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GEORGE MORRIS CENTRE

Special Report

Beef Pricing and other Contentious Industry Issues

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The Live Versus Beef Price Disparity

There is unprecedented media and producer interest in the question of why cattle prices are low and consumer beef prices are not so low following the discovery of a case of BSE in Canada on May 20, and another in the US on December 23. As usual, the answers to these questions are in the basic supply and demand numbers. This report is aimed at analyzing and explaining what's going on in the current beef market.

Current Beef Prices to the Consumer

The first part of the demand side of the equation is packer capacity. From a practical perspective, beef packing capacity is likely around 72,000+ head per week in Canada. (Canadian packers have occasionally slaughtered 73-74,000 head per week but we doubt that is sustainable). That means packer demand for cattle is bounded at around 72,000 head per week. A ***rough*** outline of weekly packer capacity is as follows:

Lakeside:	22,000
Cargill:	22,000
XL Foods:	10,000
Better Beef:	9,000
Other:	8,000

Point Number 1:
Until or unless more capacity is added, capacity is the limiting factor on the demand for cattle. In other words, that is the weekly slaughter cattle-marketing limit, and it will be until the border is opened to live trade.

Point Number 2:
Prior to BSE, Canadian cattle marketings were usually around 90,000 per week or less. Of that tally about 20,000 went south as live cattle (in normal years, about 70% of live cattle exports are fed steers and heifers, the rest are cows and some feeders). From May 20 onward, those live cattle that were normally exported each week, had to find a marketing channel in Canada.

Implication:
Combining Points 1 and 2 means there is obviously a severe over-supply of live cattle in Canada.

Point Number 3:
Before May 20, the domestic Canadian beef market typically consumed about half of Canadian packer production, while the rest was exported. Imports, in turn, filled specific but significantly large market requirements. If Canadian packers operated only to supply the pre-May 20 Canadian,

they would be running at about 40,000 head/week or less. That is roughly what they did last summer.

Point Number 4:
Since September, Canadian packers have been able to market beef from cattle aged less than 30 months all over North America and in an increasing number of countries overseas. Canadian packers are able to supply retail and foodservice requirements in the US, Canada and Mexico.

In response to those more open borders, packers increased their operations to a rate of about 90% of their capacity this past winter and last fall. By any measure, 90% is a solid rate of capacity utilization. The week ending March 5 weekly throughput was over 71,000 or 100% capacity.

Implication:
Given Canada's severe over supply of live cattle, the open borders for beef was a very positive development for cattle producers. The last thing cattle producers needed was for the industry to continue to operate at 40,000 head per week.

Point Number 5:
Given that packers are marketing beef across North America, they are able to sell product at or near prevailing price levels.   Since packers can market across North America, it is not rational for a packer to price beef any lower than the best price that can be obtained in the target markets in Canada and elsewhere. If beef prices were low in Canada, product would flow to where the price was higher. Therefore, with regard to beef pricing at the packer level, prices are based on supply and demand levels in North America

Implication:
Pricing of beef at the packer level in many respects is similar to what it was prior to BSE. The exception is the lack of export markets for offals, "thin meats" and other products that are more highly valued overseas. Furthermore, in a post-BSE environment, nothing is truly "normal," as each piece of meat requires more work to sell. Nevertheless for the bulk of the carcass, particularly those cuts that Canadians demand, it is business as usual.

Conclusion Regarding Beef and Live Prices
There is a clear answer with regard to why beef prices are not lower at the consumer level. That is because there is no surplus of beef at either the consumer or packer level. The clear answer as to why cattle prices are so low is because there is a surplus of live cattle relative to demand (capacity). This will be the case until the border is open to live cattle. Since packing plants are operating at full capacity, dropping consumer prices for beef cannot increase consumption – there are simply too many cattle for the amount of plant capacity, despite the fact that capacity utilization increased from 40% last summer to virtually 100% currently.

The excess supply problem is far worse for cows than it is for finished steers and heifers. The steaks and roasts that Canadians buy in chain stores and restaurants generally come from young steers and heifers. Older cows are generally used for manufacturing (grinding or ground) beef, and are often not processed in the same plants as steers and heifers. Movement of older cows and the beef from them (over 30-months old) is much more restricted than younger cattle because of the protocols around BSE. Prior to May 20, most Canadian cows were shipped to the US for slaughter because there is very little plant capacity for cows in Canada. Some of the ground beef from these animals was shipped back to Canada. Following May 20, neither cows nor cow beef could be shipped from Canada to the US. After December 23, cow beef could also not be shipped from the

US to Canada. Moreover, Australia, a normal source of grinding beef, is now supplying more beef to Japan because the Japanese market can no longer be served by Canada and the US.

