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AN ECONOMIC PERSPECTIVE ON THE USDA GIPSA PACKERS & STOCKYARDS ACT RULE CHANGE

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My specific concerns with the Rule change

- There is still little economics in clarifying "unfair, unjustly discriminatory," and "undue or unreasonable preference."
- The Rule change states that, "Paying a premium or applying a discount… without documenting reasons and substantiating the revenue and costs justification…" is unfair. (The document does not say contract when talking about cattle. Thus, this may apply to cash market trades.)
- The Rule change states that not offering the same contract terms to all producers that can provide the required livestock is undue or unreasonable. But it then states that the Rule change doesn't require purchases if needs are met. Differential pricing does require "legitimate business reasons" and "to maintain records that justify" differential treatment.
- Remember, within P&S Actions the burden of proof can be on the packer and the standard can be vague.

What happens if the Rule is adopted as is – given what we know from economics and research?

My intention is to not speculate and not focus on worst case scenarios. Rather, discuss what the Rule change means to an economic scientist and in the context of scientific research. There are six main issues.

1. *What happens to the cash & Alternative Marketing Agreement (AMA) markets?*

- If price differences risk litigation then pricing will become more standardized.
- If participating in the cash market or in AMAs risks litigation then there is less incentive to be in the cash market or in AMAs.
- One response to these risks is to return to commodity pricing – through posted bids and "take or leave it" bids – also make AMA pricing very standardized.
- The easiest way is for the packer to own their own animals – this is what will happen to the hog industry.
- Because of the risk in cash market transaction the Rule change can thin the cash market.
- What can be learned from the Missouri experience…

In 2001, Missouri passed a law that packers "shall not discriminate in prices paid or offered to be paid to sellers" of livestock in the state. The law was in effect from May 29, 2001 until a special session of the legislature changed it on September 28, 2001. Why?

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What was happening? Hog prices were $2.25/cwt (3.5%) lower than normal and cattle prices were also lower. There was much reduced bidding and reduced trading. Packers were fearful of lawsuits. The bill cost Missouri livestock producers an estimated $19 million.

- What can we learn from changes in beef demand over past 29 years…

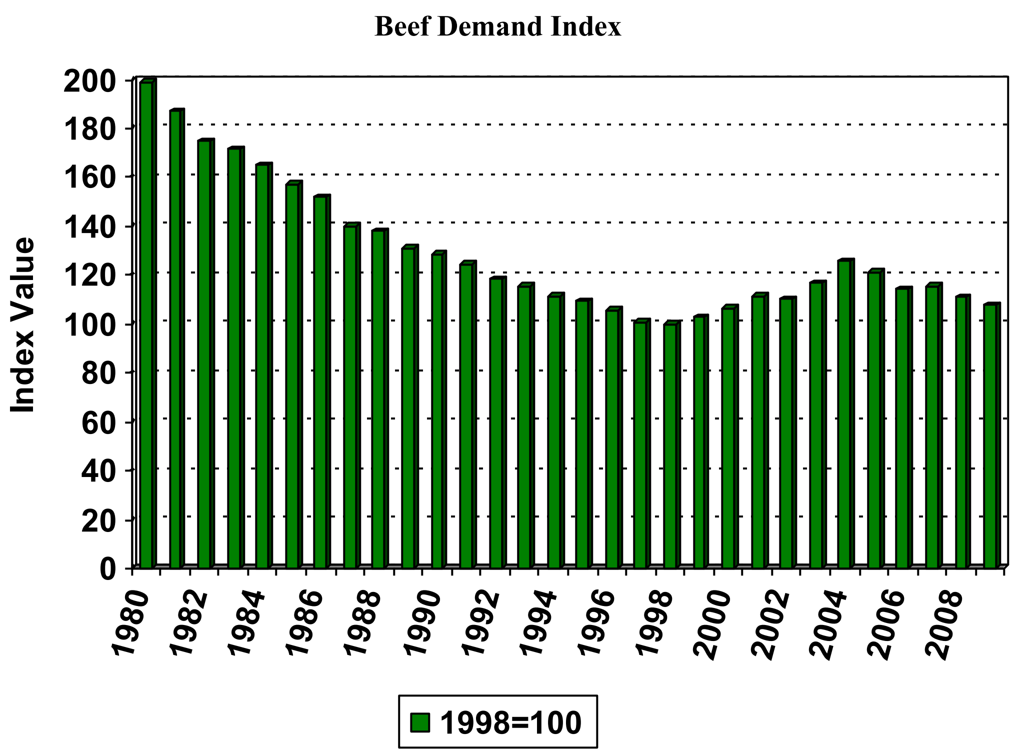
It is a fact the one of the most important economic events impacting the beef industry over the past 29 years has been the long-run decline in demand and the arrest of the decline in the 2000's. The Beef Demand Index illustrates the consumer's willingness to pay for beef holding supply and inflation constant. The index declines from 200 in 1980 to 100 in 1998. What does this mean? In 1998, consumers were willing to pay half of what they were willing to pay in 1980. This decline can only be called catastrophic. Many things have caused this decline but one fact is that the price system was not working. What the consumer valued was not being communicated to and produced by the cattle industry.

