



Responding to the National Farmers Union Report 'The Farm Crisis and the Cattle Sector: Toward a New Analysis and New Solutions'

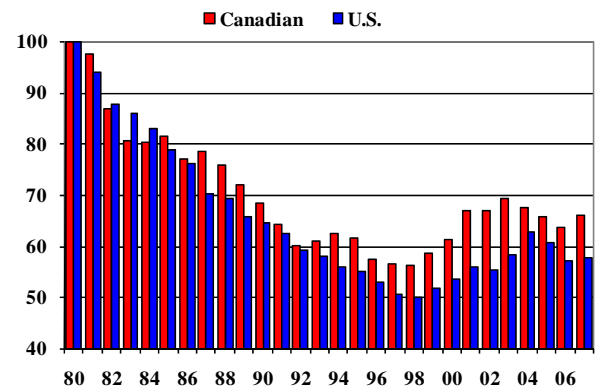
On November 19, 2008 the National Farmers Union (NFU) of Canada released "The Farm Crisis and the Cattle Sector: Toward a New Analysis and New Solutions" report. The NFU report argues that retail and packer concentration, captive supplies, continental integration and an over dependence on exports since 1989 has resulted in a declining cattle price trend (in real dollar terms). This report raised a number of questions within industry regarding historical price trends, export dependence, profit margins and marketing practices. The following is a formal response to that publication.

Historical Price Trends

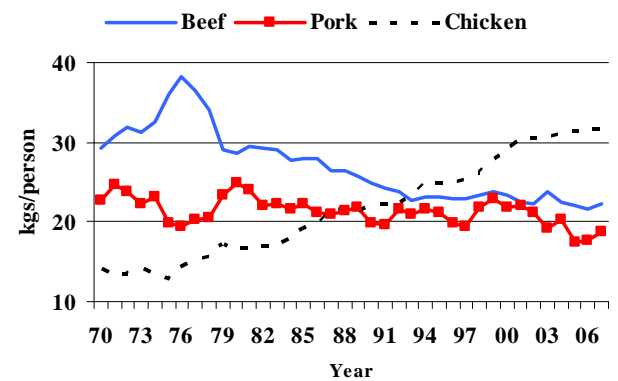
The Alberta fed steer prices fell in real dollars from \$250/cwt in 1980 to range between \$100 and \$150/cwt from 1989 to 2003. This decline in price is not unexpected, when one considers that the Canadian beef demand index fell from 100 in 1980 to just over half of that at 55.5 in 1998. The beef demand index illustrated is calculated using Statistics Canada's per capita beef consumption data and deflated retail beef prices. This index evaluates changes in consumer's willingness to pay for beef. It implies that if production remained constant, prices would have to have fallen to 55 per cent of 1980 levels in 1998 for consumers to be willing to consume the same amount of product. Beef demand in the United States also fell 50 per cent between 1980 and 1998. As Canadian cattle prices are based off of the U.S. market, the decline in U.S. beef demand has also had a significant impact on the Canadian market.

Retail beef prices have been virtually unchanged from 1975 onward. With weaker beef demand and steady retail prices consumption would be expected to decline. Per capita consumption did decline from a high of 38.3 kilograms per person in 1976 to 22.7 kilograms per person in 1993. Since then consumption has ranged between 22 and 24 kilograms per person. The issue is not so much that consumers aren't paying enough, but that as a result of changing consumer preferences and reduced prices for competing proteins beef consumption declined. The beef industry has struggled to compete with other proteins in terms of price and developing convenience oriented high quality consistent

Canadian vs. U.S. Beef Demand (1980 = 100)



Canadian per Capita Meat Consumption



Source: Statistics Canada

products that meet the needs of today's consumers who are generally more health conscious and have a busier lifestyle.

