

Competition and Efficiency in Handling CWB Grains



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Competition and Efficiency in Handling CWB Grains

The CWB system of grain origination and handling in Western Canada does not encourage competition among grain handlers to drive costs and inefficiencies out of the system, ultimately costing farmers in net returns. Although grain companies handling CWB grains are very competitive generally, the tools available to them on CWB grains are limited. With a minimal ability to compete on price, market participants will act on other incentives or drivers. This document presents and discusses some of the factors involved and the results in terms of costs to producers.

Competition and Efficiency

Competition drives costs out of any market or marketing system by disciplining the participants. Typically the low cost operator in any market is in the best position to attract business through lower costs or better prices to customers; other competitors must follow suit in order to compete. Markets with multiple sellers of a service or product intensely competing for business are usually the most efficient as participants search for new means to reduce costs and improve service in order to maintain or grow market share. Without competition, markets tend to demonstrate poor reactions to customers, inefficient systems and ultimately higher or even excessive costs along with poor service.

Conventional approach to attracting delivery of grains

In most markets, price is used as the key incentive to draw grain into the grain handling and transportation system (GHTS) or to a local processor. As farmers deliver grain and inventories in the system build, buyers will lower their price paid for new deliveries as a disincentive to deliver more, either through simply lowering the price or by weakening the basis where applicable. (The result is the same regardless; the price signal to the producer is lower and therefore less attractive). Conversely, as system inventory levels drop and demand remains steady, buyers will increase prices to farmers as an incentive to deliver more, either through raising the flat price or strengthening the basis where applicable.

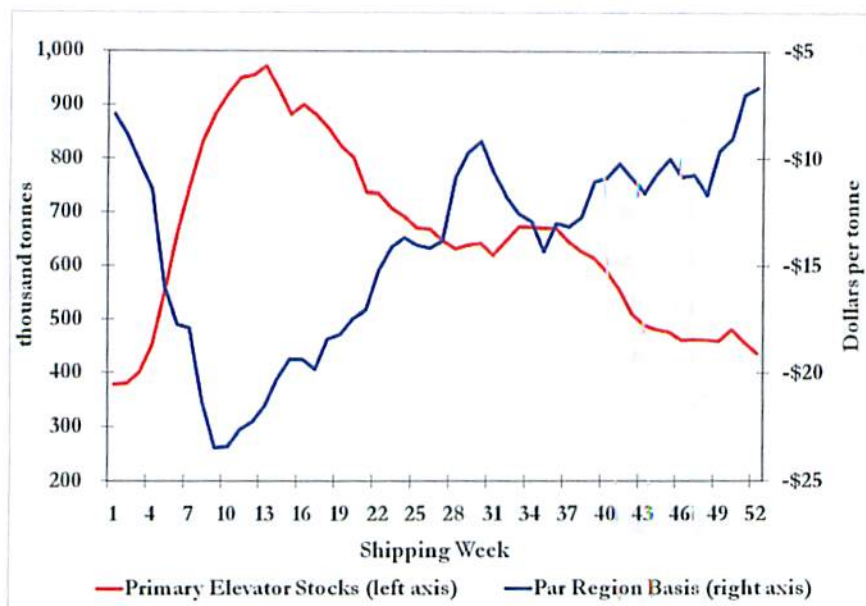
In addition to these “spot” prices (prices for immediate or nearby delivery), grain companies will offer deferred prices to farmers where farmers can “lock-in” prices to be paid on delivery at some specified time in the future. These price signals work together with spot prices; in times of large system inventories, grain buyers will offer price incentives to sell for delivery at a later time, providing price assurance to both parties and assured deliveries in the future period. In times of tight supplies, the spot price will often be higher than the deferred prices; this gives the signal to sell and deliver now as opposed to later. The buyer is not willing

to provide an incentive to hold the grain for deferred delivery; rather, he is offering an incentive to deliver now.

Combined, these two prices (spot and deferred) provide a very clear signal that the grain is needed now (and not later), or vice versa.

Chart 1 below is a visual depiction of how supply (inventory) and price interact in an efficient market. The chart represents ten-year average weekly prices (basis)¹ for canola delivered at and around Saskatoon, SK and ten-year weekly inventory levels (in primary elevators) throughout Western Canada.

