Testimony of

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Agricultural Consolidation and the Smithfield-Farmland Deal

Thank you Chairman DeWine and members of the Senate Subcommittee on Antitrust, Competition Policy and Consumer Rights for allowing the Organization for Competitive Markets to submit this testimony for the record. OCM is a multidisciplinary nonprofit organization that focuses exclusively on antitrust and competition problems and solutions in agriculture. Our members consist of farmers, ranchers, academics, policy makers and agricultural businessmen.

Horizontal concentration and vertical integration in the food and agriculture sector has harmed food producers and consumers, while the gross margins for retailers and processors increase each year. Farm gate prices for meat have trended lower during the last 20 years as consolidation increases. This is due to oligopsony market power on the buy side of the processors.

Yet consumers do not benefit - rather they continue paying more for pork. Consumers do not benefit from low live hog prices, nor do they benefit from the so-called efficiencies claimed by the packers. The claimed efficiencies of the packer and the retailers have either been false and/or overwhelmed by the market power increase, or both. In fact, during the historic live hog price crash of December, 1998, when prices dropped to eight cents per pound, packer and retailer price gouging resulted in record profits and higher pork prices for consumers. The graphs set forth below illustrate these trends.

Figure 1: Farm-to-Wholesale Price Spread for Pork: USDA data adjusted for inflation

Figure 2: Wholesale-to-Retail Price Spread for Pork: USDA data adjusted for inflation

In a competitive market, the gross profit margins would remain relatively constant because competition does not allow companies to price their sales, or buy their inputs, at levels that exceed normal levels of return. Gross profit margins will increase in a competitive market if a regulatory cost is imposed or if inefficiency pervades the industry so that normal levels of return can be achieved only with a price increase.

Figure 1 shows that the gross profit margin for packers, in the form of price spreads between the farm gate and wholesale, have increased by over one-third in the last 10 years. Figure 2 shows the gross profit margin for consumers, in the form of price spreads between the whole and retail levels. Retailer gross margins for pork have trended steeply upward for 20 years.

There are only two possible explanations for this trend. First, the packers and retailers are increasingly inefficient despite the fact that wage rates have fallen during the past 20 years. Or second, the packers and retailers are increasingly exerting market power to increase their margins far beyond competitive levels at the expense of producers and consumers. OCM has concluded that packers and retailers are exercising undue market power to the detriment of producers and consumers. Efficient resource allocation in the food system has, thus, suffered greatly.

Consider these numbers. The Smithfield acquisition will take out a major competitor, Farmland Foods. This will not cause upward price pressure for live hogs, but downward pressure. Assuming a one dollar per hundred live weight loss in market price, hog farmers will lose $2.70 per hog on 375,000 270 pound hogs per day, or over one million dollars per day. This is over $250 million per year loss for producers, and gain for packers, over one year (assuming 250 packer slaughter days). A two dollar per hundred weight loss is one-half billion dollars per year lost to Rural America's farms and main streets.

The price spread trends explain why both consumer groups and producer organizations oppose the Smithfield acquisition of Farmland Industries' pork division. If Smithfield is allowed to acquire Farmland Foods pork division, there is no reasonable argument that consumers or producers will benefit. The creditors committee in the bankruptcy court in which Farmland Industries has filed is compelling this sale to Smithfield to maximize debt payoff to the creditors. However, the public interest is in prevention of the acquisition so that Farmland may re-organize, in this Chapter 11 bankruptcy, around its profitable pork division.

PORK PROCESSING INDUSTRY STRUCTURE AND CONDUCT

Horizontal structure: The top tier of pork processors include Smithfield Foods (86,300 daily plant capacity), Tyson/IBP (72,200), Swift & Company (43,000), Cargill/Excel (32,000), Hormel Food Corp. (27,700), and Farmland Foods (25,500). Smithfield's plants include three in the East/ Southeast U.S. and two plants purchased from John Morrell & Co. in Sioux Falls, South Dakota and Sioux City, Iowa. Farmland's plants are in Crete, Nebraska; Denison, Iowa; and Monmouth, Illinois. Smithfield is number one in pork slaughter capacity and Farmland is number six. All the top six are active in the Iowa-Southern Minnesota market, which as we will see below, sets the national price for live hogs each day. The second tier competitors, which are not named here, are not relevant to setting national or regional hog prices because they are either too small, or because they are entirely vertically integrated and are not active in the open market.

