Economic Challenges and Opportunities Facing
American Agricultural Producers Today:
Restoring Efficient, Fair and Open Markets in Agriculture

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before
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Introduction

It is an honor to asked to present my views on competition policy as applied to agricultural markets as this Committee undertakes the task of revising and re-enacting the Farm Bill. I have had the privilege of testifying before this committee in the past and I have always been impressed with the commitment of its members to understanding the competitive issues that confront agriculture. I am particularly impressed with the bipartisan commitment to improving the workings of these markets manifested in the various legislative proposals from Senators Harkin, Grassley, and Enzi among others. Indeed, it is essential that the next Farm Bill address the problems of creating and maintaining fair, transparent, accessible and efficient markets. The changing characteristics of those markets are steadily eroding the capacity of farmers to find and get the benefit of workable competition.

For the last ten years, I have focused a significant part of my attention on the specific competitive issues that confront agricultural markets on both the input and output side.1 As a result, I have been studying these issues from a variety of perspectives as well as learning from many experts in the field. I have made a number of presentations to various groups on competition policy issues.2 I also have a background in some aspects of these issues. As a government lawyer some 30 years ago, I reviewed the old meat packing consent decree and in the process came to appreciate the context within which Congress crafted the Packers and Stockyards Act. In 1995, I served in Wisconsin on a committee that reviewed and proposed modifications for the regulations governing contracts for vegetables being purchased for canning. I have also done an extensive examination of the grain marketing industry in connection with a study of the famous Chicago Board of Trade decision which is a landmark antitrust case.3 In addition, my work on the competitive implications of other kinds of vertical distribution arrangements has provided me with relevant background on some of the key issues being considered today.4 In September 2001, I was one of six invited academic experts in the U.S. Department of Agriculture's Public Forum on Captive Supplies held in Denver, Colorado. 5 We were asked to evaluate the need to adopt regulations under the Packers and Stockyards

Act to deal with concerns about anticompetitive and inequitable treatment of farmers and ranchers who raise beef cattle. I have also been an invited witness in hearings before this committee and the Senate Subcommittee on Antitrust, Business Rights and Competition on agricultural competition issues.

Overview

The American farmer faces increasingly dysfunctional markets for both the inputs and outputs of the farm. The resulting squeeze threatens the traditional structure of American agriculture and is likely to result in the gradual reduction of many of those producing food and fiber in this country to a kind of economic serfdom. Moreover, the economic results of this transformation will be increased costs to consumers, a long-run reduction in innovation and technological progress in agriculture, as well as impoverishment of rural communities. In sum, the failure of agricultural markets to function efficiently and fairly is going to impose major costs on the entire economy.

As it considers the next Farm Bill, this Committee and Congress should take account of these pressures and do what it can legislatively to correct the problems and restore fairness, accessibility, transparency and efficiency to those markets. There are indeed several very worthwhile proposals that merit adoption that would substantially improve the legal framework of these markets. I would suggest that with respect to dairy and grain markets additional legislative action is required.

Unfortunately, good legislation is only effective if it is adequately enforced and therein lies a second major problem for American agriculture. Neither the United States Department of Agriculture (USDA) nor the two antitrust enforcement agencies, the Justice Department's Antitrust Division and the Federal Trade Commission (FTC), has enforced the existing laws to protect the market process. This is regrettable because, despite their limitations, those laws both constitute the markets for agricultural products and establish competition policy applicable to those markets and could be and should have been used to ameliorate many of the problems that exist.

One of the most important changes in the market for agricultural products is the decline of cash markets and their replacement with various kinds of contractual relationships. There are some efficiency arguments for this change, but there are also strategic reasons why major buyers would prefer the less transparent contract system to the more open and accessible transaction market. Moreover, there is a further problem that results from the decline in the public cash markets. Those markets continue to produce the price signals on which many contractual arrangements depend. Yet as the volume in the public market declines the risk of market manipulation increases. As a result, the emerging system of contracting needs careful and thoughtful oversight to ensure that it operates in a fair and equitable manner.

