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Extinguishing processor shares North Pacific Fishery Management Council June 2009

In August of 2005, fishing in the Bering Sea and Aleutian Island crab fisheries began under a new share-based management program (the “rationalization program”). The program includes a novel allocation of processing shares corresponding to a portion of the harvest share pool. These processor shares are allocated as long term shares, known as processor quota shares (PQS), which annually yield individual processing quota (IPQ) authorizing the holder to accept deliveries of the corresponding harvest shares. This portion of the harvest share pool, which must be delivered to a processor holding unused IPQ, is known as Class A individual fishing quota (Class A IFQ). In certain fisheries, these allocations of Class A IFQ and IPQ are required to be used in designated regions (i.e., the landing of crab and its processing must take place within the designated region).

The processor share allocations are among the most controversial aspects of the program. Those allocations required specific legislative authorization, as they are beyond the scope of the Council’s general authority under the Magnuson Stevens Act.¹ The controversial nature of processor shares was evident in the authorizing legislation, which prohibited any Council from considering the allocation of processor shares in any fishery other than the Bering Sea and Aleutian Island crab fisheries.

From the onset, several participants in the crab fisheries have questioned the appropriateness of limiting harvester deliveries through processor shares. Beyond simply constraining the marketing of crab by harvesters, processor shares are also argued to limit production efficiency gains and bias long run production in favor of established processors and methods. Others believe that the program, as a whole, appropriately balances the interests of all stakeholders in the fisheries without jeopardizing efficiency or productivity goals. Given these competing claims, the Council has undertaken a process of reviews of the program, starting with a review of certain elements after 18 months of fishing under the program and continuing with a preliminary comprehensive review of the program after 3 years of fishing under the program. After considering those reviews and public testimony, the Council has initiated a process to consider whether certain changes to the program are merited. Among those considerations is whether to modify the program by removal of all processor shares from the fisheries. To that end, the Council has requested this paper examining the issues that would arise, were the Council to pursue an action removing processor shares from the fisheries.

The paper begins with a background section describing elements of the program relevant to the allocations of processor shares that is intended to frame the issues arising with the extinguishment of processor shares. The paper then goes on to discuss those issues directly, in an attempt to identify various considerations for the Council, if it advances an action to extinguish processor shares.

Background

Prior to implementation of the rationalization program, the crab fisheries were managed under the License Limitation Program (LLP). Under that program, each holder of a license endorsed for a fishery was permitted to enter a vessel into that fishery. Fisheries were prosecuted under derby style management, under which the season opened at a designated time with each vessel competing for a share of the total allowable catch (TAC) in the fishery. Vessel harvests were monitored through the season, with managers announcing a fishery closure when they estimated that the TAC was fully harvested. To address

¹ The program was specifically authorized by an amendment to the MSA incorporated into the Consolidated Appropriations Act of 2004.

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efficiency, safety, and stock management concerns that arose under LLP management, the Council adopted the rationalization program.

Under the program, eligible license holders were allocated quota share (QS), which are a revocable privilege that allow the holder to harvest a specific percentage of the annual TAC in a fishery, based on qualified harvest history. The annual allocations, which are expressed in pounds, are referred to as individual fishing quota (IFQ). QS are designated as either catcher vessel QS or catcher processor QS, depending on whether the vessel that created the privilege to the shares processed the qualifying harvests on board. Approximately 97 percent of the QS (referred to as “owner QS”) in each program fishery were initially allocated to license holders based on their catch histories in the fishery. The remaining 3 percent of the QS (referred to as “C shares” or “crew QS”) were initially allocated to captains based on their catch histories in the fishery. These C shares are intended to be held only by persons who meet fishing participation requirements.

Catcher vessel owner IFQ are issued in two classes, Class A IFQ and Class B IFQ. Class A IFQ are issued for 90 percent of the catcher vessel owner IFQ in a program fishery. Crab harvested using these IFQ must be delivered to a processor holding unused individual processing quota (IPQ). In addition, most Class A IFQ are subject to regional share designations, whereby harvests are required to be delivered within an identified region. The delivery restrictions of Class A IFQ are intended to add stability to the processing sector by protecting processor investment in program fisheries and to preserve the historic distribution of landings and processing between regions. Class B IFQ are issued for the remaining 10 percent of the catcher vessel owner QS in a program fishery. Crab harvested using these Class B IFQ can be delivered to any processor (except a catcher processor) regardless of whether the processor holds unused IPQ. In addition, Class B IFQ are not regionally designated. The absence of delivery restrictions on a portion of the catch is intended to provide harvesters with additional market leverage for negotiating prices for landings of crab, as well as to increase opportunity for processor entry.

