October 27, 2008

Mr. Donald K. Hansen, Chairman
Pacific Fishery Management Council
7700 N.E. Ambassador Place, Suite 101
Portland, OR 97220-1384

Dear Chairman Hansen:

The members of Fishermen's Marketing Association, California, representing trawl harvesters, and the members of the Fishing Vessel Owners' Association of Seattle, representing longline interests, requested a paper from a noted and recognized economist, Dr. Jim Wilen, on why giving harvester's quota to processors is a bad idea. Dr. Wilen is a professor with the Department of Agriculture & Resource Economics at the University of California, Davis. The two associations are submitting Dr.Wilen's conclusions and comments as part of the overall record for Trawl Individual Transferable Quotas. Below are some excerpts of Dr. Wilen's conclusions.

> The most remarkable aspect of the proposal to allocate harvester quota to processors is that it is a "solution" for which there is no corresponding "problem".
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> The real reason that processors are insisting that they be granted harvester quota is money. The estimate that I have made (which I believe is conservative) is that the Council's "preferred alternative" that allocates harvester quota to processors will, if granted, be worth 100 million dollars to small number of owners of the processing sector. This dispute over processors allocations thus must be recognized for what it is—a power struggle over money rather than over a policy option that "fixes" some problem.

In most other industries where oligopoly or oligopsony power is present, a concentration level in which 4 industries handle 60% of the product is deemed high. On the Pacific Coast, 2-3 companies process 80% of the product.

On the Pacific Coast, the degree of market power in the groundfish market is probably more correctly described as a "dominant firm monopsony" in light of the extreme concentration of market power in a single buyer.

This is consistent with EIS descriptions of the harvesting sector, which is depicted as making zero economic profit, even after a buyback program that substantially reduced the number of participants.

Current options to carve processor allocations out of harvester quota subvert the normal policy process. This is because they have been added to the system design purely for political reasons rather than to address a National Standards objective or a shortcoming of a purely harvester-based rationalization program.

Just as important, granting incumbent processors allocations will disadvantage potential entrants, precisely the players most likely to bring innovation to product marketing and higher values to the whole fishery as a result.

Fishermen's Marketing Association

Peter Leipzig
Executive Director

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Why Giving Harvester Quota to Processors is Bad Policy

By

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October 27, 2008

Discussion Points for PFMC Meeting
November 1-7, 2008

Why Giving Harvester Quota to Processors is Bad Policy

The decision of the Pacific Council to even contemplate allocating harvester quota to processors is an unprecedented step in fisheries policymaking. There have been over 150 individual quota programs implemented to date around the world, and not a single one has carved a share of harvester quota out to grant to processors. There are good reasons why, at similar junctures, other policymakers have chosen to allocate quota only to harvesters. It behooves the Council to acknowledge this radical departure from accepted practice, and to understand the significant negative ramifications that such a policy will generate.

Justification

The most remarkable aspect of the proposal to allocate harvester quota to processors is that it is a "solution" for which there is no corresponding "problem". Proponents have attempted to justify this policy using arguments that have shifted and morphed over the past couple years. The initial argument was that processors would suffer "stranded capital" losses if a quota program were implemented. As I have argued, the stranded capital claim by processors is overblown; it is likely that true stranded capital losses will be negligible.[1] In any case, if there were stranded capital losses, good policy would call for not for an arbitrary quota allocation, but rather remedies based on measured capital losses, as has been typically done in public utility regulation. It now appears that while processors have abandoned the original stranded capital justification, they have not abandoned their quest for part of the initial harvester allocations. What justifications are now offered? A more recent argument delivered in testimony to the Council is that without processor allocations, processors will be disadvantaged in the ex vessel market after rationalization. In the extreme version of this argument, processors argue that they would be forced to pay prices that would bankrupt (the entire) processing industry. This is also a spurious argument. With the degree of concentration of market power that now exists in the ex vessel market, processors will continue to enjoy their asymmetric position of power, even after quotas are introduced. Another recent argument has been made that, without harvester quota allocations, processors would have to move plants and local employment would be lost. This has been addressed with various regionalization options, but it still raises the question: exactly how will allocations to processors alter decisions if economic conditions favor geographic shifts? Again it is not clear; there is no argument that I can discern that explains how processor allocations would keep plants in unprofitable locations. A final argument is that it is "fair" to allocate harvester quota to processors. This argument seems the hardest to justify since the contemplated transfer involves taking from a couple hundred small businesses with asset values on the order of a million dollars each to give to a handful of individuals (primarily two) who own businesses worth on the order of a billion dollars. The point is that all of arguments made that attempt to logically justify the need for harvester

