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United Grain Growers Ltd.

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STRUCTURE AND COMPETITION WITHIN THE CANADIAN GRAIN HANDLING SYSTEM

In western Canada², we have seen steady consolidation in the grain handling network over the past 35 years. The number of country elevators (i.e., grain collection points) in western Canada has declined from approximately 5,000 in 1966 to about 850 today. We expect the number of elevators to continue to decline to about 400 within the next two or three years. In recent years we have seen several companies build a number of high throughput concrete or steel elevators, replacing old wooden elevators. These new facilities range in size from 10,000 to 50,000 tonnes in storage capacity. These facilities are capable of loading blocks of 50 to 112 cars, usually in an 8 hour shift. The number of these facilities has grown from about 70 five years ago, to 180 today.

The western Canadian grain handling industry is characterized by strong competition from a number of players, both large and small. Table 1 gives a breakdown of the number of facilities owned (excluding port terminals) and the total storage capacity for each of the major grain companies.

Two relatively new players on the scene are ConAgra and Louis Dreyfus. In the past three years, both these companies have made significant new investments in grain gathering facilities. This is a new source of competition which, to some extent, accelerated the rationalization plans of existing players. There are also 28 independents which are a significant source of competition. Nearly half of these consist of large, single-point facilities capable of loading 50 to 100 or more cars.

¹ The views expressed in these discussion comments are those of the author, and do not necessarily reflect views of United Grain Growers.

² The four provinces in western Canada account for approximately 85 percent of Canadian grain production and 95 percent of Canadian grain exports.

Table 1: Grain Companies in Western Canada, August 1, 2000.

Company	Number of Elevators	Storage Capacity (000's tonnes)
Saskatchewan Wheat Pool	249	2,005
Agricore	242	1,503
United Grain Growers	105	797
Pioneer	83	547
Cargill	54	512
N.M. Paterson & Sons	48	272
Parrish & Heimbecker	23	251
Louis Dreyfus	12	208
ConAgra	4	125
Other	28	539
Total	848	6,759

Source: Canadian Grain Commission, Grain Elevators in Canada 2000-2001

Table 2: Financial Results Selected Western Canadian Grain Companies, Year Ending July 31, 2000.

Company	Book Equity (\$Cdn, Millions)	Profit/Loss
Saskatchewan Wheat Pool	544	(90)
Agricore	378	1
UGG	226	2

Source: Annual reports

The four largest companies (SWP, Agricore, UGG, Pioneer) account for 72 percent market share, in terms of elevator grain receipts. However it should be noted that grain companies handle, in an average year, approximately 60 percent of western Canadian grain production – the rest is either used as feed grain domestically or trucked directly to domestic or U.S. processing plants. As a result, the top four grain companies typically handle between 40 and 45 per cent of total prairie grain production.

In short, farmers have a number of competitive alternatives, among grain companies and among alternate users of grain. Competition is intense, prompting one investment analyst to say there is “too much competition³” within

³ RBC Dominion Securities, Corporate Debt Research report on Saskatchewan Wheat Pool, July 14, 2000.

Table 3: Canadian Grain Production and Net Exports (3 year average).

Commodity	Average Annual Production 1998-00 (mmt)	Average Annual Net Exports 1998-00 (mmt)	Net Exports As A percent of Production (%)
Wheat (exc. durum)	20.3	13.0	64
Barley	13.1	2.3	18
Corn	8.7	(0.5)	(6)
Canola	7.8	3.8	49
Durum wheat	5.3	3.7	71
Oats	3.7	1.5	42
Soybeans	2.7	0.5	20
Dry Peas	2.5	1.6	64
Flax	0.9	0.6	69
Lentils	0.7	0.5	69
Other Crops	1.9	0.7	39
Totals	67.5	27.8	41

Source: compiled from Canada: Supply and Disposition for Grains and Oilseeds (November 27, 2000), and Canada: Supply and Disposition for Special Crops (October 17, 2000), Agriculture and Agri-Food Canada.

the prairie grain handling industry. Profit levels among grain companies tend to support this statement. For those companies that publicly disclose financial results, Table 2 shows their performance in the latest fiscal year. Given the high degree of competition and the low profit margins in recent years, we expect there will be some consolidation in the grain industry in Canada within the next few years.