Vertical structure: The hog industry is approximately 87% vertical at the producer/packer interface . Vertical integration takes the form of packer owned hogs, and various types of contracted hogs. Ninety percent of the hog contracts pay the producer through a formula price based upon the open market price reported each day by USDA's Market News Service. All the pork packers have been aggressively going vertical and have stated as much.

In theory, the 13% of the non-vertical hogs set the price for the open market price reports. In practice, three to five percent of the hogs traded set the price. These are the hogs actually negotiated between packers and producers in the Iowa-Southern Minnesota market, the price setting market. The other non-vertical hogs either are committed to a packer through an oral formula arrangement, or are merely forced to take the "Posted Price" that the packer says it will pay based upon the Iowa-Southern Minnesota market.

Price relationship studies by economists consulting with OCM show that the Iowa-Southern Minnesota market is established each day first, and all other markets follow. Thus, it is the price setting market. It is the driving force for the broader geographic market reported as the Western Cornbelt market, by USDA, from which many contract hogs are priced. The Western Cornbelt market includes, primarily, Iowa, Minnesota, Nebraska, and South Dakota.

Conduct: Packers always have an incentive to push hog prices down to save money. But when 90% of the contract hogs are pegged to the open market price, the marginal cost of bidding higher for open market hogs is tremendously magnified. For example, if the market is approximately $47 per hundred weight for live hogs, and a packer needs to bid $49 to purchase enough hogs to fill the plant for the day, the extra two dollars only affects those hogs purchased at that price. However, with 90% of the contracts pegged to the open market price, if a packer bids an extra two dollars for the final hogs it needs, that price is reported by USDA and automatically makes all the contract hogs - tens of thousands of hogs - more expensive.

Conversely, if the packer can force the market down below competitive pricing levels, they save millions on hog procurement costs for the day's purchases. In today's concentrated packer environment, we have dominant firms interacting in a very thin market. This scenario exponentially increases their ability to drive prices lower as compared to a situation where the dominant firm bought all their hogs from a high-volume open market.

It is no surprise that the past 20 years have seen a steady downward trend in hog prices as packers consolidated horizontally and vertically even while the wholesale meat prices justify far more money for live hogs. If Smithfield is allowed to purchase Farmland Foods, this trend will increase, and not decrease. Producers and consumers will suffer as packers and retailers continue price gouging.

SMITHFIELD'S BID FOR FARMLAND FOODS

The Smithfield bid for Farmland Foods is driven by two factors. First, Smithfield continues to desire more market power through eliminating competitors so as to drive hog prices down. Second, the creditors committee, in Judge Venter's bankruptcy court in Kansas City, wants the most money it can get for all Farmland Industries' assets, including Farmland Foods. These two driving factors are inconsistent with the public interest.

Overlapping buying regions of Smithfield and Farmland pork plants: Smithfield Foods operates plants in Sioux Falls, SD and Sioux City, IA. Farmland operates two plants within the same region, one in Crete, NE and one in Denison, IA. The two companies compete for the same hogs because their procurement areas, or "draw areas", overlap significantly. The draw areas primarily include Iowa, Minnesota, South Dakota and Nebraska. Thus, such a sale would increase the buying power of Smithfield tremendously in the all important Iowa-Southern Minnesota and Western Cornbelt market areas.

Manipulating price in the key price setting region: As stated above, the Iowa-Southern Minnesota market is the national price setting market. It is the driving force within the Western Cornbelt market region - consisting primarily of Iowa, Minnesota, South Dakota and Nebraska - from which a tremendous volume of contract hogs are priced. The open market hogs from which markets are made daily in this region are only three to five percent of the national hog market volume. The biggest pork packers - Smithfield, Tyson, Swift, Excel and Hormel - have a far greater opportunity tremendously to use market power to manipulate price in a thin, low volume open market, than in a high volume market. Allowing Smithfield to reduce competition in the national price setting region will significantly increase Smithfield's - and the remaining packer's - ability to push national prices downward for both open market bid hogs and for contract hogs. But there is no reasonable argument that consumers will benefit.

