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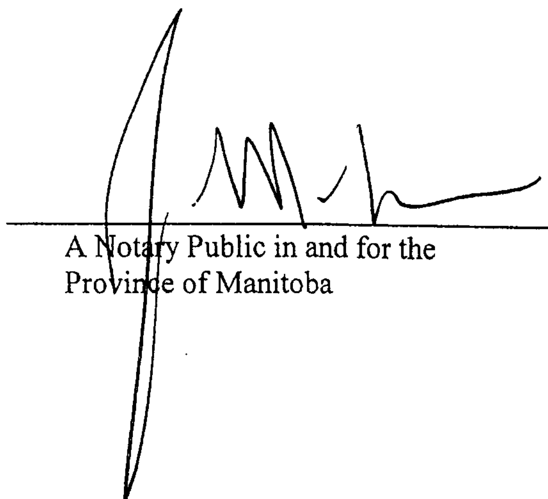

A Notary Public in and for the
Province of Manitoba

The Canadian Wheat Board
La Commission canadienne du blé

April 11, 2007

The Honourable Chuck Strahl, P.C., M.P.
Minister of Agriculture & Agri-Food and
Minister for the Canadian Wheat Board
Agriculture and Agri-Food Canada
Sir John Carling Building
930 Carling Avenue
Ottawa ON K1A 0C5

TRANSMITTED VIA FAX: (613) 944-9272

Dear Minister Strahl:

Further to our meeting of April 3, 2007, a commitment was made to provide you with analysis examining the situation the CWB would face in an open barley market. I am pleased to provide it here.

As you read it, I trust you will appreciate how, after extensively examining several alternatives, the board reached its conclusion that without the single desk, or sustainable competitive access to or ownership of a complete set of assets, the CWB can no longer add material value to the marketing of barley from Western Canada.

Sincerely,

Ken Ritter

Ken Ritter
Chair, CWB board of directors

KR\da

Attachment

POC 1779

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Analysis of the potential loss of CWB single desk on barley

Issue

This paper examines the situation the CWB would face in an open barley market. It also examines the CWB's options and requirements in the context of strategic relationships with grain-handling service providers, government involvement in industry regulation and oversight, and asset ownership.

Background

The CWB board of directors held a strategic planning session February 4-6, 2007 and examined the scenario of the potential loss of the single desk for barley. The board agreed that the following value propositions and success factors should be the critical test for a decision to continue marketing barley.

Value propositions:

For farmers: The CWB will provide farmers (that choose to continue to market barley through the CWB) with a materially higher net benefit (e.g., farm gate return) relative to competing buyers.

For grain handling companies: The CWB will provide grain company(s) with market share (i.e., volume) and therefore handling revenues at levels that would not be attainable if the CWB ceased to market barley or at least chose not to do barley business with that company.

For customers: The CWB will offer customers a package of consistent, quality products, price, and superior customer service that is at least as attractive as that offered by its competitors.

Critical success factors[1]

- whether or not the CWB would have sufficient financial backing for its operations and a cost of capital that would be competitive with competing grain companies;
- the CWB's ability to maintain historical goodwill with customers when the same product is available from other suppliers;
- the CWB's ability to achieve significant commitment and business interest from farmers;
- the ability of the CWB to assure quality barley throughout the system
- the ability of the CWB and willingness of grain companies to provide or enter into strategic alliances for handling services at competitive rates;

It was also suggested that the following factors were important for consideration:

[1] The provision of pooling by the CWB was not deemed a critical success factor. It was agreed that the CWB could choose to offer a pool if there was sufficient demand for pooling from farmers and it was proven feasible, but there was consensus that the CWB *should not be bound* to offer a pooling option for farmers.

whether or not the CWB would have the ability to source from suppliers other than farmers;

- the CWB's willingness and ability to maintain marketing expertise and business volume,
- the CWB's ability to compete with grain companies without offering farmers crop-input financing, etc.
- whether or not the single-desk would remain for wheat (identified in the paper as an assumption);
- that there be no cross-subsidization between the wheat business and the barley business.

From this session, the board reached consensus that the challenges associated with participating in the barley market without the single desk would be significant, and might well be insurmountable.

In particular, the significant obstacles identified resulted from the CWB's lack of asset ownership in the supply chain. The obstacles are:

- Competitive access to an adequate network of facilities in the country and at port with handling rates that would result in the CWB being competitive with other entities on a daily basis;
- Competitive access to the handling and transportation system, particularly during times of capacity constraints;
- Ensuring the quality of CWB-delivered grain was preserved through the handling and transportation system;
- Sustainability, over the long-term, of any commercial arrangement.

At the conclusion of this session, there was agreement that the CWB should explore the potential for strategic alliances with industry participants, government negotiations, and asset ownership.

Further defining the obstacles of an open market and requirements to address

The following section provides additional details regarding the significant obstacles identified by the board (outlined in the Background section above). It also examines what the CWB's options and requirements would be to address these obstacles in the context of strategic relationships with grain-handling service providers, government involvement in industry regulation and oversight, and asset ownership.

