Saskatchewan Wheat Development Commission

Review of Potential Changes to the Canada Grain Act

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Author:

Ward Weisensel

1.0 Introduction and Purpose of Review

The Saskatchewan Wheat Development Commission (SWDC) is a producer led organization established to grow the province's wheat industry. It was established on June 20, 2013 and it administers a mandatory (refundable) check-off used to fund research and market development initiatives that improve wheat varieties, grow their marketability and provide higher value to producers. The SWDC has requested a review of potential changes being considered for the Canada Grain Act and the implications of these changes on the activities and economics of Saskatchewan grain producers. The review encompasses the operations of the Canadian Grain Commission which was created in 1912 as a result of the passing by the Parliament of Canada of the Canada Grain Act.

The Canadian government passed the Canada Grain Act in 1912 in response to farmer lobbying that they needed protection from the unfair practices of interacting with grain traders. In this regard, the Act streamlined existing legislation and regulations concerning grain and grain handling and created the Board of Grain Commissioners for Canada.

The Canadian Grain Commission (CGC) is the organization that regulates grain handling in Canada. It also establishes and maintains science-based standards of quality for Canadian grain. The CGC's research, programs and services help support Canada's reputation as a consistent and reliable source of high-quality grain.

The object of the Canada Grain Act (CGA) is as follows:

> Subject to this Act and any directions to the Commission issued from time to time under this Act by the Governor in Council or the Minister, the Commission shall, in the interests of the grain producers, establish and maintain standards of quality for Canadian grain and regulate grain handling in Canada, to ensure a dependable commodity for domestic and export markets.

Consistent with the object of the Act, the CGC works to

- deliver grain quality and quantity assurance programs for exports of Canadian grain,
- carry out scientific research to understand all aspects of grain quality and grain safety,
- establish and maintain Canada's science-based grain grading system, and
- ensure farmers receive fair compensation for their grain.

2.0 Background

Earlier this year, Agriculture Canada released a discussion document to begin the review process. The Executive Summary of the discussion document is reproduced below as it effectively articulates the main issues that are under consideration.

The Canada Grain Act and its associated regulations provide the framework for Canada's grain quality assurance system and establish certain protections for grain farmers. The Canada Grain Act sets out the objectives and functions of the Canadian Grain Commission, which is responsible for regulating grain quality and handling in Canada to ensure a dependable commodity for domestic and export markets. The Canadian Grain Commission delivers programs and services to establish and maintain Canada's science-based grain grading system and provide various safeguards for grain farmers.

The Canada Grain Act and Canadian Grain Commission were established at a time when the Canadian grain sector looked much different than it does today. The way grain is bought, sold, delivered and handled at facilities has changed significantly, as have buyers' demands for grain quality. The Canada Grain Act has not been comprehensively updated in many years, and it is possible that some modernization is required to ensure the system is better aligned with current and future market realities.

The Government of Canada is undertaking a review of the Canada Grain Act and the Canadian Grain Commission. The review process will enable stakeholders to help collectively shape a vision for a world-class grain quality assurance system and producer protection framework that meets the needs of the sector, now and for the future. With this review, the Government of Canada aims to achieve an agile regulatory system that promotes innovation, evolves with the pace of industry change, safeguards grain farmers, enhances Canada's reputation for grain quality, and strengthens international competitiveness. We are open to your views and ideas on what a modernized, science-based regulatory body would look like within this context and what changes could be made to the Canada Grain Act and/or operations of the Canadian Grain Commission to achieve this vision.

To help initiate discussion, we have highlighted several issues that may be of particular interest:

Access to binding determination of grade and dockage

- Binding determination is intended to be an independent dispute resolution mechanism when a producer and buyer disagree on grade or dockage.
- Are there any gaps between the current system and what is needed?

Producer payment protection

- The program is intended to help ensure producers are protected against a buyer's failure to pay for grain, in a cost-effective manner that fairly allocates risk.
- Can the program be improved to better meet the needs of the sector?

CGC licensing

- The licensing system for elevators and grain dealers is designed as a framework for establishing and maintaining Canada's grain quality assurance system, while also safeguarding producers and enabling data collection.
- Does the existing licensing approach meet the sector's needs?

Official inspection and weighing:

- The system of inspection, weighing, and certification of grain for export is intended to help ensure there is dependable Canadian grain for domestic and export markets.
- Are there ways the system could better meet the sector's needs?

With the release of the discussions document by Agriculture Canada, interested parties were provided the opportunity to respond with their views and concerns. However, the onset of the COVID 19 pandemic curtailed these activities as it has for most consultative activity. Based on Canada's success in stabilizing the pandemic situation, it is expected that the consultative process will begin to pick up momentum going forward.

3.0 Author's Background

The author has extensive experience as a senior executive responsible for marketing, product development, trading, logistics and risk management activities of the CWB and G3 Canada Ltd. Mr. Weisensel was the Chief Operating Officer of the Canadian Wheat Board (CWB) beginning in 2004 until G3 Canada Ltd. purchased a majority interest in the CWB in July of 2015. With the change in ownership, Mr. Weisensel was appointed to the position of Senior Vice President Trading, Procurement and Risk for G3 Canada Ltd. He held that position until the end of 2017 and since then has been operating as a private consultant. Mr. Weisensel is the Chair of the Board of Directors of Red River Cooperative (RRC). RRC is a large retail cooperative (revenues are approximately $650 million annually) operating in Winnipeg and area.

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

4.0 Overview of Grain Company Operations and the Role of the CGC

4.1 Sales Planning

Grain sales are typically made for delivery positions 1 month to 6 months forward. As a result, all grain companies spend considerable effort on sales planning to ensure that they have a good handle on the following:

- The grains and grades they expect to be able to originate from their primary elevator systems to execute forward sales they have made and plan to make.
- The logistical capacity they believe they can secure so that they do not sell more volume than they can effectively deliver to port position in a specific time period.
- The anticipated customer demand for forward shipping positions that includes expected quantities and qualities that their customers require for various forward shipping positions.

- An assessment of the competitive environment as it relates to selling grain to customers and purchasing grain from farmers as the company is focussed on earning a trading margin that allows for an appropriate return for the capital assets in their network.

Whether the plan is formal or informal, it encompasses input across many levels in a grain company which includes but is not limited to the following:

- Input from the Company's primary elevator operators who provide the quantities they expect to be able to buy and deliver to rail cars and/or trucks (including grains, grades, protein, and other relevant quality factors) over the next number of months at assumed basis levels.
- Input from Terminal operators regarding their capacity to ship based on the grain and grade and quality distribution they expect to unload. This includes discussion on blending opportunities based upon the grain that is planned to be shipped to terminal position.
- Input from Rail Logistics regarding current and anticipated rail capacity and how this will be distributed across the company's primary elevator network.
- Input from Traders on anticipated customer demand, farmer willingness to sell and move product, and anticipated margins for the various commodity lines that are anticipated to be moving through their elevator network.

At this stage of planning, implicit in these processes are the CGC's roles as it relates to:

- the setting of grade standards,
- the issuing of CGC weekly reports on exports, receipts and shipments from primary elevators, and
- CGC capacity to provide the service levels required for the sales program the company plans to execute.

The sales plan is dynamic and changes regularly as new information becomes available.

4.2 Sales Contracting and Execution

Pursuant to the sales plan, the company makes sales to customers. A typical sales contract includes, but is not limited to, the following:

- The price, quantity and quality to be delivered,
- the shipping period (it is typically a 30 day period which is narrowed to a 2 week period a month prior to the shipping period),
- the consequences for non-performance of the parties to the contract, and
- a listing of the documents that must be produced by the seller before the customer will make payment to the seller (e.g., bill of lading, phytosanitary certification, assessment of quality delivered, etc.).

In most sales contracts today, the terminology in the contract indicates that the quality assessment and determination will be made by the CGC or a third-party at the option of the seller (i.e., the grain company). While there is not objective data available to determine the exact proportion of contracts where companies have the option of the CGC or a third-party to provide the quality assessment documents to meet their contract commitments, many would indicate that this proportion is around 80 per cent and increasing.

This is not an indication that buyers have lost confidence or do not want to use the CGC as the determination of quality on the grain they buy from Canada. Rather, it is a reflection of the fact that grain companies have been pushing customers for the addition of this option for many years. While optionality is always of value to grain companies, this effort began in earnest around the time that the CGC moved out of its inward inspection role of grains at export terminal positions (this process started in 2012-13 crop year).

Why did the CGC's move out of inward inspection drive this behaviour? In the loading of export vessels, it is not uncommon for there to be a difference of opinion between the terminal operator and the CGC regarding the assessment of quality being delivered to a vessel (i.e., the outward inspection). The CGC, in its assessment of each 2,000 tonne increment loaded to a vessel informs the terminal operator about the quality of each increment and what this means for the composite grade the CGC will produce based upon what has been loaded up to that time.

