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## Concentration, Contracting and Competition: Problems In Using The Packers & Stockyards Act To Supplement Antitrust

Michael Sykuta  
University of Missouri

## Concentration, Contracting and Competition: Problems In Using The Packers & Stockyards Act To Supplement Antitrust

Michael Sykuta<sup>1</sup>

### I. INTRODUCTION

The past two decades have witnessed significant changes in the structure and organization of the agriculture sector. Virtually every stage of the agrifood value chain in the United States, from farm inputs to farming to processing to retail, has experienced increased consolidation. These changes have been accompanied by an unprecedented integration of international food markets, with multinational firms weaving together supply networks that literally span the globe and deliver a cornucopia of food products to retail grocery shelves and consumers' plates. Despite the fact that U.S. consumers spend less money on food now (as a percentage of disposable income)<sup>2</sup> and have a greater variety and convenience of food products from which to choose than any time in the past 50 years, increased levels of concentration have fueled concerns and allegations of anticompetitive behavior among large agribusinesses.

Concerns over the competitive effects of consolidation have given rise to increased political and regulatory scrutiny of the agricultural sector. In April 2010, the U.S. Departments of Justice ("DOJ") and Agriculture ("USDA") held the first in a series of joint public workshops to learn more about the state of competition in the sector. U.S. Senator Charles Grassley (R-Iowa), speaking during the opening panel of the workshop, captured the tenor of underlying concerns stating, "Bigger isn't per se bad, but it can lead to predatory business practices and behavior. And that is what we have to be concerned about."<sup>3</sup>

These workshops represent an historic collaboration of DOJ and USDA. While DOJ has primary jurisdiction to enforce antitrust laws, USDA has regulatory authority over various aspects of agricultural production and food safety. In particular, USDA is charged with enforcing the Packers and Stockyards Act of 1921<sup>4</sup> ("PSA"), which regulates meat packers by prohibiting unfair, discriminatory, or deceptive practices. Under the rubric of "big is not per se bad, but can lead to predatory business practices," the partnering of DOJ and USDA represents a move to apply antitrust and the PSA as two blades of a scissor to cut down practices deemed inappropriate by regulators. However, neither economic theory nor empirical evidence provides a substantial basis for the concerns underlying this regulatory tag-team's offensive, although the consequences could be far-reaching.

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<sup>1</sup> Associate Professor in the [Division of Applied Social Sciences](#) at the [University of Missouri-Columbia](#) and Director of the [Contracting and Organizations Research Institute](#) (CORI).

<sup>2</sup> Economic Research Service, United States Department of Agriculture, "Food CPI and Expenditures," available at <http://www.ers.usda.gov/briefing/CPIFoodandExpenditures/>, last accessed April 23, 2010.

<sup>3</sup> United States Department of Justice, "A Dialogue on Competition Issues Facing Farmers in Today's Agriculture," transcript of public workshop held in Ankeny, IA, March 12, 2010, at 19.

<sup>4</sup> Packers and Stockyards Act of 1921 (7 U.S.C 181).

## II. A CHANGING AGRICULTURAL LANDSCAPE

As noted above, the past two decades have witnessed increasing levels of concentration at virtually every level of the agri-food system, from ground to grocery store. Among the more prominent sectors of the agricultural economy experiencing rapid structural change are the poultry and livestock sectors. MacDonald & McBride report that between 1985 and 2005, the purchasing share of the four largest meat processors increased from 50 to 79 percent for steers and heifers, from 17 to 49 percent for cows and bulls, from 32 to 64 percent for hogs, and from 34 to 53 percent for poultry.<sup>5</sup> These increases resulted both from investments in larger, more efficient processing facilities and from consolidations through mergers and acquisitions.

