Feuz Responses

Follow Up Questions for Dillon Feuz from Hearing Entitled "Concentration in Agriculture and an Examination of the JBS Swift Acquisitions"

From Senator Kohl

1. If this merger is approved, buyers of beef -- such as supermarkets, small grocery stores and butcher shops, and restaurants -- will only have three national meatpacking firms to choose from. Is this sufficient for competition, or are you concerned that so few national suppliers will lead to higher prices paid by consumers for their beef?

I have not investigated the market between packers and wholesalers or large retailers. However, for the most part beef is sold as a fresh, perishable product. Beef packers have very limited storage. Therefore, their ability to control prices is much more limited than firms in an industry where inventories can be held off the market for an extended time period. I am not concerned that this merger will lead to higher consumer prices for beef.

2. Mr. Bullard of R-Calf has asserted that for two weeks in February 2006, the top four meatpacking firms ceased buying cattle on the open market. The meatpacking firms reduced slaughter rates rather than enter the cash market. As a result, cattle prices fell sharply. Cattle Buyers Weekly said at the time that the meatpackers' conduct was part of an effort to "try and get cattle bought cheaper."

   Do you believe that JBS Swift's acquisition of the captive supply offered by the Five Rivers Ranch Cattle Feeding LLC ("Five Rivers") make it much easier for them to unilaterally engage in such conduct in the future to force cattle prices down?

The table below contains the volume of negotiated sales for Nebraska fed cattle, Nebraska cash prices and USDA reported Choice box beef cut-out values for the first 12 weeks of 2006. I am not sure which weeks Mr. Bullard is concerned with but the correlation between negotiated sales (number of fed cattle purchased by packers in the cash market) and Nebraska Live and Dressed market prices for fed cattle is -.18 and -.16, neither of which are statistically significant. However, the correlation between Live and Dressed market prices and the value of Choice Beef is +.87 and +.86, both of which are statistically significant at the 95% confidence level.

The price of beef is primarily determined by the supply of beef (number of fed cattle and weight of fed cattle are the 2 main components) and the consumer demand for beef. Packers are margin operators: they capture value when they sell beef, they incur costs when they process fed cattle into beef, and they try and purchase fed cattle at a price that covers those costs and returns some profit. Historically, those profit margins have been relatively small and quite variable. This is the primary reason for a consolidated packing industry.

Week Ending Date	Negotiated Cash Volume	Live Price	Dressed Price	USDA Choice Beef Cut-out
1/8/2006	46,097	$92.59	$148.67	$155.58
1/15/2006	68,281	$91.97	$147.66	$154.06
1/22/2006	57,211	$94.53	$151.92	$156.80
1/29/2006	37,956	$93.79	$149.53	$155.95
2/5/2006	45,061	$90.70	$144.59	$151.25
2/12/2006	50,891	$88.53	$143.40	$145.92
2/19/2006	39,401	$88.09	$140.53	$148.45
2/26/2006	82,496	$89.56	$143.00	$153.21
3/5/2006	59,740	$88.11	$141.80	$152.64
3/12/2006	55,918	$85.40	$136.58	$148.22
3/19/2006	62,757	$85.46	$136.40	$145.11
3/26/2006	54,361	$86.31	$137.54	$142.22

Source: USDA Market News, NEBRASKA WEEKLY DIRECT SLAUGHTER CATTLE - NEGOTIATED PURCHASES and NATIONAL WEEKLY BOXED BEEF CUTOUT AND BOXED BEEF CUTS - Negotiated Sales

The following text is copied verbatim from a fact sheet written by Clement Ward, Professor of Agricultural Economics, Oklahoma State University. It is the best concise summary I know of on the impact of captive supplies on fed cattle prices. I will use it as the basis for answering question 2, 3 and 4.

Captive Supply Price Relationships and Impacts
Clement Ward, Oklahoma Cooperative Extension Fact Sheets, AGEC-598

Estimated Price Impacts of Captive Supplies

Information presented above on prices and in F-597 on volume traded by pricing method seem to confirm that MPR increased the information available on captive supplies and price relationships compared with the previous price reporting system. That data also allow estimating the price impacts from captive supplies. A brief summary of previous research results is presented, followed by impacts estimated with data since MPR.

