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April 6, 2009

Producer Payment Security Steering Committee
c/o Ms Yvonne Rideout
Project Manager, Producer Payment Security Project
Keystone Agriculture Producers
203-1700 Ellice Ave.
Winnipeg, Manitoba
R3H 0B1

Dear Ms Rideout:

Re: Evaluation of Producer Payment Security Mechanisms

Scott Wolfe Management Inc. is pleased to provide the Steering Committee with our Final Report in the evaluation of producer payment security mechanisms in Canada. A summary of the report is as follows:

- producers require, and want, payment risk mitigation;
- producers are increasing their awareness of the issue; yet all producers cannot manage their payment risk by themselves;
- there is a role for a regulatory authority to ensure payment protection is in place;
- there is also a role for a regulatory authority to define a stable operating environment;
- the current system is working; there is a cost;
- producer payment security is currently largely being paid indirectly by producers;
- higher or lower cost alternative models or options cannot be proven;
- cost comparison should be considered in the context of the scope of coverage:
 - of crops;
 - of payments covered – with defined loss limits; and,
 - of channel / buyers;
- regulation offers the opportunity for an authority to define the rules for any producer payment security mechanism;
- centralized operating functions offers administrative efficiency opportunity, and product solution efficiency – a desired for any option going forward;
- mandatory participation would be necessary to continue affordability of a base level of coverage of payment security;
- there is potential for a more micro risk assessment-based system; would likely lead to higher costs for higher risk areas and lower costs for lower risk areas. There may not be one solution for the future; efficiencies may be gained if unique solutions are defined for differing needs/segments of the industry;

- the Clearinghouse model may assist reducing marketing risk in some commodity component, i.e. feed barley, of the industry in the future; however, the concept is overly complex to address the single issue of payment security;
- there may be further enhancements to continually improve the current system;
- there may be opportunity for utilizing insurance products for some components of the industry (either payables or receivables);
- there may be opportunity for a fund-based approach for all or a component(s) of the industry; and,
- to consider prospective change in the future, the authority, or rules to operate, first needs to be defined; subsequently, the insurance industry could then be requested to propose alternative(s) solutions, and a proposed business case for a prospective fund-based alternative could be developed and evaluated.

We understand the producer groups will be using this document as a basis for discussions and as possible input to the policy development process regarding producer payment security.

Scott Wolfe has appreciated the opportunity to assist the pulse, special crop, oilseed and grain industry in this important initiative and for the opportunity of working with the Steering Committee. We understand the importance of this project to the risk management strategies of grain farmers and to the promotion of a stable, sustainable crop marketing system in Canada and wish to commend the Steering Committee members for their input and feedback throughout the conduct of the project.

Sincerely,

SCOTT WOLFE MANAGEMENT INC.

Per:

Robert S. Hyde, CAC, CMC
President

EVALUATION OF PRODUCER PAYMENT SECURITY MECHANISMS

FINAL REPORT

on behalf of the
Producer Payment Security Steering Committee

Submitted by
SCOTT WOLFE MANAGEMENT INC.

March, 2009

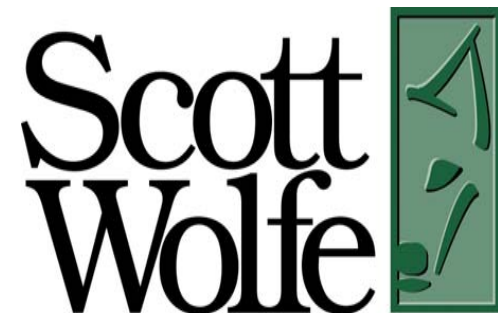


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I. INTRODUCTION

BACKGROUND

Producer payment security is a major risk for Western Canadian farmers. Farmers can be at risk for not being paid for the grain they sell to licensed primary elevators, process elevators and grain dealers. In some situations, a grain company goes out of business due to financial failure. At other times, a grain buying company is unwilling or unable to pay a farmer.

Within the existing risk management regime, if a grain buying company is licenced by the Canadian Grain Commission (CGC), it is required by law to post security that covers the unpaid purchases it makes from western grain producers. Licensees usually provide bonds or letters of credit; in some situations cash deposits or trust accounts are used. Insurance on the payables is now also used to help mitigate the risk of non-payment. Farmers can make claims to the CGC to recover the money they are owed for eligible delivered grain if a licensee is unable or unwilling to pay.

Since 1982, the CGC has had to respond to 20 incidences of failures of licensees. There have been other incidences of failure to pay by non-licensed grain buyers; there have been 2 failures of non-licensed as per CGC records. It is understood that other failures have occurred, but there is no reported data on the extent of these failures. Of the 20 incidences, there has been \$9.3 million of payout from security, and an additional payout of \$3.1 million from the CGC as ordered by the federal government at the time. Payout to farmers has thus totaled \$12.4 million over the past 27 years. These payments have involved an estimated 700 to 1,000 farmers. Because there is no data available for the total number of farmers involved in 7 of the incidents, there is a range of producers affected. Available details of some of the historic failures are summarized in Appendix A. The recorded failures have averaged .003% of annual grain sales, as measured by total crop cash receipts. While this is a small percentage of the total industry, any one incident is significant to any one farmer. The payment risk needs to be mitigated. Examples of the risk exposure to producers continue. There have been recent incidences of the CGC revoking the licenses of two grain buyers in western Canada; the details on why and the extent of this action are not currently public.

In 2007, the Federal government introduced Bill C-39 to amend the Canada Grains Act. Although the Bill died on the order paper with the dissolution of the 39th Parliament, it has been recently re-introduced as Bill C-13. The Bill includes a proposal to eliminate the CGC's ability to require security as a condition for obtaining or maintaining a license (see Appendix B for more details of Bill C-13).

The premise for the elimination of the current security-based system is that it is inefficient for the grain industry. Today's environment is characterized by historical and current government policy and direction with less regulation and government influence. Some question whether this public policy direction is sustainable with the current economic-business environment, in particular due to the current higher value of the crops, the reduced credit available to end buyers, and the higher transportation

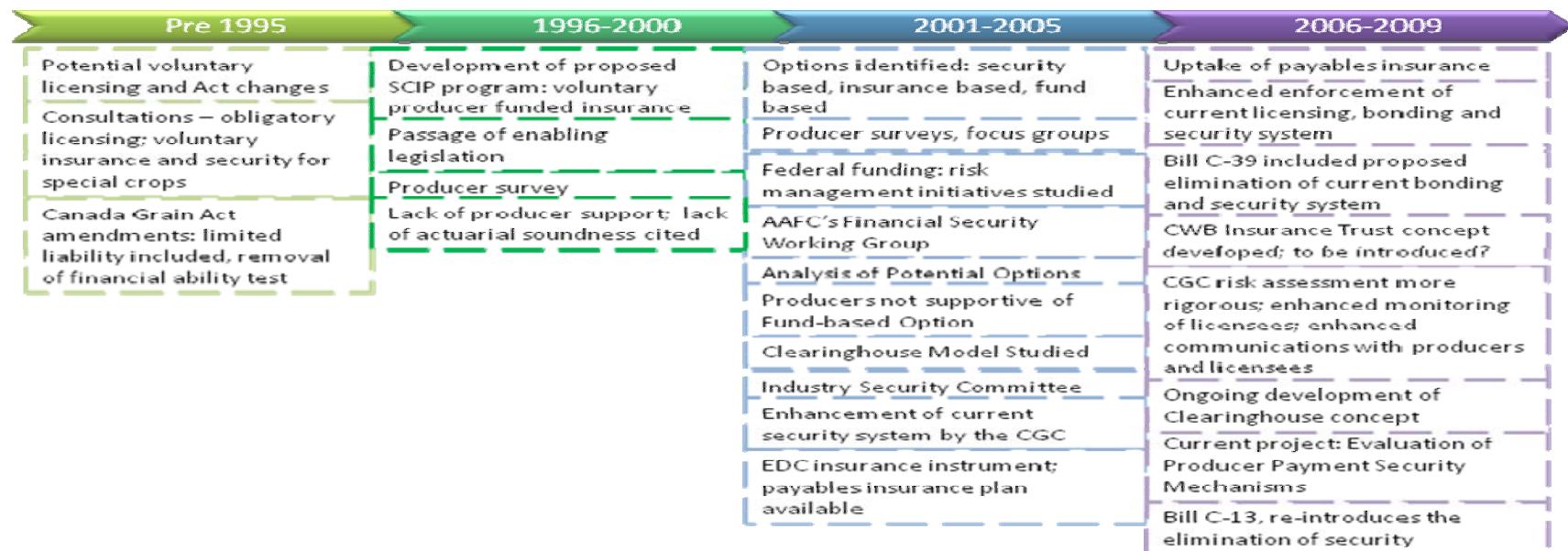
costs. This operating environment can result in increased buyer instability. Further, the current grain marketing environment is characterized by:

- ❑ there appears to be increased awareness of the risks involved by grain buyers;
- ❑ current security and information reporting requirements are viewed by some as barriers to entry for small niche buyers. Others view the current security and compliance system as an enabler for smaller niche companies to operate;
- ❑ too much security (and resulting cost) can hamper buyer competitiveness and their ability to make trade payables;
- ❑ there is an increasing level of knowledge and understanding by producers of risk mitigation;
- ❑ producers increasingly need to manage the significant market risks (larger farm enterprises; increasing value of crop production; more involvement in marketing decisions and logistics; more sales in local markets to non-licensed buyers);
- ❑ a lack of risk management tools for farmers can impede risk taking;
- ❑ the use of forward contracting by farmers is thought to likely to increase in future; and,
- ❑ increased buyer costs in the marketing system translates to higher farmer costs – increased basis.