The terminal operator is loading grain to the vessel to meet the minimum specifications of the grade contracted based on their understanding of the quality of grain they have unloaded in the terminal, including their decisions as to where unloaded rail cars are binned within the terminal. When the CGC was involved in inward inspection, the terminal operator was guided by the CGC's analysis in making their binning decisions to manage the quality segregations in the terminal (some terminals followed the CGC grade virtually exclusively in their binning decisions). As a result, when an outward export inspection result varied from what the CGC determined on the inward inspection, the terminal operator would engage and escalate the situation within the CGC. The argument made by the terminal operator was that the CGC had to be accountable for the quality they said the grain was at unload into the terminal and this should not change on the outward inspection. In most situations, this discussion resulted in a resolution where an accommodation was reached between the CGC and the terminal operator. It is important to note that these issues are much more common in poor quality years and particularly for wheat and durum where many of the grading factors are more subjective in nature (keeping in mind as well that often the CGC person inspecting on the outward side of a terminal was different from the CGC individual who inspected on the inward side).

When the CGC moved out of inward inspection, it eliminated the ability for the above discussion to occur between the CGC and the terminal operator. Particularly in poor quality years, this significantly increased the risk that grain companies were incurring, and grain companies began to consistently ask customers to get the option of third-party inspection into export contracts with all buyers. It is important to note that third-party inspection is not uncommon in the international grain trade and, as a result, customers who buy from many origins are familiar with it. The fact that 80% plus of contracts have the option is not necessarily an indication of concern with the service provided by the CGC. It is an indication that grain companies are pushing every customer for this option on every sale because this lowers their operational risk.

So how does this work in practice? In poor quality years (and particularly for wheat and durum), grain companies are using third-party inspectors at primary elevators, at terminal unload and on the outward inspection where the option exists in the contract. These third-party inspectors are prepared to guarantee their outward inspection based on what they determine on the inward side. This allows a grain company to effectively manage the risk and to the extent that their risk is lower this should put downward pressure on the basis levels farmers incur (i.e., higher farm gate prices) when they sell and deliver their grain to a primary elevator. On contracts where grain companies do not have the option of third-party inspection, the grain companies are still

using these third-party companies to manage the risk of knowing what is coming at them as it relates to inward determination at the terminal but they are relying on the CGC outward determination. One would expect, on average, that the grain loaded on contracts that have exclusive CGC inspection would be slightly better quality than grain loaded on contracts where third-party inspection is an option to be used. This reduces the company's risk that the CGC may find they have not met the contract specs on the outward inspection. This additional risk may put downward pressure on farm gate prices in certain circumstances. Interestingly, some large transnational grain traders hold out for exclusive CGC inspection, where they have the leverage to demand it, because they expect they will get slightly better quality even though they themselves use third-party inspection in their operations regularly.

As is explained above, it is at sales contract execution where the rubber hits the road as it relates to determining delivered quality and the production of documents needed for the grain company to get payment from the buyer. From a grain company perspective, this is also the highest risk element of dealing exclusively with the CGC when they are only doing inspection on the outward flow of grain to export vessels. The consequences of being unable to get the required certification of quality on a vessel cannot be overstated. At a minimum, the demurrage/despatch clock is ticking while the terminal and CGC work out what is needed to meet spec in the event the terminal stops loading while addressing CGC identified quality issues. At worst, the terminal may be forced to discharge cargo that is already loaded. The time to achieve this is incredibly costly (in the form of demurrage on all vessels in the line-up, lost terminal productivity, the cost of discharge and the potential downstream logistics impacts when a terminal stops loading grain to vessels) and grain companies are rationally trying to find all ways to minimize this risk. It is important to note that lower risk is directionally positive for farm gate returns under competitive circumstances.

In high quality years, the grain companies do not employ third-party inspectors and rely solely on the CGC on the outward side as is their option under the sales contract. In these years, the quality risks are very low and thus the only inspection cost is that of the CGC. In other years, when quality is less sure, grain companies use private third-party inspectors to manage their risk and are essentially paying for the inspection service twice.

4.3 Grain Purchasing and Farmer Delivery

Consistent with the sales planning process, grain companies purchase grain from farmers to meet forward sales commitments. The tremendous changes in rail and primary elevator infrastructure over the last 10 to 20 years have created significant changes in managing the logistics of purchasing grain from farmers.

While there are variations on this general theme, today most companies have a very good handle on the on-farm quality of their farmer customer base and they are reaching out to farmers to execute delivery of the farmer's product to meet the company's sales requirements each and every week. Modern high-throughput elevators do not generally accept delivery of product that is not needed virtually immediately to meet customer demand. In addition, more than ever before, the timing of a purchase contract with a farmer is separate and distinct from the timing of delivery. Finally, the significant increases in commercial trucking from farm to primary elevator means the farmer is far less likely to be present when the grain is delivered to the primary elevator.

Most grain companies are probing the truck delivery ahead of actual unload to confirm that the quality on the truck is consistent with what they expect from the farmer and what the company needs for the next unit train coming to the facility. The determination of quality on the unload drives payment from the perspective that the sales and purchase contract will have a base price with quality premiums and discounts determined based on the actual delivered quality. Relative to when a farmer is present at delivery, the advent of commercial trucking means a farmer is in a weaker position as it relates to the quality determined at delivery. Exacerbating this issue is the fact that each shipment to the primary elevator is much larger than it was years ago.

The CGC plays a number of roles to enhance the position of the farmer in this relationship although all are meant to address worst case scenarios. Farmers shopping their grain and constantly testing their relationships with grain companies remain the primary ways in which farmers protect their interests with grain companies. That said, the farmer has access to the CGC service of binding determination on grade at the time of delivery. The farmer is also protected by the CGC licensing and producer payment security provisions. These activities will be discussed further below.

5.0 CGC Budgeting and Recent History

The cost of operating the CGC has been an industry concern throughout its history but the pressure to reduce costs has been particularly significant over the last decade. A ten-year history of budgeted and actual revenue and expenses for the CGC is illustrated in Table 1.

Table 1: CGC Budgeted and Actual Revenue, Expenses and Net Return, 2010 – 2019.
(Thousands of $C)

Year	Budgeted Revenue	Actual Revenue	Budgeted Expenses	Actual Expenses	Budgeted Net Return	Actual Net Return
2010	**77,256**	**84,803**	**83,607**	**80,067**	**-6,351**	**4,736**
2011	**70,133**	**76,527**	**85,501**	**79,029**	**-12,368**	**-2,502**
2012	**73,344**	**83,146**	**82,651**	**81,194**	**-9,307**	**1,952**
2013	**69,896**	**77,986**	**83,884**	**97,666**	**-13,988**	**-19,680**
2014	83,580	88,108	66,789	56,590	16,791	31,518
2015	63,109	84,925	59,243	55,043	3,866	29,882
2016	59,487	84,635	61,998	55,332	-2,511	29,303
2017	59,710	83,189	64,134	59,392	-4,424	23,797
2018	63,083	71,053	65,358	60,793	-2,275	10,260
2019	60,264	68,008	67,383	63,245	-7,119	4,763

In determining its revenue requirements, the CGC prepares annual budgets based upon the variable and overhead expenditures it expects to incur to provide its services to the grain industry. The budgeted expenses represent its best estimate of the annual cost of operations. The CGC is mandated to operate on a break-even basis after accounting for the appropriations they receive from government which have amounted to just under $6 million annually in recent years.

CGC Budgeted revenues are based on a combination of fees collected from the grain industry and appropriations from government. Clearly, most revenues come from the fees charged to the industry for CGC services. In determining the fees, the intention of the CGC is to break-even on each component of the services they provide. Given that CGC inspection and grain quality control represents by far the largest component of the services the CGC provides, the vast majority of their revenue comes from the fees charged for outward inspection. In determining the per tonne fee to charge the industry, the CGC simply divides the anticipated costs to provide their inspection services including overhead and other grain quality control activities by the volume they anticipate that they will inspect over the budget period. If they underestimate this volume actual revenues will exceed anticipated expenses. By the same token, if they overestimate volumes, revenues will fall short of expense. In examining Table 1, the following observations can be made:

- Over the period of 2010 to 2019, it appears that the CGC has significantly underestimated the volume of inspections as actual revenues have exceeded budgeted revenues every year.
- Actual expenses incurred have been less than budgeted expenses for all years except 2013. In addition, actual expenses have fallen by more than 20 million dollars largely reflecting the CGC's move out of inward inspection in 2012-13. The surge in expenses in 2013 likely reflects organizational costs of the staff reductions incurred by the CGC when they moved out of inward inspection.
- The under estimation of volumes combined with the over estimation of expenses has led to the significant surpluses that the CGC has experienced.

6.0 Quality Assurance, Value and the Canadian Brand

When individuals discuss the Canadian brand as it relates to grains and oilseeds they are often speaking about very different things. Farmers commonly focus in on the importance of the quality of our products and that this allows Canadian grain to earn premiums relative to our competitors in world markets. The common quote is that "Canadian wheat, durum and canola are the best in the world and customers demand this grain in preference to other origins and this allows Canadian grain to command a premium price in the market-place." This view is generally focussed on the brand value to the end-use customer who needs to produce a high-quality end-use product.

Contrasting this are the viewpoints of grain traders where each company knows that it is trading identically the same product, competing for the same customers and sourcing the product from the same farmers. Every company takes the brand identity of the grain or oilseed they are trading as a given and while it may give Canada an edge in particular markets this product brand is not something that can be used to create additional value for any individual company. A grain company is focussed on what identifies them as different from their competitors in the market-place so that customers and farmers are more likely to do business with them as opposed to their competitors. They are focused on non-price attributes that attract farmer and customer loyalty to their firm and these are usually service and infrastructure related.

