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

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Department of Justice

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TDD (202) 514-1888

DEPARTMENT OF JUSTICE AND USDA HOLD WORKSHOP FOCUSED ON COMPETITION ISSUES IN THE LIVESTOCK INDUSTRY

Fort Collins, Colo., Workshop is the Fourth of Five on Competition Issues in Agriculture

WASHINGTON — The Department of Justice and the U.S. Department of Agriculture (USDA) today held the fourth of five joint public workshops to explore the appropriate role for antitrust and regulatory enforcement in American agriculture. The workshop, led by Agriculture Secretary Tom Vilsack and U.S. Attorney General Eric Holder, examined competition in the livestock industry and featured panel discussions on trends in the livestock industry, market consolidation and market transparency. The workshop also included opportunities for public comments.

Today's meeting was the fourth in a series of workshops intended to promote dialogue among interested parties and foster learning with a diverse group of stakeholders regarding competition and regulatory issues in the agricultural marketplace. These workshops are the first-ever to be held by the Department of Justice and the USDA to discuss competition and regulatory issues in the agriculture industry. Additional information about the workshops can be found at www.justice.gov/atr/public/workshops/ag2010/index.htm#overview.

"Ultimately, today's conversation is about much more than simply last year's trends or this year's challenges. It's about livelihoods, families, this region's economy and our centuries-old American way of life," said Attorney General Holder. "We've made these workshops a cabinet-level priority so that we can most effectively and efficiently determine how to ensure a fairer, more competitive marketplace for producers and consumers alike."

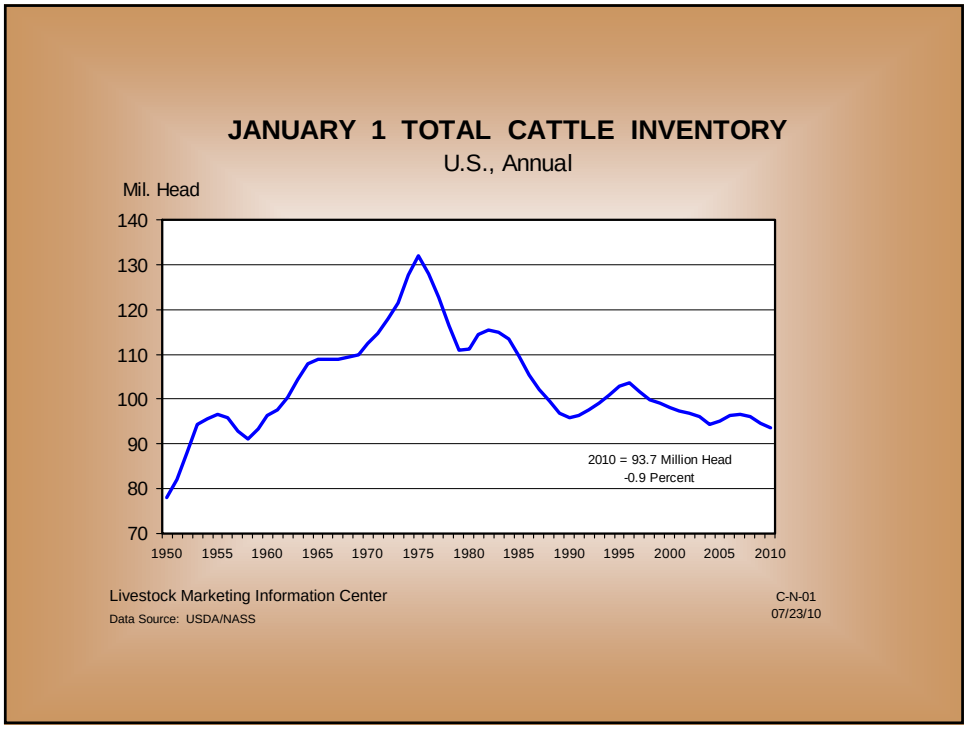
"Given the consolidation that has taken place in the livestock industry over the past decades, it is critical to ensure a fair market still exists to give all players an honest chance at success," said Secretary Vilsack. "A fair and competitive marketplace is important not only for producers, but also for consumers, and today's open and transparent dialogue with ranchers, farmers, academics and other industry stakeholders will provide us with a understanding of the complex issues in this important industry."