Previous Captive Supply Research Findings – Briefly, here is the situation that captive supplies create and the crux of the issue for cattlemen and others. When buyers purchase fed cattle by captive supply methods, the supply of cattle that can be purchased in the cash market is effectively reduced by the volume already committed to specific packers. That alone, would likely raise prices for the remaining cattle because other buyers, those without captive supplies, need to bid aggressively for a smaller supply of fed cattle. However, it also means that buyers with captive supply cattle committed to their plants need not be as aggressive in the cash market because they already have a portion of their cattle requirements met. That, in turn, may cause cash prices to decline. This is the essence of the captive supply debate. Can packers use their captive supply purchases to bid lower and depress prices paid for fed cattle purchased in the cash market? Data collected by the Grain Inspection, Packers and Stockyards Administration (GIPSA) have enabled the most detailed examination of captive supplies to date. Results from a

captive supply model with five years of monthly captive supply data (1989-93) for the U.S. suggested that larger plants use captive supplies strategically (Barkley and Schroeder). Captive supply usage by larger plants increased as cash prices increased but not for smaller plants. Captive supply usage increased as cash price variability increased, more so for larger plants than smaller plants. Captive supply usage also increased as plant utilization increased. Lastly, for larger plants, contracting and marketing agreements were substitutes for packer feeding. Therefore, in summary, larger plants used captive supplies to increase plant utilization and to mitigate rising or more variable prices.

In one of the short-term impact approaches using transaction data for 1992-93 from packers nationwide, results indicated there was simultaneity in the decision to deliver forward contracted and marketing agreement cattle and the decision to purchase cash market cattle (Ward, Koontz, and Schroeder). The same simultaneity was not found for packer fed cattle. This suggests packers feed cattle for different reasons than they used contracts and marketing agreements. Packer feeding may have been motivated more by cattle feeding profit opportunities and maintaining a steady flow of cattle to the plant, and motivated less by using packer fed cattle strategically to reduce procurement costs via its influence on cash market prices. Use of captive supplies was associated with lower prices for fed cattle generally but the amounts were smaller than many cattlemen expected, ranging from $0.01-$0.41 per dressed hundredweight.

Since the GIPSA concentration study, economists have continued wrestling with the captive supply issue. At least three “theories” of captive supplies have been developed. While there are differences, all suggest captive supplies can be used strategically by packers.

GIPSA commissioned further empirical work with transaction data from the Texas High Plains for 1995-96. Findings were similar to those of Ward, Koontz, and Schroeder. Captive supplies were associated with a small negative decline in fed cattle prices (Schroeter and Azzam 1999). However, the authors proposed an economic argument indicating why this may occur, indicating that the negative relationship between captive supply volume and cash market prices may not be strategic in nature. In later work, Schroeter and Azzam (2004) argue the negative relationship stems from the timing of deliveries to packing plants from cattle feedlots. They found a negative relationship between volume of marketing agreement deliveries in one week and the expectation of a price change from the previous week.

Estimated Price Impacts with MPR Data – Several models were estimated at OSU with weekly data for the three-year period since the beginning of MPR. All models explained over 95% of the week-to-week variation in the five-state, weighted average, live weight fed steer price. Model results were consistent with previous research in some regards but differed somewhat in others.

Consistent with previous research, a small negative relationship was found between the volume of weekly formula priced trades and cash market prices. As formula priced volume increased, cash market prices declined slightly. This finding is consistent with the concerns expressed by many cattlemen regarding the impact of captive supplies on cash market prices. However, the magnitude was less than many cattlemen expect, similar to previous research.

No significant relationship was found between volume of forward contract cattle traded and cash market prices. Fewer fed cattle were marketed by forward contract than any other marketing method in the MPR data and the relationship between forward contract prices and other prices was not as strong as the relationship among other pricing methods.