Both of the above perspectives on brand are correct on one important point. A key part of an effective brand is identifying what is different about the product you are offering relative to the product offered by your competitors. These differences allow you to differentiate your product

so that you can earn higher prices than could be earned if your product is effectively the same as your competitors.

A great example of a highly effective brand is Apple. While the commodity they are offering is a smartphone that is in principle very alike to other smartphones available in the market-place, Apple has been able to differentiate its product so that it is able to charge higher prices for its smart phones than its competitors. The reasons for this are many-fold but they are all focussed on a brand promise that customers of Apple receive a superior product and set of services than if they bought their smartphone from Apple's competitors. With this brand promise, Apple knows that customers are "willing to pay" more and thus can charge a higher price for the volume of smartphones they produce for the market. However, it is also critical that they know that the price premium they achieve profitably compensates them for the dollars they spend to create the brand promise.

Grain is very different than the situation with Apple. First, the farmer, except on some specific domestic and specialized export business, does not deal directly with Canada's end-use customers and due to the economies of scale of trading grain they are not likely to. Second, the farmer is selling predominantly to a middle-man who is a commodity trader who trades on a margin. Third, the farmer cannot differentiate the product they deliver to the commodity trader from his farmer neighbor except on measurable differences of actual grade determinants. Fourth, the commodity trader is not at all interested or supportive of seeing a farmer differentiate themselves. If a farmer tries and demands a higher price, traders will simply purchase the product from someone else. The farmer is effectively a price taker and the market price they achieve is based upon the price they are collectively "willing to accept" and this price is generally based on the more distressed sellers (i.e., farmers) in the marketplace as the individual actions of any one farmer has no material impact on the volumes and qualities that get produced and sold in any given year. The farmers "willingness to accept" is separate and distinct from the customer's "willingness to pay."

So how does this relate to a grain company? They are trying to differentiate themselves on the basis of service, access to product and infrastructure. That said, every customer knows that they can get the same product from any of the grain company's competitors. The bottom line is that the product that grain companies are trading is a commodity and no grain company can command any different price than their competitors for this commodity at a given point in time. As a result, grain trading is a very volume driven business as companies can spread their overhead over a greater quantity traded.

So how does this relate to a domestic or export customer? They may be "willing to pay" more for the product they are purchasing from Canada as they know the value of the product in creating their end-use products. But they also recognize that they can get the same product from anyone of many grain companies who are offering essentially the same set of services. They are seeking the least cost supplier in virtually every situation and will buy from the cheapest supplier which in most cases will be at a price less, and often well less, than their "willingness to pay."

Only a single seller of the product can price differentiate to extract a greater portion of a customer's willingness to pay which was the case for wheat, durum and barley with the operation of the CWB prior to the regulatory changes enacted in 2012. In that era, many customers were paying premiums for Canadian wheat and durum relative to what they would have had to pay for similar quality U.S. spring wheats and durums. That said, many customers

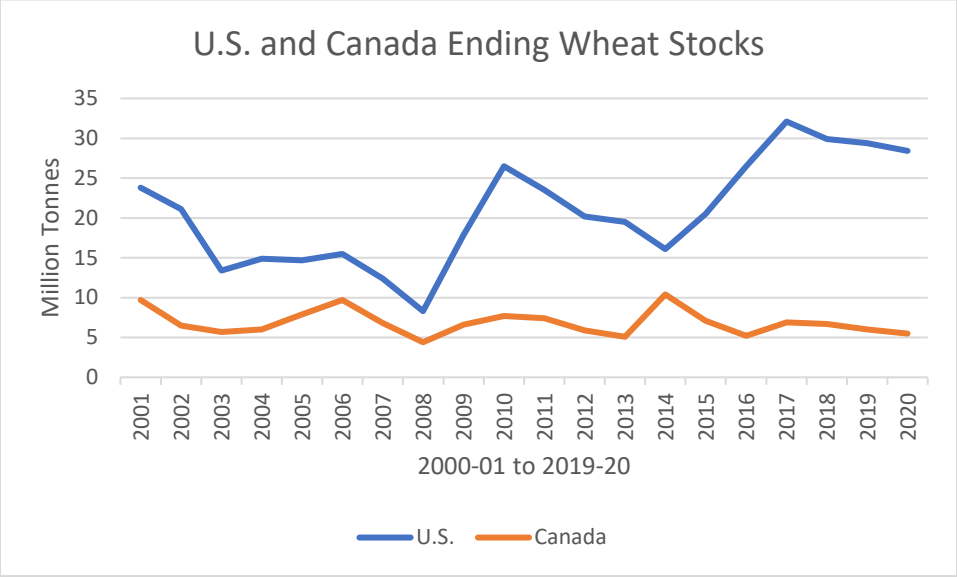
were not willing to pay premiums as the market for high quality spring wheat and durum is limited. As a result, in order to clear the market, a significant volume of grain would be traded at values at a discount to U.S. values as that is what it took to sell the grain that was offered for sale by farmers to the CWB at the time.

In the current multiple seller environment, there is no ability to price differentiate and as a result Canadian wheat and durum has and is trading at discounts to like quality U.S. wheat and durum. The level of discounting varies over time but the discounting has been a consistent feature. This is not a criticism of the system. It is simply a reflection of the fact that if Western Canada is motivated to sell and move its exportable surplus of grain each and every year, then the export surplus will need to trade at discounts to similar quality U.S. grain.

The U.S. has been the residual supplier to the market on quality wheat and durum for much of recent history. The notable exceptions to this were the time periods when the International Wheat Agreements (IWAs) were operating and when the U.S. was aggressively using export subsidies specifically to drive down wheat stock levels. To illustrate this point, Chart 1 below shows the trends on ending stocks in Canada and the U.S. over the last 20 years. With the notable influence on ending stocks of Canada's mammoth 2013-14 crop, Canadian wheat ending stocks have been relatively stable.[1]

In contrast, the ending stock situation in the U.S. is much more variable. Only once in this 20 year period have U.S. wheat ending stocks been below 10 million tonnes and this occurred during the unprecedented price rally of the 2007-08 crop year. In that year, buyers from all over the world drew down U.S. wheat stocks to critically low levels and wheat prices soared.

Chart 1: U.S. and Canada Ending Stocks 2000-01 to 2019-20. Source: USDA



[1] Higher ending wheat stocks in 2005-06 were attributable to a Western Canadian crop that was much lower in quality than normal.

Wheat production in the U.S. has been trending lower in recent years. In 2008-09, U.S. wheat production was just over 60 million tonnes. In 2019-20 this had fallen to just over 52 million tonnes. This compares to total U.S. domestic wheat consumption which has hovered around 30 million tonnes annually which means more than 50% of U.S. production is consumed in various forms in the U.S. market. U.S. domestic market participants play a key role in ensuring that they have supply security and they are competing against export alternatives to ensure they have security of supply. At the same time, U.S. farmers have many marketing options outside of the export market so they do not see the same impacts on basis levels as Canadian farmers do when stocks rise.

Compare this to Canada, where approximately 75% of our wheat is exported, with a number that is north of this for Western Canada in isolation. Given logistical constraints of moving grain from Western Canada to export position, if Canada is not consistently competitive on the export market, farmers are at risk of not moving their exportable surplus. The implications of this are significant, particularly if one considers the basis levels farmers experienced in the 2013-14 crop year when Western Canada could not move the exportable surplus and ending stocks rose to 10.4 million tonnes.

The bottom line is that Canada is not earning premiums from the market-place as grain companies acting in their own best interests are trading Canadian grains as a commodity. Canadian wheat and durum are consistently being sold at discounts to like-quality U.S. grain for the economic and market reasons outlined above. Regardless of what Canada does on the quality assurance file we cannot change the reality of Canada's overall competitive position (i.e., a small domestic market in relation to its production potential) and its unstated but important objective of selling and moving its exportable surplus each and every year.

So, what does the quality assurance system achieve for farmers?

Customer confidence in the quality assurance system as well as the intrinsic quality of Canadian grain is very important to Canada's brand in world markets. The commercial environment is driven by multiple factors but ultimately all buyers make decisions based on value. Reliability, predictability, quality, safety and regulatory compliance are key ingredients in the customer's determination of value.

Canada's quality assurance system is highly regarded by most of Canada's customers. The CGC spends significant dollars on the overhead required to maintain an effective and logically consistent grading system, including the research required to ensure that the grading determinants and tests measuring these attributes reflect what customers are demanding today and well into the future. If there is a deterioration in these attributes, it will impact the market value of Canadian grain and oilseeds relative to what is earned by our competitors. In this regard, we need to be cognizant of what our competitors are doing so that our system does not put Canada at a competitive disadvantage.

6.1 U.S. Quality Assurance System

The U.S. Department of Agriculture's (USDA) Grain Inspection, Packers and Stockyards Administration's (GIPSA) Federal Grain Inspection Service (FGIS) establishes quality standards for grains, oilseeds, pulses and legumes, provides impartial inspection and weighing services through a network of Federal, State and private entities, and monitors the marketing practices to enforce compliance with the U.S. Grain Standards Act (USGSA) and the Agricultural Marketing Act (AMA).

