gone up, and there is a real sense of urgency.

Senator Feingold commented about the same sense of urgency, and I know of your reluctance to establish a floor price, but I am wondering if that might not be an appropriate action to take on a temporary, immediate basis.

I understand that a group of Senators wrote to you, led by Senator Breaux, last week on the subject, and I wrote you a letter dated March 10, and how about doing something like that to stem the floodgates at a time when we are trying to determine what is going on?

If we really knew the answer, we might not have to take some temporary action, but at a time when there is sort of a sensitivity that the price may be too low now, at least as indicated by M–W, why not establish a temporary floor at $13.50?

Secretary GLICKMAN. I have been wrestling with that. First of all, the BFP is up $1.12 since its low, so it has come back some, and we expect that it is going to continue to go up.

Now, whether it is going to reach the $13 level or not, I cannot tell you for sure.

Senator SPECTER. Well, you have given an estimate that it will be an average this year of $13.50 in your testimony.

Secretary GLICKMAN. That is correct for the BFP.

Senator SPECTER. So why not at least stabilize it at that price now while these other tests are going on?

Secretary GLICKMAN. Well, I would say there are two things. No. 1, and then I will ask my colleagues to respond, and I hope they give you enough time so you can do it all.

First of all, I would have to tell you, this is a tremendously controversial issue, and it is one that would require us to hold a hearing to make a decision and hold a referendum.

Now, I can accelerate that as much as possible, but I guarantee you that there are people in this room and around the country who will do their best to delay this decision long enough so it will not have an impact, because probably the BFP will be up at that level by the time this decision was final, which is probably 90 days, 120 days, or more.

Senator SPECTER. Well, let us hope that is fast, and let us recognize there are a lot of people with delaying tactics, but what is the fastest you could do it to establish that base price?

Secretary GLICKMAN. If we were to go ahead and do this, I would ask Mr. Collins.

Mr. COLLINS. Let me take a shot at this. First I will say a couple of things. First of all, the forecast for the basic formula price for this year is not $13.50. It is $12.80. Second of all, $13.50 by all historical——

Senator SPECTER. You say the price is not $13.50?

Mr. COLLINS. No.

Senator SPECTER. The average is $12.80?

Mr. COLLINS. Our projection is $12.80.

Senator SPECTER. I thought the Secretary said it was $13.50.

Mr. COLLINS. You said it was $13.50 and quoted his testimony.

Senator SPECTER. No; I asked him if he did not say it was $13.50. I did not say it was $13.50. I do not testify. I ask questions.

Secretary GLICKMAN. Excuse me. The all-milk prices would average $13.75, so those are all three classes of milk. That is what my testimony said. I am sorry if I confused that.

Mr. COLLINS. Just to get the facts straight, then, to set a floor price at $13.50 would be to set a price that is above what we are now forecasting and would also be above what has historically prevailed as the BFP for a long period of time.

Senator SPECTER. What is the forecast? The $13.75, as the Secretary now says, involves more than what I have asked you about?

Mr. COLLINS. Correct.

Senator SPECTER. What is the expected price for what I have raised?

Mr. COLLINS. The forecast for 1997 for the basic formula price is $12.80 per hundredweight, and for the all-milk price, which is the average price of milk received by producers for all classes of milk, is $13.75 per hundredweight.

Senator SPECTER. What is that difference, Mr. Collins?

Mr. COLLINS. The basic formula price is of course the minimum price that we announce for class III milk. The all-milk price would be what producers actually receive from all types of uses, including fluid use, which has, of course, the class I differential added to it.

Senator SPECTER. Well, how long would it take, at the fastest, surmounting all the delays which the Secretary predicts will be attempted, how long would it take to establish a floor price of $13.50?

Mr. COLLINS. That would require formal rulemaking, and our lawyers have advised us that that could take at least 6 months.

Secretary GLICKMAN. If I may add, as opposed——

Senator SPECTER. How about subtracting? [Laughter.]

Secretary GLICKMAN. All right, subtracting, but if I may contribute, this would require a formal rulemaking as opposed to our action which I could take, depending upon the evidence received, on changing the BFP to reflect an alternative for the cheese exchange, which would not probably require a formal rulemaking. That one can be done faster. We have talked about that.

Senator SPECTER. Well, that one definitely can be done faster, but that is going to require that you make an assessment of a different price of cheese, which you are now undertaking to do.

Secretary GLICKMAN. Well, and plus the testimony that we are getting right now may also reflect alternatives to that as well which we then could use to make a decision rather quickly.

Senator SPECTER. My orange light is on, Mr. Secretary, so I am going to ask you to give me the benefit of your imaginative thinking along with your colleagues as to what might be done to meet this crisis. I do not have enough time, probably not enough knowledge to go through all of the range of possibilities which you experts know. What can be done, searching the full spectrum of your knowledge, to bring some immediate relief? That is the real question. There must be something that can be done by an imaginative lawyer from Wichita.

Secretary GLICKMAN. First of all, listening to my colleague from a similar background as I am, that we have taken some actions which have had some constructive help. That is, because of your interest and other people's interest, the price of milk is up almost 10 percent, and granted it has a long way to go, but it has moved, and we suspect it will continue to go up.

Now, we are going to continue to take those steps, including using the dairy export incentive program [DEIP], purchases on the demand side of the picture, to do what we can to try to increase sales. And I just mentioned that I took one step a couple of weeks ago on the commodity supplemental food program to add cheese to that program, where we had not done that in recent times. That is one thing that we are going to do.

Second of all, I recognize, as I have told you, that this NCE price is one that I would like to find an alternative for as quickly as possible. We have been out for comment for 4 weeks, I guess, 3 to 4 weeks, and it is my hope notwithstanding the actions we are taking to get comments and do some surveys, that we can try to come up with an alternative as quickly as we possibly can.

Senator SPECTER. Well, can you do an alternative before you finish this 6 weeks of surveys that Mr. Collins talks about?

Secretary GLICKMAN. Let me put it to you like this. We will look at the suggestions that are being made as part of that effort.

One of the alternatives is for us to conduct a survey ourselves, and if we are going to use that alternative, we have got to make sure it is statistically accurate and it reflects enough people participating in it. That may be the best way to go. We may need your help in making it so that reporting is mandatory in that process if we do not get all the voluntary response needed.

But you know, I want to move on this as fast as I can, but I want to make sure that we do it sensibly. Fortunately, we are in a period where the price looks more bullish over the next several months, and that will give us perhaps not the breathing room that all the producers need, because I know that that price is still very low for these people, but it will at least give us a little bit of time period where we are going to be approaching that $13 price level while we try to find some options for the BFP, some alternatives for it.

In the meantime, if you want to consider making this reporting mandatory, that would not be something we would oppose and it might help get the cooperation over the next several weeks.

Senator SPECTER. Well, my time is up. Thank you very much, Mr. Secretary, and thank you, Mr. Chairman.

Senator COCHRAN. Thank you very much.

Senator Kohl.

Senator KOHL. Thank you, Mr. Chairman.

What are the dangers of connecting up to a new market that may not yet be credible? I anticipate you do not want to do that until you are satisfied that the new market is credible. What are your options in that interim period?

Secretary GLICKMAN. Why don't we talk a little bit about what happens. For example, what would happen if the National Cheese Exchange would go out of business tomorrow afternoon, what would we do to try to deal with this issue, and compute the basic formula price? How do we handle it? I mean, that is a very important question, and I hand that to my experts, then.

Mr. COLLINS. Well, we would have two options if the National Cheese Exchange were not to exist. One option would be to try and find an equivalent cheese price to the one that had been on the National Cheese Exchange. And that is what we have just been talking about. One possible candidate would be a survey that we would take, such as the one we have underway now, conducted by the National Agricultural Statistics Service. We could try and beef up or improve the Wisconsin Assembly Point Price Survey that we now report weekly, which most people do not like and do not think is very accurate.

Those would probably be the major candidates that currently exist out there for a cheese price. We certainly probably could not use a futures price. There is a futures price for cheese, but I think thinness concerns with that market would probably prevent us from using that.

So we would go through a decision process of trying to identify some equivalent alternative cheese price. Failing that, then we would look at the basic formula price itself, and possibly go to some alternative that did not include a cheese price, perhaps the M–W price, adjusted only based on changes in butter and powder prices, which might not make many people very happy. But that would be one candidate that we would consider.

Going back to the old M–W price we used to use would also be a candidate we would consider. And I do not think that would make very many people happy, and it certainly does not make me very happy, because there are some serious thinness concerns with that approach as well.

Right now there is no good alternative on the table in my judgment. And that is the dilemma. That is why something has not been done yesterday. So if the National Cheese Exchange were to disappear, short of having a new exchange or a validated survey to replace it, I think we would be worse off.

Senator KOHL. All right. Well, are you saying that today the National Cheese Exchange, with its flaws, is as good or better than the alternatives that you are aware of?

Mr. COLLINS. I can answer that, in my opinion, yes.

Senator KOHL. So then are you suggesting that the National Cheese Exchange not go out of business until we have established something that is credible as an alternative?

Mr. COLLINS. Well, I would say that at this point I would recommend to the Secretary—and I hate to recommend to the Secretary in front of a Senate hearing without doing it first in his office—but I would recommend to him that he would use the National Cheese Exchange until we had a superior alternative. Yes; that is what I would recommend.

Senator KOHL. Do we have a superior alternative on the table?

Mr. COLLINS. Not to my knowledge.

Secretary GLICKMAN. Well, right now, one of the superior alternatives is in the process of determination, and that is the direct survey that we are doing on a weekly basis, which, if we get the adequate amount of reporting, is probably superior. I would think there would be no question, if you can get enough people reporting to us, it is going to be a more accurate figure than the National Cheese Exchange.

Mr. Dunn, do you have a comment?

Mr. DUNN. Senator Kohl, there are about three things that are happening. One, the Secretary has asked for comments. We have received to date 169 comments from various people of what to do about the National Cheese Exchange. Now, the majority of those have been complaints. There have not been a lot of comments stating here are some positive alternatives.

The second thing that is underway is, under our milk marketing order reform mandate, by mid-April, we plan to put out a preliminary proposal on some way to replace—to establish—a new basic price formula. So that will be coming out very, very shortly.

It begs the question, though, that you raise—and later on Mr. Tipton is going to testify the Cheese Exchange may go out of operation by May 1. And if Senate bill 2 from Wisconsin passes, it may go out even sooner, if that quickly goes into play.

So we have to look at the comments we have received, look at what NASS is doing, and certainly any other suggestions that this panel or any other dairy producers or people in the dairy business might have. Those things may catch us off guard. But by May 1, if the NCE closes, we are going to have to use whatever the Secretary has at his convenience. And we may even have to go back to an M–W series on an interim basis.

Secretary GLICKMAN. I was going to say that the survey we are doing, it does strike me that if the Cheese Exchange ceases to exist right now—the M–W system has been on the books in the past—

so we could probably go back to that and substitute it for what we are doing now. It certainly would be technically feasible to go back. I am not saying it is the best option. But assuming that we would make the determination that the Cheese Exchange—the price component on the Cheese Exchange becomes unavailable or an equivalent price is not there and we could not substitute something else, we could theoretically move back in the direction of the old M–W.

But we replaced it in 1995 because we did not consider it to be a very fair and feasible price.

That is why, again, I repeat, the surveys that we are doing on a weekly basis perhaps offer us the best option as to what we might be doing.

Mr. Collins.

Mr. COLLINS. I would like to comment on this M–W price, which is an attraction to people who want to go back and get away from cheese prices as a way to discover the price of milk. The M–W price today, the one that we report, the base-month price, is based on a survey of about 200 million pounds of milk per month from Minnesota and Wisconsin. Now, what is the total production per month in Minnesota and Wisconsin? It is something like 3 billion pounds.

Everyone is concerned about thinness in the base from which we draw our data. That is a thin base. But now, if we went back to the old M–W, that 200 million pounds comes from 170 plants. To go to the old M–W, we have to adjust the base month price using a survey of those plants that pay biweekly. When we abandoned this survey, there were only 61 plants doing that. That was 2 years ago.

If we were to go back to the old M–W, we would now have to go back and start surveying those plants that pay biweekly. What their volume of milk is, I do not know. But I bet it is substantially below 200 million pounds.

So we will be talking about an updater, an adjuster, to replace the NCE that is based on a very small sample, a very thin market, which is exactly the criticism of the National Cheese Exchange. So I do not jump into this idea of going back to the M–W as necessarily a superior alternative at this point.

Senator KOHL. All right. I think that is very important testimony. What we are hearing you say is that we need to be careful about encouraging the NCE to go out of business without an acceptable alternative that is going to be better. Otherwise, we solve a problem by creating a bigger problem. Is that what you are saying, Mr. Collins?

Mr. COLLINS. That is my opinion, Senator Kohl, yes.

Senator KOHL. On the other hand, we all recognize that there is this tremendous dissatisfaction out there with the NCE, and we need to have a sense or urgency—which I am sure you do—about developing an acceptable alternative. Is that correct?

Mr. COLLINS. That is my opinion, certainly.

Senator KOHL. Are we finally looking at an acceptable alternative in the foreseeable future—meaning a month, 2, 3, 4, or is that not going to happen, Mr. Collins?

Mr. COLLINS. No; I think there is a prospect of that happening. I think one candidate on the table is the survey we just began. And with all due respect, you do not turn a survey like that into a reliable, accurate, valid indicator without some testing, without some observation. It is one thing to pick a price off an organized market of a homogeneous product, like the one that takes place in Green Bay. It is another thing to go out to 100 plants in the United States and ask them at what price they sold cheese. They say, what cheese, what kind of cheese, sold over what time period?

There is a number of things that have to be straightened out, and it will take weeks to do that, to ensure that we have a valid series, where people are reporting a price that does not have huge standard errors in all of the weekly data that is being reported. So I think our survey is one candidate. But that is going to come somewhat slowly. That may be the best survey candidate available.

However, I would also say that that survey is a concern to the cheese industry, that we would use a price like that for regulation, primarily because it is a voluntary-based survey. Suppose cheese prices start to go up, then we are going to use that reported cheese price to raise the minimum price of milk under Federal milk marketing orders. Is it in cheesemakers' self-interest to report that the price of cheese is going to go up if it is going to cause us to raise the minimum price of milk? Will some of them drop out of the survey if the cheese price starts to go up? Will the survey get thin if the cheese price starts to go up?

That is a concern we have with a voluntary-based survey for using it in regulation. Nevertheless, that is one of the best candidates on the table at the moment.

The other primary candidate on the table at the moment is this prospect that the Coffee, Sugar, and Cocoa Exchange or the Chicago Mercantile Exchange will develop an alternative market. Those are institutions with some credibility and reputation. And there is some prospect to think that they could organize a market that could remedy some of the concerns of the National Cheese Exchange.

Senator KOHL. Do you have any intention of encouraging that to happen?

Mr. COLLINS. Yes; we have been encouraging that to happen.

Senator KOHL. Do you expect that it will happen or do you hope that it will happen?

Mr. COLLINS. I hope that it will happen. It is clearly not our decision. It is the decision of those who buy and sell cheese. But we have certainly offered our support. We, in fact, attended organizational meetings of the CSCE cheese task force. And we are very interested in support of this occurring.

Senator KOHL. All right. I thank you for your testimony.

Thank you, Mr. Chairman.

Senator COCHRAN. Thank you, Senator.

Although not a member of the committee, our distinguished colleague from Pennsylvania, Senator Santorum, has asked permission to address some questions to our witnesses. For that purpose, we recognize Senator Santorum.

Senator SANTORUM. First off, let me thank you, Mr. Chairman, for your graciousness in inviting me and allowing me to participate as a guest member of the panel. Thank you very much.

I have a couple of questions for the Secretary. I want to get back to the subject at hand here. You state that the Wisconsin-Minnesota market is thin. The futures market is thin. The NCE market is thin. Somewhere out there something is thick. What is thick, and why cannot we measure it?

Secretary GLICKMAN. There is cheese being bought and sold by several hundred plants in the United States. So that is thick. And the way to do that is to get full participation. And we are going to try to do it the best we can. But we might need authority to compel it. That would provide thick participation.

Senator SANTORUM. Let me ask you, what do you anticipate the cost of such a survey would be, and who would bear the cost?

Mr. COLLINS. We are already conducting the weekly cheese price survey under our current appropriations. I do not think the cost is really an issue here. Of course, the agency who is doing this might have a different opinion. But I do not think, really, that is the issue.

We are able to do it now. We are surveying 112 plants out of the universe of a little over 200. If it were mandatory, that would double the number of questionnaires. I think it is something we could handle.

Senator SANTORUM. So, in a sense, what you are surveying is the bulk of the market—I mean what percent of the market would you say——

Mr. COLLINS. The 112 plants represent 90 firms, and they account for 99.2 percent of cheese produced in the United States.

Senator SANTORUM. So that will give you a pretty good idea of what is out there?

Mr. COLLINS. Yes; now, it is a voluntary survey. We will not get 99.2 percent. We might get 60 to 70 percent. We do not know yet. That will be a thick sample.

Senator SANTORUM. Thank you. Another concern I have is the issue of volatility. When the CCC held stocks, we did not have this kind of volatility. As a result of deregulation, however, we now have an industry that really does not have any mechanism to control volatility.

What changes would you suggest—either through the private sector or through government—to help control that volatility? I know low price hurts, but when you lose 40 percent of your price in 3 months, that hurts even worse, because you cannot plan for it at all.

Secretary GLICKMAN. I think that Mr. Collins ought to comment on the reasons for this rapid price decline. Which if you look at the charts in the back of the testimony, you have never seen anything like this before. Certainly, in the old days, when the Government was much more involved in the price support mechanism, you would have had a support price that would have been a floor, that would provide a safety net.

Quite frankly, the last several farm bills, which I voted for when I was in the House, eliminated that. It changed the rules of the game. We went to a free market system. And the call for a higher basic formula price now is a direct contradiction to what Congress has said in earlier farm bills.

Now, that does not mean that we should be inflexible on it, but I think it is the recognition that this is in fact the case. Recently, the Washington Post, which is not known as one of the great supporters of farm bills, did an editorial, where they wrote that this volatility in dairy prices should require us to rethink the issue of farm safety net. Because, certainly, in the free market world and open borders, there is going to be a lot more variability, particularly for a perishable commodity like milk, where you cannot really put it under loan. What used to be the Government support program was the Government buying up the cheese under the loan program. But now, we really do not have any of the safety net programs operating.

Now, I do think it is worthwhile examining why this extremely rapid change took place.

Senator SANTORUM. But if you could answer—I am interested to hear why the rapid change occurred, and that is important, but I guess what I really want to get at is what risk management tools can the industry use or can we help the industry with to deal with this issue?

Mr. COLLINS. I think that is a good point. This is an industry that has had stable prices through much of its history, as the price has sat right on its support price and the Government always had stocks to sell back into the market as price started to rise. What dairy farmers are facing is the same thing that grain farmers are facing as governments have moved out of holding stocks and have moved out of direct intervention in the marketplace.

What we see in other markets, though, are more and more sophisticated risk management approaches taken by farmers. Look at the volume of contracting that takes place in grains or cotton, for example. Whether it is contracting with a local warehouse or contracting on futures and options markets, it far exceeds anything that is happening in the dairy industry.

So the dairy industry, really, is a little bit behind in terms of, I think, the risk management instruments that are being utilized by those in the agricultural industry. So, certainly, one thing that the Department can do and one thing Congress can do is to help shape public opinion within the dairy industry about an awareness of how the market environment has changed, about the tools that are available, and about how to use those tools.

And those tools run the gamut. They run from managing your inputs, such as your feed costs—should you grow it on the farm, should you buy it in the commercial marketplace—to pricing your product. Now, many dairy producers price their product through their co-op. And that is a little bit unlike grain markets. However, there is nothing to prevent co-ops from running different kinds of pools that would allow producers to lock in prices. And, in fact, some do. But it is certainly not commonplace or very widespread.

One of the things that works against hedging is the low volume of futures activity in milk or cheese or butter contracts. As those markets develop—hopefully, they will be used. The farm price volatility will hopefully cause greater volume in those markets. The more volume in those markets will encourage more people to want to use those markets. And hopefully that will start to emerge in future years.

At USDA, we do have a risk management education obligation under the 1996 farm bill. We have to be sure that that program is directed to dairy producers, not just to those who produce insurable crops, for example. We also have other authorities to run various kinds of pilot programs. And so maybe there are some things there that we can do.

Senator SANTORUM. Can you describe the activity that the USDA has undertaken with respect to programs on risk management?

Secretary GLICKMAN. It is just starting up. Because it was in the bill that passed in April, we have begun some activities.

Senator SANTORUM. We are looking for some short-term help. Is this something that could be helpful in the short term, to try to get more education for dairy producers?

Secretary GLICKMAN. Go ahead.

Mr. COLLINS. Well, I do not really see it as a short-term solution, no. This is an educational effort, and it will take some time. And all of the instruments, the tools, the mechanisms for risk management really are not there for dairy producers the way they are for, say, grain producers at this moment.

Secretary GLICKMAN. I would say, in the grains area, we are moving to a system of revenue insurance, as opposed to disaster insurance. We are moving to a system where farmers can buy insurance based upon their income. And if they have volatility in the amount of dollars received, they can ensure a minimum level of revenue. We have a pilot program in the Midwest called the Crop Revenue Coverage. It has been for soybeans and corn, and we are expanding it to more areas and more crops.

Senator SANTORUM. Does it have applicability to dairy or not?

Secretary GLICKMAN. It could. I do not know whether it does now. Producers are insuring their feed and that kind of thing—protecting their input side. But in terms of their dairy production, I am not sure.

Mr. DUNN. Senator Santorum, one of the witnesses who will testify later on is saying the price ought to be tied to what the input costs are—the feed costs, et cetera. On the other side of that coin, though, there is the opportunity, through the educational program, to assist producers to lock in protein costs, et cetera, which is very, very important to a dairy producer, so that they keep the prices need to break even lower, on an even pace throughout the year. By doing that, they can get a better return on their investment.

But we are really in the infancy on putting together those types of programs on a mass scale to assist producers. It is an area that we certainly have to do a lot of work in.

Senator SANTORUM. My understanding is there was an options pilot program in the farm bill. Can you discuss how that works?

Mr. COLLINS. We had an options pilot program under the 1990 farm bill, which we operated for the last 3 years of the 1990 farm bill. We did not operate it for 1996 because of the lateness with which the 1996 farm bill was passed. We continue to have the authority to run that program. However, the authority has been changed slightly.

We were spending about $3 million a year to run that program for corn, soybeans, and wheat in the last 3 years of the 1990 farm bill. The 1996 farm bill requires that if we run that program, we do it in a, quote, budget-neutral way. As a result of that, we have not gotten much interest from the industry to pursue the options pilot program, with one exception—the one I am sure you are leading up to.

We did get a proposal from the Coffee, Sugar, and Cocoa Exchange for a dairy options pilot program. It was a very costly proposal. And we have that now. Our risk management agency has that proposal. They are evaluating that proposal. I assume they are under discussion with CSCE. I do not know that for sure. But that proposal is now being evaluated at the Department.

Senator SANTORUM. I would appreciate it if you could at least get us some answers on how that is going and whether or not the opportunity for a pilot program exists.

My time is up. I thank you very much.

Thank you, Mr. Chairman.

Senator COCHRAN. Thank you, Senator.

Senator Specter, do you have any further questions of the witnesses?

Senator SPECTER. I do, Mr. Chairman, but I will be relatively brief because we have many more witnesses this afternoon.

Mr. Collins, a question which comes to my mind is, you have 112 plants out there with 99.2 percent of cheese production. Why not simply call them all up and ask them what the sales price was today, yesterday.

Mr. COLLINS. That is what we are doing, except we are sending them a piece of paper, so that they can write it down.

Senator SPECTER. That is a lot different. A lot different. A piece of paper comes in. It has to be read. It has to be written on. It has to be mailed. Call them up. Just call them up. People answer the telephone. Tell them you are calling from the Department of Agriculture; you would like to know what the price is.

Mr. COLLINS. Right. Well, you have to get to the right person, who has the books. And we also get other information from them. We get quite a bit.

Senator SPECTER. I understand that. I frequently make calls and have to ask for somebody else.

Mr. COLLINS. Right.

Secretary GLICKMAN. I think that the idea is something we should explore. That is, there may be a way to do this using modern technology. For example, electronic communication, e-mail, Internet, getting a more instantaneous access to information rather than sending out formal questionnaires. I think the idea is worth exploring. I think it is a good idea.

Senator SPECTER. Well, Mr. Secretary, I would like to explore that idea on February 11. I have a sense of urgency about this which is that after we went out there on February 10, and told those 500 farmers that the Secretary had the authority, unilaterally, to change the price of milk if the cheese price was changed, to find a way to find out what the price is. I want information. You want information. We pick up the phone.

Somehow it comes into the bureaucracy—Mr. Collins, with all due respect—it takes a month to do it, and then we send out letters. And people get letters, they do not like to respond to letters. I hate letters. Every piece of paper that crosses my desk is an anathema. But if I get a message on the telephone sheet that comes in from my secretary and they want an answer, can I see a group next week, I say yes or no. And I would just pick up the phone.

Will you give me a list of those 112 plants? I will call them. I will have my staff call them. I have not seen the forms you sent out, but how simple are they? If they are simple, it is the first one that is ever come out of the Federal Government.

Mr. COLLINS. It is a simple form. And if we were to do it on the telephone, it might allow us to announce the price a day or two earlier. I mean that is what you are talking about. We are talking about last week's cheese price being announced the following week with the method we have now. I do not see where your method is going to actually accelerate that very much.

Senator SPECTER. Well, let me explain it to you. If you call up the 112 people, you put five people on it, they can make 20 calls or 25 calls, they can get the answers in a day

Mr. COLLINS. Right.

Senator SPECTER. And then you write them down and you see what it is.

Mr. COLLINS. Right.

Senator SPECTER. And maybe it is vastly different from the Green Bay price.

Mr. COLLINS. Right.

Senator SPECTER. So you would say to yourself, I may want to do this survey over 2 or 3 days. I do not know why you have to do the survey over 6 weeks to have an evidentiary base to establish a different price of cheese.

Mr. COLLINS. I guess I did not understand your point. The 6-week period is not an administrative lag in data collection, which is accelerated by a phone call. The 6-week period is 6 consecutive weeks of getting people to report data, and then working with those people to report the right data, to report the cheese that has the right moisture content, cheese that has the right container, the cheese that is aged the right number of days, the cheese that is contracted during the right period.

Maybe it can be done sooner than 6 weeks; 6 to 8 weeks actually is more of a traditional time period that our statisticians have required before they have reached a comfort level to be able to report publicly. And I think it is important that the statisticians be the ones that tell us when they are comfortable.

Senator SPECTER. With all due respect, I do not think so. I think that is the Secretary's job or maybe the job of the Congress. I would have to explore what the issue is on the statisticians' comfort level. You have raised two questions. And if I may pursue this, Mr. Chairman, for just a moment or two.

You went through a sequence of what you had to find out—the right containers, the right consistency of cheese. Tell me about the complexities in pricing cheese. What are the complexities in pricing cheese? Is it different from going to the supermarket and buying cheese?

Mr. COLLINS. Yes; I think it probably is.

Senator SPECTER. Well, tell me about it. I do not know about that.

Mr. COLLINS. Well, I do not know that much about it myself either. I am not the statistician collecting the prices. I only know what they have been telling me. They have been——

Senator SPECTER. Well, then, I will ask the Secretary. What is the issue on pricing cheese?

Secretary GLICKMAN. Arlen, I do not know the answer, but I will commit to you this. However we can get the information, it needs to be collected the fastest way possible.

Senator SPECTER. Well, Mr. Collins is telling me about the consistency of cheese and the container of cheese, and he went through a whole list of things. Then I ask him what is up, and he says he does not know.

Secretary GLICKMAN. Well, I certainly do not know the answer to that question. But all I can tell you is, based upon this hearing, we will go back and we will try to determine the methodology of collecting the information, and make sure it is as rapid and complete as possible. But as we said to Senator Kohl beforehand, we have got to make sure that we are dealing with apples and apples before we can come out with a decent number that makes some sense.

Senator SPECTER. Secretary Glickman, all I know is that I have got a bunch of irate farmers. And they are madder than hell because their costs of production have gone up and the price of cheese has gone down. And I know, because you and Mr. Collins and I were there, and we all concluded and we said in that public meeting that you had the authority to change the price of milk if you establish the price of cheese.

Secretary GLICKMAN. That is correct.

Senator SPECTER. And that was more than 4 weeks ago.

Secretary GLICKMAN. And we are pursuing that. And I have been on top of this issue. And before I came to Pennsylvania, we had already done a statement to indicate that the public comment would occur through March 31. And we have to honor that time period. In the meantime, we are examining the comments. We have started our own weekly collection process. We will try to make sure that that is as accelerated as possible.

But if I may make one point, Senator, truthfully, the issue here is, and I agree with you, that this cheese price is a problem. But it is not the main problem that your dairy farmers are having trouble with. The problems go to a much bigger picture. And they, frankly, go to the fact that for years and years and years, the Government supported dairy products at high support levels. And that was ended. And now we are going through this free market gyration, with high volatility and highly variable prices. And the folks are hurting. A lot of folks are hurting because of this situation.

I want to move this cheese issue as fast as I possibly can. I think it can make some difference. However, I do not think it is going to make a material difference. I think the big difference that is going to be made is in terms of how we reform the milk marketing order system, quite honestly. So I do not want to mislead farmers to believe that the change in the cheese price is going to make a demonstrable difference in their income levels. It will not. I wish it would.

I wish I could snap my fingers and make this all well. But we have an old, antiquated, archaic system of how we price milk in this country. You have ordered us to change that. And it is going to be very controversial. We have to do our best to make sure it is done fairly.

In the meantime, we have presented the evidence to you that there is a problem in this NCE, the way it is priced. We are going to do our best to resolve it as quickly as possible.

Senator SPECTER. Well, if you are saying that the milk marketing orders have to be—that procedure has to be changed, you are talking there about a 6-month process?

Secretary GLICKMAN. Well, that is a long-time process. In fact, under the farm bill, we are required to have it complete in April 1999. I am not saying that is the short-term answer to the problem. I am just saying that in order to get some sensibility in the pricing and milk system, to deal fundamentally with the problems the dairy farmers are having, you have to deal with that side of the picture.

Senator SPECTER. Well, when will you come to a conclusion as to the milk marketing orders, which is the long-range solution? That is what you just said.

Secretary GLICKMAN. Yes.

Senator SPECTER. What is the timeframe on that?

Secretary GLICKMAN. Well, we are under the gun to get it done by April 1999. That is what the farm bill requires us to do. We plan a proposed rule in December 1997. We have to have that out about 11 months from now. But we have to have reform all finally done, finished, by April 1999.

Senator SPECTER. Well, then what is a short-term answer, besides the cheese price?

Secretary GLICKMAN. Well the short-term answer is, in my judgment, working to modify the NCE price, which we are working on right now; and continue to expand and augment our demand-increasing authorities, which means buying more cheese and selling more dairy products overseas, where we can; and working our best to make sure that there are alternative markets out there, including the futures markets. And I think with a combination of that, we can get some relief. And through your efforts and prodding, we will try to accelerate this process.

Senator SPECTER. Well, what is a reasonable date when that would happen?

Secretary GLICKMAN. You mean the NCE option?

Senator SPECTER. Anything.

Secretary GLICKMAN. We have a deadline of March 31, to get the NCE input. I wish it was sooner, but, meanwhile we have had about a $1.15 increase in the basic formula price in the last 2 months.

Senator SPECTER. Those are normal market forces?

Secretary GLICKMAN. Yes; they may be normal market forces, but we would like to think we are helping to contribute to those.

Senator SPECTER. OK.

Secretary GLICKMAN. We expect that to continue. Now, I hope it continues through the entire rest of the year. And we are going to do our best, without too unfairly interfering in the marketplace, to try to keep supply and demand in relative equilibrium, if we can. At the same time, I would like to find an alternative to this NCE. I think that using it is not an acceptable way to price milk. And I am going to work as hard as I can to get this done. Or else you are going to call me up here and keep my feet to the fire, which are feeling kind of warm right now. [Laughter.]

Senator SPECTER. Mr. Secretary, you have got asbestos shoes. [Laughter.]

Will you give me the 112 people, because I would like to call them up tomorrow and find out what the price of cheese is?

