Review of Western Organization of Resource Councils

(WORC) Petition for Rulemaking

Grain Inspection and Packers and Stockyards Administration
Packers and Stockyards Programs

August 29, 1997

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Executive Summary

The Secretary of Agriculture received a petition for rulemaking submitted by the Western Organization of Resource Councils (WORC) on October 12, 1996. WORC requested that the United States Department of Agriculture (USDA) issue rules under the authority of the Packers and Stockyards Act (the Act) that would: (1) prohibit packers from procuring cattle for slaughter through the use of a forward contract, unless the contract contains a firm base price that can be equated to a fixed dollar amount on the day the contract is signed and the forward contract is offered or bid in an open, public manner and (2) prohibit packers from owning and feeding cattle, unless the cattle are sold for slaughter in an open, public manner.

On January 14, 1997, the WORC petition was published in the *Federal Register.* USDA solicited public comments on the petition. In early April 1997, a team from USDA was assembled to review the WORC petition and assess the comments received. The comment period closed on April 14, 1997.

There were 1,757 comments received regarding the WORC petition of which 1,651 of the comments totally supported the petition. There were an additional 13 comments received that supported only a portion of the WORC petition. Forty-six comments were received that did not clearly state a position either supporting or opposing the proposed rulemaking. There were 45 comments received that opposed the WORC petition in its entirety and two comments that opposed a portion of the WORC petition.

There were 1,706 comments received from 40 states and the District of Columbia. One comment was submitted from Canada and 50 comments could not be identified to a geographic location. Of the comments received, 80 percent came from four states, Montana (31 percent), Wyoming (24 percent), South Dakota (17 percent) and North Dakota (8 percent).

Of the total number of comments received, 73 percent were in the format of a "form letter" supporting WORC's petition. Of the total comments received, 59 percent were form letters from the following states: Montana (24 percent), Wyoming (22 percent) and South Dakota (13 percent).

Information provided in the comments was used to categorize each commentor by occupation/affiliation. There were 511 comments received from persons or firms related to the raising or feeding of cattle. There were 73 comments received from various associations. Elected officials submitted 32 comments and agricultural economists submitted four comments. There were 18 comments received from other agriculture-related businesses and 163 comments that were categorized as other occupations. The balance of the comments did not state an occupation/affiliation.

A majority of the comments received supporting WORC's petition also had numerous alternative comments that offered reasons for or solutions to industry problems. The five most frequently submitted alternative comments were: (1) manipulation of market price, (2) enforce P&S Act, (3) oppose packer concentration, (4) restore competition and (5) retail beef price does not reflect lower cattle prices.

The majority of the comments that supported the petition did not provide any economic data or analysis, but referred to the petition's economic arguments or to an economic study referenced in the petition. There were 25 comments (mostly opposed) that provided economic data, analysis, or an assessment.

WORC wants the Grain Inspection, Packers and Stockyards Administration (GIPSA) to selectively regulate the fed cattle segment of the beef industry to comply with their petition. This would affect the sellers of fed cattle and their lenders by limiting the ways in which they can market their product.

The difference between the legal opinion expressed by WORC and that of the Office of the General Counsel (OGC) regarding the Secretary's authority to issue regulations under the Act is primarily the level of association required to prove a likelihood of injury or harm. OGC and GIPSA believe that a causal relationship between the complained of activity and the injury must be shown in order to regulate the activity. WORC, on the contrary, believes that the Secretary is authorized to regulate an activity based only upon any degree of association between the complained of activity and the injury.

The power of the economic, logical, and empirical arguments was the primary basis for developing our conclusions, rather than the number of comments supporting or opposing the petition. The team finds no compelling evidence to suggest that anything other than basic economic conditions determined the general price level of the fed cattle market. After weighing the economic arguments supplied by WORC, commentors (supporting and opposing), and other information assembled by the team, we could not definitively conclude that spot prices were affected or manipulated by captive supplies. The economic evidence does not indicate the use of captive supplies is a violation of the Act. Therefore, we conclude that promulgating the rules suggested by the petition is unwarranted.

Background

In early 1995, there was a sharp decline in cattle prices. This caused various groups in the industry, mainly cattle producers, to urge Congress and USDA to take action to improve conditions. During that same period of time, USDA was conducting a congressionally-mandated study on concentration in the red meat industry.[1] The study, released on February 14, 1996, confirmed the existence of concentration but provided no definitive evidence that it had an appreciable effect on cattle prices. Following release of the study, USDA has undertaken several initiatives in response to the concerns of the industry.

The Advisory Committee on Agricultural Concentration was appointed by the Secretary to review the study and a number of other issues involving concentration in agriculture. The Advisory Committee submitted its recommendations and findings on June 6, 1996.[2] The recommendations of the majority report included increased monitoring and enforcement of antitrust and regulatory policy, limiting packer activities regarding price differentiation, improving collection and reporting of market data, and value-based pricing. The Advisory Committee also submitted three minority reports. The recommendations of the minority reports included taking additional action to address the concerns of producers relating to the effects of concentration on the cattle industry, increased reporting of export data, and educating producers about the current market environment.

On July 31, 1996, the Secretary announced the first in a series of actions by USDA to improve competition in the livestock industry. These actions address two of the major areas of recommendations made by the Advisory Committee. These first actions, taken to immediately address the concerns of many livestock producers, included price reporting initiatives that broadened the coverage of market transactions reported and improved the timeliness and availability of information on the growing international trade in livestock and meat products.

On June 4, 1997, the Secretary announced new actions to address concentration and promote competition in agriculture. These actions include restructuring GIPSA in response to an independent review of its enforcement of anticompetitive practices.

The Petition

Independent of USDA's activities, the Secretary received a petition for rulemaking submitted by WORC on October 12, 1996. WORC requests that USDA issue rules under the

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[1] *Concentration in the Red Meat Packing Industry,* Packers and Stockyards Programs, Grain Inspection, Packers and Stockyards Administration, USDA, February 1996.

[2] *Concentration in Agriculture: A Report of the USDA Advisory Committee on Agricultural Concentration,* Agricultural Marketing Service, USDA, June 1996.

authority of the Act that: (1) prohibit packers from procuring cattle for slaughter through the use of a forward contract, unless the contract contains a firm base price that can be equated to a fixed dollar amount on the day the contract is signed and the forward contract is offered or bid in an open, public manner and (2) prohibit packers from owning and feeding cattle, unless the cattle are sold for slaughter in an open, public market.

The Petitioner

WORC is a federation of grassroots organizations located in Colorado, Idaho, Montana, North Dakota, South Dakota, and Wyoming that was formed in 1979. The various organizations are composed of affiliated citizen groups in 42 communities across the region. The 6,000 members of these groups are farmers, ranchers, small business owners, and working people who seek to protect natural resources, family farms, and rural communities. They include both cattle ranchers and beef consumers.

Need For The Suggested Rules

WORC has submitted this petition for rulemaking because it believes that packers' direct ownership and feeding of cattle for slaughter and their procurement of slaughter supplies through formula or basis-priced forward contracts have decreased prices paid to cattle producers. WORC also believes that because cattle sold through formula or basis-priced forward contracts are not traded publicly and packer-fed cattle are not sold publicly, these practices unjustly discriminate against some producers and provide unreasonable preferences to others. According to WORC, these practices are in violation of Section 202 of the Act and should be restricted through rules.

Request For Comments

On January 14, 1997, the entire petition was published in the *Federal Register.*[3] USDA solicited public comment on the petition and utilized the comments in assessing the need for the requested rulemaking.

USDA sought public comment on the petition from all segments of the industry (producers, marketing firms, meat packing firms, etc.), academia and other interested parties, including small entities that may be affected by implementation of WORC's proposal. Small entities were defined as firms that meet the following standards: (1) beef cattle producers, except feedlots, with annual receipts of $500,000 or less for beef cattle sales; (2) beef cattle feedlots with annual receipts of $1.5 million or less for beef cattle sales; and (3) meat packing plants with 500 employees or less.

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[3] *Federal Register*, Vol. 62, No. 9. Tuesday, January 14, 1997, pp. 1845-59.

USDA requested comments on the petition that would provide the Secretary with additional information to consider in determining whether or not the rulemaking requested by WORC should be undertaken. USDA also requested comments that addressed the following questions to be used as a framework for comments submitted:

What competitive or other economic effects would implementing the rules that WORC is asking USDA to propose (hereinafter "proposed rules") have on individual businesses and the cattle and beef industry as a whole?

2. What are the competitive effects of formula or basis-priced forward contracting and packer feeding on cattle producers, feedlots, meat packers, meat wholesalers and retailers, and consumers?

