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Congress of the United States

U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

Memorandum

To: Members, Subcommittee on Agriculture, Energy and Trade
From: Scott Tipton, Chairman
Date: June 30, 2011
RE: Subcommittee Hearing: Regulation Gone Awry: How USDA's Proposed GIPSA Rule Hurts America's Small Businesses

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On Thursday, July 7, 2011, at 10:00 a.m., in Room 2360 of the Rayburn House Office Building, the Subcommittee on Agriculture, Energy and Trade of the Committee on Small Business will hold a hearing on the United States Department of Agriculture (USDA) Grain Inspection, Packers and Stockyard Administration (GIPSA) Proposed Rule[1] on livestock marketing practices. The NRPM proffers suggested modification to rules implementing the Packers and Stockyards Act. The hearing will examine the effects of the Proposed Rule on small businesses and the failure to comply with the analytical requirements of the Flexibility Act, 5 U.S.C. §§ 601-12 (RFA).

The Committee will hear testimony from The Honorable Edward Avalos, Under Secretary for Marketing and Regulatory Programs at USDA. The second panel will consist of Mrs. Robbie LeValley on behalf of the National Cattlemen's Beef Association, Mr. Gary Malenke on behalf of the National Meat Association, Mr. Joel Bradenberger, President of the National Turkey Federation, and (minority witness).

I. Packers and Stockyards Act of 1921 (P&S Act)[2]

The P&S Act was enacted by Congress on August 15, 1921 "in response to concerns that, among other things, the marketing of livestock presented special problems that could not be adequately addressed by existing antitrust laws."[3] This legislation gave the Secretary of Agriculture

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[1] 75 Fed. Reg. 35,338 (2010) ("NPRM" or "Proposed Rule").

[2] 7 U.S.C. §§ 181-231.

[3] GOVERNMENT ACCOUNTABILITY OFFICE, PACKERS AND STOCKYARDS PROGRAMS: CONTINUING PROBLEMS WITH GIPSA INVESTIGATIONS OF COMPETITIVE PRACTICES 3 (GAO-06-532T) (2006).

authority to regulate livestock marketing activities at public stockyards and the operations of meat packers and live poultry dealers. USDA also was allowed to regulate stockyard operators and market agencies at the stockyards, and to issue reparation awards for monetary damages for violations of the law.

As stated in §192 of the P&S Act, it is unlawful for a packer or poultry dealer to:

> engage in or use any unfair, unjustly discriminatory, or deceptive practice or device; give undue/unreasonable preference/advantage to [persons or localities]; apportion supply among packers in restraint of commerce or create a monopoly; trade in articles to manipulate or control prices, if such apportionment tends to restrain commerce or to create a monopoly; or conspire to apportion territory, or sales, or to manipulate or control prices.
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> 7 U.S.C. § 192.

Regulatory responsibility of the P&S Act was assigned to GIPSA by the Secretary of Agriculture. GIPSA's role under the P&S Act is to uphold fair competition and enforce regulations within the marketplace that ensure such fair competition. GIPSA also is authorized to initiate and conduct investigations of alleged violations in the livestock industry under the P&S Act. A violator of these regulations may, after a hearing before the USDA administrative law judge, be served a "cease and desist" order, along with possible civil fines. If a packer is in violation of the P&S Act and reported by GIPSA, but ignores or refuses to pay fines, the agency has the right to refer the case to the Department of Justice which can enforce the violation through court action. In addition, the livestock producers have the right to seek their own remedies through court action. [4]

II. Background of Proposed Rule

In the decades since passage of the P&S Act, the livestock market and consumer preferences have changed significantly. Instead of selling livestock through stockyards or other mechanisms on the spot market,[5] a growing number of livestock producers[6] and most poultry producers[7] enter

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[4] GIPSA, LIVESTOCK, MEAT AND POULTRY OVERVIEW, (September 2008), *available at* http://www.gipsa.usda.gov/GIPSA/webapp?area=home&subject=lmp&topic=landing.

[5] The spot market is one in which the cash payment is made on a commodity and delivery is taken immediately. D. CHANCE, AN INTRODUCTION TO DERIVATIVES & RISK MANAGEMENT 2 (6th ed. 2004).

