The Saskatchewan Barley Development Commission

Submission to

the Canada Transportation Act review Panel

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INTRODUCTION

The difficulties in all aspects of agricultural commodity movement over the 2013-14 growing season demonstrated that Canada's grain handling and transportation system has not adapted to changes in production and marketing now available to Western Canadian farmers. The review of the Canada Transportation Act provides a significant opportunity to improve the transportation system, particularly rail that is so critical to the entire barley value-chain. The Saskatchewan Barley Development Commission has put together the following paper outlining suggested solutions from farmers in Saskatchewan. We represent the province of Saskatchewan, the most significantly affected grain producing province during the 2013-14 transportation crisis due to being the furthest from port positions.

Our recommendations focus on increasing transparency at all levels within the value chain so that all parties can make better-informed decisions; increasing competition to ensure that excessive rent is not extracted from other parties; and ensuring that all are held accountable to commitments made to other parties within the value chain. Agricultural production is wrought with high levels of uncertainty in which all parties of the grain handling and transportation system have to accommodate and contend with during anomalous years. The goal of these recommendations is a grain handling and transportation system that acts, and reacts, like a value chain.

Cost of the 2013/14 Transportation Crisis to Saskatchewan Farmers

As grain producers, we are not in control of the products we produce once they enter the grain handling and transportation system. We do not own the grain while it is being transported, however, producers pay the freight costs as they are included in discounts called basis[1] which is deducted from the world price or futures price of the grain. Limited movement of grain to ports, the USA, and domestic buyers by rail in the 2013-14 crop year resulted in an increased basis as grain companies widened the basis to limit deliveries into the primary elevator system that was not able to ship grain in a timely manner. The need for cash flow forced some farmers to accept this widened basis and deliver grain whenever the possibility existed. In February 2014, the difference between the FOB West Coast price of wheat and the price at Saskatchewan elevators reached as much as $200 per metric tonne. This increased basis level is estimated to have cost Western Canadian farmers up to $3.1 billion (Gray, 2014). Using the basis numbers from Gray

[1] Typically, the basis is the difference between the world futures price and the price at the point of sale and normally reflects transportation costs, terminal handling costs, transaction costs, demurrage costs and grain company margin. Basis can also be viewed as a market signal indicating whether there is a need or a want of a specific commodity or product as times it will be at a premium or discount to the costs listed above.

(2014), Saskatchewan's share would be $1.6 billion or approximately half of the cost for Western Canada. The excess basis would represent a significant revenue transfer from producers to the grain companies and the railways combined.

Another cost borne by producers is the undermining of the 'Canada' brand that occurred due to the inability to get product to market. In multiple instances, foreign buyers switched from Canadian suppliers to competing suppliers because product could not get to market. The search for greater rail efficiency and cost reduction has resulted in policies and procedures by railways that favour unit trains of a single commodity. Under scarcity of rail service, few cars were available for smaller acreage crops or on specific corridors resulting in damage to Canada's reputation as a consistent supplier of these smaller crops including malt barley, oats, flax, pulses, and numerous other special crops. Producers depend on cropping choices and flexibility in their planning and crop diversification. The resulting system must have the railways engaged towards the fair movement of these smaller crops and corridors to maintain or build markets and opportunities for farmers.

RECOMMENDATIONS

As producers looking for a long-term solution, we believe in the invisible hand of the market that allows each player in the value chain to conduct business in a manner that is in the best interest of that player; however the invisible hand of the market is predicated on competition reducing the opportunity for any player to earn excessive rent. Farmers are the textbook definition of perfect competition; there is less competition at the grain company level, but one could argue that there are a sufficient number of firms to create solutions close to perfect competition; and producers also have the option of bypassing the grain companies and shipping producer cars (a right that should be protected and have special consideration by the CTA). At the railway transportation level, the industrial structure is a special case of oligopoly called a duopoly. Under a duopoly, there is the opportunity for these firms to extract excessive rent from other players within the value chain as they have ability to influence prices and output, especially when there are not any other transportation alternatives to place grain in export position. Farmers and grain companies are captive shippers although farmers pay the freight costs for grain companies through basis deductions. Producers would welcome and support changes to the Canada Transportation Act that introduce competition into the rail system over regulation. Regulation is inefficient and results in externalities that are difficult to anticipate or correct. Regulation also does not adapt or allow for changes going forward into the future. Competition is technology neutral; rewards efficiency and service; and is future proof. Regulation is a distant second-best solution to competition and only done if additional competition is not introduced into the rail transport in sufficient amounts to shift the price/output levels off the duopoly profit maximizing solution.

