

Fighting for the U.S. Cattle Producer!



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August 1, 2008

The Honorable Thomas Barnett
Assistant Attorney General
U.S. Department of Justice
Office of Operations
Premerger Notification Unit, Room 3335
950 Pennsylvania Avenue, NW
Washington, D.C. 20530

**Re: R-CALF USA's Sixth Submission of Information to the U.S. Department of Justice
Regarding the Proposed JBS-Brazil Merger**

Dear Mr. Barnett:

The Ranchers Cattlemen Action Legal Fund United Stockgrowers of America ("R-CALF USA") submitted written information to the U.S. Justice Department ("Justice Department") on April 9, April 24, May 8, May 20, and May 28, 2008, regarding the proposal by JBS Acquisitions (hereafter "JBS-Brazil") to purchase National Beef Packing Co. ("National"), Smithfield Beef Group ("Smithfield"), and Five Rivers Ranch Cattle Feeding, LLC ("Five Rivers"), collectively "JBS-Brazil Merger."

Since the date of R-CALF USA's last submission of information to the Justice Department, new information from the U.S. Department of Agriculture ("USDA") and other sources has become available that raise additional concerns regarding the JBS-Brazil Merger. This new information includes:

1. USDA-developed charts depicting the ongoing erosion of the fed cattle cash market.
2. A USDA-developed report showing significant price disparities between regional markets.
3. A media report describing a distortion of competitive market fundamentals in the U.S. fed cattle market.
4. A chart showing farm-to-retail beef price spreads in constant 2007 dollars.
5. Evidence showing a propensity by the merging entities to unilaterally engage in anticompetitive behavior.

6. R-CALF USA-developed maps showing concentration of above-the-average national cattle prices over time.
7. USDA data showing that the top four beef packing firms already have surpassed optimal economy-of-scale levels.

Each of the above-mentioned items is presented below in more detail:

1. USDA-Developed Charts Depicting the Ongoing Erosion of the Fed Cattle Cash Market.

In previous submissions to the Justice Department, R-CALF USA described how meatpacker concentration facilitates the exercise of market power. More specifically, R-CALF USA demonstrated that even under existing concentration levels, meatpackers procure large volumes of un-priced cattle (i.e., formula contract cattle) and other non-cash cattle (i.e., marketing agreements and other forward contract cattle) enabling them to shun the cash market for extended periods of time (*see, e.g.,* R-CALF USA's submission of information to the Justice Department, April 9, 2008, at 18-21). Importantly, the cash market remains the price-maker market for all cattle procurements, including formula contracts, marketing agreements, and forward contracts. In other words, the basis for all cattle procurement transactions is ultimately tied to the cash market. Thus, when packers shun the cash market, competition in the cash market is reduced and all cattle procurement transactions are thereafter tied to the price generated from the competition-deficient cash market. This leads to lower prices paid for all cattle sold to all meatpackers.

The trend toward even more un-priced and non-cash cattle procurements, demonstrating the ever-increasing acquisition of market power, is strikingly evident in reports recently released by USDA. *See* USDA Cattle Procurement Charts, attached hereto as Exhibit 1. The USDA-developed charts in Exhibit 1 depict the number of slaughter-ready cattle sold in the regional markets of Texas, Oklahoma and New Mexico; Kansas; and Nebraska under cash arrangements (cash and negotiated grid) versus the number sold in these regional markets under contract (formula and forward contracts). These charts show a precipitous drop in the volume of cash cattle procurements (15.2 percent in the TX/OK/NM market, 10.5 percent in the Kansas market, and 5.3 percent in the Nebraska market) since 2005, and a corresponding and significant increase in the volume of un-priced and non-cash procurements, otherwise known as captive supplies. The charts show that beginning in 2006, the meatpackers began controlling more cattle through captive supply arrangements than they purchased in the cash market, and the volume they control has increased each year since that time.

Also in a previous submission to the Justice Department, R-CALF USA provided a study that explains why otherwise independent cattle producers would continue to participate in cattle procurement contracts that aid meatpackers in their exercise of price-depressing market power. *See* Exhibit 7 of R-CALF USA's Third Submission of Information to the Justice Department,

May 8, 2008¹; *see also id.*, at 9, 10. The referenced study explained that it is the producer's inability to coordinate action that enables a packer to obtain acceptance for exclusionary contracts, and "as long as the producer is offered at least as much as could be received in the spot market in the equilibrium with captive supplies, the producer's equilibrium strategy is to ACCEPT the contract." *See id.* Based on this finding, U.S. live cattle producers likely would be defenseless against the increased monopsony power expected to be exercised as a result of the proposed JBS-Brazil Merger. In addition, the acquisition of Five Rivers feedlots by JBS-Brazil would, by its very structure, exacerbate the ongoing erosion of the price-making cash market given that the acquisition would place JBS-Brazil in direct ownership of, and in close proximity to, the Five Rivers feedlots currently owned by Smithfield.

