Implications of Banning Packer Ownership of Livestock

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This article addresses some of the issues surrounding Sen. Johnson’s (D-SD) amendment to the Senate Farm Bill (S. 1731, The Agricultural, Conservation, and Rural Enhancement Act of 2001) that would make it illegal for meat packers to own, feed, or control livestock more than 14 days before slaughter. This discussion responds to seven critical questions that have surfaced in the debate concerning this amendment and, more fundamentally, the structure of the livestock industry.

What is control and is defining control important?

There has been much debate about this amendment in the press, and much of the debate centers on the word “control” and its likely interpretation in a court of law. The word “control,” regardless of its interpretation in a court of law, generates serious concerns. While Fuez, et. al. make arguments that this word could eliminate marketing contracts, Harl, et. al. argue that, in a court of law, control would be interpreted as ownership and would not ban marketing contracts. The issue at hand seems to be that the concept of “control” is, in fact, subject to interpretation.

The degree of uncertainty surrounding the interpretation of the word “control” will lead to increased uncertainty about legal business structures and likely increased litigation. These factors will increase transactions costs in livestock industries, making them less competitive against other protein sources in both domestic and export markets. If the natural economic tendency is toward tighter alignment of the livestock value/supply chain, as will be argued later in this article, then packers will move toward tighter vertical linkages without actual ownership, if the amendment is enacted. This tendency to push for tighter alignment may be interpreted as control without a more explicit definition and will most assuredly lead to litigation. Thus, the word “control” should be defined more explicitly in the legislation or eliminated to avoid the uncertainty and the increased litigation that would follow if it is not defined.

Is packer ownership of livestock (vertical integration) driven by market demand?

The U.S. livestock industry is a mature industry that delivers products to a set of customers with rising incomes who demand a more differentiated, higher-value set of choices in their proteins. In addition, the marketplace is increasingly concerned about food safety and the ability to trace any contamination to the root source. This suggests that the market pressures placed on the industry to deliver more differentiated, higher-

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value, traceable protein products are a key driver in the development of tighter vertical linkages in the livestock industry.

A more tightly aligned livestock supply chain allows the industry to be more responsive to consumer needs, providing growth for its products in mature markets. By increasing vertical coordination (whether through vertical ownership or contracting), the industry increases the ability of information to flow quickly and unambiguously along the supply chain (in essence through quantity and quality purchase orders), thereby permitting quick responses to changes in consumer preferences through new requirements and specifications rather than through price incentives alone.

Is packer ownership of livestock driven by cost economies?

The packing industry has large investments in fixed assets that are most economical when operated at full capacity. The best way to assure full capacity utilization and better flow scheduling, and to better match consumer or retailer quantity and quality requirements is to develop tighter vertical coordination. Thus, the industry can improve its competitive position through the improved inventory management that arises from vertical control. In addition, the shared information, learning capacity, and financial gains from vertical coordination may lead to more rapid technological adoption and enhanced efficiencies for the industry. These efficiency gains can lead to more affordable and/or desirable products for consumers over time.

Is producer involvement in vertical integration and contracting related to risk management?

Risk in the livestock industry is another important driver of increased vertical coordination. When markets are less well coordinated, the market signals and production activities may be less aligned. This misalignment can lead to wide swings in inventories and prices, creating a higher degree of variability in income for farmers and packers. Increasing vertical coordination can reduce misalignments that lead to higher variability.

In addition, the sharing of risks and rewards in coordinated systems may be different than in an “open” market. Research has shown that producers producing under production contracts (a form of packer ownership) receive lower returns on average than their “open” market counterparts. However, this same research indicates that the variability of returns for producers in production contracts is substantially lower than the variability of their counterparts’ returns. This reduction in risk could be a substantial benefit to some producers, but this and other risk reduction benefits would be reduced by the proposed amendment if it prohibits production (not marketing) contracts, which is likely.

Do packers use vertical integration to exercise market power?

