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June 3, 2008

The Honorable Herb Kohl
U.S. Senate
330 Hart
Washington, DC 20510
Via email:Margaret_Horn@Judiciary-dem.senate.gov

Re: "Concentration in Agriculture and an Examination of the JBS/Swift Acquisitions"

Dear Senator Kohl:

Thank you for holding the hearing on the JBS/Swift acquisition. The Organization for Competitive Markets appreciates your concern, your co-sponsorship of S. 1759, and your request for a GAO study on concentration in agriculture. We also recognize and appreciate the hard work of Seth Bloom, Jeffrey Miller, Phil Karsting and Margaret Horn.

Please find enclosed my responses to your questions, and those of Senators Grassley and Feingold.

Respectfully,



Michael C. Stumo
General Counsel

Encl: As noted

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

From Senator Kohl

1. 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?

   Answer: Yes. This is a market power grab. There are no efficiency gains. Plant size, management, type of processing all remain the same.

   Post-merger, three people will make cattle price decisions in the U.S. They are the head buyers for JBS, Tyson and Cargill. Every other company will merely follow. The Five Rivers portion of the acquisition will reduce the JBS demand for cattle, meeting the needs of at least 1.5 plant equivalents. The result will be more weeks of the year that competitive bidding for cattle is depressed or nearly eliminated.

2. Would a condition that JBS Swift be required to divest Five Rivers after these acquisitions make these acquisitions acceptable, or do you believe that it would still substantially harm competition even with such a divestiture? Please explain why.

   Answer: The divestiture of Five Rivers could be helpful if done in the right way. But competition will be depressed with the elimination of Smithfield and National as buyers.

   If Five Rivers is divested to another packer, or divested under terms that make the firm a captive supplier, then the result is not helpful. If Five Rivers is divested under terms that make it a competitive seller, then the result is more helpful. Another approach is to craft an open market purchase percentage guarantee for the merged entity that lasts indefinitely – i.e. does not expire.

   The combination of National and Swift in the plains is, in our view, at least as problematic as the Five Rivers portion of the acquisition.

3. 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?

   Answer: The local/regional market view is incomplete. The Great Plains region is a local/regional market for fed cattle. But that market serves as an index for other regional markets. One analogy may be the "manufacturers suggested retail price" in the auto industry. Auto dealership competition is local, but the MSRP set by Ford also has a substantial impact. The Great Plains region prices serve as that MSRP-analog for other regional bidding.

   Also, the feeder cattle market will be affected nationwide, because feeder cattle are regularly shipped more than 1,000 miles to the Great Plains. To the extent fed cattle prices are depressed, feeder cattle prices will go down because the break-even analysis (the calculation a feeder cattle buyer makes to determine what he/she can afford to pay for feeder cattle) will mathematically dictate that result.

4. 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?

   Answer: No. There is no proof that consumers have benefited from past meat packing mergers. Industry makes those claims, and some ag economists have echoed those claims. But none have provided mathematical proof. Industry personnel are consulted and quoted, thus generating the "happy talk" as I mentioned in my oral testimony. The farm-to-retail price spread increases every year, even as concentration became greater. If efficiency gains occurred, the consumer did not benefit.

   Indeed, high food prices make concentration more risky. Buyer and seller power are enhanced. Bottlenecks can be easily controlled by these three companies. All the while they will claim that supply and demand works because prices go up and down, which is not the measure of market power.

5. In his testimony Mr. Hunt makes the point that investment is needed in beef processing and only JBS is willing to invest after the merger. Is there merit to this argument? From your perspective, are some of these meat processing companies failing?

   Answer: There is no merit to this argument by Mr. Hunt, who stands to gain handsomely from this acquisition. "Investment is needed in beef processing." What is "beef processing"? Beef processing is an industry. Does he mean that every beef processing company needs investment? Are there not alternative sources of capital besides dominant firms? Which

company? Which aspect of the vertically integrated business? Smithfield Foods makes increasing net profits every year. The company is not failing. National Beef showed no signs of financial stress, and is a successful exporter. None of these companies have shown any financial records to support these claims, which are merely redundant of typical press releases issued to justify past mergers. Mr. Hunt has no data to support his vague claims.

