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Regulatory Responses to Problems in the Canadian Grain Handling and Transportation System

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Good morning, everyone. I am delighted to have the opportunity to say a few words about regulatory responses to problems in the grain handling and transportation system. The problems are well known and centre on two issues — the level of prices and the quality of service. Both of these were of concern in the grains industry over the last year as service levels received front-page attention and, perhaps even more importantly, basis levels jumped dramatically. Moreover, these problems are not new. Indeed, they have been around — on and off — for over a century.

In the time I have this morning, I would like to outline my thoughts on why these issues have remained with us for such a long time, and what response we might take to at least partially address the problems.

Let me start with why these problems are still with us. The structural reason is that both grain handling and grain transportation involve high fixed costs, which leads to highly concentrated levels of ownership, which in turn means non-competitive pricing and level-of-service complaints. In addition, both the grain handling and transportation sector in Canada have capacity constraints — in high-volume years and/or in years when other commodities are more lucrative to ship, the limited capacity creates significant rents, rents that accrue to the owners of the grain handling facilities and, to a certain extent, the railways.

Various forms of regulation have been tried over the years. In the early 1900s, the Manitoba Grains Act and then the Canada Grains Act provided the basic regulatory structure, establishing grading standards and introducing producer cars. When these provisions did not seem adequate to deal with the problems in grain handling, farmers formed a set of elevator co-operatives through a process that was completed roughly one hundred years ago. These co-operatives persisted until the early part of this century. Although there are a few exceptions, farmer ownership of grain elevators has now effectively disappeared.

On the rail transportation side, the Crow Rate served as a key regulatory mechanism for freight rates until the mid-to-late 1980s, when the Canadian Wheat Board (CWB) began using the single desk to provide countervailing power. With the removal of its single-desk powers in 2012, the CWB no longer plays this role. The revenue cap, which was introduced in 2000, also serves as a regulatory mechanism for freight rates.

With the removal of the CWB's single-desk powers and the demise of the large grain co-operatives, the grain handling and transportation system is now left with relatively few regulatory mechanisms. At the same time, the effectiveness of these measures — such as the rate cap or the grain movement requirements — is being called into question.

Consider the recent problems in the grain handling and transportation system. As Ian McCreary argues in his presentation at this conference, the most severe problem was the unprecedented and exorbitant basis levels. Yet this is not where government put its attention; instead, it acted where it had policy levers that could affect measurable outcomes — namely, weekly car movement.

At the same time, the revenue cap has come under attack from a number of different angles. The Canadian Transportation Agency has been criticized for not updating its costing exercise and undertaking a rate review. Other commentators suggest that the cap may be one of the reasons for poor levels of service, and perhaps even the size of basis levels. The perceived ineffectiveness of the cap has been part of the reason why calls for its removal have been receiving more and more credence. If the cap is removed, then neither freight rates nor grain handling charges will be regulated.

This state of affairs is unfortunate because I believe that some sort of regulation is required. The reason is simple — the railways have essentially what amounts to monopolies in grain transportation, while the grain companies possess significant market influence because of their concentration and the constraints built into West Coast port capacity. This market power is detrimental to the economic health of grain growers across much of western Canada specifically and to the competitiveness of the Canadian grain sector more generally.

So what should be done?

Before I answer this, I need to quickly discuss what is required for a regulatory mechanism to be effective. The place to start is with the observation that the economic system is too complex to be fully regulated; as soon as one element is addressed, the problem emerges somewhere else in a different form. Thus, regulation will always be incomplete, even with the best mechanisms in place. Moreover, there is no guarantee that the best mechanism will be put in place or that those put in place will be used effectively. On this front, the major concern is regulatory capture, where a regulatory agency ends up advancing the interest of the group being regulated rather than the interests of the public.

Both of these considerations hinge on the problem of information asymmetry — regulators simply do not have access to the information required for effective regulation. And the information asymmetry problem is only going to get worse. In a world of Big Data, where firms have access to customer and market information that regulators will never see, the power will truly lie with those who have the knowledge.

The fact that regulation may not be up to the task of regulating markets contributes to a growing discontent with this type of control. This growing discontent reduces the support for existing regulations and, more generally, reduces the support for regulation or intervention of any sort.