QS and IFQ are transferrable under the program, subject to limits on the amount of shares a person may own or use. In addition, QS holders may form cooperatives to organize the harvest of their IFQ collectively. Cooperatives and transferability of shares among eligible purchasers of QS and IFQ are believed to promote production efficiency and coordination of landings and provides means for compensated removal of excess harvesting capacity in the program fisheries.

The program also created processing quota shares (PQS), which are allocated to processors and are analogous to the QS allocated to harvesters. PQS are a revocable privilege to receive deliveries of a fixed percentage of the annual TAC from a program fishery. These annual allocations are referred to as individual processing quota (IPQ). IPQ is issued for 90 percent of the owner IFQ pool, corresponding to the 90 percent allocation of catcher vessel owner IFQ as Class A IFQ. As with catcher vessel owner QS and Class A IFQ, PQS and IPQ are designated for processing in a region. These processing shares are intended to protect processor investment in program fisheries and preserve community and regional interests in the fisheries. Processing shares are transferable, including leasing of PQS (or equivalently, the sale of IPQ) subject to use caps. As with harvesting shares, transferability of processing shares is intended to promote efficiency and coordination of deliveries and facilitate compensated reduction of excess capacity. Processors also have relied on custom processing arrangements to coordinate processing activities and achieve efficiencies. Under these arrangements a holder of IPQ may contract with a plant for the processing of landings supported by those IPQ. The IPQ holder remains responsible for any payments to the delivering IFQ holder and any related taxes.

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To provide a period of general stability for processors and communities to adjust to the program, a 2-year “cooling off period” was established during which most processing shares could not be relocated from the community where the historical processing occurred that led to the allocation (the community of origin). In addition, a right of first refusal was granted to community groups and CDQ groups from communities with significant crab processing history on the sale of any processing shares for use outside of the community of origin. Exceptions to the right allow a company to consolidate operations among several commonly owned plants to achieve intra-company efficiencies and the temporary lease of shares outside of the community of origin.

The allocation to regions is accomplished by regionally designating Class A harvest shares and all corresponding processing shares. In most program fisheries, regionalized shares are either North or South, with North shares designated for delivery in areas on the Bering Sea north of 56° 20′ north latitude and South shares designated for any other areas, including Kodiak and other areas on the Gulf of Alaska. In the Western Aleutian Islands (Adak) golden king crab fishery, the designation is based on an east/west line to accommodate a different distribution of activity in that fishery. Regional designations (with the exception of the east/west designation) are based on the historic location of the landings and processing that gave rise to the shares and require the crab harvested with the corresponding shares to be landed within the designated region.

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Table 1 shows the distribution of processor shares by region and community protected by the right of first refusal. In most fisheries subject to right of refusal requirements, in excess of 95 percent of the PQS are subject to those rights. The exception is the St. Matthew Island blue king crab fishery, in which most qualified historical processing occurred on floating processors outside of community boundaries. As a result, over 65 percent of the PQS are not subject to community rights of first refusal.

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Table 1 Distribution of rights of first refusal by community (2008-2009).

Fishery	Region	Right of first refusal boundary	Number of PQS holders	Percentage of PQS pool
Bristol Bay red king crab	North	None	1	0.0
		St. Paul	2	2.5
	South	Akutan	1	19.7
		False Pass	1	3.7
		King Cove	1	7.4
		Kodiak	2	0.2
		None	6	12.2
		Port Moller	3	3.5
Unalaska	8	50.7		
Bering Sea <i>C. opilio</i>	North	None	5	10.7
		St. Paul	7	36.3
	South	Akutan	1	9.7
		King Cove	1	6.3
		Kodiak	3	0.0
		None	5	2.0
		Unalaska	10	35.0
		Eastern Aleutian Islands golden king crab	South	Akutan
None	2	7.8		
Unalaska	8	91.2		
Eastern Bering Sea <i>C. bairdi</i>	None	None	21	100.0
Pribilof red and blue king crab	North	None	1	0.3
		St. Paul	5	67.3
	South	Akutan	1	1.2
		King Cove	1	3.8
		Kodiak	4	2.9
		Unalaska	4	24.6
St Matthew Island blue king crab	North	None	5	64.6
		St. Paul	4	13.8
	South	Akutan	1	2.7
		King Cove	1	1.3
Western Aleutian Islands golden king crab	Undesignated	None	8	50.0
		West	7	50.0
Western Aleutian Islands red king crab	South	None	8	100.0
Western Bering Sea <i>C. bairdi</i>	None	None	21	100.0

Source: RAM PQS data 2008-2009.

