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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

June 13, 2011

The Honorable Tom Vilsack
Secretary
United States Department of Agriculture
14th and Independence Ave, SW
Washington, DC 20250

RE: Implementation of Regulations Required Under Title XI of the Food, Conservation and Energy Act of 2008; Conduct in Violation of the Act, 75 Fed. Reg. 35,338 (June 22, 2010)

Dear Secretary Vilsack:

On June 22, 2010, the United States Department of Agriculture ("USDA" or "Department"), Grain Inspection, Packer and Stockyards Administration ("GIPSA")[1] published a proposed rule[2] to amend the Packers and Stockyards Act of 1921 (P&S Act).[3] GIPSA claims that the proposed rule would "clarify conditions for industry compliance with the P&S Act and provide for a fairer marketplace."[4] The terms of the Proposed Rule may create a "fairer" market place by commodifying the production of livestock in a way that severely undermines the capability of small businesses to differentiate their products (be they livestock producers or packers) from those of their larger competitors. The failure to assess the costs associated with this "fairer" market fatally flaws the NPRM in its current state.

It is clear that GIPSA's Proposed Rule exceeds Congressional intent of the Food, Conservation, and Energy Act of 2008.[5] Congress could not have intended GIPSA to develop the proposed rules as published as it will have unintended consequences on livestock production as a whole, and especially small businesses. The NPRM, if adopted unchanged, will alter how beef, pork and poultry industries conduct their business in a manner detrimental to the thousands of small businesses involved in those

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[1] The terms USDA, Department, and GIPSA will be used throughout these comments interchangeably. Congress delegated authority to the Secretary who then delegated, as permitted, to GIPSA.

[2] 75 Fed. Reg. 35,338 (2010) ("NPRM" or "Proposed Rule")

[3] 7 U.S.C. §§ 181-231.

[4] 75 Fed. Reg. at 35,338.

[5] Pub. L. No. 110-246, 122 Stat. 1651 (2008) (hereinafter "2008 Farm Bill").

industries. Some of the provisions also may lead to changes in business activities that could alter a company's asset structure as well as a broader change in industry structure. These alterations could require a business to force asset divestures and potentially lead to more vertical integration. The consequence would be less competition for livestock producers, packer and consumers – a result that contradicts the results sought by the Department in the Proposed Rule.

Currently, the agency is conducting an economic assessment, including a cost-benefit analysis of the proposed rule. GIPSA failed to properly assess the impacts of the NPRM on small businesses in the beef, pork and poultry industries as required by the Regulatory Flexibility Act, 5 U.S.C. §601-12 (RFA). As the Department considers a more detailed economic assessment of the NPRM, it also should undertake a thorough review of its initial regulatory flexibility analysis (IRFA) prepared pursuant to the RFA to address the severe consequences outlined in these comments. USDA then should republish the IRFA for comment to ensure that it fully understands the consequences of the changes before imposing them on thousands of small businesses.

I. P&S Act and the 2008 Farm Bill

The P&S Act was passed by Congress in 1921 to regulate the business of packers. As noted by the United States Supreme Court in upholding the constitutionality of the P&S Act:

> The object to be secured by [the PSA] is the free and unburdened flow of livestock from the ranges and farms through the great stockyards and slaughtering centers and thence in the form of meat products to the consuming cities.
>
> The chief evil feared is the monopoly of the packers, arbitrarily to lower prices to the shipper who sells. Congress thought that the power to maintain this monopoly was aided by control of the stockyards. Another evil which it sought to provide against by the act, was exorbitant charges, duplication of commissions, deceptive practices in respect of prices, in the passage of the livestock through the stockyards, all made possible by collusion between the stockyards management and the commission men, on the one hand, and the packers and dealers on the other. Expenses incurred in the passage through the stockyards necessarily reduce the price received by the shipper, and increase the price to be paid by the consumer. If they be exorbitant or unreasonable, they are an undue burden on the commerce which the stockyards are intended to facilitate. Any unjust or deceptive practice or combination that unduly and directly enhances them is an unjust obstruction to that commerce.[6]

In the 2008 Farm Bill,[7] Congress mandated that USDA develop additional regulations to implement the P&S Act:

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

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[6] *Stafford v. Wallace,* 258 U.S. 495, 514, (1922).

[7] Pub. L. No. 110-246, §11005, 122 Stat. 1651, 2120 (2008), codified at 7 U.S.C. § 197c.

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."[8]

GIPSA promulgated proposed regulations in response to the congressional directive. The regulations can be further categorized as those aimed at changing industry structure and those aimed at changing industry practices. Given the potential impact of both types of rules on small businesses, USDA is required by the RFA to consider the impacts that the NPRM will have. Before addressing those impacts, it is necessary to describe principles of the RFA to place the NPRM in its appropriate context.

