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Dear Client: Washington, May 26, 2023

Colo. River basin states agreed on water cutbacks.

Aided by a wet winter and $1.2 bil. in federal payments, the new accord expires at the end of 2026.

Drought, population growth and climate change have dropped the river's flows by one-third in recent years compared with historical averages, threatening to provoke a water and power catastrophe across the West.

WATER

Details: California, Arizona, and Nevada, forming the Lower Basin, will conserve 3 mil. acre-feet of water over the next three years... approximately 13% of their total allocation from the river. In return, the Biden administration committed to compensate the states for three-quarters of the water savings, equating to around $1 bil. to $1.2 bil. in federal funds.

Deal follows the concerning decrease in water levels in Lake Powell and Lake Mead, the country's largest reservoirs, due to two decades of drought and global warming.

Reductions are among the most aggressive ever experienced in the region, and likely to require significant water restrictions for residential and agriculture uses.

The Colorado River supports over 40 mil. people and plays a key role in seven western U.S. ag states as well as parts of Mexico, irrigating 5.5 mil. acres of farmland.

This is a temporary solution to safeguard the critical reservoir levels over the next three years. Water savings will be achieved by paying farmers and others who voluntarily forgo their water supplies. Despite the recent increase in water levels due to heavy rain and snow, state and federal officials hope these reductions will be sufficient to protect the reservoirs until 2026. At that time, a major renegotiation is planned for how the Colorado River gets divided.

MORE DETAILS

- Most of the cuts ... 2.3 mil. acre-feet... would come from water districts, farm operators, cities and Native American tribes who agreed to take less water in order to qualify for federal grants offered under the 2022 Inflation Reduction Act. Those payments total about $1.2 billion.
- Another 700,000 acre-feet would come from California, Nevada and Arizona, which agreed to work out the cuts among themselves in the coming months. If they don't, the Interior Department said it would withhold the water... a move that could face legal and political challenges.
- The reductions would save three million acre-feet over the next three and a half years, above and beyond existing agreements. But that is far less, on an annual basis, than what the federal government had demanded last summer.
- The structure of the agreement allows the Biden administration to sidestep, for now, the problem of which states will take the brunt of the cuts.
- Finding another 700,000 acre-feet remains a problem for the three lower-basin states to solve, at their own pace.

Source: Ag Letter editors

One tension was between Arizona and California, the two states that extract the most from Lake Mead. A solution had to be found that would balance the cutbacks in water use, without compromising either state's water supply. The new deal requires the Lower Basin to conserve at least 3 mil. acre-feet by 2026, with at least half of that being achieved this year.

Calif., Arizona & Nevada get their shares of water from Lake Mead, formed by the Colorado River at the Hoover Dam and is controlled by the federal government. The Bureau of Reclamation, an agency within the Interior Department, determines how much water each of the three states receives. Other states that depend on the Colorado get water directly from the river and its tributaries.

If the reservoirs fall farther than expected over the next three years, emergency provisions in the agreement will kick in. Additional actions will be taken to maintain reservoir elevations of 1,000 feet above sea level at Lake Mead and 3,500 feet at Lake Powell.

The agreement keeps the river from falling so low it would jeopardize water supply for major Western cities like Phoenix and L.A., as well as for some of America's most productive farmland.

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PROP 12 <u>Supreme Court's split 5-4 decision to uphold California's higher animal welfare standards</u> via Proposition 12 was landmark and could send shockwaves through the U.S. hog industry... and the ag sector.

<u>Implementation of Prop 12 in California can't go into effect until July 1</u>. Implementation of a similar measure in Massachusetts can't be enacted until 30 days after the Supreme Court decision.

<u>A major concern for pork producers: Prop 12 would allow private attorneys to enforce</u> its provisions through lawsuits, meaning lawyers who think they see a violation of the measure could sue farmers, farmers markets, grocery stores or food stands. Similar "private rights of action" have allowed lawyers to shake down thousands of small businesses by filing drive-by lawsuits. These suits often force business owners either to pay a settlement or to incur devastating legal fees. On many occasions, businesses have simply closed rather than face either outcome.

<u>Decision could 'catalyze wave of new animal welfare laws</u>.' David Favre, Professor of Law at Michigan State Univ. said, "While the ruling was fractured and reflected complex legal questions, it is a major victory for those working to improve farm animal welfare. A number of states will undoubtedly take advantage of the power that the Supreme Court has recognized. As a specialist in animal law, I expect that this will result in a patchwork of laws that are likely to make national meat producers very uncomfortable. Ultimately, it could push Congress to set federal standards.

<u>Farm bill could have Prop 12 override</u>. House Ag Chairman Glenn "GT" Thompson (R-Pa.) told us the "farm bill legislatively would be the place to draw the lines" on issues such as California's Prop 12. He said, "I think we can expect that the Ag Trade Suppression Act, or effectively nicknamed the Eats Act, will be introduced again. That would prevent states and local jurisdictions from interfering with the production," calling it "a pretty good starting point for any legislative solution."