[6] GIPSA, USDA, 1 LIVESTOCK AND MEAT MARKETING STUDY ES-2 (2007), *available at* http://archive.gipsa.usda.gov/psp/issues/livemarketstudy/LMMS_Vol_1.pdf (noting that 38 percent of beef cattle and 89 percent of hog volume utilize alternative marketing arrangements).

[7] J. MACDONALD, USDA, THE ECONOMIC ORGANIZATION OF U.S.BROILER PRODUCTION 2 (2008).

into formal contracts with packers, often termed alternative marketing arrangements, for the sale and procurement of livestock.[8]

Supporters of alternative marketing arrangements argue that they allow packers to better control the flow and quality of the livestock moving through their operations, increasing their own efficiency and allowing them to pay producers a premium for quality livestock while meeting consumer preferences for specific types of quality meat at affordable prices. Critics of alternative marketing arrangements claim that the contracts between producer and packer distort market signals resulting in lower prices paid to all producers, especially those that choose to sell livestock on the spot market.

In the Food, Conservation, and Energy Act of 2008[9], Congress mandated that USDA develop additional regulations to implement the P&S Act[10] that establish the following:

a. Whether an undue or unreasonable preference or advantage has occurred in violation of [the P&S] Act;

b. Whether a live poultry dealer has provided reasonable notice to poultry growers of any suspension of the delivery of birds under a poultry growing arrangement;

c. When a requirement of additional capital investment over the life of the poultry growing arrangement or a swine production contract constitutes a violation of [the P&S] Act; and

d. If a live poultry dealer or swine contractor has provided a reasonable period of time for a poultry grower or a swine production contract grower to remedy a breach of contract that could lead to termination of the poultry growing arrangement or swine production contract.

In addition, the Department was directed to publish regulations which "establish criteria that the Secretary will consider in determining whether the arbitration process provided in a contract provides a meaningful opportunity for the grower or producer to participate fully in the arbitration process."[11] Pursuant to this directive, GIPSA published a Proposed Rule that would institute what some commenters would consider the most sweeping changes to the P&S Act since it was enacted.

III. Changes Made to the Rules Implementing the P&S Act

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[8] GIPSA, "Livestock and Meat Marketing Study," February 2007, *available at* http://www.gipsa.usda.gov/GIPSA/webapp?area=home&subject=lmp&topic=ir-mms .

[9] Pub. L. No. 110-246, 445 Stat. 1651 (2008) (hereinafter "2008 Farm Bill").

[10] *Id.* at §11006 122 Stat. at 2120, codified at 7 U.S.C. § 197c.

[11] *Id.* at §11005, 122 Stat. at 2119, codified at 7 U.S.C., §228 note.

a. Competitive Injury

The Proposed Rule states that "competitive injury occurs when an act or practice distorts competition in the market channel or marketplace."[12] The likelihood of competitive injury, as defined by GIPSA, is the reasonable basis that competitive injury will occur. Competitive injury occurs when an act or practice distorts competition in the market channel or marketplace. How a competitive injury manifests itself depends critically on whether the target of the act or practice is a competitor (e.g., a packer harms other packers), or operates at a different level of the livestock or poultry production process (e.g., a packer harms a producer). The likelihood of competitive injury occurs when an act or practice raises rivals' costs, improperly forecloses competition in a large share of the market through exclusive dealing, restrains competition among packers, live poultry dealers or swine contractors or otherwise represents a misuse of market power to distort competition.[13]

The rule also extends the definition from the conduct by packers, contractors or poultry dealers to conduct by packer, contractors, and poultry dealers directed toward livestock producers and poultry growers. Any conduct that potentially decreases prices to producers and growers or prevents them from competing with other producers or growers could be considered a violation of the competitive injury provision as that term is used in the Proposed Rule. The NPRM also states that depending on the circumstance that "[c]onduct can be found to violate section 202(a) and/or (b) of the Act without a finding of harm or likely harm to competition."[14]

Opponents of this provision claim that this will change the standard of the need for competitive injury by eliminating the need for so-called antitrust injury. They also believe that the term "distorting" the market is not clearly defined, leaving endless amounts of scenarios in which packers could be in violation of the P&S Act. Proponents of this provision agree that USDA needs authority to address unfair practices that have anticompetitive implications, or that can reduce business opportunities for producers if a packer or processor cannot provide a legal justification for price disparities.

i. Record Keeping

Proposed Rule 9 C.F.R. §201.94 requires a packer, swine contractor or integrator to maintain "written records that provide justification for differential pricing or any deviation from standard price or contract terms offered to poultry growers, swine production contract growers or livestock producers."[15] This would require packers and integrators to document information and data used to determine premiums and discounts paid to growers.

