

Relationships Affecting the Choice-Select Spread

R. Curt Lacy

Extension Economist - Livestock and Assistant Professor
University of Georgia
Tifton, GA

Introduction

There has been considerable concern in the beef sector in recent years bemoaning the declining percentage of carcasses grading Choice. During this same time, the discount for Select carcasses (Choice-Select spread) has established historical highs resulting in considerable lost revenue for producers with beef carcasses grading less than Choice. Although several production and management factors are suspected of causing this decline in percentage, they are not necessarily the topic of this paper. The objective of this paper is to examine the factors affecting the Choice-Select spread and present solutions for affected cattlemen.

What Is The Choice-Select Spread?

Most cattlemen know that the Choice-Select spread is the difference in the wholesale price for Choice and Select carcasses. This price spread or difference is increasingly important for cattle producers as fed cattle formula prices based on grids have premiums/discounts based on this price relationship. Typically, it averages about \$9/cwt. for the year but it definitely exhibits seasonal tendencies (Figure 1). However, the Choice-Select spread is much more involved than many people realize.

The price difference in Choice and Select beef at any given time is a measure of the difference of supply and demand interaction for Choice beef and Select beef products. Put another way, the four factors that really affect the Choice-Select spread are:

1. Demand for Choice beef.
2. Supply of Choice beef.
3. Demand for Select beef.
4. Supply of Select beef.

The way these four forces interact determines the Choice-Select spread.

A common misconception is that pounds consumed or disappearance equals demand. That is simply untrue. The term demand involves both price AND quantity. For instance, beef demand is said to have increased in the past several years. However, people are really not consuming much more beef today than they were 10 or 15 years ago. The difference is people are paying more to consume the same amount.

Consider Figure 2 which shows an example of the supply and demand curves for Choice and Select beef. The intersection of the supply and demand curves for each product sets the price for that product. As a result, an increase in the supply of Select beef will lower its price and increase the Choice-Select spread. Conversely, if a decrease in demand for Choice beef occurs, the price for Choice beef would decline and the spread would narrow. In reality, these scenarios are played out throughout the year as people's tastes and disposable incomes change (vacation, holidays, etc.) as well as the supply of Choice or Select beef which cause changes in the Choice-Select spread.

Factors Affecting Demand

There are four factors that affect demand: population, changes in income, changes in the prices of substitutes and complements, and consumer's tastes and preferences. Although we could discuss in minute detail each of these, the major one that affects the demand of Choice and Select beef is the prices of substitutes and changes in consumer's tastes and preferences. In a very relevant study published in 2001, Dr. Jayson Lusk and others discovered that essentially, the demand for Choice beef varies by season as does its substitutability with other meats. For instance in the

winter and fall, Choice beef and Select beef substitute very easily, hence the more narrow Choice-Select spread. However, in the spring and summer when people are grilling more, Select beef does not really substitute that well for Choice beef, which gives us the wider Choice-Select spread.

Another factor that affects demand is people's eating habits. One surprising fact to many people is that there exists a market for Select beef. One need only think about the recent increases in branded beef programs especially regarding lean beef, natural beef or grass-fed beef to realize that some consumers prefer Select beef. Also, as more consumers eat more meals away from home, it is conceivable that there will actually be an increased demand for Select beef as most of the beef consumed away from home is ground (USDA-ERS).

International trade also can influence the Choice-Select spread. With the closing of the Canadian border and declining cow slaughter until 2006, suppliers were forced to look elsewhere for manufacturing beef. Although much of this beef was supplied by foreign countries, a respectable amount of Select or Standard beef went into foodservice ground beef production. Furthermore, since much of our beef exports are high-valued cuts, the loss of the Japanese and other Asian markets reduced the demand for U.S. Choice beef.

Factors Affecting Supply

Similar to demand, supply is the quantity of a product that is supplied at a given price. Factors affecting the supply of a product are changes in input prices, changes in technology, the sales price of substitutes and changes in government policy/regulations. As a result, anything that changes any of these factors will affect the supply of a product.

Two important points should be made when addressing this whole declining percentage of Choice beef question. The first is that pounds, not percentage are what we are really concerned about. A review of Figure 3 reveals that in fact, since 1997 the supply of Choice beef has actually remained fairly constant.

The second point that needs to be made is that

the percentage of beef grading Choice refers to the percentage of beef that is being graded. Since 1997, annual cattle slaughter has averaged around 34 million head. However, during this same time, the number of head that were marketed on a carcass basis increased from about 15.5 million in 1998 (46% of production) to 17.75 million (55% of production) in 2006. So, it is quite possible that in the past, producers who had knowledge that their cattle would grade Choice marketed on a carcass basis while others marketed on a live weight basis. However, as more branded programs have developed and more cattle are marketed on an individual carcass basis, the true quality of more cattle is becoming known. In other words, a very likely explanation to the declining percentage of cattle grading Choice, is that more Select cattle are being graded than in previous years.

