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**Date:** May 31, 2007

**To:** LMIC Members

**From:** Stephen R. Koontz

**Re:** RTI Livestock and Meat Marketing Study and R-CALF Press Release of May 2007

The purpose of this letter is to address some of the statements in the R-CALF press release that was dated around Thursday May 24, 2007 and entitled: "RTI Study Reveals Packer Noncompliance With PSA." PSA refers to the Packers and Stockyards Act. The version of the press release that I saw is at the end of this document. It is included so that you can see to what I am referring. R-CALF has made statements in the press release about the congressionally mandated and funded USDA GIPSA RTI Livestock and Meat Marketing Study (LMMS). The purpose of this letter is to provide you with information about the inaccuracies and potential misrepresentations. I participated in and contributed to the study, I understand the research methodology used, and I am aware of the study's strengths and limitations. I have also fielded questions regarding the press release over the past week. This memo summarizes what I have been saying. I hope you will find it useful and please feel free to share it with your extension staff or anyone with an interest in cattle and beef markets.

One portion of the LMMS measures price differences across the different pricing methods for cattle. Packer transactions data were used to measure this. The total dollars paid and the total carcass weights of individual transactions were used to calculate prices measured in carcass weight. The data also indicated which transactions were sold live, carcass, and grid. These are the different pricing methods. We found that cattle sold on a carcass weight price were lower than those sold on a liveweight price (\$1.30 per hundredweight) and that cattle sold on a grid (carcass weight with premiums and discounts for carcass quality characteristics) were also lower than liveweight prices (\$1.80 per hundredweight). The average fed cattle price during the study time period was \$131 per hundredweight. The press release states that these differences are evidence of price manipulation. The press release also states that these differences imply that carcass and grid prices do not reflect market fundamentals.

First, the statements that R-CALF has made in their press release are an incorrect economic interpretation and use of the research procedure used to measure the price differences. The procedure simply measures price differences and does not measure manipulative behavior. This is a subtle but important point. The tool measures the price difference but does not say why

there is a difference. To conclude that it is due to manipulation is an assumption made by writers of the press release and is not a conclusion of the study. Also to conclude that carcass and grid prices do not reflect market fundamentals is another assumption made by the press release writers and is not a conclusion of the study. I have had a number of people ask me, "Does the LMMS really say...?" What it says is that prices are different for different pricing methods.

Second, the press release communicates that the research team missed the result of the price differences across marketing methods. We did not. The press release communicates that GIPSA has known about the result. I am certain that the GIPSA staff did. The differences across pricing methods are one of the most well-known results in the agricultural economics cattle and beef pricing research literature. Carcass and grid prices are usually lower than liveweight prices in the scientific research that I have seen. The result has been found by numerous other researchers and published in a number of peer-reviewed scientific journals. Some of the first work was done independently by Dillion Feuz and Ted Schroeder in the early 1990s. Wayne Purcell has published some of the research and issues pieces by these and other authors through the Research Institute on Livestock Pricing during the 1990s. Clem Ward has done some of the more recent work. If you are interested in reading these works then please let me know and I will forward a citation list to you. Further, there are a large number of extension publications that discuss this research result. Some of these are available in handbook, "Managing for Today's Cattle Market and Beyond," that is available on the LMIC web site.

The bottom line is that price differences such as these have been known since the advent of grid pricing. Much of the research to which I refer looks at the question of why the prices are different across different pricing methods. The research discusses buyer and seller behavior that would result in price differences and that work has suggested that different risk preferences and different information can explain the differences. The packer assumes the dressing percentage risk in a liveweight transaction whereas the producer assumes that risk in a carcass weight transaction. Likewise, the packer assumes dressing percentage and carcass quality risks in a liveweight transaction whereas the producer assumes both risks in a grid transaction. No scientific research that I am aware of concludes manipulation is the cause. Other portions of the research to which I refer looks at pricing efficiency – the communication of price signals from the consumer down the market chain to producers. The pricing efficiency research concludes that the price differences are necessary to communicate price signals, improve quality, and address demand. It is also potentially much simpler than this. If you start with a high base, market discovered discounts are bigger than market discovered premiums. Market discounts associated with poor quality grade and poor yield grade carcasses are bigger than market premiums for good quality grade and good yield grade carcasses. That R-CALF would chose to make an issue over something that is well known and well researched is puzzling. The LMMS has the same finding as 15 years of research on grid pricing.