3. What would be the effects of implementing the proposed rules on the structure, conduct, and competitive performance of the cattle producing, cattle feeding, meat packing, wholesaling and retailing industries? What would be the effect on the structure, conduct and competitive performance of livestock and meat markets? In answering these questions, what do you consider to be the relevant markets and how do you define them?

4. How do formula or basis-priced forward contracting and packer feeding affect cattle prices? Do formula or basis-priced forward contracting and packer feeding have adverse competitive effects or other adverse economic effects? Are there competitive benefits or other economic benefits associated with use of formula or basis-priced forward contracting and packer feeding that would not support implementing the proposed rules?

5. Do the research studies cited by the Petitioner support its position that the formula or basis-priced forward contracting and packer feeding practices outlined in the petition result in competitive harm or other economic harm to cattle producers and that the practices harm competition in beef packing? Are there other studies that USDA should consider?

6. Does sufficient evidence exist to find that the formula or basis-priced forward contracting and packer feeding practices outlined in the petition violate Section 202 of the Packers and Stockyards Act? If so, what is that evidence?

7. Is regulatory action needed?

8. Are the proposed rules too broad or too restrictive?

9. Do the proposed rules adequately address the concerns raised by the Petitioner?

10. Are there alternatives to rulemaking that would address the concerns raised by the Petitioner?

Summary of Comments

GIPSA logged, as received, a total of 1,772 comments. Fifteen of the comments logged, as received, were inadvertently logged twice and were excluded from the final tally of 1,757 comments. The comment review revealed that 19 individuals submitted two comments each. Although the comments were not exact duplicates of each other, they were very similar. These multiple comments were left in the final tally.

Forty-six of the comments received did not clearly state a position either supporting or opposing the proposed rulemaking (Table 1). These comments were categorized as "no position." Many of these comments offered alternatives to the proposed rulemaking or stated that available information on the issues was inadequate or inconclusive to enter a position. One thousand six-hundred fifty-one (1,651) of the comments supported the proposed rulemaking in its entirety. Most of these comments expressed deep concern about the decline in prices paid producers, the level of concentration in the meat packing industry, the dominance of the "big three packers" and the failure of GIPSA to enforce section 202 of the Act. Thirteen of the comments voiced support for only parts of the proposed rulemaking. These comments were categorized as "support portions." Forty-five comments opposed the proposed rulemaking in its entirety. Most of these comments expressed the view that the proposed rulemaking was based on incorrect assumptions regarding how prices paid producers are impacted by a packer's direct ownership and feeding of cattle, a packers use of formula or basis-priced forward contracts, and concentration in the red meat industry. Many of the comments in opposition also stated that the proposed rulemaking was intrusive government regulation and would be counter-productive to innovations in the meat industry. Two of the comments voiced opposition for only parts of the proposed rulemaking. These comments were categorized as "oppose portions."

Table 1

Number of Comments by State and Position						
State	Support Petition	Support Portions	Oppose Petition	Oppose Portions	No Position	Total
MT	530	5	3	1	10	549
WY	414	2	2		5	423
SD	281	2	1		10	294
ND	137	1			4	142
ID	35		1			36
NE	24	1	2		1	28
NY	23					23
TX	13		5		4	22
OR	15		1			16
CO	6		8		1	15
KS	10		5			15
CA	10		2		2	14
DC	7	1	5			13
NV	13					13
MO	10		1			11
GA	8					8
OK	6		1			7
WA	6				1	7
MI	3		2		1	6
IL	2		3		1	6
AL	5					5
MA	5					5
MN	5					5
IA	4	1				5
WI	4					4
OH	1				2	3
CT	3					3
PA	2		1			3
UT	2				1	3
NC	3					3
TN	2					2
VT	2					2
AR	2					2
FL	1		1			2
IN	1				1	2
KY	2					2
NM	2					2
MD	2					2
VA			1			1
AZ	1					1
MS	1					1
Canada					1	1
Unknown	48			1	1	50
Total	1651	13	45	2	46	1757

Those wanting to comment were asked to provide the Secretary of Agriculture with additional information for consideration in determining whether or not the rulemaking should be undertaken. The USDA posed 10 questions as a framework to help commentors address their responses to the petition. Those submitting comments were also asked to include any data, analysis, or other empirical evidence that supports their position. Only 25 of the 1,757 comments submitted included some form of data, analysis, or other empirical evidence in support of their position. Instead, most of the comments expressed emotional concerns and anecdotal evidence.

One thousand seven hundred and six comments were submitted from 40 states and the District of Columbia (Table 2). One comment was submitted from Canada and 50 comments could not be identified to a geographic location. Eighty percent of the comments received came from four states; Montana (31 percent), Wyoming (24 percent), South Dakota (17 percent), and North Dakota (8 percent). The balance of the comments originated in equal proportions from the remaining states. No other state accounted for more than 2 percent of the total number received.

Seventy-three percent of the comments received were in the format of a "form letter" supporting WORC's position. Fifty-nine percent of the total number of comments received were "form letters" from Montana (24 percent), Wyoming (22 percent), and South Dakota (13 percent). Attachment 1 illustrates the locations of WORC's affiliated associations.

Forty of the comments received contained multiple signatures totaling 273 signatures. However, each comment was only counted once in the final tally of comments. These multiple signature comments were submitted on behalf of individuals, county commissioners, associations, and various state, county or local departments of government or elected officials.

Using information provided in the comments, each was categorized by the commentor's stated occupation or affiliation with a trade, association, or business entity. Table 3 provides a tabulation showing each commentor's position on the proposed rulemaking categorized by occupation or affiliation.

Table 2

Number of Comments and Form Letters By State				
State	Number of Comments	Percent of Total	Number of Form Letters	Percent of State's Total Comments as Form Letters
MT	549	31.2	421	76.7
WY	423	24.1	389	92.0
SD	294	16.7	220	74.8
	142	8.1	95	66.9
ID	36	2.0	17	47.2
NE	28	1.6	20	71.4
NY	23	1.3	20	87.0
TX	22	1.3	9	40.9
OR	16	0.9	11	68.8
CO	15	0.9	1	6.7
KS	15	0.9	1	6.7
CA	14	0.8	5	35.7
DC	13	0.7		
NV	13	0.7	12	92.3
MO	11	0.6		
GA	8	0.5		
OK	7	0.4	3	42.9
WA	7	0.4	1	14.3
IL	6	0.4		
MI	6	0.3		
AL	5	0.3	5	100.0
IA	5	0.3	1	20.0
MA	5	0.3	2	40.0
MN	5	0.3	2	40.0
WI	4	0.2		
CT	3	0.2		
NC	3	0.2	1	33.3
OH	3	0.2		
PA	3	0.2		
UT	3	0.2		
AR	2	0.1	1	50.0
FL	2	0.1	1	50.0
IN	2	0.1		
KY	2	0.1	1	50.0
MD	2	0.1	1	50.0
NM	2	0.1	1	50.0
TN	2	0.1		
VT	2	0.1		
AZ	1	0.06		
MS	1	0.06		
VA	1	0.06		
Canada	1	0.06		
Unknown	50	2.8	36	72.0
Total	1757	100	1277	

Table 3

Position on Petition By Occupation or Affiliation						
Occupation	No Position	Support Petition	Support Portions	Oppose Petition	Oppose Portions	Total
Agricultural Economist	1			3		4
Association (farm)		7	1	2		10
Association (cattle)	1	1	1	11		14
Association (other)	2	41	2	4		49
Business		18				18
Cow/Calf Producer	4	256	3		1	264
Cattle Feeder	5	59		15		79
Elected Official	2	28		1	1	32
Livestock Producer		166		2		168
Rancher /Farmer	8	49	2			59
Other	5	150	1	7		163
Unknown	18	876	3			897
Total	46	1651	13	45	2	1757

Seventy-three comments were received from various associations, national, state and local. The association comments were placed into three categories; "farm associations," "cattle associations," and "other associations." "Farm associations" and "other associations" clearly supported the proposed rule making with 81 percent of their comments voicing support. In contrast, the comments received from "cattle associations" clearly opposed the proposed rulemaking with 79 percent voicing opposition. Table 4 is a tabulation providing a brief description of the membership of each national association submitting a comment and the association's stated position on the proposed rulemaking.

