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PROCEEDINGS

PRICING AND COORDINATION IN CONSOLIDATED LIVESTOCK MARKETS

*Captive Supplies, Market Power,
IRS Hedging Policy*

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PROCEEDINGS

PRICING AND COORDINATION IN CONSOLIDATED LIVESTOCK MARKETS

*Captive Supplies, Market Power,
IRS Hedging Policy*

Wayne D. Purcell and Karen O'Connor, Editors

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Blacksburg, Virginia, August 1992*

PREFACE

This "proceedings" is a comparison to the April 1992 book Pricing and Coordination in Consolidated Livestock Markets: Captive Supplies, Market Power, IRS Hedging Policy edited by Wayne D. Purcell. That 216-page book was prepared prior to the May 28-29 conference on these issues and was distributed to registrants at the conference.

This proceedings volume provides executive summaries of the chapters in the book and adds the presentations, discussion, interactions, and questions/answers at the conference. It also provides the keynote address delivered by Virgil Rosendale, Administrator of the Packers and Stockyards Administration, USDA.

Each volume can be used independently, but the combination of the two is more effective. In combination, they capture what we know about the issues surrounding consolidation in the livestock industry and offer the challenges we still have in front of us.

Wayne Purcell
August 1992

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SECTION 1

Keynote Address

Virgil M. Rosendale
Administrator
Packers and Stockyards Administration

Keynote Address

by

Virgil Rosendale

Introduction

If we were to search for a single word that best describes livestock industry structural change, that word would be consolidation--a phenomenon that is influenced among other things by economics, economic conditions, and development and application of rapidly changing technology.

Consolidation and trends in consolidation bring challenges and concerns to all phases of the livestock, meat, and poultry industry. In particular, there are concerns over procurement, the use of captive supplies, the development of vertical coordination plans, the number of markets, the number of suppliers, and the ever-present concern for competitive prices, pricing, price reporting, price information, product, product quality, and distribution. Sound, timely, and objective analysis of these issues is vital to all segments of this industry and to society in general.

The Packers and Stockyards Administration (P&SA) is the agency in the U.S. Department of Agriculture charged with administering the provisions of the Packers and Stockyards Act to assure fair trade practices and competitive markets for livestock, meat, and poultry. The programs of the Agency are designed to foster fair and open competition, guard against deceptive and fraudulent practices, and provide payment protection in the marketing of livestock, meat and poultry.

P&SA programs cover the breadth of an \$88 billion livestock, meat, and poultry marketing industry (the Commerce Department's 1991 estimated wholesale value). This changing and dynamic industry accounts for \$65 billion, or 39 percent, of all cash farm receipts.

P&SA major program areas include payment protection, protection against unfair, deceptive, and fraudulent practices, and antitrust activities. Through the Agency's antitrust activities, we address issues related to competition, market performance, packer concentration, captive supplies, and conflicts of interest. These issues can either influence or they can be affected by structural change within the livestock marketing industry.

I would like to talk about two noteworthy matters we are dealing with at the present time: animal care at stockyards and regulation review.

Animal Care at Stockyards

A national TV program on the treatment of livestock at the South St. Paul Stockyards last year raised awareness about care and handling of livestock at stockyards.

Early last summer, P&SA initiated a surveillance level investigative program to address care and handling of livestock at stockyards. Over 500 of the 1,600+ stockyards have been reviewed.

Problems have been found at less than 10 percent of the stockyards. We are working with stockyard owners to seek voluntary correction.

Regulation Review

We at P&SA have expressed interest in a review of our regulations many times. The government-wide "moratorium on regulation" announced by the President during the State of the Union address included a process to review all regulations. P&SA is in the early stages of that review. I think this is a good process that is progressing well. It will take some time to complete.

As we move through the review, anyone who chooses may comment on the proposed regulations or changes. Virtually every P&SA regulation and policy statement will be reviewed from the perspectives of economic impact on society (costs vs. benefits), user friendliness, clarity, duplication, administrative costs, and opportunity for the market mechanism to function.

GAO Study of P&SA

Last fall the GAO released a report on P&SA. While the study dealt with all P&SA program areas, greatest interest was placed on the role of P&SA in assuring fair trade practices and a competitive market for livestock, meat, and poultry.

GAO Recommendation

GAO recommended that the Secretary of Agriculture determine a feasible and practical approach for monitoring the activity in regional markets.

Departmental Response

While we did not agree that defining regional markets is necessary to monitor for anti-competitive practices, we did agree that the structure of today's livestock and meatpacking industries requires an expanded effort for effective monitoring for anti-competitive practices. For this reason, P&SA plans to expand its role in dealing with any competitiveness issues that may be associated with concentration in the industry. As a part of that effort, the Agency plans:

- To establish an information base sufficient to define and analyze regional markets and/or to support action.
- To establish an information base sufficient to:

- predict with a reasonable degree of certainty the effect of industry changes and trends; and
 - strengthen public confidence in Agency opinions and positions on market structure and performance.
- To conduct or coordinate investigative research on concentration/integration and/or industry structural change.

A plan will be developed to provide the most practical and cost-effective way of obtaining the data and analysis needed to accomplish these objectives.

In addition, we must find ways to enhance P&SA's current monitoring activities. Experience has shown that the best deterrent to activities that are violative of the Act, including anti-competitive practices, is the visible presence of the Agency in the industry.

That visible presence is increased by more frequent regional investigations. Implementation of this response will set the direction for P&SA's role to assure competitiveness. The extent of implementation will depend on our ability to reallocate and re-prioritize available resources.

Structural Change

The livestock industry has a rich history of dramatic change from decade to decade. I have chosen today to deal with the more recent history, possible causes, measures of change, and P&SA's role to address and accommodate change.

Industry structural change can mean different things to different people and may be influenced by many factors. There are indications that much of this change may be driven by the presence of narrow per-unit profit margins, by efforts to gain efficiencies, by economies of scale, and by efforts to maintain market share. The effects, however, may be manifested in various ways, including products, product characteristics and quality, production location, plant size and location, firm size, vertical coordination arrangements, and procurement and pricing practices, to name a few. There are other factors to consider: environmental protection, waste management, supply availability, product quality, and systems that recognize and reward quality. These circumstances give risk to differing opinions relative to change.

The visionary sees industry structural change as something happening to the livestock and meat business from conception to consumption. There is also the view that focuses primarily upon structural change in the packer/marketing sector. Others point to production and still others to distribution, including retail activities.

At P&SA, we are particularly interested in procurement and pricing practices and market concentration. Concentration and consolidation are occurring in all phases of the livestock, meat, and poultry business, including production, marketing, and distribution.

I would be remiss if I failed to remind you that consumers will set the pace. The interests and choices of the consumers of this nation and the world will ultimately set the limits. These circumstances place a heavy responsibility upon all involved to know more clearly what is happening so there exists a factual basis from which to operate.

While concentration within the meatpacking industry may have begun in the early 1980s, it accelerated considerably during 1987 and has continued since that time. The top ten slaughterers of steers and heifers during calendar year 1985 merged into five by the end of 1987.

Acquisitions have resulted in the merging of specialized poultry firms with traditional red meat firms. New plants have been built near production, adding to capacity. The industry, without regard for species, finds itself with excess slaughter capacity and excess capacity to produce.

Packers usually seek ways to utilize that capacity efficiently. Consequently, they are using feeding, forward contracting, or some other form of vertical coordination to provide opportunities to assure that a portion of their slaughter needs are met. Coordination arrangements may also be a vehicle for risk management for feeders/producers. These developments have created a greater need for P&SA to review industry structural change and market performance on a continuing basis.

Packer Captive Supplies

Consistent with the aforementioned need, the Agency began to monitor the role of captive supplies and report the level of captive supplies in 1989. Information was compiled from special reports for the top 15 steer and heifer slaughterers each year. We recently released data for 1991.

The 15 largest beef packers' use of captive supplies peaked at 22.4 percent of their total slaughter in 1989 and then declined to 18.9 percent in 1990 and 17.2 percent in 1991. These captive supplies include animals owned and fed by packers and animals they bought under forward contracts and marketing agreements.

The number of animals fed by the 15 largest beef packers has remained relatively constant at 4.5 to 5.0 percent of their total slaughter, while the number of animals they purchased under forward contracts and marketing agreements declined from about 17 percent of the firms' slaughter in 1989 to less than 13 percent in 1991.

Data for the 4 leading beef packers are very similar. Captive supplies declined from about 25 percent of their total slaughter in 1989 to about 20 percent in 1990 and to 18.7 percent in 1991. The 4 largest beef packers obtain about 2 percent more of their slaughter animals from forward contracts and marketing agreements than do the 15 largest packers, but about the same percentage of their volume is obtained from their own feeding operations.

Although packers' use of captive supplies has declined in recent years, important questions will remain until more is learned about what role captive supplies play in livestock pricing and the long-term implications of captive supplies.

Preliminary Inquiry into Captive Supplies Inconclusive

Aware of concern by livestock producers about any impact captive supplies may have on prices, P&SA examined prices paid for cattle by 12 major packing plants between January and June 1990. Clement Ward at Oklahoma State University collaborated with P&SA on this project.

In October 1991, USDA released a program announcement stating that the results of a preliminary inquiry into the effects of captive supplies of steers and heifers on prices paid in cash markets were inconclusive. Economic and statistical analyses of the data did not rule out the possibility of either negative or positive effects of captive supplies on prices paid. It was difficult to separate effects of captive supplies from other factors affecting prices. We did not examine the long-term implications of captive supplies. Of course, P&SA will continue to examine the role of captive supplies in beef packing.

Packers and Stockyards Administration's Role Regarding Mergers and Acquisitions

As I indicated earlier, mergers and acquisitions have played a major role in current concentration levels. Under the Hart-Scott-Rodino Act, firms, including meatpackers, are required to submit pre-merger notification information to the Department of Justice (DOJ) and the Federal Trade Commission (FTC) concerning proposed mergers of meatpackers. The DOJ and FTC have primary responsibility to challenge mergers and acquisitions that may be harmful to competition.

The Agency maintains regular and open communication and exchange of information with the Justice Department on the structure and performance of the meatpacking industry. This is being done to coordinate our activities as we continue to monitor and investigate allegations or appearance of illegal use of market power.

Our work also entails a close working relationship with the Commodity Futures Trading Commission (CFTC). We attend CFTC surveillance meetings when livestock is on the agenda and assist each other, as appropriate, in investigations.

Competitiveness in the Marketplace

High levels of packer concentration have signaled concern for competition in the marketplace. P&SA responsibility extends to anti-competitive practices. P&SA programs and activities that address competitiveness include:

- A weekly fed cattle price monitoring program;
- Use of special and annual reports, i.e., captive supplies;
- Maintenance of an extensive computerized database of the major slaughter plants; (Data include history, ownership, and slaughter figures on each of the plants.)
- Maintenance of effective working relationships with the packing and processing industry;

- Use of inside intelligence; and
- Response to complaints.

I would like to provide some details about the weekly fed cattle price monitoring program. We use this procedure to rapidly identify price abnormalities in major fed cattle areas represented by USDA Market News price series. Sixteen regional and terminal market price series are monitored at 13 different locations.

Cash cattle prices and price movements are highly correlated among the areas. Price ratios are used as the monitoring mechanism. The ratio of each of the 16 price series to a 5-market average price is compared to a predicted or expected ratio.

The predicted ratio is based upon the statistical analysis of the relationship between the individual market and the five-market average during the most recent five years. If the actual weekly ratio deviates from the predicted ratio by an amount larger than expected due to normal statistical variation, the market conditions are examined closely to determine whether there may be unusual forces interfering with normal market relationships.

Regional market prices come from throughout the U.S., including the Northwest, Southwest, as far east as Lancaster, Pennsylvania, and include all of the major beef feeding and slaughtering region.

Packer Concentration Study

In addition to continuing these efforts, the Agency plans to expand the number and frequency of its regional investigations for all red meat species. Currently, we are receiving an assist through funding from Congress to study packer concentration. Congress appropriated \$500,000 for FY '92 to be used to study packer concentration in the red meat industry.

To make the best use of the funds and assure the most important issues are addressed in the study, an interagency working group was established. Participants in the working group include AMS, ERS, NASS, OGC of USDA, plus DOJ, FTC, and CFTC, with P&SA serving as chair. The working group will advise on all issues under consideration throughout the study.

P&SA sought public input by placing a notice in the Federal Register seeking comments on the study. We received comments from 51 individuals and organizations, including 7 meatpacking firms and meatpacking trade associations, 12 livestock producer and general farm organizations, 4 livestock markets and livestock market trade associations, 5 consultants or consulting firms, 15 persons at universities, and 8 other individuals. The most commonly recommended research areas were:

- define procurement markets;
- analyze the price discovery process; and
- examine vertical integration/coordination issues, especially the role of packers' captive supplies of cattle.

Other topics receiving numerous comments include:

- effects of concentration on prices paid;
- the accuracy of price reporting systems;
- costs and efficiencies in meatpacking; and
- entry conditions in meatpacking.

P&SA plans to address the following specific topics, subject to budgetary limitations (other topics may be added if feasible):

1. Regional Cattle Procurement Markets. This project will examine and identify regional procurement markets for slaughter cattle within the continental United States.
2. Effects of Concentration on Prices Paid for Slaughter Cattle.
3. Price Determination in Slaughter Cattle Procurement.
4. Role of Captive Supplies in Beef Packing.
5. Vertical Coordination in Hog Production.
6. Research Literature Review.

The findings of these projects will help P&SA monitor the meatpacking industry, analyze causes and impacts of concentration, and enforce the Packers and Stockyards Act. The findings also will increase public knowledge about the structure, conduct, and performance of the industry.

We selected projects that we believe have the highest priority and also have relatively common data requirements. This increases efficiency in data collection, tabulation, and analysis, thereby maximizing the impact of available funds.

Much of the balance of FY 1992 will be devoted to selecting and defining specific research projects and negotiating contracts with researchers at universities and other organizations. The Agency will begin making plans for data collection immediately, with plans being finalized when contracts have been signed with researchers. Clearances for data collection and actual collection of data will occur in FY 1993. Analyses of data also will occur in 1993. Some results may be available in 1993, but most will not be ready until 1994.

Summary

In closing, many changes are occurring and will continue to occur in the livestock industry. As participants, these changes have the potential to give each of us new direction. Assessing those changes and their complex implications requires continuous analysis and special and objective attention.

At P&SA, we have programs designed to assess market performance, and we investigate allegations or appearances of violations of the Packers and Stockyards Act. We are slowly but

surely strengthening our capacity to analyze developments in the industry. There is much to be done. And while government has its function, it will take the combined and coordinated efforts of many people and organizations to fully examine current and unanticipated relevant issues. We are pleased that this conference is focusing on many of the issues.

Let's recognize that each of us gathered here has a rather clearly defined role or responsibility to fulfill. Each of us has direct accountability to someone who impacts what we do and how it is done.

Let's not forget that what we do impacts the meat business, and let's not forget for whom we ultimately work, namely the consumers of our great nation and the world.

SECTION 2

Economic Implications of a Consolidated Industry:

Captive Supplies, Market Definition, and Buyer Concentration

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OPEN DISCUSSION

WRAP-UP

Clement Ward
Professor, Agricultural Economics
Oklahoma State University

Executive Summary of
Pricing and Competition Issues
in Concentrated Livestock Markets

by

Wayne D. Purcell

The areas to be covered in more detail in the later book chapters are explored in Chapter 1. The broad issue of consolidation of the livestock sectors, especially in beef, that occurred in the 1980s is reviewed and documented. Efforts that have been designed to look at the impact of the consolidation are also reported. For example, the General Accounting Office (GAO) issued a December 1990 report on the impact of the structural change in the livestock sector. The GAO reviewed the available literature and basically concluded that there is no consensus in the research literature as to the impact of a consolidation that has moved the four-firm concentration ratio to 80 percent in boxed beef.

A February 1990 conference conducted by the Research Institute on Livestock Pricing looked at the impacts of consolidation. Much of the attention has been on price, dealing with such issues as the impact of captive supplies on price bids to producers. Discussion during that conference indicated that the impact on costs has not yet been thoroughly reviewed. The substantial declines in the farm-to-retail price spread for beef, after adjusting for overall price inflation, during the 1980s were reviewed. It was suggested that the economies of size from the large firms may be the reason that we saw over a 20 percent decline in that inflation-adjusted price spread during the decade of the 1980s.

Increasingly, the Packers and Stockyards Administration (P&SA) is being asked to monitor the markets for competitiveness. More recently, responding to a congressional initiative, the GAO examined the P&SA programs and concluded that change was needed if P&SA is to do an effective job of monitoring the markets. They were particularly concerned about the lack of a regional definition of cattle procurement markets, for example, and felt that the impact of high levels of concentration can only be looked at in a relatively small regional market context.

In 1992, then, there is increased awareness of a need for a solid base of information. Chapter 1 continues to discuss this broad area of need and looks at the specific areas to be covered in later chapters in the book.

The issue of captive supplies is introduced. This issue was investigated by Kansas State economists working on a subcontract basis with the Research Institute on Livestock Pricing. Basically, the approach has been to explain procurement prices in the fed cattle area as a function of captive supplies, or some measure of captive supplies, plus some other explanatory variables. Purcell discusses the possibility that this approach does not capture any long-term impact on price level. The price data are collected during a fairly short time period and are collected from a market that might already have seen a price level change because the move to captive supplies has reduced the variability in the flow of slaughter livestock and reduced

packers' costs. Graphical representations are offered to suggest how this cost reduction might occur if, in fact, captive supplies allow the firm to operate near the rated capacity of the firm a higher percentage of the time.

The area of market definition was investigated by researchers at Iowa State University operating under a subcontract basis with the Research Institute on Livestock Pricing. The GAO had earlier indicated the importance of being able to accurately define regional markets when they responded to congressional initiatives and looked at the readiness of PSA to be an effective monitor. The need for regional markets was one of their major points.

The Iowa State analysts reviewed various approaches to defining markets including the use of correlation analysis to identify the various geographical areas in which price change in any one area has an impact. This approach has been praised by some analysts and criticized by others, and there is no question that continued conceptual and empirical work is needed to generate a widely acceptable way to define procurement markets. It appears that whatever the solution, plant or firm-specific data is likely to be required.

Past work that combines parts of several states into a procurement region gives mixed results. The implication is clear that such a broad area may be too large and that the aggregation involved in going to a multiple-state area in defining a market may conceal important implications of high levels of concentration. Cattle are not bought on a day-to-day basis in a national market, of course, nor or they bought in a large multiple-state region. There is clearly a need to make further progress in terms of how markets should be defined, and Chapter 2 in the book discusses these issues.

Chapter 3 deals with buyer concentration in feeder cattle auctions. This work was done by Utah State analysts under a subcontract with the Research Institute on Livestock Pricing. A large regional traditional auction (Oklahoma City) and the video sales of Superior Livestock are examined. There is some price advantage to the video sales, but it appears that one can also find evidence of market power in the video sales.

Any conclusion about the presence or absence of market power in video sales should be viewed with caution, however. It may be that the increased specificity in the description of cattle and the tendency to do a better job of identifying value-related characteristics is the reason that what appears to be market power may be found in the video sales. For example, a particular set of cattle that is unusually heavy, unusually light, or unusual in some other way is, perhaps, more nearly going to be identified as such and discriminated against price-wise in the video sale than in the traditional auction.

Electronic markets are clearly going to be a factor in our increasingly concentrated feeder cattle markets, and the video sale is obviously one possibility. There is discussion about the potential of electronic markets to expand the market, to bring in the residual buyer, and to be able to compensate for a smaller number of buyers in a traditional or particular market area. There is clearly much work yet to be done in the area of identifying just what the declining number of buyers in our livestock markets will mean to producers and to the efficiency of the entire livestock system.

Executive Summary of
Implications of Captive Supplies in Fed Cattle Industry

by

Ted Schroeder, James Mintert, Andrew Barkley, and Rodney Jones

Chapter 2 deals explicitly with the implications of captive supplies in the fed cattle industry. The growing tendency to either feed company-owned cattle or to procure them by contract is reviewed early in the chapter, and the seasonal pattern in forward contracting is also reviewed and presented. It was apparent that there is a seasonal pattern, perhaps suggesting that packers try to use contract cattle, packer-owned cattle, or cattle procured via some type of business arrangement (the three categories of cattle that combined make up what is being called "captive supplies") in a strategic way to offset expected shortages during the year. It would appear that packers feel they benefit from the ability to schedule cattle, and cattle feeders may benefit by securing a buyer and perhaps reducing their exposure to price risk.

The primary research in this particular chapter is a report of data collected at the feedlot level across a six-month time period during 1990. The collection at the feedlot level allowed the researchers collecting the data to exercise some degree of control over quality variation. This is important because one would not want, for example, to assign some cost or benefit to captive supplies if it was really related to a quality factor in the particular set of cattle. Early, it is apparent that there is no clear and evident set of implications to contracting. It would appear that day-to-day demand in the cash market will be influenced by contract activity, and one might argue that the demand for cash cattle may be more elastic in the presence of significant volumes of contract cattle. But these and other conceptual implications have to be examined in more detail empirically before inferences on the impact of captive supplies are truly justified.

Having presented the issues, the authors of Chapter 2 present a very useful review of recent empirical results. Three different studies are examined in terms of the impact of captive supplies and how the captive supplies are measured, and the authors report that there is no consensus in the limited number of studies available. This is consistent with the announcement during 1991 by the Packers and Stockyards Administration that after an extensive effort to isolate and measure the impact of captive supplies, they were not able to generate definitive results.

In the empirical study by Kansas State analysts, data were collected on individual transactions from 1,407 pens of cattle representing over 166,000 head of cattle during the period from May through late November 1990. Thirteen feedlots in southwestern Kansas were involved in this particular data set. For each pen of cattle sold, a record was made of the price bids, the feedyard and animal characteristics, market conditions, and the level of captive supplies at that particular point in time. The researchers then proceeded to model the impact of captive supplies by expressing sales price as a function of a measure of captive supplies plus other explanatory variables.

The results indicated a relatively small but negative impact attributable to captive supplies. Over the six-month study period, for example, captive supplies reduced prices in the feedyards from \$.15 per hundredweight up to about \$.31 per hundredweight. Captive supplies were measured either by total contract sales as reported by the USDA as a percent of total Kansas slaughter or, alternatively, as each of these packers' share of captive supplies as a percentage of Kansas slaughter. The share of captive supplies held by each of three packers active in the area was estimated by private industry analysts. As suggested earlier, it was found that the results varied by season of the year, and several caveats with regard to the results of this study are important.

First, it is important to recognize that the results may be sensitive to the market conditions during the data collection period. During May to November 1990, fed cattle supplies were relatively low, and that may have provided a safety net against the application of any packer market power during their efforts to arrange captive supplies. Second, estimates of price impacts of captive supplies are based on only 26 weekly observations. It is always useful, of course, to have a longer time period, but data collection in this particular study was time consuming and expensive. Third, we have to recognize that the results could be sensitive to the southwestern Kansas region. It may be that conditions would be different elsewhere. Fourth, although detailed data were collected on cash market transactions, there was no real knowledge of the prices for cattle that were received in the form of captive supplies. What net price is being paid on the cattle delivered via the captive supplies might be a factor in price on negotiated cash purchases. Finally, the feedlots surveyed were not a random sample. One cannot, therefore, generate the empirical results to the industry as a whole.

The Kansas State study makes a significant contribution to the literature in this area. The database and the time period were both more extensive than earlier studies, and the researchers were able to observe and grade the cattle and, therefore, account for price differences due to quality. A negative coefficient on the captive supply measures indicates price bids do decline as the level of contracted cattle available increases, but the coefficients were relatively small in magnitude. There is no reason, based on these results, to be overly concerned about the price impacts of captive supplies, especially when the potential long-term benefits of the large plant sizes and the related economies of size are yet to be considered.

Executive Summary of
Packer Competition, Forward Contracting Price
Impacts, and the Relevant Market for Fed Cattle

by

Marvin Hayenga and Dan O'Brien

Chapter 3 in the book deals with issues on the impact of the changing number of packers competing for cattle in a state, the price effects of captive supplies via contracting, and the relevant geographic market for fed cattle. A substantial reduction in the number of both firms and packing plants has been observed in Colorado, but less change was noted in the other major cattle feeding states. They conclude that there is no clear evidence that price relationships between states has been impacted in recent years by the declining number of plants in each state considered in the analysis.

It is interesting that the percentage of cattle being sold by large or small feedlots also failed to exert any significant influence on relative prices across states. Thus, neither the decline in the number of packing plants nor the changing size and distribution of feedlots seems to be making a difference in price relationships. The authors suggest that other factors such as the economies and efficiencies in larger plant size may be offsetting any reduction in competition due to fewer buyers in the Colorado fed cattle market.

The authors report several approaches to identifying a price impact of captive supplies. Looking at prices in Colorado, Kansas, Texas, and Nebraska, they conclude there is evidence of a statistically significant negative impact from captive supplies in Texas, while the opposite was true for Kansas, and no effects were noted for the other states. The appropriate conclusion is that there is no significant evidence of widespread downward pressure on prices due to captive supplies as has been suggested by some industry observers.

The authors then utilize several methods to define procurement markets. Exactly what the relevant market is is very important for both legal and economic reasons, of course, and this was the primary thrust of this research.

The authors conclude that overall price behavior in the primary cattle feeding states they examined show a significant amount of integration. The results support the notion that prices are related across a broad geographic area, based on both correlation analysis and more sophisticated techniques. The authors conclude that (1) a state is too small to be considered as a relevant procurement market for fed cattle, and (2) the relevant market may be larger than the normal procurement area for a particular firm, especially because an outside firm can buy at the fringe or in a distant area and send a lagged price response rippling across a broad geographical area. This latter finding appears to be particularly important because it suggests that buyers who normally don't buy in an area can come in and exert an influence, albeit a lagged influence, on prices within a particular market area. If such is the case, the authors suggest the distant buyers probably should be part of the procurement market.

Executive Summary of
A Test for Market Power at Feeder Cattle Auctions

by

DeeVon Bailey, B. Wade Brorsen, and Chris Fawson

Chapter 4 deals with empirical analysis of the impact of market power in feeder cattle auctions. The basic idea here, of course, is that as the industry has consolidated, there are fewer buyers in important feeder cattle auctions. The hypothesis is that as the number of buyers decreases, price bids to producers would decrease as well.

Two markets were analyzed. The traditional large auction in Oklahoma City, henceforth referred to as the OKC market, and the national video auction conducted by Superior Livestock Association, henceforth referred to as the SLA market, were involved. There was some indication that buyer concentration in both markets is highly seasonal. This would be expected. The seasonality tends to mirror the seasonal pattern in placements of cattle in the feedlots seen in USDA data. Large feedlots appear to buy more cattle directly or through order buyers in the first half of the year and the measure of buyer concentration, of course, increases accordingly.

The rather sophisticated analysis presented in Chapter 4 indicates the presence of some negative influence associated with fewer buyers and related market power in both the OKC and the SLA markets. While the results are statistically significant in the SLA market, the magnitude is only \$.05 per hundredweight, so one could question whether or not those results are highly important in an economic context. In Oklahoma City, the impact of buyer concentration was greater than in the SLA market. It is not clear why these differential results presented themselves, but it could be due to the different bidding processes in the two auctions. Bidding, for example, in the SLA auction is anonymous, and bidding is not necessarily anonymous in the OKC market where some buyers are in visual contact with each other. In the OKC market, it would appear that increasing buyer concentration between 1987 and 1989, the study period, reduced steers and heifer prices at that market by a total of about \$.44 per hundredweight.

The authors caution that the impact of buyer concentration could be greater in individual auction sales or in smaller markets. They caution also that we need to recognize that the cattle descriptions, in terms of detail, are perhaps better in the SLA market than in the OKC market. They were able to control for other variables such as weights, sex of the cattle, and measures of quality in the SLA sales but were not necessarily able to provide that element of control in the OKC data. The concern here, of course, would be that the measure of market power or declining number of buyers in the OKC market is actually picking up some of these other impacts that could not be controlled during the analysis. The authors emphasize that concentration may be of concern in smaller markets or for direct sales, and they are especially concerned that if the industry continues to consolidate to an even greater extent, that the ramifications of market power may appear at a more significant level. They suggest, for example, that if a buyer is able to selectively apply market power in separate markets, then the

buyer might be able to have a significant impact on price and exercise more market power in those particular market areas.

Open Discussion

QUESTION - for DeeVon Bailey - I was wondering whether Superior is a national market or is it basically a western regional market?

