STATEMENT OF DR. ROBERT A. ROGOWSKY
DIRECTOR OF OPERATIONS
U.S. INTERNATIONAL TRADE COMMISSION
before the
Senate Committee on Commerce, Science, and Transportation

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I am pleased to have the opportunity to discuss the work the U.S. International Trade Commission (Commission) recently completed and published as *Wheat Trading Practices: Competitive Conditions Between U.S. and Canadian Wheat*. The Commission instituted this investigation at the request of the United States Trade Representative (USTR) on April 12, 2001.

USTR indicated in its request letter that it had initiated its own investigation under Section 301 (foreign practices affecting U.S. exports of goods or services) of the Trade Act of 1974. That investigation concerned the acts, policies, and practices of the Canadian Wheat Board (CWB) and the Government of Canada. It was precipitated by a petition filed in October 2000 by the North Dakota Wheat Commission (NDWC). In its petition, the NDWC alleged that the CWB, a state trading enterprise with a near monopoly on Canadian wheat sales, engaged in unfair practices in its export sales of wheat to the U.S. market and to certain third country markets of interest to U.S. exporters.[1]

USTR's request to the ITC for a fact-finding study under Sec.332(g) of the Tariff Act of 1930, was to help to provide factual information to supplement work by the interagency Section 301 Committee as it pursued its investigation. The Commission made no determinations or findings, and had no part in the decision-making of the Section 301 Committee. Instead, ITC's role was as an objective and impartial gatherer of facts.

In its request, USTR asked the Commission to survey the industry. Specifically, the ITC was asked to provide to USTR the following information, to the extent possible:

- a summary of a survey of U.S. Hard Red Spring wheat and Durum wheat purchasers, including wheat millers, as to the conditions of competition between U.S. and Canadian wheat during the 5 most recent years, including such data as quantity and prices, technical considerations in the purchase and sale of U.S. versus Canadian wheat, and other relevant factors of competition;

[1] In December 2000, an estimate by the petitioner further quantified the unfair trading practices as price undercutting of approximately 8 percent of CWB wheat under U.S. wheat, over-delivered protein content in the Canadian wheat, and other transportation (rail) benefits. The petitioner recommended a tariff-rate quota on Canadian imports into the United States as a remedy for these practices.

- a summary of a survey of U.S. Hard Red Spring wheat and Durum wheat exporters as to conditions of competition in key foreign markets in Latin America, the Philippines and other significant markets, between U.S. and Canadian wheat during the 5 most recent years, providing such data as quantity and prices, lost sales of U.S. wheat versus Canadian wheat, technical considerations in the purchase and sale of U.S. versus Canadian wheat, and other relevant factors of competition; and

- a summary of the current conditions of wheat trade between the United States and Canada, including relevant information on prices, exchange rates, transportation, marketing practices, U.S. and Canadian farm policies, and other significant economic factors that might be relevant.

The Commission held a public hearing on June 6, 2001, gathered evidence, and issued separate exporters' and purchasers' questionnaires to U.S. companies during May to June 2001.[2] In addition, Commission staff conducted field visits in Minnesota, North Dakota, and the State of Washington to gather information from U.S. wheat millers, grain elevator operators, State officials, domestic farm organizations, U.S. wheat exporters, and U.S. importers, as well as from representatives of the Minneapolis Grain Exchange, the principal trading point for U.S. Hard Red Spring (HRS), Canadian Western Red Spring (CWRS), and Durum wheat. Staff also traveled to Canada to meet with CWB officials to discuss operations relevant to this study.

This report presents information in the following areas: the structure of the U.S. and Canadian industries and markets for Durum and HRS/CWRS wheat; pricing practices in the U.S. market and selected foreign markets; the influence of rail transportation on U.S. and Canadian industry competitiveness; product quality issues; and Canadian trade programs.

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[2] The Commission sent purchasers' questionnaires to firms that milled, imported, purchased, or processed Hard Red Spring (HRS) or the directly competitive Canadian wheat, Canadian Western Red Spring (CWRS), Durum, or both classes of wheat, from the United States, from Canada, or from both countries, during any part of June 1, 1996, through May 20, 2001. Respondents ranged in size from the major multinational grain companies to small firms that purchase limited quantities and types of wheat. Most firms were either grain companies or millers, or both. Four other firms were manufacturers of pasta or other products. Most purchased both U.S. and Canadian wheat. Respondents accounted for nearly all U.S. imports of Durum and CWRS wheat in the marketing year 2000/01. The Commission also sent questionnaires to U.S. firms exporting Durum, HRS, and/or CWRS wheat to eight selected markets: Algeria, Brazil, Colombia, Guatemala, Peru, Philippines, South Africa, and Venezuela. The responses were obtained from U.S. firms only, and therefore do not directly cover the pricing and/or export behavior of the CWB in world wheat markets. The responses do provide U.S. exporter views on CWB behavior and on the competitiveness of U.S. and Canadian wheat in the selected markets. Although these markets account for an important share of the world market for these products, the data and other analysis should not be construed to represent the CWB's activities in other third-country markets. The Commission received responses from 20 firms covering most of the market. However, responses for specific shipments were limited (or subject to different terms of sale) and therefore direct price comparisons were not possible for several markets.