Finally, weather and other environmental factors do play a role in the supply of Choice and Select-beef. Since intramuscular fat is the last deposited and the first removed, extreme temperatures, muddy conditions or other environmental phenomena can reduce the supply of Choice carcasses regardless of price signals.

Short-Term and Long-Term Implications and Considerations

For 2007, cattlemen can expect continued volatility in the Choice-Select spread. The stoppage in herd expansion will limit total beef supplies in 2007/2008. Furthermore, the severe winter of 2006/2007 will not only reduce overall beef supply but the supplies of Choice beef will be reduced more than Select beef. Also, the price of corn will make feeding cattle more expensive and so it is expected that supplies of Choice beef could be reduced as feeders market cattle sooner rather than later in order to save feed costs. As a result, there will likely be a premium for Choice beef in 2007. Producers should not be surprised to see the Choice-Select spread approach \$30-\$35/cwt this year.

Longer-term, several items will cause the volatility to continue in the Choice-Select spread. The interaction of increased market segmentation of beef products, increased cattle marketing on an individual

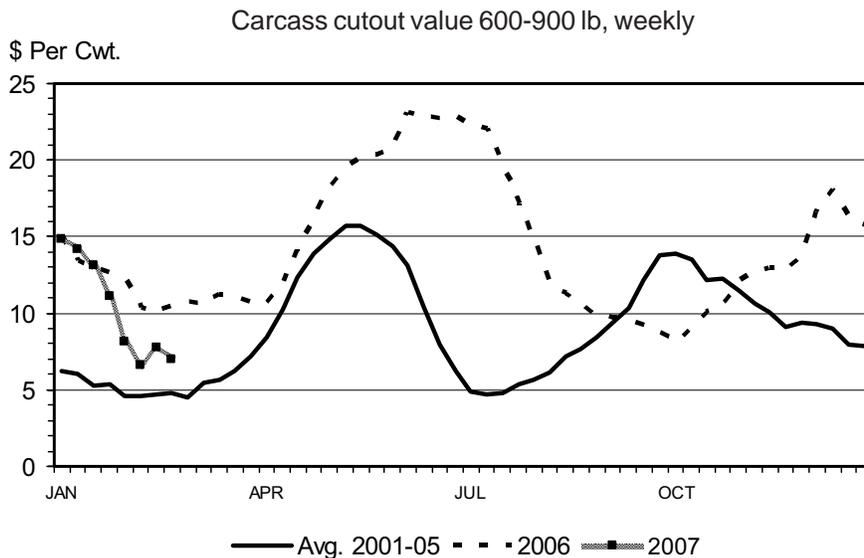
carcass basis and continued high corn prices will highlight the seasonality of consumer demand for Choice and Select beef. As total beef supplies cyclically increase, it is entirely probable that cattlemen could see Choice-Select spreads ranging from \$0-\$25/cwt. within a year.

For cow-calf producers that retain ownership, it is imperative that they know how their cattle will grade. However, as always, the focus should be on profits not price. Therefore, Florida cattlemen that retain ownership of cattle from cow herds adapted to thrive in a sub-tropical environment might consider altering their marketing plans so that they market either from October to March or mid-summer. For others who have chosen to produce high marbling cattle, they should consider marketing their beef carcasses from March-June or August-September.

References and Suggested Readings

- Davis, Christopher G and Biing-Hwan Lin. "Factors Affecting U.S. Beef Consumption". USDA-ERS. LPD-M-135-02. October 2005.
- Lusk, Jayson, L., T.L. Marsh, T.C. Schroeder and John A. Fox. "Wholesale Demand for USDA Quality Graded Boxed Beef and Effects of Seasonality". *Journal of Agricultural and Resource Economics*. 26(1):91-106.
- Stone, Kristyn. "Comprehensive Boxed Beef Cutout: Data, Analysis and Comments". Letter #29. Livestock Marketing Information Center. July 13, 2004.

Figure 1. Choice minus Select beef prices.



Livestock Marketing Information Center

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Figure 2. Supply and demand curves for Choice and Select beef.