This research also considered the relationship between the extent of negotiated pricing and cash market prices. A reverse relationship was found compared with the finding for formula prices. A small but significant positive relationship was found between the volume of weekly negotiated trades and cash market prices. As more trades were negotiated, cash market prices

increased. This, too, is consistent with those concerned about captive supplies and their support for returning to a higher percentage of negotiated transactions.

A surprising result was found for packer owned trades. The models consistently indicated a positive relationship between the volume of packer owned cattle delivered and cash market price. This is opposite what most cattlemen concerned about captive supplies would expect. Conceivably, the decision to deliver cattle from the packer's own inventory rests more with feedlot side of the business than with the packer procurement or processing side. More cattle may be delivered when cash market prices are high, thus showing better returns to the cattle feeding side of the business. Packers might also deliver more of their cattle when prices are high for a strategic reason, so as to swing supply-demand conditions more in their favor and lower future cash market prices.

References

Barkley, A.P. and T.C. Schroeder. "Long-Run Impacts of Captive Supplies." C.E. Ward, T.C. Schroeder, A.P. Barkeley, S.R. Koontz. Role of Captive Supplies in Beef Packing. U.S. Department of Agriculture, Grain Inspection, Packers and Stockyards Administration, GIPSA-RR-96-3, May 1996.

Schroeter, J.R. and A. Azzam. "Econometric Analysis of Fed Cattle Procurement in the Texas Panhandle." U.S. Department of Agriculture, Grain Inspection, Packers and Stockyards Administration, Unpublished report. November 1999

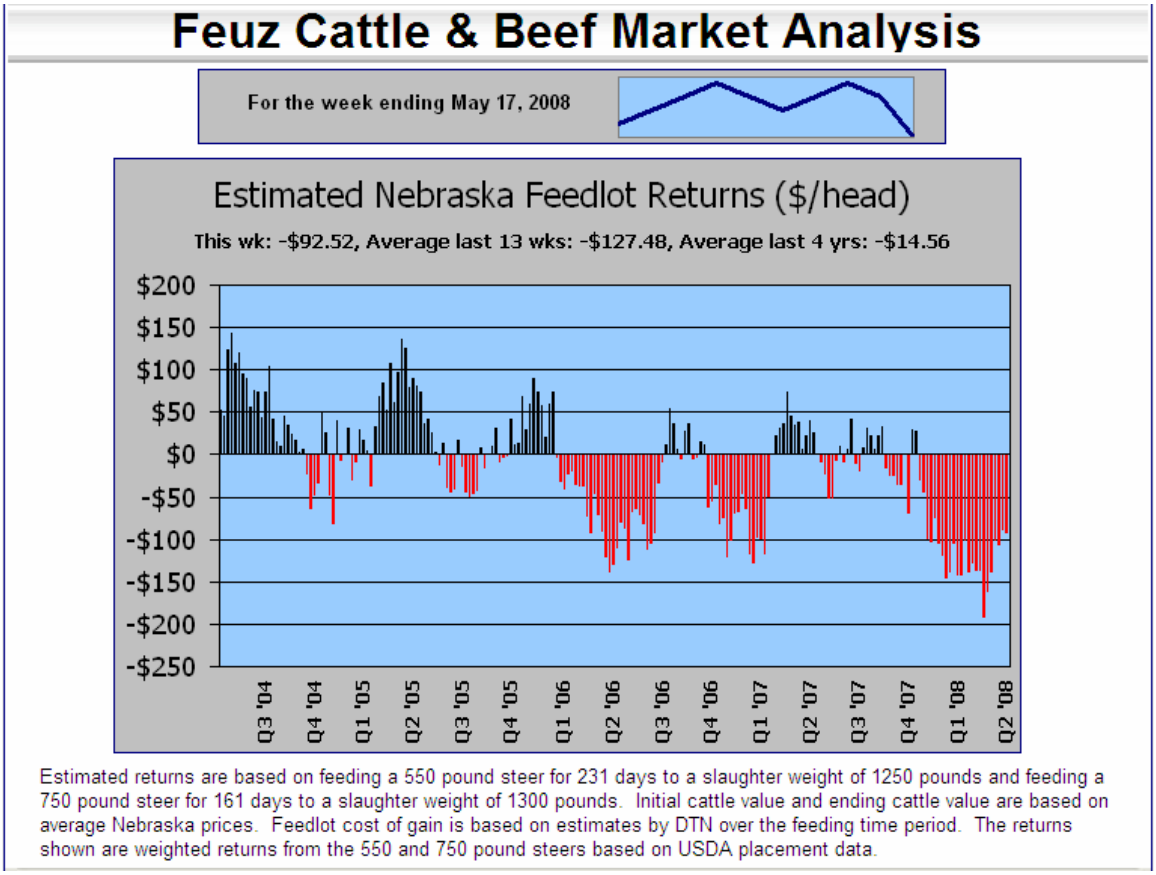
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Ward, C.E., S.R. Koontz, and T.C. Schroeder. "Impacts from Captive Supplies on Fed Cattle Transaction Prices." Journal of Agricultural and Resource Economics 23(1998):494-514.