Secretary GLICKMAN. We will give you all—we will not only give you the 112, we will give you everybody we have.

Senator SPECTER. Fine. I would like to get that from you. Can I get it this afternoon?

Secretary GLICKMAN. We will get it to you by tomorrow. I do not know if I can get it to you by this afternoon, because I am leaving. My colleagues are staying up here, because they need to hear the testimony. But I will get the names moving.

Senator SPECTER. OK, by tomorrow is fine.

Secretary GLICKMAN. Yes.

[The information follows:]

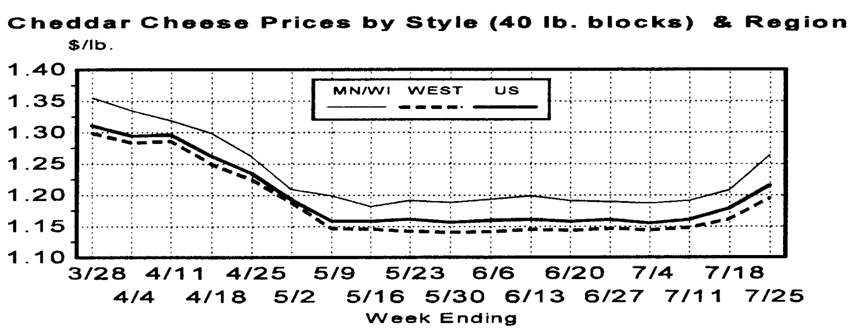
Each week NASS collects price information on sales of natural, unaged, Cheddar cheese at the first (wholesale) point of sale. Data are recorded for sales transactions completed during the survey week. A transaction is considered complete when cheese is shipped out or title transfers. The 65 plants reporting account for an estimated 85 percent of natural Cheddar cheese sales. Sample copies of two reports are provided for the Record. Pursuant to the provisions of 7 U.S.C. 2276, the Department is prohibited from releasing the names of plants surveyed.

CHEDDAR CHEESE PRICES

[Released Aug. 1, 1997, by the National Agricultural Statistics Service]

40 LB. BLOCK PRICES RISE 3.6 CENTS

Prices received for 40 lb. block Cheddar cheese rose 3.6 cents per lb. for the week ending July 25, 1997. Prices in the MN/WI region rose over 5.5 cents per lb. Prices for 500 lb. barrels increased 0.4 cents per lb. and 640 lb. blocks increased 5.3 cents per lb.



Revision Policy: This week's "Cheddar Cheese Prices" contains ten weeks of data. The extra information is published to ensure data users have the most accurate, up-to-date information. June data are no longer open to revision. Next month at this time, only July and August data will be published.

Data Reliability: The survey collects price information on sales of natural, unaged, Cheddar cheese at the first (wholesale) point of sale. Data are recorded for sales transactions completed during the survey week. A transaction is considered complete when cheese is shipped out or title transfers. The 65 plants reporting account for an estimated 85 percent of natural Cheddar cheese sales. Estimates for only the current month are subject to revision.

Notice: This report will include ten weeks of data on the following release dates: September 5, October 3, October 31, and December 5.

CHEDDAR CHEESE PRICES BY STYLE AND REGION

Style and region	Week ending—				
	Jul 25, 1997	Jul 18, 1997 [1]	Jul 11, 1997	Jul 4, 1997	Jun 27, 1997
40 lb. blocks:			Dol./lb.		
Avg. price: [2]					
MN/WI	1.2636	1.2078	1.1906	1.1868	1.1889
West [3]	1.1950	1.1617	1.1479	1.1445	1.1466
U.S.[4]	1.2150	1.1787	1.1603	1.1549	1.1603
Sales volume: [5]			Pounds		
MN/WI	1,095,379	1,697,923	1,090,694	1,066,271	1,368,780
West [3]	3,269,397	3,923,510	3,400,241	3,606,842	3,570,405
U.S.[4]	4,498,249	5,857,381	4,697,274	4,869,764	5,259,571
640 lb. blocks:			Dol./lb.		
Avg. price [2] U.S	1.2390	1.1863	1.1701	1.1644	1.1654
			Pounds		
Sales volume [5] U.S	1,055,345	863,666	1,098,164	1,121,786	1,186,785
500 lb. barrels:			Dol./lb.		
Avg. price: [2]					
MN/WI	1.2177	1.2158	1.2131	1.2017	1.2147
Other	1.1952	1.1920	1.1900	1.1886	1.1913
U.S	1.2046	1.2006	1.1996	1.1941	1.2010
Adj. price to 39 percent moisture:					
MN/WI	1.1384	1.1370	1.1295	1.1263	1.1290
Other	1.1088	1.1058	1.1036	1.0980	1.1036
U.S	1.1211	1.1170	1.1144	1.1098	1.1141
Sales volume: [5]			Pounds		
MN/WI	3,707,010	3,465,431	3,318,522	3,417,633	4,662,975
Other	5,161,707	6,121,424	4,637,298	4,717,162	6,658,133
U.S	8,868,717	9,586,855	7,955,820	8,134,795	11,321,108
Moisture content:			Percent		
MN/WI	34.75	34.77	34.48	34.92	34.37
Other	34.25	34.25	34.22	33.96	34.15
U.S	34.46	34.44	34.33	34.36	34.24

[1] Revised.
[2] Prices weighted by volumes reported.
[3] CA, ID, OR, and WA.
[4] "Other Regions" included in U.S. total.
[5] Sales as reported by cooperating manufacturers.

CHEDDAR CHEESE PRICES BY STYLE AND REGION

Style and region	Week ending—				
	Jun 20, 1997	Jun 13, 1997 [1]	Jun 6, 1997	May 30, 1997	May 23, 1997
40 lb. blocks:			Dol./lb.		
Avg. price: [2]					
MN/WI	1.1906	1.1984	1.1928	1.1882	1.1912
West [3]	1.1438	1.1453	1.1410	1.1407	1.1423

CHEDDAR CHEESE PRICES BY STYLE AND REGION—Continued

Style and region	Week ending—				
	Jun 20, 1997	Jun 13, 1997 [1]	Jun 6, 1997	May 30, 1997	May 23, 1997
U.S.[4]	1.1575	1.1608	1.1595	1.1561	1.1613
Sales volume: [5]			Pounds		
MN/WI	1,733,258	1,327,932	1,839,944	1,563,877	2,045,475
West [3]	4,005,425	3,359,164	3,820,455	3,908,574	3,842,841
U.S.[4]	6,049,131	4,854,962	5,838,913	5,654,293	6,139,062
640 lb. blocks:			Dol./lb.		
Avg. price [2] U.S	1.1684	1.1723	1.1857	1.1751	1.1717
			Pounds		
Sales volume [5] U.S	997,738	1,013,328	525,685	1,045,625	1,758,467
500 lb. barrels:			Dol./lb.		
Avg. price: [2]					
MN/WI	1.1989	1.2100	1.2184	1.2146	1.2240
Other	1.1877	1.1987	1.2013	1.1971	1.2068
U.S	1.1920	1.2033	1.2089	1.2051	1.2165
Adj. price to 39 percent moisture:					
MN/WI	1.1219	1.1273	1.1331	1.1370	1.1421
Other	1.1038	1.1177	1.1191	1.1161	1.1259
U.S	1.1107	1.1216	1.1253	1.1256	1.1350
Sales volume: [5]			Pounds		
MN/WI	3,908,680	3,912,327	3,665,436	3,359,592	4,230,711
Other	6,313,356	5,759,175	4,587,078	4,040,825	3,281,805
U.S	10,222,036	9,671,502	8,252,514	7,400,417	7,512,516
Moisture content:			Percent		
MN/WI	34.81	34.53	34.40	34.83	34.63
Other	34.36	34.58	34.52	34.57	33.62
U.S	34.53	34.56	34.47	34.69	34.62

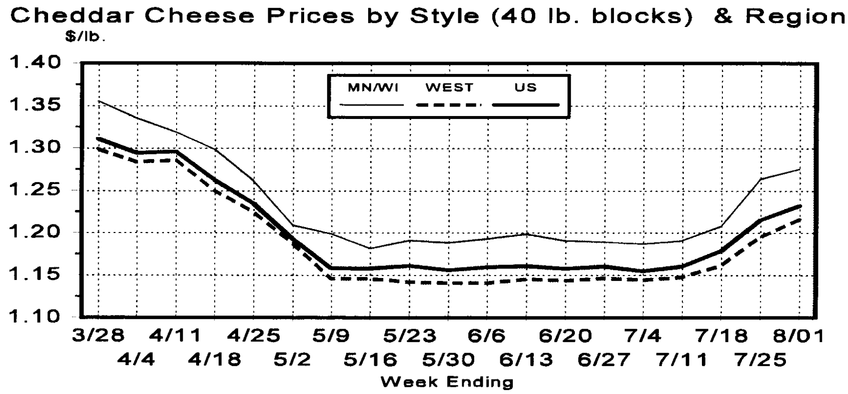
[1] Revised.
[2] Prices weighted by volumes reported.
[3] CA, ID, OR, and WA.
[4] "Other Regions" included in U.S. total.
[5] Sales as reported by cooperating manufacturers.

CHEDDAR CHEESE PRICES

[Released Aug. 8, 1997, by the National Agricultural Statistics Service]

40 LB. BLOCK PRICES RISE 1.7 CENTS

Prices received for 40 lb. block Cheddar cheese rose 1.7 cents per lb. for the week ending August 1, 1997. Prices in the MN/WI region rose over 1.2 cents per lb. Prices for 500 lb. barrels also increased 4.4 cents per lb. and 640 lb. blocks increased 2.7 cents per lb.



Data Reliability: The survey collects price information on sales of natural, unaged, Cheddar cheese at the first (wholesale) point of sale. Data are recorded for sales transactions completed during the survey week. A transaction is considered complete when cheese is shipped out or title transfers. The 65 plants reporting account for an estimated 85 percent of natural Cheddar cheese sales. Estimates for only the current month are subject to revision.

The next Cheddar Cheese Prices report will be released at 8:30 a.m. ET on August 15, 1997.

CHEDDAR CHEESE PRICES BY STYLE AND REGION

Style and region	Week ending—				
	Aug 1, 1997	Jul 25, 1997 [1]	Jul 18, 1997	Jul 11, 1997	Jul 4, 1997
40 lb. blocks:			Dol./lb.		
Avg. price: [2]					
MN/WI	1.2753	1.2636	1.2078	1.1906	1.1868
West [3]	1.2160	1.1950	1.1617	1.1479	1.1445
U.S.[4]	1.2320	1.2150	1.1787	1.1603	1.1549
Sales volume: [5]			Pounds		
MN/WI	1,072,017	1,095,379	1,697,923	1,090,694	1,066,271
West [3]	3,164,620	3,269,397	3,923,510	3,400,241	3,606,842
U.S.[4]	4,483,640	4,498,972	5,857,381	4,697,274	4,869,764
640 lb. blocks:			Dol./lb.		
Avg. price [2] U.S	1.2664	1.2390	1.1863	1.1701	1.1644
			Pounds		
Sales volume [5] U.S	478,905	1,055,345	863,666	1,098,164	1,121,786
500 lb. barrels:			Dol./lb.		
Avg. price: [2]					
MN/WI	1.2443	1.2177	1.2158	1.2131	1.2017
Other	1.2437	1.1948	1.1920	1.1900	1.1886
U.S	1.2440	1.2044	1.2006	1.1996	1.1941
Adj. price to 39 percent moisture:					
MN/WI	1.1768	1.1384	1.1370	1.1295	1.1263
Other	1.1555	1.1089	1.1058	1.1036	1.0980
U.S	1.1649	1.1212	1.1170	1.1144	1.1098
Sales volume: [5]			Pounds		
MN/WI	4,006,256	3,707,010	3,465,431	3,318,522	3,417,633
Other	5,017,545	5,186,678	6,121,424	4,637,298	4,717,162

CHEDDAR CHEESE PRICES BY STYLE AND REGION—Continued

Style and region	Week ending—				
	Aug 1, 1997	Jul 25, 1997 [1]	Jul 18, 1997	Jul 11, 1997	Jul 4, 1997
U.S	9,023,801	8,893,688	9,586,855	7,955,820	8,134,795
Moisture content:			Percent		
MN/WI	35.50	34.75	34.77	34.48	34.92
Other	34.34	34.27	34.25	34.22	33.96
U.S	34.86	34.47	34.44	34.33	34.36

[1] Revised.
[2] Prices weighted by volumes reported.
[3] CA, ID, OR, and WA.
[4] "Other Regions" included in U.S. total.
[5] Sales as reported by cooperating manufacturers.

MILK MARKETING ORDERS

Senator SPECTER. And beyond the cheese issue, which I understand is limited, I do not see any short-term fix in all that has been testified to. I understand you are buying more cheese and you are putting more demand in the market, which would raise the price. But the milk marketing orders, we are talking about a long time, until April 1999. Talking about establishing a different milk price, you are talking about 6 months. I do not see anything that is very fast.

Perhaps some of the other witnesses will have some more light to shed on that subject.

Thank you, Mr. Chairman.

Senator COCHRAN. Thank you.

Senator Kohl.

Senator KOHL. I just want to round out the discussion. You are saying that reforming the NCE and that whole process, just as a matter of fact, is not going to have a big impact on the price of milk. You are saying it is the formula price, the milk marketing order, that has to——

Secretary GLICKMAN. A major impact.

Senator KOHL. The big impact will come from that?

Secretary GLICKMAN. The Cheese Exchange can have some impact.

Senator KOHL. Some impact, right.

Secretary GLICKMAN. Yes; that is right.

Senator KOHL. But you do not want to mislead——

Secretary GLICKMAN. That is correct.

Senator KOHL [continuing]. Farmers, whether they be from Pennsylvania or Wisconsin or wherever into thinking that there is a huge impact that the reform of the NCE is going to have. You are stating it as a matter of fact, not as a matter of opinion.

Secretary GLICKMAN. I think you have characterized it correctly.

Senator KOHL. Now, on the other hand, in answer to those of us who want some short-term improvements, you are bullish about the price of milk over the short term?

Secretary GLICKMAN. Based upon the experts that work for the Department of Agriculture, the answer is yes. And you know as well as I do, the markets are variable. But, basically, we think things look pretty good over the next few months.

Mr. COLLINS. I would agree with that, but I would have to be the economist. On the other hand, you know, anything can happen. Right now, our projections are based on a very small increase in milk production in 1997. If we were to get a sudden increase in milk production, with productivity coming back—which we have not seen in 2 years—and cheese inventories are fairly high right now—we could see some weaker milk prices. But, overall, the trend, we think, is for stronger prices for the year.

Senator KOHL. I thank you.

Thank you, Mr. Chairman.

Senator COCHRAN. Thank you, Mr. Secretary, for your attendance and your contribution to this hearing. We appreciate it very much.

Secretary GLICKMAN. We will get Senator Specter his names, and hopefully phone numbers.

Senator COCHRAN. Your Rolodex, that is what he wants.

Senator SPECTER. Thank you very much.

NONDEPARTMENTAL WITNESSES

STATEMENT OF ALAN T. TRACY, SECRETARY, WISCONSIN DEPARTMENT OF AGRICULTURE, TRADE AND CONSUMER PROTECTION

INTRODUCTION OF WITNESS

Senator COCHRAN. Alan Tracy, the Secretary of the Department of Agriculture, Trade and Consumer Protection, from the State of Wisconsin, will be our next witness.

Mr. Tracy, thank you for being here. And, Senator Kohl, I yield to you for any introductory comments you would like to make.

Senator KOHL. Well, I want to welcome, Mr. Tracy and Mr. Brey, from Wisconsin, who are here to testify. I will not be able to stay through the entire hearing. But we have two outstanding gentlemen from Wisconsin, who are going to shed a great deal of light and information on this whole topic. And I think we are fortunate to have you here today.

Senator COCHRAN. Mr. Tracy, you may proceed.

STATEMENT OF ALAN TRACY

Mr. TRACY. Thank you very much, Mr. Chairman and Senator Kohl. I very much appreciate your arranging for me to be here today.

I do want to apologize on behalf of Governor Thompson, who had hoped to be here today. And I would hope to pass that word directly to Senator Specter in particular, because Governor Thompson had planned to come out earlier, when another hearing had been tentatively scheduled, responding to Senator Specter. And unfortunately he was not able to accommodate that schedule for today, but did send me in his stead.

I appreciate the opportunity to address you regarding alternatives to the National Cheese Exchange in determining milk prices. Farm milk prices and the mechanisms for determining them are of utmost importance to Wisconsin farmers and the Wisconsin economy. Wisconsin leads the Nation in the number of dairy farmers, in the number of dairy cows and in the production of cheese. The dairy industry contributes over $17 billion to Wisconsin's economy—nearly 10 percent of our State's overall economic output.

Just about 1 year ago, our Department released a report, detailing the findings of a comprehensive study on cheese pricing and trading activities on the National Cheese Exchange. That study was conducted by researchers at the University of Wisconsin, at our request and under the authority of our department to investigate business practices in Wisconsin. The report stimulated widespread interest and debate about the National Cheese Exchange.

Its findings were of particular concern because of the link between the National Cheese Exchange prices and the milk prices paid to farmers. While less than 2 percent of all bulk cheddar cheese is traded on the National Cheese Exchange—and in some years, less than one-tenth of 1 percent of all cheese—the National Cheese Exchange price largely determines the basic formula price, which is the price of manufacturing milk under the entire Federal milk pricing system. It is vitally important that the underlying market or markets be competitive and that farmers can have confidence that prices accurately reflect the supply/demand situation for milk.

Following that report, Governor Thompson convened a task force on cheese pricing to make recommendations to improve the current system of pricing for the benefit of the dairy industry and consumers. I am submitting a copy of the Governor's task force January 1 report for the record.

[The information follows:]

Governor's Task Force on Cheese Pricing

INTRODUCTION

The Governor's Task Force on Cheese Pricing was named in May, 1996, amid ongoing concern about the cheese pricing system, and the influence of cheese prices on the price for manufacturing milk. The Task Force's charge was to "make recommendations to improve the current cheese pricing system for the benefit of the dairy industry and consumers."

The Task Force held five meetings between July and December 1996. Membership included dairy producers, cheese makers, dairy marketers, and industry and state leaders. A complete list of members is included in Appendix 1. The meetings were well attended by dairy producers, farm and local media, and representatives from state and federal dairy related groups and agencies.

The Task Force recommendations address the link between National Cheese Exchange prices and milk prices, alternative pricing mechanisms for cheese and milk, cheese market information, and oversight and operating rules of the National Cheese Exchange.

BACKGROUND

Changes in U.S. dairy policy have resulted in market forces playing a larger role in pricing milk and dairy products. For most of the period from the early 1960's to the late 1980's, federal dairy price supports were instrumental in dairy pricing. Except for brief periods, cheese, butter, and nonfat dry milk prices were at or close to government purchase prices. Consequently, milk prices were driven by support prices, and price changes were small and predictable.

Large milk surpluses and resulting large price support purchases and high treasury costs led to pressures to reduce the role of government in pricing milk. The support price for milk was reduced from $13.10 per hundredweight in the early 1980's to $10.10 in the early 1990's. The support program became more of a safety net than a driver of milk prices. Manufacturing milk prices since the late 1980's have been consistently above the federal support level. More important, prices have been considerably more volatile.

With market forces replacing the government as the driver of milk and dairy product prices, attention in the dairy industry focused on how market prices were determined. The Basic Formula Price (BFP) is used in the Federal Milk Marketing Order system to establish minimum prices for milk throughout the U.S. Cheese dominates the use of milk in Minnesota and Wisconsin, where the BFP is derived. Cheese prices are determined in large part by weekly price "opinions" for block and barrel cheddar cheese. These opinions are arrived at by observers of transactions on the National Cheese Exchange (NCE), a wholesale cash market located in Green Bay, Wisconsin.

Members of the National Cheese Exchange trade cheese by open outcry in weekly trading sessions that last about one-half hour. On an average annual basis, consummated sales on the NCE represent from less than 0.5 percent to 2 percent of annual cheddar cheese production. But the price opinions based on NCE transactions are extensively used as reference prices in purchase contracts and in spot market transactions for all types of cheese.

In other words, trading activity on the NCE has an enormous influence on cheese prices, and, because of the prominence of cheese in establishing the BFP, on milk prices throughout the U.S.

The impact of the NCE on regulated milk prices underlies public policy concerns regarding NCE trading activities. A recent investigation of the NCE involved a comprehensive economic study conducted by researchers affiliated with the University of Wisconsin-Madison Food Systems Research Group at the request of and in cooperation with the Wisconsin Department of Agriculture, Trade and Consumer Protection, under its authority to investigate business practices in the state.

A report released March 19, 1996, detailed the findings of the study.[1] The report concluded that, "As currently organized, the Exchange appears to facilitate market manipulation." The report also concluded that "* * * the National Cheese Exchange was not an effectively competitive price discovery mechanism during 1988–93." Several specific problems with the NCE were identified along with related suggestions for alleviating competitive concerns.

The report stimulated widespread interest and debate about the NCE and cheese pricing, including a Congressional hearing in May, 1996. NCE traders vehemently denied allegations of misconduct. Along with some other industry participants, traders claimed that the Exchange accurately reflected supply and demand conditions for cheese.

In response to waning public confidence in the NCE, especially in its role as a driver of regulated milk prices, Wisconsin Governor Tommy G. Thompson convened a Task Force on Cheese Pricing. Members were chosen to reflect the various perspectives of the dairy industry. The Task Force was charged with making recommendations to improve the current pricing system for the benefit of the dairy industry and consumers, and to remove the link between the National Cheese Exchange price for cheese and the basic formula price for milk.

The Task Force sought a general overview of various aspects of the cheese and dairy pricing system before making recommendations for improvement. At their first meeting in July, Task Force members reviewed the background and conclusions of the UW/DATCP report. At the September meeting, members heard information about the operations and structure of the National Cheese Exchange, the cash market for cheese; and the Coffee, Sugar, and Cocoa Exchange, which trades futures contracts for cheese, butter, nonfat dry milk and milk. A representative of the U.S. Department of Agriculture's Dairy Market News Service explained the USDA cheese price reporting series. Task Force members also heard information detailing California's mandatory price reporting system for nonfat dry milk and other dairy products.

During the October, November and December meetings, the Task Force accomplished its charge. It agreed on criteria useful for evaluating proposed recommendations, then discussed the various proposals that had been submitted for consideration by Task Force members. The proposals addressed the structure and organization of the National Cheese Exchange, participation in and access to trading on the National Cheese Exchange, improvements to cheese market information services, and alternative reference prices for milk and cheese. A subcommittee of five Task Force members was formed to finalize the report, which was then sent to all Task Force members for final approval.[2]

REPORT RECOMMENDATIONS

Evaluation Criteria

The Task Force agreed on several criteria for evaluating proposals to improve the cheese pricing system. These criteria are based on the characteristics of a perfect market, which, while never observed in real life, provide guidance as to aspects of market structure that lead to desirable market performance. A perfectly competitive market consists of many buyers and sellers who buy and sell a homogeneous product. All participants have full information about the product and prices. Price is driven by supply and demand, thus no individual or firm can influence the price. Market participants are freely able to enter and exit the market.

Posed as questions, the criteria used to evaluate the proposed recommendations were:

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[1] A copy of the summary report, "Cheese Pricing: A Study of the National Cheese Exchange; Summary, Conclusions, and Policy Initiatives," is included as Appendix 3.

[2] A listing of ail materials provided to Task Force members during their deliberations is provided in Appendix 2. Copies of individual documents listed are available by contacting the Bureau of Trade Practices, Wisconsin Department of Agriculture, Trade and Consumer Protection, P.O. Box 8911, Madison, Wisconsin, 53704–8911, telephone 608–224–4918.

—Does the proposal encourage more buyers and sellers to participate in trading on the National Cheese Exchange?
—Does the proposal make it easier for current and potential traders to use the National Cheese Exchange?
—Does the proposal mitigate the potential influence of large traders vis-a-vis small traders?
—Does the proposal expand the amount of market information and equalize its accessibility to traders?
—Does the proposal improve public confidence in the National Cheese Exchange?
—Does the proposal help the market to better reflect supply and demand?

Recommendations

After careful consideration, the Task Force advances these recommendations to improve the current cheese pricing system and to remove the link between NCE prices and milk prices paid to farmers.

In addition to these specific recommendations, the Task Force recommends that the Governor lend encouragement and support to dairy farmers and marketers for efforts to expand demand for dairy products and to increase the value added by producers and manufacturers.

ADDRESSING THE LINK BETWEEN THE NATIONAL CHEESE EXCHANGE AND MILK PRICES

1. Recommend that the U.S. Department of Agriculture should no longer use the National Cheese Exchange price in the price adjustor used 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.

The USDA could accomplish this by:

—First, substituting the National Agricultural Statistics Service's (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 statistical reliability);
—and revising the weighting in the basic formula price adjustment factor to reflect national production of cheddar cheese, nonfat dry milk and butter.

And then:

—Begin substituting prices from the Coffee, Sugar and Cocoa Exchange's "BFP Milk Futures Contract," or similar contract prices, for the BFP. A schedule could be developed that increases the weight assigned to the milk futures price as the volume of milk futures contracts traded increases;

Or:

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

And simultaneously:

—Moving toward the deregulation of pricing within the Federal Milk Marketing Order System, including elimination of the basic formula price.

Discussion Points:

—The NCE price was never intended to be an indicator of national supply of and demand for milk. Any of these alternative measures 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: (1) The base month Minnesota-Wisconsin price series (M-W price) used in the BFP is highly correlated with the NCE price because most of the survey plants make cheese that is priced in reference to the NCE opinion; and (2), Over ninety percent of the weight in the price adjustment favor used in the BFP is based on the NCE price.
—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, and should weight manufactured milk product prices by the proportion of national production of these products, rather than on Upper Midwest production. In the long term, any federal order price for milk used in manufacturing should reflect markets for all manufacturing uses, not solely cheese.
—The NCE Board fully agrees with removing the NCE price from the calculation of the BFP.
—The USDA recently announced that the National Agricultural Statistics Service (NASS) will begin reporting a probability-based national average cheddar cheese price.

—The newly-reported NASS price would be more broadly based than the NCE price and is expected to include spot and contracted sales prices for bulk cheese. However, the NASS price will continue to move in close concert with the NCE price as long as prices for contracted and spot sales are pegged to NCE opinions.
—The CSCE and the CME recently initiated futures contracts for Grade A milk. These contracts represent possible alternative indicators for manufactured milk value, but Grade A futures prices are characterized by an unpredictable basis relative to the BFP.
—The CSCE is seeking authorization to trade a cash settlement BFP contract. That contract, or a BFP contract on another futures contract market, could potentially encourage broad participation of milk producers, producer cooperatives, users and manufacturers of milk-based products, as well as market speculators, in determining the value of manufacturing milk.
—The futures price could be phased in as a replacement for the BFP as the market achieves sufficient volume to be viewed as a reliable indicator of the market value for manufacturing milk.
—The alternative of replacing the BFP with a national milk price based on a survey of manufacturing plants, less over-order values and performance premiums, is consistent with the Upper Midwest Dairy Coalition's proposal for federal order reform.
—A national price survey would base milk prices on the prices that dairy plants actually pay nationally, not just in the midwest, for manufacturing milk (both grade A and grade B.)
—Deregulation of milk pricing, which would eliminate the need for setting a basic formula price, could allow milk prices to be competitively determined between buyer and seller, according to supply of and demand for milk.

ALTERNATIVE PRICE DISCOVERY MECHANISMS FOR CHEESE

2. Recommend that the Coffee, Sugar and Cocoa Exchange and/or the Chicago Mercantile Exchange establish a cash market for cheese.

Discussion Points:

—Both these exchanges would provide more frequent (daily) trading sessions than the NCE provides currently.
—These exchanges are currently regulated by the Commodity Futures Trading Commission.
—These exchanges can provide anonymous trading and offer clearinghouse capabilities and other support to members.
—Provides an opportunity for more direct linkage between the cash and futures markets; may improve liquidity in the futures markets and may improve participation in the futures markets.

IMPROVING MARKET INFORMATION

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

Discussion Points:

—Improved market information would help buyers and sellers identify trading opportunities and track regional market conditions.
—This series would represent an alternative reference price for contracted cheese sales.
—Weekly and regional cheese market information would be more useful than monthly, national information for cheese buyers and sellers.

REGULATORY OVERSIGHT OF THE NATIONAL CHEESE EXCHANGE

4. Recommend that the Commodity Futures Trading Commission and the Federal Trade Commission re-evaluate their regulatory authorities regarding the National Cheese Exchange.

Discussion Points:

—The NCE is a national market and regulation of this market is more appropriate at the federal level.
—State regulation would be ineffective if it merely resulted in the Exchange moving out of Wisconsin.
—The NCE Board has previously requested oversight by the Commodity Futures Trading Commission.

OPERATING RULES FOR THE NATIONAL CHEESE EXCHANGE

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

Discussion Points:

—There is a strong public interest in the NCE and limits may improve public confidence.

—Daily limits would allow the industry time to re-evaluate supply and demand factors when market conditions are changing rapidly.

—However, limits on price movements may limit participation and volume of trading on the NCE.

—Limits on price movements may cause prices in the short term to be temporarily above or below prices reflecting supply and demand conditions.

6. Recommend to the NCE Board that they include one or more public (non-NCE member) members on their board.

Discussion Points:

—Addition of public members recognizes the public interest in the Exchange as a driver of milk prices throughout the U.S.

—Public members would offer a broader perspective to the exchange board and could offer expertise that would be useful in establishing policy and trading rules.

—May improve public confidence in the National Cheese Exchange.

7. Recommend to the NCE Board that the identities of buyers and sellers be anonymous during trading.

Discussion Points:

—Not knowing the identity of the buyers and sellers would mitigate the potential influence of large traders vis-a-vis small traders. Large traders may be perceived as having better information, which could inhibit other traders from taking an opposite position in the market.

—Anonymous trading is common in futures contract markets, which, like the NCE, are national in scope and have broad public scrutiny.

—Anonymous trading may encourage participation in trading on the Exchange.

8. Recommend to the NCE Board that they consider implementing more frequent trading sessions for bulk cheese transactions once remote electronic access is in place.

Discussion Points:

—The Exchange will be implementing remote electronic access to their current weekly trading sessions in 1997. This is a positive first step towards improving participation and access to trading on the Exchange.

—Increasing the frequency of trading on the Exchange to more than once weekly may encourage broader participation in trading on the Exchange (assuming cost effectiveness.)

More frequent trading may result in less volatile price movements.

Remote electronic trading facilitates maintaining the anonymity of traders.

APPENDIX 1

GOVERNOR'S TASK FORCE ON CHEESE PRICING MEMBER LIST

Chair, Mr. Robert H. Burns, President, ConAgra Refrigerated Foods, 2000 S. Batavia Avenue, Geneva, IL 60134

Deborah Van Dyk, Schreiber Foods, Inc., 425 Pine Street, PO Box 19010, Green Bay, WI 54307–9010

Mr. Bernard Golbach, President, Master's Gallery Foods, Inc., 328 County Hwy. PP, PO Box 170 Plymouth, WI 53073–0170

Mr. Larry Lemmenes, President and General Manager, Alto Dairy Cooperative, N3545 County EE, PO Box 550, Waupun, WI 53963

Ms. Marsha Glenn, Vice President, Kraft Foods, Inc., 1 Kraft Court, Glenview, IL 60025

Mr. Bill McCoshen, Secretary, Wisconsin Department of Development, 123 W. Washington Ave., PO Box 7970, Madison, WI 53707–7970

Mr. Wilfrid Turba, Retired Dairy Farmer, N 9617 Turba Court, Elkhart Lake, WI 53020

Mr. Will Hughes, Wisconsin Federation of Cooperatives, 30 W. Mifflin, Madison, WI 53703

Dr. Ed Jesse, Associate Dean, Agriculture Hall, Room 146, University of Wisconsin-Madison, Madison, WI 53706

Mr. Jack Sturm, President, A. Sturm and Sons, 215 Center Street, PO Box 287, Manawa, WI 54949

Mr. Bob Wagner, President, Weyauwega Milk Products, 105 E. Third Ave., PO Box 410, Weyauwega, WI 54983

Mr. Alan Tracy, Secretary, Wisconsin Department of Agriculture, Trade and Consumer Protection, 2811 Agriculture Dr., PO Box 8911, Madison, WI 53708

Mr. Bob Thelen, Dairy Farmer, Route 2, Box 39, La Farge, WI 54639

Mr. Gary Anderson, Dairy Farmer, Route 1, Box 184, Cecil, WI 54111

Mr. Richard Gould, President, National Cheese Exchange, 130 E. Walnut St., PO Box 1844, Green Bay, WI 54301–1844

Mr. W. O'Neill McDonald, President, SuperValu-Great Lakes Division, 7400 95th Street, PO Box 330, Pleasant Prairie, WI 53158–0330

Mr. Gerald Jaeger, Dairy Farmer, N1387 Rolling Drive, Campbellsport, WI 53010–2250

Mr. Jon Peterson, Dairy Farmer, Route 2, Box 170, Cashton, WI 54619

Darin Von Ruden, Dairy Farmer, Rt I Box 23A, Westby, WI 54667

Jim Holte, Dairy Farmer, N2478 CTY H, Elk Mound, WI 54739

APPENDIX 2

Information and materials associated with and leading to the July 25, 1996 Task Force meeting

Letter sent to members of the Governor's Task Force on Cheese Pricing, dated May 14, 1996, from Governor Tommy G. Thompson.