II. Principles of the RFA

The basic premise of the RFA is that a one-size-fits-all regulation may impose disproportionate cost burdens on small entities. For example, if a regulation has a fixed cost of compliance of $100, then a business that produces 1000 units of a particular item will see an increase of $.10 per unit. A business that only produces 100 units of the same item will see the cost per unit increase of $1. Thus, the smaller business will be adversely affected in the marketplace in selling that item because it will have to raise its price more to recover the cost of the regulation.

Under the RFA, each agency must review its regulations to ensure that, while accomplishing its statutory mandate, the ability of small businesses to invent, produce, and compete is not inhibited. Agencies must balance the burdens imposed by regulations against their benefits and propose alternatives to regulations which create economic disparities among different-sized entities.

The RFA achieves this goal by requiring federal agencies to assess the economic consequences of proposed rules, and if the proposed rule will have a significant economic impact on a substantial number of small businesses, prepare an IRFA, *id.* at § 603. If the agency determines that the proposed rule will not have significant effect, it can so certify and not perform an analysis. *Id.* at § 605(b).

The RFA delineates the contents of an IRFA: a) the need for and objectives of the rule; b) an estimate of the number of small entities affected; c) projected reporting, recordkeeping, and other compliance costs of the proposed rule; d) identification of duplicative, overlapping, or rules that conflict with the proposal; and e) development and evaluation of alternatives to the proposal that lessens the adverse consequences on small businesses. *Id.* at § 603(b)-(c). Compliance with the RFA is not based on same

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[8] 2008 Farm Bill, §11005,codified at 7 U.S.C., §228 note.

irreducible mathematical formula. Instead, agencies must make a good faith effort to examine the criteria specified in § 603. The critical points are the proper identification of costs on small businesses and the alternatives that will reduce those burdens. These comments will first examine the costs of the NPRM on the industry.

III. USDA Failed to Recognize the Impact of the NPRM on the Livestock Industry

A. Small Businesses Affected by the Proposed Rule

In order to assess the impact of the Proposed Rule, identification of these businesses is the base upon which an adequate IRFA rests. The definition of a small business for the RFA is identical to that of the ones developed by the Small Business Administration (SBA) under § 3 of the Small Business Act.[9]

The affected businesses are: cattle producers,[10] hog producers,[11] auction barns, [12] swine contractors,[13] broiler producers,[14] turkey producers,[15] poultry integrators,[16] hog and cattle slaughtering and processing,[17] and poultry processors.[18] For cattle producers, hog producers and swine contractors, the

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[9] 15 U.S.C. § 632.

[10] A cattle producer is any enterprise primarily engaged in raising cattle or feeding cattle for fattening (including those only owning feedlots). OFFICE OF MANAGEMENT AND BUDGET, NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM Sector 11211 (2007) ("NAICS Manual").

[11] A hog producer is any enterprise primarily engaged in the raising of hogs including fattening them to market size. *Id.* at Sector 11221.

[12] Livestock producers that do not have contracts for their animals can sell them in live auctions held at barns, ergo the name "auction barns." *See American Meat Inst. v. Barnett*, 64 F. Supp. 2d 906, 912-13 (D.S.D. 1999).

[13] A swine contractor is a business that has a growout contract under which another business raises and cares for the swine according to instructions either set forth in the contract or pursuant to instructions of the contractor or some other person. GIPSA, THE SWINE PRODUCTION CONTRACT PROVISIONS OF THE PACKERS & STOCKYARDS ACT, FREQUENTLY ASKED QUESTIONS, *available at* http://www.gipsa.usda.gov/GIPSA/webapp?area=home&subject=lmp&topic=re-swf . A swine production contract grower would be a hog producer that, rather raising livestock for his or her own accord (to be sold on the open market), is doing so at the behest of a specifically identified business or individual who will purchase the hogs so produced. A typical arrangement might be a situation in which one producer (Producer A) has swine that it needs to finish fattening before slaughter. Producer A hires a second hog grower (Producer B) to finish the fattening process using feeds and medicines designated by Producer A. Producer A is considered to be the swine contractor and Producer B the swine production contract grower. *Id.*

[14] A broiler producer is an enterprise engaged in the raising of broilers, fryers, roasters, and other types of chickens to be slaughtered and consumed as meat. NAICS Manual, Sector 112320.

[15] An enterprise that is engaged in the raising of turkeys for meat. *Id.* at Sector 112330.

