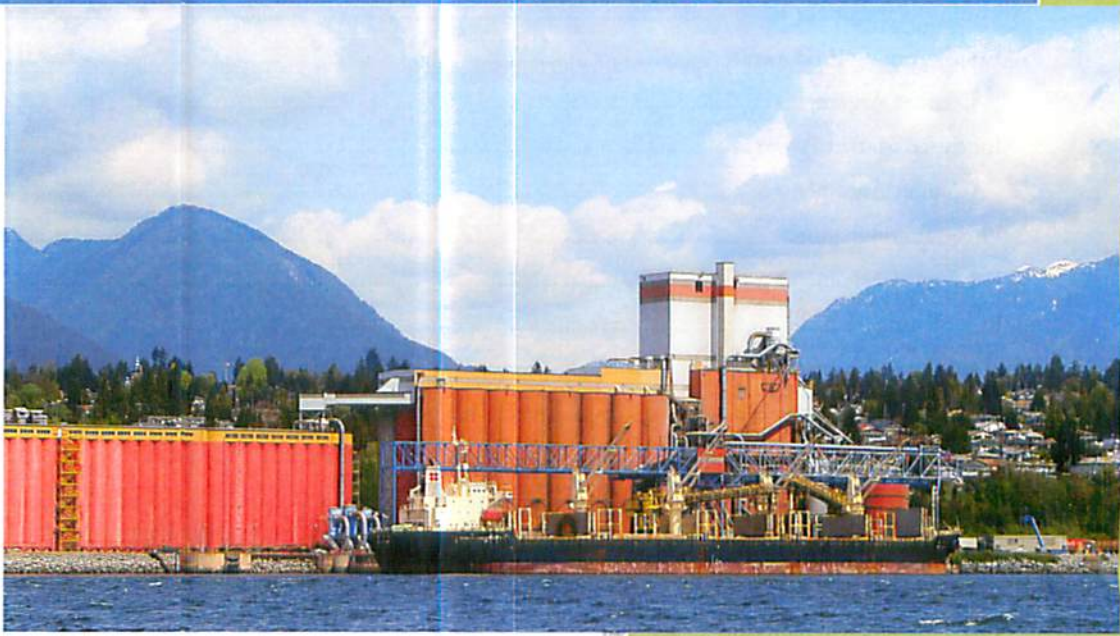


Measuring the Impact of Pooling



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Table of Contents

Pooling by the CWB.....	1
Apparent Rationale for Pooling.....	1
Equity Among Producers	1
Counter Arguments	2
Increased Market Power	2
Counter Arguments	2
Price Discrimination.....	3
Counter Arguments	3
Risk Sharing	3
Counter Arguments	3
Economies of Scale	4
Counter Arguments	4
Other Impacts of Pooling.....	4
Price Signals	4
Cash Flow.....	5
Inability to lock in high prices	5
Pools and Open Markets Don't Mix Well.....	5
The Marketing – Pooling Disconnect.....	6
Conclusions	6
References	7

Measuring the Impact of Pooling

Mandatory price pooling is a foundation of the CWB system. Pooling is meant to share the market risks among all western Canadian farmers by giving each farmer his or her fair share of the highs and lows of the marketplace. It also removes the risk for farmers that prices will drop before they are able to harvest or deliver their crop, because it guarantees that farmers will receive the same total payment for the same grade of grain, regardless of when the grain is actually delivered during the crop year.

The CWB pooling system is often criticized that it can't react to changes in market prices. Also, experience tells us that the CWB and its pooling fall short of their promise. This report looks at the basis reasons for pooling and, in that context addresses inherent shortcomings of pooling in Western Canada.

Pooling by the CWB

On its website, the CWB indicates the reason for pooling by the CWB:

Price pooling shares the market risks among all western Canadian farmers by giving each farmer his or her fair share of the highs and lows of the marketplace. It also removes the risk for farmers that prices will drop before they are able to harvest or deliver their crop, because it guarantees that farmers will receive the same total payment for the same grade of grain, regardless of when the grain is actually delivered during the crop year.

Price pooling also has an important impact on the CWB's ability to market farmers' grain. Price pooling allows the CWB to focus on taking advantage of different customers' willingness and ability to pay for different levels of quality for grain and optimizing the efficiency and effectiveness of the Canadian grain handling and transportation system as a whole. The goal is to optimize the total net returns for each of the pool accounts for the crop year.

Although there are a number of reasons to pool revenues, the main thrust by the CWB is to equalize returns between farmers and to maximize farmers' returns.