The costs of the current system are seen to be negatively impacting the marketing of grain in Canada; more efficient options are thought to be available.

Figure 1 outlines the considerable background to the analyses and advancements in addressing the payment risk issues.

Figure 1. Chronology of Events, Studies, Developments



The pulse and special crop sector of the grain industry, and the CGC, have a great deal of background information on alternative payment security programs. There has been a significant history of events during the past 15 years. Within the past few years, there has been increasing emphasis on improvements to the current system and on the risk mitigation tools available to the industry. This chronology profile also illustrates the importance of producer-based solutions in terms of design and support.

The cereals, pulses, oilseeds and special crops sectors, in co-ordination with the western Canadian provincial based producer organizations formed a Steering Committee to further assess the options for future management of producer payment security. The Steering Committee engaged Scott Wolfe Management Inc. to examine all potential options that could replace bonding of grain buyers as required under the current Canada Grains Act, and provide payment security to growers once they have delivered their grain.

Given the considerable assessment and evaluation undertaken to date, this project is not intended to re-evaluate or to re-survey the stakeholders; rather it is to build on the work undertaken to date and to assist in communicating the results of option identification and evaluation.

CONSULTING OBJECTIVES

The overall objective of this project was:

- to examine all potential options that could replace bonding of grain buyers as required under the current Canada Grains Act, and provide payment security to growers once they have delivered their grain.

The study had four specific objectives:

- quantify and qualify the magnitude of the issue;
- identify the options and criteria;
- further assess the viable options through consultations and evaluation; and,
- report the results of the study in a succinct and pragmatic style.

The project has been funded by the Private Sector Risk Management Partnerships program of Agriculture and Agri-food Canada. An overview of the work plan of the project is illustrated in Appendix C. The projects' activities have largely focused on the review and confirmation of the option identification and assessment completed over the past years. The considerable volume of documents and references is provided in Appendix D.

II. OVERVIEW OF THE CONTEXT OF PRODUCER PAYMENT SECURITY

Given the considerable complexity of the producer payment security issue, and the resulting potential for the assessment and project to lose focus, it is important to clarify several issues:

- the scope of crop receipts;
- the number and profile of grain buyers;
- profiling producers' range of business risks and the definition of producer payment security;
- identifying producer payments most at risk; and,
- describing producers' payment risk mitigation strategies.

FARM CASH RECEIPTS

There is over \$8 billion (average, 2005/06, 06/07) of farm cash receipts of crop production in Canada. A more detailed profile and analyses of farm cash receipts is included in Appendix E.

Under the [Canada Grain Act](#), the following crops are protected by security held by the CGC.

Figure 2. Crops protected by security¹

Barley	Oats
Beans	Peas
Buckwheat	Rapeseed
Canola	Rye
Chick peas	Safflower seed
Corn	Solin
Fababeans	Soybeans
Flaxseed	Sunflower seed
Lentils	Triticale
Mixed grain	Wheat
Mustard seed	

¹Canada Grain Regulations, C.R.C., c.889, s. 5(1)

Two of the more significant crops produced not covered by the current payment security are potatoes and canary seed. Farmers could have these and any other crop included in the current monitoring of producers' rights by the CGC through procedures

involving consultations, cost-benefit analyses, and changes in regulation. The complexity of the process for adding crops to the list of those covered by the current legislation have to date resulted in no additional crops being added.

Farmers are at risk for payment on all crop deliveries. It is estimated that the farmer sector is at risk for 8% of sales and deliveries, outside of the current coverage of crops.

There are considerable sales and deliveries of crops to buyers of grain who are exempt from the current security and licencing regime. These transactions include some farm to feed mills, farm to distillers, producer cars, and farm to seed dealers. There are also grain sales that fall outside of the Canada Grain Act, including farm to farm sales, farm to most feed lots, farm to many hog barns, and some farm export direct to buyers. It is difficult to determine precisely this volume and resulting value of farm cash receipts; non-licenced commerce of crop deliveries is estimated at 16 to 19%% of total crop receipts. This ratio varies considerably by type of crop.

In summary, it is estimated that the current producer payment security system assists in managing the payment risk to farmers of 75% to 80% of the farm cash receipts. 20% to 25% of all cash receipts in western Canada are sold by producers outside of the CGC payment security system.

In addition, farmers are at risk for payment of crops delivered to licenced buyers who do not have adequate security in place with the CGC. This risk is mitigated by the CGC's monitoring and compliance activities.

CURRENT LICENSEES

There are currently 166 licensees in Canada. Figure 3 profiles the licencees by class of license. Appendix F provides a recent listing of licensed grain buyers.

Figure 3. Number of Licensees

License Class	Number of companies licensed in each class	Number of locations licensed in each class
Grain Dealer	100	106
Primary Elevator	41	336
Terminal Elevator	12	16
Transfer Elevator	11	13
Process Elevator	32	46
Total # of Licensees	166	517

The CGC has undertaken enhanced activities over the past few years to increase the numbers of licensees; there are currently approximately 30 companies at varying stages of application, potentially to be added to the list of licensees. Further, there is increased monitoring and surveillance activities to help ensure adequate security is in place. There is now more timely and comprehensive monitoring of the licensees. It is also important to note that the licensing system is not only dealing with payment security, but also includes the following services:

- producers who have grading disputes with licensed primary elevators can ask the CGC to provide a binding grade decision;
- monitoring and compliance to CGC standards for quality and quantity assurance;
- sampling, grading, testing, and certification services to licensees; and,
- licensees are required by the CGC to adhere to various operational and reporting requirements.

Broader producer rights are being protected through the licensing system and the ongoing monitoring of buyers' compliance to the Act and regulations.

OVERVIEW OF PRODUCERS' RISKS

Grain farmers face a number of perils/risks with their business operations, as illustrated in Figure 4. These risks can be described as production-related, financial risks, general business risks, and market-related risks. Figure 4 provides a description of the definition and components of each area of risk, as well as illustrates the various risk management strategies available to the producer to help mitigate the risk. Producer payment risk is a component of market risk as described in the last row of the table.

Figure 4. Producers' Risks

<i>Risk</i>	<i>Definition</i>	<i>Components</i>	<i>Risk Management Strategies</i>
Production Risk	Lower than expected production.	Unfavourable weather conditions (wind, moisture, frost, heat). Natural disasters such as lightning, fire, tornados, floods. Variety, Soil fertility, Topography. Pest pressure. Field operations and timing of seeding, pesticide application, harvest. Inappropriate prescribed production. Diseases, resulting in death and/or loss in marketable values. Damages due to wildlife predation. Effectiveness of on-farm bio-security, on-farm food safety procedures.	Crop insurance. Variety selection & diversification. Geographic diversification. Fertility management. Pest management. Management practices.

Figure 4. Producers' Risks (continued)

Risk	Definition	Components	Risk Management Strategies
Financial Risk	Lower than expected return on investment.	Variability in returns. Lack of return on capital, time and labour invested in the enterprise.	Production insurance – now known as AgrilInsurance. Asset insurance. Management practices. AgriStability; AgriInvest; ad hoc programs.
Asset Risk	Associated with returns on a long-term asset.	Loss of the asset.	Property and liability insurance.
Storage and Transportation Risk	Loss of value from product deterioration, or loss of product.	Genetic defective seed. Input shortages. Increasing and fluctuating costs of inputs. Insects / pests in storage. Structural and systems failures with storage / buildings. Theft of grain. Fire, floods and acts of God. Accidents in transit to market.	No storage insurance for deterioration except AgriStability Insurance. Pest management. Management practices.
Information Management Risk	Loss of, or inadequate, management information.	Inadequate business records, financial records. Accuracy of seed certification, pedigree records. Accuracy of genetic evaluations.	Information management systems.
Relationship Risk	Critical relationships with buyers, suppliers, or other resource providers that are critical to the success of the farm operation.	Landlord. Lender. Supplier. Buyer/processor. Ethics.	Contracts. Management practices.
Policy, Regulation, Infrastructure Risk	Changing regulations and operating environment.	Contaminated inputs – inadequate evaluation, standards. Industry standards. Transportation standards. Research funding and support for grain production, i.e. scientific resources. Domestic and international trade. In-effective government programming.	Understanding the operating environment.