Draft of Press release "Governor Appoints Cheese Pricing Task Force," dated May 14, 1996.

Letter sent to Alan T. Tracy, Secretary of the Department of Agriculture, Trade and Consumer Protection, from Governor Tommy G. Thompson regarding Mr. Tracy's agreement to serve as a member of the Task Force on Cheese Pricing.

Introductory letter containing information about the goals of the Task Force, dated July 10, 1996 and sent to the members of the Cheese Task Force from Alan T. Tracy, Secretary of the Department of Agriculture, Trade and Consumer Protection.

"Cheese Pricing, A Study of the National Cheese Exchange." Mueller, Willard F., Bruce W. Marion, Maqbool H. Sial, and F.E. Geithman. The Department of Agriculture, Trade and Consumer Protection and the Department of Agricultural Economics, University of Wisconsin-Madison. March 1996.

"Cheese Pricing: A Study of the National Cheese Exchange. Summary, Conclusions, and Policy Initiatives." Mueller Willard F., Bruce W. Marion, Maqbool H. Sial, and F.E. Geithman. The Department of Agriculture, Trade and Consumer Protection and the Department of Agricultural Economics, University of Wisconsin-Madison. March 1996. (Included in this report.)

National Cheese Exchange Investigation, Summary Remarks. March 19, 1996.

National Cheese Exchange Member list.

Agenda for Thursday, July 25, 1996 Governor's Task Force on Cheese Pricing meeting.

Map to Prairie Oak Office Building.

Preliminary Draft of "Proposed Order of the State of Wisconsin Department of Agriculture, Trade and Consumer Protection Adopting Rules," dated March 15, 1996.

National Cheese Exchange Investigation, Questions and Answers, March 19, 1996.

National Cheese Exchange Investigation, Federal and State Regulatory Authority.

Statement of Alan T. Tracy, Secretary of the Department of Agriculture, Trade and Consumer Protection, on bulk cheese market pricing issues, before the U.S. House Subcommittees on Livestock, Dairy and Poultry; and Risk Management and Specialty Crops, May 15, 1996.

Submission by National Cheese Exchange, Inc., to the House Subcommittees on Livestock, Dairy and Poultry, and the House Subcommittee on Risk Management and Specialty Crops, May 15, 1996.

Statement of Willard F. Mueller, William Vilas Research Professor, Emeritus Department of Agriculture and Applied Economics, University of Wisconsin-Madison, before Joint Hearings of the House Subcommittee on Livestock, Dairy and Poultry, and the House Subcommittee on Risk Management and Specialty Crops, May 15, 1996.

Statement of Bruce W. Marion, Professor of Agricultural Economics and Director, Food Systems Research Group, University of Wisconsin-Madison, before Joint Hearings of the House Subcommittee on Livestock, Dairy and Poultry, and the House Subcommittee on Risk Management and Specialty Crops, May 15, 1996.

Written testimony of Betsy Holden, Executive Vice President of Kraft Foods, Inc. and General Manager of the Kraft Cheese Division, before Joint Hearings of the

House Subcommittee on Livestock, Dairy and Poultry, and the House Subcommittee on Risk Management and Specialty Crops May 15, 1996.

Tape recording, consisting of two cassettes, of the complete July 25, 1996 Task Force meeting.

Information and materials associated with and leading to the September 19, 1996 Task Force meeting.

Summary of Action from the July 25, 1996 Task Force meeting.

Minutes from the July 25, 1996 Task Force meeting.

Letter, dated September 6, 1996, sent to Task Force members from Bob Burns, Vice Chair, Governor's Task Force on Cheese Pricing.

Agenda for the September 19, 1996 Task Force Meeting.

Amended Agenda for September 19, 1996 Governor's Task Force on Cheese Pricing meeting.

Letter, dated September 19, 1996, from the National Cheese Exchange, Inc., to the Governor's Task Force on Cheese Pricing, concerning the operations and structure of the National Cheese Exchange, Inc.

Letter, dated June 6, 1996 to Alan T. Tracy, Secretary of the Department of Agriculture, Trade and Consumer Protection, from Blake Imel, Acting Director of U.S. Commodity Futures Trading Commission, Division of Economic Analysis, regarding the report "Cheese Pricing: A Study of the National Cheese Exchange."

Letter, dated July 26, 1996, to Alan T. Tracy, Secretary of the Department of Agriculture, Trade and Consumer Protection, from Donald S. Clark, Secretary of the Federal Trade Commission, regarding the report "Cheese Pricing: A Study of the National Cheese Exchange."

Letter from Richard E. Rominger, Deputy Secretary of the Department of Agriculture, to Alan T. Tracy, Secretary of the Department of Agriculture, Trade and Consumer Protection, regarding the report "Cheese Pricing: A Study of the National Cheese Exchange."

"Responses to Hearing Testimony and Subcommittee Members' Questions." Mueller Willard F., Bruce W. Marion. The University of Wisconsin-Madison. June 18, 1996.

"Dairy Market News," Week of September 2–6, 1996, Volume 63, Report 36.

"Dairy Market News," Week of September 9–13, 1996, Volume 63, Report 37.

"Review of Econometric Findings in the University of Wisconsin Study of Prices on the National Cheese Exchange." Gardner Bruce L. University of Maryland. July 1996.

"Comments on Bruce Gardner's Review of the University of Wisconsin Study of Cheese Pricing on the National Cheese Exchange." Marion, Bruce W., Willard F. Mueller. University of Wisconsin-Madison. September 19, 1996.

News Release, "Economist Calls Report on National Cheese Exchange 'Seriously Flawed'," July 25, 1996.

Testimony of James J. Bowe, President of Coffee, Sugar and Cocoa Exchange, Inc., before the Joint Hearings of the House Subcommittee on Livestock, Dairy and Poultry, and the House Subcommittee on Risk Management and Specialty Crops, May 19, 1996.

The National Cheese Exchange, Inc. Rules Regulating Trading, July 1996.

Tape recording, consisting of two cassettes, of the complete September 19, 1996 Task Force meeting.

Video from David Ikari, California Department of Food and Agriculture, shown at September 19, 1996 Task Force meeting.

Information and materials associated with and leading to the October 17, 1996 Task Force meeting.

Letter Dated October 9, 1996 sent to Task Force members concerning the October 17, 1996 meeting from Robert Burns, Vice Chair, Governor's Task Force on Cheese Pricing.

Map to Ramada Inn, site of Task Force meeting.

Agenda for the October 17, 1996 meeting of the Governor's Task Force on Cheese Pricing.

Summary of Action from the September 19, 1996 Task Force Meeting.

Letters from the State of California Department of Food and Agriculture concerning changes to the current Stabilization and Marketing Plans for Market Milk, received from David Ikari, along with video tape (shown at September 19, 1996 meeting).

Graphs showing various price relationships between National Cheese Exchange Prices, Federal Milk Order prices, Wisconsin Assembly Point Spot prices and CSCE futures prices.

Recommendation worksheets for members of the Governor's Task Force on Cheese Pricing from October 17, 1996 meeting.

October 17, 1996 meeting topic outline.

Examples of Alternative BFP for the month of April '96, for the month of June '96, and Proposed Phasing-in of Alternative BFP.

October 17, 1996 DATCP Rule Proposal.

A March 28, 1996 memo from Alan T. Tracy, Secretary of the Department of Agriculture, Trade and Consumer Protection, to the Board of Agriculture, Trade and Consumer Protection concerning the National Cheese Exchange; Hearing Draft Rule.

An October 9, 1996 memo from Alan T. Tracy, Secretary of the Department of Agriculture, Trade and Consumer Protection, to the Task Force members regarding proposals for the Task Force discussion.

Letter from Jon R. Peterson, Task Force Member, sent to John Norton, Director of the Bureau of Trade Practices, regarding Mr. Peterson's proposals for cheese pricing.

Letter, dated October 7, 1996, from Phillip F. Gudgeon, Dairy Producer and Commodity Futures Broker, sent to Jon R. Peterson, Task Force Member, concerning dairy's price discovery system.

Letter, dated October 7, 1996, from Bernard V. Golbach, Chairman of Masters Gallery Foods, sent to John C. Norton, Director of the Bureau of Trade Practices, regarding the October 17, 1996 Task Force meeting.

FAX, dated October 3, 1996, from Ed Jesse, Task Force Member, to John C. Norton, Director of the Bureau of Trade Practices, containing recommendations and criteria for evaluating proposals for change in cheese pricing.

Letter, dated October 1, 1996, sent to John C. Norton, Director of the Bureau of Trade Practices, from John A. Sturm, President of A. Sturm & Sons Inc., concerning proposals on how to improve the cheese pricing system.

Submitted recommendations to the Governor's Task Force on the Cheese Exchange by Gary L. Anderson, Task Force Member.

CSCE Nearby Cheddar Contract and NCE.

Memo, dated March 28, 1996, from Alan T. Tracy, Secretary Department of Agriculture, Trade and Consumer Protection, to the Board of Agriculture, Trade and Consumer Protection, regarding the National Cheese Exchange; Hearing Draft Rule.

Tape recording, contained on two cassettes, of the complete October 17, 1996 Task Force Meeting.

Information and materials associated with and leading to the November 14, 1996 Task Force meeting.

Letter, dated November 7, 1996 and sent to Task Force members concerning the November 14, 1996 Task Force Meeting, from Robert Burns, Vice Chair, Governors Task Force on Cheese Pricing.

Letter, dated November 1, 1996, distributed to the members of the Task Force on Cheese Pricing from John C. Norton, Director of the Bureau of Trade Practices, regarding an additional meeting in December.

Letter, dated November 1, 1996 from Governor Thompson to the members of the Task Force on Cheese Pricing concerning recommendations to improve the current cheese pricing system.

Letter, dated November 13, 1996, from Governor Thompson and addressed to Alan T. Tracy, Secretary of Agriculture, Trade and Consumer Protection, and Robert Burns, Vice Chair of the Task Force on Cheese Pricing, concerning the Governor's recommendations.

FAX, dated November 13, 1996, from Ed Jesse, sent to John C. Norton, Director of the Bureau of Trade Practices, concerning supplemental Cheese Task Force recommendations.

FAX article from the Coffee, Sugar & Cocoa Exchange titled "CSCE Files with CFTC to Trade BFP Milk Contact."

Memo, dated November 18, 1996, from Ann Roth, Task Force Staff Support, to the members of the Governor's Task Force on Cheese Pricing, regarding establishing a cash contact for the cheese on the CSCE.

Letter from Dan Glickman to Senator Feingold, dated October 29, 1996.

A letter, dated October 29, 1996, from R.J. Gould of the National Cheese Exchange, Inc. to John C. Norton, Director, Bureau of Trade Practices, Wisconsin Department of Agriculture, Trade and Consumer Protection, concerning the Governor's Task Force on Cheese Pricing.

Press release "Governor Expands Cheese Exchange Task Force", dated November 7, 1996.

Agenda of the November 14, 1996 Governor's Task Force on Cheese Pricing meeting.

Summary of Action for Task Force meeting held on October 17, 1996.

Minutes of the October 17, 1996 Governor's Task Force on Cheese Pricing meeting.

Statement from Upper Midwest Milk Producers Association, included with the minutes of the October 17, 1996 meeting and distributed to the Task Force members at the November 14, 1996 Task Force meeting.

Summary of Preliminary Proposals Still on the Table as of November 14, 1996.

"Why do Corporations Have More Rights than You?" Democracy Unlimited of Wisconsin Cooperative. Madison, WI. Handed out by this group at Nov. 14 meeting.

"The National Cheese Exchange: Impacts on Dairy Industry Pricing." Hamm, Larry G., Robert March. Dairy Markets and Policy-Issues and Options. Cornell University. February 1995.

Tape recording, contained on two cassettes, of the complete November 14, 1996 Task Force Meeting.

Information and materials associated with and leading to the December 5, 1996 Task Force meeting.

A letter dated November 26, 1996 sent to the members of the Governor's Task Force on Cheese Pricing from Bob Burns, Vice Chair Governor's Task Force on Cheese Pricing, concerning the December 5, 1996 Task Force meeting.

Agenda for the December 5, 1996 Governor's Task Force on Cheese Pricing meeting.

Map to the Dane County EXPO Center, where Dec. 5, 1996 meeting was held.

Summary of Action from the November 14, 1996 Task Force meeting.

Proposal to Replace the BFP submitted by Darin Von Ruden.

List of Proposals Adopted at the November 14, 1996 meeting.

FAX letter, dated November 25, 1996, from Commissioner, Gene Hugoson of the Minnesota Department of Agriculture, to Secretary Glickman concerning the NCE and pricing of cheese.

Information sheet dated November 18, 1996 and titled: "What is New With the Governor's Task Force on Cheese Pricing?"

News release, December 5, 1996, from Farm Bureau News entitled "Farmers need to take milk pricing to USDA, according to farmers on Task Force on Cheese Pricing."

Letter from Dory Kidder to the Task Force on Cheese Pricing concerning the pricing of cheese.

Letter, dated November 11, 1996, from Rod and Pam Olson, Dairy Producers, sent to Robert Burns, Vice Chair of the Governor's Task Force on Cheese Pricing, concerning their proposal for changes in the cheese pricing system.

Letter, dated November 26, 1996, from Marvin Zorn concerning the Green Bay Cheese Exchange.

The Base Month Minnesota-Wisconsin Price and Basic Formula Price released noon, C.S.T., December 5, 1996, from the Wisconsin Agricultural Statistics Service.

News release, dated December 3, 1996, from the United States Department of Agriculture titled "USDA Announces Suggested Milk Order Consolidations."

Family Farmers vs. *Kraft Foods*™. UW Greens. Madison, WI. Handed out by UW Greens at this meeting.

Letter from Kevin Kirker to Governor Thompson, dated November 27, 1996, and FAX to John C. Norton, Director of the Bureau of Trade Practices, for distribution to the Task Force members.

Letter from John Peterson, received via FAX on December 4, 1996, to the Task Force members regarding his recommendations for improving the system of cheese pricing.

Tape recording, contained on two cassettes, of the complete December 5, 1996 Task Force Meeting.

Information received after final Task Force meeting

Letter from Richard J. Gould, President of the National Cheese Exchange, dated December 26, 1996, objecting to the proposed Task Force on Cheese Pricing report. This letter is addressed to Carol Svenson, of the Department of Agriculture, Trade and Consumer Protection and Task Force Member.

Minutes of the December 5, 1996 Task Force meeting.

Appendix 3

Cheese Pricing:
A Study of the National Cheese Exchange

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 (Exhibit 1). 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 (Exhibits 2 and 3).

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 (Exhibit 4). 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.

[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).

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 (Exhibit 5).

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 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 (Exhibit 6). 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

[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

(fn. 11 cont.)
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 (Exhibits 7 and 8). 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 (Exhibit 9).

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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.

[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.

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

[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

[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.

[34]

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.

Exhibit 1. Volume of Cheese Traded on the NCE, 1974-1995

		Total Carloads Manufactured[2]		NCE as a Percent of:	
Year	Carloads Sold on NCE[1]	American[3] Cheese	All[4] Cheese	American Cheese	All Cheese
1974	43	46,558	73,434	0.09%	0.06%
1975	167	41,499	70,285	0.40	0.24
1976	490	51,345	83,006	0.95	0.59
1977	553	51,179	83,963	1.08	0.66
1978	325	51,977	87,992	0.63	0.37
1979	440	54,857	92,931	0.80	0.47
1980	264	59,528	99,607	0.44	0.27
1981	39	66,203	106,939	0.06	0.04
1982	40	68,980	113,542	0.06	0.04
1983	34	73,296	120,487	0.05	0.03
1984	307	66,279	116,850	0.46	0.26
1985	144	71,381	127,024	0.20	0.11
1986	752	69,954	130,231	1.07	0.58
1987	707	67,916	133,609	1.04	0.53
1988	361	68,914	139,299	0.52	0.26
1989	118	66,814	140,384	0.18	0.08
1990	342	72,269	151,486	0.47	0.23
1991	399	69,228	151,371	0.58	0.26
1992	380	73,412	162,207	0.52	0.23
1993	596	73,120	163,204	0.82	0.37
1994	799	74,425	168,252	1.07	0.47
1995	1151	77,373	172,857	1.49	0.67

Sources: National Cheese Exchange, Trading Activity Minutes, AMS, USDA, 1974-1993.
Dairy Products Summary, NASS, USDA 1974-1993

[1]NCE trades include carloads of barrels and blocks sold on National Cheese Exchange.
[2]American and total cheese manufactured were converted to carloads using 40,000 lbs. per carload.
[3]American includes Cheddar, Colby, granular, stirred curd, washed curd, and Monterey Jack.
[4]All cheese includes all types of cheese including cream cheese but excluding cottage cheese.

Exhibit 2. Trades on NCE by Primary Type of Business, 1980 TO 1987

Type of Primary Business	---BARRELS & BLOCKS--- Loads Sold									Loads Bought								
	1980	1981	1982	1983	1984	1985	1986	1987	Total	1980	1981	1982	1983	1984	1985	1986	1987	Total
Manufacturer of Cheese[1]																		
Land O' Lakes	172	16	22	20	106	35	115	172	658	16	12	0	1	0	0	0	39	68
Bongards'	0	0	0	0	136	78	220	39	473	0	0	0	0	0	34	0	0	34
Mid-America	0	0	0	0	0	0	129	45	174	0	0	0	11	13	5	1	0	30
Woldt's Cheese	0	0	0	0	0	0	0	0	0	36	7	0	0	0	0	0	0	43
Clearfield	0	0	0	0	0	0	0	0	0	11	0	16	0	9	0	0	0	36
Sub-Total	172	16	22	20	242	113	464	256	1305	63	19	16	12	22	39	1	39	211
Marketers of Cheese[2]																		
Kraft	55	6	8	4	5	3	94	332	507	16	2	0	8	183	98	104	0	411
Borden	17	16	0	2	5	26	20	0	86	61	9	10	0	23	0	0	16	119
Beatrice	11	0	0	6	0	0	2	0	19	20	0	0	8	56	2	635	540	1261
Schreiber	2	0	0	0	0	0	17	0	19	72	6	14	6	21	5	0	75	199
Masters Gallery	0	0	0	1	3	1	33	16	54	0	0	0	0	2	0	12	0	14
Marathon[3]	0	1	10	1	0	0	0	0	12	0	0	0	0	0	0	0	31	31
Sub-Total	85	23	18	14	13	30	166	348	697	169	17	24	22	285	105	751	662	2035
Brokers																		
Dairystate	0	0	0	0	47	0	102	84	233	0	0	0	0	0	0	0	0	0
Sub-Total	0	0	0	0	47	0	102	84	233	0	0	0	0	0	0	0	0	0
All Others[4]	7	0	0	0	5	1	20	19	52	32	3	0	0	0	0	0	6	41
Total	264	39	40	34	307	144	752	707	2287	264	39	40	34	307	144	752	707	2287

Source: National Cheese Exchange, Trading Activity Minutes, AMS, USDA, 1980-87.

[1]These are cheese manufacturers that sell significantly more bulk cheese than they buy.

[2]These are cheese marketers that buy significantly more bulk cheese than they sell. Beatrice manufactures more of its total cheese requirements than it buys from other cheese manufacturers. However, off the Exchange it sells very little bulk cheese and buys virtually all of its cheddar cheese, which is the only cheese traded on the NCE (see Chapter 2). Because of this, Beatrice is included among the "primarily cheese marketers group" of traders. Totals for Beatrice include those for Pauly cheese acquired in 1984.

[3]Marathon is a converter that cuts and packages cheese only for marketers like Kraft, Schreiber and others.

[4]Includes those companies that made less than 1 percent of all carloads traded on NCE during this period. These are Marketing Association (sold 17 carloads), Edelweiss (sold 13 carloads), Swiss Valley (sold 9 carloads), Twin Dakota (sold 7 carloads), AMPI (bought 2 carloads), Anderson Clayton (sold 4 and bought 15 carloads), Northern (sold 2 and bought 7 carloads), and N. Dorman (bought 17 carloads).

Exhibit 3. Trades on NCE by Primary Type of Business, 1988 TO 1993

---BARRELS & BLOCKS---

Type of Primary Business	Loads Sold							Loads Bought						
Manufacturer of Cheese[1]	1988	1989	1990	1991	1992	1993	**Total**	1988	1989	1990	1991	1992	1993	**Total**
Mid-America	1	3	0	0	0	0	4	6	3	48	137	132	165	491
Land O' Lakes	46	2	0	10	12	2	72	57	9	21	0	4	98	189
AMPI	0	0	0[6]	0	0	0	0	30	56	7	20	29	30	172
Bongards'	32	0	0	0	34	9	75	0	0	0	0	0	0	0
Sub-Total	79	5	0	10	46	11	151	93	68	76	157	165	293	852
Marketer of Cheese[2]														
Kraft	277	107	193	339	258	443	1617	0	0	22	0	0	0	22
Alpine Lace	0	0	62	16	30	22	130	0	0	0	0	0	3	3
Borden	2	0	3	18	19	17	59	28	0	0	4	0	0	32
Beatrice	0	0	0	0	0	0	0	118	13	172	85	165	220	773
Schreiber	0	0	6	0	0	1	7	78	28	13	123	34	46	322
Masters Gallery	0	5	2	0	0	0	7	0	0	46	16	0	0	62
Marathon[3]	0	0	35	0	0	0	35	0	0	0	0	0	0	0
Sub-Total	279	112	301	373	307	483	1855	224	41	253	228	199	269	1214
Brokers[4]														
Dairystate	3	1	31	3	0	91	129	8	0	1	7	0	13	29
Northern Wisconsin Produce	0	0	8	2	8	0	18	6	4	10	7	6	0	33
Schurman	0	0	0	0	0	7	7	0	0	0	0	2	18	20
Sub-Total	3	1	39	5	8	98	154	14	4	11	14	8	31	82
All Others[5]	0	0	2	11	19	4	36	30	5	2	0	8	3	48
Total	361	118	342	399	380	596	2196	361	118	342	399	380	596	2196

Source: National Cheese Exchange, Trading Activity Minutes, AMS, USDA, 1988-1993.

[1]These are cheese manufacturers that sell significantly more bulk cheese than they buy.

[2]These are cheese marketers that buy significantly more bulk cheese than they sell. Beatrice manufactures more of its total cheese requirements than it buys from other cheese manufacturers. However, off the Exchange it sells very little bulk cheese and buys virtually all of its cheddar cheese, which is the only cheese traded on the NCE (see Chapter 2). Because of this, Beatrice is included among the "primarily cheese marketers group" of traders. Totals for Beatrice include those for Pauly cheese acquired in 1984.

[3]Marathon is a converter that primarily cuts and packages for marketers like Kraft.

[4]Market Cheese Traders, which is owned by Alpine Lace Brands, is also a broker. NCE market activity reports do not distinguish between trades made by Alpine Lace for its own behalf or for others.

[5]Include those companies that made less than 1 percent of all carloads traded on NCE during this period. These are Dairygold (sold 14 carloads), Edelweiss Cheese (bought 19 carloads), Golden Cheese (sold 10 carloads), Marketing Association (sold 6 carloads), Northwood Dairy (sold 6 and bought 5 carloads), Hemke Cheese (bought 13 carloads), Empire Cheese (bought 5 carloads), and Alto Cooperative(bought 6 carloads).

[6]AMPI sold 10 loads through a broker in 1990.

Exhibit 4. NCE and CCC Block Prices
Weekly: 1978-94

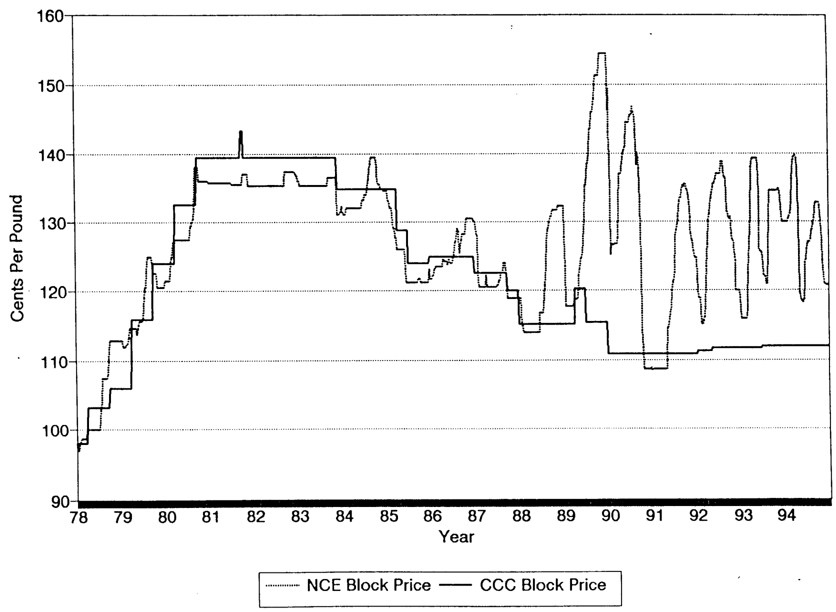


Exhibit 5.

Company	Benefit Financially if NCE Price is:	Total Loads Traded on NCE 1988-1993 Sales	Purchase
Kraft	Lower	1617	22
Borden	Lower	59	32
Alpine Lace	Lower	130	3
Beatrice	Somewhat higher	0	773
Mid-Am	Higher	4	491
Schreiber	Neutral to Higher	7	322
AMPI	Higher	0	172
Land O' Lakes	Higher	72	189
Dairystate	Unclear	129	29

Source: Sales and purchases, Exhibit 3.

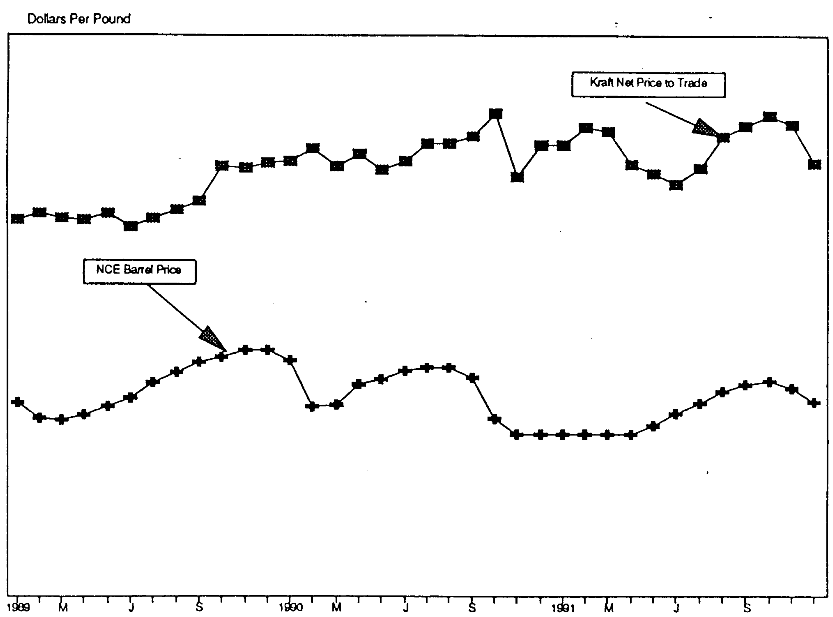
Exhibit 6. Kraft Gains or Losses on Raw Material Cheese Sales: NCE, Outside Sales, and Government, 1987-1992

	NCE		Outside Sales		Government	
	Total Volume (thousands of pounds)					
	Loads	Pounds	Loads	Pounds	Loads	Pounds
Blocks	297	11,969	514	20,684	484	20,231
Barrels	1,214	49,322	717	30,787	1,509	61,666
Squares[1]	--	--	984	36,290	--	--
TOTAL	1,511	61,297	2,265	87,762	1,993	81,897
	Gains or Losses in Cents per Pound					
Blocks	(6.16)		0.80¢		0.62¢	
Barrels	(1.49)		3.89		0.05	
Squares[1]	--		6.15		--	
TOTAL	(2.40)¢		4.09¢		0.187¢	
	Total Gain or Loss					
Blocks	($737,797)		$165,634		$125,128	
Barrels	(733,335)		1,196,795		27,596	
Squares[1]	--		2,230,437		--	
TOTAL	($1,471,132)		$3,592,866		$152,724	

Source: Kraft General Foods, Inc., Appendix Table 4.3

[1]Squares are 640-pound blocks.

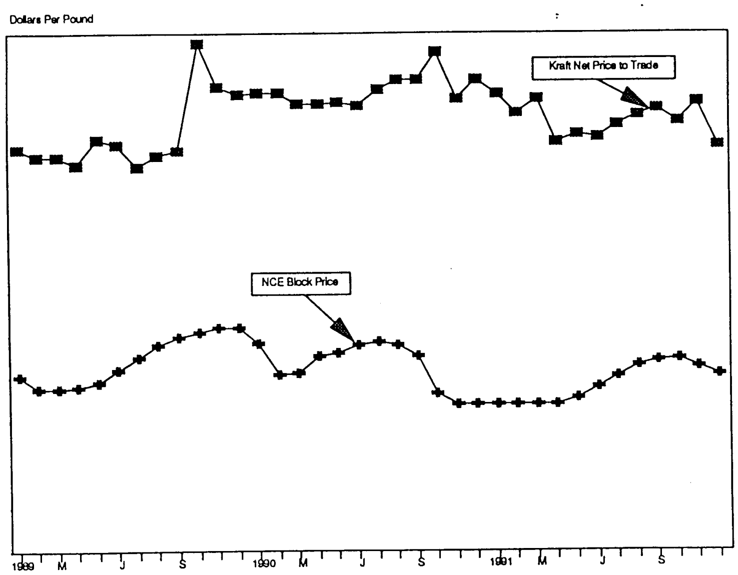
Exhibit 7. Kraft Net Price of Processed Cheese, NCE Barrel Price Monthly, 1989-1991



Source: Derived from "Kraft Retail Price, Kraft Net Price & NCE, Processed Cheese," Kraft General Foods, Inc., KGF 16912

Note: The values on the Y axis have been deleted and the scales of the net price to trade and NCE prices are altered to avoid disclosure. This 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.

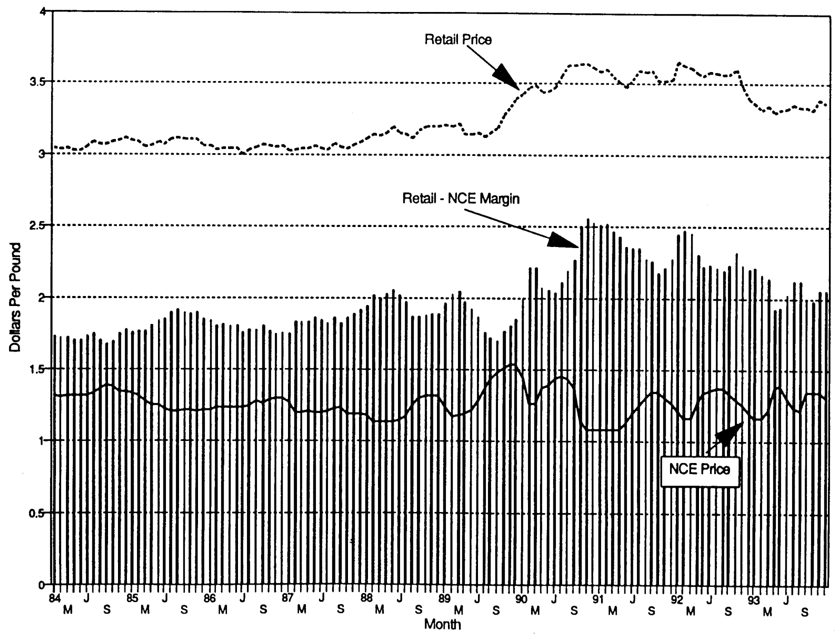
Exhibit 8. Kraft Net Price of Natural Cheese, NCE Block Price
Monthly, 1989-1991



Source: Derived from "Kraft Retail Price, Kraft Net Price & NCE, Natural Cheese," Kraft General Foods, Inc., KGF 16911

Note: The values on the Y axis have been deleted and the scales of the net price to trade and NCE prices are altered to avoid disclosure. This 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.