[16] Poultry integrators deliver chicks to broiler or turkey growers but retain title to the birds. Growers raise the poultry according to instructions provided by the integrators. Typically, the integrator retains title to the birds and provides necessary veterinary services. Kristy Boehler, *Poultry Growers in Arkansas: Agents or Independent Contractors*, 63 ARK. L. REV. 849, 849 (2010). In the Proposed Rule, integrators are referred to as "live poultry dealers," since that is the term used in the P&S Act. 7 U.S.C. § 182(10).

[17] An beef or hog slaughterer or processor is an enterprise engaged in the slaughter of animals, the preparation of meat from the slaughtered animal or the assembly, cutting and packing of meats from purchased. NAICS Manual, Sector 31161. It is

size standard is gross revenue under $750,000. Integrators, slaughtering operations, and processors are small if they have less than 500 employees.

The 2007 Census of Agriculture breaks down the total number of farms and revenue for the livestock industry (excluding broilers):[19]

- 10,304 farms with 999 or less of beef cattle averaged $529,629 per year.
- 66,972 farms with a herd of 4,999 or less of swine averaged $376,638 per year.
- 8,284 farms with 35,707 turkeys averaged $476,943 per farm.

The 2007 Census of Agriculture did not include the broiler industry. The latest data from the Department shows that there were 17,005 broiler growers with an on-farm annual income of $27,643.[20] For purposes of the RFA, USDA adopted the size standards established by the SBA for livestock producers (irrespective of the type of livestock being raised) as $750,000. 13 C.F.R. § 121.201.

Auction barns are classified by the Bureau of the Census under the NAICS sector for livestock merchant wholesalers. See NAICS Manual, Sector 424520. According to the Bureau of the Census, 97 percent of the 714 livestock merchant wholesalers have fewer than 100 employees.[21]

According to the United States Census Bureau, Statistics of U.S. Businesses in 2008, 97% of all animal slaughtering and processing facilities[22] and 80% of all poultry facilities[23] have less than 500 employees. With the industries indentified, attention can be turned to the impacts that NPRM will have on the beef, pork, and poultry industries. According to the size standards established by the SBA, all slaughterers and processors of beef, pork and poultry are small if they have less than 500 employees. *Id.*[24]

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important to note that a swine contractor also may own slaughtering and processing facilities. As a result, there is an overlap between the two segments of the industry.

[18] A poultry processor is any enterprise engaged in the slaughtering of poultry and preparing processed poultry meat and meat byproducts. *Id.* at Sector 311615. Poultry integrators also may have slaughtering and processing operations so there is overlap between these two sectors of the poultry industry.

[19] UNITED STATES DEPARTMENT OF AGRICULTURE, 1 CENSUS OF AGRICULTURE-2007 at 9, 22 and 114 (2009), *available at* http://www.agcensus.usda.gov/Publications/2007/Full_Report/usv1.pdf

[20] UNITED STATES DEPARTMENT OF AGRICULTURE, ECONOMIC RESEARCH SERVICE, THE ECONOMICS OF U.S. BROILER PRODUCTION Table 17 at 24 (2008), *available at* http://www.ers.usda.gov/publications/eib38/eib38.pdf .

[21] UNITED STATES CENSUS BUREAU, 2008 STATISTICS OF U.S. BUSINESSES, Sector 424520, *available at* http://www.census.gov/epcd/susb/latest/us/US424520.HTM. The SBA's size standard for NAICS 424520 is 100 employees.

[22] *Id.* at Sector 311611, *available at* http://www.census.gov/epcd/susb/latest/us/US311611.HTM.

[23] *Id.* at Sector 311615, *available at* http://www.census.gov/epcd/susb/latest/us/US311615.HTM.

[24] No separate data exists for swine contractors or poultry integrators since federal statistics do not have a separate North American Industrial Classification code. Such enterprises would be classified by their primary business – either production or processing. As a result, it is impossible to estimate the total number of such contractors or integrators.

B. USDA Failed to Accurately Estimate the Impact that the "Competitive Injury" Provision would have on Small Businesses

1. Competitive Injury

The thrust of the NPRM is to improve the conditions of livestock producers by preventing packers from exploiting their alleged market power to the detriment of producers. Accordingly, the NPRM defines "competitive injury" and the "likelihood of competitive injury."

The Proposed Rule states that "competitive injury occurs when an act or practice distorts competition in the market channel or marketplace."[25] The Proposed Rule does not define these distortions. Therefore, a packer could be accused of distorting the market if it chooses to change operations from two shifts to one, if the packer elects to close a plant, or transform the plant from a slaughter operation to a processing-only facility.[26] Clearly, Congress and GIPSA could not have contemplated that normal business decisions, such as shift management, would be "competitive injury." Absent a distinct definition of the term "distortion of the marketplace," the possible scenarios in which packers could be in violation of the P&S Act are endless. Thus, any decision by a small business could distort the market (depending on how the scope of the market is defined),[27] be considered a violation of the P&S Act and prohibited by GIPSA under the NPRM. The uncertainty and lack of clarity would have devastating effects on small business operations.

a. Record Keeping

Proposed §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."[28] This would require packers and integrators to document information and data used to determine premiums and discounts paid to growers. Presumably, this requirement is designed to enable GIPSA whether the contract term constitutes a "distortion of the marketplace."

