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November 6, 2002

COMMENT

Received CFTC
Records Section

11/07/2002

02-13

(13)

President George W. Bush
The White House
1600 Pennsylvania Avenue NW
Washington, D.C. 20500

Dear Mr. President:

We have taken the privilege of addressing you, Mr. President, along with Secretary Veneman and Chairman Newsome, because the issues to be discussed herein clearly transcend the legislative authorities of the CFTC, but they may well fall within the purview of the collective authorities of the USDA and CFTC. Furthermore, Mr. President, we appreciate your position as the highest-ranking beef cow man in the United States of America. Our purpose is to address matters of great concern to R-CALF USA's 6700 cattlemen members and our 32 state and local affiliates representing thousands of additional producers, which collectively represent 42 of these 50 states. We further believe that our concerns are shared by our nation's over 800,000 beef cow owners, and tens of thousands of small independent cattle feeders, backgrounders and grazers, and their immediate families.

R-CALF USA's principle emphasis has been on the market dynamics directly impacting the live cattle market, from the producer to the packer. However, the recent proposal discussed below necessitates a closer analysis of the dynamics between the packer and the retailer. The forces affecting the packer-retailer dynamic permeate the entire market structure and often give rise to the upstream market volatility and depression we are witnessing. To assist in our analysis, we have relied, in part, on the substantial research conducted by McVean Trading & Investments, LLC (McVean), other long-time colleagues within the cattle industry, and our own research and expertise. Given the severity of the current economic condition of our industry, we believe prudence dictates that we bring the following matters to your immediate attention.

To begin, the Commodity Futures Trading Commission was asked by the Chicago Mercantile Exchange on October 18, 2002 to approve certain rules changes concerning the trading of live cattle futures. We believe that these proposed changes, forcing earlier than scheduled liquidation of large long position holders, were orchestrated by selfish and well-financed special interest groups and are strongly biased in favor of large short hedgers in the cattle futures market. These

proposed changes hold the potential to negatively impact the prices received for the vast majority of all fed cattle, feeder cattle and calves produced by nearly one million American farmers and ranchers. These are clearly matters of concern to Secretary Veneman, as well as Chairman Newsome. We would like to summarize, as briefly as possible, why we hold this position, and why a favorable resolution of this matter is so particularly important to us at this extremely trying time for our industry.

The process of pricing beef and cattle is astonishingly complex. It is best understood through a model of the structure and behavior of the various key players in the game. It is clear that an understanding of these behavior patterns is beyond the scope of the CFTC's narrow authority over futures markets. However, the impossibility of understanding how the futures market works without understanding the real world of the beef and cattle trade is equally clear. For this reason, it is imperative that we have a working model of the cash side of the trade. We will then see that what is called a distortion of the futures market is quite often in reality a distortion of the cash market itself.

We begin our model with our good customers in the restaurant trade. They have done a marvelous job of promoting our product in recent years. In the short run of any given several month period, the restaurant trade is a price taker, not a price maker. This is because they are committed to running items on their menus at specified prices over extended periods of time. It is these final prices to consumers that largely determine how much beef will be sold in a given period of time. Having committed to printed menu prices, a restaurant is obligated to purchase a fairly fixed quantity of beef. It then must pay the going price in the market to secure that beef supply. In the short run, the restaurants, because of their fixed quantity demanded, are price takers, not price makers.

The price makers for beef are the large grocery store chains. These large corporations generally have impressive market shares on a city-by-city basis. Characteristically, this market share allows them sufficient power to enforce their pricing strategies. These chains actively change retail beef prices, by large amounts, on a week-to-week basis, and thereby micro manage the amount of beef that they sell to the final consumer. This is called either "featuring" (selling at a reasonable price) or "not featuring" (selling at an obscenely high price). These gyrating retail prices, called "high-low" strategies in the trade, are enforced through strong city-by-city market share. These "high-low" prices determine whether the marginal unit of beef clears the market or stacks up in inventory to subsequently depress prices. If the "high-low" retailer wants to try to buy an inventory of beef cheaper, they raise their retail prices sharply and temporarily choke off consumer purchases. Through the short-term manipulation of their prices, these large retailers have positioned themselves as the dominant price makers in the wholesale beef market.

