Prohibition on Beef Packer Ownership, Feeding and Control of Cattle: Comments and Discussion

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Introduction

Farm Bill legislation debated by the U.S. Senate in December 2001 includes an amendment to Section 202 of the Packers and Stockyards Act of 1921 entitled "Prohibition on Packers Owning, Feeding, or Controlling Livestock." The amendment prohibits packers from owning, feeding or controlling livestock intended for slaughter for more than 14 days prior to slaughter. An exception is made in the legislation for cooperatives, if a majority of the ownership interest in the cooperative is held by active cooperative members that own, feed or control livestock and the members provide the livestock to the cooperative for slaughter. Additionally, another exemption is included in the legislation for packers that are owned or controlled by producers of a type of livestock, if during a calendar year the packer slaughters less than 2 percent of that type of livestock slaughtered in the U.S. The legislation would apply to cattle, hogs and sheep, but not to poultry.

The purpose of this discussion paper is to provide background information on changes that have occurred in cattle and beef marketing in recent years, discuss why these changes have occurred, and to outline the likely impact of proposed limitations on beef packer activity on the cattle and beef markets.

What impact would the proposed elimination of cattle ownership by packers have on cattle markets?

Packers own a very small percentage of cattle slaughtered in the U.S. and available data indicates the percentage has changed little over time. Moreover, we are not aware of any published empirical research indicating that packer ownership of cattle has a negative impact on cattle prices. In fact, it's possible that eliminating cattle ownership by packers will make it impossible for some packers operating in deficit production regions to operate plants efficiently, which will raise costs for these firms. Higher operating costs at these plants will, in the long run, be borne primarily by cattle producers in these deficit production regions in the form of lower cattle prices.

The most recent U.S. Department of Agriculture (USDA) *Packers and Stockyards Statistical Report* reports data on packer ownership of cattle through 1998. According to that report, the number of steers and heifers fed for or by the largest 15 packers accounted for 3.7 percent of U.S. commercial steer and heifer slaughter in 1998. That percentage was unchanged from 1997's. At the end of the prior decade (1989) the percentage of steers and heifer slaughter owned by packers was 5.2%. The percentage of all cattle (including cows and bulls) fed by all packers was 3.1 and 3.5 percent of slaughter in 1998 and 1989, respectively.

Packers feed cattle primarily to ensure that they have access to raw inputs to operate their plants efficiently. This is consistent with the relatively small, stable percentage of cattle slaughter owned by packers. Although USDA does not publish estimates of cattle ownership by firm because of confidentiality restrictions, it's likely that packers in deficit production areas own a higher percentage of their slaughter requirements than firms in surplus production areas. Eliminating packer ownership of cattle could make it difficult for firms in deficit production

areas to acquire enough cattle to operate their plants efficiently throughout the year. Failure to operate plants efficiently can raise slaughter and processing costs significantly, as documented by Anderson and Trapp (1999). In the long run, higher costs at plants in deficit production areas are likely to be borne primarily by cattle producers in the form of somewhat lower prices paid for slaughter cattle. Since demand for feeder cattle and calves is derived from the demand for slaughter cattle, a reduction in slaughter cattle prices would also lead to somewhat lower feeder cattle and calf prices. The impact on national average prices is likely to be very small, but the impact on local prices, in some markets, could be significant.

If beef packers are not able to "control" cattle more than 14 days prior to slaughter, what impact will it have on cattle and beef markets?

Packers and cattle feeders use of various marketing agreements that commit slaughter cattle to an individual packer more than 14 days prior to slaughter is much more prevalent than the use of forward contracts. Weekly data published by USDA's Agricultural Marketing Service (AMS) indicates that in the last half of 2001 1.5 to 5.4 percent of weekly steer and heifer slaughter was sold via a forward contract. Formula pricing arrangements, which rely on an external reference price such as a publicly reported local cash market price to establish the base price for cattle, are much more common than forward contracts. During the last half of 2001, the weekly percentage of cattle marketed via forward contracts and formula pricing arrangements ranged from 39.6 to 53.4 percent of steer and heifer slaughter. Restricting or eliminating packers and cattle feeders use of contracts and formula pricing arrangements would clearly disrupt the current cattle marketing system.

Use of formula pricing agreements between packers and cattle feeders has grown dramatically because both packers and cattle feeders find them advantageous. Growth in formula pricing agreements coincided with growth in carcass weight pricing that rewards cattle producers for producing carcasses with desirable quality characteristics and discounts cattle with undesirable quality characteristics. Many formula pricing arrangements use a formula to establish a base carcass price for cattle and then use a price grid to add price premiums for desirable carcass characteristics and subtract price discounts for undesirable carcass characteristics. Cattle marketed via formula pricing agreements that include a price grid are priced on an individual carcass basis instead of on average for the entire pen or lot of cattle. Pricing cattle based on individual carcass merit will, in the long run, facilitate sending price signals originating at the consumer level back to producers. Improved price transmission from consumers to producers will, in the long run, enable cattle producers to better satisfy consumer demand for beef.

One reason growth in formula pricing and grid pricing coincided is that different packers have somewhat different grids. To maximize net returns under a particular price grid, cattle feeders need to adapt their feeder cattle procurement and cattle feeding management practices to produce slaughter cattle that consistently earn premiums via the price grid. As a result, many cattle feeders marketing cattle via price grids find it advantageous to market cattle to the same beef packer over an extended period of time. Once the decision has been made to market cattle to the same packer over time, it makes sense for the cattle feeder to negotiate a formula pricing arrangement that relies on an external price to establish the base carcass price for the cattle rather than try and negotiate the base price each week.

Improving beef demand is the key to the industry's future success. U.S. consumer demand for beef declined precipitously from 1979 through 1998. Two decades of declining domestic demand for beef exacted a high toll on the U.S. cattle and beef industry. Producers responded to the continuous demand decline by reducing herd size and the net effect was a dramatically smaller industry than otherwise would have been the case. For example, from January 1975 (the U.S. beef cow inventory peak) to January 1999, the U.S. beef cow herd declined by about 27% (Lusk et al., 2001). Domestic beef demand improved in 1999, 2000, and 2001 (based on preliminary data) (Research Institute on Livestock Pricing). Some of the improvement in domestic beef demand is tied to offering consumers new, innovative, beef products which consumers find more attractive than traditional product offerings. Future increases in domestic and export demand for beef will likely be tied to continued innovation in product offerings. Stronger linkages between cattle producers and packers will facilitate innovation in product offerings.

References

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Research Institute on Livestock Pricing website: www.aaec.vt.edu/rilp/.