Rights of first refusal lapse, if IPQ are used outside of a community by the holder for three consecutive years. The limitations of the ‘cooling off’ provision prevented the movement of most IPQ subject to the right of first refusal from the community of origin in the first two years of the program. Consequently, only in the third and fourth years of the program was any notable portion of the IPQ permitted to be moved. As a result, rights of first refusal on PQS are believed to have lapsed in only a few instances. Most notably, the right has lapsed with respect to shares arising from historic processing in St. George. The St. George harbor and its entrance were damaged by a storm in 2004. In the first two years of the program, that damage was found to have prevented processing in St. George, as otherwise would have been required by the ‘cooling off’ period limitations. As a consequence, the right of first refusal lapsed on shares for which the Aleutian Pribilof Island Community Development Association (APICDA) holds rights of first refusal on behalf of St. George. To protect the interests of St. George, APICDA has acquired a portion of the PQS on which it held a right of first refusal and has entered into other agreements (which are confidential) with respect to the remainder that PQS. Other than the rights

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formerly protecting St. George, rights with respect to less than 1 percent of the PQS in any fishery are known to have lapsed.² In four additional cases, the holder of the right has acquired PQS formerly subject to a right of first refusal to ensure the associated processing remains in the community. These acquisitions suggest that the rights have contributed to protecting community interests.

Given the market limitations created by the Class A IFQ/IPQ issuances, the program includes an arbitration system for negotiating terms of delivery, including prices. Under the system, holders of Class A IFQ without PQS holder affiliations may arbitrate the terms of any landing under a last, best offer arbitration proceeding. The arbitrator is directed to establish a price that preserves the historic division of first wholesale revenues between the harvester and processor. In addition, the system mandates the production of a non-binding price formula by an independent analyst (based on the same standard). This formula is intended to guide negotiations among participants in the fisheries to limit the number of arbitration proceedings. Some participants believe the use of this non-binding formula has effectively prevented price disputes, as fewer than ten binding proceedings have taken place to date.

The arbitration system also defines a system of matching commitments of Class A IFQ and IPQ. That share matching process establishes delivery and acceptance commitments between share holders, and is the starting point for establishing the terms of delivery. This early season commitment of delivery quantities is believed by some participants to be important to planning and scheduling operations in the fisheries. The matching of Class A IFQ and IPQ is also a critical step in the arbitration system, as it is used to define eligibility for, and the parties to, any binding arbitration proceedings.

Removal of processor shares

Several considerations arise if the Council undertakes a process to remove processor shares from the program. As suggested in public testimony, prior deliberations, and committee discussions, the removal of processor shares will allow harvesters greater flexibility in marketing their catches. This flexibility could increase production efficiency in the fishery by allowing harvesters to choose markets they believe are most beneficial. In making this calculus, a harvester will consider not only crab prices, but also any harvest cost differential that may arise from factors such as delivery location and time. These choices should lead to greater production efficiency, as choices will allow harvesters to pursue the greatest net return from their catches. While it is possible that some loss of processing efficiency could arise, particularly if independent actions of harvesters cause some loss of coordination in landings that impose costs on processors. Cooperatives (and other collective bargaining) can be beneficial in reducing these production efficiency losses by coordinating harvests and deliveries. Harvesters will have an incentive to engage in this coordination, as improved processor production efficiency should allow for a higher ex vessel price.

In addition to program changes, the Council will also need to consider the process for amending the program. The Council should consider whether extinguishing processor shares effectively creates a new limited access privilege program that must be adopted under the procedure defined for those programs in

² Monitoring of the lapse of community rights of first refusal is challenging. Electronic landings data do not include the location of processing, for deliveries that are made to floating processors. Instead these landings are reported as “at sea”. As a result, it is possible that rights could lapse without knowledge of the community. Once the lapse of the right is established, a community would have no standing to intervene in any subsequent sales of the PQS. NOAA Fisheries maintains a record of known instances of the lapse of rights of first refusal, but reporting the lapse is not required. Efforts are currently under way to rectify this reporting need.

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the reauthorized Magnuson Stevens Act.³ In other words, the program change brought on by the elimination of processor shares could be argued to so fundamental to the program that it effectively creates a new management program. In favor of this view, extinguishing processor shares would directly modify several aspects of the program identified as fundamental to the program by the Council.⁴ Processor shares (together with the arbitration system) define the distribution of benefits between harvesters and processors. The relationships driven by processor shares also affect the prosecution of the fishery, including timing of landings and location of deliveries. It can be argued that the extinguishment of processor shares will change the fishing practices through these indirect effects. Compounding this argument, other elements of the program are dependent on the processor share allocations. Most specifically, the community rights of first refusal apply to processor shares. Without these allocations communities with historic crab processing would have no direct protection of their interests in that processing activity. Based on these arguments, it could be asserted that removal of processor shares from the fishery effectively creates a new limited access privilege program. To adopt a new program the Council will be required to follow the procedure defined by the Magnuson Stevens Act as reauthorized. This includes respecification of the goals of the program, reconsideration of allocations (including allocations to small owner-operated vessels, fishing communities, and set asides for entry, captains, and crew), and the consideration of the auction of shares and the collection of royalties in the fisheries.