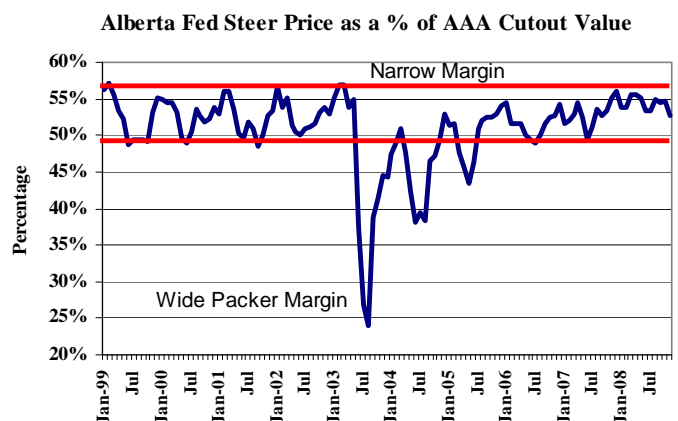
In addition production did not stay constant over this time period and instead actually increased 51 per cent from 2.25 billion pounds (carcass weight, including offal) to 3.4 billion pounds. This increase in production, in combination with reduced consumption, would have depressed cattle prices even further if export growth had not occurred to reduce beef supplies in the domestic market. Canadian beef and cattle exports increased from 206,000 tonnes in 1982 to 785,000 tonnes in 1998; accounting for 50 per cent of Canadian beef production (including slaughter cattle exports).

It should be remembered that ultimately the consumer decides the price of beef depending on their willingness to pay as indicated by the beef demand index. Cattle prices will only increase when consumer demand increases and consumers are willing to consume more beef at a higher price. The international consumer is very important as well since they will demand Canadian beef cuts that may be relatively undervalued in the domestic market or when domestic prices fall below international prices to make Canadian beef a relatively attractive supply option. While the NFU report discusses the perceived roles of packers and retailers in the decline in cattle prices, it does not address the impact changing consumer demand for beef has had on both domestic and North American prices, which is a significant factor that must be considered.

Feed grain prices and currency changes alone do not explain the decline in cattle prices since 1974. That is because demand has fallen since then making the time periods largely incomparable. Most recently we have seen the negative impact of declining domestic and international demand despite the positive effects of a weaker dollar, lower feed grain and oil prices. A decline in global demand has resulted in shrinking margins in the wholesale sector, as cutout values have been pressured down and negative pressure has been placed on prices in the primary production sectors. In contrast cow prices stayed strong throughout the summer of 2008 despite large cow slaughter due to strong consumer demand for trim product, as consumers moved away from higher priced steaks and towards cheaper hamburgers. It should be noted that feed grains and currency changes are important factors that influence returns and profitability over the short term but cannot be viewed in isolation.

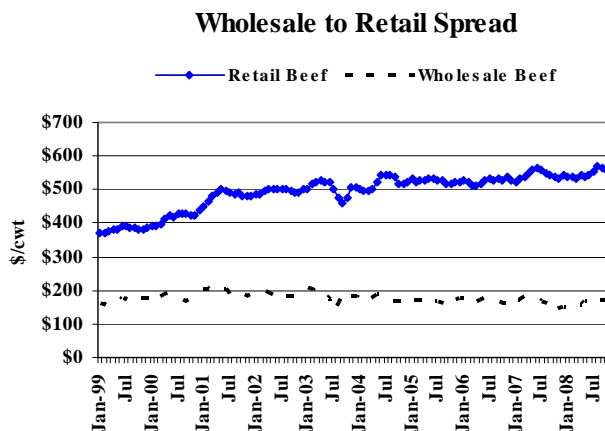
Exports and the Cutout

The increase in Canadian exports since 1989 allowed domestic packers to maximize the cutout value by marketing products and cuts not typically demanded in the domestic market into higher valued export markets. This increased the overall return to packers and therefore the price they were willing to pay domestic producers for fed cattle. Packers have been increasing their total returns since 1989. This reflects the increased returns gained from maximizing the cutout value with exports. The increase in the cutout value is reflected in increased