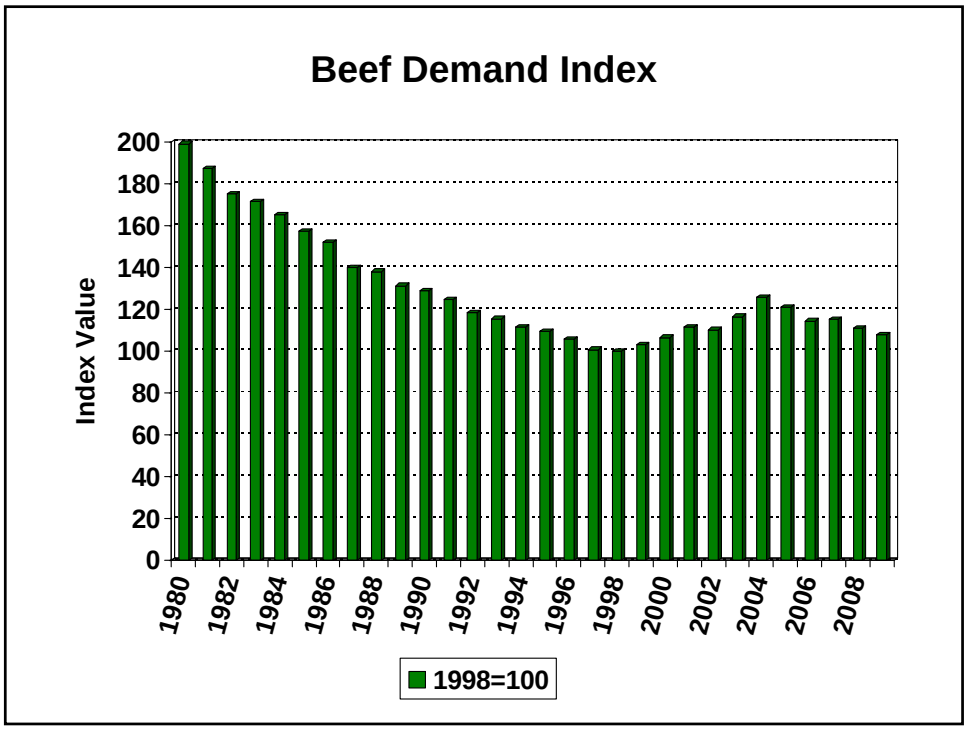
Secretary Vilsack and Attorney General Holder began the workshop with opening remarks before leading a roundtable discussion, in which Christine Varney, Assistant Attorney General for the Antitrust Division, participated with other federal and state officials, on competition issues in agriculture and the livestock industry. After the roundtable discussion, a panel of producers and feeders from throughout the country shared their first-hand experiences and perspectives on the industry. USDA and Justice Department officials then listened to public testimony from audience members.

In the afternoon, another panel will discuss trends in the livestock industry, including

"We don't know what's wrong but we know something is broke."

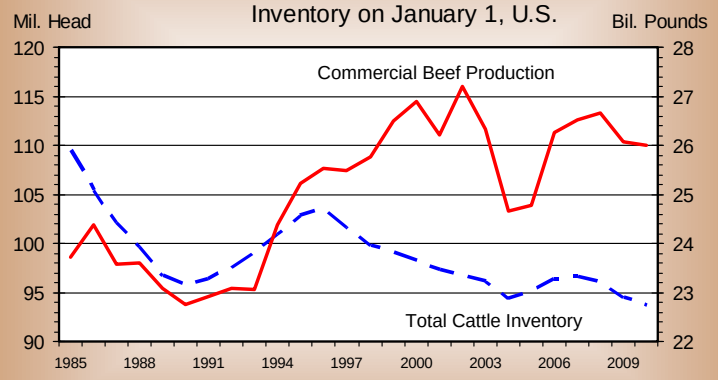
C. Varney – Asst Attorney Gen


JANUARY 1 TOTAL CATTLE INVENTORY
U.S., Annual
Mil. Head
140
130
120
110
100
90
80
70
1950
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
2010 = 93.7 Million Head
-0.9 Percent
Livestock Marketing Information Center
Data Source: USDA/NASS
C-N-01
07/23/10


Beef Demand Index
Index Value
200
180
160
140
120
100
80
60
40
20
0
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
1998=100

BEEF PRODUCTION vs. CATTLE INVENTORY

Inventory on January 1, U.S.

