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national farmers union

In Union Is Strength

Record-High Fertilizer and Diesel Fuel Prices and their Relation to the Farm Income Crisis

National Farmers Union Submission
to the Annual Ministers of Agriculture Meeting

June 27, 2001

Whitehorse, Yukon

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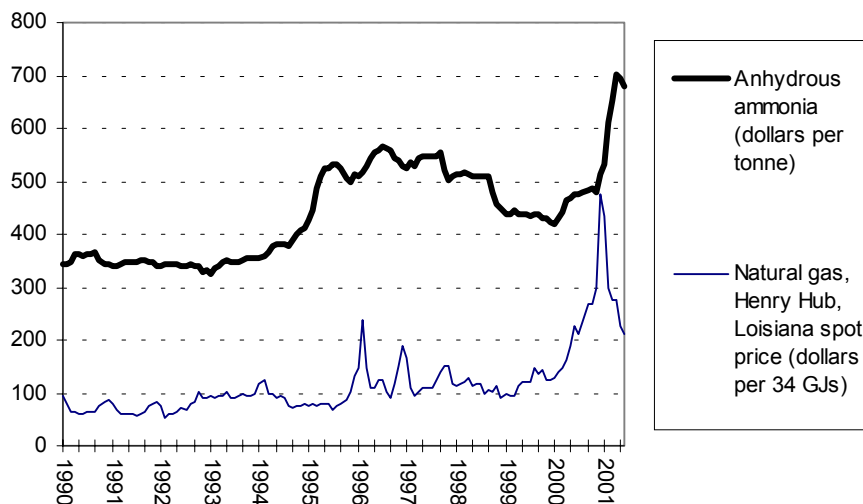
Fertilizer

Fertilizer company CEOs and marketing managers have raised nitrogen fertilizer prices to record levels. Farmers paid 50% to 60% more for nitrogen fertilizers this spring than they did a year ago. Company executives claim that they must charge more to cover higher natural gas prices. But a closer look at natural gas prices and company balance sheets reveals that fertilizer companies may not be telling the truth.

What is really behind fertilizer price increases? The answer to that question not only explains fertilizer prices, but also reveals a great deal about the causes of the farm income crisis.

Figure 1 compares the prices of anhydrous ammonia—a common nitrogen fertilizer—and natural gas—the main input in nitrogen fertilizer production. Natural gas prices did increase in the past year. Thus, it seems credible that higher gas prices might lead to higher fertilizer prices.

Figure 1: Anhydrous Ammonia Fertilizer and Natural Gas Prices, 1990-2001



Sources: Fertilizer: Alberta Agriculture, Food, and Rural Development, Alberta Farm Input Prices; Natural Gas: Henry Hub spot price courtesy of U.S. Department of Energy.

Company credibility fades, however, when we learn that fertilizer price increases have far exceeded gas price increases. Natural gas prices spiked upward for a few weeks in December 2000 and January 2001. Fertilizer companies dealt with this short-term spike by idling some of their plants and not buying natural gas on the spot market. Gas prices have since dropped substantially. Assuming that companies buy natural gas on the spot market, the cost of the gas needed to make a tonne of fertilizer in May 2001 was \$35 higher than in May 2000. However, *the price of the fertilizer made from that gas was up nearly \$235.*

Fertilizer companies need 34 giga-joules (GJs) of natural gas to make one tonne of anhydrous ammonia fertilizer. The spread between the cost of 34 GJs of natural gas (representative spot price) and one tonne of anhydrous ammonia¹ was less than \$300 for the first half of the 1990s. The spread was \$280 one year ago—before the natural gas price increases. *Today, the spread between spot natural gas costs and the farmgate nitrogen fertilizer price is at a record high: nearly \$470/tonne.*

Agrium Inc.—the largest nitrogen producer in the western hemisphere and the largest in Canada with nearly half this country’s production capacity—confirms that margins between natural gas costs and nitrogen fertilizer prices have increased. In its first quarter report (Jan. 1 to March 31, 2001) Agrium notes that its margins on nitrogen fertilizers are nearly triple those for the same period in 2000.²

Agrium officials note that while nitrogen fertilizer production *costs* were up 22% in the first quarter of 2001 compared to the same period in 2000, “nitrogen *prices* were up 52 percent compared to 2000” [emphasis added].