Market power is most harmful for perishable commodities such as pork. Smithfield's market power grab is a far greater problem in the live hog market, a perishable commodity, than market power in a non-perishable market given the same industry concentration levels. This is because a seller of hogs has to sell within a narrow time window, otherwise the hogs grow too large, are discounted in price and cost more in production costs. In economic industrial organization terms, hog farmers are unable to exercise countervailing market power through withholding hogs from the market. Rather, hog farmers have to sell - even at "fire sale" prices - because they can't hold withhold supply to force bidders to pay more over time. Whereas a seller of books, for example, does not have to sell within a narrow window because the books do not deteriorate and the book seller can exercise countervailing market power by withholding supplies from the market. Thus, concentration in the packing industry is a far greater concern than the same concentration in, for example, the book publishing and sales industry.

Shackle space crisis: Shackle spaces are another term for the plant capacity in pork packing plants. The plant capacity available for hogs is the actual demand factor in the market - consumer demand is indirectly related to live hog demand. There is a substantial prospect that Smithfield could opt to close on or two of its older Midwest plants after the Farmland acquisition. Smithfield has a history of buying plants, closing them down, and guaranteeing that they are never used to slaughter hogs in the future.

For example, Smithfield bought Dakota Pork in Huron, South Dakota on August 8, 1997. One day later, it closed the plant and laid off 850 employees. It then disassembled the plant to ensure no one would operate it again. Smithfield was reported to have sold the plant to the City of Huron early this year with a proviso that it never be used for pork packing.

Smithfield purchased a Farmland Foods plant in Dubuque, Iowa on March 28, 2000. Smithfield made optimistic promises, on April 11, 2000, to spend $10 million to renovate the plant. On June 8, 2000, Smithfield closed the plant and laid off 1,100 employees. It later stripped the Dubuque plant and it lays dormant today, unable to add to live hog demand and cause upward price pressure.

It is unreasonable to assume that Smithfield will stand by its public promises with regard to this sale when it has broken such promises repeatedly in the past and when it has tremendous financial incentives to break those promises. It is reasonable to believe that Smithfield will shutter one or more of the four plants in the Western Cornbelt market that it will own post-transaction.

Bankruptcy Proceedings are Inconsistent with the Public Interest: Farmland Industries filed for Chapter 11 bankruptcy in May 2002 to reorganize itself into a smaller, profit making entity. Fourteen months later, there has been no reorganization plan filed. Rather, the creditors committee has successfully pushed to have the assets of Farmland Industries sold off as if this were a Chapter 7 liquidation. If Farmland is to reorganize, it should do so around its profitable pork business. Antitrust concerns should eliminate the avenue of selling the pork division.

Farmland Foods President George Richter said, in a July 15, 2003 press release, "This agreement reflects the strong value of Farmland Foods. Our employees have done an excellent job over the past year growing the profitability and value of our pork business. The sales price [offered by Smithfield], which may be increased through the auction process, will bring significant value for the benefit of our creditors."

This is a creditor driven transaction. The creditor interest should take a back seat to the interest in maintaining the integrity of the open market for income to Rural America. Additionally, it is unlikely that any will bid higher for the pork division because the Smithfield bid has the support of the management team (who want to keep their jobs) and the all-important creditors committee.

Farmland has sold its beef, fertilizer, and grain business. It maintains a petroleum business - which is highly cyclical in nature - and its pork business, Farmland Foods. Farmland Foods is quite profitable, with increasing profits each of the last seven quarters as compared with the same period one year prior. The pork division, which is a stand alone ongoing business, reported $9 million in 3rd quarter operating profits ($36 million annualized) on July 14, 2003.

But for Smithfield's bid to obtain dominant market share at a high price and to scare off other bidders, Farmland could seek bidders that are not an antitrust concern or reorganize around the pork division as several experts speculated they could do.

CONCLUSION

America's farmers and ranchers do not want to receive their income from the taxpayers through a government farm program. They want to make money from a fair and open market. However, the government is presiding over market deterioration that is eliminating the opportunity to engage in private agriculture. The Super Bowl is a hard core, competitive game enjoyed by millions, but it requires rules of the game and umpires to enforce the rules. Fans and advertisers would soon lose interest if the game was mere anarchy and survival of the fittest in the short term. Similarly, market require rules and enforcement of the rules. Congress should not allow such deterioration, even as it proclaims that it wants development in Rural America. The Smithfield acquisition should be prevented.

Thank you for your interest in this issue.

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