Chapter 6—Kraft Trading Activity During 1990-1992

The preceding chapter examines the overall trading activity of leading seller-traders and buyer-traders during 1988-1993. Since Kraft was the preeminent trader on the NCE during 1988-1993, this chapter examines in more detail its trading activity from January 1990 through December 1992. We chose this period because we have the most documentary evidence for it, in addition to the trading activity reports for the NCE.\(^1\) We focus on the nature and apparent impact on NCE prices of Kraft's trading during each price cycle, including the price decline, bottom, rise, and top. We also examine the roles played by other leading traders during these periods. Finally, we examine the relationship between NCE prices and Kraft's wholesale prices during 1990-1992.

To facilitate following the events discussed herein, readers should refer to Figure 5.1 and Appendix Figures 5.1-5.2, which display the weekly NCE trading activity of leading traders during this period. See also Figure 6.1.

A. Price Decline and Price Bottom, January-March 1990

In 1989 a reduction in herd numbers and milk production caused a large rise in cheese prices. NCE prices peaked in November 1989 and remained unchanged during the last eight weeks of the year. The industry anticipated that the return of flush milk supplies in 1990 would cause cheese prices to decline. After one company "polled" nine "major" cheese companies regarding expected price and other market conditions for the year, a November 17, 1989, internal memorandum reported, in part, that the lowest projected price for block was $1.28, with

\(^1\) The Department of Agriculture, Trade and Consumer Protection Demand for Production of Documents was served to companies in early 1992. A limited amount of information was obtained for periods before or after this date.
Figure 6.1: NCE and CCC Barrel and Block Cheese Prices, Weekly, 1990-1992

Cents Per Pound
most company estimates in the range of $1.30-$1.32. At the time this document was written, block prices were $1.545. Based on the poll, the company prepared two Industry Forecasts (showing expected monthly prices) that projected block prices would bottom at $1.28-$1.32 and barrel prices at $1.24-$1.28, with the expected low to occur in April-May.

**The Price Decline**

There was an industry consensus that cheese prices would fall substantially in 1990. The main questions were how much prices would fall, when the price decline would begin, and who would lead the market down. One leading competitor apparently expected Kraft to lead off the price decline, since “One source reported that Kraft might try to work on the barrel market today [January 5].” In fact, neither Kraft nor anyone else sold barrels on January 5. Two other traders, Alpine Lace and Marathon, sold 9 loads of blocks, causing block prices to fall 8.25 cents per pound while barrel prices remained unchanged. This development caused block prices to be 4.25 cents per pound below barrel prices, creating an atypical relationship since blocks usually

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2 All of the major companies polled were suppliers or customers of the company. [[Source deleted in public report as not essential.]]

When questioned about the November 17, 1989, memorandum, a purchasing official of the company explained how he generally developed such information: "Getting an understanding of what others are thinking, for some companies, the way I would determine what their thinking was, I would give Mid Am a call and say, How is your milk supply at this point? How do the solids look? What do you expect for the next three or six months and what do you expect to happen in the markets? and see what they say. So there would be typically companies like Mid-Am or AMPI that we are doing business with on a committed supply basis. [[Source deleted in public report as not essential.]]

3 [[Source deleted in public report as not essential]]

4 Schreiber Foods, Inc., Purchasing Director-Western Region, to Vice-President-Purchasing, "Pre-Market Update," E-mail transmission, January 5, 1990, 8:27 a.m., Bates 5059.
sell at 2 cents to 4 cents per pound above barrels. This relationship was corrected the following week when block prices rose while barrel prices fell.

(All references below to trading volume and prices on the NCE are based on the trading activity reports prepared weekly by the Agricultural Marketing Service (AMS), USDA, unless another source is cited.)

During the next three weeks--January 12, January 19, and January 26--NCE barrel prices dropped a total of 10.75 cents. Most of the decline occurred January 19, when Kraft led the trading in barrels; it made 30 offers and reduced offers to sell barrels, causing prices to drop 7.25 cents for the day, but no sales were consummated. No other trader offered barrels during the session. Kraft, joined by Alpine Lace and Marathon, also led off the decline in block prices on January 19. Block prices dropped until Beatrice began buying near the end of the session.

Dairystate, a broker, was the only trader to offer barrels on the NCE on February 2, 1990. It opened trading for the day by offering 5 loads of barrels at $1.3975, the previous week's close. During the first 18 minutes of trading, Dairystate reduced its offer 24 times, dropping the price 7.25 cents. Between 10:18 a.m. and 10:31 a.m., Beatrice Foods and Masters Gallery covered all offers, purchasing 10 loads. Although 10:30 a.m. is the customary closing time of the NCE, trading rules provide that activity continues until one minute elapses after the last action. On this day, trading in barrels continued to 10:53 a.m., by which time Dairystate had

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5 One industry source observed: "This is only the second time in recollectable history that the cost of Barrels is greater than Blocks...." Schreiber Foods, Inc., Director of Copack Services to Senior Vice-President and General Manager-Retail Division, "Schreiber Report-Rough Draft No. 4," E-mail transmission, January 10, 1990, Bates 2298.

6 Dairystate is generally viewed by industry participants as a broker on the NCE, although it describes itself as a cheese trader or reseller. It sometimes takes title to the cheese it sells, although it typically sells the cheese of others for a fixed fee and does not take the price risk of an owner. Typed transcript of recorded interview of Dennis Wyssbrod, Dairystate Brands, August 11, 1993, pp. 2 and 24.
reduced its offer 50 more times without any takers, and NCE barrel prices had dropped a total of 19.75 cents. One minute later, block trading also ceased (see below).

Dairystate was offering cheese for AMPI, which apparently did not wish to sell in its own name. Two weeks before February 2, 1990, AMPI had offered another cheese company cheddar barrels to sell on the NCE. An internal document of that company dated January 19, 1990, stated:

AMPI has offered barrels to us in steel based on today's market down to $1.2500. In other words, if we want to offer barrels they would provide the cheese and absorb any risk of market decline.

An internal memorandum of this company written before the opening of trading the morning of February 2, 1990, stated:

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7 Immediately after Black Friday, an industry trade paper stated that Dairystate was a broker that represented, "among other firms,...Associated Milk Producers Inc.," *The Milkweed*, "'Black Friday' at Green Bay," December 1989, p. 4. (The February 1990 issue of *The Milkweed* was dated December 1989.) This source did not specifically state that Dairystate had sold for AMPI on February 2. During the course of this study we learned that it is common industry knowledge that Dairystate had been selling for AMPI. We were not able to determine whether any companies, in addition to the one cited below, knew on February 2, 1990, that Dairystate was selling for AMPI.

We have found no evidence that AMPI has sold on the NCE on any other occasion between February 2, 1990, and the end of 1993. AMPI purchased 172 carlots on the NCE during 1988-1993 (Table 5.1).

An executive of a leading cheese company said that "...after the market on February 2, Beatrice field men were out telling farmers that AMPI was responsible for the market drop in areas where they compete for milk." (Source deleted in public report as not essential.)

8 Schreiber Foods, Inc., Purchasing Director-Western Region, to Vice-President-Purchasing, "Pre-Market Update," E-mail transmission, January 19, 1990, 8:10:56, Bates 5055. When the vice president-purchasing was asked why Schreiber did not accept the AMPI proposition, he replied: "...we simply don't participate in that kind of thing." Typed transcript of recorded interview, May 26, 1993, *Id.*, p. 16.
AMPI, North Central, are still offering us 10 loads of barrels to go to the exchange with and they would absorb market decline. They are very perturbed at Mid-Am's activity on the exchange.  

While this company declined the AMPI proposition, Dairystate did offer barrels on the NCE for AMPI. We have been unable to determine how much cheese Dairystate was prepared to sell, but after it had sold 10 loads, it offered five more, none of which was covered; by the close of trading it had reduced the offer to one load.

Although Kraft did not offer barrels during the February 2 price decline, it did participate in NCE block trading. As its only trade for the day, Alpine Lace first offered two loads of blocks, an offer that Beatrice covered after the price of barrels had dropped by 4.5 cents per pound. At that time, Marathon and Kraft began offering blocks and continued until the price had declined another 10 cents, although only one of these loads was sold. In total, Beatrice bought two loads and Mid-America one load of blocks. Clearly, Beatrice Foods, Mid-Am and Masters Gallery, the only buyers on February 2, held a different view of the appropriate price than did the other traders.

AMPI's motive for taking down the barrel market price remains unclear, but in light of the memorandum cited above it appears that AMPI expected its actions to drop the market. Nor

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10 During the course of an interview of AMPI officials, an official stated that it was not AMPI's purpose to lower the price on the NCE February 2, 1990. Mark Firth, North Central Regional Manager, typed transcript of recorded interview of AMPI officials, July 29, 1993, p. 41.
is it plausible that AMPI was selling on the NCE merely to reduce excess inventory. The Exchange clearly is not a viable outlet for surpluses of the size Dairystate was prepared to sell on February 2, particularly during a period of declining prices. Indeed, most companies, both large and small, look to better means for solving excess inventory problems (See Section D, Chapter 4). AMPI's motives for selling on February 2 are puzzling, especially considering subsequent events. First, on the following Friday it led off bidding for both barrels and blocks and ended up purchasing two loads of barrels and one load of blocks. Second, AMPI made no further bids for blocks or barrels during the rest of 1990 although it did buy in the spot market. Finally, as discussed below in the internal memoranda of other companies, in the weeks following February 2 many companies, apparently including AMPI, had no extra cheese available for spot buyers.

**The Price Bottom**

Once the market hit bottom on February 2, 1990, barrel prices remained at a low of $1.20-$1.205 for the next seven weeks as Kraft filled all but one bid for barrels. When Kraft failed to fill one bid immediately on March 2, 1990, the bid was increased twice, resulting in a 0.50 cent price increase, whereupon Kraft filled that bid and all others for the day. During February-March 1990, Kraft sold a total of 100 loads of barrels. Dairystate was the only other trader selling barrels during the period.

Kraft also was active in block trading during the February-March price bottom, selling 18 loads in all. Closing block prices ranged between $1.2525 and $1.2675.

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11 On March 12, 1990, AMPI purchased three loads of barrels in the spot market from Dairystate, which was selling for Borden. Records of Dairystate Brands, Inc.

12 See notes 16-17.
When Kraft stopped filling barrel bids at 10:23 a.m. on March 30, buyer-traders immediately began bidding up prices, which went up 1.5 cents per pound for the day. Block prices also rose 1 cent for the day.

Summary of Kraft Conduct at Price Bottom

Although Kraft's role in the market decline before and on February 2 is ambiguous, Kraft appears to have played a less ambiguous role in keeping prices virtually unchanged over the next seven weeks. Kraft's persistent and largely solitary selling over this period raises the question, did its trading keep prices below those warranted by competitive supply and demand conditions? Below is summarized evidence relevant in answering this question.

1. During January-March 1990, industry commercial stocks and CCC stocks were lower than in any other like months during 1980-1993.\textsuperscript{13}

2. Kraft did not have a surplus at the end of 1989. On the contrary, Kraft's 1990 procurement plan, prepared in November 1989, projected a 35 million pound shortage for 1990.\textsuperscript{14} Nor did Kraft believe it had an inventory problem in early 1990.\textsuperscript{15}

\textsuperscript{13} Figure 6.2, Appendix Table 6.3.