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[25] 75 Fed. Reg. at 35,341.

[26] A facility that does not slaughter livestock only processes it for product. In *City of Clinton v. Pilgrim's Pride Corp.*, 654 F. Supp. 2d 536, 542 (N.D. Tex. 2009) , *aff'd on other grounds*, 632 F.3d 148 (5th Cir. 2010) (decision on P&S Act not by district court not appealed) there were allegations that the selection of growers far from another poultry integrator constituted a violation of the P&S Act.

[27] If the market is defined in a narrow enough manner, either by product or geographic scope, it is possible for even a small business to exercise market power. However, competitive injury, as that term is used in the context of the P&S Act, generally comports with federal antitrust law. *E.g., Wheeler v. Pilgrim's Pride Corp.*, 591 F.3d 355, 357 (5th Cir. 2009); *Pac Trading Co. v. Wilson & Co., Inc.*, 547 F.2d 367, 369-70 (7th Cir. 1976). Measurement of the market in the context of the antitrust laws generally requires assessment of the area of effective competition which may be geographically narrow but generally is not. *See Wampler v. Southwestern Bell Tel. Co.*, 597 F.3d 741, 744-45 (5th Cir. 2010). Furthermore, the product market also must be defined, including likely substitutes for the particular, again suggesting something other than a very narrow market. *See Todd v. Exxon Corp.*, 275 F.3d 191, 199-200 (2d Cir. 2001). As a result, small businesses, except in the most unusual circumstances would not be able to exercise market power except through the badly defined standards of the Proposed Rule.

[28] 75 Fed. Reg. at 35,351.

For small packers, the provision will have additional costs, especially in contrast to their larger competitors. If the concept of "distortion in the marketplace" tracks the concepts of competitive injury in antitrust jurisprudence, then the packer, swine contractor, or integrator will have to show that the term was not unreasonable.[29] Given this basic principle of antitrust law, a term or condition in a contract that might otherwise look non-competitive, may have significant benefits to the packer or producer or both. Having to demonstrate this will be very problematic for small packers, swine contractors, and poultry integrators. Small firms do not have lawyers and economists on staff steeped in the intricacies of antitrust law and economics. Hiring such expertise will require the diversion of scarce capital from business operations to regulatory compliance. While GIPSA asserts that it will be a simple matter to demonstrate a contract does not distort the marketplace,[30] a quick perusal of Supreme Court decisions on the reasonability of any particular price restraint or contract term belies that simple notion. This conclusion is buttressed by USDA's rather generalized discussion of the factors needed to determine marketplace distortions and competitive injury. If GIPSA, with access to a phalanx of lawyers and an entire bureau of economists (the Economic Research Service) cannot ascertain the scope of reasonability in the context of antitrust law, it will be nigh impossible for a small business to do so. Yet, the NPRM expect such costs to be minimal for small businesses.

USDA asserts that small businesses will not face significant administrative costs as a result of the documentation requirement in the NPRM.[31] Small businesses frequently survive in the market through filling niches not covered by large processors selling commodified livestock products. Thus, it is far more likely that small businesses will have significantly more contracts with niche growers raising a special type of livestock than a large packer that can use a standardized contract across for most of its producers. This is the classic example, as noted in Part II of these comments, where compliance costs will disproportionately fall on small businesses.

If the Department is simply seeking pricing transparency rather than an effort to determine on a post-hoc basis whether a particular action by a packer constituted competitive injury, such transparency already is available through the mandatory price reporting program originally enacted in 2000 and reauthorized in the 2008 Farm Bill.[32] The NPRM then simply is a redundant regulation adding unnecessary costs to small businesses. If the provisions are aimed at examining the competitive injury and market distortions, then small packers will face inordinate costs to demonstrate something that is usually plainly evident – small businesses (except in very rare circumstances) have no market power and therefore are unable to distort the market. Again small businesses will face unnecessary costs without the government obtaining benefit from the regulation.

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[29] Under the Sherman Anti-trust Act, only unreasonable restraints of trade constitute competitive injury. *Continental, T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 49 (1977). Determining the reasonability of a restraint requires consideration of the following factors: a) information about the business, the type of restraint, its nature and effect; and b) the market power of the business (requiring an assessment of the geographic and product markets in which the business operates). *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 885-86 (2007).