Chart 1: Western Canadian Canola: Weekly Visible Stocks vs Basis (10 year average)



As deliveries of canola into the primary elevator system increases at harvest (weeks 3 through 13) and are greater than the flow of canola out of the elevators, the inventory builds; through the period covered, the average inventory builds from about 400,000 tonnes to almost 1 million tonnes. A natural reaction by buyers to this increased flow and build up of inventory is to reduce the price through widening the basis; here the average reported basis moved from about \$7.00/tonne under futures to almost \$25/tonne under futures.

Price (basis) is reduced for two reasons. First, it acts as a disincentive to farmers to deliver more canola. Second, the basis is reduced as grain companies look for fresh demand for canola in order to clear the market of the added stocks. Some buyers are more price sensitive than others and as the price drops, new buyers may enter the market and begin to buy where they weren't before. The system of price incentives is used to both reduce the supply and increase the demand.

¹ Source: ICE Futures Canada

The chart also shows what happens when the supply begins to drop. Following harvest, deliveries from farmers begin to drop off, but demand (shipments) continue, so the combined effect is the inventory levels begin to drop. As inventory drops, the grain buyers raise their price to attract more canola into the system.

These well established price signals, based in basic economic theory, are considered the most efficient means of managing the flow of grain from producer to end user. Although these examples are showing how these signals work between the producer and the buyer, they work equally well throughout the value chain.

CWB system of drawing grain into the grain handling system

Unlike participants in most open, or unregulated, markets, the CWB does not use price to draw grain into the grain handling and transportation system (GHTS). Rather, it employs a system of contracts and “contract calls” to administer the flow of grain into the system.

This approach starts with farmers entering into a delivery contract with the CWB. A CWB delivery contract is a binding contract whereby a producer offers grain to be sold and delivered to the CWB through an Agent of the CWB. It specifies the type, grade and quantity of grain the farmer wants to deliver. Producers must have a delivery contract signed up before being allowed to deliver grain and receive a cash ticket for the grain delivered to an elevator.

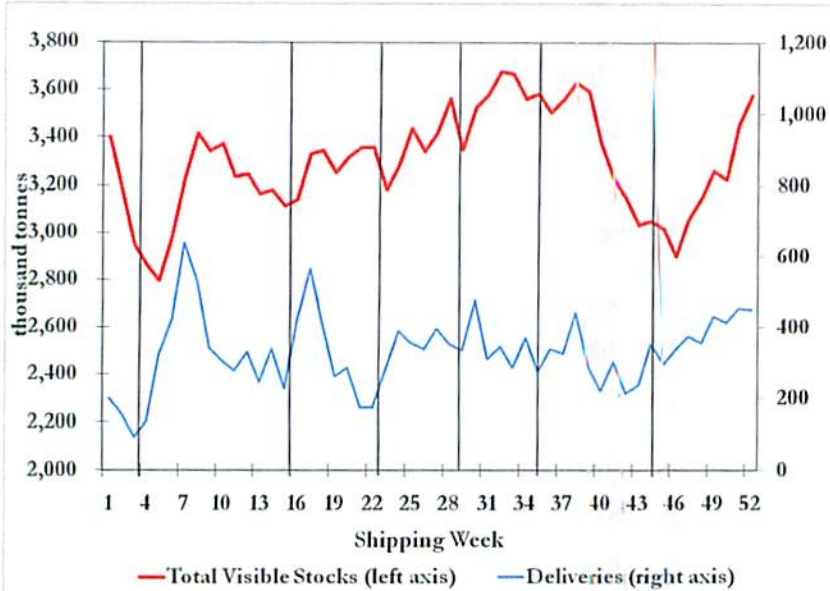
The most common method of contracting grain for delivery is the “Series Contract”. This contract allows producers to advise the CWB with regards to the type, grade and quantity of grain for delivery. Once the CWB has assessed all the contracts and the amount of grain offered from farmers and the market demand for that grain, it announces an acceptance level – a pro-rated amount of each contract that the CWB will call for at some time in the future.

In addition, the CWB provides Guaranteed Delivery Contracts and “GrainFlo” contracts, both of which are aimed at enabling producers to contract grain for a defined delivery period; the CWB matches these contracts to specific sales requirements.