Structural Differences Between Durum Wheat Markets

In the United States, the Durum market is more narrow and more heavily dominated by Canada than is the HRS wheat market. Durum has no close substitutes and has only one principal end use: pasta production. HRS wheat has several substitutes (of varying quality) and is used in the manufacture of an array of breads and other bakery goods. With nearly 60 percent of world trade in Durum in crop year 2000/01, Canada is almost three times larger than its closest competitor, the United States.

One advantage the CWB has in the Durum market is the ability to forward contract for future delivery, as substantiated by the responses to the Commission's purchasers' questionnaire.[3] Because there are now few futures contracts traded for Durum wheat on the Minneapolis Grain Exchange (MGE),[4] and even the volume of cash Durum trade is spotty and thin, the process of price discovery in U.S. and world Durum markets is much more opaque than that for HRS or Hard Red Winter wheat. In this market environment, the CWB can forward contract Durum to U.S. and/or third-country purchasers in a way that no U.S. Durum supplier can do given the high level of risk and price volatility facing small suppliers in a thinly traded market.

The demise of the Durum futures contract on the MGE is partly related to the presence of the CWB. The U.S. market is dominated by a few large suppliers and a few large domestic purchasers, but relatively low volumes. The other factors that undermined the use of futures contract in the U.S. included the difficulty in specifying contract delivery terms and annual protein and quality variation.[5]

In contrast to Durum, Canada supplied only 17 percent of global non-Durum wheat exports in the 2000/01 crop year and accounted for only 5 percent of world production. The United States supplied 28 percent of world wheat exports other than Durum in that year, and produced 10 percent of world output.

Structural Differences Between U.S. and Canadian Industries

[3]Eight firms responded to the Commission's purchasers' questionnaire that the CWB Durum future delivery was of value to them; six firms (three of which did not engage in importing) said the future delivery was not of value. See Chapter 4, "Contract Structure."

[4]The Durum wheat futures contract volume on the MGE fell from16,000 contracts in 1998 (the year it was first introduced) to 559 contracts in 2000, and to 67 contracts during Jan.-Apr. 2001, according to data of the MGE. See also Monte Vendeveer and C. Edwin Young, "The Effects of the Federal Crop Insurance Program on Wheat Acres," USDA, ERS, *Wheat Situation and Outlook Yearbook*, March 2001.

[5] Ibid. Also Commission interview.

The wheat producer and user sectors in the United States and Canada are generally similar in structure. The main difference between the two nations' industries lies in the middleman sector, between the producers (farmers) and users (millers or foreign buyers). In the United States, the middleman sector consists of numerous producer cooperatives and small and large grain trading companies. In Canada, the entire middleman sector consists of the CWB, which is empowered with both monopsony and monopoly power in the marketing of western Canadian wheat.

Market power is only one of the CWB's notable structural characteristics. The Board is in all significant respects an arm of the Government of Canada, with Government approval and backing of its borrowing and other financing, which reduces its costs and insulates it from the commercial risks faced by large and small U.S. grain traders.

Further, the CWB's producer pool system (by which Canadian wheat producers are remunerated) gives the CWB flexibility in marketing beyond the ability to forward contract. Producers receive a Government-approved and -guaranteed initial payment early in the crop year, with subsequent interim and final payments as the crop is harvested and sold on world markets. Not only are such subsequent payments payable only to the extent the CWB makes money on its sales, but they are subject to a variety of CWB-determined deductions for freight and other expenses. Some of these deducted expenses are "phantom" expenses (expenses not actually incurred by the CWB). The resulting surplus revenue gives the CWB a price cushion in its negotiations with domestic and foreign buyers.

The lack of price transparency within Canada gives the CWB an inherent marketing advantage over U.S. competitors. This is particularly true in Durum markets, but also in HRS markets. The CWB's basing-point price system (using Vancouver, British Columbia, and Thunder Bay, Ontario, as base pricing points) for producer remuneration enables the CWB to adjust output prices for both domestic sales and direct Prairie sales to the United States (i.e., all shipments that do not go through either basing point) to meet its local competition. Pricing practices are the subject of the following two sections.