CANADIAN GRAIN PRODUCTION AND EXPORTS

Table 3 shows the average Canadian grain production and net exports over the past three years. Wheat continues to be our biggest crop, although acreage and production have trended downward in recent years. Exports however, continue to be important, accounting for 64 percent of our wheat production and 71 percent of our durum wheat production over the past three years. In terms of production, barley is Canada's second largest crop. Most of the barley is used in the domestic feed industry. Most of what is exported is used for

malting purposes. Corn is our third largest crop, almost all of which is grown in eastern Canada. In recent years Canada has been a small net importer of corn. Canola is Canada's fourth largest crop in terms of production, second most significant in terms of value. About half of Canadian canola production is exported, in order of magnitude, to Japan, China, Mexico and the United States. Canada also has a mature oilseed crushing industry. The United States is our largest export market for canola oil and meal. Canada also grows significant quantities of many other "special" crops, including dry peas, flax, lentils, mustard and chickpeas. For several of these, Canada is the world's leading exporter.

As noted by Klein, Canada's share of world trade in wheat and barley is expected to decline. Klein cites FAPRI projections that estimate world trade in wheat to grow by 23 percent by 2010, while Canada's growth in wheat exports will be a modest 4 percent. Similarly, FAPRI projects a 21 percent increase in world barley trade by 2010, while the Canadian growth in barley exports is projected at 7 percent. In my view, these are reasonable estimates. If anything the Canadian estimates may be on the high side. Significant growth in Canada's domestic livestock industry together with modest growth in domestic food processing will limit any potential growth in exports, particularly in off-shore markets. Having said this, we expect that Canadian exports to the United States of wheat, barley and most other crops will increase over time.

CANADA/U.S. GRAIN TRADE RELATIONSHIPS

Klein notes that Canadian wheat exports to the United States have climbed since the implementation of the Canada-United States Trade Agreement (CUSTA) in 1989. He cites three reasons:

- elimination of wheat quotas and tariffs under CUSTA;
- elimination of Canadian transportation subsidies on grain shipments east and west; and
- the use of the Export Enhancement Program by the United States.

We would concur with these factors, although it should be noted that the U.S. has not used EEP on wheat exports since 1995, so this is no longer a contribut-

Table 4: Canadian Net Exports to the United States, Selected Commodities, Three Year Averages, 1989-91 and 1997-99.

<i>Commodity</i>	<i>Average Net Exports 1989 to 1991 (Cdn \$ million)</i>	<i>Average Net Exports 1997 to 1999 (Cdn \$ million)</i>
Wheat	31	327
Durum	48	125
Flour	4	48
Mixes, Doughs, Cereal & Bakery	(4)	193
Pasta	(6)	(37)
Oats	73	209
Barley	51	143
Canola:		
Seed	7	86
Oil	90	329
Meal	<u>51</u>	<u>229</u>
Total Canola	148	644
Corn	(70)	(122)
Flax	56	76
Soybeans	(29)	(44)
Soybean meal	(162)	(234)

Source: Grains and Oilseeds Statistics – December 2000, Agriculture and Agri-Food Canada

ing factor. To the Klein list, we believe the following reasons could be added as contributors to increased exports of wheat and other crops to the United States:

- appreciation of the U.S. dollar against almost all other currencies;
- greater economic integration – U.S. companies are looking to secure access to supplies of grain with certain quality attributes; and
- improved and lower cost rail linkages.

