Dairy Co-Op Faces Price-Manipulation Probe

Regulators Examine Trading, Payment To Former Director

BY JOHN R. WILKE

FEDERAL REGULATORS are investigating allegations that the nation's largest dairy cooperative, Dairy Farmers of America, has manipulated milk and cheese prices, and are separately reviewing a secret transfer of cash to a former director of the organization.

The farmer-owned cooperative, which controls a third of the U.S. milk supply, also faces antitrust lawsuits by farmers and retailers alleging it conspired to suppress prices it paid for raw milk in the Southeast, while raising prices to the region's retailers.

The allegations and the respective government inquiries follow six years of rapid consolidation in the dairy industry, one of the reasons milk prices have risen sharply in recent years. But it is difficult to determine how much the alleged manipulation, if it took place, might have affected consumer and farm-level prices because so many other factors help to determine them.

Dairy prices fluctuate in response to supply and demand, drought and more recently, fast-rising feed and energy prices. Since the start of 2004, government data show consumer milk prices have risen about 32%, compared with a 15% increase for food prices in general.

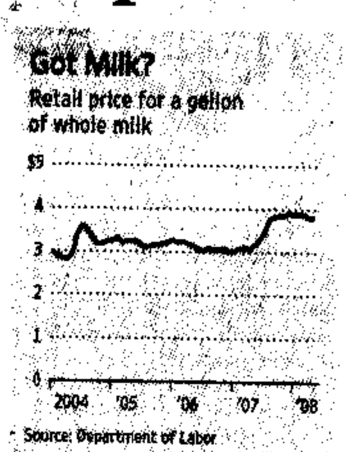
DFA, which is based in Kansas City, Mo., picks up raw milk from its more than 18,000 member dairy farms across the nation, processes it and sells it for bottling, or making cheese, butter and other products, at its own plants or at other dairy companies.

In the price-manipulation inquiry, the Commodity Futures Trading Commission is looking into whether DFA sought to drive up the price of milk through its trading of cheese contracts at the Chicago Mercantile Exchange. Cheese prices at the exchange affect milk futures and also are a key component of the complex formula used by the U.S. Department of Agriculture to set the minimum prices dairy farmers receive for their raw milk.

The agency is preparing to bring charges against DFA focused on an alleged coordinated effort to boost prices in 2004, said industry executives and lawyers close to the case. DFA, which is under new management, has said the co-op didn't violate the law and that it has been cooperating with CFTC.

In a separate inquiry, the USDA's inspector general found that other dairy companies misreported prices for powdered milk, another key component of the federal milk-pricing formula. The agency said the misreporting, which ended in April 2007, had the effect of reducing the price paid to farmers for raw milk, investigators found.

What has most riled dairy farmers, though, is the co-op's disclosure to its members May 7 of a secret $1 million payment to a former board member. In an extraordinary letter to members and a subsequent conference call with dairy trade publications, DFA's new chief executive, Richard P. Smith, said the former chief executive, Gary Hanman, arranged an improper and "unauthorized transfer of money," concealed through a DFA affiliate in 2001.



Mr. Hanman, who retired in 2006 at age 71, helped drive the consolidation of the dairy industry, leading the merger of four large co-ops to create DFA in 1998.

The letter said that DFA's "past and present board members were not involved in this wrongdoing, and the current board and management team only recently became aware of it." The co-op said it retained a law firm to conduct an independent probe of the incident, and determine whether other payments were made. It offered no reason for the payment, but said that the money had recently been repaid to DFA, with interest.

In an interview, Mr. Smith said, "We don't have all the facts, and we want to know if there was anything else. This was a severe breach of trust, and we are not going to cover it up."

The Justice Department was briefed on the incident last week, and is preparing to start its own probe, people close to the matter said.

DFA officials confirm that they contacted the Justice Department about the payment, and say they will cooperate with any further investiga

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tion. They say the payment was discovered recently when the co-op consolidated its books with an affiliate, National Dairy Holdings, a big milk bottler.

Mr. Hanman didn't return calls to his home in Platte City, Mo. The Washington lawyer who is listed as representing him in civil lawsuits in Tennessee also couldn't be reached.

Mr. Smith, who has been DFA's chief executive for two years, said he is determined to change the culture of the organization to make it more transparent and responsive to members. For years, he said, DFA has focused on rapid nationwide growth and a string of acquisitions. Now, he said, "we need to become more focused on our members' needs."

In March, DFA reported that revenue in 2007 had grown sharply, but the organization posted a net loss after one-time charges. "Driven by record-high milk prices," DFA said, revenue grew to $11.1 billion in 2007, up $3.6 billion from 2006. The net loss for the year was $109 million, after $145 million in one-time charges related to plant closures "and the revaluation of DFA's past investments." But the co-op said that it enjoyed strong operating profits in most businesses.

Mr. Smith said the co-op would continue to fight the civil antitrust suits, which were consolidated before a single judge in U.S. District Court in Greeneville, Tenn. In the suits, farmers and retailers, including the grocery chain **Food Lion** Inc., allege that DFA and its affiliates, along with **Dean Foods** Co., the nation's largest bottler of milked, have abused their market power in the southeastern states. Dean and DFA have denied the claims and asked the court to dismiss the cases; the judge has said he'll rule shortly on whether to let the lawsuits go forward.

One of the suits, filed by DFA members last July, alleges that the co-op conspired with Dean and others to keep prices paid to farmers lower than they would be in a competitive market. In addition to this antitrust conspiracy, the suit says, "DFA management also diverted millions of dollars [and] assets that lawfully belonged to DFA dairy farmer members through a pattern of inappropriate transactions" with affiliates. A related suit, filed by independent dairy farmers, alleges that DFA and Dean kept independents from competing.

The suit filed last year by Food Lion and other retailers alleges that bottlers fixed prices and drove out competitors throughout the Southeast, resulting in higher consumer prices.

The lawsuits and separate government investigations have in common an increasingly concentrated market for dairy products. The Bush administration cleared the largest merger in the sector, between Dean and Suiza Foods, another big bottler, in 2001.

The Justice Department required the two merging firms to sell 11 bottling plants to prevent them from dominating certain markets, mostly in the Southeast. But the plants were all sold to DFA, which already had close ties to Dean through exclusive supply contracts in many of its operating regions.

The Justice Department has monitored the industry since then and opened another antitrust probe two years ago, but hasn't filed a case. In 2005, it did challenge DFA's plans to invest in a small Kentucky bottler, Southern Belle Dairy.