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[12] 75 Fed. Reg. at 35,341.

[13] *Id.* at 35,341.

[14] *Id.* at 35,351.

[15] *Id.* at 35,351.

Opponents of this provision are concerned that a packer, swine contractor or integrator will have to show that their price difference didn't "distort the marketplace". In order to do so, there is a possibility that they will have to hire lawyers, or economists who are experts in the intricacies of antitrust law and economics. This can be particularly harmful to small businesses that have a small amount of capital available for additional regulatory compliance.

Proponents claim that currently there is no recourse available for producers who appear to be able to deliver the same product as another producer, but receive a lower price. Commenters believe that better documentation of price differentials would allow the USDA to better enforce the P&S Act.

b. Prohibiting Packer-to-Packer Sales

A new proposed 9 C.F.R. § 201.212(c) would "prohibit packers from purchasing, acquiring, or receiving swine or livestock from another packer or packer-affiliated companies."[16] USDA believes that price information exchanged during packer-to-packer sales creates a situation where packers may be able to manipulate the prices, which would in turn be harmful to the producers.[17]

Opponents of the packer-to-packer ban believe that GIPSA is undermining the utility of packer livestock ownership. Critics of this provision believe that packer would further integrate into the production of livestock in order to limit their risks under the P&S Act, thereby furthering the "exploitation" of livestock producers through onerous contract terms. Commenters believe packers would have to utilize feedlots that could be out of reasonable shipping distance to their slaughtering operations which would increase transportations costs and reduce the price paid to producers.

Proponents of this provision believe that price manipulation happens when information is exchanged between packers, allowing the packers to manipulate prices to the detriment of the producers. They also feel that this provision will open the market to more buyers since each packer would have its own buyer, preventing conspiracy between multiple packers using the same buyer.

i. Packer-Buyers[18]

Section 201.212 of the NPRM, 9 C.F.R. § 201.212 provides that dealers who "operate as packer-buyers must purchase livestock only for the packer that indentifies that dealer as its packer-buyer."[19] The Proposed Rule creates a bright line demarcation with respect to dealers and their

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[16] *Id.* at 35,346.

[17] *Id.* at 35,346.

[18] Packer-buyer is a term of art and does not necessarily connote that the individual doing the purchase at an auction is an employee of a packer or processor. Rather, the packer-buyer is a representative purchasing on behalf of a packer or packers.

[19] *Id.* at 35,352.

relationship with packers. To have an exclusive arrangement with a buyer, the packer would have to identify the individual as its packer-buyer by filing forms approved by USDA. A packer-buyer is often hired by more than one packer to purchase specific types of livestock for their needs. This provision would require each packer to hire individual buyers for each purchase.

At auction barns, packer-buyers are bidding on livestock for multiple packers. These packer-buyers are usually bidding on a wide variety of animal types for numerous individual packers and they purchase livestock according to each packer's needs. Small isolated auction barns typically have smaller sales volumes, which reduce the number of animals in a daily sale that might be of interest to a particular packer or packer-buyer.

Opponents are concerned that this provision will result in fewer buyers traveling to remote or small auctions, resulting in lower volumes at these smaller auctions, which could reduce competition and, in the long-run, eliminate a valuable outlet for livestock producers. If that is the case, then more alternative marketing arrangements that have given rise to complaints about packer market power would be needed to replace the absent auction barn spot market.