Agriculture presents some very specific problems for the development of efficient and open markets for products. First, there are long lag times between the time a crop is planted or an animal received for feeding and the sale or delivery of that crop or animal. This increases the risks to which the farmer is exposed with respect to changes in market price. Contracts are a way to shift risk and potentially can create more efficient allocation of risk. But, in the case of

farming, even the largest producers are often relatively small in relation to the buyers. Hence, by contract, powerful buyers can shift risks of loss to farmers in ways that insulate the buyer and leave the farmer with disproportionate exposure to such risk relative to the potential for upside gain. When markets are more competitive and farmers are better informed about the alternative contracts, much more equitable risk allocation is possible. But this can happen only when farmers have access to information and have workably competitive buying markets into which they can sell their products. A number of the current proposals in Congress seek to ensure better information and more competition in those markets. This is important to the restoration of workable competition in the markets for agricultural commodities.

A central and recurring concern in these markets is the existence and abuse of buyer power. Historically, Congress through such statutes as the Packers and Stockyards Act and Capper Volstead Act has sought to redress the balance between buyers and sellers as well as insure that markets operate in fair and open ways. Unfortunately, with the changes in the structure of many of the markets for agricultural products and changes in the methods of buying those products, these older statutes have had increasingly less relevance to the ways in which modern markets operate. Some of the problem, however, comes from the failure of the USDA to use the authority Congress conferred on it to develop and implement rules that would restore the relevance of these statutes. I am particularly concerned with the failure to adopt rules under the PSA to regulate the contracting process in livestock and poultry markets. Equally distressing the total failure of the USDA to revise the regulation of milk market orders to limit the unfair and inefficient conduct of a few dominant cooperatives and their customers. In subsequent sections of this statement I will spell out in some greater detail my concerns on these topics.

In the last decade a new threat to American agriculture has emerged in the form of the expansive definition of the rights of patent holders to control the post-sale uses of crops produced with patented genetics. To date these rights have been used to exploit farmers in the purchase of seeds in ways that grossly exceed any legitimate interest in the promotion of innovation, but with the rapid increase in the value of some of the crops farmers raise with such seed, there is a clear risk that the patent holders will seek to appropriate some or all of the gains coming from higher prices for corn and soybeans. Given the attitude of the Antitrust Division toward patent rights, only Congress can protect the American farmer from this new threat of exploitation.

These forces are driving competition from the market for agricultural products and the current legal framework for these markets greatly facilitates these forces. In addition, the failure to have a vigorous merger policy has contributed greatly to the concentration of buyer power. If Congress fails to restore workable competition so that the prices are fairly and competitively set whether in connection with contracts or direct sales, then I think it is quite likely that Congress, in order to preserve American agriculture, will eventually be compelled to resort to direct controls over contract prices. Such controls would compel buyers to pay no less than some minimum amount to compensate for the productions services provided by farmers. I phrase it that way because the failure of competition will destroy the last vestiges of a cash market and only contracts for production services will remain. When that happens, Congress will find it necessary to set the minimum terms for such contracts. This is not an desirable or efficient outcome, but it is the kind of economic regulation that will become inevitable if the number of

competitors and their methods of doing business continue in the current direction.

I have been asked to discuss the present state of the competition in agricultural markets as well as how this sad state of affairs has emerged. In my view, there are three legal elements that are relevant to the state of competition in any market. First is the set of rules that constitute the market; these are rules that define the kinds of permitted or forbidden transactions as well as the rights of buyers and sellers. Second is the structure of markets including both the market shares held by buyers and sellers as well as their relative strengths; markets with few large buyers and many small sellers (or the reverse) have greater need for legal regulations compared to markets in which both sides are more nearly comparable in relative size. Third is the actual conduct of firms in the market. The rules constituting the market and its structural characteristics define the range of reasonably possible conduct while antitrust rules can impose limits on the conduct that firms can actually pursue if such rules are actively enforced.

I have focused this statement primarily on the need for better market facilitation regulation. This topic falls squarely under the jurisdiction of this Committee. However, the rules facilitating market access and competition in supply must be framed in terms of the market structure and on-going conduct of the buyers in the market. Hence, this discussion will also focus on the implications of weak antitrust enforcement which effects both the structure and conduct in these markets.

The following sections will discuss briefly the current state of markets for inputs to and outputs from agriculture with an emphasis on specific current or recent past actions that have undermined or will undermine the capacity of these markets to be fair, accessible, transparent and efficient. I have organized this discussion around the three major agricultural activities: dairy, livestock and crops. In addition, the structure and resulting conduct of the downstream markets including the retail grocery business merits discussion as well.