Apparent Rationale for Pooling

In a paper presented to the 2005 Annual Meeting of the Canadian Agricultural Economics Society, Kate Stiefelmeyer and Al Mussell of the George Morris Centre, presented a explanation of the apparent rationale for pooling. The factors they presented as reasons why price is pooled are used to here to structure a critique of the CWB's pooling activities.

Equity Among Producers

Pooling has its roots in the cooperative movement, with its initial purpose to provide equity among producers. Some believe that all producers, regardless of the timing of their deliveries should share in all market opportunities available throughout the crop year. This concept is, at times, extended to the issue of sharing infrastructure costs as well.

For some farmers that support the CWB single desk and the concept of pooling, this is a fundamental aspect of the value they see in the CWB. They have said they don't care if the CWB gets them the best price or not, as long as everyone gets the same.

Counter Arguments

- The counter argument is manifold, but primary to the argument is the issues of whether the CWB is adding value to the marketing of farmers' grain. If it can be shown that farmer returns with the CWB are lower than without it, equity is a very difficult argument to support.
- Pooling takes the decision to price or value away from the producer; all producers are assumed equal in the eyes of the CWB. However, they are not. Farmers are being denied the ability to make value decisions for their individual farm operations; farmers have different cost structures and different needs. They sell for different reasons; pooling reduces their ability manage their own enterprises to the best of their ability.
- Pooling also takes the decision of how much to sell away from the producer. There are many situations where the CWB failed to sell as much grain as many farmers would have liked or needed. A prime example of this is the durum pool in the 2009-10 crop year in which the CWB accepted only 52% of the crop contracted by farmers. Analysis showed that the total farm revenue was about \$3.50/bu in Saskatchewan; with a typical 40 bu/acre yield, this represented total revenue of about \$73/acre. With typical cost of production of \$140/acre, this meant that durum farmers ended the year with a cash flow deficit of about \$67/acre, or over \$10,000 per quarter.
- Because of pooling, Western Canadian farmers cannot develop a value-added processing enterprise outside of the control of CWB pooling. If a farmer (or group of farmers) wanted to vertically integrate and process their own wheat, they would still need to sell their wheat into the CWB pool (for the pooled return) and then buy it back for processing. Since the domestic market is a premium market for the CWB, the farmer-owned processor would pay more for the wheat than what the farmer-owners would get paid. Although the sale price to the processor would be a commercial price, this gap between what the farmer receives and what the processor pays is an impediment to enhancing and stabilizing farmers' businesses. The purpose of vertically integrating is to remove the pricing of the grain from the equation all together; the CWB's approach (due to pooling) fails at satisfying that need, so fails at providing market stability and wealth for farmers, one of the foundations of pooling.

Increased Market Power

According to Stiefelmeyer and Mussell: "The amalgamation of many producers product allows small-volume producers to compete with larger scale producers for market opportunities. Having a large amount of product to offer a buyer can result in improved bargaining power and possibly improved prices. If the pool is large enough to act as a primary seller this can also increase competition among buyers of the product."

Counter Arguments

- The grain industry is mature and is populated with many competent marketers, most of which can execute very large sales. CWB pooling is not required to improve bargaining power.
- It has been reported that, at times, smaller producers struggle to get access to the grain handling system due to preferential treatment to larger farmers. Although it is not the role of this report to address that issue, it must be stated that the CWB does not control the grain handling system and elevator operators' differentiation between producers of different sizes if they deem appropriate. In other words, CWB pooling does not assist "small-volume producers to compete with larger scale producers for market opportunities".

- Pooling impedes farmers' ability to develop and service niche markets. This is particularly true for smaller farms that would benefit from developing an alternate market for grain to avoid competing with larger farms for access to the conventional grain handling system.

Price Discrimination

According to the George Morris presentation: "A large pool may receive higher prices in certain markets if it can effectively price discriminate among regions, customers, or end uses. Price discrimination among various customers increases total revenue and thus the average price received over the pooling period."