Once the acceptance levels are determined, the CWB periodically announces “Contract Calls” which are aimed at regulating the flow of grain into the system to meet demand. Chart 2 below depicts the relationship between Contract Calls, the flow (deliveries) of grain into the system, and inventory levels. The red line depicts the weekly total inventory of wheat in the GHTS; the blue line represents the weekly physical deliveries of wheat into the system; the vertical black lines show the dates when the CWB issued a Contract Call. It is clear that producers react to Contract Calls by increasing deliveries immediately following the Call; this indicates that if they were able, they would have delivered prior to the Call. Also, it should be noted that

price does not play a role in CWB deliveries as the price is the same regardless of when it is delivered. Also, on most grades of wheat, there are no other options but to deliver to the CWB.

Chart 2: 2008-09 Weekly Wheat Inventories and Deliveries²



Handling CWB grains from a grain company perspective

Grain companies buy grain from producers on behalf of the CWB as agents of the CWB. As such, they do not have price risk (or opportunity); they do however, have quality risk (both in terms of the quality upon delivery and the potential loss of quality). CWB grain is handled by grain companies on the basis of predetermined tariffs for handling and cleaning that are charged to the producer. The grain company pays for the grain on behalf of the CWB, paying the producer the Initial Payment specified by the CWB, minus deductions for handling, cleaning and rail freight. The CWB pays the grain company for the grain upon unload in an export terminal or shipment to an end user.

The CWB pays terminal operators directly for the service of receiving, cleaning, blending and loading vessels.

From a competitive perspective, the biggest issues for grain companies is that they have only minimal control over the flow of grain into the system. Once the CWB announces a Contract Call, the grain companies' only competitive position is to be accessible with space to receive grain. There is minimal ability or need to use price (reduce their charges for handling, etc) to attract CWB grain.

² Sources: Canadian Wheat Board; Canadian Grain Commission

For example, when the handling system is stressed with large inventories (low available space), companies cannot easily send a signal to slow or curtail deliveries of CWB grains; for example, they cannot charge more for handling than specified in their tariffs (to create a disincentive to deliver like they do with canola or other non-CWB crops). They accept what is offered to the extent they can, depressing non-CWB prices as they send signals to reduce deliveries for space reasons. The biggest competitive tool they have is to make sure they have space.

Alternatively, when the system is not stressed and there is ample space, grain companies have an incentive to compete for CWB grain deliveries, but this is tempered by an inability to control the outflow of grain from the elevator. In other words, not wanting to “plug” their elevators with grain that won’t move, the elevator company will not aggressively compete for CWB grains when it is unclear as to when the grain will be shipped out of the elevator. For this reason, the elevator approach to CWB grains is to coordinate the deliveries into the elevator with known upcoming shipments, as best they can.

In addition, there are situations where open contract calls have been satisfied and producers are limited to what they can deliver anyway. In other words, elevator operators would like to draw in more grain, but the amount available on Contract Calls may be limited and they may be unsure when the CWB will request the grain they bring in. Under these circumstances, they have little incentive to offer better pricing (as an incentive); lowering their charges to producers would do little to bring more grain in since producers don’t have open Calls.

Notwithstanding, there are times when the grain companies have a need to attract more deliveries. In these instances, they will offer “trucking premiums” as a form of increasing the price to producers. However, these tend to be limited to less than \$10 per tonne.

Net-Back Costs: CWB and non-CWB grains

Elevator companies handle both CWB grains and non-CWB grains. The relative difference in costs, or charges, borne by producers is a strong indication of the impact of competition.

Table 1 below presents the total system costs (net-back costs) to handle spring wheat, durum wheat and canola, as reported by the federally appointed Grain Monitor, Quorum Corporation. It should be noted that the data for canola takes a different format and is from a different source than the data on CWB grains. CWB grain net-back data is from the CWB itself (CWB costs and transportation savings), the Canadian Grain Commission (primary elevation and cleaning tariffs) and grain companies (trucking premiums). This provides a fairly detailed calculation of the costs incurred by producers taking wheat from the elevator to a port position.

