Recommendations for Settlement Options in the JBS/National Merger

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December 26, 2008[1]

Background:

R-CALF USA and OCM have two primary concerns regarding a possible settlement in the JBS/National merger litigation brought by the U.S. Department of Justice (DOJ) and 17 State Attorneys General (hereafter "DOJ/States"). First, because the merger would reduce the already limited number of buyers in the market, it would reduce competition and increase market power held by JBS and the remaining packers. Second, with fewer buyers in the marketplace, i.e., less competition, the merger would facilitate the exercise of market power by JBS and the remaining packers. Any proposed remedy should address the increased market power and the potential exercise of that market power.

In this case a structural remedy of the divestiture of beef processing plants is a necessary but not sufficient remedy to the competitive concerns raised by this merger. We believe that from a structural perspective the divestiture of beef processing facilities in both the High Plains and Southwest markets is essential to restore competition. Absent those divestitures there would be significant harm in either or both of these markets.

However, the divestiture of a stand-alone packing firm would not likely be successful in a market environment where dominant participants continue to wield both buying power and selling power. Thus, any settlement agreement must address the existing market conditions that may limit the ability of the acquirer of the divested assets to fully restore competition.

We recognize that typically the DOJ prefers the divestiture of a facility or ongoing business. Yet in some cases both the DOJ and FTC have supplemented structural relief with additional remedies to help ensure that the acquirer of the assets has the incentive and ability to fully restore competition. For example, earlier this year in the Monsanto/Delta Pine merger, the DOJ required the divestiture of not only the Stoneville Pedigreed Seed Company owned by Monsanto, but also required the divestiture of other assets owned by Delta Pine and imposed additional behavioral relief to ensure that the acquirer of the divested assets had the incentive and ability to fully restore competition. This combination of assets was called the "Enhanced Stoneville Assets" by the DOJ. Our proposal is for a similar "divestiture plus" approach to remedy.

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[1] This document solely addresses the potential remedies to alleviate the competitive harm in the procurement of fed cattle market. It does not address the need for proposed remedies in the downstream market of the purchase of boxed beef.

Mitigating the Merger's Inherent Harm (Reduced Competition):

In the Southwest market, the merger of National's Brawly, California, plant and JBS' Tolleson, Arizona, plant would result in the absolute elimination of competition in that market – there would be only one remaining buyer. There are no mitigation measures with which to minimize the harm from the complete loss of competition in the Southwest. Therefore, any settlement must require the divestiture of either the JBS or National plant in the Southwest market.

In the High Plains market, there are currently four packers: including National, with two plants, and JBS, with three plants. Together the five plants owned by JBS and National in the High Plains market account for approximately one-third of the total fed packing capacity in the High Plains. Tyson and Cargill own the other major plants in the High Plains. Inherent harm would result if the two National plants were merged with JBS as the number of buyers/competitors in the market would be reduced from four to three. The only means of mitigating the inherent harm associated with the loss of a *competitive* buyer (an acquirer of assets with fewer than two plants in the High Plains market would not be competitive in the current market) would be to require the divestiture of either two of JBS' three plants or both National plants operating in the High Plains. This would ensure that the High Plains market would continue to have at least four *significant* buyers/competitors.

In both markets either all of National's plants or the JBS plant in the Southwest and two of JBS' three plants in the High Plains must be divested. These are markets in which there is already evidence of the exercise of market power. Thus, JBS should not be able to increase its market share in either of these markets, for example, by acquiring one of the two National plants in the High Plains area.

Mitigating the Merger's Contingent Harm (Exercise of Market Power):

We believe that the facts alleged in the DOJ/States complaint set forward a strong case of why no greater concentration in the beef processing market should be permitted. A strong structural remedy should ensure that JBS is unable to increase concentration to any significant extent because of this merger.

However, any remedy has to consider the level of competition in the marketplace. As we documented in numerous submissions to DOJ, there are severe competitive problems in the cattle procurement market. An effective device packers use to exercise market power in the cattle procurement market is captive supply. Captive supply refers to livestock that are accumulated by packers through non-regulated future pricing schemes and other non-regulated procurement methods, including certain forward contracts, formula contracts, exclusive marketing agreements, exclusive purchasing agreements, and packer-owned cattle. Captive supplies accord packers the ability to create market access risk for cattle sellers by restricting their timely access to an appropriate market outlet.[2] Packer-owned cattle are the most direct form of captive supplies

[2] GIPSA Livestock and Meat Marketing Study, January 2007, Volume 3, at 5-4 ("market access risk" refers to "the availability of a timely and appropriate market outlet"), available at http://archive.gipsa.usda.gov/psp/issues/livemarketstudy/LMMS_Vol_3.pdf.

