

Submission to the Productivity Commission's
Draft Report: Regulation of Australian Agriculture

“In defence of Real Choice in Marketing”

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About this submission

This submission has been prepared by Mr Jonathan Pavetto, an independent agricultural economist from five generations of farming family in North Queensland.

Mr Pavetto has extensive experience working in economic policy development roles with a number of peak industry associations in the agricultural sector across Australia and is a graduate of the Australian National University's College of Business and Economics.

The purpose of this submission is provide an independent view on three key areas:

1. Provide high-level feedback to the Commission on a number of its Draft Recommendations and Findings;
2. Respond to a number of specific claims made by the Commission with regard to sugar marketing arrangements in Queensland; and
3. Propose a number of issues for examination by the Commission that may require a regulatory response.

This submission has been prepared with the aim of ensuring sensible outcomes in the regulation of Australia's agricultural industries.

No compensation has been provided by or sought from any party from the development of this submission.

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Summary

- The Commission's analysis of the impact of environmental regulations on the agriculture sector are accurate. However, analysis should be expanded to include current and proposed environmental regulations associated with management of the Great Barrier Reef;
- Regulation of ag-vet chemicals need to account for the economic impacts of regulatory decisions and ensure public benefit is not attained at private cost;
- Current transport regulations for heavy vehicles used for agricultural purposes are not fit-for-purpose. A new regulatory framework should be developed for these vehicles;
- Real Choice in Marketing regulations in the sugar industry are not unnecessarily burdensome, complex or redundant and should be retained;
- In the Draft Report, the Commission has made a number of false and misleading statements regarding sugar marketing arrangements in Queensland. These statements should not be repeated in the Final Report; and
- The Commission should examine a number of additional issues in its Final Report:
 - Impact of regulations in the electricity sector on agriculture;
 - Vertical integration in the agricultural supply chain; and
 - Geographic concentration of ownership of economic infrastructure.

Introduction

The Federal Government should be congratulated for directing the Commission to hold an inquiry into regulation of Australia's agricultural sector. Similarly, the Commission should be commended for its extensive analysis of a number of key issues in its Draft Report.

It is encouraging for many in the agricultural sector that the Commission understands that some regulation is needed to ensure effective operation of imperfect and asymmetrical markets.

The Commission's framework for assessing regulation (PC, p4) is appropriate. Applying this framework to regulations will ensure the objectives of regulation are indeed relevant while minimising costs to industry participants and maximising benefits to the Australia community.

The Commission's observation that quantitative information on regulatory burden is hard to find is true and correct. However, in lieu of quantitative information, the Commission should seek more robust qualitative information from all participants across in the agricultural supply chain.

It is clear by comments made in some sections of the Draft Report, that the Commission has failed to appropriately examine all perspectives of industry specific issues, choosing to conduct only a desktop level study and selectively report on information received. This level of analysis does not meet the the Commission's usually high standards and the offending sections of the Draft Report should be amended or removed in the preparation of the Final Report.

Judgements made by the Commission about potential gains to the Australian community through regulatory reform must principally focus on improving economic returns to Australian farmers and farming communities as a whole, not individual companies.

High level comments on Draft Recommendations and Findings

Environmental regulations

Excessive environmental regulations in Australia are a significant barrier to improved productivity and profitability across the agricultural sector. Not only are many environmental regulations inhibiting expansion of agricultural production (key objectives of both White Papers on Agricultural Competitiveness and Developing Northern Australia), but also undermining community and commercial confidence in existing farming operations.

Industry association input

Building on Commission's Draft Recommendations on environmental regulations, agricultural industry associations should also be included in any future consultation on future native vegetation and biodiversity conservation regulations.

Great Barrier Reef Regulations

In preparing its Final Report, the Commission should also consider the implications of proliferating environmental regulations with respect to the management of the Great Barrier Reef.

Farmers in catchments of the Great Barrier Reef Catchment are already subject to additional onerous regulations with respect to vegetation, water, nutrient and farm management which have a punitive impact on the agricultural sector's productivity and profitability in these catchments.

Recent indications from the Queensland Government's Great Barrier Reef Water Science Taskforce suggest farmers in reef catchment areas could be subject to additional regulatory and reporting requirements. The existing and proposed regulations warrant the Commission's scrutiny.

Improving communication flows

The Commission's observations regarding the need to improve information flows are accurate.