Table 1: Producer "Net-Back" Costs

		04-05	05-06	06-07	07-08	08-09
CWB Spring Wheat	CWB costs (gross)	6.50	9.16	8.14	11.64	10.14
	Transportation savings	(1.49)	(1.32)	(1.79)	(1.76)	(1.70)
	CWB costs (net)	5.01	7.84	6.35	9.88	8.44
	Primary elevation	11.64	11.76	12.07	12.52	13.02
	Cleaning	4.19	4.43	4.68	4.93	5.15
	Trucking premiums	(3.68)	(4.56)	(5.15)	(5.55)	(6.17)
	Applicable rail freight	33.74	34.80	37.18	37.57	37.83
	TOTAL	50.90	54.27	55.13	59.35	58.27
CWB Durum Wheat	CWB costs (gross)	22.79	23.52	24.55	31.43	30.09
	Transportation savings	(1.49)	(1.32)	(1.79)	(1.76)	(1.70)
	CWB costs (net)	21.30	22.20	22.76	29.67	28.39
	Primary elevation	11.53	11.77	12.15	12.59	13.00
	Cleaning	4.12	4.24	4.35	4.62	4.85
	Trucking premiums	(4.24)	(4.76)	(5.42)	(6.24)	(6.47)
	Applicable rail freight	30.98	31.43	33.93	35.21	39.10
	TOTAL	63.69	64.88	67.78	75.85	78.87
Canola	Price differential	34.11	34.20	37.79	45.23	40.82
	Trucking premiums	(0.34)	(0.43)	(0.50)	(0.49)	(1.20)
	TOTAL	33.77	33.77	37.29	44.74	39.62
Without Freight						
CWB Spring Wheat	TOTAL	17.16	19.47	17.95	21.78	20.44
CWB Durum Wheat	TOTAL	32.71	33.45	33.95	40.75	39.77
Canola	TOTAL	3.69	3.69	4.74	11.21	4.37

The canola net-back is based on a calculation; input includes the "par region" basis as reported by Ice Futures Canada and the instore Vancouver cash market (basis), also provided by Ice Futures Canada, as reported to it by trade participants. The difference between the par region and the instore prices determines the estimated net back – it represents the estimated difference between the price the grain companies are paying for canola in the country and the price they are selling it for in Vancouver. This calculation is quite different than the CWB calculation in that it is an estimate based on market quotations, not on actual tariffs, charges or transactions.

The net-back costs for CWB wheat have been in the range of \$50.00 to \$60.00 per tonne over the last five years; durum is higher with a range of about \$64.00 to almost \$79.00 per tonne. Conversely, canola net-backs ranged from about \$33.00 to \$45.00 per tonne.

Comparing the net-backs of canola and CWB grains is often cited by some as an improper and misleading comparison due to the different methodology used for each. However, due to the sheer size of the difference in net-backs, it provides a relevant comparison in terms of order of magnitude, as well as a very good indication of trends in the charges over time.

Moreover, removing the rail freight component out of each, results in a much greater appreciation of the difference in charges to producers. “Applicable rail freight” charges are clearly identified in the CWB calculations; for canola, we estimated it to be the applicable freight from Northern Alberta to Vancouver. For 08-09, this leads to an estimated canola net-back charge for all other services (elevation and cleaning) of \$4.37 per tonne; for the 5-year period, these charges range from \$3.69 to \$11.21 per tonne. This compares to net-backs (without freight) for wheat and durum of roughly \$20 per tonne and \$35 per tonne for wheat and durum respectively. Although not a precise comparison, it clearly demonstrates that the costs to handle canola to a port position is dramatically less than the total cost of handling and moving CWB grains to port.

Looking at the charges in detail reveals that producers pay more for the services of the elevator company for CWB grains in addition to paying for CWB costs, which the producer does not pay at all on canola. Just CWB costs alone in 08-09 were \$8.44 and \$28.39 per tonne for wheat and durum respectively (and zero for canola). Grain company charges for CWB grains were \$18.17 per tonne for wheat and \$17.85 per tonne for durum. As indicated above, it is reasonable to assume the total canola net-back without rail freight covers all elevator charges (elevation and cleaning); in 08-09 that totaled \$4.37 per tonne, about 25% of the grain company charges for CWB grains.

The main reason for this wide divergence in elevator charges is competition. With the demand for canola split between domestic crushing and export, the canola market is much more diverse and competitive in Western Canada than the markets for CWB grains. Although there is some Western Canadian demand for CWB grains, the majority of the demand is through the elevator. And for the reasons cited above, grain companies are limited to how much they can reasonably compete on price.

Tenders

The CWB issues tenders to grain handlers for up to 20% of grain exports through the ports of Thunder Bay, Churchill, Vancouver and Prince Rupert. Grain companies bid on the right to deliver a given quality and quantity of grain to a specific port at a specific time. The competition among grain handlers to win these tenders results in discounts to the handling tariffs of these companies, which are paid to the CWB by the company winning the tender.