New marketing strategies have been introduced by retailers like Wal-Mart, which now offers "everyday low prices" for beef. Studies indicate that Wal-Mart sells beef at an average of 20 percent less than the "high-low"-type retailers, and this strategy appears to be capturing market share from the "high-low"-type retailers. We believe this market strategy, characterized by less volatility in retail pricing, will increase consumer demand for beef.

We applaud the USDA's initiative to utilize scanning and computer technologies to accurately monitor and report current retail prices. We would like to encourage a high-tech and holistic approach to beef market surveillance. In addition, the USDA's retail price work could be integrated with the CFTC's monitoring of the cattle futures market. Authorities would then be better able to evaluate retail versus live cattle market anomalies. Traders on the Chicago futures market are often blamed for price distortions at both the retail beef and live cattle level. However, given the price distortions arising from "high-low" retailer strategies, which permeate the production channel and affect live cattle prices through packer procurement practices, these traders are doing what an otherwise free market speculator is supposed to do. They are reading market signals to anticipate eminent price adjustments. Unfortunately, today's market signals include both the traditional supply/demand signals and the new signals arising from market distortion practices.

A national report published in Sunday papers showing a city-by-city, major retailer by major retailer, computer printout of the current week's retail beef prices would put the USDA in a powerful weekly "bully pulpit." With modern computer technology, why shouldn't this be done? We believe bringing retailer pricing strategies to the light of day would reduce the volatility in beef prices. Additionally, it would allow us to identify any remaining causal relationships if the current volatility in live cattle cash and futures markets were not similarly reduced.

We are suggesting the USDA begin furnishing timely, accurate, real time prices to the public, and we think the media would take that ball and run with it. Sporadic price gouging on beef, the most important food item in the United States, should be exposed to the public. A retailer offering fair value to the consumer should applaud this effort. It is great publicity, it is free, and it will bring more business to his stores. Through available technology, at small expense to the USDA, the agency would significantly improve the efficiency of the food distribution system by better informing consumers on the values of beef. It is not the beef prices featured in the newspapers that we worry about; it is the ones that don't show up. Studies indicate that in a "high-low" store, these unmentioned prices are as much as 30-40% above featured prices. Please don't forget, in a functioning, competitive market, the final price to the retail consumer is the most important price in the whole system. In the short run, it is this retail price that drives changes in final demand for beef. Sporadic inconsistencies in retail pricing are costly to our entire industry. Timely information would bring improved consistency to the retail market. More consistent retail prices would reduce inefficiencies in the distribution channels and would eliminate a major contributing factor to persistently low and volatile producer prices for all classes of cattle.

Moving on to our "friends," the beef packers, they also have a meaningful degree of buying power. Three of them control the lions' share of industry processing capacity. They are highly computerized and have learned to micro manage slaughter rates and cattle purchases in immediate, almost real time, response to changing order flows. In this light, they are conduits for "high-low retailer induced price distortions," resulting from sudden changes in retailer pricing strategies. One of our great concerns here is following these initial "high-low retail induced price distortions" through to their impact on current cash and futures prices for cattle.