Proponents of this provision believe that by limiting each packer to one packer-buyer it would open the markets to more buyers and prevent collusions between multiple packers using one dealer exclusively. In addition, proponents asseverate that the provision will lead to more buyers attending sales thereby increasing revenue for auction barns.

c. Tournament Systems

Tournament systems, used in most poultry contracts, are arrangements in which growers are paid in relation to how their performance ranks against other growers. Under the NRPM:

(a) If a live poultry dealer is paying growers on a tournament system, all growers raising the same type and kind of poultry must receive the same base pay. No live poultry dealer shall offer a poultry growing arrangement containing provisions that decrease or reduce grower compensation below the base pay amount.
(b) Live poultry dealers must rank growers in settlement groups with other growers with like house types.[20]

The NPRM establishes a base compensation and different types of houses would have to be in different ranking systems. In essence, the Proposed Rule prohibits an integrator from rating different house types under one combined ranking system.

Supporters of this provision claim that the tournament system provides the façade of allowing poultry growers to compete fairly for pay based on the grower's performance. They believe that since the grower's performance is determined by inputs (birds, feed and medicine) supplied by the poultry integrator, the ranking system has allowed poultry integrators to shift the risks of

[20] Proposed 9 C.F.R. § 201.214, *id.* at 35,352.

providing quality birds to growers without being able to control the inputs. To the proponents of the Proposed Rule, it institutes a level of fairness otherwise missing from tournament systems.

Opponents of this provision believe that if the competitive tournament system is eliminated through a mandatory base payment, companies will have no choice but to ensure everyone receives the median pay, rather than the current system in which some growers receive higher than the median and some receive less.[21] GIPSA believes that by removing the tournament system all growers will be raised to a higher common price, but critics of this proposal believe that all growers will be moved toward a lower common price, hurting high quality producers and packers seeking the highest quality poultry.

d. Suspension of Delivery of Birds

The NPRM states in proposed 9 C.F.R. §201.215 that integrators would be required to provide notice of any suspension of delivery of birds at least "90 days prior to the suspension taking effect."[22] Some within the industry find this problematic because there is seldom 90 days of down-time between the raising of flocks. Industry commenters critical of this provision believe there is a high probability that an integrator would have to suspend delivery while their growers are raising an existing flock – sometimes while the flock is no more than halfway through its growout cycle. As a result, the grower might not have a customer or may not be able to find a new customer before the flock is fully grown. Commenters in support of this provision believe that a 90-day period is excessive since unforeseen events[23] could warrant a shorter notification period.

e. Dealing with Capital Investments

Under the NPRM, if the integrator asks the grower to make additional investments in housing or equipment, the grower would be offered a contract which would allow the grower to recover "80 percent of the cost of the required capital investment."[24] USDA declares it needs authority to limit successive capital investment upgrades mandated by integrators due to the potential adverse impact such upgrades would have on a producer's financial position.[25] The industry is concerned about the federal government setting rates of return for the producer. Critics of this proposal also fear that an underperforming producer would have an unfair advantage over a more efficient producer. Proponents of this provision believe it will protect growers from onerous one-sided contracts or those that do not have the financial capacity to meet the capital investment requirements of integrators.

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[21] If all growers did not receive the median payment, then GIPSA might find that to be a "competitive injury" violation of the P&S Act.

[22] 75 Fed. Reg. at 35,352.

[23] Catastrophic or natural disasters and/or other emergencies.

[24] Proposed 9 C.F.R. § 201.217, 75 Fed. Reg. at 35,352-53.

[25] 75 Fed. Reg. at 35,347.

Currently, integrators already present growers with estimates of expected costs and returns on suggested improvements. The Proposed Rule also would require each integrator to maintain detailed records for every capital improvement for each grower.[26] Opponents to this proposal believe that requiring additional recordkeeping mandates will add costs to integrator operations that they will absorb by reducing the capital improvement they seek from the growers. Proponents feel that if producers are often required to make capital investments as a condition to keep their contracts, this provision will keep producers from furthering their debt.