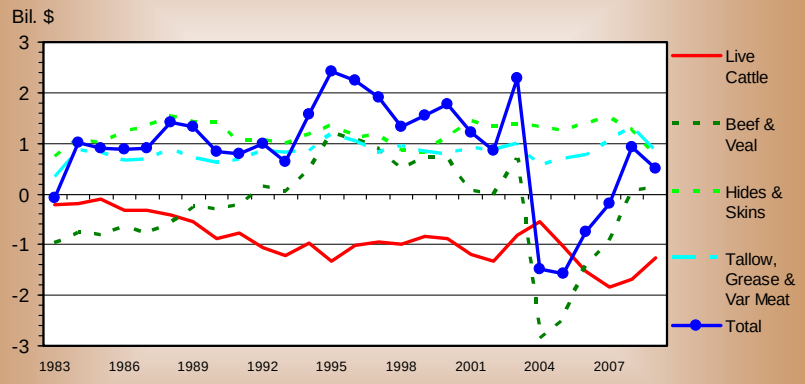


Livestock Marketing Information Center

M-S-23
08/30/10

U S BEEF INDUSTRY NET EXPORT VALUES

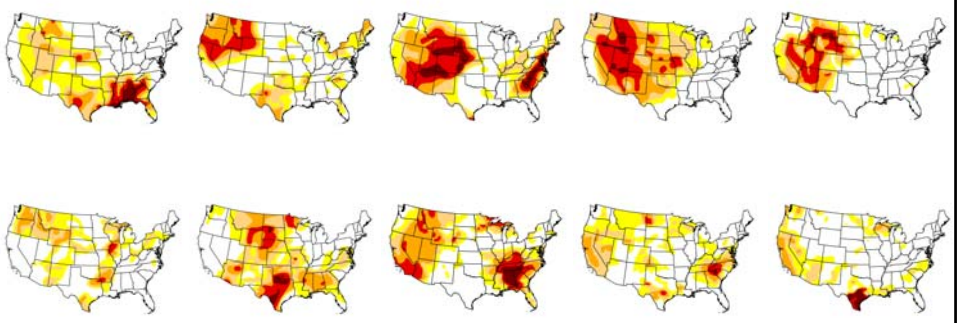
Annual



Data Source: USDA-FAS; Analysis by LMIC

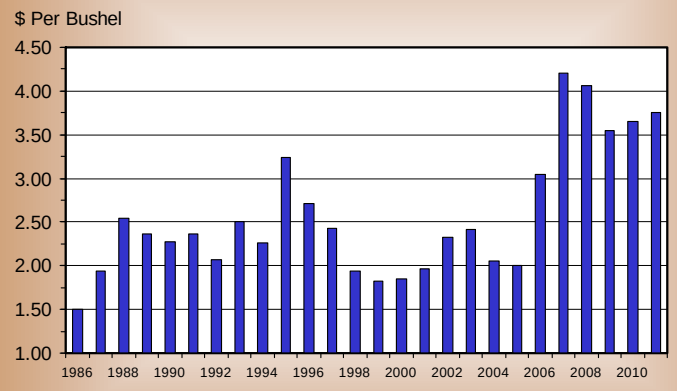
I-N-72
08/27/10

Drought Monitor – All Augusts from 2000 to 2009



NATIONAL AVERAGE CORN PRICE

Crop Year, Received by Farmers



Data Source: USDA-NASS, Compiled and Forecasts by LMIC

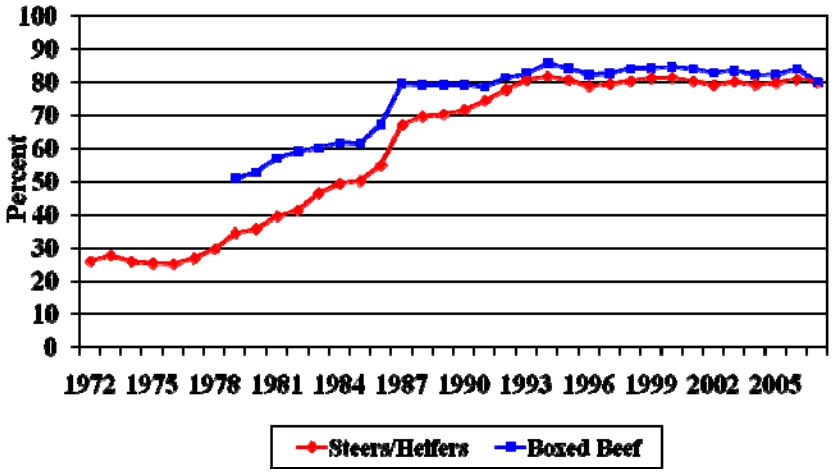
G-NP-03
07/12/10

Crude Oil Futures Prices – Monthly

So why is the beef herd & number of producers down?