Pricing in the U.S. Market

The U.S. price as a basis for the Canadian price

Most U.S. purchasers of HRS and Durum wheat indicated that the price negotiating (bid-offer) process was much the same in the United States as in Canada. One firm reported that there is greater liquidity in the U.S. market owing to the presence of more sellers. Other respondents stressed the importance of price in the purchasing decision and stated that negotiated prices for CWRS wheat are based on U.S. prices, which in turn are negotiated using futures prices or cash market prices.

In questionnaire responses, the Minneapolis Spring wheat contract was by far the most commonly cited contract on which the CWB reportedly relies in price negotiations. Even in the pricing of Durum wheat, one firm reported that the CWB's prices are expressed in relation to Minneapolis Spring wheat futures. Normally, it was reported, Canadian Durum wheat commands a premium over the Minneapolis price of $0.05 to $0.10 per bushel ($1.84 to $3.67 per metric ton). Most firms were unable to specify whether the CWB's pricing practices in the U.S. market differed between exchanges.

Canada's large share of the U.S. and the world Durum markets suggests to some U.S. industry members the possibility that the CWB's actions can affect Durum prices on U.S. exchanges.[6] In this view the CWB is not entirely a price-taker in the U.S. Durum market but has some effect on prices by its decisions on how much to market.

Terms of sale between U.S. and Canadian wheat in the U.S. market

Discounts and premiums

There are few differences in the terms of sale of U.S. versus Canadian wheat, according to questionnaire respondents. A few purchasers of Durum wheat reported that contracts for U.S. wheat specify quality discounts for grade factors that do not meet contract specifications, while Canadian contracts generally do not. Generally, it was reported, Canadian contracts specify only the protein level and grade, the latter to be determined on the basis of Canadian grade standards. Grade No. 1 (# 1) CWRS wheat generally commands a premium of $0.03 per bushel over # 2 CWRS wheat, which reportedly is the same price differential applied to the equivalent U.S. wheat.

Delivery terms

Firms that purchased wheat directly from the CWB for delivery reported more forward than spot contracting, but none reported multi-year contracts. Slightly longer delivery terms were noted for a larger portion of sales of Canadian wheat as compared to U.S. wheat.

Transportation costs are generally either paid by the CWB or split between the CWB and the customer. However, respondents were generally unable to report average transportation costs between the principal Canadian origin points and principal U.S. destinations, because the price for Canadian wheat is often referenced to a "gateway" or entry point in the United States, with Minneapolis being the most frequently cited.

[6] Commission interviews.

Price comparison of U.S. and Canadian wheat

Eighteen firms provided 785 individual price contracts for the 60 months during the marketing years 1995/96 to 2000/01. Direct comparisons between contracted and delivered prices for U.S. and Canadian wheats were not possible owing to differences in reported contracting terms as noted in Chapter 4. Given these data issues, the Commission conducted two analyses of the price data: an analysis of the contracted (largely "gateway") prices for comparable wheats (U.S. and Canadian # 1 Durum, # 1 HRS and # 1 CWRS, and U.S. # 2 HRS and # 2 CWRS) during 1996/97 to 2000/01, and an analysis of delivered prices in the Minneapolis area.
Regarding contracted prices (largely through the "gateway") in the U.S. market during 1996/97 to 2000/01, reported Canadian Durum prices were above U.S. prices for all comparable months except one. For # 1 CWRS/HRS wheat, price relationships were mixed, with some Canadian prices equal to or above U.S. prices, and others below. Prices for # 2 CWRS wheat were generally higher than those for # 2 HRS wheat, with most contracts reported after January 2000. These observed time series relationships are consistent with previous responses from firms regarding the CWB's use of grain exchanges for pricing wheat in the U.S. market.

Exports to Third-Country Markets

Level of export sales to subject markets

Data supplied by reporting firms on their exports of U.S. and Canadian Durum, HRS, and CWRS wheat to the eight markets covered in the survey show declining U.S. exports of Durum and HRS wheat and increasing exports of Canadian Durum and CWRS wheat in 2000/01. The data also show exports of Canadian Durum and CWRS wheat overtaking exports of U.S. Durum and HRS wheat in 2000/01.

Export marketing practices

Questionnaire respondents indicated that there are no material differences in transportation costs, seasonality of delivery, or use of futures or spot markets that affect the relative competitiveness of either nation's wheat in the eight subject foreign markets. Respondents also reported no quality discounts and reported no other special discounts from the CWB.