Table 4

National Associations		
Association	**Membership**	**Position**
American Farm Bureau Federation	Farm organization representing 4.7 million member families in the U.S. and Puerto Rico.	Opposes Petition
American Meat Institute (AMI)	Represents packers and processors of beef, pork, lamb, veal and turkey products and their suppliers throughout North America. Approximately 1103 members.	Opposes petition
American Veal Association	Represents over 1,300 U.S. veal growers supplying product to meat packers, feed companies, and animal health companies	Opposes Petition
Food Marketing Institute (FMI)	1500 members include food retailers, wholesalers and their customers in the U.S. and 200 international members from 60 countries.	Opposes Petition
Farm Aid	Public organization to raise awareness about the plight of the American family farm and provide assistance to farm families	Supports Petition
Livestock Marketing Association (LMA)	Represents livestock marketing businesses, including auction markets, dealers and livestock commission firms throughout the U.S. Approximately 1,200 members	Opposes Petition
National Meat Association (NMA)	Represents interests of meat packers, processors, and equipment manufacturers and suppliers who provide services to the meat industry. Over 600 members throughout U.S., Canada, Australia, and Mexico	Opposes Petition
National Association of State Departments of Agriculture	Represents Commissioners, Secretaries, and Directors of Agriculture form 50 states and 4 territories.	No Stated Position
National Cattlemen's Beef Association (NCBA)	Represents 40,000 individual members, 46 state cattle associations and 27 breed organizations	Opposes Petition
National Farmers Union	Represents 300,000 family farmers and ranchers	Supports Petition
National Farmers Organization (NFO)	Represents independent livestock producers nation wide.	Opposes prohibitions on forward contracts Supports prohibitions on packer feeding and ownership
National Catholic Rural Life Conference	Information unavailable	Supports Petition
National Family Farm Coalition	Information unavailable	Supports Petition
Rural Advancement Foundation International, USA	Organization dedicated to the conservation of agriculture biodiversity and socially responsible development of technologies useful to rural societies.	Supports Petition
Women Involved in Farm Economics (WIFE)	Organization of Women throughout the U.S. with interests in all Agriculture commodities.	Supports Petition

There were 1,757 comments received regarding the WORC petition, of which 990 letters had additional or alternative substantive comments. There were other alternative comments such as ranching is not lucrative and ranchers should be able to make a decent living without working in town. Although these types of alternative comments may be true, they offer nothing of substance regarding solutions to industry problems. Of the 990 alternative comments that were classified as substantive, 297 letters had multiple alternative comments. These alternative comments ranged from comments stating that manipulation of market prices is the main reason for low cattle prices to concerns about the affect on producer packing cooperatives to a comment that the definition of captive supply should be redefined. Table 5 lists alternative comments received that either support WORC's petition totally, support a portion of the petition, or commented without taking any position on the WORC petition. Also included is the number of letters received for each comment and the number of comments that were "form letters."

Table 5

Alternative Comments	Number of Comments	Number of Form Letters
Manipulation of market price	495	422
Enforce P&S Act	465	380
Oppose packer concentration	92	41
Restore competition	85	65
Retail beef price does not reflect lower cattle prices	37	37

The following comments are a sample of other alternative comments received. Some of these comments were received from more than one commentor:

- More and/or better market price information
- Mandatory market price reporting
- Report fixed price contracts
- Oppose beef imports
- Label imported meats
- Regulate imports
- Imported meat should show country of origin
- Report import prices
- Report captive supply
- Prohibit captive supply

- Change definition of captive supply
- Opposes non-competitive captive supply
- Prohibit packers from controlling captive supply beyond 7 days
- Oppose vertical integration
- Future packer mergers should be prohibited
- Repeal ban on interstate shipment of state-inspected meat
- Prohibit packers from buying feedlot cattle using an average price for all cattle
- Oppose 30 minute window for feedlots to market their show list
- Government should force packers to divest all ownership in livestock
- Stop packer ownership of feedlots and ranches
- Packers should not be allowed to feed their own cattle
- Concerned that beef industry is headed toward vertical integration like the poultry industry
- Totally eliminate all forward contracting
- Disputes the theory that there is an over supply of cattle
- Limit the packers market share to 7 percent
- Limit packers board of trade buying and selling
- Packers should report purchase and delivery dates
- Packers should report fixed contract prices
- Public bidding is the best marketing method
- The P&S Act needs to be amended in order to keep up with today's changes in marketing
- Wants level playing field with poultry
- Reverse decision regarding yogurt as a meat substitute
- Require packers to report prices paid, the number of head purchased, the kind and the quality of their purchases
- Require packers, processors, wholesalers and distributors to report the types of product sold, the price and to whom
- Prohibit packers and processors from speculative "short" selling of commodity futures contracts
- Require packers and processors to divest themselves when production capacity exceeds 20 percent of total production share
- Require USDA to report the retail value of all meat and meat products

- Require country of origin identification for all livestock, meat and meat products
- Require all imported or domestic meat, poultry and seafood products to be subject to the same inspection, testing, labeling and standards
- Implementation of a value-based pricing structure for live purchases that reflects potential premiums received by the packer when the meat is sold

There were 45 comments opposed to the WORC petition of which 28 had alternative comments. Of the 28 alternative comments, a majority had multiple alternative comments. None of the comments received opposing the WORC petition were form letters. Some of the comments gave reasons why cattle prices are low and offered ways to improve cattle prices in addition to other statements regarding the industry. Some of these comments were received from more than one person. The following is a majority of the substantive alternative comments:

- Continue to enforce the P&S Act
- Market price reporting should be mandatory
- USDA should do more/better market price reporting
- Imported meat should be labeled
- Industry must work to make beef a more consistent product and a more competitive animal protein
- Elimination of captive supply will work to the detriment of the beef industry
- Cattle prices move inverse to the trend in beef production
- Average price selling encourages the surplus production of below average cattle
- It's the consumers who determine the real value of beef
- Per-capita beef consumption has declined 14 percent in the past 10 years
- Quality of beef has deteriorated during the past several decades
- Change definition of captive supply
- Opposes any limitation of any method of marketing fed cattle
- Supports free market system
- Opposes any type of action that alters current trends toward private business arrangements in the beef industry
- Captive supplies have had a small negative effect on fed cattle prices
- Develop value-based marketing system
- Checkoff monies should be used more for new product development and product quality enhancement
- Value-adding marketing cooperatives should be developed

- Better price discovery
- Concerned about the effect the WORC petition would have on small packers
- Captive supply helps packers control costs, run at near capacity and avoids large price peaks and valleys thus allowing more stable prices
- Large packers pay higher prices for cattle
- Beef is not a consistent product, not convenient to prepare and is high in cholesterol
- More buyers do not necessarily equal higher prices
- The law of supply and demand is working
- Cattle prices have always been cyclical
- Cattle should be sold on a carcass merit basis in order to improve quality
- Implementation of the WORC petition would cause lower cattle prices
- Packer concentration is caused by a combination of declining demand for beef and the need to increase efficiency

Table 6 shows the number of comments that addressed the ten questions posed by USDA in the *Federal Register.* The table also shows the number of comments that provided information for each question with their comments.

Table 6

Number of Comments That Addressed Questions Posed by USDA in the Petition		
Question Number	Addressed Question	Provided Information
1	439	
2	361	
3	28	
4	346	2
5	13	4
6	24	2
7	1692	1
8	47	
9	26	
10	32	1

Assessment

Problem Statement

In preparing their rulemaking petition, WORC believes that less than competitive prices are being paid to fed cattle producers because of increased packer concentration and packers' use of procurement practices commonly referred to as "captive supplies." Concentration (size distribution of firms) is one of several attributes describing industry structure that influence the nature of the competitive process. Captive supply is but one of many industry practices or attributes (conduct) describing firms' behavior. In WORC's petition, their problem statement (pg. 1846) is "[p]ackers' direct ownership and feeding of cattle for slaughter and their procurement of slaughter supplies through forward contracts have decreased prices paid to cattle producers . . . [and] unjustly discriminate against some producers and provide unreasonable preferences to others."

The problem that WORC wishes to address refers to the use of captive supplies, which is an industry practice or behavior issue, rather than a market structure problem. Coordination activities, such as captive supply, are utilized to transfer information, specify quality, transfer risk, and enhance scheduling and timing of production. Furthermore, WORC's proposed regulations only address coordination activities that are part of the actual operation and conduct of individual firms.

WORC's written comment submitted April 11, 1997, on behalf of their own petition, identifies meat packer concentration as the root of the problem. WORC ". . . contends that the current methods of using captive supplies to procure cattle for slaughter are the mechanisms by which the major packers exercise the market power created by the rapid increase in market concentration."

WORC also ". . . seeks to reduce the disadvantages of a concentrated market by instituting rules which will move the market closer to the outcome observed in competitive markets, without going to the extreme of plant divestiture and losing either the advantages of reduced processing costs or the risk reduction packers get when they can ensure the supply of cattle to the plant."