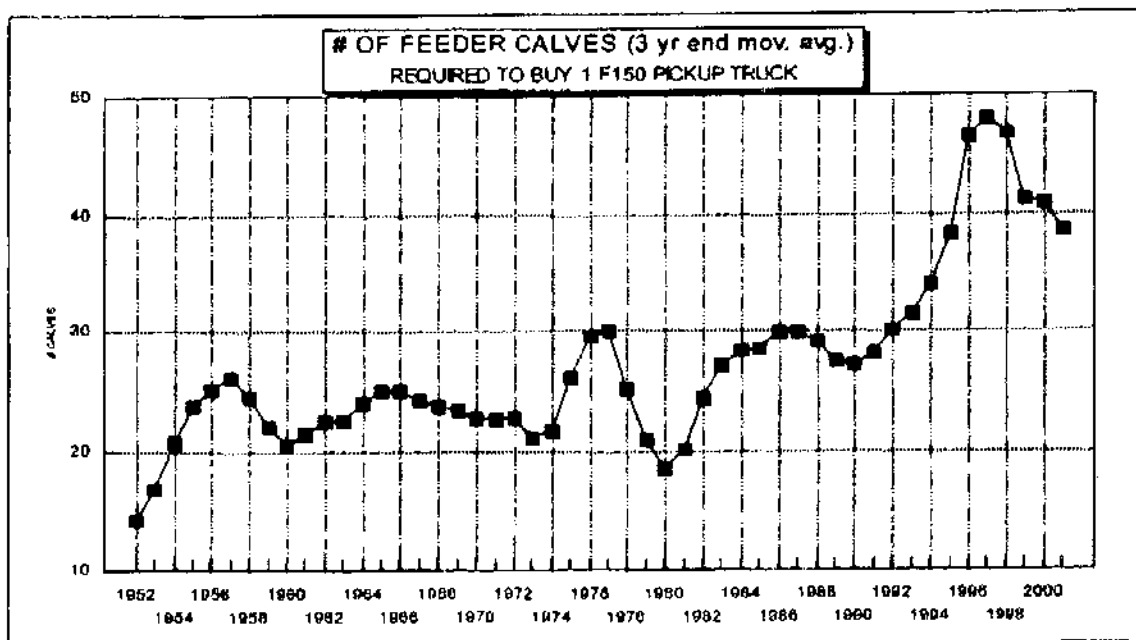
Meanwhile, at the producer level, by virtue of our sheer numbers (nearly one million), our geographic dispersion, and the perishable nature of our product, we collectively have no pricing power whatsoever. We are relegated to take whatever price is offered in the market place, whether it is a legitimate price or a distorted price.

Suppliers to our industry, in many cases, are large corporations with significant market share. In many cases they have significant influence over the prices we pay for their products. This is true, for example, of veterinary supplies and fence wire, and new tractors, hay balers, and pickup trucks.

We are nearly one million producers sandwiched between downstream oligopolies and upstream price makers. If anything at all goes wrong, we can sometimes be the victims of vicious cost price squeezes. This time the catalyst for trouble has been the worst drought in modern history for our industry. As you know, Mr. President, it began in Texas in 1996 and has persistently rolled across the cattle country to the present time. The drought is currently centered in a vast area around the state of Colorado. It has pushed enormous numbers of cattle to market prematurely. All in all, ours is not a pretty picture. The following three charts prepared by McVean Trading & Investments, LLC, pretty well sum up our predicament.