<u>Impacts</u>: Estimated costs of converting sow barns to group pens range from $1.9 bil. to more than $3.2 bil., according to a Univ. of Minnesota study, which was based on pens that provide 16-18 square feet per sow. National Pork Producer Council estimates farmers would need to invest about $3,500 per sow, or $7 million for a 2,000-head sow farm to comply with Proposition 12. Most of the cost likely would get passed onto consumers.

INTEREST RATES <u>Deere economist on interest rates</u>. Kanlaya Barr, Director of Corporate Economics for John Deere, said: "Interest-rate expense is only about 6% to 7% of total ag production expenses, but a little over half of that is tied to mortgages, which are mostly fixed at a lower rate. The portion tied to operating loans tends to be more variable and is about 3% and that number is even smaller for row-crop producers; their interest rate expend is less than 1% of their overall operating expenses. The impact of higher interest rates is much smaller than the tailwinds from lower input costs and fuel costs. With that said, rising interest rates have also had an impact on real estate. While the housing market has been significantly affected by the elevated interest rates, the farmland market has been relatively immune, and farmland values continue to hold up through Q2 of this year."

<u>Deere's Dave Gilmore, SVP, Ag and Turf Sales and Marketing, added</u>: "To add some context, comments that came from the Federal Reserve Bank of Kansas City earlier this spring is that when you put interest rates in perspective relative to history, roughly $0.12 of every dollar of a Midwest U.S. farm earnings is going to interest cost today versus the long-term average of $0.15. As a result, customers are managing this expense very well." He also noted that "As the Fed reported, the marginal increase in interest costs on operating loans is the financial equivalent of an additional 2.5 bushels of yield for corn. That's why a major component of our smart industrial strategy is focused on helping our customers better manage volatile periods by delivering products, and solutions that minimize costs and increase yields. Our goal is to deliver products, and solutions that offset and improve the variable cost structure of our farmers."

BSE <u>No major trade policy implications from BSE confirmed in a cow in South Carolina</u> that was traced back to a herd in Tennessee. The U.S. has a negligible risk status for BSE and an atypical case will not alter that status and no major trade disruptions are expected. This is the seventh case of BSE found in the U.S. and the first since 2012.

<u>As for China, Phase 1 of the U.S./China agreement says</u>: "Provided the United States maintains its OIE negligible risk classification for that disease, China shall not impose new import restrictions or requirements related to that disease on imports of U.S. beef."

FED RESERVE

Fed Chair Jerome Powell gave a clear signal he's inclined to hit the pause button on interest-rate increases next month and said rates could top out at a lower level than previously expected. "We've come a long way in policy tightening and the stance of policy is restrictive, and we face uncertainty about the lagged effects of our tightening so far and about the extent of credit tightening from recent banking stresses," Powell told a Fed conference in Washington. "Having come this far, we can afford to look at the data and the evolving outlook to make careful assessments," he said, reading from prepared notes.

Minneapolis Fed President Neel Kashkari said he could support holding interest rates steady at the central bank's next meeting... June 13-14... to give officials more time to assess the effects of past rate increases and the inflation outlook. "I'm open to the idea that we can move a little bit more slowly from here," he said in an interview with the *Wall Street Journa*l. "I would object to any kind of declaration that we're done. If the committee chooses to skip a meeting because we want to get more information, I could make the argument why that makes sense," Kashkari said. "A skip to get more information is very different in my mind than [saying], 'Hey, we think we're done.'"

MARKETS

Corn: Planting in most parts of the country has gone off without a hitch. There are still a few states running behind… North Dakota in particular… but much of the rest of the Corn Belt has seen planters roll nearly uninterrupted. That will put attention onto initial condition ratings. Demand for U.S. corn is flagging, especially with recent sales to China being canceled.

Soybeans: Planting has moved rapidly this season in most areas. The planting window stays open longer for soybeans, but the mostly favorable planting weather has kept progress well ahead of average. Condition ratings will be important, but take on increased importance in August when yield potential is set. Demand is slowing seasonally as Brazil exports its record crop.

Wheat: Continuation of the Black Sea grain deal has shifted the next concern two months down the road. Global supplies will remain ample. In the U.S., drought has hit the Plains HRW wheat crop and acreage abandonment is likely to grow. Spring wheat planting continues to lag, especially in North Dakota. But ample global supplies have tempered demand for U.S. wheat.

Rice: Some sales of U.S. rice are being rolled ahead into the new-crop marketing year, causing a major slowdown in old-crop business. Tight old-crop supplies are lifting prices, eating into U.S. competitiveness. New-crop planting has progressed and crop ratings are coming in slightly above average, keeping a potential lid on prices.

Cotton: The inverse between old- and new-crop futures recently broke higher as tight old-crop supplies helped propel both through technical resistance. Demand has been solid for U.S. cotton on the global market but could be starting to flag as prices rise. Weather again is important with less acreage planted to cotton for harvest this year.