[30] GIPSA asserted that the "justification [for the contract term] need not be extensive but should be enough to identify the benefit-cost basis of any pricing differential ...." 75 Fed. Reg. at 35,344.

[31] *Id.* at 35,349.

[32] 2008 Farm Bill, § 11001, 122 Stat. at 1350, codified at 7 U.S.C. § 1636(g).

2. Prohibiting Packer-to-Packer Sales and the Effect on Small Businesses' Ability to Integrate

Proposed new § 201.212(c) would "prohibit packers from purchasing, acquiring, or receiving swine or livestock from another packer or packer-affiliated companies."[33] With the proposed ban of packer-to-packer sales on livestock, it appears that GIPSA is attempting to undermine the utility of packer livestock ownership for small businesses. This ban could have unintended adverse consequences on small livestock producers that want to integrate vertically upwards to reap benefits of value-added agriculture or packers that want to focus on higher quality meats,[34] by controlling livestock production.

Currently, if an integrated packer cannot process certain types of livestock that are noticeably different from the traditional livestock they process in their plants, i.e. cull sows[35] compared to market hogs, the packer sells the cull sows to other packers who specialize in processing cull sows and producing the items that those hogs will yield. Under the Proposed Rule, the packer will have to sell the cull sows to a third party who will then resell them to the exact processor the original packer sells to today. This will put the original packer at a competitive disadvantage to others who can purchase cull sows without the need of an intermediate purchase by introducing unnecessary costs and inefficiencies. Consequently, packers may not be able to purchase all types of livestock from their producers requiring the producers to absorb the costs of transportation and marketing livestock to multiple packers. These significant costs would be imposed – not through any market logic – but simply as the result of regulatory fiat.

Additionally, prohibition on packer-to-packer sales will have the perverse effect of forcing larger processors to own more livestock thereby furthering the "exploitation" of producers through onerous contract terms. The impact of contracted or packer-owned production was not estimated by GIPSA but could be significant on small independent producers.

a. Packer-Buyers

The Proposed Rule §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,"[36] drawing a line with respect to dealers and their relationships with packers. To have an exclusive arrangement with a dealer, the packer would have to identify the dealer as its packer-buyer by filing with USDA on approved forms. This would require each packer to hire its own buyer for each purchase, which would be a significant cost increase to the packer.

Larger packers may have fewer purchases with more livestock in each purchase; therefore small businesses will have higher transaction costs especially if they need high quality livestock from many

[33] 75 Fed. Reg. at 35,346.

[34] Some examples might be grass-fed beef, free range poultry or USDA prime meats.

[35] Cull or culling is the process of removing animals from a group based on specific criteria. This is done in order either to reinforce certain desirable characteristics or to remove certain undesirable characteristics from the group.

[36] 75 Fed. Reg. at 35,352.

sellers. In addition, smaller packers may have to rely on independent buyers while larger producers can maintain in-house buyer staffs. Independent buyers need to make a profit which they will pass on to the smaller processors. Again, this represents a disproportionate impact on small businesses.

b. Packer-Ownership Ban

The NPRM bans packer and packer-affiliates from selling livestock to other packers. This is extremely problematic for producer-owned packing plants. Producers who have more livestock than can be processed at their own facilities often sell to other packers, which would be prohibited under the Proposed Rule. They will be forced to sell their excess livestock to a dealer, at lower prices and reduce their marketing options. This could then jeopardize the ability of producer/owners to sustain their farm operations due to lower revenue – a cost that GIPSA failed to measure.

c. Packer-Buyer Ban and the Effects on Small Auction Barns

At auction barns, packer-buyers[37] 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. The Proposed Rule would require dealers that operate as packer-buyers to purchase livestock only for the packer that identifies a specific dealer as its packer-buyer for that particular auction.

Under the NPRM, it would be prohibitively expensive for small packers to send individual buyers to every auction barn for every market. With fewer buyers traveling to remote or small auctions, the volume at these auction barns will, of necessity, decline due to the lack of competition. Auction barns will suffer a reduction in commission fees and producers that rely on these smaller auction barns will be adversely affected by the lower prices on sales. In the long-term, this may lead to closures forcing producers to either incur the expense of transportation to distant auction barns or entering into contractual arrangements with packers thereby reducing producer options for disposal of livestock. If the idea is to make the long-run market for livestock producers more competitive, this does the opposite.

C. USDA Failed to Specify the Impact that Contract Provisions that Change Industry Practice would have on Small Businesses

In addition to amorphous "competitive injury" standard, the NPRM also specifies a number of specific contracting provisions that would violate the P&S Act. Rather than attempting to change the structure of the livestock industry, these provisions are aimed at modifying the quotidian practices of the industry. Whether such changes are appropriate, USDA must examine the impact of these changes on small business – something GIPSA failed to do.