Counter Arguments

- Measuring the actual effect of price discrimination is difficult since some "price dispersion" (price differentiation) is expected in the market for a commodity (Rude, Brewin and White 2008). There is no reason that the dispersion should necessarily imply that explicit price discrimination is being practiced. Put another way, mandatory pooling is not the only means to achieving price discrimination. In fact, there is evidence that grain trade participants price discriminate in open market (non-pooled) commodities such as canola. Japan is a consistent buyer of canola, regardless of the price; however, Mexico is more price sensitive and will buy only when the price is right. In years when the Canadian market needs to clear canola to additional markets (such as Mexico), the market responds with lower prices to generate demand from these additional buyers. Once the demand is satisfied, the market rebounds to a higher level in response to a new supply/demand balance equilibrium. Traditional buyers like Japan continue to buy at the higher levels; in this way the market has created a price dispersion in many ways not unlike the results of intentional price discrimination.
- Studies have indicated that the impact of price discrimination such as what the CWB suggest may be too small to be concerned with.
- Often, price discrimination or price dispersion is on the basis of product differentiation (quality differences); for example, the CWB often indicates that it can get a premium for Canadian wheat (a type of price dispersal) due to the high quality of Canadian wheat. This price difference would exist even without the single desk and pooling.

Risk Sharing

Pooling provides a mechanism for producers to share in the proceeds of sales at different prices (Johnson, 1999) and different times. Therefore, producers' market risk is shared with other pool participants because all producers share in the highs and the lows of the market and receive the same payment for their wheat, regardless of when it is actually delivered or sold during the pooling period. This is the risk management aspect of pooling; many farmers have expressed support of pooling for this reason alone.

Counter Arguments

- Pooling and the inherent poor price signals it provides mutes proper incentives for the demand for grain handling services.
- Revenue does not need to be pooled to manage risk; there are other more efficient methods available. At a minimum, farmers that are attracted to the notion of averaging out market volatility over a crop year can arrange to have their production sold at predetermined intervals so that their crop is sold throughout the year. For example, farmers can sell one-twelfth of their production each month.

Economies of Scale

In theory, economies of scale in marketing efforts, transportation, and logistics may be realized as a result of pooling. For the CWB with its dominant size and position in the grain sector, this means it has considerable countervailing power over other players in the sector.

Counter Arguments

- As a dominant player in the grain system, controlling shipments of all pooled grain, the CWB does hold considerable countervailing power over grain companies. Through tendering, grain companies compete for additional railcars of CWB grains. These tenders show the grain companies' willingness to discount their handling revenues in order to get additional volumes; however, the CWB restricts the amount they tender to less than 20% of the total CWB program.

Other Impacts of Pooling

Price Signals

One aspect of pooling is the fact that a full price cannot be provided on delivery or reported publicly during the crop year. This is due to the fact that prices change over the year and there is no way of knowing with certainty what the final payments will be. For this reason the CWB pays only an Initial Payment on delivery into the pools – typically about 65% of the expected year end value (which is also an estimate). In an effort to provide meaningful price signals the CWB issues monthly a Pool Return Outlook (PRO).

According to the CWB's website, the objective and purpose of the PRO is as follows:

The CWB Pool Return Outlook (PRO) is a projection of how much money the CWB will end up returning to farmers who deliver wheat, durum or barley for payment through the pool accounts. The pool accounts provide farmers with the average return (for a particular grade and class of grain) that the CWB obtained from all customers who bought western Canadian grain throughout an entire crop year.

The first PRO is released in February, before seeding has even taken place, and continues each month until March of the following calendar year. After that, PROs for wheat, durum and malting barley are issued every other month until September (March, May, July and September). The feed barley PRO continues on a monthly basis.

The PRO represents the best forecast that can be made at the time. For obvious reasons, it becomes increasingly accurate as the crop year progresses and grain sales proceed.

A huge variety of factors affect prices for wheat durum and barley. Because of this, the PRO can only be a forecast, not a guaranteed price.

The PRO is designed to give farmers market signals and to provide an indication of cash flow expectations. It gives farmers an idea of what pooled payments to expect. It can also be used to help decide when to take advantage of off-board markets or use Producer Payment Options to manage individual price risk.

The most critical time for price signals is in the late-winter / early spring, when cropping decisions are being made. All crops compete for acreage and farmers need meaningful information regarding the relative value of each cropping option. The PRO is the only signal available from the CWB on wheat, durum and malt barley. However, the main difference between the PRO and open market signals such as forward contracts is critical; prices of non-CWB crops can be locked in while the CWB PRO cannot be used to lock in prices.

Since PROs cannot be locked in, there are somewhat meaningless and can be potentially misleading. The following table shows the amount the PRO for each CWB crop missed the final value of the crop in each of the last four years.

In 07-08, the initial (Feb) PRO on each crop proved to be dramatically low when compared to the final return. In the subsequent two years, the PROs were dramatically higher than the final pool returns. In the current crop year (10-11), the final pool returns are not yet available; current PROs are dramatically higher than the first PRO issues in Feb 2010.

