Preparing for the Future

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▪ Introduction

My comments in Banff, as the wrap-up speaker, will presumably be affected by those who speak before me. Therefore, this paper addresses a number of factors about where the hog and pork industry is at present and that may affect it in the future. Then it addresses some ideas about preparing for a future that will contain those factors.

▪ Current and Likely Future Situation

For an industry that is traditionally characterized by risk and uncertainty, there may well be even more than usual in the future. We see outbreaks of disease, rapidly changing consumer patterns of preference, and abrupt changes in government policy. The latter includes a less-than-well thought-out trade policy by a US government that seems to be strategically challenged (eg "all of you free-world countries follow us blindly in the war on terrorism and shut up while we kick you in the teeth with our trade and agricultural policies"). Simultaneously, all industries bear special risk from a group of religious fanatics who cannot sell their beliefs democratically anywhere, but feel that they have some spiritual right to disrupt everyone's lives.

In this chaos are at least a few factors that seem to be systematic or, in the case of country of origin labeling, we can begin to anticipate some scenarios and what they may mean. So, in the first part of this paper, we address four factors:

- The declining relative cost advantage of (especially) western Canada in hog finishing. This includes both short and long term factors.
- Country of origin labeling, and its implications.

- Canada's world trade position.
- Environmental issues.

Cost Competitiveness

In 1997 and 1999, the George Morris Centre produced reports that said Canada, especially western Canada, had cost advantages over other locations in hog production. In early 2002, we produced an update that suggests things have changed. The following is an excerpt from the conclusion to that report.

> "The results of this study are surprisingly clear. Southern Minnesota holds an advantage over the Canadian Prairies in the farrow-to-finish and finishing enterprises. The Eastern Prairie region has an advantage in farrowing. This is a departure from two previous studies completed by the George Morris Centre that found the Canadian Prairies to have a competitive advantage.

The nature of the Southern Minnesota advantage lies in relatively inexpensive feeds and relatively high hog prices. These two factors deserve further discussion.

Why are feeds cheaper in Southern Minnesota? There are several factors, including:

- Reduced US corn prices. US corn prices have fallen largely due to the impact of US farm programs. The impact of US farm policy in reducing crop prices has been well documented (see, for example Martin, Brethour, and Stiefelmeyer, 2001). Essentially, these programs give Midwest farmers the incentive to grow corn despite market signals to the contrary, and leave them willing to sell at prices well below production cost, especially in the summer months. The data presented here, as indicated in section 3.0, indicate that the largest price discrepancy occurs in the summer. No such program exists in Western Canada. This presents a policy-driven market distortion that damages the competitive advantage of the Canadian Prairies in both feedgrain and livestock production. Thus, US farm programs have much to do with the southward exodus of Manitoba weaner pigs and other losses in Western Canada's advantage.

- At the same time, Western Canadian feedgrain prices have not decreased in price as much as the US corn price. On the surface, this is surprising given that corn is a ready substitute for barley and feed wheat in hog and cattle rations. Part of this is clearly associated with the ongoing drought in the Western Prairies. In addition, the Prairie feedgrain market cannot arbitrage with the US because of its regulated nature.

- The results show that vomitoxin is a major issue in the Eastern Prairies. The magnitude of the damage done by vomitoxin varies by location within the Eastern Prairies. However, in the comparison of variable costs for farrow-to-finish operations, removing the vomitoxin charge tilts the balance toward Southern Minnesota in 1999 and 2000 using our base adjustment of $13.50 per tonne. Some of our reviewers are rather adamant that the additional cost is actually closer to $20/tonne. If so, this alone gives a competitive disadvantage to finishing hogs in the Eastern Prairies.

