GEORGE MORRIS CENTRE

Competitive Dynamics Change Again in Alberta Beef

Summary

- It is roughly the one year anniversary of the loss of XL Foods due to the *E.coli* calamity.
- This time coincides with new, and tougher, Country of Origin Labeling laws being imposed on Canada by the Obama administration.
- In addition, a new company has announced that it would begin processing cattle in Alberta in the spring of 2014.
- As such, it is a good time to reflect on the competitive dynamics and status of the industry on the Prairies.
- Unfortunately there is more than the usual amount of uncertainty and risk for both cattle feeders and packers.
- The jockeying for competitive positioning is only beginning. When the dynamos begin to fall it will make 2014 the most interesting year in the past decade.

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Introduction

Now is the approximate one year anniversary of the forced shutdown of the XL Foods plant in Brooks. The gloomy anniversary coincides with the more rigorous and harmful version of Country of Origin Labeling being forced on the Canadian livestock industry by the Obama Administration. Mixed into that is the recent announcement of a new player in the Alberta beef industry as of next spring. As such it is a good time to step back and assess the implications for these events on the situation and prospects for the Prairie cattle industry.

One Less in the Market

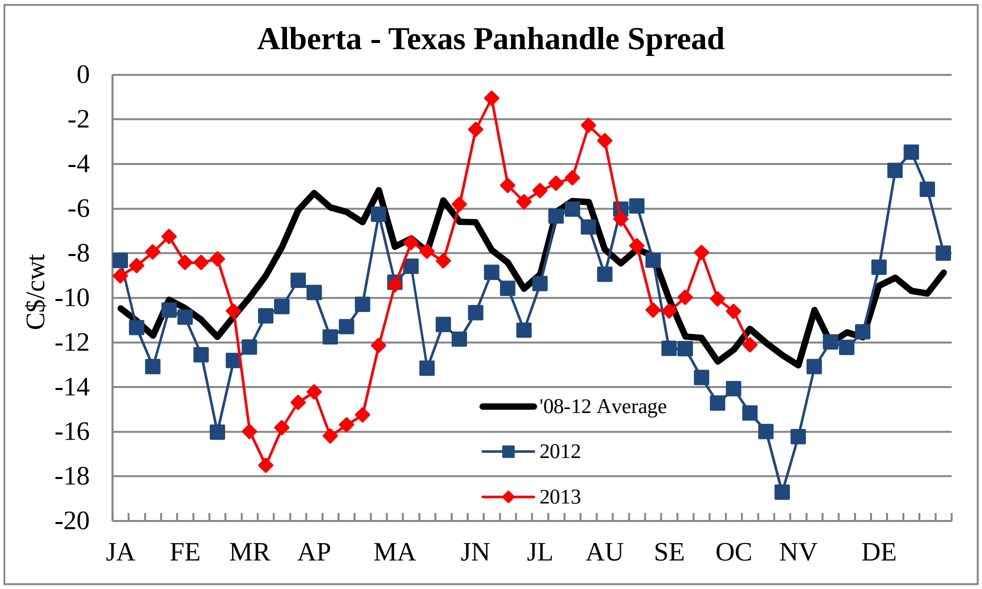
On the one year anniversary of the CFIA/XL *E.coli* debacle it is interesting to reflect on what is different in the marketplace. Starting with the obvious, there is one less competitor in the market. Yes, it is true that before XL was forced out of business there were two packers, XL and Cargill. One year later there are still two with JBS and Cargill. With that acknowledged, this is not the simple case of saying that before XL left the business there were two packers in Alberta and now with JBS there are still two packers in Alberta. The competition in Alberta is much more than the two domestic plants.

Prior to the loss of XL, the competition was comprised of five companies which include the two domestic packers and three US-based plants: Agri Beef in Yakima, Washington; Tyson in Pasco, Washington; and JBS in Hyrum, Utah. Those three plants have daily capacities of 1,600; 2,200 and 2,500 head respectively according to Cattle Buyers Weekly. The two Alberta plants in Brooks and High River can slaughter over 4,000 per day. After XL was out of the business, there are only four active participants in the western Prairie fed market: JBS (Brooks and Hyrum), Cargill, Tyson and Agri Beef.

Prior to the XL closure last year, the two Washington plants could be counted on to pull up to an average of 4,000 head total per week while Hyrum bought in up to 2,500 each week. Alberta fed slaughter amounted to about 35,000 roughly each week prior to last fall. That means that the US shipments comprised about 15-18% of fed cattle marketings with JBS representing about 6%. Depending on markets and relative pricing, at times JBS could pull more than 5,000 head each week.

