Organization for Competitive Markets Briefing Paper

11/30/2016

Distorted Incentives: The Simple Arithmetic of Captive Supply

The dominant captive supply arrangement is a marketing agreement with a base price tied to the residual cash market price. Under such an agreement, for example, the cattle buyer may pay the producer "the highest price paid for cattle in the open market in the past two weeks from the date of sale." Such agreements distort buyer incentives. This is basic Economics 101. These distorted incentives are apparent in the following statement made by a fed cattle buyer to Randy Stevenson[1]:

> *"… an IPB cattle buyer … looked at high quality cattle we had on our show list for sale. The market was about $66/cwt in the cash market, based on live weight. (He) was very complimentary of our cattle's quality. He said his hands were tied and he could not offer more for the cattle, despite their above-average quality. (He) said, '**In the old days I would have been able to offer $67.50 for these cattle, but now paying more would screw up 20,000 formula cattle**.' It was completely clear to me that the buyer was telling me paying a higher price for my cattle would influence prices for cattle bought on a formula contract basis (off the cash market). We lost money in this deal because IBP would not allow its buyer to engage in competitive bidding."*

Here is the simple arithmetic. Suppose that the base price for the 20,000 head of formula cattle was the top-of-the-market price. We know such contracts exist. Also suppose that another packer—maybe a very small packer—had already established the weekly top-of-the-market price at $66.00. If the IBP buyer pays Randy an additional $1.50/cwt ($18/head) for his pen of 1,000 high quality cattle, then the "additional cost" is the extra $18,000 for Randy's cattle, plus an extra $360,000 on the 20,000 head of formula cattle. Paying Randy an extra buck fifty on 1,000 head would have cost IBP an extra $378,000, because if IBP was purchasing 20,000 head within the two-week period after the sale of Randy's cattle they would have had to pay the producer with 20,000 head the higher price of $67.50 a pound instead of the $66.00 (or an additional $1.50 per pound). Obviously, IBP would not be willing to bid $67.50 in a $66.00 market. Looked at another way, offering $67.50 for Randy's pen of high quality cattle would have been the equivalent of offering $97.50/cwt in a cash market without the captive arrangement.

Such arrangements obviously soften bids, in this illustration costing Randy $18,000. In the lingo of economics, marginal cost of slaughter cattle is higher to the buyer because of the marketing agreements tied to cash price, ***causing*** cash price to be lower than it would be without such captive arrangements.

Marketing agreements harm feeders selling on the cash market, and they also harm captive feeders who participate in these marketing agreements.

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[1] Affidavit by Randy Stevenson, Dated October 11, 2002.