Table 4 illustrates the growth in trade between Canada and the U.S. since the CUSTA was implemented. The value of wheat exports from Canada to the United States has increased 10 fold since implementation of the free trade agreement. Durum exports have increased over two times. While this growth is substantial, in my view, these increases are actually less than what we would have seen under a completely free trade environment. That is, for political reasons, the Canadian Wheat Board (CWB) is restricting the amount that it sells into the United States. Absent the CWB, I am convinced exports of wheat

Table 5: Canadian Net Exports to Mexico, Selected Commodities, Three Year Averages, 1989-91 and 1997-99.

<i>Commodity</i>	<i>Average Net Exports 1989 to 1991 (Cdn \$ Million)</i>	<i>Average Net Exports 1997 to 1999 (Cdn \$ Million)</i>
Wheat	11	156
Durum	0	2
Barley	2	14
Canola:		
Seed	20	221
Oil	1	7

Source: Grains and Oilseeds Statistics – December 2000, Agriculture and Agri-Food Canada

and durum wheat from Canada to the United States would increase, unless the United States was able to restrict imports through some protectionist measure.

Interestingly, Canada has turned a small trade deficit in mixes, doughs, cereal and bakery products into a significant trade surplus. It would seem that Canada's competitive position in these products has improved over the past decade. We have also witnessed strong growth in the export of oats to the United States. Oats were removed from the jurisdiction of the Canadian Wheat Board in 1989 and are now freely traded under an open market, and produced and transported without subsidization.

The growth in barley exports primarily relates to an expansion of malt barley exports to U.S. maltsters. There has also been significant growth in the export of canola and canola products to the United States. Notably, the value of canola exports is nearly twice that of wheat exports. Canola and canola oil compete directly in the edible oil market against soybeans and soy oil. Canada is a significant and growing importer of U.S. corn, soybeans and soybean meal, a trend which is likely to continue.

CANADIAN GRAIN TRADE WITH MEXICO

Over the past decade, Canada has also seen substantial growth in the export of grain to Mexico, in part due to reduced tariffs under NAFTA and

Table 6: Trade Friction Matrix, Canada and the United States.

Commodity	Open Border	Market Distortions	Trade Friction
Wheat	NO	Yes	Yes
Barley	Semi	Minor	Minor
Malt Barley	NO	Minor	Minor
Canola	Yes	Yes	No
Oats	Yes	Yes	No
Flax	Yes	Yes	No
Corn	Semi	Yes	Yes
Flour	Yes	No	No
Mixes, Doughs, Cereals, Bakery Goods	Yes	No	No
Pasta	Yes	No	No
Soybeans and Meal	Yes	Yes	No

Source: compiled by author.

improved transportation and commercial linkages. Table 5 summarizes Canadian exports to Mexico.

RELATIONSHIP BETWEEN FREE TRADE AND LEVEL OF TRADE FRICTION

In examining the Canada-U.S. grain trade relationship, it is apparent that the highest degree of trade friction occurs for those commodities that are least freely traded and/or are subject to a high degree of market distortion. There is virtually no trade friction in those commodities where there is an open border. As shown in Table 6, products that fall into this latter category include canola, oats, flax, flour, mixes, doughs and bakery products, pasta, soybeans and soymeal.

Following is a brief commentary on the trade relationship for each of these commodities:

Wheat (including durum). Unquestionably, this commodity accounts for the greatest source of trade friction in the Canada-U.S. grain trade relationship. Perhaps this should be of no surprise. It is the commodity that is also characterized by the highest degree of government intervention and border control. Wheat is not freely traded. Farmers in western Canada are prohibited

from exporting their wheat (and barley) directly. They must first sell their wheat to the CWB. They are permitted to purchase their wheat back from the CWB and then export, however in such a case, they are viewed in the same manner as any merchant who buys wheat from the CWB for export. Western Canadian farmers who have attempted to sell their own wheat directly to the United States bypassing the CWB, have been convicted and have spent time in jail. Imports of wheat into Canada are permitted, although the relative prices are such that this happens only under exceptional circumstances, and in very modest amounts.