Legal Assessment

The Review Team asked the Office of the General Counsel (OGC) to explain the difference between the position expressed by WORC and that of OGC regarding the Secretary's authority to issue regulations under the Packers and Stockyards Act (the Act). The difference is primarily that OGC and P&S believe that a causal relationship between the complained of activity and the injury must be shown in order to regulate the activity. Such a relationship would support a finding that the complained of activity is likely to result in a harm or injury that the Act was intended to prevent. WORC, on the contrary, believes that the Secretary is authorized to regulate an activity based only upon a showing of some lesser degree of association between the complained of activity and the injury.

WORC asserts that the Secretary's rulemaking authority is broad and limited only in that the activity or practice must in fact violate the Act, citing *Swift & Co. V. Wallace*, 105 F.2d 848 (7th Cir. 1939). OGC agrees with WORC's assertion.

In its petition, WORC cites *Armour & Company v. United States*, 402 F.2d 712, 717 (7th Cir. 1968) and cases cited therein for the proposition that to find a violation of Section 202(a) and (b) of the Act, the Secretary need only find either some non-competitive intent or some likelihood of competitive injury; there is no requirement to find actual injury. 62 Fed.Reg. 1857. WORC offers its legal opinion that the Secretary has the authority to issue the proposed regulations if the Secretary concludes that the practice violates the Act, and to establish that it does, the Secretary need only find either some non-competitive intent or some likelihood of competitive injury; there is no requirement to find actual injury. OGC agrees with WORC's opinion on this point.

WORC goes further, however, to state that any association between captive supplies and declines in prices paid to producers is sufficient to support a finding of the reasonable likelihood of injury:

> [I]t is not necessary to show any certain degree or level of association between the use of captive supplies and declines in price. To show that there is some adverse impact on producer prices is all that is necessary to provide sufficient basis for the proposed rules. WORC Comment, p.11.

If there is a reasonable likelihood that a harm the statute was designed to prevent will occur, the Secretary can regulate that activity even before any harm results. In the opinion of WORC, the likelihood of competitive injury would be shown by **any** degree of association between captive supplies and decline in prices paid to producers. According to WORC, only a minimal showing of relationship between the allegedly violative practice and the harm likely to result therefrom is necessary to support regulation of that practice by the Secretary.

Practices of packers must violate the Act in order for the Secretary to take enforcement action to prohibit those practices, and as the *Armour* court states, evidence of the likelihood of injury, or predatory intent must be shown to support a finding that such practices violate the Act. The level of association required to prove a likelihood of injury or harm is the critical point of divergence between the opinions of WORC and OGC. OGC has opined:

> In order to prohibit activities of the packers through regulation or to file a complaint citing a violation of section 202, the Department must develop evidence that the packers have either predatory intent or that there is the likelihood that the complained of activity will

> result in injury. (OGC Memorandum to the Chief Economist, June 20, 1996, p.5 (Attachment 2)).

Case precedent supports this statement of the Secretary's authority to regulate packer activities. As the *Armour* court states:

> The clearer the danger of the [likelihood of competitive injury], as when competitors conspire to eliminate the uncertainties of price competition, the less important is proof of [predatory intent]. Conversely, the likelihood of injury arising from conduct adopted with predatory purpose is so great as to require little or no showing that such injury has already taken place.

Armour, 402 F.2d 717. WORC has not asserted that the packers have or are conspiring to reduce prices paid to producers through the use of captive supplies (predatory intent). Therefore, to satisfy the *Armour* test, WORC would have to establish a violation of the Act based on evidence of the likelihood of injury. The likelihood of injury must be more than "the mere specter" (*Central Coast Meats v. USDA*, 541 F.2d 1325, 1328, n.2 (9th Cir. 1976)) that WORC avers is sufficient. In order to prohibit captive supply, there must be a likelihood that the complained of activity will result in the kind of injury the Act was designed to prevent. Whether or not that likelihood is present is made under a "reasonable person" standard. If a reasonable person who reviewed the evidence would find that the Act was likely to be violated if the complained of activity continued, then the Secretary could prohibit that activity through the regulatory process.

WORC's position that only a minimal showing of injury or the likelihood of injury is sufficient to authorize rulemaking has not been adopted by the courts. Conversely, the OGC opinion of the Secretary's legal authority under the Act to promulgate regulations is based on case precedent, statutory interpretation and analysis of the legislative history of the Act.

Economic Evidence Regarding the Proposed Rule

The vast majority of the comments that support the petition, did not provide any economic data or analysis, but either referred to the petition's economic arguments or to the same economic studies referenced in the petition. Only 25 comments provided economic data, analysis, or assessment. Most of these were comments that opposed the petition's rulemaking. This section presents the economic arguments from the petition, supporting comments (primarily WORC's comment), opposing comments, and other publicly available economic studies. The discussion follows the order of the principal (and related) economic arguments presented in the section "Economic Evidence Supporting the Proposed Rule" starting on page 1848 of the petition.

Impact of Concentration

Quoting the Center for Rural Affairs' report on livestock competition, the petition states (p. 1849) "[t]here is a large body of economic research establishing a high positive relationship between the level of concentration among sellers and prices buyers must pay. About three-fourths of the more than 70 studies undertaken in this field in general conclude that concentration is related to prices (Weiss 1988). Although this research relates to situations in which the concentration level is high among sellers (called oligopoly) rather than among buyers (called oligopsonies), the basic theory is the same on both sides of the market. Higher levels of concentration should result in price levels that favor the more concentrated side of the market--higher prices for concentrated sellers (oligopolies), lower prices for concentrated buyers (oligopsonies)."

The studies referenced in the petition used two major approaches to examining industry competition and concentration, the Structure-Conduct-Performance (SCP) and New Empirical Industrial Organization (NEIO). The Structure-Conduct-Performance (SCP) paradigm attempts to examine the relationships between industry structure (number, size, location, and concentration of firms) and performance (prices paid/received and profitability). The SCP models test the hypotheses that industry structure affects performance. Structure-performance correlations were then indicative of some form of noncompetitive behavior (practice or conduct).

The New Empirical Industrial Organization (NEIO) approach attempts to focus more on the conduct of firms in the industry. This approach starts with an explicit theoretical model of firm optimization, usually profit maximization. Based on an application restricted to an explicit theoretical model, empirical results (through statistical inference of price-taking behavior) are used to assess aspects of market power.

The petition (pp. 1848-49) also quotes Dr. John Helmuth "Economic studies show that when the four-firm concentration ratio gets over 40% firms start to have enough market power to have some control over price. By the time it gets to 80% they have as much power as a monopoly would have." In response, Professor Clem Ward, Oklahoma State University, (p. 4) writes "[t]he petition quotes John Helmuth regarding when the four-firm concentration level becomes problematic. In fact, there is no definitive literature regarding this issue."

Many of the comments supporting the petition (mostly form letters) stated that the big three packers controlled over 80 percent of the cattle market and were manipulating prices. Also, many of the comments in support of the WORC petition cite the petition itself as evidence enough or they cite the same studies reviewed in the petition. A couple of comments cited concentration studies and statistics for other species and agricultural industries. Albert Medvitz discusses concentration in the U.S. lamb industry by citing a Texas A&M University study and the National Farmers Union discusses concentration issues in the livestock, grain, and food processing industries.

Several of the commentors, in particular, the agricultural economists, commented on the petition's lack of references on the most recent and exhaustive studies on the packing industry. Clem Ward laments that "the resulting research reports [GIPSA concentration study] have been virtually ignored by agricultural journalists, industry associations, analysts, and producers."[4] He goes on to say "[m]any contractors involved in the P&SP study have a long history of addressing concentration, pricing, and related industry issues. Our access to data was better for this study than any ever before undertaken. In many cases, data came from a broader segment of the industry, covered a longer time period, and contained information never before available. In short, this was the most thorough work done on these issues to date and the results should not be buried or ignored because some people had preconceived ideas not supported by scientific research." He concludes (p. 121) "Did this study find negative effects from concentration? No. Did this study exonerate packers from questions about use and abuse of market power? No."

Professor Wayne Purcell, Virginia Polytechnic Institute and State University, writes (p. 11) "[e]ven more important is the fact that the 1996 round of studies published under the auspices and via the coordination of the Packers and Stockyards Administration is a result of a massive effort that far exceeds anything that has been possible prior to that date with regard to researching these various issues. Because the industry didn't like the results that came out of those studies, results such as no serious price impact from captive supplies, or no decisive and expected negative relationship between concentration and prices paid for cattle, the research has been largely dismissed and ignored."