Under the provisions of the USGSA, grain exported from U.S. export port location is officially weighed and inspected. The USGSA does not require FGIS inspection of grain that is not sold or described by a U.S. grade but based on discussions with those involved in U.S. grain trade this is a rare circumstance. FGIS provides its weighing and inspections services directly but it also accredits State based services to do weighing and inspection in its stead. FGIS also accredits private inspectors on domestic based business.

In administering the USGSA, FGIS is responsible for the following activities:

- Establishing and maintaining official U.S. grade standards for grains and oilseeds.
- Promoting uniform application of official grade standards by official inspection personnel.
- Establishing methods and procedures and approves equipment for the official inspection and weighing of grain.
- Providing official inspection and weighing services at certain U.S. port locations.
- Delegating qualified State agencies to inspect and weigh grain at certain U.S. export port locations.
- Designates qualified State and private agencies to inspect and weigh grain at interior locations.
- Providing oversight of delegated State and designated agencies.
- Investigating alleged violations of the USGSA or AMA.
- Investigating complaints or discrepancies reported by importers.

At export, FGIS and its designates test for a wide range of grade determining factors defined by the official grade standards. However, unlike the CGC, FGIS does not test for many intrinsic quality and food safety factors. These tests are available from private inspections services within the U.S. As many customers require these additional tests, it is not uncommon for two inspections services and charges to be involved in certifying quality on a specific export contract. Based on discussions with an individual experienced in the trading of U.S. grain, this is very common on U.S. wheat and durum with more than 80% of exports requiring a third-party inspector to provide analysis on non-grade specifications. On corn and soybeans, third-party inspection is much less common as customers are comfortable with the actual grade determinants.

On export vessels, FGIS offers a service that provides a uniform plan for sampling and inspection as part of their loading protocol. The uniform inspection plan for shiplots is called the Cu-Sum Plan. It establishes statistically based tolerances known as breakpoints for accepting those occasional portions of a lot that, due to known sampling and grading variations, may grade below the desired lot quality. The Cu-Sum Plan was adopted to ensure that the entire lot of a cargo is of uniform quality.

Under the Cu-Sum Plan, a shipment or “lot” of grain is divided into “sublots” for the purpose of maintaining quality. The sublot size is based on the hourly loading rate of the elevator and the capacity of the vessel being loaded. A sublot may represent up to approximately 3,000 tonnes. The grade and factors determined on each sublot must meet, within specified tolerances, the official grades and factors requested in the export terminal’s load order. Sublots that do not meet specified tolerances can be removed from the shipment or certified separately at the discretion of FGIS or its accredited agent. In normal course, FGIS certificates represent the entire lot of grain based on the weighted average of sublot results at the time of loading. That

said, customers can request the sublot log that supports the FGIS composite grade decision. Grain sold on this basis are called Cu-Sum grade contracts.

U.S. grain is also sold on the basis of average grade contracts where the grade determination is based on the composite of all sublots without any tolerances by sublot. The grain company in conjunction with the demands of the customer determines whether the contract is average grade or Cu-Sum grade and the grain company informs FGIS of the type of contract in the loading order. FGIS inspects the grain accordingly based on the loading order instructions provided by the grain company.

Traders in the U.S. sell on the basis of both contract types based on the demands of the customer but they do charge a premium for a Cu-Sum based contract. The Cu-Sum based grades are the norm on corn contracts and they are also relatively common on wheat and durum contracts. However, when the CGC changed to average grade contracts in Canada, the trend in the U.S. has shifted to a greater portion of average grade contracts as well. Today, average grade contracts are the dominant form on wheat and durum shipments.

In contrast to the CGC, FGIS has a significant role in the determination of quality at country elevators and domestic processors as it or its accredited parties are performing inspections at these locations at the request of the companies operating at inland locations. The U.S. grain trading system is structured differently than is the case in Canada. In Canada, the vast majority of shipments from country elevators to port are within the same company and there is no specific determination of the value attributable to the primary elevator versus what is attributable to the export terminal. In Canada this is commonly called the pipeline revenue. Grain shipments from one company with primary elevators to an export elevator owned or controlled by another company are settled on the basis of third-party inspection on grade and weight but this represents a relatively small portion of the business in the Western Canadian system.[2]

In the U.S., virtually all shipments from country elevators to export terminals are governed by a contract where the weight and grade and, thus, value paid to the country elevator by the terminal is determined by FGIS or its accredited agent's inspection. As a result, the grain trade is very reliant on FGIS and its agents for the determination of value and quality at key points in the supply chain. Therefore, when there are discrepancies on quality on the outward inspection at an export terminal, the terminal operator can point directly to the quality that they purchased from country locations that was inspected by FGIS or their accredited agent and verified in the sales and purchase contract. The bottom line is that the U.S. grain trade uses FGIS predominantly on their export contracts. In discussions, a key player estimates that well less than 10% of export contracts have a third-party option for actual grade determinants. However, they do have third-party inspection for the non-grade determinants required by customers.

FGIS charges fees for their services that reflect the direct costs of providing their services. The overhead associated with maintaining the U.S. quality assurance system is covered by the U.S. government. The USGSA is very specific in its language that FGIS fees will only be for the actual cost of providing the inspecting service with the government picking up the public good aspects of the quality assurance and overhead of the inspection system. As a result, the cost of the FGIS system is less than the cost of the CGC program. In 2015, WKM Consulting

[2] With the significant increases in export terminal capacity in Vancouver, it is likely that this proportion will grow from recent historical volumes.

estimated FGIS cost at U.S. $0.52 per tonne (Cdn $0.69 per tonne).[3] At that time, they estimated the CGC costs at Cdn $1.34 per tonne.

FGIS fees have continued to increase and comments from participants in the U.S. indicate the cost today is around U.S. $0.60 per tonne (Cdn $0.80 per tonne). The cost of third-party inspection in Canada today is around Cdn $0.40 per tonne.

Similar to Canada, the trade in the U.S. is advocating for FGIS to accredit third-party inspectors but their reason is focussed on having one inspector that can provide all of the grain quality inspection services for customers as opposed to the current need to commonly use FGIS and a third-party so that the full contractual quality assessment can be made.

6.2 Additional Benefits of an Effective Grading System and Quality Control Processes

A functioning grading system and a quality control process supporting it ensures that customers have a good understanding of what they are purchasing when they indicate that they have demand for a particular grade of grain. As an example, when a customer is buying a #1 or #2 Canada Western Red Spring wheat (CWRS), they are buying a milling wheat that will carry other inferior quality milling wheats and still produce the end-use product the customer expects. This varies by customer as some are buying 1 or 2 CWRS to use at 20-30% while other inferior and cheaper products fill out their requirements. Others may be using virtually 100% 1 CWRS as this is what they require to produce the product they want. The bottom line is that the customer is looking at the least cost sources of grain to supply their end-use products and needs. Ensuring that the product achieves what the customer expects is essential to the brand and the brand promise.

Also critical is that all key players in the supply chain understand the grading system and grading attributes. The transparency of this understanding ensures that all players are segregating in a manner that creates value for the customer and that this value is reflected back to the ultimate producer. If this does not exist, then farmers and grain companies may not be focussed on what creates value for the customer and, as a result, value may be lost by focussing on producing and segregating the wrong attributes.

Finally, a properly functioning and well understood grading system creates symmetry of information between buyers and sellers and this is critical to ensuring that producers receive appropriate payment for the quality that they produce. In the absence of this symmetry of information, those with more information will create more value for themselves than for those with less information and this deteriorates the incentive structure to produce what customers are demanding. In Western Canada, the increasing importance of quality determinants that are not part of the official grade have weakened the transparency of what has value and how value is compensated by grain companies with farmers.

7.0 Licensing

Under the Canada Grain Act, the CGC is responsible for the licensing of grain handling facilities operating within Canada. The CGC has set up a number of categories of licensing to deal with

[3] Exchange rate used throughout this document is Cdn $1 = U.S. $0.75.

the different levels of involvement as it relates to handling grain and interfacing with farmers. The main categories are export terminals, primary elevators, grain dealers and processors.

The CGC charges grain companies a fee for the licensing of facilities that is based on the recovery of the CGC's variable and overhead costs associated with managing the licensing area of the CGC. Licensing is an important element in ensuring that the CGC is regulating the grain handling system in Canada and licensing is a necessary condition to ensuring that the CGC can put in place services that protect the interests of farmers as well as managing the CGC's mandate to manage quality assurance throughout the grain handling system. All of the issues discussed in the following sections are in some way dependent on the operation of a grain handling licensing system.

8.0 CGC Outward Inspection

The CGC completes an outward inspection on all off-shore exports and produces a certificate final as required by the Canada Grain Act and regulations, regardless of whether this is required in the contract between the buyer and seller. The CGC used to do the export inspections on all inland shipments by rail to the U.S. and Mexico (this was done at the primary elevator where the train was loaded) but it relaxed these provisions and made these exports exempt from the certificate final process. The main reason for this change was the staffing and logistic difficulties the CGC faced in providing service levels at primary elevators across Western Canada that were shipping to the U.S. and Mexico. When they were not able to perform, the company involved incurred significant costs in the form of lost rail incentives and productivity. The CGC exempted this business from the requirement for a certificate final and the business was quickly picked up by the private inspection companies who became the determiners of quality on export contracts. Inland grains and oilseeds exports to the U.S. and Mexico range between 5 and 15% of total Canadian exports on an annual basis.