ANSWER - DeeVon Bailey - The data that we have shows sales from over 40 states during particular time periods and during certain times of the year. It may be more of a western sale or a southeastern sale depending on a particular point in time. For instance, during the fall, you will see a lot of cattle from the West and a lot of calves from the West. During the spring months, you will see a lot of cattle coming from the Southeast. But it is a national market, and, consequently, the data set is very unique. There is not another market that functions the way that it does, with cattle from all over the country and buyers from all over the country. The data set offers unique opportunities from a research standpoint.

QUESTON - Has anyone taken a look at the market for cattle in the Kansas State study that were captive supply vs. cattle sold in the open market? What is the difference in cost or margin per head to the packers on those captive supply cattle?

ANSWER - James Mintert - The answer is no, we did not do that. One reason we did not is we don't know the cattle bought via captive supply and what was paid for those cattle. We don't have any data on what the contracted cattle brought nor do we know anything about what formula price cattle brought in that time frame.

COMMENT - Wayne Purcell - It's an important issue. In my discussions with Ted and with Jim, we talked about the fact that one of the things we need to do here is to find out what those contract cattle actually did trade at. Go ahead and expand on that. You did not have that in the data set, did you?

ANSWER - Ted Schroeder - Yes, but one of the big problems, as Jim mentioned, is that we don't know what those contract cattle are netting in terms of price. I have a strong suspicion that they are probably not the same type of cattle, either. The work that Jim has done in surveying feedlots suggests that different types of cattle are probably going to the contractors. As an incentive, if you've got good cattle, send them through the contract method; if you don't have above average cattle, you're probably going to take a hit using contracts. So, you are comparing apples and oranges even if you did try to compare the prices. Wayne, you probably have more data on that than anybody with the hedging comparisons you've done between contracting and elsewhere. I don't think anybody has been able to tell the differences otherwise.

COMMENT - Wayne Purcell - If I get a question on this that I can't answer I'll refer to Clem Ward. There was a suspicion that the contract cattle were going at a differentially bad price because of basis assignments. Clem and I have worked on these things, and it does appear that the quality is not consistent. It does appear that one type of cattle gets contracted and the other one doesn't. In other words, there is asymmetry involved. You get penalized if cattle don't measure up to contract specs, but you don't get any premiums if the cattle are above specs. So, there is a tendency to put the better cattle in the contracting program. Clem, do you have anything else on that work that we did with surveys that would shed some light on this issue?

ANSWER - Clem Ward - Not really. The only thing I might add is that Jim talked about the packers and feeders being able to negotiate those specs in the contract. We found that when you adjust for transportation costs, hedging directly by the feedlot and contracting with packers are nearly the same. This is a different result than what Elam found in the work he did prior to ours. He had concluded that when you contract, you give up some basis or net cash price to the packer.

COMMENT - Wayne Purcell - Since we got into that issue, is that clear to everybody? One of the reasons we were motivated to do that piece of work was the results being reported in some of the trade magazines which said the contracted cattle were getting a bad basis assignment, i.e., the price was to the disfavor of the producer. What Clem is saying is based on what we could find. We did not get as much data as we would have liked or needed to have, so that caveat needs to be remembered. Once you correct for who's bearing the transportation cost, there was no significant difference between the basis contract cattle as compared to the hedging opportunities or forward pricing opportunities directly in the futures market.

QUESTION - In the Kansas State studies, when you made the presentation, you said that the packer had little influence and that the contracts were not a valid way to influence cattle quality because so many specs were waived or eliminated. I wonder if you looked very closely at the procedure to draw a contract. Do they go into the yard and offer contracts on certain things that they may have an idea are going to be the kind of quality they want anyway? Is there, then, little to gain or lose by waiving the contract specs?

ANSWER - Ted Schroeder - Rodney, maybe you want to add into this since you were involved with that data collection. My initial reaction to that is I don't think the motivation was to try to influence quality by the packer. I think the motivation was to try to influence quantity and that the captive supplies were used primarily for that reason. The way they influence quality contracted is by adjusting basis bids across all cattle, not by adjusting basis bid, by what they suspect quality may be. That is my initial reaction.

QUESTION - So if the packer/buyer goes into feed and the feedyard has 5,000 cattle and the feedyard owner decides he wants to contract 2,500 of them, is the packer willing to let the feedyard make the choice on which cattle he is going to contract?

ANSWER - Rodney Jones - I think it would be subject to some negotiation, but I definitely think feedyard managers have some input into this decision. It is a negotiable point like anything else in the contract.

COMMENT - Wayne Purcell - What he is saying is that it would be the packer and feedlot manager who decide which cattle. The feedlot manager has some power over that.

COMMENT - Ted Schroeder - Wayne, could I add to that. DeeVon asked me a related question up here which was, "Are the contracts which are offered to cattle feeders standard?" What he meant was if some farmer-feeder calls up and says he's got only 300 head to sell versus a large feedyard, do they get the same contract? Based on the limited amount of data, my response to that is no. They do not get the same contract. We have at least some evidence to suggest that the same packer dealing with commercial feedyards within about 75 miles or so of each other was offering written contracts with pre-printed forms that had different specifications regarding

the quality of the cattle. The differences regarding the weight specs, differences regarding the yield grade specs, and differences regarding the dressing percent were a "fill in the blank" kind of thing on most of the contracts. But the other variables are mostly pre-printed in the form. The same packer at approximately the same time was offering or using different contracts with different feedyards. That is based on very small samples and very limited data, but at least we have some evidence of differences.

QUESTION - Was that at the same basis level? Were there different specs at the same basis level?

ANSWER - Ted Schroeder - They were close, but I can't remember if they were exactly the same basis.

COMMENT - Wayne Purcell - That would be important because if the basis level changes, the specs would change. One of the things that I think we can probably say, Clem, with regard to this effort, is that we looked at the basis assignments in contracts compared to what you could have done by forward pricing directly. It was difficult to find data on the contracts. Part of it is that maybe some people were reluctant to give it up. But I think more importantly, they just don't have it. I think a lot of what we're talking about here are things the guys from Kansas State would agree that we haven't done yet. We need to be alert to the fact that those data may not be out there and publicly available. If they have any information on contracting, it's in a cardboard box over in the corner. The pen close-outs are computerized, and never the two shall meet. In order to get at some of these issues we have to recognize that there are some data issues that are going to be involved.

QUESTION - for Marvin Hayenga - A lot of the studies in recent years have been criticized because you say you cannot look at a national concentration ratio. But I thought I heard you say that the fed cattle market comes a lot closer to approaching the national market than not. Did I hear you say that, and if so, how would you respond to some of this past criticism?

ANSWER - Marvin Hayenga - I'd like to go to the last part first. It looks like the regional market may not quite approach a national market, but keep in mind we had prices in Arizona, California, Washington, Colorado, Texas, Nebraska, Kansas, Iowa, and Illinois. There was nothing to speak of east of the Mississippi. It looks like we have to include at least the major cattle feeding areas in what we call the "market." Suppose there was a plant on the edge of Colorado. The question is whether they can buy a plant in Illinois. Let's have them buy a plant in Illinois. If you had such a firm and it was a maverick, trying to control things, it would be creating all kinds of havoc and force any cartel to not work effectively. That is the basic definition being used when you start looking at what's the appropriate relevant market in anti-trust discussions. The next question is what is a specific market? More broadly, what's happening in terms of the concentration? The two are related but not exactly congruent. For states or regions, you have a whole bunch of them and you end up with a much wider cross-section and with time series data sets. You get a lot more observations and a lot more statistical degrees of freedom. If you lump all those together, there are a lot fewer observations. You are much less likely to get enough variability over time in prices and still be able to account for all the other things and be able to isolate a price impact of structural change.

QUESTION - Wayne Purcell - I don't think I get exactly what you are saying, but I picked up the implication that concentration measured at the national level might be okay. Is that true?

ANSWER - Marvin Hayenga - It might be okay because price behavior, etc., would probably be highly correlated to the big region.

COMMENT - Wayne Purcell - That's what was bothering me; you haven't fixed it yet and resolved my uncertainty.

COMMENT - Marvin Hayenga - I may not fix it. I don't know. I don't know for sure that using the national concentration rates will be appropriate. It might be good enough, but I don't know.

QUESTION - When you were talking about the definition of a market for anti-trust purposes, it occurred to me there is another definition of markets for merger analysis in terms of whether a firm can sustain certain types of price changes. For example, a price decrease over a certain length of time within a region might be a major determination in merger decisions. How do you think that the region you defined would fare in a test like that?

ANSWER - Marvin Hayenga - Well, first of all in merger questions like this (and really I think it is not just a merger question), I think you are really looking for more potential competition.

QUESTION - I am, but I am also studying the definition in a much broader sense.

ANSWER - Let's take one at a time. I think there is a 5 percent increase in price called for in the Justice Department merger guidelines. Let's say, instead, that there is a decrease in procurement price for fed cattle. Let me pursue that and give you something to think about. If a packer, in this case, were talking about dollars per hundredweight, 5 percent of the full price of a steer is how many dollars a head? Around \$45 per head. Is that a good figure? If I were a packer and could get \$45 more profit per head on every steer that I ran through in a year, how much return on investment would I have? A 1000 percent return? You have to look at it from a profitability standpoint as opposed to a price percentage standpoint because they turn over the inventory so fast in the packing industry that dollars per unit of sale is ridiculous as a criterion. We need to come up with an entirely different criterion to help define market power and the capacity to sustain a price change. So basically, I say let's toss that ability to sustain a 5 percent price change out completely because it makes absolutely no sense in the fed cattle market in the short run, and it may not make any sense in the long run. I don't know where they came up with that number in the first place. I think relative to profitability, we need to do what is required to encourage somebody to enter a particular market. When you start talking about making a 30 percent return on an investment, there are a lot of you that will start getting together on a cooperative basis and start investing and building up clients to get into that business. If I go to 25 percent, you still might be interested. That's the kind of criterion we need to be using as a guideline and then work back from that. That is a more reasonable criterion than the current one.

COMMENT - Wayne Purcell - The reason the 5 percent price decreases talked about here comes up is that they were written into the merger guidelines and presumably were used in the 1980's to decide on some of the merger requests. It wouldn't surprise some of you if I were to say that

I think the safety net against excessive market power, the 1984 merger guidelines, has holes that are big enough to drive a semi through.

Do you want to pursue this issue or do you want to go to another one?

QUESTION - About the same issue, part of the price data that you are looking at has been the fact that the cow cycle increased prices. In general, when we come into the part of the cow cycle where packers are not going to be scrambling for cattle, not many of us are going to be scrambling for feeder cattle. I think we're going to have an entirely different ball game. I am not sure what is applicable today is going to be applicable in the future. I am really interested in your perspective on when the packers scramble to keep their lines running, what is that going to do to price? How about when they don't have to scramble because numbers are cyclically higher?

ANSWER - Wayne Purcell - Let me give that a little bit of context because I think it is a very important issue. We've said in other settings that in situations we've seen in recent years with relatively limited cattle (remember we've gone from 132 million head in 1975 down to around 100 million head), that we have excess packing capacity, and we are building more capacity. What you are saying is that we now have a safety net in front of any market power that packers might want to wield to the disadvantage of producers in the form of limited cattle numbers. You might ask, when the numbers of cattle come back to a higher level on a cyclical basis, then what will happen? Is that a fair paraphrase?

QUESTION - That is fair. I want to ask how to fix the contracts. In the future is the packer just going to offer you a basis contract? What about quality specs when the cattle are more plentiful?

ANSWER - Jim Mintert - I don't think any of us knows the answer to that question, so let's just talk about some possible scenarios. If the primary motivation for packers forward contracting cattle today is what Ted described a few minutes ago--an attempt to secure numbers--one possible scenario under an expanding slaughter supply would be simply for the packers to reduce the amount of contracting they do. This would put us back in a situation not unlike what we have experienced in the past. I don't know if that is going to happen or not, but I think that is one possible scenario. Now, let's give Ted a chance to answer. Let's see if he has some other scenarios, but I think that would be one possibility.

ANSWER - Ted Schroeder - One of the things that Jim is concerned about is that if we do see a substantial increase in cattle numbers over the next couple of years, what typically happens when you see an increase in supply is that margins for both packers and retailers increase. If I were in Jim's shoes as a livestock marketing economist, I would be concerned that increased margins would be construed as a result of concentration and not a cyclical phenomenon. The next part of the cattle cycle is where we should see an increase in supplies. That means packer margins and retail margins should get wider based on economic theory. A lot of that "getting wider" may get attributed to concentration. The question to researchers is how to separate out the two effects?

ANSWER - Wayne Purcell - I hear what you are saying. It makes the model specifications extremely important, doesn't it? You don't want to indirectly attribute the increased margins

to rising levels of concentration when it actually, in a simplistic sense, is due to increases in the supply of cattle. That makes what type of analytics we use and what type of methodology we apply very important.

ANSWER - Jim Mintert - Going back to the original question, I am not sure that the kind of increases that we are likely to see in cattle supply will really be sufficient to make any significant change in packer capacity utilization. I see the possibility of a 1 to 2 percent increase in numbers for a few years, or something like that. If producers haven't expanded by now, you are not going to see much in the very near future. So, I think the basic premise here is that there is going to be a lot more cattle, and there is going to be a much higher percentage capacity utilization. I see a big plant in Lexington (Nebraska) that is killing a lot of cattle where they did not have any before. I don't see that same thing likely in the next two or three years unless you see different numbers than I do. So I basically disagree with your premise, and I wouldn't really worry about the other implications because I think cattle feeders are going to continue to try to compete and keep their margins to a pretty low level. It is a perfectly competitive market out there and the cattle feeders, and particularly feeder cattle producers, are going to continue to be the tail of the dog. When things are good, they're going to be very, very good, and when they are bad, they are going to be horrible. I don't see very much change in the next ten years. I would suggest that with the contracting question, in the cattle business, the quantity side of things has been a primary motivation for security for the packer. Quality has not been there yet. I think in the next decade, that's going to be the major change that you need to start thinking about. They will start to contract for quality as well.

COMMENT - Marvin Hayenga - I just did a survey of pork packers, and they haven't done much contracting. Compared to the cattle industries, it is nil. If you talk about where the change is going to be taking place over the next five to ten years, pork is where the action is going to be. It's going to be quality driven more than quantity driven (not exclusively), but quality is going to be the primary motivating factor in many cases. I think that is logically going to be happening as you get more into branded beef merchandizing programs and more Japanese export business in the beef business as well. Quality is going to become even more critical than it has been in the past. You can't just trim off the mistakes. I think that is the area that is going to be particularly important to the beef industry. It will have to deal with a lot more factors than it has before in terms of controlling the genetics and controlling the feeding so you end up with a lean, but edible, animal compared to the dukes mixture we have out there now.

COMMENT - Wayne Purcell - That is a good point, Marv, but just don't lose that other point. One of the things that I think we need to do in this session is to put some footprints on some methodological issues. I sense in the discussion that we need to be very careful in analyzing the two changes, concentration and cyclical swings, in getting at price impacts. Just don't lose that point, especially those of you who might end up being involved in this analytical arena.

QUESTION - Wayne, I just want to raise a methodological issue that goes back to your initial model that you put out at the start of this session and I think everyone is using today. That model seems to be a model where the dependent variable is price paid by packers. The hypothesis is that concentration in the industry, either at the packer or feeder level, is leading to some depression of those prices. I guess I might admire coming up with what might be the alternative hypothesis, that hypothesis being that if you have concentration you could actually

see some fattening of profits. I am wondering if anyone has taken a look at profits rather than price? I thought I'd get Marv looking into that area but he did not get very far. I think that is what we ought to be looking at: profits rather than price.

ANSWER - Wayne Purcell - Let's see if we can get into that a little bit. From my perspective, I think it is a perfect question because we are concerned about what margins might be and what return on investments might be. In many instances, those are very difficult data to get. It doesn't mean, for example, that during the P&SA's research initiatives they could not get that type of data.

QUESTION - for DeeVon Bailey - Do you know of any piece of work that has dealt with the profit issue? I think the data basically are available at the firm level.

ANSWER - DeeVon Bailey - Yes, that would be my point. We would love to work with profit rates if we could in this particular industry, but profit data are not publicly available. You have publically available prices, and that is probably why we have worked more with prices than we do with profit levels.

COMMENT - Audience - What I am hearing from all of you up there is that when you look at prices, the results of high levels of concentration are pretty indeterminant.

ANSWER - DeeVon Bailey - Really, I think the optimal way to analyze this would be to look at a fully integrated system. You have a situation where you have a great deal of difference between costs for some producers. The beef industry may not be able to become a broiler industry or even a hog industry. Certainly, what they have done is recognize we do have this large disparity in costs that exists between one producer and another. The way we can survive is to try to eliminate that disparity by increasing efficiency. To do that, you basically have to have cooperation up and down the channel. What I think I see happening is some recognition that we have to have more cooperation between the feedlots and the packer. That is obvious when you see what is happening in captive supplies. We will see more cooperation via contracting. Hopefully, that is the way the industry is moving to stabilize quantity and quality. The problem I see in the future is quality, not just quantity. The only way you are going to be able to get at that sort of issue is to have more cooperation up and down the channel. I don't know if some sort of profit-sharing scheme would be the eventual way to deal with the need for coordination, but I think profit would be probably the best way to look at conduct and performance. Performance is occurring in the channel, but we just don't have the information.

QUESTION - If that information is not available, is there any evidence that people are rushing to get into the industry?

ANSWER - Wayne Purcell - When you start talking about whether people are rushing into the industry, you get into one of the arguments that was used by the Justice Department in the 1980s: the notion of contestable markets. Basically, the contestable market theory says we don't have to worry about anything in terms of concentration and size as long as a new competitor can come into the marketplace. The argument in the literature states that they can come in, and if there is excessive profits or exploitation, they can come in and reap those profits for just a few weeks, or even months, and exit the industry again. I have to say I have a little trouble buying that theory. One of the examples I heard used up in the halls in Washington,

D.C., was the Rocco effort to move into lamb slaughtering in Northern Virginia. I had that one tossed at me when I raised some concerns about the theory, and they said we've got an example in lambs where a new firm can come in. Well, the new firm came in and lost about \$30-40 million in about a two-year period and got out. I am not sure what that proves. I am not sure that we've got a safety net of protection because a new firm can come in. One other point is, and I'll pass it down the table, there is a perception, of course, that because we're dealing with commodities, there are no barriers to entry. I think that is totally wrong. There are tremendous barriers to entry into boxed beef activity, for example. The large firms may not have branded products, but they certainly have differentiated services, networks in communication and distribution systems, quality control, and quality guarantees. I can imagine it will be very difficult for a new firm to come into boxed beef. Anybody on the table have anything to add to this discussion?

ANSWER - Marvin Hayenga - Let me respond to the profit question that you raised. One of the letters that got written to the P&SA was one that I wrote. One of the things I suggested is that if they want to monitor what is going on, they ought to at least monitor profitability measures. I guess I've never seen that done. Secondly, if you take a look at the studies that have been done, particularly in the livestock and meat industry, nothing has been related to profitability per se at almost any level. In many cases, profits are looked at in terms of what happens with regard to supply response at the feeder or primarily at the cow/calf level. Let me just point out to you, though, that there have been some more aggregate studies that tried to get at that. Remember when the Federal Trade Commission had their line of business reports back in the mid-70s? There were studies that tried to look at the line of business reports on a fairly aggregate basis. I am sure some of those dealt with profitability and margins to some extent as opposed to just price. Secondly, you might want to refer to a book written by Leonard Weiss at the University of Wisconsin. He put together a summary of the plethora of concentration and performance studies that had been completed by industrial organization types on a whole variety of industries over the years. I don't recall the specifics anymore, but I can refer you to that particular reference.

COMMENT - Ted Schroeder - I just want to make one comment. Is profitability really the relevant question here? Welfare is the question and profitability and welfare may not be necessarily related. If you get more profitable but you are also more efficient, that should be a net gain to society. So, I personally have problems with the profitability discussion. I don't think that is the relevant issue any more than what we are already looking at in terms of prices, but that is just my perspective.

COMMENT - Audience - I think what you're looking at is some measure of producer surplus in profitability and profits. Also, with regard to profitability of producers or packers, I am uncertain as to which profitability you are concerned about.

COMMENT - Wayne Purcell - Before we move on to some related issues, let's make sure of what has been said here. There is an implicit hypothesis that captive supplies have had a depressing impact on price. I would offer an explicit hypothesis that it may have an increasing impact on price due to increased efficiencies and lower costs. We haven't studied that yet. Concentration may have reduced cost enough to have pushed price bids higher. I don't think any of the guys here who have done the work are disagreeing with me on that. I think that in your Kansas State study, when you made the presentation, you said we still need to look at the

cost side. When we get the P&SA call for proposals and people respond, then maybe we'll do something about that end.

COMMENT - Audience - I just want to throw out a comment which concerns me a bit when I hear three words used in the same sentence: profit, monitor, and government. The government can't even monitor their own ledgers, let alone private industry, so we need to be a little careful. Wayne, one of the things that concerns me is that when you talk about profit and price, you're leaving out a third variable that is really germane to the whole evaluation. I am especially concerned about what P&SA does when they start to do their own evaluation. There is a thing in there called price value (that's "purchasing jargon" for things that don't show on cents per pound). It relates to things like price certainty or prices that reduce risk, and we see some of those in the pork contracts. I am really concerned that when you do your evaluation, you look also at the non-price factors that are involved in these contracts because if people are entering into them, I doubt that they are doing it solely because they are coerced. The packers may see an advantage in assured supply, and the feedlot people may see an advantage in knowing the buyer and, perhaps, the price ahead of time. They may choose, over time, to participate in quality programs, and to do a price analysis without looking at that segment would be flawed from the start.

QUESTION - Someone mentioned concerns over whether there are enough observations to research these issues. What are they referring to?

COMMENT - Wayne Purcell - What he is asking is do we have enough contracting going on? If not having contract prices is a barrier to good analysis, should we think about trying to get those prices? Can we get them? I don't know if anyone up here can answer that or not. I bet there is someone in the room that can. Anybody have any comments on that?

ANSWER - Marvin Hayenga - Let me offer a speculation. That is the kind of thing that automatically comes to mind because you are talking about a market for contracts in addition to the direct markets that everybody knows and loves. That is what we are probably going to get more and more into, a market for contracts of various types. It might be production contracts where there is a fee for services, or it might be marketing contracts. The same packer was offering different contracts to different people at the same time, according to the Kansas State analysts. Now when you start multiplying that by packers and by different areas, how are you going to concisely report all of the important economic variables that are specified in the contract unless you require standardization of contracts, which I would avoid like the plague? Let me report one study that they tried to do in Wisconsin about ten years ago. AMS was asking whether we should report contracts for vegetables. All of you are familiar with production contracts for vegetables. What's different about vegetables and hogs or cattle or whatever? They went out and actually selected those particular contracts, looked at them all, and they had a time trying to come up with anything that was comparable that they could reasonably report. But that is where you have to start to see if you can come up with enough similarity or commonality that you really could report.

QUESTION - Is there an offer price in the contracts? Why not just report those?

ANSWER - Marvin Hayenga - Well that's fine, but that's why you need to report the basis. That's the important part. If you were offered another basis contract by somebody else and if

you were a cattle feeder, you would have information so you wouldn't end up hurting yourself in the negotiation. All market information does is provide some equity in terms of information for both parties in the negotiation. It also gives some data to economists who know and love that kind of stuff and use that for the basis of their existence.

QUESTION - I know it is hard to report the going rate except that feedlots are cooperating on the cash market basis by fax or whatever. Are they doing a similar thing in this contract market for the exchange of that information as it becomes available?

COMMENT - Wayne Purcell - That's an interesting question. Do we know of feedlots that are exchanging information about contracts?

ANSWER - Ted Schroeder - I guess I can respond in one personal observation that we've seen in Kansas. We've seen some cooperative marketing that has its roots, not in explicit written agreement, but in implicit cooperative methods of providing live cattle to a given packer. We've seen these situations in Kansas. But I'd like to continue with the previous discussion on price reporting. We have the problem in terms of price equaling quality already in the live market. It seems to me we ought to be able to get into at least some sort of proxy basis that contracts are trading at. We should be reporting some sort of basis, and I think that is a very important thing, especially when we talk about getting information to the smaller producers that aren't in a communication network.

COMMENT - Clem Ward - I have a lot of confidence in AMS, and I don't think there is any question that we or they could figure out a way to report the complicated nature of contracting in basis. I think that is a mechanical kind of thing that we could do. The problem I think is that most of the contracting is being done by just very few packers and by large feedlots. AMS's policy on cash price reporting is that they have to give conformation, and I don't think they can get conformation from the large packers and the large feedlots. Many feedlots cooperate in terms of reporting deliveries, but they won't participate in reporting prices and basis data. That is the same kind of problem we ran into in trying to collect some of this data. They either don't have it, don't want us to have it, or they don't want anyone else to know what it is, and I don't think they are going to tell AMS.

COMMENT - Audience - I'd just like to add one comment on that. I think it is getting to the point where a lot of feedyards are large enough that they also have market power, and as a result, they don't want information made public either.

COMMENT - Clem Ward - You're exactly right. If neither side wants to report this information, we're the only ones that care, right? I think that's right. If neither side wants to report it, it's going to be hard to get the information.

QUESTION - I have a couple of questions. First, following up to the gentleman next to me on the captive supply issue, he raised an issue that we talked around here but really haven't addressed. We talked about the effect of captive supplies on price, but I haven't heard anything methodologically about how to address factors affecting quantity that is kept in captive supplies in certain places--the quantity that producers choose to put under contract.

ANSWER - Wayne Purcell - Let's deal with that one before we get to the second one. What you're essentially saying is that the emphasis has been on captive supplies as it might impact price. Your point is to ask about what drives the decision on quantity of cattle to contract?

Yes, we don't understand that basic question. How, then, are we going to fully understand this effect on prices, it's long term effect?

ANSWER - Ted Schroeder - I agree with you but I think it is a two-stage decision. First, there is what determines when we're going to place cattle on contract. Secondly, what are the terms when we're going to pull them off and slaughter them. Those are two separate decisions with two separate sets of individuals who are the major role players. I think in the first decision, cattle feeders have more of a choice. Both have choices initially in terms of when they contract, so it is a supply and demand question essentially. When are you willing to supply contracting, and what are the people demanding contracts going to do? So that's just trying to build a model. I am not sure what it looks like. The shorter-run scene, though, is complicated when the packer decides to pull the cattle off the showlist or, in this case, the captive supply list instead so it is a two-stage decision.

QUESTION - Wayne Purcell - So the critical issue here is the packer's decision about whether he buys off a showlist or whether he pulls from captive supplies and how he makes that decision?

ANSWER - Ted Schroeder - Yes, that is the short-run issue. Clem has done work in terms of surveying what the long-run motivations are for the packer and the feeder to enter a contract, and that is essentially the decision you are talking about. I believe it is more interesting to work on what drives the decisions over time. I think a lot of it is just packers' anticipation of the kind of market they're going to be facing.

COMMENT - Wayne Purcell - There are a number of things in this entire complex that are at odds with each other.

COMMENT - Marvin Hayenga - Remember, they're not all basis contracts. Some of the flat price contracts relate to futures, and it then depends on when the profit opportunities are present in the futures market. That has made an influence in terms of when a feedlot is going to be hedged. A packer doesn't care what the particular price is at a particular point in time or what the initial basis levels are because they are going to hedge anyway. As long as the basis behaves well at the close of the contract, they are pleased. They don't have any better price, necessarily. They usually try to have their contract operations at least on a break-even basis so the guy running the contracts doesn't look bad compared to the guy who is buying on the live market. The primary thing, I think, is that the flat pricing it is going to be related to what's being offered in the futures, how it looks relative to what they think the price is actually going to be two, three, four, or five months down the road, and whether they can lock in a profit or not. I haven't heard that mentioned yet as a major behavioral force. I think that is certainly one of them.

QUESTION - Wayne Purcell - Clem, what do we have, roughly 75 percent of contracts that are basis and 25 percent flat price?

ANSWER - Clem Ward - It's about 2/3, 1/3, based on one year's observation.

QUESTION - Wayne Purcell - About 2/3 basis and 1/3 flat price. Is that about what you guys in Kansas would estimate?

ANSWER - Jim Mintert - We don't have any data, but I would guess based on our experience in Kansas that a higher percentage would start out as basis contracts.

COMMENT - Audience - I don't think it is a safe assumption that contracts are always 100 percent hedged.

COMMENT - Marvin Hayenga - I didn't say they were. Packers tend to be short-term speculators at times just like grain merchandisers, elevator operators, and virtually anybody else.

QUESTION - Marv, in your discussion of relevant markets, there is one dimension you did not discuss at all. Would you care to discuss that? That is product definition: steers vs. heifers vs. boxed beef.