Sections I – IV discuss in detail the operating challenges of relying on competitors' grain handling infrastructure to market CWB barley. The mechanics of grain handling and merchandising are described for a dual market environment in which the CWB would seek to market barley but without any of the above provisions. Several examples are provided in which a grain company would clearly have an opportunity, and indeed a responsibility to its owners/shareholders, to engage in pricing, access and quality control activities that would increase its own earnings, but that also would severely limit the CWB's ability to compete. Section V then discusses how and to what extent the above provisions, from strategic alliances to regulation to asset ownership, represent opportunities to address those challenges.

I. The level of interest of others in the value chain in forming alliances or partnerships that would not put the CWB at a competitive disadvantage.

The question here is simply – would there be grain handlers and/or customers that would have an interest in forming an alliance/relationship with the CWB for barley marketing?

Grain handling companies

Grain handling companies could be expected to form an alliance with the CWB or at minimum show an interest in forming an alliance with the CWB if they considered the following value proposition to be achievable:

> *The CWB will provide grain company(s) with market share (i.e., volume) and therefore handling revenues at levels that would not be attainable if the CWB ceased to market barley or at least chose not to do barley business with that company.*

Any company with an interest in handling and/or marketing western Canadian barley would consider this an incentive to form an alliance with the CWB.

Of greater significance to this discussion is the incentive grain companies would have to form an alliance with the CWB in order to "court" CWB farmers and customers. This would better position these companies for longer-term success in the barley value chain. This is an important consideration as it reflects the reality of operating a grain company and, if not accounted for, would give the CWB a false sense of long-term sustainability.

For these reasons, it can be expected that grain companies would show an interest in forming an alliance with the CWB. Whether they would agree to terms that would not put the CWB at a competitive disadvantage (e.g., rates, access, etc.) is addressed later in the paper.

The following provides some additional details in support of the above conclusions that, generally, there would be short-term interest from companies in forming an alliance with the CWB:

- At the outset of an open market and assuming the CWB is able to retain its existing barley sales managers, the CWB could possibly retain some market share by leveraging historical goodwill with its traditional customers and with farmers who currently strongly support the CWB. Grain companies might therefore compete for the ability to handle CWB barley in anticipation that the CWB would be able to retain some portion of this direct business. As long as the CWB was able to retain and attract business, grain companies would likely consider it advantageous to have that grain move through their facilities instead of their competitor's facilities. Retaining this business base over the longer-term would obviously be uncertain and would be entirely dependent on the CWB's ability to remain competitive with customers and farmers. Note that in the case of China, accredited exporters have also done business there in recent years and several have good contacts among Chinese customers, so the CWB's close relationships with Chinese customers is not exclusive.

- There are inland grain handling companies that are not as well positioned as others to be barley market participants absent the CWB. These companies do not have a well-established customer base in global markets and assuming these companies would have an interest in participating in these markets, could possibly have interest in leveraging the CWB's customer base through an alliance with the CWB The longer-term interest of these companies in forming an alliance with the CWB would depend on the volume of barley the CWB was able to bring their facilities and/or whether or not they were able to establish their own network of customers over time. It should also be noted that these companies could alternatively form alliances with the major private companies (as several already have), instead of the CWB, in order to gain access to markets.

- The grain companies well positioned to market malting barley absent the CWB are among the four who own all the major West Coast grain terminals. Only West Coast terminals are well-positioned geographically for overseas malting business. A voluntary CWB would require competitively priced access to a port terminal(s) to market barley, and one or more of the terminal owners would have to decide to make that available.

- As a strategic tactic - any grain company seeking to court 'CWB' farmers and customers would likely be better positioned to do so if it knew which farmers and customers initially did business through the CWB.

The better positioned and more inclined a grain company is to approach major malting barley customers directly, the (far) less likely it is that a strategic alliance between that grain company and the CWB would be sustainable. The top four grain companies who own all the major West Coast grain terminals (and whose dynamics may change as a merger of some kind is concluded) are much closer to this category than grain companies who own no terminal facilities on the West Coast. Note that while the latter may have more desire to sustain a strategic relationship with the CWB, they would have less ability to do so, since such a relationship could be interrupted or compromised by the major West Coast grain terminal which would handle the barley at export position. The latter are also not as geographically well-dispersed in the country, which would be an important factor for the CWB in acquiring handling services – unless the CWB was willing to serve only certain farmers in certain regions of the Prairies.

Ultimately, any grain company's interest would also depend on the demands of the CWB and the conditions of the partnership it attempted to achieve. These conditions are not insignificant. However, they would be required for the CWB to ensure it is not placed at a competitive disadvantage in serving farmers and customers.

Customers

In an open market for western Canadian barley, customers (both domestically and globally) would be motivated by three things – price, quality and supply security. Customers' interest in forging any sort of long-term relationships with the CWB would depend on whether or not customers believe the CWB will be able to achieve and sustain the following value proposition:

> *The CWB will offer customers a package of consistent, quality products, price, and superior customer service that is at least as attractive as that offered by its competitors.*

As outlined already in this paper, the CWB's ability to achieve this value proposition would be dependent on its ability to acquire competitive access to the grain handling and transportation system at fair cost. It would also be dependent on its ability to demonstrate to farmers (through price) that it is a competitive player in the industry. However, even if the CWB was able to achieve these conditions, the CWB's value proposition to customers would not be unique. Each of the major companies would be positioned to offer customers the same services and the same prices as the CWB, or better. In short, customers would buy from the CWB if it offers price, quality and supply security equal to or better than its competitors.