Based on discussions with the CGC, they indicated that they made the change to exempt inland shipments to the U.S. and Mexico by issuing an order pursuant the Commission's authority under the Canada Grain Act (CGA). The CGA provides the commission the authority to issue orders that result in changes to regulatory operations. Where a change in operations is beyond the Commission's authority to issue orders, the commission can seek changes in regulations pursuant to the regulations that exist under the CGA. A change in regulation requires the approval of the Governor in Council and as such is a government cabinet decision. More significant changes can only occur via changes to the CGA which must be approved by the federal parliament.

The trade has been critical of the CGC's level of service on outward inspection at export terminals as compared to the service they can attain from third-party private inspections services. The CGC union environment does limit the flexibility CGC management has in addressing specific service issues from time to time. But these issues are not a lot different from the challenge terminal operators have in dealing with stevedores (who are part of a union) and their own union staff. In discussing this situation with the CGC, grain companies have to give notice to the CGC if a company wants to load vessels over a weekend or holiday. This notice is very similar to the notice that must be provided to stevedores and other union staff for very similar reasons.

This issue is less critical for terminals at the west coast where loading operations are much more continuous as compared to terminals on the east coast where volumes are lower and more intermittent. The key difference is that the CGC is scheduling regular crews at the west coast but this does not make sense for the volumes at many east coast export terminals.

The CGC inspection services are significantly more costly than private third-party inspectors. Third-party inspectors do not have the same overhead costs associated with maintaining the Canadian quality assurance system that is one of the CGC's key responsibilities. This overhead is clearly significant. The CGC also maintains that they invest a lot more in the training of their staff than is the case with the private inspectors. This point has merit as many of the personnel working for third-party inspectors are former CGC staff. In the absence of the CGC, private inspection firms would likely have to do more training in Canada to maintain standards. However, while they have this supply of former CGC personnel, they are, in a sense, free riding on the trained staff they can hire from the CGC from time to time.

Given the prevalence of former CGC staff working for the private inspection companies in Canada, it is difficult to discern differences in the quality of services provided by the CGC versus a third-party inspector. Third-party inspectors working for grain companies are involved at several key checkpoints in their assessment of quality. As a result, there is more of a partnership in ensuring that both parties are meeting their mutual needs. For instance, the presence of the third-party inspector does affect how the company buys and bins different qualities of grain so that they can meet the contracted quality on export contracts. As has been indicated earlier, the third-party inspector will guarantee the outward grade to vessel (for a price) if the company meets its quality requirements through the supply chain. In this sense, there is a partnership between the inspection company and the grain company that allows each to meet its mutual objectives.

While the CGC is first and foremost a regulator, when it was in the inward inspection service there was an understanding within the trade that the CGC was accountable for consistency between inward and outward inspections so in a sense this was also a form of partnership that ensured the consistency of quality through the supply chain. However, when the CGC moved out of the inward inspection, this partnership changed for reasons already discussed earlier and this made reliance on the CGC outward inspection riskier for the grain company employing third-party inspectors. When third-party inspection is cheaper as well, it is understandable why grain companies continue to seek changes to the CGC's mandate.

How relevant are Canadian grade and grade determinants in the purchasing decisions of Canada's export customers? Based on my experience and recent discussions with those actively trading, the grades specifications remain very important. That said, in discussions with those actively in the business, they indicate that the vast majority of export sales of wheat and durum have specifications in addition to determinants for an actual grade. Specification on HVK, falling number and DON are common additions to the grade. As an example, it is common to sell 2 CWAD in all respects but with HVK in excess of 80%. Similarly, CWRS sales commonly have falling number or DON guarantees. Where additional specifications are part of the contract, the CGC will do this analysis and produce a letter of analysis in addition to the determination of grade and protein to ensure that grain company can show that they have met or exceeded the export contract specifications.

What is the CGC process that allows them to export certify an export cargo (what is the CGC loading protocol)? Each export terminal has CGC-approved sampling infrastructure that allows

the CGC to randomly sample the flow of grain from the terminal to the export vessel. Prior to the loading of a vessel, the grain company provides the CGC with a loading order outlining the quality required including any non-grade specifications. The CGC provides the grain company an assessment of the quality for each 2,000 tonne increment consistent with the instructions provided in the loading order. The terminal operator closely monitors the CGC's assessment of each increment and makes adjustments based upon the composite of the increments it has received. If the specifications are below grade, the terminal looks to sweeten subsequent increments to achieve the composite grade. If the specifications are well above grade, the terminal takes the opportunity to add some lesser quality to a subsequent increment.

The CGC final assessment (the certificate final) of grade and protein (including letters of analysis for any non-grade specifications outlined in the loading order) is based upon the composite of all the 2000 tonne increments for the specific export contract. This loading protocol has been pretty much unchanged since the deregulation of the CWB. Prior to that, the loading protocol required that each 2000 tonne had to be within a tolerance in addition to the composite of the increments exceeding contract (similar to the FGIS Cu-Sum program). While this change was not publicized at the time, there were many customer complaints following this change as it did result in greater inconsistency across cargoes. This was particularly the case for buyers who were serving multiple customers where vessel unloading occurred at several different ports.

Third-party inspectors use processes that are very similar to those used by the CGC. They are using sampling infrastructure in the terminals that is similar to the CGC. They are somewhat flexible to the increments being tested recognizing that greater effort will result in a higher cost of service and they are seeing the grain at some key check points in the supply chain. They also are more flexible than the CGC as they do not have some of the difficulties of dealing with a union environment. Most importantly, they are prepared to guarantee quality on an export contract based upon the sampling and inspection processes they have in place within the grain company's supply chain. In low and variable quality years, this guarantee is important to reduce company risk.

Are they less diligent than the CGC and does this harm Canada's quality control system? As a first response to this question, it is important to recognize that in poor quality years, the vast majority of business exported from Canada is inspected by third parties for the purposes of quality determination on export contracts. Furthermore, third parties are used all over the world so buyers not purchasing exclusively from Canada (this would be most if not all customers) are familiar with third-party private inspectors. This all said, on balance, it is fair to say that a third-party inspector is likely to be somewhat more flexible on a determination of grade than the CGC would be in the same circumstance. However, there are limits to this flexibility as the inspection company has its own reputation and it will not sacrifice its reputation to inappropriately address a grain company's mistakes.

8.1 Accreditation of Third-Party Inspectors

Some parties are currently advocating that the CGC move to accrediting third-party inspection companies to do the outward inspections. Their motivation is largely focussed on reducing the costs of inspection services in two ways. First, they point to the cost of the CGC service which is very high in part due to the fact that the fees the CGC is charging are to recover the overhead costs (many of which are public good related) associated with overseeing the entire quality control system. As noted earlier in this report, the U.S. government in the USGSA specifically

prohibits FGIS from including these public good costs into the fees they charge to inspect grain for domestic or export consumption. Second, the parties note that accreditation would mean that fees would be paid to only one inspection service as opposed to two services which is often the case today.

From a producer perspective, there are a number of important questions in evaluating CGC accreditation of third-parties, particularly considering that farmers are the primary beneficiaries of maintaining and promoting the Canadian brand as it relates to quality control and assurance. If accreditation were to occur, the cost to operate the CGC would drop but there would still be a significant shortfall if the CGC were expected to maintain the quality assurance system that supports the outward inspection process. This shortfall would have to be covered by government procurement or a fee structure that accredited third parties would add to their private inspection services. In the absence of either form of funding, the CGC would have to curtail its operations to a point where it would potentially be in-effective and this would have significant implications to the Canadian brand. This would ultimately hurt the competitive position of farmers. That said, the CGC needs to be encouraged to be cost effective in its mandate.

The move to accreditation would reduce costs as it would eliminate the current process where the same grain is inspected twice. For the reasons outlined earlier, it would also reduce risk to the trade on contracts where the customer is demanding CGC inspection in the contract. The combination of reduced cost and lower risk should on average translate into more competitive export basis levels to the farmer but this is not guaranteed as there are many factors that affect export basis levels in the market and these could easily over-shadow the cost and risk considerations of this change.

There are also significant risks to the brand of making this change, so if it was to occur these risks would need to be addressed and managed. The main risk is the perception of customers and the potential that they see this as a significant deterioration of the Canadian quality assurance system. What can be done to mitigate this risk?

The accreditation process would have to be rigorous. The CGC would have to have the ability to deny accreditation on the basis of inadequate capability or less than adequate performance. The CGC would also be responsible for defining all the key processes that the accredited inspectors would follow including the loading protocol. The CGC would also have to take a lead role in the training or at least in administering the training of third-party inspectors to ensure that they live up to Canada's brand promise. Finally, the CGC would need to do periodic audits to ensure that all accredited parties are following the CGC-approved processes and protocols.

In an environment where accreditation was in place, the CGC would have to be clearly responsible for the following activities:

- Establishing and maintaining official Canadian grade standards for grains and oilseeds.
- Promoting uniform application of official grade standards by official inspection personnel.
- Establishing methods and procedures and approvals of equipment for the official inspection and weighing of grain.
- Leading grain quality assurance research to ensure that Canada remains a world leader in grain quality assessment and measurement.