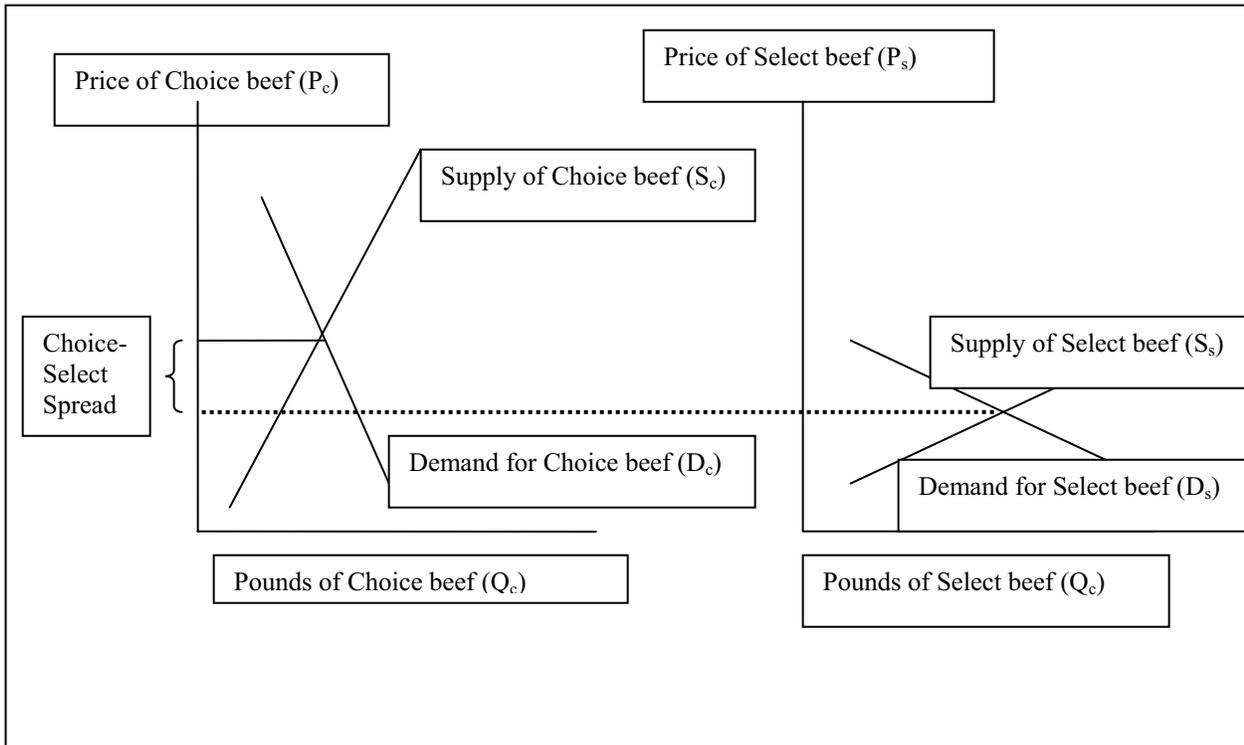
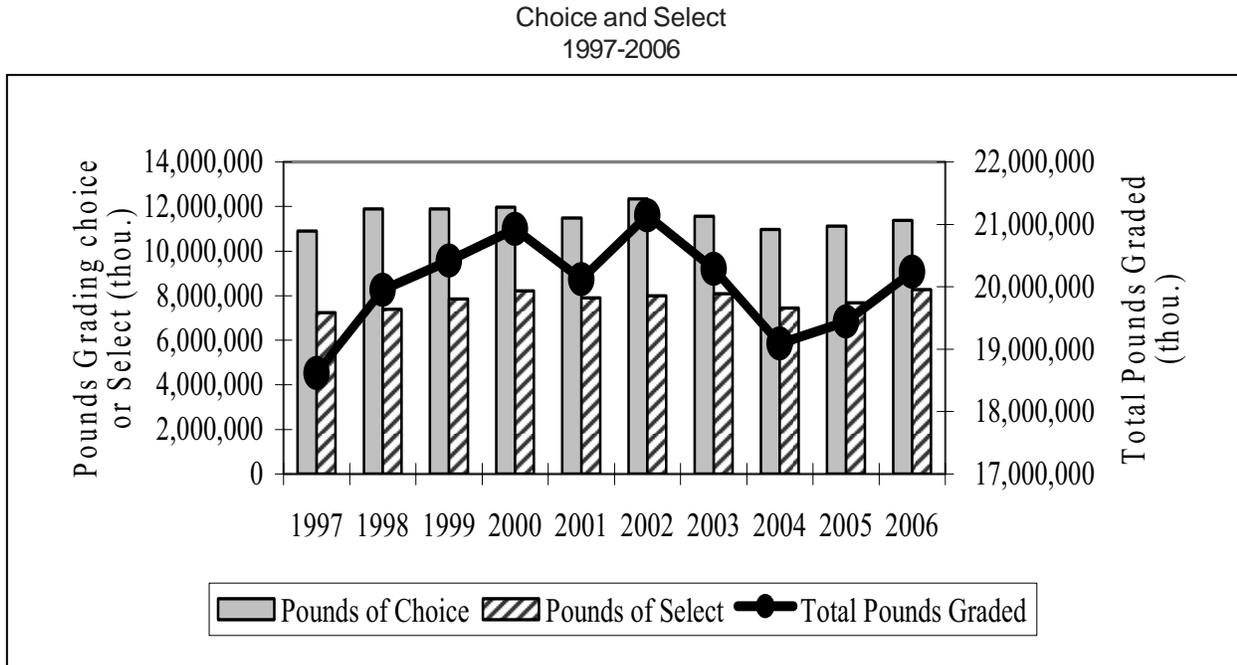


Figure 3. Total pounds of graded beef and pounds of beef graded Choice and Select.



Source: Livestock Marketing Information Center

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