Exhibit 9. U. S. Retail Price of Natural Cheddar Cheese, NCE Block Price and Retail Price-NCE Price Margin, Monthly, 1984-1993



Sources: CPI Detailed Report, Bureau of Labor Statistics, U.S. Department of Commerce; and Dairy Market News, USDA.

TASK FORCE RECOMMENDATIONS

Mr. TRACY. I would like to just quickly summarize the recommendations in it. The first and lead recommendation is very much to the point of these hearings. The recommendation is that the U.S. Department of Agriculture should no longer use the National Cheese Exchange price in the price adjuster used to determine the basic formula price for manufacturing milk. The price of manufacturing milk under a Federal milk marketing order should be based on supply of and demand for milk used in the manufacture of dairy products. I will return to that one.

The next recommendation was that the Coffee, Sugar, and Cocoa Exchange and/or the Chicago Mercantile Exchange establish a cash market for cheese. That has not happened yet, but we have seen some hope that that could occur.

The next recommendation was to recommend that USDA expand the weekly Wisconsin Assembly Point Price series to a statistically reliable and regional series that would include major manufacturing areas. And also mentioning the possibility of mandatory reporting, if necessary, for statistical reliability. And I am pleased that USDA is proceeding on that recommendation.

The fourth recommendation was that the Commodity Futures Trading Commission and the Federal Trade Commission reevaluate their regulatory authorities regarding the National Cheese Exchange. And that is the very subject of a bill that Senator Kohl has introduced.

Then there were four more recommendations that were directed to the National Cheese Exchange board, dealing with such things as daily price limits, anonymous trading, electronic trading, and so on.

I would like to caution the subcommittee that these suggestions are not magic solutions that will miraculously provide high, stable milk prices for our Nation's dairy farmers. With the end of the Federal dairy price support program in sight, we have left the era of Government-supported, stable milk prices and entered the era of market-driven national and even international pricing.

However, the task force suggestions would, if implemented, move milk pricing to markets that are more competitive and that will more accurately represent the supply and demand in milk for all of its manufacturing purposes.

Returning to that first recommendation. The recommendation includes both an interim replacement for the National Cheese Exchange price in the current basic formula price, as well as longer-term replacements for the basic formula price itself. In the short term, the NCE price can be replaced by a national average cheese price, collected and reported by USDA's National Ag Statistic Service. And you have heard a report on how that series is being developed.

In the longer term, we suggested a couple of alternatives. One would be substituting an average monthly milk futures price for the basic formula price or, two, replacing the basic formula price with a competitively determined milk-pay price collected through a national survey of prices that dairy plants actually pay for milk.

The task force has also recommended that USDA and the Federal dairy policy should be moving toward the deregulation of milk pricing, including the eventual elimination of setting a basic formula price for milk.

It is easy to get lost in the complex details of the milk marketing system, but for the purposes of illustration, let us compare the current pricing mechanism with milk to the pricing mechanism for corn. Imagine for a moment that Cargill, Continental Grain and Mitsubishi sat down once a week with Ralston Purina, Nabisco, and Tyson's Foods, just for examples, to buy and sell a few trainloads of corn. And that regardless of whether any corn actually changed hands, the prices at which corn was traded or was at least offered or bid became the price of corn for virtually every corn transaction in the coming month. Corn farmers would be up in arms.

Yet this is just about what happens for milk, based on trading on the Cheese Exchange, where a handful of large companies set the price for more than 100,000 dairy farmers in the United States.

Dairy farmers, however, unlike corn farmers, do not have the option of storing their product to wait for a better price. And currently, they do not even know what they will be paid until the month after they ship their milk.

Now, compare that scenario that I gave for what actually does occur in the corn market. Every day, thousands of farmers and hundreds of grain elevators sell and buy corn or agree to buy and sell corn at a future time using prices from the futures contract markets. In addition, Wall Street investors and market speculators bring their knowledge and their expertise to the futures market, and actively participate.

The expectations of thousands of individuals on the future supply and demand for corn are measured by the minute. Compared to the level of information about, participation in, and sophistication of the market mechanism for corn, our dairy market mechanisms are still in their infancy.

If we have a clear vision of where we would like to go, we can better determine what direction to take the next step. For the best future dairy pricing mechanisms, why not use as a model the systems used in corn, wheat, soybeans, and other agricultural commodities, and adapt it to the peculiarities of milk? Why could not dairy farmers, at least on a monthly or quarterly basis, evaluate offers from various dairy plants for their upcoming production? Such offers could cover a range of time periods from which the milk producer could choose.

Dairy farmers could also price their product in advance on the futures market. The plants, at the time they contract for future production, could sell milk futures that they would buy back as the milk is delivered.

Further, processors could also hedge their purchases. Investors and speculators, seeing the makings of a real market, would bring their money, their expertise, and their analysis to that market. The dairy futures market would work to provide a clear measure of future price expectations, updated by the minute.

I am optimistic that dairy futures markets will grow, that they will eventually provide a competitive, dynamic market, reflecting an accurate value of the demand for and supply of milk and dairy products. I would like to specifically suggest that dairy futures prices could be phased in to the basic formula price calculation as participation in those contract markets grows.

USDA and Federal dairy policy need to evolve, reducing Government involvement and relying more on the marketplace. We need action now to improve the milk pricing mechanism, but we also need to take a longer term view of the milk pricing reform effort currently underway.

One of the farmers who came to Washington with Governor Thompson in February, and met with Senator Kohl and others of our delegation and Secretary Glickman, made a statement to Secretary Glickman that I would like to repeat for you today. This was Pete Knigge of Omro, WI, and he said: “I am not here to complain about the price of milk. I am here to fix the way milk is priced.”

No; he was not happy about pay prices this past winter. But he does not want you or the USDA or any other Government entity to set dairy prices. Now, that is not the only view of Federal pricing in Wisconsin, but I do believe it is the majority view.

Mr. Knigge wants those prices set in the marketplace. But I think he and all of the farmers in Wisconsin, virtually, agree that they want a mechanism that they can trust to accurately tell them what the market price is for their product. I think Pete’s statement concisely describes the mission before us today.

PREPARED STATEMENT

I thank the committee and the chairman for your interest in this topic, and especially Senator Kohl for arranging for me to be here, and for your continued constructive work on national dairy policy reform. I look forward to questions.

Senator COCHRAN. Thank you, Mr. Tracy.

[The statement follows:]

PREPARED STATEMENT OF ALAN T. TRACY

Good morning, Chairman Cochran and Subcommittee members. Thank you for inviting me to share with you my perspective on current dairy pricing issues, and in particular, alternatives to the National Cheese Exchange in determining milk prices.

Farm milk prices, and the mechanism for determining them, are of utmost importance to Wisconsin farmers and Wisconsin's economy. Wisconsin leads the nation in the number of dairy farmers and dairy cows and in the production of cheese. The dairy industry contributes over $17 billion to Wisconsin's economy, nearly 10 percent of our state's overall economic output.

Just about a year ago today, our department released a report detailing the findings of a comprehensive study on cheese pricing and trading activities on the National Cheese Exchange (NCE). The study was conducted by researchers at the University of Wisconsin at our request and under our authority to investigate business practices in Wisconsin. The report concluded that "As currently organized, the Exchange appears to facilitate market manipulation." The report stimulated widespread interest and debate about the NCE, including a Congressional hearing before the House Committee on Agriculture's Subcommittees on Livestock, Dairy and Poultry, and Risk Management and Specialty Crops.

The report's findings were of particular concern because of the link between NCE prices and milk prices paid to farmers. While less that two percent of all bulk cheddar cheese is traded on the National Cheese Exchange, the NCE price largely determines the "Basic Formula Price," the price of manufacturing milk under the entire Federal milk pricing system. It is vitally important that the underlying market or markets be competitive and that farmers have confidence that prices accurately reflect the supply of and demand for milk.

Wisconsin Governor Thompson convened a Task Force on Cheese Pricing to "make recommendations to improve the current system of pricing for the benefit of the dairy industry and consumers." A copy of the Task Force's report to the Governor is attached for the record. Governor Thompson, along with Task Force members, representatives of our farm organizations and members of our Congressional delegation met with USDA Secretary Glickman in early February to present the Task Force's recommendations.

At the outset, I would like to caution this Subcommittee that these suggestions are not magic solutions that will miraculously provide high, stable milk prices for our nation's dairy farmers. With the end of the federal dairy price support program in sight, we have left the era of government supported, stable milk prices and entered the era of market-driven, national, and increasingly, international pricing. However, the Task Force suggestions, if implemented, will move milk pricing to markets that are more competitive and that will more accurately represent the supply of and demand for milk for all its manufacturing uses.

The Task Force recommendations include both an interim replacement for the NCE price in the current Basic Formula Price (BFP), as well as longer term replacements for the BFP. We have suggested that in the short term, the NCE price be replaced by a national average cheese price, collected and reported by USDA's National Agricultural Statistics Service (NASS). NASS has recently begun collecting this price series. For the longer term, we have suggested two alternatives: (1) Substituting an average monthly milk futures price for the BFP; or (2) Replacing the BFP with a competitively determined "milk pay price," collected through a national survey of prices that dairy plants actually pay for milk, less performance premiums, Class I pool disbursements and over-order values. The Task Force has also recommended that USDA and federal dairy policy should be moving toward the deregulation of milk pricing, including the eventual elimination of setting a Basic Formula Price for milk.

Compare the current pricing mechanism for milk with the pricing mechanism for corn. Imagine for a moment, that Cargill, Continental Grain and Mitsubishi sat down once a week with Ralston-Purina, Nabisco and Tyson Foods, for example, to buy and sell corn, and that regardless of whether any corn actually changed hands, the prices at which corn was traded (or was offered or bid) became the price of corn for virtually every corn transaction in the coming month. This is what happens for milk, based on trading on the NCE. Compare this scenario with what actually occurs in the corn market: Every day, thousands of farmers and hundreds of grain elevators sell and buy corn or agree to sell and buy corn at a future time, using prices from the futures contract markets. In addition, Wall Street investors and market speculators bring their knowledge and their expertise to the futures market and actively participate. The expectations of thousands of individuals on the future supply of and demand for corn are measured by the minute. Compared to the level of information about, participation in and sophistication of the market mechanism for corn, our dairy market mechanisms are still in their infancy.

If we have a clear vision of where we would like to go, we can better determine in what direction to take the next step. For the best future dairy pricing mechanisms, let's use the systems used for corn, wheat, soybeans and other agricultural commodities, adapted to the peculiarities of milk. Why couldn't dairy farmers, on a monthly or quarterly basis, evaluate offers from various dairy plants for their upcoming production? Such offers could cover a range of time periods from which the milk producer could choose. Dairy farmers could also price their product in advance on the futures market. The plants, at the time they contract for future production, could sell milk futures that they would buy back as the milk is delivered. Further processors could also hedge their purchases. Investors and speculators, seeing the making of a real market, would bring their money, expertise and analysis to the market. The dairy futures market would work to provide a clear measure of future price expectations, up to the minute.

I am optimistic that the contract markets for dairy futures will continue to grow, and that they will eventually provide a competitive, dynamic market reflecting an accurate value of the demand for and supply of milk and dairy products.

USDA and federal dairy policy need to continue to evolve, reducing government involvement and relying more on the marketplace. We need action now to improve the milk pricing mechanism, but we also need to take a longer term view of the milk pricing reform effort currently underway.

One of the dairy farmers who came to Washington with Governor Thompson in February, Pete Knigge of Omro, Wisconsin, made a statement to Secretary Glickman that I'd like to repeat for you today. He said, "I'm not here to complain about the price of milk, I'm here to complain about the way milk is priced." No, he wasn't happy about his pay prices this past winter. But he doesn't want you, or USDA, or any other government entity to set dairy prices. He wants them set in the marketplace, but he wants a mechanism he can trust to accurately tell him the market price for his product. I think Pete's statement concisely describes the mission before us today.

I want to thank the committee for your interest in this subject and I especially want to thank you, Senator Kohl, for arranging for me to be here today and for your constructive work to reform national dairy policy. I would be pleased to answer any questions committee members may have.

[CLERK'S NOTE.—The task force report appears with Mr. Tracy's testimony previous to this prepared statement.]

STATUS OF THE NATIONAL CHEESE EXCHANGE

Senator COCHRAN. Senator Kohl.

Senator KOHL. Thank you very much, Mr. Chairman.

Mr. Tracy, can you bring any information to us with respect to the National Cheese Exchange? Are they closing? Are they closing soon? How quickly do we have to develop an alternative? What can you tell us, Mr. Tracy?

Mr. TRACY. Well, I think you will have some other people who will be testifying later, who are closer to that than I am, who are, for instance, members of the board of the exchange. I believe that there are some here who are members or at least have those members as memberships of their associations. And I think that is better directed to them.

I am pleased that the USDA is proceeding to put together the price series that they are working on. I agree with Assistant Secretary Collins that they do need to do some proofing or some truthing of that mechanism before they substitute it for the NCE right now. I do think that the M–W does provide an alternative—not precisely the old M–W, because there are some things that are wrong with it. But you could modify the M–W and go back to that mechanism. It did not use the Cheese Exchange price directly in the calculation, as the basic formula price does.

One of the problems with the M–W is that it was based purely on grade B pricing, grade B milk shippers, and the number of those is continuing to decline in the upper Midwest, and yet much of the grade A milk that is shipped in Wisconsin is also used for manufacturing purposes—over 80 percent of it. So you could substitute grade A milk in for a percentage of the grade B, modify that M–W, and come up with something, if you had to, and I think USDA could do that if they had to.

But I am hopeful that they will rather quickly be able to acquire some assurance that their milk survey work is a suitable substitute.

Again, keep in mind that that is still going to reflect an awful lot of what the Cheese Exchange dictates. Right now, most of the trades that occur between plants who buy and sell cheese are done with the basis of the Cheese Exchange. So, even if we are surveying cheese prices, we are going to be getting—and we are surveying maybe 30 percent of all the sales, for instance—we are still going to be reflecting what goes on in that very narrow market in the Cheese Exchange price.

That is why I would like to see us develop a price discovery mechanism for milk. You know, there is not a price discovery mechanism for milk now. This is the No. 1 agricultural commodity in the United States and there is no price discovery mechanism for it. It is purely a calculated price, calculated by USDA for the base price, and then additional calculations made by the plants who pay the farmers, in turn, calculated off the cheese price. There is a price discovery mechanism for cheese, but it does not involve the participation and the broad number of players with broad amounts of information that would make it as good a market as it can be.

Senator KOHL. All right. I am done. I just want to ask a question, if I might, quickly. Could you give us an opinion on what could happen in the dairy industry, and in dairy States as important as Wisconsin, if we continue to have a segmentation regionally?

Mr. TRACY. Well, that is a good question.

Senator KOHL. Can you give us an opinion? I would like your opinion of it for the record. How concerned are you that we might have a segmentation of the dairy industry in this country that would really wreak havoc?

Mr. TRACY. Well, there are two kinds of segmentation that take place. One is political segmentation. The dairy industry, being a powerful force in every State in the Nation virtually, is very powerful in its regional groups. As you know, it is easier to stop something from happening here in Washington than it is to make something go.

Unfortunately, when the dairy industry has not been in agreement with each other, it has been easy to keep things from happening. That is why, I think, that the progress that was made in the 1996 farm bill of requiring some changes in the milk marketing order system, in requiring some changes in the way that prices are developed, are really important, because now something has to happen. Of course, you kind of dumped it in poor Secretary Glickman's lap. But something definitely has to happen in terms of changing these pricing mechanisms.

If the dairy industry is together, they are unstoppable, because they are so powerful. But any one broad regional group has heretofore been able to stop pricing. The other that you have talked about, in segmentation, I think what we mean is a balkanization of prices or the continued lack of a national pricing system.

Oddly enough, we do have a national pricing system for cheese. The pricing for it tends to come out of our part of the country, where we have roughly one-fourth of the dairy farmers. But there is a national pricing system for cheese. There is not a national pricing system for fluid milk.

Fluid milk is priced order by order. I know the chairman has done a lot of work in trying to overcome European export subsidies and European import barriers. Yet what you have, between individual marketing orders for fluid milk is very similar to what Europe has, with its variable levy for imports of agricultural commodities that bring that price back up.

If, for instance, you ship a load of fluid milk from Wisconsin down to, let us say, the south Florida order—I cannot remember exactly what that differential is in the south Florida order, but it is darn near 100 percent fluid utilization and it is something over $4 a hundredweight—so those farmers in that area are guaranteed a minimum price of something like $4 over the BFP. That is a pretty powerful price.

Well, you would think, with free trade, that would work itself out. We have interstate highways now. We can ship a truckload of milk from Wisconsin to south Florida without even turning on the refrigerator and not lose more than 1 °C of temperature in it, with modern equipment. But what happens is that the bottler who receives that milk in south Florida has to pay that differential into that local pool in south Florida where it gets distributed to Florida milk producers, even though that milk might have come from Wisconsin. And the Wisconsin milk producers get none of the benefit of the higher fluid milk price for that load. They essentially get the manufacturing price.

That is the regionalization of pricing that we have through the order system. So getting at the 10 orders is going to help. You are still going to have big differences in utilization. You still have barriers to trade. I think that those compensatory payments are a terrible thing that are a restraint of trade within the United States.

Senator KOHL. Thank you, Mr. Tracy.

And thank you, Mr. Chairman.

Senator COCHRAN. Senator Leahy, have you any questions for the witness?

Senator LEAHY. Thank you.

Are you suggesting that a better way is to do something like the Cheese Exchange, or did I misunderstand you?

Mr. TRACY. No; not at all. We proposed a number of specific alternatives to the Cheese Exchange for pricing.

Senator LEAHY. Because I was going to say, having somebody meet for a couple of hours a week and manipulate it, I would hope you would not want that.

Mr. TRACY. Right.

Senator LEAHY. I am sure the dairy farmers would be delighted to hear how powerful they are. I think in my region in New England, I think they make up about one-tenth of 1 percent of the population. I think they are going to be impressed to hear from you just this enormous power they have. I can think of some of the States that have joined for what they think is best for both consumers and producers, and that includes States that have about a dozen dairy farmers in their whole State.

Maybe if you spent time in some of these States, it looks a little different. It may be the case in Wisconsin. Maybe this is a major part. I think in my part of the world, they have neither the electoral or financial muscle that they might have in Wisconsin. And if they get gains with our State legislators or with members of Congress, it is because they have made a darn good case for what they want, not because they have any muscle at the ballot box. And, frankly, I think they have made some darn good cases.

I just thought I would throw that in, for whatever it is worth.

Mr. TRACY. Thank you very much.

Senator LEAHY. If we are going to be speaking in these kind of euphemisms, Mr. Chairman, I just thought I would throw in a few facts.

Senator COCHRAN. We are trying to find out what everything is worth today.

Mr. TRACY. If I could respond very briefly, Senator. I agree with you. I did not intend to imply that they had the power to overcome the wishes of consumers. Only that, in terms of things like details of dairy policy, that if the entire dairy industry is together, because they are constituents of all 100 Senators of the U.S. Senate, for instance——

Senator LEAHY. If they are all together, it is a lot better.

Mr. TRACY [continuing]. They can accomplish a lot. But it is also possible, when they have regional differences, that they stymie each other.

Senator LEAHY. I have been here for 22 years, and I have always wished fervently for the dairy industry, nationwide, to be together on some of these issues. And being an optimistic sort, and this close to St. Patrick's Day, I will keep on wishing. [Laughter.]

Mr. TRACY. Thank you, Senator.

Senator COCHRAN. Thank you, Mr. Tracy, for being here and for your testimony at this hearing.

Next, I am going to call on a panel of dairy farmers and producers we have with us today: Mr. Harold Howrigan, president of St. Albans Cooperative Creamery, Inc., in Vermont; Buckey Jones, board of directors of Mid-America Dairymen, from Mississippi; Arden Tewksbury, manager of the Progressive Agricultural Organization; Bill Brey, president of the Wisconsin Farmers Union; and Ken Zurin, a dairy farmer from Pennsylvania.

We appreciate very much the attendance of this panel of witnesses. And you can be assured that it is your interest that has provoked the questions that we have raised to the Secretary and the policymakers here in Washington about dairy pricing and whether reforms are indicated and, if so, what reforms ought to be considered.

Let us start with Mr. Howrigan. We have copies of statements. They will all be placed in the record in their entirety. We encourage you to summarize your comments so we will have a chance for questions.

Senator LEAHY. Mr. Chairman.

Senator COCHRAN. Senator Leahy.

Senator LEAHY. Mr. Chairman, I appreciate your courtesy. Because, as you know, Mr. Howrigan has an airplane back to Vermont and we do have a big storm coming in the morning. So he needs to get this one. So I appreciate that.

Senator COCHRAN. We appreciate that, and we hope this does not cause anybody any inconvenience.

Mr. Howrigan, you may proceed.

STATEMENT OF HAROLD J. HOWRIGAN, PRESIDENT, ST. ALBANS COOPERATIVE CREAMERY, INC., VERMONT

Mr. HOWRIGAN. Thank you, Mr. Chairman, members of this committee. I am very honored, of course, to be here. And I intend to do just that, summarize briefly and touch on a few points. I am a dairy farmer from Fairfield, VT, the president of St. Albans Cooperative Creamery, and I speak on behalf of our 600 members and the other farmers of the Northeast who share our concerns that we are addressing here today.

Vermont has just under 2,000 dairy farmers in production. The average size is 85 to 90 cows. And they produce 1 to 1.5 million pounds of milk annually. In Vermont, we produce over 400 million dollars' worth of milk, 94 to 95 percent of which is sold outside of Vermont. Which means that nearly $400 million of outside money comes into the State each year. This is generator income. It has a multiple factor of 4 to 5 times its initial value.

Vermont dairy farmers employ about 40,000 people directly and with the related businesses. In our county, Franklin County, in the northwest section of Vermont, we exported over 700 million dollars' worth of agricultural products in 1995. The dairy industry is of utmost importance to the State of Vermont. In Vermont, dairy farming accounts for 80 percent of our agricultural income—a higher percentage than any other State in this country.

We are well located to supply one-third of our consuming public, which live within a 500-mile radius of our source of supply. Which guarantees them a direct and immediate source of fresh product. I think this is very important.

We need our farms in Vermont and New England. And our farmers are dependent on this basic formula price, which is, of course, very directly correlated to the National Cheese Exchange and the cost of production in the United States. Dairy farmers throughout the Nation need a base price that is understandable and creates a fair price.

The information used to formulate this basic price needs to come from broad, reliable sources. This information must have a track record which could be used to calculate past prices for comparison as well as to provide a prediction for the future market changes.

The futures market for cheese has been suggested as an alternative. The most intriguing portion of this futures market is the minimum price fluctuation requirement used in the commodity markets. This will provide a cap or a damper on excessive movement, as we have witnessed in this last fall of our milk prices.

The basic formula price is important to all our dairy farmers nationwide. And this basic price should be connected to a pricing mechanism that is more reflective of market condition. The trading of less than one-half of 1 percent of a product should not establish a basic price for the other 99.5 percent. I think this creates a problem.

A more stable activity here could restore the dairy farmer confidence in the formulation of the prices that they are paid for their milk. Now, it may take time to implement a variable alternative to the price data from the National Cheese Exchange. And within this timeframe, again, we need to look at some of the existing pricing mechanism and not rely solely on a new source, but be aware of the excessive fluctuation that might occur.

I would like to quote my brother Francis. He was in our local State legislature. He is quoted as saying that farmers must live like they are going to die tomorrow, but you farm like you are going to live forever, because of our long-term investments.

PREPARED STATEMENT

I thank you again for the opportunity to address you on these issues, and I appreciate your interest in taking some proper, corrective action. And it was touched on a little bit previously on the basic price of fall, over spring, milk. And it is interesting to note in our co-op at St. Albans, we have kept a fall incentive. And we pay our members $1 a hundredweight over their basic price in the fall. Just an extra, additional premium for fall production over the spring 4 months. The months of March, April, and May as a base, then the months of September, October, and November is the payback. This has worked very well to level our production in our small co-op.

We thank you very much.

Senator SPECTER [presiding]. Thank you very much, Mr. Howrigan.

[The statement follows:]

PREPARED STATEMENT OF HAROLD J. HOWRIGAN

I would like to thank this committee for the opportunity to speak to you today regarding the National Cheese Exchange.

My name is Harold Howrigan and I am a dairy farmer from Fairfield, Vermont. At the current time, I farm three farms with my family. The three farms comprise a total of 1,800 acres and 500 head of Holstein cattle. In 1996, my family shipped over 7 million pounds of milk to the St. Albans Cooperative Creamery, Inc. I am the President of the St. Albans Cooperative Creamery, Inc., and I speak today on behalf of 600 dairy farmer members in Vermont and upstate New York.

In 1996, Vermont dairy farmers produced over $400 million worth of milk. Most (94–95 percent) of this was sold outside of Vermont, which means that nearly $400 million of out side money comes into Vermont because of the investment and hard work of our dairy farmers. This is generator income and has a real impact of 4 to 5 times greater than its initial value to our local economy.

Vermont agriculture and its related businesses employ 40,000 people in Vermont. Franklin County, Vermont alone exported over $700 million in agricultural products in 1995. The dairy industry is of the utmost importance to the state of Vermont.

The livelihood of our dairy farmers and of our State's economy is dependent of the Basic Formula Price. The BFP is used to formulate the prices for Class I, II and III milk. These Class prices, along with Class III–A, are used to calculate the blend prices paid to dairy farmers based on percent utilization of each Class of milk in Federal Order 1. The average blend price paid to dairy farmers in Federal Order 1, Zone 21 for 1994 was $13.10, for 1995, $12.66 and for 1996, $14.63. The cost of production of milk in the Northeast as reported by the USDA was $17.68 in 1994 and $17.77 in 1995. Grain prices were elevated in 1996 so the cost of production of milk was higher still in 1996. As you can see, farmers in the Northeast are not being paid at a level that meets the USDA's calculation of the cost of production. I have attached a graph summarizing this information for 1995 and 1996.

There has also been volatility in the average blend price between 1994 and 1996. From 1994 to 1995 the price decreased by 3.48 percent. Between 1995 to 1996 the price increased by 7.90 percent. Dairy farmers have been riding a roller coaster of milk prices within the year as well. The lowest blend price for 1996 occurred in April at $13.53. The highest blend price occurred in October at $16.04. This is a 18.6 percent increase in price in 6 months. The January 1997 blend price for Zone 21 was $12.96. This represents a 23.8 percent drop in the blend price in 3 months. This volatility is linked to the Basic Formula Price and to the National Cheese Exchange prices for 40 pound blocks of cheddar cheese. Attached is a chart for 1996 showing the direct correlation between the Basic Formula Price and the National Cheese Exchange 40 lb. Block price.

The National Cheese Exchange is a part of the Basic Formula Price calculation, although it was not established for this purpose. The weekly market was established over 50 years ago to allow cheese makers and buyers to sell excess cheese or buy cheese when short. Its purpose was not intended for use in the calculation of the national base milk price. There are many concerns about the National Cheese Exchange including price volatility, representativeness of trades, "thin market", and market dominance.

We have witnessed the price volatility this year, with record highs and rapid declines in prices. The National Cheese Exchange is considered a "thin market" because of little trading volume and the possibility that individual firms can exert undue influence on prices and other terms of trade. The volume of cheese traded is small compared to the entire United States market for cheese. The less than 1 percent of cheese traded at the Exchange sets prices for all the cheese produced. This "thin market" concern and that of market dominance has been made evident by a recent report published by Mueller, Marion, Sial and Geithman which accuses Kraft of manipulating the market to depress cheese prices.

The Cheese Exchange does not represent a large amount of cheese or a diversity of cheese products. The 40 members of the Exchange trade cheese for 30 minutes each Friday morning. Trading on the Cheese Exchange represents only .2 to .5 percent of annual cheese production. Prices have been volatile on the cheese exchange and in the last part of 1996 were dramatic. The high for 40 pound blocks occurred in August of 1996 at $1.6942 per pound and the low occurred in December at $1.2373 per pound. Alternatives to the National Cheese Exchange must or should be more reliable indicators of market supply and demand for products and provide more stability in milk prices. Cash markets such as the National Cheese Exchange are indicators of supply and demand conditions for particular companies that trade on the Exchange, but may not indicate what is being paid in the marketplace.

Cheese is an important part of the national dairy industry. Approximately 36 percent of the United States milk supply is made into cheese. In years past, University of Wisconsin Economists determined that 92 percent of the change in the Minnesota Wisconsin prices series could be explained by changes in the cheese price. Prices paid for cheese will need to play a role in the formulation of a base price for manufacturing milk.

A replacement is needed for the National Cheese Exchange price data in the formulation of the Basic Formula Price. Accurate price discovery is very important to any milk pricing system. The market value of manufactured products can be obtained by price surveys, trading on cash markets, trading on futures markets or specific data on sales transactions. I am pleased that the USDA has begun a survey of cheese prices nationwide. This survey could be a useful alternative to the National Cheese Exchange data but, I also have concerns about the information contained in this survey. The comparisons must be real. Cheese prices must be reported for identical product composition (more/less moisture or fat) and insure pricing reflects same terms of sale.

It is important to obtain weighted average prices received that is reported by manufacturers for actual commodity sales. This should be done for all commodities and not just cheese. It should provide the most accurate value of manufactured products and the value of milk going into these products.

The replacement for the National Cheese Exchange price data must also have historical information available. Historical information could be used to calculate past prices for comparison as well as provide a prediction for future market changes. The futures market for cheese has been suggested as an alternative. The most intriguing portion of the futures markets is the Minimum Price Fluctuation requirement used in the commodities markets. This provides a cap to price movement on the market. This cap would provide more stability to dairy farmer prices through a more incremental and known change in cheese prices. Futures markets can be very beneficial to processors and producers in time. However, based on the current minimal activity, I am not sure that the futures price should be used to base current milk prices. If a new cash market is used in the calculation of the basic formula price and there is no historical information, it would be important to have some kind of price snubber for a period of time to ensure that this new cash market reflects true market conditions.