The analysis of protein delivery in exporter contracts for U.S. # 2 HRS and # 1 and # 2 grade CWRS wheats[7] shows that over-delivery of protein occurs in exports of both U.S. and Canadian wheat. Most over-delivery was found to be small, equal to or less than 0.2 percentage points over contract specifications, and this level of over-delivery occurred in both U.S. and Canadian contracts. Since most contracts have penalties for under-delivery of protein, it is likely these differences are due to actions by exporters to ensure that the minimum delivery requirements are

[7] Data were not sufficiently available to analyze protein over-delivery in U.S. and Canadian Durum export contracts.

met. However, a higher frequency of protein over-delivery in the higher ranges was found for the CWRS wheats. For example, the comparable Canadian export contracts had protein over-delivery of 0.8 percentage points or higher.

The Commission's questionnaire responses from exporters also showed that delivered prices of both U.S. and Canadian wheat are often not adjusted upward in the event of protein over-delivery, although, as noted above, most over-delivery was found to be small in the reported data. However, among the wheats/grades analyzed, price increases were found to be more frequent for the higher grades of wheat (# 1 CWRS and U.S. # 1 HRS), as compared to the # 2 grades of these wheats.

Lost sales for U.S. wheat exporters

Three out of 20 responding firms indicated that price competition with Canadian wheat is an "important" issue and that they had to cut prices to avoid losing export sales of U.S. wheat. Six responding U.S. firms reported that they had lost sales to Canadian competition. One firm reported it had difficulty competing with direct sales by the CWB.

Export price comparisons

Comparable export price data were evaluated for the Venezuelan market. These price comparisons, for export shipments to Venezuela for # 2 CWRS and # 2 U.S. HRS wheat, show that export prices for the two wheats generally moved in the same pattern during 1996/97 to 2000/01.

Rail Transportation

Rail transportation is one of the most important factors in wheat industry competitiveness.[8] Railroads have typically been regulated in both their rate-setting and their operation of trunk and branch lines, both of which are important to wheat industry competitiveness.

In recent years, the U.S. rail industry, unlike the Canadian rail industry, has been fully deregulated: U.S. rail rates for all commodities, including wheat, are now set by railroads in negotiations with individual

[8] In addition to the economists' studies submitted to the Commission by counsel for the North Dakota Wheat Commission and for the Canadian Wheat Board, *see* The Hon. Willard Z. Estey, "Grain Handling and Transportation Review: Final Report," submitted to the Minister of Transport (Canada), Dec. 21, 1998; USDA, ERS, "Effects of Railroad Deregulation on Grain Transportation," Report ERSTB1759, 1989; and William Coyle and Nicole Ballenger, eds., "Technological Changes in the Transportation Sector--Effects on U.S. Food and Agricultural Trade," ERS Miscellaneous Publication No. 1566, 2000.

shippers. Only if there are disputes over rates, or proposed mergers that might restrict competition and raise rates, does the U.S. Government (the Surface Transportation Board) become involved.
In August 2000, the Canadian Government implemented new regulations for the movement of CWB wheat by the two main railroads, Canadian National and Canadian Pacific. These new regulations place "caps" on the overall revenues received by these railroads from the transport of CWB wheat and other grains (see Chapter 3 for details). Shipments to the eastern and western ports for overseas export are regulated--rates are below comparable commercial rates--as are domestic shipments to Armstrong or Thunder Bay, Ontario.

Significantly excluded from the revenue cap is western wheat shipped to the U.S. market.[9] U.S.-bound shipments from Canadian west coast ports are excluded, and rates for such shipments are free to be negotiated between railway and shipper (the CWB is the shipper of record for all wheat to the United States).

According to a report commissioned by the Canadian Department of Transportation, the CWB provides railcars to railroads "without charge." The North Dakota Wheat Commission and North Dakota State University have suggested that this is partly to compensate railroads for the lower rail rates for CWB grain.

The CWB asserts that higher U.S. versus Canadian rail rates are due to "greater railway monopoly concentration" in the United States.[10] However, with an equal number of Class I railroads servicing shippers of the subject wheat, and a roughly equal layout of short lines, there is no clear evidence that railroad concentration is higher in the United States. More broadly defined (i.e., including alternative transport modes such as trucking or riverine transport) transport concentration may be lower in the United States, although it is hard to measure precisely such concentration. The reason for lower Canadian rates appears instead to be greater railroad regulation in Canada, at least with respect to the transport of western grain.[11]

An additional rail rate issue, discussed in Chapter 3, is the freight charge the CWB deducts from its reimbursements to individual Canadian producers, and how that charge compares with the rate the

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[9] Canadian Transport Agency, "Western Grain: Railway Revenue Cap," retrieved Aug. 2, 2000, from http://www.cta-otc.gc.ca.