From Senator Grassley

1. What evidence do you have that this concentration in agriculture trend has been harmful to consumers? What evidence do you have that concentration in agriculture has been harmful to independent producers?

   Answer: As to consumer harm, the farm to retail price spread has increased over the last 20 years. Lower cattle prices seldom, if ever, translate into lower consumer prices. In a competitive market, if cattle prices go down, consumer prices would follow.

   As to producer harm, market access has diminished for independent producers. Many of OCM's small producer members cannot attract a buyer to consider their cattle. Many of OCM's mid-sized and large producer members experience many weeks of the year when no competitive bids are offered, because captive supplies have filled the shackle space. Prices go down, and take two to three weeks to recover.

2. In your opinion, does the Justice Department have an appropriate understanding of the agriculture industry, and thus is appropriately evaluating mergers in the agriculture sector? For example, do you believe that the Justice Department understands monopsony problems in agriculture?

   Answer: The Justice Department employs very intelligent people, but OCM believes they are insufficiently worried about buyer and seller power in relation to farmers. OCM believes DOJ views agriculture as just another industry in the antitrust analysis.

   Agriculture is different because of (1) the disparity in power between farmers and industry as compared to other vertical players in other industries – i.e. each farmer has virtually zero market power; (2) the lack of substitution available to farmers for their input needs or sales product; (3) the local/regional nature of ag markets, which is sometimes confusing because national price averages and futures markets create the illusion of a national market; (4) the perishability of many agricultural products; (5) the disparity in sophistication between farmers and firms supplying inputs to or buying from farmers.

The result is lack of market access, increased market power, and an increased farm to retail price spread in most commodity and food products.

3. Is the Justice Department doing all it can under the current antitrust laws to address concentration in agriculture?

   Answer: No. The Department of Justice allowed Monsanto to acquire Delta and Pine Land Company last year. That merger was abandoned in 2000 after DOJ pressure, but the current DOJ allowed it with insubstantial divestitures of cotton seed trait lines that are not sufficient to enable competition. The DOJ also allowed Smithfield to purchase Premium Standard Farms last year, enabling a southeastern U.S. pork packing monopoly. Justice stated that hogs can travel 700 miles, among other mis-statements, when justifying the decision to allow the merger. These were mistakes.

4. How can the Justice Department merger approval process be improved with respect to the agriculture sector? For example, the Justice Department Antitrust Division currently has guidelines that it utilizes when it reviews mergers. Do you believe that they are adequate with respect to agricultural mergers? Do you support the provision in my bill S. 1759, the Agriculture Competition Enhancement Act, which would require DOJ to craft guidelines specifically for agriculture transactions, taking into account the special characteristics of the agriculture industry?

   Answer: OCM supports S. 1759 as an essential start to correcting the problem. Agricultural guidelines should be created to distinguish agriculture from other industries in the manner I stated above. Pro-competitive effects or efficiencies are often accepted without proof, while proof of harm is always needed. The proper analysis, at this stage of concentration in agriculture, is to recognize claimed pro-competitive effects or efficiencies only when they are (1) mathematically proven by clear and convincing evidence; (2) not achievable by means other than merger; and (3) to the extent that the benefits are likely to be passed to consumers or producers.

5. Do you believe that the Justice Department does enough to monitor the market performance of an ever-consolidating agriculture industry, including what happens to the marketplace after mergers have gone through? What would you propose the Justice Department do differently? Do you believe that the provisions that have been included in S. 1759 would help monitor market performance in agriculture?

   Answer: The DOJ does not monitor the performance of the industry after a merger. They handle a transaction, make a decision, and do not look back. DOJ could benefit by crafting agricultural merger guidelines and forming a

commission to include outside persons in production agriculture to analyze past mergers to determine whether competition was maintained. S. 1759 would assist this process greatly.

6. What is your opinion of the investigation process that the Justice Department conducts when it looks into a merger? Do you believe that the process could be more transparent and open? Do you believe that third parties are able to provide input on the merger? In your opinion, how good of a job does the Justice Department do in giving that input weight in their investigations? What would you do to improve the process?

   Answer: The DOJ investigative process has been open in the sense that OCM's input has never been denied. We do not feel great weight has been given to OCM's concerns, primarily because the evaluation of a merger is based more on personnel ideology, in our view, than ongoing standards. The factors for analysis should be created and should be published. Input could then be targeted more precisely, and the DOJ ideology of the day would be less of a variable.