2. A USDA-Developed Report Showing Significant Price Disparities between Regional Markets.

The USDA Agricultural Marketing Service ("AMS") has very recently compiled new cattle market reports following the July 21, 2008, resumption of mandatory price reporting. One of the new reports provides regional fed cattle prices and shows that the cash price difference between some of the regions is nearly \$6 per hundredweight, which would be a difference of approximately \$75 per head based on a typical 1,250 pound fed animal. *See* AMS Report, attached hereto as Exhibit 2. For example, the report shows the week-ago price for "Negotiated Grid: Live Basis" (which means a negotiated base cash price subject to certain quality based discounts and premiums) was \$93.66 per hundredweight in the TX/OK/NM region, while the price in the Western Cornbelt region was \$99.65 per hundredweight, a difference of \$5.99 per hundredweight. *See id.* This significant price difference between regions demonstrates that the U.S. fed cattle market, unlike the wholesale beef market,² consists of several regional markets, and should *not* be viewed as a national market.

3. A Media Report Describing a Significant Distortion of Competitive Market Fundamentals in the U.S. Fed Cattle Market.

On July 11, 2008, the Associated Press issued a news article stating that National Beef had attributed its higher third-quarter profits to, *inter alia*, increased beef demand and lower cattle prices. *See* National Beef Reports Larger Profits, attached hereto as Exhibit 3. This is a counter-intuitive outcome for a properly functioning competitive market as higher demand for beef should translate into higher prices for the fed cattle from which the beef was derived. But, just the opposite has occurred. According to USDA's High Plains Cattle Feeding Simulator, U.S. cattle feeders operated at a net loss when marketing their cattle in each of the 10 months August 2007 through May 2008. *See* High Plains Cattle Feeding, attached hereto as Exhibit 4. During the 3-month period concurrent with National Beef's reported profit increase – March, April and May 2008 – the period in which beef demand reportedly increased, U.S. cattle feeders

¹ Captive Supplies and the Cash Market Price: A Spatial Markets Approach, Mingxia Zhang and Richard J. Sexton, *Journal of Agricultural and Resource Economics*, 25(1): 88-108, at 98 (Exhibit 7 in R-CALF USA's May 8, 2008 Third Submission of Information to the Justice Department).

² *See* R-CALF USA's Third Submission to the Justice Department, May 8, 2008, at 11 (citing a study finding that the wholesale beef market is a national market).

suffered estimated losses of -\$11.67, -\$11.36, and -\$4.88, respectively. *See id.* Cattle prices during the first two months of this 3-month period – March and April – were significantly less than the prices received during the previous 3-month period – December 2007, January 2008 and February 2008. *See id.*

This absence of cattle feeding profitability in the face of increased beef demand is not an anomaly. Indeed, Auburn University economist C. Robert Taylor has adjusted for inflation Iowa State University data that show the profitability of cattle feeding was reduced by more than half during the period 1994-2007, when compared to the earlier period 1981-1993. *See Cattle Feeding Charts*, attached hereto as Exhibit 5.³ Yet, beef demand during the earlier period, 1981-1993, actually fell every consecutive year throughout the entire period, and it strengthened during the latter period when cattle feeding profitability was severely reduced. *See Annual Beef Demand Index*, attached hereto as Exhibit 6.

It is R-CALF USA's position that this ongoing market distortion is accomplished through the exercise of market power, i.e., National Beef and other packers are able to purchase cattle for less in the face of increased beef demand because they can control the price paid for live cattle. This ongoing market distortion would be expected to worsen if the JBS-Brazil Merger is consummated.

The reduction in cattle feeding profitability described in Exhibit 5 also demonstrates why the Justice Department should not apply, in this merger review, the typical 5 percent test to determine the smallest relevant market within which a hypothetical monopolist or cartel could impose a profitable significant decrease in price (in the context of buyer power). The typical 5 percent threshold is far too high to be applied to the U.S. cattle industry. For example, Exhibit 5 shows that the net returns (in current dollars) from feeding yearling steers averaged less than only \$14 per head over the 1994-2008 period. For a \$1,000 per head fed steer, the 5 percent test would allow a merger that would decrease price by \$50 per head, which would mean that cattle feeders would be losing \$36 per head compared to the historical average profit of about \$14 per head. A price decrease of only 1.4 percent would completely eliminate the modest profits realized by cattle feeders over the period 1994-2008. Therefore, criteria typically used to define markets and to define an acceptable level of market power in the merger approval process are inappropriate to the U.S. cattle market.

