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REFORM OF THE CANADIAN WHEAT BOARD: A "MADE IN CANADA" APPROACH TO MARKETING GRAIN

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Executive Summary

While hot button issues like single desk selling are currently subject to considerable public debate, opportunities for improving the day-to-day operations of the Canadian Wheat Board (CWB) remain under-explored.

This Information Bulletin argues that modest changes in the CWB's modus operandi can lead to increased transparency, efficiency and, therefore, better prices for producers.

By additional outsourcing of functions, namely by making use of available specialists in the logistics, marketing and trading (LM&T) of grain, the CWB can unburden itself of a range of operational tasks, allowing it to focus on long term strategy. Instead it would auction to the highest qualified bidder the LM&T functions for the expected harvests in the various market segments.

Such a system would

- rely on standard benchmarks like Minneapolis or Kansas City grain prices, making for transparency of net revenues achieved for producers and thus revealing the value of the CWB;
- allow the shifting, for a price, of credit and performance risks to specialists, while guaranteeing payments to producers and timely delivery to customers;
- retain all other aspects of the current interactions between producers and the CWB; and
- be consistent with the current outsourcing by the CWB of the management of its foreign exchange and interest rate risk as well as its IT-management.

The Information Bulletin presents two hypothetical scenarios of how the proposed system of auctions by the CWB of LM&T-contracts would work.

- In the first scenario a newly emerged Canadian specialist trader is the winning bidder. Given its small size and less than AA+ credit rating, the CWB insists on a (third party) guarantee that assures the CWB, hence producers, of the contractor's performance. The costs of guarantees will be built into the bid.
- In the second scenario a large traditional trading house is the successful bidder on two contracts, and its credit rating and capitalization are not a concern for the CWB. In this example the trader makes a loss on one contract and a slightly lower gain on the other. Regardless, the CWB will receive the contracted payment and pay producers, and the deliveries will occur according to the contract specifications. No new risks arise for producers.

The competitive bidding for the LM&T contracts brings costs and revenues into the open. The reliance on specialists is likely to result in better prices for producers, as outsourcing generally has that effect. No other change is required. Therefore the likelihood of trade disputes does not increase. And the CWB Board of Directors is enabled to concentrate on its mandated tasks.

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Introduction

The debate continues: whether or not single desk selling of Western Canadian grain provides the best return to producers. It is methodologically difficult to show that better returns may have been foregone in the past, yet the experience in Illinois suggests that, absent the CWB, farmers could also achieve worse results. While this battle – a battle that is in part ideological in nature – has been taking place, the world has moved forward and new services markets have evolved. There may indeed be $20 bills on the sidewalk that can be picked up by moving with the world – without, for the time being, abandoning the single desk.

In this brief discussion paper we argue that the Canadian Wheat Board (CWB) can improve its performance through increased recourse to specialized skills. As such, our proposal advocates further specialization of the process of marketing Western grains by out-sourcing functions which the present structure of the CWB is ill-equipped to perform itself. Our argument is to push the CWB further in the direction in which it has already ventured, for example, in some of its financial risk management practices.

1. What have we learned and what assumptions do we make?

It is useful to establish some desirable criteria for any change in the organization of the CWB. Accordingly we can likely agree on the following at the outset:

- Return maximization for producers is a key objective of the CWB.
- 'Single desk' is justified if monopoly power exists or is attainable. This is an empirical question that will be set aside here.
- The Auditor General's comments regarding the Board of Directors' performance should be addressed: there is no need for Directors (and producers) to engage in, or focus on, individual transactions and transactional risk management.
- Since marketing of grain and its logistics are closely related and affect profitability, proposed changes must consider logistics.
- Explicit recognition of funding costs and the cost of government guarantees must be made.
- Proposed changes must not increase the risk of trade disputes.

2. How Specialized Skills Can Modernize the CWB

The current CWB reliance on specialized risk management expertise is invisible to most observers. When the CWB borrows in foreign currencies (and it does[1]), it employs experts to manage the resulting foreign exchange and interest rate risks. The CWB's annual reports indicate that swap contracts are being used to alleviate/offset these risks. In other words, the CWB relies on the financial markets in its risk management. In its IT-management the CWB also relies on outside expertise.