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[1] Wilen, James E. Stranded Capital in Fisheries: the Pacific Coast Groundfish/Whiting Case, forthcoming in *Marine Resource Economics*, 24(1), April 2009. See also: Wilen, James E. Stranded Capital in Fisheries, White Paper prepared for Environmental Defense Fund, August 2008.

allocations to processors in order to solve a "problem" do not hold up under closer scrutiny.

The real reason that processors are insisting that they be granted harvester quota is money. The estimate that I have made (which I believe is conservative) is that the initial proposal to allocate harvester quota to processors to cover "stranded capital" was worth 100 million dollars to the small number of owners of the processing sector.[2] This dispute over processor allocations thus must be recognized for what it is---a power struggle over money rather than over a policy option that "fixes" some problem. If the Council bows to political pressure rather than logic and responsible program design in this decision, it will surely reduce its own legitimacy in the eyes of the public. When the well-placed prevail simply because of their power, observers start to believe that the process is unfair, and that outcomes are essentially determined the simple "follow the money" notion.

Implications

There is more at stake than simply the question of how to split a fixed pie between contending interests. In this case, the decision to allocate to processors will also generate economic inefficiencies, some of which will negate the very reasons for implementing the policy in the first place. It will also have severe ramifications in terms of future rationalization programs, since it will open the door to unlimited wrangling and process holdup. Finally, it will reduce some of the incentives for stewardship and conservation motives that are among the more important reasons for implementing a quota program in the first place. These are reasons why no other quota design of the 150 that have been implemented has included the step of allocating to processors.

In the sections below, we summarize various implications of allocating harvester quota to processors.

Economic Implications

- ***Processor allocations reinforce existing market power in the ex-vessel market***

Allocating harvester quota to processors will exacerbate the power imbalance in an ex-vessel market that is already uncompetitive. As the EIS document outlines, both the whiting and non-whiting groundfish exvessel markets are dominated by an unusually small number of buyers. Generally, markets dominated by small numbers of input buyers are referred to as "oligopsonies". Oligopsonists exploit their buyer's power by under-paying resource suppliers (harvesters), and hence collect an 'oligopsonist premium" as a result of their market power.[3] In most other industries where oligopoly or oligopsony

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[2] See Appendices in Wilen (2009, 2008), *op. cit.* Estimates based on proposals to allocate 50% of shoreside whiting to processors and 25% of non-whiting groundfish to processors. Current preferred alternative proposals are worth (conservatively) 60 million dollars to processors.

[3] Alaska's pre-AFA inshore pollock fishery is a good example of an unusually effective oligopsony. Throughout much of its history, just 3 companies have dominated the inshore pollock market, 2 of them owned by Japanese conglomerates and the other (Trident) owned by an American family. The Japanese conglomerates have had every incentive to negotiate the lowest possible ex vessel prices, so that profits in their integrated operations can be shifted to Japan. Likewise, Trident has had every incentive to go along with those low prices. How effective has this exercise of market power been? In the inshore pollock

power is present, a concentration level in which 4 industries handle 60% of the product is deemed high. On the Pacific Coast, 2-3 companies process 80% of the product.