Because of this problem, a private/public sector consortium in Manitoba invested in developing a vomitoxin-resistant feed wheat variety several years ago that became available during 2000. Unfortunately, the variety was not recommended for licensing by the Canadian Wheat Board on the ground that it is not "kernal visually distinct". So once again the economic well being and potential for value adding in the Prairies is compromised because the Prairie grain handling system continues to rely on the antiquated technology of visual distinction. And this is another step that ensures the Prairies remain as an exporter of low value, raw materials. Our conclusions depend heavily on the rations used to compare feed costs. Some reviewers criticized the Western and Eastern Prairie rations on the basis that actual rations have adjusted away from our specification as ingredient prices have changed. No doubt this has occurred, and to the extent that it has occurred our feed cost estimates will unduly penalize the Eastern and Western Prairies. Some reviewers suggested that field peas should be included in the ration. One reviewer in the Western Prairies found that peas reduced his feed cost by over $1/pig. However, broad statements about the use of peas in hog rations are difficult to make, because further investigation led to a number of significant producers asserting that they simply are not using them in many regions. Hence, the rations we use appear to be similar to standard industry practice.

Others suggested that canola meal should have been included. Canola meal is widely used in hog rations in Western Canada, as is soymeal, since they are near perfect substitutes. However it is difficult to argue that canola meal is consistently cheaper then soymeal on a protein adjusted basis, because, (unlike barley) there is nothing to stop soymeal and canola meal prices from arbitraging. Thus, in the long run, little detail would be added by including canola meal.

Finally, in recognition of recent trends toward corn in Prairie rations, it can be argued that corn should be included in place of barley and feed wheat. But by doing so, we would only be replicating the Southern Minnesota ration, and would determine that the Eastern and Western Prairies have a feed cost that is simply freight over Southern Minnesota. Consequently, while we acknowledge that there has clearly been some substitution away from the traditional Prairie hog rations used here which causes the analysis to overstate the feed cost disadvantage to the Canadian Prairies, this overstatement is not likely to be substantial and reformulating the Prairie rations would not solve the problem. Fundamentally, the analysis shows that the West no longer has a cost advantage when producing hogs with Western feedgrains.

Historically, Western Canadian processors have paid lower prices for hogs than are paid in the Midwest US. This exacerbates the difficulty caused by increases in relative feed costs. However, it is worth noting that the trend in relative prices shows that they are increasing in Manitoba and Alberta relative to Iowa/Minnesota. This has contributed to a gain in relative profitability for the Eastern Prairies in recent years. But the analysis shows that it is relatively less profitable to finish hogs in Western Canada than in Iowa/Southern Minnesota. This, plus the advantage that is shown for producing weaner pigs leads to the conclusion that those who place sow barns in Western Canada and then ship the weanlings to the US to finish them are merely being rational.

Based on these results, it appears that the Eastern Prairies' only advantage is lower cost labour and lower interest costs. The former is likely related in part a higher unemployment rate than in the US. The latter is a fleeting advantage at best.

Nothing that has happened in the hog market, or the grain markets, since this report was published would change our conclusions. In fact, the 2002 US Farm Bill has more incentive in it to produce corn, and at least as much incentive in it to market it late in the crop year. So, it will encourage lower prices of corn, and continue to encourage US producers to market during the summer months, driving down US prices in the summer, just when they tend to be highest in Canada. I remain convinced that the 2002 US Farm Bill is largely about giving the US a synthetic advantage in livestock production.

Looking at this longer term, one has to be concerned about whether Canada will be able to regain competitive advantage, even if weather conditions return to normal, and the Farm Bill effects are minimized. First, there continues to be no obvious solution to the vomitoxin problem, even if in this crop year it is less of a problem (and don't forget that a lot of grain remains in fields as of late November.

Even more fundamental is the ability of western Canada to produce feedgrains competitively. Figures 1 and 2 contain actual and trend yields of barley and corn in Alberta and Iowa. Assuming they are representative of the US corn belt and the prairie region, two major factors immediately jump out from the two graphs. The first is that yields in Iowa are more than 2 ½ times those in the prairies. Second, they are growing much faster in Iowa. The coefficients for the trend lines indicate that yields are trending upward at an annual rate four times higher in the US than in Alberta. If this trend continues, the prairies will lose any inherent cost advantage that they may have had.