Figure 4. Producers' Risks (continued)

Risk	Definition	Components	Risk Management Strategies
Market Risk - Access	Not having a viable market for the commodity.	Grown on speculation. Grown for agronomic reasons. Competitive behavior, domestic and foreign. Acceptance by buyers of technologically advanced products.	Production contracts. Align with a value chain or coordinated system.
Market Risk – Quality	Unexpected quality level in the grain that affects the grain's value through discounts or reduced premium.	Variety. Growing condition quality. Contamination. Operator error based quality. Storage quality. Measurement. Rejection.	Crop insurance. Variety diversification. Management practices i.e. test and save samples.
Market Risk – Price	Price variability.	Demand fluctuations, domestic and international. Variation in selling prices. Market “specials” in price and delivery Lack of price discovery.	Contracts. Hedging strategies.
Market Risk - Contract	Contract default by the producer or the contractor; termination of multiple year contract.	Contract default; breach of contract. Lack of understanding fine print. Producer violations. Price. Delivery terms. Contamination.	Addressing each component of the contract. Understand contract.
Market Risk - Product Liability	Producer may be liable for any problems associated with the grain they have sold.	Contamination. Grade-quality. Food safety.	Canada's grading system. OFFS programming.
Market Risk – Producer Payment	Producer may not get paid for the grain they have delivered; nonpayment from buyers.	Nonpayment to the buyer/agent from end-buyer. Payment risk to the farmer is a function of value and time. Risk Assessment: buyer solvency, buyer business practices, scope of commodities, scope of licensees, adequate coverage by licensees, ongoing monitoring.	Payables Insurance. CGC producer payment security system Revenue Insurance: AgriStability involves many variables, including timeliness of payment. Management practices/ best practices, including direct payment.

PRODUCER PAYMENT RISK

Producer Payment Risk is the risk a producer has in not getting paid for the grain they have delivered. It is non-payment from any buyer for any reason. The risk of payment to the farmer is a function of value (i.e. perceived, magnitude of the sale) and time.

Value is determined by:

- perceived versus actual coverage by farmers – farmers' understanding of the risk management / coverage that is in place, and their individual attitude towards taking risk;
- seeking relatively higher value typically involves incurring higher production and market risk, including producer payment risk, particularly if markets are thin and are characterized by non-main stream, niche market buyers operating in non-regulated / non-standardized parts of the industry, and/or world markets or locations; and,
- the magnitude of the sale – the farmer is willing to place at higher risk a small proportion of farm revenue;

Time includes the period:

- between delivery and when settlement occurs (settlement occurs after grade and value is determined, which does not need to be at delivery - can be a day later in the case of some testing mechanisms for certain attributes);
- between exchange of ownership of the grain and when payment of funds are made, i.e. risk is very low if payment is made upon delivery with funds transferred electronically;
- between payment issued by the buyer and payment received and deposited by the seller (float is risk to the seller);
- between transaction date and deferral date of a cash ticket - for tax planning purposes; as well as,
- when grain is in storage and not priced (buyer is providing storage services to the farmer); and,
- when not paid directly, the producer has a receivable on grain that has been delivered and shipped by the buyer or broker.

Risk assessment of the payment issue involves measuring and monitoring, on a regular basis, the following risk elements:

- buyer solvency;
- buyer business practices, including payment practices;
- the scope of commodities being purchased by the buyer;
- the scope / type of the licencees' security in place; and,
- the amount of payment coverage in place by licencees.

Another example of risk assessment methodology is that which is being proposed within the CWB's risk assessment of the accredited agents of the Board. Elements of risk include: inventory shortage; cash tickets total; deferred cash tickets held in trust; advances (Board and non-Board); freight adjustment factor; unpaid freight bills; and unpaid deliveries (producer to agent, agent to agent).

RISK MANAGEMENT STRATEGIES

As with any business, management attempts to mitigate production risks, implement strategies to minimize the risks, and use appropriate products to insure against specific perils.

For grain farmers, there are some measures in place to allow them to manage many of these risks. These include:

- insurance products for specific perils, such as production shortfalls, market price declines (income);
- insuring germination of seed stock with pedigreed seed use;
- insurance products that cover loss due to fire, wind, flood, etc.;
- mutual insurance programs as developed by some commodity groups for specific diseases;
- compensation provided by the Canadian Food Inspection Agency in the event of mandated loss; and,
- programs offered by provinces and insurance agencies to offset losses caused by wildlife predation.

In addition, the national production insurance program provides subsidized crop insurance coverage to crop production. This subsidy is based on federal and provincial governments cost sharing program administration, and producers paying 40% of the actuarially sound premium (with both levels of government contributing to the remainder). Crop producers can obtain coverage up to 80% of the insured value in the event of a loss due to a specified peril. Crop insurance allows the crop producer to plan for a minimal cash flow in the event of most uncontrollable natural factors (weather, disease, insects, etc.), that reduce the marketable yield on the insured crops.

It is also important to consider other producer payment influencing factors. One factor is the feature of the Canadian Wheat Board Act that provides payment for Board grains to producers. Under the CWB Act, the Government of Canada is responsible for pool account losses. While producers are guaranteed payment, any losses incurred by the CWB or its agents in sales of wheat and barley would result in lower receipts to the producers. Payment security to the producer is a risk factor to producers in the marketing regime of the CWB.

The AgriStability Program and the broader Business Risk Management suite of programs [and its predecessors, CAIS, CFIP, AIDA, NISA] provides some degree of financial income insurance for producers. This type of risk management programming is designed to mitigate the risk of revenue and net income shortfalls to address some of the perils listed above. However, this program has significant shortcomings in mitigation of non-payment from grain buyers. There is no certainty of mitigating the risk of non-payment.

In addition to revenue and net income risk management, there are multiple approaches available for contributing to the management of marketing-related risk. As described in CGC publications, there are “common-sense” ways to manage nonpayment risk. When a farmer makes a grain delivery and does not seek payment or defers payment for tax reasons, the farmer is, in effect, either lending grain, money or both to the buyer. Generally, the sooner a farmer receives payment, the lower the risk of payment loss. The longer payment is delayed, the more risk is assumed by the seller. Some practical tactics to limit risk include:

- arrange for, and confirm, payment terms prior to delivery;
- do not wait for payment, ask for payment;
- do not sell to only one buyer. Selling to more than one buyer spreads risk;
- get paid after each delivery when making a series of deliveries (rather than grouping deliveries into one large payment);
- deliver to buyers you trust, ask for references from the buyer and contact these references;
- confer with other farmers and advisors on the trustworthiness and timeliness of payment of the buyer;
- be particularly careful when selling grains destined for either specialized, riskier or smaller markets or markets that lack adequate hedging mechanisms. Such commodities require increased vigilance; and,
- make certain the contract is understood, use legal advisors when warranted.

Currently, producer payment risk mitigation tools include those that can be affected by the producer, and those that are more system wide. More effective use and management of these tools can reduce the cost to producers, buyers and exporters, and to the overall system.

those tools affected by the producer:

- utilizing good business practices in selling, such as:
 - selling to licensed grain buyers, and undertaking more due diligence on their own. Producers are self-regulating or assessing the risk more than ever. The current business environment is promoting this attitude;
 - effective contracting, and contract execution;
 - minimizing exposure by limiting the value of unpaid deliveries;
 - requiring eligible documents that confirm delivery or payment;
 - depositing payments as soon as possible; and,
 - seeking legal challenge and proceedings as required.

those tools system-wide to grain marketing:

- the current payment security system. The CGC currently oversees the existing payment security system under the authority of the Canada Grain Act. Recent changes and improvements have included:
 - increasing the number of licensees by proactively seeking eligible grain buyers;
 - increased monitoring of licensees;
 - a more rigorous process for monitoring grain buyers in terms of timeliness and comprehensive evaluation;
 - utilization of more payables insurance, versus bonding, or letters of credit, as a current lower cost, or more favourable alternative for some buyers.
- buyers implementing good business practices, such as:

- potential for buyers to help manage producer risk by increasing/varying their security to align with value of business in a timely manner;
 - reducing their liabilities;
 - paying more promptly/accelerating payments, i.e. wire transfers;
 - limiting deferred settlements;
 - utilizing certified cheques; and,
 - continuing to encourage producers to price out their deliveries.
- utilizing payables insurance
- for buyers: AON Reid Stenhouse distribution, Atradius underwriting; and,
 - for buyers and exporters, EDC underwriting.