- *Demand is down 50%.*
- *Productivity (or supply) is up 30%.*
- *Reduced trade dollars.*
- *Persistent drought.*
- *Ethanol demand and corn prices.*
- *Input costs.*
- *Credit availability.*
- *…*
- *I think the list is long before you come to large agribusiness processing and marketing firms or retail and food service firms having a negative impact.*

Percent of Slaughter & Boxed Beef Fabrication Conducted by the 4 Largest Firms



Source: GIPSA USDA

Interesting Quotes in 1940's Research

Nicholls (1940) states, "Only after considerable further investigation will we know whether or not reform in the packing industry is necessary. It is conceivable that such monopoly elements as exist yield desirable results. A less extreme possibility is that results are undesirable but not sufficiently bad to bother about."

Nicholls, W.H. "Market-Sharing in the Packing Industry." Journal of Political Economy 22(1940): 225-240.

I think the "considerable further investigation" has occurred. And that we know the answer.

A Synthesis of Market Power Research on the Cattle and Beef Industry

Stephen R. Koontz*

December 30, 2009

Comments Submitted to the
U.S. Department of Justice and U.S. Department of Agriculture
Regarding
Agriculture and Antitrust Enforcement Issues in Our 21st Century Economy

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Summary of Market Power Research

Significant and Problematic Market Power

Significant and Modest Market Power

Insignificant Market Power

It is a reasonable conclusion that there is significant but modest market power in the beef packing industry.

Generally, some fraction of 1% of fed cattle prices but maybe, at times, 1-2% of fed cattle price.

Cost Economies Research

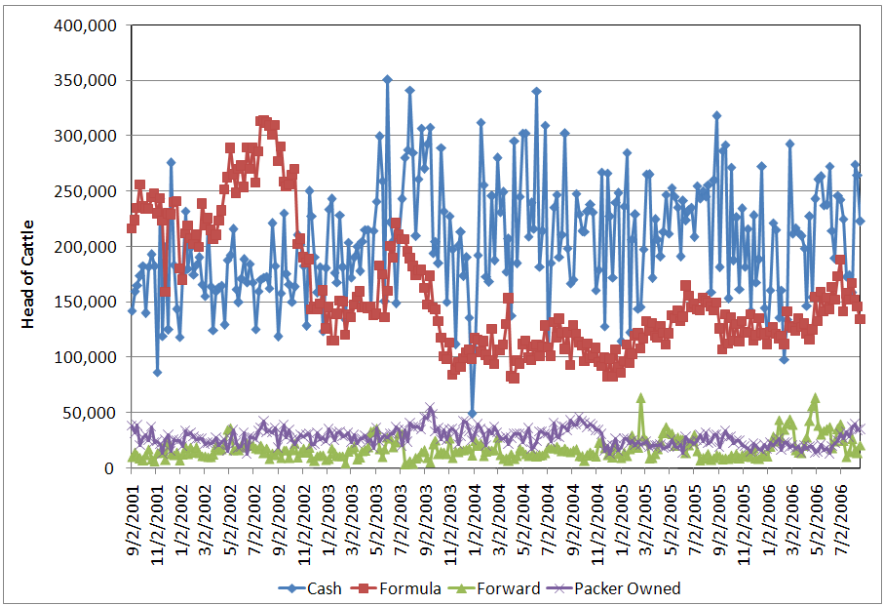
- *So if it's not market power driving concentration then what is it? It is the cost economies of larger firms.*
- *Any discussion of the problems of concentration without recognizing this well-documented benefit is dishonest.*
- *There is a need to assess the costs – market power and coercion – and the benefits – lower costs and expanded industry size.*
- *All studies that measure the costs & benefits find net benefits to industry change that has occurred – the benefits are orders of magnitude larger than costs.*

Summary of Concentration Research

- *This issue is and has been important to the agricultural economics research community.*
- *The bottom-line conclusion is that: market power is present and modest.*
- *The bottom-line conclusion is that: there are tremendous economies of size.*
- *And, comparisons of benefits and costs find the current industry structure is a net benefit – to cattlemen and to consumers.*
- *In Nicholls words, "A less extreme possibility is that results are undesirable but not sufficiently bad to bother about."*

What's the "beef" with Captive Supplies?