Wayne Purcell - I'll paraphrase that if you didn't pick it up. He's saying that our discussion did not really deal with the problem of steers vs. heifers vs. boxed beef, etc., in talking about market definition.

ANSWER - Marvin Hayenga - That's true and it is an important issue in some situations, but basically it depends on the kind of question you are trying to answer. Most analyses that have been done have been related to the concentration on the steer and heifer side. This is because the large packers tend to concentrate on steers and heifers to the exclusion of cows and miscellaneous livestock. However, there are a few packers that kill both steers and heifers and cows. They're clearly substitutes in some cases. I think the product market questions aren't that terribly important. It's basically the species that are separated, but then within the species, I don't really think there is much difference. I am not sure that too much would be gained by trying to delve into the product definition issue in detail. Upon further thought, I might change my mind, but that would be my first inclination. Anyone want to add a point?

COMMENT - Wayne Purcell - Yes, I am going to add a point by dealing with one other question, and we're then going to ask Clem Ward to come up with a cogent, brief, and brilliant summary of what we've heard this afternoon.

QUESTION - I'd like to add one question about the Kansas study. On your conclusion based on statistical figures from captive supply measures, did you interview feedlot operators about their overall perceptions of captive supplies on the market?

ANSWER - Rodney Jones - We got pretty mixed perceptions from feedyard management in our study. Some absolutely hated contracting or any other form of captive supplies. There were others who just loved it. I guess most people were somewhere in the middle and had mixed feelings about captive supplies.

Wrap-Up

Clement Ward

First of all I would like to commend Wayne for this, the third, of these conferences since the Research Institute on Livestock Pricing was formed. I think they have accomplished a number of things. They've raised awareness of some of the issues that need to be addressed. Here today, we've provided a stimulus for some additional research work. I look forward to the one in 1994, or perhaps 1995, when we have some of the results back from the Packers and Stockyards Administration (P&SA) study and any other pieces of work that happen to be started at the same time.

I want to make a couple of comments relative to the discussion today. It seems to me that increasingly our findings in the research is that there are small negative price impacts from increasing concentration and the moves to captive supplies.

I think the emphasis should be on small, and that raises the question of how important they really are, which goes back to the issue of what is significant. Is it economically significant or is it statistically significant? In my recent American Journal of Agricultural Economics article, I looked at this issue. Over a 1-month period, the big 3 packers paid \$.20 per hundredweight lower prices than their competitors for cattle purchases in the Southern Plains. There are lots of caveats you could make about that piece of work. That \$.20 may or may not be important. The point that I want to make about that is if you take \$.20 per hundredweight, some people will say that relative to a \$75 market, or maybe higher at that time, that is not really very important. Why even mess with this? But when you look at it from the standpoint of profits, will \$.20 per hundredweight sustain you? If that number is correct, that is about 20 percent of the average profit per head from the feedlot for an 11- or 12-year period based on industry data that Jim Trapp used at Oklahoma State. If you take that \$.20 per hundredweight, \$.20 per head approximately, and relate that to a 1 percent return on sales, which we say is an average industry profit rate for the packing industry, that is about a 25 percent increase in profitability. Again, what is economically significant and what is statistically significant may not always be the same.

The other thing I think we have to talk about is that in a lot of these models we're explaining 60, 70, and 80 percent of the variation in the prices, which means there is quite a bit of unexplained variation. Our models may be misspecified to the point that the \$.20 per hundredweight may be from something else, and it may not even be an accurate figure. Despite the fact that we try to take into account a lot of the factors that affect price, we may or may not always get that done. I think that what we have to date, and we've talked about that today, is we've had a lot of different models using different data, and we're getting different results. Even though there is some thread of similarity over time as a result of these studies, mixed efforts are what we're doing. We're looking at an inconsistent set of studies. I think what we need to do is find a much more consistent methodology and a more consistent way to monitor the market. That's what P&SA is interested in, and it is what I think they ought to be interested in.

One of the things that I think needs to be done is take a look at some of these different models, apply them to the same set of data, and see whether or not we get consistent or inconsistent results. Marv did a little of that in the Colorado study but not to the extent that we need to do it. I think we have a serious data aggregation question and a lot of questions that need to be addressed. What should we be looking at, transaction prices? I argue that one of the places that you are going to find differences from captive supplies and concentration is going to be in transaction prices. Transaction prices are very difficult to get. I am convinced, based on the recent work that I've done, that I won't be able to get those data. Probably no one will be able to go out and collect the kinds of transaction price data that we really need for some of the same reasons that Ted talked about. We can't get all the information that you need on captive supply concentrations given all of the quality factors that affect prices. So do we look at daily prices, weekly prices, or annual average prices? A lot of the studies that have been done have been using average annual prices. I have a problem with that. It seems to me that every time we aggregate to another level, we're losing information that may be very important. But I don't know what the actual price observation is that we ought to be using. As has been mentioned a couple times, I worked with P&SA on a study a year ago. I can't talk about that study, but I will say that one of the things we did when we got the data is that we looked at some plants. I was really impressed at the amount of variability in numbers from plant to plant, from day to day, and from week to week. Again, every time you start aggregating, we're losing information. In the study that I mentioned was recently published in the AJAE, the results found that for the big 3 packers when I aggregated and put all the packers together, I got different kinds of behavior results. Again, every time we start aggregating we may be losing a certain amount of information. So, what should we look at? Plant level? Firm level? CR4 or big 3? Or should we look at the entire industry? I am not sure, but I think we need to address that issue.

We talked here today about some of the problems relative to time periods. The work that I did was probably the shortest, one month long. We've had the Kansas State study, which was a six-month project, and then we heard suggestions of going up to several years. In annual average data, then, you almost have to do 15 to 20 years in order to have any kind of reasonable analysis. Again, what should we really be looking at? What is a relevant time period, and how do we deal with this whole question of relevant market area? We can look at one market, as DeeVon is doing with Superior, or we can look at a few counties as I did and like Ted and the guys at Kansas State did. We can look at states and individual states as Marv did. We can look at regions or at the entire U.S. I don't think we really know what the relevant area is that we need to be addressing. Again, based on some of my work and what I think I have heard others say, every time you aggregate, we're losing information. We have to resolve that. The more we aggregate the easier it is to collect data; the more we disaggregate, the more difficult and more costly it is, and so probably there is some happy medium in there. I am not sure we know exactly what it is.

Two years ago in my talk, I argued that we needed to look at both the horizontal and vertical aspects of competition. What we've heard this afternoon, and if you read these chapters in the book, what you will see is that most of the time we either look at the horizontal or the vertical impacts, and we don't look at both. I'll go back and say that what I said two years ago may not have been right in terms of proposing some kind of a measure, but I think we've got to look at a sort of matrix. I think we need to look at a combination of horizontal and vertical flows or arrangements, and all of our studies so far have either looked at only the horizontal or

only the vertical. The Kansas State study has come closest to looking at both. I think Ted and Jim would agree that they did not really look at both because of the time frame.

I'd like to talk about something else that came up, and that is the question about increased supplies. We may yet find significant negative effects from concentration and we need to take that into account in our studies. We had a discussion relative to how to separate the impact of concentration from the impact of a cyclical increase in supplies. I am not so sure that it is absolute supplies. I think Marv touched on this and hit it on the nose. It isn't absolute supplies of cattle that are most important. To me there are two elements: one is demand, which we haven't talked about today, and the second one is supplies, relative to industry capacity. I think we've had a very poor demand picture. I think most would agree with that based on the data in the past several years in the beef and pork industries. Demand for beef has not improved, which tends to keep a lid on the retail price level. Packers can't push up prices, causing them to have to focus more and more on costs, which they've been doing by capitalizing on scale economies in plant and in multi-plant operations. Also, it means that if we have those large plants, we have to keep them operating at high rates of utilization in order to achieve those economies. The way we do that is through numbers. It again goes back to the rationale for captive supplies; it is part of a numbers game. You must keep enough cattle or hogs through those plants in order to keep average costs as low as possible and to be as profitable as possible. I don't think, therefore, that it is just an increase in supply that we need to think about. I agree with those who aren't talking about major increases in supplies anyway in the next four or five years. It probably is going to have as much effect if we have a pretty significant excess capacity in the slaughtering/processing industry. Some of those plants out there are pretty old. If they are replaced, we all know that they are going to be bigger than they are now. Close a 250,000 to 500,000-head plant and replace it with a million-head plant of cattle. Close a million head-per-year hog plant and replace it with a 3 or 4-million head-per-year plant. After that, even though numbers in an absolute sense may increase, numbers relative to industry capacity may not change enough to have an adverse price impact.

I think very soon we have got to move beyond just doing these independent studies as I mentioned. We have to go to the next step and talk about policy and what we're going to do about this. It's very nice to put up a series of studies and say we found this, this, and this. A lot of congressmen are going to be asking, producers will be asking, and packers are asking: So you found this, so what? What are you going to do about it? I think we've got to address that, start coming up with some answers, and not turn back the clock. We're not just going to one day say we're going to react throughout this industry. That kind of thing doesn't happen very often, and so we need to be thinking in terms of what are some relevant policy alternatives to address this if, in fact, it is a big problem. Also, I think there are some economists and some people in industry, and maybe I am in this group, that feel like we won't be happy as economists until we find some dirty laundry out there. We're going to keep doing these studies until we find something really bad about somebody or some group. I think we've got to be very careful about that. I think we have a public responsibility to work in this area. It is an area of concern to a lot of people. We need to make sure that we maintain our objectivity. Positive findings saying that the industry is competing in a competitive-like manner is just as good as finding a result that shows some kind of non-competitive pricing. I hope that both of those kinds of work would be equally publishable, and I am not so sure that is the case. So I would offer that as a caution in what we're doing.

SECTION 3

Industry-wide Issues of Coordination

Wayne Purcell
Director, Research Institute on Livestock Pricing
Agricultural Economics, Virginia Tech

Fred Knop, Former Editor
Drovers Journal

Jack Maddux, President
Maddux Cattle Company

Rodger Wasson, President
Marketlinks

Dell Allen
Excel Corporation

Tom DeMott
Safeway

OPEN DISCUSSION

WRAP-UP

Fred Knop

Introduction: Industry-wide Issues of Coordination

by

Wayne Purcell

Just to be absolutely blunt about it, beef, pork, and lamb have for a long time been losing the battle for market share, and they continue to lose. Without belaboring the evidence, I think anyone who has thought about the industry would recognize that. Let's deal, then, with some background for this section.

A general charge was extended in writing to the distinguished gentlemen you see in the front of the room. The charge suggested that when we're dealing with this issue of market share, the industry may not be as progressive, competitive, tough, and efficient in the battle for market shares as it could be. I am talking about the meats industry now as it competes with poultry, seafood, etc. This charge is true for beef, pork, and lamb. One of the reasons, we charged, is that the industry is characterized by a number of profit centers along the continuum from producer to consumer, and each of the profit centers has its own agenda and is motivated by short-run profit objectives. The result is that there is no coordinated effort to enhance the performance and competitiveness of the industry as a whole. That is a harsh statement and a tough "charge," but it was designed to get a point across.

For a long time now, I've been endorsing and talking about the possibility that we might need some type of an oversight group with an accepted responsibility to look at the industry as a whole and generate an assessment of the industry in terms of its performance and effectiveness and make an annual state of the industry report. This is not intended to be a group that would compete with the existing industry institutions. Rather, the idea is to have a group that comes together with some broad perspective in terms of experience and just looks at what is going on in this industry as a whole. I think the idea that we've perpetuated is that we have these separate profit centers, that instead of having an assembly line that starts at the bottom and finishes with a product at the top, we have adversarial attitudes along the "line." In theory, those at the top see what the consumer wants and then make sure it gets produced and offers price incentives back down through the system. But the theory does not always work out in practice. We often have a loose and unholy marriage of five or six different profit centers and different objectives.

That is the reason that I've been arguing that maybe we need a different approach and a group that looks at how we're doing as a whole. Fred Knop has agreed with that. We have talked about the issue from time to time, and across the years this idea has been thrown out and discussed, including the Dallas conference over two years ago. We wanted to put together a session this morning that deals with this issue of industry coordination from bottom to top. We have four distinguished people from the industry who deal with some of these issues. We are going to present as we did yesterday and then we will have discussion. With that background, I am going to move out of the way and let Fred Knop come up and coordinate this session through the discussion period. So, think about what these issues are, see whether or not you agree with us, see whether or not these talks are current in orientation, and be ready to get at our presenters in the discussion session. Thanks, and welcome Fred Knop.

Background, Purpose

by

Fred Knop

There are a couple of reasons why I am here. Number one, as Wayne just said, we have discussed this matter of industry coordination and what is really being done about it over the years. When he asked me to moderate this session, I leaped at the opportunity. My other motivation is my concern and love for the red meat industry and, as editor of a cattle publication, of the cattle industry in particular. It is a great industry comprised of great people. I am concerned about what is happening to the share of market of the red meats, particularly beef.

Look back to the peak year of production for beef, the 1975-76 period. In 1975, beef's market share was 44 percent, pork's was 36 percent, and broiler's was 30 percent. In 1975, beef's market share was 44 percent, pork's 22 percent, and broiler's 19 percent. By 1985, beef's share had shrunk from 44 percent to 36 percent, pork's was at 24 percent (it was an up year for them), and the broiler's had risen from 19 to 26 percent. By 1990, beef's share was down to 30 percent, pork's was 22 percent, and broiler's 31 percent. A few years back at a national conference, we had a panel, and some predictions were made. The broiler industry felt that by the year 1995, beef's share would be down to 25 percent, pork's would be at 25 percent, and broilers would have a 32 percent market share. It's not the only part of the horror story that we need to give attention to. Per capita consumption of beef, which has been the big loser, dropped from 94.5 lbs. in 1976 to 78.5 lbs. in 1986. In 1991, it stood at only 67 lbs. In the meantime, while nominal prices have gone up, real or inflation-adjusted prices for beef were lower in 1990-91 than in 1976. An alarming share of beef carcass has gone into low-value ground beef.

I've only been a full-time journalist for the last ten years. Prior to that time, I spent 25 years in industrial marketing where I saw the figures that I have just given you change and watched the reduction in the beef herd from 132 million to 100 million. There has been a drop-off in the numbers of producing females, but a relatively constant total beef supply has been maintained, at least through 1986. I get concerned because one of the things that we have done during that period is mongrelized what was a 3-breed herd way back to a herd that has, by some estimates, 70 breeds in it today. That's not good. I look at the industry by comparing it with the industry that I worked in, in industrial markets. If this were the U.S. Cattle Company or if this were any industrial corporation in America, we would have a very structured existence. We would have market guidelines that would show us an understanding of consumers. We would have product development research being done. We would identify and characterize competitive products. We would have raw materials procurement and acquisition for the product we're going to sell, and there would be specifications to guide that procurement. We would have raw materials quality control that came into play before we ever made a product. We would have production that would be cost efficient. We would have production quality control to make sure the product produced was safe and effective and within specifications. We would have a marketing department with responsibility for developing strategy and tactics for selling that product. We would have promotion, advertising, and communications all intended to

maximize savings. We would have an effective distribution department that would effectively service the trade and do so efficiently. We would have a sales department equipped with the tools that it took to sell the product on its own merits and to optimize our market share. Above all, we would have a finance and accounting department that would control the whole process from a financial standpoint and make profits.

Now this is not an industrial company--it is an industry. Beef, pork, and poultry are industries that compete with each other. But if you look at it in terms of what the situation would be if it were the U.S. Cattle Company, there are some things we do very well, and there are some things that we don't do very well at all. The market research in the last ten years has helped, and we have an understanding of customers that we have never had before. We've done some product research that has been particularly strong in the area of identifying and characterizing competitive products. We have put a lot of money in promotions and advertising. Regardless of what you think of that effort, there is pretty good research to show that it is paid a good deal of attention to by consumers, although beef's share of the market continues to drop. I think you can put a question mark by distribution from the standpoint of its effectiveness, efficiency, and sales. Certainly in the areas of raw material production, raw material quality control, production costs, and control of the product coming out, we're not doing much in a coordinated way. That may be what we need to focus on today.

When Wayne and I discussed what we might do this morning, the thought on my mind seemed to be to have a try at doing a "state of the industry presentation," at least a state of the industry in four key areas. We have speakers prepared to do that for us.

Our first speaker will be from the live animal side, and this will be Jack Maddux, who is President of Maddux Cattle Company in Wonida, Nebraska. We have here a very able and prominent member of the production sector. Jack graduated from Colorado State University in 1953 and served in the military as an air force pilot. Jack has served this industry and agriculture nationwide through the National Cattlemen's Association, in particular, and has traveled extensively taking the message of better management to producers. He served on the NCA task force that looked at concentration and integration in the packing industry, a task force which went beyond that focus to look at beef's competitive position relative to other meats. One of the very important things that Jack has done is to serve on the task force last year on the standardized analysis system for beef cattle operators, which I think has begun to be a highly important efficiency tool as we go down the road. Jack was NCA Cattle Businessman of the Year a number of years ago and deservedly so. I could go on and on about Jack and the honors that he has received nationally and within his state, but please welcome Jack Maddux. Jack will deal with the "state of the industry" at the producer level.

State of the Industry: Production

by

Jack Maddux

The cattle business is winding down one of the longest and most profitable periods in my memory and I think in anyone's memory. All the segments have been profitable most of the time. We had some problems with the dairy buy-outs in the mid-'80s, and we've had some problems with feedlot weights this last fall. But generally speaking, most of the industry has been profitable since the mid-'80s. The packers have had some problems as they brought their mega plants on line. They've had some overcapacity, but they're working through that and they've had some profitable times, too. Coupled with that, we've had declining inflation; costs are easier to keep under control than they were. We've got our cow numbers in line, which helped a lot, and all and all we've been making some money. We've been profitable, and we've gotten along pretty good the last five, six, or seven years. I think that has made us all complacent; I think it has made us fat and happy. I think it has led to a euphoric feeling of general well-being that sometimes borders on arrogance. I have a haunted feeling as I think about the heyday of the lamb industry after World War II when they were profitable and were making money. They were losing market share, but they were doing pretty well. I wonder whether our brethren there may have had some of the euphoric feelings that we have today in the beef business.

Now, I want to talk first of all about some old news. I want to talk about the NCA, beef industry concentration, and the concentration/integration task force. That was a politically motivated kind of thing. NCA looked around and said we have some people out there that are raising questions about concentration or integration. We want to look at it, we want to do it right, and we're willing to put some resources into it; and so they did. Now I am proud to have been a part of that effort, and my friend George Sullivan over here was on that task force. I think he will confirm to you that it gave us a view of the industry we just couldn't have gotten any other way by being able to talk to whole segments of the industry and by being able to have some insight as to how the industry works. I think that it was a wonderful experience to be able to look at the industry from an outsider's perspective. Chuck Lambert, who is here today, was our exceptionally competent staffer who did lots of leg work, and I have a good feeling about the task force report.

I want to tell you about a really interesting part of it. We looked at cow/calf producers, cattle feeders, packers, and retailers. We looked at big ones and little ones. We did the West and the East. We even looked at the chicken industry. We went down to Atlanta and talked to those people and got a feel for what they were doing and how they were doing it. We talked to some swine integrators that were doing some integrating in the swine business. We looked at what their competitive position was and how they were controlling costs and genetics and those things. What was particularly interesting were the packers.

I want to tell you about the packers. What was a very interesting thing, first of all, was that the three big packers were very cooperative. They didn't send just anybody; they sent the CEOs. CEOs came to Denver one at a time, not all together, for they were concerned about

antitrust problems. They came separately, they all came into Denver, and they brought their people along, their staff and public relations people. I'll tell you something about the Chief Executive Officer of a major packer. They did not get there by being bashful. They came to tell their side of the story and they did it. They did it pretty well, and I think they convinced us that they were an exceptionally competitive business. They had some problems laying up enough numbers for those mega plants that were coming on board, serious problems. It is a good thing they had their public relations people there because they talk pretty straight. The public relations people had to smooth it out a little bit. They did a good job; I think they convinced us of their positions.

The most interesting thing was the second tier of packers, those people underneath the big 3. There are about half a dozen or ten of them. They are there, and they have a segment of the market. We issued them an invitation to come to Denver and talk to us and to tell us about their problems. The first thing that happened was nothing. We did not even hear from them. They did not even want to come. They said, "No, we're busy, we can't do that." After a lot of arm twisting, we talked to all the western states' packers and asked them to come because we had talked to other people. Finally, we had four of them show up. Interestingly, they were a little bit different breed of cats. They did not wear their hard hats and smocks when they came in, but they brought their packing house language. First, they told us about their segment of the business and so forth. We kind of gently suggested to them (beating around the bush a little) that NCA has a lot of political clout and do you guys think maybe you need a little help in competing against those big 3. Don't you need some help? Maybe we can go to the Justice Department and get you some help to compete against those big 3. Their answer was not only no, it was hell no. "This is our business, and we don't want you fooling with our business," they said. One of them put it extremely well. He said, "If we're not smart enough to find a niche in the market that we cannot or will not fill at a lower cost than the big 3 can, then we don't deserve to be there. I'll bet you they (the big 3) all came in here on a corporate jet." He said, "You know, I came in the 'cattle car' with 150 people on that airplane in coach class." He said they could compete. The big 3 have corporate overhead that we don't have. He said, "If we can't compete, if we can't do it more economically, find a niche that they don't want to or can't fill, then we ought not to be in the business. We just might as well not be there." I'll tell you that it was kind of a heart-warming thing to have those entrepreneurial free market people come in and tell us that they could take care of their own business.

Now, a major part of that study went outside the beef industry, and we found what we thought were some world-class economists that were outside of our business. We wanted them to take a look at our business and tell us what they saw. We purposefully did not go to a land grant university because we wanted some outsiders. We wanted some people that had credibility, and we said to them take a look at the beef industry and tell us what you see. Now the answer came back (it was slightly slow in coming). I know you guys are all economists. Like all economists, the first thing was 50 or 100 pages long, took 3 months longer than it was supposed to, and cost more money than it was supposed to. It came out a big thick thing, but the message in that 50-150 pages could have been written on the back of a business card because it was a very short and simple message. It said, you are losing market share at an alarming rate. The reason you are losing market share is because your costs are too high. Very simple statement. This conclusion has been independently confirmed from some studies that have been done inside the business. I think it is common knowledge. Now the important point of my story is not what they said or what happened. The point of my story is what happened after the report

came out. We put a lot of time and effort in that concentration and integration report. Our message was that the free market system is alive and pretty well and that it is going to continue to be, but our costs are too high, and we've got to address that issue. Now most interesting is what happened when the report came out, what I call the "conspiracy buck." You know what the conspiracy buck is? He's the guy that, when the market takes an adverse turn, says the Merc has got to give those speculators some profit. You've heard of them, those people that think every adverse turn in the market is a conspiracy of some kind or that the packers are going to take over the beef business. You've heard it. I've heard it a thousand times, but let me tell you, they came out of the woodwork when that report came out. Now NCA, as strong and as good as it is, is a political organization. You know it is based on representation of politics, and when all of that came out, the Board of Directors of NCA said this is too hot of a potato to peel. Why don't we just let it go. We have it out there, but it is politically too tough to handle. So they did not adopt it. It is probably in a drawer someplace up in Denver. I think Chuck and some of the staff people got it out, took a look, and designed some programs around it about being competitive and so forth.

So my point is that there are some real perception problems out there in the production end of the beef industry. I think the bottom line to that is at least some of the leadership of the beef production segment neither comprehend the nature nor the magnitude of our competitive problems. Those people who say there is room for everyone, regardless of their cost structure in beef production, are blowing smoke. Let me give you an example of that. There is a guy back there in the middle, Larry McQuatters, who runs HyGain feedyards out in western Nebraska. If not the best, it is one of the best feedyards in the state of Nebraska and, I think, in the whole U.S. I think you could compare the feed conversions, the cost of grain, the death loss, any way you want to compare feedyards, and he has a good one. McQuatters is down at that feedyard seven days a week. If you stop in there late Sunday morning, Larry will be in there seeing if everything is going right. He runs a tight ship, and it is a good one.

I want you to contrast that for a minute. We have a little range feedyard or a farmer feed yard, 3,000-4,000 head of cattle, and we do a pretty good job. I try to get sound information, and we keep our conversions in line. But the next \$125,000 feed wagon I have to buy, I have to think about what I ought to be doing. I'll be putting \$125,000 in a feed wagon that I can use 4 or 5 hours a day, when Larry McQuatters has one he uses 12 hours a day. If the day comes that we can't take our little unique advantages in our little operations and be competitive with Larry McQuatters, we're going to send our cattle over there. We've already sent a few over just to keep ourselves honest. That is the kind of thing that we've got to get across to people. If your cost structure isn't right, you've got to reorganize your assets. I think the government was wrong when in the '70s and '80s they put the Farmers Home business administration people out there and said we're going to keep everybody down on the farm regardless of the cost structure. What they did was take some people who had some equity and made them spend it all and go bankrupt because their cost structure wasn't in line, and they could not compete. They did a terrible disservice to those people who lost what equity they had. That is a different story, however, and I won't get into it.

I want to look for a minute at some of those changes and perceived changes that have taken place in the industry. We've made some giant strides in productivity. These are rough numbers just to illustrate the point, but they are reasonably accurate. In the '70s, we had around 120 million cattle around, and we produced 23 billion pounds of beef. In the '80s, we had only

108 or 110 million cattle, and we produced 23 billion pounds of beef. In the '90s, we had only 100 million cattle, and we produced about 23 billion pounds of beef. You can say it another way. In the '50s, we produced about 260 pounds of beef for every cow in the country. In the '60s and '70s, it was 440 pounds, and we come up to the '90s and we produce 526 pounds of beef per cow in the U.S. today. We can be kind of proud of that. I think this parallels the rise in the Beef Improvement Federation, the bull test stations, that statistical wonder of expected progeny differences (EPDs), and the introduction of growth genetics from the European breeds.

These are a lot of important things, and they all help to see where we are today. But the problem with this great leap in productivity is that it was also helped along by some one-time, unsustainable structural changes that we won't be able to take advantage of in the future. An example is the beef-dairy mix. Dairy cows have been going down for 30-40 years, and as you get a change of mix, you get more production per cow, more beef per cow. We've had a decline in calf slaughtering. Calf slaughtering was a big deal in 1960, but it is inconsequential today. That made a difference in our productivity, in how much meat we're getting from a cow. We've got more imported cattle in the mix than we've had before. Every time you import a steer from Mexico and bring him in here, it changes that number a little because there was no cow coming along with him. That adds to the productivity per cow. With the growth in large feedlots, we've increased the turnover rate. It's higher than it was before. Most of these types of things are used up. They are not going to help our productivity a great deal down the road. The problem is that our competitors in other portions of the feed business have made orders of magnitude more in progress on costs than we have. That is not a very good message.

Now, how are we getting along with our product? How are we getting along in consistency, size, flavor, and tenderness of our product? Everybody talks about how you are getting along with that issue. Let me tell you about a friend of mine. A friend of mine describes the cattle business in a metaphor. He said it is like a great big funnel. We pour things in from every part of the country. We take a little hair-ball calf from the Western Desert that weighs 300 pounds, and we pour him in the funnel on one side and process him down through there. Then we take Brahma crosses from the South and we pour them on another side of the funnel. We take those good Charlois-Angus cross calves from the Northern Plains and we pour them in another place, and we take those milk fat and creep-fed 800-pound calves from the Mid-West and we pour them in another place. All of us take our heiferettes and we pour them in on the side; we don't really tell people. We take those three-year-olds and we pour them in here and there just so we can kind of get rid of them and maybe make a Choice, kind of just sneak one by. So we've got this big funnel, and we're pouring all this stuff in there. Down at the bottom is a very small hole, and out of that hole we expect, out of all that stuff we poured in, a 750-pound yield grade 2 U.S. Choice carcass to come up continually. The funny part is how many of that kind do come out of that hole. I think it is a tribute to the industry that out of this great funnel, more than half are U.S. Choice, and 35 to 40 percent of them are YG2 or better.

Before you get the idea that I am an optimist, I am going to change my tune a little bit. Let me tell you that it isn't good enough by a large margin. You only have to look at the results of the national beef quality audit to see that. I don't know whether you've looked at the audit or not, but if you haven't, you should. In my judgement, the bottom line is full of concerns. The first and most critical is the estimate of quality losses per slaughter steer or heifer due to problems, defects, or shortcomings. Nonconformity of some kind was \$270 per every head

slaughtered in the U.S. in 1991. Now what if that number was wrong? What if it was twice too high? What if it was only \$125? Same story. It is a cost that we cannot afford. Worse yet, in the audit their analysis was that almost \$200 of that figure was excess internal or external, trimmable fat. Almost \$200 of that \$279 was fat! Secondly, and perhaps the most interesting part of the audit, was the contrast between an audit done 17 years ago and the audit done last year. The truth is we lost ground in both yield grades and quality grades. We lost ground; we have higher yield grades today, and we have lower quality grades than we had 17 years ago. This is zero progress, and it's worse on the external fat. Seventeen years ago external fat averaged about .59 inches on each carcass. We got it worked down so that it is .58 today--great progress. We're really going to beat those chicken people up!