And why the recovery in 1999? Like the decline, many things caused the improvement but three things are apparent. First, consumers changed including increased consumption of beef away from home. Second, improved beef related food technology. And, third, there was improved communication through value-based marketing. The important message is that long-term changes in demand have had substantial impacts on the cattle industry.

Another important consideration is what would the beef demand index be without these three changes? It is very likely demand would have continued to erode to an index value between 60-80. This implies fed cattle and feeder cattle prices at least 20% below were they are today. Changing demand is the most important economic factor affecting the beef industry today and affecting the beef industry's long-term economic health.

2. *How is price discovery impacted?*

- If price differences risk litigation then there will be fewer price differences – pricing becomes more standardized.
- But consider
  - changes in the Beef Demand Index.
  - industry improvements through value-based marketing.
  - product development work that has involved cattlemen – as opposed to food technology.
- How will innovation be treated? It appears to not be recognized in the rule. For example,…



Suppose a packer and a group of producers have an idea for a better product. They build a program to produce that product and work with a retailer to market that product. Premiums are offered to producers but the packer keeps some of the benefit. How must the program work so that it is not "unfair," "unjust," or "undue"? The rule appears to say that any producer that wants into the program has to be allowed access – regardless if they contributed to the development of the new product or simply want to learn about and use the efforts of others. What if the size of the product market is not large enough for all the producers that want to participate? This is not recognized in the rule. What if the producers and the packer simply want to experiment and attempt to grow a market? The rule does not recognize this. And many examples are offered in the rule document but there are none that communicate what it means for a packer to "justify" premiums and discounts paid. Currently, these programs have a market justification. If the program makes the participants money commensurate with risk then they will continue.

- The Rule change does not appear to recognize, and thus could easily constrain, the price discovery process. This will likely not result in increased price transparency.
- If a packer purchases at different prices it will have the *opportunity* to explain itself to GIPSA. And any legal process is costly.

3. *What is the impact on small or medium producers and processors?*

- Small producers benefit from the Rule change if preferential treatment and market power are the cause of current price differences. But research does not support this view.
- Packer margins are thin and volatile – increasing costs and risk to the packer will require more conservative bidding in the cash market and is an incentive to move away from the cash market.
- And it is the cash market that smaller producers use.
- What about smaller packers attempting to not be in the beef commodity market? The issue is not big versus small producers or packers. The rule will hurt "good" producers.
- What about small auction markets? Small auction markets and the producers that use them will suffer and face increased costs under the Rule change.

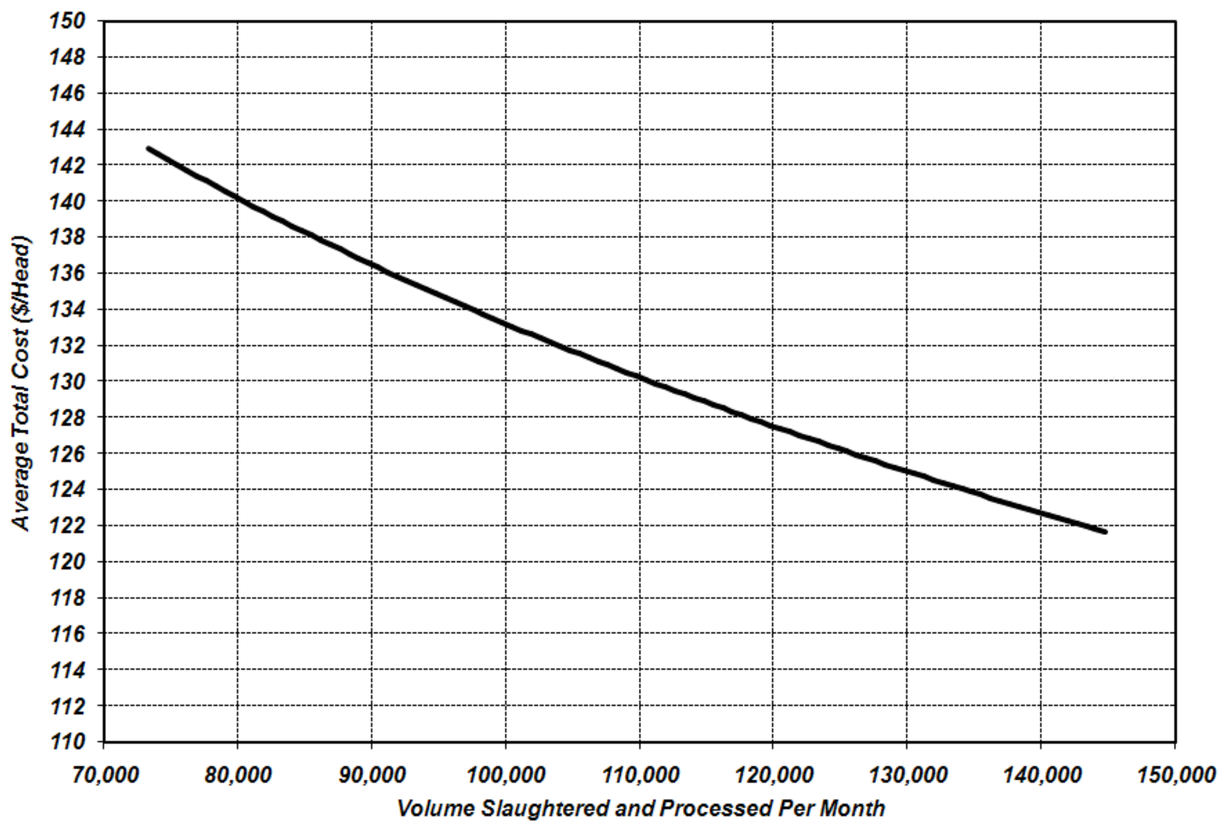
4. *What is the impact on large producers and processors?*