Grain companies bid on these tenders because when they win the tender, the CWB provides additional rail car capacity to the winner, who perceives this as incremental business. Tenders clearly demonstrate the positive impact of competition between elevator companies as they compete for additional business. This competition is characterized by a net reduction in elevation charges on the grain being shipped in the tender. The elevators still charge farmers the same amount but the grain company winning the tender pays the CWB an amount equal to their bid.

Table 2 below shows a summary of the recent tendering process.

Typically, there is much more grain offered under tenders than accepted, with only about 40% of what is offered actually shipped. In times of full capacity utilization, we would expect the amount of bids on tenders to go down.

Table 2: Summary of CWB Tenders (04-05 to 08-09)

	04-05	05-06	06-07	07-08	08-09
Number of tender bids	1,048	955	862	629	822
Tonnes offered in tenders	5,722,904	7,130,992	6,753,560	4,396,656	5,622,144
Tonnes shipped under tenders	2,387,713	2,447,482	2,651,606	1,900,017	2,246,620
% of offers accepted and shipped	41.7%	34.3%	39.2%	43.2%	40.0%
Tenders as a % of CWB exports	18.0%	16.2%	17.8%	14.3%	14.4%

As mentioned before, the CWB holds the amount of tenders to less than 20% of its total export program ("Tenders as a % of CWB exports" in the table). Although the CWB was to tender as much as 50% when the tendering process was established, it was felt by many in the industry that tendering unfairly favoured the larger grain companies that operate both primary elevators and export terminals (those operating both primary elevators and terminals enjoy a greater total revenue stream on shipments of CWB grains, allowing greater discounts on tender bids; also, small shippers would need terminal authorization for the additional cars, often which would not be granted). As tenders could be seen as a tool for the large company to dominate over the smaller companies, the CWB has chosen to balance the benefit of tendering with the benefit of competition, thereby keeping the total amount tendered to less than 20% of the total CWB program.

Tender bids range between having no discount to around \$20 to \$25 per tonne discount. For example, if a company won a tender for 100 cars of wheat with a bid of a \$20 discount, upon shipping the 100 cars, the grain company would pay the CWB \$180,000 (assuming an average of 90 tonnes per car).

The success of tendering is a function of system capacity. For the most part, the Western Canadian grain handling system is in a state of over-capacity; in this situation, grain companies will tend to aggressively bid on CWB tenders as a means of getting additional business. In times when the capacity is being fully utilized,

it stands that grain companies will not bid aggressively on CWB tenders as they would not see a need (or have the capacity) for additional CWB business.

Terminal Rebates

The CWB has negotiated terminal rebates with selected export terminals, providing a reduction in terminal costs for producers. The most prominent agreement is with Mission Terminal in Thunder Bay. The CWB receives from Mission Terminal a “terminal rebate” for all shipments of CWB grains directed to Mission Terminal (the amount of rebate is not publicly known).

Although, on the surface, these activities reduce the producers’ costs, there also appears to be a lack of competitive forces in play. It has recently been reported that Mission Terminal, with 121,240 tonnes of space (just over 10% of the total capacity in the port) is receiving as much as 60% of all the railcars of CWB grains shipped to Thunder Bay; the other six operating terminals share the other 40%. Moreover, even though Thunder Bay has excess, unused capacity, the CWB shipments into Mission Terminal have been so great that Mission has recently expanded its storage and receiving capacity, utilizing a grant from the provincial government of Ontario.

Although this does not cost producers anything directly, it is indicative of a very inefficient approach to grain handling on behalf of the CWB.

Conclusions

There is ample evidence to support the premise that the CWB system is a high cost system as it relates to the non-CWB system of marketing grain. Not only are the handling charges by elevator companies higher on CWB grains, but producers also cover CWB costs.

Moreover, the system of drawing CWB grain into the elevator system is passive, not allowing much latitude in pricing by elevator operators since they do not control the flow of grain, in or out of the elevator; additionally, they are limited in terms of price incentives they can offer to increase deliveries from producers and, there is very little they can do to decrease or delay deliveries of CWB grains in order to manage the flows of CWB and non-CWB grains to the most efficient level. Ultimately, all this comes at a large cost to producers.