On this score, calls for less regulation of the railways and the elevator companies has to be seen in a broader context, one in which both belief systems and economic interests support the greater use of market instruments and less use of the command-and-control structures of government. Whether it is in the financial industry or the labour market or the grain handling and transportation sector, the pattern is the same — government intervention is being removed. And where government remains involved in the economy, the chosen tools, such as performance contracts, are increasingly market-oriented.

So, if regulation is not as effective as we might like it to be, and is in fact in some disrepute, what can be done? In particular, what can be done that fits both the information constraints that are increasingly important and the market orientation that dominates policy thinking today? This latter consideration is critical because policy options that do not fit the existing belief systems will not receive attention.

I am going to suggest two broad ideas.

The first concerns the creation of a new baseline level of competition in the grain transportation industry, and perhaps even in the larger grain transportation and handling sector. While this new baseline would not move the industry to perfect competition, it would represent an improvement over what is in place today. The second idea concerns the creation of new competition within both the grain handling and the grain transportation systems. Let me consider these two ideas in turn.

The idea of creating a new baseline level of competition builds on some new insights in competition policy. In a recent paper, “Cooperation vs. Collusion: How Essentiality Shapes Co-opetition,” Patrick Rey and Jean Tirole outline how industryimposed price caps can be welfare improving (Tirole, I should add, was awarded the Nobel Prize in Economics in the fall of 2014).

To understand Rey and Tirole's scheme, think about a cable company that is jointly owned by the content providers. In addition to selling packages of channels, the joint agency would be required to set caps on the price of individual channels sold by the content providers and to refrain from offering discounts on channel bundles. Consumers could then purchase a package of channels or individual channels from either the joint agency or the individual firms. Regardless of how the channels are purchased, the amount paid for channels separately would never exceed the price paid for the same channels purchased as a bundle.

How could this idea be applied to grain transportation and handling? Consider first the railways. Suppose the railways were given the right to set up a jointly owned exchange, one that could create and sell rail transportation service bundles by mixing and matching the individual services offered by each of the railways. The individual services would take the form of separate access to the rail bed, railcars, and locomotive power. The exchange could, as an example, sell a bundle that consisted of the use of CN's rail bed, CP's railcars, and CN's locomotives. These services could be further broken down — e.g., CN's rail bed for part of the route and CP's rail bed for the remainder. Note that the exchange could be focused on a single commodity, such as grain, or on a number of commodities.

Two things would be required to make the exchange play a regulatory role. First, the individual railways would be required to offer each of their services separately — e.g., CN's rail bed, CP's rail bed, CN's railcars, and so on would all have to be offered independently of each other. Second, the exchange would be required to set price caps on all the different services and to ensure that the price of individual services purchased separately would not exceed the price paid for the same set of services bundled together. Since these caps would limit the price that either CN or CP could charge for their own services (provided separately or bundled at the railway level), the creation of the exchange would provide a form of regulation.

Why might this form of regulation be beneficial to both shippers and the railways? The reason is that the various services — rail bed, railcars, locomotive power — are complimentary; all of them are required to get the grain to port. While the owner of each service wants to push up the price of its service, it does not want the other owners to do the same thing for the services they offer. The reason is that rising prices for the other services dampen the demand for services overall. In short, the service providers need to find a way to co-operate and limit their price increases. The creation of the exchange with price caps provides a way to achieve this co-operation. And, of course, the price caps also mean better prices for users.

Conceptually, the creation of the exchange introduces, albeit not fully, the concept of joint running rights. While the various services are separated and sold separately, which is one of the features of joint running rights, only the members of the exchange are allowed to provide services. As a consequence, the level of competition is not as great as would be the case if access were truly open.

The benefit of this regulation is that those people setting the price caps have access to the information required to make the decision and the incentive to use the information in a way that tends to increase overall welfare rather than reduce it. This incentive occurs because setting price caps in the regulatory context described above should improve the profits of the railway (as an aside, the creation of a joint agency might be a very good way to encourage better co-ordination and efficiency in train movements). In short, this form of regulation sets a new baseline of market competition that is technically and economically feasible.

While I have described the exchange as being owned by the rail companies, there is no reason not to include the grain handlers as well. In this case, the exchange would put together service bundles that would include the various individual rail services plus grain handling services. The price caps would be extended to the grain handling services as well.

Although the exchange would create a new competition baseline, it is not sufficient to fully address the market power problems in the grain handling and transportation system. Additional competition is needed.