Shifting administrative burden

In preparing its Final Report, the Commission should investigate the shifting administrative burden of environmental regulations from government regulators onto the agricultural sector.

The Queensland Government's design of environmental regulations has shifted significant compliance costs from the administering agency onto landholders. For example, when errors and inaccuracies are identified with mapping or compliance tools developed by Queensland Government agencies, the landholder (at their own expense) must hire independent consultants gather evidence to correct the regulatory tools.

Failure for the landholder to correct the maps or regulatory tools could result in significant fines or charges being laid against the landholder, through no fault of their own.

Compensation for taking property rights

In preparing its Final Report, the Commission should investigate the introduction of "regulatory taking" provisions with respect to managing the burden of environmental regulations on the agricultural sector. These provisions currently operate in the United States and are designed to compensate landholders where environmental protection laws deprive economically reasonable use of property.

In the Australian context, "regulatory taking" provisions should be investigated as a means of reducing the costs of environmental regulations on private landholders (principally, farmers).

Regulation of ag-vet chemicals

Economic considerations needed

Similar to the Commission's analysis of environmental regulations, the regulation of agricultural chemicals by the APVMA must equally balance economic and environmental considerations.

For example, a number of effective and productive chemicals used in North Queensland have been banned by the APVMA (for example, Diuron in 2013) without consideration for agricultural productivity or profitability. The bans have impacted the agricultural sector greatly.

Ensuring public cost for public benefit

The decision to ban chemicals often results in substantial financial burden being placed on farming enterprises. The financial burden is born through increased production costs by using newer, more expensive chemicals or through reduced productivity from sub-optimal farm management (for example, allowing the proliferation of weeds).

In making a decision to ban a chemical that causes financial stress on the farming sector, a subsidy should be paid to lower the cost of new chemicals to the price point of the existing chemicals.

In preparing its Final Report, the Commission should investigate the merits of this proposal as a means of reducing the costs of chemical regulations on farming enterprises.

Transport regulations

Heavy vehicle regulations

To reduce the burden on heavy vehicle regulation on the agricultural sector, there needs to be a better understanding of road access requirements for heavy vehicles used in the agricultural sector.

There are two different functions of heavy vehicles in the agricultural sector:

- Heavy vehicles involved in freight – trucks travelling repeatedly on public roads, on a defined route between two locations.
- Heavy vehicles involved in agricultural activities – moving machinery on public roads in a defined geographical area, often between paddocks. These vehicles are almost always Over-Size and Over-Mass (OSOM), attracting very strict and cumbersome permitting systems.

Regulations that govern the movement of OSOM agricultural vehicles are not fit for purpose and place a heavy – yet unnecessary – compliance burden the agricultural sector. The Commission's analysis of this issue in the Draft Report (PC, p313) is accurate and commonplace throughout the agricultural sector.

The Commission's view that "ideally, permits would only be required where there is a material risk to public safety or infrastructure that must be managed on a case by case basis" (PC, p306) would provide the best outcome for the agricultural sector. This outcome can be achieved through the creation of a new regulatory framework (separate to the NHVR and NHVL) for OSOM heavy vehicles involved in agricultural activities. The regulations could be set at a regional level to accommodate the unique operational requirements of different agricultural industries.

In preparing the Final Report, the Commission should examine the benefits of establishing fit-for-purpose regulations, designed for the movement of OSOM heavy vehicles involved in agricultural activities.

Specific comments on sugar marketing

In addition to the comments made in this submission, the Commission should request additional information from industry participants regarding the physical structure of the industry before drafting the Final Report.

The physical structure of the industry is economically imperfect and generates a number of barriers to a truly competitive market between suppliers (growers) and purchasers (millers) of a good (harvested sugarcane). Understanding these dynamics are important to providing informed advice.