The press release states that the LMMS shows there are losses of \$10.15 per head for producers selling on a carcass weight method and \$14.06 per head for producers selling on a grid method compared to producers selling on a liveweight method. And that the total losses to the cattle industry are over \$200 million. This is not an appropriate use of the LMMS and let me provide some evidence to support this. For the time period of the study, the packing industry plant-level profit and loss statements showed an average a loss of \$2.40 per head. The volume slaughtered

and fabricated was 58 million head. There is a loss of equity in the packing industry of at least \$140 million. If prices do not reflect market fundamentals then why is the packing industry not making money? Something that is also well known is that during tight cattle numbers – and this occurs during the study period – producers can get packers to assume the dressing percentage and carcass quality risks by trading on liveweight. If there's a price that does not reflect market fundamentals during the study period it's the liveweight price.

Another result that comes from the price difference model but that is not discussed in the press release is that auction prices are \$2.40 per hundredweight higher than liveweight direct trade cash market prices. Ten percent of the transactions were purchased through auction markets. Can we use the same procedure as in the press release to calculate the “losses” to the cattle industry from not selling all cattle through auction markets? It is straightforward. Ninety percent of 58 million animals were traded through methods other than auction markets. A \$2.40 per hundredweight improvement in price on a 781 pound carcass is an \$18.74 per animal “loss” and results in \$978 million “losses” to the industry. The policy conclusion is also straightforward – prohibit all but auction market transactions. This is the same reasoning as in the press release. But it is not an appropriate use of the model to say prices would be higher if all cattle were sold through auction markets. Nor is it appropriate to say carcass weight and grid transactions are too low. So how is it that these two pricing methods that both involve the cash market result in different prices? In part, it is simply that prices are different for different pricing methods. Cattle purchased through auction markets tend to be long-fed, high USDA Quality Grade, but poor USDA Yield Grade. These cattle are also well-shrunk once they reach the packing plant so calculating a carcass weight price reflects this. The study period also includes a time period where cattle numbers are tight, packers are aggressively pursuing cattle, and are losing money. The liveweight direct trade and auction prices, in part, reflect this.

Third, there appears to be issues with the line between economic science and law. There two issues here that warrant discussion. The first of which is that the LMMS is not a P&S action. The R-CALF press release makes strong statements about violations of the P&S Act and that GIPSA should take legal action based on the LMMS. In fact, there are legal boundaries between the study and legal action. The LMMS was and is subject to federal law – specifically the Confidential Information Protection and Statistical Efficiency Act of 2002 (CIPSEA) – that governs how information revealed in the process of the study can be used. In short, it is my understanding that CIPSEA requires that the information collected for research cannot be used for investigative purposes.

The second science and law issue is that R-CALF suggests the entire study be dismissed because lawyers were not involved. The Request For Proposals (RFP) that was released by the USDA and the public comments that started the research process – all of which were published in the Federal Register – make clear the purpose of the study. It was to be a comprehensive economic and business study of the costs and benefits of marketing methods used in livestock and meats industries. It is neither a legal analysis nor an investigative action. Legal and political conclusions are not drawn in the LMMS. Economic and business conclusions are. The economic impacts of different policy actions are considered but that is all and that was a requirement from the RFP. For example, we looked at what the costs and benefits to the cattle industry would be if different alternative marketing arrangements were prohibited. The LMMS,

all six volumes of the Final Report plus Interim Report, deliver what was required by the RFP. The reports are large but so were what the research teams were asked to do.

And the LMMS is good science. The scientific process used by the economists and business school professional in the LMMS is well established by those fields. Further, the process generalizes to other scientific disciplines. Scientists recognize good science. I am willing to stand by the study in any type of scientific integrity proceeding. The quality of the research would come through. But that is the problem with good science, sometimes it is inconvenient, sometimes we don't like what it says. But that is also the purpose of science – to discover truth, to build knowledge, and to change minds. Even if you don't like the conclusions, the honest person must step back and say, "What is good science and does this study measure up?" And then if it does, the conclusions should be respected even if one disagrees with them.

R-CALF is trying to make hay from the differences in price levels across different pricing methods. And it's poor hay. Please drop me an email if you need more information.

#### **R-CALF: RTI Study Reveals Packer Noncompliance With PSA**

Washington, D.C. – Today, R-CALF USA delivered a letter to James Link, administrator of the Grain Inspection Packers and Stockyards Administration (GIPSA), to request a formal investigation of a pattern of practice by the meat-packing industry that raises concerns regarding compliance with the Packers and Stockyards Act (PSA). These concerns were discovered during a thorough review of GIPSA's February 2007 RTI Study, which revealed a particular pattern of pricing for cattle transactions that appears to raise issues regarding compliance with the PSA.