An alternative view suggests that extinguishment of processor shares does not create a new program. Persons supporting this view are likely to note that the removal of processor shares will not remove the existing allocations of QS and IFQ. Those harvest share allocations give the program its identity as a limited access privilege program and therefore its identity as an existing program. Absent any reissuance of QS and IFQ, it could be argued that the program is not a new program. Even if the program is not identified as a new limited access privilege program, it is not altogether clear whether changes to the program would need to be adopted under the procedure identified in the Magnuson Stevens Act as reauthorized. The transition rules adopted in the reauthorization state that the rules in effect prior to the reauthorization apply to limited access privilege programs adopted within 6 months after the reauthorization, but that Council's can incorporate criteria from the reauthorized act into any such program. Clearly, any elements of such a program as originally adopted would be subject to the Act in effect prior to the reauthorization and that a Council, at its discretion, could include provisions from the reauthorized Act in the original program or amendment. Amendments to the program, however, might need to be adopted in accordance with applicable procedures defined in the reauthorized Act. Alternatively, the Council would arguably be limited only by Section 303(d) as in effect prior to reauthorization. That section provides a limited framework for the adoption of individual fishing quota programs (see Appendix A).⁵

Although this uncertainty concerning authorizing legislation creates some uncertainty concerning procedural matters, the basis for proceeding with an action should be the Council's opinion of other aspects of the action to remove processor shares from the program.

³ A limited access privilege program is defined as a program under which persons are allocated fishing privileges that authorize the harvest of a portion of the total allowable catch of a stock. An IFQ is defined as a limited access privilege.

⁴ See Summaries of the Bering Sea and Aleutian Islands crab rationalization program, submitted to the U.S. Congress, August 2002 and May 2003.

⁵ Although that section provides a limited framework for the Council action, the Council would arguably be bound by National Standards, which provide more general considerations that apply to any Council action.

Processor share holder considerations

Removal of processor shares will most directly affect the marketing of landings by IFQ holders. This change in marketing is likely to affect both the distribution of landings among processors and ex vessel pricing. Implicit in any changes in distribution of landings among processors and ex vessel prices arising from the extinguishing of processor shares are detrimental effects on the holders of processor shares. If extinguished, holders of processor shares will lose the certainty of landings and any price and delivery term negotiating leverage that arises through those shares.⁶ This change, in the absence of any compensating measure, would shift the distribution of benefits established by the current program. PQS holders would lose the benefit derived from their shares, while QS holders would gain an added benefit from the marketing flexibility. In addition to the effects on the distribution of benefits under the initial allocations in the program, recipients of QS and PQS by transfer would also be affected. Persons who acquired QS would receive an added benefit beyond that expected at the time of their acquisition, while persons who acquired PQS would lose the benefits associated with their purchase.⁷ In considering a change in the program, the Council should assess whether holders of processor shares should be compensated for any loss of interest arising from extinguishing those processor shares. Of particular concern are those persons who acquired PQS since implementation of the program⁸, who have invested in processing in the fisheries in reliance of the programs attributes.

To be clear, the Council should note that under the authorizing legislation, it is under no obligation to compensate for the removal of processor shares. That legislation provides:

An individual processing quota issued under the Program shall be considered a permit...and may be revoked or limited at any time in accordance with this Act. Issuance of an individual processing quota under the program shall not confer any right of compensation to the holder of such individual processing quota if it is revoked or limited and shall not create, or be construed to create, any right, title, or interest in or to any fish before the fish is purchased from an individual fishing quota holder.⁹

Yet, the absence of an obligation to compensate should not be construed as justifying a possible inequitable outcome, should the Council find that removal of processor shares is unfair to their holders.

It is helpful to examine the exchange of processor shares since program implementation, when considering whether some form of compensation is appropriate on their extinguishment. A substantial portion of the PQS pools in the various fisheries have changed hands in the first four years of the program. Transfers have brought new entrants to the processing sector, as well as increased the holdings of some existing processors (see Table 2). While these changes in holdings suggest an active market for PQS, the degree of market activity is both overrepresented and underrepresented in these records. In some instances, changes in holdings are simply changes in named holder, which reflect minor structural

⁶ The arbitration system has limited the leverage that may be asserted by processing share holders. Yet, the shares provide some leverage by limiting the ability of harvesters to freely market landings of crab harvested with Class A IFQ. Also, processors can gain certainty in landings, but that certainty will come at the cost of a higher ex vessel price paid to induce a harvester to provide that certainty.

⁷ To the extent that a change in the program was anticipated at the time of a transfer, it is possible that prices of QS and PQS might have been adjusted to reflect the potential for change. Clearly, Council agendas suggest that change is possible, so such a price adjustment is also possible. The degree of any such price adjustment is not known.

