Grain transportation under a new wheat marketing regime

A grain company perspective

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APPROACHING THE QUESTION

Top down

Bottom up
WHAT IS A “GRAIN COMPANY”?
COMPANIES DIFFER STRATEGICALLY
Pooling

Closed loop contracting

Inventory protection, control & rationing

Port designation/terminal agreements

Car allocation

Customer exclusivity
LOBBYISTS
Because it's hard for politicians to decide stuff on their own.
INFLECTION: BUT WHICH WAY?
POTENTIAL STRATEGIC MOVES

- Processors originate
POTENTIAL STRATEGIC MOVES

- Processors originate
- Originators process
POTENTIAL STRATEGIC MOVES

- Processors originate
- Originators process
- Pure handlers merchandise
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- Inventory security
INDUSTRY WIDE CHANGES

1. Working capital
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2. Seasonality & price volatility
INDUSTRY WIDE CHANGES

1. Working capital
2. Seasonality & price volatility
3. Margin volatility
INDUSTRY WIDE CHANGES

1. Working capital
2. Seasonality & price volatility
3. Margin volatility
4. Dynamic market
PRINCE RUPERT THROUGHPUT (MILLION TONNES)

Source: Canadian Grain Commission
INDUSTRY WIDE CHANGES

1. Working capital
2. Seasonality & price volatility
3. Margin volatility
4. Dynamic market
5. Different OD pairs?
WESTERN CANADIAN OATS AREA (HUNDRED THOUSAND HECTARES)

Source: Statistics Canada
PAUL'S QUESTION

“It is likely that the “new CWB” will be contracting with farmers for supply and with end users for final sale, but will have to contract with the current grain companies, who will also be its competitors in the market, for logistical services. The key question is whether this can be made to work in a free market situation or whether some regulatory control is necessary.”
TIME TO MOVE FORWARD

Thank you for your attention
Good morning. It’s a privilege to be here with you—and to be honest, also a little weird. In all my years of working in and around the grain industry, I never imagined being in this situation, talking about the Wheat Board losing its monopoly and regulatory role.

Normally, at this point in a speech, I would be expected to impart some humour—but I’ll dispense with that. First of all, as my kids repeatedly told me over many years, I’m not that funny. Secondly, the topic at hand is complicated, and I have a limited amount of time to cover a whole bunch of issues.

So let’s get right to it. I was approached to be here today, as your agenda says, to “provide an informed opinion on the way the grain industry will change with the new policy environment”. Some people analyze “top down” and look at macro issues, providing a description of the landscape from 35,000 feet. Others prefer a “bottom up” approach, looking at individual market participants. As a Canadian, I have chosen to compromise—no, not look at this sideways; but to compromise by using both approaches, bottom up and top down.
I’ll start with the latter, if only because I presume the reason why I’m standing here is because I ran one of those bottom up “grain companies” for 17 years. Those two words “Grain Company” probably conjure up some sort of mental image in each and every person in this room—the way the word “car” or “boat” does. The fact is, a Chevy is not a Ferrari, and a dinghy is not the Queen Mary. Accordingly, I think it would be worthwhile to take two seconds to do a deeper dive into the two words “grain company”.

Generally speaking, “grain companies” are intermediaries. They don’t grow grains or oilseeds. They’re not the ultimate consumer of those raw materials. Grain companies do things in between the growing and the consuming. They move grains and oilseeds and, perhaps, process them—to generate profit by changing form, location, or both form and location.

Some may disagree, but in my experience each and every grain company has at least one competent, credible competitor. Just being a “grain company” involves accessing lots of capital and day to day material business risk. To generate an appropriate return means doing
something different than your competitor. Hence, each and every company has its own distinctive twist on how to “go to market”. Put differently, each company has its own distinctive strategy.

No doubt, we have all experienced—or created—some form of the following simplified value chain slide. The starting point for value creation is at the farm. At some point, farmers transfer ownership of their production to a grain company—in the case of Board grains, the form of that ownership transfer is prescribed by agreement between the grain company and the CWB. Although the grain company has title to the grain and is responsible for maintaining its quality, the grain company is also an agent and will move the grain in accordance with the instructions of the Wheat Board. In doing so, the grain company provides various services and earns revenue—the grain is more valuable by virtue of being cleaned and put in position for subsequent direct movement to a customer, or in position for transshipment by vessel to an off-shore customer.

Now let’s overlay some hypothetical firms. First, let’s consider Company A. Its strategy involves cultivating
farmer customer loyalty, and leveraging this “downstream” to promote a reputation that it is a strong, reliable grain originator. It may sell inputs, bins, or provide financing. It has a low presence in transforming raw materials.