Clem Ward writes (pp. 3-4) "[s]everal studies cited and discussed were conducted by me, either alone or in conjunction with others. The petition discusses market shares in national and local markets, citing some of my work. However, the petition fails to address the question of relevant markets anywhere and does not draw on the research pertaining to defining relevant markets in the GIPSA concentration study." He also states (p. 4) "[t]he petition addresses the relationship between packer concentration and prices paid for livestock. My work, which can support both sides of this issue, is cited. The research literature is not consistent on this question. Considerable relevant, recent research is omitted from the discussion. (1850) While citing some of the work by Azzam, the petition does not include some of his more recent work. Implications and inferences from some of my studies and others extend well beyond those that are possible based on the data used and time period covered. The literature review by Azzam and Anderson in the GIPSA concentration study is considerably more thorough and correct and I'll defer to it rather than attempt to indicate the numerous limitations of the review in the petition."

Azzam and Anderson, from their recent exhaustive literature review of packer studies state (p. 123-24), "[i]n summary, because of interpretational difficulties, stemming largely from

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[4]Ward, Clement E. "Important and Ignored Messages from the Packers and Stockyards Program's Concentration Research Study," in *Price Discovery in Concentrated Livestock Markets: Issues, Answers, Future Directions*, ed. Wayne Purcell (Research Institute on Livestock Pricing, Department of Agricultural and Applied Economics, Virginia Tech., Blacksburg, VA, February 1997), p. 110.

using *ad hoc*, reduced-form models, SCP studies of the U.S. meatpacking industry offer no objective benchmark for judging the reasonableness of their empirical assessments of market power. Parameters lack clear, fundamental, economic interpretations to which the analyst can appeal in seeking to validate empirical results. Therefore, the validity of SCP methodology in the assessment of competition in the U.S. meatpacking industry is questionable. . . . an overall conclusion of noncompetitive conduct from the empirical results seems unwarranted. . . . The same is equally true of NEIO models. The key parameter estimates, from which market conduct (in the sense of price-taking behavior) is inferred, are extremely sensitive to the functional forms of the auxiliary demand and supply curves, and of cost or production functions."[5] They conclude (p. 124) "[t]he returns from the considerable investment in SCP and NEIO studies may appear fairly meager; but given measurement and interpretational problems, that is the most one should expect from such studies. We must, finally, reach the decision that the body of empirical evidence from both SCP and NEIO studies is not persuasive enough to conclude that the industry is not competitive."

The most recent and exhaustive review of the relevant economic literature conducted by Azzam and Anderson confirmed the earlier findings of the 1990 GAO report on beef industry concentration. The 1990 GAO concluded, ". . . our review of empirical studies did not lead us to draw any overall conclusions regarding the impact that market concentration in the beef-packing industry has on the prices packers paid for steers and heifers in the 1980s. Industry analysts and experts we spoke with said that recent packer concentration has not lowered steer and heifer prices in the 1980s. Some industry analysts believe that cattle prices may be higher because the increased efficiencies that accompanied increased concentration enabled beef packers to pay more for cattle. . ."[6]

Schroeder, et al. based on numerous meat industry studies state, "[t]wo questions that surfaced recently relative to packer concentration and captive supplies are: (1) whether recent declines in fed cattle prices have been created by packer captive supply? and (2) whether recent high margins of beef packers are related to captive supply levels? The answer to each is no."[7]

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[5]Azzam, Azzeddine M. and Dale G. Anderson. *Assessing Competition in Meatpacking: Economic History, Theory, and Evidence.* Grain Inspection, Packers and Stockyards Administration, U.S. Department of Agriculture, GIPSA-RR 96-6, May 1996.

[6] United States General Accounting Office, *Beef Industry: Packer Market Concentration and Cattle Prices.* GAO/RCED-91-28, December 1990.

[7] Schroeder, Ted C., Clement E. Ward, James Mintert, and Derrell S. Peel. "Beef Industry Price Discovery: A Look Ahead," in *Price Discovery in Concentrated Livestock Markets: Issues, Answers, Future Directions*, ed. Wayne Purcell (Research Institute on Livestock Pricing, Department of Agricultural and Applied Economics, Virginia Tech., Blacksburg, VA, February 1997), p. 63.

Impact of Packer Feeding on Prices

The petition (p. 1850) cites the findings of a "... Packers and Stockyards Division study that examined the price impacts from packer-feeding in the mid-1960s explains how an oligopsonistic packer that feeds its own cattle can adversely affect prices paid to other producers for slaughter supplies."[8] The petition then concludes that "[t]his study found that packer-fed cattle caused a significant decline in the local market price when the packer had some oligopsonistic power."

Clem Ward comments (p. 3) "[t]here is no evidence that packer feeding has increased significantly in recent years. GIPSA data I believe suggests packer feeding has remained a relatively small proportion of fed cattle marketings over the past decade." He also states (p. 4) that "[t]he petition bases much of its argument on a single study conducted 35 years ago. It ignores more recent research from the GIPSA concentration study on captive supply impacts." The GIPSA study that Clem Ward refers to is the captive supply study that states (p. 81) "[p]rices for packer-fed cattle were not significantly different than cash market cattle."[9] The study also concludes (p. 82) "[t]he overall short-run impact on fed cattle transaction prices from captive supply deliveries or inventories based on the this study was small and would be virtually impossible to observe in raw transaction price series."

Forward Contract Impact on Price

The WORC petition cites two studies that examined forward contracts. The first focussed on southwest Kansas marketing region during six months in 1990. The second is the GIPSA concentration studies. WORC states (p. 1850) that these "studies have found that forward contracting for fed cattle supplies has a depressing effect on prices."

Clem Ward states (p. 4) "[t]he literature on impacts from forward contracting on balance suggests decreased prices result as forward contracting increases. However, the magnitude of the impact varies considerably based on data period and coverage. When the petition cites the more recent work in the GIPSA study on captive supplies, the much smaller magnitude of negative impacts found was not reported. Increases in deliveries of cattle from the inventory of forward contracted cattle were associated with $0.03-$0.05/cwt. (dressed weight basis) lower cash market fed cattle prices. The petition correctly reports findings from the GIPSA study indicating that contracting increased when cash prices and cash price variability increased. Rather than

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[8] Aspelin, Arnold and Gerald Engelman, *Packer Feeding of Cattle; Its Volume and Significance*, Packers and Stockyards Division, Consumer and Marketing Service, USDA, Marketing Research Report No. 776, Nov. 1966.

[9] Ward, Clement E., Ted C. Schroeder, Andrew P. Barkley, and Stephen R. Koontz. *Role of Captive Supplies in Beef Packing*, Grain Inspection, Packers and Stockyards Administration, U.S. Department of Agriculture, GIPSA-RR 96-3, May 1996.

concluding that this behavior by packers 'is likely to have the effect of manipulating prices,' this finding simply verifies that packers behave rationally in their use of forward contracts."

Wayne Purcell writes that "[t]he findings from these efforts [GIPSA concentration study]... indicated either no statistically significant impact on prices [Purcell's emphasis] paid or coefficients on measures of captive supplies, while statistically significant because of the large number of observations, were relatively meaningless in an economic context." [Purcell's emphasis] (pp. 3-4)

Use of Formula-Priced Forward Contracts

Addressing the use of forward contracts and formula pricing arrangements, the WORC petition for rulemaking follows closely the Secretary of Agriculture's Advisory Committee on Concentration in Agriculture minority report.[10] One of the petition's allegations is price manipulation. The petition (pg. 1847), quoting from the USDA Advisory Committee minority report, states "[w]hen the futures market is used to establish a base, the packers are heavy players on both sides. Their futures market activities, whatever the motivation and whether the packers are long or short in the market, affect the price they pay for formula cattle and, ultimately, for negotiated sales." WORC alleges that packers manipulate futures market prices to lower prices paid in the cash market.

The Commodity Futures Trading Commission (CFTC) investigated similar allegations that the largest meat packers manipulated futures market prices during the period April 4 through June 30, 1994. The CFTC issued two separate reports based on their investigation. The first report was on CFTC's analysis of large trader position data that examined end-of-day futures positions and day-to-day position changes.[11] This report concluded (p. 6) "[t]hese overall data do not support an assertion that beef packers engaged in a pattern of consistent selling of live cattle futures or that their futures trading was a principle contributor to the fall in cattle prices that occurred from mid-April to late May." The second report was on CFTC's packers intraday trading analysis.[12] This analysis was conducted to see if packers manipulated futures prices within a trading day to lower cash prices that same day. The second report concluded that packers did not engage in manipulative intraday trading activity, stating (p. 5) "[p]acker day trading generally was not a large portion of their total trading, representing less than 11 percent of all packer

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[10] *Concentration in Agriculture: A report of the USDA Advisory Committee in Agricultural Concentration*, Agricultural Marketing Service, USDA, June 1996, pp. 29-36.

[11] Commodity Futures Trading Commission, Report to Congressional Oversight Committees and National Cattlemens Association. Market Surveillance Section, Division of Economic Analysis, CFTC, Washington, DC, June 20, 1994.