Now, I think you asked me to talk a little bit about the seed stock industry, and because this leads right into that, I think the implications for the seed stock industry are pretty obvious. I think that their focus on show ring standards, frame scores, and large mature size have been extremely counterproductive. We now have a national herd of giant, long-legged, meatless wonders traveling the show circuit. Before you laugh too much, some of the land grant universities have to share some culpability in perpetuating this fraud in the industry. In some places there is kind of an incestuous relationship between university and show business or show ring people. You judge my show, and I'll judge your show. I would ask you university people, when you go back to your university, call up your dean and ask him if this is an institution that is based on scientific method and objectivity, why in the world are we sending rhinestone cowboys around the country trying to place cattle in a show ring when they ought to be placed on the racetrack or whatever they are? I think that the dean might agree with you. We're fortunate that there are some purebred people out there that haven't paid any attention to that stuff. Most of the commercial people haven't paid much attention, so we've got the genetics to do the things we need to do. I think one of the problems is to go back again to the university and the extension people. The extension people go out to a county fair, put one of those giants up, and kind of illustrate to producers out there that they want large, mature size. I don't think that is right, and we ought to do something about it.

I want to go back to the universities for just a minute. I think this attitude comes about: The chairman of the finance committee down at the state legislature gets on the phone, takes a cigar out of his mouth, gets a hold of the chancellor or the dean over there, and says, "Dean, my constituents are having some problems out there. Some of them are going broke, and some aren't making any money. Those folks out in the cattle business out there are having some problems. You know, I just wanted to tell you that we're just marking up your budget this week, and we're going to take good care of you over there at the university just like we always have. But I have a little problem." He takes a puff on his cigar and says, "Let me tell you...." He doesn't say some of my constituents out there are having problems because their costs are too high. He doesn't ever say that. He says they're just having problems; some aren't making any money, and there is some talk around that the big 3 packers are taking over the beef business. He takes another puff on his cigar and says, "Dean, will you put some of your research people on that? Let me tell you something. Those packers don't vote in my constituency do they?" So, you know, the dean has got a university to run. He's got to have that money from the state legislature. So we get more studies. The same thing happens on a national level only it is a bigger deal. The Chairman of the Appropriations Committee with a bigger cigar, takes it out of his mouth. He calls and says, "Mr. Secretary of Agriculture, we are marking up the budget, and we want to make sure you get your share. Let me tell you

something. Some of my constituents aren't making any money. They are almost profitless in some cases and going broke. We think there is going to be a conspiracy out there. Now that Virgil down at P&SA, we take good care of you and him, and we want him to be a policeman and go out and look and see why my people are not making any money in the cattle business." So we get the same thing and we get pressure on Virgil. He is there to be a policeman to make sure people don't lie, cheat, and steal. That's what he is there for. He isn't going to divide up the market. He is there to make sure that everybody is honest, and it seems to me that we've got here via politics, and we've got to where we are asking the wrong question.

I know what you think. There was some good stuff in those presentations yesterday. You said the Utah State guy was talking about efficiencies in the video thing and how that might work better, and we need that information. We need it because it will help us to put our system together. I think we need some help, particularly from you academics and you economists, and we need some leadership and some research to help us move to a pricing system that starts at the bottom of the funnel or even further down. We need one that starts early and brings a price message back to the outside of the funnel, some way or other, to give us a better system than what we have so that we can start doing the things that have to be done for us to be competitive in the long run.

I think there are really good reasons to be encouraged. First of all, that \$279 worth of waste in the quality audit we have out in front of us, and we can work on that. That isn't nebulous; it is there. We can work on it genetically, management-wise, and educationally, and we're going to do that. Another real advantage we're beginning to see now is that land costs are going down. They are the biggest costs we have in the business. I heard in some places a week or two ago that agricultural land on an inflation-adjusted basis was 49 percent less than it was in 1981. That is great news, not for the guy who lost his farm, but it is great news for our competitive position in the industry. Most of all, I think what is so encouraging to me is the entrepreneurs out there in our business (whether it is a packer or an old boy down the road that's got a few cows) that are resilient and that respond to price and markets, and I think they all have faith in the free market system.

Fred Knop - Thank you, Jack, for an excellent presentation. You stirred us up a bit, and we needed that.

Next on our program is Rodger Wasson. I have known Rodger for a long time. He has held positions of leadership in the beef sector and in the lamb sector, and he is currently President of Marketlinks, his own consulting firm. Rodger will deal with the "state of the industry" in product development. Welcome to Rodger Wasson.

State of the Industry: Product Development

by

Rodger Wasson

I was assigned to talk a little bit about the state of the industry with regard to new products and product development. There's a lot of data. I'll throw out a couple of figures, but it seems like the best way to start is to take a look in the supermarkets. We will just "go into the stores" like a lot of you do. We can measure what is going on in terms of the dollars spent on research and what others are doing, but the proof is in the store.

There are 30,000 items in the modern supermarket. Not too many years ago, I can remember when it was 15,000. Of those 30,000 items in the store, do you realize they tried to introduce 15,000 new items last year? Almost all of them failed. A lot of people tried. As we get into the fresh meat case, we're going to take a closer look. This happens to be one section with a typical format: all the chickens on one side, and all the beef items on the other side. What we're going to find is a lot of change in the stores that we are now facing as an industry. Some of you have been to the salad bars; there is big growth in the salad bars.

There are a lot of changes taking place in the food service industry as well. This chain (Subway) went from being nothing to the leading franchise in the country in growth. But we are also seeing franchises starting to look into going into supermarkets. There are Pizza Huts actually in the supermarket. There are three or four other concepts like this that are actually mixing things up. It is getting confusing. I can't keep track of who's in the food service business or the take-home business or the stop-and-get salads.

When I was in Hungary just last week, I stopped through Vienna and decided to take a look at their meat department. It wasn't too much different from what we see here: typical trays, the wrap-over, and they've got a big hunk of fat in there with vegetables that you can see. But there were some interesting packages that were showing up as well. They had lots of these little compartments with products that were individually wrapped and vacuum sealed in the meat section.

I came back to America to take a look at what is going on in the poultry case. As I started walking down the poultry case, I thought, "These are the guys who have come up with all kinds of packaging labels, new products, and new cuts." Who are these people? The Turkey Star variety of poultry products that they've got in colorful packing; give these guys an Armour gold star. This is our big beef company that is doing this in poultry. There are a lot of new products. You wonder, why aren't we getting beef and pork to the degree that we've gotten chicken? Certainly, one of the things that Jack Maddux talked about is a big part of that. Look at the costs that we're starting with in the first place. Look at Tyson, and look at all the products that they are coming out with; they are loaded.

I had some film to use in my camera, and I said let's just shoot some of this array of products in the store. This is a Healthy Choice product. This is an America's Cut product; you see a lot of this in a lot of stores. I think we've got to give some credit to the National Pork

Producers Council for getting behind that product and getting some penetration of the product. It is an attractive package. Look at the cuts and the trim; they are very appealing. Dell Allen, for you I've got some of Excel's experiment with retail-ready beef.

There is much said in our industry about how Excel's effort represented a direction for the future, but were we there to support it to the degree that we needed to? Was there more the industry could have done to help this product be successful?

There are some of these products that are out in the fresh case, and it seems like a little bit more is there all the time. Have any of you tried some of these? Fajita mixes and other things prepared by your supermarkets? I have, and they're fine but not terribly exciting. We've gotten excited about the Healthy Choice product, and that has been good news to see that product out and also to see one of our packers, ConAgra, get behind it with some money to promote the product, to get a label, and to get it into the store. So far, though, it is interesting that some of the people that I've talked to say in their actual volume this Maverick light beef, Maverick's ground beef program, is selling more than the Healthy Choice. That doesn't hold true all over the place, but it was surprising to me when I talked to a couple about their actual sales in the store.

When you start taking another look at some of these products, you see they don't have any meat in them and they are in the fresh meat case. Instead, they are vegetables for stir fry in the specialty meat department. Where is the meat? Here's something else--adding bacon and cheddar to a pork chop product as well. More stir fried beef fajitas and kabobs and a variety of different products. Again, that is being done by the supermarkets. They are putting a mix of products into the store. When we get back into some of the packaging such Chicken by George and Golden Star Armour products, attractive products have been added, seasoning, packaging that has some promotions behind it, fajita kits, and breakfast strips. We bought a whole bunch of these things, tried them, and talked to people that had tried them. We have seen lots and lots of variety.

Have you seen how much growth there is in the microwavable sections? These "kids' kitchens" and other items were nonexistent about a year ago, and it is just exploding, but where are we? Where are the red meat products in this? You can look at a lot of surveys, but the best test is for each one of you to go to the store and just count. Just look at what is being sold. Look at the space being used, and then count the number of items. One of the things that I think we need to be thinking about as an industry is that, if you look at these top shelf stable products that we see out there in grocery shelves, there is a traditional pork company, historically, Hormel, that has the biggest percentage of beef items of anyone you look at. What does that tell you? Maybe it tells you it doesn't matter who the marketers are. If Hormel can do it with beef, maybe they should do it instead of us hammering on the Excels or the ConAgras and say they have to do it in the marketing area. Maybe we as an industry have to admit they, the big 3, are not necessarily going to be doing the market development work. These large organizations are operating like separate units or separate profit centers in their marketing. We may say it ought to be different, but that is not going to change it, so instead, perhaps we should focus on the marketers like Hormel.

What does it take to meet the needs of these marketers to get beef or pork or lamb into these boxes and into these microwave items? Again, it's not just "boy I wish we could get IBP

to do more." It is nice if they do more; it is great. We need Excel to do more, and it's fine if they do more. But it is also not bad if they'd recognize what they are good at and stick to it. It could be that they shouldn't be marketers. Maybe these packers ought to kill cattle, kill hogs, and go to the box-ready product. They apparently know they're not marketers. They don't have the resources behind it.

Have you taken a look at this frozen entree section? If you routinely go down and start counting the items, the frozen entrees that are showing up, track the sales and the growth in that area, tremendous amounts of resources are going to this area. Healthy Choice has had a big growth, and we all welcome that, but do you remember when Jack Maddux got involved in his study? One of the things that everybody said that was going to be great about concentration was that we will get vertical integration. We'll get all of these products and product development because of the move to large firms with their "deep pockets" and vertical integration. That part did not quite hold true because they are so big that each division acts like separate companies and separate profit centers. So the people who actually package this will "source" from an Excel or an IBP as readily as they do themselves. Sometimes they get better products when they go outside because there is a feeling in America, not these individual companies necessarily, that you can dump on your internal customers. You don't necessarily get the advantage that we thought we were going to get from vertical integration.

Look at all these products. These facings are great! You see a tremendous growth in the number of Healthy Choice items out there, but you count the percentages of beef with the company that has a huge beef operation, and it is the lowest that you will find in the frozen entree section. It is not nearly as good as the mix in the Hormel products, which is primarily supposed to be a pork or poultry operation. The ConAgra Company has very few beef items in their mix. We thought that the Healthy Choice was going to be just taking off, but this area is being taken over by some other products. Do you know what they are? Other healthier products? No, they are pasta with cream sauce and cheeses, rich and fattening. Some of you saw the story in the Wall Street Journal a few weeks ago. It looked at what is happening with these new products and commented on the fact that pastas were taking off and eating into some of the ground that other products once had.

I put this proposed new product up here because we were involved when I was at the American Sheep Producers Council. We thought we needed to use some of the product from the front quarter of the carcass, and we needed to get some new products. We worked on getting this lamb product introduced. It doesn't take a lot of money. Often, we think that we've got to go back to some basic research and put chunks of meat in a big drier, spin it around, and get bones out of it, stuff and press it together, and make it shaped funny, study it for two or three years, and that sort of thing. We hired a couple of people that worked in a kitchen and put together some entrees that were under 300 calories, wrapped them up, put them in an ice chest, bought a seat for the ice chest, flew to Cleveland, and fed them to Stouffers. They liked it, and we said okay, here is what we will do. We'll help you coordinate the supply and everything, and they did some tests. They went down periscope on us for three or four months, and they wouldn't tell us what was happening. But then we end up coming out and getting this product on the shelf. But you know what killed it? We could not get the supply coordination. We had the idea, we got some people to introduce this product, we gave them the research, and we did everything else. But we couldn't get the support from the packers. They couldn't put the product together to hit the price points they needed. Our costs were too high, and we were

too proud to say a product like that we may have to "source" from New Zealand or Australia in order to keep it on the shelves. But you just don't go to imported product if you're a trade association. You go ahead and lose the market instead. We lost it, and they pulled the product.

The Healthy Choice product line was a mix of the battles that were taking place. All of these things, the Ultra Slim Fast, the Weight Watchers, the stir fry. Where are we? Where are we with regard to getting into these products? Well, some of us are saying we've got obsolete policies in our check-off organizations. We don't put money behind brands. We're not going to get in bed with others at this finished end of the product. Or they don't really want us, because they think we will blab to other people.

I don't know how many of you think that fresh naked cuts of meat are the future, but I don't. People are saying, "Oh, we're back to comfort, mashed potatoes and gravy, pot roast, popcorn, and laying around the house watching movies." But there are very few exceptions to seeing that when society has made progress and is doing less work, they've ever gone back the other way. Some of you may sew your own clothes, some of you may make your own furniture, but you do it as a hobby. We're doing that too as a hobby. We've got people that are "empty nesters." They say they are going to fix up a gourmet dinner tonight and they're really going to get back to basics and all that. Some of that is happening, but over the long run, I put my money on products that are going to be offering convenience.

Where does the meat industry fit in all this? We're going to stick beef, pork, or lamb in these packages and then they put all the sauce and seasoning over them? You have to have low cost and consistency: two things we don't do real well. To be able to make it into these products, we have to look at the shelving space and look at the other parts of the supermarket where more and more products are showing up. How do we compete? Are we ready to get in there with these products? Do we have a vision of the future? Can we give the variety of products and make sure that the red meat industry has its share of the action? How do we get ourselves positioned? There's been a lot of talk in this past couple of years about McLean Deluxe, and I think this is one where we need to give a pat on the back to Beef Industry Council for their work. Some of the land grant universities are developing some new product ideas that were funded and are getting them into the marketplace. But many consumers give McLean Deluxe an "F"; they say as a new product they give it an F. They went on and said that the problem is you can't go over the deep end on this McLean issue. People want a little assurance that something is healthy but they are really wanting to also stay with the juiciness and taste, which many people thought wasn't there in the McLean Deluxe. McDonalds is kind of crippling along with it; it is doing less than 1 percent of the volume in the stores. They will probably stay with it for a while anyway just because it is a good public relations thing. But it hasn't been the blockbuster that people thought it was going to be.

We in the industry have our own versions of disasters. How do you come out of it? You have people that crash and burn or have the riots at the meat counter. We've had companies like Excel that have gone out there and tried some new products and made major efforts. How do we make sure, as an industry, that they succeed? There's a couple of things. Certainly, you get back to the total emphasis toward total quality, you work with a supplier, you listen to the customer, you identify customers' future needs, and you continually improve. We get entirely too scientific. Some of these marketers would just embarrass you the way you get things done. They don't say, "Hey, we've got this big hunk of meat; how can we shape it

different? We can run it through some stuff, we can stick needles in it, we can juice it up, we can make it get kind of soft and soggy, we can take this cheap stuff from a cow, we can press it and shape it and make it taste like a really top end steak, and let's study this for two or three years. Let's come up with this fancy way so we can get scientific papers on it." They just kind of rush into the market and try stuff. Some of you have heard Don Tyson talk. He talks about how they rush into the market, and they try a lot of different things because a lot of them fail. But as an industry do we create an environment for that kind of a risk? Or do we let ourselves get carried away with our own interests and say we've got to be very methodical, we've got to study this, and we're going to approach this like scientists doing marketing? I mean if there is ever an invitation to disaster, that is probably it! Working in the market is not a very scientific process except that listening to the customers is a key part of it. If you look at the successful marketers, they use one tool more than the laboratory and more than the kitchen--it is a focus group room. Behind that mirror there are cameras, and sometimes a client sits there and observes. You get consumers and say, "Would you buy a chunk of meat that had gravy on it, that had peas and corn in it, and had this kind of a package? Here's a picture of what it might look like, and if it was priced above this, would you get it?" They would say, "No, it's too high; no, I think it's too salty; it wouldn't excite me. I don't think I would buy that." They get all of those reactions and then come up with, "Okay, that's what is going to sell." That is called marketing.

Advertising is just selling what you have; marketing is having what sells. So you listen, you meet their needs, you package it that way, and then you go into the marketplace with it. As an industry, it is a big shift in thinking. It means we put our emphasis on marketing, promotion, advertising, and efforts to develop the product, and we're all going to rush to the store, and any stuff we've got in the store they will carry out. This listening, improving, changing, and getting products out to the market, that is different. One of the things that we have to start, whether it is the beef industry, pork industry, or the lamb industry, is when we are working with people that are going to go out there with products, we need to be able to do our homework and have it founded in the economics of the business. They look at those price dips and how they can take advantage of getting in there and buying the products. They need to be able to develop new products when it is at the right stage of the market. They can look at not only the current year but say, "Hey, I think this is a good time for me to be in the market." Or they can look at chuck prices, retail vs. wholesale, and take advantage of a pattern in relationships. Can you remember a year when we haven't had that pattern? It was always that way. What is going to happen with chuck prices? It doesn't take a rocket scientist to say that, in this and some other products, we look at major efforts by the industry to be able to level off those price valleys, given that new products in some of those areas are critical. You can't go launching into a marketing program unless you have the basics on the economics and some feedback on where we need to be from the consumer standpoint.

Back to South L.A. There is a correlation here. Who wants to be in the business now? Who wants to be putting a beef item or pork item in the fresh meat case, or take the plunge? How are you going to do it? Does anybody, if you had millions of dollars to invest? I can't decide; it is a coin toss. I either think I am going to build a business in South L.A. or I am going to introduce a new fresh meat product. Actually, you'd probably go back to South L.A. Why? Because of some of the new programs that are going to come into place. It is going to be enterprise zones. It is going to be goals and programs to make companies go where they don't want to go, where they wouldn't, just based on the market situation. By the same token,

as an industry to get to the stages we need, we probably need policy thinking in terms of, "If that meat case is like South L.A., who wants to get in there?" We want to go get marketers and we need to get some people that will take some products into the market if we want to get some new players in. It is not just an Excel, an IBP or a Monfort. It could be a customer for them; let them just be packers. Maybe we don't need to have all the case-ready type products we're thinking of. Maybe that is more of a labor issue than a consumer-demand issue. If the consumers want a variety of different products that our product can fit, if we have the consistency, and if we pay attention to the costs of the product, we can succeed. How are we going to get organized to get it done, and what type of strategic alliances will we see to ensure it will be done? Or will it be done at all?

Fred Knop - Thanks, Rodger. You have your finger on the pulse of the pervasive problem in our industry, I think. We simply have to do more in this product development area.

Dell Allen is well known to all of you. He was on the faculty at Kansas State before moving to Excel, and he is a long-time observer of the industry. We appreciate his candor and willingness to "tell it like it is." Dell will deal with the "state of the industry" at the processing level. Let's welcome Dell Allen.

State of the Industry: Processing

by

Dell Allen

My first association with the packing industry was as a young boy riding with my father, who wasn't making a living from a farm, as he drove a cattle truck. He would haul livestock from southeastern Kansas up to Kansas City to the Armour Plant. I was probably in the 7th or 8th grade when I first did that with him and saw the old packing plant at that time, a huge operation. I grew up in a town with 150 people, and there were more people on the loading dock at the plant than there were in my whole town. That was my first experience. In high school I started to learn how to judge meat. I was taught to grade beef by looking at the beef carcasses. In those days, and that was the mid-'50s, not all that long ago in my perspective, we did not rib the beef carcass. We graded them much like lamb carcasses are graded today. I was in a cutting plant in Wichita when I first went inside and I saw a fellow on the killing floor slitting calf carcasses with a big broad axe. I still remember that sight. A plant typically killed cattle, calves, and hogs. The Armour plant that I talked about killed hogs, cattle, and sheep. Those were multi-story plants, huge things. I don't know how many workers they had in them. There were tremendous amounts of investments in buildings, people, overhead, and that type of thing.

That was in the '50s. In 1962 there was a new kid on the block, IBP. They had a little different idea, a little different approach to the whole beef business. But one of the things that they had at that time, which was a big advantage, was the fact that they did not have much overhead. They did not have a corporate hierarchy. Armour, Swift, Cudahy, Wilson, and most of those firms had big corporate structures in Chicago. I visited Armour headquarters once in Chicago when I was at Kansas State in the late '60s. They had two or three floors in the Sun Times building. I don't know what the rent was for those two or three floors. It was more money for rent for those two or three floors than one of our competitors made last year in profit. Yet, we wonder sometimes how that transition took place. It is not very difficult to figure out why we now have an industry that is dominated by what I've heard described as a "mature industry." It is a mature industry, all right, from the standpoint of size, volume, and market share. In fact, it is in a declining state as I've heard it said. But it is an industry that is dominated by companies that are adolescents. They are not mature companies. The company I work for is owned by Cargill. They have had ownership of Excel now for 12 years. That is not a very long time span to get a company culture established, a company direction established, and personnel in place to do the things that go on. The oldest of the big 3 is IBP from 1962. The youngest is probably ConAgra in terms of recent acquisitions.

Even though we call it a mature industry, it is thus, basically, one that is dominated on the beef side by adolescents. Its characteristic for the last several years has been one of over capacity. When you have over capacity, the low-cost producer or producers are going to win. That is what has caused the shrinking number, if you will, of players in the packing industry.

Oscar Meyer no longer kills hogs. I used to go into their facilities routinely when I was at Kansas State, and they had huge hog kill operations. They got out of the business because

there was no money in it. Wilson obviously would agree. We've got new players in the pork side: Excel and IBP. Players in that business are going to shrink in the coming years. The pork business is one historically that was structured under the Armours, the Swifts, the Wilsons and that type of firm. They killed hogs because they needed the supply of raw material to cure hams, make sausage, etc. The fresh products out of that type of program were marketed as a surplus item. It is very difficult currently to make money in the fresh pork business because that perspective is accepted in terms of all segments, from us on up through retail. The fresh loins and butts, all that product, are sold largely at a minus-cost basis. That, plus the fact that we've got over capacity, makes it very difficult to make money in the fresh pork business. So we're going to see further shrinkage in players in the pork business. We hope to be one of those pork players which survive.

There are a couple of other points on the maturity of the industry, or rather its immaturity. One of the things that is going on basically, as you look at the pork and the beef industries and how things are changing, is the relatively new players on the pork side of things. I am talking about IBP and Excel, having, in the last ten years, come into the corporate business. One of the things that you need prior to coming into markets is to establish why you're there, why you should be there, and how your product is differentiated from someone else's product. At IBP, I have to give them credit for recognizing this. They came into the pork business, and what did they do to make their product different from anybody else's in the industry at that time? Very simply put, they went to a closely trimmed primal. They took the fat off the pork, and that established their market niche and how they were going to approach the pork business.

We have still, to this date, not taken the fat off beef. We still have a beef industry that is selling an awful lot of fat. We're not doing that, at least on the fresh cut of the pork. We still sell an awful lot of fat on the pork in delis, sausage, etc., but on the fresh cut, the pork industry is ahead of the beef industry. IBP came in, wanted to establish a place, a reason why people should buy their pork, and they offered a closely trimmed product. Now they're in front, and we moved the industry to their standards. That has not happened in the beef industry as of yet. I think it is not a case of if it is going to happen, but rather when it is going to happen.

Why aren't some of these things happening? First of all, the beef industry has a high "RC factor," with RC being resistance to change. That is changing in itself as we talk because, as you see, I am in the business here. That is totally unlike what you would have seen out of the major meat companies 10 or 15 years ago. To hire some bonehead Ph.D. out of some university to come in and work with them, that is a definite difference. When I went to work for Excel, they already had one Ph.D. on board; I was the second one. Now they have five in our company. So, there is starting to be a relatively rapid change going from what I would have termed as a muscle-driven business to one that is technologically driven. We're moving in that direction much more rapidly than a lot of people realize.

We've had a lot of problems over pricing changes. The reason you have those problems has already been talked about today. There is a whole series of profit centers through the chain. The old adage goes, "If it ain't broke, don't fix it." You're going to do everything within your profit center that you can to make that profit center look good. I'll guarantee you there is a series of profit centers right in our packing houses. We had a procurement division, and they

obviously are profit driven. They are judged by how well they buy their cattle in relation to what their costs are, what Choice prices are, etc. So they do everything they can in their power, just as any one of you would, to make sure their profit center looks good. Next we have a slaughter division profit center. Their charge is to kill the animal. They get credit for the drop-off items, the carcass, and the price transferred back. Now they are going to do everything that they can to ensure that their division or profit center looks good. Then we have a fabrication center whose job it is to receive that carcass at a price, fabricate it, and turn it over to the sales department at a "price." They are obviously going to do the same thing. We also have shipping and transportation; they're a profit center. So we've got a company that is a whole series of profit centers, and many times because of the concentration on the profit centers within the company, you can almost have conflicting things going on between them. That is not unlike many other companies and many other industries. Again, it goes back to the old profit motive--capitalism and free enterprise.

One of the things I left out is that I feed cattle. I first started feeding cattle for university profs when we decided we were going to get rich. We started feeding cattle in 1968. Right after that, we discovered the commodity futures market and started trading in the commodity market. I had to continue to teach to support my addiction. I did that until I joined Excel, and now I can't do that because it conflicts with interests, and it is probably the best thing that ever happened to me. The reason I can say this jokingly is that I joined Excel thinking that is where all the money is. I heard all my life that these packers make a lot of money. I began to worry after two years that they might put some kind of causal relationship together from the time I joined them. They weren't making very much money. So it has not been real good in the packing business in the four to four and a half years I've been there. One of the things that does for you, though, is it really makes you start looking. Jack Maddux made the statement that the guys that run these things are no shrinking violets. I guarantee you there are no shrinking violets, particularly when things are in the red. There are no sacred cows when the business is in the red. You really start looking at this profit center mentality that is going on.

At the same time, you also become involved in a total-quality process that Rodger Wasson alluded to. You start looking at internal customers and what you're doing to that internal customer from the product you're supplying. There are a lot of false price angles that are caused by that, and it has really resulted in a profit center mentality. Dressing percentage has been way over-emphasized. That is the procurement profit center driving force because that is the proportion of live weight that they turn over to slaughter; so it is extremely important to them. It is always going to be important to them. The thing of it is we have taken it, because of our out-dated specs that I've alluded to, to the extreme. We take average-muscled cattle and we push them too much from a profit standpoint and make them too fat, all to improve the dressing percent. We don't get penalized for it until we get to the breaking and fabrication line. Once everything is there, it is the other way. You get hammered if you go over. But there is an incentive to push the dressing percentages. The only way to take these problems out is to look across all of the chain where the inefficiencies are.

Yield grades are another thing that give us false pricing. We work with average fabrication yields because we cannot beat averaging, and if we sell everything, we'll bring in better profits. Up until a few years ago, most packers had one set of fabrication standards, and that was the average yield grade 3. They had no knowledge of what the differential was in fat yields between the lean cattle versus the fatter cattle within those yield grades. I think most of

them have taken a look at it now, and they do know the differences. One of the things that I laugh about all the time is the perception on the part of our customers and the industry that no-roll cattle or Select cattle are leaner than our Choice cattle. This is totally wrong with the exception that cattle that aren't on feed long enough to have any change of grading Choice typically go into that mix. You do have some leanness advantage, but it is because you have lean cattle or unfinished cattle that end up there in the Select breeds. If you're going to buy cattle fed long enough to have a chance at making the Choice grade, the yield grade mix between Select and/or no-roll cattle is no different than it is for Choice cattle. Yet, the perception across the fence is that there is lean advantage to Select and to the no-roll carcass.

There is a lack of incentive for lean cattle; we've got an antiquated grading system. I don't know how to change it. I have my own ideas, but they're not going to sell. There's too much politics in it. Every individual I've ever met is an expert on beef grading, so we just might as well forget about ever changing it because everybody has an opinion. There aren't a great many of the opinions that are the same. But we are using a 1927 Model T. That is when the grading system was developed. I still believe that there can be a change at some point in time. It has changed over the years.