\textsuperscript{15} On February 28, 1990, Kraft's director of cheese procurement and inventories stated that, although usage and receipts were not on Plan, in his view this did not pose a problem. As he saw it:

\textit{This over Plan condition is a result of usage being under Plan by 11 million pounds and receipts over by 3 million during the November-January period. Based on our latest forecast for the balance of 1990, this 14 million pounds will be required to cover heavy Fall demand.} Kraft General Foods, Inc., Wayne Hangartner, Director of Cheese Procurement and Inventories to Don Butte, Vice-President and Director-Refrigerated Operations, "Letter of Comment-February 1990," February 28, 1990, KGF 3168-3169, emphasis added.
3. Whereas industry cheese supplies appeared adequate in February, by March they appeared to have tightened (especially for barrels) more than implied by NCE prices.\textsuperscript{16} Two

\textsuperscript{16} A March 1, 1990, internal memorandum of one company stated, in part: Inventories gradually continue to drift downward as a result of the restrictions we have on receipts. Production schedules continue to run light also.

Reports and rumors are taking a little different light this week, especially in the natural block trade. AMPI, North Central, reports they are having trouble filling all block orders. Mid-Am reports the same....

Market Cheese Traders is reportedly looking for blocks. This seems a little unusual in as much as First World [name subsequently changed to Alpine Lace], their parent company, sold blocks recently on the Exchange.

Rumor has it that Kraft is storing all the barrels they can get their hands on.

Pacific Cheese advises that bulk sales in CA are terrific and they could market more blocks than Hilmar, their supplier, can make. They were also having some problems in locating 3 cars of current Wisconsin State Brand and needed references. [[[Source deleted in public report as not essential.]]]

A March 7, 1990, internal company memorandum stated, in part: Kraft has contacted some of our suppliers and offered to buy all the barrel cheese that SFI does not take. They have also instituted premiums for barrels to 2 cents over market (we had just dropped to flat market). Schreiber Foods, Inc., Vice President Purchasing to President and CEO, and seven other executives, "SFI Market Position and Current Strategy," March 7, 1990, Bates 4659, 4660.

A March 7 memorandum of a Kraft competitor expressed the view that Kraft appeared to be buying to keep prices down while building inventories: It looks like Kraft covered bids at the NCE on Friday [March 2] to moderate short term market pressures, while building their inventories for the fall. [[[Source deleted in public report as not essential.]]]

A March 9, 1990, internal company memorandum stated, in part: "Most major suppliers suggested that they were basically sold out for the month of March." Schreiber Foods, Inc., Purchasing Director-Eastern Region, to Vice President-Purchasing, "Premarket Update," Interoffice Memorandum, March 9, 1990, Bates 5045.

An internal memorandum of another company, March 30, 1990, expressed a similar sentiment: Barrels are exceptionally short. Smaller companies such as NU-TEK, Dairyland, Sargento and Northfield are experiencing shortages of barrels. Block is also
cheese companies looking for extra cheese in March said that AMPI reported having none available for them, perhaps because Kraft was selling on the NCE cheese acquired from AMPI, a leading Kraft supplier. Some AMPI cheese was shipped all the way from AMPI's Stephenville, Texas, plant located over 1,200 miles from Green Bay.

The market might have been even tighter had not Kraft's heavy selling on the Exchange apparently discouraged some buying for inventory. For example, one large cheese company moving very well and premiums are rising on both barrels and block. Borden Company, Intercompany memorandum, March 30, 1990. Also see references in note 17.

17 A March 15, 1990, internal company memorandum said that its co-packer had reported that:

They have contacted all major dairies/co-ops and their regular suppliers and no one is willing to sell them more than their commitment levels. AMPI told them short term they could not assist with additional load requirements, and WI Dairies has refused to lower the balance of the incremental premium of $.0150. WI Dairies continues to state they can sell the product elsewhere. Schreiber Foods, Inc., Director of Copack Services to President and CEO, Senior Vice-President and General Manager-Retail Division, and four others, "Co-Pack Bulk Cheese Tightness," E-mail transmission, March 15, 1990, Bates 5042.

An internal company memorandum of March 15, 1990, of a leading cheese company stated:

AMPI, Sanborn, is running about two loads per week shy of their projections of 10/week....we have been soliciting some extra blocks without success. So far we have checked for extra cheese at other AMPI North Central areas; AMPI, Southern; Wisconsin Dairies; and Swiss Valley. No one has any uncommitted production available at this time. [[Source deleted in public report as not essential.]]

18 Later, on March 29, 1990, an internal company memorandum of a large cheese company stated, in part:

Two different suppliers are getting an influx of phone calls from buyers wanting to buy blocks and [are] willing to make commitment thru the year. Sounds like October 1989[.] Mid-Am and AMPI continue to state that they are short of needed production. [[Source deleted in public report as not essential.]] Reference to October 1989 is to a period of considerable shortages.
had limited such purchases because it feared prices might decline further. Only when NCE prices rose April 8 did the company authorize making additional purchases.19

4. During February and March 1990, Kraft sold 100 loads of barrels and 18 loads of blocks on the NCE.20 During the same period, however, Kraft reported selling no loads of barrels and only one load of 40-pound blocks in the spot market, despite a quite strong demand (see 3 above).21 Kraft calculated that on NCE sales of 92 loads it incurred average losses of 17.5 cents per pound in February and 4.9 cents per pound in March.22 The much larger losses in February probably occurred because Kraft had purchased some of the cheese at the higher January prices, whereas all March sales involved cheese purchased in February or March.23

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19 On April 9, 1990, the company’s purchasing director stated:
For some time now, we have capped receipts from some committed suppliers to control the young cheese for process inventory growth in anticipation of further market declines....At yesterday’s President’s Staff Meeting, approval was given to purchase barrel cheese from committed suppliers for Missouri and Wisconsin; i.e., the cheese that we had not been accepting. Schreiber Foods, Inc., Vice-President Purchasing to Business Requirements Planning CAT Members, April 9, 1990, Bates 1475.

20 National Cheese Exchange, Trading Activity Minutes, AMS. USDA, reported these sales for February-March 1990. Only 92 of these 118 loads were reported in Kraft’s “Raw Material Cheese Sales” report for February-March 1990. The remaining 26 loads were reported in April. See note 45 below which explains the reason and significance of these differences.


22 Kraft General Foods, Inc., Raw Material Cheese Sales, December 1990, KGF 23760. This source calculates losses for 92 loads for February and March. Twenty-six loads sold in March are included with the April sales, on which Kraft lost an average of 4.9 cents per pound. Id.

23 The March losses apparently reflected in part the relatively high transportation costs between Green Bay and some of Kraft’s supplier plants.
If Kraft's only motive for selling on the NCE during February and March had been to dispose of excess inventories and maximize returns on such sales, it would have preferred to sell in the spot market, as it often did on other occasions. Typically, Kraft's sales in the spot market were more profitable than its sales on the NCE (Appendix Table 4.3), especially when supplies were tight, as they evidently were during this period. Indeed, Kraft itself appeared short at times since in March, at least, it reportedly was looking for more cheese.\textsuperscript{24} These actions are inconsistent with the notion that Kraft was selling barrels on the NCE to reduce inventories.

Note: Below and elsewhere in this Report, all references to specific prices shown in Figures 6.4 and 6.5 (see page 44 below) have been temporarily redacted pursuant to an agreement with Kraft General Foods, Inc., pending judicial resolution of trade secret issues. Pending judicial resolution, the authors have agreed to express in percentage terms all references to these prices in this Report.

5. Kraft had a strong financial interest in lower NCE prices in February and March 1990. It had raised the average price of Kraft processed cheese to the trade by about 15 percent between January 1989 and January 1990 (Figure 6.4). Because NCE barrel prices had risen sharply in the fall of 1989, the spread between Kraft's net prices to the trade less NCE barrel prices (hereafter Kraft's price-cost margin) had risen only about 10 percent over the period. When NCE barrel prices dropped sharply February 2, 1990, Kraft's processed cheese price-cost margins widened by about 35 percent between January and February 1990, because Kraft did not lower net prices to the trade. Kraft's price-cost margin for natural cheese also rose by a small amount between January and February--about 15 percent (Figure 6.5). These margins apparently represented historic highs\textsuperscript{24} and gave Kraft a strong financial incentive to prevent

\textsuperscript{24} See note 16 above.

\textsuperscript{25} As shown in Appendix Tables 6.10 and 6.11, retail prices of Kraft brands rose steadily and substantially between 1981 and 1990. In contrast, average NCE block and barrel
NCE prices from rising. We estimate that during February and March 1990, Kraft cheese profits rose by over $1.0 million for each 1 cent per pound decrease in raw material cheese costs due to lower NCE prices.

In sum, the available evidence does not support the hypothesis that Kraft's heavy selling on the NCE during February-March 1990 was dictated by excess Kraft or industry inventories. Rather, the evidence supports the hypothesis that Kraft's heavy selling on the NCE during the period was designed to keep the NCE price from rising, thereby widening its profit margins on cheese.

prices dropped about four cents per pound between 1981 and 1990. Hence, Kraft's gross profit margins measured by retail prices less NCE block and barrel prices, rose substantially. For example, the gross margin of Kraft's Velveeta brand rose from 43 cents per pound in 1981 to $1.96 per pound in 1990 (see Appendix Table 6.11).

Kraft's reported losses on NCE sales during February and March were $336,971. Kraft General Foods, Inc., *Raw Material Cheese Sales, December 1990*, KGF 23760. Kraft actually sold 118 loads on the NCE during February and March. The results of these sales are reported during February-April in KGF 23760. These losses were small compared to the increase in Kraft's gross profit margins during these months. See Figures 6.4 and 6.5 in Section E.

This estimate is based on the following assumptions:
1. Each 1 cent per pound decrease in NCE prices resulted in a 1 cent per pound decrease in the cost of purchased bulk cheese, as well as cheese made in Kraft-owned plants because the lower NCE prices lowered manufacturing milk prices.
2. In 1990, Kraft sold about 800 million pounds of finished cheese products to retail outlets (Appendix Table 6.4c) and about 265 million pounds to other outlets (25% of Kraft's total sales are non-retail sales. Chapter 7, p. 8).
3. About 0.85 pounds of bulk cheese is required for each one pound of finished cheese product.
4. About one-sixth of all cheese utilized by Kraft in 1990 was made or procured in February-March 1990.
B. Price Rise, Top and Decline, April 6-November 2, 1990

As noted above, after remaining virtually unchanged from February 2, 1990, until March 30, 1990, when Kraft stopped filling bids, NCE prices rose 10.25 cents the following session, April 6, 1990. Just six days later, April 12, 1990, McKinsey & Co. consultants prepared a
document entitled Short-Term Cheese Options,\textsuperscript{28} for discussion purposes with senior Kraft

\textsuperscript{28} Kraft General Foods, Inc., \textit{Short Term Cheese Options}, Kraft, USA, Discussion Outline, April 12, 1990, KGF 3026-3033.

Kraft employees interviewed in the course of this study said the McKinsey document did not reflect Kraft policy because it was prepared by outside consultants and was not acted upon by those interviewed, all of whom were involved in cheese procurement.

Wayne Hangartner, former Director of Cheese Procurement and Inventories, denied much familiarity with the document. Hangartner said the options "were not presented to me. They weren't prepared to be presented to me. I did not hire McKinsey to do this." He added, "I know that this was a period where the senior management hired McKinsey financial people, strategy people [who] were looking at our cheese business...." Kraft interview, \textit{op. cit.}, p. 67.

When asked if McKinsey would provide strategy information to him, Hangartner replied:

No, I think I'd characterize it this way. With all the volatility and what was happening to Kraft's cheese business, senior management was concerned and wanted an outside viewpoint—that's the reason for consultants...we hired them to look at the total Kraft cheese business.... \textit{Id.}, 68.