7. Do you think that the current antitrust laws need to be amended to take into account the unique characteristics of the agriculture industry? Do you support the burden shifting provision in S. 1759?

   Answer: Yes. Amendments are necessary and S. 1759 is a good start. The courts have been hostile to antitrust in recent years, and no DOJ guidelines will change caselaw. Changes to the substantive law of agricultural antitrust should be considered, especially with regard to the presumptions of anti-competitive results and the increased skepticism of pro-competitive benefits.

8. Do you believe that the Department of Agriculture should play a greater role in reviewing mergers in agriculture? Why or why not? In addition, do you believe that the creation of the Special Counsel for Agricultural Competition at USDA contained in S. 1759 would be a beneficial thing?

   Answer: USDA should play some role in the review. However, USDA has been compromised by being a promoter of concentration unfortunately. Very little industrial organization expertise, the subspecialty applicable to antitrust economics, exists at USDA. Agricultural merger guidelines would assist in constraining the variable ideology of USDA personnel. Congress should create the Special Counsel for Agricultural Competition at USDA to professionalize the antitrust and competition expertise of the agency.

9. Some opponents of S. 1759 argue that market conditions do not show monopsonistic prices for farm commodities or monopolistic prices for farm inputs, thus there is no need for this legislation. In addition, they argue that the

bill would discourage investment in U.S. agriculture, and actually harm competition. Do you agree with these claims?

Answer: These opponent claims are false. In poultry, hogs and cattle, market access has diminished greatly. Increasingly, a producer can sell only if he/she has a contract. In poultry, you may only grow birds if a processor bestows a contract on you. In hogs, the poultry scenario is true in the southeast, and may soon be true in the Midwest. In cattle, many weeks of the year have non-competitive bidding because of captive supplies and only contracts allow consistent market access. Free markets do not work this way.

Also, the farm to retail price spread in pork and beef continues increasing, showing consumer harm.

Lastly, all credible studies show a strong correlation between more captive supplies in livestock and lower prices. The pro-competitive claims are based upon anecdotal evidence and industry interviews, not facts.

10. How do you rate the Justice Department's performance in pursuing anti-competitive and predatory business practices in the agriculture industry? Do you think they could do more? How would you suggest they improve in this area?

Answer: The DOJ has performed poorly in ways discussed above. S. 1759 addresses many of these problems. Ultimately, the caselaw must be changed through legislation with a focus on shifting the burden of proof to the defendant to prove that the merger will not substantially lessen competition.

11. In your opinion, has the Department of Agriculture done all it can under the Packer and Stockyards Act to address anti-competitive and abusive practices in agriculture? What more can it do to improve enforcement of the Act?

Answer: No. The USDA has don nothing on this score. The USDA should issue regulations constraining captive supply and defining levels of concentration that are anticompetitive. The USDA should issue regulations making captive supply contracts tradeable and transparent, turning a market harming device into a pro-market device.

12. Do you believe that the State Attorneys General have been as vigilant as they should be about these mergers in agriculture and competition issues in agriculture in general? Do you think they could do more? If you do, what should they be doing to address competition problems in agriculture?

Answer: State Attorneys General could be more active. They are hampered by the caselaw problems discussed above.

13. There is less vertical integration of the cattle supply chain than is evident in the hog supply chain. Moreover, this proposed merger would make beef packers even more highly concentrated than pork packers. Is the live cattle industry less susceptible to packer control through vertical integration than is the hog industry?

    Answer: Smithfield was a vertical integration driver in the hog industry. It has created Five Rivers Cattle Feeding in the cattle industry. JBS plans to acquire that feeding company, which will produce enough cattle to fill the annual capacity of 1.5 major plants without participating in the open market. Cattle are not only susceptible to vertical integration, but well on the way. Policy makers can change this now with less pain than later action.

14. The significance of an ever-increasing price spread between prices paid to cattle producers and prices consumers pay for beef has been dismissed by industry analysts as a function of ever-increasing value-added beef products. In your opinion, does the increase of value-added products explain increased beef price spreads?

    Answer: No. Value added products are not included in the USDA numbers giving rise to the price spread. The data would be worthless if you changed the data inputs to the time series. Thus, USDA properly does not include it. Industry analysts are wrong.