Figure 1: Alberta Barley Yield, 1985-2001 (from Statistics Canada: CANSIM II DATABASE - Table number 001-0010)

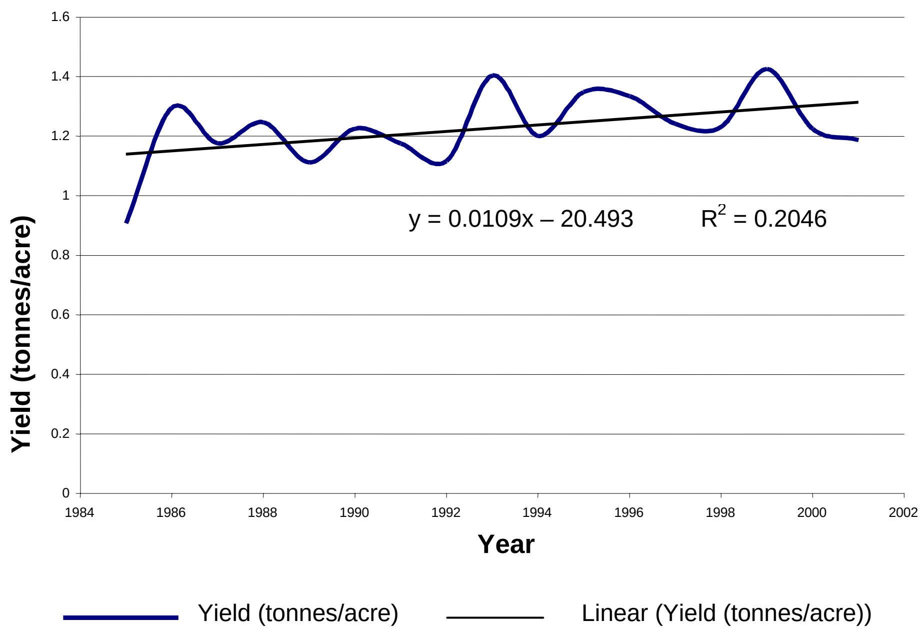
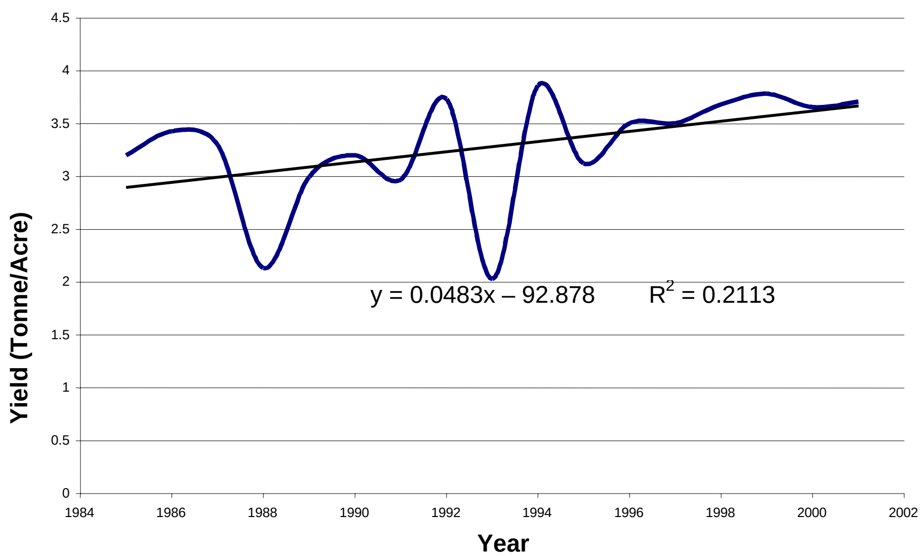


Figure 2: Iowa Corn Yield, 1985-2001 (from USDA – NASS Database)



Country of Origin Labeling (COL)

As we all know by now, the US passed legislation early in 2002 that makes labelling:

- pork from weaners born in Canada, raised in the US and processed in the US
- pork from those born and raised in Canada, but processed in the US
- pork from pigs born, raised and processed in Canada
- pork from those pigs born, raised and processed in the US

all separate products.

It's interesting that this also applies to beef animals, fish, fresh produce and peanuts, but not poultry or dairy products. Do you suppose it may have something to do with what we export, not with the safety or wholesomeness of products?

It is also clear that this silliness is voluntary until 2004, at which time it is scheduled to become mandatory. And it is also clear that it will cost red meat processors in the US a substantial amount of money, even if they do not process any livestock of foreign origin. This is because they will need to have full traceback protocols in place to prove that they are not processing them even if they are not. Finally, it will increase the cost and price of red meat in the US relative to its competitors.