Some key points:

- Milling infrastructure forms natural economic monopolies:
 - Sugarcane is grown in different regions, which supply a single mill (or group of mills owned by the same company);
 - There is no natural competition between mills for cane. When harvested, sugarcane becomes perishable and sugar content reduces over time. Transport from a farm in one region to a mill in another region is prohibitive; and
 - There are also substantial barriers to entry in establishing a new sugar mill (inclusive of capital cost, barriers to securing already contractually committed cane supply and regulatory planning and environmental barriers to developing such substantial infrastructure assets).
- The “cane payment formula”:
 - Is a formula used to develop a price for cane in an imperfect market (most efficient and transparent price discovery mechanism in a monopoly market);
 - Is commercially agreed between the mill and its suppliers (growers) which provides proportionate returns to both growers and mills based on the world sugar price;
 - Includes economic incentives for growers to invest in growing better cane (produce cane with higher sugar content – CCS) and for mills to invest in additional crushing capacity; and
 - Can be used to determine an “economic interest” in a single unit of sugar sold, based on the proportional returns to both the grower and the mill.
- Sugar marketing has traditionally been a single desk:
 - Prior to deregulation, sugar marketing was conducted by a statutory marketing agency; and
 - Following deregulation, sugar has been marketed through a “voluntary” single desk (Queensland Sugar Limited – QSL), existing through voluntary agreement of both mills and growers in the industry.

How Real Choice in Marketing promotes competition and innovation

Real Choice in Marketing seeks to enforce competitive tension in sugar marketing amongst mills who wish to market sugar they have manufactured by introducing a separate third party marketer of choice for growers’ economic interest in sugar manufactured – competitive tension in this form has not previously existed in the sugar industry, anywhere in the world.

Recent proposals by some milling companies to market sugar manufactured in their own mills will simply substitute existing the marketer with a mill-marketer, establishing the mill as the monopoly marketer of sugar produced.

Under both the previous and mill-marketer models, there is no competition in marketing that can drive innovation and increased productivity for the industry as Real Choice in Marketing can.

In defence of *Sugar Industry (Real Choice in Marketing) Amendment Act 2015*

Commission's framework for reviewing existing regulation

The Commission appears to have formulated Draft Recommendation 11.2 without applying its own framework for reviewing existing regulation (PC, p48) to the *Sugar Industry (Real Choice in Marketing) Amendment Act 2015* (Real Choice in Marketing).

Applying the framework demonstrates the value of the regulations governing sugar marketing, as summarised below.

| Framework for reviewing regulation | Response |
|---|--|
| What are the objectives of the regulation? | Ensure competition in the Queensland sugar industry's marketing arrangements. |
| Are the objectives of the regulation clear and relevant (do the objectives address an economic, social or environmental problem)? | Yes – the regulation addresses the economic problem of monopolistic commercial structures in sugar marketing. |
| Does the regulation achieve these objectives (is it effective)? | Yes – the regulatory framework is effective. All milling companies (bar one) and their grower suppliers have agreed upon new Cane Supply Agreements. |
| Could the costs of the regulation be reduced or the benefits increased (is there a more efficient way to achieve the same objective)? | No – all milling companies (bar one) have reached a commercial agreement with their grower suppliers. |

Implementation of Real Choice in Marketing

Implementation of Real Choice in Marketing has occurred across the sugar industry without significant compliance cost or economic distortion.

In formulating advice, the Commission is encouraged to present a view supported by the whole industry, not a single industry participant. All milling companies (bar one – Wilmar) have either reached agreement with both growers and third-party marketers or are close to reaching finalising their agreements.

Wilmar is the only milling company in the industry who appears to be employing a deliberate and disruptive strategy to implementing the Real Choice in Marketing regulations.

Response to specific claims made in Draft Report

This section seeks to clarify a number of claims made by the Commission in its Draft Report on the issue of sugar marketing.

These claims are factually incorrect and should not be repeated in the Commission's Final Report.

Before making these claims the Commission should have requested more in-depth information from industry participants.

Claim: re-regulation of the sugar industry (PC, p418)

The Commission consistently refers to Real Choice in Marketing as “re-regulation” of the sugar industry.

Re-regulation, as defined by the Oxford Dictionary is a “specific reversal or mitigation of deregulation.” An elementary understanding of Real Choice in Marketing would demonstrate that its enactment is not re-regulation of the industry.

Real Choice in Marketing makes no attempt to reinstate any of the now repealed historic regulatory protections granted to sugarcane growers, such as: production regulations (the production peak system), import tariff protections, statutory marketing and/or single desk selling arrangements.

Claim: Real Choice in Marketing is an expropriation of mill marketing rights (PC, p29)

There is no historical basis for the claim that milling companies had rights to market sugar manufactured in Australia.