Each of these tools is used within the umbrella of the current producer payment security system administered by the CGC.

However, with the changes proposed in Bill C-13, there will be substantial non-payment risk within the grain industry. Producers, and the grain marketing system, have expressed that this risk has increased dramatically with the increased value of the commodities and the sustainability of buyers with more limited credit facilities currently available. Producers have expressed a need for cost-effective strategies, investigation of options, and development of appropriate tools for guaranteeing payment.

III. OPTIONS FOR PRODUCER PAYMENT RISK MANAGEMENT

Options for producer payment protection are described in four general categories:

- security-based: companies buying commodities are required to post security with a licencing body to cover liabilities to producers;
- insurance-based: either producers or buyers, or both, pay an insurance premium;
- fund-based: a fund is created by contributions from producers, buyers or both to cover liabilities; and,
- clearinghouse model: a third party guarantor that provides settlement services and ensures that both buyers and producers (the sellers) are able to meet their contractual obligations.

Within each category there are many combinations of sub-options with respect to such characteristics as: who pays the costs of risk management (producers, government, and/or industry); who administers the program(s) (federal government, provincial governments, producers, and/or industry); the level of coverage or guarantee necessary; and whether the system is voluntary or mandatory. Appendix G provides a more detailed overview of the four producer payment options identified in the “*Government Response to the Fifth Report of the Standing Committee On Agriculture and Agri-Food, Review of the Canada Grain Act and the Canadian Grain Commission Conducted by Compass Inc.*”

SECURITY BASED MODEL

Security-based models are distinguished by the requirement to post security with a licensing body to cover liabilities to producers. Examples of this model include:

- the current CGC Producer Payment Security System (see Appendix H for more details of the current system used);
- Quebec Agricultural Marketing Board; and,
- Dairy Farmers of Ontario Credit Program.

The key attributes of the model are:

- issuance of a license to purchase from farmers;
- the posting of security by licenced buyer: a bond, a letter of credit, payables insurance, cash, or trust account;
- a negotiable level of security based upon risk assessment;
- a level of coverage contingent on monitoring and enforcement activities;
- considerable reporting requirements of the buyer to the regulatory or compliance monitoring body; and,
- costs to the buyer, costs to the regulatory system, and indirect costs to the farmer.

Profile of the Costs of the Current Producer Payment Security System

Currently, there is 100% coverage of the licensed buyers within scope of crops included. There have been two exceptions to this feature within the historic failures (2002, and 2004), where the shortfall of over \$1.3 million resulted from the improper reporting of the buyer to the CGC.

Cost elements for licensees:

- ❑ cost of security: Licensees are required to post security to cover outstanding liabilities with producers licensees paying an average of 1.5% on their security (taking into account all classes of licenses). Based on the status of grain dealers and tonnage handled, the security rates vary between 0.5% and 3.5%. As of January, 2009, there was a total of \$440 million of total security in place. This level of security in place varies according to seasonal volumes, the number of licensees, and the cyclical values of the crops. The current cost of security is calculated at \$6.6 million;
- ❑ compliance (providing audited financial statements and monthly liability reports to the CGC): are estimated to collectively cost companies an additional \$1 million per year; this varies depending on the complement of licensees, class of license, and their business models; this cost element is estimated to be from \$5,000 to \$10,000 per licensee per annum. These compliance activities are estimated to cost the grain buyers \$1.0 million per annum;
- ❑ regulatory compliance costs such as weigh-overs and statistical collection and reporting are viewed as ‘the cost of good business practices’ by most licensees and are not defined and are not included as a cost of producer payment security; and,
- ❑ additional costs of lost opportunities with reference to the committed collateral that licensees utilize to support a letter of credit or bond are thought to exist, but are not defined and are not included as a cost of producer payment security.

Cost elements of the CGC are estimated to \$1.4 million annually. This cost includes all risk assessment, monitoring, audit and administration. The estimate of these costs involves some cost allocation to producer payment security, as many of the activities involved are in the context of CGC’s overall programming to protect producers’ rights.

Figure 5 summarizes the estimated annual costs.

Figure 5. Summary of Estimated Annual Costs of the Current Security System

Cost Element	Direct Buyer Costs	Direct Producer Costs	Direct CGC Costs	Estimated Total Costs per Annum
Licensee security (level x rate) \$440 million x 1.5%	\$6,600,000			\$6,600,000
Licensee compliance costs	\$1,000,000			\$1,000,000
CGC Administration			\$1,400,000	\$1,400,000
TOTAL	\$7,600,000	\$0	\$1,400,000	\$9,000,000

Licensees pay an annual fee to be licenced. These fees currently total approximately \$230,000 per annum; these fees are likely to continue regardless of whether producer payment security is a part of the future responsibilities of the CGC.

Costs of the current producer payment security system are paid directly by the buyers and by the CGC, and not by producers. It is assumed that the costs of a licensee are passed onto producers through increased elevation fees, other tariffs or lower grain purchase prices.

INSURANCE BASED MODEL

Insurance based models for payment risk management involve either farmers or buyers paying a premium for an insurance product to cover the risk identified. Examples of this concept includes:

- the Special Crops Insurance Plan (SCIP), which was proposed in the 1990's, subsequently evaluated and not supported for implementation;
- the Insurance Payables tool for exports, underwritten by the Export Development Canada (EDC);
- the Insurance Payables tool, brokered by AON Reed Stenhouse, underwritten by Atradius, and utilized by grain buyers; and,
- the recently developed and proposed CWB Insurance Trust.

An insurance based concept is characterized by the following attributes:

- issuance of a license to purchase grain;
- payment of an insurance premium, based upon risk assessment;
- the risk assessment determines the premium levels – it is risk rated;
- there are actuarial computations to determine the features of the product, i.e. level of coverage, deductible;
- the product requires a distribution system, and underwriter(s);
- there are considerable reporting requirements of the buyer to a regulatory body;
- the costs of the risk mitigation are paid by a buyer and/or by the farmers; and,
- the documented policy defines what is covered by the insurance.

Insurance is viewed as a distinct option or model in this analyses. Insurance can also be, and currently is, a component of the security based model described above – it is one means of providing security by a buyer to meet its obligations in the current system.

An example of an emerging insurance based risk management tool is the CWB Insurance Trust. This concept applies to CWB grains and covers the risk of non-payment for these grains by the buyer (accredited sales agents). Under the CWB Act, the Government of Canada is responsible for pool account losses. Buyers of producers' CWB grains are acting on behalf of the CWB. Payment defaults by accredited sales agents are the responsibility of the CWB. The CWB Insurance Trust is a proposed risk management tool for this

particular situation and is not intended to be used more broadly. It is an example of a seller buying insurance to mitigate the risk of the performance of the buyers.

Insurance is available now as a means of providing security within the current system. The following features indicate some of the complexity of the insurance options:

- ❑ *What is insured?* Most forms of insurance can cover a wide range of “what is insured”. What is insured could include a range of crops, a range of selling situations, export sales versus all sales, perhaps a range of producers. Related to this issue is whether individual units of grain sales are insured, or is a larger sale volume insured.
- ❑ *How crop insurance coverage is defined - investment or marketable value.* Coverage is generally restricted to the value of the grain (i.e. the producer’s investment in the grain) and not for loss of potential gain or profits (determined by the level of payment). In the case of the potential gain, coverage could extend to the value of the marketable product. Specific coverage is available in other species; for example, racehorses and show horses are a group that can have specific coverage for the nature of their activities.
- ❑ *How product quality should be handled.* The grain sector has many value added quality programs. Some of these measures could help mitigate payment risk to the extent that product quality conflicts affect non-payment. If a specific product trait is produced, and through testing, there was product contamination – not 100% deliverable on the trait – is this (should this be) an insured peril? If so, how can the insurer determine whether the contamination occurred after the grain left the farm?
- ❑ *How comprehensive is the program.* What level of financial protection is intended to be offered? What levels of coverage are offered – 80% of value, etc.
- ❑ *How are marketable products covered?* The marketable product can be different; for example, seed stock versus commercial grain versus animal feed versus industrial use. Should the coverage be allowed for a specific number of weeks for purchasing replacement grain? Or would these be specific riders that can be purchased? This issue extends into whether asset loss is only covered, or whether business interruption losses are covered.
- ❑ *Underwriting considerations.* Underwriting considerations include the value of the grain insured, and depending on value and/or type of coverage, whether an inspection report (examination) is required. Other considerations would include: timing delays between delivery of and payment for the grain; who adjusts for loss; and what considerations can be taken into account to determine the liability of the insurer. How potentially does a clearinghouse or third party adjuster account for poor management, or for the influence of a potential number of causes, when some may be insured perils and others not?
- ❑ *Moral hazard.* The risk of moral hazard to the insurer is high, and the insurer will place the onus on the insured (the producer) to ensure attention to good management practices.
- ❑ *Who underwrites the insurance?* If an insurance program is offered, is it underwritten by the government (or one of its agencies, i.e. EDC, provincial crop production insurance agencies), or is it offered in association with a private insurer?
- ❑ *What is the role of private sector risk management partnerships funding?* Private risk management partnerships funding has been used by industry organizations to develop programs to insure against specific perils, i.e. broiler hatching eggs. Can this approach address the gaps in grain buy-sell insurance?
- ❑ *What is the impact on private insurers?* Because of possible loss of clients and premium income, production and income insurance offered by a government may impact on the ability of private insurers to offer insurance products to grain producers.