15. The efficiency gains for producers and consumers can only occur with sufficient competition from rival packing firms. Are two large rival firms sufficient competition? Isn't collusion among three large firms easier than among 5 or more? Are there a sufficient number of smaller, fringe firms that may comprise potential competitors should prices paid for fed cattle or received for beef products get out of line?

    Answer: The big five firms are the market makers. Three rival firms are insufficient for competition in this buy-side, auction-style market characterized by substantial partial vertical integration. The fed cattle market is only marginally competitive now, and this JBS acquisition plan will substantially lessen competition. Collusion in an auction-style market is very easy, but "parallel behavior" is more likely. The firms can easily find out what their putative competitors are doing each day, gaining multiple important pieces of information on price, volume and behavior. They are unlikely to break an unspoken consensus on competitive behavior because it is too costly and is unlikely to outweigh the benefits of the tacit agreement.

    Second tier firms are helpful, but are not market makers. The big firms establish the baseline price, and the small firms either gather cattle supplies from established relationships or bid prices up in small locales. They do not report prices to USDA and thus their bidding is not part of the USDA price reports.

16. The numbers of producers of all livestock continue to decline. However, independent cattle producers remain the largest body of producers in the United States. Could the shrinkage of the number of cattle operations in the U.S. be caused by something other than market power exerted by a concentrated packing industry? In other words, could the shrinkage simply be a function of some producers being more efficient and producing cattle cheaper than other producers? Despite the decline in the number of U.S. cattle operations and the reduced size of the U.S. cattle herd, isn't it true that due to improved genetics, technology, and management, the U.S. is producing more beef from each animal, suggesting that the decline in both the U.S. herd and the number of cattle operations is simply a function of improved industry efficiency?

    Answer: OCM members that produce cattle worry most about lack of market access. They are most likely to quit the business if market access is reduced, sporadic, or terminated. Macro-factors unrelated to market power can cause a reduction in producer numbers. But the facts show that more captive supplies lower price. Fewer buyers in an auction-style market lower price. Vertical integration and horizontal concentration reduce market access. Efficiency gains are not passed to producers or consumers as shown by the increased farm to retail price spread; and the disconnect/nonresponsiveness between the farm price and the retail price. Also, standard monopsony theory predicts that price depression will result from monopsony power, reducing supply volume, and the result is bad for the economy because the economy does not produce at full capacity. The cattle industry is following that monopsony model. We could produce more cattle for our population. Better genetics, technology and management lower per animal production costs, but do not explain the decline in herd size.

17. Some have asserted that increased consolidation among processors allows the processors to achieve economies of scale through larger size. Do you agree with this assertion? Do you agree with the opinions of the JBS and National Beef witnesses about the benefits of the JBS merger? If you don't, what do you believe are the more significant problems presented by this transaction?

    Answer: No economies of size will result because the plant sizes will be the same. No multi-plant efficiencies have been claimed. The merging parties have multiple plants now, so little change will occur. If efficiencies are claimed, they must outweigh the market power harm, be unattainable through other means, and be passed on to consumers. This is a market power grab.

From Senator Feingold

1. Mr. Stumo and Mr. Bullard, how will this acquisition affect the feeder cattle, Holstein and cull cow markets? How is the price for beef cattle related to the price for these other animals?

Answer: Feeder and Holstein prices are pegged to the fed cattle price. Holstein trade in a range – or basis – stemming from the fed cattle price. That basis range can vary. But if the fed cattle price is lowered, the Holstein price follows almost linearly. This is because Holsteins produce mostly hamburger, which fed cattle also produce. Holsteins have fewer high-value cuts than fed cattle, which explains the basis price reduction from fed cattle. But the retail market supplied is very similar.

Feeder cattle are priced using a break-even analysis. A buyer of feeder cattle must calculate the expected fed cattle price for gross revenue, and then subtract the cost of feed, medication, interest, yardage and other known costs. The result is the price that can be paid for a particular lot of feeder cattle. If the fed cattle price is lower, this will lower the break-even price for the feeders. If market access is restricted for fed cattle, this causes more risk which also depresses the break-even price… this is a risk premium. If more fed cattle buyers go out of business, there will be a decline in competition for feeder cattle. This latter result is being seen in many auction markets today.