An alternative argument for the increase in vertical coordination is that packers are exercising their ability to control the price of live animals. This argument contends that packers have market power in the industry and thus can squeeze producers’ margins.
when they are more vertically aligned. Most studies have found little evidence that packers are exercising pure market power in the live animal markets. However, there is some research suggesting that packers might strategically use captive supplies (company owned or contract produced animals) to reduce the number of animals that they purchase from the open market without risking capacity utilization shortfalls; the result of this behavior is lower live animal prices than would have otherwise prevailed on the open market. However, if packers have the ability to manipulate live animal prices, it is unlikely to disappear under the terms of the proposed amendment. If there exists substantial market power, then packers will likely find ways to exercise it via exploitative marketing contracts that fit within the bounds of the proposed amendment. If the problem in the livestock industry is one of market power, and it can be documented, then it is an issue of anti-trust and not one of industry structure. Furthermore, the market power of packers is unlikely to be significantly affected by banning packer ownership of livestock.

**What form of supply/value chain governance structure might emerge if this amendment is enacted?**

Packer vertical integration in the pork and beef industries is relatively small when compared to that of the broiler industry. The latest statistics show packer ownership in beef to be between 5 and 7 percent, while pork is closer to 30 percent. However, more than 80 percent of hogs were marketed through some form of non-spot market transaction in January 2002. And, the incidence of vertical integration in beef and pork is rapidly increasing. Thus, while this amendment would eliminate vertical integration in its purest form (i.e., ownership of livestock raw materials), it is unlikely to reverse the trend toward tighter alignment in the livestock supply chain and re-establish the dominance of independent producers of livestock and open access market coordination between producers and packers.

The argument above is that tighter vertical alignment through ownership and/or contractual arrangements is primarily driven by the need to meet consumer demands and lower cost. If this is the case, it is unlikely that this amendment (assuming control is not defined as eliminating detailed quality and quantity specified procurement/marketing contracts) would curtail the industry’s move towards tighter vertical alignment. That is, this amendment is unlikely to preserve the “independence” of livestock producers.

The benefits of tighter vertical alignment can be obtained through two forms of supply/value chain governance. The first form would be through vertical integration or ownership. This has been the primary choice of the poultry industry, which is widely credited with being more responsive to customers’ needs, and has led to increases in the demand for poultry products at the expense of beef and pork. It should be noted that the poultry industry is not included in the proposed amendment.

Because this amendment would eliminate the possibility of vertical integration (at least, backward integration by packers), the other choice of governance structure to obtain some of the benefits of vertical alignment is through marketing contracts. However, the
economic pressure will likely be to create very tightly controlled marketing contracts with a limited set of “preferred suppliers.” This limited set of preferred suppliers would consist of producers with the ability to deliver the quality and quantity of livestock needed by the packer to take advantage of the economic forces in the market place. The “preferred” suppliers would have an extremely close relationship with the packer and would, in effect, act as an agent or franchisee for the packer, more or less imitating the vertical integration structure.

This change in the structure of the livestock industry is at best a marginal change from the currently emerging structure. While it is likely that this amendment would shift some of the margins in the industry towards producers, it is likely that these margins would be collected by relatively few select producers “hand chosen” by packers. This leaves most other producers in an unchanged situation with limited access to markets and the necessity to sign contracts (albeit with production companies rather than packers) that more or less specify their production practices and who may own the livestock.

Would packers and producers in areas with limited livestock production and only one or two packing facilities suffer?

It seems likely that livestock production in fringe areas could suffer under this amendment. As stated previously, the fixed cost nature of the packing industry requires a high degree of capacity utilization to achieve profitability. In “fringe” areas where livestock production is limited, packers may need to own a portion of the livestock production to maintain an economically feasible throughput in their plants. By eliminating ownership, these plants may have no alternative but to shut down or be sold at a loss. Because of the limited production and packing capacity in these regions, farmers would likely have to cease operations as well. Thus, it would appear that this amendment might favor the regions where production is most concentrated, at the expense of less concentrated areas of production.

Summary

In summary, there is a sound argument that vertical coordination in the livestock industries is driven by changes in consumer demand to deliver high-quality, differentiated products to the market place, and the desire of some producers to improve the risk/reward sharing between themselves and packers. This amendment would simply eliminate one form of vertical coordination for delivering products to consumers and would be unlikely to affect the market power of packers. In fact, the amendment could, at the margin, increase the packers’ market power since it would likely lead to an increase in contracting, placing more of the ownership of specific assets in the hands of producers who would subsequently be in a weaker bargaining position with packers. The new market would be one for contracts rather than for live animals, and with more producers seeking those contracts, the potential for packers to extract price discriminating rents from the producers is not likely to decrease. This amendment is likely to make only marginal changes in the structure of the pork and beef industries with a few large
producers creating tighter coordination linkages with packers and a few limited production areas being eliminated.