LIMITING CAPTIVE SUPPLY ARRANGEMENTS IN LIVESTOCK PRODUCTION

A BACKGROUND PAPER

by Philip Mattera
Director of the Corporate Research Project

Good Jobs First
1311 L Street NW 4th floor
Washington, DC 20005
(202) 626-3780 ext. 32
pmattera@goodjobsfirst.org

August, 2003

Support for this paper was provided by the Jessie Smith Noyes Foundation.

On January 7, 2003 a bipartisan group of four U.S. Senators -- Chuck Grassley of Iowa, Tim Johnson of South Dakota, Mike Enzi of Wyoming and Tom Harkin of Iowa-- introduced S. 27, a bill to amend the Packers and Stockyards Act of 1921 to make it unlawful for a meatpacker to own, feed or control livestock intended for slaughter. The bill revives a provision that was adopted as a floor amendment to the Senate version of last year's comprehensive federal farm bill, but which faced strong opposition in the House and was not included in the final version of the farm bill.[1] On February 12, Rep. Leonard Boswell of Iowa introduced a companion measure in the House (H.R. 719).

The new bill, like the previous measure, enjoys strong support among groups seeking to protect the vitality of family farms by restoring fairness and competition in livestock markets. On January 21, 2003 a letter to heads of the Congressional agriculture committees signed by 127 such organizations --among them the National Family Farm Coalition, the Western Organization of Resource Councils and the Campaign for Family Farms -- endorsed the ban on packer ownership.

Many of these groups are also endorsing additional measures designed to halt the meat industry's increasing use of captive supply arrangements in which the big meatpacking companies exercise undue control over the terms on which livestock is produced and sold. Hardest hit by the spread of captive supply arrangements are small ranches and family farms.

Along with the packer ban, many family farm advocates are putting their support behind a bill -- the Captive Supply Reform Act -- introduced by Senator Enzi in the last session and reintroduced in May 2003 as S.1044. This measure would require that supply contracts and agreements between packers and livestock producers include fixed price formulas and that these arrangements be conducted in the open. This would prevent packers from pressuring livestock producers to accept secret, one-sided deals and instead would put the transactions into an open marketplace in which all parties would be subject to the same competitive conditions.

Another approach to the issue is taken in a bill (S.325) introduced by Sen. Grassley on February 6 of this year. Written as an amendment to the Agricultural Marketing Act of 1946, the bill is called the Transparency for Independent Livestock Producers Act. It would require that 25 percent of a packer's daily kill come from the spot market. Grassley says that this measure would both strengthen the mandatory price reporting system by bringing more transactions into the open marketplace while discouraging packers from conducting a very high percentage of their procurement through private marketing agreements.

This paper provides background on the industry changes that have weakened the economic position of family farmers and ranchers and created the need for the reforms now being considered in Congress.

INDUSTRY BASICS

The livestock industry -- which includes the production of cattle, hogs and sheep -- consists of three main processes:

- breeding
- feeding (fattening)
- slaughtering (packing)

In the cattle and sheep sectors, the three processes were traditionally handled by different parties acting at arm's length from one another. Ranchers did the breeding on their land. Cattle-feeding operators took over the fattening of animals for several months before they were ready for slaughter. At the end of that process, the cattle were sold directly to beef-packing firms or to agents working for them. Over the past few decades, this arrangement has been changing in various ways. The feeding process is increasingly done by large-scale commercial feedlots, which are often involved in the sale of livestock to packers. Packers and producers are to an increasing extent using arrangements such as market agreements rather than spot (open) markets. See below for more on these forms of what is called vertical coordination.

In hog production, it has long been common for the same operation to breed and fatten the animals. At the end of the feeding stage, the animals in each segment are sold to packing firms for slaughtering and processing. As described below, the percentage of hogs procured by packers from sources other than the spot market has risen sharply in recent years. The evidence shows that for hogs there is a high percentage of direct packer ownership, while in the beef sector, the packers typically exercise their control through marketing agreements.