In addition to increased concentration at the meat packing level, the livestock sector has also experienced a dramatic change in organizational structure as packers and producers adopted various forms of contractual relationships to govern the supply, and in some cases production, of animals. Unlike the poultry industry, which since the 1950s has been dominated by production contracts between integrators that own hatcheries, feed mills, and meat processing plants, and producers that provide land, labor, and physical facilities to “grow out” the birds from chicks until they are ready for processing (typically 5-9 weeks), the livestock industry was predominantly a cash-market industry as late as the early 1990s. From 1993 to 2009, the share of hogs sold in cash markets decreased from 62 to just 8.1 percent,<sup>6</sup> while hogs sold under some form of alternative marketing agreement (“AMA”) increased from 11 to 67 percent of hogs sold. Over the same period, the share of beef cattle sold under contract increased from roughly 18 to 29 percent.

The shift of large shares of livestock from cash markets to some form of contractual arrangement presents at least two levels of concern for regulators. First, does the use of AMAs allow, or even encourage, packers to manipulate cash markets for the remaining, or marginal, supply of livestock? Many independent livestock producers, which tend to be smaller operations, argue that reduced demand for cash-market animals results in thin markets that are more easily manipulated by small numbers of buyers. Moreover, because most livestock marketing agreements use some form of market-based pricing formula to determine the contract price, critics argue packers have increased incentive to opportunistically manipulate cash market prices to affect their overall cost of supply. Naturally, these types of concerns become more pronounced as consolidation and concentration further reduce the number of potential buyers in a given local market.

The second concern extends to poultry as well as livestock; namely, do packers engage in discriminatory, unfair, or deceptive practices in their design and implementation of contract programs? Particularly in the cases of poultry and hogs, producers must invest in relatively long-lived assets (buildings) that are designed to meet the specifications of the contractor and that typically require financing on the part of the producer. Critics argue that this indebtedness, along with the fact that marketing agreements may have shorter durations than the assets themselves, create greater leverage for packers to reduce prices, particularly at renegotiation and renewal.

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<sup>5</sup> J. MacDonald & W. McBride, *The Transformation of U.S. Livestock Agriculture: Scale, Efficiency, and Risks*, Information Bulletin No. 43, Economic Research Service, US Department of Agriculture, January 2009, p.25.

<sup>6</sup> G. Grimes & R. Plain, *US Hog Marketing Contract Study – January 2009*, University of Missouri-Columbia Working Paper AEW 2009-1. Available at <http://agebb.missouri.edu/mkt/vertstud09.pdf>, last accessed April 26, 2010.

Poultry production contracts have an added wrinkle. Payment is typically based on an individual producer's performance relative to a pool of peers on such measures as mortality rates and feed conversion.<sup>7</sup> This basis occasionally gives rise to suspicions (or allegations) of discriminatory treatment towards different producers based on the construction of the pool (placing like producers together to reduce variance in relative performance and, hence, bonuses) as well as on the quality of inputs provided across pool members (e.g., placement of healthier chicks with favored producers). Here again, the assumption is that consolidation among packers increases individual packers' abilities to engage in such deceptive and unfair practices.

### III. ENTER THE PACKERS AND STOCKYARDS ACT OF 1921

Despite what appears to be a relatively recent phenomenon of consolidation and structural change in the livestock industry, neither the fundamental concerns nor the idea of strengthening PSA enforcement are new. Indeed, the Act was passed in 1921 in response to a Federal Trade Commission finding that farmers were "at the mercy of [five major beef producers] because they control both the market and the marketing facilities."<sup>8</sup> The presumption of the legislation was that behaviors of concern did not fall within the scope of the Sherman Act or Clayton Act, and thus fell outside the reach of the DOJ and FTC.