When I was young and started grading, we had six degrees of maturity--we now have five. Somewhere in the '60s they dropped what was then called C maturity and grouped it into A and B, and then C, D, and E became old cows. When I graded beef in college, we had six maturity levels. That was in 1959. When I started coaching the judging team in 1966, they had five. That was a big change because it basically lowered the grades by about a full degree of marbling, just by eliminating C maturity. We have also lowered the marbling standards over the years in my lifetime by a simple means of interpretation. There is nobody on earth that can tell me from a quantified standpoint what a small degree of marbling is, which is what the "magic bullet" is for low Choice. In other words, if you asked somebody what the proportion is of marbling or fat that is within the muscle, for small marbling, there is no quantification on a large-scale basis. If you go back, in my opinion, and look at what we called small marbling in 1959 on the meats team in college and what is called small marbling now, there has been a dramatic decrease in the marbling levels in our beef in that period of time. This change has been strictly through interpretation, no change in standards, just a difference in interpretation, and it is still going on.

From a marketing standpoint, we are not marketers in the packing business. We don't know how to market. Remember our company is 12 years old from the standpoint of ownership. In 12 years, you don't develop a very sophisticated marketing element. You don't even get it in 30 years. If you're an IBP, maybe you will take exception to that, but the packing business is a volume-driven, low-cost producer. That is how the success has been achieved by the big 3. It has not been achieved through marketing. The people running those companies are the people that have been the most successful at holding down cost and increasing volume. Those are the people running the company; those are not marketing-oriented people.

One of our big challenges in the future is the lack of people. The meat business, historically, has been a people-using business. If you look at it historically in this country, we've always operated off the latest wave of immigrants coming into the country. I see in the paper we're still getting a lot of them coming in, but we don't seem to be getting them in our business in the numbers that we need. We also have a problem from the wage structure

standpoint. Once they land and get on their feet, they soon look for something else to do. It is not only the wages, but also the tough physical work, and it is not a very friendly environment that they work in. Because of a lot of things, we need to keep our temperatures down and our work places rapid and volume driven. There are a lot of reasons why that environment is really not an effective and creative environment to work in. It is difficult for us to get people. And that, coupled with the fact that our plants are located in areas of the country that have small populations, compounds the problem. That is the number one problem facing this industry in the future. Where are we going to get the manpower to continue to do our business?

As positives, first of all I see the beginnings of the mentality in our companies, and I am talking about all three of the big packers, to get into the value-added business. Margins are so narrow that cost competition is close between competitors. Profits are so narrow that we've got to do something if any of us are going to stay in business. It is because of that that I see us looking at taking the next step, which is going into value-added products of some type. We at Excel are in the completion stage right now of our first product development center, which is in Wichita. It will be completed next Monday. Most of the Ph.D.s have been added in that area. We are getting some technically trained people in our facilities. We spent over a million dollars in the last two and a half years putting laboratories in each of our major facilities. Those are quality assurance laboratories designed to help us in the areas of food safety and product quality monitoring. That is a big step, much beyond what you have seen those companies do in the past in the way of technically oriented activities. We have staffed those laboratories in most cases with people who have at least a master's degree. In fact, we don't have any in the labs that are above that. Four out of seven of our people in those positions have master's degrees in Microbiology. We've also got good chemists in those positions as well as in the meat-oriented, trained animal science areas. So, we're starting to bring technology and knowledge into that business, which has been a muscle-driven business up until now. I think that is a very optimistic sign.

Because of the people pressures, we are looking, as I am sure our competition is, every way that we can at automating job procedures, particularly those jobs that are highly repetitious. It is because of that movement that I foresee a narrowing of that funnel, that Jack Maddux talked about, of the mix of cattle going through one of our facilities. Most manufacturing companies take a series of raw materials and make them into a uniform product. We don't have that option. We've got too much diversity of the raw materials. We've got to take all of them, so we do a lot of sorting to try to make it more uniform as it comes out the other end. But we still have tremendous spreads from the composition standpoint, from a muscling standpoint, from a size standpoint, from a bone standpoint, and from a quality standpoint. All of those things mean we have a tremendous spread in the diversity of the end product. As we move towards this whole thing of modernization forced on us by lack of people, by OSHA rules, by safety rules, and all those things, the animal that we will take in the front door is going to have to become a more consistent product coming to us. I think that is one of the big changes I see right in front of us in the next few years.

We were each asked to address our particular area from the standpoint of the health and well-being of the industry. People that own Excel are great people. One of the benefits that I have had since joining Excel, and one of the reasons I felt free to join you here today, is that nobody has ever told me what to say or what not to say. But I will guarantee you that people at Excel also know when things are profitable and when they are not profitable. So does IBP

and ConAgra. If our business becomes routinely unprofitable, they won't stay with it over the long haul. They will turn it over to somebody else. Therefore, one of the things you've got to assess in the industry is profitability.

In the packing industry in the four years that I've been in it, I've looked at a lot more than we used to. The return on investment does not make sense. If it were your money, I daresay you would really question how much of it you want to continue to spend when you can do a lot better somewhere else. You can almost put it in savings, and savings account returns aren't great now. It takes a tremendous amount of capital to run these businesses, and some profitability has to be generated. Profitability per unit in the last few years (particularly on the pork side where there has, in most cases, been no profitability) is important to look at, and we typically look at it in numbers of animals per unit of employee. In fact, it is an extremely important thing to look at because it measures or gives some indication of technological improvements in the system. Most of the emphasis, I think, from here forward is to take the manpower out of the system, automate it, and get rid of some of the problems that we face from the manpower standpoint. Then, capital needs to be looked at. The level of capital committed is going to be an indication of this thrust toward value-added product. We are a commodity business. We sell commodities. You go in any supermarket or a Safeway store and I'll guarantee you, unless you go in the back room or happen to know somebody that works there, you don't know if they are selling IBP products, Monfort products, Excel products, or some natural product, other than ground beef, which is starting to show some brand names. Fresh beef is still pretty well a commodity business. As we go down the road and we see product line additions like the Healthy Choice steak that ConAgra came out with, etc., I think you're going to have a major hand in knowing what is going on internally in that business from a standpoint of R&D and product development. We have to compete.

Fred Knop - Thanks, Dell, for an excellent job. We appreciate your candor and your insight into these important issues.

Tom DeMott of Safeway will address the "state of the industry" from his perspective in distribution and retailing. Safeway is a leader in the meats area at retail, and Tom DeMott is a leader in the industry. Please welcome him to the podium.

State of the Industry: Distribution/Retailing

by

Tom DeMott

My remarks will be limited to my own personal and professional observations on the state of the beef industry and suggestions on how we in the industry can begin to monitor beef's progress in the future. First, before spending a lot of time on beef, I want to just say a few words about pork and lamb because they've kind of gotten moved to the back burner for much of this meeting. I've heard some conflicting things from Dell Allen on the pork industry. But I have a different perspective on pork. I think pork has enjoyed much success in the last five years, and I suspect it will continue to enjoy success. My personal opinion is that they've achieved this because they've made progress with genetics and they've improved the standards. They've improved the feedlot conditions and the feeding management. All of this has happened with a much higher and more consistent quality of pork that I, as a retailer, can sell to my consumers. Throughout all this progress, the pork industry has effectively lowered the cost and reduced break-even prices, which has allowed pork to better compete against poultry. Maybe from the packer end the economics are not there at this particular point. I see true demand in my consumer's demand for pork today because it is giving consumers more of what they want. A lot of it is because of closely trimmed cuts, the America's Cut, and just more variety that we as retailers are able to give to our consumers at much better prices in relationship to beef. It is becoming a little more price competitive, especially compared to chicken breasts. Most branded chicken breasts out there sell at regular retail anywhere from \$4.99 to \$5.99, and a boneless center-cut pork chop can be found very readily at \$3.99 to \$4.99 retail. So we're talking 100 percent animal meat versus 100 percent meat; there is a good competitive advantage.

Just a few brief comments on the lamb industry. Lamb has struggled the most in the past few years. I did not realize, as Jack Maddux suggests, that after World War II the lamb industry was the place to be. We've seen a lot of problems at the producer end primarily because of oversupply, which I think started in 1987. But I think the real problem is that there is poor demand for lamb around the country. My opinion is that the entire lamb industry needs to target and produce the USDA Certified Lamb, which will give the ultimate consumers consistent high quality lamb. The inconsistencies with lamb have over the years produced a situation at retail that I, tongue in cheek, refer to as the cracker jack box syndrome--a lamb surprise in every box. It is sometimes a good surprise but very often a disappointment. This is why we at Safeway have embraced the Certified Lamb, which assures us and our ultimate consumer of a consistent, high-yield quality, excellent flavor, and no surprises. We are truly proud to offer this product to our customers. Until the entire lamb industry addresses the tremendous quality difference in this live production and the methods of feeding (and we should only feed to keep the optimum market weight for maximum customer satisfaction), the industry will struggle. There will be continued struggles in the marketing of their product and obviously problems for growers and producers in terms of profits.

Let's spend the rest of my time here talking about beef and the retail sector. You've heard already that the number one problem in beef today is fat elimination. There are reports

of many retailers and packers beginning to work together, and this has been in the last year or two, to produce closely trimmed beef primals and sub-primals that do not require any further trimming to go in the retail package. Unfortunately, this is still being achieved by the knife. Instead of fat being cut at retail, it is now being cut at the packing plants. This should only be a short-term solution because the waste fat should not be cut by retailers or by packers. It should not be produced.

We continue to see more Select beef being produced, and this development will result in improving the overall quality. We believe this will provide a more consistent product for retailers and consumers who want either the Choice beef or a wider availability. Since the industry has more Select beef, we have seen the Choice-Select spread, over the last two years in particular, lower than normal. I have stated many times that when the industry begins to offer 30 to 40 percent of graded beef of Select, we will also see this price spread continue to diminish. The impact of restaurants in forcing the middle meats up, in my opinion, is what provides the wide spread on the Choice side.

Texas A&M did a study on the beef industry, and this study showed a wide range of tenderness and palatability characteristics with all beef, especially Choice. The industry has serious problems with consistency. Whether the retailer uses all Choice or all Select, our customers are not getting consistent flavor for their beef purchases. The study by Texas A&M showed this clearly. I have not seen anything done by this industry in addressing this problem.

The area of consumer usage has little progress to report. Someone already talked about the fact that consumers are using more of the lower-end beef products instead of the upper-end. We definitely see that in retail. Consumers who eat beef seem to narrow their selections between what I call ground beef and patties and steaks from the rib and the loin. This is a slight exaggeration, however, but overall very true. The challenge to this industry is to develop stronger markets for usages for the chuck and round cuts. Again, that is no surprise to this group. As lifestyles have changed, these products are becoming dinosaurs in our meat cases. How many consumers under the age of 40 have cooked a beef roast, excluding rib roast, in the last six months? How many people would we find? I question the percentage out there in the country cooking roasts. It is a dying art if anything. The industry needs to help all of us. We need a retail food service to develop new methods of cutting and easier customer preparation methods that are very simple, fast, and have a consistent, satisfactory flavor.

Rodger Wasson was talking earlier about product development, new products on the market, and where the poultry industry has gone. What a wonderful opportunity we have to take the lowest cost part of our beef structure, the rounds and chucks, and do something exciting with them. I think there are things we can do. I hate to keep needing people at the check off counter, but there seems to be other things we can do versus advertising to "pull" demand through at retail. There seem to be things we could be doing as far as research and product development that would help us in selling more of the products from the round and chuck which the consumers are avoiding unless we drive the price down. You put \$.99 on anything and it is going to sell. Again, that doesn't provide any value for ourselves, for the packer, or for the producer.

Because the industry continues to produce excess waste fat, beef remains at a big competitive disadvantage compared to poultry. I mentioned earlier that the products made in

pork have a lower cost and have seen an increase in consumer demand. Pork is giving customers more of what they want consistently. Beef remains non-competitive compared to poultry, and it is also losing ground with pork. Beef demand seems to be tied closely with price. As prices go down we sell more beef, and as they increase we sell less. The majority of our in-store labor also revolves around beef production, in cutting the beef, and in trimming off the fat. But our beef "retails," and this is going to be a surprise for some of you, do not reflect the true cost of producing beef in the back room. If we were to allocate the labor that we have in our stores separately to the beef, pork and poultry categories, beef retail prices would probably go still higher. Smoked meats, poultry, and pork would probably go down in cost. In effect, the other products we sell are subsidizing the beef production that we're currently offering. I am not sure how long that is going to last.

The public and media attacks on beef continue, and there is reason to believe they will continue for the future as well. Attacks on beef are affecting us less at retail as consumers seem to grow skeptical of many of the allegations made by media or some of the animal rights advocates. After the most recent Prime Time Live show, I believe, in all of our six U.S. divisions, we had a total of three phone calls. That particular show followed the riots in L.A., so the whole U.S. may have been focused on something else, possibly lowering their response to this issue. Much of the damage has already been done over the years related to health issues. The industry is getting better at addressing the claims and the issues head on. But there is still much that can be done to include our retailers in that line early on in the loop so that we can respond directly to media requests. The local TV and radio stations don't want to talk to someone from Washington, Chicago, New York, or Denver. They want someone right in their market to address any and all issues. There are more people who need to be included in the loop on dealing with media crises that are affecting the industry.

Whether we like it or not, the government plays a big role in the production and marketing of beef. They govern the playing field that we all compete on each day and provide the rules that we must follow. I believe the future of the entire beef industry, in the role the government could play and the leadership offered in the entire beef industry, will embrace changes and will effectively lower costs and produce a more consistent, safe quality product that is always tender, juicy, and flavorful. Obviously, I am describing motherhood and apple pie here. I am generally an optimist, as is Jack Maddux. I am hoping, unlike Dell Allen suggests, that positive changes will occur and that he will be around to see it.

I'd like to refer to a Colorado State University newsletter that came out on April 27. This whole article was about the national beef quality audit talking about the \$279 per head that we're losing in this industry. It talks about the waste in size and about packers' concerns versus retailers' concerns. You know we're not even on the same wave length in terms of what we're trying to fight and what we're trying to improve in this industry, so we're not even talking the same language. The war on fat, which was declared back in 1988 or 1989, is a minor skirmish. The study talks about cutting problems and in particular, with the restaurant people, excessive seam fat. I do want to read this one comment on pricing out of the market. In this article they quote Russ Wolf, who is a friend of mine. I'll just read this quote:

Much has been written about health concerns, changing lifestyles and convenience, and I believe all of them are valid. But I do not think enough attention has been paid to the possibility that we are pricing ourselves out of

the market [he's talking about beef here]. The point becomes obvious when one compares the 1976 price of beef, \$1.46 per pound at retail, compared to \$2.87 in 1991; \$1.34 price per pound for pork, compared to \$2.16 in 1991; and whole fryers for \$.60 in 1976, and they are \$.90 in 1991.

It goes on to talk about problems with beef tenderness, inconsistencies, and consumer concerns. I thought it was an excellent summary of the report that came out.

I arrived here mid-afternoon yesterday, and I got a chance to hear some of the speakers' comments yesterday in the other conference room. Some of the comments I heard, and again I don't mean to be disrespectful of anybody who presented yesterday, were about concentration concerns by packers and various price spreads that people seem to be very concerned about, etc. You obviously spend a lot of time studying it, but I have to tell you that that is not where it's at. I'll give you an analogy. Looking at packer concentrations in the beef industry today is like changing a light bulb when the house is on fire.

Obviously fat elimination has to be the number one priority for positive change. I believe all packers, beginning with Dell Allen here, need to go on a close trim program and make this the industry standard. IBP, when they came out with their boxed beef program, created that standard 30 years ago. They arbitrarily came up with this 3/4-inch spec with a one-inch max. What is to say that can't change to 1/4 inch or 1/8 inch? Let me tell you about the waste fat at Safeway. We trim off at retail in our 880 stores 15 million pounds of fat. We pay 20 to 25 million dollars for this privilege of trimming this fat. Guess what? We get from the renderer \$400,000 for \$20-25 million worth of fat. Guess who pays for the difference? The consumer pays for the difference. Packers should not only not pay for the excess fat, but they should charge back to the feeders for the cost of removing the fat. The bottom line is that no one should profit from producing waste fat, but they should be rewarded for producing tender, tasty, lean beef. The target needs to be beef which is highly palatable and in demand by consumers. That should be the target regardless of how many profit centers we have up there because, in the future, we may not have profit centers to talk about.

The industry needs to grade more Select beef. This would naturally reduce some of the waste fat. Contrary to what you heard here from Dell Allen, I have to take exception--we do cutting tests. We do thousands of cutting tests every year, and we find an improved yield, meaning less excess fat, with Select than with Choice, and it is significant.

The beef industry needs to spend check-off dollars on developing new markets for chucks and rounds and helping retailers, food service, and consumers to process and prepare these primals and their cuts in a fast and convenient way to produce consistent, satisfactory results. This whole area of consistency and greater competitiveness, some of what we investigated here today, will then improve, making beef versus poultry a little more competitive. Real progress will not occur, I believe, until the industry, along with government, does the following. But, before I go into these comments, I want to say that I am not an animal scientist. I wasn't raised on a farm or have any exposure other than driving down the road and seeing dairy cows in upstate New York. My insight into what I am about to say is being an educated observer on the outside looking at the various commodity groups out there and seeing what has worked in poultry and pork.

First of all, work aggressively to eliminate the dollars now lost by each animal slaughtered as reported by the national beef quality audit. Develop the ideal genetic characteristics (I believe we have them today but no one has targeted what those are) to provide consumers with beef products that cost consumers less. All poultry and pork are grain fed through production. I believe that if the beef industry were exclusively on a calf-fed beef program, beginning at about six to eight months, for all their productions consumers, retailers, and packers would consistently get the good tasting beef they are looking for. So what is the problem with that proposal besides the fact that I haven't really thought it through totally? I am just kind of throwing it out there for the group. One thing obviously is grading. These animals, no matter how tender, juicy, and flavorful, will not grade out as well under the current rules of the Choice and the Select, and they won't produce the maximum profits for the feeders. But we all recognize that fat is the enemy, and our current standards for establishing carcass value are a major contributor to the fat produced in this country. The excess fat production not only increases cost but also adversely affects the quality for our consumers. We're fighting so many battle fronts here. It is not only excess fat, it is not only increased cost, but it is also the fact that customers are not happy with the product. It is not consistently tender, juicy, and flavorful, whether it's Choice or Select.

The industry needs to work with the government to examine this entire issue. We need to develop a guideline that if this method of production produces consistently superior beef over traditional Choice and Select, then there needs to be a way to bring this product to the market without penalizing the feeders. In fact, we should figure out a way to reward this product, if this works, to get everyone to produce it. I believe that this method of production would not only improve the overall quality characteristics of beef that is consumed, but it would lower the cost of production for everyone and would improve yields for both packers and retailers with this consistent product.

In terms of monitoring beef's progress in the future, I think we need to start setting up a mechanism whereby we can follow the pounds of closely trimmed beef that are starting to be sold in this country. I think that in the future they are going to be sold in larger and larger quantities. Looking at the number of retail stores that are buying and selling only exclusively closely trimmed beef, and possibly looking at a 100 percent buyer, a 75 percent buyer, a 50 percent buyer, we need to be looking at pounds of case-ready or deli-ready being sold. Preferably, a lot of this data will be by primal by vendor if the vendor community would agree to doing this maybe through a central agency like NCA or the National Livestock and Meat Board and collecting some of this data so we keep the identity of vendors confidential.

On the issue of competitiveness data, I agree with Jack that we need to review data that shows the progress of being more or less competitive. What can we do in 1992 and 1993 to minimize the \$279 per-head loss? We need to work to reduce that number. We need to closely follow the relationship of beef costs compared to poultry, pork, and lamb. If this calf-fed production program I suggested has any merit at all, that is something that should be monitored closely and encouraged through cooperation of industry and the government and then follow the numbers that are produced.

In summary, the beef industry has been in gradual decline for years, not only in numbers but also in real demand among consumers. It is a tribute to the entire beef industry that it not only recognizes the problem but is moving, although slowly, to address the root causes of the

declining consumer demand and the non-competitiveness compared to other meats and proteins. I hope that from meetings such as this we can continue on the path of making positive changes that will benefit the end consumer and the major segments that make up the beef industry. I offer a word of caution; time is of the essence. The progress made in both pork and poultry continues to build, and these products are growing, not only in market share but also in what I call real demand among consumers.

Discussion, Questions and Answers, Action Plans

COMMENT - Fred Knop - In 1991, of new product introductions, 38 percent were poultry products, 24 percent seafood, 20 percent pork, and only 13 percent were beef. One of our main problems in beef (and I wonder if this isn't a problem in pork) is that people are still being rewarded for producing fat. This factor has been identified as the industry's number one source of loss. We've heard that there is no integrated effort to fix the problem. We have the various profit centers in which everyone is looking out for number one. In the meantime, the product is in decline. We've heard some positive things from Dell Allen on what the packing industry is gravitating towards in terms of automation and product development. We've heard from Tom DeMott that time is of the essence; if we don't get in gear these things may come along too late. So I would invite your reaction to this summary to what you have heard here. Why is this the case and how do we fix it?

QUESTION - This question is for Tom DeMott. Why does the average spec approach still get used? If you don't want to have all of the high costs that come with it and the excess fat, why don't you just quit buying the product with an excessive fat cover? Why don't the packers cut it off?

Fred Knop - Are you saying, then, that the way to solve this problem is at the retail end?

ANSWER - Tom DeMott - I think I understand the question. First of all, this says the three packers are highly competitive. We're highly competitive with all our competitors out there, and we have to change that. Nobody does it better than Safeway. It is really for competitive reasons that I am here today. Frank Lusk and I have played a role in working closely with the industry for progress and for change because we want to change the industry on a lot of these things. If we were to go to Excel and work out a situation where we want a closely trimmed product from them, we would find ourselves at some point in time at a competitive disadvantage with that product as far as sales and possibly not being price competitive with some of our competition. We're very interested in doing this, and our method of working with the industry is forums like this and many of the other forums that we participate in.

COMMENT - Fred Knop - Let me verify this. Are you saying that the impetus for change would have to come from your packer supplier?

ANSWER - Tom DeMott - Ours is an industry working for the supplier.

QUESTION - Along that same line then, there has to be somebody willing to go out front and say, "We're going to start discounting at yield grade 3. There are going to be huge discounts, or we're not going to buy anything with a .8-inch fat cover. There has to be some sort of collusion."

ANSWER - Tom DeMott - Let me clarify that point. We will, at Safeway, buy a closely trimmed product, and we will pay for the yield difference for that product as compared to the regular product that we're buying right now. I can state that unequivocally. So, from the standpoint of us not buying the product, we are willing to buy a product as long as the yield difference is comparable to the traditional product. We are more than willing to do that to date.

The only restrictions we have are that in two of our marketing areas where we have labor contracts set, they will not allow that product into the marketplace. But once that product is available, it would provide us with an impetus to go to the union management and negotiate those restrictions coming off the contract.

QUESTION - Dell Allen, what is your reaction to Tom's statement?

ANSWER - Dell Allen - I presume that they get benefits from the closely trimmed product and therefore, they should be willing to pay more for it. We have to get compensated for the extra trimming costs. You ought to know that we offered a closely trimmed product line in 1986 or in 1987, I don't remember exactly which one it was. At that time I heard it said by other people that we were ahead of ourselves. We could not sell enough volume of our product to make it work. I think we'll do it sometime. I just don't know when the timing is, when we go back to that type of a closely trimmed product line.

QUESTION - Is it sufficient for the Safeways of the world and the Excels of the world just to have a dialogue and perhaps negotiate? Is that sufficient to get the ball rolling and solve the problems that we have?

ANSWER - Tom Demott - From my standpoint, yes, and we have dialogues with packers every single day, and sometimes more than once a day, along these lines and any other concerns we have. I recently read some research that was done by the Food Marketing Institute. Their survey shows 84 percent of retailers would like buying a closely trimmed product. What is the problem here? Well, it hasn't been available outside of small supplies from small packers until recently. As I alluded to in my comments, we're seeing more activity by packers today and we are moving in that direction.

COMMENT - Audience - Now what I hear is that the intention is there, but not everyone wants to pay the price for having that fat removed at the packer level.

COMMENT - Tom DeMott - As I said before, we will pay for the yield difference and processing fee on top of that, and we're more than willing to do that today.

QUESTION - Dell, if everybody has the attitude that Tom has, would that pull the plug at the packer level?

ANSWER - Dell Allen - I would say yes, it would. If enough retailers came to us with that same attitude, I am sure things would change.

QUESTION - Is it a fair statement then that not enough of them have yet come around with that attitude?

ANSWER - Dell Allen - Industry people tell the retailer that they should not pay more for that closely trimmed product. But that is the product that the consumer wants or the consumer desires. So, it is up to the industry to actually produce it and to do it in the most competitive manner. To get it started we are probably going to have to see lots of people and talk to lots of people to get it done. But I still maintain that on a long-term basis, the individual that does that now, and I am talking about the cattle producer, and feeder who learns the system, will

have an advantage. In 10 or 15 years, it will become the norm, and everything else will be discounted from it.

COMMENT - Audience - I'd like to just comment on that. It is hard to believe that in this industry, if we can make some headway in getting started on more closely trimmed beef, that we as producers are going to start to see the price effect. Dell Allen alluded to the fact that his buyers and different divisions within Excel get rewarded based upon dressing percent. If the packer is not selling the fat, the last thing he ought to want to do is reward one of his divisions for high dressing percentages. It is going to be the pounds shipped out the back door to the retailer, the service institutions, and/or the wholesalers that will be the method by which they are going to be judged in the future. Hopefully, at that point they will then go back to our friendly feedlot guys and discount the product that is not meeting the specifications as far as the lean product that they are selling to their ultimate consumer. Hopefully, it will begin this process of rewarding the lean production and discounting the fat production.

QUESTION - This would be for Dell Allen, and I would be interested in Tom DeMott's comments too. This morning we heard from you that the communication between packer and feeder is a problem in beef. Does the beef industry need help from Washington to get us to work together? Or is it an impediment to the need for change in the business?

ANSWER - Dell Allen - I have not seen too many people from Washington that I think would help. I don't think we have to have more regulation. I don't know of a business that I have been around that is any more regulated than our business from the standpoint of Uncle Sam or oversight from a lot of different areas. I have long been a proponent that probably the most efficient system is the situation where I talk to Tom DeMott, or whoever, and we agree that he has a set of specifications that he wants without someone from USDA sitting here telling us that this beef meets some specifications. As you read the history of grades, you will find that when they started, they were not an instant success. Packers started their own grades as a result of the government starting grades. They had "house grades" and that is where Armour Star and Swift Premium and all those names came from. Grading became mandatory in the U.S. during World War II. It was during that time period that all of a sudden retailers or people that bought meat found out that if they bought USDA-graded meat, it was a more consistent product than what they had been buying from the old packers with their house grades. You just want an inspection, and I think we will see the industry go back to that type of a system again where private labels are used. Again, whether it is imminent or not I don't know, but it will have to happen.

QUESTION - We probably all watched Firing Line a couple of weeks ago. They talked about food safety and packers involved in taking a little responsibility in meat inspection and USDA trying to make policy. As the packer, how do you feel towards the food safety inspection, and what role and responsibility do you think that the private industry should take in that?

ANSWER - Dell Allen - No matter how pure any company is, there is need when it comes down to public health and public safety. There is a need for those types of inspection people in our facilities. I think at the same time, however, that our company has taken a very active stance on this. We cannot afford any type of a food safety problem. That is the one thing that could run us out of business quicker than anything else. We've made in the last year over a million dollars and in the last two and a half years over a million and a half plus dollars in investment

in laboratories to ensure quality control. At the same time, right now we have two SIS plants (as they've been called) in Texas that Prime Time has gone to. For two years running, one of those plants has been the leading plant in all of the USDA's ground beef samples for the school lunch program in terms of the cleanliness of that product from a microbial standpoint. I have accredited a large part of the cleanliness of those plants to the fact that we have to assume the responsibility. Those plants are probably better from a sanitation food safety standpoint than traditional plants are. We have taken a lot of those good things that we learned from those SIS plants and put them in our traditional slaughter plants. I would really concentrate on ground beef, as far as how clean a plant is and microbial counts on ground beef, because it comes from every part of the carcass. It has probably been over most of the belts and has had every opportunity to be contaminated, so you are looking at how you can tell whether the plant is clean or not. We are very proud of our facilities. I think they are as clean and as good as anybody's in the country.

QUESTION - The poultry industry has integrated to control the raw materials. Some of the four swine plants are moving pretty fast in that direction. I'd like Jack Maddux and then Dell Allen to respond to what it is going to take in the beef sector to make a more homogeneous raw material to allow you to cut cost and put the product in the form it needs to be for consumers?