- ❑ *Who pays the premium directly?* Is it possible for the insurance industry to provide an insurance product directly to producers for non-payment from buyers? Could buyers provide the product directly to producers as an option tied to the sale?

FUND BASED MODEL

A fund-based model is when funds are accumulated by contributions from producers, buyers or both to cover liabilities. Working examples include:

- ❑ the Ontario Fund Model (Grain Financial Protection Program);
- ❑ Alberta Livestock Producer Check-Off Program; and,
- ❑ U.S. Perishable Agricultural Commodities Fund¹.

The fund-based approach is used in the cattle and grain sectors in Ontario, and in a range of other industries. Such a fund can be referred to as a “producer assurance fund” as it is not an insurance fund – rather it provides assurance to producers that payment will be made. The basic parameters of the programs are the following:

- ❑ only producers make contributions in proportion to their sales;
- ❑ the contributions are deductions made by the buyer and submitted to the fund (the flow of funds can be to a commodity association for a series of check-offs and then the payment security deduction is made by the association and sent to the fund);
- ❑ contribution rates are low compared to product value (e.g., 5 cents per head of beef cattle, 2 cents per tonne of soybeans, 1 cent per tonne of corn, 20 cents per tonne of canola which is less than 0.005% of product value);
- ❑ in the cattle sector, it is possible that a payment is made more than once on the animal, with more than one sale possible (to feedlot and to processor);
- ❑ with cattle, auctions also contribute the 5 cents (as well as the seller) since the auction market has risk on the receivable (from the buyer);
- ❑ claims are made if payment is not received within 10 days after shipping grain, or 2 days if grain is in storage in the elevator (and 3 days after cattle have been delivered (with electronic fund transfer));
- ❑ if there is payment default, the program contributes 90% of product value (settlement price) or estimate of market value on day of default;
- ❑ late payment is defined as three days after the sale is made when funds are transferred electronically;
- ❑ farm to farm sales are not covered;
- ❑ deferred payment programs are not covered (due to the higher risk exposure);
- ❑ a key program success factor is having producers aware of the program design, and their responsibility (knowing the time frame for payment, when to advise the program administrators of default, ensuring that buyers are licensed);

¹ U.S. *Perishable Agricultural Commodities Act* (PACA) establishes a combination of measures to ensure against non-payment by dealers or brokers for perishable commodities. Fees collected establish a fund to cover instances of non-payment to producers. See Appendix G for more details.

- ❑ buyers must be licenced. In some producer fund models, a purchase cannot be made unless the buyer is licensed (such as cattle), while in other approaches, the program does not cover sales to unlicensed buyers (such as in grain to unlicensed buyers or through farm to farm sales); and,
- ❑ licensing is typically annual and requires a review of audited financial statements, as well as other data requested by the program administration. If the applicant (the buyer) passes a financial test (based on some financial ratios, etc), then no additional security is required. However, if the applicant does not get a pass on the financial test, then some type of security is taken. This can range from letters of credit to taking security on an asset to posting shareholder loans to the administrator. Letters of credit are based on the monthly volume of purchases by a buyer.

In some producer fund schemes, as with any program, the financial risk increases as the time between product delivery and actual payment increases. Limits are placed on when a claim can be made. Ambiguity arises when payment is through the mail versus electronic transfer, as the producer may believe the cheque is in the mail.

Fund balances are currently approximately 0.5% of annual crop value for soybeans, and 0.6% for corn. For cattle, the fund balance is just over 0.6% of the annual value of cash receipts.

Administration costs are under \$500,000 per annum, with the bulk of these costs covered by the provincial government. The main driver of administration costs is the review of the audited financial statements of buyers. With fewer buyers, less time is required for this activity. The beef program has administrative costs covered by government that are around \$200,000 per annum, and the grain program is around \$300,000 per annum.

CLEARINGHOUSE MODEL

The clearinghouse model is where a third party guarantor provides settlement services and ensures that both buyers and producers (the sellers) are able to meet their contractual obligations. Examples include:

- ❑ the clearinghouse model proposed by the Western Barley Growers Association (WBGA), referred to as the Agriculture Commodity Clearing proposal; and,
- ❑ proprietary clearinghouse functions.

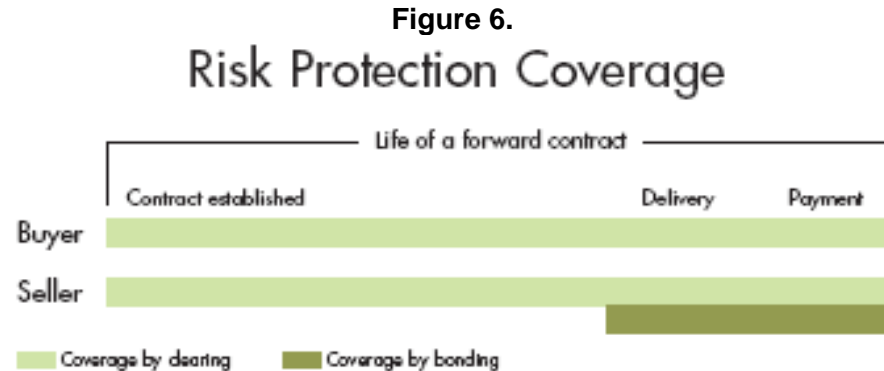
The Agricultural Commodity Clearing proposal is modeled after the NGX (natural gas exchange located in Calgary, AB). NGX “uses clearing to give buyers and sellers 100% assurance that their deals will be honoured”.²

A clearinghouse is “the facility – or business- that manages the settlement process between sellers and buyers. In clearing, settlement refers to delivery, acceptance and payment”. A clearinghouse provides more than just payment security. It provides

² Ag Clearing February 2008

protection over the life of a forward contract (or deferred contract). Buyers and sellers are equally protected. Clearing is part of an exchange. An exchange “allows buyers and sellers to post bids and offers, usually anonymously, with the purpose of trading or exchanging goods for cash”.³

The following Figure 6 compares the length of the coverage provided by a clearinghouse to the amount provided by the current security system. The bonding system covers delivery and payment. The clearinghouse manages risk throughout the length of a forward contract, and is therefore described as being a broader risk management tool intended to address broader market risk and not only payment risk .



The WBGA views the clearinghouse as having the following advantages:⁴

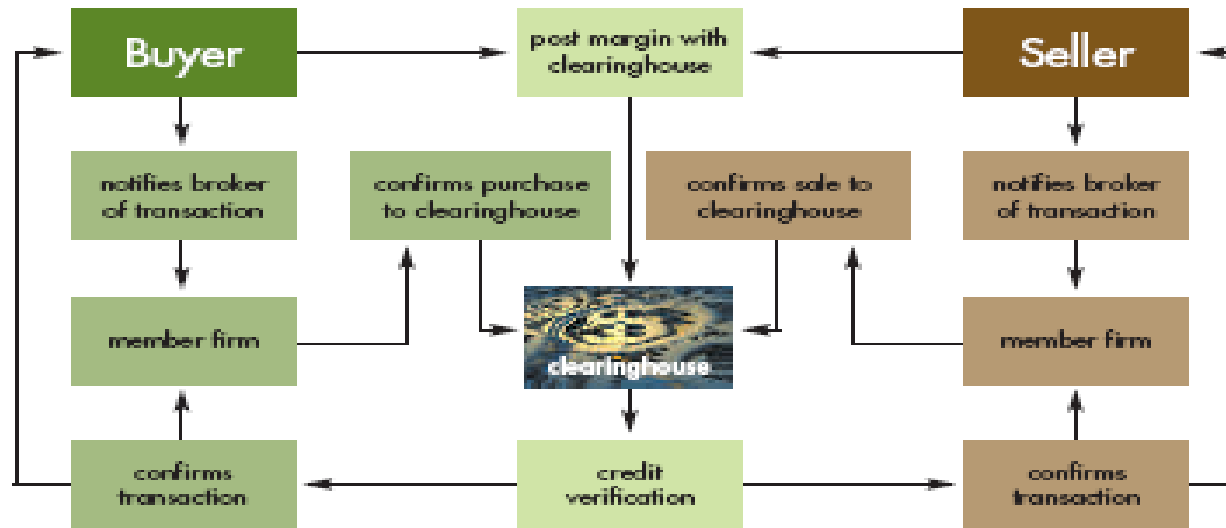
- “performance assurance;
- standardized rules and procedures;
- impartial arbitration procedures and dispute resolution;
- a more competitive marketplace that has narrower bid/ask spreads;
- voluntary participation for sellers and buyers;
- improved contracting options (spot and deferred); and,
- improved price transparency”.

