The Hog Pricing Formula Discussion

Alberta Pork's Chair Frank Novak, sent a note to Alberta producers in November 2016 under the heading "Is There a Better Pricing Formula in Your Future?" The message starts by saying that "During the 47th Alberta Pork Annual General Meeting held on Wednesday November 9, 2016, it was suggested that pork producers should come together to discuss alternative ways to approach pig pricing." The following are some of the points from the letter:

- Sharp declines in pricing mean that the formula used to set prices is not working.
- The primary price tool for Alberta, the Iowa Southern Minnesota 206 report may be scrapped in the U.S. as too few hogs are included.
- The CME is looking at alternative options for pricing given shrinking negotiated trades.
- Western price discovery is based off of a pricing system in another country which has different market conditions.
- At this time, there is incredible pressure on the producer, in the past the reverse has been true for the packer.

The letter ends by saying that "Now is the time for the Canadian packer and Canadian producer to be in sync with each other to secure a more sustainable future for both. Therefore, as indicated at the Annual General Meeting, Alberta Pork will be looking to hold a number of smaller meetings over the next month to discuss how producers might address pricing change for the future.

The letter does look at the bigger picture because it acknowledges that while the producer is on the short end now, next year the situation could be reversed again due to expanding U.S packing capacity. The letter also hits on the long held concern that so much of the industry in both Canada and the United States is priced off a very thin cash market. The letter was accompanied by a recent Daily Livestock Report which showed the negotiated cash or spot market trade represents the low single digits share of all marketings.

The nature of the trade between producers and packers now is more longer term. Contracts are typically of a year or more. As such it is not amenable to spot cash trades. Packers and producers prefer a formula approach for transactions that occur over a longer term. The formulas however are mostly in one way or another based on the cash trades. Almost all the trade in the U.S. is influenced by a very thinly traded market of limited liquidity. That has been a concern for years and the trend is continuing towards thinner cash trades. At the very least, a good argument is made that when the trade is so thin, small movements are exacerbated and there is heightened volatility. Another argument is that at some point, the cash is so thin that it no longer represents true supply and demand. That one is a tougher idea to pin-down, but it is a legitimate argument.

The question then is, if not the cash hog trade as a base for all trades then what?

The focus of interest is to price off the packer pork cutout. That cutout value is reported daily and it represents the combined values of all pork cuts sold in the United States. Packers required by law to report the value of their trades under mandatory price reporting rules.

A Canadian packer's cutout will vary from the U.S. cutout but not materially. Some days or weeks a Canadian packer may do better or worse than its norm relative to the U.S. That would be the same for any U.S. packer. Some days or weeks any packer or packers in a region do better or worse than the published cutout. The starting point is that if there is a desire to change to pricing off the cutout, then the U.S. would be a good place to start.

With that noted, there is not much difference between the pork cutout and the live hog price with regard to magnitude, pricing direction and fluctuation. Based on my data and analysis of the U.S. cutout versus the hog price, from 2012 through 2016, there is a 96% correlation between the cutout and the hog on a monthly basis. In 2016 the correlation was 92% while in 2014 it was 98%. The cutout averaged nearly $90.30/cwt over 2012-2016 while the hog carcass averaged just over $84, a difference of over $6/cwt. The fact that the cutout is generally $6 higher than the hog is due to of course supply and demand, but also due to the fact that the cutout and by-products have to pay for slaughter and operating costs at the plant as well as margin recovery.

The fluctuation in price of the cutout is also less volatile than the hog price. The standard deviation off the average from 2012-2016 was just over $14/cwt for the cutout compared to nearly $17 for the hog. That makes sense given that the overall experience in industries is that the further up the chain the less price volatility there is in the market. Nevertheless, as one goes, so goes the other.

It should be noted, however that the fact that the cutout tracks so closely to the live, tends to support the idea that the current live pricing, with all its faults, is still a good gauge of supply and demand. Nevertheless at the very least, if pricing is off the cutout, there is a greater liquidity and market representation. There is also less volatility.

In addition most producers would like to see more clarity or transparency in pricing formulas. If all packers moved to pricing off the US cutout, it could become easier to compare contract offers, something which might encourage price competition (apples to apples comparisons).

If the Canadian industry wants to price off the U.S. or some Canadian derivative cutout, then there remains the issue of how. Currently the industry prices off the U.S. hog through a formula that includes a division or multiplication factor, in addition to premiums and discounts. Those factors are ultimately the local or regional pricing basis which reflects local or regional supply and demand. To me, this is the real issue. While the choice of U.S. reference is central, the most important pricing component is the local basis as reflected in the factors and premiums. This reflects packer demand and local supplies.

In the case of Alberta, if Olymel decided that it made sense to change the reference from ISM to the U.S. cutout, the most critical issue then would be the factor to bring the price back to Alberta hogs.

Ultimately, as I have been assessing here for the past two years, it is up to the packers to decide the price that they need to attract enough hogs to the plant. This is within the context of their own supply base, which in the case of Olymel Red Deer is material in the 50-60% range. Producers then decide whether that is enough money to make the investment in the business worthwhile. Packers make the offer and producers decide whether it is acceptable based on their decision criteria. The decision is whether they will ship weaners south, finish hogs for the prairie competitors or leave the business.

As I have noted many times, it seems to me that the packers have determined that making pricing more attractive on the prairies would be a zero sum game. Based on their actions they must consider that higher prices would not result in more production and greater supplies. Instead it would simply mean packers get into a battle with each other with no net gain. Whether that is right or not is beside the point.

Packer actions in late 2016 however, are indicating that the packers are starting to use price to compete more vigorously. Olymel's signing bonus, Maple Leaf's Sig 3&4 blending and top up as well as the new formulas from Donald's Fine Foods are testimony to that. Whether this is enough to generate more production or simply results in shuffling numbers between packers is the critical issue.

For their part, producers must also consider the prairie barriers to expansion. These barriers are just as important or more than price. Construction costs on the prairies far exceed those in the U.S. That plus the environmental regulations and the animal welfare changes make every producer's expansion plans much more challenging, in addition to the pricing issue.

Alberta's sow herd represents 11% of the Canadian herd this year compared to 12% in 2010. Alberta has shown almost no tendency toward growth within a context of a Canadian industry that has shown modest or tepid growth. As the Novak note says, "To survive in the marketplace, both the packer and producer need to work together." That sentiment is often said as a platitude. The reality is that the industry now has so few players that it is necessary for both packer and producer to address all barriers to expansion and growth. Packers need to have producers on board more than ever and vice versa.

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