

Saskatchewan Wheat Development Commission
Review of Proposal to Raise Western Canadian Primary Grade
Tolerances to Export Grade Tolerances

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Author:

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1.0 Introduction and Purpose of Review

The Saskatchewan Wheat Development Commission (SWDC) is a producer led organization established to grow the province's wheat industry. It was established on June 20, 2013 and it administers a mandatory (refundable) check-off used to fund research and market development initiatives that improve wheat varieties, grow their marketability and provide higher value to producers. The SWDC has requested a review of potential changes being considered to raise primary grade tolerances to export grade tolerances for wheat and durum and the implications of these changes on the activities and economics of Saskatchewan grain producers. In the preparation of this report, I would like to acknowledge the insights and comments provided by Dr. Harvey Brooks.

2.0 Author's Background

The author has extensive experience as a senior executive responsible for marketing, product development, trading, logistics and risk management activities of the CWB and G3 Canada Ltd. Mr. Weisensel was the Chief Operating Officer of the Canadian Wheat Board (CWB) beginning in 2004 until G3 Canada Ltd. purchased a majority interest in the CWB in July of 2015. With the change in ownership, Mr. Weisensel was appointed to the position of Senior Vice President Trading, Procurement and Risk for G3 Canada Ltd. He held that position until the end of 2017 and since then has been operating as a private consultant. Mr. Weisensel is the Chair of the Board of Directors of Red River Cooperative (RRC). RRC is a large retail cooperative (revenues are approximately \$800 million annually) operating in Winnipeg and area.

In his various roles, Mr. Weisensel had significant contact with the Canadian Grain Commission at virtually all levels of the organization. Prior to 2012, the executives of the CWB and CGC would meet regularly to discuss operational issues as well as the overall direction each organization was taking. In his role at G3 Canada, Mr. Weisensel engaged with the CGC on operational issues important to G3 Canada Ltd.

3.0 Comparison of Current Primary and Export Tolerances for Canada Western Red Spring (CWRS) and Canada Western Amber Durum (CWAD)

Table 1 shows the primary and export standards for CWRS and CWAD for test weight (kg/hl), foreign material (%) and wheat/durum of other classes (%). The premise behind the differences in the primary and export standards is that the distribution of grain quality delivered into the primary elevator system (where the minimum delivered quality is the primary standard) can be blended as the grain is shipped to export position such that achieving the higher export standard is statistically certain with a high level of confidence. In essence, there has been recognition of the observed statistical improvement in grain quality from natural blending that occurred in Western Canada due to the highly geographically distributed primary elevator system. Much of this statistical improvement did not require any effort by the grain companies. In addition, the companies acknowledge that they also actively blend at primary facilities or take advantage of the natural improvement of certain producer deliveries, to offer producers higher grades than their individual quality would allow or improve their profit position. No records are kept of this company activity. That said, there is no question that the spread between primary and export standards has allowed producers to deliver higher grades and earn greater revenue than if they had to abide by the export standard when they deliver to a primary elevator.

In the development of this report, I have seen no statistical evidence that supports the proposal to change the primary standard. That said, it is likely that the natural improvement in quality

between primary delivery and export position has been affected by the more concentrated high throughput primary elevator system, larger train sets, etc. This has made the achievement of meeting export standards on export contracts somewhat riskier.

4.0 Issues Associated with Narrowing the Primary Export Standards

The debate around differences between the primary and export standards has been around a long time at least since the advent of primary elevator consolidation in Western Canada. I recall the debate in the 2000-2005 period that ultimately led to the reduction in the differences between the primary and export standards in 2005. At the time, many companies that owned inland terminals, but did not own export terminals, were required by contract by the export terminal to ship grain at the export standard. Export terminals at the time were trying to manage this risk.

The discussion around the narrowing of the primary/export standards in 2005 was somewhat similar to the discussion that is happening today. The Western Grain Elevator Association (WGEA) was calling for the elimination of the differences. At the CWB, we were asking for data to support the need for the change. At the same time, we were asking the CGC for data to show the implications to farmers if these changes were made. In both cases, the data was very limited. That said, we were all aware of the implications of the consolidation in the primary elevator system and that this did escalate the risk of not meeting export standards on export contracts. We were also aware that inland terminals without export terminals were being required to ship at the export standard and that this was affecting the competitive environment in the country. Ultimately, it was agreed to narrow the standards at that time. Primary standards were increased, in effect lowering the percentage of wheat that would qualify for the higher grades. The impact on producer revenues was not quantified and it is a difficult calculation as it would depend on the year, quality profile, prices and the competitive environment between companies. The most that can be said, is that it was directionally negative for producers and directionally positive for grain companies.

As indicated, the discussion today sounds very similar to the discussion in 2005. That said as one considers the changes being considered, it is important to reflect on what has changed relative to 2005. The first is the change in the export vessel loading protocol that occurred in 2012. Prior to 2012, export terminal shipping was assessed by CGC inspectors on the basis of 2,000 tonne increments as they loaded export contracts to export vessels. They did not have to hit the export spec on every increment but there were limits in terms of how far they could be below spec on any individual increment. The purpose of the policy was to ensure uniformity of quality across the cargo.

