Testimony of

Mr. Tom Connelley

August 23, 2002

Mr. Chairman and Members of the Committee:

My name is Tom Connelley. I am a rancher, independent order buyer, and cattle feeder from Belle Fourche, South Dakota. I grew up in Colorado on our family cow ranch. At an early age, I learned to care for and raise cattle. After high school, I completed a course offered by the National Institute of Meat Packing. In 1973 I began buying slaughter-ready cattle for the American Beef Packers. In 1980 I became an independent order buyer operating on my own. I now own mother cows and I usually retain ownership of my calves until they are ready for slaughter. In 1970 I also began studying the futures market, and believe me, I paid my tuition to the school of hard knocks.

In recent years I have managed to earn a profit as a speculator in the futures market. As a speculator, my success or failure depends on my knowledge of the forces affecting the live cattle market. I can trade whether the market is weak or strong. It is unfortunate but true that while I have extensive knowledge regarding the functioning of the futures market, and can be successful as a speculator, I cannot apply that knowledge to profitably conduct my cattle operation. The live cash price paid by packers is very unpredictable, and I cannot depend on a price close to the futures price. The live cattle market is simply too weak to recover production costs, let alone a profit.

I wish to thank you today for holding this field hearing. Our United States cattle industry is at a crossroads and the future of our industry will be decided by either the action or inaction of Congress. Those of us involved in the production end of the United States beef industry, which is the live cattle industry, lack the economic and political power to change our present course leading toward a non-competitive marketplace. We, therefore, rely on you to help us shape a workable marketing framework that will restore an open and competitive market structure for our industry.

I am here today to tell you firsthand what is happening in the U.S. beef industry. In the 70s I was a salaried buyer and I purchased slaughter ready cattle for the American Beef Packers (one of the larger packers at that time), and later Flavorland Industries, which was a smaller packer. Every week I competed against buyers from 23 other packing companies in order to fill my packers' orders. I had a new order each day and I purchased cattle every day. My packers would give me a "hot price," which is the price they are willing to pay for a carcass ready to go into the cooler. It was my job to evaluate each pen of cattle, either in a commercial feedlot, the cattle owner's own feedlot, or, less frequently, in a stockyard. In my evaluation, I would estimate the cattle's grade and yield percentage. I would then estimate the live cattle price I could pay that would equate to my packers' "hot price." If the owner of the cattle didn't think my bid was high enough, he would turn it down and for sure, within a few hours, another buyer from a different plant would be there

to estimate the cattle's value and would offer the owner a new bid. If my packer let me know the plant would pay a higher "hot price" than originally established in order to fill the plant's capacity for that week, I would call the cattle owner and offer him a correspondingly higher price, provided he didn't already sell to one of my competitors.

Over the past 8-10 years, the marketplace has changed radically. Today, when I am ready to sell my cattle ready for slaughter, the commercial feedlot feeding my cattle will put my cattle on what is called a "show list." The show list contains all the cattle the feedlot has that are ready for slaughter. If I am lucky, I may have three or four packer-buyers pick up the feedlot's show list. I do not receive any bids on my cattle at the beginning of the week because the packers are either killing their own cattle or the cattle they control through contracts. If one or more packers need to buy cattle later in the week, usually on a Thursday or Friday, I may get a single bid from one of the packers. Oftentimes, the buyer will give me a take-it or leave-it offer for my cattle during the time we are talking on the phone. Other times I may be given an hour to make up my mind. However, I am not usually able to get a second bid from another buyer during the hour I am considering the first offer and even if I do, the bid will be exactly the same. It is usually the case that if I don't take the bid during the first week, I must wait until the following week for another bid. And, the following week's bid is typically lower than the initial bid (the packer knows my cattle will depreciate in value if I don't sell them when they have reached their optimum weight). Although I can't remember the last time I actually received three bids in one week, in the weeks in which I did received more than one bid, both bids were for the same price.