The recommendations are primarily focused on creating market structures that enhance efficiency and reduce transaction costs. Competitive, market-based solutions to enhance efficiency and service to all parties, create transparency, and enhance certainty for market access. In absence of finding a market solution, we then recommend guidance on what is required for a regulated framework. The key component is that increased competition is preferred over regulation; however in absence of increasing competition in a meaningful way, regulation is absolutely necessary. Farmers understand that rail companies are relied upon by other industries and other resource sectors, and that solutions for one industry may affect other sectors. Farmers also understand that many of these other sectors and industries are also captive shippers; and that the solutions must keep railways from extracting excessive rents from all captive shippers.

If a bid-car system, similar to what is available in the United States, is considered as a way to increase transparency, we recommend that this is delayed until full, unfettered competition to increase rail service capacity is achieved. Without this kind of competition the bid car system would result in the institutionalizing of a method for the railways to extract the maximum rent available from every shipment. This would only increase the revenue transferred from grain companies to railways, and farmers would be paying the costs in higher basis levels.

1.1 Enhance Competition with Running Rights

The simplest, most-efficient solution would be to increase competition at the rail service level. This would include the ability of other Class I railways to use Canadian track, or allowing Class III (shortline) railways the ability to venture beyond their own track to provide service to other shippers than those directly on their lines. The competition would keep rates and service in line and provide farmers and grain companies shipping alternatives for market access. Currently, farmers have to go through either of the two railways for shipping to port. The duopoly nature of the export grain transportation allows the railways to exert excessive market power over farmers. Farmers cannot store large amounts of grain between crop years due to storage constraints and cash flow requirements. Thus the railways can reduce supply, increase shipping rates thereby extracting excess rent from their captive shippers. In these instances, greater competition would allow other suppliers to enter the market and provide service to farmers and grain companies.

One variant of joint running rights is interswitching (Nolan and Skotheim, 2008). It is expected that increasing the interswitching distance from 30km to 160km would increase competition for grain companies between the railways. This was extended in the Fair Rail for Grain Farmers Act and this should be enshrined in the Canadian Transportation Act. The Fair Rail for Grain Farmers allows for railways the ability to solicit for traffic within the interswitching distance. Note that this, in essence, allows for 'open access' by other railways within the interswitching distance. The Parliamentary intent of the Fair Rail for Grain Farmers supersedes Section 138 of the Canadian Transportation Act therefore, ruling that running rights as relief for captive shippers would keep railways in check and enhance competition across Western Canada. Greater competition, at all levels of Canada's grain handling and transportation system, is in the public interest.

It is our recommendation that joint running rights provided by Section 138 and 139 of the Canadian Transportation Act be viewed within the context and Parliamentary intent of the Fair Rail for Grain Farmers Act. Enhanced competition should be the primary goal of Section 138. We encourage the Agency to use this provision for the purpose it was intended and allow running rights on other federally regulated railway's assets.

In absence of increasing competition at the rail transportation level, the alternative recommendations include a number of regulatory instruments to keep the railways from exerting market power over farmers and other captive shippers. These are presented below as a package that would be an alternative to increasing competition. Note that we believe these to be a second best solution to increasing competition.