⁸ The Council might also consider PQS investments made prior to program implementation. It is likely that some transactions preceding implementation of the program were founded on the upcoming allocations of PQS. Future PQS allocations likely formed the basis of and determined the price of these transactions.

⁹ See MSA Section 313(j)(7).

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changes in the underlying holder’s ownership. In other cases, substantial changes in underlying ownership of the holder have occurred with no corresponding change in the named holder. Despite these uncertainties, it is clear that transfer activity has occurred in all fisheries. Any extinguishment of processor shares would not only be disruptive to business arrangements structured around the current processor share regulatory structure, but would also deprive all holders of PQS (including those shares acquired since the program’s implementation) of the value of those shares. These changes in share holdings should be considered when determining whether it is equitable to compensate PQS holders, if those shares are extinguished.

If the Council elects to proceed with an action to remove processor shares from the program and to compensate PQS holders for the loss of their shares, it would need to identify a mechanism for making that compensation. In prior deliberations, the Council has considered attempting to develop a means for financial compensation. The Council abandoned those discussions, as financial compensation would likely require Congressional authorization and appropriations. An alternative to financial payments could be compensation by transferring a portion of the QS pool to PQS holders. This mechanism is currently under consideration in a separate action that could reduce annual IPQ allocations by converting owner QS, which yield Class A IFQ and Class B IFQ, to crew QS, which are not subject to that IFQ share division. The compensation by conversion of extinguished PQS to harvester QS is clearly within the authority of the Council. To date, these are the only suggested means of compensating PQS holders for extinguishing all or portion of the processor share pool, should the Council determine to extinguish processor shares and that compensation is appropriate.¹⁰

Table 2. Number of new PQS holders and PQS holders that have increase their holdings since implementation of the program.

pqs

Fishery	Number of holders	New PQS holder in the fishery		New PQS holder in all fisheries		PQS holders that increased holdings	
		Number of entrants	Percent of QS pool acquired	Number of entrants	Percent of QS pool acquired	Number of holders	Percent of QS pool acquired
Bristol Bay red king crab	16	6	22.7	5	22.0	6	22.7
Bering Sea <i>C. opilio</i>	20	5	19.7	4	19.6	6	19.7
Eastern Aleutian Islands golden king crab	10	5	21.7	4	20.7	5	21.7
Eastern Bering Sea <i>C. bairdi</i>	21	5	11.5	4	11.5	7	11.9
Pribillilof red and blue king crab	13	2	16.3	1	2.5	2	16.3
St. Matthew Island blue king crab	10	4	13.9	3	5.9	4	13.9
Western Aleutian Islands golden king crab	10	4	53.0	3	52.6	4	53.0
Western Aleutian Islands red king crab	8	3	62.5	2	35.4	3	62.5
Western Bering Sea <i>C. bairdi</i>	21	5	11.5	4	11.5	7	11.9

Source: RAM PQS database.

¹⁰ If the Council elects to compensate holders of processor shares that are extinguished with QS, it will need to determine the magnitude of that compensation. Neither values of QS nor PQS are well established. Estimates of the relationship between these values can be derived for use by the Council in determining appropriate compensation. But these estimates will rely on price information that is considered relatively unreliable. In addition, any estimated QS value will be the value of the QS under the existing program. Extinguishment of processor shares will change QS values. This change in QS value will need to be considered in determining the appropriate level compensation, if the Council decides to compensate PQS holders with QS. Shortcomings of these type are often present in the Council’s policy making process. The shortcomings should be considered, but should not prevent the Council from advance with an action otherwise deemed appropriate.

Regional landing requirements

The current distribution of landings in the fisheries is greatly influenced by the regional landing requirements associated with Class A IFQ and IPQ. In three of the six fisheries open last year, approximately 80 percent of the annual allocation of IFQ (including catcher processor IFQ and crew IFQ) was subject to a regional landing requirement (see Table 3).¹¹ In a fourth, the Western Aleutian Island golden king crab fishery, half of the annual catcher vessel owner IFQ allocation (or almost 25 percent of the total annual IFQ) are subject to regional landing requirements. In addition, regional landing requirements will apply to the Pribilof red and blue king crab, St. Matthew Island blue king crab, and Western Aleutian Island red king crab fisheries, all of which have been closed in recent years. In those three fisheries, substantial majorities of the total IFQ allocations will be subject to regional landing requirements.

The importance of regional landing requirements differs greatly across fisheries and regions. The Pribilof Island communities depend greatly on landings from the Bering Sea *C. opilio* fishery for revenues and economic activity. Community representatives maintain that North region landing requirements are vital to both of the Pribilof Island communities. Likewise, West region landing requirements in the Western Aleutian Island golden king crab fishery are supported by Adak representatives, who maintain that landings from that fishery that are supported by the regional landing requirement are vital to maintaining a shore-based plant in the community. Regional landing requirements for South communities (specifically, Akutan, King Cove, and Unalaska/Dutch Harbor) are arguably less important, as most of those communities have a greater diversity of landings activities.