The two principle regulatory sections of the PSA are Section 202, which prohibits packers and live poultry dealers from engaging in "unfair, unjustly discriminatory, or deceptive practices" and from engaging in activities "for the purpose or with the effect of manipulating or controlling prices, or creating a monopoly;" and Section 312, which prohibits unfair, unjustly discriminatory, or deceptive practices by stockyards in relation to marketing of livestock through the stockyards. In July 2008, Congress added specific guidelines for poultry and hog production contracts requiring that producers be allowed to terminate the contract within three days of its execution and requiring disclosure of any necessary capital investments prior to executing the contract (Section 208), establishing a Federal judicial forum for resolving disputes (Section 209), and granting producers the option to refuse to be bound by any arbitration clause included in the contract (Section 10).<sup>9</sup>

Given the scope of unlawful practices enumerated in Sections 202 and 312, it is clear to see why critics of the current industry structure view the PSA as an alternate means of disciplining or curtailing the activities of meat packers and integrators, especially in the face of increasing concentration and consolidation that may not rise to the level of conspiracy in restraint of trade under the Sherman Act or to the level of price discrimination or other transactional prohibitions of the Clayton Act. The PSA provides for enforcement across a broader set of contractual margins that packers and stockyards might exploit, particularly if the increased concentration in the meat packing industry has created increased market power. Moreover, arguments concerning the potential effects of further consolidation on livestock marketing transactions may influence the DOJ's evaluation and review of future mergers and acquisition in the meat industry. Thus, the newly-formed collaboration between USDA and DOJ provides a symbiotic relationship for regulatory action.

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<sup>7</sup> Feed conversion refers to the amount of animal weight gain relative to the amount of feed consumed by the animal. Higher feed conversion rates suggest more efficient production, as weight increases with less feed required.

<sup>8</sup> US Trade Commission, Report on the Meat Packing Industry, Summary and Part I (1919), quoted in C.M. Bass, *More Than A Mirror: The Packers and Stockyards Act, Antitrust Laws, and the Injury to Competition Requirement*, 12 DRAKE J. AGRIC. L. at 425 (2007).

<sup>9</sup> 122 Stat 1651, Pub. L. 110-246.

What is not clear is the extent to which the PSA affords an easier route to enforcement than traditional antitrust actions. The language of Section 202 (a) and (b) simply refers to “unfair, unjustly discriminatory, or deceptive” practices and to “undue or unreasonable preference or advantage,” respectively. Section 202 (c)-(e), however, prohibits actions “for the purpose or with the effect of” restraining commerce, manipulating or controlling prices, or creating a monopoly. This raises the question of whether complaints under the Act must demonstrate injury to competition in order to be successful, and what constitutes injury.

Bass argues that the plain language of Section 202 (a) and (b) do not require plaintiffs to plead or prove an effect on competition.<sup>10</sup> In *London v. Fieldale Farms Corp.*, the Eleventh Circuit interpreted Section 202 as only making unlawful those unfair and deceptive acts that adversely affect competition.<sup>11</sup> The Eighth Circuit rejected the argument in *London* in reviewing *Schumacher v. Tyson Fresh Meats*, arguing that the PSA is broader than prior antitrust legislation and may proscribe practices that antitrust acts would permit.<sup>12</sup> The Fifth Circuit, however, determined in *Wheeler v. Pilgrim's Pride Corp.* that the purpose of the PSA is to promote competition, and therefore only prohibits practices that would adversely affect competition.<sup>13</sup> Thus, the case law is unsettled on the competitive requirements of complaints under Section 202.

If injury to competition is required, there is then a difficulty in determining what constitutes adverse competitive effects. For example, to the extent that long-term contracts for supplies of hogs may reduce marketing opportunities for independent hog producers who choose to market their animals in the cash market, one might argue there is an adverse competitive effect that injures those independent producers. However, the use of contracts by packers may itself be a competitive market response. Given consumer demand for more specific quality characteristics in meat products, contracts with producers may be the most efficient means for packers to secure a steady supply of animals with the appropriate quality attributes.<sup>14</sup> The nature of modern meat packing technology creates very narrow scale economies, imposing steep costs if production volume varies much from the efficient scale of operation.