Since 2012, the export loading protocol has changed and it no longer requires 2,000 tonne increments. Today, as long as the export terminal can meet minimum spec on the entire composite of grain loaded to the vessel, they are consistent within contract with the revised loading protocol. On large vessel lot contracts, this change has clearly reduced the risk at the export terminal of maintaining the current differences in the primary and export grade tolerances.

Second, one needs to examine the market environment in which we are operating. In 2005, Canada was selling good quality CWRS and CWAD at sizeable premiums to similar quality spring wheats and durum being sold out of the U.S. In the study provided to the SWDC, in October 2020, I had explained that at that time Canadian wheat and durum were being sold at

discounts to like quality U.S. wheat and durum. I also explained the economics of this change in pricing relationships. It is my understanding that Canadian wheat and durum continue to be traded at a discount to like quality U.S. wheat and durum. Under these circumstances we need to consider where our export standards are relative to our competitors. If the decision is to narrow the standards, the more appropriate approach may be to look at lowering the Canadian export standards than raising the primary standards.

Third, today we are in an open market environment where farmer access to the system is rationed by price as opposed to by delivery contracts and delivery calls. When farmer pressure to deliver into the system is greater than the system's ability to move the product, basis levels widen to ration access to the system. Alternatively, when system capacity to move the grain exceeds farmers demands to deliver grain, basis levels narrow as grain companies are very aggressive to get access to those farmers who are prepared to sell and deliver at that time. In this latter situation, the basis reflects the costs the companies must cover to trade grain including the risks associated with executing export contracts with differences between the primary and export standard. In the former case, the basis clearly exceeds these costs and any risks the companies need to cover. If competition for producers' grain is intense relative to availability, it is possible that companies will assume certain risks in order to improve throughput. If this intense competition occurs, producers are the beneficiaries and are unlikely to be paying for all of the risks.

To summarize, in a situation where deliveries are tight relative to available system capacity basis levels will likely cover the primary/export tolerance risk, unless competition is intense. Where delivery pressure is beyond system capacity, basis levels compensate grain companies well in excess of this risk. The bottom line is that producers would usually pay for the primary/export tolerance risk when crops are smaller and demand by producers to use system capacity is less. While not universally true, this has the tendency to align with times where downgrading associated with raising the primary standards could be most significant.

5.0 Competitor Export Standards

Table 2 outlines the export standards for our most important competitor for wheat and durum (the U.S.). As it relates to test weight, the export specifications for U.S. spring wheat and other wheat (which includes durum) are for the most part lower than the export specifications in Canada. When looking at the specifications for foreign material and wheat of other classes the export standards are similar or slightly tighter than those in Canada.

6.0 Conclusions

Farmers may pay for the risk associated with differences in the primary/export standard when system capacity exceeds farmers demand to deliver product (i.e., a short crop situation). However, when farmer demand exceeds system capacity to move grain, basis levels are wide and this risk is essentially immaterial to prices farmers are earning. In this regard, the grain companies are compensated for this risk either in the basis levels they set or in how they buy the grain at country position. The only exception to this would be an environment of intense competition.

It is beyond the scope of this work to determine the implications of raising primary standards as it relates to the downgrading that will occur for grain delivered in Western Canada. It will be dependent on the year, but it is clear there will be more grain downgraded in all cases. It is also clear that when degrading issues do exist, the price difference between grain meeting the spec

and not meeting the spec will be sizeable reflecting the economics of scarcity. For example, in years where the crop is broadly impacted by fusarium, the price spread for grain that meets the tolerance versus grain that does not can be very wide.

Export standards on test weight in wheat are lower in the U.S. than they are in Canada. Given that Canadian grain is already trading at discounts to U.S. grain, it likely makes more sense to lower our export standards for test weight at least to U.S. levels than to raise Canadian primary standards to our export standards. If there are some customers who require these higher specs it would be better to sell to them on these higher specs than downgrade a good portion of our crop for the needs of customers buying a small portion of our crop. Customer outreach ahead of revising these specs would be advised.

In the very short time I have had to study this overall situation, I cannot help but question the merit of the approach under consideration. In my mind, the key issue is not the narrowing of the primary/export spec. Given all the changes that have occurred in the Western Canadian grain handling system over the last 15 years, I think it would be more appropriate to look at all of Canada's export specifications to determine how we want to position ourselves in world markets. We are no longer trading products at premiums to customers around the world for reasons that have been addressed in my earlier work for the SWDC in October of 2020. Our export specifications should address this reality by looking at the entire situation holistically. Actions to raise primary standards to export standards in the absence of this broader context will simply reduce producer revenue with very little if any off-setting gains.

The broader discussion on where we want our export specifications is also important to the messaging and direction we provide to all supply chain participants. Long-term clarity on export quality assessment is important to farmers, grain companies, customers and plant breeders. Providing this clarity should be a key goal of our quality assurance system.