Now, let’s consider Company B. It gets market leverage from focusing its capital and management on transforming raw materials into both significant and niche market consumables. Its strategy involves having distinctive competence in product innovation manufacturing efficiently. It mainly relies on others to originate product.

Company C has chosen another strategic path. It has chosen to vertically coordinate its business. By using supply management skills, it “keeps money in the family”, to optimize financial returns and volatility.

Company D is a foreign player, with no Canadian assets. However, it merchandises wheat and barley globally to leverage its skills in risk management, and ocean freight and logistics.
I’m now going to use the same value chain slide—but instead of considering individual companies, I’m going to place a number of squares through the chain, which describe some of the ways the Wheat Board has had an influence historically. This is not an exhaustive list—but captures some of the more significant items.

- The Board as a monopoly has had exclusivity and employed price pooling. Price pooling largely removes volatility and seasonality from the pricing of wheat and barley. The Wheat Board uses formulas to finalize grade spreads within a wheat class—some would say this further masks market signals.
- The Wheat Board limits closed loop contract production, where grain companies can work with end-users to grow varieties with specific attributes.
- The Board has protected inventory through the year, so that customers wanting particular qualities can access supplies through the year. In years where production of certain qualities is limited, the Board has prevented so-called “cherry picking”, rationing particular grain to certain customers, and also...
moderating the flow of grain into the market through the year.

- The Wheat Board has determined port clearance location, and by way of handling agreements, has at times designated the particular loading terminal within a port.
- The Board administers rail cars allocation. While the system has changed over the years, in the interest of time, I would simply paraphrase a recent movie and say “It’s Complicated”.
- By determining which port and terminal through which it will fulfill sales—and administering car allocation separately—the Wheat Board has in essence fragmented “the grain pipeline”. It really hasn’t mattered one iota whether a Wheat Board handling agent is a Wheat Board accredited exporter. Grain companies with country elevators, merchandising and transportation skills, and port terminal assets have been prevented from creating an integrated management approach to combine and synergistically leverage those skills.
Let’s move the discussion along by combining my previous slides. In short, this is a schematic diagram of the past and current Wheat Board market environment for grain companies. In this world, companies are indeed free to compete in one, some, or even all of the fragments. Companies that resemble Company A compete to provide farmers with handling services. They can compete effectively without downstream merchandising skills because the Wheat Board will merchandise and allocate cars. At the other extreme, grain companies that process wheat and barley do not have an absolute business need to either own assets to originate grain—or formally contract with originators. The Wheat Board protects inventory for firms like Company B—and fulfills orders to grain companies like Company B through the car allocation system. The same goes for Company D. So, Company B or D can choose to own origination assets, or not. Owning origination capacity does not materially impact on Company B’s ability to focus on manufacturing, or Company D’s ability to run a global merchandising business in wheat. As I mentioned, Company C is prohibited from implementing
any plan that crosses two or more of the big red lines that split the Wheat Board marketplace into six or more pieces.

In this market, grain companies have an incentive to lobby for change—or lobby for the status quo—to protect or enhance their competitive position. It’s no wonder the grain industry has been a political cauldron—especially when it comes to Wheat Board grains. The industry has experienced ongoing vigorous debates, as in the case of the Estey report, which proposed removing a number of my big red lines. The debate rages on today, with one of the hot buttons being the issue of “port access”.

The Government has stated it will remove the Wheat Board’s monopoly. For the sake of this presentation, I assume this will happen as planned. Customer exclusivity will be no more. That change will tip over other dominoes. Grain companies free to sell anywhere will be free to designate loading port and terminal. Companies will in turn allocate cars—as is the case with canola—to optimize their networks. Companies will be free to buy inventory to meet sales, and will be free to invent
storage programs, invest in storage assets, and develop different and/or new forms of grain contracting—including contracting for specific end use customers. In summary, the freedom to market will, in turn, remove the barriers that have created a series of fragmented sub-markets within the Canadian grain industry.

So, back to the question I was asked to address: what are the implications for grain companies? One of the most common answers to any question applies here—“it depends”. Are you Company A, B, C, or D? What are your assets? What’s your capital base? What talent do you have on your bench? That’s why I started this presentation with a “bottom up” view of the industry.

Five months ago, the consensus was the federal election would produce an outcome that would, in all likelihood, sustain the status quo within the industry. I strongly suspect that five months ago, most grain companies figured they would stick with or maybe tweak their existing strategy. The unexpected change to the Wheat Board—expected to occur over a relatively short period of time—shifts the tectonic plates of regulation. Companies that materially relied on the Wheat Board to
provide shipping capacity, volume, rail cars, and/or inventory security now face a potential strategic inflection point. An inflection can be either up or down—there will be winners, and losers.