The point of the above is to show the relative importance of the US buyers and the JBS Hyrum plant in particular. JBS is of extra note because it is now participating in Alberta through Brooks and Hyrum. The three US plants are part of the competitive mix. It is too stark to state that they put a solid recognized, dependable floor under the market because often they do not. Their ability to set a floor depends on their own supplies and opportunities. Often the three US packers would love to pull wide-basis Alberta cattle but are unable to given their own situation. In other times they do serve to put a floor under Alberta prices and Alberta buyers price cattle to keep them out of Washington and Utah.

With one less competitor, it is natural to want to assess the competitive impact. One of the best ways to measure competition and demand is to look at the local price spread or basis. In that regard, on the surface it does not appear that the drive down to four competitors has had much of a price impact.



In the eight months prior to the *E.coli* tragedy last year, the spread averaged C$-10/cwt. This year the spread averaged C$-9/cwt. The five year average spread from January through August was C$-8/cwt. By that gauge there does not appear to be much difference. Of course timing is important. A discussion such as this in April this year would have indicated that there was a huge competitive disruption. At that time, cattle feeders were decrying the loss of XL as the situation looked like a major structural market imbalance had occurred. Conversely in June and July, cattle feeders were saying that a made-in-Canada market was entirely preferable and that a new era of pricing strength had arrived.

In my estimation it is too early to state what the impact of the XL departure is going to be on the basis. The argument for a wider basis is that it is logical for JBS to ease back and run Brooks at a lower rate and let cattle flow south to Hyrum. That is especially the case given the rock bottom cost of the plant for them. The argument for no change in the basis is that JBS is more exposed than ever to Alberta. Instead of buying 2-3,000 a week from Alberta, often opportunistically, now they are almost committed to buying 25,000 a week from Alberta.

COOL Implications…Continued

In some respects COOL makes the above discussion an academic exercise. The new Obama COOL rule announced last spring changed the US packer buying dynamics on Canadian cattle. The new COOL rule has made it even more burdensome for US packers to handle Canadian cattle. As a result effective this November packers in the US have further restricted the numbers and types of Canadian cattle that they will handle.

Under the COOL rules, cattle that were born, raised and slaughtered in the US are called "A" cattle. Cattle that were born in Canada but raised and slaughtered in the US are called "B" cattle while those that were born and raised in Canada and slaughtered in the US are called "C" cattle. Under the new rule Agri Beef will continue to buy slaughter cattle or "C" cattle but it will not slaughter "B" cattle, those that were born in Canada and fed in the US. Hyrum will take "C" cattle which is no change. The biggest issue is that Pasco is no longer taking "C" cattle but will take "B's".

Tyson Pasco likely took on average about 2,000-2,500 per week for a total of about 120,000 per year. While the numbers of Alberta fed cattle at the plant have been steadily declining over the years, they still comprise about 25% of the kill at the plant. The Northwest probably does not have the feeding capacity to make up for the lost Canadian market cattle. This raises serious questions about whether Pasco can survive going forward if the new COOL rule stays in effect. Conversely it also raises questions of whether they will stick with the no "C" decision.

What if Pasco…?

At the risk of being accused of scaremongering, it is prudent to look at the implications of no kill at Pasco. Before that, however, even with Pasco operating, the reality for western Prairie cattle feeders is that without Tyson in the mix for "C" cattle, the new buyer list slips to three from five last year at this time. As such, the "US Floor" under the Alberta market is being shouldered by Agri Beef which probably pulls about 1,500 head per week. Even if they get more active because they don't take "B's", that floor looks much shakier than it did last year at this time. JBS cannot be counted as part of the US floor now, given that their primary procurement tactics will be allocation between Brooks and Hyrum. Once again, that points to the huge difference it makes not having XL in the buying mix. If XL had not been out of business, not only would there be another buyer, but the US floor would be JBS and AB.

The 120,000 or more fed head per year that used to go to Pasco can be absorbed readily in Alberta, between Brooks and High River. Kills have not been up to capacity for a long time in Alberta and the extra 2,500 will fit nicely into the schedules. The extra 2,500 would also help to ease back lingering supply challenges for packers in Alberta. In other words, the extra cattle would help to ease back basis pressure in the spring when cattle are needed most. The extra cattle will also, however, be an added burden on the fed cattle basis at those times of year when supplies are most flush.

Now if Tyson decides they cannot run Pasco and shut it down once the new COOL rules are finalized, then there is another picture entirely. It is one thing for Canada to find a home for 120,000 head of its own cattle, but there are at least another 280,000 US cattle that Tyson kills from the US Northwest that need to be accounted for. With an extra 280,000 head of fed cattle on the market in the US Northwest, Agri Beef would not need to be in Canada at all. Hyrum would also have little or no need for Canadian cattle. At that point then there literally would just be two buyers for Alberta cattle. The truly made in Canada pricing structure would kick in, but not in a way that cattle feeders envisioned.