While the EIS documents the small number of buyers in the Pacific Coast groundfish market, it does not go far enough in its description of the asymmetry in current processor market power. This is because it ignores the ramifications of the interaction among the small number of dominant buyers. On the Pacific Coast, the degree of market power in the groundfish market is probably more correctly described as a "dominant firm monopsony" in light of the extreme concentration of market power in a single buyer. A dominant firm monopsony is able to exploit suppliers to an even greater degree than a small group of oligopsonists. Typically, a dominant firm sets its buying price at a level just barely enough to induce suppliers to remain in business. This is consistent with EIS descriptions of the harvesting sector, which is depicted as making zero economic profit, even after a buyback program that substantially reduced the number of participants. When a dominant firm monopsony exercises its control over a market, there are few incentives for other fringe firms to deviate since they benefit from the price leadership of the dominant monopsony. With high barriers to entry, this form of market power and the exercise of such power over ex vessel prices can be very stable, and can persist under substantial changes in economic, regulatory, and institutional circumstances.

The EIS punts on the market implications of this policy, stating "it is not clear how the Council's preferred alternative (which allocates 80% to shoreside harvesters) will impact ex vessel prices relative to status quo conditions". In reality, it is clear. A dominant firm is likely to be able to exercise full control in a market, even if **all** quota is granted to harvesters. With this extreme degree of concentration, harvesters will still be at the mercy of asymmetric market power in the exvessel market, and reducing their holdings to 80% will certainly not make the market more competitive. This is clearly a move in the wrong direction; the Council ought to be encouraging rather than discouraging vigorous ex-vessel market competition for reasons we next discuss.

- ***Processor allocations reduce incentives to generate market-side innovations***

There is virtually unanimous evidence that rationalization programs in place around the world have generated new and often significant gains in economic returns. Most often this is attributed to the **cost savings** that emerges when quota is consolidated and vessels are retired and/or reconfigured after the race to fish is eliminated. The EIS for the Pacific groundfish program outlines similar expectations, ascribing the potential gains from rationalization to input cost savings via consolidation. Less appreciated, however, is the fact that **revenues** have also increased significantly in many rationalized fisheries.[4] How does this happen? Basically by innovation by processors and handlers as

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fishery, real ex-vessel prices prior to the AFA were virtually constant to harvesters year after year. These ex vessel prices barely covered expenses for harvester vessels, leaving them with close to zero economic profit. Remarkably, ex-vessel prices did not vary even though the yen/dollar exchange rate varied widely over the same period. In a competitive market, exchange rate variation would be reflected in ex-vessel prices.

[4] See See Casey, K., C.Dewees, B. Turris, and J. Wilen. 1995. The Effects of Individual Transferable Harvest Quotas in the British Columbia Halibut Fishery, *Marine Resource Economics*, 10(5). See also

they create new product forms, establish new market niches, and increase raw fish quality. But product innovation requires vigorous competition among processors and handlers. A policy design that locks in the existing dominant firm status of the current ex-vessel market will delay if not forego important market-side gains that have proven so significant in many other rationalized fisheries. Just as important, granting incumbent processors allocations will disadvantage potential entrants, precisely the players most likely to bring innovation to product marketing and higher values to the whole fishery as a result.[5] There is a significant amount at stake here; market-side rents that have been generated from marketing innovation have been on the order of 40-50% of total industry revenues in some fisheries.[6] Moreover, these gains are realized almost immediately, whereas gains associated with consolidation and cost savings often take years to realize. The lesson is that, in fisheries as in every other industry, innovation is the engine of new wealth generation, and competition is the engine of innovation.