- Providing official inspection and weighing services if there are gaps in accredited services (e.g., in instances where third parties were not available due to an action taken by the CGC)
- Accrediting and designating and overseeing/auditing qualified third-parties to inspect and weigh grain at export locations.
- Investigating alleged violations of the Canada Grain Act.
- Investigating complaints or discrepancies reported by importers.

An effective communication plan would be critical if the move to accreditation were to occur. Helping the situation is the fact approximately 80% of customers have already agreed to the option of third-party inspectors in their sales and purchase contracts. This reality needs to be leveraged. All parties have to consistently communicate to customers that this is a CGC accredited program and the CGC remains in charge of Canada's quality control system.

In order to foster competition in inspection services, the CGC needs to be encouraged to ensure that more than one company is available as an accredited third-party inspector. In the absence of government funding for the overhead public good aspects of the CGC, the CGC would have to put in place a fee with the accredited third-party inspectors that would pass through to the users. While the CGC would need to control whether a third-party is accredited, it still makes sense from a competitive perspective that the grain companies would pay the fees of the third-party inspector including the CGC pass through fee as they would be choosing the service provider from the accredited list and outlining the service package they wanted from the third-party. As part of this service package, all activities associated with outward inspection for export would have to be consistent with the CGC protocols for accredited third-party inspectors.

Regardless of the decision on accreditation, the CGC should give consideration to tightening up the current loading protocol. Customers have pointed to the change in the 2012-13 crop year as a significant deterioration in the uniformity of cargo delivery. The fact that FGIS has a uniformity protocol in place as an option on loading increments and Canada does not is difficult to understand.

9.0 Access to Binding determination

As part of its services under the Canada Grain Act, the CGC provides farmers the ability to arbitrate the determination of grade and dockage with their grain handler. The purpose of this service is to enhance the negotiating position of the farmer in their discussions with grain companies about the quality they are delivering which ultimately affects the price the farmer receives for the product they deliver. Access to binding determination is largely about the threat that it may be used as a lever in discussion with grain companies. As a result, the extent of its use is not necessarily an indicator of the effectiveness of this tool. The reality is that farmers shopping their grain and constantly testing their relationships with grain companies remains the primary means by which farmers protect their interests with grain companies. That said, the Canada Grain Act provides access to binding determination in those instances where a farmer is not satisfied with what they can achieve in their individual dealings with grain companies.

The actual use of binding determination over the last five years is shown in Table 2 below.

Table 2: Incidences of the Use of Subject to Inspector's Grade and Dockage Determination (STIGD): 2015-16 to 2019-20

Year	Incidences
2015-16	135
2016-17	151
2017-18	241
2018-19	236
2019-20	233

Source: Canadian Grain Commission

In discussions with the CGC, they indicate that they see greater use of the program in years with lower crop quality. This makes sense as the subjective nature of grade determination on grains like wheat and durum can create significant uncertainty in poor quality years.

Under the current system, the grain company is compelled to rely on STIGD if requested by the farmer but they are only compelled on actual grade determinants tied to the official grade. The companies are not compelled on non-grade determinants which have become an increasingly important component of the determination of value between grain companies and farmers. The grain company can agree to the addition of non-grade components voluntarily but there is reluctance to do this.

Given the increasing prevalence of non-grade quality factors, like falling number, DON and HVK enhancements to name a few, there does appear to be a gap in the effectiveness of STIGD to balance the interests of the farmer in relation to the grain company. These gaps could be addressed by adding these factors to the STIGD process, although in the case of falling number and DON, another possibility is adding these factors as grade determinants.

Another factor that affects the use of STIGD is that it is only available at the point of delivery. With the increasing use of commercial trucking many farmers are not present at delivery and this makes the use of this tool more challenging. Program changes to address this issue are challenging as it is important that any changes maintain an appropriate balance between the grain company and the farmer.

10.0 Producer Payment Protection

Producer payment protection is achieved under the CGC's Safeguards for Grain Farmers Program. Under the program, CGC licensed grain companies are required to tender security for their outstanding liabilities to farmers in the form of either a bond, letter of credit, letter of guarantee or payables insurance. If the licensed company defaults on paying farmers, the CGC uses the security held to compensate those farmers who are eligible. Under the program, farmers must submit claims for compensation within 90 days of actual delivery or 30 days from the date the cash purchase ticket or cheque was issued, whichever is less.

This program is often a target of criticism by grain companies who view the monies tied up as security (in whatever form provided) as an unnecessary expense that costs them and ultimately farmers as the price takers within the system. There is no question that there is a cost to operating the system and that farmers ultimately bear the cost of it via the basis levels they are effectively charged when they deliver to the farm gate.

This cost can be viewed as an insurance premium that all farmers effectively pay to ensure that they have coverage in the event of a default by a grain company. The most recent default by ILTA grain in 2019 represented the largest total security payout in the CGC's history. In January of 2020, the CGC announced that 222 eligible unpaid farmers would receive $11.1 million which was covered by the security posted by ILTA grain prior to when ILTA grain was put under creditor protection in July of 2019. These producers were paid all they were owed because the CGC had security in place to cover their risks.

That said, not all farmers dealing with ILTA grain were covered by the CGC security. In particular, 44 farmers who had delivered canary seed were not covered as canary seed is not regulated by the Canada Grain Act and as a result, they are still owed about $2.1 million. There were also some other farmers who were not covered due to the fact that their deliveries were made outside the program eligibility period. These farmers will be left to seek whatever assets are available for distribution after the secured creditors have been paid out as part of the bankruptcy process.

The ILTA grain failure is a textbook case for why the CGC has producer payment protection programs in place. When any company gets into financial trouble, they are seeking any manner to maintain cash for operations and this means slowing payments to farmers and unsecured creditors. At the end of the day, farmers are at risk as they cannot know the financial particulars of a company's situation until it is generally too late. The ILTA grain situation points to the limitations of the CGC program as it relates to eligible grains and eligible deliveries.

In 2009, Scott Wolfe Management estimated the total cost of the Producer Payment security program at $9.0 million annually. The costs were broken down as follows:

- $1.4 million for CGC administration.
- $1.0 million for grain company administration, and
- $6.6 million for grain companies to post security.

Based on approximately 40 million tonnes of farmer deliveries in 2009, Scott Wolfe Management estimated the average cost for the program at $0.23 per tonne for the CGC to maintain insurance on their behalf. Subsequent to this study, the CGC has gone to an insurance-based system with Atradius insurance. This change has further reduced the per tonne cost of the program. In discussions with industry, the cost with this new program is in the range of $0.10 per tonne.

Ultimately, the cost of the program must be weighed against the fact that this is an insurance policy to protect against the unknown. It wasn't that many years ago when Saskatchewan Wheat Pool (SWP) was on the verge of bankruptcy. Given the public nature of the company, the financial issues were well known at the time but there was still a lot of concern that the company would go into receivership. In today's environment, most companies are not publicly traded so farmers are unlikely to be aware of an issue until it is relatively late in the game.

Like any insurance policy, the CGC's policy on producer payment protection is a matter of weighing the costs against the risk and implications of grain company failure in the system. While the risk is low, the consequences to farmers caught in a company failure situation are significant and potentially fatal to the farm business. In the absence of the CGC security program, farmers would need to be singularly focussed on their accounts receivable so that they minimize the risk of default on the grains they deliver.

11.0 Statistical Data Collection and Reporting

As part of its role in regulating the grain handling system, the CGC collects data from its licensees regarding grain exports, primary and export elevator volumes, producer car shipments and exports of grains from Canada in total and by port. This data is very valuable to grain companies who are constantly assessing their competitive position in the market. It is also valuable to producer organizations to keep abreast of grain movement and execution within the system and decision makers looking to make sound policy decisions based on accurate current and historical data regarding grain handling and exports.

Relative to the U.S., Canada has very limited reports that allow farmers to track current and historical information that is important to their business. Most of the gaps in reporting are related to pricing and value which is not a CGC responsibility. For instance, in the U.S. interested parties are able to get relatively current and historical basis pricing levels at all U.S. ports. This information is also readily available from the USDA at many in-country locations and key inland market places like Minneapolis, Kansas City or Chicago.

The CGC reports outlined above are very transparent and reliable. Farmers' interests are supported by maintaining and expanding reporting that enhances transparency for better decision making.

12.0 CGC Governance

The Governance of the CGC has been a topic of discussion for many years with many views held by many different interests. These interests are often focussed on who ultimately pays for the costs of operating the CGC or who the CGC has as its core customers. While these are considerations in the discussion, they are generally not fundamental to the determination of the governance of an organization. For instance, all corporations have customers and these customers pay for the goods or services produced by the corporation but it is not typical for these groups to be represented on a Board of Directors. An exception to this is the governance seen in the cooperative sector but the key difference in the cooperative sector is that the customers are usually also the owners of the business and as owners they have a say in the individuals they select to govern and direct the organization.

Whether it is a cooperative, a privately-owned company or a limited liability corporation, the key point is that it is the owners who determine who sits on the Board of Directors. The owner(s) also determine the authority they are conferring to the Board of Directors so that they can govern the organization on their behalf.