At the same time, concentration in the retail grocery industry has affected the terms of wholesale supply agreements with meat processors to provide consistent quantities and prices over longer periods, inducing demand for a stable supply of inputs at predictable margins. Large-scale animal producers may have competitive advantages over their smaller scale rivals in being able to meet the volume and quality needs of packers on a consistent basis, suggesting contractual ties between these producers and packers reflect efficient market competition. Thus, what may appear to be injury to independent producers may in fact be the result of vibrant competition. Moreover, independent producers typically are so by choice, intentionally choosing not to participate in contract production and therefore voluntarily subjecting themselves to any perceived harm. Difficulty in disentangling these relative effects may make effective enforcement of the PSA more difficult than may first appear to proponents of it use.

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<sup>10</sup> Reference, *supra* note 7.

<sup>11</sup> *London v. Fieldale Farms Corp.*, 410 F.3d 1295 (11<sup>th</sup> Cir. 2005).

<sup>12</sup> *Schumacher v. Tyson Fresh Meats, Inc.*, 434 F.Supp.2d 748 (D.S.D. 2006).

<sup>13</sup> *Wheeler v. Pilgrim's Pride Corp.*, 591 F.3d 355 (5<sup>th</sup> Cir. 2009).

<sup>14</sup> For a more detailed explanation and evidence of this motivation for contracting, see J. Jang & M. Sykuta, *Contracting for Consistency: Hog Quality and the Use of Marketing Contracts*, CORI Working Paper No. 2009-02, (March 4, 2009). Available at SSRN: <http://ssrn.com/abstract=1372404>.

#### IV. THE BACK-STORY ON CONTRACTING AND THE CONSEQUENCES OF A CRACKDOWN

The above arguments of the competitive motivations for contracting represent just some of the explanations that have been proposed in the agricultural economics literature. The adoption of new organizational structures to govern the production and processing of poultry and livestock reflects a myriad of complementary and interconnected market and technological forces.<sup>15</sup> Consolidation at the meat packing level is only one part of the equation. Consolidation at the farming level has resulted in a relatively small number of producers raising a large share of the animals produced each year, especially in poultry and hogs. Consolidation at the retail grocery level has also placed competitive pressures on meat packers. Improvements in animal genetics and meat processing combined with changes in consumer preferences create additional competitive incentives for meat packers, especially when international markets are brought into the picture.

Contracts also serve a significant role in producers' access to financial capital. Marketing contracts are one means of risk management for the farm operation, reducing uncertainty of cash flows and ability to service debt. Lenders may require evidence of secured marketing or production agreements before providing funds for working capital or, even more importantly, capital investments such as buildings for raising poultry or hogs. When the move to AMAs first began, lenders had little experience in evaluating the risks associated different types of contracts and contractors. Fifteen years later, agricultural lenders are more accustomed to evaluating borrowers' contract programs and the risks associated with them. This external assessment provides one more competitive check against abuse of contract terms or market power by packers.

#### V. WHAT'S THE EVIDENCE TO-DATE?

In 2003, Congress ordered the USDA's Grain Inspection, Packers and Stockyard Administration ("GIPSA") to undertake an extensive study of the U.S. livestock and meat marketing industries. In addition to the final report, published in 2007,<sup>16</sup> several articles have been published in peer-reviewed academic journals. Vukina & Leegomonchai test whether poultry integrators use their market power to hold-up contract poultry growers who invest in contract-specific assets.<sup>17</sup> The authors can only claim "moderate support" for the presence of hold-up, which is itself a generous interpretation of the empirical results and modeling framework laid out in the paper. It is certainly not evidence to suggest poultry processors are dealing unfairly or deceptively.

Zheng & Vukina examine whether the use of AMAs increases pork packers' market power and find that, while they do discern evidence of market power in the cash market for hogs, they cannot say that the market power is related to the use of AMAs.<sup>18</sup> They suggest that more

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<sup>15</sup> For an extended discussion of the roles of complementarities in the adoption of alternate organizational forms, see H. James, P. Klein, & M. Sykuta, *Contracts, or Integration? The Adoption, Diffusion, and Evolution of Organizational Form*, CORI Working Paper No. 2007-01 (April 2007). Available at SSRN: <http://ssrn.com/abstract=980301>.