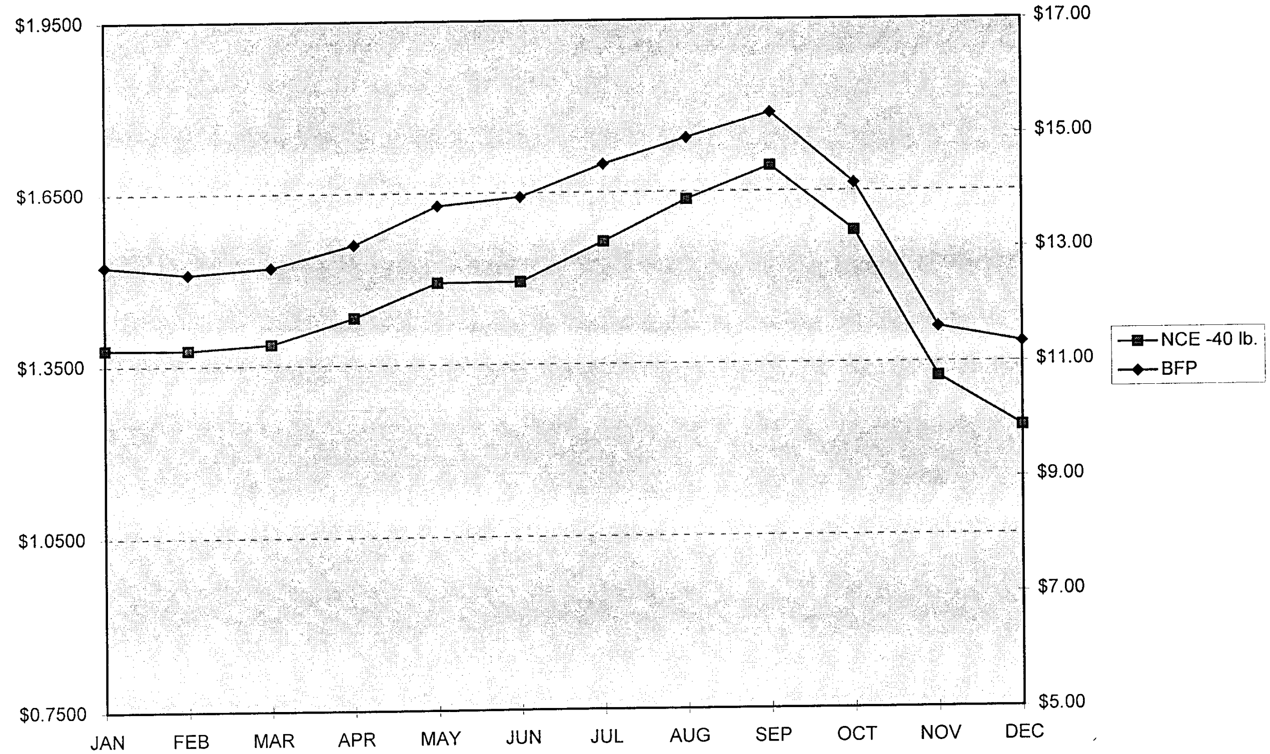
Obtaining the price data required for the calculation of the Basic Formula Price should be one step in the overall reform of this pricing system as part of the federal order consolidation. Several options have been proposed for an alternative to the Basic Formula Price. I would ask you to appraise each proposal using the following criteria: Long life, will the proposed alternative to the BFP be useful for at least 10 years; Understandable, this pricing mechanism must be clear and evident to the dairy farmers that must survive its outcome. They must have confidence in the process; Geographic uniformity, manufactured dairy products compete in a national market which suggests a uniform national price for milk used in manufacturing; and this pricing system must reflect the manufacture milk market, be it prices for butter, nonfat dry milk and cheese.

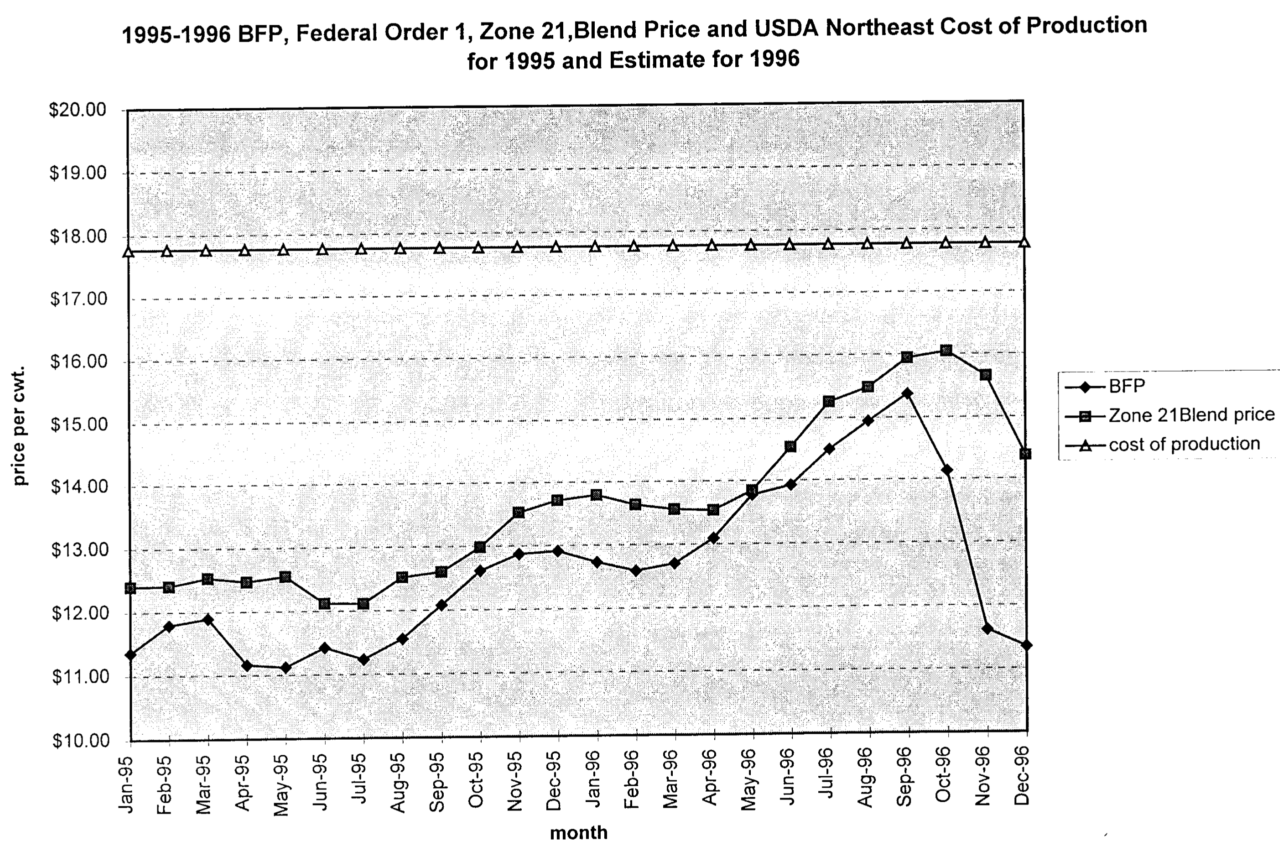
The Basic Formula Price is important to all dairy farmers nationwide. The basis for the calculation for the BFP should be connected to a pricing mechanism that is more reflective of market conditions. A pricing mechanism that has broader trading activity and oversight of this trading could restore dairy farmer confidence in the formulation of their milk price to calculate their milk checks.

Farmers must live like they are going to die tomorrow, but must farm as if they are going to live forever.

I thank you again for the opportunity to address you on this issue.

Basic Formula Price and the National Cheese Exchange
Monthly Average 40 lb. Block Prices 1996




1995-1996 BFP, Federal Order 1, Zone 21,Blend Price and USDA Northeast Cost of Production
for 1995 and Estimate for 1996
price per cwt.
$20.00
$19.00
$18.00
$17.00
$16.00
$15.00
$14.00
$13.00
$12.00
$11.00
$10.00
Jan-95
Feb-95
Mar-95
Apr-95
May-95
Jun-95
Jul-95
Aug-95
Sep-95
Oct-95
Nov-95
Dec-95
Jan-96
Feb-96
Mar-96
Apr-96
May-96
Jun-96
Jul-96
Aug-96
Sep-96
Oct-96
Nov-96
Dec-96
month
BFP
Zone 21Blend price
cost of production

NATIONAL SURVEY OF CHEESE PRICES

Senator SPECTER. Senator Leahy has questions.

Senator LEAHY. I wonder if I might, Mr. Chairman. I appreciate this, because I think that Mr. Howrigan is going to have to leave right after for an airplane. I would note—and his whole statement is in the record—he makes a point that we should all think about. In here, he says farmers must live like they are going to die tomorrow, but must farm as if they are going to live forever. And in your State, my State and all others, that is the case.

And to the extent that governmental policies can give some sort of predictability, I think we should. This chart next to me, Harold, shows that not once between 1974 through 1993 did any trading on the Exchange account for more than 1 percent of total cheese production. But the Department of Agriculture accords prices found on the Cheese Exchange a significant amount of weight. These tiny amounts of trading carry a huge, disproportionate amount in triggering the prices.

Now, Secretary Glickman has said that he will work with us to devise a better option for replacing it. Senator Jeffords and I made a proposal to him. We suggested that they do some kind of an online random thing, like the New York Times Best-Seller List does. They do not go to the same bookstore every time to check which books are selling, because it would be very easy just to manipulate that by the publishers just going in and buying those books. They go random.

Do you think something like that, a national survey of cheese prices, random, electronic, weekly, mandatory, could give a price that represents the market, rather than something that could be really open to manipulation because of the tiny amounts?

Mr. HOWRIGAN. I think, Senator, it is very obvious we need a broader and more responsible mechanism and pricing reporting that would truly reflect its actual value of the milk that goes into it.

Senator LEAHY. Would you say that, in your membership, that is a pretty universal feeling?

Mr. HOWRIGAN. It appears to be. It certainly is in our area. The farmers are very concerned and frustrated when they lose 25 percent of their income in a couple of months' time.

Senator LEAHY. Well, you had milk prices shot up in September, fell through the floor in December, got to rise a little bit again now. Obviously, that kind of a yo-yo situation does not help anybody. It does not help the consumers and it does not help the producers. Do you think that there is a connection between that and the Cheese Exchange?

Mr. HOWRIGAN. There is certainly a strong suspicion of that. And our bankers get very concerned when our prices go to heck. I will tell you.

Senator LEAHY. I bet they do.

Thank you, Mr. Chairman. I appreciate the courtesy of letting Mr. Howrigan go first.

Senator SPECTER. Well, thank you, Senator Leahy. We are glad to accommodate him on his plane schedule.

Mr. Howrigan, do you have any suggestion as to what might be done in the short run, immediately, to help farmers on this terrible problem they are facing?

Mr. HOWRIGAN. Well, there was a lot of discussion earlier with the Secretary and Mr. Collins and Mr. Dunn, and you had some very good questions, Senator. And I would hope that they would act forthwith, and provide some of that immediately. I think flooring that basic price would go quite a long ways.

Senator SPECTER. Well, we are going to call up all those sales tomorrow and see what that shows. I do not think it is up to the statisticians. I think it is up to the policymakers. That is my idea in public policy.

Mr. Howrigan, we thank you. And if you have to catch a plane, we will understand your departure.

Mr. HOWRIGAN. We thank you very much, Senator.

Senator SPECTER. And, Senator Leahy, if you have to catch a plane, we will understand your departure.

Senator LEAHY. No; I am just going to make sure I get Harold to the place where he has to go.

Senator SPECTER. If you do not have to catch a plane, Senator Leahy, we will still understand your departure. [Laughter.]

Senator LEAHY. Mr. Chairman, I know that I am in my mother's arms as long as you are here.

Senator SPECTER. Thank you very much.

Senator Cochran has asked me to chair the meeting. I am not only the next ranking in seniority on the subcommittee, I am the only person left.

So let me turn now, in order of listing on the panel, to Mr. Arden Tewksbury, manager, Progressive Agriculture Organization, a man I have known for many, many years, and a very strong advocate of the dairy farmer.

Mr. Tewksbury, the floor is yours.

STATEMENT OF ARDEN TEWKSBURY, MANAGER, PROGRESSIVE AGRICULTURAL ORGANIZATION, PENNSYLVANIA

Mr. TEWKSBURY. Thank you, Senator Specter.

I do have a prepared statement that has been circulated, and I understand will become a part of the record.

Senator SPECTER. Your full statement will be made a part of the record, without objection, as will all the full statements.

Mr. TEWKSBURY. Thank you.

I guess I will then center my remarks around observations I had both in my remarks and what I have heard today. I have to tell you that I am very disappointed on many things I have heard today so far. You and I both were at the meeting at the college, where our records show 750 people were there. We did hear remarks that attempts would be made in the very near future to raise prices to the dairy farmers.

Evidently many have long-term and short-term memories. We know now the basic formula price fell by $4.03 in a short period of time, and people are talking as if this never happened before. Yet, as I check my records, in 1989 through 1990, I find the same prices fell $4.25 per hundredweight in 1 year's time to our dairy farmers all across the United States. We did not have the basic formula price at the time. We had what was called the M–W series price, which tied all of our milk prices together, and they fell that time also.

So history now has repeated itself as to what happened just 7 years ago.

The M–W, as a replacement for the basic formula price, in my opinion, would be no real improvement, because this happened back then. And I surveyed the M–W pricing back about that time and found out, as we have heard today, it was a very small portion of the milk, grade B milk, produced in the upper Midwest. And of the milk that was produced, it was probably less than one-half of that milk that was surveyed to see what the prices were being paid to the dairy farmers by those processors.

And I think we are completely on the wrong track of trying to produce milk in the United States. Now, I know we are probably trying to step a couple steps above and beyond the scope of this hearing. But if we are going to deal with the problems we have facing dairy farmers, we must elicit all viewpoints as to what is the problem and what needs to be done.

We have a very, very serious short-term problem here in the United States for our dairy farmers. Of course, I have got to admit that I really have not heard any reputable solution to it today. And then we have a long-term problem.

Now, I have been told over and over again lately that if enough Senators, including yourself and others—30-some—and some 30-some secretaries of agriculture—would petition the Department of Agriculture, we could expect to have the basic formula price raised to a level of $13.50. Evidently, all the people across this country that circulated that remark were not hearing what really was going to happen. But we certainly heard today there is no movement afoot, on a short-term basis, to raise the basic formula price 1 cent per hundredweight, let alone to the level of $13.50.

I have not heard anybody say today, as they have been talking about milk prices, that the cheese prices on the Green Bay Cheese Exchange have stayed stagnant for 3 straight weeks. And the barrel prices went down 1 cent last week, which would indicate probably the block prices will not go up tomorrow. So that means we have 4 weeks of cheese prices not going up in this country, and will not affect the prices paid to dairy farmers any more than where we are today.

It is strange that this has been omitted.

Now, if we are going to give dairy farmers some income, we have to raise prices. We have got to raise prices to them. It has got to be done one of three ways. We thought the Secretary did have the authority to do it without going through the hearing procedure. And what he said today is exactly what he said on December 19, that it would take 6 months to do it. Well, that is 6 months from December 19. Now it is 6 months from today, which is now 9 months from December 19.

At the same time, in Pennsylvania, the producers that we are representing, we know the average dairy farmer is going to lose—and our testimony proves that—is going to lose about $26,000 in gross income. The dairy farmers in Pennsylvania are going to lose $280 million of gross income in 1 year's time. The economy in

Pennsylvania, in our estimation, will be adversely affected by $1.9 billion, just in Pennsylvania alone, with this decline in milk prices.

If the Secretary—and I hear nothing today—is not going to be able to raise prices, raise the basic formula price, I would have to enlist the support of the U.S. Congress to step in and either raise the basic formula price to the level we have advocated the Secretary to do. Our suggestion, of course, as it has been and will continue to be, is $15 per hundredweight. We would buy into a $13.50 on an interim basis until we got this situation resolved.

And I am sorry the Senator from Vermont had to leave, because our second alternative then would be to do what was done in the U.S. Senate in the spring of 1991. And that was to raise the class I differentials on all milk, fluid milk across the United States, by $3 per hundredweight.

And I would urge the Congress to consider stepping in and doing that method. Because my concern is just as keen for the farmers in California and Wisconsin as they are in Pennsylvania. And we would have to pool that $3 nationally to all dairy farmers. And I have talked to the Dairy Division of the USDA, and they said, yes, it can be done—some problems, but it could be done.

Now, in Pennsylvania, the gallon price of milk in our area has now gone from $2.29 to $2.35. We have recaptured 6 cents of the 46-cent drop that hit us in the last 3 or 4 months. Consumers—I have talked one-on-one with 4,000 consumers in the last 2 months—and outside of two of them, every one of them supports what we are trying to do.

I am also concerned that if milk per gallon is selling for $2.35 in northeastern Pennsylvania, why is that same milk selling for $3.55, $3.56, and $3.59 per gallon in Orange County, CA? Maybe it is time, if we are going to keep this manufacturing price as the mechanism to price milk, that we should not only include the wholesale price of our dairy products, but include the retail price of products into a formula that would more adequately give a price to our dairy farmers.

Because our survey also finds that in northeastern Pennsylvania, I can buy top-quality butter for $1.55 a pound. My son did a survey in California yesterday for me, and we found a national brand butter selling in Orange County, CA, for $2.99 a pound. Now, it would be awful nice if we capture some of those retail dollars back into the hands of our dairy farmers.

I also went across the Delaware River in Port Jervis, NJ, and I found that same butter selling down there for $2.99. So it does not matter if it is on the east coast or the west coast, this national brand butter is commanding $3 a pound.

Now, if this is a way that the predecessors to this panel are saying the free market works, it sure as the Devil does not work to the benefit of our dairy farmers. If it did, then why did we see, in 1996, the price of butter on the Chicago Mercantile Exchange go from 80 cents a pound on January 5, 1996, up to $1.50 in June 1996, at the same time the raw milk product price went up only $1.05 per hundredweight, which was a tremendous windfall for somebody in the butter business? I do not know who made the money, but the consumers got raped and the dairy farmers got gouged on a pricing mechanism like this.

So, in essence, what we are saying, Senator, is in the short-term situation, one option has been declined today because the Secretary has very clearly announced to us that he cannot raise the milk prices on the basic formula price without a hearing. And if we went through all that, it may take 6 months. That is not what farmers are waiting to hear.

The second alternative is, can the U.S. Congress step in and do that? And third, if they can do that, will they step in and do what you did in 1991, when 60 Senators voted to raise the class I differential, including you and the late Senator John Heinz, by $3 per hundredweight, and pool that milk across the United States to get some money into the hands of our dairy farmers?

PREPARED STATEMENT

Senator SPECTER. We thank you very much, Mr. Tewksbury.

When you say you are disappointed, so am I. I think that at least we could get an answer on the cheese issue, should have gotten an answer on the cheese issue a long time ago.

I will have some more questions for you, but we are going to go through the rest of the panel at this time.

[The statement follows:]

PREPARED STATEMENT OF ARDEN TEWKSBURY

My name is Arden Tewksbury, I own and operate a dairy farm in Meshoppen Township, Wyoming County, state of Pennsylvania.

I have been operating my present farm since October 1957.

In addition to operating my dairy farm, I am the consulting manager of the Progressive Agricultural Organization. (Pro-AG).

Pro-AG was formed in February 1991, following the severe pricing crisis that faced dairy farmers in 1990–91. Pro-AG has membership in Pennsylvania, New York and New Jersey. We work very close with the National Family Farm Coalition located in Washington, DC. The Coalition has membership in approximately 35 states.

My appearance today is being made on behalf of the Progressive Agricultural Organization, and the thousands of dairy farmers that we have met with during the last few months.

I want to recognize the quick response that Senator Cochran, Senator Specter and other Senators on this Committee have illustrated by calling this special emergency hearing.

Mr. Chairman, in late October 1996, it became obvious to Pro-AG that dairy farmers, once again were going to be seriously victimized by an inadequate milk pricing formula.

I have been, and will continue to be very critical of the farm organizations across the United States for not working closer together in an attempt to ward off the serious decline in milk prices paid to all dairy farmers.

On December 19, 1996 I attended a special meeting along with other organizational leaders, that was called by the U.S. Secretary of Agriculture, Mr. Dan Glickman. At that meeting, I urged the Secretary to establish a floor under the basic formula price of $15.00 per cwt. (on all milk). I was astonished at suggestions that were made by leaders of our milk cooperatives to floor the basic formula price at $13.00 per cwt., on Class I and Class II milk only. At the meeting with the secretary, I urged him to come into Northern Pennsylvania and observe the mood of our dairy farmers.

Since December of 1996, Pro-AG has held nearly 20 meetings with farmers and business people to explain the decline in milk prices, and attempt to find out from dairy farmers how they feel regarding short term, and long term solutions to the milk pricing dilemma the dairy farmers are facing. Over 2,000 dairy farmers and business people attended these meetings. In addition, nearly 300 people attended a Dairy Farmers Rally with Senator Rick Santorum. At all of these rallies, the dairy farmers voted overwhelmingly to support a new milk pricing formula that would relate to the average cost of producing milk. In other words—establish the value of milk at the farm level.

On February 10, 1997 a dairy farmer rally was held in Keystone College, La Plume, Pennsylvania, 10 miles north of Scranton, PA. This meeting was called by our distinguished Senator from Pennsylvania Arlen Specter. Everyone in North Eastern Pennsylvania was pleased that Senator Specter brought with him U.S. Secretary of Agriculture Dan Glickman. Never before had our area had the presence of a U.S. Senator and U.S. Secretary of Agriculture on the same podium.

A crowd of at least 750 people turned out for the rally at 8:30 AM. Many at the rally were consumers. These consumers came to support the dairy farmers. Both Senator Specter and Senator Glickman announced they were there to hear from the farmers, and, they certainly did hear from the farmers.

Some of the key points made at the rally were:

1. Dairy farmers are in a serious milk pricing dilemma.
2. Dairy farmers want the basic formula price floored at $15.00 per cwt.
3. Dairy farmers need a blend price paid to them of $16.00 per cwt.
4. Consumers were supporting the dairy farmers 100 percent.
5. Consumers announced they would pay more for milk and milk products, providing the additional funds went to the dairy farmers.
6. On a long term basis—once again, the dairy farmers wanted their milk priced on the average cost of production.

Mr. Chairman, it is now nearly three months since the first meeting with Secretary of Agriculture, Dan Glickman. Something now has to be done to improve prices to dairy farmers.

While this hearing is being held mainly regarding the continued inclusion of the National Cheese Exchange as a component of the Basic Farmer Price; we have sever reservations regarding any other cheese pricing points that will influence the basic formula price enough to have a positive effect on the prices paid to dairy farmers.

For instance—The most recent National Exchange price announced was $1.32½ cwt. per lb. The Wisconsin Assembly price was between $1.32–$1.35½. Obviously these types of prices will not raise prices to dairy farmers.

In addition to the National Cheese Exchange, the M–W price series is still a main component of the basic formula price. The M–W Series only represents a very small portion of the milk produced in the United States. The M–W is the price paid by processors to Grade B producers in the upper Midwest. Five years ago, I did a survey of the M–W Series. I found out that there was less than 5 billion lbs of Grade B milk in the M–W area and approximately 2½ billion lbs of milk was surveyed for the determination of the prices paid to dairy farmers. Certainly, dairy farmers will never receive a fair price for their milk, unless there are enough changes in the components of the Basic formula price.

We are estimating the average dairy farmer in Pennsylvania will loose $25,970 between October 1996 through September 1997. The comparison price we used was September 1996.

Mr. Chairman, attached to our testimony are three charts: Chart No. 1 illustrates the decline in milk prices; Chart No. 2 illustrates the predicted losses to dairy farmers shipping milk under the provisions of federal milk marketing Order No. 2 (NY-NJ); and Chart No. 3 illustrates Class prices in Order No. 2 for different periods of time in 1996.

The chart also illustrates the blend price that would be achieved by Pro-AG's proposal, the Commissioner of Agriculture's proposal and the proposal made by National Milk Producers on December 19, 1996.

All quoted prices are generated from various stated basic formula prices. Final prices reflect prices that would be paid to Order No. 2 producers.

The gross dollar loss to the dairy farmers in Pennsylvania will be approximately 280 million dollars for one year. However, the economic loss to the rural areas in Pennsylvania will be 1.9 billion dollars. Imagine what these figures come to on a National level.

SHORT TERM SOLUTIONS

1. The Secretary of Agriculture should, if he has the authority, place a floor under the basic formula price of $15.00 per cwt. for an indefinite period of time.
2. If the Secretary can not establish the floor price, then Congress should take the appropriate steps to establish the same floor.
3. If suggestion numbers one and two are not followed, then Congress must take action and raise the Class I differentials in all federal milk marketing orders by $3.00 per cwt. for an indefinite period of time.
4. If cheese prices are continued to be used then the formula must represent the retail value of cheese as well as the wholesale value of cheese. The same would be true of butter prices.

LONG TERM

Mr. Chairman, the time has now arrived when we must review other ways of pricing milk to our dairy farmers across the United States.

We strongly feel the value of the dairy farmers milk must be established on the actual cost of producing milk.

The USDA currently surveys the cost of production by several regions across the United States.

Three main components make up the cost of production: 1. Cash Cost; 2. Return on investment; and 3. Unpaid labor.

The manufactured value of milk could be established by using the cash cost-plus an adequate return on investment.

The value of fluid milk could be established by using the cash cost plus the return on investment plus a fair figure for unpaid labor.

In our estimation, this formula would return a pay price to our dairy farmers of nearly $16.00 per cwt. Different organizations will be submitting a detailed copy of this formula to the USDA during the next two weeks.

GENERAL OBSERVATIONS

1. I can buy top grade butter in Meshoppen for $1.55 per lb. Yet, I go to a Shop-Rite store in Port Jervis, New Jersey and find a National Brand butter selling for $2.99 per lb. What's going on?

2. I can go into Meshoppen and purchase American cheese for $2.00 per lb. Yet, I can go to other stores and find National brands of cheese selling for $4.00 per lb. This is very confusing.

3. During February 1 gallon of milk was selling for $2.29 per gallon in Northeast Pennsylvania yet, in many stores in Elmira, Horseheads, Corning and Binghamton, New York stores, milk was still selling as high as $2.75 per gallon in some super markets.

4. In Orange County California, milk is selling for nearly $4.00 per gallon.

5. On January 5, 1996 the Chicago wholesale price of butter was $0.80 per lb. By late June of 1996, the price went to $1.50 per lb. At the same time the raw milk price used for butter went up $1.05 per cwt. Something is wrong.

These observations are only a few of the many inequities facing dairy farmers and consumers.

Mr. Chairman, the time has come to take the speculation and manipulation out of milk prices.

Dairy farmers and consumers are highly recommending the time has arrived to price milk on the cost of producing milk at the dairy farm.

Thank you.

CHART 1.—*Prices received by dairy farmers under Federal Order No. 2 at the 200–210-mile zone*

Basic formula price:	
September 1996	$15.37
October 1996	14.13
November 1996	11.61
December 1996	11.34
Decline	−4.03
Class III price:	
September 1996	15.43
October 1996	14.19
November 1996	11.67
December 1996	11.40
Decline	−4.03
Class I price:	
November 1996	17.79
December 1996	16.55
January 1997	14.03

February 1997	13.76
Decline	−4.03

Blend price:	
September 1996	15.81
October 1996	15.62
November 1996	14.87
December 1996	13.79
January 1997	[1] 12.56
February 1997	[1] 12.65
Decline	[1] −3.16

[1] Estimate.

CHART 2.—GROSS DOLLARS LOSS PER FARM

[Compared to September's 1996 price of $15.61 per cwt.]

Month	Blend price	Loss per hundred weight	100,000 lb. producer per month	50,000 lb. producer per month
October	$15.62	$0.19	$190	$95
November	14.87	.94	940	470
December	13.79	2.02	2,020	1,010
January	[1] 12.60	3.21	3,210	1,605
February	[1] 12.61	3.00	3,000	1,500
March	[1] 12.81	3.00	3,000	1,500
April	[1] 13.20	2.60	2,600	1,300
May	[1] 13.31	2.50	2,500	1,250
June	[1] 13.31	2.50	2,500	1,250
July	[1] 13.52	2.29	2,290	1,145
August	[1] 13.60	2.21	2,210	1,105
September	[1] 13.70	2.11	2,110	1,055
12-month loss			25,970	12,985

[1] Estimated blend price.

CHART 3.—FEDERAL MILK MARKETING ORDER NO. 2

The highest blend price that Order No. 2 producers received was for September's 1996 milk, $15.81 per cwt.

Below are the class prices of milk that achieved the $15.81 September 1996:

Class 1	$16.91
Class 2	14.79
Class 3	15.43
Class 3–A	15.91
Blend	15.81

The highest class prices in 1996 were:

November:	
Class 1	$17.79
Class 2	15.67
September: Class 3	15.43
July: Class 3–A	16.04

Pro-Ag's proposal—floor the basic formula price at $15.00 per hundred weight:

Class 1 price	$17.42
Class 2 price	15.30
Class 3 price	15.06
Class 3–A price	12.00
Blend	15.72

State commissioners of agriculture's proposal—basic formula price $13.50:

Class 1	$15.92

Class 2	13.80
Class 3	13.56
Class 3–A	12.00
Blend	14.30

Co-ops proposal—basic formula price $13.00 (on class 1 and 2 milk only):

Class 1	$15.42
Class 2	13.30
Class 3	12.10
Class 3–A	12.00
Blend	13.45

STATEMENT OF KENNETH E. ZURIN, DAIRY FARMER, MOUNT JOY, PA

Senator SPECTER. I would like to call now on our distinguished Pennsylvania farmer, Mr. Ken Zurin, from Lancaster. Mr. Zurin, the floor is yours. Thank you for coming.

Mr. ZURIN. Thank you, Senator, for inviting me. I agree with Mr. Tewksbury, and pretty much everything that he says here, but I am just a farmer. I only found out Monday night that I was invited down here, and I did not have a lot of time to get a lot of the numbers together. But my wife and I, she is in the audience back here, we own a herd of 300 dairy cows which gives a total of right around 6 million pounds a year. And also, by the way, we milked cows this morning at 3:30 before we came down here.

The dairy industry is in a difficult situation. The BFP does not work. The price of milk, like they said, dropped from the $16 range down to the $12 range in a little less than 4 months' time with record high feed prices, and I do buy some feed. This drop in milk price alone costs me just a shade over $20,000 a month for 4 months. So that is not too hard to figure. That is $80,000 I was out. And that is not even figuring the higher cost of feed. This gives us a financial crisis in the dairy industry. We need a more stable market, like everybody was saying here, like most other businesses.

Prices in 1996 compared to 1995 were 13 percent higher for milk. Now, that sounds well and good. But the feed prices were 26 percent higher in 1996 compared to 1995, which my feed prices make up over one-half of my production costs, and I came up with this. If I were to pass this on to my two sons, this farm, I do not think I would be doing them a favor.

Now, you want a quick fix? I do not know what to tell you about a quick fix other than like Mr. Tewksbury said, you know, have the Congress put a $2 or $3 increase on us. That would be very nice. But I talked to a couple of neighbors around my place there, my dairy farm, and we were talking here the other evening and I said how about it if we would have just a class I and a class II price? All Class I price is all human consumption product. I do not care if it is fluid milk, ice cream, cheese, or whatever. And then butter, also in that.

Then class II would be dry powder milk or anything else, anything used for animal feed, dogfood, catfood, you know, anything like that. And then let supply and demand set the price. Now, that is going to take time to do that. It is not going to be a quick fix, but I think over time, I think that would work.

Now, we are going to have to set the country off in about 8 or 10 orders or regions, whatever you want to call them. I, myself, think that would work, because every region in the country has separate or different costs to produce milk. Where I am at I have land right around me selling for $7,000 and $8,000 and $9,000 an acre. But you go out to Wisconsin, why, that sells a good bit cheaper. So their production costs are not quite as high as what ours are in here, and we have the population here where we can sell our product.

That is about all I have.

PREPARED STATEMENT

Senator SPECTER. OK, Mr. Zurin. We appreciate your coming down. When you got up at 3 o'clock in the morning to milk the cows and came down here, we understand that is not easy. Thank you for being here.

Mr. ZURIN. And that is every morning.

Senator SPECTER. What time do you go to sleep?

Mr. ZURIN. Well, it was 11:30 last night.

Senator SPECTER. You are a good man, Mr. Zurin.

[The statement follows:]

PREPARED STATEMENT OF KEN ZURIN

I am Ken Zurin from Lancaster County, PA. We own a herd of 300 dairy cows which give us a total of about 6,000,000 lbs. of sellable milk per year.

The dairy industry is in a difficult situation. The B.F.P. does not work. The price of milk dropped from the $16.00 range down to the $12.00 range in four months time with record high feed prices. This drop in milk prices alone cost me $20,000 per month not even figuring in the higher cost of feed. This gives a financial crisis in the dairy industry. We need a more stable market like most other businesses.

Prices in 1996 compared to 1995 were 13 percent higher for milk in 1996 than 1995, but feed prices were 26 percent higher in 1996 and feed costs made up over half of the cost to produce milk.

If I were to pass the farm over to my two sons, I do not think I would be doing them a favor at numbers like these.

Alternatives:

The B.F.P. will not work with the N.C.E. (National Cheese Exchange) setting the price because very little cheese is sold on the exchange. I think we should have 8 Federal orders in the United States—Have Class I and Class II. Class I would be all dairy products for human consumption (except dry powder milk). Dry powder milk and anything else would be Class II. Then let supply and demand set the prices.

STATEMENT OF BUCKEY M. JONES, BOARD OF DIRECTORS, MID-AMERICA DAIRYMEN, INC., MISSISSIPPI

Senator SPECTER. Now we will turn to Mr. Buckey Jones, board of directors of the American Dairymen. Thank you for joining us, Mr. Jones. The floor is yours.

