

Executive Summary

Ontario chicken processors and producers have been in discussion on approaches to allocate live chicken to processing plants. Chicken Farmers of Ontario (CFO) requested the JRG Consulting Group to provide an independent analysis of processor allocation and to review selected processor allocation approaches. This report was prepared in early 2005 to assist the CFO as they negotiated with processors a framework agreement on industry issues, including allocation of chicken to processing plants. The objective of this report, therefore, is to assist the CFO in advancing a position on allocation of live chicken to processors that meets the needs of growers, processors, and the overall chicken market, whether provincial, regional, or national in scope.

Ontario has had at least 9 different plant allocation systems over the last 25 years. These have ranged from open sign-up and contracting, to an unrestricted bottom-up approach, to plant lock-ins, to assignment of supply, to supply setting agreements, to using base supply and allocation of growth (overbase quota), to mandated Tribunal decisions. None of these approaches were acceptable to all of the parties at the time they were in effect, and accordingly the CFO and processors are working to implementing a new allocation system.

A reason these allocation approaches were not satisfactory to growers and to all processors is that some processors favour certain allocation approaches, which may not be satisfactory to growers and their needs. This issue is compounded by the fact that Ontario has at least 29 chicken processing plants, with many of these processors having different objectives; some want differential growth to allow them to pursue market opportunities, and others want equal growth for all to preserve current market share.

Moreover, some of the allocation systems enable processors to collectively control the volume of chicken produced in the province. Consequently, processors collectively have the ability to obtain economic rent (higher profits) out of the supply management system by requesting a provincial allocation that is somewhat insufficient for market requirements at the pre-established live price. This economic rent is comparable to the premiums that processors pay growers with open sign-up or contracting when allocated supply is less than the market requires. This economic rent also accrues to processors when the plant allocation system is a form of plant supply quota and processors collectively would rather process slightly less than market requirements to protect their margins. It is for these reasons that certain plant allocation systems can result in supply management moving from the farm gate to the processors shipping door.

In contrast, with open sign-up processors have the incentive to supply all market requirements and to pursue new growth opportunities, and it allows for differential growth between processors. However, a processor faces more risk on the actual volume that they can procure from growers.

Plant allocation system can not be separated from fundamental market parameters, such as; (1) how market requirements for Ontario are determined, (2) whether Ontario receives its requested market requirement, and (3) whether live chicken price is established prior to determining market requirements, or whether the live price is used as an market equilibrating mechanism after supply has been established.

Five plant allocations are assessed to assist the CFO in their deliberations, including:

1. Bottom-up approach, where processor's allocation equals their request;
2. Open-sign up or contracting by processors;
3. A base allocation to processors, with growth in provincial allocation (overbase) distributed to processors through a bidding system;
4. A base allocation to processors, with growth in provincial allocation (overbase) allotted to processors using pre-specified criteria; and
5. A base allocation, with growth in provincial allocation (overbase) allocated on a pro rata basis, and overbase is tradable between processors (this is a plant supply quota which is partially tradable).

A true bottom up allocation approach is the preferred approach, and is considered to be the best system for Ontario from a grower perspective; however this is conditional on Ontario being allocated its requested allocation of chicken production. This system may not be supported by all processors, or by other provinces as Ontario may increase its share of national production.

With open sign-up, processors are not guaranteed any volume, but based on the volume of production allocated to Ontario through their request to CFC, processors sign-up growers to meet their own market requirements. Open sign-up provides the incentive for processors to supply the market at the supply management price versus controlling supply to allow them to increase margins and profitability. With this approach the industry is competitive and responsive to customer requirements. As well, most processors can obtain their individual requirement and this allows for differential growth, and individual processors can take on new market opportunities. With open sign-up the power balance remains with growers, implying that supply management ends at the farm gate. This system does not provide processors with any entitlement on market share, and avoids the need for plant supply quota and it becoming a permanent part of the cost structure in the processing industry. However, each processor has more volume risk than today.

The option which has a base allocation to processors and the provincial overbase distributed to processors through a bidding system is preferred over the other overbase options in the way it allows for incremental growth by processors. Allocating overbase quota through the use of pre-specified criteria is an improvement over the system that was in place in 2004 and early 2005 through the way it allows for differential growth, innovation and market development. The last option is least preferred, even though it allows for incremental growth through leasing and trading of plant supply quota, since the approach adds unnecessary supply chain costs in the Ontario chicken industry. A long run consequence can be that overtime processors in other provinces that do not have these costs, and have a lower operating cost structure, can be in a better position to supply national accounts. As well, incremental production volume will gradually shift to provinces that have not built these costs into their system.

Developing the appropriate method to allocate chicken production to processing plants is an opportune time for CFO to rebalance the power in the chicken supply chain back to producers, where one can argue it was intended to be through the regulatory powers provided to chicken producers. This also has longer run implications for the dynamics and competitiveness of the chicken industry in Ontario and Canada.