fed cattle prices with a correlation of 0.67. This means that for every \$1 increase in the AAA cutout value live Alberta fed cattle prices increased by \$0.67 from 1999 to 2008. The chart below shows that fed steer prices as a per cent of the AAA cutout value have increased since 2004 to be back in the historical range of 50 to 55 per cent. This relationship had widened to a record 25 per cent in 2003 due to a captive market that resulted in an oversupply of cattle in Canada with the closure of the U.S. border to Canadian live cattle. Large supplies and limited marketing opportunities depressed cattle prices, while cutout values remained relatively stable.

The following chart shows the spread between wholesale and retail beef prices and demonstrates that growth in share occurred at the retail level and not the packing level. Part of this increase reflects the move towards more value added processing and labeling. Packer costs have also increased with more value-added packaging and regulations (i.e. specified risk material removal).



Returns vs. Margins

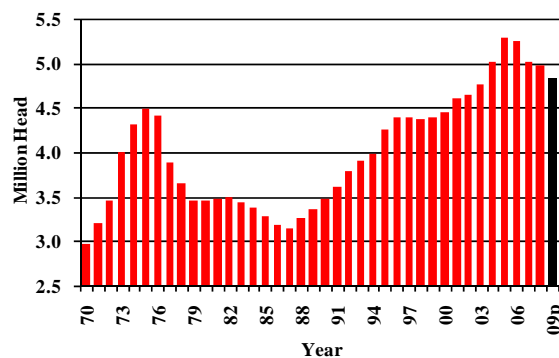
Profits move through the supply chain. In order for production signals to work retailers earning a larger margin on beef than competing proteins must provide an incentive to suppliers to increase or maintain supply. Increased retail demand results in stronger wholesale beef prices. Increased revenues at the packing sector in turn results in packers being encouraged to process greater numbers of fed cattle; increasing the demand for fed cattle and subsequently resulting in improved live cattle prices. This in turn will result in price transmission throughout the supply chain. These production signals work the other way as well, with losses resulting in liquidation of the national herd; reducing available cattle and beef supplies until supplies shrink to the point where prices begin to increase. While the NFU report acknowledges that positive or negative returns in the feedlot sector result in increased or decreased calf prices, it is important to note that a similar relationship is also be present between the packing and feedlot sectors. As noted above this does not work perfectly and spreads widen when borders restrictions occur and limit live cattle movement. When borders are open and free trade occurs, domestic packers must compete with U.S. packers for fed cattle and price signals more clearly move throughout the supply chain. In contrast when borders are closed or only partially open for trade, domestic packers have an advantage in that there are greater domestic supplies available. Increasing domestic supplies, while having a fixed demand (limited by total slaughter capacity in Canada) will always depress live cattle prices.

It should be remembered that the higher cattle prices (in real dollars) in the 1970s do not imply larger profits for producers. In fact given the higher feed grain prices shown for that time period and the trend of fewer farms over time would imply tight margins and periods of negative returns in the industry discouraging young people from entering the business. It is these small margins that lead to larger operations and eventually the consolidation within the packing and retail sectors. Currently soft beef demand domestically and internationally has created large spread losses throughout the production chain; encouraging large cow slaughter. What is different about this liquidation is that all

sectors of the industry have faced losses due to higher costs and reduced returns. In past liquidation cycles it has been the case that one sector of the beef industry has been able to make a small profit, with the sector shifting over time.

The NFU report points out that *“current prices are clearly signaling that farmers should supply fewer cattle.”* That is happening right now, with large spread liquidation in the national cow herd. Producers are responding to market signals; however it needs to be pointed out that large supplies built up between 2003 and 2005, due to market restrictions, delayed normal market responses. With improved market access for cows, producers would have liquidated the national herd in 2004 and 2005, based on negative market signals provided. Part of the lower prices experienced now are due to the resulting larger supply of calves. The industry is now liquidating those cows and bringing the national calf crop back to more historical levels.