Mr. JONES. Thank you, sir. I am Buckey Jones, dairy farmer from Mississippi, on the Corporate Board of Mid-America Dairymen. I understand I have got 5 minutes. I sincerely believe you should handicap us guys from down South that talk so slow and give us 6 minutes. I would have brought two of my assistants——

Senator SPECTER. Mr. Jones, you have 6 minutes.

Mr. JONES. Thank you. [Laughter.]

I would have brought two of my assistants to help me, but I was afraid you may get on them like you did the Secretary's assistants. And so I left them milking the cows and feeding the calves.

Senator SPECTER. You thought I got on them, did you?

Mr. JONES. Yes, sir.

Senator SPECTER. You ain't seen nothin' yet. [Laughter.]

You ought to see if we were in a courtroom. [Laughter.]

Mr. JONES. I am glad to hear that milk is $4 a gallon in California. It gives us hope to get it up to about what it is worth, which is about $6 a gallon.

The National Cheese Exchange, I guess, is the topic that we are here to discuss today, and I sincerely believe, as we look at the entire structure of the National Cheese Exchange, that it is one small portion of the problem, and maybe it is not the problem at all. As we look at the structure of the dairy industry since 1990, we have certainly seen dramatic changes. I think the authors of the 1990 farm bill told us to expect extreme gyrations in the market, and as far as that is concerned, we certainly have not been disappointed, because we have seen some extreme fluctuations in the market.

But on the National Cheese Exchange, the charges are that very little cheese as a percentage of the whole is traded there. But I would like to suggest to you if you look at the players on the National Cheese Exchange, those players—Kraft, Simplox, Land of Lakes, AMPI, Mid-America Dairymen, Beatrice, whoever—they do in fact buy and sell and produce and market most of the cheese in the country.

So it is a reflection of what the market is, the cheese market, and as we in the South look toward the cheese market, we do not see that there is a bugger under every rock, and that there are people in the cheese exchange that have some strong desire to destroy the industry or anything of that nature. As a whole, I think the National Cheese Exchange has the support of the industry.

But I would like to raise a question today, if I may, that somewhere in the process decoupling class I milk from the cheese price and having cheese control the fluid milk price in this country, which amounts to about 42 percent of the production in the country, is somewhat out of sorts as we look to the future of a changing industry.

People in Florida, for instance, have a very hard time trying to understand why their milk would drop in price by 25 percent because the cheese supply in Idaho, which is almost 3,000 miles away, is in abundant supply. Some people note that to be sort of like showing up at kindergarten when you are 6 years old and having to stand in a corner for 3 days with your nose to the board because your sister broke a window pain 6 years before. It is just two things that do not correlate.

Can it be done? I sincerely believe with the wisdom of the dairy industry in this country and the wisdom of the Congress, we can have a system whereby fluid milk can be separated from the cheese price, and therefore to some extent cushioning the industry from the volatility and the frustration of fluctuations that we have had in the last 4 months. There is really no good reason to base fluid milk prices on the cheese price. There is just no good reason to do it.

We have had, in the fall of 1996, the highest milk prices for the consumer in my area of the world that we have ever had, and yet sales continue to grow. Are the consumers bucking or rejecting the milk prices, or milk because the milk price is too high? The truth is that sales have continued to grow. So therefore, I say to you in all sincerity, if we dairy farmers want more money out of the market, and we want more money in our check, we need to go to that market and claim it for ourselves.

I say sincerely that there is just really no good reason to price fluid milk because Idaho, California, Minnesota, and Wisconsin happen to produce most of the cheese and let Idaho, Wisconsin, California, and Minnesota set the price for the entire dairy industry. Can we convince the other 46 States that the cheese prices set the fluid milk prices? I doubt it. Because of this, I think that the 30-percent value that we lost last year because of cheese prices was something that farmers had in their hand and lost, and they should not have lost it.

This was a time when we were scrounging all over the country in my part of the world just to get enough milk for the fluid market. In my area of the world, the production is approximately 12 billion pounds of milk. The market for milk and dairy products in that part of the world is over 15 billion pounds. We gave up years ago all the hard product market, but our consumers deserve a wholesome, fresh source from fluid milk, and they deserve it locally.

If you look at the record, and I am a history major so I believe in what goes on in history, the highest priced milk anyone in Mississippi ever drank was not that high-priced class I differential milk that was produced in Mississippi, but that milk we brought from outside in the fall to fill the market that we did not have milk for. So if milk is such a rare commodity in the Southeast and if you think the price is too high, I invite you down to start a dairy. There are a lot of them for sale because of this cheese price.

Somewhere in this arena I think that we all have to step up and say, as the Secretary said, this is an antiquated system that we have, and now is the time to change it. And we have a golden opportunity, I think, at this point in time to do that very thing as we look to the future as dairy farmers.

Class I price separated from the cheese price is not an impossible task. It can be done, and I think we can do it. Somewhere, we all must realize, every one of us dairy farmers must realize, that parity was a wonderful thing, but parity today would be about 27 bucks a hundredweight, and someone should calculate for me really quickly how much milk we would have in this country at $27 a hundredweight without some kind of production control.

So with the lack of production control and the lack of parity, we must all realize that the cost of production plus whatever dairy farmers are willing to settle for as profit, plus the hauling and the freight, will eventually set the market for the system. The Federal order system, in my opinion, has worked well. It is not perfect, but we do not need to scrap it.

Senator SPECTER. Mr. Jones, could you summarize? I have just been advised that the majority leader wants to close the floor by 6 o'clock, and I have to be back on the floor for another matter.

Mr. JONES. I have two more points.

Senator SPECTER. OK.

Mr. JONES. I think if we look at what Rich McKee put out this week for class I pricing options, I think that here again we see an example of continuing to base everything on a cheese price. Some of those options have some validity, but we still believe that separating class I from cheese is the way to go, and we will support that, and our co-op supports it wholly and it has a considerable amount of support throughout the other cooperative systems.

Let me say that our cooperative supports exports and the export programs, and we believe sincerely that 10 years from now the American dairy market will dominate the world market because of our abilities and what we can do on an annual basis. Even though we cannot compete with the coffers of the European Common Market, we can compete once those subsidies are reduced.

Senator Cochran mentioned the seasonal base plan that is so important to the Southern producers, and I sincerely hope that we can reinstate or at least get some messages back to the Congress that the seasonal base plan is, in fact, a good thing for the Southeast. It is good for the consumers because they are the ones that ultimately pay the price that we all receive.

Let me say that I sincerely appreciate the opportunity to visit with the committee, and I sincerely hope that somewhere in this arena that we dairy farmers, only less than 100,000 Grade A dairy farmers in the entire country, we could all get into the University of Tennessee football stadium and have room left over, and yet we go around shouting at one another going in 1,000 directions. Sometime we have to come to the conclusion that the dairy industry can work together and get at it.

Thank you.

PREPARED STATEMENT

Senator SPECTER. Thank you very much, Mr. Jones. We appreciate your testimony. Your statement will be made part of the record.

[The statement follows:]

PREPARED STATEMENT OF BUCKEY M. JONES

I am Buckey Jones, a dairy farmer from Smithdale, Mississippi. I appreciate this opportunity to appear before this subcommittee today and discuss some of the issues that face our nation's dairy farm families. I am a member of Mid-America Dairymen, Inc., a milk marketing cooperative with approximately 18,000 members in 30-plus states. I am a member of the Mid-Am Corporate Board of Directors.

Much has been said and written about the National Cheese Exchange in the last few weeks. The NCE alone is not the problem. It merely reflects the market conditions of the cheese market. Over time it is a barometer of the market conditions that exist. While a major percentage of the total cheese actually sold in the U.S. is not traded on the Exchange, the Exchange itself is made up of members who DO produce and market a very large percentage of the total cheese marketed. The Exchange is the major place in the country where buyers and sellers come together weekly to buy and sell cheese based on their estimates of the supply and demand in the market.

As the dairy industry has begun to deregulate, we have seen increased volatility in prices for all dairy products. (See attached graph) It is for this reason that we need to take a new look at the basis on which the different Classes of milk are priced. The price of Class III (milk used to make cheese) should be based on a product formula based on the cheese values. This should continue to be the data generated from National Cheese Exchange activity. If there is increased regulatory oversight of the Exchange, it should be by the Commodity Futures Trading Commission (CFTC). The price of cheese will ultimately set the price of milk used to make cheese. However, it is at this point that prices set for other Classes of milk should be disassociated from the cheese market.

Given the volatility and wild fluctuations in the dairy commodity markets the last two years, and given the inelasticity, consumption, and production of fluid milk, there is no good reason to continue basing fluid milk (Class I) and soft products

(Class II) on the price of cheese. These need to be decoupled from the commodity markets. Four states—Idaho, Wisconsin, Minnesota, and California—produce most of the American style cheese in the United States. Yet, these four states, by setting the cheese price and thus, the Basic Formula Price, set the price of milk for the rest of the country—even in areas of deficit production. (See attached graph of cheese prices versus BFP) For example, during the last 4 months of 1996, we experienced a decline of nearly 30 percent ($4.03 per hundredweight) in fluid milk prices. It was during this same period the region of the country that I live in was spending millions of dollars to purchase and transport milk into a deficit market. All of these dollars were not recouped from the market place, therefore dairy farmers paid part of the costs.

The concern about the general economic conditions our nation's dairy farms is so great that 31 Senators recently signed a letter to Secretary of Agriculture Dan Glickman and to President Clinton asking for a temporary $13.50 price floor as a basis of calculating Class I prices in the Federal and state orders. The letter had bipartisan support and I commend those Senators who signed the letter. This is a perfect opportunity, given the concern about the NCE, the general dairy situation, and the desire to reform the system, to actually decouple Class I from the cheese market.

As a basis for establishing Class I prices, we suggest a Supply/Demand adjuster using a 12 month rolling average compared to the previous 12 months rolling average and adjust prices $0.12 for each 2 percent change in Class I utilization. The Federal Milk Market Administrators should also be given the authority, under the informal rulemaking process, to make short term adjustments in Class I prices based on industry comments.

Butter and nonfat dry milk powder prices, such as the current Class IIIa should be used as the basis for a new class, Class IV.

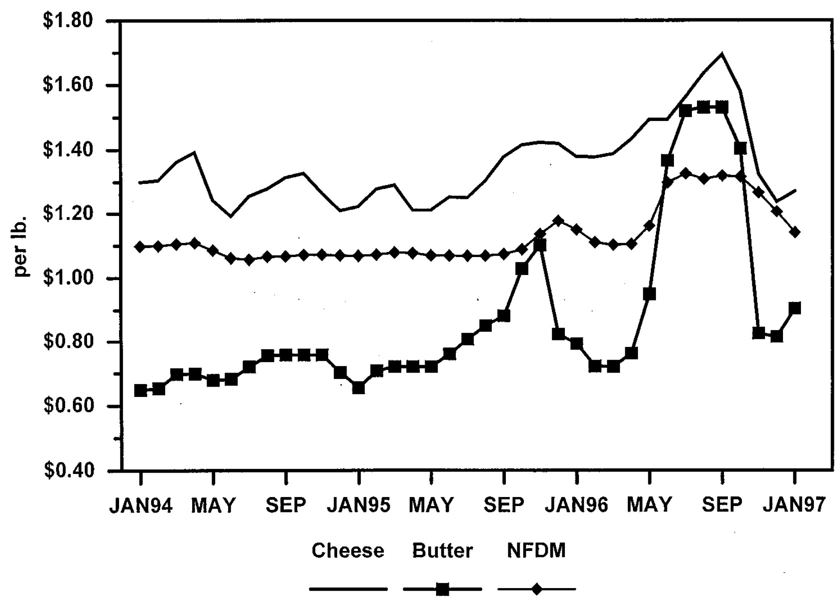
We need the ability to export dairy products in a competitive world dairy market environment, therefore, we would like to see an export class developed. I realize that many of these issues are to be taken up by the Secretary in the Federal order reform process, and are not the basis of any currently proposed legislation, but our position is one that we believe to be realistic and equitable.

I have also been asked to comment on the Seasonal Base Plan issue. Seasonal base plans are an appropriate tool for market orders to use in trying to achieve a more seasonally balanced milk supply. Base plans are not price enhancements but are a means of redistribution of proceeds to those who perform for the market by reducing spring production and increasing fall production, when milk supplies are traditionally tighter. We support reauthorization of Seasonal Base Plans.

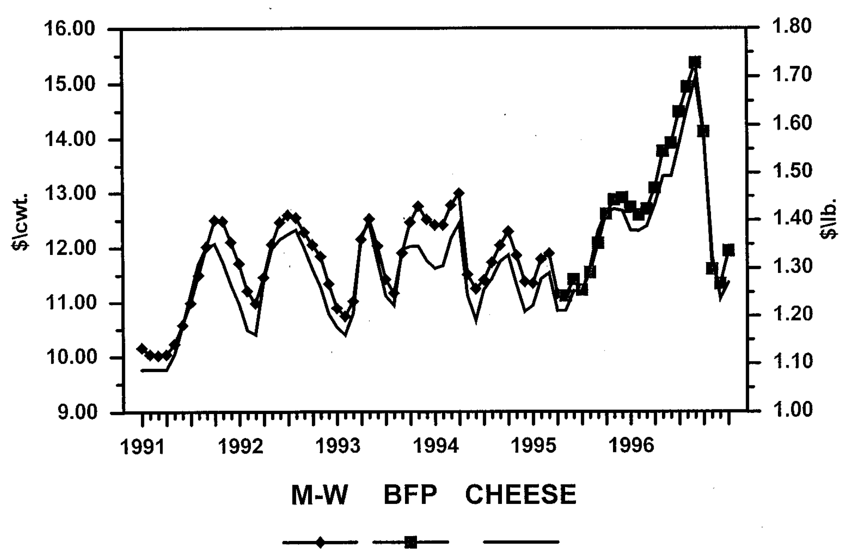
Federal orders have performed a vital function for farmers, processors, and consumers. We support the Federal order system and will work to aid in the reform process currently underway.

I thank the Chairman and Committee for this time and opportunity and will be happy to answer any questions that you might have.

Dairy Commodity Prices



MINNESOTA-WISCONSIN / BASIC FORMULA PRICE VS BLOCK CHEDDAR CHEESE



STATEMENT OF BILL BREY, PRESIDENT, WISCONSIN FARMERS UNION

Senator SPECTER. I would like to turn now to Mr. Bill Brey, president of the Wisconsin Farmers Union. Mr. Brey.

Mr. BREY. The comments that we have here today, and I thank you very much for this time constraint we are under, and I am from Wisconsin, I will have to talk twice as fast. So if you cannot understand it, I did apply it so it is in the record. I hope you accept it.

Senator SPECTER. It will all be in the record, Mr. Brey. We understand you fine.

Mr. BREY. What we are advocating is that the delinking of the National Cheese Exchange and the response of what Mr. Jones has talked about a little bit is that the regionalism that that causes, even though there was a shortage of fluid milk, the National Cheese Exchange priced all milk, so we recognize that, as he does, as farmers and dairy producers, that that is not a place because of the thinly traded to hang our hat on as far as receiving our production costs.

What we are talking about in the interim that you are urgently trying to find is that as dairymen and the 20 States belong to National Farmers Union, and as we get together as farmers we have a much different conception of how we want our milk priced to farmers as the industry uses the National Cheese Exchange as their place to price the milk. So the industry is not really—there is a difference there, and we are farmers, so we are here from one end or part of that that makes that industry. Without our sustenance the industry will no longer survive.

So from that side, one of the things that we would like to implement in this short-term price relationship is the production costs. And we can either use U.S. Department of Agriculture figures over the last 4 years, calculate them, average them, increase the inflation that is in there, or we can look at a price-to-feed ratio and put that as one component of a pricing system.

For example, it was talked about today that the basic formula price is moving up. But price-to-feed ratio also is, if you look at the chart, in October 1996 when we had the highest milk price, we also had the highest milk-to-feed ratios that gives us the profit that we need as dairymen to stay in business. But now, even though the basic farmer price is creeping up, our costs our outpacing it. So the cost of milk-to-feed ratio is 2.30, which is quite a bit different than the 2.89 back in October when we could take that feed and make a little money on it.

One of the other things that we think should be included in this mix is that wholesale price. It is based on a wholesale price from cheese manufacturers throughout the United States, and that is what the Secretary alluded to. But we need mandatory reporting so that it shores up, so that it becomes meaningful, and not based on what continues to happen on the National Cheese Exchange as basing that price from what the reporting is.

The other place that we are looking for is a retail price, and that was also alluded to by the farmers, the share in what happens out there. This, again, is current information that could be put together with a lot of phone calls quickly. That could come from the Bureau of Labor.

So here we have three different entities that would make this price of milk more reliable to the farmer. It brings the confidence back into the market by looking at 90 percent of the milk or better, and costs that are exchanged to get that milk or the profits derived from that milk, versus just looking at the National Cheese Exchange and trading 1 percent and saying that should be the same price for the milk fluid or whatever. It is not quite right.

Senator SPECTER. Mr. Brey, I do not understand your point. Are you saying there are some other prices we could look at besides the cheese price which could raise the price of milk?

Mr. BREY. Yes; to the farmer.

Senator SPECTER. Such as what? I do not understand.

Mr. BREY. One would be to look at the wholesale price and take that into a barometer, take the retail price, take that into—however it fits. I am not sure how it would fit. I do not have the answer.

Senator SPECTER. OK, you could do that, but there would have to be a total change by the Department of Agriculture on how they price milk.

Mr. BREY. Well, this is what can be implemented as we move into order reform as a new BFP, but it also gives us relevance to the urgency that you are asking and talking about.

Senator SPECTER. I think it is. I think it is. Proceed.

Mr. BREY. I mean, if one of the—if there is an idea that says that these—looking at where we get the information from the cheese is not accurate enough or it is not sure enough, I think if you put all these other ones and lay them together, whatever percentages that we want to put on them will give us a more timely benefit of them.

The other thing that was mentioned today is exchange trading. Again, it is too early. The announcement and the implementation of that is not even there yet. How can that be a barometer so urgently needed at this time. I think it has to see the participation and whatever that is going to be on that. So that is too speculative at that point, and with the influence of the National Cheese Exchange still being there, that is why it is thinly traded also at this time, because they always use the crutch that will get them to where they want to be at the most rapid rate.

The other thing is looking at economic formulas, I know USDA has called and put a committee together, or whatever, to put together a new basic formula price. But most of that early testimony was done before the crash of the cheese exchange. That was supposed to be in there. So some of that summation does not have any relevance of where we are today as producers in losing that $4 a hundredweight as producers losing it. So that should be reopened and maybe thrown out, or at least revisited so that it is more meaningful at the current time. I mean, times are changing that fast, and we have to be up to current and looking at what is happening now, not at something that happened prior to and assuming the National Cheese Exchange was going to be there as a pricer.

The other thing that we——

Senator SPECTER. Mr. Brey, could you summarize, please, at this point?

Mr. BREY. The other one is that the basic formula price has to be changed, and we hope that that could also be something that you could work on quite readily.

The last one is we are not necessarily removing the National Cheese Exchange, but as Wisconsin Senate passed the bill bipartisanly, 28 to 5, to bring about trading against interest law, that gives the indication that that is where the cheese exchange has to be done only on the national level also, so that it is not moved to another State and still creates the entity that it does in pricing all our milk.

PREPARED STATEMENT

And this is what we are trying to do to provide stability, not only to what the farmers have, but every time there is a spike or volatility in the market the consumer ends up paying also. And this is why we want to have more stability in the market, and that is why we are needed and we are very fortunate to be here today as producers on this panel. So thank you very much, Senator.

[The statement follows:]

PREPARED STATEMENT OF BILL BREY

Good afternoon. My name is Bill Brey. I am a dairy farmer in Sturgeon Bay, Wisconsin and I serve as president of the Wisconsin Farmers Union and on the board for the National Farmers Union. Thank you for the opportunity to discuss viable alternatives to the National Cheese Exchange. Replacing the NCE price as the main price setting component in the basic formula price is critical to restoring fairness and stability. My testimony today will address the position of the National Farmers Union on price reform and will also outline action that should be taken pending the reform.

POLICY OF THE NATIONAL FARMERS UNION ON PRICE REFORM

Ten days ago delegates to the annual convention of the National Farmers Union passed policy calling for the replacement of the National Cheese Exchange in setting the basic formula price. Delegates agreed that the most important factor in pricing milk should be the cost of production, the same factor that other businesses use in pricing their products. Delegates agreed that additional factors for calculating the formula price should include both wholesale and retail prices.

1. *Production Cost.*—There are several ways to measure production cost. One possibility is to use the cost of production figure calculated every four years and indexed annually by the United States Department of Agriculture.

Another viable possibility calls for basing the cost of production on the milk-feed ratio, i.e., the amount of feed a producer can buy for one pound of milk. This number is calculated on a monthly basis also by USDA. Using the milk to feed ratio would let the formula reflect the producers' bottom line. For example, many non-farmers would see that milk prices were higher in February of 1997 than the previous month and therefore assume producers were better off. However, the milk-feed ratio actually declined in February, indicating that feed prices rose faster than milk prices and so the producer was actually in worse shape in February than January.

The following table of the milk-feed ratio shows how producers have fared in the past six months. Keep in mind that producers do best when the milk-feed ratio increases.

Pounds of feed that can be purchased for 1 pound of milk

February 1997	2.30
January 1997	2.40
December 1996	2.61
November 1996	2.78
October 1996	2.89
September 1996	2.61
August 1996	2.27
July 1996	2.20

NOTE.—Calculations are based on a 16-percent dairy ration, and 3.67 test milk.

Source: USDA, NASS

The milk-feed ratio is especially critical to producers who are forced to purchase a large share of the feed they use. However, it should be emphasized that while cost of production is a critical factor in calculating the formula, it should not be the only factor used.

2. *Wholesale Price.*—The wholesale price will become available from the National Agricultural Statistic Service (NASS) in May of 1997, and will be announced for the nation as well as individual regions, on a weekly basis. It is based on the wholesale price from cheese manufacturers throughout the United States, and is expected to include over 90 percent of the nation's cheese. We commend Secretary Glickman for his decision to collect and publish this data.

3. *Retail Price.*—The retail price component could be based on the information collected by the Bureau of Labor, used for measuring the consumer price index (CPI). While some adjustments may be needed, we believe such data is properly part of the formula used to calculate dairy prices.

EXCHANGE TRADING

We are watching with interest the current effort of the New York Coffee, Sugar, and Cocoa Exchange (CSCE) to develop a cash market for dairy. This may provide an alternative to the National Cheese Exchange and has the potential advantage of oversight by the Commodity Futures Trading Commission. However, since this contract does not even exist yet, it is impossible to estimate its potential as a price indicator. And, even if the CSCE successfully develops its cash market, the price set there should not replace the cost of production factor as the key component in setting the producers' price.

USING AN ECONOMIC FORMULA

Of the alternatives we have reviewed, the economic formula proposed by University of Wisconsin Dairy Economist Ed Jesse is one of the few that uses the cost of production in calculating the producers' price. Jesse's model is based on 3 factors and reflects: (1) changes in the cost of producing milk, (2) disposable consumer income, and (3) prices for manufactured dairy products. We are optimistic that economic formulas, such as the Jesse proposal, are among the least affected by the NCE price and seem to produce a relatively stable producer milk price. We still have questions as to how the model might be adjusted to ensure it will yield a price that allows the dairy farmer to earn an adequate return while continuing to provide a stable supply of milk and dairy products to the consumer.

ACTIONS TO TAKE PENDING REFORM OF THE BASIC FORMULA PRICE

1. *Setting a floor.*—We commend Congress and the administration for enacting legislation calling for reform of the basic formula price. Such reform takes time, yet many producers need action now. For the short term, action should be taken to enact a temporary price floor under the basic formula price. Emergency action should assist producers in all regions, and should not be dependent on whether the milk produced on a particular farm or region is used for fluid, ice cream or cheese. In order to be fair, the price floor should be set under the BFP. If alternatively, a floor is set under only class I or II, national pooling should be used to ensure an equal distribution of the emergency assistance.

2. *National Cheese Exchange Oversight.*—As long as the National Cheese Exchange continues to be the biggest factor in setting producer milk price, the Commodity Futures Trading Commission should be directed to provide oversight of the NCE. In addition, Congress should enact a federal rule prohibiting trading against interest, a form of market manipulation. The Wisconsin Senate has passed a bill at the state level, although action is still pending in the Wisconsin Assembly. In the absence of federal legislation, the NCE can avoid regulation by moving to another state.

3. *Restoring Price Stability.*—In addition to replacing the current basic formula price, Congress and USDA should take action to rebuild market price stability. In the past years under the dairy support price program, producers and bankers could at least be certain of a price floor. With the enactment of the FAIR Act, the floor will continue to decrease, disappearing entirely by the year 2000.

While price volatility may benefit exchange brokers, it is only a detriment to producers and consumers. Wild price fluctuations make it needlessly difficult for producers to meet their cash flow needs and make it difficult for financial institutions to make loans. Volatility also harms consumers because the store price rises when the farm price rises but fails to come back down a proportional amount when the farm price falls. Congress should repair the safety net by reinstating the support price at a level that would at least prevent free-fall of producer prices and eliminate consumer price spikes.

CONCLUSION

Thank you for the opportunity to testify today. We look forward to continuing to work with Congress and the administration to ensure that there will still be family farmers supplying consumers with a wholesome and readily available milk supply in the future.

PRICE OF CHEESE LONG-TERM SOLUTION

Senator SPECTER. Thank you, Mr. Brey. The suggestions that you made, Mr. Brey, are useful ones. They are looking to a long-term solution, and what I have been looking to is not only a long-term solution but a short-term solution.

It is true that Congress could change the milk price. We can do lots of things here. If the President signs it, it is done. If he does not, we can override a veto.

And I understand what you are saying, Mr. Tewksbury, and I reluctantly say that it is highly unlikely that that is going to happen. We are not going to get a bill through the Congress. I have pushed hard on this price of cheese because that is an immediate factor.

Now, we did not hear when we were in Pennsylvania on February 10 that there was going to be a very small differential. We did not hear that, and I am not sure it is a small differential. I want to know what the facts are.

I am going to get those 112 people who count for 99.2 percent of the price of cheese, I am going to call them up, and I am going to ask Mr. Tipton, who is going to testify next, what questions I should ask them, because Mr. Collins did not—he went through a lot of things about the size and the bulk and the containers, but when I asked him what they were he said he did not know. That was up to the economists, the statisticians.

I think this is a matter of policy. It is up to the Secretary of Agriculture to establish what enough statistics are, and I had expected that if there was a sufficient evidentiary base—that is what I said in northeast Pennsylvania, a sufficient evidentiary base that we could get some relief here.

As Mr. Tewksbury said, he is disappointed, and so am I.

Mr. Tewksbury, pull the microphone over. We will give you the last word for this panel.

Mr. TEWKSBURY. Senator Specter, we have tracked some of the other cheese pricing points, and unfortunately we also are finding that they are not responding to any large increase over the National Cheese Exchange.

It is possible that the same players are playing in the other markets that are playing in the exchange, and maybe what we thought would raise the prices may not do it.

My question is, then—because I am asking a question now, instead of making a statement. If the Secretary cannot raise the price to our dairy farmers, and if Congress cannot or will not step in and raise the prices to our dairy farmers, and the cheese prices have now been stagnant for 3 straight weeks and probably will be for a fourth week tomorrow—we probably have seen the largest increase in the basic formula price we are going to have for a while—and our dairy farmers are facing these figures that I have given to you and other members of the panel have given to you, what do we tell our dairy farmers back home tomorrow as to what they can expect for the next 2 or 3 months, to have the prices go up?

Because January's milk, regardless of what anybody has been saying, was 81 cents per hundredweight less than it was in 1981. That is 16 years ago, and we paid billions of dollars in to keep the dairy program. That is one hell of a reward to our dairy farmers to have those prices less than they were in 1981.

Senator SPECTER. Mr. Tewksbury, I do not have an answer for you. I am struggling with the one opening that I saw, as I said, on the cheese price, and you heard me ask the question to the experts here, Mr. Collins, who is the most technical expert above and beyond the Secretary or the Assistant Secretary, because they have had experience with it, and I went out into the hall—I had to step out for a few minutes, went out in the hall, thanked the Secretary for coming and said, Mr. Collins, I expect something imaginative.

We still have two more witnesses, Mr. Tipton and Mr. Coughlin, to see if we can shed some additional light on this. I am prepared to do everything I can. I am coming back to the Northeast. I am going to be back in the Northeast, in Luzerne County, to talk to farmers again. We break on recess—we are in session next week, then we break on recess, and I will be up there on Tuesday the 25th to give you my best thinking. I am prepared to face the music.

The music, Mr. Jones, is a lot tougher than the music Mr. Collins had. You should have been up there with 750 farmers. I thought there were 500, but Mr. Tewksbury said 750.

Mr. TEWKSBURY. The bleachers held 500. Then there were all the chairs around, which makes it 750.

Senator SPECTER. It was a big crowd, and it was a very unhappy crowd.

I am prepared to go back and talk to them again to tell them what I am trying to do so they will know there is at least some interest here. This is a special hearing on this issue, and I have an instinct that if we push at the edges hard enough we can find something. I think we can, and I am prepared to do the work to try.

Mr. TEWKSBURY. I am saying our farmers are going to be more disappointed and more upset to learn that nothing can be done in the immediate future to raise their prices. They are going to be more upset than they were when they realized where the milk prices went to in January and February. I think there are things that are going to happen across the United States.

Senator SPECTER. Well, I am committed to keep working on it, but I do not have an answer by myself.

Mr. TEWKSBURY. I appreciate that.

Senator SPECTER. OK. Thank you very much, Mr. Jones, Mr. Brey, Mr. Zurin, and Mr. Tewksbury.

I would call our final panel now. Mr. E. Linwood Tipton and Mr. Ed Coughlin. We thank you, gentlemen, for coming. We thank you for being patient. We have Mr. E. Linwood Tipton, president and CEO of International Dairy Foods Association, a long-time expert in the field. Mr. Tipton and Mr. Coughlin, as I said.

We are on the balanced budget amendment and I have to make a floor statement before 6 o'clock, so to the extent you can summarize your statements, we would appreciate it. Your full statements will be made a part of the record, and if your statement does not answer the question as to how we raise the prices of milk, that is what I will ask you when you finish your statement.

Mr. Tipton, the floor is yours.

STATEMENT OF E. LINWOOD TIPTON, PRESIDENT AND CEO, INTERNATIONAL DAIRY FOODS ASSOCIATION

Mr. TIPTON. Thank you very much, Mr. Chairman. I appreciate it. I have four points that I want to talk about, I think the same four subjects that you have been talking about, volatility and prices, the economics of milk prices, the cash markets for cheese, and finally, the basic formula price and what our suggestions might be with respect to that.

I think with respect to volatility there is one thing that I would like to make a point of, and that is, while prices have changed rather drastically recently in the milk industry, the fact is the volatility in the milk industry is still well below the volatility in virtually all of the other commodities. The prices of corn, wheat, soybeans, cotton, et cetera, are much more volatile than the price of milk has been, and even this past year——

Senator SPECTER. Mr. Tipton, do those lines face the same kind of crisis that milk is facing now?

Mr. TIPTON. Well, I think—I am sure when the prices are fluctuating they have found ways to deal with it, and that is what I want to talk a little bit about, about how you deal with it, because I think that everybody thinks we ought to get rid of the volatility, and my point is that that is virtually impossible, and other commodities have more volatility, so there ought to be a way that we ought to be able to deal with the volatility that we have.

In that connection there is, and we have already talked about it, authority under the FAIR Act of 1996 for some training programs as well as some pilot programs with respect to the futures markets, and we would urge you to work with the Secretary of Agriculture and make sure those programs get up and operative. I think that is a great opportunity for everybody and would serve the industry enormously well.

The second point that I wanted to talk about is the dynamics in the milk pricing, and most of the discussion today has been the decrease that occurred in the price in September, from September and October through December. The fact of the matter is that when the Government got rid of its surpluses and got some lower price support programs and the Government did not have surpluses of powder or cheese or butter, that is what allowed the prices to go as high, last fall, as they did. There was a problem. Grain prices were going up, and farmers needed more money. Prices went up, and that is the way the market ought to operate.

