



Productivity Commission
Submission to the
National Competition
Policy Review of the
Wheat Marketing Act 1989

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PRODUCTIVITY
COMMISSION

From the Chairman's Office

6 July 2000

Mr M Irving AM
Chairman
NCP Wheat Review
Department of Agriculture, Fisheries and Forestry
GPO Box 858
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Dear Mr Irving

The Productivity Commission is grateful for this opportunity to make a submission to the National Competition Policy Review of the Wheat Marketing Act 1989.

As noted in the issues paper for the Review, a major focus of the Committee will be on the single desk export arrangements for wheat. This submission concentrates on the potential costs and benefits of these arrangements and feasible alternative arrangements. Because the Commission has not had the advantage of the consultative processes and evidence available to the Committee, this submission does not attempt to quantify costs and benefits of current arrangements. Rather, it sets out to provide a framework for analysing economic arguments for continuation of the single export desk for wheat.

The submission draws on a forthcoming staff research paper, *Single Desk Marketing: Assessing the Economic Arguments*, an advance copy of which is enclosed. The staff research paper is under embargo until 1.00am Monday, 17 July 2000, at which time the submission will be placed on the Commission's website.

Yours faithfully

Gary Banks

Submission to the National Competition Policy Review of the *Wheat Marketing Act 1989*

1 Introduction

Marketing arrangements for Australian wheat have changed substantially over the past decade or so. Domestic wheat marketing has been opened to competition and the AWB has been re-established as a private corporation with explicit allocation of shares to wheat producers-cum-owners. These and other changes have improved the efficiency of marketing and related activities with consequential benefits to wheat growers. The relevant question today is whether the remaining monopoly over wheat exports is helping or hindering this major export industry.¹

The Commission recognises that a majority of producers continues to support the single export desk for wheat, though a large and growing number appears keen to explore alternative marketing arrangements. Opposition to change may, in part, simply reflect an attachment to accustomed ways of doing things. Some growers may be concerned that they will be compelled to perform unfamiliar marketing functions themselves, or be forced to deal with international commodity traders and processors. Some producers may also consider that they would be worse off due to reduced wheat prices, and/or removal of the implicit cross-subsidisation that typically occurs under current averaging arrangements. As joint owners of AWB Limited, growers may also fear a reduction in asset value (and profits) if competition is allowed, as well as loss of their control over marketing functions.

This submission, drawing on more general research on single-desk arrangements, provides a framework in which these and other economic issues relevant to wheat marketing may be further explored and evaluated by the Committee. While not having the benefit of the consultative process and evidence available to the

¹ This submission draws on the Productivity Commission Staff Research Paper *Single-desk Marketing: Assessing the Economic Arguments*, AusInfo, 2000, as well as previous reports and research by the Productivity Commission and its predecessors, the Industry Commission and Industries Assistance Commission. Relevant references are listed in the staff research paper.

Committee, the Commission considers that many of the concerns and objectives of growers can be addressed by more targeted mechanisms than the single desk while, at the same time, giving growers greater choice of marketing arrangements and service providers. Moreover, while the interests of growers and the wheat industry are very important, the Competition Principles Agreement correctly requires that the interests of the wider community should be paramount.

2 Potential benefits of the single export desk for wheat

Some of the claimed benefits of single-desk selling of wheat derive from the potential to raise wheat prices by controlling the quantity sold on export and domestic markets. Others derive from collective marketing of wheat itself, including the potential for achieving various economies of scale and scope. Another strand of argument relates to grower control of wheat marketing. In the Commission's view, it is important to 'unbundle' the various arguments in order to assess which aspects of the single desk might deliver benefits.

Influencing prices in export markets

Single-desk export selling compels individual growers of wheat to export via AWB Limited or with the permission of the Wheat Export Authority (WEA), in consultation with AWB Limited. These arrangements can act as a mechanism for exploiting Australia's market power in international markets for wheat *only if the potential for such power exists*. Such market power is not created automatically by the establishment of a single desk. This is because the export desk can control the volume and characteristics of Australian exports, but it cannot control foreign supplies of wheat or substitute products.