An overview of how a clearinghouse works is shown in the following Figure 7. As the information underneath the diagram indicates the life of the contract can range from 3 days to 24 months or more.

³ WBGA, “Ag Clearing”, 2008.

⁴ WBGA, “Ag Clearing”, 2008.

Figure 7.
How it works: registering a trade



Source: AgClearing project

Clearing a contract begins from the moment a deal is made to the moment a trade is completed. The clearinghouse assures delivery performance and payment throughout the life of the contract, which can be as little as three days or as much as 24 months or more. As well, clearinghouse contracts, rules and regulations are balanced between sellers and buyers.

WBGA, "Ag Clearing", 2008.

There are nine major processes performed in the clearinghouse. Information on each process in terms of the responsibilities of the buyer/seller, clearinghouse and financial institution is shown in the following Figure 8. The information indicates that both the buyer and seller must provide security to the clearinghouse and maintain the appropriate amount of margin.

Figure 8. Profile of Business Processes of a Clearinghouse

	Buyer/Seller	Clearinghouse	Financial Institution
Registration	Complete Customer Registration Form Agree to Customer Agreement Agree to Clearinghouse Rules and Procedures Complete risk profile Submit Credit Evaluation information	Process Registration Form Pre qualify client Initiate contact to financial guarantor	Confirm client/lender arrangement

Figure 8. Profile of Business Processes of a Clearinghouse (continued)

	Buyer/Seller	Clearinghouse	Financial Institution
Credit Evaluation	Post calculated security upon credit approval	Process credit application Determine risk profile and position limits Calculate and recommend rating Approve or decline client Collect security from approved account Activate trade status	Provide financial information of requesting client Approve or decline lending arrangements as required Arrange for electronic fund transfers based on daily valuations and open positions
Deal Capture	Complete over the counter (OTC) transaction Report details to clearinghouse directly or through a broker Post additional security if required	Register reported transaction into clearinghouse system Confirm transaction with counterparty Process confirmed transaction Process offsetting positions Calculate security and margin requirements for both parties Notify respective financial institutions of transaction details Determine valuation process	Acknowledge transaction with clearinghouse Prepare for credit and debit processes against margin calls
Contract Process	Issue internal contract Price any un-priced quantity prior to shipment Schedule loads with counterparty Arrange transportation as required	Monitor contract status Contract pricings Deliveries & balances Disputes	Monitor contract status Deliveries and settlements
Delivery Process	Party responsible for transportation arranges shipments Ship or pick-up loads as per contract terms Report deliveries to clearinghouse	Track loads against open contract Adjust margin requirements accordingly	
Settlement Process	Advise clearinghouse of shipment and receipt Confirm acceptance of load Confirm if load represents last load on contract Balance accounts with clearinghouse - payment and receipt	Collect settlement from buyer according to shipment advice Credit seller's account with settlement proceeds Charge counterparties clearinghouse fees Distribute funds	Track settlements on deliveries against any outstanding loans Provide adequate funds for final settlement
Mark to Market	Post adequate funds to meet margin calls Pay or collect margins based on daily valuations	Determine market valuations for all open positions Calculate open contract exposures based on current valuations Pay/collect margins daily Report daily adjustments based on market valuations to client	Make or receive financial transfers to/from clearinghouse

Figure 8. Profile of Business Processes of a Clearinghouse (continued)

	Buyer/Seller	Clearinghouse	Financial Institution
Position Monitoring	Insure all new contracts are reported to the clearinghouse Report all shipments/receipts to clearinghouse Advise completion of open contracts	Monitor and record all reports of contract activity from clients Insure clients stay within approved position limits Secure additional funding as required representing position exposure	Monitor client exposure
Adjustments / Disputes	Record any discrepancies from contractual terms Maintain samples or official inspection results Report all disputes to counterparty for resolution Irresolvable disputes must be reported to the clearinghouse for mediation/arbitration	Record all reported disputes Gather information from counterparties Mediate dispute or appoint arbitration panel Deliver final ruling to counterparties	Provide adequate funds for final settlement and dispute resolution

The WBGA has developed a standardized contract as well as a set of rules for the clearinghouse. A summary of the draft rules for managing credit risk are shown below in Figure 9. Clearinghouse participants may be required to contribute to a fund which helps backstop the clearinghouse.

Figure 9. Draft Rules for Managing Credit Risk

“OVERVIEW OF RULE 4 (RISK MANAGEMENT)
This Rule deals with measures and procedures the Clearinghouse follows in order to measure and manage Clearing-related risk, including:

- *assessment of each Member’s level of creditworthiness, and assignment of a Credit Category to each Member;*
- *calculation and regular redetermination (by processes that include valuing Forward Contracts based on current Market, and offsetting to produce a single obligation amount covering all Contract Positions) of the amounts of Margin and Security that Members must provide to the Clearinghouse to cover their Contract obligations;*
- *limits that the Clearinghouse can place on a Member’s Positions or obligations;*
- *the accepted forms of Margin and Security and the process for providing them;*
- *requirements for Members to contribute to the Guarantee Fund, as a further backstop to cover potential Member defaults;*
- *nature, use by the Clearinghouse of, and failure of Members to provide Margin, Security and Guarantee Fund contributions;*
- *recourse of the Clearinghouse to address unacceptable risk levels; and*
- *risk of loss and/or damage to Commodities.”*⁵

The Agriculture Commodity Clearing proposal continues in its development. Infrastructure details are being challenged and tested, brokers are being consulted, and prospective lenders are reviewing the concept. It is anticipated that the model will be tested with selected end-users beginning in 2009.

⁵ Star Legal Services, “AgClearing Rules”, Working Draft August 17, 2005.

SUMMARY OF ATTRIBUTES

A summary of the description and distinguishing features of each option is illustrated in Figure 10.

Figure 10. Summary of Attributes of the Options

	Security-based	Insurance-based	Fund-based	Clearinghouse
Current application	Status quo regulatory function of the CGC.	Insurance Payables tool / scheme (distributed by AON Reed Stenhouse, underwritten by EDC and Atradius) is currently a component of security in the current system.	Financial Protection Fund Program.	In development.
Crops Currently Covered	Barley, beans, buckwheat, canola, chick peas, corn, fababeans, flaxseed, lentils, mixed grain, mustard seed, oats, peas, rapeseed, rye, safflower seed, solin, soybeans, sunflower seed, triticale, wheat. Estimated 73% of farm cash receipts.	Currently limited to the 21 crops: Barley, beans, buckwheat, canola, chick peas, corn, fababeans, flaxseed, lentils, mixed grain, mustard seed, oats, peas, rapeseed, rye, safflower seed, solin, soybeans, sunflower seed, triticale, wheat.	AgriCorp – 100% of corn, soybean, wheat, canola sold to licenced buyers.	All crops with standard contracts. Peas and barley are forecast to be the heaviest users - riskier and unreliable buyers, as per the focus group discussions conducted in the Clearinghouse development work.
Risks Covered	Non-Payment. Plus broader producer protection, quality assurance, grain safety.	Non-Payment for exports – EDC. Payment for some domestic sales.	Non-Payment.	Non-Payment, within context of broader market risk.
Parties Covered	Seller (producer) .	Seller (producer).	Seller (producer).	Buyer and seller, reseller when applicable .
Amount of Coverage	100% subject to adequate security in place. If inadequate, pay-out pro-rated	100% of insurance.	AgriCorp – Corn and wheat 90%, soybean and canola 90%.	100% of transaction.
Who Pays/Funds?	Buyer. Seller indirectly.	Buyer. Seller indirectly.	Seller on grains (also buyer in case of cattle).	Buyer and seller.
Total Pay-Out to date	\$12.4 M over 27 years.	1 historic, 1 pending.	\$2.4 M over 18 years.	n/a
Fund Size	n/a	n/a	\$10.8 M and growing.	n/a