The importance of regional landing requirements likely varies year-to-year with total allowable catches (TACs) and conditions in the fisheries. For example, in years with high TACs and little ice, North region processors might draw more landings from the Bering Sea *C. opilio* fishery, if regional landing requirements did not require landings to be made in the South region. Regional landing requirements, however, add stability by ensuring the region will receive a portion of landings in every year. Although most beneficial to remote regions that could lose landings to locations that provide better access to goods and services, the application of regional landing requirements to less remote areas provide stability to those locations and prevent a large shift in the distribution of landings across time.

Table 3. IFQ subject to regional landing requirements by fishery (2008-2009 season).

Fishery	Region	Pounds	Percent of total pounds*
Bristol Bay red king crab	North	387,853	2.1
	South	14,886,834	81.2
Bering Sea <i>C. opilio</i>	North	19,382,290	36.8
	South	22,250,814	42.2
Eastern Aleutian Islands golden king crab	South	2,355,261	83.1
Western Aleutian Islands golden king crab	West	599,474	23.5

Source: RAM IFQ database.

* Including catcher processor allocations

¹¹ Approximately 10 percent of the annual catcher owner IFQ allocation is Class B IFQ not subject to regional landing requirements; approximately 3 percent of the annual catcher vessel allocation of IFQ is allocated as crew IFQ not subject to regional landing requirements; all catcher processor IFQ is exempt from regional landing requirements; and all or a portion of the Class A IFQ allocations in the Eastern Bering Sea *C. bairdi*, Western Bering Sea *C. bairdi*, and Western Aleutian Islands golden king crab fisheries are exempt from regionalization.

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If the Council elects to advance an action extinguishing processor shares from the fisheries, it could choose to retain regional landing requirements to protect regional interests in the fisheries. Retaining regional landing requirements will have an offsetting effect on the overall freeing of markets for IFQ holders, by limiting potential markets to those within specific geographic areas. If the current distribution of processing facilities is maintained, it is possible that in remote regions a holder of regionally designated IFQ could have only one or two markets to choose from. This constraint on markets has led some harvest sector participants to suggest that the arbitration system should be retained, if the Council elects to maintain regional landing requirements. To retain an arbitration system in the program without IPQ will require substantial restructuring of that system. The arbitration system relies on the matching of Class A IFQ and IPQ to define the parties to an arbitration proceeding. In the absence of this share matching, a system will need to be developed by which a processor commits to accept a delivery from IFQ holder. Each commitment would then define the parties to a potential arbitration proceeding. These modifications of the arbitration system would likely require substantial industry discussion, similar to the committee discussions used in the initial development of the arbitration system. If the Council elects to proceed with a modified arbitration system, it should also develop a process for the development of those modifications.

In deciding whether to include an arbitration system in any action to remove processor shares from the fisheries, the Council will need to assess whether the use of an arbitration system is consistent with its purpose for considering the action to extinguish processor shares. Specifically, to the extent that the Council is considering removal of processor shares as a means to simplify the program and remove market constraints for landings, the adaptation of the arbitration system to the program would reintroduce complexity and could lead to additional constraints on landing markets (depending on the structure of IFQ and processor delivery commitments that support the arbitration system). The Council will need to reconcile these tensions between the its purpose for extinguishing processing shares and the added complexity that would arise, if the arbitration system is retained.

In any case, the Council will need to determine whether regional landing requirements should be retained in the absence of processor shares, if they elect to proceed with this action. If regional landing requirements are retained, the Council will then need to determine whether to complement IFQ constrained by those requirements with an arbitration system to ensure that IFQ holders have an adequate negotiating position.

Rights of first refusal considerations

Under the current management, community interests are protected, in part, through rights of first refusal on processor shares. Since these rights apply to processor shares, the extinguishment of processor shares would erase those rights by removing their subject. Consequently, in considering whether to advance an action to extinguish processor shares, the Council will need to consider the importance of those rights to protection of community interests in the fisheries. If the Council chooses to move forward, it could either extinguish those rights with the processor shares or develop alternative forms of protection for community interests.

The portion of the processor share pool subject to rights of first refusal varies by fishery. Over 85 percent of the processor shares in the Bristol Bay red king crab and the Bering Sea *C. opilio* fisheries are subject to these rights; over 90 percent of the processor shares in the Eastern Aleutian Islands golden king crab and the Pribilof red and blue king crab fisheries are subject to these rights; and slightly more than 35 percent of the processor shares in the St. Matthew Island blue king crab fishery are subject to these rights. The two Western Aleutian Island king crab fisheries and the two Bering Sea *C. bairdi* fisheries are exempt from rights of first refusal.