<sup>16</sup> A copy of the final report is available on the GIPSA website at <http://www.gipsa.usda.gov/GIPSA/webapp?area=home&subject=Imp&topic=ir-mms>.

<sup>17</sup> T. Vukina & P. Leegomonchai, *Oligopsony Power, Asset Specificity, and Hold-Up: Evidence from the Broiler Industry*, 88 (3) AMER. J. AGRIC. ECON. 589-605, (2006).

<sup>18</sup> X. Zheng & T. Vukina, *Do Alternative Marketing Arrangements Increase Pork Packers' Market Power*, 91 (1) AMER. J. AGRIC. ECON. 250-263, (2009).



traditional oligopsony issues may be at work, absent any effect of the use of AMAs. However, oligopsony models imply that the exercise of market power will necessarily result in quantity restrictions to levels below the competitive market outcome. To my knowledge, there are no studies showing systematic underproduction of meat products in the United States to corroborate a model of effective oligopsony power. This is not to say that such power is not exerted, but only that there is little evidence to support such a conclusion in a manner consistent with economic theory.

Finally, Wohlgenant provides an estimation of the welfare effects that would result from legislation restricting the use of alternative marketing arrangements in the hog industry.<sup>19</sup> He finds that restricting packer ownership of hogs (either through vertical integration or production contracts) would decrease the welfare of independent hog producers, packers, and consumers, but would have little welfare effect on contract hog producers. His results are surprising in the sense that proposed legislation restricting packer ownership of livestock is intended to aid independent producers. Although his model employs somewhat restrictive assumption, the results should give pause before policy makers undertake aggressive changes in regulations of contracting activities.

## VI. CONCLUSION

The concentration and consolidation of the agricultural sector does not appear to be slowing down anytime soon. JBS's recent acquisition of Pilgrim's Pride is just the latest in a string of deals that have increased the market share of the leading four meat packers in all three categories (chicken, pork, and beef). While consolidation seems on course to continue, evidence suggests the use of AMAs has stabilized. Regardless, the combination of concentration and contracting continue to be the focus of angst—and anger—among small, independent agricultural producers and Congressional champions of the mythical family farm. While DOJ has promised more stringent reviews and antitrust enforcement in future mergers, industry critics believe the Packers and Stockyards Act of 1921 should be more aggressively enforced as well to “ensure a level playing field” in the context of the current mix of marketing channels.

Christine Varney, Assistant Attorney General for Antitrust at the DOJ, speaking at the April 2010 DOJ/USDA workshop on competitive issues in agriculture, offered the following comment concerning the Packers and Stockyard Act:

USDA has tremendous expertise here, but we got a lot of lawyers at DOJ that can back you up. So we're looking forward to and have started the conversation at the staff level of how we can work collaboratively to ensure the federal government is taking full advantage of the authority that's delegated to us in the Packer and Stockyards Act.<sup>20</sup>

However, with authority comes responsibility. While the Packers and Stockyards Act appears to provide a strong tool for preserving competition, there are significant challenges that need to be addressed. Economic research has thus far provided little empirical evidence to support allegations of competitive harm either from consolidation or from the use of alternative marketing arrangements. More importantly, little work has been done to provide a robust understanding of the economic forces that have so dramatically changed the agricultural

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<sup>19</sup> M. Wohlgenant, *Modeling the Effects of Restricting Packer-Owned Livestock in the US Swine Industry*, 92 (3) AMER. J. AGRIC. ECON 654-666, (2010).

<sup>20</sup> *Supra* note 2 at 51-52.

landscape. Regulators should exercise restraint in their enforcement of rules, the consequences of which we so little understand.