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[37] Packer-buyers 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.

1. Contracting Proposals

a. 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.[38]

Therefore, 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.

Some smaller growers raise their flocks to meet certain requirements such as pasture-raised grown poultry.[39] Pasture-raised poultry occurs on a smaller scale than birds produced in larger coops and utilizes different diet formulas that are usually exclusive to the grower. In order to raise this particular type of bird, the grower incurs greater unit costs than larger coop-based production. By doing so, smaller growers have created niche markets for these unique birds. Under the Proposed Rule, all poultry growers in a tournament system must receive the same base pay. If one grower invests in new technology, a more expensive diet formula, or a higher cost free-range system, that grower will receive the same pay as a grower who has not made the extra investment.

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.[40] GIPSA seems to believe that by removing the tournament system all growers will be raised to a higher common price, but in reality all growers will be moved toward a lower common price. That will hurt high quality producers and packers seeking the highest quality poultry. The end result is that the NRPM would further commodify production of livestock thereby harming those small producers attempting to differentiate their livestock and obtain higher returns. USDA did not assess what happens to these growers or the packers they supply as a result of this movement to a median common denominator pay scale.

Finally, elimination of the tournament system would simply result in the packers rating growers informally resulting in less information available to producers. This will make it more difficult for

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[38] Proposed 9 C.F.R. § 201.214, 75 Fed. Reg. at 35,352.

[39] Pasture-raised poultry feed in open fields and are free to graze rather than being confined in a poultry house.

[40] 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.

producers to find information they need to improve their poultry.[41] Full information is a necessary condition for a competitive efficient free market; the elimination of the tournament system undermines the ability to maintain a competitive market. It also will impose costs on producers as they attempt to ascertain how they are rated by packers. If the point of the P&S Act is to maintain a competitive livestock market, then GIPSA failed to examine how the elimination of such system will affect the ability of producers to obtain needed information to make appropriate market-based investment in their operations. The ultimate cost will be borne by small producers losing revenue in their efforts to raise a higher-quality bird.

b. Suspension of delivery of birds

The NRPM 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."[42] This is problematic because there is seldom 90 days of down-time between the raising of flocks. Under this provision, 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. The economic consequences of failure to find a buyer are severe and need not be further discussed. Yet, GIPSA failed to discuss the economic consequences to small growers.

The costs facing growers could be compounded if an integrator has an exclusive contract that prohibits sales to other packers. This could cause the integrator to bear expenses, i.e. feed or medicine, without any likelihood of finding a buyer if a suspension notice has been issued. The concomitant increase in costs to the grower or integrator or both would defeat the whole purpose of contracts which is to ensure that growers and integrators know the costs of production. Again GIPSA filed to examine this problem in the Proposed Rule.

c. 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."[43] Given the margins, small integrators may find it difficult, if not impossible, to make such assurances. If they cannot make the guarantees required by the NPRM, the small integrators would be unable to get the quality of poultry they need. The end-result is that such integrators or packers would lose customers or be forced to leave the business. Fundamentally, this is price setting, i.e., the prices of the bird will be 80 percent of the increased costs plus whatever add-on price, if any, the integrator can get in addition from the packer. If the integrator happens also to be the packer, it is unlikely that the grower will be able to negotiate any more than coverage of 80 percent of the costs since that is what is set in regulation. Rather than setting a price

[41] A packer that informed certain producers on what they needed to improve through an informal grading system might be considered to be distorting the marketplace under other aspects of the NPRM.

[42] 75 Fed. Reg. at 35,352.

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

floor, the NPRM used government price setting to tacitly set a price ceiling that can be received by high quality producers. The costs to small growers and the competitiveness of the marketplace were not examined by USDA.

Most integrators already present growers with estimates of expected costs and returns on suggested improvements. The Propose Rule would require each integrator to maintain detailed records for each capital improvement for each grower resulting in a significant administrative burden. The requirement presumably was added to ensure that GIPSA can identify whether the integrator is providing an 80 percent reimbursement of additional capital expenses. However, additional recordkeeping mandates add costs to integrator operations that they will absorb by reducing the overall capital improvement they seek from growers. The end result will be a more commodified poultry for which growers will receive overall lower payments. Finally, if integrators and growers already know their costs, imposing additional administrative burdens provides no benefit to either party while adding unnecessary expenses that GIPSA failed to examine.

i) Swine contracts and capital investments

Swine production contracts are sufficiently similar to poultry contracts. The analysis already performed for the poultry industry applies with equal force to the pork industry. 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. This contract feature is vital for smaller producers who have limited resources to cover continuous bad years in the market. It is doubtful that small packers could honor this kind of contract for all of their producers. If they 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.[44] Therefore, these contracts may disappear and the benefits to small hog producers of such contracts were not examined.