REINING IN THE BIG FIVE

For both cattle and hogs, changes in industry dynamics have been greatly influenced by dramatic alterations in the structure of the packing sector, the one part of the meat industry dominated by giant corporations. This process has a long history.

Anti-competitive practices in the meat industry have been a problem for more than a century. A federal investigation of price-fixing by beef packers helped to bring about the Sherman Antitrust Act of 1890. The law banned practices such as the apportionment of territories for livestock purchases, but collusion continued among the Big Five meatpackers -- Swift & Co., Armour & Co., Morris & Co, Wilson & Co. and Cudahy Packing Co. In *The Robber Barons*, his classic study of industrial concentration, Matthew Josephson wrote: "The power of the kings of animal food was supreme, grandiose and feudal; sad to relate, like many earlier dynasts they abused it."[2]

In 1917 President Woodrow Wilson ordered the Federal Trade Commission to investigate the industry. The FTC found that the Big Five had a stranglehold on the meat industry, thanks to their extensive control of stockyards, transportation and market outlets.

Soon after the publication of the FTC report, the federal government filed an antitrust suit against the Big Five, which was resolved in 1920 when the packers signed a consent decree. Its provisions required the Big Five to end their involvement in retailing and to divest their interests in public stockyards, railroad terminals and market outlets. These reforms were codified in 1921 when Congress passed the Packers and Stockyard Act (7 U.S.C. 181 et seq.). The main results of the Act were that packers could not apportion territories, that stockyards had to post their rates and that market agencies and brokers were subjected to rules barring unfair, discriminatory or deceptive practices.

The Act created the Packers & Stockyard Administration (PSA) within the Department of Agriculture. PSA was given authority to oversee matters such as prompt payment to livestock sellers, bonding of livestock buyers and accuracy of weighing equipment. It was also empowered to collect data on the industry and to investigate complaints of anti-competitive practices. PSA was authorized to bring administrative proceedings against parties that broke the rules, but it had to refer more serious matters to the Justice Department.

UPHEAVAL IN MEATPACKING

Federal regulation raised the level of competitiveness in livestock markets and allowed ranchers to enjoy a decent standard of living. This stability, however, began to be upset in the 1960s, with the arrival of an upstart company called Iowa Beef Processors (IBP), which set up slaughterhouses in cattle-raising areas and began to undercut the old-line packers, whose processing facilities were mainly in Chicago. The pressures brought on by IBP (which was owned by Occidental Petroleum from 1977 to 1991) helped put the older packers into play during the merger waves that began in the 1960s.

The bus company Greyhound bought Armour in 1970, and after a period of labor unrest in the 1980s sold it to ConAgra (formerly Nebraska Consolidated Mills). Swift changed its name to Esmark, and its meatpacking business was later spun off as Swift Independent Co., half of which was sold to ConAgra. MBPXL, the result of the 1974 merger of Missouri Beef Packers and Kansas Beef Industries, was acquired in 1979 by Cargill, which changed the name to Excel a few years later. Wilson Foods, purchased by the conglomerate LTV in 1967, was spun off in 1981, went into Chapter 11 in 1983. It was then taken over by Doskocil Companies in 1988, which, after a bankruptcy of its own, became FoodBrands America, now part of Tyson Foods, which has branched out from poultry into beef and pork. (Today, Tyson also owns the once mighty IBP, which in 2001 succumbed to a takeover in the wake of scandals relating to its operations and finances.)

This upheaval resulted in a dramatic consolidation within the industry, so much so that a 1991 report by the U.S. General Accounting Office concluded that meatpacking had become more concentrated than it was before the passage of the Packers and Stockyards Act in 1921.[3] This was especially so for cattle. Using data from the PSA, the GAO found that the market share of the four largest beef-packing firms had increased from 25 percent in 1975 to some 70 percent by the end of the 1980s. The market share of the top four firms in sheep and lamb slaughter fluctuated during the same period, but ended up increasing from 58 to 74 percent. The four-firm ratio in hog production, however, remained relatively constant at about 35 percent.[4]

Over the past decade, the concentration has proceeded apace. Here are the latest market share data for the key parts of the meat industry:

BEEF

According to the most recent annual statistical report by the Grain Inspection, Packers and Stockyards Administration, or GIPSA (which was formed by the 1994 combination of PSA and the Federal Grain Inspection Service), the top four firms accounted for 81.7 percent of steer and heifer slaughter in 2000. Back in 1980, the share of the leading four firms was only 35.7 percent.[5]

Another key measure provided by GIPSA is the top four firms' share of boxed fed beef fabrication, which is an indication of the extent to which the meatpackers have moved into the final processing and packaging of meat for retail sale. In 2000 the top four's share of boxed fed beef was 84.7 percent. Twenty years earlier it was 52.9 percent.[6]

GIPSA tends not to mention company names, but a trade publication called *Cattle Buyers Weekly* publishes an annual list of the top beef packers, ranked by capacity. The companies at the top of that list are[7]:

- IBP (Tyson Foods).. 35,000
- Excel (Cargill).. 26,700
- ConAgra.. 20,600
- Farmland National Beef (Farmland Industries)................... 10,000
- Smithfield Foods.. 8,525

(capacity measured in number of head of cattle per day)

PORK

Concentration in the hog slaughter business has accelerated dramatically since the publication of the GAO report in 1991, thanks in large part to the relentless expansion of Smithfield Foods, which has taken over older packers such as Cudahy and John Morrell and built new, state-of-the-art plants. GIPSA data show that the market share of the four largest firms has climbed from about 40 percent in 1990 to 57.1 percent in 2000.[8]

The names of the current industry leaders, ranked by daily capacity are as follows[9]:

- Smithfield** 80,300
- IBP (Tyson Foods).. 71,000
- Swift*.. 43,000
- Excel (Cargill)... 32,000
- Hormel Foods.. 26,000
- Farmland** 25,500

(capacity measured in number of hogs per day)

* In 2002 ConAgra sold a majority interest in Swift to two private investment groups, which are operating the company under the name Swift & Co.

** In July 2003 Smithfield announced that it has entered into an agreement to purchase substantially all of the assets of the pork business of Farmland Industries, which had filed for Chapter 11 bankruptcy in 2002.

Most of the leading pork packers also own a substantial amount of livestock. The overlap is seen in the "Pork Powerhouses" list of the largest producers compiled by *Successful Farming* magazine.[10] Here are the positions of the largest packers among the top producers, ranked by the number of sows owned:

1. Smithfield Foods *.. 744,341
5. Cargill 104,500
11. Tyson Foods.. 70,000
17. Farmland Industries 36,000

* Does not include participation in joint ventures in Mexico, Brazil and Poland.

SAGGING LIVESTOCK PRICES

While the packing companies have grown larger and more powerful, independent livestock producers have seen their market position weaken. This is clear from the trend of prices received by farmers for their livestock. The National Agricultural Statistics Service compiles an index in which the prices in the period 1990-1992=100. For meat animals in general, the index fell from 105 in 1990 to 97 in 2001.[11] There was fluctuation in between, but for the most part livestock producers are struggling to keep up.

Even more revealing is the trend in the relationship between the prices received by farmers and wholesale or retail prices of meat. A paper on the packer ban written last year by John Connor of Purdue University and three other academics [Peter C. Carstensen, Roger A. McEowen, Neil E. Harl] looked at the spread between livestock prices and wholesale prices of beef. They found that since the mid-1990s the price spread has increased sharply, which they noted was contrary to what should be the case in a competitive market. Referring to the fact there are a limited number of buyers for cattle, the authors stated: “Exertion of oligopsony power is the only plausible explanation for the strong upward trend in the F-W [farm-to-wholesale] spread for beef.”[12]

Data assembled by the Economic Research Service (ERS) of the Agriculture Department show that a declining portion of the retail price paid by consumers for meat products represents income received by producers, which ERS calls “farm value share.” ERS found that the farm value share in 2000 was only 30 percent, compared to 46 in 1990 and 51 in 1980.[13] In other words, an increasing share of the money paid by consumers is going to meatpackers, wholesalers and retailers -- and a declining share to farmers and ranchers.