In the late 80s and early 90s, packers increased the number of cattle they owned and fed themselves. They also began introducing new tools that allowed them to control even more cattle. These new tools included formula pricing, Basis the Board Forward Contracts, and marketing agreements. Forward contracts became popular because the lack of competition for live cattle ready for slaughter caused cash prices to be depressed and producers were looking for a means of beating the depressed cash market. With a Basis the Board Forward Contract, producers could forward contract on a live-price basis using the Chicago Mercantile Exchange (CME) futures market. The producer could price his cattle (Basis the Board) at any time prior to the delivery month stipulated in the contract. The price the producer selects is not a price based on competitive bidding for his cattle. Instead, the producer selects a price from the futures market for the month in which he must deliver his cattle to the packer. In an uptrending market, the producer would price his cattle when he thought the market was at its peak, but oftentimes the producer would price to early, fearful that the market might weaken. In a downtrending market, however, producers would wait to price their cattle at the latest possible date, at the end of the month, in hopes the market would strengthen. The packers know this is the usual behavior of the contracted producers and they are able to use this knowledge to drive down prices. (Attachments 1-6 are charts showing the effects of packer efforts to drive down the cattle futures market.)

In the past two years, I have sold most of my cattle on a grid basis. This is either based on the average Nebraska beef price for the week, or the average live price in Kansas for the week. Then, depending on the yield, grade, and cutability, I receive premiums or discounts from the average price. I have been receiving more than the weekly Kansas high because my cattle grade well above the plant average. I do not advocate this way of selling but it's the only way I have to get

some form of premium for higher grading cattle. I have to commit my cattle to the plant for next week before I know what the basis price is for this week. When I commit my cattle as required on Monday or by Tuesday, the packers will then establish the base price for the week late Thursday or Friday using the cattle they are purchasing from the cash market. This type of arrangement encourages packers to use their influence to keep the cash market low. No, I don't like to commit my cattle before I have a base price, but I have no alternative given today's market structure. If I didn't like the price they established after I committed my cattle and refused to deliver, I guarantee they would not let me commit cattle ever again.

As reported by the Data Transmission Network (DTN), Cattle Fax, and other reporting entities, packers sometimes own or control 40 to 50 percent of the cattle they kill during various weeks of the year. Last week, for example, the DTN reported that formula cattle in the Kansas, Nebraska, and Texas markets totaled 181,601 head. The live cattle purchased in these markets during the same period was reported at 169,865 head. Thus, 52 percent of the cattle slaughtered last week in these three markets were captive-held inventories, and 48 percent were cattle purchased in the cash market. Because they control such a large portion of the cattle they need, they don't need to be as aggressive in their efforts to obtain the remaining 50 to 60 percent of the cattle they need. In fact, packers have learned to use their own inventories of cattle to not only lessen their aggressiveness, but also to lower the prices of the remaining cattle they need.

As mentioned above, one cattle procurement method used by the packers is called Basis the Board Forward Contracts.Under Basis the Board Forward Contractsa producer must commit to deliver his cattle to a specific packer for a price that (a) is not negotiated, and (b) depends on the reported futures price on the Chicago Mercantile Exchange for the particular month stipulated in the contract. This means a producer is at the whim of the CME Board for a price determination, and the producer is completely excluded from any negotiation or input into price. All cattle committed under Basis the Board Forward Contracts are inherently taken off the cash market and become a part of the packer's captive supplies.

Packers have large numbers of cattle contracted on the futures market in Basis the Board Forward Contracts. This means cattle are committed to them before their price is determined or known. Packers know that producers who own these contracts must price their cattle before the last futures trading day of the previous month. For example, on a June Basis the Board Forward Contract, cattle must be priced by the last trading day in May. It is to the packers' advantage to keep the futures price low until the producers have priced their cattle. Only after producers price their cattle will the market begin to rally, as it should have before the packers applied their economic muscle to the marketplace. It is the combination of the packers' control of a large portion of their needed inventories, the packers' dominant position in the futures market, and an established deadline that gives the packers the tools they need to gain a tremendous economic advantage over producers in the marketplace. This control equates to millions, if not billions of ill-gained profits. For example, if a packer has 50,000 cattle on Basis the Board Forward Contracts, and the packer can hold down the price by just $3.00 per cwt, producers would lose $36.00 per head on their cattle, but the packer would realize a savings of $1.8 million on the 50,000 head of contracted cattle. (See Accompanying Charts 1-6.)