- *Packers get the formula cattle without having to bid on them.*
- *For example,*
  - *Packers need: 20,000 per week.*
  - *Half of supplies are formula – only need 10,000 head.*
- *Flaw in argument?*
  - *If the packers don't have to buy them then feedlots don't need to sell them.*



A Correct Example of AMAs

	Low AMA	High AMA	Trouble	Actual
Packer needs:	20,000	20,000	20,000	20,000
Formula	5,000	16,000	16,000	12,000
Cash	15,000	4,000	4,000	8,000
Feedlot showlists:	20,000	20,000	25,000	18,000
Formula	5,000	16,000	16,000	12,000
Cash	15,000	4,000	9,000	6,000

The number of formula cattle slaughtered by the packer has to be equal to the number of formula cattle moved by the feedlots.

The market is in balance with the first two examples – low numbers of AMA cattle and high numbers of AMA cattle.

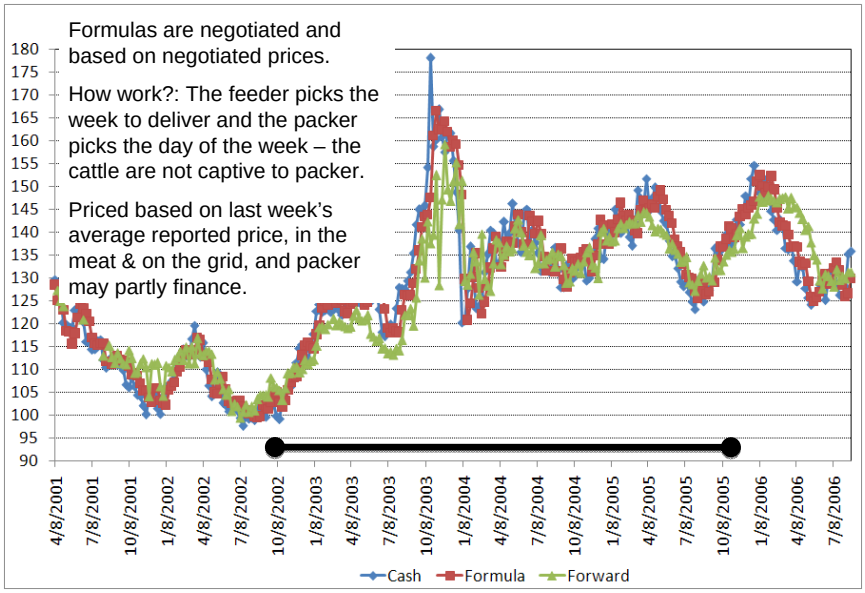
The market is out of balance in the "Trouble" scenario.

The "Actual" scenario is what we have seen since 2003 & certainly in 2010.

Captive Supply Research

- *Much concentration legislation is focused on prohibiting captive supplies.*
- *Very well studied: dozen published works.*
- *Very thoroughly studied:*
  - *1996 Concentration Study (Red Books)*
    - *13-Month study period: 4/1992-4/1993 with transactions for every pen of animals traded in the country.*
  - *2007 Livestock & Meat Marketing Study*
    - *30-Month study period: 10/2002-3/2005 with transactions for every pen of animals traded in the country.*
  - *Both studies Congressionally mandated and funded.*
- *Strategic behavior by packers in the use of captive supplies was hard to find.*

Cash, Formula, and Forward Prices – Dressed Beef



What did the analysis of procurement transactions data show?

- *When AMA use increases cash prices decrease:*
  - *10% increase in AMA use (as % of plant capacity) is associated with a **$0.40/cwt** of carcass weight decrease.*
  - *10% increase in AMA use is associated with a **0.3%** decrease in cash price.*
- *Impacts are economically small but statistically significant. Average transactions price of $138/cwt.*
- *AMA use is not strategic – packers use more AMAs when more AMA cattle are available and when AMA cattle are cheaper.*
- *If AMAs were eliminated then cattle prices would have been higher by ½% or $0.68/cwt of carcass weight for this time period with the model estimated…*

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October 2007 Newsletter 1 | 2 | 3 | 4 | 5

Captive Supplies Caused Nearly 10% Decline In U.S. Net Farm Income

From OCM's General Council Michael Stumo

USDA numbers reveal the significant price hit you are taking on hogs and cattle because of captive supplies. In January, USDA released a report by the Research Triangle Institute on captive supplies.