Kraft legal counsel asked Wayne Hangartner, "...just so there's no mistake about it. These supposed options that this consultant presented, were those options adopted by you in your performance of your job responsibilities in charge of procuring cheese?"

Hangartner replied: "They definitely were not adopted, and I can't recall any Kraft management above my level suggesting that." \textit{Id.}, 69.

Marcia Glenn, Director of Dairy Economics, stated the following as to her understanding of the genesis of the document:

This is a document that was prepared by an external consulting firm...during the spring of 1990 when prices were really quite [hectic]....We contributed parts, a couple pages to it, some information...and they had outlined some options that we could or could not take as they're outlined there. \textit{Id.} 66.

...there were some new people that had joined the organization and were not familiar with the market; we were in a period of rapidly moving prices and asked McKinsey to have a look at the situation. \textit{Id.}, 67.

It is our view that the McKinsey "Options" document is a legitimate representation of Kraft's view concerning the way in which it could use the NCE to influence bulk cheese procurement costs. This is apparent when this document is read in the context of prevailing market conditions (see below) and in the context of other Kraft documents that imply using the NCE to control raw material costs (see Chapter 4,
management. It summarized the short-term problems facing Kraft as follows:

- Changes in the nature of the cheese market have led to unprecedented raw material cost volatility.
- If the current relationship between Kraft wholesale price and raw material costs does not improve, the result will be a [...] profit shortfall versus financial plan.
- Our current understanding of overall cheese supply and demand indicates that raw materials costs should fall in four to six weeks.
- Between now and that time, Kraft has several options on the National Cheese Exchange and in the wholesale market.

The memorandum summarized "Kraft’s Options" as follows:

- National Cheese Exchange

Sections D and E). Moreover, McKinsey consultants were familiar with Kraft's operations. Kraft personnel had contributed parts to the options document. Glenn, op. cit., 66. Moreover, Kraft had employed McKinsey consultants both before and after the April 1990 document was prepared. For example, the Kraft General Foods, Inc., Refrigerated Products Group, 1989 Strategic Plan cited McKinsey as a source. KGF 27977, 28026. Marcia Glenn said that McKinsey also had looked at specific Kraft activities six months after the April 1990 report. Kraft Interview, op. cit., 68. Marcia Glenn and other Kraft employees also consulted with McKinsey personnel regarding issues relating to futures trading in cheese. Kraft General Foods, Inc., Lance Friedman to David Brown, Conference Call, May 31, 1990, with c.c. to Matt Christoff (McKinsey) and Marcia Glenn (KUSA Operations), KGF 16966. Also, Marcia Glenn to D. Baily, October 6, 1992, stated that they were working with McKinsey. KGF 26984, 26986. Kraft General Foods, Inc., 1993 KUSA Operations Strategic Plan, November 23, 1992, KGF 28053, 28114, refers to McKinsey as the source of a Retail Cheese Consumption by Channel study.

Interview with Kraft personnel, December 8, 1992, typed transcript of recorded interview, op. cit., p. 67. Senior management who met with McKinsey included Jim Kilts, president, and Dick Baily, Vice-President of Operations. Marcia Glenn, Id., p. 68.

Short Term Cheese Options, op. cit., KGF 3027.

Id., KGF 3031.
- Commit to sell an agreed upon volume in an attempt to prevent the barrel opinion from rising. Increased cheese supplies from the flush milk period should then decrease price in May/June time frame.

-Sell no cheese on the exchange, allowing prices to increase further, followed by a May/June decrease.

- Actively sell into the market to reduce price.

• Wholesale market

- Maintain current prices.

- Increase prices immediately, with an understanding that they may have to be decreased in two or three months.

This document can best be interpreted within the context of NCE activity during March and early April 1990. As noted above, Kraft had enjoyed unprecedented large gross profit margins during February and March 1990, when it sold heavily on the NCE. The McKinsey memorandum of April 12, 1990, appears to have been prepared in response to the 7.25 cent rise in barrel price on April 6 after Kraft stopped selling on the NCE. It discussed alternative price strategies that Kraft might pursue in response to the expected further price increases if it remained inactive on the NCE.

Kraft did not immediately adopt either the memorandum’s first option of selling on the NCE to prevent barrel prices from rising nor the third option to actively sell into the market to reduce price. Rather, Kraft remained inactive on the NCE from April 12 through July 13, 1990, during which period NCE barrel prices rose by another 9.75 cents, with only one bid filled during the period. However, Kraft did increase net wholesale prices of processed and natural cheese sufficiently to increase margins in April through October (Figures 6.4 and 6.5). This action was consistent with the McKinsey memorandum wholesale market “option” of
“increasing prices.” Kraft did not follow this option in its entirety; i.e., it did not subsequently reduce wholesale prices “in two or three months.”

On July 20 Kraft began selling into the barrel market.\(^3^2\) During the five trading sessions July 20-August 17, Kraft sold 17 loads of barrels as the barrel market peaked (during the sessions of July 27 and August 3) and then declined gradually for four sessions and remained unchanged September 7. Thereafter barrel prices fell a total of 32.5 cents per pound on offers and reduced offers by Kraft and Borden in eight sessions, with only two offers covered. Barrel prices hit bottom November 2, 1990, at 1.75 cents per pound below the price support level.

The virtual free fall in barrel prices was quite typical of trading patterns once price began falling off a high. As one large trader put it:

Experience tells us that as markets start to soften, everyone in the use chain holds back purchasing (to get the best price or minimize inventory devaluation), thereby exacerbating the backup and forcing a market drop.\(^3^3\)

The overall pattern in blocks was similar to that in barrels, though more and different actors were involved. Kraft appeared to begin topping the block market July 6 and July 13, 1990. On July 20, Kraft was joined in selling by Alpine Lace, and prices peaked July 27. During the following weeks prices began their descent, as Kraft and Alpine Lace continued

\(^3^2\) On July 13, 1990, a competitor of Kraft reported that, Stephenville [an AMPI plant in Texas that supplied Kraft] cut us 1 load of blocks this week and I understand they have cut Mid-Am more in favor of shipping Kraft more. However, the blocks that Mid-Am bought from Kraft last week on the exchange was filled with Stephenville [AMPI] blocks. [[Source deleted in public report as not essential.]]

This illustrates how Kraft exercised control over its committed suppliers to determine whether their surplus was disposed of on the NCE or in the spot market.

selling. Thereafter, prices declined irregularly until November 2, 1990, when blocks were 2.25
cents per pound below the price support level. Although other block traders, particularly
Dairystate and Alpine Lace, joined in offering the block market down, Kraft was the principal
player, selling 35 loads of blocks during the 18 sessions July 6 through November 2, 1990.

These events suggest that in April 1990 Kraft decided to let the NCE price rise initially
and then, beginning in July, to "actively sell into the market" until prices topped and then
decayed again. These events also imply that, as the McKinsey document suggests, Kraft does at
times have the ability to influence NCE prices and its net wholesale selling prices should it
decide to do so.

Summary of Kraft Conduct

Kraft did not have a surplus problem when it topped the market in July 1990,\textsuperscript{34} nor did it
believe there was a surplus problem when it began taking the market down in August.\textsuperscript{35} On

\textsuperscript{34} Kraft's Director of Cheese Procurement and Inventories made monthly status reports on
cheese receipts and usage to the Vice President of the Refrigerated Products Division.
On July 6, 1990, Kraft's purchasing director reported, in part:

\begin{quote}
We have sold no raw material cheese into the industry since mid-June. Based on
latest projections, Kraft's estimated cheese supply over the balance of 1990 will
cover demand and desired safety stock levels. These projections indicate no
surplus. Kraft General Foods, Inc., Wayne Hangartner, Director of Cheese
Procurement and Inventories, to Don Butte, Vice President and Director-
\end{quote}

\textsuperscript{35} On August 24 Chris Emerson, Manager-Raw Material Cheese Planning, gave an
optimistic report on expected usage and receipts for the remainder of calendar year 1990
and 1991:

\begin{quote}
Projected usage, for the balance of 1990 is 5.2 million pounds over the previous
projection....Also, 1991 growth has been increased by Marketing. This increased
usage has resulted in a projected shortage of 10.6 million [pounds], by year's end.
The projected shortage should not be a problem, because receipts have been
exceeding estimate and safety stock reductions could cover the shortfall. Kraft
General Foods, Inc., Chris Emerson, Manager-Raw Material Cheese Planning to
Wayne Hangartner, Director of Cheese Procurement and Inventories, "Letter of
September 24, 1990, Kraft purchasing planners warned that events were not unfolding according to plan because receipts were higher and usage was lower than expected.\footnote{36}

On October 8, 1990, Emerson reported:

September year-to-date actual commercial usage is...2.4\% over plan and...2.8\% over prior year....While this performance is impressive, demand for the balance of 1990 is down from previous estimates and is projected to be under plan. In addition, finished product inventories are significantly over plan.\footnote{37}


Hangartner raised the specter of a potentially serious surplus problem November 1, 1990, when he reported:

Tentative figures indicate that Kraft will close October with a total raw material of cheese inventory of 214 million pounds, 25 million over Plan, and 6 million over our latest estimate. Our latest projections indicate a December 1990 ending inventory of...26 million pounds over Plan. Due to our present inventory mix and demand for current cheese over the remaining two months, it will not be possible to bring our inventory down to a totally desirable year end level.

We are developing plans to reduce this surplus through reduced receipts and government sale. Due to firm supplier commitments, the government sale program will result in some level of loss and also have the impact of increasing Kraft's receivables. As soon as we finalize this program, it will be shared with Operations financial to determine the exact financial impact. Kraft General Foods, Inc., Wayne Hangartner, Director-Cheese Procurement and Inventories to Don Butte, Vice President and Director-Refrigerated Operations, "Letter of Comment-October 1990," November 1, 1990, KGF 3213; emphasis added.
By November 19, 1990, Kraft's purchasing director estimated the surplus would be 40-50 million pounds during November 1990 through 1991. As shown in Figure 6.3 and Appendix Table 6.1, Kraft's actual inventory exceeded the 1990 Plan each month during September through the end of December. From the outset Kraft's 1991 Plan had anticipated solving the surplus problem by reducing the amount of cheese procured and by selling to the CCC.

Once the purchasing executives discovered in September 1990 that Kraft had a serious and growing surplus problem, they had a strong incentive to quickly take prices to the support level so Kraft (and the industry) could dispose of the surplus to the CCC. In eight trading sessions beginning September 14, Kraft--often joined by Borden--led barrel prices down 32.25 cents. At this point the NCE barrel price was 1.75 cents below the support level for barrels and 2.25 cents for blocks. During the eight-week price plunge from September 14 to November 2, only two of Kraft's offers to sell barrels and none of Borden's were covered before prices had

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38 Kraft General Foods, Inc., Wayne Hangartner, Director of Cheese Procurement and Inventories, to Kathy Williams, "Surplus Inventory," November 19, 1990, KGF 3232.

39 Kraft's 1991 Raw Material Operating Plan, prepared in November 1990, stated: The 1991 surplus supply will not be procured and inventory reductions will be made based on the seasonal supply curve. Sales to the government have already been initiated. Kraft General Foods, Inc., 1991 Raw Material Operating Plan, KGF 3236. Also see text at note 42 below regarding Kraft's planned method of disposing of the surplus.