2. 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.[45]

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. No logical reason would exist to go through an arbitration proceeding only to have to litigate before GIPSA the fairness of the

[44] 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.

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

proceeding. If GIPSA determines that the proceeding was not fair, the parties would then either have to rearbitrate or go to court to settle the dispute. Absent some a priori mechanism to establish the fairness of an arbitration proceeding, it would be a waste of resources, especially for smaller swine contractors, integrators, and processors.

D. *Studies on Economic Impact to Small Businesses*

On November 8, 2010, Informa Economics, Inc. released a study on the economic effects of the NRPM.[46] The study identified the following costs of the NRPM:

- Packers would be forced to invest in technology to adequately and accurately maintain written or electronic records or some combination of both. Packers facing these costs will be forced to pass them on to the consumers and reduce prices paid to producers.[47]

- Transaction costs associated with getting livestock from the initial packer to their final destination will result in higher input costs to be absorbed by packers. Small packers would find it harder, due to an absence of market power, to pass on these costs to consumers.

- A "middle man" will be required for all transactions lowering the price the producer will receive so that the "middle man" can earn a profit.

- Packers will face extra costs by having to send individual buyers to every auction barn for livestock sales.

- Livestock producers relying on smaller auction barns will fail due to fewer buyers attending auctions. Transporting livestock to larger markets further away will add unnecessary transportation costs to be absorbed by the producer.[48]

- Integrators will be forced to continue using inadequate growers to accusations of illegal contract termination under the P&S Act. This will result in lower overall efficiency and higher costs throughout the poultry industry.

- Swine producers under contract will have additional costs to comply with the Proposed Rule limiting production efficiencies. The end result will be a loss of production in the hog industry.[49]

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[46] INFORMA ECONOMICS, AN ESTIMATE OF THE ECONOMIC IMPACT OF GIPSA'S PROPOSED RULES (2010), *available at* www.informaecon.com.

[47] In some cases, packers would not be able to pass on costs. Large packers with market power might be able to pass on these costs or while small packers would likely have to absorb such costs. Again this represents the type of disproportionate impact discussed in Part II of these comments.

[48] Informa estimates that as many as 200 of the nation's smallest sale barns could be at risk of closing. The loss of these barns and the consolidation of the sector is expected to result in a loss of over 800 jobs.

[49] The reductions stem from provisions that restrict the contractor's ability to require facility and equipment upgrades.

- Packers would unable to keep risk-sharing contracts available to their producers because the Proposed Rule would put the packer at risk of violating the P&S Act. By eliminating these kinds of contracts, there are many producers that would not survive a stretch of negative margins, such as the industry has incurred the last two years.

Informa found that the NPRM is likely to reduce animal numbers in the beef sector by 494,000 head and in the pork sector by 1.25 million. For broilers the expected decline was 55.2 million birds and for turkeys the Proposed Rule was expected to reduce output by an amount equivalent to 659,000 birds.[50] Informa concluded that if the Proposed Rule was adopted unchanged it will reduce the GDP by just over $1.5 billion and cost the US economy nearly 23,000 jobs. While a reduction in head would increase the prices received for remaining producers, the NRPM could force many small producers and their packer customers out of business.

IV. USDA Failed to Comply with the RFA

Competitive injury as stated in the NPRM "occurs when an act of practice distorts competition in the market channel or marketplace."[51] How 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)."[52] There is no mention in the IRFA of how "distorting" the marketplace will affect small businesses. The Proposed Rule states that if a "packer harms a producer" they are in violation of the competitive injury clause of NRPM. The Proposed Rule also reads, "there were 8,995 hog producers with swine contracts, almost all of these producers would have been classified as small businesses."[53] Therefore, under the competitive injury proposal close to 9,000 small businesses could be affected by the provision. As shown in the preceding section, the impact on these small businesses will be significant. USDA clearly failed to examine this information in their IRFA. Had the agency done so, it would have reached the same conclusions as these comments. This would have led GIPSA to develop less burdensome alternatives for small businesses. In its current form, the IRFA does not comply with the RFA with respect to "competitive injury."

The NRPM also failed to consider the costs imposed on small businesses due to additional record keeping practices. "The costs related from compliance with the records retention, notification costs, and contract revisions, also if applicable, are similar to the sections related to the production contracts for similar reasons and are also not expected to be large to the entities that are small businesses subject to these sections of the proposed regulations."[54] As demonstrated in the prior section, USDA clearly underestimated the significance of the costs associated with these requirements. An accurate estimation would have led GIPSA to develop less burdensome alternatives. This failure constitutes

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[50] *Id.* at 70.

