

All Vital Signs Bad for Dairy Farmers of America

by Pete Hardin

A massive swarm of negative financial events in late 2008 threatens the financial condition of Dairy Farmers of America (DFA). How can the nation's largest dairy producers cooperative continue business as usual???

* CFTC hits DFA with \$12 million penalty for Cheddar price manipulations at CME.

On December 16, the federal Commodities Futures Trading Commission (CFTC) finalized a \$12 million penalty against DFA for manipulation of Cheddar cheese cash markets at the Chicago Mercantile Exchange (CME). That penalty was a limp slap on the wrist for DFA's involvement in a narrow time-frame of CME cash market distortions during spring 2004. (See related article, pages 1 and 2 of this issue).

In a press release, DFA President/CEO Rick (alias "Tricky Rick") Smith mumbled about agreeing to the \$12 million penalty assessed by CFTC in order to stop the co-op's mounting legal costs related to the investigation. Smith optimistically concluded that DFA's leaders could now focus on the co-op's bright future: "We are looking beyond past problems and forward to our bright future."

"Tricky Rick" – a lawyer by training – should have foreseen the next moves: numerous lawsuits filed against DFA by wide variety of financial victims of DFA's Cheddar price manipulations at CME.

* Follow-up lawsuits against DFA explode.

Nothing inspires the piranha-like attributes of this nation's legal community like a price-fixing settlement with the federal government involving a major commodity. Within two weeks of the CFTC price-fixing case settlement, DFA was hit with a legal broadside – numerous class-action lawsuits alleging financial losses to a variety of plaintiffs. These legal complaints seek class-action status. Those complaints, if sanctioned by the federal courts, would expose DFA to endless litigation and legal costs ... regardless of the final outcome.

DFA's overt Cheddar price manipulations at CME during spring 2004 drove up Cheddar prices to \$2.20 per pound, an all-time price peak. Those sky-high Cheddar prices caused harm to many, many parties in the extended dairy industry. That's because CME Cheddar prices – along with prices for other commodities like nonfat dry milk and Grade AA butter – are used, directly and indirectly, by state and federal agencies to set farm milk prices. Further, a range of dairy-based futures and options contracts are traded at CME. Settlement of those contracts is based – directly and indirectly – on events in the CME cash trading. Parties included in these class action complaints filed against DFA include: a cheese processor, a futures/options speculator, a fluid milk processing firm that operates a chain of dairy stores, etc., etc.

The legal costs, and related time/expenses, for DFA's defense against a half-dozen (at last count) lawsuits will be massive. (See page 10)

* Year-end dairy commodity price collapse deeply wounds DFA's already-shaky financial underpinnings.

Collapse of dairy commodity markets in the final days and weeks of 2008 has saddled DFA with additional serious problems. At year's end, all three major dairy commodities' prices are at, or within a few pennies, of USDA's dairy support prices. Those support prices translate into farm milk prices of around \$10 per cwt. for manufacturing grade farm milk.

The dairy commodity collapse contains at least three severe financial hits for DFA:

— Erosion of DFA members' monthly milk sales volume, used by the co-op as collateral for DFA's debts.

The approximately 80 cents per pound decline of CME Cheddar prices since early October 2008 sets the table for a \$7.00 per cwt. (or more) reduction in farm milk prices, by the time the pain filters through the dairy pricing system back to the farm. Trouble is: DFA uses money not yet paid to members for their milk sales to the co-op as collateral for DFA's debts.

(It's impossible to for outsiders to get a full handle on DFA's full package of debts and obligations. But *The Milkweed* estimates DFA's debts and obligations to total in the range of \$1.2 to \$1.5 billion – roughly \$120,000 to \$150,000 per member farm shipping milk to DFA. DFA added \$300 million to its indebtedness during 2008.)

Most DFA members do not understand that their co-op uses as collateral the funds from their as-yet unpaid milk deliveries. At any time, the co-op has nearly one month's worth of members' milk sales for which the farmers have not yet been paid.

How did DFA get authority to use milk money due members as collateral to partially cover the co-op's massive debts? Most DFA members' contracts specify that the members will adhere to the co-op's by-laws and articles of incorporation. Those documents specify that members' milk obligations are subordinate to the debts of the co-op. In other words: DFA's creditors get paid first, members last. Anybody doubting the accuracy of this charge need only review statements made by Moody's Investors Service on September 16, 2008. Moody's review of DFA's financial condition noted, in part:

"The cooperative structure provides important financial flexibility that, in a stress scenario, and on an infrequent basis, would allow DFA to quickly raise a significant amount of cash through a reduction in the bi-monthly member milk payment."

DFA's total indebtedness is almost impossible for outsiders to determine from the co-op's hard-to-find financial audits. DFA's December 31, 2007 financial audit listed a total of \$538.5 million "due members and milk haulers." In

the estimate of *The Milkweed*, close to \$500 million of that amount was milk money due DFA members.

The December 2008 "all milk price" calculated by USDA was \$15.90 per cwt. That compares with the December 2007 all milk price of \$21.50 per cwt. The fourth-quarter 2008 dairy commodity price collapse will shave about \$5.00 per cwt. off farm milk prices for December 2008's all-milk price (compared to December 2007). That decline, projected on DFA's members' year-end unpaid milk checks will shave about \$150-200 million off the amount DFA used as collateral for its borrowings at the end of 2007.

DFA's other major "assets" are bookkeeping fictions. The co-op's December 31, 2007 financial audit listed a combined total of \$500 million as "good-will" and "intangibles." Bogus.

— Year-end fiasco: massive inventory value declines

On December 31, 2008, all major dairy commodities' cash prices at the CME had declined to just above USDA's dairy support prices. Block Cheddar stood at **\$1.25 per pound, Grade AA butter was \$1.13 per pound, and Grade A nonfat dry milk was \$.85 per pound.** These prices represent a massive decline in value over the final several months of 2008.

As a major processor of cheese and butter, DFA holds many tens millions of dollars worth of dairy commodity inventories and finished products. DFA's December 31, 2007 financial statement listed \$219.6 million in inventories. Closing the books on 2008 will force DFA to write down tens of millions of dollars in inventory values from its scarce pile of *tangible* assets.

— Astronomical legal fees to defend against many lawsuits

DFA's plight in the courtroom – facing so many newly-spawned, complex lawsuits – might inspire some sympathy, except for that fact that DFA's brazen, long-term dairy commodity market manipulations have caused so much devastation in the dairy industry to date. Legal costs to defend against so many lawsuits will be staggering for the cash-flow strapped cooperative.

These are difficult times in the U.S. economy, particularly for firms with inadequate assets and operating problems. DFA has many past ghosts coming back to haunt the cooperative. The most gruesome of those ghosts: DFA's asset base that's built upon intangible assets and members' unpaid milk deliveries.

At what point do these deteriorated assets and the growing pile of major lawsuits levied against the cooperative cause a loss of confidence ... in creditors and members. Admitting the depth of these problems seems beyond the capability of DFA's management and directors. The "bright future" that "Tricky Rick" Smith spoke of, remains to be defined.