It is also worth noting that domestic customers would be more able than export customers to arrange supply security and select quality specific to their needs. Domestic customers would continue to deal either directly with farmers or in partnership with grain handling companies. It is quite unlikely the CWB could achieve the stated value proposition for domestic customers, without handling facilities of its own and without control over supplies that it currently has with the single desk.

II. Whether competing grain companies would price access to their facilities competitively.

In order for the CWB to source barley from farmers, it would need to offer spot bids that were competitive with rival grain companies[2]. In other words, it would need to ensure that the net price a farmer received for his/her grain would, at minimum, make that farmer indifferent between delivering to the CWB or to a rival grain company, all things considered.

This means the CWB would need the flexibility to adjust its spot bids on any given day to attract deliveries from farmers. This flexibility would also be important in situations where the CWB needed to deter deliveries from farmers. The CWB handling rate could be readily "undercut" (especially by the company with which the CWB had an alliance if that company was competing for supplies) if rival companies were attempting to attract market share. The CWB may only discover that it had been priced out of the market after it failed to receive any deliveries from farmers. The CWB would need the market intelligence to know if its bids were competitive. Without an extensive network of field staff, it would likely need to rely on the grain company with which it had an alliance for some of this market intelligence.

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[2] Note that in the February 2007 planning session, there was a consensus among board members that pooling would not be sustainable. Therefore, this paper assumes the CWB would be competing on a spot basis to attract farmers' barley.

As an example, assume the CWB (operating in alliance with Grain Company B) and Grain Company A made parallel sales of 100 000 tonnes of malting barley at an identical price FOB Vancouver and both companies were in the market attempting to source this barley from farmers. The CWB would need the ability to offer farmers at least the same price as Grain Company A. Grain Company A would have the following approximate handling charges to work with in determining what price it would reflect to farmers and ultimately how competitive it would be in sourcing barley from farmers:

Primary elevation	$16 per tonne
Cleaning	$8 per tonne
Terminal elevation	$11 per tonne
Rail incentives	$7 per tonne
Total	$42 per tonne

Since much of the actual costs are fixed, Grain Company A could apply a basis of any amount between and $5 per tonne[3] and $42 per tonne to attract grain from farmers. Assume Grain Company A chose to apply a $30 per-tonne basis. To compete, the CWB would need the market intelligence to know what basis level was being applied by Grain Company A, it would need to find a way to be equally flexible in its ability to adjust its basis to farmers, and it would need an agreement with Grain Company B whereby it would pay only that amount (i.e., $30 per tonne) for handling services. If the next day, Grain Company A dropped its basis to $10 per tonne, the CWB would need to be positioned to adjust its basis to do the same and not incur losses in doing so. There are some circumstances such as excess capacity under which Grain Company B might informally discount its handling fee by offering incentives to farmers to bring in CWB barley. But this will not occur uniformly across all locations and time periods. Where it does not occur, one of the only scenarios where this level of flexibility might be possible would be if the CWB and Grain Company B had an alliance whereby the CWB was the exclusive marketer of barley. In other words, where Grain Company B was restricted from marketing barley and therefore had an incentive to ensure the CWB's competitiveness in the barley market. However, note that this would require Grain Company B to enter into an agreement whereby it would have no certainty over the handling margins that it would receive. It cannot be expected that many (if any) companies would be interested in an arrangement with these terms. In every scenario, the CWB is likely to be bound by fixed handling charges, negotiated up front, and therefore would not have the flexibility it would need to adjust basis levels to be competitive. Additional details on an exclusivity arrangement are discussed later in the paper

In addition to these being unlikely scenarios, they would also not achieve the necessary condition of a materially higher net benefit to the farmer delivering to the CWB. To achieve that condition, the CWB would need to negotiate the receipt of a portion of the handling earnings of Grain Company B. Furthermore, the CWB would be unlikely to know the handling costs vs. handling earnings of the company with which it was aligned on individual sales or collectively on all CWB business, for that matter. For this reason, it is likely the CWB would need to simply negotiate per-tonne margins (e.g., marketing margins) for its barley sales.

Lastly, note that even if the CWB was able to negotiate competitive handling rates, it would not necessarily achieve the same level of 'profitability' as rival grain companies. Grain companies are able to add revenues through blending activities. The CWB would not have this ability unless it was in an exclusive arrangement with Grain Company B and received the full blending revenues of Grain Company B. As is the case with the variable basis requirement, it is not

[3] or some very small amount to cover variable costs

expected that grain companies would be interested in an arrangement with these terms. Without these terms, if rival companies chose to pass a portion of their blending revenues back to farmers (versus shareholders), the CWB would be at a competitive disadvantage.
For this handling alliance to be achievable, a company would have to consider CWB handling volumes (and therefore the portion of the handling volumes it would retain in this relationship) to be incremental to what it could achieve absent the CWB. Potentially, there may be companies that would agree to these terms. However, as identified above, the grain companies with facilities in the country and that might be most interested do not own a large share of the handling capacity in Western Canada (i.e., less than 20 per cent (see Appendix A)) and are not geographically dispersed enough for the CWB to be an option for all farmers. Similarly, the terminals that might have interest are not located at the West Coast and are not well-positioned for the majority of the overseas barley business.