[51] 75 ,Fed. Reg., at 35,348.

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

[53] *Id.* at 35,348. This comports with data examined earlier in these comments.

[54] *Id.* at 35,349.

non-compliance with the RFA.

The NRPM would "prohibit packers from purchasing, acquiring, or receiving swine or livestock from another packer or packer-affiliated companies."[55] This would be harmful to livestock producers, particularly producers who raise value-added or higher quality livestock. As analyzed in the prior section, this will have severe economic consequences for small packers by further commodifying livestock markets and making it more difficult for such packers to obtain needed livestock on which to base their differentiated products. Such consequences should have been examined in the IRFA and alternatives for niche producers and packers should have been developed. Their absence demonstrates non-compliance with the RFA.

The packer-to-packer ban will completely change how packer-buyers operate by precluding producers with ownership in a packing plant, who also raise livestock, from selling to another packer. These impacts will be severe on such companies or producers seeking to vertically integrate as already discussed. There is no mention of producer-owned companies in USDA's IRFA or any discussion on the effects of such bans on small businesses in the livestock food chain. Therefore, USDA failed to comply with the RFA.

Small auction barns in isolated areas across the United States will suffer dramatically from the packer-buyer provision as already explained earlier in these comments. The NRPM states that "GIPSA identified 180 livestock auctions where one buyer bought cull cattle for more than one packer."[56] Assuming that this data is correct, a full IRFA would need to break down how many of these auctions occurred in small auction barns. Hypothetically, if all 180 auctions were in small auction barns, in more isolated parts of the United States, then this provision would have serious consequences for small businesses. Moreover, the data in these comments shows that there are about four times as many small auction barns as suggested in the IRFA and no mention is made of how the changes proffered in the NPRM will affect those auction barns. The failure to examine, in any meaningful way, impacts on auction barns is further evidence of non-compliance with the RFA.

For four of the proposed standards relating to contract provisions: tournament compensation, suspension of delivery of birds, dealing with capital investments, and arbitration the NRPM states, "summarizing the costs that the proposed regulations related to production contracts entail, these costs are substantively borne by packers, swine contractors, and live poultry dealers."[57] This certainly is a correct statement. The missing analysis is any indicia of the magnitude of these costs. Those costs, as examined earlier will be significant for small businesses and these comments have identified that most businesses in this industry are small. If USDA would have analyzed the effects of the NRPM they would have realized that any extra costs to growers represent a significant economic burden to businesses with already slim margins. This is especially true for small growers who are unable to take on the additional costs of capital improvements. Thus, GIPSA's failure to comply with the RFA is twofold: an inadequate cost assessment; and an inadequate examination of less burdensome alternatives.

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

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

[57] *Id.* at 35,349.

Despite the voluminous information provided by the agency in the NPRM, it failed to make a good faith effort to examine the criteria specified in the § 603 of the RFA. First, USDA failed even to state categorically whether the impact will be significant under the RFA. As a result small businesses have no way of knowing whether the agency believes impacts will be significant on small businesses. Even if USDA concluded that the proposed rule would have a significant economic impact on a substantial number of small businesses, it failed to provide an accurate estimate of the costs that would be incurred by small businesses operating under the proposed rule. The agency also failed to assess the impact on significant sectors of the industry affected by the NPRM, such as auction barns, small grower-packers, or small producers seeking to integrate vertically. Finally, the agency made a fundamental mistake by not considering a no-action alternative, i.e., leaving the P&S Act of 1921 unchanged for small businesses.

Had the agency done proper assessment of economic impact on small businesses affected by the NPRM, it would have developed alternatives that lessen the impact on small businesses. The agency's failure undercuts its effort to promulgate sensible and rational rues for implementing the P&S Act. Full compliance with the RFA would help the agency achieve that goal – sensible rules under the P&S Act.

V. Conclusion

USDA should be commended for attempting to prepare an IRFA despite the evident inadequacies of that document. However, GIPSA should revise its IRFA in order to comply with §603 of the RFA as part of the more detailed economic analysis currently under way. After that, USDA should publish the IRFA for comment to ensure small businesses can inform the agency on its effects to their businesses. Until this is done, any regulatory change is premature. As a final matter, please include these comments in the record of the rulemaking proceeding. Should you have any questions about these comments, please do not hesitate to contact Brooke Shupe or Barry Pineles of the Committee staff at 202-225-5821.

Sincerely,

SAM GRAVES
Chairman
House Committee on Small Business

SCOTT TIPTON
Chairman
Subcommittee on Agriculture, Energy and Trade

cc: Under Secretary for Marketing and Regulatory Programs, Hon. Edward Avalos
Administrator, Grain Inspection, Packers and Stockyards Administration, J. Dudley Butler