[12]Commodity Futures Trading Commission, *An Analysis of Intra day Trading of Beef Packers in Live Cattle Futures*. Market Surveillance Section, Division of Economic Analysis, CFTC, Washington, DC, September, 1994.

trading." The report also stated (p. 6) "[o]ver the period, packers on average were net buyers of futures on each day of the week. Moreover, total sales on each weekday over the period varied little. . ."

WORC also contends in their comment (p. 6) that "[f]orward contracts that are not traded publicly give preferences to those producers who are offered contracts over those who are not." In the petition (p. 1851), WORC states that ". . . marketing agreements as defined by the report [GIPSA concentration study] are included in the definition of forward contract in the proposed rule. . ." They also state (p. 2) that "[u]ndue preference or discrimination and the tendency to manipulate prices are inherent in privately negotiated captive supply agreements, as the case GIPSA has brought against IBP for its arrangements with selected Kansas feeders has shown."

GIPSA's complaint and subsequent hearing before a USDA Administrative Law Judge alleges that IBP, inc. has violated sections 202(a) and (b) of the Packers and Stockyards Act by paying a preferential price for fed cattle to an exclusive group of Kansas feedlots. GIPSA's complaint did not allege price manipulation as suggested by WORC.

The WORC petition (p. 1851) states "[t]he report states: Small firms use spot markets almost exclusively, whereas the Big Three packers are more likely to use alternative procurement methods." WORC continues, "[t]he report clearly demonstrates that the Big Three packing firms and the largest feedlots account for the vast majority of the formula-priced agreements. . . This data suggests that in practice the largest feedlots have preferential access to marketing agreements -- and therefore to an assured market for their cattle. And that this preferential status does not only ensure market access in the long term but also provides a price advantage not available to producers not offered the marketing agreements." WORC also alleges (p. 1847) that smaller feeders are ". . . most easily pressured into exploitative, captive supply contract arrangements." They also suggest (pp. 1847-48) that because of "severe discounting" and "volatile" market prices, retained ownership by cow/calf producers ". . . involves an intolerable and unnecessary degree of price risk."

Clem Ward writes (p. 3), ". . . I know of no evidence that smaller feeders are 'pressured into exploitative, captive supply contract arrangements.' In fact, the GIPSA concentration study verified that most forward contracting and marketing agreement arrangements are between larger packers and larger feeder, not smaller feeders." Ward continues. ". . . there is no evidence of 'severe discounting of feeder prices in response to the volatility of the fat cattle market.' There are clear economic reasons to discount input prices (feeder cattle) where possible in light of increased volatility, both for outputs (fed cattle) and other inputs (grain). Such volatility gives rise to contractual relationships that benefit both buyers and sellers. This petition would have little effect on retained ownership opportunities. . . . In fact, reducing the use of forward contracts might increase price volatility and reduce the attractiveness of retained ownership."

Based on the concentration study that larger packers and feedlots were general users of forward contracts and marketing agreements, results do not show causation or preferential treatment. The concentration study analyzed individual transactions data (including prices for forward contracted, marketing agreement, and packer fed cattle) for 43 beef packing plants that slaughtered at least 75,000 steers and heifers per year. As such, the captive supply use of smaller packers was not examined. Conclusions about the use of captive supplies cannot be drawn beyond the scope of the concentration study data and the study's results.

Clem Ward writes (p. 4), "[t]he petition draws on findings from the GIPSA concentration study to incorrectly conclude 'that in practice the largest feedlots have preferential access to marketing agreements.' . . . Higher prices paid by larger packers to larger feeders relate in part to the increased plant efficiency resulting from having consistently large supplies of cattle available for slaughter. Throughout the petition, any research related to plant efficiency is omitted. Yet cost of operation is critical in understanding the competitiveness of rival firms in a margin business such as meatpacking."

In their comment (p. 6), WORC believes that packers dictate delivery times for formula priced marketing agreement cattle to manipulate prices, stating "[f]orward contracts that do not contain firm-base prices establish the incentive for packers to manipulate captive supply inventory and delivery levels..." Referring to marketing agreements and alliances, Schroeder, et.al. state that it is the cattle feeders, not packers, decision when to deliver cattle, writing "[f]requently, cattle feeders determine the day or week cattle will be delivered, giving them more control over deliveries and the terminal date than in cash market trades."[13]

Grande Ranch Company comments that "[t]he vast majority of formula price agreements in place in the industry today have been proposed by the feeders/producers as ways of generating premium prices for above average cattle. They are not the idea of the packers. . . In the Northwestern corner of the country, while there are smaller packers, one packer (IBP) dominates the market. The majority of cattle in this area are sold to IBP on a formula based on the weekly averaged price in areas of the country (such as Kansas) where many packers competitively bid the fed cattle. By using this formula agreement, feeders get access to a series of premiums and discounts for quality, but more importantly, they get access to a base established by competitive bidding."

Kevin Brockhoff of BeefEx (the Beef Exchange electronic market) writes (p. 4) ". . . eliminating basis contracts would be of benefit to the majority of producers who do not understand basis trading." However, Wayne Purcell (p. 6) writes ". . . it is very important for the producer to be able to determine the time of pricing. A basis contract that ties the final price to the futures contract and leaves the flexibility of timing of the final price to the producer can be a very effective forward pricing instrument . . ." Based on this, he continues by saying (p. 7) ". . . I

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[13]Schroeder, Ted C., Clement E. Ward, James Mintert, and Derrell S. Peel. "Beef Industry Price Discovery: A Look Ahead," in *Price Discovery in Concentrated Livestock Markets: Issues, Answers, Future Directions*, ed. Wayne Purcell (Research Institute on Livestock Pricing, Department of Agricultural and Applied Economics, Virginia Tech., Blacksburg, VA, February 1997), p. 37.

prefer the basis contract to the formula price contract" and (p. 6) ". .would be inclined to want to see discontinuance of the formula price contract."

Captive Supply Decisions and Impact on Price

The WORC petition (p. 1851) contends that the GIPSA concentration study ". . . does demonstrate that the use of captive supply procurement methods in the cattle industry causes a decline in the cash-market price for cattle. It shows that packers increase their captive supply inventories when cash-market prices increase. The report also demonstrates that as packers increase the deliveries of captive supplies, the cash-market prices decline." However, WORC's comment (p.10) even questions causality between captive supplies and prices, stating ". . . the negative associations shown for all three captive supply types to spot prices say nothing about causality..."

Clem Ward states (p. 4) "[t]he petition correctly reports findings from the GIPSA study indicating that contracting increased when cash prices and cash price variability increased. Rather than concluding that this behavior by packers 'is likely to have the effect of manipulating prices,' this finding simply verifies that packers behave rationally in their use of forward contracts. . . In fact, while many of our findings suggested negative relationships between captive supplies and cash market prices, the magnitude of those negative effects were small. While statistically significant, they may not be economically significant."

Wayne Purcell writes that "[t]he findings from these efforts [GIPSA concentration study] ...indicated either no statistically significant impact on prices [Purcell's emphasis] paid or coefficients on measures of captive supplies, while statistically significant because of the large number of observations, were relatively meaningless in an economic context." [Purcell's emphasis] (pp. 3-4) He continues by stating that the GIPSA concentration study ". . . found that when captive supply cattle were more readily available at larger percentage levels, the slaughtering facilities operated more nearly at capacity and with less variation around their designed capacity level. In turn, the studies showed that when packing plants operated consistently at and around designed operating levels, higher prices were paid for cattle. . . It would appear, then, that one of the possible ramifications of captive supplies is to cut off the price peaks and fill up the price valleys and make prices paid for cattle more stable over time than they would be in the absence of that procurement practice. This does not argue, however, that the mean price paid for cattle is reduced by captive supplies. The research says that captive supplies are not in any economically significant way related to lower cattle prices, meaning changes in captive supplies are not an important factor in explaining short-run variations in fed cattle prices."

Impact of Number of Buyers on Price

The WORC petition summarizes several studies that examined the number of bidders and bids on prices. The results from these studies generally support the view that more buyers and bidders increase livestock price.

Wayne Purcell (p. 6) contends that if the petition's regulations are enacted that ". . . it would prompt some disinvestment by the current big 3 packers. . . .[and] that capacity [would] move into the hands of more disaggregated smaller packer/processors who inevitably are going to face higher costs of operation. [Because] the economies of size in packing and processing are clearly very large and very important . . . [t]his would probably bring at least some 'window dressing' competitiveness in the industry because it has the potential to raise the number of bids a particular producer might garner. The question, then, becomes one of whether or not more bids from higher cost, smaller operations result in better prices to cattle producers and cattle feeders than do fewer bids from larger, more cost effective operators."