- ***Processor allocations reduce the efficiency of initial harvester allocations***

All rights-based systems have generated conflict over who among harvesters should receive initial allocations, and if so, how much. In virtually all cases, however, initial allocations bear close connection with the catch histories of the vessels in question. As Liebcap has argued, this **is** the most efficient way to determine initial allocations among incumbents.[7] The reason is that the historical pattern of catch records already reflects an intense competitive process among incumbents, and existing agglomerations are consistent with optimal production scale and size. The proposal to carve 20-30% off historical catch records to give to processors is equivalent to a tax of that magnitude on incumbent harvesters, and it will thus reduce the efficiency of operating vessels that have been built and operated to harvest efficiently under current conditions. Reducing harvester allocations below the levels that have been revealed as efficient will require many new rounds of trades of both leased and owned quotas, the paying of transactions costs that are incurred with these market operations, and adjustment by an industry that has already configured itself into production units that exhibit efficiency. The process of consolidation normally takes several years to work its way through the vessel capital structure. It make sense from an efficiency point of view to begin the process with vessels and catch histories that are close to production portfolios that will emerge after

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Homans, F. and J. Wilen. 2005. Markets and Rent Dissipation in Regulated Open Access, *Journal of Environmental Economics and Management*, 49(2):381-404.

[5] In British Columbia, we interviewed processors before and after the IFQ program was implemented as background for a study of IFQ impacts (Casey et. al. 1995, *op. cit.).* The more striking comments detailed how innovative buyers opened up new markets for halibut in the middle of Canada where supermarket consumers had never seen halibut under the race to fish. These new markets were created by vigorous competition and market innovation among both established processors and new (generally small) handlers, innovation that was responsible for higher profits to processors and buyers as well as increases in ex-vessel prices.

[6] Cf. Wilen, James. 2006. Why Fisheries Management Fails: Treating Symptoms Rather than Causes, *Bulletin of Marine Science*, 78: 529-546.

[7] Liebcap, Gary (2007). Assigning Property Rights in the Common Pool: Implications of the Prevalence of First-Possession Rules for ITQs in Fisheries, *Marine Resource Economics*, 22(4): 407-424, pg. 408.

adjustments have taken place. By reducing harvester allocations to allocate to processors, existing harvesters will begin the adjustment process below production levels likely to be long run equilibrium levels.

Policy and Process Implications

- ***Processor allocation options are a subversion of Council process***

Current options to carve processor allocations out of harvester quota subvert the normal policy process. This is because they have been added to the system design purely for political reasons rather than to address a National Standards objective or a shortcoming of a purely harvester-based rationalization program. When processors argued that they needed allocations to compensate for stranded capital, there was at least a possibility of designing policy remedies to address that problem, if indeed it was a problem. Sensible remedies would have involved measuring actual stranded capital, and tying compensation to measured losses with a hold-back fund or similar option. But by abandoning the stranded capital justification, there is no new credible justification for arguing that processor allocations are needed. Yet they remain part of the preferred alternative.

If the new argument is that processor allocations are needed to ensure that they can maintain their current power imbalance in the ex vessel market, then they also subvert the Council's "constraints and guiding principles" provisions, which state that goals and objectives should be achieved while "avoiding provisions where the primary intent is a change in marketing power balance between harvesting and processing sectors". If one believes that quota programs will give harvesters a bargaining advantage, then adding the processor allocation to address that effect flies in the face of the Council's own "constraints and guiding principles". If one does not believe that harvester-only quotas will affect market power, then there are virtually no credible justifications for them in the first place.

- ***Processor allocations will induce future policy holdup***

Pacific Council members will not be thanked by members of other fisheries management councils for veering from precedent in designing quota programs. Moreover, the fallout will not be simply shunted to other regions and will likely come back to haunt future Pacific Councils as other west coast fisheries are rationalized. This is because a decision to allow processors to claim part of the initial harvester allocation will invite holdup of the process everywhere. Designing efficient quota programs is difficult enough to get right, and it is contentious enough to determine a qualifying period and set of allocation rules that allocate among harvesters. The processor allocations that are part of the Council's preferred options here will, if granted, open the door to endless wrangling over similar programs in the future. Enormous amounts of effort and funds will be spent lobbying, wasting future Council members' time, and delaying the implementation of programs that produce genuine new wealth for the industry. In the limit, processor allocations will delay creating real wealth that could be going to fishermen and processors, and instead waste it on attorneys, lobbyists, expert witnesses,

and political campaigns in endless wrangling and needless dispute. This aspect of processor allocations is the least discussed effect to date, and will probably turn out to be the most important in the long run.