QUESTION - Jack, if I could just add to that question, why do we have the problem in the first place and how do we solve it?

ANSWER - Jack Maddux - First of all, there has been a lot of speculation and a lot of fear that we're going to turn the beef business into the poultry industry. That is obviously not going to be true. First of all, we've got that funnel that comes from all over the U.S., and we're not going to have total control over our product like the poultry people do. I don't know what the industry is going to look like. I don't think anyone else does either. But I think we can see some trends that are starting to take place now in the contract and specification selling and the formula pricing of cattle based on what they are actually worth in the box. Those kinds of things, I think, are coming. I think they are very important, and I think they are controversial kinds of changes that are taking place which are going to be difficult for a lot of people to accept. Now if we don't accept them, we go right down the road towards the lamb industry and go our own merry way if we want to. But those changes must take place if we're going to have a viable meat industry 20 or 50 years down the road.

COMMENT - Dell Allen - What I see happening, and I don't think there is any one entity that is big enough to vertically integrate the beef industry (capital requirements and management requirements can't be met) is a lot more of what I've talked about and call contractual integration. The thing that will make that work is to share information back and forth, to have no barriers, like the ones Wayne Purcell identified up here originally. So, you're going to learn a lot more about my business if you're my supplier, and I'll learn a lot more about your business. We are going to work together to get the inefficiencies out. We're going to see a lot of that going on down the road.

COMMENT - Audience - I was just going to say that I talked to several restaurant chains that are getting interested in genetics. Their attitude is that they need to know what is out there and what the potential is, and their attitude seems to be we'll find someplace to kill the cattle. There has been a considerable interest in that. A couple of them are making some major investments,

too, in research. They can say, "This is the breed of cattle or these are the specs that we are going to have. Now, who is going to slaughter those cattle for us?"

QUESTION - Jack, you started off introducing those 70-plus breeds. We talked about problems in consistency and quality several dozen times this morning. Dell Allen said that eventually, when cattle supplies are not so tight, they will start to buy more on a spec basis and that contracts will specify quality, not just time and quantity. Isn't that a key first step in getting us talking about what we need today? A key step in coordinating?

ANSWER - Jack Maddux - I don't think there is any doubt about that. That is a key first step. The encouraging thing is that there are some things happening that are bringing us closer to what Dell is talking about and what you talked about in terms of expected prodigy differences on a carcass basis. We're beginning to see those breed associations doing some substantial work on the genetics that I am positive are out there to produce what we need to produce. As I mentioned earlier this morning, the real problem becomes the price signal, to get that price incentive out there to people who will respond to price signals and get it done. I don't have the answer on how to do that. I just know it can be done and it has to be done.

QUESTION - Jack, those specifications that Dell dealt with in the late '80s were very widely publicized, and there was ample chance for producers to plan their production. Let me ask the panel why there was no significant response.

ANSWER - Jack Maddux - First of all, you remember that when Dell first went public with that, there was a tremendous outcry from the industry saying, "Dell, lighten up." Do you remember that Dell? When he gave an indication of some of the problems in terms of perception and education we have in the industry, that we have a mindset from a production point of view. We've got a wonderful tool in heterosis that we haven't used very well. The beauty of heterosis is that it does the most for those traits that are least heritable, and we can do more things that way. But the breed associations must change their attitude in terms of how they fit into the system. If we are going to have a truly heterosis-driven program in the beef industry, there has to be complementary efforts and attitude from more than one breed, and that is a problem. I just went to a conference of a breed association where we spent half our time defending the show ring, and secondly we said how can we make this breed all things to all people? It's not going to happen that way.

QUESTION - Dell, do those specifications need to be updated? Are they still valid?

ANSWER - Dell Allen - Back in 1968, I gave a talk describing the ideal beef, lamb, and pork carcasses. That description was derived from a survey done with a wide variety of industry people. The only difference between the 1968 specs and what we brought out in 1987 was a 50-pound differential in weight. So, again, it is not that they haven't been around for a long enough period of time for people to know about them. The value has been there. As Jack indicated, we have not had proper price signals to bring it about. The encouraging thing is that the industry has in the last 10 or 12 years gone through a series of tough times in one segment or another, and that is what is going to bring change. We can sit here and talk all day and all night, but until we get into a loss position and people start really looking at where the inefficiencies are and start tackling them, we're not going to do anything about it. As long as things are not problems, we are going to go right on down the road doing the things we have

been doing. That is where the beef industry was through the '60s and even up really until the mid-to-late-'70s. It has only been in the last 10 years that we're starting to realize that we've got a problem and wondering if we're going to be around. That is what is going to change the system.

QUESTION - Dell, let me keep you on the microphone with another question. It is about that same time you developed the scoring system as a guide for procurement. I understand that because cattle supplies have been tight, it has been hard to implement. Does that system still look like a good guide for the producers today?

ANSWER - Dell Allen - I think so, yes. There is nothing dramatic about it. It is a more finite breakdown of the USDA grading system. I'd like to relate one story which gets back to why I am for paying more for closely trimmed beef. Again this happened in the late '60s when I was a cub professor at Kansas State. On a panel much like this with a retailer from Fleming, who had also been in the packing business and in an area I had done my Ph.D. research on, we were to quantify the value advantage of yield grade 1 versus 2, 3, 4, and 5. Yield grading at that time was in its infancy. It just had been adopted on a voluntary basis in 1965, so there was a lot of discussion about it. I made my pitch and it had the numbers and it showed yields and obviously the 1 is worth more dollars than the 2 and on down the line. I get down and after the discussion got started, he asked whether it is not the leaner, more rapid growing animal that is more profitable. His comment to me at that time was that the producer really wanted a double premium for producing that calf. Is that not right? And that is the last time that I have ever argued for a price premium on producing the right kind of calf. That is what the whole industry, the individual producer, the packer, and all the rest of us that fill out that market are faced with. Is this free enterprise system still going to be in business 15 to 20 years from now and doing well? Will we all participate in that process? The ones that don't are going to be on the sidelines talking about packer concentration or whatever.

QUESTION - for Rodger Wasson - It seems to me the underlying root and cause of the whole controversy is that the image red meats have, as it pertains to the public consumption, is as a product with saturated fats. Whether it has or not, the connotation is there that red meats are primary deliverers to the body of saturated fat. Are we ever going to be able to unload that label and not have a primary reason why the general consuming public has backed off?

ANSWER - Rodger Wasson - That has been our conventional wisdom. In fact, the industry has spent several hundred million dollars along that premise; that is the problem. I think there is something more to it, though. My own philosophy is when we had the meat boycotts in the early '70s, I think one thing that started happening then is that you saw a lot more chicken stories start showing up. The publications that I talked to at that time were saying that their readership survey showed that if they ran a story about chicken, people read it more. So, they told their reporters to go write more stories about chicken. Part of the thing you go back to also is "cheap." If you could have a product that was cheap but was also good for you, then you tell everybody we're serving chicken tonight. We're cutting back on red meat. I think that price competitiveness was also a big part of the attention. To this day, when I talk to restaurant chains about the trends (there is a trend toward some salads and that sort of thing), several of them tell me that part of their business is selling grease, sugar, and salt. People say one thing and do another; they like flavor, they like juiciness, and they like to splurge. All I am saying is don't discount the health and the cholesterol concerns, but that is not necessarily what drives

a market—certainly not exclusively. We've got problems in poultry with fat, and there are problems in pork with fat. We've almost spent too much time in the beef industry debating who is going to cut it off. That becomes an obsession, but the point is most stores in the nation right now have a pretty closely trimmed product. The consumer is not seeing the fat in the supermarket. So, it is an economic question. We're kind of hiding behind the health issue and not facing up to some things like imports and things like figuring out how we raise cattle cheaper to get our prices down. I feel the industry can hide behind the diet health issue, and it is a great big bird if we see it haunting us. There are some other things that we can take some steps to correct as an industry, but they are difficult.

QUESTION - Wayne Purcell - We have an industry, I have suggested, that is made up of several profit centers, and they do not necessarily coordinate what they do into a unified system. Everybody has agreed with that in their way. But how do we change and improve? How can we do that? We can go two ways. If we get vertically integrated, and I mean integrated like in poultry, that is one approach. Management directive is used to offset the lack of coordination we see in our open market systems. But if you watch what is happening, we find people are finding ways to eliminate price and the pricing system. Contracts are being used to bring the inter-level coordination without integration via ownership, but the pricing system is disappearing. A second reason is that we have a motive for the profit centers to coordinate and work together. Dell Allen gave a real contribution to this group's thinking when he said he has profit centers within his firm that are doing things that are inconsistent within the firm. Dell, why is it that in 1992 Excel cannot figure out that the most important thing they need is the profitability of the combined operations instead of just the procurement function, the slaughter function, or the fab function? What is it we're going to have to generate as a measure of how much your firm and the industry is hurting itself when they don't coordinate before things will change?

ANSWER - Dell Allen - Don't ask me why it hasn't happened before because I did not major in business. It is again the situation where the industry has basically been profitable under the system that they have been using. As a consequence, they are not going to change it until tough times hit. Packing industries, if you look through the late '60s and through the early '80s, were very profitable growth industries, and easy to get into.

COMMENT - Wayne Purcell - But the packing industry is not all that healthy. Many smaller firms have been driven out. Behind the scenes, the cattle industry has downsized 20 to 30 percent. That is the thesis behind this whole session: Nobody is worried about the well-being and economic viability of the entire industry. We wondered if we could set up a group that monitors a few things, a few measures of effectiveness and performance, and keep it in front of everybody. I wish we'd pay attention to what things need to be monitored, and maybe we can bring it into being in some way. I don't know if we can count on you to be in the monitoring business and to worry about the industry 20 years down the road.

COMMENT - Dell Allen - I don't either except we want it to be there because we want it to be a part of the industry.

COMMENT - Wayne Purcell - But if the beef industry is not there, then you go and do something else, right?

COMMENT - Rodger Wasson - Wayne, a couple of food companies have just spent millions of dollars for some of the major international management consulting companies to come in and look at their operations. They came back with a report that said it would be better if you treat yourself right inside. They paid millions of dollars to hear that maybe you shouldn't pay more money for a product you buy from yourself. Maybe at least you should get as good a quality as your competitors get from you. So, there is some change starting to go on in that direction. They are starting to look at how they can get more efficient in taking care of themselves. But if you are in beef or you are in pork, you can't necessarily count on them to be looking out for beef or pork. I think it raises an important issue. The American Meat Institute is now going to be representing poultry more and more. So it raises an issue of whether there needs to be an industry view of looking over the whole thing. We could continue to wring our hands and say they ought to become marketers, but I appreciated Dell's honesty--it isn't going to happen fast. Maybe we are going to have to, in some cases, say if these guys are going to kill efficiently, let's find a marketer, but let's look at the whole thing. If ITT and Apple can get together on a venture, why can't we put some otherwise competitive groups together?

COMMENT - Fred Knop - I think we'll use the few minutes we have left to try to extract some ideas on what we might do using the idea that Wayne has put forth to help this situation. It is frightening for me to stand up here and hear people say that beef is falling behind, particularly behind pork and poultry. Beef has the potential for going into a decline like the sheep industry did years ago. As a journalist, I can say that there have been a hundred times that the alarm clock has rung for this industry. Each time the alarm has rung, somebody has reached over and punched the button down and gone back to sleep. How can we put this alarm clock on a repeat basis that would be more effective in waking people up? Can I hear some ideas on that? Would it help if the communications were on a more frequent basis and perhaps a more structured basis?

COMMENT - Audience - Well, I think we talked about the need to get the alarm clock ringing on the right frequency and tuned in on the right station. I think it has been mentioned that there is a boogie man we all like to hide behind and build up the beef industry's problem in animal rights, fat and cholesterol, and bad press when really the beef industry's problem is the beef industry. Until we get the cost of production down, become more competitive, and develop a new product, we will struggle. You know those need to be the sounds that are heard out there. They had not been heard until just the last year or two, and they have only recently really come to the forefront.

COMMENT - Tom DeMott - The problems are systemic throughout the whole industry, and again you've heard a lot of great people talking. There are great people out here in the audience who know and understand this part far better than I. We just have to move in the direction by pulling all the industry groups together, even if some of them are very political, all moving in the same direction so that my goal and the feeder's goal and the packer's goal is all the same as it relates to the health and welfare of the beef industry. Otherwise, if we're not all moving in the same direction, shooting at the same goals and objectives, we're going to be back here five years or ten years from now, if there is an industry to talk about, dealing with these same issues.

SECTION 4

Implications of IRS Policies to Market Effectiveness and Price Discovery

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OPEN DISCUSSION

WRAP-UP

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Executive Summary of

IRS Policy on Hedging vs. Speculation: Possible Implications to Market Efficiency and Price Discovery in the Cattle Markets

by

Wayne D. Purcell

This chapter was prepared to introduce the increasingly controversial area of Internal Revenue Service (IRS) interpretations of hedging vs. speculative activity in the futures and options markets. The issue has moved to prominence recently in the wake of the 1988 Supreme Court decision typically referred to as Arkansas Best. The Supreme Court ruling is being seen to have substantial ramifications for what is and is not legitimate hedging activity even though the case itself did not involve hedging vs. speculation, and it did not directly involve futures markets.

The process of price discovery is introduced and discussed. An implicit hypothesis is that who is trading the futures markets will have a significant impact on the effectiveness of that trade and the effectiveness and efficiency of the price discovery processes. Given the current situation, there is concern that cattle feeders may be discouraged or even blocked from participation in the futures market and, therefore, from participation in the price discovery process by the developing IRS policy. The chapter reports on a research plan that is designed to investigate this issue and to provide an information base on what ramifications evolving IRS policy might have to the efficiency of the cattle futures markets.

A conceptual framework is presented which suggests that over time, the cattle futures markets undulate around some underlying equilibrium. In an industry like the cattle feeding sector, it is suggested that that underlying equilibrium might be a zero return to the feeding enterprise given that excess capacity exists in the industry and margins are highly competitive. There is discussion of what type of trader might be involved when the markets move away from the equilibrium to the high side and show what might be considered excessive profit margins to the potential cattle feeder. Conversely, and perhaps more importantly, there is also discussion of what type of traders might be involved when the market moves away from the zero-based equilibrium on the downside, and only large losses are being offered to the potential cattle feeder who looks at the forward pricing opportunities in the live cattle futures for guidance on placement decisions. An hypothesis is presented that any policy which blocks involvement of cattle feeders, with their access to proprietary and high-quality information, would tend to impede or impair the effectiveness of the price discovery process. The research program that is discussed is designed to generate a base of information that would allow an effective empirical testing of this hypothesis.

The results of a survey of cattle feeders in Kansas and Texas are presented briefly. In general, the results suggest that many cattle feeders are blocked from participating in the live cattle futures markets or the feeder cattle futures markets in the price discovery context. They enter the markets, if at all, only in the traditional short hedge in the live cattle futures or long hedge in the feeder cattle futures. Since empirically it can be established that the markets

seldom are offering a profit to the cattle feeding program given the open access to cattle feeding activity, the inference is that most of these cattle feeders are seldom in the market and are, therefore, seldom participating in any way in the price discovery process.

Building on that base of survey results, an empirical analysis of large trader activity in the mid-1980s is presented. The results show that when the market moves away from the zero-based equilibrium on both the positive and negative sides, it is the large speculator that is involved, active, and is the most important in turning the market back toward an equilibrium. This is especially important, it would appear, when the market moves down and has only very negative feeding margins. It is not the long hedger, but the large long speculator, that tends to move into the market, buy, and move the margins back toward the zero-based equilibrium.

An argument is presented that cattle feeders, with their access to information, if allowed to participate fully in the price discovery process, would make the market more effective and efficient. The prolonged periods of negative margins that have been offered on a number of occasions during the 1980s would not be eliminated, but they might be minimized to the extent that cattle feeders' participation in the price discovery process increased the efficiency of the market. The cost of continued exposure to price risk could perhaps be reduced, and over time the benefits of increased efficiency would be passed onto consumers in the form of lower beef prices.

The chapter calls for continued research in the area. There is an indication that the third phase of the planned program of research will investigate the magnitude and the distribution of any cost or benefits from more complete cattle feeder participation in the price discovery process. The idea is, to be explicit, that if a cattle feeder is facing nothing but a huge negative margin and normally buys feeder cattle, he might instead sell the nearby feeder cattle futures, buy the distant live cattle futures, and help move the market back toward a more reasonable feeding market margin position. Such "reverse feeding" activities by cattle feeders would, in the current environment, be labeled as speculative by the IRS. There is a suggestion, then, that IRS policy needs to be examined in the context of what it is doing to impair the efficiency of the markets and what, in the process, it might be doing to the economic well-being of everyone in the system from producer to consumer.

Cattle Sector on IRS Hedging Policy

by

Jack Frick

The Supreme Court ruled in the 1956 Corn Products Refining Co. case that Corn Products' futures activities "constituted an integral part of its manufacturing business" and, like other aspects of the taxpayer's business, should give rise to ordinary income or loss rather than capital gain or loss. This rationale was further reinforced in 1972 by the IRS ruling that "hedging losses should be treated simply as a form of business insurance expense rather than a loss from the sale of exchange of property."

Agribusiness successfully implemented various risk management strategies on these interpretations for 32 years until the Arkansas Best ruling in 1988. Arkansas Best did not involve hedging; however, the Court's comments on Corn Products have been read by some to affect business hedges. Many IRS personnel read Arkansas Best as treating property as a "capital asset," resulting in capital gain or loss upon a sale or exchange of property instead of ordinary gain or loss.

To illustrate the tax consequences to the livestock feeding industry, I will demonstrate some hypothetical situations. For simplification, I will assume a zero basis between futures and cash and will also demonstrate the difference between IRS treatment of paying taxes on capital gain or loss rates under Arkansas Best scenarios at 28 percent, and the Corn Products ordinary income rate of 31 percent for an individual.

Assume a cattle feeder purchases 1,000 heifers with a breakeven of \$69 per cwt. A put option with a \$68 strike price costs \$2 including all commissions. A \$74 call option could be sold for \$1.50 net including all commissions.

We will look at two widely used industry hedging strategies and three different selling prices and the resulting differences in net profit or loss per head as well as taxes payable and the resulting increase or decrease in cash flow to the cattle feeder.

Selling Price: \$67 per cwt. on 1,000 pound heifer

Example 1. Feeder buys a \$68 put only, sells the put at \$1.25 when marketed.

Item	Tax Consequences		
		Arkansas Best	Ordinary
Cattle Profit	(20.00)	Tax on Cattle	(6.20)
Net Cost of Put	(7.50)	Put	2.10
Net Profit	(27.50)	Tax	(4.10)
			(3.87)

Net Cash Flow + or -

Arkansas Best	(23.40)
Ordinary	(23.63)

Example 2. Buys a \$68 put and sells \$74 call, sells put for \$1.25 when cattle are marketed, call expires worthless.

Item		<u>Tax Consequences</u>		
			Arkansas Best	Ordinary
Cattle Profit	(20.00)	Tax on Cattle	(6.20)	(6.20)
Net Cost of Put	(7.50)	Put	(2.10)	(2.33)
Net Call	15.00	Call	4.20	4.65
Net Profit	(12.50)	Tax	(4.10)	(3.88)

Net Cash Flow + or -

Arkansas Best	(8.40)
Ordinary	(8.62)

Selling Price: \$74 per cwt. on 1,000 pound heifer

Example 3. Feeder buys a \$68 put only, put expires worthless.

Item		<u>Tax Consequences</u>		
			Arkansas Best	Ordinary
Cattle Profit	50.00	Tax on Cattle	15.50	15.50
Net Cost of Put	(20.00)	Put	(3.00)	(6.20)
Net Profit	30.00	Tax	12.50	11.30

Net Cash Flow + or -

Arkansas Best	17.50
Ordinary	18.70

Example 4. Buys a \$68 put and sells \$74 call, put expires worthless and call bought back for \$.25.

			<u>Tax Consequences</u>	
			Arkansas Best	Ordinary
<u>Item</u>				
Cattle Profit	50.00	Tax on Cattle	15.50	15.50
Net Cost of Put	(20.00)	Put	(3.00)	(6.20)
Net Call	12.50	Call	3.50	3.88
Net Profit	42.50	Tax	16.00	13.18

Net Cash Flow + or -

Arkansas Best	26.50
Ordinary	29.32

Selling Price: \$84 per cwt. on 1,000 pound heifer

Example 5. Feeder buys a \$68 put only, put expires worthless.

			<u>Tax Consequences</u>	
			Arkansas Best	Ordinary
<u>Item</u>				
Cattle Profit	150.00	Tax on Cattle	46.50	46.50
Net Cost of Put	(20.00)	Put	(3.00)	(6.20)
Net Profit	130.00	Tax	43.50	40.30

Net Cash Flow + or -

Arkansas Best	86.50
Ordinary	89.70

Example 6. Buys a \$68 put and sells \$74 call, put expires worthless and call bought back for \$.1025.

Item	<u>Tax Consequences</u>			
	Arkansas Best		Ordinary	
Cattle Profit	150.00	Tax on Cattle	46.50	46.50
Net Cost of Put	(20.00)	Put	(3.00)	(6.20)
Net Call	(87.50)	Call		(27.13)
Net Profit	42.50	Tax	43.50	13.17

Net Cash Flow + or -

Arkansas Best	(1.00)
Ordinary	29.33

There are a number of points to be made from the results of the above scenarios.

1. Income Tax Liability. Under Arkansas Best the obligation would be increased drastically in the event of an extreme upward movement of cattle prices. Example 6 demonstrates it would be possible to completely offset \$29,330 net profits after taxes calculated under ordinary gain on the 1,000 heifers and leave the taxpayer with a \$1,000 loss. Furthermore, the taxpayer would still have to recognize \$104,500 in capital losses, and they could only be charged against other capital gains or used at the rate of \$3,000 per year for IRS taxes. Also note that cash flow calculated under ordinary rates is increased 10.6 percent after taxes in Example 4.
2. Risk Reward Ratio. In a strategy where a feeder buys a put and sells a call, the feeder is willing to risk a \$12.50 per-head loss for a chance to make a \$42.50 profit as shown in Examples 2 and 4. This is generally considered a good risk-reward relationship, but under Arkansas Best, as the cash price increased above \$75, the income tax liability would increase until there would be no reward to the risk at \$84.

Examples 2 and 4 illustrate that a complex option strategy (buy a put, sell a call) maximize profits and decrease losses compared to a simple strategy of only buying puts as in Examples 1 and 3. Risk managers are willing to forgo extremely large profits in exchange for a window of opportunity that the complex option strategy affords. However, IRS seems to disallow the complex strategy more than the simple strategy.

In conclusion, if a cattle feeder is not allowed to offset futures losses against cattle income, the feeder in time will have to take a wider margin of profit. This will happen at the expense of the cow-calf producer as feeder cattle prices are decreased and passed back down the production chain. In the long run, the added costs are passed up to the consumer. Also, cash cattle to futures basis will become more volatile and price discovery will be diminished with the reduction of the use of the live cattle contract.

Commodity Futures Trading Commission (CFTC) on IRS Hedging Policy

by

Joseph Dial

Our topic today affects all business sectors which use futures and options to hedge market risk. The Arkansas Best decision, or rather the IRS's interpretation of that decision, has led to considerable uncertainty as to the characterization of income and loss from hedging activity. Until 1988, hedging gains and losses had been afforded ordinary treatment, which allowed for the deductibility of hedging losses against ordinary business income. Since 1988, the IRS has interpreted Arkansas Best to mean that only a narrow category of legitimate business hedges will receive ordinary tax treatment. This means that gains and losses on many different kinds of hedges must be treated as **capital** gains and losses. Such capital losses are not deductible against ordinary business income, which can significantly reduce or even eliminate a hedger's after-tax profit.

As a consequence of this interpretation, American business is experiencing financial loss and a diminished ability to use the futures and options markets to manage risk effectively. The uncertainty that this problem has caused puts the hedger on the horns of a dilemma--does he attempt to hedge his business activity and risk subsequent adverse tax treatment, or does he forego the protection of hedging through futures and options, and leave himself open to market risk?

In addition to the problems for market users, it appears that the IRS's interpretation of Arkansas Best may compromise the futures and options markets themselves by keeping the most informed participants--those with proprietary information about their business activity--out of the price discovery process. Dr. Purcell is currently conducting research on this question, and he recently participated in an Arkansas Best panel discussion at an April 27, 1992 meeting of the CFTC's Agricultural Advisory Committee. At that meeting, Dr. Purcell postulated that the individuals with the most reliable, up-to-date information about their operations and production may not be using the markets because of the possible unfavorable tax treatment they may receive. In essence these market users are saying, "I can't take the tax risk of using futures and options to hedge my market risk." This "barrier to entry" may result in increased price variability and market inefficiency, which in turn may interfere with the futures markets' vital function of providing a mechanism for risk transfer and price discovery.

The CFTC has taken an active interest in this issue. Prior to the Agricultural Advisory Committee's panel discussion, the CFTC's Financial Products Advisory Committee, chaired by Commissioner Sheila Bair, addressed Arkansas Best at its March 12, 1992 meeting. Phoebe Mix, who is on the panel today, did an excellent job of moderating the presentations of that panel. As a result of the exchange of ideas at these Advisory Committee meetings, the membership of both Committees expressed their strong concern in recent letters to the Chairman of the CFTC, the Honorable Wendy Gramm.

In her letter, Commissioner Bair stated:

" . . . FPAC was deeply concerned that continued uncertainty in the tax treatment of these transactions has the potential to disrupt the efficient operation of the markets which the Commission oversees."

In my letter, I noted a similar concern, and also stated:

The result of a continuation of the status quo will be to continue to impair the ability of American agriculture to implement effective risk management techniques and participate in the price discovery process. A vibrant United States economy requires that American agribusiness be able to make appropriate decisions to manage market risk.

CFTC's interest in this issue is two-fold. First, it appears that the IRS's interpretation of Arkansas Best may interfere with the efficient functioning of the futures and options markets. Second, market participants may be adversely affected by this interpretation. The Commission has taken several steps toward addressing these problems. In its April 27, 1992 Report to the President on the 90-day Regulatory Review process initiated by President Bush in his January 1992 State of the Union address, the CFTC noted problems and inequities raised by Arkansas Best issues. In addition, on the same date the Commission wrote a letter to Secretary of the Treasury Brady on this topic. In that letter, which refers to the CFTC's report to the President, the Commission stated:

[t]he uncertainty surrounding the tax treatment of hedging transactions has several negative consequences. First, serious tax inequities are possible if hedging transactions are treated as property subject to capital gains and losses. Second, severe tax penalties can be levied against otherwise innocent commercial interests who have been following the commonly accepted tax procedures for these hedges. Third, treatment of futures and options as property for tax purposes can reduce the effectiveness of business hedges. As a result, businesses may rationally choose to remain exposed to price risk rather than hedge in the uncertain environment that now exists.

Our letter to Secretary Brady indicates this uncertainty has the potential to disrupt the markets, create market inefficiencies, and impose needless costs to the markets and market participants.

The Congress of the United States has established the CFTC as the federal government authority over hedging transactions involving futures and options, and as such it is in a unique position to provide technical expertise on how to define legitimate hedging transactions, as well as information about potential market effects. The CFTC's statutory definition of hedging is found in Section 1.3(z) of the Regulations to the Commodity Exchange Act, which defines a bona fide hedging transaction as one which normally represents a substitute for a transaction in a physical marketing channel, and where the transaction arises from the potential change in the value of assets, liabilities, or services, and is economically appropriate to the reduction of risk.

17 C.F.R. §. 1.3(z)(1) (1992). The regulations enumerate specific examples of bona fide hedging, and provide for exemption from speculative position limits for other non-enumerated transactions. 17 C.F.R. §§ 1.3(z)(2), 1.3(z)(3), 1.47 (1992).

In 1987, the Commission published two statements in the Federal Register relating to the definition of hedging. The first release clarified that the "temporary substitute" criterion is not a necessary element of bona fide hedging. 52 Fed. Reg. 43,633 (1987). The second statement was an interpretation of Commission Regulation 1.61 regarding speculative position limits, and was intended to assist exchanges in amending their speculative position limit rules to include risk management exemptions in addition to exemptions for hedging and arbitrage or spreading. 52 Fed. Reg. 34,633 (1987). These interpretations exemplify how the Commission has clarified the availability of other exemptions in light of new strategies and concepts in the futures markets. The Commission's functional definition is grounded in sound economic principles of risk transfer, and permits market users to manage risk effectively in an ever-changing marketplace through the use of futures and options.