DECLINING NUMBER OF PRODUCERS

The combined effect of increased concentration among packers and declines in livestock prices have served to drive large numbers of livestock producers away from the business. According to USDA’s Agricultural Statistics Data Base (available at www.nass.usda.gov/ipedb/), the number of beef cow operations in the United States has decreased from 1,013,570 in 1986 to 805,080 in 2002 -- a drop of 20 percent. In the same period, the number of hog operations has decreased from 346,090 to 75,350 -- a fall of more than 78 percent.

Those who remain struggle to survive. In his book *Fast Food Nation*, Eric Schlosser paints a dismal picture of America’s cowboys:

> Many of the nation’s remaining eight hundred thousand ranchers are faring poorly. They’re taking second jobs. They’re selling cattle at break-even prices or at a loss…The sort of hard-working ranchers long idealized in cowboy myths are the ones most likely to go broke today. [14]

CAPTIVE SUPPLIERS

The shrinking number of livestock producers find themselves at a distinct disadvantage with respect to the big packing companies. Over the past few decades, the packers have increasingly avoided buying their livestock in open markets and instead have forced producers to enter into forward contracts or marketing agreements. These arrangements, along with situations in which packers do their own feeding or hold interests in feedlots, are known as vertical coordination.

Forward contracts are binding arrangements for the delivery of a specific quantity of cattle, with specified quality, on a particular date. Prices may be fixed when the contract is signed, but usually the parties agree to use a formula based on market prices. Marketing agreements, which may be written or verbal, establish an ongoing relationship between producers and packers. They usually specify quantities over time as well as prices, with the packer generally dictating terms.

According to the most recent GIPSA annual data, 38.2 percent of the total steer and heifer slaughter of the four largest beef packers in 2000 was obtained through some form of vertical coordination.[15] The comparable number in 1988 was 20.5 percent. In 2000 the breakdown was as follows:

- marketing agreements 27.1%
- forward contracts 2.0%
- packer fed cattle 9.1%

GIPSA does not regularly collect comparable data for hog production, but research by the University of Missouri and the National Pork Board found that in 2002 approximately 83 percent of hogs were sold through some arrangement other than the spot market. This was a jump from about 64 percent only a few years earlier in 1999 and about 38 percent in 1994.[16]

A more current source of data for cattle is USDA's Agricultural Marketing Service, which uses slightly different terminology than GIPSA. According to the agency's data for March 21, 2003 (the most recent as of this writing), domestic deliveries to meatpacking plants fell into the following categories[17]:

Negotiated 50%
Formula 43%
Forward contract 7%

THE EFFECTS OF CAPTIVE SUPPLY ARRANGEMENTS

Growing use of captive supply arrangements harm independent producers in various ways. These were summarized in testimony given before the Senate Agriculture Committee last year by Michael Stumo, General Counsel of the Organization for Competitive Markets.[18] Stumo listed three main problems: market closure, market unfairness and manipulation of the system by packers.

By market closure, Stumo was referring to situations in which non-captive hog farmers, for example, have been finding it difficult to get any bids on their output from packers. Market unfairness refers to the fact that large feedlots or corporate hog farms with contracts tend to receive price advantages over smaller, independent producers. Stumo's discussion of manipulation refers to the ability of large packers to use their captive supplies to pull out of spot markets at key times to drive down market prices--and then buy cheaply.

DEALING WITH THE NEW REALITY

Groups representing family farmers and ranchers have been warning for years that increased concentration among the meatpacking companies and the increased use of captive supply arrangements are undermining fair competition in the industry. Although this is an area in which GIPSA is mandated to act, the agency has been reluctant to do so.