The price at which the CWB could secure handling services would determine the CWB's competitive position, its ability to source necessary supplies and ultimately its ability to serve farmers. As illustrated in the discussion above, achieving rates that would make the CWB competitive and add value to farmers would be difficult, if not impossible.

III. To what extent CWB barley would receive less preferential access to system capacity during times of capacity limitations

The following are examples of situations related to grain transportation in which the grain companies' incentives would be misaligned with the CWB's business requirements. In each example, the grain company clearly has an opportunity, and indeed a responsibility to its owners/shareholders, to prioritize grain movement to increase its own earnings.

- A CWB vessel and a grain company vessel are waiting in the port of Vancouver to be loaded with the same variety of malting barley with similar specifications. Both CWB stocks and grain company stocks exist at the terminal, but the grain company is 2 000 tonnes short of its contractual requirements. Both vessels are on demurrage due to a supply disruption, such as a railway strike, plugged country elevators, road bans, insufficient car availability, an avalanche, etc. More malting barley will arrive at some point once service resumes. The grain company would have the incentive to informally "borrow" 2 000 tonnes of CWB stocks to load its own vessel, trusting that adequate malting barley to replace them will be enroute. The grain company vessel is loaded first. The CWB is seen by the customer to supply poorer service and the CWB has to factor in additional demurrage (or less despatch) into its bids to farmers and offers to customers, both of which become less competitive. Demurrage on handysize and panamax vessels currently ranges from US$25,000 to US$45,000 per day.

- Rail cars containing grain owned by the CWB and rail cars containing grain owned by the grain company arrive together at a plugged or near-capacity terminal elevator. The terminal does not have sufficient space to unload all the rail cars, and so some sit on a siding and are charged demurrage by the railways. The grain company has the incentive to unload its own cars first to avoid steep railcar demurrage charges, which range from $60 - $75 per day per car. The combination of results is: a) CWB marketing costs increase relative to the grain company's, reducing the attractiveness of bids to farmers and offers to customers; and b) CWB vessels are not loaded as quickly as grain company vessels, further reducing the overall attractiveness of the price/service package the CWB is able to offer to the customer.

- The terminal is plugged to the extent that no cars can be unloaded in the near term, yet the railway has spotted cars at a country location, and these must be loaded if the primary elevator wishes to avoid demurrage and damages (which can be extremely costly, $10,000-$25,000 for a unit train). The grain company can load its own grain or CWB grain into the cars. If it loads its own grain, it avoids rail car damages at the primary elevator, but incurs demurrage at the terminal. If the grain company chooses to load no grain, it avoids demurrage at the terminal but incurs damages at the primary elevator. If it loads CWB grain into the cars, it incurs neither category, leaving the CWB to incur the terminal demurrage.

- Similar examples exist with respect to:
  -harvest pressure for movement off the combine;
  -plugged primary elevators; and
  -constrained inspection resources (CGC on-site inspection)

IV. Whether or not the CWB would have the ability to ensure the grain committed to it by farmers was the grain loaded on a ship

The following are examples of situations related to grain quality in which the grain companies' incentives would be misaligned with the CWB's business requirements. Examples are provided in which a grain company would clearly have an opportunity, and indeed a responsibility to its owners/shareholders, to engage in quality control activities that would increase its own earnings, but that also would severely limit the CWB's ability to compete.

- Two farmers each make 5,000 bushels of the same variety of malting barley available to a primary elevator, one for grain company account and one for CWB account. Both are of sufficient quality to meet the grain company's and CWB's contractual specifications for two upcoming sales, but the barley for the grain company is 95 per cent plump and the barley for the CWB is 98 per cent plump. The grain company has the incentive to supply its own customer with the higher quality barley, leaving the lower quality for the CWB customer. This example would apply similarly to other quality parameters such as germination, colour, chitted, protein, peeled and broken, and it would apply to terminal as well as primary elevator position. Customers find the CWB is unable to provide barley of equivalent quality to grain companies competing for the business, either because it is unable to enter into contracts guaranteeing the tightest specifications, or its barley shipments are frequently, if not always, barely meeting the minimum contractual quality specifications which are sometimes, or often, exceeded by its competitors' barley. Note that with malting barley some specifications are not possible to control with numerical specifications. Factors such as colour require some judgement by a selector and the grain handler. This makes it difficult to control the integrity of CWB stocks via contracts with the handling company. The end result is the grain company's cost structure decreases relative to the CWB's, since one organization does not receive the benefit from any blending gains, while the other receives the blending benefits from both the CWB's and its own inventories.

- Both the grain company and CWB have virtually identical barley from the same farmer selected, and expect to have it delivered to the primary elevator in March. The recheck sample at delivery indicates that the grain company's lot of barley has insufficient germination. While not all elevator staff would view such activity as ethical, in some cases a grain company employee might offer a higher price to or otherwise influence the farmer to have the poorly germinating sample represent the CWB barley. Because of the

disadvantage of having fewer staff in the country relative to the grain company, the CWB concludes the barley has legitimately gone out of condition and takes costly, remedial action to fulfill its contractual obligations to the customer. The CWB finds that its cost structure is higher than that of competing grain companies' since it has higher rates of barley going out of condition and therefore higher risk management costs.