[10] CWB, prehearing brief, p. 8.

[11] See Chapter 2. Indeed, the CWB concedes as much: "The Canadian railway transportation system is more highly regulated than in the United States and results in lower freight rates for all goods carried, not just wheat and barley." CWB, prehearing brief, p. 8. However, the CWB's conclusion likely is correct only with respect to grain, not "all goods." See Transport Canada, *Vision and Balance*, Final Report of the Canada Transportation Act Review Panel, June 28, 2001, p. 29. ("The National Transportation Act, 1987, freed railways and their customers to negotiate charges and conditions for moving products, except for grain.") Available on the Internet at Transport Canada's website: *http://www.reviewcta-examenltc.gc.ca/english/pages-/finalreport.htm.*

CWB actually pays to Canadian railroads. The Commission did not obtain actual rail costs of shipping wheat from Canada to U.S. destinations from its questionnaire.

Product Quality Issues in the U.S. Market

Protein "over-delivery"

Most respondents to the Commission's purchasers' questionnaire reported that to their knowledge, the CWB's deliveries of wheat exceeding contracted protein specifications are considered minor and not generally anticipated. In fact, respondents reported that deliveries from both U.S. and Canadian suppliers tended to exceed the minimum contracted protein level in both the U.S. and export markets. To assess the extent of over-delivery of protein content in domestic wheat purchases, the Commission analyzed differences in contracted and delivered protein in 615 Durum, HRS, and CWRS wheat contracts reporting both sets of data. For all but # 1 CWRS wheat, most contracted purchases were shown to have a tendency toward over-delivery of protein content. However, all contracts for all comparable wheat grades and classes tended to meet or exceed the contracted protein specification for final delivery of the product. Out of 510 reported U.S. shipments of HRS and U.S. Durum wheat, 65 percent reported protein over-delivery, while 54 percent of 105 reported CWRS and Canadian Durum contracts reported over-delivery of protein. Most of these differences were found to be within a 1.0 percentage points range above the contracted protein specification, and nearly all were within 1.5 percentage points, for both U.S. and Canadian wheat.

> Generally, firms reported that, to their knowledge, no adjustments to prices were made when the delivered protein content of wheat, from either U.S. or Canadian sources, exceeded contract specifications. The Commission's analysis of actual price and purchasers shipment data revealed that when the delivered protein content exceeded the contract specification, the delivered price also exceeded the contract price in about one-fifth of the reported purchasers contracts.

For both U.S. and Canadian wheat, firms reported that prices are generally reduced when the delivered protein content falls below contract specifications. Some firms indicated that price adjustments for variations in protein levels are handled on a case-by-case basis, and that a load could be rejected for not meeting the protein specification.

Dockage

"Dockage" is the foreign or undesirable matter in wheat, such as straw, weeds, pests, and broken hulls. Dockage levels are commonly included in contract specifications. Many firms reported that the CWB delivers below-dockage wheat (i.e., "cleaner" than called for in the contract); in fact, all reporting firms indicated that 95 to 100 percent of their CWB shipments were delivered below the contracted dockage level by more than a 0.2 percentage point.

The Effects of Canadian Trade Programs and CWB Pricing on U.S. Exports to Canada

The U.S. industry has indicated that Canadian regulations and laws, as well as operations by the CWB, have virtually precluded marketing of U.S. milling grade wheat or milled flour to Canadian mills and buyers. As shown in Chapter 2, U.S. exports of wheat into Canada are negligible, amounting to less than $50,000 in 2000/01. Canadian trade policies and programs, particularly the varietal registration program and end use certificates for U.S. wheat, have been reported by U.S. exporters as adversely affecting the level of U.S. wheat exports to Canada. Information supplied by both U.S. industry interests and the Canadian Government indicates that the Wheat Access Facilitation Program is no longer in use. The program was implemented by the United States and Canada as part of the Record of Understanding in 1998, to facilitate exports of U.S. wheat directly to Canadian elevators.

Additionally, the CWB sells wheat to domestic Canadian millers using a North American pricing policy that ensures that its selling prices to Canadian millers are competitive with U.S. prices. According to U.S. interests, the CWB will lower its price to Canadian wheat mills in order to eliminate any possibility of U.S. wheat or flour coming into Canada.[12]

[12] According to these interests, the disparity in westbound U.S. and Canadian rail rates resulted in the CWB paying the Canadian wheat mills a bonus.