**Canadian Beef Cow Numbers
January 1**



Source: Statistics Canada

Market Trends and Marketing Options

The wide range in historical prices is an excellent example of the cattle cycle and consequently the price cycle where higher prices encouraged production and lower prices encouraged liquidation. The NFU report notes that a much narrower price range is observed after 1982. This is partly due to producer’s ability to respond to market signals in a more timely fashion. This removed the large swings in prices and consequently the large booms and busts in the industry. This was partly due to producers rising use of the futures market. The Chicago Mercantile Exchange started the live cattle and feeder cattle futures in 1964. The most generally recognized functions of futures markets are risk transfer and price discovery. This price discovery allows actual market prices to converge on the price determined by the economic forces of supply and demand. Those who utilize these prices are able to make better resource allocation decisions when futures prices reflect true supply and demand conditions. This results in more stable commodity prices, when the futures market reflects supply and demand. Currently the futures markets have been influenced by speculators, wide fluctuations in grain prices and the financial markets. These factors create disparity between the futures and actual supply and demand situations.

The NFU report points to captive supplies as a way packers control live cattle prices. The term captive supplies refer to cattle procured by the packer in advance of slaughter. Captive supplies take one of three forms: 1) packer owned cattle 2) cattle procured on forward contracts and 3) cattle procured under formula price (or marketing) agreements. The report asks what’s wrong with contracts since some producers prefer contracts because it gives them access to premiums. The report responds by asking how grateful should farmers be for a few dollars of premiums when prices are well below the historical average. Having indicated above that margins not gross returns are what matter in business here is another item to consider. The use of forward contracts, grid pricing and packer ownership reduces the risk taken on by feedlots. These marketing tools provide flexibility and increase the return to the producer by being able to lock in a profit or take advantage of higher yielding/performing cattle. The development and

use of these marketing tools provides producers the stability needed to survive in a volatile market. Captive supplies ranged from 31 to 40 per cent of fed cattle procurement in Alberta from 1998 to 2007 with an average of 35 per cent. Captive supply arrangements arise out of economic incentives for cattle producers and beef packers to engage in such business arrangements. If these options were removed producers would be exposed to the increasingly volatile market place. A feedlot's ability to custom feed packer owned cattle at a profit is important to overall resilience in a small margin industry.

Conclusion

The NFU report states that packer and corporate concentration, export overdependence, captive supplies and vertical integration have resulted in significantly lower live cattle prices since 1989. The report points to several of what they call "False Causes" and while these factors (high feed costs, an appreciating dollar, ethanol, SRM removal costs, BSE, capacity utilization, government regulations, retail prices and labour costs) are not the only ones that influence margins in the beef industry they do have a significant influence. The solutions recommended aimed at increasing prices by limiting supply would ultimately result in fewer producers and consolidation would continue, as the benefit of economies of scale and lower average costs would still be present.

A succession of competitive challenges including border closures, a volatile dollar, rising labor costs, enhanced regulations, rising cost of gain, and significant market uncertainty have resulted in large losses and significant declines in profitability throughout the Canadian beef industry over the last several years. At the same time many of these factors have been out of the control of the Canadian beef industry. The one factor that has resulted in significant challenges for the beef industry and resulted in declining prices is reduced beef demand across North America. Increased exports since 1989 have increased packer returns which have been passed onto the producer in increased cattle prices as profits or losses move through the supply chain. However, decreased demand has resulted in lower cutout values domestically depressing live cattle prices.

A feedlots ability to use various marketing options including contracts with packers is an important part of an operations risk management. Taking away mechanisms such as packer ownership that were developed to reduce producer risk and lock in profits is not the answer. Increasing beef demand both domestically and internationally is needed to increase the overall cutout value and will ultimately have the most impact on feedlot and cow/calf returns.