The analysis already performed for the poultry industry applies with equal force to the pork industry given the similar nature of the supply chains in poultry and pork.[27] However, there is one major distinction between the two industries – the use of risk-sharing contracts by some hog producers and swine contractors or processors. These contracts allow for ledger accounts in which producers essentially receive a loan from packers when the market price is below a specified breakeven price. This type of loan is paid back when prices are above breakeven – a feature that producers highly value. If packers decide to offer risk-sharing contracts to some producers, but not to all, they would be in violation of the P&S Act as a result of the NPRM.[28]

Critics of this provision believe that risk-sharing contracts are vital for smaller producers who have limited resources to cover continuous bad years in the market. Supporters opine this puts producers who are not in a risk-sharing contract at a competitive disadvantage to those who are.

f. Arbitration

The P&S Act was modified in the 2008 Farm Bill to address arbitration provisions in livestock contracts. 7 U.S.C. § 210. As a result of the amendment, the P&S Act now prohibits packers, swine contractors, and live poultry dealers from imposing mandatory arbitration on their producers; growers will have the option to opt out of arbitration and thus settle disputes through court litigation. Even if the grower and producer voluntarily agree to arbitration, GIPSA would examine the procedures of the arbitration to ensure their fairness.[29]

The Proposed Rule would allow the Secretary to establish the criteria considered when "determining whether the arbitration process in a contract provides a meaningful and fair opportunity for the poultry grower, livestock producers, or swine production contract grower to participate fully in the arbitration process if he/she so chooses."[30]

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[26] *Id.* at 35,347.

[27] *See* text accompanying notes 7-8, *supra.*

[28] If all producers do not have the ability to participate in risk-sharing contracts, then GIPSA might find that to be a "competitive injury" violation of the P&S Act.

[29] Proposed 9 C.F.R. § 201.219, 75 Fed. Reg. at 35,353.

[30] *Id.* at 35,353

Supporters of this provision assert that it ensures that producers will have the opportunity to fully participate in the arbitration process if they so choose. Critics believe that GIPSA's determination of the fairness of the arbitration proceeding after its conclusion undermines the incentive to use the less costly mechanism of arbitration to settle disputes.

IV. The RFA

By law, GIPSA is required to properly assess the impact of the NPRM on small business in the beef, pork and poultry industries as required by the RFA. If the consequences of a proposed rule are significant on a substantial number of small businesses, then the agency is required to prepare an initial regulatory flexibility analysis or IRFA. The IRFA must contain an assessment of the number and type of affected businesses, the costs imposed on those regulated entities, and offer alternatives that will ameliorate those significant adverse effects. The agency published an IRFA along with the Proposed Rule and found that the NPRM, if implemented, would have a significant economic impact on a substantial number of small entities.[31]

V. Issues that Remain

Subcommittee Chairman Tipton, along with Chairman Graves sent a letter to the USDA contending that the IRFA was not adequate because it failed to properly assess the full economic consequences of the NPRM on small businesses. For example, the two Chairmen note that even though USDA prepared an IRFA, it never stated that the Proposed Rule would have a significant economic impact on a substantial number of small entities so one can only surmise that the Department believes the NPRM is significant because it prepared an IRFA. In addition, the letter cited USDA's failure to fully assess the consequences of the changes on the entire supply chain, particularly as it relates to small livestock producers seeking niche markets.[32] Nor did USDA, according to the letter, assess other sectors of the industry affected by the NPRM, such as auction barns, small grower-packers, or small producers seeking to integrate vertically. Finally, the two Chairmen claimed that the agency should have examined alternatives to Proposed Rule that would have been less burdensome on small businesses.

USDA currently is undertaking a full economic review of the consequences of the NPRM. The letter sent by the two Chairmen requests that USDA consider revising its IRFA to correct the faults outlined in the letter. After completing the economic review, USDA has the following options: 1) issue a new Proposed Rule; 2) issue a final rule that modifies the proposal based on a more detailed economic analysis, particularly with respect to the small businesses examined in an updated IRFA; 3) issue a final rule without any changes, which the Chairman doesn't believe is an appropriate regulatory alternative; 4)leave existing rules in effect except as necessitated by the changes in the 2008 Farm Bill.

The ultimate issue to be addressed is which one of these alternatives USDA decides is

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[31] 75 Fed. Reg. at 35,348-35,349

[32] Should any staff or Member be interested a copy of the letter it is available from Brooke Shupe, Professional Staff Member, Committee on Small Business.

appropriate. The hearing expects to examine these options within the context of better compliance with the RFA by USDA and GIPSA in the development of rules to implement the P&S Act.