Figure 10. Summary of Attributes of the Options (continued)

	Security-based	Insurance-based	Fund-based	Clearinghouse
Mandatory / Voluntary	Mandatory to buyer.	Voluntary to buyer.	Mandatory – all sales subject to check-off.	Voluntary to buyer and seller.
Gaps / Voids	Scope of buyers. Scope of commodities. Farmer to farmer. Other: seed-food processor.	All but exports for the EDC underwritten service / tool Is a supplementary tool for security within the current system.	Farmer to farmer. Non-licenced buyers.	Focused default payment risk. Spot market coverage (3 day minimum time period?)
Government Involvement	CGC	CGC EDC	Provincial agency AgriCorp	Supporting ongoing development; proposed authority through provincial securities and exchange commission(s);
Special Features	Licensing includes other features,CGC compliance activities to protect producers' rights.	Reduces cost of alternative security to buyer: bond, line of credit. The insurance industry has recently proposed an insurance quotation to the CWB as a tool to mitigate risk of payment to producers from sales of accredited agents.	Requires buyer registration upon evaluation. Additional security is requested by Agricorp as required.	A new broader, complex marketing service. Live market monitoring. Potential for additional margin cost to producer is dependent upon market conditions. Posting and maintaining margins ensures that both parties will perform as per the contract.
Future?	Ongoing modification and enhancement as allowed with current legislation. Proposed Bill C-13 to eliminate.	Individual assessments now: would be more efficient with aggregating all receivables.	Further investigation would be required.	Review with possible brokers and lenders; test with end-users; further development and possible implementation in 2009; transition to private sector until it is a sustainable approach
Implementation / Delivery	Specific administration in place.	General administration in place; CGC currently monitors / audits.	AgriCorp – administration in place in Ontario.	Private sector driven

IV. EVALUATION FRAMEWORK

In determining needs of grain farmers for buyer non-payment risk management and potential product solutions, the key issues to be considered include:

- what are the guiding principles, the “must meet hurdles” for an option to be considered a viable option;
- what are the essential criteria, or higher priority points, that the options must be assessed against; and,
- what other additional criteria should be considered in the evaluation of the options.

GUIDING PRINCIPLES

Enhancements are being pursued through market driven solutions. Universality is desired; however, universality may require trade-offs in design and utilization to be applicable to the fragmented and competitive grains industry sectors. It is generally understood that any viable alternative should be:

- affordable:** including consideration to development, implementation, and ongoing delivery costs. The option should enable effective use of capital throughout the industry. There needs to be positive benefits to cost, with reasonable coverage levels;
- sustainable:** there needs to be consideration for future grain industry economy / structure / mode of operations. For example, the option should be adaptive to possible increasing use of forward contracting and larger value individual farmer sales. Further, any viable option needs to be actuarially sound;
- non-restrictive to farmers** who seek value added opportunities;
- encouraging Good Business Practices** of farmers and buyers;
- comprehensive** to all grain, oilseed, pulse, and special crop production and marketing;
- transparent** in terms of fees and other costs; and,
- administered by a 3rd party** to farmers and buyers.

It is understood that each of the models can meet the basic guiding principles, as indicated in Figure 11. This is not intended to illustrate a comparable evaluation between the options, but provides a profile of whether each option is viable vis-à-vis the guiding principles.

Figure 11. Guiding Principles

Guiding Principle	Security-based	Insurance-based	Fund-based	Clearinghouse
Affordable	Has had minimal payout requirements; some buyers have challenged the efficiency of the current system.	Depends on use / failures; but examples indicate it can be.	Depends on use / failures; but examples indicate it can be.	Depends on uptake.
Sustainable	Status quo is viewed as inefficient by some; yet, has been providing effective risk management to farmers for years.	Can be designed to be.	Can be designed to be.	Not yet proven.
Not Restrictive To Value Added	Not thought to be.	Should not be.	Should not be.	Should not be
Enhances GBP	Needs education and communication to farmers.	Needs education and communication to farmers.	Needs education and communication to farmers.	Needs education and communication to farmers.
Comprehensive In Scope	yes	Can be designed to be.	Can be designed to be.	Can be designed to be; is intended to address market risk issues more extensive than producer payment.
Transparent Costs-Fees	Part of overall licencing and monitoring function to protect producers' rights; costs to producers are indirect; transparency could be improved.	yes	Can be designed to be.	Can be designed to be, yet is part of a broader service.
3^d Party Administration	yes	yes	yes	yes

CRITERIA AND ASSESSMENT

There has considerable evaluation of the options considered over the past 15 years. Long-lists of potential evaluation criteria have been shortened and have been ranked using weightings schemes. Qualitative evaluation has been documented based upon industry

consultations. Numerical rankings have been developed to rank the options considered. An example of the typical evaluation approach is in Appendix I (although this example did not include insurance as a distinct option).

A more focused evaluation is warranted to assist in decision-making. The key criteria reflect what is required of an effective option. Essential criteria have been identified as:

- effective mitigation of producer payment risk;
- relative cost: to the farmer in all stages: development of option, implementation of option, operations of the option;
- available to all farmers;
- available to all crops under the Canada Grain Act; and,
- minimizing limitations to farmer market opportunity.

Evaluation of the four option models can be summarized as illustrated in Figure 12 below. The precise details of the design and operations of each of the options would affect its effectiveness.

Figure 12. Summary Evaluation Using Essential Criteria

Criteria	Security Based	Insurance Based	Fund Based	Clearinghouse
Effective Mitigation of Risk	yes	yes	yes	yes
Relative cost	Estimated annual cost of current security-based system is \$9 million per annum, based on the assumption of 40 million tonnes of crops receiving coverage, average industry cost is \$0.23 / tonne.	Variable, based on risk assessment, volume, demand, loss limits, ease of administration; estimated to be from 1% to 1.5% of sales value. Could vary from <\$0.01 to >\$10.00 / tonne.	Variable, currently operating at \$0.01 (corn) to \$0.20 / tonne in Ontario.	Projected at \$0.50 / tonne; probable range \$.50 to \$1.00 / tonne.
Available to all farmers	yes	yes	yes	yes
Available to all crops under the Canada Grain Act	yes	yes	yes	yes
Not limiting market opportunities	Producer groups indicate current system encourages participation of niche market buyers.	Depends on the features.	Depends on the features.	yes

There is no apparent constraint to the applicability of each option, if designed appropriately. A more detailed cost comparison is illustrated in Figure 13.

Figure 13. Summary of Cost Comparison

	Security-based	Insurance-based	Fund-based	Clearinghouse
Cost to Producer	Indirect costs of the buyers: \$7.6 million annually or .07% of farm cash receipts. Indirect costs of the CGC: \$1.4 million annually or .01% of farm cash receipts.	Payment for insurance on exports: indirect, as charged through to producer. Receivables insurance could be paid by producer directly.	Annual license fees Direct contributions: in Ontario fund based models have been 20 cents on canola, 10 cents on wheat, 2 cents on soy and 1 cent on corn – which is less than .05% as noted in a prior section.	Fee per transaction. \$.50 to \$1.00 initial estimate. Margin call – security required, placed in trust.
Cost to Buyer	Average rate is 1.5% of the buyer's sales for the bonding security rate, plus internal administration and fees. Insurance currently used by 36 licensees; average 1.1% of sales; range 0.5% to 3.5%.	Focused on facilitating exports. Does not require indemnification or collateral; free of encumbrances Frees up working capital Flexible – can accommodate security requirements.	N/A	Fee per transaction. \$.50 to \$1.00 initial estimate. Margin call – security required, placed in trust.
Coverage level – risk exposure	Scope of buyers. Scope of commodities. Up to 85% of farm cash receipts.	Potentially all, but currently focused on exports. Used primarily as a supplementary tool for higher risk selling.	As per organized by individual commodity groups or provincial insurance agencies.	As per uptake / usage by farmers. Efforts to illustrate the return on investment using interest rate savings (bank recognizes a cleared trade as secure and would offer better rates relative to unsecured grain) have not been successful. ⁶

⁶ WBGA, "Executive Summary – AgClearing Concept Testing 2007".

Additional, desired criteria include:

- suitable to all geographic regions;
- suitable for a broad range of commodities;
- relative ease in administration; and,
- relative ease in understanding – low complexity.

Further assessment against these additional other criteria are summarized in the following Figure 14.