The agency's most recent annual assessment of the industry avoids the conclusion that packers are acting in concert to restrict competition. Noting cases in which hog prices have fallen and few packers bid on cattle at certain feedlots, the report states: "These circumstances do not necessarily suggest that firms are acting in concert to restrict competition and instead may be attributable to normal supply and demand forces, competitive bidding processes, or personal relationships that have developed over time between packers and livestock sellers."[19]

GIPSA also adopts a sanguine approach toward the spread of captive supply arrangements. While acknowledging the concerns of family farm groups, the agency says that there are other observers who contend that captive supplies do not affect market prices and that they play a beneficial role. GIPSA avoids taking a strong position of its own by saying that "concerns about the possible effects of captive supplies are complicated by questions about the accuracy of publicly available captive supply statistics."[20]

The bills introduced by Senators Grassley and Enzi represent an effort to get around GIPSA's weak enforcement record by strengthening the provisions of the Packers & Stockyard Act.

The Grassley proposal on banning packer ownership would not prohibit marketing agreements or forward contracts. Critics of the original floor amendment adopted by the Senate had claimed that the ban would outlaw those arrangements, so Sen. Grassley introduced a second-degree amendment making it clear that the word "control" in the provision would not ban all contracts between producers and packers.

Grassley's current bill also provides an exemption for producer-owned cooperatives and packing plants that process less than 2 percent of the country's total slaughter of cattle or hogs. According to an analysis by the Congressional Research Service, this would mean that the ban would affect three beef packers: Excel, ConAgra and Farmland National Beef. (Three other packers slaughtered at least 2 percent of U.S. cattle but they are said not to own cattle.) In the hog sector, CRS found that there are nine packers that own hogs and meet the 2 percent threshold. They are: Smithfield, IBP (Tyson Foods), Excel (Cargill), Hormel, Farmland, Seaboard, Premium Standard, Hatfield and Clougherty.[21]

These companies and their trade associations were expected to be active in opposing the Grassley and Johnson measures--as they were last year when the packer ban was proposed during the farm bill deliberations. The National Cattlemen's Beef Association and the National Pork Producers Council, both opponents of the packer ban, commissioned a report from a research outfit called Sparks Company Inc. that claimed that the ban would cost the meat industry at least $4 billion. Senator Grassley responded by saying, "Anyone with enough money can hire folks to rationalize that pigs will fly someday."[22] Writing in the *Livestock Market Digest*, Lee Pitts pointed out that Sparks, in addition to its consulting role, has a commodity trading arm and a large feeding operation that supplies cattle to IBP.[23]

Smithfield took a more aggressive approach. The company chief executive, Joseph Luter III, took out a full-age ad in a Sioux Falls newspaper threatening to shut down his firm's operations in South Dakota if the packer ban amendment introduced by Sen. Johnson became law.[24]

Opponents of the packer ban will no doubt take heart from a recent ruling by a federal judge in Iowa that declared unconstitutional a state ban on packer ownership that was enacted a quarter of a century ago. But the basis for the ruling was that the law was an infringement of interstate commerce. Sen. Grassley saw the decision as a boost to his bill in Congress: "The court case says that if you are to have a packer ban, you have to have it imposed nationally by Congress and not by the states."[25] The question now is whether Congress will rise to that challenge.[26]

Congress has not yet acted on the packer ban proposals; instead, in the fiscal year 2003 omnibus appropriations bill, it mandated a $4.5 million study of the packer concentration question.[27] However, when GIPSA announced that it was embarking on the research, it shifted the focus from concentration to "a broad study of marketing methods used in the livestock and red meat industries."[28] Proponents of the packer ban are concerned that the existence of this study -- which has no specified deadline for completion -- will be used as an excuse for delaying action. Comments on the GIPSA announcement submitted by Susan Stokes of the Farmers' Legal Action Group on behalf of the Western Organization of Resource Councils and the Campaign for Family Farms argued that "the proposed study is redundant and an unnecessary expenditure of taxpayer money…The action that is necessary to preserve an open, fair, and competitive market is not another study, but rather for Congress to pass the captive supply bill and the ban on packer ownership."[29]

NOTES

[1] A packer ban provision was originally offered in November 2001 by Sen. Paul Wellstone during committee markup of the Senate farm bill, but it was defeated 9-12.

[2] Matthew Josephson, *The Robber Barons: The Great American Capitalists,* New York: Harcourt, Brace and Co., 1934, pp. 286-287.