- The terminal elevator is unloading many rail cars of the same variety of malting barley with a wide range in quality. On average, the barley is of sufficient quality to load two vessels waiting for barley of equal specifications, one for the CWB and one for the grain company. Since the overall quality just barely meets contractual specifications, both vessels will receive the same overall quality. To maximize value for shareholders, the grain company's vessel is loaded with barley that has a very narrow range of quality variation (e.g. for protein, the barley used to load this vessel ranged from 12.4 per cent - 12.6 per cent at unload to meet a 12.5 per cent protein guarantee). The CWB's vessel is loaded with barley and receives the identical certificate final regarding average quality specifications, but is loaded with barley that had a wider range of quality variation (a range of 11.4 per cent - 13.6 per cent protein to meet the 12.5 per cent protein guarantee). Customers find that barley shipped by the CWB has poorer processing performance than barley of the same specifications shipped by competing grain companies.

- Similar examples exist with respect to:
  -existing or potential food safety parameters; and
  -stock switches resulting in grain companies' inventories taking greater advantage of multiple car rail incentives.

V. Requirements to address the obstacles

Clearly, inventories and movement of CWB grain would be placed at significant operational risk, increasing the CWB's cost structure above that of competing grain companies. The obvious solution to this is to own grain handling infrastructure. Potential other approaches are discussed below

1. Sufficient CWB terms for an operationally workable strategic alliance with a competing grain company.

As stated previously, it is highly likely every grain company would answer "yes" if asked whether they would be interested in forming a strategic alliance with the CWB. The answer would most certainly differ if the CWB was to make its terms explicit. In order to limit or prevent the problems outlined resulting from misalignment of grain company and CWB incentives, a detailed operational agreement with the grain company would have to be reached. It should be noted that although potentially workable, these are more costly than asset ownership. The CWB's proposed terms would include:

a) The grain company could not use CWB inventories without permission in order to load its own vessels/trains faster. Aside from whether the grain company would be inclined to agree to this, a first step would be to create a process to reliably detect whether this activity is taking place. At minimum, this would have to include some form of daily reporting of primary and terminal elevator inventories by grade, including declaration of blending activities, so legitimate blending activity could be disassociated from illegitimate stock switching activity. Penalties would have to be negotiated to effectively deter this activity. The required inventory reporting could be performed by grain company personnel if subject to a sufficient

audit procedure. The grain company and CWB would have to share equally in monitoring and audit costs in order to avoid creating strategic disadvantages for either party's cost structure.

b) The grain company and CWB must agree to incur the same levels of rail car and vessel demurrage and penalties. This would be a complicated arrangement, since "equal" demurrage and penalties would have to be defined for a wide range of grains and handling volumes, and sufficient penalties would have to be established and agreed. To monitor compliance, a system to track rail car and vessel demurrage and penalties would have to be designed and audited, and then paid for "equally" (which would have to be defined) between the grain company and CWB.

c) The CWB would require assurance from the grain company that the grain delivered on CWB account by farmers is, overall, the same grain shipped to CWB customers. Blending would occur, but all gains made on CWB grain would accrue to the CWB and its customers and farmers, not to the grain company handling the operations on the CWB's behalf. This would require the creation of a reliable monitoring system. The CWB would require the right to have grain measured or inspected inward and outward at both primary and terminal elevators. Subjective grading factors would have to be measured to assess blending activity—for example, by rating colour based on a 1-10 index. Measurement/inspection would have to be conducted or audited by a CWB-hired grain inspector or an objective third party. While the CWB would have the right to examine each lot of grain, the actual extent of examination would likely take the form of an audit approach, and depend on the CWB's risk assessment. Similar to other terms, the grain company and CWB would have to share equally in costs; however, these costs are likely to be substantial, and would put the CWB and the grain company with whom it has the strategic alliance at a structural cost disadvantage to grain companies not connected to the CWB.

d) The CWB would require a sample of each farmer's grain, both initially and at delivery, and then access to the grain company's internal quality database with the provision to audit it. The grain company would have to agree to penalties if excessive germination loss in storage was discovered, or it was otherwise detected that the CWB had higher incidences of its barley going out of condition vs. the grain company.

e) The CWB would require assurance from the grain company that CWB barley shipments are not created from blends of quality factors any wider than the blends the grain company creates for itself. This is not possible to reliably detect through objective measurements. The CWB would have to place its own quality control staff at terminal(s) when CWB supplies were arriving.

f) Similar safeguards would have to be negotiated for:

-priority of elevator access for movement off the combine;
-priority of access into plugged primary elevators;
-priority of access to constrained inspection resources (CGC on-site inspection);
-existing or potential food safety parameters; and
-stock switches resulting in grain companies' inventories taking greater advantage of multiple rail car incentives

2. Sufficient CWB terms for an operationally workable strategic alliance whereby the CWB is the exclusive marketer

A long-term strategic alliance with a grain company (that has both country and port facilities and is geographically well-dispersed in Western Canada) whereby the CWB was the exclusive marketer of barley (i.e., the grain company would be restricted from selling barley) would have the following implications with respect to sections III and IV above:

a) the problems associated with the CWB receiving less preferential access during times of capacity constraints would still exist but would only be the result of grains other than barley receiving preferential access. Provisions similar to those identified in 1 (b) would be required.
b) the problems associated with the grain company using CWB inventories and any quality-related issues would be significantly reduced. Provisions identified in 1 to address these issues would therefore likely not be required.
c) as identified in the section on handling rates, the relationship would have to provide the CWB with appropriate flexibility to source supplies at competitive costs. As noted earlier, grain companies are unlikely to agree with these terms on the basis that they would have no certainty over the handling margins they would receive on the barley portion of their business.