I. Dairy

It should a source of concern that there does not appear to any effort to include significant changes in the way in which farmers are paid for milk. The current situation is one in which a handful of milk processors dominate the fluid milk market. Farmers need access to that market in order to participate in the Federal Milk Order pools that provide the best returns. The dominant firms have in turn entered into long term exclusive supply contracts with a small group of cooperatives even in regions where those cooperatives do not have members. The result is individual dairy farmers and their cooperatives have been forced to merge with or affiliate with these dominant cooperatives. The end result is that at the farm gate where it counts the dairy farmer is getting less than before even though in many regions with concentrated supermarkets, the price of milk has continued to rise.

Another problem in dairy is that milk is being trucked long distances so that it can be included in the pools with the highest fluid milk prices. The farmers in the receiving region pay for the shipping and receive lower farmgate prices for their own milk. The premium that they should expect for producing milk near to the place of consumption is diluted by the unnecessary importation of milk from remote sources. This is an inefficient and counterproductive activity,

but it reflects the enormous power of the dominant cooperatives.

Several provisions of the milk order law have facilitated this outrageous situation. First, the major cooperatives have the right to cast all their members votes. Hence, they can approve any order terms that the USDA will propose even if it is contrary to their members interests. Second, the law recognizes the cooperative as the legal seller of the milk and so while it must get the minimum order prices, its farmers members have no comparable right. Third, because there are few other fluid milk outlets except those with exclusive dealing contracts with the large cooperative, farmers cannot easily withdraw from the cooperative. Moreover, the major cooperatives have lobbied successfully to have the rules changed to increase the volume of milk that must be delivered for fluid use and the length of time it must be delivered. This makes it even harder for independent cooperatives to survive because, once again, the major cooperatives have tied up most of the outlets for fluid milk. Fourth, the cooperative can pool funds across orders and allocate the money as the cooperative desires. This encourages the shipping in of out-of-area milk whether it is needed or not if it belongs to a major producer who has friends in the cooperative's top management.

It should be noted that much of this problem is a direct result of the Antitrust Division's decision to allow Suiza to merge with Dean. This created a single milk processing giant with more than 30% of the milk processing business. Worse, to get approval the parties sold a group of plants to National Dairy Holdings which in turn has Dairy Farmers of America as a major stockholder. After the merger was approved, Dean also entered into an exclusive supply contract with DFA. Thus, directly and indirectly DFA controls access to a very substantial part of the total fluid milk market in the entire country. Moreover, its share of fluid milk supply rights reaches monopoly proportions in some regions of the country. Thus, antitrust enforcement has failed to control structure and to date, despite a lengthy investigation, the Antitrust Division has so far failed to challenge any of DFA's conduct.

The USDA could have remedied much of this abuse. It has the authority to make rules that would ban most of this conduct as unfair competition. But it has totally failed to exercise any control over the destruction of the competitive market in milk. Congress must intervene and use the farm bill to reduce the power of very large cooperatives to manipulate the milk order process for the benefit of insiders and the detriment of ordinary dairy farmers.

II. Livestock and Poultry

Once again, the first competitive fact that requires recognition is the continued increase in concentration in pork, beef and poultry processing. Most notably, the antitrust authorities permitted Pilgrims Pride to acquire Gold Kist thus increasing concentration in chicken processing. In addition, the government is currently evaluating the proposed acquisition of Premium Standard Brands by Smithfield. If allowed, this merger would reduce the number of major pork processors in the Southeastern part of this country from two to one. Moreover, it would also reduce competition in pork processing in the Midwest by eliminating PSB as an increasingly important factor in buying hogs and hog feeding services. It would also increase the vertical integration of Smithfield which in turn makes it more feasible for that company to engage in price manipulation on the cash market. The Antitrust Division has been studying this merger since last September and recently announced that it was extending its review until the

end of this month. Despite this prolonged review, most media reports suggest that ultimately the merger will be allowed. If this happens, it will have a seriously negative effect on the ability of farmers to get competitive bids either to provide feeding services or to sell their hogs in the cash or contract markets. At the same time, Swift is planning on selling its operations in both beef and pork. If the antitrust enforcers allow an existing competitor acquires those assets, this will further increase concentration in both the areas.

Also, undermining the operation of the markets, the federal courts have been unwilling to interpret the Packers and Stockyards Act to provide protection against discriminatory practices in both pork and beef markets. In particular the 11th Circuit has imposed a requirement that such discrimination have an adverse effect on competition. Worse, it has created a sweeping defense that excuses any discrimination that has any business justification even if there are less harmful ways to accomplish any legitimate business purposes. A recent decision from a federal court in Texas involving chicken growers has adopted a different interpretation of the discrimination standard that is substantially more in line with the language of the statute.6 Whether on appeal, the reviewing court will sustain that interpretation is at best uncertain.