Given the information problems I sketched out earlier, the additional competition has to involve people who: (a) have access to the information within the system; and (b) wish to use this information to improve the performance of the system. One way to meet these two criteria is to ensure that those using a service have some ownership and control of the assets required to deliver the service. As users of the system, they will have an incentive to improve its performance. And as asset owners, they will have access to the relevant information and will be able to use it appropriately.

What I am arguing, in effect, is that we need co-operatives in the grain handling and transportation system. Thus, it is "back to the future" — we need to think about doing what farmers did one hundred years ago. However, the call for producer-ownership is not a nostalgic desire for institutions of the past. Instead, this suggestion is built on the observation that co-operatives have proven useful in regulating the grain handling system elsewhere. The most salient example is the United States, where grain co-operatives such as CHS have emerged as significant players in the industry and have shown themselves capable of providing farmers with the services they need at prices that more or less reflect the cost of this service provision.

The introduction of farmer-ownership into the Canadian grain handling system is a realizable goal. Given its ownership of the Canadian Wheat Board, the Canadian government has the ability to ensure that farmers could obtain ownership of significant grain handling assets. They could do this through the transfer or sale of the CWB's assets to a farmer group, thereby allowing a full-fledged co-operative to develop. All that is required is the political will to make this happen.

From a public policy perspective, I believe that no other option for the CWB generates the overall benefits — the public benefits — that farmer-ownership would provide. The reason is simple. Farmer ownership creates a group that has the incentives to improve the efficiency of the system and it ensures that this group has access to the information it needs to carry out this goal. In addition, the only way that farmers would benefit from the price caps introduced by the exchange that I have outlined would be if they owned grain-handling assets.

Grain handling, of course, is only one part of the grain handling and transportation system. What, if anything, can be done to create more competition in the rail industry?

The answer is simple — create a co-operative railway. While this possibility sounds farfetched, consider the outcome if one of Canada's large railways was purchased by the shippers — the grain companies, a grain co-op, the potash companies, the coal companies, and the oil companies. As in the grain-handling sector, the organization would be expected to push the overall sector to provide top-level service at a reasonable price. While there would be many issues to resolve — a good example is how the fixed capacity at any given time would be allocated among the different shippers and at what cost — there is no reason in principle why such an entity would not work.

Moreover, a co-operative railway would not have some of the usual problems faced by other co-operatives. Specifically, it should not have trouble raising capital for investment and expansion in the way that farmer-owned co-operatives often have. For instance, while the current market capitalization of Canadian Pacific is $36.8 billion, raising this amount is well within the power of a group of shippers.

While public policy could not dictate co-operative ownership of a railway, it could encourage such a structure through tax policy that ensured that the creation of a co-operative provided benefits both to its members and to society at large. An incentive like this may be required, because although it would benefit the shippers to form a railway co-operative (even if this involved the purchase of an existing railway), the transaction costs of putting the co-op together are often large enough that they preclude formation. Offsetting some of these costs can be welfare improving.

Let me conclude. The takeaway message from today is that it is possible to imagine alternative regulatory responses to the problems facing the grain handling and transportation industry. Such responses are badly needed, since if I am correct, we may soon be left without any form of regulation. First, regulation will get more difficult as industry participants get access to more and more proprietary data, and second, the current policy climate and belief system provides no support for such intervention. This lack of regulation will hurt the entire Canadian economy, not just agriculture.

The alternatives I have outlined, as well as others that can and should be presented, are not likely to be favourably received by everyone. This is particularly the case for those who are part of the current policy subsystem — the space in which grain handling and transportation issues are debated, discussed, and ultimately decided upon. Existing belief systems, commercial interests, and loss aversion create a strong bias against change for people within this subsystem. This is true even though the proposed rail transportation exchange has the potential to benefit both the railways and the shippers.

However, as we know from other issues, policy change does occur. In virtually all cases, the source of the change is from outside the policy subsystem and from people who are disadvantaged in some way with the current policy. They are successful in introducing change when they are able to recast the policy problem.

I hope that I have been able to get you to think differently about the particular policy problem facing the grain handling and transportation system. While history tells us that this problem is unlikely to disappear, we do need to find a response to it that is appropriate for the time. We can only do so by looking in new places and in different ways.