The positive attributes of an exclusivity arrangement require CWB marketing exclusivity for both export and domestic sales. Grain companies with terminal ownership to whom this arrangement could apply are currently involved directly or indirectly in export and domestic marketing and could view these terms as restrictive in the extreme.

3. Sufficient government regulation to ensure an operationally workable strategic alliance.

If grain companies are unwilling to agree to CWB terms at reasonable cost, then a regulatory approach is also a potential solution, although likely much less desirable. A regulatory approach would have to be overseen and managed by the federal government. Its basic elements would include:

a) Each of the monitoring systems described in item 1 for demurrage, stock-switching, and blending.

b) A monitoring system to ensure that the CWB did not bear a disproportionate share of the regulatory cost.

c) A provision to access farmer and grain company samples, and then access to and provision to audit grain companies' internal quality databases.

d) The CWB's own quality control staff at terminal to supervise blending activity. Under a regulatory approach where the grain company does not agree to this, CWB staff would require regulatory authority to be present and to order corrective action where necessary.

Regulation is a potential solution to safeguard against operational problems, but it would be slow, costly and inflexible. In addition, while it may be possible to regulate companies' grain handling behaviour (just barely, and at too high a cost), it is likely not possible to effectively

regulate their prices to ensure that the CWB faces a similar, if not the same, cost structure. It is unlikely in the extreme that the federal government would send in auditors to monitor companies' internal grain handling cost structure with the intent to force them to provide a similar cost structure to competitors.[4]

3. Asset ownership

Asset ownership generally solves the problem of misaligned incentives and removes the need for the extensive terms outlined above regarding strategic alliances and a regulatory approach.

If the CWB owned both terminal and an adequate contingent of primary elevators[5], then the problem of misaligned incentives is removed, and the CWB faces the same set of operating problems as any grain company, i.e., the business isn't easy, but the CWB does not face any strategic disadvantage either. Of course, the CWB would need a source of capital to purchase assets, and assets would need to be available for purchase.

If the CWB owned a port terminal(s) only, the terms outlined in item 1 would continue to be required for shipments to the CWB port terminal from primary elevators.

However, many legal issues would arise in connection with the possible purchase by the CWB of grain handling assets, including the fact the CWB cannot currently acquire real estate. Some significant legal issues would arise in the areas of competition law and tax law.

In addition, having the authority to own assets is not sufficient. The CWB would need adequate capital to purchase a port terminal and/or an adequate contingent of primary elevators and these assets would need to be available for purchase. Also, the timeframe of a change in the CWB's mandate would be important as the CWB would need sufficient time to position itself to compete through asset ownership. The likelihood of achieving these conditions is considered low. However should the conditions be achieved, the CWB's value proposition to farmers would consist solely of 'service at cost', i.e., passing back to farmers the net revenues earned on the movement of grain through the CWB facilities.[6]

4. Port buying

The primary reason for misalignment of grain company and CWB incentives is the CWB's attempt to have a farmer contract and interface at the front end of the primary elevator, thus taking ownership of grain before it goes through other business owners' facilities. If the CWB were to take ownership of grain at FOB position, then many of the operational challenges would be reduced, or in some cases eliminated, since many of the incentives for grain companies to treat CWB grain differently disappear. However, grain companies would still have some ability to provide higher service levels for their own sales contracts vs. CWB tenders. The CWB would receive the minimum acceptable, contractually established parameters with respect to grain quality and delivery timing, while the grain company would be able to periodically offer its customers timing and quality advantages. This approach has the following implications:

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[4] This is not entirely unheard of as some elements were present in the telecom industry as it deregulated).
[5] A large number of geographically well-dispersed elevators.
[6] This assumes revenues would continue being earned in excess of costs, i.e., the rates would continue to reflect a market that is not perfectly competitive.

a) the grain company still owns the grain as it moves through the system. Since there is no split ownership, there is no incentive to misrepresent or allocate priority of CWB vs. grain company inventories based on:

- Rail car demurrage;
- Misrepresentation of farmer samples;
- Grain quality and blends;
- Stock switching;
- Contract default;
- priority of elevator access for movement off the combine;
- priority of access into plugged primary elevators;
- priority of access to constrained inspection resources (CGC on-site inspection);
- existing or potential food safety parameters; and
- stock switches resulting in grain companies' inventories taking greater advantage of multiple rail car incentives.

b) The CWB would minimize its operating risk. It could tender for malting barley supplies when sales opportunities become available, and conclude both contracts simultaneously if a positive margin and acceptable terms and risk are available.

c) There is no guarantee of competitive offers from grain companies.

d) The CWB may still require its own quality control staff at terminal position to regulate blends.

e) The CWB would not have a meaningful interface with farmers.

f) Operating as a pure export broker (port buyer) would fundamentally change the CWB's value proposition to farmers and would not satisfy the test of providing a materially higher net benefit to farmers. However, unless grain merchandising is perfectly competitive and efficient, the CWB's buying and selling function would technically increase the degree of effective arbitrage. One example of this would be an enhanced ability for independent primary elevators to access and participate in export barley markets. The added value would likely be similar to a situation in which the CWB was port buying canola.

