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# PRICING PROBLEMS IN THE FOOD INDUSTRY
# (With Emphasis on Thin Markets)

A compendium of papers presented at the Symposium on Pricing Problems in the Food Industry (with Emphasis on Thin Markets), Washington, D.C., March 2-3, 1978

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# PRICING PROBLEMS IN THE FOOD INDUSTRY: RESEARCH NEEDS

Read P. Dunn, Jr., Commissioner
Commodity Futures Trading Commission

The Commodity Futures Trading Commission (CFTC) is interested in prices and pricing problems in the food industry because commodities in the food industry are important in futures markets. Over two-thirds of the contracts traded on futures markets are basic agricultural commodities. These include the mainstays of the food industry.

Cash prices of these commodities are important to CFTC for several reasons. The function of the futures market is to provide a means of price risk management. The main purpose of the CFTC is to see that the futures markets perform these functions as accurately as possible, which is to say, that futures prices are not manipulated, but reflect the supply and demand conditions in the cash market. CFTC is expected to see that the futures prices do not get out of line with cash prices. Its surveillance and analysis are based on cash prices. For the analysis to be good, the price data must be good—accurate and representative.

Another reason for CFTC's interest is the price aspects of the futures contracts themselves. The contracts provide for delivery at certain locations and usually for delivery of various quantities at points on and off the base quality. The CFTC has the responsibility to see that these differentials are as accurate a reflection of the cash market differences as possible so the contract does not give an undue advantage to either the buyer or the seller.

Another interest CFTC has in price is the quotations of the spot committees of the Exchanges under the agency's jurisdiction. It must assure itself that their quotations are fairly determined and accurate.

The CFTC is also assigned the responsibility to prevent manipulation in cash markets. The possible scope on this authority is so enormous that for practical reasons CFTC has decided to limit its regular surveillance of the cash markets to prices at delivery locations, but that is still a large and pervasive responsibility.

The quality of price information is obviously important to the Commission. The thinner the market the more questions I have about the price quotations. To define the term "thin" I mean a low volume of the commodity traded with visible price information in comparison to the annual total marketed.

At the outset we must recognize that the sales volume of any commodity varies. Sales of seasonal agricultural commodities by producers characteristically peak during the harvesting period and taper off as the season advances. The primary markets are usually thinnest at the tail end of the season.

My first question is on the accuracy of cash price information in the primary markets. The basic source of data for the food crops is the USDA. The main interest of the USDA is in prices in order to estimate farm income. Their primary source is the AMS quotations of cash prices on the various spot markets. However, some of these quotations on the smaller markets at the tail end of the season are so very erratic, I wonder about their

accuracy and their significance. Then, as more producers sell forward, less of the total movement is reflected in the spot market sales.

We found in our studies of the spot markets at Kansas City and Minneapolis that only about 20% of grain moving through those centers was ever sold on the spot exchange. The greater part is sold "to arrive" or forward. Some of the spot markets still being quoted by USDA have literally dried up. The volume of grain sold on the spot market in Chicago, for instance, is negligible. Most of the grain moving in and out of Chicago is not sold spot. Chicago is no longer a primary or central market for producers. It is a secondary terminal market, which provides my next major concern.

Increasing concentration in agricultural marketing leads to fewer transactions. Trends toward concentration can be observed in all the agricultural commodities. Larger farms and cooperatives mean producers sell in larger units; the concentration of marketing is very noticeable, so is concentration in processing. Vertical integration of all these functions is appearing in some sectors, and partical integration is apparent in many. Rising costs of warehousing and transportation are facilitating and encouraging this trend.

What is more noticeable to me is the decline in primary central markets where producers bring their produce for sale and the growth of what I call the secondary dealer to processor markets.

In grain today I think prices are determined not by negotiation between the country elevator and the farmer at Cedar Point, but in the trading rooms of the big grain companies that sell most of the U.S. grain to processors in the U.S. and around the world. I think it is the price established by these grain company sales to the processors that is reflected down to the country elevators and to the farmers. This I think is the dominant price. But what is this price? Does anybody outside the inner sanctum of the trade know? These are not spot transactions as a rule; they are mostly forward sales. Oft times these forward sale prices are caluclated on the futures, not on the spot price of grain at Cedar Point. Spot prices and producer sales seem to be influenced primarily by current supply and demand conditions, while sales and prices in the forward markets seem to be influenced primarily by prospective supply and demand conditions.

The accuracy and validity of spot prices seem to be most questionable in the case of the imported agricultural commodities. These are clearly secondary markets where dealers are selling to processors. Producers are rarely involved. In these commodities (coffee, cocoa and sugar), the dealers and the processors are highly concentrated. A very large part of the business is done by a relatively few firms. These larger processors buy forward, not spot. They tell you they pay little attention to spot prices. Only the small buyers who can't afford to purchase ahead are in the spot markets. The sales in the spot markets from merchant stocks have to reflect the cost of handling and storage, which has become quite high in major centers. Sometimes sales in the spot market are of distress merchandise which result in price aberrations.

My questions really are: Where is the main stream in the commodity flow? What is the main stream price? Who should report it and how?

If, as I now believe, the mainstream price is determined in the secondary market by relating it to a future, how should we evaluate the future price against the cash? Somehow we have to get a separate cash price for comparison. But how?

Then, how do we use the spot cash prices in the thin periods like the tail end of the season? To illustrate, I became quite concerned summer before last when the July cotton futures hit 93¢. Surveillance said there was no problem because the differential between spot cash and futures had not changed, indicating the futures did reflect the real supply and demand. But on checking I found only 30,000 bales of cotton were sold in July in the entire country, an insigificant amount. The total volume sold on the futures market in July was over 8 million bales. Lots of cotton was being sold — merchants were selling millions of bales in July to mills at home and abroad, but not spot cotton — it was cotton yet to be produced, to be delivered December through May. These cash sales were based on the futures market and hedges against them were in the futures market. I think the July spot price was simply a reflection of the July future and not a mainstream price.

You ask about research priorities. I would like to find the mainstream of sales and prices and learn how they relate to the futures market. I would like to know how we should judge the performance of the futures prices against the cash, and which cash prices to use and when.