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Rights of first refusal have been a controversial element of the program for several reasons. Applying rights of first refusal to any assets is known to reduce its value in transfer. To the extent that processor shares are intended to compensate historic processors who choose to exit the fishery, the right can reduce the amount of that compensation. On the other hand, several structural aspects of the rights of first refusal protect share holder interests in processing activity undertaken using processor shares. A processor share holder has the latitude to move processing between communities without triggering the right. If the holder uses the shares outside the community for three consecutive years, the right lapses. The right applies to any transaction that includes a transfer of the shares, on the terms of the transaction. So, to exercise its right a community must accept all terms of the transaction including assets other than the shares and a purchase price that may be inflated by those other items. These structural aspects of the right provide flexibility for processors to use their shares and receive the expected compensation for a sale that includes the shares, but they also limit the accessibility of the right to community representatives. The Council is considering an action to strengthen community rights, but it remains unclear whether that action will (or can) address all of these issues.

Although the structure of the right of first refusal provides ample opportunity for processor share holders to circumvent community interests, to date, processor share holders have shown a reluctance to exploit those opportunities. In three instances, share holders negotiated agreements for the transfer of processor shares to community representatives without the exercise of rights. These share holders likely could have avoided triggering the rights or could have prevented the exercise of rights by structuring their transactions in a manner that discourages that exercise. These negotiated transfers are arguably a better outcome than the exercise of a right by a community representative, as they provide an agreed (and planned) transition of interests from processor share holders to communities, which is likely less disruptive to business operations and reduces risk to community representatives that may take on far greater risk, if confronted with the all-or-nothing proposition of intervening in a transaction through the exercise of the right.

The negotiating leverage the right provides communities and these negotiated arrangements also provide protection to communities. On its face, the right of first refusal provides community representatives with a mechanism for acquiring processor shares that are being transferred for use outside the community. Yet, no cases of the right being triggered or exercised under its structure are known to have occurred. Instead, the effect of the right has been to provide community representatives with a platform for negotiations with PQS holders that are considering share transfers. The development of these negotiations has likely improved the position of community representatives, especially those that lack the wherewithal to exercise a right of first refusal on large transaction that includes assets other than processor shares. In addition, negotiated transactions (as leveraged by the right) have led processors to consider community interests when considering a transfer of share holdings that is likely to affect the community. Overall, the rights of first refusal have had the effect of providing community representatives with negotiating leverage with respect to processing shares originating from their community.

In considering whether to initiate an action to extinguish processor shares, the Council should recognize that rights of first refusal applying to those processor shares would also be eliminated. The Council will need to consider whether a substitute protection is merited. The form of that protection could take several forms and would depend on the Council's objectives in protecting community interests in the fisheries. Under the Magnuson Stevens Act as recently reauthorized, Councils may consider applying regional and port specific landing requirements to IFQ.¹² These requirements would be similar to current regional

¹² See MSA 303A(c)(5)(B)(i)

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designations on IFQ, but could be more specific. For example, a QS holder could be required to always (or for some subset of years) land yielded IFQ in a particularly community. These port specific landing requirements could resurrect other issues and complications. First, QS holders who assert that regional landing requirements limit markets to an extent that arbitration is required are certain to assert the arbitration system will be necessary, if port landing requirements are adopted. As under a program with regional landing requirements and no processor shares, the arbitration system will need to be adapted as processor shares are currently used for identifying commitments and parties to arbitration proceedings. Modification of the arbitration program would likely require substantial discussion by harvesting and processing sector representatives and the Council, as the procedural structure of that system can greatly affect the relative bargaining positions of participants. Second, IFQ usage and its tracking by both cooperatives and NOAA Fisheries administrators will be substantially more complicated, as each pound of IFQ held by a cooperative will need to be tracked by its applicable port designation. Current systems of recording landings do not adequately track landings for this purpose. As a result, fish ticket and catch accounting modifications would likely need to be developed. In considering whether port specific landing requirements are an appropriate measure to protect community interests, the Council should consider whether these added complexities are consistent with its overall objectives for considering an action to extinguish processor shares from the fisheries.

Other measures to address community interests could be considered. For example, the Magnuson Stevens Act as reauthorized allows for the allocation of harvest shares to communities. Several considerations could affect the Council's decision of whether to proceed with a harvest share allocation to communities. Harvest share allocations would provide a different interest to the community than the processing interest represented by rights of first refusal. In addition, CDQ groups already receive substantial allocations in these fisheries. Additional community allocations are likely to be controversial and provoke objections from historic private participants who may view the allocations as eroding their fishery investments. These arguments may be more difficult to overcome, if the Council elects to compensate PQS holders for the extinguishment of processing shares with an allocation of QS, as that would further erode current QS holdings. Although other approaches to protecting community interests under the program might be possible, the Magnuson Stevens Act suggests only these two measures for the protection of communities in the development of limited access privilege programs.