1.2 Costing Review

A formal costing review is required to ensure the maximum revenue cap is relevant to current transportation costs and volumes. The western Canadian grain handling and transport system has evolved and adapted over time. Efficiency gains in agriculture at all levels have been brought about by technological advances, logistical advances, and more efficient equipment. In transportation, grain companies have consolidated and farmers are typically hauling further to unit-train loading facilities thereby making railways logistically more efficient. Other cost efficiencies and cost increases had undoubtedly taken place since the last comprehensive costing review occurred. To have fair and effective regulatory framework in place, a comprehensive costing review is required and it is our recommendation that this be completed. Understanding the costs of placing grain in export position is the first step in making sure the revenue cap is appropriate, and if excess rent is being extracted from farmers.

1.3 Rail Revenue Cap

We would recommend that a commitment be obtained that the maximum revenue cap would remain in place to protect Western Canadian farmers. Without the maximum revenue cap in place, the railways would be in a position to charge and receive monopoly rent for the movement of grain. Western Canadian farmers cannot afford these extra costs with no prospect for improved service. As indicated previously, a bid-car system without significant and meaningful increases in competition would institutionalize a rent extraction method for the railways and would be done under the guise of a false market. This should be avoided until significant and meaningful competition is introduced to the system.

Shippers have indicated that the railways have created an array of ancillary service charges outside of the cap to increase their revenues from the shipment of grain. Moreover, under the cap, it appears that the railways are increasingly effective in pricing their services to extract their maximum allowable revenue from western grain producers and shippers throughout the barley value chain. We would recommend that these additional charges and fees be included within the rail revenue cap calculations and that the rail revenue cap formula be transparent to all parties within the value chain. These ancillary service charges should be identified and addressed with respect to their validity within the costing review, and allocated accordingly.

1.4 Transparency and Information Requirements

Asymmetrical information can lead to one party taking advantage of another in a transaction. Within the Canadian grain handling and transportation system, some parties have much greater information than others. There needs to be additional reporting of grain handling, marketing and transportation information, so farmers can make informed decisions in marketing their grain. This mandate needs to be included in the Canada Transportation Act. The type of information required is listed below although this list should not be viewed as complete:

Weekly car allocation by corridor
Weekly port unloads
Vessel line ups by port
Producer Car allocations and outstanding orders
Ocean freight rates with demurrage/despatch levels
Weekly rail car movement by corridor
Forward sales by commodity
Lake freight values and availability
Performance measures for all industry participants

We also recommend the establishment of a planning mechanism to assist in preparing the proper capacity with the Canadian Grain Transportation System. The grain handling and transportation system in Canada is complex and without some planning, misallocations can happen (number of ocean vessels waiting to load in Vancouver harbour last year broke all previous records by significant amounts). This mechanism would use stakeholder information so that planning may take place to accommodate sales and facilitate movement. Farmers ultimately pay the demurrage through the basis. The objective of planning should be the minimization of demurrage and meeting sales commitments on all corridors. The efficient and timely shipment of grain would be a step towards restoring Canada's reputation as a reliable shipper. Quorum (the grain transportation monitor) may be a natural fit for collecting and sharing this information.

1.5 Producer Cars

Producer cars (and dealer cars) are of critical importance to farmers as these represent an option to circumvent the grain companies; to move down the value chain; and collect greater rent and or reduce costs. In many instances, producer cars represent the only option for delivering a product to market. The option of producer cars restricts the grain companies' ability to extract excessive rent from farmers, however this is dependent on the availability of producer cars and the ability to ship them. Gray's study (2014) shows nearly $3.1 billion was transferred away from western Canadian farmers during the 2013/14 crop year, some of this cost to producers may have been avoided with a properly functioning producer car system. At the midpoint of this crop year, producer cars were well behind movement from primary elevators (Canadian Grain Commission statistics). At the end of the year close to 5000 cars had not been shipped. Recent restrictions on producer car orders to a two to four week period will not give the appropriate signals of producer car demand. The inability to source producer cars resulted in lost sales and a degradation of our shipping reputation with one of our largest customers, the processing industry within the USA.