Today, packers use their captive supplies to strategically time their entrance to and exit from the competitive market, to the disadvantage of the producer. Because they require contract and grid cattle to be committed on Monday, or at least by Tuesday noon of each week, they know exactly how much inventory they have for each week and how much inventory is needed. This control allows the packer to stay out of the market until the end of the week, usually until Thursday afternoon or Friday afternoon, after the futures market closes. By waiting until after the futures market closes, even if the packer pays a higher price on Thursday afternoon, it is not disclosed until the USDA market reporters quote prices paid for Thursday's cattle on Friday morning. If packers wait to purchase cattle on Friday after the futures market closes, it is not disclosed until the following Monday morning, and the packer can continue to purchase cattle after close without producers knowing that higher prices may have been offered.

I would like to describe for you a typical week in the futures market. While there is minimal, if any, cash trade at the beginning of the week, Monday and Tuesday will normally find the futures market trading higher, with expectations for a higher cash market. Wednesday futures will probably be lower (the optimism is fading). If by Thursday we have not traded any cattle yet, the CME Board will have a big sell-off. If feedyards fold and sell lower, the futures will be higher on Friday. If feedyards don't sell, futures will be lower on Friday. When Feedyards don't sell any cattle for the week, or have light sales, futures traders assume we are backing cattle up and will sell the market off. Then we have to sell lower. This is how packer-owned cattle, contract, and formula cattle are used by packers to influence the cattle market for their benefit.

Most Grids and Formulas are based on the weekly average dressed cost or the weekly average live price. The packer then determines the plant average grade and yield, and calculates premiums or discounts based on these averages. For example: If the plant average yield for the week is 63 percent and my cattle yield 62.5 percent, I will be discounted for the one-half percent difference below the average. If the plant average grade for the week is 52 percent and my cattle grade 80 percent, I will receive premiums on the 28 percentage points above the average. There are also premiums and/or discounts on Yield Grade 1-5. While these premiums and discounts appear to offer rewards or penalties to the cattle producer based on quality characteristics, the fact is that by keeping the base or average price low, the cattle producer still loses between $2 to $3 per cwt even after receiving premiums for his higher quality cattle.

With the amount of cattle sold on this basis, it is to the packer's advantage to keep the weekly average live price low. This is why, when I try to sell cattle live, I will only get one bid. If I turn it down, they will most likely bid me lower the next week. Not every pen of cattle has the same value. Depending on the grade, yield, cutability, and bone-out percentage, each animal will have a different value. Why should all cattle sell for the same price? Packers want to keep the average price low. This provides them the ability to pay less for a higher quality animal than they would if the animal were sold in a competitive market. Using the example of a packer-established $110.00 hot beef price on choice grade and a $100.00 hot beef price on select grade, A pen of steers that will yield 63 percent carcass weight and grade 85 percent choice is worth $68.55 live weight. A pen of steers that will yield 63 percent carcass weight and grade 50 percent choice is worth $66.15 live weight.

In the foregoing example, when the packers establish the cash price they are willing to pay, both pens of cattle will sell for the same cash price and may well be in the same feedlot side-by-side. Thus, if cattle are selling for $66.15 in the cash market, the pen with the 85 percent choice cattle will not be rewarded for their higher grade. On the other hand, if the cash market is trading higher, the lower quality cattle will benefit from the higher average. This reveals why fewer quality cattle are being traded in the cash market, despite the fact that the premiums paid under the grid system are also inherently unfair when the same cash market also determines the base price of the grid system.

The following example will help explain how the packers are benefiting from the pricing structures they have designed:

Week of 8/08/02 from Hales Cattle Letter

1200# steer 1200# steer
x62.00 cwt Texas Avg. x .63 % hot yield
$744.00 to Cattle Feeder 756# carcass weight
x105.41 Beef cutout value 50% choice
$796.90
-744.00 Original Cost
1200# steer 52.90
x7.55 drop credit +90.60 offal value
90.60 offal value $143.50
-40.00 kill costs
$103.50 Per Head Packer Profit

As revealed by this example, the packer earns an additional $52.90 from the higher quality animal purchased from the producer in the cash market, but not reflected in the producer's cash market price.