as they are owned, controlled, and fed by the packers. The non-competitive effects of captive supplies in the U.S. cattle industry are documented in government studies, independent academic research, and earlier antitrust litigation.[3]

- The 2007 Livestock and Meat Marketing Study (LMMS) commissioned by the U.S. Grain Inspection Packers and Stockyards Administration (GIPSA) found that "[t]ransaction prices associated with captive supply transactions are the lowest among all the procurement methods [including cash market procurement methods],"[4] and proffered that the results of the study may suggest that "farmers who choose forward contracts are willing to give up some revenue in order to secure market access . . ."[5]

- The LMMS found that a 10 percent shift of the volume of cattle procured in the open market to any one of the alternative procurement methods is associated with a 0.11 percent decrease in the total cash cattle market price.[6]

- The comprehensive econometric analysis documented in *Pickett v. Tyson Fresh Meats, Inc.*, which covered the period 1994-2004, showed an even greater sensitivity to shifts is cattle procurement. The analysis showed that for each 1% increase in captive supply cattle, total cash cattle prices decreased 0.155%.[7]

- Captive supplies have been shown to increase the instability of prices for cattle producers and hold down cattle prices.[8]

- Researchers found that a 1 percent increase in regional firm concentration as measured by the regional HHI raises the probability that packers would use packer fed arrangements (captive supplies) by 3.18 percent.[9]

- Researchers have found that individual producers within the U.S. cattle industry will agree to sign captive supply contracts even while knowing that the aggregate effect of captive supply contracts is to depress the cash market price and make all producers, including him/herself, worse off.[10]

The JBS/National merger would significantly increase JBS' propensity to exercise market power by conferring on JBS significant additional captive supplies. JBS has already acquired Smithfield's Five Rivers Ranch Cattle Feeding, LLC (Five Rivers), which has provided JBS an

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[3] *See also*, e.g., R-CALF USA letter to DOJ, April 9, 2008, at 10-21.
[4] *Id*., at 2-36.
[5] *Id*.
[6] *See id.*, at ES-5.
[7] *See* Trial Transcript in *Pickett et al. v. Tyson Fresh Meats, Inc. (IBP, Inc.)* Civil No. 96-A-1103 N, U.S. District Court for the Middle District of Alabama, Northern Division.
[8] *See* John M. Connor, "The Changing Structure of Global Food markets: Dimensions, Effects, and Policy Implications," Staff Paper #3-02, Department of Agricultural Economics, Purdue University, February 2003, at 7-8.
[9] Examining Packer Choice of Slaughter Cattle Procurement and Pricing Methods, Oral Capps, Jr., et al., Agricultural and Resource Economics Review, April 1999, at 21.
[10] 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.

additional 2 million packer-owned cattle per year.[11] National has a captive supply arrangement with its underlying owners – U.S. Premium Beef, LLC (U.S. Premium Beef), which, if merged with JBS, would accord the merged firm with approximately 676,000 additional captive supply cattle.[12] Thus, any settlement that would allow JBS to acquire the captive supply arrangement between U.S. Premium Beef and National would result in a dramatic increase in captive supplies available to JBS that were not available to the firm prior to October 20, 2008, the date after which JBS acquired Five Rivers. JBS would then have control of over 2.6 million additional captive supply cattle, representing approximately 10 percent of the 27 million steers and heifers slaughtered annually in the United States.

It is critical to recognize the impact of the acquisition of Five Rivers on the potential for future anticompetitive conduct and strategic conduct by JBS to diminish the ability of the acquirer of the divested assets to effectively compete. Prior to the JBS/Smithfield acquisition, Smithfield could not operate Five Rivers as an integrated captive supply source due to the considerable distance between Smithfield's plant locations and its Five Rivers' feedlots. Smithfield's capacity could not be manipulated. JBS, however, does not share this limitation because its plants are in closer proximity to Five Rivers' feedlots and can, therefore, operate Five Rivers as an integrated captive supply source.

JBS' current use of captive supplies, which is greatly enhanced by the Smithfield acquisition, puts JBS in a position where it can undermine any structural relief in the High Plains market by manipulating captive supplies. Because JBS controls such a large portion of supplies it can manipulate the input market by artificially increasing the market price of cattle for the acquirer of the divested assets. As these costs increase the acquirer would find it increasingly difficult to compete against JBS and the remaining processing firms. It may exit, or at least its ability to compete will be severely diminished.

