An Economic Perspective on the USDA GIPSA Packers & Stockyards Act Rule Change

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2010-08-26

My specific concerns within the rule

- *There is still little economics in clarifying "unfair, unjustly discriminatory," and "undue or unreasonable preference."*
- *"Paying a premium or applying a discount… without documenting reasons and substantiating the revenue and costs justification…" is unfair. (Doesn't say contract when talking about cattle.)*
- *Not offering the same <u>contract terms</u> to all producers that can provide the required livestock is undue or unreasonable. But doesn't require purchases if needs are met. 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?

1. *What happens to the cash & AMA markets?*
2. *How is price discovery impacted?*
3. *What is the impact on small or medium producers and processors?*
4. *What is the impact on large producers and processors?*
5. *Producers not in marketing agreements seem to be saying the Rule change will not impact them. Correct?*
6. *Will the Rule change result in better cattle prices?*

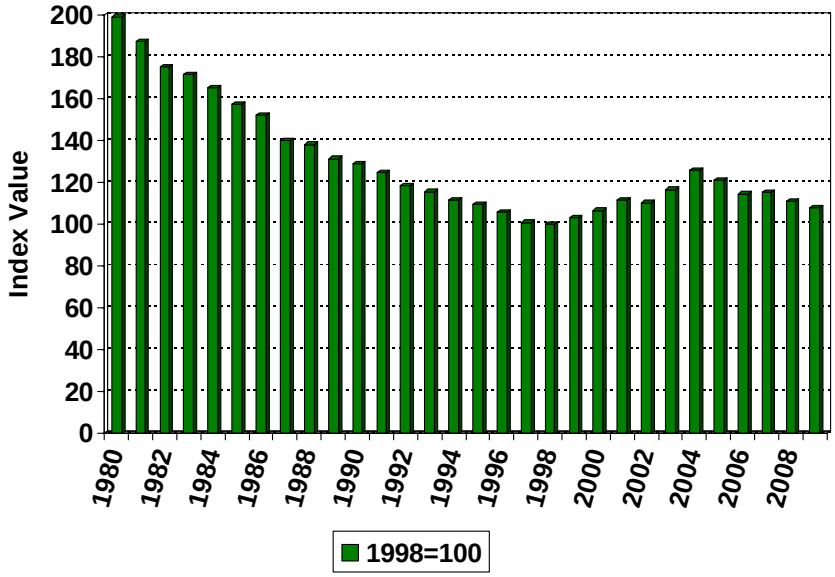
1. What happens to the cash & AMA markets?

- *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 prices 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.*
- *The Rule changes can thin the cash market.*
- *Missouri experience…*
- *Changes in beef demand over past 29 years…*

Missouri experience…

- *In 2001, Missouri passed a law that packers "shall not <u>discriminate</u> 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? What was happening?*
  - *Hog prices were $2.25/cwt (3.5%) lower than normal & cattle prices were also lower.*
  - *Reduced bidding.*
  - *Reduced trading.*
  - *Cost Missouri livestock producers $19 million.*

Beef Demand Index



2. How is price discovery impacted?

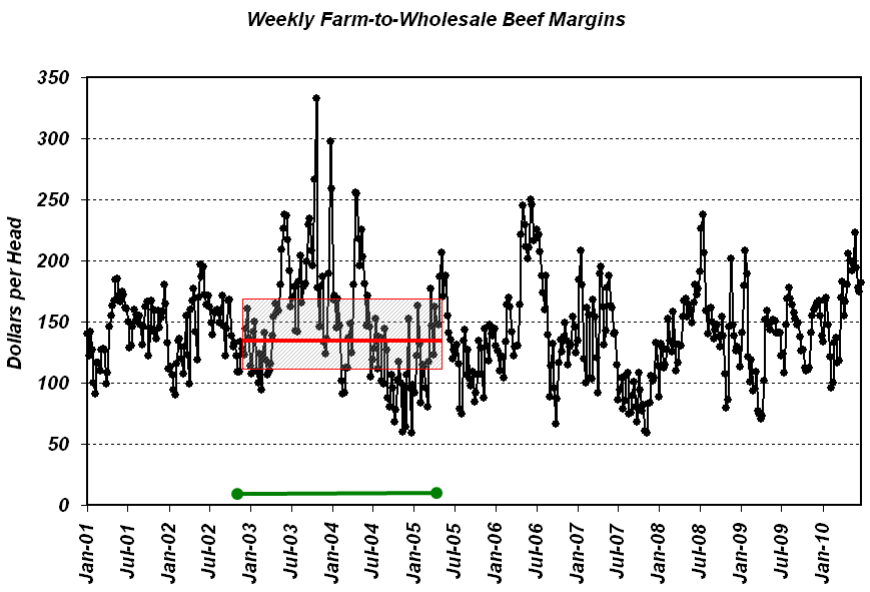
- *If price differences risk litigation then there will be fewer price differences – pricing becomes more standardized.*
- *But consider*
  - *changes in the Beef Demand Index.*
  - *industry improvements through value-based marketing.*
  - *product development work that has involved cattlemen – as opposed to food technology.*
- *Innovation example…*
- *The Rule change does not recognize and could constrain the price discovery process.*
- *If a packer purchases at different prices it will have the opportunity to explain itself to GIPSA.*

How will innovation be treated?