The ironic result is that there appears to be a shortage of manufacturing beef in Canada relative to the demand, resulting in relatively high ground beef prices. But at the same time there is a severe over supply of cows from both the dairy and beef herds relative to the very limited processing capacity for them. Under these circumstances, an additional cow has very little value in the market.

Some Thoughts on the Current Pricing Controversy

The George Morris Centre has been criticized by both producers and beef buyers for saying that packers have not been gouging anyone in the beef supply chain. We stand strongly by that statement. The dictionary refers to gouging as some sort of extortion. This is not the case. There are nefarious meanings associated with the word gouging that are simply not applicable to pricing in this industry.

The live cattle pricing issue for a packer is to place a value on a commodity that is in significant over supply. It is rational economic behavior to pay just what it takes to get the cattle to move to the plant. Furthermore, it is important to remember that the over supply of cattle is caused by the border closure. That is a problem not of the packers making. It is a problem that is not going to be solved by accusations. If the border remains closed, then the Canadian cattle herd is too large. High cattle prices will not encourage it to be downsized. The situation is an economic disaster, but it is the border closure that caused it.

Another important point to note is that, based on our ongoing and constant discussions with retailers and foodservice suppliers, there is no issue with consumers about beef prices. Consumers are not backing away from beef because they think prices should be lower. Despite best attempts to convince them otherwise, consumers are not showing any unusual interest in beef prices.

From our perspective, there are only two groups who are really concerned about the price of beef at retail. One group is reporters and the other group is cattle producers. The reporters' interest is based on trying to find a villain using simplistic arguments about an industry that most don't understand, and who clearly fail to grasp the longer term issues.

Producers are focused on the price of beef for two reasons. One is the obvious natural frustration of seeing prices for your raw product collapse while the price of the final product stays firm. As understandable as that frustration is, it can be explained in the discussion above. The other reason producers want beef prices to be lower is the belief that lower prices would help product move faster. If product moves faster and in greater volumes, then the logic goes that more cattle would move and cattle prices would firm.

There are a number of assumptions that need to be made to decide whether lower prices at retail would help producers. The first is the sensitivity of beef consumption to price. Economic research indicates a variety of results with regard to this topic. A good guide is that for every 1% decrease in price, consumption increases by 1%.

This year, live cattle prices are about 20% lower than they would have been if the border were open.* If we go a little further to make a point and say that Canadian beef prices should decline by

* Based on "normal" price spreads versus current spreads

25%, then we might see consumption increase by 25%. That 25% increase in consumption is equal to about 13,000(+-) head per week. That 13,000 head is still well short of what needs to move, but it would obviously help the situation.

Of course that discussion ignores the fact that, as discussed above, we do not have the capacity to slaughter an additional 13,000 head per week. To do so would require another plant about the size of one of the two major ones in Alberta operating on a single shift basis – or a series of smaller plants that add up to the same thing.

Some suggest that the problem would be solved if we cut off imports – ie we could replace imports with domestic beef. Certainly, on paper the domestic demand for beef and domestic production look to be a good match. The problem however, is that the imported product is mostly manufacturing beef (hamburger and further processed product) which, as discussed above, generally comes from cows. For a variety of reasons, historically Canada has not supplied Canadian manufacturing beef requirements (other opportunities, structure…). Also, as we showed above, based on current cow kill capacity, Canadian suppliers simply don't have the ability to sustain domestic demands now either. Furthermore, it would be more than a bit of a challenge for an export-dependent nation like Canada to argue against imports before international tribunals.

The Canadian Boxed Beef Cutout Report

A final point to note is the Canadian Boxed Beef Cutout Report that is posted on the Canfax website (Canfax.ca). The George Morris Centre writes and compiles the report, with assistance from Sparks Companies in Memphis. The Beef Industry Development Fund finances this report. As noted on the Canfax website, the Canadian Cattlemen's Association saw the need for improved information and analysis regarding the price and value of boxed beef cuts to address challenges and opportunities pertaining to beef market conditions and beef market development. This report will help the industry: 1) assess the areas of the carcass that require the greatest marketing efforts and understand impacts of value changes in those areas; 2) assess the possibility of utilizing boxed beef cut-out values as a cattle pricing tool; and 3) provide information regarding current beef market conditions to cattle producers and industry participants.

The report is a hybrid of a couple of reports that have been done by the USDA for approximately twenty years. In fact, industry participants have been asking Ag Canada to do a similar report for about ten years, but to no avail.