It goes without saying that the CFTC is concerned about this issue for all areas of American business. Some examples of common agribusiness hedges are:

1. **Long Anticipatory Hedge.** Assume a corn processor establishes a long corn futures position of 200 contracts at a price of \$2.75 per bushel to protect against the risk of future price increases on 1 million bushels of corn that will be needed to meet anticipated processing requirements. The current cash price for corn delivered to the processor's location also is \$2.75 per bushel. The processor later purchases the needed corn supplies at \$2.95 per bushel, and then offsets the long futures hedge position on the board by selling the 200 contracts at \$2.95 per bushel. The processor gains \$.20 per bushel on his hedge transaction thereby offsetting the \$.20 per bushel price increase in the cash price of corn over the intervening three-month period.

This hedge, which is not considered to be problematic under Arkansas Best, is within the definition of an enumerated hedging transaction in Regulation 1.3(z)(2)(ii)(C), which includes:

Purchases of any commodity for future delivery on a contract market which do not exceed in quantity [. . .] Twelve months' unfilled anticipated requirements of the same cash commodity for processing, manufacturing, or feeding by the same person [. . .]. 17 C.F.R. § 1.3 (z) (2) (ii) (C) (1992).

The regulation also requires that the position be reduced in the last five trading days so as not to exceed the person's unfilled anticipated requirements for that month and for the next succeeding month. Unlike the long anticipatory hedge we have just seen, each of the following examples is arguably problematic under the IRS's current interpretation of Arkansas Best.

2. **Short Inventory Hedge.** Assume a commercial grain company establishes a short futures position on 100 contracts to hedge the purchase of 500,000 bushels of wheat. This strategy achieved price protection, however the company had \$.02 per bushel worth of expenses for which it assumed the risk. The cash purchase and the short position on the board are both completed at \$3.60 per bushel. At a later date, the company sells the wheat at \$3.80 per bushel and offsets its short futures position at a price of \$3.75 per bushel. The company gains \$.20 per bushel on its cash position and loses \$.15 per bushel on its futures position and, as a result, receives a net profit of \$.03 per bushel.

This hedge is within the CFTC's definition of an enumerated hedging transaction in Regulation 1.3(z)(2)(i)(A), which includes:

Sales of any commodity for future delivery on a contract market which do not exceed in quantity [. . .] ownership or fixed-price purchase of the same cash commodity by the same person. 17 C.F.R. § 1.3 (z) (2) (i) (A) (1992).

This section is also applicable to two more of the hypotheticals that I will cover.

3. **Short Processor Hedge.** Assume a flour miller goes short the board 200 wheat contracts at the same time it purchases for inventory 1 million bushels of wheat. These transactions are initiated in order to reduce the risk of loss if the price of wheat, and therefore flour, goes down. The cash purchase and the short position on the board are both completed at \$3.75 per bushel. Add \$.10 per bushel to the purchase price to cover the cost of milling. In due time the flour is sold for an average wheat equivalent price of \$4.00 per bushel. The miller has offset the short futures position at an average price of \$3.89 per bushel. As a result of these transactions, the miller has secured a gain in the wheat-equivalent price for the flour and byproducts of \$.15 per bushel, an offsetting loss on the futures transactions of \$.14 per bushel, and overall net profit of \$.01 per bushel.

This hedge is within the definition of an enumerated hedging transaction in Regulation 1.3(z)(2)(i)(A), which includes:

Sales of any commodity for future delivery on a contract market which do not exceed in quantity [. . .] ownership or fixed-price purchase of the same cash commodity by the same person. 17 C.F.R. § 1.3(z)(2)(i)(A) (1992).

and 1.3(z)(2)(iv), which includes:

Sales and purchases for future delivery described in [the preceding paragraph] may also be offset other than by the same quantity of the same cash commodity, provided that the fluctuations in value of the position for future delivery are substantially related to the fluctuations in value of the actual or anticipated cash position. 17 C.F.R. § 1.3(z)(2)(iv) (1992).

The regulation prohibits holding such a position during the last five trading days.

4. Options Hedge. Assume a cattle feeder has 1,000 steers in a feedlot with a breakeven price of \$71 per cwt. He wants price protection at \$70 per cwt. so he pays a premium of \$2 per cwt. for a put option at a \$70 per cwt. strike price. At the same time, he sells a call option at a \$76 per cwt. strike price and collects a premium of \$1.50 per cwt. Thus, the net premium cost is \$.50 per cwt. By putting a fence with options on this pen of steers the feeder made the decision to assume the risk of losing \$1.00 per cwt. and at the same time limit his potential profit to \$5.00 per cwt. The feeder sells his finished cattle at \$80 per cwt. and covers his short call option for \$4.50 per cwt. His put option expires worthless. The feeder collects \$80 per cwt. from the cash market transaction thereby realizing a gross profit of \$9.00 per cwt. The feeder has a net option premium cost of \$.50 per cwt. and it cost him \$4.50 per cwt. to cover his short call position. The overall net profit for this set of steers is \$4.00 per cwt.

This transaction falls under the general definition of a bona fide hedge found in Regulation 1.3(z)(1)--a transaction which normally represents a substitute for a transaction in a physical marketing channel, and which arises from the potential change in the value of assets, liabilities, or services, and which is economically appropriate to the reduction of risk. 17 C.F.R. § 1.3(z)(1) (1992).

5. Multiple Hedges. Assume a cattle feeder has 1,000 steers on feed with a breakeven price of \$70 per cwt. When the cash market price reaches \$73 per cwt., the feeder is no longer comfortable with the risk/reward ratio and hedges the steers by taking a short futures position at \$73 per cwt. Subsequently, the cash and futures prices decline to \$70 per cwt. and the feeder removes his hedge by offsetting the short futures position. (The feeder is still comfortable with the risk at \$70 per cwt.) The cash and futures prices again move up to \$73 per cwt. and the feeder re-establishes his short futures hedge position. The cash and futures prices then increase to \$80 per cwt. and he sells the finished cattle and offsets his short futures position. The feeder makes a profit of \$10 per cwt. on the cash market transaction, a \$3.00 per cwt. profit on the first hedge, and incurs a loss of \$7.00 per cwt. on the second hedge. Net profit on this pen of steers is \$6.00 per cwt.

This hedge is within the definition of an enumerated hedging transaction in Regulation 1.3(z)(2)(i)(A), which includes:

Sales of any commodity for future delivery on a contract market which do not exceed in quantity [. . .] ownership or fixed-price purchase of the same cash commodity by the same person. 17 C.F.R. § 1.3(z)(2)(i)(A) (1992).

The important point to note about this hedge transaction is that, while the **total** number of positions taken seriatim may exceed the number of cattle owned, at any one point in time the number of positions is appropriate to the amount of the cash commodity.

As you can see from the foregoing examples, the CFTC's functional definition of hedging applies to all of the above situations where businessmen and women have made rational, economically efficient decisions to hedge their business activity. The more stringent definition, which is apparently being applied by the IRS, is creating difficult restrictions in this process. While I'm not attempting to formulate the IRS's tax policy, I've taken the time to go through these examples because I think it is useful to think about the conceptual underpinnings of hedging, and pursue a commonsensical rationale for the tax treatment of hedging based on the economic and legal realities of the transactions. Perhaps this exercise would be helpful in formulating an appropriate resolution to this problem.

Chairman Gramm has encouraged Treasury to take expeditious action to end the uncertainties caused by Arkansas Best, and has indicated the CFTC's willingness to assist in efforts on the part of the Treasury Department to resolve the issue.

The Commission recognizes hedging as an important adjunct to economically efficient business conduct. Impediments to such conduct are deleterious to capital formation and growth, which in turn negatively affects the United States economy. To fail to address the Arkansas Best problem is to ignore President Bush's efforts to cut back excessive and misguided government actions that impose a large burden on the economy, and levy a hidden tax on American households in the form of higher prices for goods and services.

Financial Sector on IRS Hedging Policy

by

Phoebe Mix

I find the whole area of Arkansas Best and hedging one of a series of ironies which, if you have a good sense of humor and you're not personally involved, is extremely entertaining. As you become more and more involved, however, the more it looks like a bad dream and possibly a tragedy. When it first came out, it seemed like the people who were most interested in talking about this issue, apart from tax lawyers, except those of us who have client interests, were people in the futures markets. We have to thank Wayne Purcell and the Commodity Futures Trading Commission for having taken up the cause, and I thank you all for listening today.

As Wayne said, the Arkansas Best case really does impact much more seriously on the financial markets than the agricultural community. I think most of you are maintaining what are considered to be "tax inventories." I say tax inventories because you and I might consider inventory different from the IRS. Banks, for example, do not maintain inventories. Banks do have large portfolios and mortgages, but they don't have inventories. They don't have protections in a cash market and they may find, after Arkansas Best, that their hedging losses are not going to be allowed by IRS. Another major sector of the economy which is impacted is airlines. Their rides are not inventories as we understand them. When an airline goes out to hedge its fuel exposure, it is an ordinary expense. But it is not an inventory expense, and because of that, all those hedges are at risk after the Arkansas Best with its apparent narrowing of focus to inventories.

There is a lot of money involved in this issue. The first litigated case to go forward involves Fannie Mae. Mortgages at issue in that case were \$2 million dollars in disallowed losses with respect to hedges using interest rate futures. Just to give you a sense of a time lag with these issues, the tax years at issue in Fannie Mae were 1978-80. There is quite a time lag in litigating this issue. A second case involves interest rate hedging. There is no guidance coming out of Washington on the subject of the IRS's interpretation of Arkansas Best or what the IRS thinks the popular definition of hedging is after Arkansas Best. That is not coincidental. It was a source of discussion at IRS when I was there and left in 1990.

The IRS has apparently contemplated an attempt to resolve the issue administratively, but it could not. They looked at the issue, and the major factor in any "legislative fix" would be the pay-as-you-go required in tax legislation. Pay-as-you-go means you can't present something that is going to cost money unless you find someone that is going to pay for it. Another thing that means is you have to decide what the cost of a piece of legislation is. If you conclude that current law is what the IRS is promoting in the Fannie Mae case, then when other cases go forward, if you're talking \$200 million dollars for one taxpayer for two years, you have a substantial amount of money involved. Then you are going to have to make it up somewhere, and there is question as to where you would find that much money to support the legislative fix. The alternative, of course, one could conclude, is that the current law is not much different from

what the past law is. It is possibly even more expansive than the past law was. In this case, there is very little revenue cost involved but also very little need for legislation.

Another interesting thing about this issue to me is what I call the "conspiracy of silence." When I was at the IRS and we were waiting for people to call to complain, I can count on one hand the people I talked to. I cannot quite count on one hand how many people I talked to about this issue on the outside. There are not a lot of people out there sitting on top of the issue. It makes sense. Anybody involved in interest rate hedging in the mid-80s was taking a bath on those hedges because of the expectations that the rates were going to rise. They were hedging against that expectation. Rates in fact fell, so there were people who lost money on their hedges that wouldn't have incurred losses otherwise. People have been disinclined to come forward to speak about it, disinclined because if they are like Fannie Mac, they're about to go to tax court, and it would be inappropriate to go forward and talk about it. If you do not already have the IRS agent at your door, you are disinclined because you're afraid you just might prompt the agency to do something. You might point out to the agent that might not otherwise realize it that you were involved in hedging transactions, and the agent would probably want money. People have said we never know about government agents; they might just overlook it. So maybe I won't tell them I am here.

The net result has been very little activity, so the uniform comment coming out of the IRS, the Department of Treasury, and the congressional staff is that nobody is talking about it. I just want to encourage all of you today to talk about it. Raise the profile, tell your congressman it is important, tell your senator it is important, that it is not the comments of a few tax lawyers in Washington, that it really is a big economic issue. It is not just a big banking issue. The banks have a lot of money in it, but it is going to affect all of us. My guess is that in the particular problems facing the livestock industry, the moves on hedging will be curtailed to any legislation that fixes the old hedging definition, and they probably will move with some caution even there. Whenever you get Congress in micro managing, you may end up with the same a b c d e & f, maybe giving the impression that it is one way or maybe it isn't. They just haven't thought about it. My guess is that they will eventually come up with an application requirement. That is the one thing policy makers are really hung up on. They want an up-front identification as to whether it is actually going to be treated as a hedge. They feel that the taxpayers cannot decide after the fact, based on whether or not they made a loss or made money out of a transaction, whether or not it was a hedge.

Any hedging definition is going to have to acknowledge both basic production and the wide cost of "yield enhancement" aspects to a hedge. That is to say, you buy a put to protect against drops in prices, and in some cases, fund the cost of that put by selling a call. The premium gained on the call offsets the cost of the put. You want to make sure that both of those are included so that any legislation actually addresses the hedges the people are using and not the simple-minded hedges that the IRS has in mind when they talk about the issue. I think we are a long way from any sort of definition today. The IRS tends to move very cautiously with respect to transactions that it doesn't understand. It doesn't understand futures and options.

An analogous area is what they found with respect to foreign currency. They have a great deal of latitude in commerce over how to deal with foreign currency and introduced the notion of integrated treatment providing integrated timing and character with respect to making transactions. So if you, for example, enter into borrowing in yen, and hedge the yen exposure

so that your net cost for funds is fixed in U.S. dollars, you just treat it as fixed U.S. dollar borrowing. That sort of model doesn't seem very attractive to many people. In your example in the cattle business, there would be an integrated cost of any hedge with the net proceeds or whatever you receive when you sell cattle. The IRS has essentially adopted a uniform treatment, but they started with perfect opposites. The hedge has to come off the same day the cash product is sold, and it has to be matched dollar for dollar. You couldn't "leg in" or "leg out" of a hedge.

I'll tell you a little bit about the Fannie Mae litigation because I think it tells you what the dangers are in the current environment. Historically, for example, the IRS wanted one-for-one matches on hedges. They had to be dollar-for-dollar. Fannie Mae's hedges were on a selective basis. Sometimes the exposure was hedged, sometimes it was not, and not all of the exposure was always covered. Was it speculation because Fannie Mae was not hedging its entire portfolio? It must be speculation, the IRS maintained, and therefore is not a hedge. It is hard to put that next to the historic view of hedges, but you need to understand they have gone to court and said that. Some have said that this shows a lack of supervision in the IRS. I think that is correct. I take that as a given in the playing field in which you are working. The absence of any guidance from the national office means the government agents are free to read the Arkansas Best decision however they want to read it. There is no one in Washington telling them they can't read it that way.

I have heard people suggest the only hedges that are valid hedges after Arkansas Best are those in which the taxpayer is holding or accumulating inventories. In light of the history of interest rate hedging that I have pointed out for you, that position seems absurd. But there isn't anybody in the agency that thinks it is absurd.

There has been some activity in Washington, some lobbying of Treasury and lobbying of the IRS, to change the situation administratively and also working with Congress to see what can be done legislatively after the Arkansas Best ruling created so much confusion and uncertainty. The National Chamber of Commerce is taking the lead. They are looking for other supporters with members of the Senate Finance Committee. Any of you in a district who has a senator on the Finance Committee might want to consider encouraging them to join this effort and sign off on the Chamber's initiative to get something changed. I think that I will leave the rest of it for the question and answer period.

Agricultural Sector on IRS Hedging Policy

by

Mike Clark

You're different from the groups I normally end up speaking too, which I have to confess are usually groups of tax lawyers. I haven't had too much experience with some of the material on the program this morning. I was listening to the presentations on the cattle markets, and I find them interesting. I hope you will find the material I will share with you about some of the turmoil in the tax arena with respect to hedging also interesting, although perhaps out of your ordinary day-to-day thoughts. In some respects I am happy to be here, but in some respects I also regret that I have to be here. The fact that we are having an afternoon session on the tax consequences of hedging really is in some respects evidence of a failure of our tax policy to treat transactions in an economically neutral way. We really should do it that way. After the 1986 tax reform, the idea was that the taxpayers would go about their business without having special tax preferences for certain types of income or dramatic rate differentials between ordinary and capital income. In fact, in the hedging area, that isn't working out as anticipated. It is evidence, perhaps, of a failure of our tax policy, and hopefully we can, perhaps with education and some lobbying activity by people who are most affected by this policy, get some movement in the next couple of years. If not, hopefully we'll get some movements in some of the cases that are moving towards litigation.

I am going to try to give you some background about what really is the catching problem. Some people refer this to the Arkansas Best problem, but it really wasn't created by Arkansas Best. It has been around for a very long time. There are two tax aspects of the problem that need to be addressed. There are two problems that arise when you put on a hedge. I am going to give you an example that illustrates those problems. One is the character of the gain or loss on a hedging position. In our tax system we have always, at least since the early days of federal income taxes, made a distinction between the taxation of ordinary income and capital gain income. We still have that distinction in the tax law even though the tax rates for a corporation aren't much different now on a capital gain. Individuals pay 28 percent on a capital gain and 31 percent on ordinary income, which obviously shouldn't make a great deal of difference. But we do have a problem with the treatment of capital losses in that capital losses may not be used to offset all ordinary income. So there are strict limitations on the use of capital losses. I want to illustrate that problem as I go through my comments.

The other problem is the timing. When is your gain or loss recognized? As some of you may remember, in 1981 we had a very substantial revision in the way that futures transactions are taxed. No longer do we have normal realization. When you close out a transaction, that is when it is realized. We have a mark-to-market system, and there is a hedging exception to the mark-to-market system. But part of its applicability depends on the character of the gain or loss. So we need to look at how those rules apply to common situations, and I will explain what Arkansas Best has done to create some uncertainty.

Suppose we have a situation where we have someone who operates a cattle feedlot. He needs to acquire cattle in February and is concerned that the price of the feeder cattle is going

to go up substantially before he actually makes the purchase. One thing a cattle feeder might do is acquire a long future position in feeder cattle futures to anticipate the purchase of those cattle as a source of supply for his feeding operations. Contrary to expectations, as often seems to be the case in these situations, the market prediction was wrong and our cattle producer ends up buying physical capital (the feeder cattle) for \$100,000 less than anticipated. At the same time, he has to close out that futures position and incurs, roughly, a \$100,000 loss on the futures position. He goes on happily through the end of the year and doesn't have any more hedging transactions or anything else out of the ordinary. At the end of the profit cycle when the cattle are ready to go to the market, because he has a \$100,000 lower than expected acquisition cost for his feeder cattle, he ends up making \$100,000 he wouldn't have otherwise made. At the end of the year when he goes to fill out his tax return, he says, "I had \$100,000 extra profit on my cash inventory, and I have a \$100,000 futures loss. But that is really a net economic wash, so why should that give me any great problem?" Well, under the tax law it does. If that transaction is not treated as a hedging transaction, it can give you a very big problem. If the transaction is not viewed as a hedge, then the \$100,000 ordinary income that is realized when the cattle are sold in the cash market is fully taxable with no "offset" from the loss on the futures.

Let's go back and look at history for a moment. After 1929, when people had a lot of stock sitting around which had substantially decreased in value, Congress was concerned that if people were able to eliminate their incomes by recognizing capital losses, that there wouldn't be very much left of the tax base, at least after the cataclysmic events of 1929. So Congress limited capital losses, and the rules for the level of that limit have changed from time to time over the years. Currently, the only way corporations can deduct a capital loss is if they have capital gains to offset. There are liberal rules which allow them to carry capital losses back three years and forward five. For an individual, the carry-forward rule is, you carry forward only but only for a limited period of time. Individuals also get a break in that they can deduct \$3,000 a year. But, let's say our feedlot operator is doing business in corporate form. He has an extra \$100,000 on his inventory that he has to pay tax on, and he has no other capital transaction. He has a \$100,000 loss which is unusable. So if you assume our corporate tax rate is 34 percent, he basically pays an extra \$34,000 to the government on transactions which was a net zero in terms of profits.

There is also another tiny problem. Suppose in our example that we have a situation where our cattle feeder is an individual, and he is into the futures market in December of 1992. He puts on his long futures position in February futures in anticipation of his February purchase of the actual physical inventory. The market in this case behaves as the cattle feeder expected and goes up. At the end of the year under the Internal Revenue Code when you hold a position in regulated futures contracts, you are supposed to "mark that position to market." So, if our cattle feeder did not bother to identify it as a hedge, then potentially you have timing dissimilarity in that a gain has been recognized. As a result of the futures contract price, the gains would be taxable on his 1992 return. He is not actually going to buy physical capital until the next year, and he is not going to realize any offsetting loss or cost when he actually buys the physical capital until his 1993 return. So if this transaction isn't a hedge, you can have a timing dissimilarity and the potential consequences are that you have to pay tax on gain that you ultimately won't have.

Now, I don't mean to imply by the use of these examples that there are not necessarily some pretty good arguments that these transactions I described are hedging transactions. I think, in fact, there is a pretty good argument that they are, and we have pretty solid cases where we are treating our feeder cattle purchase as an appropriate hedging transaction. But I did want to tailor the examples to some extent to illustrate problems for the markets that are center to you folks. Believe me, there are some other examples in which the result isn't quite so clear. I hope this illustrates the difference in tax treatment that can result if you don't qualify as a hedger.

Why is hedging a big concern now? People have been hedging for a very long time and the Internal Revenue Code has been around for a very long time. One would think this problem ought to have been satisfactorily dealt with before now. Up until 1988, I think most people thought that the law wasn't altogether satisfactory, but at least it was somewhat understandable if not perfect.

I think there are two reasons why we have a problem right now. The first reason is simply one that pervades the tax law in that the tax administrators and the law really lag, to some extent, developments in the marketplace. We have products now in the futures markets that simply were not available 25 to 30 years ago. We have currency futures, we have financial futures, and we have options on futures. It is particularly those financial futures and options on futures which revenue agents are not always familiar with when they encounter those transactions. When they look to establish precedence in the tax law, they aren't going to find any. If you think about how long it takes to get a tax case from audit into litigation and get the judge to write an opinion (and that can be appealed), you're looking at maybe 10 years from the time the taxpayer filed the return. So, for products that were developed and first came into use in the early '80s, we're just beginning now to see those things come to light in terms of litigation activity. Thus, when agents look for precedence, they are not going to find anything. That is one problem.

The other problem has been really created with the decision in Arkansas Best, which came down in 1988. That problem arose from the fact that the Internal Revenue Code is the source of our tax laws. It doesn't really tell you any place what a hedging transaction should be to avoid capital treatment. There are some definitions that have been added from time to time in connection with some of the rules on the straddle provisions. But, really, we have never had a tax code definition of hedging. That wasn't really a problem because back in the 1930s the IRS issued a pronouncement that said hedging, by and large, would be considered to produce ordinary gain or loss, and the reason they said that was that they said hedging is a form of price insurance. The example that they used in their pronouncement was somebody who is in the cotton business who was involved in the futures market. To the extent that losses were realized on the futures transactions to protect against gains or loss in the ordinary business of that cotton producer, that should be treated as ordinary or as a legitimate form of business insurance essentially as a way of insuring against catastrophic losses in that individual's business. There are certainly a few twists and turns in the law over the years from that time. There are disputes about how perfect your hedge has to be and how much trading could go on within the scope of what is legitimate hedging. For example, there were disputes where individuals put on a hedge, and then they would, for various reasons (mostly related to their view of the market), trade that futures position periodically and readjust their hedge position as prices change.

There are also situations where taxpayers would sell the physical commodity and try to replace that commodity with holdings in the futures market. The question: Is that hedging? The IRS said no. So there were certainly squabbles around the edges as to what was an appropriate hedging transaction. The basic principle remained clear, however, that hedging gains or losses, if you appropriately define them as hedges, did produce ordinary gain or loss. The real reason for any difficulty is what the cases were trying to distinguish, why it was important, why the individual got in and out of the market, how closely related the quantity of the positions were to the actual physical commodities held, and all of that is important. This is because we had, and still have, a system where people who are professional speculators, who trade on the floors of the exchanges, receive capital treatment on their income from trading activities. The question was, how do we distinguish those professional speculators from the people who are regular market participants? Who is going to get ordinary fees? So the question is: Are you really hedging? Are you really protecting a physical position? Are you closely matched to that position, or are you indeed in speculation?

The relative quiet in the area with respect to hedging changed in 1988 with the Arkansas Best case. Now Arkansas Best doesn't have anything to do with hedging, and it doesn't have anything to do with the futures market. Nonetheless, what the Supreme Court said in the process of deciding that case has caused a great deal of turmoil with respect to trying to figure out what the treatment of hedging is. I can illustrate Arkansas Best most effectively by giving examples. Suppose corporation A is a bank holding company, and the business of a corporate holding company is owning other corporations. One of the corporations that holding company A owns is corporation B, a national bank. National bank B keeps losing money. (We have to remember that banks losing money is not a recent phenomenon; it also occurred back in the 1970s.) Bank B kept losing money and the Arkansas Best Company kept putting money in the bank because they were afraid that, as a bank holding company, it would be embarrassing if one of their banks failed. So, they kept putting money into the bank. Ultimately, in 1975 they finally washed their hands of it, gave up, sold the stock in the bank, and had a loss of 10 million dollars.

Well, Arkansas Best management had read some of the hedging cases, and one of those hedging cases was a case called Corn Products. I might let other speakers illustrate some of the facts of that case. Basically, it was a situation where a corn processor needed physical corn to make into various refined products, and the taxpayer incurred a gain on long positions in corn futures contracts that were bought to guarantee a supply of corn. The taxpayer tried to get favorable capital gains treatment on those gains. The Supreme Court said, no, that's related to your ordinary business activities. We don't think that Congress intended that income from ordinary business activities be accorded favorable capital gain treatment. So, in Corn Products the taxpayer lost, and thereafter it was pretty much settled law that if you have income that was closely related to your ordinary business activity, it ought to receive ordinary treatment and not capital treatment. Arkansas Best management said that the reason we put this money into our bank was that if the bank went down too, we were afraid that no one would deal with any of the banks that are owned by our holding company. Therefore, we think that relates to our ordinary business of operating subsidiary corporations and we should get ordinary treatment. The Supreme Court said "no. They said the loss is capital and, therefore, subject to the limitations on capital losses and, in the case of Arkansas Best, not deductible.

The reason they said that is partly the reason that I pointed out earlier. We don't have in the tax law perfect definitions of the boundaries of capital asset treatment. The way the Internal Revenue Code works is that they say that everything is capital except for several narrow categories that are excluded. You won't find hedging defined in any of those narrow categories. Nonetheless, the IRS and the courts previously said that ought to be there somewhere. The two most likely categories that are applicable are stock trades or inventory or property held for sale for customers under normal course of business. The Supreme Court looked at the stock in this failed bank and said that it doesn't look like any of those things that are in that list in the Internal Revenue Code that are excluded from capital treatment. We think that previous cases meant to say, and in particular the Corn Products case, that the transactions that were an integral part of the taxpayers' inventory purchasing system are entitled to ordinary treatment. It doesn't mean that everything the taxpayer does as part of ordinary business is entitled to ordinary treatment. That is too broad, so they say, essentially, that you have to find a specific pigeon hole in the code to exclude a transaction from capital treatment, and none of the pigeon holes fit this particular stock transition. The stock is perhaps the classic example of what is normally productive of capital gain or loss so the taxpayer was stuck and ended up having capital treatment on its losses.

The problem that this really focuses on with Arkansas Best is for those hedges where you can't readily find one of the pigeon holes in the code for arguing for ordinary treatment. Arkansas Best may not be the end of the world for hedging with respect to agricultural products because if you have agricultural products, the Supreme Court said activities that are closely related to your inventory purchase system ought to be receiving ordinary treatment. That actually may be a slightly broader statement of the law than some of the old hedging cases that spend all sorts of time trying to find out if you were perfectly hedged or not. That statement may, in fact, be helpful in litigating hedging cases that are closely related to inventory in areas such as the agricultural markets. It is a little more problematic when you get to areas like hedging interest rate risk. You have to search pretty hard to find a specific provision in the code to get out from under that problem. And, in addition, the emphasis is on "inventory purchases" and that may not fit the short-hedge situation where you sell live cattle futures to protect against price declines on cattle already on feed and in "inventory."

I am out of time, but I want to say that these are real problems. We have a couple of on-going audits that we are monitoring, one of which we are going to be taking to litigation within the next month or so. To the extent that you have heard about taxpayers that have been audited and hedging losses have been disallowed, we certainly should be hearing from you. IRS agents are going out, and there is no guidance coming from the national office at the IRS, at least at the present time. People are getting transactions disallowed which perhaps should not be disallowed. There is also certainly a danger in the case now pending with respect to interest rate hedging. I would be happy to go into some of the litigation in the questions and answers.

Discussion, Questions and Answers

QUESTION - for Joseph Dial - You gave five recognized hedges. It wasn't clear to me who they are recognized by.

ANSWER - Joseph Dial - Actually, what I gave were five hypothetical possible hedges. Then I tied the definition in the commodity exchange regulations. You should treat those particular hedges in terms of our interpretations of legitimate hedges.