In terms of the pending Farm Bill, the increased concentration in both livestock and poultry processing combined with the substantial use of contracts to obtain animals point toward the need for revising the PSA to make it more relevant to contemporary business practices and to clarify its intent to protect individual farmers from discrimination and other unfair practices without regard to the overall effect on competition. In my view, one of the most serious problems is the ability of buyers to refuse to deal with willing sellers offering the commodity the buyer wants. One of the most invidious ways that large buyers exercise their power is by refusing to offer favorable contracts to producers. This discrimination works to intimidate sellers and ensure that they do not seek out competitive alternatives for fear of losing their primary customer. The justifications for the use of contracts do not wrrant the refusal to deal with all producers who are ready, willing and able to provide the necessary products. It is vital to ensure viable competition in livestock production that all producers have the ability to make contract sales if they so choose. This also means that any effort to keep "grids" or other contract terms confidential must be prohibited. Only with full disclosure can farmers know what their options might be and make informed decisions.

A related problem is the decline in the size of the cash market in livestock. It has entirely disappeared in poultry. As the volume in these markets declines, it is easier for interested parties to manipulate the resulting prices in their own interest. There are already well documented examples of such manipulation in cheese and butter markets. Various proposals exist to remedy this problem. If the cash market is to remain an important base point for contracts, it is essential that there be a sufficient depth to those markets to ensure reliable prices. This suggests either that the use of other buying methods in beef and pork must be limited or that some other, deeper market must be used as the base on which prices can be based.

In sum, it is vital that the next Farm Bill revise the PSA to make it more relevant to the contemporary market for livestock. This must also include more ways for farmers to enforce its protections directly. This is essential in light of the continuing failure of the USDA to engage in any meaningful enforcement of this statute. I want to emphasize that this failure has occurred

under administrations of both political parties. This means the failure is systemic and can be remedied best by providing for enhanced direct action by those who are harmed as a result of discriminatory and unfair buying practices.

III. Crops

With respect to crops, we are seeing a sudden surge in prices for corn with a resulting shift in planting that will reduce supplies of soybeans and cotton. Those reductions are likely to create upward pressure on the prices for those crops. At the same time, we are seeing a marked increase in the use of contracts and other strategies to reduce or avoid the impact of the cash market. Moreover, currently, farmers producing crops do not have the protections, such as they are, of the PSA. I applaud the proposal to expand the coverage of the PSA to all agricultural production. There is no logical reason not to require fair treatment for farmers regardless of the type of farming they engage in.

As in other areas, we are seeing increasing concentration on both the buying side and the production of key inputs, especially seed. In this area, the most troublesome pending proposal of Monsanto, the overwhelming dominant firm with respect to genetically modified seed, to acquire Delta Pine and Land which is the dominant seller of cotton seed. Overall, DPL has about 50% of all seed sales and a much larger share in some regions. If this merger, which is under investigation by the Antitrust Division, is allowed Monsanto can foreclose significant potential competition in the production of new genetic modifications for cotton seeds. In addition, it will be able to keep seed prices high reflecting its dominance of seed genetics thus denying cotton farmers the advantage of a more competitive market in seed technology.

I want to bring to your attention two other issues related to the use of patent law that have or are likely to affect farmers substantially. The first is Monsanto's practice of granting seed producers and through them the farmer only a limited right to use the genetics to plant one crop. In other words, a farmer can not save seed and replant it. The farmer must buy new seed. This protects the interest of seed producers but is not essential to protecting Monsanto's interest in its intellectual property. Monsanto could, assuming that it even has the right to restrict such replanting, establish a system by which farmers pay it for the right to replant. This would ensure full compensation for any rights Monsanto has in saved seed and would result in substantial savings to farmers. This system is in use in other countries where patent rights are more limited. Unfortunately, the Federal Circuit has upheld Monsanto's right to impose any post sale restraint it wants on farmers. While I remain skeptical about the lawfulness of this expansive right,7 to date the courts have taken a different view and applied it expansively including authorizing Pioneer to restrict the resale of corn seed that include patented genetics eventhough there was no realistic risk that the buyer could appropriate any element of Pioneer's intellectual property.8 The implications of this expansive patent right is that patent holders can exploit farmers beyond any legitimate interest that they have in their inventions. This results in transferring the values created by farmers to the patent holders and the other seed companies who act in concert with them.