40 By this time there was an industry-wide surplus problem, which had developed because of an increased supply of milk and a decline in retail sales. As early as August 8, one leading cheese marketer noted that milk production was higher than anticipated, attributable, in part, to very mild and cool weather in the Midwest and South. California cheese production also was up. Schreiber Foods, Inc., Purchasing Director-Western Region to Vice President-Purchasing, "Pre-Market Update," August 9, 1990, Bates 5000.
Figure 6-3
Kraft Planned and Actual Raw Material Cheese Inventory, 1989-1992

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.

Source: Appendix Table 6.1
fallen below the support level.\textsuperscript{41} Thus, it appears that during the price drop Kraft was not active on the NCE to dispose of surplus, but to use it as an instrument for taking the NCE price below the support level in order to dispose of surplus to the CCC. As Kraft's purchasing director Hangartner stated November 19, 1990:

Now that the cheese market has settled out at support level, we are in a position to deal with our surplus inventory position and also our surplus commitments through 1991. Our latest planning indicates a surplus in the 40-50 million pound range November 1990 through 1991. This situation will be dealt with through a combination of commitment reductions and sale to the Commodity Credit Corporation, with the majority handled through the government sales program.\textsuperscript{42}

Significantly, Hangartner made no mention of sales on the NCE in the surplus disposal plan.

In summary, these events suggest that Kraft was the primary actor in topping the market in July and initiating the decline in August.\textsuperscript{43} When the surplus dictated a further price decline in September, Kraft again led prices down until they were below support levels.

What, then, is the significance of these events? First, they document Kraft's leadership role in placing the upper limit on prices in this price cycle and in leading the market down. Second, they document that during the price decline, Kraft used the NCE to lead prices below the support level in order to sell its surplus to the CCC rather than using the NCE merely to

\textsuperscript{41} During this period when Kraft and Borden were taking down NCE prices, Kraft bought 10 loads of blocks. As discussed in Chapter 5, Section E, Kraft bid blocks at times during this period for the apparent purpose of influencing the spread between NCE barrels and block prices, not because it needed blocks. Kraft also bought 12 loads of blocks August 4 and 31, 1990.

\textsuperscript{42} Wayne Hangartner, Director of Cheese Procurement and Inventories, to Kathy Williams, "Surplus Inventory," November 19, 1990, KGF 3232. Emphasis added.

\textsuperscript{43} After Kraft had initiated the decline August 17, Alpine Lace and Dairystate became the most active seller-traders in taking down the block market.
dispose of surplus. And because Kraft did not lower its wholesale prices correspondingly, it enlarged its gross profit margins.

When barrel prices fell below the support level November 2, 1990, Kraft lowered its wholesale price (Figure 6.4 and 6.5). Nonetheless, the spread between the NCE barrel price and Kraft's average net price to the trade for processed cheese widened by about 35 percent between July and December 1990. Thereafter Kraft's average processed cheese margins widened. During November 1990 through April 1991, Kraft net wholesale prices remained well above earlier levels even though NCE barrel prices remained below support levels through April 1991 (Figures 6.1 and 6.4).

C. Price Cycle November 1990-February 1992

The Price Bottom, November 1990-May 10, 1991

After NCE prices fell below the CCC support level November 2, 1990, Kraft and other companies immediately began contracting to sell to the CCC. From the week ending November 19, 1990, through the week ending May 24, 1991, the industry sold 39.5 million pounds of blocks and barrels to the CCC (Appendix Table 6.2).

Kraft played the leading role in trading NCE barrel and block prices during the 29 weeks they remained below the support level. Except for one sale of two loads made by Borden, Kraft was the only seller-trader in barrels, selling 84 loads during November 2, 1990, through May 10, 1991. In blocks, Kraft sold 31 loads and Dairystate sold 4 loads. In total, Kraft sold 115 of the 121 loads sold on the NCE during the period. During this period, Kraft made 95 percent of all
sales on the NCE. In contrast, Kraft accounted for about 40 percent of all cheese sales to the CCC during November 1990-May 1991.\footnote{Kraft sold 6,716,948 pounds of block cheese and 9,015,330 pounds of barrel cheese to the CCC in 1991. Kraft General Foods, Inc., “Raw Material Cheese Sales, December 1991,” KGF 23757. This represented 40 percent of CCC sales in 1991 (Appendix Table 6.2.)}

Barrels were in shorter supply than blocks during this period. Indeed, there were no net barrel sales to the CCC after February 8, 1991. A Kraft document shows that it sold only five loads of barrels to the CCC in April and none thereafter.\footnote{Kraft General Foods, Inc., “Raw Material Cheese Sales,” December 1991, KGF 23757. Some or all of the five loads may actually have been contracted for sale to CCC earlier, since this source often reported the month in which transactions were consummated, not always the month in which Kraft made a trade on the NCE. This source frequently reports an NCE sale made at the end of one month among the sales reported in the gain/loss report the following month. Although the number of loads reported in Kraft’s gain/loss reports for a month may not correspond precisely with the number of loads traded in a month, loads sold on the NCE and loads reported in the gain/loss report are virtually the same over the course of a year. Nor does this reporting practice result in a consistent bias when comparing Kraft’s losses or gains of NCE, spot and CCC sales for particular months or groups of months.}

On the other hand, Kraft sold heavily on the NCE, selling 75 loads of barrels during April through May 10, when barrel prices rose to the support level.\footnote{By this time barrels were in especially short supply. A month before barrel prices rose to the support level, one leading company internal memorandum commented, in part:
--There is a significant interest in barrel cheese.
--Outside of Kraft no one has surplus barrels
--Barrels will drive the cheese market increases. Schreiber Foods, Inc., Purchasing Director-Western Region to Vice President-Purchasing, “Pre-Market Update,” April 12, 1991, Bates 4916.} For the period, Kraft reported sales of only five loads of barrels to the CCC
and 10 loads in the spot market.\textsuperscript{47} For April and May, Kraft reported sales of 63 loads of blocks in the spot market and 56 loads to the CCC.\textsuperscript{48}

Kraft reported losses of 1.7 cents per pound on barrel and block sales on the NCE for April and May, whereas it had gains of 1.9 cents per pound on barrel and block spot sales and 1.1 cents per pound on CCC sales.\textsuperscript{49} The pattern of Kraft's sales conduct on the NCE, especially in barrels, implies that it was motivated by a desire to keep NCE prices below support levels. Had Kraft's motive for selling barrel and blocks during April and May been solely to maximize profit on these sales, it would have sold them in the spot market or to the CCC rather than on the NCE.

The above facts demonstrate that Kraft played the leading role in maintaining prices below support levels during November 1990-May 1991, especially for barrels. Even without Kraft’s actions prices would have dropped to support levels in the fall of 1990 since there was clearly an industry-wide surplus problem. But Kraft appeared to determine the timing and swiftness of the price drop. This may have reflected that Kraft had a larger surplus problem than most, much of it self-imposed, and had somewhat exacerbated the industry-wide problem because of its wholesale pricing conduct.\textsuperscript{50} But NCE prices, especially for barrels, might well have risen above the support level somewhat earlier had Kraft sold more to the CCC rather than on the NCE.


\textsuperscript{49} Id.

\textsuperscript{50} See Section E below, this chapter.
During the period that NCE prices were below support levels, Kraft took important steps in dealing with its surplus problem as had been planned in November 1990.\textsuperscript{51} By the end of May 1991, Kraft's inventory was below planned levels for the first month since August 1990 (Figure 6.3 and Appendix Table 6.1).

**The Price Rise May 17, 1991-September 26, 1991**

When Kraft did not participate in the May 17, 1991, trading session, NCE prices immediately began rising. The upward trend continued, with block prices peaking September 27 and barrel prices October 18. Throughout the rise, supplies were quite tight. As early as May 21, 1991, the purchasing official of a leading cheese company reported:

Along with the price rise, we will experience cost over market pressure—especially for barrel cheese for processing. Many of our suppliers of barrel cheese are reporting that our competitors are willing to pay $0.020/pound higher cost over market premiums for incremental volume.\textsuperscript{52}

On June 7, 1991, another company reported that:

\textsuperscript{51} By the end of August 1991, Kraft's purchasing director was able to report that Kraft had essentially solved its surplus problem. During the first 8 months of 1991, we have sold approximately 60 million pounds of raw material cheese, reduced Kraft production approximately 12 million pounds, and reduced Procurement receipts by over 35 million pounds. Our latest estimates indicate an additional surplus of approximately 7 million pounds for the period of September through November, but it is questionable if this surplus will actually develop. Currently, receipts are coming in under estimate and usage is running slightly over estimate. Actual surplus and the decision to sell additional quantities into the industry is being addressed on a weekly basis. Wayne Hangartner, Director of Cheese Procurement and Inventories, to Don Butte, Vice President and Director-Refrigerated Operations, "Monthly Letter of Comment-August 1991," August 28, 1991, KGF 14675.

Kraft sold "into the industry" during the fall of 1991 for the apparent purpose of moderating the rising price trend in the fall of 1991 even though doing so reduced its safety stocks, as discussed below.

American cheese production showed a drop in April of 6%. This drop in production plus the government contracts are tightening the supply further.\(^{53}\)

Government contracts refers to the USDA's so-called secondary support program announced in early May. For this program, the USDA temporarily suspended the resale of CCC cheese and NFDM inventories and instead bought cheese for the 1992 school lunch and other domestic feeding programs. This action reduced the supply of cheese available to the commercial market and eliminated the tendency for CCC resales to place a cap on cheese prices.

During the following weeks internal company reports made frequent reference to tight bulk cheese supplies, especially barrels, but noted the availability of such cheese from Kraft in the spot market.\(^{54}\) As tightening market conditions caused prices to rise, Kraft periodically sold


on the NCE for the apparent purpose of "moderating" the price rise. During the weeks of rising prices beginning May 17 through October 11, 1991, Kraft's periodic selling appeared to slow, or temporarily stop the upward trend. During these weeks, Kraft sold a total of 146 loads of barrels and 33 loads of blocks on the NCE. The only other Exchange sellers during these weeks were Borden, which sold 8 loads of barrels, and Land O' Lakes, which sold 10 loads of barrels.

The inference that the motive for Kraft's periodic selling during this period was to stop or slow the price rise is not ours alone; various personnel of a large cheese company arrived at the same conclusion:

**June 14, 1991 Trading Session**
...Kraft seems to be taking the position that they will sell to prevent a panic market run up but will not stop an orderly market rise.\(^{55}\)

**June 28, 1991 Trading Session**
It appears that Kraft is continuing to over commit for both blocks and barrels so that they are in a position to cover their commercial orders as well as influence and trade at the Exchange.\(^{56}\)

**July 19, 1991 Trading Session**
The cheese available, especially barrels, continues light--with Kraft's selective selling moderating the rise in markets.\(^{57}\)

**September 19, 1991**
Wayne [Hangartner, Kraft's purchasing director] believed that they will have more available in future weeks and that they don't want to carry more than they need for their own requirements; however, *he wanted to have some trading inventory.*\(^{58}\)

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\(^{55}\) [[Source deleted in public report as not essential.]]

\(^{56}\) Emphasis added. [[Source deleted in public report as not essential.]]

\(^{57}\) [[Source deleted in public report as not essential.]]

\(^{58}\) Emphasis added. [[Source deleted in public report as not essential.]]
October 8, 1991
Kraft selective selling continues to moderate the upward movement.59

In order to continue selling "into the industry,"60 for the apparent purpose of moderating the price rise, Kraft drew down its inventory to below plan, thereby reducing safety stocks below normal levels. On October 3, 1991, Kraft purchasing director Hangartner explained the rationale for doing so:

Our window of opportunity to sell surplus cheese into the industry will close as soon as market values start their decline. For this reason, as well as financial considerations, we are currently reducing safety stocks below normal levels to ensure that we are at absolute minimum inventories when the markets start to head south.61

Left unsaid was the fact that, as Hangartner certainly knew, Kraft had already begun to top the market on September 27, 1991, and in a few weeks would trigger a steep price decline (see below). Kraft's strategy succeeded: prices declined and when they bottomed out in early 1992, Kraft rebuilt inventory so that it was right on Plan by April 1992 (Figure 6.3 and Appendix Table 6.1).