- ***Processor allocations open up future rationalization programs to irresolvable conflict***

A critical problem with allowing a stakeholder group to simply make an arbitrary claim on initial allocations is that it opens up future disputes to conflict that will be literally irresolvable. With processor allocations that are currently in the preferred alternatives, there is neither problem-based justification for adopting them in the first place, nor a logical mechanism that connects the proposed remedy to the problem. Moreover, there is no quantitative assessment of the alleged problem or a careful quantitative analysis of how the proposed remedy will fix the "problem". If the Council goes ahead anyway and adopts processor allocations, it will set precedent and signal willingness to consider claims that are virtually without limit. If claims for 20% are granted without need to rigorously justify the policy amendment, why not try for 50%, or 75% next time? Good policy that preserves the legitimacy of the process requires that radical departures from accepted practice have a logical and transparent reason being adopted.

- ***The tenuousness of politically allocated distribution***

Allocations that are seen as rewarding political connections are generally tenuous and prone to the need to be revisited and overturned in the future. The crab rationalization program in Alaska is a good example. Crab processors succeeded in convincing policy makers to deviate from accepted practice and implement so-called individual processor quotas that required harvesters to deliver to their past handlers. In many cases, this restriction on deliveries meant that processors gained monopsony status in certain regions. The regional monopsonies required another artificial negotiated market to be established to prevent processors from exercising their administratively-granted monopsonies. But after only a few years, these artificial and negotiated markets are already under review for their deficiencies. For example, harvesters are chafing against provisions that force them to deliver 90% of their catch to the same processors who historically processed their fish. Participants also claim that the price negotiation process reduces the incentives of processors to innovate with new products and create new market niches. In addition, there are objections to the barriers to entry that are created by the limited entry plan that processors also convinced the Council to adopt in order to protect them from "stranded capital" losses. This process of unraveling artificial restrictions and administrative constraints will continue as long as the special favors that have been granted to particular stakeholders prevent profit-making opportunities from being exploited.

Conservation and Stewardship Incentives

- ***Processor allocations will subvert conservation objectives***

A primary reason for establishing a quota system in the Pacific Coast groundfish fishery is to reduce bycatch and encourage other ecosystem conservation measures. Conservation and stewardship ethics automatically emerge in rights-based fisheries precisely because quota takes on value.[8] When quota becomes valuable, it is in the interest of the quota holder to take actions that maintain that value, both individually and collectively. But quota held by harvesters will generate a different set of incentives and actions than the same quota allocated to processors. Quota allocated to harvesters will dominate their wealth portfolios and hence they will each have strong incentives to take actions that conserve the productivity of the resources they have a financial stake in. In contrast, processors' wealth portfolios will be dominated by the value of their plant and equipment, and quota holdings will be insignificant in comparison. Thus when tradeoffs occur between decisions that affect both plant and equipment capital and quota value, processors will tend to make decisions that favor the larger part of their assets. And quota allocated to processors will inevitably involve conflict between profits and conservation objectives. In contrast, harvester/owners' profits are linked directly to the biological health of the fishery ecosystem. This provides incentives to conserve the resource productivity and exhibit stewardship behavior that has been observed in many harvester-based quota systems around the world.

Fairness

- ***Pacific Coast processor allocations are essentially unfair***

This policy has been argued as "fair" because allocation will be made to both the harvesting and processing sectors. In fact, however, the policy of processor allocations is not one where allocations are split among sectors so much as among individuals. The reality is that income will be taken from over a couple hundred small businesses with vessel-value wealth on the order of a million dollars each, and allocated primarily to two very wealthy private individuals who control companies with sales on the order of a billion dollars. This is not the definition of "fairness" that most people have in mind when they argue for fair political processes.

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[8] Cf. Wilen, James. 2006. Why Fisheries Management Fails: Treating Symptoms Rather than Causes, *op.cit*.