- *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 does the program work so that it is not "unfair," "unjust," or "undue"?*
  - *Similar treatment of like producers?*
  - *Size of the market? Experimenting with the new?*
  - *Premiums to producers have to be justifiable?*

3. What will be the impact on small producers?

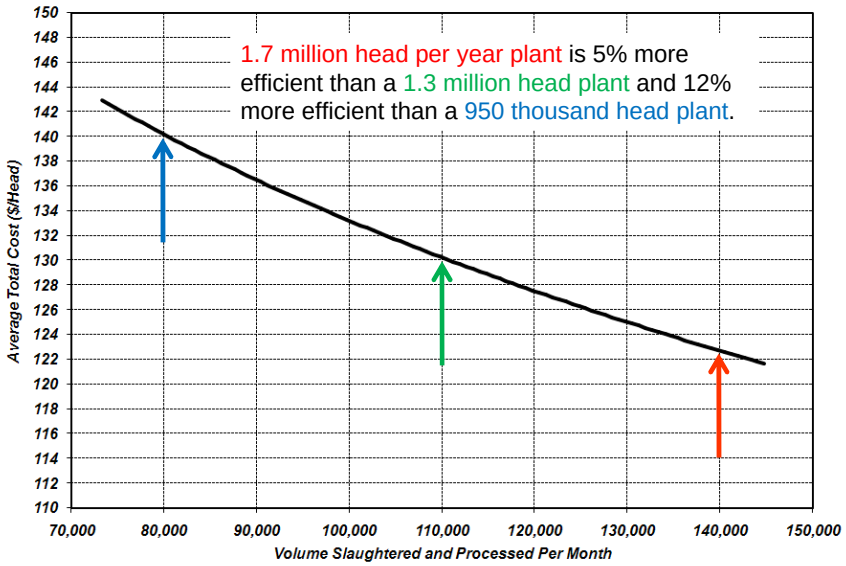
- *Small producers benefit if preferential treatment and market power are the cause of current price differences. But research does not support this view.*
- *Packer margins are thin and volatile – increasing costs & risk to the packer will require more conservative bidding in the cash market and is 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?*
- *What about small auction markets?*



4. What will be the impact on large producers?

- *Large producers and processors are some of the most efficient. This is an undisputable fact from research…*
- *These firms will continue to do business.*
- *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? We examined the elimination of AMAs…*
- *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"?*

Average Slaughter and Fabrication Costs Per Head for the "Representative Plant"



Market Impacts of Eliminating AMAs

Impacts (Billion $2003)	*Short-run*	*Long-run*
– Consumers	*-$1.9*	*-$10.5 (4.4%)*
– Retail	*-$0.5*	*-$6.1 (1.9%)*
– Wholesale	*-$0.8*	*-$7.0 (5.0%)*
– Fed Cattle Producer	*-$2.8*	*-$15.3 (6.8%)*
– Feeder Cattle Producer	***-$5.4***	***-$21.2*** *(13.8%)*
– Total of All Producers	***-$9.5***	***-$49.5*** *(5.9%)*

- *Long-run impacts are cumulative discounted 10-year impacts.*
- *Feeder Cattle (Cow-Calf) Producers are "residual claimants…"*

What did the packer P&L data show?

Variable	*Mean*	*Standard Deviation*	*Minimum*	*Maximum*
Average total cost per head (ATC)	***$138.61***	***10.7476***	***$120.32***	***$164.21***
Average gross margin per head (AGM)	***$140.72***	***38.8241***	***$22.62***	***$211.98***
Average profit per head (PPH)	***–$2.40***	***43.8242***	***–$137.36***	***$73.34***

Loss because of irregular expenses relative to irregular revenues. There are very large losses during this 2½ year time period (10/2002 - 3/2005).

Almost every packer has a problem plant or plants. There is excess capacity in the packing industry – it's about 15-17%...

5. If you are not using marketing agreements then the Rule change will not effect you?

- *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".*
- *It has the potential to be an institutional market change.*
- *It appears to me that the litigation risk to the packer is increased.*
- *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 these Rule changes increase 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.*