[3] U.S. General Accounting Office, *Packers and Stockyards Administration: Oversight of Livestock Market Competitiveness Needs to Be Enhanced*, GAO/RCED-92-36, October 1991, p.15.

[4] *ibid*. p.16.

[5] U.S. Grain Inspection, Packers and Stockyards Administration, *Packers and Stockyards Statistical Report: 2000 Reporting Year*, October 2002, p.44.

[6] *ibid*., p.49.

[7] *Feedstuffs*, December 10, 2001, citing *Cattle Buyers Weekly*. We did not have access to the original source. According to the December 6, 2002 issue of *Cow-Calf Weekly*, the most recent edition of the *Cattle Buyers Weekly* list shows the market share of the top five increasing to 63.1 percent.

[8] U.S. Grain Inspection, Packers and Stockyards Administration, *op. cit*., p.47.

[9] National Pork Board, *Pork Facts 2002/2003*, p.25.

[10] "Pork Powerhouses 2002," *Successful Farming*, October 2002; available online at http://www.agriculture.com/sfonline/sf/2002/october/porkpowerhouses2002.pdf.

[11] The 1990 figure comes from Table 798, p.525 of the *Statistical Abstract of the United States: 2002* published by the U.S. Census Bureau. The 2001 figure comes from p. A-11 of *Agricultural Prices: 2001 Summary* published in July 2002 by the National Agricultural Statistics Service of USDA.

[12] John Connor, Peter C. Carstensen, Roger A. McEowen and Neil E. Harl, "The Ban on Packer Ownership and Feeding of Livestock: Legal and Economic Implications," available online at <http://www.econ.iastate.edu/outreach/agriculture/reports/PackerOwnership.pdf>.

[13] The data can be found online at the Economic Research Service website at <http://www.ers.usda.gov/briefing/foodpricespreads/basket/table2meat.htm>.

[14] Eric Schlosser, *Fast Food Nation,* Boston: Houghton Mifflin, 2001, p.136.

[15] U.S. Grain Inspection, Packers and Stockyards Administration, *op. cit*., p.30.

[16] University of Missouri and National Pork Board, "Hog Marketing Contract Study," January 2002; available online at <http://agebb.missouri.edu/mkt/vertstud.htm>.

[17] http://www.ams.usda.gov/mnreports/lm_ct105.txt

[18] Written Testimony of the Organization for Competitive Markets presented to the United States Senate Committee on Agriculture, July 16, 2002; available online at <http://www.competitivemarkets.com/news_and_events/pressreleases/Stumo2.SenateAg.PackerBan.071602.htm>.

[19] U.S. Grain Inspection, Packers and Stockyards Administration, *Assessment of the Cattle and Hog Industries: Calendar Year 2001*, June 2002, p.49.

[20] *ibid*., p.53.

[21] Jerry Heykoop, *Livestock: A Proposed Ban on Ownership and Control by Packers*, Congressional Research Service, January 2, 2003, pp.2-3..

[22] Gebe Martinez, "Livestock Plans Goes to 'Meat Grinder,'" *CQ Weekly*, March 23, 2002, p.821.

[23] Lee Pitts, "Study This," *Livestock Market Digest*, December 17, 2002; available online at http://www.worc.org/issues/famfarms.html#

[24] Rob Swenson, "Smithfield Threatens to Close Morrell," *Argus Leader*, February 4, 2002, p.1A.

[25] Quoted in Jerry Perkins, "Iowans Push for Packer Ban at Federal Level," *Des Moines Register*, January 24, 2003, p.1D.

[26] Some observers have noted that the Iowa ruling may not undermine packer bans in other states, including Nebraska. See, for example, the March 2003 issue of the newsletter of the Center for Rural Affairs at: http://www.cfra.org/newsletter/current.htm#Impact%20of%20Iowa%20Ruling.

[27] PL-108-7, Division A, Title I.

[28] 68 Federal Register 32,455 (May 30, 2003).

[29] Comment letter from Susan Stokes of Farmers' Legal Action Group to Tess Butler of GIPSA, June 30, 2003, p.6