Nevertheless, to date, the requirements are scheduled to become mandatory in 2004.

In November, the George Morris Centre completed a preliminary analysis for the Manitoba Pork Council of the implications for the Canadian pork industry. As this is written, the final report is not finished, but some preliminary conclusions are available.

One major component of the project included interviews with US packers and retailers about how they plan to adjust to the labelling requirements. We got back two responses from a major segment of the packing industry. Some said they have crunched the numbers and concluded that they will stop buying hogs of Canadian origin because the cost of segregation will be too high. Others said they have not crunched the numbers, so they don't know what they will do yet. None said they would reserve special runs for hogs of Canadian origin.

US retailers had a different story. They all say COL is a monumental waste of time and money to provide information of no value to anyone, because US consumers simply don't care whether pork comes from Canada, nor is there any reason for them to care. They want to continue to buy pork from Canada.

However, whether they will or not depends on how much more it costs them to handle the extra SKU's associated with COL.

Our preliminary analysis of the economic impacts **because of the pork COL (not beef)** from the report submitted in late November is quoted below. This is what may happen if US packers and retailers both significantly reduce their purchases of Canadian hogs and pork.

"At worst, Canada will either lose a substantial export market or retain it only at a significant price discount.

In the negative scenario, we estimate:

- Canadian hog and pork industry could lose over 450 hog farms and farm income totaling over $350 million.
- Feed mills would close
- A market for 250,000 acres of cropland would be lost.
- Including grain farms, losses could be up to $750 million in farm income lost along with over 3,000 farms."

Environmental Issues

To date, environmental issues are less of a problem in Canada than the US. And the Canadian industry needs to continue to look for ways to ensure that it stops being looked upon as a problem. Within Canada the picture is not clear. Quebec continues to impose moratoria from time to time on building new production units. Ontario recently passed legislation with very stringent regulations, that may, ironically, make it easier to obtain building permits. Alberta passed legislation the objective of which was to make it easier and more consistent. But, to date, few if any permits have been granted. Manitoba and Saskatchewan appear to be in the middle.

Putting environmental concerns in the context of COL gives an interesting picture. Canada sends over 5 million pigs to the US, either as weaners or slaughter hogs. This means, taking COL to its limit, Canada needs to develop feeding spaces and processing capacity for 5 million more pigs, while the US needs to develop sow, finishing and nursery spaces for these 5 million.

This raises two issues. One is that the farm bill will encourage more pork production and lower hog prices. The second is that the environmental concerns for sows is lower than those of the equivalent number of finished animals.

Canada as an Exporter of Pork

The brightest spot in this big picture is that Canada has become the world's largest exporter of pork. Others on the program at the Banff conference will talk about this in detail, so only one thing more will be added here. That is that COL will, at least in the short run, likely cause a shortfall of pork in the US. This will give Canada a chance to take offshore export market share away from them, which we need to keep.

▪ Preparing for the Future

With these factors in the present and future, what do we need to think about as components of a strategy? I suggest the following:

- Help find ways to ensure that the US does not make COL mandatory.
- Find ways to bend COL into an advantage. Are there attributes of Canadian pork or Canada that can be used to create a premium in the US market? The US represents about 40% of Canada's market for hogs and pork. Canadian imports represent about 8% of US consumption. Sounds like a niche opportunity waiting to happen. How do we ensure that Canadian product gets maximum shelf space?
- Similarly, develop a strategy to take away offshore markets from the US and keep them.
- Develop ways to quickly and effectively bring COL (and other parts of the US Farm Bill) to NAFTA and the WTO to bring legal sanctions against the US for imposing them.
- Ensure that financing is available to build finishing spaces in Canada.
- Ensure that incentives are in place to obtain the labour required to move a number of Canadian processing plants to double shift capacity.

In addition, if Canadian hogs cannot move to the US, Canadian and US prices will be divorced from each other. Moreover, in the past when arbitrage was impaired, Canadian hog prices fell relative to the US. This suggests that new and more modern pricing mechanisms need to be investigated.

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