59 [[Source deleted in public report as not essential.]]

60 Indeed, Kraft's purchasing director stated explicitly August 28, 1991, that decisions to sell "into the industry" were being addressed on a "weekly basis." See note 51 above.


During 1991, Kraft reported sales of 720 loads of cheddar barrels and 40-pound blocks in the spot market, 375 loads to government, and 343 loads on the NCE. It also reported sales of 457 loads of 640-pound blocks in the spot market. Appendix Table 4-3. Kraft General Foods, Raw Material Cheese Sales, December 1991, KGF, 23757. Kraft reported average gains of 0.6 cents per pound on government sales, average gains of 4.2 cents per pound on spot sales, and average losses of 1.7 cents per pound on NCE sales. Id.
The Price Top and Subsequent Decline, September 1991-February 1992

During September 6 through October 10, 1991, Kraft sold into a rising market. Prices for barrels peaked October 18, remained unchanged through November 1, and began falling November 8, 1991, as Kraft continued heavy selling. Thereafter, Kraft, joined primarily by Borden and Alpine Lace, offered the barrel market down until it bottomed on February 7, 1992; the block market bottomed February 21, 1992.

Summary of Kraft Conduct

Kraft played the leading role in maintaining NCE prices below the support level during November 1990-May 1991. Although an industry-wide surplus problem dictated that prices drop to the support price, Kraft's active selling determined the timing and swiftness of the price decline. Once NCE prices were below the support level, they might well have risen to, or above, the support price somewhat earlier had Kraft sold more to the CCC rather than on the NCE. The fact that Kraft incurred losses on its NCE sales during April and May 1991, whereas it enjoyed gains on its spot and CCC sales, implies that it was selling on the NCE to influence prices, not to maximize profits on these sales.

Between mid-May and October 1991, Kraft played the central role in shaping price movements as NCE prices rose from below support levels to their seasonal highs, after which they declined steadily until February 1992 (Figure 6.1). Kraft slowed the price rise by periodic selling into the market. Between the sessions in which Kraft sold on the NCE, prices rose in active bidding with virtually no consummated sales. Kraft effectively topped the market by selling heavily in successive sessions, and continued to sell as prices began a long decline on November 8, 1991.
Kraft apparently was able to influence NCE prices because it had access to large amounts of cheese, much of which it chose to sell selectively on the NCE, even though demand in the spot market was strong and sales there more profitable than sales on the NCE. For June through December, 1991, Kraft reported average losses of 2.4 cents per pound for 237 loads of barrels and blocks it sold on the NCE, whereas it enjoyed an average gain of 3.8 cents per pound on [...] loads of barrels and blocks sold in the spot market. These facts imply that Kraft was acting against its own interest had its objective been solely to maximize profits on sales.

Kraft had more than met its goal of reducing inventory substantially during 1991. Indeed, in each month from May through December 1991, Kraft's actual inventories were below Plan. By the end of December 1991, Kraft's inventory was [...], 6 percent below its 1991 Plan (Figure 6.3 and Appendix Table 6.1). As noted above, Kraft accomplished this, in part, by reducing its "safety stocks" below normal, anticipating their replenishment after prices had declined.


Overview of 1992

Kraft began 1992 with a modest surplus problem. At the end of January cheese inventories were 2.8 percent over the 1992 Plan (Figure 6.3 and Appendix Table 6.1).

Commercial usage was 12.6 percent under 1992 Plan. Kraft initiated actions to remedy the

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63 Kraft General Foods, Inc., Chris Emerson, Manager-Raw Material Cheese Planning, to Wayne Hangartner, Director of Cheese Procurement and Inventories, "Letter of
situation. By April 1, 1992, Kraft's purchasing director was able to report that they had negotiated further cutbacks with committed suppliers, thereby reducing the projected surplus to only [...] million pounds through November 1992, which he believed could be easily disposed of by spot sales to industry or the NCE, if and when necessary. At the end of April Kraft's Director of Purchasing reported that the projected surpluses had been eliminated through reduced commitments and increased demand.

During July-December 1992, Kraft's actual inventories closely followed planned inventories (Figure 6.3 and Appendix Table 6.1). Indeed, Kraft began 1993 under the 1993 Plan.


Kraft’s efforts to regain market share by reducing wholesale prices and income began paying off during 1992 (see below). Although commercial usage did not increase immediately, by the fourth quarter total retail sales exceeded those in the fourth quarter of 1991.

**Pricing Conduct Over Price Cycle**

The price cycle of 1992 was similar to those during 1990 and 1991 (Figure 6.1). Barrel prices bottomed February 7 at $1.135 per pound. During February 14 through March 27, barrels traded in a $1.1350 to $1.1425 range until prices began rising during the April 3 trading session, with Kraft intermittently selling into the rise. The most active barrel sellers during February 7 through April 3 were Kraft (71 loads), Borden (13 loads) and Bongards’ (16 loads). The most active buyers were Beatrice (74 loads) and AMPI (10 loads).

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68 For a discussion of Kraft’s wholesale price conduct see Section E below. In November 1991 Chris Emerson had anticipated that Kraft’s price reductions in 1991 would not immediately impact demand: “At present, the [...] per pound price rollback is not expected to impact short range demand. Philip Morris had agreed to reduce income in order to regain share. This support has given renewed impetus to the Sales/Marketing effort.” Kraft General Foods, Inc., Chris Emerson, Manager-Raw Material Cheese Planning, to Wayne Hangartner, Director of Cheese Procurement and Inventories, Monthly Letter of Comment--November 1991,” November 22, 1991, KGF 26482. Information has been temporarily redacted in this report pursuant to an agreement with Kraft General Foods, Inc., pending judicial resolution of trade secret issues.

Public sources, however, place Kraft’s price decrease at about 22 cents per pound and discuss the reasons for the decrease. On March 28, 1992, a Kraft official informed the editor of The Milkweed, a Wisconsin farm magazine, that Kraft had lowered its cheese prices 22 cents per pound in December 1991. The Milkweed, April 1992, p. 5. Other public services also discuss Kraft’s December 1991 price cut averaging 8 percent or “slightly more than 20 cents” for Kraft natural cheese and processed cheese slices in order to “regain” market share losses during 1990-1991. See Advertising Age, January 27, 1992, p. 16; Wall Street Journal, March 18, 1993; Milkweed, January 1992, p. 4.

Philip Morris Companies Inc. CEO reportedly told marketing analysts that Kraft’s loss in supermarket cheese sales had reduced Kraft’s net profits by $125 million in 1991. The Milkweed, February 1992.

69 Appendix Table 6.4c.
The price pattern in blocks generally followed that in barrels. The block market bottomed February 14 and remained in a $1.1525 to $1.1625 range through March 20. Prices began rising March 27. The leading block seller-trader was Kraft (22 loads); and the leading buyer-traders were Mid-Am (12 loads), Beatrice (8 loads) and AMPI (8 loads).

Illustrative of Kraft's preference for selling on the Exchange rather than the spot market are the following events. On March 30 and 31, 1992, Kraft received requests from four companies to buy 10 to 12 loads of barrels and four loads of blocks aged 30 days or less, i.e., the age qualifying for sale on the NCE. Kraft sold two loads of barrels to one of these parties on the NCE April 3, 1992. One of the other parties was told that Kraft's excess was sold to their direct customers. Kraft informed another party that they had no available cheese. No response was apparently given to the fourth prospective buyer. Although Kraft apparently could have sold another 12-14 loads in the spot market, it evidently chose to sell on the NCE instead, where on April 3, 1992, it sold 27 loads of barrels and two loads of blocks.

From April 10 through July 31, barrel prices rose by 16.75 cents per pound on bids by several buyer-traders, especially Schreiber, Beatrice and Dairystate, with no actual sales until the last few weeks of the rise. Kraft evidently approved of the price rise since on April 16 it made one bid for barrels and one bid for blocks. Kraft's actions were interpreted as sending a "message to the industry" that Kraft approved of the rising price trend. One of the traders bidding up the market during these weeks observed:

A significant event occurred today. When the block was bid to $1.27 Kraft entered a bid for four cars of blocks at $1.27 and for five cars of barrels at $1.24/pound--Kraft's

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— Kraft General Foods, Inc., Jeff Voermans to Wayne Hangartner, Director of Cheese Procurement and Inventories, "Requests for Cheese" April 6, 1992, KGF 16023.
message to the industry was that they were not going to sell any blocks or barrels at this point in time.\textsuperscript{71}

Kraft's approval of the rising price trend evidently reflected its view that economic fundamentals dictated an increase in prices. In Kraft's view, weak milk production and government procurement activity was causing a counterseasonal rise in price.\textsuperscript{72}

The barrel price remained at the seasonal high of $1.35 for only two weeks. Then on August 14, 1992, Kraft, which had remained inactive since sending its April 16 "message" approving the rising price trend, began offering the barrel market down. It was joined by Borden and Alpine Lace. The barrel price continued to decline for 22 weeks, dropping a total of 23 cents a pound and reaching bottom January 15, 1993.

The downward pattern in blocks generally followed that in barrels. Prices began falling August 21 on offers by Kraft and Alpine Lace. Block prices also hit bottom on January 15, 1993. Although several traders joined in offering the block market down, Kraft (90 loads), Alpine Lace (14 loads) and Golden Cheese (10 loads)\textsuperscript{73} accounted for over 90 percent of all loads traded.

**Summary of Kraft Conduct**

Kraft's trading patterns during the 1992 price cycle were generally the same as in previous cycles. Kraft sold heavily on the NCE during the price bottom of March and April

\textsuperscript{71} [[Source deleted in public report as not essential.]] Emphasis added.


\textsuperscript{73} These were the only loads sold by Golden Cheese of California during 1988-1993. See Table 4.2, note 5.
1992 and during the price decline of August through December 1992. For the year, Kraft reported incurring losses averaging 5.2 cents per pound on NCE sales of barrels and blocks versus average losses of 2.4 cents per pound on its spot barrel and block sales. If 640-pound squares (which are close substitutes for 40-pound blocks) are included among spot sales, Kraft enjoyed gains of 3.8 cents per pound on its total spot sales (Appendix Table 4.3).

For the three years 1990-1992, Kraft reported losses of 3.9 cents per pound on NCE sales, gains of 2.9 cents per pound on spot sales of blocks and barrels, and gains of 0.57 cents per pound on CCC sales (Appendix Table 4.3).

Kraft’s NCE sales during March 1992, appeared to be designed to maintain the price bottom and the sales during April appeared to slow the subsequent price rise, not designed to dispose of surplus. NCE sales during the August-December price decline appear to have been directed at reducing NCE prices, since during August-December 1992, Kraft’s commercial usage exceeded cheese receipts, causing actual inventory to fall short of planned inventory (Figure 6.3 and Appendix Table 4.3). Thus, although Kraft no longer had a surplus problem, it had access to sufficient cheese for trading purposes to influence prices on the NCE.