In the case of the CGC, it is clear the organization is owned by the federal government. It exists due to legislation passed by the Parliament of Canada. It is the regulator of the grain handling industry in Canada and changes to the Canada Grain Act or the regulations that exist pursuant to the Act are determined by the Parliament of Canada and the Governor in Council, respectively. As a result, it is logically consistent that the Governor in Council appoints the Board of Directors/Commissioners of the CGC.

In the Canada Grain Act, Commissioners are full time positions appointed on good behaviour for a term of up to seven years by the Governor in Council. The object of the Canada Grain Act is as follows.

> Subject to this Act and any directions to the Commission issued from time to time under this Act by the Governor in Council or the Minister, the Commission shall, in the interests of the grain producers, establish and maintain standards of quality for Canadian grain and regulate grain handling in Canada, to ensure a dependable commodity for domestic and export markets.

The Canada Grain Act was passed in 1912 largely to address and protect the interests of producers in their interfaces with the grain handling system and that remains the case today as is indicated by the object of the Act. Historically, many of the government appointments have been actual and former grain producers likely reflecting the object of the Act and the politics associated with the Grain Commission appointments. As full-time appointments, the Commissioners effectively act as both a Board and collectively as the CEO of the organization. This was essentially the same situation that existed at the Canadian Wheat Board (CWB) prior to the change in governance structure that occurred in 1998.

There have been discussions regarding changing the Commissioner positions to part-time roles as is the case with a more traditional Board of Directors who would then hire a Chief Executive Officer (CEO) to manage the operations of the Commission. From a governance perspective, this change in structure would require the Board of Directors to confer authority on the CEO who would be empowered by and accountable to the Board to run the day to day operations of the CGC. While this change is easy to articulate, it is more challenging in practice as the principal agent issues (i.e., conflicts in priorities between a Board of Directors and the representative authorized to act on their behalf) that can occur between a CEO and a Board of Directors are well documented in governance literature. Saskatchewan Wheat Pool is often cited as a case study highlighting principle-agent issues in a large organization.

The challenges of the principal agent relationship can be managed by a Board that is well trained in governance and that has a good understanding of the role of a Board relative to the role of Management. When this governance change was implemented at the CWB, the Governor-in-Council of the day appointed 5 Board members who operated alongside 10 elected farmers. The five appointments were experts in Board governance and they were instrumental in assisting the Board and Management grow into the new structure and their respective roles. This was a process that took time and effort and there were some significant lessons learned along the way.

The CWB was a regulator but it was primarily a supply chain company. As a result, there was a very large operational role that was reasonably suited to the traditional Board/CEO model. This is less clear in the case with the CGC as its role is a regulator and as a result it would be expected that most of the pressures on it as a regulator would likely be addressed at the Board (and/or Commissioner) level as they are commonly questions that affect multiple interests in opposing ways.

The CGC's current governance structure and particularly the length of the term on good behaviour does protect the organization against the short-term political pressures newly elected governments face from time to time. This protects the overall direction of the organization from short term intense political pressure from interest groups who are pushing for specific change that is meant to enhance their interests. As an organization that acts in the interests of grain producers, it is important that the governance structure ensures that producers' interests are protected from the parties that are meant to be regulated by the Canada Grain Act.

It is a reality that grain companies have far more interactions with the CGC at the decision making level than do producers. As the regulator of the grain handling system in Canada, grain companies are consistently lobbying the CGC for changes that enhance their financial position, potentially at the expense of producers or perhaps even the Canadian brand. This is not a criticism of grain companies as they are simply operating in their own self-interest and self-interest is a powerful motivator.

The changes in the loading protocol that removed the specification limits on each 2,000 tonne increment is a classic example of effective lobbying that created an advantage for terminal operations at the expense of the Canadian brand and therefore ultimately producers. Nothing was ever announced when this change was made but the customer complaints speak for themselves.

No governance model is perfect as all models will suffer from decisions from time to time that appear wrong with the benefit of 20-20 hindsight. It is key that the model allow for thoughtful decisions consistent with the object of the Act irrespective of the lobbying of special interests.

13.0 Summary

The Government of Canada is undertaking a review of the Canada Grain Act (CGA) and the Canadian Grain Commission (CGC). The review process is meant to provide stakeholders the opportunity to provide input into the changes they would like to see regarding the CGA and the CGC. The SWDC has hired this consultant to analyze the potential changes being considered to the CGC and the CGA and the implications of these changes on the activities and economics of Saskatchewan grain producers.

13.1 Industry Overview

The report provides a broad description of the operations of grain companies in Western Canada as it relates to trading and merchandising grain. This description is important to understanding grain company behaviour as it relates to the interfaces with the CGC. It also explains why grain companies are asking for the CGC to accredit third-party inspectors on the CGC outward inspection process.

The report outlines the CGC budgeting process and the CGC's recent history as it relates to budgeted revenues and expenditures and contrasts that with actual revenues and expenditures. In determining its revenue requirements, the CGC prepares annual budgets based upon the variable and overhead expenditures it expects to incur to provide its services to the grain industry. The CGC is mandated to operate on a break-even basis after accounting for the appropriations they receive from government which have amounted to just under $6 million annually in recent years.

CGC revenues are based on a combination of fees collected from the grain industry and appropriations from government. In determining the per tonne fee to charge the industry for outward inspection, the CGC simply divides the anticipated costs to provide their inspection services, including overhead and other grain quality control activities, by the volume they anticipate that they will inspect over the budget period. Over the period of 2010 to 2019, the CGC has underestimated the volume of inspections and overestimated expenses in most years. This explains the surpluses the CGC has experienced.

13.2 Quality Assurance, Value and the Canadian Brand

It is a reality that Canadian grain is not earning premiums relative to U.S and other origin grain in international markets. Despite long-term and largely successful efforts to differentiate Canadian grain in the eyes of customers, many of whom are likely willing to pay more for the grain they buy from Canada, the reality is that they do not have to as Canadian grain is effectively a commodity merchandised by multiple grain companies. The strengths of our quality assurance system cannot change the reality of Canada's overall competitive position (i.e., a small domestic market in relation to its production potential) and its unstated but important objective of selling and moving its exportable surplus each and every year. This reality, however, does not lower the importance that the quality assurance system plays with Canada's customers and the value that producers capture from the marketplace.

Customer confidence in the quality assurance system as well as the intrinsic quality of Canadian grain is very important to Canada's brand in world markets. The commercial environment is driven by multiple factors but ultimately all buyers make decisions based on value. Reliability, predictability, quality, safety and regulatory compliance are key ingredients in the customer's determination of value.

Also important in the customer's determination of value is their assessment of Canada's quality control system against that available from Canada's competitors. In this regard, the report describes the U.S. inspection system as well as the interaction of the U.S. grain industry with their Federal Grain Inspection Service (FGIS). While FGIS does not offer many of the producer protection programs provided by the CGC (e.g., binding determination of grade and dockage and producer payment protection), FGIS does offer a grain inspection service package that is similar to the CGC. However, there are four key differences between the Canadian and U.S. grain inspection and quality control systems.

First, FGIS, as directed by law, is only allowed to charge the U.S. grain industry for the direct costs of grain inspection. All overhead costs associated with maintaining grain standards, testing and support for the U.S. quality control system including grain quality research are paid by the U.S. federal government. FGIS costs for export inspection are around U.S. $0.60 per tonne (Cdn $0.80) which is well less than the fees charged by the CGC as the CGC fees include significant overhead.

Second, FGIS is significantly more involved in the determination of quality and value at in-country position than is the case with the CGC in Canada. This is a direct result of the fact that virtually all U.S. shipments from country position to export terminal are subject to a sales and purchase contracts between the in-country elevator and the export terminal. FGIS or their accredited agent in the majority of cases are the determiners of quality on these contracts. In contrast, the CGC has not had an in-country presence of any significance since it moved out of inward inspection at some point during the 2012-13 crop year.

Third, FGIS offers two types of loading protocols at export terminal position. The FGIS loading protocol ensures that they are evaluating each 3,000 tonne increment (the size of the increment does depend on the size of the vessel, the size of export contract and/or the loading rate of the terminal) being loaded to a vessel to determine that the cargo will meet the quality requirements of the contract. The first type of protocol is called an average grade contract. Under this contract, the total cargo meets contracted quality as long as the composite average of all increments meets or exceeds contract. The second type of protocol is referred to as a Cu-Sum

grade. Under this protocol, not only does the composite have to meet grade but there are also tolerances on each 3,000 tonne increment. Cu-Sum is available for customers who have greater concerns about uniformity of quality across the cargo (they pay a premium for this). Today, the CGC offers average grade contracts but prior to 2012-13, the CGC loading protocol was very much like the Cu-Sum program but based on 2,000 tonne increments.

Fourth, FGIS will only perform analysis on actual grade determinants at export position. They will not do additional testing on non-grade factors that customers require for their own quality or domestic regulatory requirements. As a result, in the U.S. grain companies employ third-party inspectors to provide customers analysis of the non-grade specifications they require. In contrast, the CGC will do analysis of non-grade factors if it is required in the export contract based upon the loading order provided by the export terminal.