I think the odds are reasonable—not 100%, but I think greater than 50%—there will be significant, dynamic competitive moves made by some grain companies over the next year. Because competitive business actions are dynamic, the actions of one firm may impact on the subsequent business tactics of others. There is a potential for surprises, and bold actions. The overarching motivators for this are two-fold: first, some companies must address strategic weaknesses that, left unaddressed and put bluntly, stand an excellent chance of becoming fatal weaknesses. Second, some companies may see this period of major change as an opportunity. I don’t think it would be appropriate for me to drill down into what specific companies I think might do what and when, but I will outline a few of the strategic business moves that might make sense.

- Grain companies that process and have relied on the Wheat Board to source grain through its country
handling agents will move to address this weakness—through contract, construction, or purchase.

- Some grain companies may choose to enter processing, or expand existing processing operations. This will certainly be the case if capital markets are not in the tank, and agriculture retains its investment glow.
- Originators that have limited merchandising and logistics expertise will seek to address this weakness. Some may do it through strategic alliances. Some may hire talent. Others may look to sell at a time when processors will be looking for origination assets.
- Non-aligned port terminal operators that have relied upon the Wheat Board for base volume will seek to address the lack of committed consistent inbound volume. I will return to this subject later.
- Companies that have had limited presence in Canada are likely to change that. At its simplest, firms may establish a trading office. At the other extreme,
foreign firms may look to have their own country assets.

- Companies—both Canadian and non-Canadian—that need very specific qualities of grain for their own purposes, or for export customers, will either build storage or develop on farm storage and/or contracting programs to secure inventory.

So far, I have been doing “bottom up” analysis of the changes that appear to be imminent. The collective actions of various firms will be a major part of how history will be written, ten or fifteen years from now.

But there are other implications for grain companies, independent of what any owner, CEO, or Board may decide. These are changes that are largely independent of any individual company—or involve issues that no one grain company can decide. I could probably make a list of 20 or 30 things that may change—I will focus on five.

The first implication is one that I suspect has already or is being dealt with by all grain companies, and it involves financing purchases. This is relatively straightforward—when companies buy grain they pay farmers. Historically,
grain companies have been able to finance Wheat Board transactions using off-balance sheet tools. The evolution from a monopoly will mean grain companies will need to finance wheat and barley purchases. That could mean the industry may need as much as about $1.5 billion in additional working capital. This change should not be difficult for most grain companies to execute—it will have the effect of making communications a bit more complex.

A second and more significant potential development relates to volume seasonality and price volatility. A system where initial prices are set in August—and possibly increased during the crop year—combined with a “contract call” process is a regime with much greater stability than the open market. Now imagine a scenario where wheat and durum prices at harvest are high and forecast to decline. Many farm businesses will seek to convert inventory into cash in the proverbial “asap”. I believe market is likely to incent grain companies to build more surge storage—probably in the form of big volume annexes or even flat storage. The new ICE Futures Canada wheat contract is likely to provide grain
companies with a carrying charge market, and if this is indeed happens, the construction of surge storage is even more probable.

The general stability inherent in an “initial price-contract call” system has been the main contributor to lower grain company gross margin volatility in CWB grains. Over my roughly 25 years of first hand observation, I would unequivocally say that Wheat Board gross margins per tonne have fluctuated within a relatively narrow range compared to canola or special crops. Some observers not familiar with how grain companies generate margins have said that charges for wheat and barley are regulated and will deregulate in the future. This is of course not the case—the relative stability of grain company margins is more a function of the stability of the underlying price for wheat under the CWB, and the fact that under the monopoly, price has not been the primary signal for farmers to deliver wheat. In my humble opinion, the removal of the monopoly leaves price as **THE** lever—indeed the **only** lever—to signal the demand (or lack thereof) for farmers grain. As prices fluctuate, and various companies execute their
strategies, as a third “top down” implication, I predict grain company gross margins are going to be more volatile.

A fourth implication for grain companies stems from the Wheat Board disappearing as “Producer-Director” of grain flow. Much as a puppeteer controls the actions on-stage, the Wheat Board has “top down” managed its programs on behalf of farmers exporting wheat, durum, and barley. To use one “for instance”, as I mentioned before—and said I would return to—the Wheat Board has sold grain ex certain ports. The Wheat Board has, at times, cross-hauled grain—paying adverse freight—to meet commitments at those ports. Judging by media coverage alone, it would seem there is a strong consensus that the volume of grain moving through Churchill will drop—the question being if it will be to the point where the facility cannot generate sufficient annual volume to cover its fixed cash costs.