- Large producers and processors are some of the most efficient. This is an undisputable fact from research. A review of the scientific research on the beef industry clearly shows that large firms are more cost efficient than small – especially within the beefpacking industry. The research also shows market power exists but is small relative to efficiency gains. The beef cattle industry can only be economically harmed by changing the structure of the packing industry.

The following table is a summary of average total costs of slaughter and fabrication for beefpacking firms. The data are from the 2007 RTI Livestock and Meat Marketing Study and are from packer P&L statements. Simply put a large plant that process 1.7 million head per year is more efficient than a "small" plant that processes 950 thousand head per year. The large plant is $20 per head more efficient. The objective producer is left asking, "Would I rather have one bid or two bids were both of those bids are $20 per head lower?"

- These large firms will continue to do business. These large firms will adapt to new policy – they did so with respect to mandatory price reporting and country of origin labeling – and will continue to compete effectively with higher cost marketers.
- But the demand and efficiency benefits will be impacted if AMAs are made more standardized.
- What does the 2007 RTI Livestock and Meat Marketing Study say? The study examined the elimination of AMAs. The impacts are clear. AMAs resulted in lower costs and better quality. If costs are increased through lost efficiency and demand is impacted through lost quality then the beef industry loses. Producers with cow calf operations lose the most. Feeder cattle prices will be $0.50/cwt lower (the decline moderates some but persists) and the industry will shrink 5% (and it is the smaller industry that supports feeder cattle prices). Total losses to the industry are $10 billion in the short run and $50 billion in the long run after 10 years.

Costs of Slaughter and Fabrication for Plant-Level P&L Data ($2003)



This is a loss of 15% of the wealth created by economic activity within the cow-calf industry.

- Finally, I have two questions for you:
  - What packing firms will be least impacted by more standardized pricing?
  - What packing firms can, "Buy them all, pay one price, and sort them in the cooler"?

5. *Producers not in marketing agreements seem to be saying the Rule change will not impact them. Is that correct?*

- That could be the case…
- But, as an economist, the Rule change does not clarify to me what is meant by "unfair, unjustly, and undue".
- The Rule change has the potential to be a major institutional market change.
- It appears to me that the litigation risk to the packer is increased with the Rule change.
- Costs to packers of documenting business decisions clearly increase.
- And demand will be impacted.
- If that is the case then the entire market will be impacted – the cash market, AMAs, and value-based efforts.
- And market power will be lessened…

6. *Will the Rule change result in better cattle prices?*

- Fewer bids and more conservative bids. Incentives to move away from the cash market.
- More risk and more costs to the bidder. Disincentives to innovate and do something different – with AMAs…
- Small and medium sized producers and packers can be impacted the most.
- Large packers given incentives to use standardized AMAs and return to the business model of "buy them all and sort in the cooler."
- There is the potential for fundamental market changing impacts.

Finally, perhaps the issue that bothers me most about the Rule change is the lack of clear need based on scientific research. There are two substantive studies of AMAs in the cattle and beef industry. The first was the 1996 Concentration Study and the second was the 2007 RTI Livestock and Meat Marketing Study. Both studies were Congressionally mandated and funded by competitive grants. Both were coordinated through GIPSA. The reports for both are available on the GIPSA website. Having participated in both, I do not make the connection between the results of the two studies and the Rule change. Nor is either study referred to in the Rule change document. And I believe that policy change without clear need linked to scientific facts will have the potential to have substantial unintended consequences and these are in addition to negative impacts on beef producers and the cattle industry that are developed above.