This was a $4 million study mandated by the 2002 Farm Bill, when the packer lobby blocked captive supply reform. USDA is hostile to making markets work well, and picked RTI and other academics to write a report saying things were just fine. RTI tried hard, even coining a new feel good term for captive supplies – "Alternative Marketing Arrangements" or AMA's. Who could be against marketing alternatives?

But the report itself shows a stunning decrease in prices caused by packer ownership and contracts. The study shows a $69 per head price decrease for cattle and at least $32 per head for hogs.

The USDA-commissioned report finds that 9% of hogs and 62% of cattle were sold on the open market from 2002 to 2005. The cattle number is almost certainly too high, but I will use those number for now.

Most cattle studies have found that each one percent increase in captive supplies is correlated with – or causes - a .145% to a .25% decrease in cattle prices. Using the USDA report numbers of 38% captive supplies (probably too low) and a low end .15% negative price impact, the price decline today is $5.75 per hundred weight. In other words, you are receiving **$69 per head less** (on a 1200 pound animal) than you would be in a free market.

The hog picture is worse. The USDA report found that each one percent increase in contract hogs causes – yes, causes - a spot price decline of .75%. The authors also said a one percent increase in packer owned hogs causes a spot price decline of .24%.

Assuming 20% of hogs marketed are packer owned, the negative price impact is $4.80/cwt live, or $13.44 per hog. Then adding the contracted hog effect, we get another $43.28/cwt price depression (58% x .75) for a **total of $48.30/cwt.** This is a tremendous price decline.

But let's assume the price effect is more like cattle, at about .15% for every 1% of captive supply. The price depression effect is $11.65/cwt or **$32.62 per head** for a 280 pound hog.

Commercial hog slaughter numbers for 2006 were 104.7 million head annual hog slaughter in 2006. Hog producer received **$3.4 billion** less than they should have in a free market (at $32.62/head price decline).

Commercial cattle slaughter numbers for 2006 were 33.7 million head. Cattle feeders received **$2.3 billion** less than they should have in a free market (at $69/head price decline).

To put this in perspective, net farm income for all commodities for the United States in 2006 was $60.6 billion. Net farm income would have been nearly 10% higher if we had fair, open and competitive markets in livestock agriculture.MS

"But the report itself (the RTI-Livestock & Meat Marketing Study) shows a stunning decrease in prices caused by packer ownership and contracts."

"… $5.75/cwt less…"

"… $69 per head less…"

These calculations are not correct and the RTI project leader wrote Mr. Stumo and detailed the errors.

It's not $5.75/cwt. It is $0.68/cwt.

2007 study results very similar to the 1996 study and all other captive supply research.

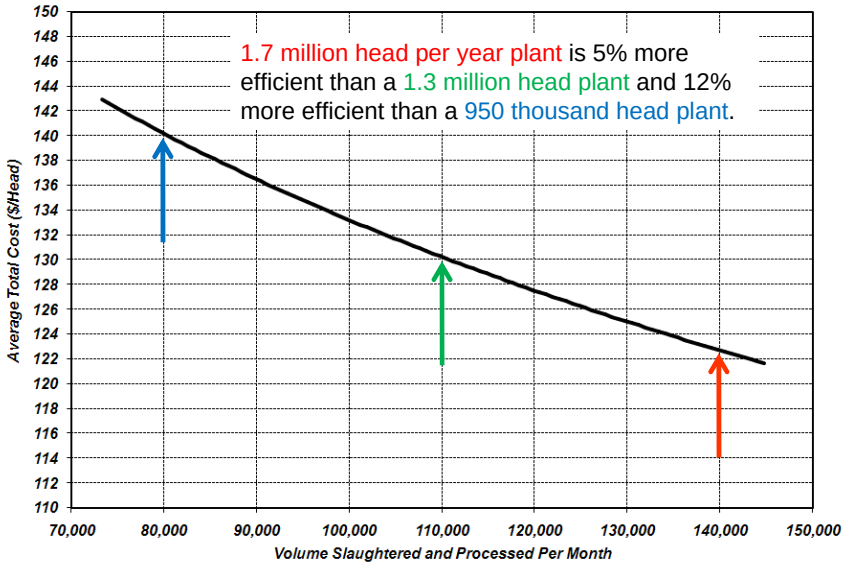
What did the packer P&L data show?