The government of Canada assures farmers' right to ship producer and dealer cars be protected no matter what changes are made to marketing or transportation functions by virtue of the Canada Grains Act, subsection 87(1) and 87(2). This is being undermined by reduced service and we have concerns that over time the railways and grain companies will reduce their access to the infrastructure and remove this competitive tool for farmers. We recommend that the Canadian Transportation Act clearly identify the importance of producer cars and prioritize their movement as well as ensure that sufficient loading facilities are available and maintained.

Shortlines and producer cars are inherently linked. Usually, shortlines are the result of the Class I railways abandoning lines because of a lack of elevators on a line, or if the grain company sells the elevator, it will be under the provision that the elevator cannot ship grain from that location. Shortlines therefore typically only can load producer cars. Provisions should be created that allow shortlines which can put together multi-car shipments from their lines and within their interswitching distance, be rewarded with reduced costs at a schedule representing the reduced costs to the Class I railways. Shortlines have attempted to lease cars however restrictions on the use of these cars deterred some from proceeding and frustrated those who did. Shortline railways have a unique position in the transportation infrastructure and this position needs to be recognized and facilitated within this process.

In addition, the Canadian Transportation Agency should be empowered to investigate and rule on a railway's genuine 'operational interest' in underserviced and unused rail lines in which other parties have expressed an interest. These lines should go through the de-commissioning process and be put up for commercial sale.

1.6 Dispute Resolution Mechanism

Farmers want a system that provides reliable market access; unbiased information to base decisions on; and meaningful marketing options. In years past, there was the Canadian Wheat Board whom because of their mandate and powers, took the railways to court on several occasions on behalf of the producers. Today there is a discrepancy in the power between the railways, grain companies, and farmers. The final offer arbitration provisions in the Canadian Transportation Act can work for large shippers, like a grain company (a shipper has to incur freight charges of over $750,000 following unsuccessful negotiations) and while there is a simplified process for charges under $750,000; the complexity and expense of final offer arbitration is daunting for small shippers and processors, which can cost in the order of $500,000 or more. In most cases, the grain company would have to file the complaint to final offer arbitration to meet the $750,000 requirement, however the grain company is open to reprisals from the railway and the farmer is ultimately paying the transportation costs. Thus, it is doubtful that any grain company would bring forward any complaints to final offer arbitration.

Farmers do not have the resources or patience required to take rail companies to court over service complaints and in most instances they are not the official shipper of the product. We recommend the creation of a quick and meaningful dispute resolution mechanism that can resolve issues quickly and efficiently so that the parties can go back to their respective businesses with minimal disruption. The process must be transparent, penalize or reward damages for harm done on either side, and be resolved in a timely manner.

CONCLUSION

The market failure implicit to the Canadian Transportation Act with respect to railways is that with only two railways capable of placing grain in export position, farmers and grain companies are captive shippers. The railways have the incentive and capacity to extract the maximum revenue from each shipment thereby placing Saskatchewan farmers at a greater disadvantage than farmers in other countries with whom we compete. Two firms result in a special case of oligopoly which is a duopoly, and the railways have a natural duopoly in that there are significant barriers to entry. Our first and best solution is to introduce competition into the system through running rights. The addition of firms to a duopoly moves the system to a competitive solution very quickly (provided collusion and other non-competitive activities are thwarted). If this is not feasible, then to extend the regulatory system that is in place, with a costing review and review of the maximum rate cap. Our other recommendations revolve around providing farmers with marketing options (producer cars) and facilitating market transparency. Transportation planning becomes an important component to ensure that Canada regains its reputation as a reliable shipper, so recommendations are also provided to that objective.

We appreciate the opportunity to provide input into the review process from a purely grain-producer perspective. The experience of 2013/14 illustrates the massive transfers of revenue that can occur if producer interests are not represented in ongoing operational decisions in grain transportation, and publicly available information is not sufficient to allow for effective decision making by all participants in the industry. It is clearly demonstrable that these costs predominantly fell to primary producers. Our recommendations are designed to assist in providing a more balanced framework for us to operate with in future years. We look forward to further discussion on our concerns and recommendations.

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