Agrium also reports that whereas the company recorded a loss in its first quarter in 2000, it posted a healthy \$11 million profit for the first quarter of this year.³ For its total operations, Agrium calculates a 33% “gross profit” level versus 28% last year.

Thus, despite higher input (natural gas) prices, fertilizer companies and their shareholders are enjoying *higher* margins and *larger* profits. Seen another way, fertilizer company officials may be using higher natural gas prices as an excuse to raise nitrogen fertilizer prices to unnecessarily high levels simply to increase profits.

The picture becomes more disturbing when we learn that Figure 1’s natural gas prices are not the prices fertilizer companies actually pay. Because of fixed-price contracts and hedging, the prices companies pay are lower and more stable. Thus, company margins are higher. In the fourth quarter of 2000—a period when Agrium’s net income (profit) was up 400% compared to the same period the previous year—Agrium boasted that it was buying three-quarters of its gas at less than a third of the market price.⁴

¹ All anhydrous ammonia prices are: per tonne, actual nitrogen basis, full service, applicator included.

² Unless otherwise noted, Agrium information from: Agrium Inc., News Release and Q1 Interim Report, May 1, 2001.

³ All amounts converted to Canadian dollars except where noted.

⁴ Agrium, news release, December 14, 2000. See also: Bruce Little, “New Winners, Losers, from Power Pricing,” *Globe and Mail*, February 13, 2001.

For the first quarter of 2001, company officials note: “Agrium’s overall gas costs averaged ... 42 percent of NYMEX prices for the quarter.” And Agrium remains well-protected from gas price increases in the future:

Agrium has hedges totaling 75 percent of its gas requirements for 2001 at approximately 46 percent of the current NYMEX forward strip price.
Agrium has also hedged 55 percent of its 2002 requirements at 53 percent of the current NYMEX forward strip price.

While the company’s foresight in hedging could have helped shield farmers from dramatic fertilizer price increases, Agrium chose to sell a significant portion of its hedged and contracted gas at a profit over the winter. Agrium Board member Grant Devine told farmers and media in Davidson, Sask. that:

Agrium ... has shut down half of its plants because selling natural gas earns the company more profit than selling fertilizer.⁵

The newspaper report clarified:

Agrium bought its natural gas at a much lower rate than the current market price, so the company is cashing in on the demand by selling its gas on the world market.

Rather than making cheaper fertilizer out of cheaper, hedged or contracted gas, Agrium sold that cheaper gas, pocketed the profit, made more expensive fertilizer out of more expensive gas, raised fertilizer prices far higher than necessary to cover spot market gas prices, and passed “one-hundred-and-ten” percent of alleged gas price increases onto farmers—further adding to its profits. While this seems like good business for the company, it reveals a profound lack of competition. Fertilizer companies have the ability to price according to what the market will bear with little fear that a competitor will sell for less.

Potash Corporation of Saskatchewan (PCS) is the largest nitrogen producer in the U.S. with approximately 20% of that country’s capacity. Like Agrium, PCS posted strong profits in the first quarter of 2001, despite high natural gas prices.

PCS produces potash, phosphate, and nitrogen. In terms of profits, however, PCS CEO Bill Doyle stated: “Nitrogen was really our ace in the first quarter of this year.”⁶ PCS states that “Higher prices for nitrogen contributed to record nitrogen sales revenue and a first quarter net income of \$62.4 million” [US\$]; and “First quarter margin in nitrogen expanded almost five times....”

Like Agrium, PCS hedged its gas supply well below rising spot prices. PCS stated: “While competitors struggled with natural gas prices that hit historic highs in January, PotashCorp benefited from its gas contracts in Trinidad and its hedge position in the United States.”

⁵ Tara de Ryk, “Nitrogen Fertilizer Prices Not Done Upward Climb,” *Davidson Leader*, February 12, 2001.

⁶ All PCS information from its May 2001 news release: “First Quarter Shows Depth of PotashCorp Lineup.”