In the past, when the Government had surpluses, they sold whatever their surpluses were back on the market once the price had gone up 10 percent, so that effectively set a lid. They could not go above that.

When we got rid of the surpluses, they can go up to whatever it takes in order to generate a reasonable supply of milk and take care of the economic situation on the farm. That is what occurred last fall. We think that is appropriate and right.

Once the milk production started coming back, started increasing, the prices began to fall. They fell, and they have started correcting that.

Now, people were talking about them not coming back real fast right now. They have come back significantly, I think, when you are going into a period that is traditionally the flush period of the milk production cycle, so it may be a couple of months, April or May, when traditionally that is the largest milk production, that they may be a bit laggard.

However, our prediction is, and the Secretary of Agriculture is a tiny bit higher in his predictions than we were, that for 1997 milk prices will be the second highest prices on record. 1996 was the highest; 1997 will be the second highest; and feed costs are coming down, and I think that 1997 will be a successful year for dairy farmers.

Moving to the cheese market, the National Cheese Exchange has been in effect since 1918, for a long time. It has had the scrutiny of Federal and State agencies, including the State of Wisconsin extensively recently, including the Federal Trade Commission, and including the Commodities Futures Trading Commission, all of which have investigated it, and all of which have issued letters indicating that they had found no manipulation, no illegal activities, nothing that would be out of the ordinary.

Senator SPECTER. Who has issued that, Mr. Tipton?

Mr. TIPTON. Excuse me?

Senator SPECTER. Who has issued the statement you say that there is no irregularity or no manipulation, you say by the Green Bay Cheese Exchange?

Mr. TIPTON. That is correct. The letters have been from the attorney general of the State of Wisconsin, from the Federal Trade Commission, and from the Commodities Futures Trading Commission.

Senator SPECTER. The statement by Mr. Tracy at the bottom of the first page references the study conducted by researchers at the University of Wisconsin and the report concluded, "As currently organized the exchange appears to facilitate market manipulation," so that is at least one authoritative conclusion to the contrary.

Mr. TIPTON. Well, it is not an official body. That was two professors at the University of Wisconsin. Prior to that, the attorney general of the State of Wisconsin conducted his investigation and found that there was no basis for taking any action. That was two professors at the University of Wisconsin that had been commissioned by the Secretary of Agriculture to undertake that analysis.

Senator SPECTER. Well, the Secretary of Agriculture has adopted their conclusion and thinks it is sufficiently reliable to adopt it. I do not want to get into a dueling war about experts, but the Secretary of Agriculture makes a big point of it.

Mr. TIPTON. It is kind of beside the point in any event, in my opinion.

Senator SPECTER. I did not make the point, Mr. Tipton.

Mr. TIPTON. The reason I say it is beside the point is because the National Cheese Exchange, it is the intent of the associations I represent and the National Cheese Exchange to create a new exchange, either with the Chicago Mercantile Exchange or with the Coffee, Sugar, and Cocoa Exchange.

Senator SPECTER. How soon will that happen, do you think, Mr. Tipton?

Mr. TIPTON. It is our target to have that done by May 1. There are a number of things to be done.

Senator SPECTER. Will they have a price in effect by May 1?

Mr. TIPTON. It is our target to have the trading occur on May 1.

Senator SPECTER. Well, if trading occurs, then you have a price.

Mr. TIPTON. Well, yes, it would have that week, yes.

Senator SPECTER. You would not have to send out a lot of questionnaires.

Mr. TIPTON. No.

Senator SPECTER. Make a lot of phone calls.

Mr. TIPTON. No.

Senator SPECTER. What questions should I ask tomorrow, Mr. Tipton? What is this about containers and about size, all of those things that Mr. Collins mentioned, rattled off, and then when I asked him about specifics he said only statisticians knew that.

Mr. TIPTON. Well, I think people do have a tendency to think cheese is cheese, as they often think milk is milk.

Senator SPECTER. Oh, no. I buy Swiss, I buy American, I buy cheddar, I buy all different brands of cheese.

Well, what questions am I going to ask tomorrow when I call these people?

Mr. TIPTON. I think I need to provide just a tiny bit of background, and then I will try to answer that, if I may.

Senator SPECTER. OK.

Mr. TIPTON. The tiny bit of background is that the National Cheese Exchange and the new commodities, or new cheese exchange will deal with cheddar cheese only. That is the basic product.

So in asking people for prices, which they do in the survey, you have to make sure that you get—and this is the kind of information that I think you would want to know as well if you were going to base your prices on it. You are going to have to get that it is a homogeneous product. Its age makes a big difference. Under the exchange rules it cannot be more than 30 days old, and it cannot be younger than 3 days old.

It has to be at what location it is delivered, what are the delivery times. There is a lot of information that actually affects what the contract price might be for selling cheese. It depends on what services they add to it. Are they adding services of certain delivery services, certain time restrictions on when it is delivered, those kinds of things.

Those are the things that complicate the issue, and those are not issues under a cash market, because we specify under the terms and the rules of that cash market what cheese it is that must be delivered.

Senator SPECTER. Why is it only cheddar cheese? Cheddar is only one kind of cheese. Why is it that, as opposed to some other type of cheese?

Mr. TIPTON. Well, there is a tremendous range in the value and cost of cheeses, and that is trying to get at one of the largest shares of the market that is a homogeneous product.

Senator SPECTER. So it is an indicator of price to be calculated into the milk price.

Mr. TIPTON. Yes; and it is a homogeneous product that you can get a price on.

Senator SPECTER. So it is from 3 days to 30 days old, that is one. Location, delivery time—well, I see the time. It has to be for a time certain. Location depends—so that involves transportation.

Mr. TIPTON. But a lot of contracts might provide that I will deliver next month, not this month, and that is the price I am giving you for next month.

Senator SPECTER. Well, that is not helpful. That is a futures market.

Mr. TIPTON. No; that would be individual business transactions, commercial transactions between companies.

Senator SPECTER. OK. It would be what the price is next month. They are contracting today for delivery for next month, and we want to know what it is today.

Mr. TIPTON. Yes.

Senator SPECTER. OK. I think I have the point.

Mr. TIPTON. Thank you.

The last point I would make is that we do expect to have that new market up and running May 1. It may slip a little bit, but that is our target, and we are doing the best we can to accomplish that, but that does create a dilemma as the Secretary talked about, because at that point we would then anticipate that trading under the National Cheese Exchange would be discontinued, and that is the basis for the pricing under the formula, and so the Secretary would be compelled at that point to find an equivalent—under the law to find an equivalent series.

Senator SPECTER. I think he would be kind of happy to do that at this point.

Mr. TIPTON. I hope so, and I hope that he would make the choice then of this new exchange as the basis, at least in the interim until they can get some other kinds of reform or look at other data to see what might be a suitable way of doing it.

So it is our recommendation that the new exchange should be the basis used in the basic formula price.

PREPARED STATEMENT

Senator SPECTER. Mr. Tipton, thank you very much for your testimony. We appreciate your expertise in the field. I had called when I got back from northeastern Pennsylvania, and you were an encyclopedia of information, and I appreciate your cooperation and your assistance.

Mr. TIPTON. Thank you. You are very kind.

[The statement follows:]

PREPARED STATEMENT OF E. LINWOOD TIPTON

My name is E. Linwood Tipton, and I am President and Chief Executive Officer of the International Dairy Foods Association (IDFA) and its constituent member, the National Cheese Institute (NCI), a national trade association of processors, manufacturers and marketers of cheese and cheese products. NCI members market about 85 percent of the cheese consumed in the United States. Many of our members buy and/or sell cheese on the National Cheese Exchange, which currently provides the only cash market for cheese in the United States. I appreciate the opportunity to appear before you today to present our views on the National Cheese Exchange (NCE), the role of a cash market for cheese, and alternatives to the use of NCE prices in determining the Basic Formula Price (BFP) used in Federal milk marketing orders to set class prices.

Questions about trading activities on the National Cheese Exchange and their effect on milk prices are not new. These subjects have been examined intently over the past decade, by both state and federal authorities, with no findings of improper or illegal acts. The real basis for concern today, however, is not the National Cheese Exchange itself, but rather, recent changes in farm milk prices.

I. A COMPARISON OF MILK AND OTHER COMMODITY PRICE CHANGES

Price volatility is experienced by virtually every commodity. For several decades, however, dairy commodity prices were stabilized by federal programs. Because of this long period of price stability, the dairy industry did not develop futures contracts or other risk management tools that are common in other agricultural sectors. As you can see from the attached graph, which compares the price volatility of seven different commodities as recently as during the period 1991–95, milk prices experienced less volatility than other major agricultural commodities (see Graphs 1 and 2 attached).

When the Federal Government held inventories of dairy products, and dairy support prices were above what market prices would have been absent the high support prices, the release of Government inventories effectively placed a lid on how high dairy prices could go and the support price placed a floor on how low they could go. This range was normally about 10 percent, because CCC inventories of dairy products were released at prices 10 percent above the support price.

Now that market prices of dairy products regularly and substantially exceed the support price and the CCC does not have a stockpile of dairy products, prices for milk and dairy products are considerably more volatile. During 1996, this worked to the great benefit of dairy farmers who were confronted with much higher feed costs. Because the Federal Government did not have stocks to resell to the commercial market when market prices rose well above the former 10 percent lid, milk and dairy product prices were able to increase to reflect the higher feed costs. This relieved much of the burden on America's dairy farmers.

Under the current dairy program, therefore, increased volatility of milk and dairy product prices should be expected. Dairy farmers and processors are beginning the process of learning how to better cope with and manage this increased volatility. In this regard, we urge USDA to implement an educational program within the dairy industry to help dairy farmers, manufacturers and processors better understand how to use available risk management tools. Authority for such a program was provided in sections 191 and 192 of the Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act).

II. RECENT DEVELOPMENTS IN THE MARKET DYNAMICS OF MILK PRICES

Last year, a shortage of feedgrains drove up feed prices, which increased dairy farmers' costs of producing milk and led to a reduction of milk production. Tight milk supplies coincided, however, with strong demand for milk and other dairy products. Milk prices paid to farmers therefore rose substantially, increasing more than 21 percent over the six months of March to September. By September of last year, milk prices had soared to an all-time historic peak of $15.37 per hundredweight as reflected in the BFP, and $16.30 per hundredweight as reflected in the all-milk price.

At the same time, cheese production was higher than previous year's levels. Although cheese sales were also above year-earlier levels through summer, they were not keeping pace with production, and commercial inventories grew. In September, when increased cheese and milk prices finally reached the consumer, sales declined. Good harvest weather led to near-record crops, reducing costs and adding to both the expectation and actuality of stronger dairy supplies.

As a result of all these factors, commercial inventories of cheese were building and there was an overall surplus of cheese. This excess of supply over demand was predictably reflected in a sharp decline of cheese prices on the NCE from the highest levels in history.

The confluence of these particular conditions in the market was, however, a temporary phenomenon. With lower cheese prices last fall, wholesale demand recovered. As we moved into 1997, cheese prices began to rise. Similarly, after declining from September through December, the BFP turned around and increased in January and February 1997. I would note for your attention, however, that even with the year-end declines, the average annual BFP for all of 1996 ($13.39) was the highest in history (see Graph 3 attached).

As 1997 began, both producers and processors of dairy products were publicly optimistic about the outlook for milk prices. On January 3, our organizations and the National Milk Producers Federation jointly issued a press release, projecting the BFP in 1997 to be the second highest on record—second only to last year's record high. Our projections are for the BFP to average $12.66 this year. The first quarter estimates are probably too low, since the February BFP is already at $12.46, suggesting that we may have been too conservative for the rest of the year as well.

In short, any discussion of recent volatility in milk prices must take account of the fact that recent short-term price declines followed an historic surge in milk prices, with even the annual average reaching an all-time high. Moreover, milk prices paid to farmers today are again on the upswing.

III. THE NATIONAL CHEESE EXCHANGE AS A CASH MARKET FOR CHEESE

The National Cheese Exchange in Green Bay, Wisconsin, has been in operation since 1918. As with all cash markets, the NCE provides a method of trade that allows those who have more cheese than they want or need, to sell it to those who want or need more. Its primary functions are to provide a means of inventory management and of price discovery. These are the primary purposes of virtually any cash market exchange. It is supply-demand driven. It is an open outcry market. The buyers, sellers, prices and quantities of trade are known immediately. This is the epitome of an open competitive market, where knowledgeable buyers and sellers openly trade.

As previously mentioned, questions about the National Cheese Exchange and its role in dairy prices are not new. At various points in time, trading on the NCE has been the focus of examination by state and federal authorities, in response to allegations of price manipulation, or other improper trading activity. None of the authorities has ever found evidence of price manipulation, or any legitimate basis for taking action against the NCE or its trading members.

—In 1988, after an inquiry concerning potential state antitrust violations, the State of Wisconsin's Attorney General stated that no evidence of price fixing agreements or violations of Wisconsin antitrust laws had been found, and determined that no further action was warranted.

—In July 1996, after reviewing a controversial study of the NCE conducted by two University of Wisconsin professors, the Federal Trade Commission (FTC) found no factual basis for a violation of Federal antitrust laws, and determined that no further review by the FTC was warranted.

—The Commodity Futures Trading Commission (CFTC) also reviewed the University of Wisconsin study, and similarly found insufficient facts to warrant further action under its authority, in June 1996.

—On February 27, 1997, the CFTC issued a report specifically on the National Cheese Exchange, in connection with an application by the Coffee, Sugar and Cocoa Exchange to trade a futures contract based on the Basic Formula Price. Because of the linkage between the BFP and NCE prices, the CFTC closely examined the operations of the NCE. It found the NCE to include a wide variety of both buying and selling interests, with no significant barriers to membership. Trading activity was observed to be regular and transparent. Importantly, the CFTC found the NCE transactions to represent a "significant portion" of the spot market for cheese. No aspect of the NCE gave the CFTC cause for concern, and it formally approved the BFP futures contract application.

In short, no state or federal authority has found evidence of price manipulation, or of any illegal trading activity at the National Cheese Exchange, despite repeated allegations and reported suspicions. Even the criticism of it being a "thinly traded" market was discounted by the CFTC in its most recent report, which noted that "a number of the contract markets trading pursuant to CFTC designation are 'thinly' traded." (CFTC report at p. 15, n. 15). (Copies of these documents have been provided to the committee staff.) Moreover, the volume of trading on the NCE has been increasing, tripling over the past four years.

What can be accurately stated about the National Cheese Exchange is that its prices reflect the prevailing conditions of supply and demand in the market at the time. This fact has been corroborated by a former chief economist of the U.S. Department of Agriculture, as well as by current USDA policies and practices. In July 1996, Dr. Bruce Gardner, former USDA Assistant Secretary for Economics from 1989–92 and then a Distinguished Professor at the University of Maryland's Department of Agricultural and Resource Economics, found that "general supply-demand factors had quite consistent and statistically strong effects on NCE prices." He stated, “the data clearly show that the NCE reflects supply and demand conditions, and shows no evidence of manipulation by the actions of any individual trader or group of traders.”

IV. A NEW CASH MARKET FOR CHEESE

Notwithstanding our confidence in NCE prices as a reflection of demand and supply conditions, the members of the National Cheese Institute realize that repeated controversies over the NCE are undermining its sustainability. Earlier this year, momentum built within the Wisconsin state legislature to enact legislation restricting trading activities on the NCE. This series of developments, in conjunction with NCI’s interest in developing more viable dairy futures markets, led the NCI to pursue actively the establishment of an alternative cash market for cheese that would also improve the structures and processes which provide for cheese transactions.

Over the past month, the National Cheese Institute along with the NCE has been engaged in a private sector initiative to establish a new cash market for cheese. Our efforts to date have been very productive, and the opening of a new cash market for cheese may occur as early as May 1997. When trading begins on the new cash market, trading on the NCE is expected to cease.

Like the NCE, the new cash market will provide the industry with a competitive forum to buy and sell cheese on a spot basis. A new cash market, however, will have several characteristics that are designed to improve and expand its use. For example, the new cash market will likely allow for more frequent cheese trading sessions and use a broader network of established brokers which will make it more accessible to a wider spectrum of food industry participants.

Furthermore, the new cash market will be part of an established exchange which has a long history and distinguished reputation for managing futures contracts pursuant to the regulatory requirements and oversight authority of Federal regulators. By affiliating the cash market with an exchange that also offers dairy futures contracts, we will be strengthening the links between the cash and futures markets, and moving the dairy industry another step closer to more viable futures markets for price discovery and risk management purposes. As discussed previously, the lack of viable futures contracts has made it very difficult for the dairy farmers and processors to manage price volatility.

The details for establishing a new cash market are still being worked out and, therefore, I am not able to provide many of the specifics at this time. A committee of NCI members has been tasked with reviewing proposals by the Coffee, Sugar and Cocoa Exchange and the Chicago Mercantile Exchange, both of which have indicated serious interest in starting a cash cheese market. Next week on March 17, representatives of these two exchanges will be making presentations of their specific proposals to NCI and NCE board members. A final decision and announcement of the establishment of the new cash market will hopefully be forthcoming soon thereafter. If all goes well, we look forward to a seamless transition from trading on the NCE to trading at the new exchange.

V. THE BASIC FORMULA PRICE (BFP) FOR MILK

After years of bitter complaints and challenges by various parties, the Secretary of Agriculture eliminated the “Minnesota-Wisconsin” price series from use in setting Federal milk class prices, and began using a new formula. The Minnesota-Wisconsin price series used the prices paid to dairy farmers in the states of Minnesota and Wisconsin for manufacturing grade milk (Grade B) during the preceding month as the base. This base was updated or adjusted by prices paid to the same dairy farmers during the first half of the month to which it applied, plus an estimate of what would be paid for the rest of the month. The Minnesota-Wisconsin price was announced by the 5th of the month following the month to which it applied. With the decline in the amount of manufacturing grade milk and the fact that fewer companies made separate payments for the first half of the month, continuing to use this formula was difficult to justify.

The Secretary noticed and convened a hearing to find an alternative. The result of that process was the announcement in January 1995 of the current formula for calculating the BFP. This formula uses the prices paid to Minnesota and Wisconsin dairy farmers for Grade B milk in the preceding month, the same as the base price used under the old Minnesota-Wisconsin price series. To update the previous month’s price, it uses changes in (1) the price of cheese as reflected by trading on the NCE, (2) butter prices on the Chicago Mercantile Exchange, and (3) powder prices obtained by survey. These commodity prices are weighted according to the amount of milk in Wisconsin and Minnesota used to make each product. This formula, or slight variants of it, was broadly supported by processors, manufacturers and dairy farmer organizations, and the Secretary said that "after reviewing the various formulas, it is concluded the best updater would include" the price series just enumerated. In its decision of just a little over two years ago, USDA concluded that NCE's cheddar cheese, 40 pound block price reflected supply-demand conditions and should be the primary price adjuster in the basic formula price. The following year, after conducting a rigorous analysis of NCE prices and comparing it to other price quotations for Wisconsin and elsewhere, Dr. Bruce Gardner concluded that "the NCE price is a good indicator of national cheese market conditions. There certainly is no evidence of any better indicator to be found."

Nevertheless, the NCE will soon discontinue trading, which necessitates the Secretary finding an equivalent price to replace the NCE price used in this formula. Each Federal milk order contains the following provision:

"10xx.54 Equivalent price

> If for any reason a price quotation required by this part for computing class prices or for other purposes is not available in the manner described, the Market Administrator shall use a price determined by the Secretary to be equivalent to the price that is required."

The IDFA organizations including the National Cheese Institute believe that the new cash market for cheese will be an improved, equivalent price series which the Secretary should identify as an "equivalent" price within the meaning of the law. We believe that it will reflect supply and demand conditions for cheese; will represent trade and traders from a broad number of companies and interests; and is better than any other alternative. This action can be taken administratively by the Secretary. However, if the BFP is to be modified in other ways, it would require a full fledged hearing subject to procedures prescribed in the law. This would probably take considerable time to complete.

The Secretary of Agriculture already has underway a review of many elements of Federal milk marketing orders including the Basic Formula Price. We urge the determination of the equivalency of the new cash market for cheese as the best alternative to the NCE, pending more indepth review of long-range solutions and changes in Federal orders.

Some have urged USDA to develop a survey of cheese companies to determine what they were paid for cheese they manufactured. We think such a survey could have merit as a basis of providing more market information. We are therefore cooperating and assisting USDA in its design and efforts to obtain industry participation. We believe such a series could be helpful in evaluating markets and provide another basis of price discovery. However, it is a brand new technique which needs to be evaluated as to how well it may reflect supply and demand conditions There are a number of issues to be addressed regarding such a survey. For example, will participation be adequate to be representative and reliable? Will the same companies complete the survey every week, week after week? How will services provided to the buyer be excluded from the value of the unprocessed cheese? How will quality and service premiums be excluded?

IDFA and NCI have pledged their willingness to work with USDA to develop such a survey and the association members hope it can be accomplished successfully, but whether it should be used as part of the Basic Formula Price remains subject to serious open question.

VI. CONCLUSION

To support continued growth, the dairy industry needs to continue moving in the direction of being market-driven. This means that there will be price volatility, as there is in all other market-driven sectors of agriculture. It also means that the entire dairy industry, from the dairy farmer on, needs the same kind of capabilities to manage price volatility that producers and processors of other commodities enjoy. IDFA and NCI will continue their efforts to enhance those capabilities.

Mr. Chairman, in conclusion, we would like to leave you this afternoon with four main points in mind—

(1) The volatility of milk and dairy product prices has increased.

(2) Last year's record-high farm milk prices are likely to be followed this year by the second-highest recorded prices.

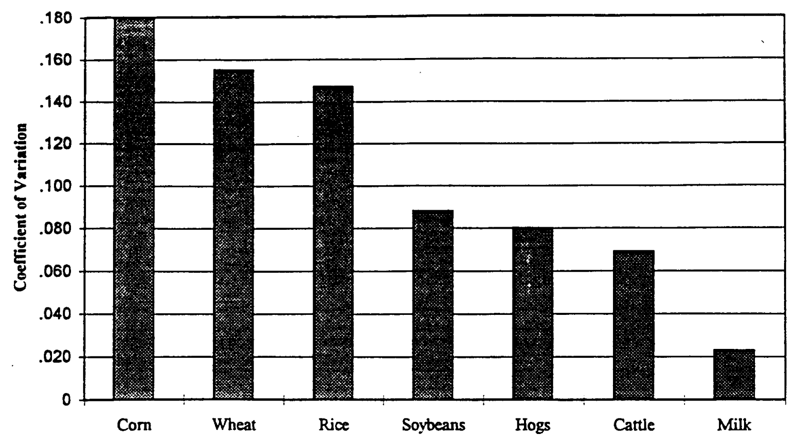
(3) The NCE should be replaced by a new cheese cash market in a few months.

(4) When that occurs, the Secretary should use the new cheese cash market as one of the "adjusters" in setting the Basic Formula Price.

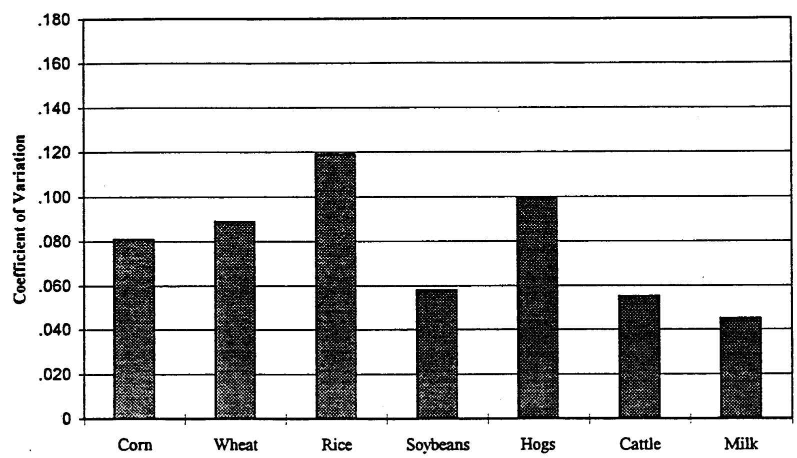
I appreciate the opportunity to appear before you today to share these views with you.

COMPARISON OF VARIOUS COMMODITIES' VOLATILITY OF PRICES AT FARM LEVEL, 1991-95

GRAPH 1
Year-to-Year Price Volatility



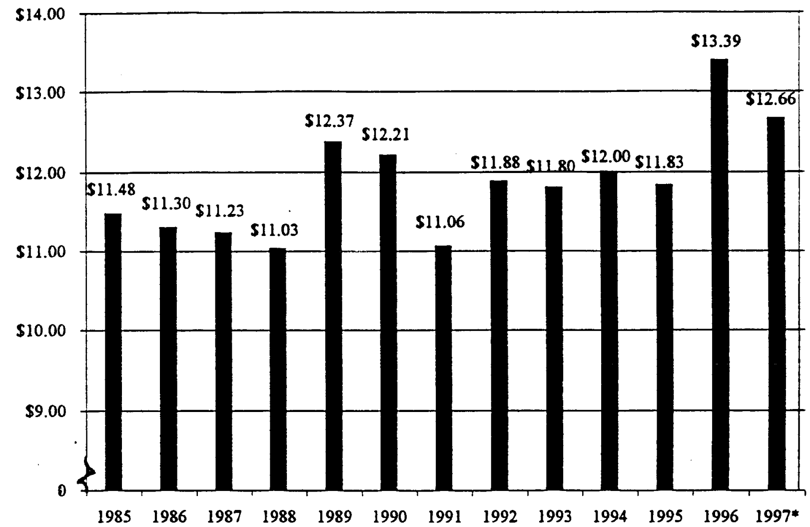
GRAPH 2
Intra-Year Price Volatility



Source: Coefficients of Variation, as reported by
USDA Chief Economist at Agricultural Outlook Forum, February 1997

GRAPH 3

AVERAGE ANNUAL MILK PRICES
(Minnesota-Wisconsin / Basic Formula Price)
per hundredweight of milk



Source: Dairy Market News, 1985-96
*Source: 1997 projection identified by National Milk Producers Federation and International Dairy Foods Association

STATEMENT OF ED COUGHLIN, ACTING CEO, NATIONAL MILK PRODUCERS FEDERATION

Senator SPECTER. I would like to turn now to our final witness, Mr. Ed Coughlin, acting chief executive officer of the National Milk Producers Federation. The floor is yours, Mr. Coughlin.

Mr. COUGHLIN. I will be short.

Senator SPECTER. Thank you.

Mr. COUGHLIN. The National Milk Producers Federation is a commodity group of about 60,000 dairy farmers, and what we have today, basically that is about 60 percent of all the dairy farmers in the country.

A year ago about this time the House addressed some of the same issues we are addressing here today. At that point in time, the federation members maintained that the trading level on the National Cheese Exchange was accurately reflecting the value of cheese and could be used to determine the Federal milk order price. Our position today is the same.

The federation and its members are aware of the controversy surrounding the National Cheese Exchange, and they are very sensitive to the concerns expressed by producers who lack confidence in that market. Dairy producers, as has been stated earlier, have a very important financial interest in the National Cheese Exchange prices, since the cheese prices are the single most important factor used in establishing milk prices in the United States.

It is important that the industry have confidence in the method used to determine prices, and that confidence be restored as promptly as possible.

We believe that the complaints that the National Cheese Exchange is not functioning in the best interests of dairy farmers and their cooperatives is unfounded. Now, the National Cheese Exchange is going to close, so it appears as though that is a foregone conclusion. Closing the exchange creates a Federal order pricing problem. Specifically, in the Federal order the 40-pound block cheddar cheese price of the National Cheese Exchange is used in determining the Federal milk order basic formula price.

I would suggest to you that one of the things you want to do if you want to look at prices is, the National Cheese Exchange has specific criteria for the cheese that is sold on that exchange. If you call up cheese plants, you say, here are the criteria. Let us say I want a quote from you of, if this cheese was sold on the exchange, what would your price be, I think that would probably—there is a set of criteria that is there. That may not encompass all of what you want to find out. For example——

Senator SPECTER. Mr. Coughlin, will they have that same kind of criteria with the new cheese exchange that Mr. Tipton is talking about?

Mr. COUGHLIN. I would defer to Mr. Tipton on the answer to that, but I am sure that they would have to.

Mr. TIPTON. It would be our intent that the rules of trading, at least the description of the product that is traded would be very similar.

Senator SPECTER. Thank you. Mr. Coughlin.

Mr. COUGHLIN. That provides the homogeneous product. In other words, they are not comparing apples and oranges. You are comparing a product, that here is what you are looking at.

To deal with the situation where the Secretary needs a price quote and where one is not available, every order, every milk order contains a provision whereby the Secretary of Agriculture can determine an equivalent price quotation. Thus, absent the 40-pound block price the Secretary of Agriculture will have to make that. As you suggested, he might like that.

But there are two sides to that. You know, we have talked today about the producer side. Mr. Tipton did not talk about it, but when the Secretary of Agriculture establishes a price, he is establishing a price that every plant must pay, so that he is establishing a minimum obligation for the plants that have to pay.

Now, when you establish that, you have got to be very concerned that you do not establish a price that the market does not return, so if you establish a price for *x* cheese company and *x* cheese company's price that you establish exceeds the price you get out of the market, and you do that under a Federal order regulation, that is a problem, because *x* cheese company does not get the money to pay that.

Now, it would be nice if *x* cheese company got that money and they could pass that on to their producers, but there are two sides of this transaction, that processors have to pay that price, and they have to get the money out of the marketplace, and the best measure of the marketplace, as you heard Mr. Collins say today, is the National Cheese Exchange, and that, in our opinion, is still the fact.

Our members make a lot of cheese. Mr. Jones was up here. He represents Mid-America Dairymen. They make a lot of cheese, but they have to account for that price, and then whatever is left over from what they get out of the marketplace is what they can pay to their producers, so I think those are important. That has to be considered.

You cannot just go out and set the price at a higher level. The manufacturers have to be able to get that out of the marketplace in order to be able to have the money in their bank account to pay it. I mean, there is a cash flow problem there.

But we would certainly—I represent producers, and we feel strongly that producers deserve a fair price, but at the present time we have not seen a better basis than the National Cheese Exchange.

However, we do not quite go along with Mr. Tipton. We do not think that the Secretary should automatically use the new cash market that might be established. I mean, we want to see what happens.

I would love to say that yes, we can jump in and use the new cash market, and if the first month the prices on the new cash market went up and prices to producers rose, that makes somebody look good. But on the other hand, if the prices went down, I do not want to be the one that gets blamed because we are using that new cash market.

So we do support improvements in the National Cheese Exchange and ways to find a better alternative. A key improvement to broaden trading activity, we think that would be done on the new exchange, expanded trading hours, I think that is in the process, electronic trading. Anonymous trading is another thing that I think is very important, and I think that would be accomplished with this new change.

Another goal is additional oversight. You know, using the existing exchanges, I think that brings a track record of some success in managing it.

Whatever the exchange is for the cash market, whether it is the National Cheese Exchange or another exchange, the important point is that any changes made yield an accurate price for U.S. dairy products.

I would say another thing that was testified to, and this was not in my formal statement, the National Milk Producers Federation did ask Secretary Glickman to establish a $13 per hundredweight floor under the basic formula price in Federal orders for purposes of establishing the class I price. We did it for a temporary period, January to June, period.

Secretary Glickman has turned that proposal down. That leads me to conclude that the supply-demand conditions which currently set established milk prices will continue to establish those milk prices.

PREPARED STATEMENT

Senator SPECTER. Mr. Coughlin, may I interrupt your testimony for just a minute? I am going to have to step out for just about 3 or 4 minutes. We will recess for just a few minutes, and then I will be right back.

[A brief recess was taken.]

[The statement follows:]

PREPARED STATEMENT OF EDWARD T. COUGHLIN

Mr. Chairman, I am Edward T. Coughlin, Acting Chief Executive Officer for the National Milk Producers Federation (NMPF), the national farm commodity organization that represents dairy producers and the dairy cooperatives they own and operate throughout the United States. I appreciate the opportunity to testify today about issues involving the National Cheese Exchange (NCE) and pricing milk used to produce cheese.

Last year I testified before the U.S. House of Representatives on the same issue we are addressing today. Simply stated, the Federation's position is the same as it was last year. The Federation members maintain that trading levels on the NCE accurately reflect the value of cheese and can be used to determine federal order prices.