Summary of Scenarios

The following is a summary of management's conclusions regarding the spectrum of possible scenarios that it could face in an open market for barley and discussed in this paper. Management has added as scenario #1 the current mandate as a basis for comparison.

Scenario #1: Single desk marketing of barley for human consumption and export

- CWB marketing discipline and market development efforts achieve single-desk premiums for farmers.
- Independent analysts have calculated the annual value of the single desk for malting barley to be approximately $59 million or in the range of $35 to $40 per tonne.

Scenario #2: Strategic alliances with competitors, no strict provisions as per section V, no country staff, no assets

- Companies will indicate interest in alliances with the CWB.

- CWB only able to leverage goodwill with customers and farmers until there is a realization it cannot be competitive with rival companies.
- Not sustainable beyond a very short term.
- Would not achieve the CWB's value proposition of providing farmers a materially higher net benefit.

Scenario #3: Strategic alliances with competitors, with strict provisions as per section V, no country staff, no assets

- Companies are likely to be less interested given the provisions the CWB would be demanding.
- Companies may form an alliance with the CWB knowing that without government regulation and without CWB staff in the country, the CWB's ability to monitor and enforce the provisions would be difficult. The risk of repercussion for the companies if contracts were violated would be limited without government oversight and regulation.
- Not sustainable beyond a very short term.
- Would not achieve the CWB's value proposition of providing farmers a materially higher net benefit.

Scenario #4: Strategic alliances with competitors, with strict provisions as per section V, with country staff, no assets

- Companies are likely to be less interested given the provisions the CWB would be demanding.
- Companies may form an alliance with the CWB knowing that CWB staff in the country is only partly sufficient for the CWB to be able to monitor and enforce the provisions. The risk of repercussion for the companies if contracts were violated would be limited without government oversight and regulation.
- Problems would still exist with respect to being disadvantaged at terminal position.
- CWB cost structure relative to companies would be a concern.
- Modestly more workable than scenarios 1 and 2, but not sustainable.
- Would not achieve the CWB's value proposition of providing farmers a materially higher net benefit.

Scenario #5: Long-term strategic alliance whereby the CWB is the exclusive marketer, with necessary strict provisions as per section V, no assets

- Companies are likely to be least interested in this option as it would restrict them from selling barley, both domestically and for export.
- Companies would only form an alliance like this if they felt the CWB would bring a combination of handling volumes and corresponding margins that are in excess of what that company could do on its own and net of what it would lose from the exclusivity provisions.
- More workable than scenarios #2, #3 and #4, but the likelihood of finding a large company with a port facility and a significant network of elevators that is willing to form an alliance with these terms is very low.
- The CWB would be competitive in its bids for barley only if the arrangement effectively enabled the CWB to instruct the grain company to adjust its basis levels such that the CWB was offering farmers the same price as rival grain companies. These terms would be difficult to achieve as they effectively mean the company could not assess the margins it could expect to earn from this arrangement.
- Could achieve the CWB's value proposition of providing farmers a materially higher net benefit only if the CWB could negotiate a significant share in the company's barley handling profits.

- This arrangement would need to be long-term in nature to avoid the problems identified earlier whereby a company only keeps the alliance for as long as it needs to court the 'CWB's' farmers and customers. A tightly-defined contract that provides the grain company very few (ideally no) out-clauses and includes significant penalties for breaking the contract would be required. In addition, to protect the CWB's assets (employees, customers and farmers), the contract would need to include strict provisions to prevent the grain company from waiting out the term of the contract, hiring the CWB's marketing team and then going after the CWB's customers. Given that the grain company would have direct contact with the CWB's farmers, preventing the grain company from going after CWB farmers is not realistic. These concerns are confirmed by the CWB's experience in previous exclusive arrangements.
- This is likely not sustainable beyond the short term.

Scenario #6: Strategic alliances, with strict provisions as per section V, with country staff, with terminal assets

- CWB would have an improved value proposition for companies that do not own port assets.
- Would still require alliances with strict provisions in the country that would still have some vulnerabilities. Achieving handling alliances with the necessary provisions with these companies may be more feasible as a result of the CWB owning a port facility.
- Higher likelihood than scenarios #2, #3 and #4 of achieving the CWB's value proposition of providing farmers a materially higher net benefit, but no guarantee.
- CWB value proposition for farmers/owners becomes the net handling revenues earned by the CWB and, to some extent, an enhanced ability for independent primary elevators to access and participate in export barley markets.
- Definitely a more favourable option than scenarios #2, #3 and #4, however sufficient timelines would be critical for this to be a realistic option.