Not all fertilizer companies posted profits. Terra Industries—a top-five nitrogen producer in both the U.S. and Canada—lost money in the first quarter of 2001. Terra points out, however, that this was a much smaller loss than in the same quarter in 2000. The company credits the improvement to higher nitrogen fertilizer prices. While the nitrogen division lost money in the first quarter of 2000, it showed a large profit in the first quarter of 2001.

Another factor that underscores fertilizer companies' impressive profitability is their explosive growth. Terra Industries' fertilizer revenues are eight times larger than they were ten years ago. Agrium Chairman Frank Proto and CEO John Van Brunt note that Agrium has been able "to increase the size of our Company by over 800 percent since we went public in 1993."⁷ PCS's 2000 revenues were *12 times* larger than its 1990 revenues.

Just as company executives cannot explain record-high fertilizer prices by pointing to higher natural gas prices, they cannot point to taxes or tax increases. According to the Canadian Fertilizer Institute, approximately 15% of the cost of fertilizer is tax. That 15% consists mainly of corporate income taxes and royalties on natural gas. Farmers pay neither provincial nor federal sales tax on fertilizer. While farmers may want lower input costs, they do not want the government to stop taxing corporate profits or collecting reasonable royalties on our natural resources. Further, given the profiteering outlined above and below, farmers suspect that even if the government did eliminate taxes and royalties, fertilizer companies would simply pocket that windfall.

Finally, fertilizer company executives cannot justify record-high prices by pointing to "supply and demand." The June 14th issue of the *Western Producer* reports:

High [fertilizer] inventories are an industry-wide phenomenon, as high fertilizer prices, low commodity prices and dry seeding conditions led farmers to reduce nitrogen use by five to 10 percent.⁸

Agrium responded by shutting down nitrogen and ammonia plants in Redwater and Fort Saskatchewan, Alberta and in the U.S. In the *Western Producer* article, Agrium Chief Financial Officer Bruce Waterman says the shutdowns "are a result of lower demand this spring in Western Canada and the U.S." He says that: "We've had a buildup of inventory of both ammonia and urea [nitrogen fertilizers]...." And goes on to say that "if inventories remain high, there will be more shutdowns to bring supply and demand back into balance."

⁷ Agrium Inc., 2000 Annual Report, p. 4.

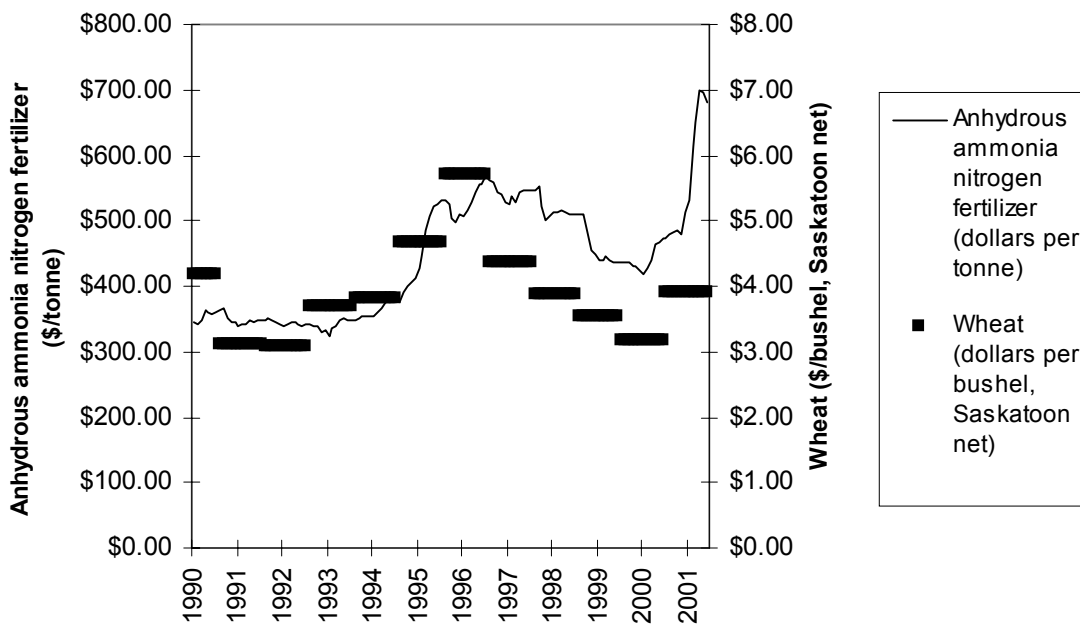
⁸ Fertilizer plants adjust to slump, Saskatoon Newsroom, *Western Producer*, June 14, 2001, p. 3.