The Federation and its members are aware of the controversy surrounding the NCE and are sensitive to the concerns expressed by producers who lack confidence in the NCE as a viable cash market. Dairy producers have an important financial interest in NCE prices. Cheese prices are the single most important factor in establishing the milk price that all U.S. dairy producers receive each month. It is important that industry confidence in the method used to determine milk prices be restored promptly. We believe that complaints that the NCE is not functioning in the best interests of dairy farmers and their cooperatives are wholly unfounded.

The NCE may close soon. Closing the NCE will create a federal milk order pricing problem. The 40 pound block Cheddar cheese price at the NCE is used in determining the federal milk order Basic Formula Price and in determining the protein price in some orders that include a multiple component pricing program.

To deal with a situation where a price quotation needed to determine a federal order price is not available, every order contains a provision whereby the Secretary of Agriculture determines an equivalent price quotation for the information that is not available. Absent an NCE 40 pound block Cheddar cheese price, the Secretary of Agriculture will have to make an equivalent price determination.

At the present time, the National Milk Producers Federation believes that the Secretary should consider all relevant information in making an equivalent price determination. Relevant information would include the 40 pound block Cheddar cheese price on any new cash market, information USDA gathers during the Cheddar cheese price survey that was started recently and any other pertinent data.

Perhaps after we gain some experience with a new cash market and evaluate the survey data that USDA has started to collect we can support a specific alternative to the NCE 40 pound block Cheddar cheese price. For now, we think the best alternative is to allow the Secretary of Agriculture discretion in determining an equivalent price.

The National Milk Producers Federation supports improving the NCE or finding a better alternative. A key improvement would be to broaden the trading activity. This might be achieved through expanded trading hours, electronic trading and anonymous trading. Another goal is additional oversight. This might be accomplished by establishing a cash market with an exchange that has a successful track record for managing its operations.

Whether within the NCE or through another exchange, the important point is that any changes made yield an accurate price for U.S. dairy producers.

This concludes my testimony. Thank you, Mr. Chairman. I will be happy to respond to any questions.

REQUEST TO ESTABLISH PRICE FLOOR

Senator SPECTER. We will reconvene. Mr. Coughlin, please pardon the delay, and proceed.

Mr. COUGHLIN. Mr. Specter, I was just about through with my testimony. The point I was making is that the National Milk Producers Federation did ask Secretary Glickman in December to establish a $13 per hundredweight floor under the basic formula price in Federal orders for purposes of establishing the class I.

Senator SPECTER. Who made that request?

Mr. COUGHLIN. The organization I represent, the National Milk Producers Federation.

Senator SPECTER. Yes.

Mr. COUGHLIN. We asked that that be done on a temporary basis for the period of January through June 1997. Secretary Glickman turned that request down. That leads me to the conclusion—you asked in the question about what has to be done to raise milk prices—that we are going to continue to see a system of supply-demand base prices based off of the National Cheese Exchange or some other exchange unless the Congress takes some action to change milk prices.

Senator SPECTER. Mr. Coughlin, when you asked the Secretary to do that in December, did he tell you it would take 6 months for it to be effectuated?

Mr. COUGHLIN. He did not tell us it would take 6 months. I do not want to argue with the Secretary. There are administrative procedures whereby the Secretary could go today and issue a hearing notice on 3 days' notice, hold a hearing on an emergency basis, issue an emergency decision, and there is existing authority under the Rules of Practice and Procedures for Marketing Orders that it can be done a lot quicker than 6 months.

Senator SPECTER. What would be the minimum time?

Mr. COUGHLIN. Let us see, today is the 13th. I suspect, on using emergency procedures, if the Secretary wanted to, he could try to implement something the first of next month.

Now, I am giving you an answer to a question in a very—what can be done. The industry, the producers, would have to go to the Secretary and convince the Secretary that, one, there were emergency conditions that warranted it.

Senator SPECTER. Do you think there are emergency conditions which warrant it?

Mr. COUGHLIN. What I would look at as evidence is the level of milk production. Is the level of milk production declining so that we do not have enough milk supply in this country? The data published by the Department of Agriculture does not indicate that to be the case. We would look at prices. Certainly, the prices, as has been pointed out here, the prices have recovered somewhat from their low point, so the standard that is in the Agricultural Marketing Agreement Act is a supply-demand standard.

So I think the Secretary would have to conclude, to operate on an emergency basis that there were real emergency conditions, that there was not adequate milk supply or we were facing a prospect of an inadequate milk supply. Do those conditions exist today? I think it would be hard to determine that they do exist. I think such an action would be challenged in the courts, and I think the Secretary's record, because the record of that hearing would be what would have to be presented to the court to be judged on the basis of the evidence in the record, I think it would be difficult to present a solid case that the emergency conditions that would enable the Secretary to act are there.

Senator SPECTER. Do you think it might be overturned as being arbitrary and capricious on his part?

Mr. COUGHLIN. Yes.

Senator SPECTER. Could you provide me with a short memorandum as stating the best case to present to the Secretary, which I will transmit to him, ask for his consideration on that?

Mr. COUGHLIN. Yes.

Senator SPECTER. I ask you to do that because you have the expertise in the field, and you also represent the milk producers. I would like to see that, and I will transmit it promptly to Secretary Glickman.

That, and the price of cheese, to whatever extent that would change, are there any other avenues which could provide some immediate relief for the farmers?

Mr. COUGHLIN. The single-most important thing that the Secretary of Agriculture can do was mentioned here earlier today with respect to the dairy export incentive program. In the past the dairy export incentive program has done a significant job.

Senator SPECTER. The export program?

Mr. COUGHLIN. Yes, the dairy export incentive program. The dairy export incentive program has done a good job of moving products out of the United States into export markets.

Senator SPECTER. To raise the price of milk.

Mr. COUGHLIN. Yes; it does have the impact of tightening the domestic supply.

Senator SPECTER. Is there more the Secretary should be doing on that?

Mr. COUGHLIN. Yes; I think somebody mentioned the December 19 meeting earlier. At that time, one of the things that our organization urged the Secretary to do was to do what the FAIR Act said, which was to make full use of the dairy export incentive program.

Senator SPECTER. Is he not making full use of it?

Mr. COUGHLIN. Under the Uruguay Round GATT agreement we have a certain quantity of dairy products that can be exported with a subsidy under the dairy export incentive program. That year for the exports begins July 1, 1996, and runs through June 30, 1997. Now, we are already 8 months, close to 9 months, into the period of time, and the quantity of product that has been exported is roughly—I am going to say 20 percent. I could furnish you exact numbers.

In other words, we have got 3 or 4 months left of the year to comply with what the Congress said in the 1996 farm bill, make maximum use of it, export everything we can. That has not been done, in my opinion.

Senator SPECTER. Could you give me a short memorandum on that?

Mr. COUGHLIN. I will.

Senator SPECTER. I will take that up with him, as well.

So we now have three options we are talking about, the cheese price, the export increase, and the administrative action he would take, which you think there is not really a sound evidentiary base or may not be so viewed, either by the Secretary or by the courts. Anything else?

Mr. COUGHLIN. Again, I say if the Secretary did it I believe the action would be challenged in court, because what you are doing is raising the price that processors would have to pay. So I think the processors would see that as an opportunity to go to court.

Senator SPECTER. But the Secretary has pretty broad discretion. They would have to show it was an arbitrary and capricious exercise of discretion.

Mr. COUGHLIN. Well, the Secretary would have to demonstrate that the record in the hearing demonstrated that he had an emergency condition that warranted taking such action.

Senator SPECTER. And those who challenged it would have to prove that he was arbitrary and capricious.

Mr. COUGHLIN. You are the lawyer. Yes.

Senator SPECTER. OK. Anything else that you might have to suggest that we could look toward here?

Mr. COUGHLIN. No; I do not have anything else.

Senator SPECTER. Mr. Tipton, do you have any suggestion as to what we might look toward here to provide a short-term correction?

Mr. TIPTON. Well, as I said in my statement—before I answer that, if I could, I think I need to correct the record. I apparently misspoke, and it is 4 to 30 days old cheese that is traded on the exchange, and I think I said 3 to 30.

Senator SPECTER. Yes; it is 4 to 30, then.

Mr. TIPTON. Yes; I am sorry.

We believe that the market itself is correcting the situation, and I have a very difficult time understanding that there is a dire emergency that warrants a 3-day hearing when we are looking at a situation in which the prices in the United States came off of an all-time high, and second, this year will most likely be the second highest prices ever recorded. So, that is, the Secretary would have to go to an evidentiary hearing, and I think it would be very difficult to make that case.

Senator SPECTER. OK. You think option two is not a very good one. My question is do you have an option four?

Mr. TIPTON. No; I do not, other than the market, and I think the market will do it. It seems like there is always difficulty in recognizing that the market may take care of some of these things. The market took care of the price last fall by going up enormously, and I think that it will do that again this year.

Senator SPECTER. All right. I am delighted to yield back the gavel to our distinguished chairman, Senator Cochran.

Senator COCHRAN. Senator Specter, thank you very much for suggesting this hearing. I think it has been helpful in getting a broad range of input on this issue and this question about what can be done, if anything, about the pricing of dairy, the calculations of it, the formulas used, and the inputs that are analyzed, and I think we will study the statements with profit in our effort to understand it better. And, I appreciate Mr. Tipton and Mr. Coughlin being here to help give us a balanced view of this situation.

SUBMITTED QUESTIONS

I have additional questions and several members of the subcommittee have questions which will be submitted to be answered for the record. We also have questions from Senator Rod Grams and Senator Rick Santorum.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

Questions Submitted by Senator Cochran

DAIRY PRICE MECHANISMS

1. USDA has recently proposed 6 options to make changes to the Class I price structure. The options would still use a market-driven basic formula price plus an added differential. Differentials are made up of one or more of the following: (1) a fixed component; (2) a location adjustment; (3) an adjustor relating to utilization; or (4) the cost of balancing the market. Many of these options would hurt farmers in the Southeast. Milk differentials are very important to Mississippi.

Question. How does lowering the price of milk in a deficit area, such as Mississippi, encourage increased milk production for the market?

Answer. The effects of lowering the Class I differential in a deficit area cannot be answered without also considering adjustments in Class I differentials elsewhere. Ultimately, a national price surface must be determined that reflects local, regional and national supply and demand for milk. Prices established under the Federal order program are minimums, and these minimum prices are not intended to encourage production beyond what market forces dictate. Moreover, as minimums, Federal order prices may be exceeded in particular markets as supply and demand conditions warrant.

The Department continues to accept comments from interested parties on Federal order consolidation and reform, and the Department has not made any decision regarding the pricing structure under Federal Milk Marketing Orders. All options remain under consideration at this time, which include options that would lower as well as raise Class I differentials.

Question. If differentials are reduced in one area where a short supply of milk exists, how does this help dairy producers in a different area which may be called on to provide supplemental milk supplies?

Answer. A lower differential in a deficit market could lead to lower blend prices and therefore lower milk production in the deficit area and increased milk shipments into the deficit market from surplus areas. This could raise milk prices in surplus areas. In addition, lower milk prices in the deficit area would reduce the amount of milk available for the manufacturing milk market, supporting manufacturing milk prices nationally. However, the effects of lowering the differential in a deficit market on producers in surplus areas depends on how Class I differentials are adjusted in fluid surplus markets. In addition, Federal orders only establish minimum prices for milk according to use, with actual pay prices to producers in many deficit markets exceeding the minimum Federal order blend price. Lowering Class I differentials in those markets where producer prices exceed the Federal order blend price may have only a modest effect on prices paid to producers.

2. Many have alleged that the National Cheese Exchange is subject to manipulation of dairy prices.

Question. Is there any evidence that this is true? Do you believe that it has cost producers or consumers money?

Answer. The University of Wisconsin study concluded that there was evidence of manipulation on the National Cheese Exchange (NCE) by large traders. Both the Federal Trade Commission and the Department of Justice reviewed the University of Wisconsin study and concluded there was no evidence to suggest either a conspiracy or monopolization theory. A subsequent study from the University of Maryland found problems with the University of Wisconsin study's methodological approach and conclusions. The alleged problems have been disputed by the researchers involved in the University of Wisconsin study. Most recently, the Commodity Futures Trading Commission examined the issue of manipulation as part of the approval process for a new fluid milk futures contract and concluded the potential for manipulation of NCE prices was not sufficient to deny contract approval.

To address concerns raised by dairy producers, the Department announced in late January that it was seeking comments on the use of NCE prices in the determination of minimum prices under Federal orders. This comment period ended on March 31, and we are currently reviewing those comments. In addition, the Department started in early March a weekly survey of cheddar cheese prices in response to concerns about the accuracy of NCE prices and are in the process of reviewing that information. The Department has no clear-cut evidence to indicate that the NCE has cost consumers or producers.

QUESTIONS SUBMITTED BY SENATOR MCCONNELL

Question. What is the status of the NASS weekly/monthly price survey and when does USDA expect it to be operational?

Answer. The Department has been collecting the cheese price survey data on a weekly basis since early March. Tentative plans call for the first release of the data in early May. We continue to work with the cheese industry to ensure maximum cooperation and that the data collected are accurate, timely and useful to the dairy industry.

Question. If the National Cheese Exchange (NCE) price no longer exists, or if USDA delinks it from the Basic Formula Price (BFP), what price series will the Department use for cheese in the calculation of the BFP or its replacement?

Answer. The Department has not made any decision on what price series it will use once the NCE price series is no longer available. We continue to review possible options and will continue to work with interested parties to develop a satisfactory replacement.

Question. Mr. Secretary do you support the current Class I differentials that exist throughout the Federal Order System? If not, what changes are you contemplating and what impact will these changes have on mink prices in states such as Kentucky?

Answer. The Department has not made any decision regarding Class I differentials and continues to accept comments from interested parties. When the Department presents its proposed rule for Federal order consolidation and reform this winter, the Department will provide estimates of the effects of the proposed changes on regional milk prices.

Question. Do you think milk prices will be less volatile with the elimination of the National Cheese Exchange? Will milk prices to dairy producers be any higher?

Answer. Several very unusual events caused milk prices to be especially volatile in 1996 and we should not gauge 1996 as the norm. However, the events of 1996 do point out how government intervention in the past helped to stabilize milk prices. The variability in milk prices probably has much less to do with the NCE than with the reduction in support since the early 1980's. Producers should not expect to see any major increase in milk prices following elimination of the NCE, since the BFP is not determined by the level of cheese prices on the NCE but by the month-to-month change in those prices and many cheese transactions occurring off the NCE tend to reflect the NCE price.

QUESTIONS SUBMITTED BY SENATOR BUMPERS

Question. If state legislation or other actions result in the closing of the National Cheese Exchange, how quickly can USDA implement another pricing structure to establish the Basic Formula Price?

Answer. There exist "equivalent pricing provisions" under each of the Federal orders. These provisions would enable the Secretary to substitute an "equivalent" price for the NCE price in the BFP without USDA going through formal rulemaking procedures, assuming an equivalent price exists. Such provisions could be implemented as quickly as needed.

Question. Does the Secretary have the authority to resume use of the Minnesota-Wisconsin pricing system?

Answer. If the NCE closes and there was no other "equivalent" price that could be substituted for NCE prices, one option would be to revert back to the M–W price series. However, the Department replaced the M–W series with the BFP starting in May of 1995 because of concerns about whether the M–W price was statistically reliable as an indicator of the value of milk, and statistical reliability may be even more of a problem now. In addition, using the former M–W price series doesn't address the need to price protein, which is currently tied to the price of cheese on the NCE, in those orders with multiple component pricing.

Question. To what extent have changes in the 1996 Farm Bill increased farm price volatility in both direct crop prices, like feed grains, and indirect prices, like dairy?

Answer. The 1996 Farm Bill probably had very little to do with the recent volatility in grain prices. Going into the 1996/97 marketing year, government inventories of corn amounted to only about 30 million bushels, about one day's use. So, the 1996 Farm Bill was not responsible for the increase in price volatility for grains in recent months. Rather, the increase in price volatility reflects government policies beginning in the mid-1980's to reduce price support rates and government stockpiles combined with reduced yields and strong export demand.

Question. Do you think the volatility of milk prices last fall, if caused at least in part by changes in the 1996 Farm bill, will soon be seen in other commodity areas?

Answer. Traditionally, milk prices have been more stable than prices for grains and, despite the events of this last fall, that trend seems to be holding. For example, the all-milk price declined by 18 percent from September 1995-February 1996, while corn prices declined 24 percent over the same period. Of course, such large fluctuations in prices for both commodities over such a short period are certainly not the norm.

Questions Submitted by Senator Kohl

Question. What criteria will you use in deciding whether a new cash market or new price survey for cheese is credible enough for use as a reference price in setting the BFP?

Answer. We will use several criteria to judge the merits of any replacement for NCE prices in the BFP. We would like any price estimate to be based on a reasonably large number of transactions of a standardized product and be accurately reported. We especially believe that the new replacement should have wide acceptance within the dairy industry. Dairy producers must have confidence they are receiving a fair price for their milk, and dairy processors must have confidence the reported price is an accurate reflection of the value of cheese.

Question. When the comment period ends on the issue of delinking the BFP from the Cheese Exchange, do you anticipate acting immediately to make a change, or are there other hurdles that need to be crossed before any action can be taken?

Answer. After the comment period closes on March 31, we will review the comments received and consider the available options. "Equivalent pricing provisions" in each of the orders will allow us to act as quickly as necessary to replace NCE prices in the BFP, if we choose to do so following a review of the comments or after obtaining further input from the dairy industry.

Questions Submitted by Senator Grams

I understand from remarks made by the former head of the President's Council of Economic Advisers that the Northeast Interstate Dairy Compact will increase the cost of food nutrition programs by 10 percent in the affected region. This includes food stamps, WIC, and school lunch. I also understand that other States, including 15 in the southeast are contemplating a compact of their own.

Question. Mr. Secretary, if low-income Americans are not intended to absorb this hit, how do you intend to pay for the increased costs to these programs that result from the Compact?

Answer. I believe that assisting dairy farmers in the Compact region should not, and need not, come at the expense of low-income people in the region. I sought to address those concerns by laying out my expectation that the Commission provide assistance to offset any increased burden on low-income families in the Compact region. My finding of a compelling public interest in the Compact region assumes that the Commission will address these concerns, and I will consider revoking my authorization of the Compact or taking other actions if the Commission does not address those concerns.

Question. Would you provide me a copy of the letter you received from the President's Council concerning the Compact?

Answer. You should contact the Chairman of the Council of Economic Advisers to obtain a copy of the letter you refer to.

Questions Submitted by Senator Santorum

1. The dairy industry was protected from large price swings when the CCC held stocks that were available to be sold back to the industry at 10–15 percent above the support price. While price stability was the norm for many years, the support program encouraged overproduction. However, cheese and nonfat dry milk stocks have largely not been available for sell-back from government stocks since mid-1988, and butter has not been available since 1995. As a result of this history of price stability, the dairy industry has been late in developing and leveraging the tools commonly used in other industries to manage price risk, such as futures markets.

Question. Do you believe the industry currently has adequate risk management tools to deal with the price volatility inherent to all agricultural commodities?

Answer. This question is best left up to the dairy industry to answer. The Department stands ready to help the dairy industry develop better risk management tools, but we also believe that any effort should be in partnership with the dairy industry. Ultimately, the success or failure of those efforts will depend on whether the dairy industry chooses to use those tools.

Question. What additional tools and training can USDA provide the industry to allow the private sector to better address the inherent price risks of supply and demand-driven markets, both on the input (feed, etc.) and output (milk) side?

Answer. The Department stands ready to work with the dairy industry to identify and develop appropriate risk management tools and to help provide training in the use of those risk management tools. We believe that such efforts, if conducted in partnership with the dairy industry, can be accomplished within existing budgetary constraints.

2. In 1996, the dairy industry experienced record high dairy commodity and milk prices levels, previously approached only briefly in the late eighties when a combination of drought and international market forces combined to increase cheese prices to $1.545 ($.15 below last year's peak). Most economists have suggested that the record high dairy prices in 1996 were largely the result of reduced milk production related to price strength in the feed sector, particularly corn. Corn prices, according to the NASS Agricultural Prices report, rose to $4.43 per bushel, before dropping back $1.80 to $2.63 per bushel in December. Clearly, we are now focused on the volatility in the dairy sector, but the price comparisons between both agricultural sectors stimulates some questions. The U.S. all-milk price dropped $3 per hundredweight (or 18 percent) from its record peak of $16.30 in September to its February low. This drop has resulted in an outcry from the producer community that has ranged from a request to floor the BFP to claims of market manipulation. In contrast, the corn price drop of $1.80, representing 41 percent of the peak value, has not led to similar calls and allegations.

Question. What characteristics between the two sectors are causing the very different responses to the supply and demand-driven price declines, and what can the dairy sector learn from the crop production sector to be better able to weather price volatility in the future?

Answer. The amount of price volatility in a market depends on a variety of market factors, such as the sensitivity of supply, demand and commercial stocks to changes in prices, and the size of external shocks to supply, such as weather. In addition, there are differences between grain and milk which can affect the ability of producers to withstand large variations in market prices. Grain is a storable commodity, so grain producers can avoid the consequence of some variability by storing; dairy producers cannot. Grain producers generally receive production flexibility contract payments which can cushion the effect of variability on farm income; dairy producers do not receive payments. Finally, grain producers have many options to use futures or forward pricing; dairy producers have fewer pricing options available to them.

The lesson for dairy producers is that with the gradual phase out of the price support program dairy producers can expect milk prices to be more volatile. Increased price volatility does not necessarily mean lower average prices for producers. In fact, last year milk prices were record high.

Question. How does dairy price volatility compare with other agricultural commodities?

Answer. It would appear that milk prices are less volatile than grain prices at present. This continues a long tradition of grain prices exhibiting larger annual swings than milk prices. Grain prices likely show more volatility because grain supplies are more prone to weather than milk production.

3. Prior to implementing the current Basic Formula Price in May of 1995, your staff undertook an extensive review of numerous options and selected the base month M–W updated with changes in dairy commodity values as the most accurate reflection of the value of milk for manufacturing.

Question. Is there any reason to believe that the conclusions reached less than two years ago were wrong?

Answer. This is no reason to believe that the decision to replace the M–W price series was wrong. In fact, that decision was supported by evidence provided at a national hearing on replacement of the M–W price series. However, producers must also have confidence they are receiving a fair price for their milk.

Question. Is there any reason to believe that the current BFP does not accurately reflect supply and demand conditions (or that it reflects those conditions to any lesser extent than the old M–W price)?

Answer. Overall, it would appear that the BFP is just as accurate an indicator of supply and demand conditions for milk as the M–W price series. The Department replaced the M–W price series with the BFP in May 1995. Over the 21-month period from May 1995 through January 1997, the BFP exceeded the base month M–W prices in 11 months by an average of $0.13 per cwt., and the BFP was below the base month M–W price in 9 months by an average of $0.19 per cwt. The base month M–W price averaged $12.79 and the BFP averaged $12.78 per cwt., or just $0.01 per cwt. lower since May 1995.

While the BFP and M–W price have averaged nearly the same since May 1995, we are concerned that the BFP may be more volatile than the M–W price. The BFP has generally exceeded the base month M–W price during the spring and summer months but has been significantly below the base month M–W price during the last quarter of the year. During the last quarter of 1996—a period of rapidly declining milk prices—the BFP averaged $0.32 per cwt. below the base month M–W price.

4. In response to the Federal Order reforms required under the FAIR Act, a USDA committee has been reviewing the basic formula price and potential replacements. As part of this review, the committee has collected data on actual sales prices for cheese and has performed some statistical analysis to examine the correlation with the National Cheese Exchange.

Question. What kind of correlation have you found between the NCE and the actual prices received for cheese?

Answer. The statistical analysis conducted to date shows a strong correlation between NCE prices and survey prices.

Question. What conclusion does this correlation lead you to regarding the validity of the National Cheese Exchange?

Answer. At the present time, the only conclusions drawn from this analysis are that cheese prices are closely linked to NCE prices, but the direction of causality is not clear. Regarding the comparability of prices, a much larger survey over a longer time period would be needed. It is envisioned that the Department's weekly survey of cheese prices would provide a more accurate indicator of cheese prices and provide a better basis for evaluating NCE prices.

5. The existing Basic Formula Price used in the Federal Order System incorporates five commodity price series (NCE cheddar 40# blocks, CME Grade AA butter, Western States nonfat dry milk, Western States buttermilk powder) to quantify the change in milk value from the base month period to the current month.

Question. How have you validated each of these price series as representative of their respective markets?

Answer. The M–W price series was replaced with the BFP following a national hearing on replacement of the M–W. The price series used in the update of milk prices from the base to the current month reflects industry input and the expertise of dairy marketing specialists within and outside of the Department. All of the series used were recommended by the industry and judged by industry experts as being the most representative markets for cheese, butter, nonfat dry milk and buttermilk powder.

Question. Are you comfortable that each of these price series correlates with broader based measures of the respective markets?

Answer. The Department believes these price series correlate very well with actual market conditions in each product market. But, the Department remains open to alternatives. While the comment period on the use of NCE prices in the BFP closed on March 31, 1997, the Department continues to accept comments on Federal order consolidation and reform, including replacement of the BFP.

Question. Has the replacement of the current month payment estimate for grade B milk in the old M–W with the commodity price updating calculation in the current BFP significantly impacted the correlation between cheese prices and milk prices?

Answer. Replacement of the M–W price series with the BFP has not significantly changed the correlation between milk prices and cheese prices. Both the M–W price series and the BFP begin with a survey of prices paid for milk by plants purchasing Grade B milk in Minnesota and Wisconsin. The only difference between the two series is the method for updating the survey information to the current month. The BFP uses product prices to update the survey information, while the M–W price series used a supplemental survey of plant pay prices. Since most of the milk in Minnesota and Wisconsin goes into cheese production, both the M–W and the BFP price series are highly correlated with cheese prices.

6. You have invited public comment on the role of the National Cheese Exchange price in the updating portion of the current Basic Formula Price calculation.

Question. How does the current request for comments interface with the broader Federal Order Reform process and the efforts already underway by the BFP Committee?

Answer. The current request for comments relates specifically to whether NCE prices should be used in the BFP and, if not, what alternatives to NCE prices exist. Under Federal order reform, much more fundamental questions regarding minimum pricing are being considered, such as whether the BFP should be eliminated, whether Class I and II prices should be decoupled from the BFP, whether the BFP should be replaced entirely with a product price formula and what are the appropriate components to use in constructing a BFP.

Question. Is there greater risk in making a hasty change to the BFP that is not properly deliberated than in focusing your efforts on the longer term objective of comprehensive reform?

Answer. The Department will not make a hasty decision. We will carefully consider all of the options available and work with the dairy industry before contemplating any change. In addition, we will not let short-term expediency adversely affect our long-term objectives of consolidation and reform of Federal milk marketing orders.

7. Senators Feingold and Kohl have asked the Coffee, Sugar, Cocoa Exchange to develop an alternative cash market to the NCE. Additionally, I understand that the industry has solicited proposals for establishment of an alternative cash market under the umbrella of the existing Futures Markets.

Question. Will the establishment of a new cash market under the umbrella of the existing Futures Markets bolster USDA's confidence in the validity of the price?

Answer. It would be premature to respond to this question since we do not know the characteristics of such a market. Our ideal would be a market with a large volume and many traders. Unfortunately, these characteristics have not been the norm for most cash and futures markets for milk and dairy products. In addition, we believe other features, such as affiliation with an existing exchange, which could offer resources for oversight and surveillance, daily trading, anonymous trading and trading limits, would lend integrity to a new cash market.

Question. Would USDA use this new cash market in a similar manner to the existing NCE as a price mover in the BFP?

Answer. Whether the Department elects to use this new cash market in the determination of the BFP would depend on many factors, such as the volume of trading on the cash market and how well that market tracked with other indicators of the value of cheese. In addition, it would depend on what, if any, other options are available as possible replacements for NCE prices. We will carefully review comments from interested parties and review available options before reaching any decision regarding replacement of NCE prices.

8. Minimum pricing under the Federal Milk Marketing Order system is sometimes cited as an impediment to developing the dairy futures markets. Specifically, proprietary handlers that are subject to the FMO minimum pricing provisions are limited from hedging on the futures market and offering forward pricing to dairy producers that may result in a price below the minimum regulated price.

Question. Since forward pricing and the use of the futures market are valuable tools in managing the price volatility that has been of such great concern in recent months, does USDA have the flexibility, authority and desire to allow proprietary processors an exemption from minimum pricing provisions to the extent that they have a bona fide forward price contracts with producers and those contracts are appropriately hedged on a futures market?

Answer. The Department would have to use formal rulemaking procedures, including a national hearing, to establish the merits of such a provision, with the final decision based on the hearing record. In addition, any modification to the orders has to be approved by producers in a referendum.

9. One challenge inherent to the Federal Order reform process is the development of analysis that does not rely heavily on historic relationships, since those historic relationships were likely distorted by past policy. This challenge would point to the use of a model that is not confined by current milk movement assumptions, but instead seeks a solution based on nonregulatory factors. Also, in addition to the traditional goals of ensuring an adequate supply of fresh, wholesome milk, etc.; an appropriate goal for the Federal Market Order System should be to encourage an efficient market. It appears that the only option discussed in the Summary Report on Class I Pricing Options released last Friday that attempts to reflect the value of milk based on what would likely result from an efficient market is Option 1A. This option is based on a complex model run by Cornell University that considers production, demand, and transportation costs to determine relative prices across the country.

Question. Do you agree that milk price regulations should encourage an efficient market?

Answer. The Department agrees that the Federal order system should encourage an efficient market for milk. However, we also believe that Federal orders should help ensure that producers receive a fair price for their milk, producers are treated equitably and all producers have a market for their milk.

Question. What approaches, other than Option 1A, are consistent with this goal of an efficient market?

Answer. The Department agrees that analysis of Federal order pricing options should not depend on historical data, since historical relationships may be distorted by past policy. However, nearly all dairy economic models are based on historical data. For example, the Cornell model uses historical data on production, consumption and the location of processing facilities to determine the least cost way of distributing milk to consumption areas. In addition, the results on any model are contingent upon a variety of assumptions and subject to alternative interpretations. For example, Option 1B in the Department's report is also based on a run of the Cornell model. In addition, we believe efficiency in milk markets is not the only goal of Federal orders. The options presented in Department's pricing report reflect a range of efficiency and equity considerations.

10. In the Summary Report on Class I Pricing Options released last Friday, several options (2 and 3B) include an adjustment to the Class I differential based on the ratio of Class I milk to other milk pooled in the Order. Although this approach has some initial intuitive appeal since it would seem to adjust automatically with supply and demand conditions, this approach has several problems in application. Specifically, milk is not pooled based on its geographic location, but rather can be affiliated with a pool in another location or can remain unpooled if sold for other than Class I use. For example, there is a long history of some Texas milk being affiliated with the Chicago Regional Order. Additionally, manufacturers purchase mostly pooled milk in some areas, and mostly unpooled milk in other areas of the country. Both of these scenarios result in the Class I percentage in the pool not accurately reflecting local supply and demand conditions.

Another cause for concern under this "self-adjusting" scenario is the inherent disruption in processor sales that will be caused when the adjustment in neighboring orders does not move on a parallel track. I am advised that is quite conceivable, for example, that the Class I differential could be adjusted upward in one Order, while being simultaneously adjusted downward in a neighboring Order. The result would likely be very disorderly marketing as buyers shift markets in response to the new price relationships.

Question. Do these two issues—first, the potential inaccuracy of Class I utilization in reflecting local supply and demand, and second, the disruption caused by lack of price alignment that would result from the automatic adjustment feature—argue for the elimination of utilization formulas from consideration for Class I pricing?

Answer. The above points are valid. However, the problems mentioned could be partially overcome by restricting how milk is pooled or by restricting the frequency with which differentials are adjusted. In addition, allowing Class I differentials to adjust over time based on Class I utilization would eliminate the existing rigidity in Class I differentials, which would eliminate potential distortions in the current Federal order system.

CONCLUSION OF HEARING

Senator COCHRAN. The next hearing of this subcommittee will be on March 18 in this room, 138 of the Dirksen Senate Office Building, where we will continue to review the budget request of the Department of Agriculture for fiscal year 1998.

That concludes the hearing. The subcommittee will recess and reconvene at the call of the Chair.

[Whereupon, at 5:48 p.m., Thursday, March 13, the hearing was concluded and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

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