We are proposing here that the CWB similarly engage in outsourcing grain marketing and trading. The role of the CWB vis-à-vis producers would be unchanged. CWB contract calls would continue, and CGC-grain grading standards would apply, and producers would continue to receive initial payments upon delivery.

What would change is grain marketing and trading: this function would be out-sourced to specialists that have developed as the world moved forward while the debate raged about the necessity for a single desk.

The nature of the proposed out-sourcing will be described below. It should be stressed here that this would simply be a step in the direction of using specialized expertise where it has become available at transparent service charges.[2] The benefit would be that market forces determine and deliver an explicit payment to producers, via the CWB, for the value of the CWB. The result would be a payment that is benchmarked, hence transparent. Analogous to outsourcing of the IT-function and the foreign exchange risk management function, the CWB would contract with specialists for the marketing and trading of grains. A producer asking, "Do we need to have our hand on the throttle, or can we have our hand on the shoulder of an operator who has his hand on the throttle?" would find that the latter would do just fine.

The flow diagram below outlines in detail how the proposed system would work.

- The entire left-hand side of the diagram shows the present system of unchanged interactions between producers and the CWB. The administrative functions are unaffected: risk management, policy determination, compliance and farmer advocacy roles are unchanged.
- A competitive bidding process will be instituted for the exclusive right to market and trade on behalf of the CWB specific amounts of grain for export. The CWB would treat grains for domestic human consumption exactly the same as grains destined for export markets.

1 See page 89 of its latest annual report where it is stated that the CWB's use of swap contracts converts all borrowings to the equivalent of floating rate obligations. http://www.cwb.ca/public/en/about/investor/annual/pdf/06-07/2006-07_annual-report.pdf

2 The CWB already uses "accredited exporters" extensively to market the grain. "Accredited exporters are national and multinational companies authorized to purchase grain from the CWB for resale to customers and other exporters. …Accredited exporters also facilitate sales through freight sharing and acceptance of financial risk." http://www.cwb.ca/db/buying/sales_process/accredit.nsf/accexppage?ReadForm

- This outsourcing agreement would be for a specific period, tendered on a regular schedule.
- Each bidding process will be on a commodity-specific basis as determined by end-use (e.g. malt barley), so as to attract niche market capabilities.
- The functions of the risk management contractors would be domestic and international logistics, marketing and trading, all on behalf of the CWB.
- Bids for the right to manage the risks of marketing and trading CWB grains would be quoted as a spread over a transparent benchmark price for a scheduled volume, e.g. Minneapolis or Kansas City futures.
- Non-pooling price proposals (Producer Pricing Options or PPO) would be separate from the primary marketing function and non-exclusive. As primary marketing, trading and logistics gives clear benchmark prices, the PPO-program can be administered by numerous competitors.
- Cash transactions would be under the auspices of the CWB to avoid credit risk to the outsourcing agents on actual grain movements.
- Primary and PPO contractors may resort to Export Development Canada (EDC) for performance assurance guarantees to supplement their own credit rating, if necessary.
- The timeliness of grain movements would be contractually governed.
- The risk management agreements would follow the documentation of the International Swap and Derivatives Association (ISDA). Its practices are well established and already used by the CWB.

3. Example #1: A Small Specialist Wins the Bid

Outsourcing of the marketing and trading function would take the form of an invitation to bid. In March, for the ensuing crop year, the CWB Board of Directors auctions off the rights to market and trade the winter wheat crop grown in Western Canada. Let us assume past experience, producers' surveys, and analysts' projections suggest a crop of, say, 100,000 tons, grading 50% #1 and 50% #2, with a range from 80,000 to 120,000 tons, and grade as high as 60% #1 and as low as 40%.

Based on these parameters, bids are invited and a handful or more entities submit bids for the logistics, marketing and trading (LM&T) of this expected crop. Among the bidders are domestic grain companies, multinationals, small trading companies, including new specialists who previously worked for the CWB.