The report discusses weekly boxed-beef movement, market conditions and pricing, from buyer and seller perspectives. It also estimates gross margins[**] for packers or at least a representative packer. In normal times, an estimate of packer gross margins is a useful marketing tool for cattle feeders. In these unusual times, the estimate has served to fuel irritation amongst producers and packers. That is because the estimated margins suggested by the report have been very good for packers. We stand by those reports but packers have hotly disputed their accuracy. The reports can and will continue to be improved over time, likely with the help of packers.

With regard to packer margins, it makes some intuitive sense that returns have been very good this fall and winter. Back in the early summer when they lost tens of millions of dollars each week, however, there was no media interest whatsoever, and some of the media now like to use that period

[**] Gross margins are beef revenue plus by-product revenue less cattle costs. Gross margins do not include operating costs and packaging.

for comparison to say how much margins have risen. Furthermore, while the gross margins are large, so are packers' operating costs. During the last six weeks margins have been declining rapidly and appear to be very narrow on a net basis. That fact will receive little coverage.

Implications

Understanding the extraordinary supply and demand factors at work in the beef market can assist in coming to grips with whether some kind of competitive problem exists. Fundamentally, we have a market situation for the cattle/beef industry with strong demand for beef, limited processing capacity because the borders are closed to exports of live cattle and, therefore, a surplus of live cattle. The solutions to the fundamental situation are either to open the borders or reduce the number of cattle in the country.

Misunderstanding and misusing information promotes nothing useful. We offer the following comments in favour of getting it right.

- Actually, the entire beef industry should be thankful that consumers are not concerned about the price of beef, for obvious reasons. If consumers thought they were being taken advantage of, they would simply purchase less beef. That of course would be very detrimental to cattle producers in Canada.

- The more the media chooses to focus on the price of beef, the more the ultimate root cause of the issue will be discussed. The ultimate root cause of the issue, of course is the two BSE cases. It seems to make sense for the cattle industry that the less said about BSE and beef the better since it does not seem to be a serious health issue, especially given the fact that Canada's inspection system worked well by keeping the single infected cow out of the human food chain. Those who continue to try and stir up media and political interest in beef pricing will ultimately succeed in making this a consumer issue. If it becomes a consumer issue, the entire beef chain will be the loser for it.

- A further point needs to be addressed regarding the merits of suggestions to artificially lower the price of beef at retail. Is there any policy maker or beef industry representative who wants to stand in front of a crowd of hog and chicken producers and explain why lowering the price of beef is a good idea? Hog producers know from first hand experience that dramatically lower beef prices (see last summer) lead to dramatically lower pork consumption. Lower pork consumption in turn means that hogs get price discounts and more hogs are exported. And, as we have just seen, that fact has now led to countervail and anti-dumping cases against the Canadian pork industry. When there is little possibility that lowering beef prices will help the beef industry and a strong possibility that doing so will spread the pain to other industries, we wonder where some people's heads are.

- Canada has an institution to investigate whether price "gouging" occurs, ie the federal Competition Bureau. It is investigating and will undoubtedly do so using appropriate information and techniques. Let it do its job. Little will be gained by hurling charges based on inappropriate data intended for other purposes.

- This entire discussion has been quite effective in taking the emphasis off the truly important issues. They are:

- There is no issue at all if the border is opened[1]. Everyone's efforts need to be concentrated on how to do that, either through existing processes and/or by having the debate over whether Canada should move to mandatory testing for all exports of beef, even with little or no scientific basis for doing so.

- It is apparent that the international protocols for dealing with animal diseases **can** impart economic hardship well in excess of the threat the diseases pose to humans. It is clear that Canadian and US consumers decided very quickly that these two cows posed little threat to them. Yet the machinery in place to protect consumers has created an economic disaster for beef producers. What's the proper balance? If as much time and effort was used to focus on that question as has been focused on the pricing question, someone may have contributed something useful to the real policy debate.

- Whatever the answer to the foregoing, Canada needs to come to grips with whether and, if so, how to develop export industries with less vulnerability to the risk of losing market access. This is not a trivial question. Canada has a huge supply of natural resources available for agricultural production. Many countries with growing incomes, populations and demands for quality products do not. From an international and human perspective, it will be the height of human folly not to use our joint resources wisely. Carping among ourselves about short term problems contributes nothing to the longer term strategy development. Nor does it contribute leadership in a world that desperately needs it.

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[1] At least not for young cattle. The issue will remain for cows.