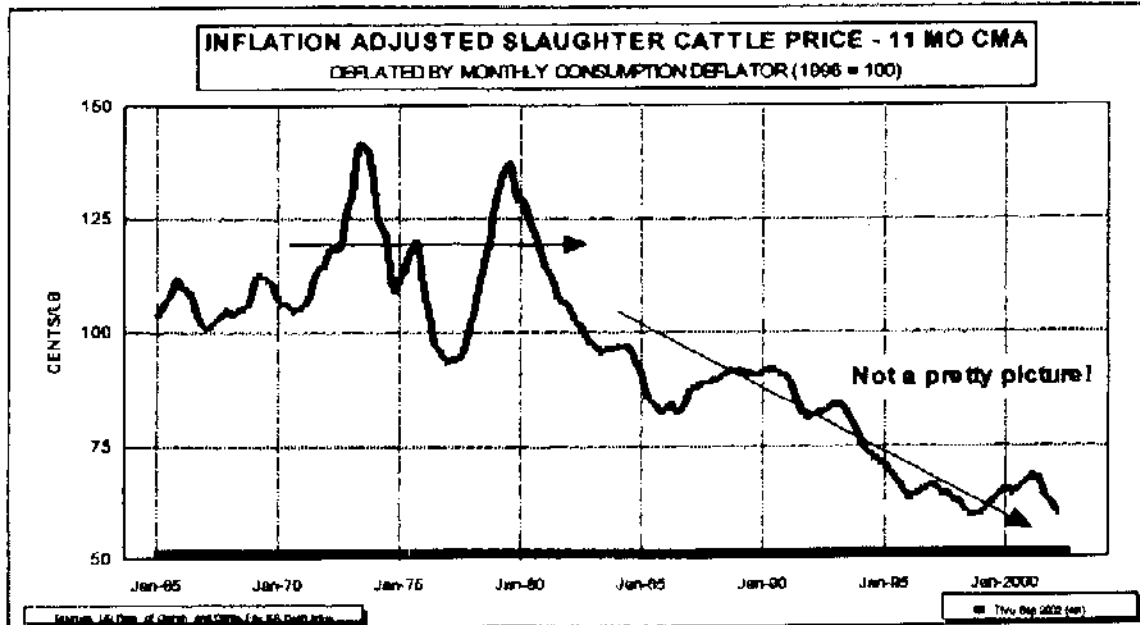
As ranchers, we sell calves and among other things buy pickup trucks. The number of calves we have to sell to buy one pickup truck tells a lot about the financial health of our industry. Obviously, it's not very good.

Chart 1



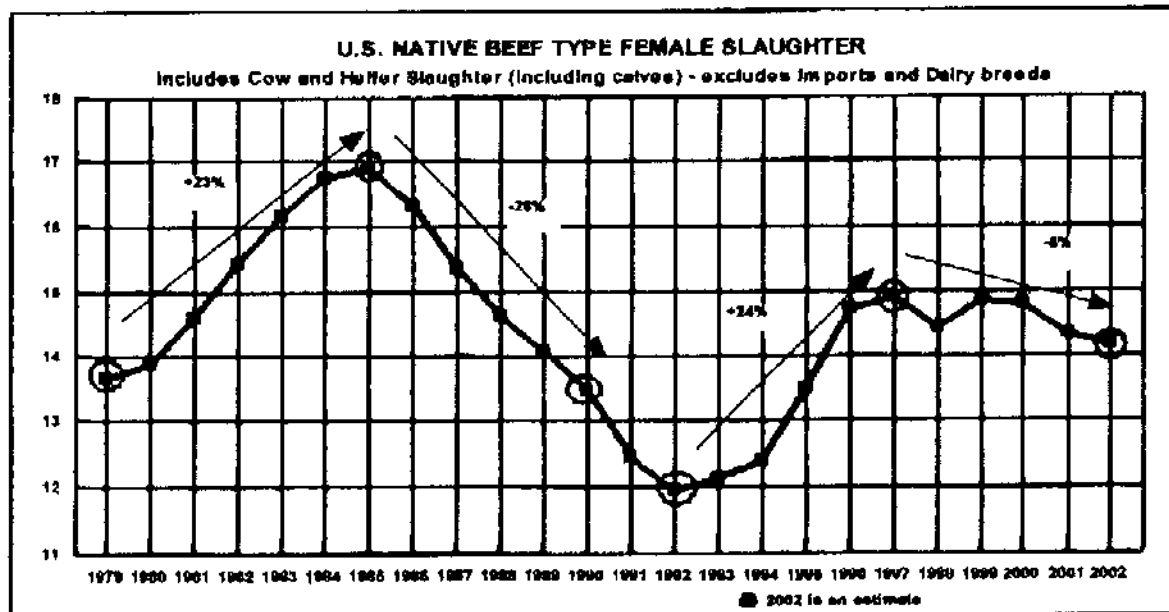
Turning to fed cattle prices, we see how they look when adjusted to real terms using Chairman Greenspan's favorite personal consumption price deflator. In real terms, these are near depression level prices.