Fertilizer: Conclusion

Farmers are paying record prices for nitrogen fertilizer. Fertilizer companies have increased fertilizer prices more than would be necessary to cover increases in spot natural gas prices, and *far* more than necessary to cover their *actual* natural gas costs, taking into account hedging and pricing contracts. So what accounts for sky-high fertilizer prices and healthy company profits in the midst of a farm income crisis? Market power.

This is not the first time that fertilizer companies have used their tremendous market power to raise prices. In the mid-1990s, when grain prices rallied, fertilizer companies increased prices in perfect sync. See Figure 2, below.

Figure 2: Anhydrous Ammonia Fertilizer and Wheat Prices, 1990-2000



Sources: Fertilizer: Alberta Agriculture, Food, and Rural Development, *Alberta Farm Input Prices*; Wheat: Canadian Wheat Board.

As wheat prices rose in 1995 and 1996, fertilizer prices tracked those increases perfectly. While natural gas costs remained relatively flat, fertilizer companies raised prices 75% to ensure that they would capture a large portion of farmers' increased net incomes.

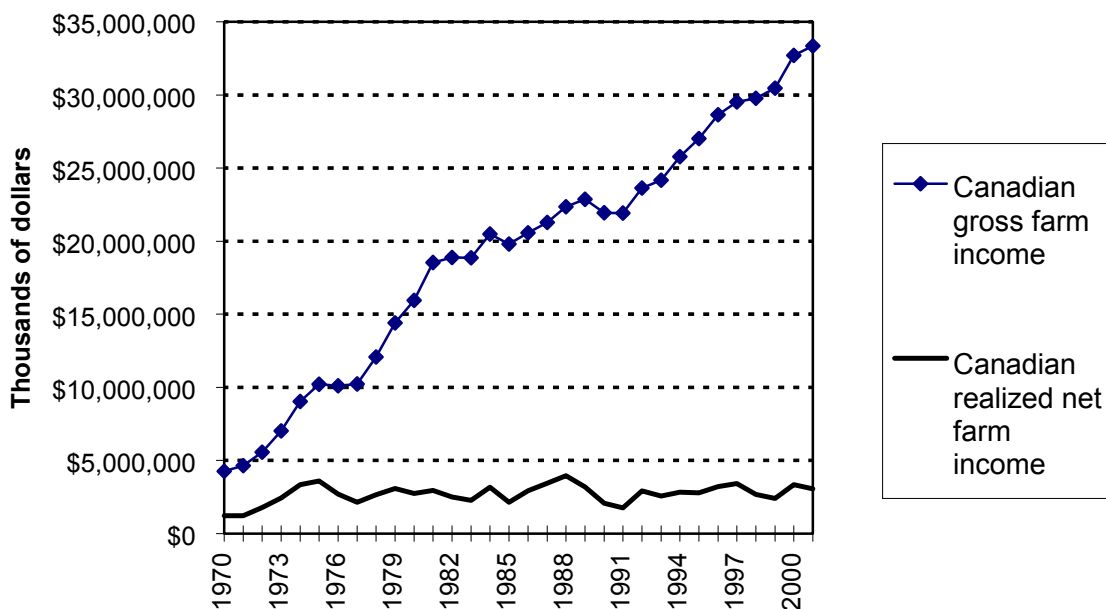
To farmers, such market power is remarkable. And for fertilizer companies to *increase* their profits over the past year—a period when the spot price of their main input *increased*—is a dazzling prospect for farmers. Farmers cannot pass on cost increases because they operate in a competitive market of hundreds-of-thousands of farmers in North America and hundreds-of-millions worldwide. In contrast, three nitrogen producers control 71% of Canadian capacity and five control approximately the same portion of U.S. capacity.

In the mid-1990s, fertilizer companies could not honestly cite higher costs to explain price hikes. Nor are today's record prices the result of higher production costs or "supply and demand." Current record prices are the result of tremendous market power, little competition, the quest for larger shareholder profits, and the ability to price according to what the market will bear.