For this example we assume that the winning bid is from a small specialist, "Buyers of Wheat in Canada" (BWC) offering "average Kansas City wheat futures" less $0.15 per bushel.

As BWC is a smaller company and does not have a credit rating of AA+ from any of the major rating agencies, the CWB will require a performance guarantee. Such a guarantee is nowadays readily available from EDC or from private insurance companies, and its cost would have been built into the price offered by BWC. Thus the CWB and producers will be insured against non-performance by the (smallish) winning bidder, by the other entities involved, and against non-payment by end-purchasers.

The winning bid would contain important details, such as the timelines for the movement of grain. For example, it might specify "50% movement 'off-the combine', with the remaining 50% moving by Christmas". To ensure this performance, BWC will have contracted not only with the railroads for car availability and movement, but also with inland and port grain handlers, resulting in a chain of contracts between BWC and these logistics experts. Yet, reliance on practices and procedures developed by the ISDA will allow that the payment to grain handlers and shippers will be made by the CWB. The documentation of the contract between the CWB and BWC will enable shifting these payments to the CWB, while non-performance compensation, if any, would go directly to the CWB from the insuring agent.

Suppose a bad outcome happens for BWC and they achieve an average *cash* grain sale of only $8/bushel, $1 less than the Kansas City futures price specified in the bid ($9.00). As in all good trading cultures, cash market losses tend to be offset by gains in other market segments. Let us assume that futures, forwards, options and other derivatives traded by BWC on behalf of the CWB gained an additional $1.50 per bushel for an overall gross return of the Kansas City futures price plus $0.50 to the CWB. In that event the CWB would pay BWC $0.65/bushel, or nearly $2.5 million (1 ton is equivalent to 36.733 bushels of wheat). Though this is a large amount paid to the LM&T agent, the cheques to the producers would still come from the CWB, and on time, and the average return to Canadian winter wheat producers would have exceeded comparable US producers' returns for the first time in 5 years.[3]

By way of further explanation of our example, we are "divulging" that the winning bid by BWC was actually linked to its bid for the marketing and trading of *feed wheat* for the crop year in question. BWC's internal rationale for the linked bids was the substitutability between these two types of wheat in many markets. And BWC had bid only $5.90 per bushel of feed wheat vs. $5.93 of the highest bidder. The CWB would normally auction each class of grains separately (i.e. barley, HRSW, etc.) to the highest bidder in order to benefit from specialists' expertise in each market segment. In this case, however, it had decided that the better winter wheat bid by BWC (on a larger volume) more than offset the $0.03 per bushel opportunity cost on feed wheat.

Suppose further, that in the course of the crop year the price of feed wheat collapsed to $4.50 from $5.90 per bushel due to timely rains in the US corn country and that BWC, for reasons of its own (technical analysis), did not sell until the price was below $4.75. Not having another hedge, BWC did incur a rather major loss on that contract with the CWB (around $3 million), but not much in excess of the gains on the winter wheat contract ($2.5 million). With netting provisions in the two LM&T contracts between the CWB and BWC, a payment of $500,000 by BWC to the CWB will have settled the two contracts. Had the loss on feed wheat exceeded BWC's equity capital, the CWB would have been able to claim against the performance guarantee written by EDC or a private insurer.

In this example, the small specialist makes a loss (and learns a lesson), but the CWB nevertheless delivers to producers.

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3 Pedde, R. (2007) Canadian Wheat Board Performance Benchmarking. *Information Bulletin 89.* University of Alberta: Western Centre for Economic Research.

4. Example #2: A Major Foreign Trader Wins the HRSW-Contract

In the same crop year the LM&T-contract for #1 and #2 HRSW, 13% and higher in protein, is won by a major multinational grain trader (Japanese or American). The bid was 'the higher of CDN$ 8.75 per bushel or the daily average Minneapolis DNS futures less $0.10 per bushel'. This bid leaves the CWB with the option to choose the more advantageous price when the future has become the present, an option attractive to the CWB. The condition attached to the bid was the extension of the contract on the same terms for an additional crop year, giving the multinational the benefit of another opportunity to perform its services.