One port that has received much less media attention is Prince Rupert. Over the course of the last 25 or so years, Wheat Board grains have been the mainstay of the business of Prince Rupert—accounting for well over 90%
of volume in most years. Despite the significant rise in the production of canola and pulses within western Canada, Board grains pay the bills at Prince Rupert.

The ownership, financing, and legal structure of Prince Rupert is complicated. Put simply, the terminal was conceived amidst the bullish mindset of the late 1970’s. It was financed by the Government of Alberta—soon after it became operational, grain markets went into a tailspin. The losses incurred at the terminal were simply added to the outstanding principal, due in 2035. The amount outstanding is high—this debt will probably not be repaid in full.

Business 101 suggests the owners of Prince Rupert have an incentive to use it simply as a surge terminal. To the extent to which it makes sense to fully use Vancouver terminals, companies will do so—providing Prince Rupert with enough volume to cover annual fixed cash costs. The volume needed to do this is well below the volumes of recent years. In years where grain production is high, or there are strong seasonal surges that max out Vancouver, it will make sense to use Prince Rupert.
The topic of Prince Rupert provides an excellent segue into my fifth point—that being a potential for very different origin-destination pairings to emerge post Wheat Board monopoly. This could be significant for some or all grain companies. To the extent it does or does not happen involves one other party besides the Wheat Board and grain companies—that being the railways. Movement to Prince Rupert is via rail owned by CN. When grain volumes to Prince Rupert are in the four to five million tonne range, CN probably generates close to $100 million in revenue. What will CN do with its rates to Prince Rupert?

There are other situations where freight rates can create or preclude a market from developing. In the early 1990’s, trade in barley opened briefly under the “Continental barley market”. During that short time frame, California emerged as a significant purchaser of Canadian barley. The dairy industry in California is large—servicing a population of close to 40 million. In an era of where corn fetches over $7 per bushel, is California a potential barley market? A lot of Canadian
canola meal makes its way to that area—the logistics chain exists.

Unrelated to barley, Bunge, Itochu and a freight partner are opening a new loop track terminal in Longview, Washington—advertised to be capable of handling 8 million tonnes annually. As Canadian rail carriers look at this facility, will they provide shippers with rates that Canadian grain companies find attractive and viable?

Relative to a situation where the Wheat Board is involved, for companies longer term, a more dynamic market with greater price and volume fluctuations could have knock-on effects. I will explain by way of an example. For many years under CWB and Crow rate, Alberta was a key originator of oats for the US market. In the aftermath of oats being removed from the Wheat Board—and after the demise of WGTA, with full freight charges applying—oats became generally less attractive to Alberta farmers relative to other crops. I recall giving presentations to UGG country meetings during the mid-1990’s, saying that, over time, the production fulcrum for oats would shift east. It has happened. Similarly, I think that in the future, as the markets provide fully
transparent pricing to farmers regarding the value of various classes of wheat, there is a good potential for wheat and barley production to diversify and become more regional.

I would be remiss in my presentation if I did not mention, as an implication for grain companies, the impact of the Wheat Board itself as an ally or competitor to one or more grain companies. On the screen is part of the invitation e-mail I received from Paul Earl, in which he said:

“The key question is whether this can be made to work in a free market situation or whether some regulatory control is necessary.”

The Wheat Board has said it has evaluated 17 business models. At the end of the day one will prevail—so the last reel of the movie has yet to play out. In my last life, we had a number of false starts on Wheat Board change. It should come as no surprise that at those times we had lots of discussions about changes to the Wheat Board—both as a management team, and with the Directors. Some of the business models the Board may be
considering could have a big impact on grain companies. Others may not.

Just like any other organization, without a monopoly the Wheat Board will need to continually innovate, adjust its strategy, aggressively manage expense, and react to market events that present threats—and opportunities.

A harvest of success for the Wheat Board of the future will not germinate from the seeds of regulation. So to answer Paul’s “key question” of “whether some form of regulatory control is necessary”, I would unequivocally say “no”. It is time for the grain industry to stand proudly and independently. There are provisions under the Canada Grain Act that provide farmers and customers with various options and resources. Canada’s Competition Act has been relevant several times in the evolution of the competitive landscape of the grain industry.

I think it would be a sign of collective confidence, if the grain industry moved forward alongside energy, potash, mining, and forestry—without special treatment—as pillars of the western Canadian economy of the future.