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%...

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



What did the packer P&L data show?

- *Plant costs are statistically significantly lower for those that procure through AMAs.*
  - *Costs are lower – all else constant – 0.9%.*
  - *Costs are lower because of higher volumes – 2.6%.*
  - *Costs are lower because of predictable supplies – 1.2%.*
- *These measures are conservative in that all are within-plant measures – no across-plant measures.*
- *Cost savings are approx 4.7% or $6.50 per animal.*
- *Related to fixed costs and much less to variable costs.*
- *If AMAs were eliminated then cattle prices would decrease $6.50/head.*

Some Cowboy Math

- *Captive supplies save the packing industry $6.50/head – from the RTI Study – and it would be larger today…*
- *Captive supplies save the cattle feeding industry conservatively $5-$10/head – from the RTI Study – and…*
- *Packing and feeding appear to be breakeven industries…*
- *So captive supplies put how much money in the pocket of the cow-calf industry and the backgrounding industry?*
- *And eliminating or limiting them would…?*

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…"*

Proposed Rules

Federal Register
Vol. 75, No. 119
Tuesday, June 22, 2010

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

DEPARTMENT OF AGRICULTURE

Grain Inspection, Packers and Stockyards Administration

9 CFR Part 201

RIN 0580–AB07

Implementation of Regulations Required Under Title XI of the Food, Conservation and Energy Act of 2008; Conduct in Violation of the Act

AGENCY: Grain Inspection, Packers and Stockyards Administration, USDA.

ACTION: Proposed rule.

SUMMARY: The Department of Agriculture (USDA), Grain Inspection, Packers and Stockyards Administration (GIPSA) is proposing to add several new sections to the regulations under the Packers and Stockyards Act, 1921, as amended and supplemented (P&S Act).

The new regulations that GIPSA is proposing would describe and clarify conduct that violates the P&S Act and allow for more effective and efficient enforcement by GIPSA. The proposed regulations would clarify conditions for industry compliance with the P&S Act and provide for a fairer market place.

DATES: We will consider comments we receive by August 23, 2010.

ADDRESSES: We invite you to submit comments on this proposed rule. You may submit comments by any of the following methods:

- *E-mail: comments.gipsa@usda.gov.*
- *Mail:* Tess Butler, GIPSA, USDA, 1400 Independence Avenue, SW., Room 1643–S, Washington, DC 20250–3604.
- *Fax:* (202) 690–2173.
- *Hand Delivery or Courier:* Tess Butler, GIPSA, USDA, 1400 Independence Avenue, SW., Room 1643–S, Washington, DC 20250–3604.
- *Federal e-Rulemaking Portal: http://www.regulation.gov.* Follow the on-line instructions for submitting comments.

Instructions: All comments will become a matter of public record and should be identified as "Farm Bill Comments," making reference to the date and page number of this issue of the Federal Register. Comments will be available for public inspection at *http://www.regulations.gov* and in the above office during regular business hours (7 CFR 1.27(b)). Please call GIPSA Management Support Services staff at (202) 720–7486 to arrange a public inspection of comments.

FOR FURTHER INFORMATION CONTACT: S. Brett Offutt, Director, Policy and Litigation Division, P&SP, GIPSA, 1400 Independence Ave., SW., Washington, DC 20250, (202) 720–7363, *s.brett.offutt@usda.gov.*

SUPPLEMENTARY INFORMATION:

Background

The P&S Act sets forth broad prohibitions on the conduct of entities operating subject to its jurisdiction. These broad provisions make enforcement difficult and create uncertainty among industry participants regarding compliance. In enacting Title XI of the Food, Conservation and Energy Act of 2008 (Farm Bill) (Pub. L. 110–246), Congress recognized the nature of problems encountered in the livestock and poultry industries and amended the P&S Act. These amendments established new requirements for participants in the livestock and poultry industries and required the Secretary of Agriculture (Secretary) to establish criteria to consider when determining whether the P&S Act has been violated.

In accordance with the Farm Bill, GIPSA is proposing regulations under the P&S Act that would clarify when certain conduct in the livestock and poultry industries represents the making or giving of an undue or unreasonable preference or advantage or subjects a person or locality to an undue or unreasonable prejudice or disadvantage. These proposed regulations also establish criteria that GIPSA would consider in determining whether a live poultry dealer has provided reasonable notice to poultry growers of a suspension of the delivery of birds under a poultry growing arrangement; when a requirement of additional capital investments over the life of a poultry growing arrangement or swine production contract constitutes a violation of the P&S Act; and whether a packer, swine contractor or live poultry dealer has provided a reasonable period of time for a grower or a swine producer to remedy a breach of contract that could lead to termination of the growing arrangement or production contract.