4. A Chart Showing Farm-to-Retail Beef Price Spreads in Constant 2007 Dollars.

In previous submissions of information to the Justice Department, R-CALF USA presented charts depicting the historical spread between producer cattle prices and consumer beef prices and asserted that the widening price spread over time is evidence that the marketplace has become inefficient and inequitable for both cattle producers and consumers. *See R-CALF USA's first submission of information, April 9, 2008, at 9; see also R-CALF USA's second submission of information, April 24, 2008, at 8.* The attached Exhibit 7 is a farm-to-retail chart recently prepared by C. Robert Taylor of Auburn University that shows, in constant 2007 dollars,

³ C. Robert Taylor, College of Agriculture, Auburn University, 208 Comer Hall, Auburn, Alabama, 36849.

a dramatic increase in recent years of the farm-to-retail price spread for beef. This new chart, combined with the previously submitted charts, demonstrate that both cattle producers and consumers already are being harmed by the existing, highly concentrated structure of the U.S. cattle and beef marketplace. Again, it is R-CALF USA's position that the proposed JBS-Brazil Merger, which would significantly increase market concentration, would significantly exacerbate this adverse market outcome.

5. Evidence Showing a Propensity by the Merging Entities to Unilaterally Engage in Anticompetitive Behavior.

Among R-CALF USA's concerns regarding the proposed JBS-Brazil Merger is that it would create such an intensely concentrated market that any anti-competitive behavior exercised by any one of the post-merger meatpackers would have a profound, negative impact on a large portion of the U.S. live cattle industry. Each of the meatpacking firms involved in the JBS-Brazil Merger has been accused of unilaterally engaging in anti-competitive practices. R-CALF USA previously provided evidence indicating that JBS-Brazil paid a penalty of \$8.5 million after being accused of engaging in anti-competitive behavior in its home country of Brazil. *See* R-CALF USA first submission of information, April 9, 2008, at 21. Recently, R-CALF USA learned that Swift and Company d/b/a Swift Beef Company (now known as JBS Swift) stands accused by USDA of willfully violating provisions of the Packers and Stockyards Act ("PSA") by, *inter alia*, failing to pay the full amount due to livestock sellers for hot carcass weights. *See* USDA Complaint filed June 18, 2008, attached hereto as Exhibit 8. Also, on March 4, 2008, National entered into a Consent Decree with USDA and paid a penalty in the amount of \$50,000 after being accused of violating the PSA by failing to disclose freight charge deductions and data errors that affected the price paid for cattle purchased pursuant to quality-based pricing grids. *See* Consent Decision, attached hereto as Exhibit 9. On Oct. 11, 2007, Smithfield entered into a Consent Decree with USDA and paid a penalty in the amount of \$325,000 after being accused of violating the PSA by, *inter alia*, paying livestock producers on improperly rounded hot carcass weights during the multi-year period Nov. 21, 2001 through Nov. 4, 2004. *See* Consent Decision, attached hereto as Exhibit 10.

The foregoing examples demonstrate that each of the meatpackers subject to the proposed JBS-Brazil Merger (JBS SA, National, and Smithfield) have paid penalties for engaging in anticompetitive behavior that adversely affected livestock sellers, thus demonstrating these meatpackers' propensity to exploit livestock producers. R-CALF USA is not aware of any compensation or reimbursements paid to the livestock producers who were harmed by the foregoing examples of anticompetitive behavior. If such anti-competitive behavior were to persist post-merger, the impact on U.S. live cattle producers would likely be widespread and severe.

Unfortunately, for many years USDA has not properly enforced the PSA that prohibits many anticompetitive livestock marketing practices. A 2006 audit report by the USDA Office of Inspector General ("OIG Audit") found that in 1997, USDA did not have adequate resources for "proper monitoring of the livestock procurement market for anti-competitive behavior." *See* OIG Audit, at 2, attached hereto as Exhibit 11. The OIG Audit found that the U.S. General

Accountability Office (“GAO”) concluded in September 2000 that USDA’s investigative processes and practices “are not suited for the more complex anti-competitive practices they [USDA] are addressing now.” *Id.*, at 3. The OIG Audit found in 2006 that, *inter alia*, USDA still did not have an adequate control structure and environment that would allow the agency to ensure open and competitive livestock markets (*see id.*, at 5); USDA’s process for managing investigations inhibited the agency’s ability to investigate anti-competitive activities in livestock markets (*id.*, at 9); and, USDA did not sufficiently implement the corrective actions needed to resolve the agency’s deficiencies that were previously identified in 1997 and 2000. *See id.*, at 17.