Alternatively, if the larger packers do not divest from the industry, because of their economies of size and cost efficiency, smaller higher cost packers may be forced to exit the industry. This would result in a more concentrated industry and the potential for fewer bidders. This view is shared by several commentors. Don Anderson of the Colorado Cattle Feeders Association writes, "[r]estricting procurement practices would likely inhibit the ability of small- and mid-sized packers to compete and could actually contribute to increased packer concentration." Lynn Cornwell of the Montana Stockgrowers Association believes that the petition ". . . could actually contribute to more packer concentration in that bigger packers could bid on smaller 'nitch market' cattle contracted by smaller packers or alliances." Cindy Garretson-Weibel with the Wyoming Stock Growers Association suggests "[i]mplementation of the rules asked for by WORC could adversely affect small packers and branded beef promotion efforts, which would only serve to further increase packer concentration."

Conclusion from Economic Studies

WORC's petition (p. 1852) argues "[t]he economic studies discussed above provide substantial evidence supporting findings that the current use of forward contracts [including marketing agreements] and packer-owned cattle to procure captive slaughter supplies are likely to have the effect of manipulating prices by depressing those prices paid to cattle producers. These studies also support a finding that the trading of forward contracts and packer-owned cattle in a public market designed to encourage more bidders on cattle is likely to improve prices paid to producers."

Clem Ward's (p. 5) reaction to this section of the petition is that "[t]he first sentence in this section is simply wrong. Economics research does not 'provide substantial evidence supporting findings that the current use of forward contracts and packer-owned cattle to procure captive slaughter supplies are likely to have the effect of manipulating prices by depressing those prices paid to cattle producers.'" Ward also states (p. 2) ". . . the intent appears to be protection of a declining segment of the livestock industry, i.e., public markets. Public markets have played and continue to play an important role in the livestock economy. However, there is no per se reason to single them out for protection and alter the evolution of markets. Direct marketing of fed cattle has replaced public marketing for sound economic reasons, not because anyone imposed them onto the marketplace." Wayne Purcell also states (p. 10) [m]uch of the thrust of the petitioner's proposed changes is based on the notion that unless prices for cattle are negotiated in some sort of public arena, we can't possibly have effective price discovery. <u>This assumption, assertion, or whatever it may be called, is very wrong</u>. [Purcell's emphasis] . . . Just negotating the price of cattle on a liveweight basis in an auction arena, any electronic system, or any other publicly accessible price arena in no way guarantees effective and efficient price discovery."

Schroeder, et al. conclude "[t]wo questions that surfaced recently relative to packer concentration and captive supplies are: (1) whether recent declines in fed cattle prices have been created by packer captive supply? and (2) whether recent high margins of beef packers are related to captive supply levels? The answer to each is no."[14] Clem Ward also concludes "Did this study [GIPSA concentration study] find negative effects from concentration? No. Did this study exonerate packers from questions about use and abuse of market power? No."[15]

Wayne Purcell states (p. 5) "[m]y overall conclusion is that captive supplies that allow meat packers to schedule flows of cattle into the plants in future weeks or months are not a major factor in the relatively low cattle prices of recent years." Despite his reservation regarding formula prices, he goes further, (p. 8) "'Is regulatory action needed?' My response is no." He also writes, (p. 5) "I think the proposed rules are both too broad and too restrictive. I don't see the justification for this type of constraint on how the seller and buyer can interact in the important fed cattle complex."

The Secretary of Agriculture charged the Advisory Committee on Concentration in Agriculture (p. iii) to review market concentration in meat packing industry, including the effects of procurement practices (captive supplies) and concentration on prices for slaughter cattle.[16] The chairman of the Advisory Committee, Dr. Daniel I. Padberg, Professor Emeritus of Agricultural

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[14] Schroeder, Ted C., Clement E. Ward, James Mintert, and Derrell S. Peel. "Beef Industry Price Discovery: A Look Ahead," in *Price Discovery in Concentrated Livestock Markets: Issues, Answers, Future Directions*, ed. Wayne Purcell (Research Institute on Livestock Pricing, Department of Agricultural and Applied Economics, Virginia Tech., Blacksburg, VA, February 1997), p. 63.

[15] Ward, Clement E. "Important and Ignored Messages from the Packers and Stockyards Program's Concentration Research Study," in *Price Discovery in Concentrated Livestock Markets: Issues, Answers, Future Directions*, ed. Wayne Purcell (Research Institute on Livestock Pricing, Department of Agricultural and Applied Economics, Virginia Tech., Blacksburg, VA, February 1997), p. 121.

[16] *Concentration in Agriculture: A report of the USDA Advisory Committee in Agricultural Concentration*, Agricultural Marketing Service, USDA, June 1996, pp. 29-36.

Economics, comments (p. 1) that "... we considered the evidence available to us, and what we could produce from hearings. . ." He continues, "[s]hould our industry have restrictive rules placed on it? As it turned out, the majority answered, **No** ..." [Padberg's emphasis]

General Economic Conditions

Historically, the cattle industry has suffered through periods of cyclically low prices. Industry participants and analysts have often pointed to many general economic factors for observed price levels. WORC states in their comment (p. 2), "[t]he increases in market concentration and use of captive supplies are not the only factors affecting prices paid to producers." They also write in their comment (p. 12), "[a]nalysts who seek to minimize the impact of captive supplies on prices often do so by showing that normal supply and demand factors are at work and responsible for changes in prices. It does not follow from this that captive supplies do not have an effect on prices, unless it is shown that all of the change in prices is caused by supply and demand forces. Of course, it is perfectly possible for the supply of cattle, the price of corn, industry concentration and the level of use of captive supply all to effect the price of fed cattle at one time." However, WORC did not specifically address industry supply and demand factors in the petition. Also, the petition did not address all of the economic benefits and reasons feeders and packers use various marketing arrangements. Most of WORC's discussion focusses on their allegations of economic harm.

General economic conditions of supply and demand factors are important determinants of price. There are also many benefits for using various marketing arrangements not specifically addressed. Several comments presented supply and demand analyses and reasons for using captive supply arrangements. The following sections present arguments on these topics.

Supply and Demand

Several comments stipulate that declining demand for beef is a primary problem for the industry. Andrew Gottschalk (p. 1) writes "Beef demand peaked during the spring of 1979 and remains in a continuous downtrend." Gottschalk also states "[t]his primary problem of declining beef demand is precipitous and ongoing." Wayne Purcell (p. 5) concurs, stating that decreased beef demand ". . . is one of the long-term structural-type changes in the industry that has prompted lower fed cattle prices." Purcell continues by writing (p. 10) ". . . the long-term villain in the beef business that is responsible for the often desperately low prices in recent years is the sustained decreases in demand. Those decreases have occurred primarily because the product offering made available to the consumer is outdated, outmoded, and totally lacking in adherence to modern consumer preferences." Andrew Gottschalk (p. 2) says "[t]here is no disagreement with the fact that the quality of beef has deterioated during the past several decades." Jerry Bohn of the Kansas Livestock Association (p. 2) also says ". . . declining beef demand and loss of market share remains the most significant challenge faced by all beef producers." Andrew

Gottschalk (p. 1) suggests that "[c]umulatively, each consumer's decision has led to a 14% decline in per capita consumption of beef during the past ten years (equivalent to losing 36 million consumers) and a 28% decline since beef production peaked in 1976."

Beef's loss of market share to competing meats has hurt the industry. Tim Hammonds with the Food Marketing Institute says "[t]he competition to beef is not found within the beef distribution system. It comes form alternative meat sources -- chickens, turkeys, pork, lamb, fish, and shellfish." Andrew Gottschalk says (p. 2) ". . . during the period form 1990 - 1996 combined meat supplies increased 13.2 billion pounds. Of this increase, beef comprised only 21% (2.8 billion pounds) of the combined 13.2 billion pound production gain. The competing meats, reflecting consumer [Gottschalk's emphasis] preference, comprised 79% (10.4 billion pounds) of the combined increase in beef, pork and poultry production during the 1990 - 1996 period. Thus, the shrinkage in beef's market share continues." Wayne Purcell states (p. 5) that per-capita beef consumption "has declined from near 95 lbs. in 1976 to just above 65 lbs. in the early 1990s."

On the production (supply) side, Andrew Gottschalk writes (p. 2) "[a]dding confusion to this issue, cattle inventories declined from 132 million head during 1975 to 103.5 million in 1996, a 21.6% decline. Ignored by the petitioners is the basic [Gottschalk's emphasis] fact that during this period, average carcass weights increased from 579 pounds to a peak of 709 pounds in 1994. This represents a carcass weight gain of 22.4%, which offsets the entire reduction in cattle inventories. Thus, during the past year, commercial beef production at 25.4 billion pounds nearly equaled the previous peak beef production during 1976 at 25.7 billion pounds. The level of beef production in 1996 was achieved with a cattle inventory approximately 25 million head (103.5 million vs. 128.0 million head) smaller than in 1976."