Thus any settlement must address JBS' acquisition of captive supply arrangements. We recommend that the proposed settlement should prohibit JBS' acquisition of the captive supply arrangement between U.S. Premium Beef and National and require the divestiture of the Five Rivers' feedlots.[13] Prohibiting the structural acquisition of the U.S. Premium Beef captive supply arrangements and requiring the divestiture of Five Rivers' feedlots would reduce JBS' ability to exercise market power.

In addition to this limit on acquisition of captive supplies, there are several other measures that are necessary to limit JBS' ability to either: (1) diminish the ability of the acquirer of the divested assets to restore competition, and (2) manipulate captive supplies to harm competition in fed cattle procurement. Among the options the DOJ/States should explore to minimize JBS' exercise of market power in the context of settlement negotiations are:

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[11] *See* R-CALF USA letter to DOJ, April 9, 2008, at 21, 22; see also R-CALF USA letter to DOJ, May 8, 2008, at 11-13.

[12] See R-CALF USA Letter to DOJ, May 28, 2008, 1-6.

[13] If the divestiture of all of the Five Rivers feedlots is not required, a remedy must be imposed to limit JBS' use of captive supplies out of Five Rivers.

1. a requirement that all advanced cattle procurement contracts must contain a firm base price that is publicly reported in the week the contract was executed;
2. a prohibition against the use of a formula price in cattle procurement contracts;
3. a requirement that all advanced cattle procurement contracts, in addition to containing a firm base price, must be offered in an open, public manner that allows both buyers and sellers to participate in the bid and to witness bids that are offered and accepted, and that do not require the delivery of more than 40 head of cattle from any seller;
4. a requirement that a majority of cattle slaughtered by JBS each week must be procured from the open spot market, not from advanced cattle procurement contracts;
5. a requirement that any premiums offered for quality characteristics or efficiencies (i.e., savings on transportation costs) must be available to all cattle sellers, regardless of size; and,
6. a requirement that any cattle owned or fed by JBS be offered for sale to all other packers in an open and public manner prior to slaughter.

Finally, to ensure that the structural divestiture is effective, we recommend that the acquirer of the High Plains divested assets have the ability to choose which plants it wants to acquire (either the JBS or National plants). With that requirement, there will be a greater assurance that the divestiture will be successful.

We recognize that the DOJ may be reluctant to use remedies that would put the government or the Court in a position of regulating an industry. We believe that none of these provisions would create this problem: all of the provisions are self-executing and would not impose a significant regulatory burden.

Mitigating the Merger's Contingent Harm (Exercise of Market Power) in the Context of its Effect on the Likelihood for Success of Any Stand-alone Merger Component:

While the foregoing mitigations should minimize the ability of JBS to run-up input costs (i.e., live cattle prices) in the short-term to effectively disadvantage a stand-alone firm created by a partial divestiture of the JBS/National merger, the DOJ/States must thoroughly investigate the wholesale selling practices of JBS and other dominant packers along with the buying practices of the highly concentrated retail sector. The DOJ/States must first identify and then impose mitigating measures to counteract any buying and selling practices within the concentrated wholesale beef market that would competitively disadvantage a stand-alone firm in a wholesale beef market dominated by three highly concentrated packers.

Conclusion:

In any settlement agreement, the DOJ/States must protect independent cattle producers from two separate though interrelated harms arising from the JBS/National merger: These harms include the inherent harm arising from a reduction in the number of buyers/competitors in the market and the contingent harm arising from the actual exercise of the inherent market power held by a dominant participant in the highly concentrated cattle market.

In this case where there is the ongoing exercise of market power, structural relief is a necessary, but not sufficient approach. At a minimum the DOJ/States should not permit JBS to increase their market share in either of these markets.

Structural relief alone is insufficient. The efforts of the DOJ/States will be for naught if after the merger JBS is able to use captive supply arrangements to hamper the ability of the acquirer of the divested assets to restore competition. In the current environment, JBS has the power to use captive supply arrangements to increase costs and turn the acquirer of the divested assets into a competitive pauper. Neither consumers nor cattle producers will benefit from such a remedy.

Similarly, a solely structural approach will not solve the loss of competition in the procurement of fed cattle. Post-merger JBS will be able to use captive supply arrangements, enhanced by the Five Rivers' acquisition, to continue to exercise market power and dampen competitive forces in procurement.

To remedy both of these concerns we recommend that the DOJ/States additionally consider the use of several non-structural approaches to relief to diminish the ability of JBS to undermine the goals of the consent or to exercise market power post-merger.

Please let us know if you have any questions.