Cattle: The atypical case of BSE in a cow that was five years old or older in South Carolina marked the seventh case of BSE since it first appeared in 2003. But six of the cases have been atypical, which by World Animal Health Organization standards can pop up without any cause. But the U.S. is considered negligible risk for BSE so this one case does not alter that and should mean no major trade impacts. Despite that, traders are cautious about what China may say and do. But as we note elsewhere, the U.S./China Phase 1 accord deals with situation like this.

Hogs: Cash markets are rising seasonally, but traders have been actively removing premium from summer-month futures. Given the lack of strength in pork cutout, it suggests holiday demand may not match typical levels. Disappearance coming out of Memorial Day will be key for price direction into early summer.

Poultry: It has been four weeks since a commercial growing or breeding operation has been confirmed with bird flu. Data is starting to show the impacts of the reduced numbers at this point in 2022 and are coming in solidly ahead of year-ago marks. But demand has not gained ahead of the holiday like it typically does, raising some concerns.

Dairy: Milk production has taken a few hits recently, with cow numbers in Texas dropping by 15,000 head in April due to the major fire that hit a big dairy operation. Winter in California has also tempered output in the Golden State, down nearly 2% from year ago in April. Financial losses are mounting this spring and areas like the Midwest could see significant pressure on herds.

TRUCKING Mexico's gov't is requesting Texas to discontinue its state-run cargo truck inspections at the border due to long delays and significant trade losses. Texas Department of Public Safety (DPS) initiated these inspections on May 2 at the Veterans International Bridge in Brownsville and Free Trade International Bridge in Los Indios, causing delays from 8 to 27 hours. This has had a significant impact on perishable products and has been costly to American consumers.

Perspective: In 2022, the U.S. imported $18.7 bil. of produce, including fresh, frozen, and processed fruits, vegetables and nuts from Mexico, according to USDA.

Background: Texas DPS's checkpoints are supplementary to the commercial truck inspections performed by U.S. Customs and Border Protection (CBP). The DPS inspections have significantly slowed down CBP's processing. The Texas DPS stated the inspections' goal was to ensure road safety by checking that trucks are functioning properly. After initially inspecting all trailers from Mexico, DPS reduced the number of inspections from May 8.

Possible USMCA complaint. Despite the reduction, the Mexican gov't has threatened to lodge a complaint under the United States-Mexico-Canada (USMCA) trade agreement if inspections are not halted immediately. The Mexican economy ministry argues these actions stem from an "anti-Mexican vision," despite Mexico being Texas's main trading partner with an average annual trade value of $231 billion.

RUSSIA Russia targets 55 MMT of grain exports annually. Russia plans to harvest on average around 130 MMT of grain a year and export up to 55 MMT, Russian First Deputy Agriculture Minister Oksana Lut said. She noted Russia had managed to increase its grain exports despite some countries rejecting its supplies because of the war in Ukraine. Russia is currently shipping around 80% of its grain to the Middle East and North Africa, with Turkey, Egypt, Iran, Saudi Arabia and Algeria comprising the top five buyers, according to Eduard Zernin, the head of Russia's grain exporters union.

UKRAINE The war in Ukraine has forced farmers to risk planting crops in fields potentially littered with explosives left by Russian forces, the *Associated Press* reports. As a result of the Russian invasion and ongoing occupation, Ukrainian farmers face a difficult decision of risking their lives to plant and harvest crops during the critical spring planting season. This is compounded by soaring production and transportation costs caused by Russia's blockade of many Black Sea ports. Some European countries have also imposed import restrictions on Ukrainian grain to prevent a surplus.

Impacts: Industry insiders, Ukrainian government officials and international organizations predict at least a 20% to 30% reduction in grain output, lower quality crops and potentially thousands of bankruptcies next year. This could pose a significant threat to global food security as Ukraine is often referred to as the "breadbasket of the world," providing essential supplies of wheat, barley and sunflower oil to regions like Africa, the Middle East and parts of Asia. The U.N. Food and Agriculture Organization has reported that 90% of ag businesses in Ukraine have lost revenue and 12% have land contaminated with mines. These conditions may lead to a further reduction in land planted with grain, with significant consequences for local farmers and the global food supply.

OLIVE OIL The price of extra virgin olive oil has surged to an all-time high, with a 46% increase from last year, resulting in a price of $6,269.63 per metric ton. This ranslates to about $6 per liter for consumers, although additional shipping, marketing and sales costs will significantly raise the final price. Filippo Berio, a leading olive oil brand, reports that the latest olive season was the most challenging in 30 years due to record-low crop yields. This price spike is largely due to severe drought in Spain, the producer of about 40% of the world's olive oil. The country experienced its hottest and driest summer on record last year, leading to a significant drop in production. Spain has requested emergency funds from the European Union to support its farmers.

Best regards,

The Ag Letter Editors

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