PRO to Final Pool Returns

	07-08	08-09	09-10	10-11
CWRS	-\$152.06	\$78.64	\$52.20	-\$117.00
CWAD	-\$272.53	\$84.76	\$97.85	-\$117.00
2Row Malt	-\$59.59	\$45.95	\$54.58	-\$45.00

In those years when the initial PROs were low, it can be argued that farmers may have decided against growing CWB crops because other options looked more attractive. Alternatively, when the early PROs were higher than the result, farmers have grown something based on an artificial price signal that they can't respond to. In many respects, farmers end up acting on faith rather than certainty. Knowing this, many farmers have opted out of growing wheat except for rotational requirements.

Cash Flow

The issue of cash flow was already addressed above, however from the perspective of the total deliveries available to a farmer. There is another cash flow issue with pooling. Due to the conservative managing of the risk to the pool through paying only an Initial Payment on delivery, farmers are dealt with a significant cash flow issue. This is exacerbated with the CWB's passive approach to allowing deliveries into the system through Contract Calls.

For example, early in 2010-11, durum farmers were allowed to deliver only 25% of the amount they contracted to deliver; additionally, the Initial Payment for #1 CWAD 13.0 was only \$1.73/bu in Saskatchewan. Assuming a yield of 40 bu/acre, this meant that durum farmers with high quality durum could only deliver 10 bu/acre and receive a total of \$17.30/acre. When compared to the cost of production of \$140/acre, it becomes clear the magnitude of this problem in cash flow terms. (Many producers faced with this, sold high quality durum to the local feed and/or ethanol markets for \$4.50/bu, with no limits on what they can deliver.)

Inability to lock in high prices

PROs are used as a market indicator but are unavailable to lock them in. Many farmers are also good marketers and would benefit from the ability to lock in prices effectively on CWB grains when they see a price opportunity that works for them. The lack of ability to do this impedes wealth creation at the farm level. (The CWB has developed a number of Producer Pricing Options (PPOs) for farmers to use to react to the market. Their use is variable as they come with a high cost and are unnecessarily complicated due to the fact that the CWB prices them through the pool.)

Pools and Open Markets Don't Mix Well

- Particularly in the barley markets, we see that pooling and open markets don't mix well. The pool price (PRO), as a forecast and not a reflection of the current market price, has a tendency to distort the open market values. For example, the feed barley PRO (conservatively reflecting the CWB's assessment of

potential export prices) tend to be lower than the domestic market for feed barley in many areas. This tends to be considered by many in the domestic markets as a floor price to the domestic market; if the domestic market price drifted lower, the level of the PRO would provide some support since it is assumed that farmers could simply sell to the CWB instead of to the domestic market. However, the CWB is often limited to the amount of feed barley it will accept in the pool due to lack of markets.

- In times of strong markets, domestic feed barley prices have been known to rally strongly while malt pooled barley prices (PRO) remain flat. The current year is an excellent example of this; the malt barley pool price is flat even though all crop prices are rallying. The CWB sold a large amount of malt barley early in the year when prices were relatively lower. The crop ended up being a very poor quality and there is limited amounts left to be selected for malt and so the CWB is limited to what it can sell at the higher prices. For this reason the pool return is flat while the domestic feed barley price is rallying and farmers that have good quality barley that could be used for malt are selling it into the domestic feed market. This non-responsive pricing system makes it very difficult for maltsters to ensure a good flow of barley into their plant; further, it impedes their ability to send farmers meaningful price signals to get barley grown in the first place.

The Marketing - Pooling Disconnect

Marketing begins at deciding what to grow and how much of it to produce and what specific parameters will be sought. It continues on to selling and shipping the finished product.

Pooling by the CWB impeded this whole process; the initial stages of marketing – those performed by the farmer (deciding what to grow and how much to produce, then tending to the production and safe storage of the finished product) – are being performed in isolation from the rest of the process. It's pooling and the processes around it that is interfering with this process.

Conclusions

Pooling is used by the CWB to provide equity among farmers and to maximize returns for farmers. All farmers who sell into a CWB pool do indeed get the same price and delivery opportunity. However, although the CWB argues that pooling is required to achieve its goal of maximizing returns for farmers, it can be shown that pooling is not required and in fact creates more problems than it solves.

The CWB could maintain its single desk without pooling, providing farmers with meaningful spot prices and effective risk management tools.

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