The Farm Bill also instructed the Secretary to promulgate regulations to ensure that poultry growers, swine production contract growers and livestock producers are afforded the opportunity to fully participate in the arbitration process, if they so choose. We are proposing a required format for providing poultry growers, swine production contract growers and livestock producers the opportunity to decline the use of arbitration in those contracts that have an arbitration provision. We are also proposing criteria that we would consider in finding that poultry growers, swine production contract growers and livestock producers have a meaningful opportunity to participate fully in the arbitration process if they voluntarily agree to do so. We would use these criteria to assess the overall fairness of the arbitration process.

In addition to proposing regulations in accordance with the Farm Bill, GIPSA is proposing regulations that would prohibit certain conduct because it is unfair, unjustly discriminatory or deceptive, in violation of the P&S Act. These additional proposed regulations are promulgated under the authority of section 407 of the P&S Act, and complement those required by the Farm Bill to help ensure fair trade and competition in the livestock and poultry industries.

In recent years, there has been an increased use of contracting in the marketing and production of livestock and poultry by entities under the jurisdiction of the P&S Act. This increased contracting coupled with the market concentration has significantly changed the industry and the rural economy as a whole, making proposed regulations necessary, especially in those situations in which packers, live poultry dealers or swine contractors use their market power to harm producers or impair private property rights of growers and producers. Transparency, competition and financial integrity of the marketplace have also diminished.

Section 407 of the P&S Act (7 U.S.C. 228) provides that the Secretary "may make such rules, regulations, and orders as may be necessary to carry out the provisions of this Act." Pursuant to this

What's the issue?

- *The P&S Act has two sections different from antitrust legislation which are used in legal proceedings*
  - *"unfair and unjustly discriminatory"*
  - *"undue and unreasonable preference"*
- *The 2008 Farm Bill required GIPSA to more clearly define "undue or unreasonable preference" with respect to poultry and pork production contracts.*
- *GIPSA proposed Rule changes to both sections and with respect to all livestock and poultry contracts – poultry, pork, and beef – and production and marketing contracts. And changes competitive injury.*

Competitive Injury

- *Courts – especially appeals courts – treat the P&S Act as antitrust legislation.*
- *I think it's hard to argue it's not or more than.*
- *Therefore, courts want to see some market impact that injures competition.*
- *The GIPSA Proposed Rules says injury to the marketplace is not required.*
- *I think this is an effort by a Federal administrative agency to expand their responsibilities into areas that are well-covered by state law.*

Competitive Injury

- *"Competitive injury occurs when an act or practice distorts competition."*
- *"Likelihood of competitive injury occurs when an act or practice raises rivals' costs, improperly forecloses competitive through exclusive dealing, restrains competition, or otherwise represents misuse of market power to distort competition."*
- *"To show competitive injury or likelihood of, it is not necessary to show the act or practice effected price levels.*
- *No cost/benefit analysis, no rule of reason, & not even an impact on prices.*

Unfair, Unjustly Discriminatory & Deceptive Practices

- *"Eight specific examples of conduct deemed unfair." So unfair is defined by some examples. But I count seven…*
- *"Paying a premium or applying a discount… without documenting reasons and substantiating the revenue and costs justification…" is unfair.*
- *The proposed rule does not say "contract" when talking about cattle so I assume that means any transaction.*
- *Packer-to-packer trades are unfair.*

Undue or Unreasonable Preference or Advantage

- *"Not offering the same <u>contract terms</u> to all producers that can provide the required livestock is <u>undue or unreasonable</u>. But doesn't require purchases if needs are met. Does require "legitimate business reasons" and "to maintain records that justify" differential treatment.*
- *Prohibits packer buyers from buying for more than one packer. (Small auction market impact.)*
- *Requires sample contracts to be submitted to GIPSA for public posting.*

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 bids.*
- *The easiest way is for the packer to own their own animals – this is what will happen in the hog industry.*
- *The Rule changes can thin the cash market.*
- *Missouri experience…*
- *Changes in beef demand over past 29 years…*

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 will 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"?*

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.*