Figure 14. Summary Further Evaluation Using Additional Desirable Criteria

Criteria	Security-based	Insurance-based	Fund-based	Clearinghouse
Suitable to all geographic regions	yes	yes	yes	yes
Suitable for a broad range of commodities	yes	yes	yes	yes
Ease in administration	yes	yes –yet not if receivables insurance provided directly to producers; administration costs are projected to be very high by the insurance industry.	Commodity specific; regional/provincial specific?	Transition to private sector.
Ease in understanding	Currently in place; some level of understanding now.	Could be simple.	Could be simple.	Most complex mechanism.

V. SUMMARY

Mitigating the risk of payment to producers is a highly desired goal among producers. The magnitude of the prospective losses, while historically not large under the scope of the current system, could be significant. The current system provides some protection to producers in the event of a catastrophic event in the industry. In addition, the losses outside of the Canada Grain Act system are not known. All producers cannot manage their payment risk by themselves. Effective risk management tools need to be developed by producers and service providers, but enabled by regulators.

AUTHORITY / REGULATION

The grain marketing environment may be at a point in time where producer payment security is most warranted. There is a role for a regulatory authority to help ensure there is adequate producer payment protection in place. The regulatory body should define the environment for competitive solutions and cost-effective security. Producer groups emphasize there is need for a level playing field for new entrants, both crops and grain buyers, to be entering the industry and to operate competitively.

Prospective private sector participation in payment risk mitigation requires a stable operating environment; one with defined rules and parameters.

OPERATIONS AND ADMINISTRATION

The current system has undergone considerable improvements over the past few years in terms of the more comprehensive monitoring, compliance, and audit activities being utilized by the CGC.

3rd party administration is important to a complex and diverse industry, i.e. 20 to 30 individual commodities, 150 to 200 buyers, 75,000+ farmers. A most efficient risk assessment function could be centralized and delivered by a third party agent. Economies of scale apply to all options.

A fund-based option has existing infrastructure in place to potentially build upon to manage the necessary flow of dollars.

A most efficient risk mitigation system would also, in theory, be characterized by centralized buying of the product solution from many competitors who would design and propose their product solution. For example, receivables insurance purchased by thousands of individual producers is projected to be prohibitive in cost by the insurance industry.

COST COMPARISONS

The cost is small for any of the options being considered relative to the potentially large impact of non-payment to producers. However payment security does have incremental cost to the industry. Either indirectly or directly, producers will largely be paying for payment security. The cost of payment security exists in all options considered. There is opportunity for each of the models to contribute to effective payment security for producers.

The cost comparisons do not clearly distinguish any of the options as the low cost model. The Clearinghouse model is viewed as a higher cost risk management tool, but it is addressing more comprehensive issues than producer payment security.

Producer payment security for all relatively higher volume grain commerce (i.e. wheat, canola, barley) can be viewed as not a significant cost to grain buyers to help assure stability and structure in the Canadian grain industry. Under the current system, the CGC's cost to administer the program is approximately \$1.4 million, or \$8,400 per licensee, or 1/10th of 1 cent per \$1 of average total farm cash receipts.

Cost should not be considered the primary criteria. Seeking the lowest cost alternative may lead to selective use of producer payment risk management tools and place producers at significant risk of being paid.

WHO PAYS?

Producers have indicated their desire to not pay for payment security; however, producers are largely paying now for payment security indirectly through grain buyers in basis costs. Producer payment security is largely a producer issue; producers should increasingly use practical business tools and decisions to minimize payment risk. Payment security can also be considered a factor adding to the stability of the grain industry more broadly; and if this is the case, some cost elements should also be the responsibility of all participants in the grain industry.

Direct premium payment for the prospective higher return and high risk marketing situations is not an unreasonable expectation of producers. Paying directly provides ongoing incentive to keep program costs down. However, paying directly with receivable insurance may impose administrative challenge in terms of the costs to administer, risk assessment, compliance, and data management due to the large number of producers. The fund-based option could build upon existing infrastructure to enable more direct payment than the current payment security system.

Producer payment risk mitigation and related costs may be an insignificant issue in the realm of all market risk issues facing a buyer; however, too much security can contribute to competitiveness of buyers and their ability to make trade payables in a timely manner.

COVERAGE

Lower than 100% coverage would be less costly. Coverage is multi-dimensional; it includes the dimension of crop coverage (wheat, sunflowers, beans, etc), payment coverage (such as 90% with funds), and channel coverage (licensed dealers, farm to farm, feedlot, etc). Loss limits need to be reviewed and redefined for any future solution. Whereas 100% producer payment risk coverage is the goal, economics will likely determine the optimal level.

MANDATORY VERSUS VOLUNTARY

Buyers will not voluntarily provide producer payment security. Depending upon the alternative model used in the future, producers may need to provide pressure to buyers to provide payment security service features.

Mandatory participation would reduce the overall costs. Fixed costs would be spread over large volumes and values of grain. Voluntary participation may be appropriate for the component of the risk management that aligns with those producers seeking the high value opportunity. There will be industry participants, both farmers and buyers, who will not understand producer payment risk and will not seek their own risk mitigation until it is too late. Farmers have indicated in a recent survey that they seek mandatory producer payment coverage⁷.

MULTIPLE TOOLS AND SOLUTIONS

There may not be one solution to manage all producer payment risk - there may be a range of risk management tools available to mitigate producer payment risk. There can be multiple tools and solutions for different sectors / components of the industry.

An advantage of this type of program is that buyers that are well financed, with strong balance sheets, may not have to tie up some of their capital through letters of credit, or other security mechanisms. These buyers may also not require a high loss limit. However, less financially solvent operations, particularly if buying and brokering in commodities characterized with more payment risk, would be required to provide the necessary security to have the right to purchase crops from producers.

Higher risk elements may require more than one mechanism.

Efficiencies may be gained if unique solutions are defined for the differing needs / segments of the industry – the differing needs as determined by risk assessment. Solutions and the related costs should be aligned with payment risk.

Requirements for the successful use of each option / model are summarized in Figure 15.

⁷ Producer Survey, Saskatchewan Pulse Growers.

Figure 15. Requirements for Success for Each Option / Model

	Security Based	Insurance Based	Fund Based	Clearinghouse
Authority	Ongoing legislated authority under the Canada Grain Act	Authority under the Canada Grain Act. Clarity in authority .	Federal authority and / or Provincial agencies.	Supporting ongoing development; proposed authority through provincial securities and exchange commission(s).
Adminstration	CGC	Centralized risk assessment.	Provincial agencies, national farm group, or national / provincial commodity groups.	Transition to private sector.
Key success factors	Ongoing authority. Lower costs and improved efficiency. Ongoing modification and enhancement of monitoring and compliance procedures. Flexibility to enable greater use of the insurance-based product solution. Defining acceptable loss limits: i.e. what is the need % of the crops? % of the payments covered? % of the industry buyers?	Efficient risk assessment, compliance and audit functions. Buyers will buy basis their merit. Defining acceptable loss limits: i.e. what is the need: % of the crops? % of payments covered? % of the industry buyers? Buyers could sell payment security to producers as a service feature. May enable the application of a lower cost solution within the regulatory framework of the CGAct.	Support for prospective losses in start-up years. Defining acceptable loss limits: i.e. what is the need: % of the crops? % of payments covered? % of the industry buyers? Effective administration, by commodity?, by region?	Support by prospective lenders. Uptake of the service by buyers and sellers to help minimize overall market risk.
Shortcomings?	Existing authority is at risk with current federal government’s proposed changes. Perceived costs – considered costly, inefficient system by some of the industry. Fragmentation of the industry: many buyers; many producers.	Insurance underwriters indicate there is a lack of flexibility in current system to enable more comprehensive payables insurance and receivables insurance solutions. Larger “lower risk” buyers will not support if cross subsidization of niche buyers exists. Mandatory requirements would lower the costs. Defining the authority or rules for the future – who does the insurance industry approach? Fragmentation of the industry: many buyers; many producers.	Larger “lower risk” buyers will not support if cross subsidization of niche buyers exists Mandatory requirements would lower the costs. Fragmentation of the industry: many buyers; many producers.	Overly complex to address producer payment security issue as a single goal.

NEXT STEPS

The current system offers payment security to producers within the scope of the Canada Grain Act. Producers, industry and government should continue to define and evaluate viable alternatives to offer a level of payment security to producers.

The next steps to consider in moving forward in this complex industry challenge include:

- government and regulators should confirm and define the future authority and operating environment;
- producers and grain buyers should request input from prospective risk management product suppliers (insurance brokers, underwriters, financial institutions) for product / service solutions for the industry to consider; and,
- producers and grain buyers should develop a proposed business case for a fund-based alternative approach to payment risk management; more detailed definition and assessment of operations and administration is required to determine its potential application to producer payment security.