Today, with the increased value of crops, especially corn, I foresee a second and even more anticompetitive use of the expansive rights conferred on patent holders. As patent law now stands, I see no reason why a Monsanto or a Pioneer can not impose restrictions on the

farmers' right to sell their crop. Thus, the patent holder would in return for a payment from ADM or Cargil restrict the right of those planting seeds with patented genetics in them to sell the resulting crop to any buyer other than one approved by the patent holder. By this device, the patent holder could appropriate most of the increased value that we are now seeing in corn and the expected spillover price increases in other crops. So far as I know, none of the major seed genetic patent holders has yet attempted to impose a restraint on resale of crops of this sort, but I think there is a clear and present danger that they will attempt it given the state of patent law.

The expansion of the PSA rights to all types of contractual relations involving the sale of crops provides a means to limit the scope of patent rights as they relate to the sale of farm commodities. I would suggest prohibiting any restraint by input suppliers on the sale of crops resulting from the planting of seeds that contain patented genetics or are patented themselves.9 It would also be very desirable if the same prohibition were to apply to resale or replanting of such seeds provided the seller or re-planter has paid a patent royalty to the patent holder.10

IV. Concentration in Downstream Markets Including Supermarkets

It is important to recognize that improving the fairness, efficiency and transparency of the upstream markets in which farmers sell their products is necessary but not sufficient to ensure the proper overall operation of the marketplace. Downstream buyers with market power can impose significant burdens on upstream producers even two or more levels away. This was illustrated in the cheese price manipulation case. There the goal was to lower the price of cheese, but the effect was to reduce the price of milk used to produce cheese. Hence, the victims were dairy farmers and not the cheese makers.

A central overall concern, therefore, is that if downstream markets become more concentrated, the resulting buyer power will result in lower prices at the farmgate regardless of the efficiency, openness, fairness, etc., of the upstream market. We are in fact seeing this problem emerging in both agricultural and non-agricultural markets. Recent work in the U.K. shows that there a grocery chain with 9% of total grocery purchases in the country has substantial buyer power. It can use that power to cause its suppliers to impose discriminatory and exclusionary terms on smaller customers as well as to drive down the prices of such suppliers. These suppliers in turn impose price reductions on their suppliers, especially those who have relatively weak bargaining positions. Ultimately, it is dispersed and powerless groups such as farmers who bear the ultimate burden.

There has been a very substantial increase in concentration in the retail sale of groceries. As a result a handful of major retailer chains now have very substantial buyer power. This increased concentration is in significant part a result of the failure to enforce vigorously the antitrust law prohibitions on mergers that may harm competition. In addition, there have been a number of mergers in the food processing industries that have also gone unchallenged. These mergers are often rationalized as necessary to give the merging firm the capacity to withstand the power of the merger grocery chains. In addition, of course, to creating greater downstream bargaining power, these mergers increase the ability of these firms to add to the pressure upstream on the dispersed and powerless producers of agricultural commodities. Fair, efficient and accessible markets at the farmgate will not fully protect farmers from the impact of such downstream buyer power.

There is little that this committee can do in the Farm Bill to remedy the broader problem of increased concentration downstream from agricultural commodity markets. Yet it is important to recognize the broader linkages that exist in the economy. For that reason, I urge you to advocate to your colleagues the need for stronger and more active merger enforcement.

Conclusion

I am impressed with the number of good proposals for enhancing the facilitation of competition in agricultural markets. The bipartisan support for better regulations to facilitate the efficient and fair operation of these markets is very encouraging. Legislative action is long over due. If it is not forthcoming soon, there will be an even more serious crisis in American agriculture. At that point, as I have suggested, it will be necessary to impose even more draconian regulation. Indeed, if that time were to come, the regulations would necessarily have to replace the market and impose direct controls over prices and contracting. Such a dire outcome can be avoided, if the next Farm Bill incorporates a competition chapter that provides effective and relevant statutory standards to facilitate a fair, accessible, open and efficient market. As I have repeatedly noted in this discussion, good legislation is necessary, but it will not be sufficient unless there is also active enforcement of its terms as well as a renewed commitment to enforcing the antitrust laws in these markets.