Chart 2



Cheap prices and vicious droughts, both persisting over the last seven years, have proven to be a lethal combination for our industry. They have caused the longest liquidation of beef cows in recorded history. The cattle cycle is most clearly observed through the long recurring waves of female slaughter. It moves up in liquidations, down in expansions.

Chart 3



Typically, female slaughter peaks in the second or third year of liquidation and then declines dramatically. Notice the 26% decline over the subsequent five years from the previous peak in 1985. In comparison, this time the female slaughter remains near its cyclical peak after a record seven years of liquidation. This is a depression, not a recession.

Many in the industry believe that the USDA is seriously underestimating the impact of this extended liquidation cycle on the size of the nation's beef cattle herd. This is especially true in your home state of Texas, Mr. President. The situation may already have degenerated to the point that it represents a very real threat to our nation's future food supply.

The Chicago Mercantile Exchange cattle futures market has a great influence on the pricing of our fed cattle, feeder cattle and calves. Therefore, any rule change that potentially tilts the structure of the playing field in favor of shorts in the futures market can be expected to feed very directly into structurally weaker prices paid to the unhedged producers who represent 96% of the industry. This 96% would include virtually all of the beef cow men in the country. Over long periods of time, prices of cattle largely determine future beef supplies for the consumers in our country.

We are concerned that cattle prices have been far too low for far too long already. The drought is obviously not our only problem. If it were, the Southwest and Southeast would already have begun to rebuild their herds, given their improved moisture conditions over the last two years. We ask you, Mr. President, a rancher from Texas, and you, Chairman Newsome, a cattleman from Florida and Mississippi, to check your industry connections to see if herd rebuilding has kicked in along with improved pasture conditions in your home regions. Our many trade connections in your areas tell us there is no appreciable heifer retention in the South. If anything, we are told that the herd liquidation is continuing. By implication, therefore, our industry problems are deeply rooted and structural in nature; they

are not merely cyclical. The South had already experienced its longest liquidation in history as of two years ago. The structural problem driving the destruction of our cow-calf industry is that the system of pricing cattle in the United States is systemically biased toward prices that are too low to sustain our producers. "High-low" retailer behavior is a major culprit, and it has been complimented by regulatory bias favoring short hedgers in the futures market.

Detailed studies have shown that short hedgers produce only about 4% of our steer and heifer beef. These hedgers tend to be large commercial feed yards and packers. They have always dominated the rules making process at the CME, but this time we feel they have gone too far. We independent producers have been systematically excluded from any input whatsoever into these most recent rules changes. We vigorously oppose their implementation. We also object to the backroom, almost underhanded fashion, in which they were proposed to the CFTC.

We are hereby asking the CFTC to deny the implementation of these changes. Furthermore, we are asking that the CFTC use its influence to see that the governance process of the CME, in respect to cattle futures, is completely restructured to allow for proportionate and equitable representation of all of the various segments of the beef and cattle industry. The integrity of their futures contract is critical to the establishment of fair prices for our unhedged cattle. The systemic downward bias to prices, deriving from the traditional favoring of short hedgers, is a second meaningful component of our industry's structural pricing problem. It has in effect, though certainly not through intent, acted in concert with "high-low" retailer behavior to impose structurally lower prices on the unhedged producers who comprise 96% of our industry. We will present a theoretical illustration of this point.

There is very little visibility in the foggy world of fed cattle pricing. This fog is so deep that no one at the CME or the CFTC has any chance of knowing with any accuracy what packers are actually paying for cattle. The market features country prices, auction prices, delivered prices, formula prices, grid prices, basis prices, controlled prices, unreported prices, quality premiums and discounts, weight discounts, freight adjustments, time premiums, breed premiums and special weighing conditions. This fog is thick indeed.