In this case the CWB did not require a performance guarantee as the multinational has an AA+ credit rating.

Suppose, the multinational sold HRSW to Iran during the first crop year and Iran defaulted on the payment due to domestic turmoil. In this event the financial strength of the multinational enables it to withstand the loss, with the CWB, hence producers, fully compensated and without the need for recourse to the Canadian Government – as was the case with the infamous Russian grain purchases which raised the ire of American producers on account of the implied government subsidy.

Assume the Minneapolis DNS daily average price for the crop year was $8.50 per bushel and some of the HRSW-purchasers contracted by the multinational (on behalf of the CWB) paid substantially less than that. In this event the multinational would compensate the CWB the difference so that the #1 and #2 HRSW account paid producers the contracted CDN$8.75 per bushel.

For the same crop year the CWB might have contracted the PPO function with Morgan Stanley and Goldman Sachs, leaders in such financial markets. These specialists are assumed to provide internal risk management of these contracts for a fee of $0.02 per bushel. Producers choosing to participate in the PPO program would receive payment in the traditional fashion from the local grain elevator and the CWB. Rumours that Goldman Sachs and Morgan Stanley did well on the risk management contract – if that was the case - would entice future competitors into this segment. National Bank of Canada and Deutsche Bank Canada might be expected to bid more aggressively in the future, and the market will become deeper.

5. What Does It All Add Up To?

The point of these admittedly stylized and hypothetical examples is to show that Prairie producers can access the expertise of an increasing pool of professional traders without taking on additional risk. The CWB, modernized along the lines described, can play a productive role: it can coordinate and administer contracts with skilled logistics, marketing, and trading entities while preserving its three pillars of single desk selling (where it has identified market power), price pooling, and initial/interim payment guarantees.

The proposed changes in the CWB's modus operandi merely push it further in a direction the CWB has already embarked on. The CWB's auction activities will attract new and different types of competitors precisely because ownership of physical assets is not required. The existing Canadian grain companies will continue to provide handling services, and the winners in the bidding process may well not be the traditional grain companies, like Cargill or ADM. Toepfer International, for example, is a trading firm for agricultural products, with 43 offices worldwide handling more than 42 million tons annually, and it has a shareholder base that spans the globe. Firms like Toepfer International can be expected to participate in CWB auctions, bringing a whole new range of skills to bear with the ultimate benefit being a better price for producers.

It can also be expected that a global commodities trader like Phibro Inc. (a subsidiary of Citigroup) that deals in the 'over-the-counter' (OTC) cash, forward and options markets for crude and refined oil products, natural gas and various soft commodities, will become a bidder at CWB auctions. Marubeni and Itochu, Japanese trading houses, with established grain trading expertise, would likely be interested bidders and current staff in the CWB trading group might spin off to form as a new player in the LM&T process.

A final aspect of our proposed change in modus operandi pertains to the treatment of the smaller but not insignificant market segments, like the organic market producer-owned cooperative mills and breweries and direct export sales of niche varieties. The current debate about the value of these sectors to the single desk selling philosophy can be shifted in the direction of more transparency and possible resolution by including them in the auctions. For example, the specialty segments could be included in the auction for HRSW. If the best bid under these circumstances is 'HRSW Minneapolis futures price plus $0.05', but 'HRSW Minneapolis futures price plus $0.04' is the best bid with the organics excluded, information about the value of the organic segment becomes available and transparent. In fact, the marginal benefit of managing a particular niche segment by means of the single desk approach may turn out to be negative, giving the directors concrete evidence for excluding that niche market from inclusion in the single desk approach.

In light of the reduced likelihood of trade disputes and the above mentioned benefits of greater transparency from the application of specialists' skills that result from a bidding process, our reform proposal would appear to avoid downsides. With an approach not unlike the CWB's current recourse to financial expertise for its interest and foreign exchange risk management, a further step in the direction of beneficial division of labour would be taken and the CWB would join the 21st century.

Flows in a Restructured CWB Environment