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Current Policy Issues
Regarding Commodity Pricing Systems*

by

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Issues may arise from the grassroots at consumer or producer level or from the interaction of federal agencies with client industries. Recent issues concerning thin markets illustrate that observation. Three recent cases include producer concern about thin markets in eggs and in beef and the concerns of CFTC and Justice about committee price-reporting on certain commodity exchanges. As most of my attention will be on beef, let me briefly dispose of the other two cases.

The CFTC staff about two years ago reported on three situations in which committees on supervised exchanges were issuing spot market quotations on rather thin markets. The three included grain at the Kansas City and Minneapolis exchanges and sugar at the New York Coffee and Sugar Exchange. The sugar pricing case had the most severe problems of a thin market. Actual spot transactions were infrequent--about once every ten days. A committee issued daily price quotations based on its judgment of the market. The possibilities of

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committee manipulation seemed apparent, but no evidence of inaccurate or improper price quotations was found by CFTC. Nevertheless the Justice Department moved against the sugar committee. A new committee system has been devised with the objective of eliminating any possibility of manipulation. This new system has been cleared by Justice and is in the process of CFTC clearance.

Meantime, the Minneapolis committee quit making spot price quotations, and the Kansas City exchange seems to have shown that their committee procedure is mainly mechanics that are not subject to possible manipulation. In both grain cases, there were more transactions than in sugar, resulting in less credibility problems for the price reporters. (Material gathered from conversations with John Helmuth, Blake Imel, Vern Pherson, Marvin Hayenga and others.)

The credibility of reported prices and of the price reporting system is a common theme in these thin market issues. Producers, of course, have frequently been distrustful of prices and pricing institutions in their markets. In recent years two groups have had their day on the Washington scene as they complained of the pricing system for their commodity. Egg producers held the stage for several years in the early 1970s. Meat and especially beef has received attention recently. As the issues in eggs and beef have many similarities, I'll focus on beef in the short time available.

All of us are familiar with those political devices such as Congressional hearings, the introduction of bills, special studies, and governmental task forces by which government guages the extent of public discontent and either shapes a response or postpones it until the discontent withers away.

You also realize that there are many rings in the Washington circus. Even though beef pricing has received the full gamut of political attention in terms of hearings, bills, studies and task forces, it is still likely that the average Congressman has little knowledge or concern about the Yellow Sheet and the accuracy of its reporting of wholesale beef prices. Thus, we are discussing a genuine political issue but one that is still at the localized level of Congressional committees and the U.S. Department of Agriculture. Whether it actually mushrooms into an issue to be dealt with by the Congress and President is a matter of conjecture.

Background

A technical study of the National Commission on Food Marketing in 1966 expressed concern about formula pricing in the wholesale meat industry. Among its concerns were:

(1) the accuracy with which a narrowing base of negotiated prices can reflect supply and demand conditions, and

(2) the possibilities of manipulation of quoted prices.

Recent concerns have largely been expressed through legislative hearings. The leading Congressmen have been from the Cornbelt. Congressmen Thorne of Nebraska and Bedell of Iowa held Agriculture subcommittee hearings in the fall of 1977. They introduced a bill entitled the Meat Market Reporting Reform Act which proposed certain penalties for false reporting. Their efforts also helped to instigate a special study by GAO in 1977 entitled, Marketing Meat: Are There Any Impediments to Free Trade? It was a superficial effort that summarized allegations by the Meat Price Investigations Association (also headquartered in Iowa) and the rather sensational story in the December 6, 1974, issue of the Wall Street Journal as to how the manipulation of the Yellow Sheet's quoted prices was possible.

The most concerted effort has been led by Congressman Neal Smith of Iowa in his role as chairman of the House Small Business Committee. He has held hearings in 1977, 1978, and as recently as this month. Congressman Smith has shown great concern about the alleged deficiencies of the Yellow Sheet as well as the growing market power of the nation's largest beef packer, IBP.

Among the findings and conclusions of the Smith Committee as published in their report of October 13, 1978, (p. 32) were:

-"Of all meat sales, 70 to 90% are based on 'formula pricing'; that is, based on the price as shown on 'The Yellow Sheet' on the day of shipment or some day in the future."

-"Based upon a detailed study of 'The Yellow Sheet' for a 25-day period, 'The Yellow Sheet' is not effectively servicing the industry because:

(a) Their prices are based on a thin market.

(b) The detailed study indicated that a majority of their prices are not backed by any trade nor identified as based on no volume.

(c) They utilize trades in determing price [in ways] contrary to their published rules."

-"Under existing law and reporting practices, 'The Yellow Sheet' is subject to being easily manipulated;"

-"The giants in the industry are successful by using the present system of utilizing only 'The Yellow Sheet' as their basis for trading and are opposed to change;"

-"The USDA has recognized the problems detrimental to the industry but has been ineffective in enforcement or recommending necessary changes."

In response to these Congressional concerns, the USDA in December 1978 published a quickie study, entitled the <u>Beef Pricing Report</u>. Their data indicated that 70% of steer and heifer carlot carcass sales were formula priced, but that only about one-half of the 30% of negotiated sales was reportable. Trades actually reported to the Yellow Sheet were only about 2% of all volume rather than the 15% possible. However, on the basis of admittedly limited data, the analysis found no statistical proof that:

(1) the Yellow Sheet quotations reflected inaccurately the prices reported to it,

(2) Yellow Sheet prices were significantly different from average negotiated prices, or that

(3) formula prices on the average were significantly different from average negotiated prices.

While this report did not confirm the worst suspicions of the Smith committee, it did not quiet all concern. Clearly the reported volume of trades to the Yellow Sheet is a tiny fraction of all trades.