Let's assume for the moment that one could figure out what packers were paying during the delivery period, and let's call it the "cash price." Let's further assume that our "friends," the retailers, have gone on one of their temporary buyers' strikes and have raised retail prices significantly and for no apparent reason. They hope to temporarily break the wholesale beef market or prevent it from rising. The packers have immediately cut their bids for cash cattle or refused to raise them in the face of stockpiling beef supplies. Let's further assume that well-informed, large speculators have seen through this ploy and recognize that it is just one more of the predictable "high-low retailer induced price distortions" which pass through our market place. They then elect to sit tight with their positions, expecting that reduced supplies ahead will force the retailers back into the market, bringing the packers along with them. Futures remain fairly steady. Under these conditions, the "cash price" is driven below what we will call the "fair market value" by a "high-low retailer induced price distortion." The futures have held in line with "fair market value" but above the current "cash price." Under the existing regulatory regime, this situation is deemed to be a basis distortion, and the

futures market is arbitrarily held to be out of line with the presumed to be legitimate "cash market." The traditional remedy for this situation is to threaten longs in the futures with punishment, and one way or another force them to reduce their positions. This brings pressure on the futures market, which in turn will put downward pressure on the cash market. Thereby, the bear raid by the retailers has been validated by the CME surveillance staff in Chicago. The losers are the sellers of unhedged fed cattle, feeder cattle and calves. We are not saying that the speculators are never wrong. We are saying that the predatory "high-low" pricing strategies of certain retailers can be the initial instigator of a misalignment between cash and futures prices.

To summarize, we have two technical problems, not just one: A) regulators cannot determine what packers are actually paying for cattle to begin with, so they do not know what the "cash market" is with any degree of certainty, and B) even if they did know what packers were paying, they have no means of knowing when the "cash price" might be unduly driven below "fair market value" by yet another "high-low retailer induced price distortion" or by a corresponding packer's exercise of non-cash cattle procurement practices. The concept of "fair market value" as opposed to "cash price" deserves serious consideration at the CME and the CFTC. Simply put, if packers are not fully replacing the inventory they are slaughtering during a given period of time, we have sufficient reason to suspect that the "cash price" is below the "fair market value." We all know that thin markets often give rise to price distortions. This test should be applied to alleged basis distortions to determine whether it is the cash or the futures that is out of line with "fair market value." Furthermore, a careful look should be given to determine whether or not there is a significant "high-low retailer induced price distortion" at play in the market place at this particular time.

In closing, we believe in free markets for free men. We also know that fair rules making is as important to efficient markets as it is to democratic government. As applied to the cattle futures market, these principles dictate the following:

- A) Proportionate representation by all segments of the industry in the governance process.
- B) Absolutely equal rights for longs and shorts alike. As previously discussed, the bias currently favoring the large shorts, predominately the packers and large formula feeders, should be considered with an eye toward seeking changes that would eliminate this inequity.
- C) The Exchange should not increase contract delivery weights beyond existing specifications as producers delivering cattle at weights above current specifications are subject to severe discounts under existing marketing terms.

We request that the domination of the rules making process by large short interests and the regulatory induced downward bias it imparts to futures trading be stopped once and for all. The CFTC should begin by rejecting the rules change proposed by the CME on October 18, 2002.

We believe the prevailing structural downward bias to the pricing of our cattle that emanates from the retail level can be largely corrected through the introduction of two improvements. First, we need the CFTC to provide for a perfectly level playing field for the live cattle futures market. Second, and of equal importance, we need the USDA to implement a high tech and real time system of retail price reporting. Together, these changes would help bring our cattle industry improved fairness and efficiency through free markets and technology. A top priority for our industry must be to restore unfettered marketplace competition as the rightful determinant of the fair market value for cattle sold by all sizes and types of producers. After all, this is the American way, is it not?

Thank you for your time and consideration.

Sincerely,



Leo McDonnell
President
R-CALF USA

cc: Ann Veneman, Secretary, USDA
James E. Newsome, Chairman, CFTC