As stated above, agribusiness corporations can use their market power to extract record prices and profits *even in the midst of a farm income crisis*. Seen another way, the companies' market power and their ability to extract record prices and profits *are the causes* of the income crisis.

Since 1975, farmers have tripled their gross revenues and their net incomes have *declined*. The explanation: over the same period, farmers' expenses—the money farmers pay to input manufacturers—increased 4½-fold. Since 1975, gross farm income has increased from \$9 billion to \$33 billion. *Corporations which sell inputs used their market power to capture 100% of that increase*. Recent fertilizer price increases can best be seen as the continuation of that process. See Figure 3, below.

Figure 3: Canadian Farmers' Gross Revenue and Realized Net Income, 1970-2001



Source: Statistics Canada, Agriculture Economic Statistics, Cat# 21-603E.

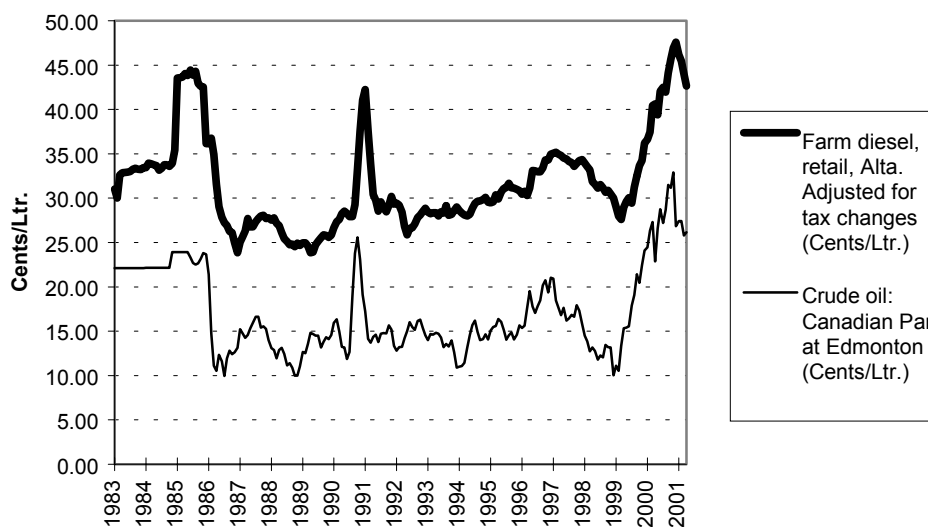
Had farmers continued to maintain their one-third share of every gross income dollar that they enjoyed in the first half of the 1970s, they would have received a total of \$116 billion additional net income dollars over the past 25 years. Instead, those billions were captured by input manufacturers. \$116 billion is approximately three times the total farm debt.

Diesel Fuel

Oil company executives have raised diesel fuel prices to record levels. Like fertilizer makers, oil executives point to higher costs—in this case, high world crude oil prices. It is therefore illuminating to examine the relation between crude oil and diesel fuel prices.

Figure 4 demonstrates that oil prices and farm diesel prices have fluctuated over the past 18 years and are now both at record highs. Oil companies recently raised farm diesel fuel prices in Alberta above 45¢/litre—up 75% in just two years. Farmers in other provinces faced similar increases.

Figure 4: Alberta Crude Oil and Farm Diesel Fuel Prices, 1983-2001



Sources: Crude oil: Statistics Canada and Natural Resources Canada;
Diesel Fuel: Alberta Agriculture, Food, and Rural Development, Alberta Farm Input Prices.
Diesel fuel price data has been adjusted to account for changes in federal and provincial taxes and rebates.