Conclusion

Processor shares (and the associated arbitration system) define the harvester/processor relationships under the rationalization program. Any action to eliminate processor shares from the program would cause fundamental changes in that relationship. Negotiation of pricing and all delivery terms will be affected. If the Council elects to proceed with an action to eliminate processor shares, it will need to assess these changes and determine whether offsetting program elements are necessary. Beyond balancing negotiating leverage between the sectors, elements could be considered to provide for stability within the sectors and in harvester/processor relationships.

Extinguishment of processor shares will require the Council to revisit not only the distribution of interests between the sectors, but also consider revisions to other aspects of the rationalization program. The processor share component of the program is a lynchpin that supports other program defining elements – most importantly community and regional protections. If processor shares are removed from the fisheries, the effects on these aspects of the program should be considered. Regional requirements on IFQ could be continued, but may require consideration of a revised arbitration system. Rights of first refusal on processor shares cannot be maintained, but other community protections could be substituted. The MSA as revised suggests two possible measures to protect community interests - port landing requirements and community allocations. Either of these measures will have effects on other aspects of the program.

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Community allocations would further erode the owner harvest share pool allocations. Port landing requirements would further complicate administration of the program and would further constrain harvester markets increasing the need to develop revisions to the arbitration system.

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Appendix A Section 303(d) as in effect October 11, 1996

303(d) INDIVIDUAL FISHING QUOTAS.--

(1) (A) A Council may not submit and the Secretary may not approve or implement before October 1, 2000, any fishery management plan, plan amendment, or regulation under this Act which creates a new individual fishing quota program.

(B) Any fishery management plan, plan amendment, or regulation approved by the Secretary on or after January 4, 1995, which creates any new individual fishing quota program shall be repealed and immediately returned by the Secretary to the appropriate Council and shall not be resubmitted, reapproved, or implemented during the moratorium set forth in subparagraph (A).

(2) (A) No provision of law shall be construed to limit the authority of a Council to submit and the Secretary to approve the termination or limitation, without compensation to holders of any limited access system permits, of a fishery management plan, plan amendment, or regulation that provides for a limited access system, including an individual fishing quota program.

(B) This subsection shall not be construed to prohibit a Council from submitting, or the Secretary from approving and implementing, amendments to the North Pacific halibut and sablefish, South Atlantic wreckfish, or Mid-Atlantic surf clam and ocean (including mahogany) quahog individual fishing quota programs.

(3) An individual fishing quota or other limited access system authorization--

(A) shall be considered a permit for the purposes of sections 307, 308, and 309;

(B) may be revoked or limited at any time in accordance with this Act;

(C) shall not confer any right of compensation to the holder of such individual fishing quota or other such limited access system authorization if it is revoked or limited; and

(D) shall not create, or be construed to create, any right, title, or interest in or to any fish before the fish is harvested.

(4) (A) A Council may submit, and the Secretary may approve and implement, a program which reserves up to 25 percent of any fees collected from a fishery under section 304(d)(2) to be used, pursuant to section 1104A(a)(7) of the Merchant Marine Act, 1936 (46 U.S.C. App. 1274(a)(7)), to issue obligations that aid in financing the--

(i) purchase of individual fishing quotas in that fishery by fishermen who fish from small vessels; and

(ii) first-time purchase of individual fishing quotas in that fishery by entry level fishermen.

(B) A Council making a submission under subparagraph (A) shall recommend criteria, consistent with the provisions of this Act, that a fisherman must meet to qualify for guarantees under clauses (i) and (ii) of subparagraph (A) and the portion of funds to be allocated for guarantees under each clause.

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(5) In submitting and approving any new individual fishing quota program on or after October 1, 2000, the Councils and the Secretary shall consider the report of the National Academy of Sciences required under section 108(f) of the Sustainable Fisheries Act, and any recommendations contained in such report, and shall ensure that any such program--

(A) establishes procedures and requirements for the review and revision of the terms of any such program (including any revisions that may be necessary once a national policy with respect to individual fishing quota programs is implemented), and, if appropriate, for the renewal, reallocation, or reissuance of individual fishing quotas;

(B) provides for the effective enforcement and management of any such program, including adequate observer coverage, and for fees under section 304(d)(2) to recover actual costs directly related to such enforcement and management; and

(C) provides for a fair and equitable initial allocation of individual fishing quotas, prevents any person from acquiring an excessive share of the individual fishing quotas issued, and considers the allocation of a portion of the annual harvest in the fishery for entry-level fishermen, small vessel owners, and crew members who do not hold or qualify for individual fishing quotas.