The real basis at that point is not going to be set by the two packers and whatever "C" cattle manage to go south. Instead the basis is set by the number of feeder cattle that go south. In that regard, the Prairie cattle business is going to look like the Prairie hog business. The number of "C" hogs going south from the Prairies has always been negligible since COOL came into effect. Smaller specialty packers in the US take "C" hogs but that is about it. Alternatively there are tens of thousands of B hogs that go south each week. Packers need to price market hogs such that enough weaner pigs stay on the Prairies. Alternatively, the loss of 70,000 weaners through North Dakota each week keeps the supply of hogs on the Prairies much tighter than Canadian packers would like.

The potential loss of Pasco could have similar results for cattle. The basis is going to be set by the number of feeder cattle that leave the Prairies 120 days prior. In addition, more and more of the feeder trade would shift to the eastern Prairies. With Agri Beef not taking "B's" then there is little or no Agri-Beef Canadian feeder buy. AB was a major presence in the western feeder market. That is not the case now with the new COOL rule and their resulting corporate decision. In addition, the fact that Tyson will take “B’s” means that Nebraska becomes an even stronger pull for feeders. Tyson Lexington is going to be an important plant for Canadian feeder cattle. Eastern Prairie backgrounders and ranchers have a much greater advantage than their counterparts to the west.

The big irony is that the Northwest US cow-calf operator is going to be hurt more than their counterparts in Canada if Pasco shuts. They were the ones that were the strongest advocates for COOL. With radically reduced demand for cattle in the Northwest, hundreds of thousands of feeder cattle will need to go to Colorado at an added freight cost of $4-5/cwt. It is tempting to say that it will look good on them.

Harmony

An interesting final twist to this whole discussion was added recently with the announcement that a new packer would begin operations in Alberta. The October 16 edition of the Calgary Herald reported that the Ranchers Beef plant, which was closed in 2007, is going to be purchased effective November 1. Rich Vesta, a Colorado native and a 47-year veteran of the meat industry, is president of Vesta Holdings and the soon-to-be owner of the former Rancher’s Beef plant. “His purchase agreement (the selling price has not been disclosed) with the facility’s current owners, Sunterra Beef, is expected to be finalized Nov. 1. If all goes as planned, Vesta says the plant — the failed dream of BSE-weary Alberta ranchers and feedlot operators — could be slaughtering cattle again as early as June 1, 2014.” Vesta said the plant, renamed “Harmony Beef,” will process 700 to 800 head a day.

Cattle Buyers Weekly (CBW), October 21 says that Vesta Holdings is banking on several factors to operate the plant successfully. The plant is modern and the only one of its size in Canada certified to sell beef to the European Union. It is small enough not to compete directly with Alberta’s two large plants at High River (Cargill) and at Brooks (JBS). Yet its per head operating costs will be competitive with larger plants due to the use of new technologies, notably over water use. Harmony Beef is also counting on USDA’s new country of origin labeling rule to force more cattle to stay in western Canada. Technology upgrades are planned to maximize worker and food safety, humane animal handling and data collection. The original plant is quite new and so provides a high quality base on which Vesta Holdings can build, he says.

The reports in the Herald and CBW indicate not only a great deal of expertise but also significant effort to differentiate the plant so that it is not on the radar of Brooks or High River. Vesta is highly regarded by those who know of him for his expertise in the beef business and in plant operations. His track record backs that up. Furthermore, with regard to the supplies for the plant, it would be surprising if the plant was not firmly engaged in discussions and plans with some of the original large scale suppliers to Ranchers. In other words, supplies are likely going to be secured ahead of time to varying degrees.

So on the surface; there is significant operational expertise, a modern plant, new markets and a potential source of supplies. With that noted however, all new businesses talk of new, untapped markets in Asia and Europe. In reality, however, there are no untapped markets. JBS and Cargill, two companies that know that know a thing or two about global markets, have experience filling these untapped markets quite well. While it is true that COOL will result in fewer fed cattle going south, there will likely be more feeder cattle go south. Furthermore cattle supplies will tighten as ranchers finally begin to rebuild herds. A plant killing 4,000 per week will definitely by on the radar at Brooks and High River.

The bottom line is that it is never wise to doubt the power of a committed and skilled entrepreneur. At the same time however, the plant is going to result in a tighter basis as the competition increases. That is good for cattle feeders. It is not particularly good for packers however, as tight supplies will already be pinching margins.

Next year was already shaping up to be a challenging year for packers and feeders. It just got a little more challenging in Alberta.

Kevin Grier
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A version of this report first appeared in the George Morris Centre publication, Canadian Cattle Buyer. If you would like a free two month trial to Canadian Cattle Buyer, please e-mail kevin@georgemorris.org