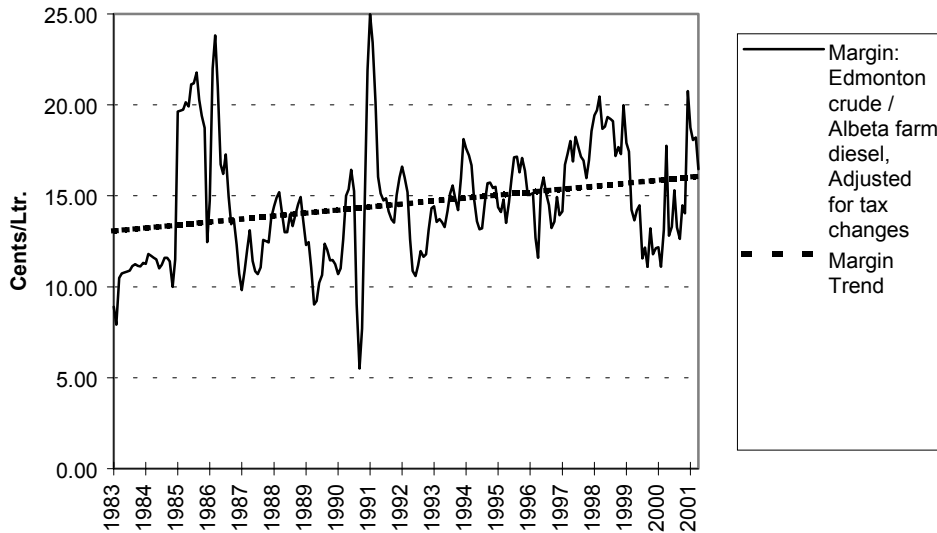
While it is not immediately apparent from the graph above, the margin between diesel fuel and crude oil prices has increased significantly over the past 18 years (see Figure 5, below). Note that the peak diesel fuel prices of December 2000/January 2001 correspond to the *highest* diesel/oil margins in the past ten years.

Even after allowing for increased crude oil “costs,” the amount that companies make on each litre of diesel fuel they sell to farmers has increased significantly. While oil companies have been blaming high world oil prices for rising gas and diesel prices, the spread between crude oil and diesel prices—the profit on each litre of diesel—has increased, not decreased.

It is also important to understand that crude oil is not simply an “input cost” for the companies that refine our diesel fuel. Most of these companies are “integrated” oil companies: they produce crude oil, refine it, and retail the gasoline and diesel. Thus, *these*

companies are not merely making increased margins on diesel fuel, they are reaping record revenues and profits on the oil that goes into that diesel fuel. The companies are cashing in twice: profiting from high oil prices, then using high oil prices as an excuse to raise diesel and gasoline prices.

Figure 5: Oil/Diesel Margin and Trend, 1983-2001



Sources: Calculated from data in previous graph.

Three integrated oil companies produce, retail, and distribute the bulk of Canadian oil, gasoline, and diesel fuel: Petro-Canada, Imperial Oil (Esso), and Shell Canada. These companies confirm that margins and profits are up. For the first quarter of 2001, Petro-Canada reported *record* quarterly profits of \$358 million. It credited strong refining margins for a significant portion of its profits. Its return on equity was 28.4% for the twelve months ending March 31, 2001, up from 6.2% for the twelve months ending March 2000.⁹ Farmers earn less than a 1% return on their equity.

Ironically, Petro-Canada notes: “The Company has placed new decals on the pumps at Petro-Canada stations across the country, showing the components that make up the price of the average litre of gasoline in Canada. *Gasoline pricing is one of the key issues facing integrated companies...*” [emphasis added].

Also citing “strong industry refining margins,” Imperial Oil reported profits of \$382 million for the first quarter of 2001. Imperial Oil’s return on equity for the twelve months ending March 31, 2001 was 34.8%, up from 17.0%. In April share prices hit a record high.

In nearly identical fashion, and citing “exceptional market conditions” and “increasing refining margins,” Shell Canada reported record quarterly profits of \$354 million.

⁹ All Petro-Canada information from its First Quarter Report (released April 24, 2001)

These three oil companies had combined profits of almost \$1.1 billion in three months. If they maintain that pace, their profits will exceed \$4 billion for the year. This number will be approximately *ten times* the profits earned by Canada's 276,548 farm families.¹⁰

Diesel Fuel: Conclusion

Paralleling the relation between fertilizer and natural gas prices, increases in diesel fuel prices far exceed the amounts needed to cover increased crude oil prices. And when one understands that the integrated oil companies that market Canada's diesel fuel are both the buyers and the sellers of that crude oil, the argument that "diesel and gasoline prices must rise to cover oil price increases" becomes especially suspect.