Based on my experience and based on the published research findings, some of which were summarized by Ward in the fact sheet, I do not believe that the purchase of Five Rivers feedlots will give JBS Swift the power to "force cattle prices down".

3. Would a condition that JBS Swift be required to divest Five Rivers after these acquisitions be desirable? Please explain why or why not.

I do not think that it would be that advantageous to force JBS Swift to divest of Five Rivers as part of this acquisition. First, ownership of cattle is not that profitable. The chart shows the predicted returns to Nebraska feedlots over the last four years.



Second, historically Monfort and then ConAgra were the beef packers with the greatest ownership of feedlot cattle. They were not the dominant packers. Third, even if ownership of cattle were banned and even if control via contract were banned, if large feedlots and large packers find it advantageous to have exclusive marketing agreements for supply management, then they can continue these arrangements with no contractual agreements.

4. Alternatively, would a condition requiring the cattle at Five Rivers be made available to all of the remaining beef processors in a non-discriminatory be a desirable remedy? Why or why not?

NO! Let the free market operate. I do not believe it is the role of government to be telling private firms who they must do business with. The cattle industry is a mature industry that continues to seek efficiencies to remain competitive. One of those efficiencies for both feedlots and packers is to harvest fed cattle at the appropriate time. Many feedlots have found it advantageous to seek out a relationship with a specific packer to be able to market cattle when the cattle need marketed. This ultimately results in a more consistent supply of beef, and a more consistent product to be offered to consumers.

5. We've heard a lot of testimony about the number of beef packers across the country. But shouldn't we really evaluate this transaction based on its effect on

local and regional geographic markets? Isn't it true that meatpacking plants mainly obtain their cattle from no more than a few hundred miles away?

In partial response to your question, I copied part of the following government report:

Backgrounder Release No. 0062.96

USDA BACKGROUND REPORT ON MEAT PACKING INDUSTRY CONCENTRATION STUDY

February 14, 1996

Beef Sector

Defining Cattle Procurement Markets (Oklahoma State University with collaborators at Kansas State and Iowa State University)

One reason to define procurement markets is to determine if there is a potential for local price manipulation by a single or very few buyers; for example, if cattle cannot be easily and cheaply transported to take advantage of better marketing opportunities in other marketing regions. However, research conducted for this project suggests that fed cattle procurement markets behave as if cattle are traded nationally. Although regional differences do exist, predominantly east of the Mississippi and west of the Rockies, cattle movements and price adjustments among areas are sufficiently strong to promote similar prices among regions. Kansas and Nebraska tend to lead the price discovery process, and price linkages are strongest between the Midwest and Plains, the major feeding and slaughtering regions.