E. Relationship between NCE Prices and Kraft’s Wholesale Prices

Cheese marketers, like Kraft, that do not couple their wholesale prices to NCE prices benefit financially from lower NCE prices, other things being the same (see Section C, Chapter 4). Here we examine the relationship between Kraft’s wholesale pricing conduct and NCE prices during 1990-1992 and the consequences of this conduct.
This analysis focuses on Kraft’s cheese sales to food retailers, which account for about 75 percent of Kraft’s total commercial cheese sales. In 1990, Kraft brands reportedly had the following retail sales and market shares (measured in dollars) for various styles of cheese:

<table>
<thead>
<tr>
<th>Cheese Styles</th>
<th>Value of Retail Sales (Millions)</th>
<th>Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Processed cheeses</td>
<td>$1,554</td>
<td>58%</td>
</tr>
<tr>
<td>Natural cheeses</td>
<td>1,059</td>
<td>30%</td>
</tr>
<tr>
<td>Cream cheese</td>
<td>381</td>
<td>75%</td>
</tr>
<tr>
<td>Total</td>
<td>$2,994</td>
<td>44%</td>
</tr>
</tbody>
</table>

Kraft retail brands compete in two market segments, branded cheeses and private label cheese sold by food retailers. Kraft dominates the branded market segment. The private label market segment is larger than the combined shares of all cheese brands other than Kraft brands (Appendix Tables 6.9a-9c).

Kraft brands and private-label brands of food retailers (also called store brands) are in separate strategic groups or submarkets. Whereas Kraft brands are highly differentiated products, private-label brands are undifferentiated products. The purpose of product differentiation is to create a gap in buyers’ perceived value of a brand relative to other brands. The greater the difference in perceived value, the larger premium buyers will pay for the brand. Differentiation is achieved by strategies that increase perceived value, e.g., creating new products, establishing a reputation for product quality, and designing attractive packaging. The

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74 February 21, 1994 letter from Roibin Ryan, Kirkland and Ellis, to Reid Klopp, DATCP, providing data on Kraft’s volume of cheese manufactured, purchased and sold in 1992 in response to DATCP survey of December 1993.

75 SAMI Million Dollar Brand Directory. Another source, which does not report Kraft’s processed and natural cheese sales separately, estimated Kraft’s brands had a retail value of $2,647 million in 1990. Appendix Table 6.4d.

perceived value of the product is enhanced by extensive advertising and promotion efforts.

Successful product differentiation creates consumer loyalty for the brand, which reduces buyers' propensity to switch brands as price gaps widen.

Kraft has succeeded in differentiating its brands by using the above and other strategies that enhance the perceived value of brands. This has given it a significant degree of independence in pricing relative to private-label brands. Between 1981 and 1988 Kraft increased substantially the retail price gap between its brands and private-label brands without losing share to these brands. During the period, this price gap increased as follows: processed cheeses—15.2 percent to 25.7 percent; natural cheeses—15.7 percent to 23.1 percent; and cream cheese 21.0 percent to 27.1 percent (Appendix Table 6.10). This was accomplished without loss of share to private-label brands (Appendix Tables 6.9a-6.9c). Rather, private-label brands lost share over the period. Although Kraft lost some share in natural cheeses, this loss was to two aggressive new cheese marketer brands, Sargento and Sorrento.

Kraft's product differentiation advantage permitted a gradual widening of the Kraft-private label price gap between 1981 and 1988 by an annual average of 2.4 percentage points for processed cheese, 1.6 percentage points for natural cheeses, and 1.5 percentage points for cream cheese (Appendix Table 6.10). Kraft's success in widening the price gap without losing market share apparently was due in part to its strategy of gradualism, which gave consumers less incentive to switch brands than a strategy that would have increased the price gap in a few large steps. A single large increase in a price gap causes consumers to immediately reevaluate their perception of the relative value of the premium brand. Also, such increases encourage retailers
to promote their own lower price private brands, emphasizing the size of the new price gap.

Private label suppliers may also give promotion incentives to retailers in these circumstances.

The success of Kraft's strategies apparently increased its gross profit margins to record levels by 1988.\textsuperscript{77} At the end of 1989, the Kraft strategic planners reported that Kraft had enjoyed exceptional earnings growth driven by increasing prices in an environment of declining commodity costs and increasing productivity.\textsuperscript{78} The planners cautioned that recent increases in the Kraft-private label price gap were causing Kraft to lose market share.\textsuperscript{79} Their strategic plan for 1990 therefore called for a return to more normal earnings growth, and an acceleration of volume and market share growth.\textsuperscript{80} During 1990 and 1991 Kraft did not follow the planners' advice. Instead they pursued a strategy of rapid earnings growth and substantial widening of the Kraft-private label price gap, causing large losses in market share.

\textit{Note: Below and elsewhere in this Report, all references to specific prices shown in Figures 6.4 and 6.5 have been temporarily redacted pursuant to an agreement with Kraft General Foods, Inc., pending judicial resolution of trade secret issues. Pending judicial resolution, the authors have agreed to express in percentage terms all references to these prices in this Report.}

\textsuperscript{77} Kraft General Foods, Inc., \textit{Refrigerated Products Group, 1990 Strategic Plan}, December 1989, KGF 21183, 21190. The Plan was forwarded December 6, 1989 by Mitch Wienick to Jim Kilts, Doug Conant, Pat O'Neil and Dave Rickard, KGF 21182. Kraft's gross profit margins are determined by the spread between the average net wholesale price charged retailers and other customers and the average cost of making finished cheese products (raw material costs, mainly cheese and other forms of milk, average about 75 to 85 percent of the cost of making finished cheese products in the U.S. cheese industry).

Also see note 25 above.

\textsuperscript{78} \textit{1990 Strategic Plan, op cit.}, KGF 21185, 21190, and 21203.

\textsuperscript{79} \textit{Id.} KGF 21185, 21194, 21203. This reference evidently referred to the decline in share during 1989 relative to 1988 (Appendix Table 6.4a).

\textsuperscript{80} \textit{Id.} KGF 21185 and 21190.
Figure 6.4 compares the average NCE barrel price with the average *net* wholesale price to the trade of Kraft processed cheese from January 1989 through December 1991, as reported in a Kraft document. In January 1989, the spread between the NCE barrel price and Kraft’s

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81 Kraft changed list prices and trade allowances several times during 1989-1991. These changes were not uniform across all lines, often affecting only certain brands. This explains in part why the average *net* wholesale prices shown in Figures 6.4 and 6.5 vary from month to month and do not always correspond to the price changes reported below.

A large price increase occurred during September-October 1989, increasing average net prices of processed cheese by about 35 cents per pound and average net prices of natural cheese by about 60 cents per pound (Figure 5.4).

Kraft reported to the editor of *The Milkweed* the following price changes for “Kraft Natural Chunk” cheese: A trade allowance of 17 cents per pound was given during the period October 1990-July 1991; list prices were reduced 18 cents per pound in April 1991; and list prices were reduced 22 cents per pound in December 1991. This represented a net decrease of 40 cents over the period. Pete Hardin, “Kraft Natural Chunk Pricing,” *The Milkweed*, April 4, 1992. These dates identify periods in which significant reductions were made in Kraft’s net prices to the trade during this period and are reflected in Kraft’s net prices to the trade as reported in Figures 6.4 and 6.5. However, similar cuts were not made for all products; prices were raised for some products during the period.


In addition to making several reductions in the wholesale price for processed and natural cheese, in September 1990 Kraft announced a large promotion effort involving reported expenditures of $75-$100 million including trade promotion allowances and consumer coupon redemption programs. George Lazarus, “KGF to Deck Halls with Mega Promo,” *Chicago Tribune*, September 7, 1990, p. 2. (This program apparently included the trade allowances reported above for the period October 1990-July 1991.) The promotion program was aimed not only at cheese but also at 34 Kraft General Food brands, including Miracle Whip salad dressing, Maxwell House coffee, and Jell-O pudding. Kraft reported that the promotion program made available $500 million in cents-off coupons. It is not possible to estimate the effect of these coupons on retail
average net price to the trade (hereafter Kraft's price-cost margin) averaged about [...] cents per pound. Thereafter the margin narrowed as NCE barrel prices rose. Between January 1989 and December 1989, Kraft increased by about 15 percent the average net price to the trade of its processed cheese. This increase restored Kraft's price-cost margin in December to about that of January 1989. But as NCE barrel prices dropped beginning in January 1990, Kraft's price-cost margin for processed cheese widened, so that during February and March 1990 the margin averaged about 40 percent above that of January 1989. In the following months the margin always remained well above those in 1989. At its high point, in October 1990, the margin was about 80 percent greater than in January 1989. For the six months November 1990-April 1991, when NCE prices were below support levels, the margins averaged almost 70 percent above those in January 1989. Thereafter, the margins narrowed. But even after a sharp cut in net prices to the trade between November and December 1991, the price-cost margin for processed cheese was about 35 percent above that in January 1989.

Figure 6.5 reports the same information for Kraft natural cheese as Figure 6.4 reports for processed cheese. Changes in Kraft's margin for natural cheese differed somewhat from those for processed cheese. However, during the entire period January 1990-November 1991, Kraft's price-cost margins for natural cheese were well above those in January 1989. During the six months NCE prices were below the support level, November 1990-April 1991, these margins for cheese prices since this figure applies to 34 Kraft General Foods brands. Moreover, few coupons issued are redeemed. A Congressional Research Service report states that less than 2 percent of all coupons issued during cereal promotions were redeemed. Givenell Bass, "Cereal Pricing," Economics Division, Congressional Research Service, December 23, 1994, p. 8.
Figure 6.4: Kraft Net Price of Processed Cheese, NCE Barrel Price

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

Figure 6.5: Kraft Net Price of Natural Cheese, NCE Block Price

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.
natural cheese averaged about 35 percent above those of early 1989. After a price cut in December 1991, Kraft’s average price-cost margins for natural cheese were about where they were in early 1989. This contrasted with Kraft’s processed cheese margins which in December 1991 remained well above those in early 1989. This difference reflected Kraft’s greater success in differentiating its processed cheeses than its natural cheeses.

A statistical analysis was made of the price and gross margin information shown in Figures 6.4 and 6.5. A regression of Kraft’s net prices to the trade for processed and natural cheese as a function of NCE barrel and block prices found no statistically significant relationship between these prices. This was as expected since Kraft sells its branded products using list prices that are not coupled to NCE prices. Regressing Kraft’s gross margin for processed cheese (as measured by Kraft’s net price to the trade less NCE price) on NCE barrel prices yielded a coefficient on the gross margin of -0.988 with a t-value of -4.73. This indicates that as NCE barrel prices decreased by 10 cents per pound, Kraft’s gross margin on processed cheese increased by about the same amount. The same analysis for Kraft’s natural cheese products yielded a coefficient on the gross margin of -0.730 with a t-value of -3.51. This implies that when NCE block prices decreased by 10 cents per pound, Kraft’s gross margins for natural cheese increased by 7.3 cents per pound.

Table 6.1 reports our estimates of Kraft’s gross profit margins for processed and natural cheese in 1989-1991.\textsuperscript{82}

\textsuperscript{82} The annual gross profits reported in Table 6.1 were calculated as follows. Kraft’s annual processed and natural cheese volume for 1989 are from the \textit{SAMI Million Dollar Brands} report. IRI Infoscan (Franklin and Cotterill, \textit{op. cit.}) does not divide Kraft’s total sales into these two categories. However, IRI data were used to estimate Kraft’s quarterly volume of processed and natural cheese during 1989-1991. The SAMI report does not report quarterly data nor Kraft annual volume data for 1991. Kraft’s quarterly processed cheese volume in 1990 and 1991 was estimated using changes in the quarterly
Note: We do not report in Table 6.1 our estimates of Kraft’s gross profits. An agreement with Kraft General Foods, Inc., provides that the price data in Figures 6.4 and 6.5 are temporarily redacted pending a subsequent judicial resolution of a good-faith dispute over the trade secret status of the information.