The foregoing discussion reveals that the agency responsible for protecting against anti-competitive practices in livestock markets has failed to properly do so for over a decade, and the very recent findings of anti-competitive practices (since late 2007) provide no indication of how pervasive and widespread these anti-competitive practices are within U.S. cattle markets. Thus, there is no basis for which to presume that regulatory action pursuant to the PSA would serve to mitigate any post-merger, anti-competitive practices. Instead, the propensity by the meatpackers to unilaterally engage in anti-competitive behavior - discovered despite *de minimis* regulatory oversight – portends a clear and present danger to livestock market competition should the JBS-Brazil Merger be consummated.

The proposed merger would significantly increase the volume of cattle controlled by JBS-Brazil, and because the motive for engaging in anti-competitive behavior is to increase profit – which is a function of per-head margins multiplied by volume – the proposed merger inherently would increase the incentive for JBS-Brazil to engage in such profit-motivated, anti-competitive behavior. Presuming the above allegations against JBS-Brazil and each of the merging meatpackers are true, each of these entities already had determined that the potential economic rewards for engaging in anti-competitive behavior were worth the potential risks. Post-merger, the potential risks would remain unchanged, but the potential economic rewards for JBS-Brazil would be substantially greater, as a direct result of its control of larger volumes.

The proposed merger also would make it more difficult to identify anti-competitive behavior because cattle sellers, who may suspect that they are being subjected to anti-competitive practices, would need to carefully weigh the strength of their suspicions against the potential for retaliation, which could result in the loss of a future buyer for their cattle. This would be no small concern, particularly in regional cattle markets where only two buyers may remain. Thus, the post-merger market structure may actually decrease the meatpackers’ potential risks associated with engaging in anti-competitive practices, as it would increase the producers’ risk of filing a complaint for suspicion of anti-competitive conduct.

6. R-CALF USA-Developed Maps Showing Concentration of Above-the-Average National Cattle Prices Over Time.

In an effort to illustrate the effects of declining competition on cattle prices, R-CALF USA developed maps contained in the attached Exhibit 12 that show changes over time to the

mix of states with cattle prices either above or below the average national cattle price.⁴ The maps correspond to the level of concentration in livestock purchases by meatpackers as measured by the Herfindahl-Hirschman Index (“HHI”) and the four-firm concentration ratio (“CR4”). (Note that this is a measurement of “livestock purchases” and not of “steer and heifer slaughter concentration.”) For livestock purchases by meatpackers, the HHI increased from 759 in 1987, to 1,170 in 1997, and then to 1,269 in 2006 (latest available data).⁵ The CR4 increased during the same period from 47 percent to 61 percent to 66 percent. These maps show that the number of states with above-the-average cattle prices are becoming fewer and are becoming more concentrated in the central United States. It is R-CALF USA’s contention that the blue states depicted in the maps are increasing in number because there are fewer significant buyers and thus, below average prices.

7. USDA Data Showing that the Top Four Beef Packing Firms Already Have Surpassed Optimal Economy-of-Scale Levels.

USDA data show that in 2006 the profitability (measured by operating income as a percentage of sales⁶) of mid-sized and smaller packers was greater than the profitability of the four largest meatpackers.⁷ In fact, the four largest meatpackers overall reported losses in 2006 while the 5th through 8th largest, and the 9th through 20th largest overall reported profitable operations, with the 21st through 40th largest meatpackers having overall reported near-record profitability in 2006 when compared to the past fifteen years.⁸ These data suggest that the four largest meatpackers may not be able to adequately adjust to changing market conditions, as can their moderate-sized counterparts. The following chart derived from USDA data suggests that the maximum economy of scale is achieved by mid-sized meatpackers.⁹

⁴ Data source for the maps include Meat Animals Production, Distribution, and Income 2007 Summary, U.S. Department of Agriculture, National Agricultural Statistics Service, April 2008, at 9, attached hereto as Exhibit 13; and corresponding data from USDA NASS summaries for 1987 and 1997, available at <http://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1101>.

⁵ Packers and Stockyards Statistical Report: 2006 Reporting Year, U.S. Department of Agriculture, Grain Inspection, Packers and Stockyards Administration (GIPSA), May 2008, at 51, attached hereto as Exhibit 14, available at http://archive.gipsa.usda.gov/pubs/2006_stat_report.pdf.

⁶ *Id.*, at 6.

⁷ *Id.*, at 52, 56.

⁸ *Id.*

⁹ *Id.*, at 56.

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Beef Packer Operating Income as a Percent of Sales (GIPSA/USDA data) by Size				
Time Period	Big Four	5th to 8th	9th to 20th	21st to 40th
2006	-0.2	2.3	2.22	5.42
2005	0.92	1.69	4.47	3.51
Average 1992- 2006	1.46	2.34	3.86	1.77

R-CALF USA appreciates this opportunity to provide the foregoing information for your consideration during your investigation of the proposed JBS-Brazil Merger. If you should have any questions or need any additional information, please do not hesitate to contact me.

Sincerely,



Bill Bullard
CEO, R-CALF USA