All sugar mills in Australia (bar one – Wilmar) have reached, or are close to reaching, an agreement with their growers that incorporates Grower Economic Interest into their marketing arrangements.

Claim: Real Choice in Marketing will deter investment in milling capacity (PC, p29)

There is no basis for the claim that Real Choice in Marketing will deter milling investment.

All milling companies invest in milling capacity because they are incentivised to do so under the Cane Payment Formula, agreed on commercial terms between mills and their suppliers (growers).

Claim: Real Choice in Marketing will force mill exit, restricting milling competition (PC, p29)

There is no basis for the claim that Real Choice in Marketing will reduce milling competition.

Sugar mills in Australia are natural monopolies, they do not compete between each other for cane supply.

Further, sugar mills in Australia have never historically derived revenue from the process of selling (marketing) sugar. Competition in marketing arrangements will not negatively impact existing mill revenues and will therefore not impact mill viability.

Claim: reregulating the Queensland sugar industry will limit the competitive forces driving innovation and productivity growth in sugarcane farming (PC, p245)

There is no basis for the claim that Real Choice in Marketing will negatively impact on industry productivity, particularly farming productivity.

The Productivity Commission, describes productivity in the following way

To economists, productivity is the efficiency with which firms, organisations, industry, and the economy as a whole, convert inputs (labour, capital, and raw materials) into output. Productivity grows when output grows faster than inputs, which makes the existing inputs more productively efficient. Productivity does not reflect how much we value the outputs — it only measures how efficiently we use our resources to produce them. (Productivity Commission, What is Productivity and How is it Measured?, May 2015).

Using this definition, there is no way that any process in which sugar is marketed (or the change in revenues derived from marketing) could impact the process in which farmers use inputs (fertilisers, farm machinery etc.) to grow and harvest a crop of sugarcane.

Claim: reduced mill capacity will reduce structural adjustment in sugarcane growing (PC, p29)

There is no basis for the claim that Real Choice in Marketing will influence mill capacity or influence the size or productivity of sugarcane farms.

In addition, the Commission has indicated its desire to ensure regulatory reform would “yield net benefits to the community.” (PC, p47). As pursuing structural adjustment as an outcome on its own does not yield net benefits to the community, the Commission should not repeat this claim in its Final Report.

Claim: Real Choice in Sugar Marketing legislation is causing agreement re-drafting that may prohibit the industry taking advantage of high prices (PC, p422)

There is no basis for the claim that Real Choice in Marketing is causing agreement re-drafting issues across the industry.

All sugar mills in Australia (bar one – Wilmar) have reached, or are close to reaching, a commercial agreement with their growers that incorporates choice in sugar marketing.

It appears Wilmar is deliberately creating redrafting delays to create an anxious culture amongst their growers, while prices are high, as a deliberate negotiation tactic. Wilmar’s choice of negotiation tactics is not representative of the industry at large.

Claim: Competition would enable claims by millers that they can generate higher premiums for growers through alternative marketing arrangements to be tested in the marketplace, and drive innovation (p422)

There is no basis for the claim that Real Choice in Marketing would prohibit alternative marketing arrangements.

On the contrary, Real Choice in Marketing is designed to promote innovation in marketing arrangements and competitive tension in the supply of marketing services.

Further, without Real Choice in Marketing there is no way that the millers’ claims that they could generate higher marketing premiums for growers could be tested against an alternate, non mill-marketer.

Claim: It [Real Choice in Marketing] is likely to constrain innovation in marketing and continue to limit the premiums available to sugarcane growers (PC, p425)

There is no basis for the claim that mill-marketers are able to provide higher premiums to growers than under the existing arrangements.

The Commission should investigate these claims, with similar rigor applied to claims made regarding price premiums in the NSW rice industry.

Further, there is no basis for the claim that Real Choice in Marketing will restrict innovation in sugar marketing.

Other issues must be given equal consideration

In its Draft Report, the Commission has analysed the issue of sugar marketing from the perspective of a single company – Wilmar – without any due scrutiny of the claims presented. It appears no consideration has been given in the Draft Report to the implications of sugar marketing arrangements on the over 4,000 farming enterprises or on smaller milling companies in the Queensland sugar industry.