Table 6.1. Estimated Gross Profits for Kraft’s Processed and Natural Cheese (Excluding Cream Cheese), 1989-1991

<table>
<thead>
<tr>
<th>Year</th>
<th>Kraft Processed Cheese</th>
<th>Kraft Natural Cheese</th>
<th>Kraft Total</th>
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<tbody>
<tr>
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<td></td>
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<tr>
<td>1991</td>
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</tbody>
</table>

---millions of dollars---

1989  
1990  
1991  
Change

1989-1990
1989-1991

*See note 82 for method used to make these calculations.

By our estimate, Kraft’s gross profits for processed and natural cheese sold to retailers were 31% higher in 1990 than in 1989, and 26% higher in 1991 than in 1989. We cannot make similar calculations for Kraft cream cheese sales and non-retail cheese sales. Such sales are

volume of Kraft American cheese between 1989 and 1990-1991, as reported by IRI. Kraft’s quarterly natural cheese volume in 1990 and 1991 was similarly calculated using changes in “all other” Kraft cheese volume as reported by IRI.

The gross profits reported in Table 6.1 were calculated by multiplying the Kraft quarterly estimated volume data by Kraft’s quarterly price-cost margins (Kraft’s net prices less NCE prices) shown in Figures 6.4 and 6.5.

We believe the estimates in Table 6.1 understate Kraft’s gross profits for processed cheese and overstate the volume of Kraft’s natural cheese, the net effect of which is to understate somewhat the estimates of Kraft’s gross profits. Our estimate for 1991 of Kraft’s processed cheese (440 million pounds) shown in Table 6.1 is substantially less than the 556 million pounds reported by Kraft for 1992 in response to our investigative survey (Exhibit D of Kraft’s submission of February 21, 1994, by its counsel Roisin J. Ryan, Kirkland and Ellis, to Reid Klopp, Counsel, DATCP). Our estimate of natural cheese sales (225 million pounds) used in Table 6.1 was only slightly less than figures reported by Kraft for 1992 (232 million pounds).
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about 15 percent and 33 percent, respectively, as large as Kraft's processed and natural sales to retailers.\textsuperscript{83} Hence, Kraft's estimated gross profits for all cheese sold increased by more than the amounts reported above.

Gross profits measured by net wholesale prices to the trade less raw material costs do not translate directly into greater net profits. During these years, Kraft's manufacturing costs, excluding raw material cheese, very likely changed little, whereas its advertising and non-price promotion costs probably increased. In sum, we believe the above calculations approximate the increase in Kraft's gross profits between 1989 and 1990 and between 1989 and 1991 for processed and natural cheese sold to retailers, but that they may overstate the relative change in net profits between 1990 and 1991.\textsuperscript{84}

The large increases in Kraft's price-cost margins adversely affected its share of retail food store cheese sales. Between 1988 and 1992, Kraft's share of total retail cheese sales, excluding cream cheese, fell 8.4 percentage points, and its reported total retail cheese sales, excluding cream cheese, declined by 78 million pounds (Appendix Tables 6.4a and 6.4c).

Kraft's share decline occurred primarily because of the widening gap between its prices and private label brand prices. As noted above, in 1989 Kraft planners had urged caution in making future increases in this price gap. This gap began widening in early 1990 and peaked in the first two quarters of 1991 (Appendix Figure 6.1). The continued widening occurred primarily because private label retail prices rose less and began to decline sooner than those of

\textsuperscript{83} Appendix Table 6.6a and text at note 75 above.

Kraft brands (Appendix Table 6.7). The retail price gap also widened somewhat between Kraft and Borden, Kraft's leading branded cheese competitor in processed cheese (Appendix Figure 6.2 and Appendix Table 6.8).

Kraft's price gap strategy beginning in 1990 marked a drastic departure from that pursued earlier. Between 1981 and 1988 the Kraft-private label retail price gap increased much more gradually than thereafter. The gap for processed cheese grew by 16.7 percentage points for the entire 1981-1988 period (Appendix Table 6.10). In contrast, the gap for American cheese widened by 24.6 percentage points between 1988 and the first half of 1991 when the size of the gap peaked (Appendix Table 6.7).85 The size of the gap for all natural cheeses rose by 11.4 percentage points for the entire 1981-1988 period; in contrast, between 1988 and the first half of 1991 the gap for natural cheeses, excluding shredded, widened by 23.6 percentage points and the gap for shredded natural cheese by 21.7 percentage points. Thus, Kraft decision-makers chose to ignore the planners' advice in 1989 not to substantially widen the Kraft-private label price gap (Appendix Table 6.7).

The impact of Kraft's declining market shares on retail sales (measured in pounds) is estimated in Table 6.2. Had Kraft's market share remained constant, its estimated total retail sales would have increased by 10.6 percent between 1988 and 1992, and its retail cheese sales in 1992 would have been greater by 135.8 million pounds.

85 We compared all American cheese in the latter period with all processed cheese in the former period because the data source used for the 1988-1991 comparison does not combine all processed cheese. The American cheese category used by I.R.I. Infoscan most closely approximates the total processed cheese category used by SAMI. The I.R.I. Infoscan data are reported in Appendix Table 6.7.
Kraft's pricing conduct may also have had an adverse affect on total industry retail cheese sales. Retail-NCE margins were significantly higher 1990-1992 than either before or after these years (Figure 6.6). Without this increase, retail prices would have been correspondingly lower. Retail natural cheese prices were about 6 percent higher during

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<th>Kraft's Reported Total Sales</th>
<th>Estimated Kraft Total Sales at 1988 Market Share</th>
<th>Estimated Lost Retail Sales of Kraft</th>
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<tr>
<td></td>
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<td>w/o cream cheese</td>
<td>all cheese</td>
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<tr>
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<td>655.1</td>
<td>793.4</td>
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<tr>
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<td>800.1</td>
<td>660.2</td>
<td>818.6</td>
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<td>799.7</td>
<td>640.8</td>
<td>878.3</td>
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<tr>
<td>1991</td>
<td>756.4</td>
<td>597.8</td>
<td>884.9</td>
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<tr>
<td>1992</td>
<td>738.8</td>
<td>577.0</td>
<td>877.6</td>
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<tr>
<td>Percent Change</td>
<td>-6.8</td>
<td>-8.8</td>
<td>+10.6</td>
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1Appendix Table 6-4c.

2Estimate based on Kraft's 1988 market share of 46.38% without cream cheese and 49.0% including cream cheese (Appendix Table 6.4a) and total retail cheese sales (Appendix Table 6.6a).

3Estimated sales less total reported sales.
Figure 6-6
U.S. Retail Price of Natural Cheddar Cheese, NCE Block Price and Retail Price-NCE Price Margin, Monthly, 1984-1993

1990-1992 than during 1993. (The 1990-1992 prices were about 17 percent higher than during 1988.) Assuming a price elasticity of demand of -0.5, prices that were 6 percent higher would have reduced retail cheese consumption during 1990-1992 by about 3 percent. \(^{86}\) We cannot estimate the effect on total cheese consumption because we do not know what happened to wholesale cheese prices to the food service and industrial cheese customers. However, it appears that Kraft’s wholesale price policy had an adverse impact on total cheese industry sales as well as on its own sales during 1990-1992. Since Kraft has the dominant retail brand for most types of cheese, it is not surprising that their pricing behavior affected the pricing of competing brands sold to retailers.

Why did Kraft’s top management disregard the planners’ 1989 warning that the company should not accelerate earnings growth by widening substantially the Kraft-private label price gap? Some commentators have attributed the change in Kraft’s pricing strategy after 1988 to the Philip Morris takeover of Kraft effective December 1988. Shortly after the takeover was consummated, the newly appointed president of Kraft General Foods, Inc., reportedly stated that what Philip Morris wanted was “further and faster growth” from all of the Kraft General Foods food units. \(^{87}\) He reportedly told financial analysts that Kraft U.S.A. was expected to post an operating profit of $1.3 billion for 1989, an increase of 30 percent over its 1988 operating profits. \(^{88}\)

\(^{86}\) See Chapter 2 for price elasticity estimates. This implies that the estimates in Table 6.2 understate the decline in Kraft’s retail sales.


Kraft apparently responded to the higher profit objective by increasing cheese gross profit margins. Initially, Kraft’s pricing strategy seemed to work, as profits surged. The *Wall Street Journal* reported: “After Philip Morris Co. bought Kraft in 1988 and merged it with General Foods Corp. in ’89, profit growth at Kraft General Foods averaged more than 20% the first two years [1989 and 1990].”

But while Kraft’s pricing policy increased profits in the short term, a Prudential Securities, Inc., financial analyst was quoted as saying he believed “50% of [Kraft’s] problems [loss of market share] were caused by aggressive efforts to maximize profits. They pushed too hard, and now they’re paying the price for it.” On another occasion this analyst reportedly said: "Kraft had taken five years’ worth of price hikes [in cheese] in two years."

In 1993, a *Wall Street Journal* article summarized Kraft’s post-acquisition pricing conduct and its consequences as follows:

Soon after Kraft was acquired, Kraft General Foods began to steadily increase the prices of such stalwart brands as Kraft Singles and Velveeta. At first the concept worked: the cheese business reported results in both 1989 and 1990.

In late 1990, however, the market for some cheese ingredients plunged, allowing private-label manufacturers to lower their prices. This price gap between packages of Kraft cheese slices and private-label versions, typically 30 cents, more than doubled. The Philip Morris unit was slow to make the adjustments, and its share of the $5.2 billion

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retail market slid three or four percentage points, to 42%. Last year alone, that lost share cost the company $125 million in profits.\footnote{Id. Another source reported that Michael Miles, CEO and Chairman of Philip Morris, had reported that Kraft had netted $125 million in reduced profits in 1991. “Kraft Grips Publicly About Lost Cheese Profits,” The Milkweed, February 1992, p. 3.}

Philip Morris efforts to accelerate Kraft earnings growth after the 1988 takeover may well have placed added pressure on Kraft to lower cheese procurement costs. Kraft enjoyed some of its largest margins during periods when it sold actively on the NCE with the apparent effect of depressing bulk cheese prices, without the corresponding decreases in prices for finished cheese products.

F. Summary and Conclusions

During January 1990 through December 1992, Kraft made 83 percent of all barrel sales and 54 percent of all block sales on the NCE. During the same time, the three leading seller-traders, Kraft, Borden and Alpine Lace, made 90 percent of all barrel sales and 75 percent of all block sales.

During these years, Kraft apparently followed the same general trading pattern over each price cycle, trading most persistently at price tops and price bottoms, and intermittently when prices were rising. At price bottoms, Kraft 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 bid up the market, often with few consummated trades, except when Kraft engaged in "selective selling," having the effect of “moderating” an upward price trend. At price tops, Kraft initially filled bids with the apparent purpose and effect of slowing or stopping the upward trend. Thereafter, Kraft filled bids or it offered to sell as the market topped and began to subside. Once
a downward price trend was established Kraft frequently continued offering to sell, often joined by Borden and Alpine Lace—and sometimes by other traders. However, in periods when buyer-traders bought heavily in an apparent effort to counteract seller-trader activity, the other leading seller-traders usually left Kraft to carry the burden of selling, which it generally did at a loss. The apparent effect of Kraft’s selling conduct was to shape the pattern of NCE prices over each price cycle.