Scenario #7: Strategic alliances, with strict provisions as per section V, with country staff, with terminal and country assets

- Highest likelihood of achieving the CWB's value proposition of providing farmers a materially higher net benefit.
- CWB value proposition for farmers/owners becomes the net handling revenues earned by the CWB and, to some extent, an enhanced ability for independent primary elevators to access and participate in export barley markets.
- Adequate geographic representation through primary elevator ownership would require a large number of facilities that are well-dispersed across the Prairie region.
- The best option, other than a single desk, however sufficient timelines would be critical for this to be a realistic option.

Conclusion

Due to the significant obstacles that emerged from the February 2007 planning session discussion and which are further defined in this paper, it is the CWB's conclusion that retention of the single-desk on barley with a continued focus on providing flexible pricing, payment and

delivery options is the option that best fulfills the board of director's desired value proposition.[7] No other option identified and explored in this paper achieves or comes close to achieving the value provided to farmers through the single desk.

Other options that were explored improve the potential of providing farmers with a higher net benefit relative to competing buyers, however the likelihood of achieving such conditions is deemed to be extremely low. Given this, if the government and grain companies cannot or would not agree to these conditions, it is the CWB's view that a plan to transition the CWB out of barley would be required.

However, should the value proposition be modified such that simply existing to provide a brokerage service between buyers and sellers is acceptable recognizing that the potential net-benefit to farmers of this arrangement is very close to zero, then port buying may be an option for the CWB. This option, however, is not consistent with the government's vision of a strong and viable CWB. As a port buyer, the CWB would simply buy barley from grain companies at port position and sell to customers at commercially competitive prices (i.e., there would no longer be any single-desk premiums). The CWB would not have a direct presence with farmers in barley and would provide only limited value to farmers.

In addition, should there be the possibility of discussions with government about options that would better-position the CWB and farmers, terminal ownership at port would be imperative, but not sufficient, to overcome the significant obstacles that emerged from the February 2007 planning session discussion. Without facilities in the country, the CWB would still need to negotiate alliances with companies with the strict provisions outlined in section V of this paper in order to ensure its competitiveness with customers and farmers. These strict provisions would be necessary given the CWB's conclusions that government regulation and oversight is not a workable solution for the problems that exist. An adequate transition period would also be imperative. Lastly, an important element that is not addressed in detail in the paper is the need for CWB staff in the country—selecting barley, managing alliances at the elevator level, developing face-to-face relationships with farmers and monitoring issues at the country level.

[7] The CWB will provide farmers (that choose to continue to market barley through the CWB) with a materially higher net benefit (e.g., farm gate return) relative to competing buyers

Appendix A – Grain company market share statistics

Table 1 – Primary capacity – Western Canada (as at January 30, 2007)

Company	Number of facilities	Handling capacity (tonnes)	Share of total capacity (per cent)
Agricore United	82	1,258,320	24.6
Saskatchewan Wheat Pool	44	1,131,090	22.1
Pioneer Grain (JRI)	56	618,990	12.1
Cargill[1]	33	503,140	9.8
Louis Dreyfus Canada Ltd.	10	344,820	6.7
Paterson Grain[2]	39	332,050	6.5
Parrish & Heimbecker	19	323,330	6.3
Independents (non-aligned)	10	317,310	6.2
Independents (aligned)	8	131,600	2.6
Others (includes ADM, Bunge, small operators)[3]	36	150,000	2.9

1 – 11 small (<10,000 tonne) facilities make up approximately 14 per cent of total capacity
2 – 31 small (<10,000 tonne) facilities make up approximately 40 per cent of total capacity
3 – approximation

Minister
of Agriculture and
Agri-Food
and Minister for the
Canadian Wheat Board

Ministre
de l'Agriculture et de
l'Agroalimentaire
et ministre de la
Commission canadienne du blé

Ottawa, Canada K1A 0C5

MAY - 8 2007

Quote: 100612

Mr. Ken Ritter
Chair, Board of Directors
The Canadian Wheat Board
423 Main Street
PO Box 816, Station Main
Winnipeg, Manitoba R3C 2P5

Dear Mr. Ritter:

Thank you for your letter with which you enclosed an analysis of the situation the Canadian Wheat Board (CWB) would face in an open barley market. I appreciate receiving this report.

As you know, the Government remains committed to providing western Canadian grain producers with the option of selling their barley to any domestic or foreign buyer, including the CWB, effective August 1, 2007. It is in this context that the CWB will need to operate. I would hope, therefore, that the Board of Directors and management of the CWB will give every consideration to ways in which the organization might continue to operate without its monopoly marketing authority for barley. As we discussed in our meeting on April 15, 2007, I am disappointed that there appears to be little positive consideration of options such as handling agreements or alliances with other market participants. I was glad to hear that exploration of possible options continues and remain hopeful that the CWB will find a way to work in a marketing-choice environment.

The analysis you have provided on the situation the CWB would face in an open barley market has been passed on to officials with Agriculture and Agri-Food Canada for their information and assessment.

Thank you again for providing me with the analysis prepared by the CWB.

Sincerely,

Chuck Strahl

Canada

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