"The RTI data suggest that packers have been able to manipulate the grid system to engineer a lower overall average return to producers who sell on a grid basis, and this practice fails to send the right market signals to producers and feeders," said R-CALF USA Vice President/Region II Director Randy Stevenson, who also chairs the group's marketing committee. "The RTI data reveal an unreasonable and unfair depression of cattle prices for those producers who sell on a grid basis that is contrary to market fundamentals, as well as being contrary to the overall theme of the RTI report.

"The fact that data reported in the RTI study shows a violation of the law is amazing," he pointed out. "This revelation was right under their noses, and they didn't even recognize what it meant. Academic and political conclusions were drawn without legal expertise and a legal comparison to the requirements of the law.

"R-CALF suggests that all the conclusions of the study are invalid if they have not been based on legal expertise, which is the same problem USDA's Inspector General identified, and the same problem identified in the Government Accounting Office report back in 2000 – both said there should be legal involvement sooner rather than later," he pointed out. Now, the study that GIPSA commissioned has demonstrated the same shortcoming.

"RTI concluded the market is not broken, yet the data in the RTI study shows otherwise," he emphasized. "This study is based on information provided to RTI by USDA. That information has always been available to GIPSA, yet GIPSA has never been able to see a law violation, which highlights the problem of the lack of expert legal counsel involvement in investigations.

"In particular, it appears from the market data analyzed and reported by RTI that there are two significant anomalies in the prices paid by meat packers for live cattle," the letter states. "First, it appears that the prices for cattle sold on a live weight valuation basis are higher than the price paid for cattle that is sold on a carcass weight basis. Second, it appears that the prices paid for cattle that sold on a live weight basis are also higher than prices paid for cattle sold on a cash grid with quality and yield premiums and discounts. Together, it is estimated that these two price penalties for dressed weight and grid cattle lowered revenue for producers by more than \$200 million in the period studied by RTI."

“Apparently, the RTI researchers were so busy analyzing the data USDA had requested they show, that they overlooked the fact that their results prove that grid marketing is not sending the right signals to feeders – signals that RTI claims have huge benefits to consumers,” Stevenson commented. “As I understand the PSA, it doesn’t matter whether this was with ‘purpose (intent)’ or with the ‘effect.’ What is significant is that the RTI results show that the grid penalized participating feeders. The underlying impetus here is that grid marketing is a deceptive trade practice.”

The RTI study states that in direct trade transactions based on a carcass weight valuation, the average cattle price is 1.3 cents lower than the average price for direct trade transactions with live weight valuation. Even more striking is the difference for grid valuation transactions, where prices average 1.8 cents lower than the average price for direct trade transactions. Assuming an average dressed weight for cattle of 781 pounds, this price differential translates into a loss of \$10.15/head for producers selling on a carcass weight basis and a loss of \$14.06/head for producers selling on a cash grid basis compared to producers selling on a live weight valuation. When this price difference is multiplied times the volume of cattle sold during the period examined by RTI, it adds up to a total loss of \$202,631,068 for producers who sold their cattle on the cash market on a carcass weight or grid basis rather than a live weight basis.

“These results are counterintuitive and would seem to contradict a conclusion that packer pricing behavior creates incentives for producer quality,” Stevenson continued. “The prices a producer will receive when selling on a carcass weight or grid basis cannot be known with certainty when a producer enters into such an arrangement. Prices under these arrangements are lower than the average prices for cash sales on a live weight basis and reveal that pricing arrangements for carcass weight and grid transactions fail to adequately compensate producers for the risks they take on.

“Producers may be accepting carcass weight and grid basis pricing terms that fail to reflect market fundamentals because they lack access to the same kinds of information that packers have regarding prices, quality, yield and other market dynamics,” he explained. “So, pricing terms that appear to provide an advantageous opportunity for producers who prize quality and yield characteristics of their cattle may actually be depriving these producers of the full revenue they would receive in an open and transparent market with more equal bargaining power between producers and packers.”

“These points make it imperative to get the Competitive and Fair Agriculture Markets Act passed, as it addresses these points head-on, and we strongly believe other means likely will be insufficient,” Stevenson concluded. “The reasons that GIPSA and RTI failed to recognize a broken market right in front of their face could be incompetence, or bias, or both. In any case, there is a crying need for reform.”