Both buyer-traders and other seller-traders often seemed to defer to Kraft’s actions, perhaps because they feared the consequences of not doing so, if Kraft’s view of the most appropriate price level was proven correct. This fear may have stemmed from several sources. First, experience had shown that Kraft’s view generally prevailed. Second, Kraft’s large size gave it superior knowledge of overall industry conditions.93 Other traders acknowledged this fact and were therefore reluctant, especially during turning points in a price cycle, to oppose Kraft’s view of market conditions as implied by its trading activity.94 Finally, Kraft typically

93 Kraft included among the implications of being the largest cheese buyer the “Potential for better information about the industry as a whole.” Kraft General Foods, Inc., Cheese Procurement Strategy, Operations, December 6, 1989, KGF 2948, 2990. It therefore included among its profit maximizing strategies the development of superior market information of industry conditions and demand for Kraft products. Id. 2992, 2993-2994.

94 For example, an official of a large Kraft competitor stated:
...[W]hen Kraft starts selling, people start looking at their inventories real carefully. I mean, they have a lot of respect [for Kraft]. You think supplies are tightening, and Kraft’s on that market selling. I assure you the CEO’s are going to their economists and saying, are you damn sure things are tightening? Wayne Hoecker, general counsel of Mid-America Dairymen, Inc., typed transcript of recorded interview, August 2, 1993, p. 62.

This person subsequently added that,
[The reason] people look [to Kraft] is the respect the industry has for their economists and their ability to forecast. Now they’re the biggest company in the industry, very sophisticated in their forecasting, and they have a lot of human resources dedicated to it. Id., p. 65.
built excess supplies, so-called safety stocks, into its annual plans. It also had alternative methods of reducing supplies should circumstances make this the preferred alternative. These and other factors generally gave Kraft access to ample supplies for sale on the NCE when it decided to sell there.\(^{95}\)

Evidence presented in this chapter supports the hypothesis that Kraft’s trading activity was motivated primarily by a desire to influence NCE prices, not to dispose of surplus cheese on the NCE. During 1990-1992, Kraft managed its surplus problem predominantly by reducing

\(^{95}\) Very important is Kraft’s agreement to take, with minor exceptions, the entire output of its committed suppliers. (Interview of Wayne Hangartner, former Director of Cheese Procurement and Inventories, Kraft General Foods, December 8-9, 1992, typed transcript of recorded interview, pp. 7,9, 55). This gives Kraft control over where these suppliers dispose of their surplus, enabling Kraft to divert a supplier’s surplus cheese either to the NCE, the spot market or the CCC when this alternative is available. While a supplier may benefit from Kraft’s agreement to accept the supplier’s entire output, were the decision left to the supplier it most probably would prefer to sell in the spot market rather than the NCE, since lower NCE prices adversely affect the supplier. Kraft gains additional control over the amount of cheese available for sale on the NCE because some of its committed suppliers have “balancing” plants that can switch between block and barrel output. \textit{Id}, p. 55. Kraft officials acknowledge that their Annual Plans cover projected demand plus safety stocks. Chris Emerson, \textit{Id}, p. 2.

A Kraft employee explained its planned surplus policy as follows:

\begin{quote}
Raw Material Cheese Inventories and Procurement always plans and operates with a projected...surplus of cheese availability. The surplus may range from [...to...] million pounds and is disposed of by trade sales, government sales and milk diversion to other commodities when Kraft doesn’t need the cheese. This method reduces the chance of Kraft running out of raw material cheese on short-term situations.
To be able to do this, certain supplier(s) must be able to produce 640s or Drums on short notice in order to balance raw material cheese requirements within the existing supplier base.
\end{quote}

procurement of bulk cheese, selling in the spot market, and periodically selling to the CCC. Kraft's total NCE sales were unprofitable, whereas its total 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 sale elsewhere. Such conduct constitutes *trading against interest*, the practice of purposely not selling at a profit-maximizing price. In the context of NCE trading, this implies that Kraft anticipated that unprofitable sales would enhance overall company profits by lowering the prices paid for bulk cheese purchased under NCE-based formula price contracts. Evidence in this and the preceding chapter indicates that, at times, Kraft successfully kept bulk cheese prices below those justified by industry-wide supply and demand conditions.

An analysis of Kraft's pricing of finished products documents how Kraft's profits are affected since its wholesale prices are not coupled to NCE prices. In the fall of 1989, Kraft raised the *net* wholesale price for most leading Kraft brands when NCE prices rose, but it did not lower them when NCE prices dropped sharply in February 1990. Between December 1989 and November 2, 1990, NCE barrel prices fell from $1.5050 per pound to $1.0525 per pound, where they remained through May 3, 1991. Yet, Kraft's average net wholesale price for processed cheese was higher in the latter months than in December 1989. This increased substantially the margin between NCE and Kraft's wholesale prices, and, therefore, Kraft's gross profits during 1990 and 1991. Because other marketers, especially those selling cheese for the private label brands of retailers, raised their wholesale prices less, and lowered them sooner, than did Kraft, the retail price gap between Kraft and private-label brands widened substantially, causing a large drop in Kraft's share of retail cheese sales. Kraft adopted a strategy of sacrificing income to regain market share by reducing wholesale prices in December 1991. This price reduction
caused an appreciable drop in profits in 1992, though they apparently remained above those in early 1989.

During 1990-1991, Kraft may have kept the spread between its net wholesale prices and NCE prices too large for too long, as it attempted to meet the aggressive profit goals set by Philip Morris. But this experience demonstrates how Kraft can benefit when NCE prices decline while Kraft leaves unchanged its net wholesale prices.

Kraft’s conduct during 1990-1992 affected others besides itself. The decline in Kraft market share contributed to its surplus problem beginning in late 1990. This, in turn, adversely affected Kraft’s suppliers as it reduced purchases from them. Kraft’s higher wholesale prices appeared to also encourage higher cheese prices by competitors. The resulting higher retail prices very probably reduced, somewhat, overall cheese consumption, thereby reducing the total amount of milk used in manufacturing cheese.\footnote{One source reported that many dairy farmers “were angered by Kraft’s decision to maintain high cheese prices despite falling milk prices, which curtailed cheese sales.” William D. Dobson and Robert A. Cropp, “The Dairy Marketing Initiative of Upper Midwestern Cooperatives,” in R.G. Cotterill (ed.) \textit{Competitive Strategy Analysis for Agricultural Marketing Cooperatives}, 1994, p. 186.}
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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.

Sources: Kraft Documents: KGF 004118; 004089; 004071; 004054; 004033; 019740; 004303; 015453-015457; 015465; 015468-015478; 004507; 004226; 004249; 004176; 004153; 003651; 003728; 003680; 026622; 026575; 026593; 026562; 026517; 026531; 026549; 026490; 026467; 026425; 026442; 026414; 026403; 026392; 02636; 026349; 026349; 026333; 026313; 026297; 026277; 026255; 026231; 026627-026628; 026429-026431; 026226-026227; 015469-015478; 015455-015457; 026629-026630; 026432-026434; 026228-026229; 018746-018743; 023755

Note: 1989 Actual Inventory includes Kraft and supplier owned inventories.
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**Total** | **17314** | **10141** | **291** | **27746** | **11741** | **0** | **0** | **11741** | **39487**


1/ Adjusted purchases are total purchases, contract basis, less cancellations. Negative numbers can result when previous week(s) cancellations exceed current week purchases (contract basis).
### Appendix Table 6.3
End-of-Month Commercial Stocks of American Cheese and CCC Stocks of Natural (Blocks and Barrels) Cheese, 1980-1993

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Source: Dairy Market Statistics, Annual Summary, USDA.
### Appendix Table 6.4a: Kraft Market Share of Retail Quantity of Cheese Sold, by Type, 1988-92.

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---Percent Share of Total Pounds Sold---

Appendix Table 6.4b: Kraft Market Share of Retail Dollar Sales of Cheese, by Type, 1988-92.

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Source: Franklin and Cotterill, op.cit.
Appendix Table 6.4c: Kraft Brand Retail Cheese Sales, by Type, 1988-92.

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Source: Franklin and Cotterill, op.cit.
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---Sales in Millions of Dollars---

Source: Franklin and Cotterill, op.cit.
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Source: Franklin and Cotterill, op.cit.
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----Percent Share of Total Dollar Sales----

Source: Franklin and Cotterill, op.cit.
### Appendix Table 6.5c: Private Label Brand Retail Cheese Sales, by Type, 1988-92.

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Source: Franklin and Cotterill, op. cit.
Appendix Table 6.5d: Private Label Brand Retail Cheese Sales, by Type, 1988-92.

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--- Sales in Millions of Dollars ---

Source: Franklin and Cotterill, op.cit.
### Appendix Table 6.6a: Total Retail Cheese Sales, by Type, 1988-92.

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---Sales in Millions of Pounds---

Source: Franklin and Cotterill, op.cit.
Appendix Table 6.6b: Total Retail Cheese Sales, by Type, 1988-92.

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---Sales in Millions of Dollars---

Source: Franklin and Cotterill, op.cit.

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1988  $2.32   $1.88   $0.45  23.79%  $2.72  $1.64  $1.08  66.30%
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1990  3.02    2.31    0.71  30.94  3.38  1.99  1.39  69.94
1991  3.14    2.15    0.99  46.01  3.42  1.88  1.54  82.11
1992  3.09    2.19    0.90  41.07  3.39  1.93  1.46  75.61
## Appendix Table 6.7 (cont.) Kraft and Private Label Retail Cheese Prices and Price Gaps, by Types, 1988-1992.

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Note: Price per pound is calculated as the difference between the Kraft and Private Label retail cheese prices, adjusted for the type of cheese. The price gaps are expressed as a percentage of the Kraft natural price.
Appendix Table 6.8  Average Retail Price Per Pound of Kraft, Borden, and Private Label Brand American Cheese.

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<th>Private Label Brand</th>
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<th>Kraft Less PL</th>
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Source: Franklin and Cotterill, op.cit.
Appendix Table 6.9a. Market Shares of Company Brand Sales of Processed Cheeses

----Percent Share of Retail Sales in Dollars----

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Source: SAMI Million Dollar Brands
Note: Individual market shares do not always add to 100%.
Appendix Table 6.9b. Market Shares of Company Brand Sales of Natural Cheeses

---Percent Share of Retail Sales in Dollars---

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Source: SAMI, Million Dollar Brands.
Note: Individual market shares do not always add to 100%.
Appendix Table 6.9c. Market Shares of Company Brand Sales of Cream Cheese

---Percent Share of Retail Sales in Dollars---

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Source: SAMI, Million Dollar Brands.
Note: Individual market shares do not always add to 100%.
### Appendix Table 6.10. Average Retail Prices of Kraft and Private Label Brands

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Source: SAMI Million Dollar Brands
## Appendix Table 6.11. Retail Prices of Natural and Processed Cheese, Leading Brands, 1981-1990

### NATURAL CHEESE

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<td>Cracker Barrel</td>
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<td>Harvest Moon</td>
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<td>Land O' Lakes</td>
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<td>Lake to Lake</td>
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<td>Beatrice</td>
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<td>County Line</td>
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<td>Pauly</td>
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<td>NCE Blocks</td>
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### PROCESSED CHEESE

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<th>Price Per Pound</th>
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<td>NCE Barrels</td>
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<td>1.211</td>
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Source: SAMI Million Dollar Brands.
Appendix Figure 6.1

Source: Appendix Table 6.7
Appendix Figure 6.2: Kraft, Borden & Private Label Brands of American Cheese, Average Retail Price and Price Gaps, 1988-1992

Source: Frankin and Cotterill, op. cit.