COMMENT - Wayne Purcell - It is an interesting point that he raises, that hedging as seen by IRS may be inconsistent with the CFTC criterion of a hedge.

COMMENT - Joseph Dial - It is set up for exact language of definition. The hypotheticals I used are used in a sense of saying this is a hypothetical situation. In my opinion the definition of hedging applies to this, making it a legitimate hedge from that perspective. I am not saying that is what IRS is doing. The hypotheticals I used were designed to comply with the language found in the Commodity Exchange Act where it defines hedging. Thus I consider these examples, which by the way are being used in the normal course of risk management in today's markets, to be legitimate hedges. I am not saying IRS agrees or even recognizes the definition of bona fide hedges as it appears in the Commodity Exchange Act.

COMMENT - Wayne Purcell - Note that the CFTC has worked at defining what a hedge is and is not. We've heard on several occasions there is no definition of a hedge in the IRS code or in their operating procedures.

QUESTION - for Phoebe Mix - You talked about the Fannie Mae case that dates back to the 1970s. Does the IRS have some kind of statute of limitations beyond which, if you claim it before that time, they are not going to come after you?

ANSWER - Phoebe Mix - No. The reason that the cases are so old is because, as most of you know, there is a three-year statute of limitations on tax cases and six years in the case of product, but appeal and services are so far behind in the audit cycle that repeatedly they will come to you and say would you please extend the statute. If you don't, we will hand you a notice of deficiency essentially disallowing everything, and given that alternative, everybody says, sure, I'll sign it. This is how Fannie Mae came to have the years 1978-80 coming to litigation in 1992.

COMMENT - Mike Clark - I do a lot of tax litigation, and I just finished a pretty large corporate case last year which involved taxable years 1972-76. It takes a long while for these things to get through the process.

COMMENT - Wayne Purcell - So you are not safe here, I think is what Phoebe and Mike are saying. Whatever you have in mind, they can still come get it!

COMMENT - Phoebe Mix - If they finish and you've completed the entire process, in some parts of the country, you've settled out with the IRS or they've issued enough challenges, then

you don't have a problem because the year is closed. But with any open year, you will have a problem and it goes back as far as we have open years.

QUESTION - Wayne Purcell - for Jack Frick - My survey with Texas and Kansas cattle feeders indicates that, for substantial numbers of them, concern about how they would be treated by the IRS does, in fact, keep them out of the futures market. I run into skepticism from some people because there is a perception that the cattle feeders trade the way that they want to regardless of how they have been treated for tax purposes. What is your sense of that? Is it right that some cattle feeders who, at least might otherwise be effective participants in the market, stay away from it because of this tax-related concern? What do you think?

ANSWER - Jack Frick - Yes, I think that is right. I know of two cases in Kansas. I know one firm, in fact, has stopped using futures altogether because, with their challenge from the IRS (they were using option strategies before similar to what I had up there), they don't have faith in the deductibility anymore.

QUESTION - There have been two potential solutions to this dilemma discussed. One is going to Congress and generating legislation to deal with it. The other is going to Treasury and trying to get some changes in administration. I would maybe start with Phoebe and whoever else might wish to come in on this to give us better views on the potential for either of these strategies.

ANSWER - Phoebe Mix - I think it is interesting that the Chamber of Commerce's letter or initiative that they are circulating would go to the Senate Finance Committee and Treasury to say, "What do you think is the best way of resolving this issue between the legislative and administrative front?" I guess my personal view is that if it is going to be resolved in the near future, it will come from the administrative branch, the Treasury, because they have been pressured to do so by Congress and by the White House. They won't do it on their own, but the IRS has felt for quite some time that the Treasury has been concerned that if they pose an identification (of a hedge vs. non-hedge) requirement, they would get some support in Congress for doing such a thing. With some interest expressed by Congress, the Treasury may fix it, and it would probably make them feel a lot more comfortable by providing some sort of administrative fix.

QUESTION - Wayne Purcell - Would you expand on this identification requirement that we are talking about a little bit please?

ANSWER - Phoebe Mix - The identification would be that a taxpayer engaging in a futures transaction would have to mark in some manner on his books and records what the hedging transaction was, identify both legs, identify the time into the hedging transaction, and call it a hedge. It is a requirement familiar to those of you familiar with the futures contracts. You do have to make that identification to qualify for the hedging treatment for the mark-to-market provisions. Essentially, it would be that identification requirement imposed across the board.

COMMENT - Mike Clark - Following up on that, I guess I don't really have a big problem with an identification requirement. It seems to me it is just following up on something that is already in the mark-to-market rules. If that is the price we pay for Treasury fixing the hedging problems, so be it. I would agree with Phoebe that I think the most likely source of relief in the near term is through the administrative process. The IRS really had worked over the years

to develop some parameters for what were appropriate hedging transactions. They certainly haven't reached a perfect solution and have gone in kind of bits and starts through litigation. At least it was not a scenario with agents totally without guidance moving around and disallowing transactions. I think it is incumbent upon the IRS to get some guidance out to people in the field. As I said, I don't think Arkansas Best is really catastrophic with respect to people in the agricultural market. The Supreme Court clearly recognized that if you are hedging something that is related to your inventory, that ordinary hedging transactions related directly to your inventory ought to be given ordinary treatment. I don't see why it should be all that difficult for the Treasury to at least mark down some things that everybody should be able to agree on. At least there ought to be some guidance out there saying that some very basic transactions such as the anticipatory purchase of supply and commodities needed in your business or anticipatory sale of product of crops you have on the ground or livestock that you have on the feedlot are hedges. I don't see why we couldn't at least get some of those simple things taken care of. I personally think that the IRS ought to be able to take care of some of the tragedies that Jack was talking about. That may take a little more doing, and I hope that we will be making some efforts in that respect in the next few months, but it seems to me that the way to at least initially get started is for the IRS to get some guidance out so that we aren't running around totally without knowing what sort of transaction they ought to be looking at. At least get those things that clearly ought to be okay off the table.

In the long run, liability hedging is going to be, I think, a tough problem. Personally, I think the IRS could be helpful in an administrative context, but realistically, while litigating the Fannie Mae case, I am not sure what incentive there is for them to abandon ship. So I think the Fannie Mae case is going to go on for quite a while. The opening briefs are due in July, and the next phase is then in September. If you allow time for the judge to write an opinion and for possibly that opinion to be reviewed by other judges on the tax court, you're looking at maybe the summer of 1993. Whoever loses is going to appeal, so that case is going to be kicking around for a while. The case that we are currently contemplating taking to claims court we would hope would get to court sometime next year, but you never know how quickly a judge would rule on that and deal with the situation. Again, litigation isn't going to produce movement anytime soon. My personal opinions are pretty clear about the legislative forefront. Maybe I will let Commissioner Dial speculate as to what is happening in Congress.

QUESTION - Wayne Purcell - Now that we are through here, I want everyone to give us an assessment, based on their exposure and experience, of how likely they think an administrative solution within the next year and a half really is. Jack, why don't you start your prognostication. You've been in the Washington scene and you are on the advisory committee to the CFTC. I know you've been heavily involved in these discussions with Treasury, etc. Do you think it is going to get fixed administratively, and what is the likelihood?

ANSWER - Jack Frick - There are hopes that we could do that, but I don't think we should be too optimistic. I don't really have a real good feel for what our chances are of getting it fixed administratively. The IRS hasn't had a lot of pressure put on them yet, and I know that process is just now starting. So, I guess my hopes are a little higher now than they were yesterday. Hopefully, maybe in a year, we can get some relief. We thought something might develop late last year, but recently everything has come to a stop.

ANSWER - Phoebe Mix - I would say that if there was going to be an administrative solution, the chances are we will see it sooner rather than later. The longer this goes on the more difficult it may be for the IRS to back off. As Mike pointed out, it is going to be difficult for them at the moment to back up because they have gone forward with the Fannie Mae case. I was one of those who half thought that the IRS would, on the White House steps, repent of this folly. One has to really wonder whether they really want to win this case. This is really one of those that you don't necessarily want to win and perhaps they would be better off admitting defeat. I have more confidence that political pressure will move this issue administratively faster than will common sense or rational economic sense. If you asked me again what was going to be the administrative solution, I am not sure.

QUESTION - Wayne Purcell - I am no expert in this area, but the ironic thing to me is, like I said in my earlier presentation, that for 25 years we in the livestock sector have often not known for sure what a hedge is. I think that all Arkansas Best does is raise this issue to a lot more people. I hear Mike talking about the fact that there are no rules, and I thought: Why aren't there any rules? It is 1992 and we don't have them. Why are they going to come and issue rules for us now when they have never issued them before?

ANSWER - Phoebe Mix - There wasn't any need until the Arkansas Best decision in all cases to define what a hedge was because you had ordinary treatment if you could establish your business purpose. Your problems were solved if you could establish a business purpose acquiring property, and so the debate about whether or not something was a hedge was essentially moot, at least in my view. This is, I think, why there was very little litigation or discussion about what a bona fide hedge was up until 1988. Now, possibly in the agricultural sector the question of whether or not you could justify a complex hedging strategy and know what treatment you were going to get might be an issue, but I don't recall much concern before 1988.

COMMENT - Wayne Purcell - I tend to disagree a bit with that because you showed that the notion of a hedging definition and whether multiple or selective hedges and "fences" using options were issues before Arkansas Best.

ANSWER - Phoebe Mix - It was an issue not in terms of whether it was a hedge, but whether or not it was speculative. We may be splitting hairs. You could establish a business purpose for acquiring a position. It did not matter whether it reduced risk and constituted a hedge. All you had to establish was that it had a business purpose as opposed to speculation. Now the argument with the Arkansas Best decision is you don't have the business purpose to hide behind so that if you can't fit into whatever the definition of a hedge is, then you are in trouble. It has raised some pressure points on what constitutes a hedge.

QUESTION - Commissioner, on the hypotheticals that you presented, was it clear on any of them prior to Arkansas Best how IRS would have treated them? I am just thinking back on the ones you presented. Anything that had to do with selective hedging or that sort of thing was up in the air and unknown and uncertain all along and has always been. Is that not right?

ANSWER - Commissioner Dial - Yes, and we've had movements both ways depending on who the agent happened to be and that sort of thing. That is true. Getting back to your original question, in my opinion, unless there is considerable pressure from American businesses on

Congress and the executive branch, I don't think anything will happen. To get the IRS to take steps to be more definitive in where they are coming from and where they are going, I don't personally (this is my personal opinion, not an opinion of CFTC) see anything being moved.

QUESTION - It is not entirely clear to me what the recommended solution is. I hear the desire that IRS define a hedge, but whose definition of hedge are you recommending? That the CFTC definition of a hedge be adopted as a solution? What is the desired actual solution to the definition?

ANSWER - Commissioner Dial - No, CFTC is not recommending that IRS do anything. What CFTC is saying is that in the Commodity Exchange Act hedging is defined in the regulations and the Act enumerates specific examples of bona fide hedging. We're suggesting that IRS, inasmuch as they apparently don't have that type of fix on bona fide hedging, should perhaps look to the agency that has been mandated by the Congress of the United States to deal with those markets--the CFTC--(in which hedging is a moving force) to look at the definition that is already there. That definition has been considered and reviewed over a long period of time and everyone needs to look at it before they deliberate on what IRS is going to do. Chairperson Graham has made it very clear that CFTC stands ready to offer whatever technical expertise the IRS would like to have from CFTC, inasmuch as we are the congressionally mandated authority in hedging.

QUESTION - Wayne Purcell - Jack, think about that for just a moment. I think it is an interesting question. What does the National Cattleman's Association want by way of a solution?

ANSWER - Jack Frick - We want to get some clarification, of course. I get real antsy when we start talking about making a hard definition on a hedge because as new tools come along that we can use, I want to be able to use them. If we go too far at this time and define a hedge and are expected to stick with it hard and fast, we possibly won't be able to use some of those new possibilities. The industry possibly could get behind Commissioner Dial's example where he hedged and re-hedged and used a selective or multiple hedging strategy so long as your open interest never exceeded the total number of cattle you had on feed. But, go one step further with this scenario where a feedyard has an interest in keeping cattle on feed year round. There are scenarios when there is no way that you can put on a hedge that is going to eliminate risk or even substantially reduce it because the market is offering only negative margins. So there is thinking out there that possibly they would like to have a total volume of open interest that they could use as an annual guideline. Even on a 10,000-head feedyard, you could have an annual use of 25,000 head, given the turnovers, if you want to put them on one time and try to hedge in a trend. If the market trend is high in March/April, you then try to hedge in that trend for the rest of the year and hold positions back down to the low point. I realize this is pretty different from anything we've had and when the market gets down to the bottom, (this ties in with some of the things that Wayne Purcell is trying to do) you need to be able to ride it up as a cash speculator, and I'd like to think of it as maximizing profits for that institution and for that cash-based operation. So, I think that we need to think about it in several different ways and not eliminate the possible chance of using a particular strategy as other products become available in the future and as we learn how to use the ones we have available now.

QUESTION - Wayne Purcell - What do the exchanges want by way of a solution? I have a feeling that the question may have been motivated partly by what I am also sensing. I thought that there was more of a concerted effort by the coalition of interests to get something done that had a main point in mind than I am sensing now exists. Is that kind of what you were getting at?

QUESTIONER - You can't get anything unless you have something specific that you want. If you are unsure of what you want, you aren't going to get anything.

ANSWER - Phoebe Mix - To date, by and large, those who have been lobbying have been asking to restore the status quo, and they don't want to do anything else.

COMMENT - Wayne Purcell - I am going to be one, with what impact I have, who advocates not just putting the bandage on Arkansas Best and going back to what we had before. There are a number of educators in the room. I would be interested in what some of you folks could tell us as to whether or not you've had some concerns, over time, about what was a hedge and what was not as you've worked with livestock producers, grain producers, etc., who were interested in multiple hedges, partial hedges, and the newer option strategies.

ANSWER - Audience - Absolutely. Over time, when you get into lifting hedges and all these practices that have always been in question with regard to selective hedging, the issue always comes up with producer groups. More recently, there is uncertainty about the options strategies such as those Jack Frick presented.

COMMENT - Wayne Purcell - And it interferes with their effective use of the market to protect their business interests, which is kind of what Jack Frick was talking about, isn't it? Do whatever it takes to be competitive and protect your business interests. One of the things that the Arkansas Best case does, and both the attorneys said this, is that it clearly says that your motive for doing something in the market is no longer relevant. Is that not right? Because we used to have the notion that if it is a legitimate business-related activity and what you're doing is consistent with the on-going, day-to-day business operation, somehow it was a hedge. But isn't that gone now?

ANSWER - Phoebe Mix - I think that if one thing was clear about the Court's opinion, it was that they do not want to be looking at people's motives for activities such as Arkansas Best buying stock. That was an issue in the case, and they clearly said they didn't want to do that.

COMMENT - Wayne Purcell - The ruling said motive does not matter, and that issue of motive is in a lot of the historical cases that I have looked at.

QUESTION - About a year ago there was a case called Circle K. I'd like to hear your thoughts on the decision of Circle K for the taxpayer about it being ordinary loss.

ANSWER - Phoebe Mix - At issue in Circle K was stock in an oil company. Circle K was a bunch of convenience stores where 35 percent of their profits came from sales of gas at the pumps. This was in the early '70s, and they concluded that in order to guarantee a source of supply (at one point during the emergency they had been unable to get enough gasoline to pump, so they wanted to be certain that they had gas) they bought stock in an oil company. They then

argued that when that stock became worthless, that they had acquired the stock to guarantee a source of supply. The IRS has a history of rulings which specifically say that to guarantee your source of supply is to get ordinary treatment, and the courts agreed with the taxpayer that they were generating supply. In a typically odd fashion, it was not a full conclusion of the court, and other issues in the case are still in limbo, so we don't have a complete decision yet. Anybody can appeal, which the IRS assures us they will do.

QUESTION - Wayne Purcell - Are you telling us now that IRS is disallowing that as a legitimate deduction?

ANSWER - Phoebe Mix - Well, characterized as ordinary, yes.

QUESTION - Wayne Purcell - Now, this has been since Arkansas Best?

ANSWER - Phoebe Mix - You have to wonder. This is a case involving stock, which was the one thing the Supreme Court was absolutely clear about, that is always capital. It does seem that the lower courts really don't believe the Supreme Court in what they had said in Arkansas Best.

QUESTION - What do you mean when you say that there is not a decision yet that can be appealed?

ANSWER - Phoebe Mix - I think this gets us to another issue. When the judge sits down to write a decision, and that has not happened yet, then the decision is final. He did decide the motion. Until there is a final decision, nobody can appeal. The IRS cannot appeal it. They already have the gist of a decision that they, the IRS, won't follow. But in my understanding from litigators, they fully intend to appeal this case when, and if, it is finally decided.

QUESTION - So what we are seeing is just that Arkansas Best did not entirely overrule Corn Products, that Arkansas Best itself could be re-stated to expand the definition beyond inventories again?

ANSWER - Phoebe Mix - I think you could make the case, but you could react in so many number of ways and I thought at one point what the IRS ought to do was declare a victory and go home. The IRS had to look at the Arkansas Best opinion and say, "Oh thank you very much Supreme Court. You've given us innovative timing and character rules and you've required up-front identification. We win, goodbye." But it seems to me that when the case went back to the Supreme Court, they might be as likely to adopt any view of what is meant with respect to hedging transactions. They could say we were talking about inventory, but of course we mean the mortgage that was held by banks. Those were ordinary assets; you want to get ordinary treatment when you hedge those. Of course, we mean the airlines hedging fuel exposure should get ordinary treatment on those hedges because jet fuel is an ordinary expense tool. It seems to me we really don't know what the Supreme Court thinks about hedges because the issue of hedging is not before them.

COMMENT - Mike Clark - I think Phoebe just made a very important point, that the Arkansas Best case wasn't a hedging case, and I personally think the result in Circle K indicates a very helpful trend in that the first court that had to seriously look at Arkansas Best was very reluctant

to read it broadly. I think that gives us hope for cases like the Fannie Mae case, that the tax court in that case will not seek to adopt a far reaching interpretation of Arkansas Best. Arkansas Best is itself internally inconsistent with how ordinary transactions are to be treated. The court said very specifically, "We don't like this particular transaction with bank holding company stock. We think stock ought to be capital." There is also a footnote on the opinion where the Supreme Court had a number of past decisions, like Corn Products, where the taxpayer had tried to get capital treatment on things which were very closely related to their ordinary business. The Supreme Court said, "Our opinion is not overruling those cases." So on the one hand, the courts opinion could be read to say that the law should be construed very narrowly and that unless you could find a specific clear directive to give this particular asset ordinary treatment, it should be capital. On the other hand, if you look at their footnote where they said, "We're not overruling those other cases" (if you look for a place in the code to find ordinary treatment for those you will be looking for an awfully long time), I think there is room for courts to read their comments narrowly. I think in the inventory area there is room for the courts or the IRS to take up the Arkansas Best case and say they said to allow inventory related hedges and let's go out and define what those are.

QUESTION - Is the IRS inclined to clarify things on their own? Would they prefer to go through litigation?

ANSWER - Phoebe Mix - Not seeing any other ready volunteers, I'll take that one. I think the IRS should be inclined to clarify the situation, and there was initial activity at the Treasury Department after Arkansas Best came out to put out some guidance. That rather abruptly stopped in the fall of 1990 because evidently someone higher up in the IRS decided this was an issue that was simply going to have to wait for legislation. We have a danger here in that, with the Chamber of Commerce and a number of groups seeking legislation, the natural response for people on the IRS side is to say that it is going to be dealt with legislatively. Why should we stick our necks out and go rushing out to try and fix the problem? Congress is going to deal with it, so there are some tensions there with the legislative efforts, perhaps creating a disincentive for the IRS to deal with the situation. The IRS is going to start having situations where agents are out there in the agricultural sector, for example, raising issues that are going to get the IRS in the litigation, and they are going to have to decide what it is they want to do at that point. As those issues start bubbling up through the audit cycle, it seems to me that in and of itself institutions help put pressure on the IRS to get some guidance out there, to tell its agents what they ought to do. They are already pretty far along, in any case, with the interest rate hedging. It seems to me it is harder now for them to back away from that and put out some guidance because they've already taken a position in litigation, and I think that may be a little slow, in fact, and perhaps the agriculture side might have to wait because of the Fannie Mae litigation.

QUESTION - Was there any consideration of having someone from the IRS on this panel this afternoon?

ANSWER - Wayne Purcell - Yes, I talked to some contacts. We had a fairly long talk, and I thought this gentleman was going to make a really nice addition to this presentation. We kept talking, and all of a sudden something occurred to me. I said, "What you are implying to me is that if you agree to come to Chicago and participate in this program, you can't say anything, can you?" Basically he agreed that because of the impasse that has developed, he could not say

anything. So we don't know if there is going to be a resolution. He finally said, "Now I'll be honest with you if I come, I can't say anything." So at that point in time I decided it wouldn't be very productive to have him on the panel. Hence, we don't have him.

QUESTION - Wayne Purcell - Let me ask Commissioner Dial, as a representative of a public agency, and Jack Frick, as a representative of one of the key private sector groups that has a lot of interest here, to just think a moment about this. Think about what you would like to see people in this room do from here, what you would like to see happen, and what would help move us forward in a policy move on this issue. What would it be?

ANSWER - Commissioner Dial - I think what I said a while ago, that the people that are impacted by Arkansas Best, by IRS's interpretations and actions relative to Arkansas Best, have got to speak to the legislative process and to the executive process. If they don't, it is going to be a long time before this issue is dealt with one way or the other. So the industry needs to say something and the industry in this case, in my opinion, must come forward aggressively.

ANSWER - Jack Frick - I think we need to be in contact with our congressional members, ones that are on top of committees, put the pressure on, and get the word out. We need to educate our membership like the National Cattleman's Association and the whole profile of our membership. They don't realize the implications this has to our industry. I think we all have a stake in that corner. I think education and getting the word out is the first step. If we fail there, then we'll have to start on the legislative ground.

QUESTION - Wayne Purcell - Are there programs in place now to get this educational mission accomplished within the NCA, or are those in the planning process?

ANSWER - Jack Frick - We really haven't, at this time, dealt with this issue in a broad and association-wide way.

Wrap-Up

by

Todd Petzel

I have to tell you that we have a very strong motivation as an exchange at the CME to have interest in this tax legislation. We just celebrated last year and the year before 25-year anniversaries for live cattle and live hogs, 30 years in bellies, 20 years in currencies, and 10 years in stock index futures. We have prided ourselves in being able to diversify our product mix so that if one area of our product mix is soft, we would have other areas to help us out. There is no diversification that can get us out of this tax-related pickle. Whether it is cattle, feeder cattle, hogs, Eurodollars, or currencies, we are facing tremendous risk as an institution. But I think as Commissioner Dial said, the markets are facing a much greater risk. I am going to speak very briefly about a few things that I would like to highlight.

There are several ironies in this discussion. The first irony comes from something Mike Clark and Phoebe Mix both mentioned, which is the double jeopardy that seems to occur when you follow the standard accounting practice of identifying your hedges. If you are a good business person, you pre-identify your hedge transaction and the case transaction that goes with it. If you lose money, the IRS steps up and says, "No, that is not a hedge, sorry." If you make money on that hedge they do not run up to you and say, "Oh, that is not a hedge." They say, "Well I missed that one, so I'll pay ordinary income." That is okay. Now the economists in the crowd understand that this is an option pricing problem. I am hopeful that we will not see in our economic journals some analysis of the option characteristics of the tax gain that the IRS is beginning to play before we get an ultimate solution to this.

The treatment of options is also quite ironic. Commissioner Dial gave us good examples, and Jack Frick gave us good examples of standard hedge transactions using "fences." I'll give you another one and extend on the analogy a little bit. If you buy a put and sell a call at the same strike price, we know that is a synthetic short futures position. I believe even the IRS understands such a synthetic short futures position and that it would qualify for a hedge treatment. If we separate the strike prices by the smallest amount, say \$2.00 in cattle, all of a sudden we call into question which of these transactions is a hedge if any of them? That is very strange, and I think it is kind of a clue that we have intellectual inconsistencies here.

The other thing I want to point out to the academic economists in the crowd is that we have spent decades writing very archaic papers about what is an optimal hedge ratio, looking at risk return ratios, and saying 42.6 percent of our wheat crop should be hedged. We get suggestions from some people in the other areas of our life, the IRS and tax accountants, that say if it is not 100 percent hedged, it is not a hedge, or we get any other bunch of curious answers. That is a problem we have to consider. There are several risks, and Commissioner Dial was very good in articulating the risks to our marketplace. I won't go into that further. But I will add that for the longest time we have had kind of a quasi-monopoly on very efficient futures and options markets in this country, which is no longer true. In the last ten years, literally tens of futures and options markets have opened up. Ten, 20, 30, or so futures and options markets have opened up around the world ranging from Latin America to Europe, all

very efficient markets, all very hungry for business, and all very anxious to provide risk management services to their clients. I would hate for our country to clamp down on this industry, which has been one of our hallmarks of efficiency, when the rest of the world is improving its status.

The hedge definition Wayne wants me to comment on, the CFTC's view, is very old and it is really quite serviceable. Commissioner Dial emphasized several of the specific hedging definitions. I also want to remind you that there is a general hedging definition that is really quite good. You know for a fact that any regulation that has a number of sub-paragraphs, 1.3Z22C, obviously has been well thought out, and we should be able to learn something from that. The shorter paragraph has the general hedging definition, in fact, that has a lot more power in it than we might have talked about here today, but I think that is the source of a lot of opportunity. Wayne asked what the Chicago Mercantile wants in terms of resolution. What we would like to do is step back from the old premise. The old premise is that there are businesses out there that are independent entities, and whatever they do is their business. Whenever they step over to the futures and the options world, those are separate activities and have to be treated for accounting and tax purposes as separate entities. I don't think that way. I don't think Jack Frick thinks that way. I don't think most of the people who are active in these markets think that way. When Jack Frick decides to sell his cattle forward, he has many opportunities. He can sell on the board at the Merc, or he can sell on a forward contract with Dell Allen. He can sell to a whole bunch of other packers and can sell forward. It seems to me that what we have to do is get rid of the distinction of futures as separate entities and start thinking of them as one of many alternative ways of managing a business. When that becomes a reality, when futures and options trades are realized to be normal everyday courses of business, then a lot of these problems on defining hedging will go away.

A lot of the CFTC definition on hedging has to revolve around the speculative position. The question over here is what is the CFTC's definition largely to determine whether somebody is liable to speculative limits and to potentially manipulate the market. That is an interesting distinction. The Hunt brothers buying silver is an open question as to whether that was speculation, but nobody questioned their ability to buy physical silver. They just questioned their ability to buy silver futures. I would argue that both of those transactions might have had the same influence on the silver market and probably should be treated in an equal way. The same thing holds for Jack's forward contracts with a packer or a forward sale on the Merc.

The final advice I have is don't put total reliance on Mike's comments because it may not impact on agriculture if you're only doing inventory hedging. Inventory hedging seems to be a nice umbrella to protect us against that particular Arkansas Best storm, but not all of your hedging is inventory hedging. Your anticipatory purchases of feed certainly don't qualify under inventory hedging. Your anticipatory purchases of fuel don't qualify, and if you manage to adjust your interest rate risks by moving from fixed rates to floating rates using Eurodollar futures or swap contracts, that is not inventory. So I wouldn't say we are completely out of the eye of the storm here. What I do believe, though, is that there is some cause for optimism. I am not going to say there is a legislative solution on the horizon. I don't see one anymore than anybody else here does, but what I see is the potential impact of a lot of people getting very upset. IRS agents (I unfortunately do not have any personal experience on this) from my observations are like miners. When they see a vein, they will continue to mine that ore until either it runs out or somebody tells them not to do it. So you might see the situation where

cattle feeding operation after cattle feeding operation is hit by different aggressive field agents, and the grain elevator operator down the road doesn't seem to be hit because there is no exact precedent on challenging a grain operator. Sooner or later they are going to run out of cattle feeders, and they are going to look at those grain elevators, and they are going to look at people who do interest rate hedging in the Eurodollar market. I can tell you that the Eurodollar open interest at the Merc right now stands at a nominal value of over two trillion dollars. It is a fairly nice size market. If those hedges would come into question, you would see the forces of American business rise up as one and try to find some justice. It won't be just the Merc's interest in the Eurodollar contract that will be challenged; it will be the basics of swaps and everything else. I think at that point--I hope long before that point--we will see a more reasonable solution here. I can't believe from an intellectual standpoint that the silliness can go on too much farther given the amount of money that is being affected.

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