Although prices adjust quickly among areas as if the fed cattle procurement market were national, in fact, cattle are not transported long distances for slaughter. On average, packers obtained 64 percent of their cattle within 75 miles of their plants, 82 percent within 150 miles, and 95 percent within 270 miles. But low costs of transporting cattle, and the availability of multiple outlets (firms) within regions, likely diminishes opportunities for local price manipulation by significant amounts or for extended time periods.

Research has shown that regional fed cattle markets behave as if there were one national market. While packers do try and obtain cattle that are in close proximity to the plant, there are many instances where cattle are shipped greater than 500 miles to the plant.

I don't believe this merger would impact the regional market structure for fed cattle. Cull cow slaughter is different than fed cattle slaughter. Slaughter cull cows are often transported over 500 miles to a cull cow slaughter plant. The proposed merger would put under the same ownership an isolated plant in Arizona and one in California. Cattle producers in some areas served by these two plants may have had two independent bid for their cull cows. There would likely now only be one bid coming from one of the two

plants. However, if those bids declined, there would likely be an arbitrager move into the market place to buy the cull cows and ship them to another location.

6. Should the meatpacking firms gain lower prices for cattle because of their increased buying power, do you think it likely that these price savings will be passed on to consumers? What does the historical record in this industry tell us?

Research at Kansas State found that an increase in captive supply led to a small increase in the farm to wholesale beef marketing margin. Their conclusion was that if captive supplies lead to a slightly lower cash market price, at least some of that cost savings was not passed on to consumers. I think it would be safe to assume that if beef packers were able to buy cattle cheaper, some, but not all, of those savings would be passed on to consumers.

7. We have heard some analysts say that there is an overcapacity in the meatpacking industry, and predict that JBS Swift will close some plants after the merger is completed. Do you believe there is overcapacity in the meatpacking industry? And do you expect JBS Swift to close any plants in the years ahead if it completes these transactions?

I believe there is overcapacity in the beef packing industry. I believe that closing a plant would not be compatible with the current objective of JBS Swift to be a dominant world beef firm. However, economic conditions change and management objectives change, and I would therefore not speculate on the long term possibility of JBS Swift closing one of its beef packing plants.

From Senator Hatch

1. Professor Feuz, what affect will this proposed merger have on Utah's ranchers and feedlot operators? What will happen to the meatpacking plant in Hyrum, Utah?

I don't believe that this merger will have any significant impact on Utah ranchers and feedlot operators. The majority of Utah calves are shipped to Colorado, Kansas and Nebraska to be fed. There is generally adequate competition in those areas for fed cattle. Utah feedlots only presently have the one plant in Hyrum which is close to them. It is presently owned by JBS Swift so the merger will not change that ownership. There is a potential advantage for Utah producers in that after the merger, producers would have much greater access to marketing cattle through the US Premium Beef cooperative. In the past, the pricing grid for cattle marketed through US Premium Beef has been favorable to producers. If that continues, Utah producers would be able to take advantage of that and still ship their cattle to Hyrum, rather than having to ship cattle to one of the National plants located in Western Kansas.

2. Professor Feuz, I have been informed that most experts agree that there is overcapacity in meatpacking industry. I understand that many meatpacking

> facilities require modernization in order to efficiently prepare their products for consumers. The BSE episode of 2003 eliminated, almost overnight, the largest export markets for American beef. So, what happens if this merger does not proceed? What signal will it send to others who wish to invest in the meatpacking industry? Is that message that the regulatory hurdles are just too high? If this infusion capital does not occur, what happens to National Beef and Smithfield as well as the market as a whole?

I believe that the CEO of National Beef testified before the Senate sub committee that National was in some financial difficulty and that only JBS Swift had come forward with any offer. That would indicate to me that most individuals who possess the capital required to purchase National do not believe that they could earn a sufficient return on their investment. If this merger is not allowed by the government, I cannot see how that would instill any more confidence in investors to buy a beef packing plant. I am not in the position to speculate on the survivability of National Beef without this infusion of new capital. However, I do believe that it would be more troublesome to cattle producers to lose the three National plants due to bankruptcy than to lose one independent packing owner due to a merger.