While there are differences in processes and procedures in the Canadian and U.S. quality assurance systems, both are highly regarded by international customers. Both countries spend significant dollars on the overhead required to maintain an effective and logically consistent grading system including the research required to ensure that the grading determinants and tests measuring these attributes reflect what customers are demanding today and well into the future.

That said, the U.S. is Canada's main competitor, particularly in the high-quality spring wheat and durum market and when there is a deterioration in the attributes addressed by the Canadian system relative to our competitors, this will impact the actual and perceived value of Canadian grain in the eyes of our customers. In this regard, we need to be cognizant of what our competitors are doing so that our system does not put Canada at a competitive disadvantage.

Also critical is that all key players in the supply chain understand the grading system and grading attributes. The transparency of this understanding, which in large part relies on the organization responsible for quality assurance (i.e., the CGC) ensures that all players are segregating in a manner that creates value for the customer and that this value is reflected back to the ultimate producer. If this does not exist, then farmers and grain companies may not be focussed on what creates value for the customer and, as a result, value may be lost by focussing on producing and segregating the wrong attributes.

Furthermore, a properly functioning and well understood grading system creates symmetry of information between buyers and sellers and this is critical to ensuring that producers receive appropriate payment for the quality that they produce. In the absence of this symmetry of information, those with more information will create more value for themselves than for those with less information and this deteriorates the incentive structure to produce what customers are demanding. In Western Canada, the increasing importance of quality determinants that are not part of the official grade have weakened the transparency of what has value and how value is compensated by grain companies with farmers.

The bottom line is that the customer is looking at the least cost sources of grain to supply their end-use products and needs. Ensuring that the product achieves what the customer expects is essential to the brand and the brand promise.

13.3 CGC Outward Inspection and Accreditation

The CGC completes an outward inspection on all off-shore exports and produces a certificate final as required by the Canada Grain Act and regulations, regardless of whether this is required in the contract between the buyer and seller. Over the last 8-10 years an increasing proportion of export contracts have included the option of using a third-party inspector or the CGC as the determiner of the quality delivered. Today, it is estimated that more than eighty per cent of export contracts have the option of using a third-party inspection company. This change is not a reflection that customers have concern with the services provided by the CGC as the CGC's reputation with customers continues to be excellent. Rather, this reflects that grain companies, acting to reduce their risk, have been pushing for this option on export contracts for many years starting in earnest with the CGC's move out of inward inspection in 2012-13.

The CGC inspection services are significantly more costly than private third-party inspectors. Third-party inspectors do not have the same overhead costs associated with maintaining the Canadian quality assurance system that is one of the CGC's key responsibilities. This overhead is clearly significant. The CGC also maintains that they invest a lot more in the training of their staff than is the case with the private inspectors. This point has merit as many of the personnel working for third-party inspectors are former CGC staff.

Third-party inspectors use processes that are very similar to those used by the CGC. They are using sampling infrastructure in the terminals that is similar to the CGC. Most importantly, they are prepared to guarantee quality on an export contract based upon the sampling and inspection processes they have in place within the grain company's supply chain. In low and variable quality years, this guarantee is important to reduce company risk. Also important is the fact that as non-union organizations, they are more flexible than the CGC in the offering of service. They are also likely to be somewhat more flexible on a determination of grade than the CGC would be in the same circumstance. However, there are limits to this flexibility as the inspection company has its own reputation and it will not sacrifice its reputation to inappropriately address a grain company's mistakes.

Some parties are currently advocating that the CGC move to accrediting third-party inspection companies to do the outward inspections. Their motivation is largely focussed on reducing the costs of inspection services in two ways. First, they point to the cost of the CGC service which is very high in part due to the fact that the fees the CGC is charging are to recover the overhead costs (many of which are public good related) associated with overseeing the entire quality control system. As noted earlier in this report, the U.S. government in the USGSA specifically prohibits FGIS from including these public good and other overhead costs in the fees they charge to inspect grain for domestic or export consumption. Second, the parties note that accreditation would mean that fees would be paid to only one inspection service as opposed to two services which is often the case today.

From a producer perspective, there are a number of important questions in evaluating CGC accreditation of third-parties, particularly considering that farmers are the primary beneficiaries of maintaining and promoting the Canadian brand as it relates to quality control and assurance. If accreditation were to occur, the cost to operate the CGC would drop but there would be a significant shortfall if the CGC were expected to maintain the quality assurance system that supports the outward inspection process. This shortfall would have to be covered by government procurement or a fee structure that accredited third parties would add to their private inspection services. In the absence of either form of funding, the CGC would have to

curtail its operations to a point where it would potentially be in-effective and this would have significant implications to the Canadian brand. This would ultimately hurt the competitive position of farmers.

The move to accreditation would reduce costs as it would eliminate the current process where the same grain is inspected twice. For the reasons outlined in the main body of the report, it would also reduce risk to the trade on contracts where the customer is demanding CGC inspection in the contract. The combination of reduced cost and lower risk should on average translate into more competitive export basis levels to the farmer but this is not guaranteed as there are many factors that affect export basis levels in the market and these could easily over-shadow the cost and risk considerations of this change.

The accreditation process would have to be rigorous. To summarize, in addition to a comprehensive communication plan, a move to third party accreditation would still require the CGC to be responsible for the following activities:

- Establishing and maintaining official Canadian grade standards for grains and oilseeds.
- Promoting uniform application of official grade standards by official inspection personnel.
- Establishing methods and procedures and approvals of equipment for the official inspection and weighing of grain.
- Leading grain quality assurance research to ensure that Canada remains a world leader in grain quality assessment and measurement.
- Providing official inspection and weighing services if there are gaps in accredited services (e.g., in instances where third parties were not available due to an action taken by the CGC)
- Accrediting and designating and overseeing/auditing qualified third-parties to inspect and weigh grain at export locations.
- Investigating alleged violations of the Canada Grain Act.
- Investigating complaints or discrepancies reported by importers.

13.4 Producer Protection within the CGA

In addition to the quality assurance activities of the CGC, the CGC also provides specific protections to producers in relation to binding determination on grade and dockage, payment security and the provision of grain handling information. Under the current Subject to Inspectors Grade and Dockage Determination (STIGD) system, the grain company is compelled to rely on STIGD if requested by the farmer but they are only compelled on actual grade determinants tied to the official grade. The companies are not compelled on non-grade determinants which have become an increasingly important component of the determination of value between grain companies and farmers.

Given the increasing prevalence of non-grade quality factors, like falling number, DON and HVK enhancements to name a few, there does appear to be a gap in the effectiveness of STIGD to balance the interests of the farmer in relation to the grain company. These gaps could be addressed by adding these factors to the STIGD process, although in the case of falling number and DON, another possibility is adding these factors as grade determinants.

The CGC payment security program has experienced changes over the years mostly focussed on reducing program cost while maintaining the same level of producer protection. Today, the cost of the program is estimated to be around $0.10 per tonne. Ultimately, the cost of the

program must be weighed against the fact that this is an insurance policy to protect against the unknown. In today's environment, most companies in Canada are not publicly traded so farmers are unlikely to be aware of financial issues that could affect payment risk from a grain company until it is relatively late in the game.

Like any insurance policy, the CGC's policy on producer payment protection is a matter of weighing the costs against the risk and implications of grain company failure in the system. While the risk is low, the consequences to farmers caught in a company failure situation are significant and potentially fatal to the farm business. In the absence of the CGC security program, farmers would need to be singularly focussed on their accounts receivable so that they minimize the risk of default on the grains they deliver.

Finally, the CGC publishes many reports that provide transparency regarding the regulatory activities of the CGC as well as grain volumes moving through the grain handling system. These reports are very transparent and reliable. Farmers' interests are supported by maintaining and expanding reporting that enhances transparency for better decision making both in real time and by using the historical information to assist in policy analysis and development.

13.5 Governance

The Governance of the CGC has been a topic of discussion for many years with many views held by many different interests. These interests are often focussed on who ultimately pays for the costs of operating the CGC or who the CGC has as its core customers. However, regardless of these considerations, it is clear the CGC is owned by the federal government. It exists due to legislation passed by the Parliament of Canada. It is the regulator of the grain handling industry in Canada and changes to the Canada Grain Act or the regulations that exist pursuant to the Act are determined by the Parliament of Canada and the Governor in Council, respectively. As a result, it is logically consistent that the Governor in Council appoints the Board of Directors/Commissioners of the CGC.

There have been suggestions for some time that the CGC governance structure should move to a more formal Board of Directors who appoints a CEO to run the day-to-day operations of the CGC. While this change is easy to articulate, it is more challenging in practice as the principal agent issues (i.e., conflicts in priorities between a Board of Directors and the representative authorized to act on their behalf) that can occur between a CEO and a Board of Directors are well documented in governance literature. Saskatchewan Wheat Pool is often cited as a case study highlighting principle-agent issues in a large organization.

The CGC's current governance structure and particularly the length of the term on good behaviour does protect the organization against the short-term political pressures newly elected governments face from time to time. This protects the overall direction of the organization from short term intense political pressure from interest groups who are pushing for specific change that is meant to enhance their interests. As an organization that acts in the interests of grain producers, it is important that the governance structure ensures that producers' interests are protected from the parties that are meant to be regulated by the Canada Grain Act.