Reasons Packers and Feedlots Use Captive Supplies

Several commentors also discussed the reasons for and benefits of captive supply arrangements in the livestock industry. Buyers and sellers enter into various marketing arrangements expecting to benefit in some manner. In the cattle industry, Clem Ward states (p. 6) ". . . that many times feeders have approached packers regarding alternative means of marketing and pricing fed cattle." Larry Ragains of the Idaho Cattle Association states that "[c]aptive supply and various forms of price discovery have been developed over time for inventory and risk management by both producers and packers."

There are several benefits for cattle feeders and packers to enter into various marketing arrangements. Schroeder, et al.[17] write, "[p]rimary benefits to cattle feeders may include improved risk management, access to more financing options, guaranteed buyer for cattle,

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[17] Schroeder, Ted C., Clement E. Ward, James Mintert, and Derrell S. Peel. "Beef Industry Price Discovery: A Look Ahead," in *Price Discovery in Concentrated Livestock Markets: Issues, Answers, Future Directions*, ed. Wayne Purcell (Research Institute on Livestock Pricing, Department of Agricultural and Applied Economics, Virginia Tech., Blacksburg, VA, February 1997), p. 57-58.

improved opportunity for carcass quality premiums, and reduced marketing costs. Packers' primary benefits include securing cattle slaughter needs so they can operate large packing plants near capacity, having more control over the type and quality of cattle to fill their plants, and reducing procurement costs." They also suggest "[s]ome captive supply agreements are also a step toward value-based marketing of live cattle. Captive supply agreements that contain price adjustments for varying carcass quality attributes provide cattle feeders increased incentives to produce cattle possessing desired quality characteristics."

Andrew Gottschalk agrees by writing "[s]o called 'captive supply' cattle circumvent the latter problem, [average pricing of cattle] as producers are paid for the quality of their production with premiums and discounts paid on carcass merit. Average pricing occurs when feedlots sell a pen of high quality cattle together with a pen of lower quality cattle at a single price. Andrew Gottschalk (p. 2) argues that "'[a]verage pricing' only encourages the surplus [Gottschalk's emphasis] production of below [Gottschalk's emphasis] average product."

Effect On Current Procurement and Pricing Methods

The WORC petition is requesting rules that would restrict or limit the industry's use of common procurement and pricing methods. The petition would restrict packers from procuring cattle for slaughter through the use of a forward contract (including marketing agreements), unless the contract contains a firm base price that can be equated to a fixed dollar amount on the day the contract is signed and the forward contract is offered or bid in an open, public manner. The petition also restricts packers from owning and feeding cattle, unless the cattle are sold for slaughter in an open, public market.

Fed Cattle Industry Procurement Methods

Spot Market

Spot market transactions are purchases directly from the feedlot or seller at a fixed price at the time the transaction is agreed upon. The cattle are usually picked up by the packer within 1 to 7 days. Spot market transactions would not be affected by the proposed rules.

Marketing Agreements

Marketing agreements are normally long-term arrangements between a packer and a feedlot in which the packer agrees to purchase cattle offered for sale by the feedlot for the period of the agreement. Cattle procured by marketing agreements are generally priced by using a formula agreed upon by both the packer and feedlot. Essentially, the WORC petition eliminates marketing agreements by disallowing formula pricing. This is because, if applied literally to a marketing agreement contract, the rule requiring a firm base price would require the buyer and seller to agree upon a firm base price at the time the cattle are contracted. This would be possible, but somewhat impractical and risky given the long-term nature of the agreement.

Feedlots that utilize marketing agreements usually deliver cattle to the packer on a regular basis. There is almost a continuous flow of cattle going from the feedlot to the packer. Negotiating price on every delivery would possibly disrupt this flow of cattle, and defeat at least one of the reasons for having an agreement, i.e., a dependable supply of and/or outlet for cattle. The marketing agreement not only allows the stream of cattle to keep flowing out of the feedlot and into the plant but it also offsets the dilemma that the feedlot, and the packer would face in trying to guess what the market price will be at some future date. Under the proposed WORC rules, neither the packer nor the feedlot could count on any individual group of cattle entering the flow, until a price was agreed upon.

Packer Feeding

Packer owned or fed cattle are cattle that a packer owns and is feeding either at a custom feedlot or at a feedlot owned and controlled by the packer. These are usually cattle that the packer has procured as feeders and placed on feed. However, they could be cattle that the packer procured during some stage of their feeding period and is finishing them to a heavier weight and hopefully to a higher grade. The WORC proposed rules likely would discourage this method of procurement because it would require packers to offer their own cattle for sale publicly. This would cause packers to incur a marketing cost which would add to their overall cost of procurement.

Forward Contracts

Forward contracts are contracts to purchase cattle, which a packer enters into with a seller and in which both parties agree that delivery of the cattle will occur at some future date. (Basis contracts are a form of forward contracting as well as a pricing method) The rules proposed by the WORC petition would allow only contracts which specified a fixed price or a fixed base price.

Fed Cattle Industry Pricing Methods

Formula Price and Basis Contracts

Basis contracts are so called because they utilize the futures market to establish a base price from which the contract price is computed. The difference between the futures price and the contract price is referred to as the basis. Although basis contracts are never written with a firm base price, they always have a firm "basis" at the time the cattle are contracted. If applied literally to a basis contract, the rule requiring a firm base price would mean that the price must be tied to the sale of a futures contract or contracts on the day the cattle are contracted to the packer. Under the present method, timing of the pricing decision is in the hands of the seller. Typically, the seller has several weeks in which to select the day on which to price the cattle. Sellers always try to price the cattle on a day which favors themselves. Conversely, the price isn't important to most packers because they usually hedge these cattle as soon as the seller picks a futures day. If the cattle are hedged, the price is irrelevant to the packer, because it becomes more or less an even trade and the only thing relevant is the basis. The WORC petition requiring a firm base price would effectively eliminate basis contracts.

Formula Priced Cattle

On page 1847 of the petition for rulmaking submitted by WORC it states " 1. Restrictions on use of forward contracts . No packer shall procure cattle for slaughter through the use of a formula or basis price forward contract." Later on the same page it states that: " packers and producers could still enter into contracts in which the price is set through a formula if there is a firm base price which can be equated with a specific dollar amount when the contract is entered into." The WORC proposed rules would eliminate all types of formula priced transactions including Carcass Weight, Grade and Yield and so called Grid sales unless they are tied to a firm base price. It would also eliminate liveweight transactions which are based off market reports.

Conclusions

The vast majority of the comments supported the WORC rulemaking petition to restrict the use of captive supply arrangements. A large percentage of these comments were form letters that referred to or endorsed the petition's arguments.

The power of the economic, logical and empirical arguments was the primary basis for developing our conclusions, rather than the number of comments supporting or opposing the petition. The team finds no compelling evidence to suggest that anything other than basic economic conditions determined the general price level of the fed cattle market. After weighing the economic arguments supplied by WORC, commentors (supporting and opposing), and other information assembled by the team, we could not definitively conclude that spot prices were affected or manipulated by captive supplies. Furthermore, the economic evidence does not indicate the use of captive supplies is a violation of the Act. Also, there was insufficient evidence to show that implementation of the petition would improve or solve WORC's stated problems. Therefore, we conclude that it is unnecessary and unwarranted to effectively ban the industry's use of various procurement (marketing agreements, forward contracts, and packer fed) and pricing (basis price and formula price) methods that the industry relies on to assure packers a reliable source of cattle, assure feeders an output market, a mechanism to transfer risk, and the opportunity to reduce transactions costs.

WORC wants GIPSA to selectively regulate the livestock industry by requiring only the fed cattle segment of the beef industry to comply with their petition. It would be unfair to the sellers of fed cattle and their lenders to limit the ways in which they can market their product. It should be noted that hog, lamb and special-fed veal producers rely heavily on the use of marketing agreements and contracts without fixed prices. These producers select the type of contract or marketing agreement that they feel most comfortable with. Fixed price contracts have always been an option available to sellers of fed cattle, however, sellers might prefer to price their livestock using an alternative method, i.e. formula or basis pricing. Some sellers are reluctant to commit to a fixed price for their fed cattle with a delivery date 2 to 4 months in the future without some mechanism for offsetting that price risk. Livestock producers, including sellers of slaughter cattle, use marketing agreements and contracts other than fixed price, to market their livestock because they choose to. The buyer and seller enter into a contract or marketing agreement freely, both expecting to benefit in some manner.