Working in combination with the packers pricing schemes is the retailer who also enjoys the benefits of a less than competitive market for live cattle. The relationship between retail beef prices and live cattle prices has been lost and, consequently, retailers are maximizing their profits by keeping retail prices at the level the market will bear but purchasing their inputs at prices determined not by a competitive market, but rather, by the after-effects of the packer's use of buying power. This is why consumers have been paying at or near record prices for beef in recently while independent producers are receiving well below their cost of production. Below is an example of the share received by the retailer:

Week of 8/08/02 from Hales Cattle Letter

1200# steer
x .38% yield
456# Boneless Beef
x2.76 weekly Avg. retail beef price
$1258.56
-887.50 cost leaving packinghouse in carcass

$ 371.06 retailer profit less transportation expense and labor
103.50 packer profit
$474.56 Difference between live steer value and what the consumer pays for beef.

Thus, the giant food stores like Kroeger, Albertsons, Safeway, Walmart, and others are contributing to the shrinking share received by producers. Both packers and retailers are maintaining large profits on beef, at the expense of both producer and consumer. This monopoly-like control is choking our live cattle industry.

On May 21, 2002, I faxed the letter reprinted below to Mr. Michael Caughlin of the Packers & Stockyards Administration:

Beef Cutout Close Choice 750-900# $119.61
Select 750-900# 109.28
$228.89

$228.89 divided by 2 = $114.45 X .63% hot yield = $72.10 Live equivalent
for 50% choice fat steer.

Packers today were buying cattle in Kansas and Texas for $64.00 cwt. live basis and $103-$104 hot beef price in Nebraska. This is how captive supply allows them to control the market. Today June live cattle futures closed at $59.40. Packers have large numbers of cattle contracted Basis The Board. Producers with these contracts have to price their cattle before June 1. It is to the packer's advantage to keep the futures price low till producers have to price cattle. After these cattle are priced, we should anticipate a good rally in June futures. When packers own or control 40 - 50% of their kill, they don't have to be aggressive in their procurement.

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The Packers and Stockyards Administration never responded to this letter. However, my prediction turned out to be entirely accurate. As the attached June chart shows, on May 31, 2002, the market closed at $60.47/cwt and by June 17, 2002 it rallied to $64.17/cwt.

Ladies and Gentlemen, I have shown you how the Big 3 controls the price of fat cattle through packer feeding, forward contracts, formulas, and futures pricing. Now, let me draw you a picture of the cattle industry 10 years from now, if we now do nothing to change their present practices.

As we now have 3 big packers controlling about 80% of the red meat slaughter, we will then have 5 or 6 large feeding companies finishing all of the cattle. Cactus Feeders, Con-Agra, Caprock Industries, Sparks & Co., and Continental Grain all have packer ties and formula deals. When the small feeder (family farm), the commercial feedyard (depending on investors to place cattle), and all small independent feeders are forced out of business, then these feeding giants will buy feeder cattle directly from the cow/calf producers in the same way packers are now buying from independent feedlots.

All independent order buyers like me will be gone unless they go to work for the giants on salary. Ranchers will be at poverty level on their own land. But large packer-owned feeding and processing businesses will be profitable. As you can see, we have now reduced market competition clear down to the producer level.

Ladies and Gentlemen, the hour is late and time is of the essence. We must act NOW to enforce the laws already on the books. The Packers and Stockyards Act and the Sherman Anti-trust act were written to prevent the monopolistic practices we now see in the packing industry. I urge Congress to immediately pass the ban on packer ownership of livestock, to prohibit all contracts that do not contain a firm base price at the time the contract is entered into, to investigate the packers futures trading activities for the 15 days prior to each contract delivery month, and to take any additional steps necessary to prevent the packers from interfering with the competitiveness of our live cattle markets.

Oh, just in case you believe this will be consumer friendly and hold prices down for meat consumers, think again. When we have so few in control of meat products, they will write their own ticket. To keep agriculture a free enterprise and to keep independent producers in business, you must act NOW.

Thank you.