Congressman Smith introduced a bill, H.R. 91, in this current session of the Congress that is consistent with those findings. It is vague in spots but seems aimed at:

(1) mandatory reporting of negotiated carlot trades,

(2) stiff penalties for furnishing or reporting false price quotations,

(3) licensing of meat price reporting services, and

(4) the establishment of a Meat Industry Marketing Standards Board with responsibilities for recommending specific policies ~~in the above areas as well as helping to develop~~ on a national computerized market for wholesale beef, ~~and~~ the prohibit~~ing~~ion of formula trading, and the reporting of meat prices.

The passing of such legislation and its vigorous enforcement would represent far-reaching mandatory changes in an industry that has stoutly resisted governmental regulation.

In response to these legislative concerns and the pro and con industry pressures thereby generated, the Secretary of Agriculture set up last April a ten-member Task Force on Meat Pricing. The Task Force contained three members from the meat industry, four members from producers, one representative of consumer groups, and two agricultural economists from state universities. The Task Force was instructed to recommend:

(1) improvements in meat marketing, pricing and price reporting,

(2) the USDA response to H.R. 91, and

(3) any additional legislation in this area that USDA should seek.

The Task Force held six days of public hearings, accepted all written testimony offered it, and then developed by June 12 a report to the Secretary.

Task Force members could question each of the many witnesses and could call upon legal and economic expertise provided by the USDA. The public hearings predictably contained much old material and the singing of familiar litanies, but some new evidence was developed and the overall impact was educational.

It quickly became clear to the public members that the industry-producer majority had already made up their minds on the second and third of the three charges to the Task Force. They were generally opposed to Neal Smith's general approach and to H.R. 91 and--indeed--were opposed to any new legislation.

The strong antipathy of those ~~seven~~ members to governmental intervention of any sort set narrow constraints upon the Task Force. The problem was how to recommend changes and improvements that did not involve governmental "thou shalt" or "thou shalt not."

Most but not all of the testimony was in the same vein. Fairly representative was the testimony of the executive secretary of the feedlot division of the Kansas Livestock Association. Referring to Neal Smith's H.R. 91, he said, "In short, his program is designed to allow the government more power to decide what is reported and who reports it. Smith has overlooked one very basic factor in his attempt to replace Lester Norton, owner of The National Provisioner, with the government. That is the fact that cattlemen distrust government even more than they distrust Lester Norton." While none of us other three members on the Task Force were avid supporters of governmental regulation, the recommendations would likely have been a bit stronger if we had been the majority.

The major recommendations of our Task Force focused on voluntary efforts by industry and encouragements by government rather than regulation. We easily agreed to oppose any ban on formula trading. We found formula trading to be operationally very efficient and widely acceptable to industry participants. A 50-employee meat distributor in Montana put it this way in his letter to us.

"...companies in our situation don't 'buy meat,' we select a supplier whom we must count on then to keep us competitive." "In the absence of formula pricing, which automatically picks up the market movements we would be priced off the supplier's price list."

We easily agreed that the carcass market was thin and getting thinner. However the gap between the 2% reported and the 30% negotiated suggested that the proportion reported could be increased through industry efforts. We suggested a little armtwisting by government of a few big firms that have a policy against reporting. As a few of these do not report on advice of their attorneys who are worried about antitrust suits, we urged investigation of the legal realities and steps to protect price reporting from antitrust concerns if there is in fact a problem. We also urged the Yellow Sheet to cover more aggressively the national market and to reduce its dependence on prices phoned in. There were a few of us who suspected that some sort of mandatory response system and a new price reporting service will be necessary to achieve a price reporting system that is both accurate and largely free from public suspicion.

The Task Force did an about-face on an electronic market. That concept was strongly opposed by the majority of testimony. Packer and producer groups and firms, such as IBP, went into detail as to why the problems in the trading of meat cannot be handled by a computer. The industry representatives on the Task Force seemed generally to agree. Agricultural economists in testimony and on the Task Force, consumer representatives, and Mr. William Albanos (the director of the Meat Sheet which is a competitor of the Yellow Sheet) were virtually the only supporters of electronic trading.

However, the final report of the Task Force carries a rather vigorous endorsement of electronic markets. Perhaps, we in the profession can claim some credit for that educational job. The most credit, however, must go to Mr. Albanos. In concert with General Electric, he has developed a computer software system for wholesale meat trading. Several large firms, including one and perhaps two represented on the Task Force, have agreed to participate in pilot runs of this electronic market this fall, provided enough buyers and sellers can be signed up. Thus the Task Force eventually perceived that an electronic market could be feasible and that private enterprise was trying to make one work. The endorsement of the enterprise became possible. It is worth noting that in today's political climate, an electronic market has the powerful advantage of being a potential <u>free enterprise tool</u> for change.

A strong supporter of electronic markets might well question why we as a Task Force spent so much effort on the Yellow Sheet, etc. Won't an electronic market solve all the problems? Perhaps it will. However, some of us supporters think that success is not assured. There are undoubtedly some industry interests who want it to fail. There could be bugs in the present models that will long delay successful trading. Formula trading and direct negotiation may continue to be more attractive. Thus, we felt it wise to hedge our bets and to make recommendations improving the present system in case the electronic market leaves many problems unsolved.

As I reflect on the Task Force experience, I would suggest two lessons for us agricultural economists:

(1) a greater appreciation for the relevance of the quality of a price reporting system to the whole question of thin markets;

(2) a greater appreciation of the extent to which a political mandate is essential to much public action.

Let me elaborate briefly on the last point. Despite the attention given by the Smith committee, there was not and is not, a strong mandate for reform of the meat pricing system. Some market participants complain a bit and a very few are quite exercised about the problems. But there is a silent majority who are busy in the day-to-day business and who see no problem big enough to call in the feds. Those conditions dominate the feasible solutions.