There are a number of examples:

- The Commission repeatedly expresses concern about the impact of Real Choice in Marketing on future mill investment, yet has not examined the impact of the repeal of the same regulation on future investment in the farming side of the industry;
- The Commission has not investigated the impact of reduced transparency in marketing arrangements or the of potential loss of regional price premiums on returns to growers;
- The Commission has expressed concern about the implications of mill exit on the industry, yet have not examined the impact of grower exit on the industry; and
- The Commission has not examined how sugar is marketed internationally and how proceeds from the sale of sugar are passed from mills to growers in other markets.

Further, the Commission appears to have not examined the benefits Real Choice in Marketing provides to a number of sugar milling companies who are not vertically integrated with international sugar trading business. The Commission has also not considered the impact of changes in sugar marketing arrangements on bulk storage and port logistics across the sugar industry.

In preparing its Final Report, the Commission must examine these issues and the broader impacts changes in sugar marketing arrangements have on the farming side of the sugar industry.

Weighing up the costs and the benefits

The introduction of Real Choice in Marketing has not added any additional regulatory burden to sugar mills and has not reduced any revenue earning capacity from the process of sugar milling. The regulation is not unnecessarily burdensome, complex or redundant.

At the same time, Real Choice in Marketing has ensured competition in sugar marketing which will foster innovative marketing practices, in turn improving the international competitiveness of the whole Australian sugar industry.

Further, the transparency in price discovery secured by Real Choice in Marketing underpins the confidence required for the 4,000 growers in the industry to continue to invest in the growing sugarcane.

Further areas that may require a regulatory response

There are a number of issues affecting the agricultural sector that deserve further investigation by the Commission, in preparation of its Final Report.

Electricity prices

System-wide regulatory failure in the electricity sector is inflating electricity prices and keeping them artificially high. While high prices affects all electricity consumers, they are of particular concern to many farm businesses – with greater impact on productivity and profitability than water or labour regulations.

An option to reduce the burden of regulatory failure on the agricultural sector is to require network companies to develop a suite of tariffs dedicated irrigation. The development of tariffs dedicated for irrigation can be achieved in accordance with the National Electricity Law, as it will be economically efficient to classify irrigators as a separate customer class.

The impact of regulatory failure in the electricity sector and its impact on the agricultural sector deserves particular attention in the Commission's Final Report.

Vertical integration within the supply chain

At a time when various competition reforms in health, education and the utilities sectors are trying to breaking up monopolies (or make various functions of monopolies contestable) economic monopolies are proliferating in agricultural sector.

Vertical integration in the agricultural sector is proliferating and creating natural monopolies throughout the supply chain. In nearly all cases, the vertical integration is occurring between the purchasing and manufacturing of agricultural products, with monopolistic impacts (sub-optimal pricing) on the farming side of the sector.

The effects of growing vertical integration are straightforward: less competition between food manufacturers and marketers is driving monopolistic pricing behaviours of manufacturers towards farmers. In many cases, the increasing vertical integration of an industry increases international market risks for the primary producers, without any commensurate increase in farm-gate returns (as marketing premiums are often captured by the vertically integrated manufacturer/marketer).

Another issue that warrants further investigation by the Commission is the risk of monoponistic behaviour from vertically integrated, internationally-owned food businesses. The cause for concern originates from the economic incentives for large food businesses vertically integrating with raw commodity manufacturers in Australia – principally to secure access to reliable produce at cost price (without manufacturer retail margin).

In this environment, not only is there are risk of anti-competitive pricing behaviour towards primary producers, there are also risks to the broader community through potential corporate tax avoidance between the Australian entity (the manufacturer, seller of a commodity) and the international entity (the food business, purchaser of the same commodity).

The Commission should investigate these issues and examine the need for regulation to ensure increasing vertical integration in the agricultural supply chain is beneficial to other industry participants and the Australian community at large.

Geographic concentration of economic infrastructure

Increasing concentration of key economic infrastructure in the agricultural is becoming an impediment to competition that is impacting the productivity and profitability of other participants in the agricultural supply chain.

Of principal concern is the concentration of ownership of manufacturing assets in particular agricultural zones, creating natural economic monopolies through physical ownership. These natural monopolies remove competitive forces within certain segments of the agricultural supply chain, stifle commodity-wide innovation and enable monopolistic pricing behavior.

In its Final Report, the Commission should examine the community-wide merits of regulation that prohibits the geographic concentration of ownership of key economic infrastructure in the agricultural sector.