Increases in diesel fuel prices cannot be explained by citing increased oil prices or rising taxes. The real explanation for high fuel prices and accompanying record company profits is the tremendous market power and the low level of competition enjoyed by these corporations.

¹⁰ For a discussion of the difference between farmers' profit and net farm income, see the NFU's report "The Farm Crisis, EU Subsidies, and Agribusiness Market Power."

Input Costs: Conclusion

When explaining the farm income crisis, many politicians, academics, and reporters uncritically repeat clichés and misinformation. The litany includes:

“Farmers grow too much wheat”

In reality, Canadian farmers have diversified faster than farmers elsewhere, certainly faster than U.S. farmers. More important, according to provincial government calculations, per-acre net returns for wheat exceed those for canola, flax, peas, and most other major crops. Net returns for wheat are second only to those from lentils—a crop that can be grown only in certain parts of Canada and only every third year, due to crop disease concerns. By growing a significant amount of wheat (between fields of lentils, borage, chickpeas, coriander, and other specialty crops), farmers are *maximizing* their net incomes.

“Overproduction is the problem”

To the contrary, world wheat stocks/use ratios are at a 25-year low.

Stocks/use ratios are the most often-quoted measure of supply and demand. The ratios compare the amount of grain in the world at a given time to the amount used throughout the year. For the current crop year, the world stocks/use for wheat will be 22.30%. This number is down dramatically from levels that approached 40% in the mid-1980s. For the past 15 years, the world has consumed significantly more wheat than it produced, drawing down world reserves.

Data for coarse grains (corn, barley, oats, etc.) shows similar low stocks/use ratios. The ratio for the current year is the third lowest in the past 20. World coarse grain reserves have been falling for 15 years: consumption is exceeding production.

“EU subsidies depress prices”

Had the European Union (EU) not subsidized its farmers, there is no evidence that world grain production would today be lower, or prices higher. The argument that EU subsidies cause overproduction and, thus, reduce grain prices runs aground on two facts:

- as noted above, there is no overproduction or oversupply; and
- production rates have increased just as fast, or faster, in relatively unsubsidized countries such as Australia, Argentina, and Canada as they have in highly subsidized jurisdictions such as the EU and U.S.¹¹

¹¹ For a complete analysis of the myth that EU subsidies are the cause of the current farm income crisis, see the NFU’s “The Farm Crisis, EU Subsidies, and Agribusiness Market Power.”

“Farmers need to be more efficient”

Farmers produce grains, oilseeds, meat, and other foods *for the same price they did 25 years ago*. Few corporations can claim the same level of efficiency.

Despite economists’ claims that larger producers—such as huge transnational corporations—enjoy economies of scale and should be able to deliver cheaper goods and greater efficiency, the evidence from the agri-food sector demonstrates the opposite: That small family farms have been more successful in increasing efficiency and productivity than have the agribusiness transnationals that process and retail our food. Since 1975, the price of bread has tripled. Because the farmgate price of wheat has not changed, all of that increase must have been taken by huge transnational millers (Archer Daniels Midland, for instance), bakeries (Maple Leaf’s Canada Bread), and retailers (Safeway). Clearly, in the production chain that produces Canadian bread, the tiny family farms are far more “efficient” than the huge corporations that control the other links in the chain.

The real cause of the farm income crisis is one that politicians and their corporate partners are not eager to admit: as transnational agribusiness corporations merge to giant proportions, as they all but eliminate competition, their overwhelming market power allows them to extract huge profits from the agri-food revenue stream. This furious extraction of dollars leads to ever-tighter farm margins, the expulsion of family farmers, the impoverishment of rural communities, the degradation of rural infrastructure, lower pay for workers, and unsustainable strains on our eco-systems. The farm income crisis is the result of market failure caused by a huge imbalance in market power.

Huge, near-monopoly retailers and processors take the lion’s share of the consumer dollar and pass only a few cents back to the family farms that produce the food. The little bit of money that farmers do receive is quickly seized by giant, near-monopoly input manufacturers. The preceding analysis of fertilizer and diesel fuel pricing is a small illustration of how these mechanisms work.

National Farmers Union 2001