In the United States, wheat is a major beneficiary of public support. The wheat (and durum) market is characterized by a significant degree of market distortion, primarily the CWB control over marketing in Canada, and the marketing loan (LDP) program in the U.S. Again these factors contribute to the trade friction currently being experienced.

Feed and Malt Barley. The export of feed and malt barley from Canada to the United States is subject to the same restrictions that apply to the export of wheat and durum. That is, farmers are not permitted to sell directly and instead, are required to sell to the CWB prior to export. Exports to the United States consist primarily of malt barley – these supplies enter without too much protest. In recent years, some moderate quantities of feed barley have been exported from Montana into the feedlot markets in southern Alberta. Again, this trade has taken place with little friction arising.

Canola is freely traded. Canada is a large net exporter to the United States, although trade is two-way as North Dakota farmers often truck canola to crushing plants in southern Manitoba. This business is growing as American farmers expand their acreage of canola. Canada welcomes this development. The canola market is, however, characterized by a high degree of market distortion. Canola (or to be more precise, canola oil) competes directly with soybeans and soybean oil. In our view, the relatively high support prices for soybeans and oilseeds under the U.S. marketing loan program are leading U.S. farmers to expand soybean, canola and flax acreage. The resulting subsidy induced production is having a depressing effect on oilseed prices. Canadian canola farmers are being caught in the crossfire. In our view, Canada has a

legitimate grievance over this level of market distortion, however given the importance of the U.S. market to Canadian canola farmers, it is not one they are likely to press.

Oats were removed from the jurisdiction of the Canadian Wheat Board in 1989. They are now freely traded. Since that time, Canada has witnessed a dramatic growth in the production and export of oats, with little or no trade friction. The market however is not free of market distortion. The United States continues to import large quantities of subsidized oats from the European Union. These highly subsidized imports are having a depressing effect on prices for both U.S. and Canadian oat producers.

Flax is freely traded in a friction-free environment. The market is subject to the distortion caused by the high oilseed support price in the United States, although this does not appear to be having any adverse impact on the trade relationship.

Corn is freely exported from Canada to the United States, and until recently was exported freely from the United States to Canada. In November 2000, Canada imposed prohibitive dumping and countervailing duties on U.S. corn imported into western Canada. The duties were imposed by the Canadian Customs and Revenue Agency at the preliminary investigation level of a trade action brought by corn growers in the province of Manitoba. The duties were terminated in March 2001 because injury requirements were not met.

Flour, Mixes, Doughs, Cereals and Bakery Products, Pasta. These products trade freely between Canada and the United States. Tariffs are no longer applied and there are few trade irritants.

Soybeans and Soybean Meal. Again, these products are freely traded without engendering any material trade friction. As discussed, the U.S. marketing loan program is however a source of significant market distortion.

This analysis suggests that Canada-U.S. trade friction in the grain sector occurs chiefly in those commodities where there is the greatest amount of government intervention. Those products that are freely and openly traded are

not a source of trade friction. Market distortions are sometimes a factor in trade disputes, although there are some commodities, notably oilseeds and oats that appear to trade without any significant degree of trade friction, despite the presence of some significant market distortions.

CONCLUSION

The Canadian grain industry appears to be characterized by a high degree of competition, although low profit margins are expected to lead to some consolidation. Over the past decade, trade in grain and grain products between Canada and the United States has grown substantially. In particular, Canadian exports of wheat, wheat products, oats, canola and canola products to the United States have expanded considerably. The CUSTA was cited as only one of several reasons for expanded trade. Canadian exports of grain to Mexico have also increased significantly over the past decade, in part due to NAFTA and improved commercial linkages.

The paper also examined the nature of the trade relationship between Canada and the United States, and concluded that trade friction occurs in those commodities that exhibit the highest degree of government intervention. Those commodities that are freely traded are generally not a source of trade disputes, even in the face of significant market distortions.