If Australia were the sole global exporter (and sole producer) of wheat (and there were not close substitutes available), it clearly would have market power which the single desk could exploit. If it were the *dominant* supplier, it also would be likely to have some market power. In practice, however, though a significant wheat exporter, Australian wheat exports overall constituted about 16 per cent of international trade in wheat in 1998-99 (ABARE, *Australian Commodity Statistics 1999*). Australian production of wheat represented less than 4 per cent of global production. In addition, in many end uses, other grains are substitutable for wheat to varying degrees.

Even in those markets where Australia has a substantial market share (for example, in 1998-99, Australia accounted for 76 per cent of Iran's imports of wheat; 49 per cent in Iraq; and 48 per cent in Indonesia), there can be no presumption that Australia has market power which would allow it to extract a price premium. This will depend on how easily importers in these markets can switch to alternative suppliers.

That said, arbitrage across export markets is unlikely to be perfect, allowing prices in some markets to diverge from world prices. This could give Australian wheat producers a degree of market power in some markets which, in turn, the single desk could exploit. As discussed in chapter 3 of the attached paper, such circumstances include transport or seasonal advantages and certain trade policies of importing countries which restrict competition among suppliers.

The Commission understands that AWB Limited claims that it can exploit market power in some markets due to transport advantages and the buying policies of some countries. It also has been suggested that the single desk allows AWB Limited to counter monopoly buying power of some importers, and the grain subsidy policies of the United States and European Union. These arguments are considered in turn.

Transport and seasonal advantages

If Australia has a locational (or seasonal) advantage in supplying some markets, which generates lower transport or storage costs for Australian producers than competitors, Australian exporters could capture the transport or storage 'premium'. This could be achieved by controlling the supply of exports to that market to the point that the selling price of Australian exports was just below the price of (potential) competitors. Through this strategy, Australia would be the sole supplier of wheat exports (of a certain quality) to this market.

A major risk of such a strategy is that the apparent 'natural' advantage may not be permanent — rival exporters may be able to reduce their costs. If exports are restricted in the belief that Australia has a permanent advantage in supplying a market when, in fact, the advantage is transitory, limiting exports to the market would encourage competition from rivals and reduce Australia's market share in the longer run.

Preferential access to export markets

Some importing countries' import policies or practices (possibly driven by political constraints or objectives) may give preferential access to Australian wheat exports. Others might allocate quotas for Australian wheat imports as part of an overall

import quota policy. In both circumstances, there may be some scope for extracting a premium in these markets, relative to world prices, because scope for competition from rival exporters is restricted.

In the past, the AWB has suggested that it could extract a premium in countries where buying was controlled by State Trading Enterprises. It is possible that these government-buying monopolies pursued political or other non-economic objectives and thus were prepared to concede a premium to Australian wheat exporters (over and above any premiums for higher quality and customer service). Capturing the premium might require some coordination of exports to that market to restrict price competition by Australian exporters.

However, care should be taken in evaluating claims that rely on an importer allowing Australian wheat exporters to capture premiums at the importing country's expense. It also is important to clarify whether any estimates of premiums from such countries can be genuinely attributed to market power, rather than to 'earned' premiums arising from the supply of special customer services. For example, AWB Limited suggests that it can extract premiums by negotiating long-term contracts and agreements with buyers. But any premiums may reflect the value placed on guaranteed supplies by the buyer (and the additional costs of supplying the guarantee) rather than market power being exercised by Australia. The Commission also understands that controlled government buying (via State Trading Enterprises) in several important wheat markets in the Middle East and Asia is being dismantled.

Countering monopoly buying power

Some large importing countries may attempt to exercise buying power to push down the price they pay for Australian wheat. However, a countervailing strategy can be successful for Australia only where competition (and potential competition) from other suppliers is weak or constrained — allowing Australia to affect prices. If the buyer simply can switch suppliers without incurring higher prices — which is more likely to be the case in world wheat markets — Australian exporters will not have any scope to raise the price they receive by restricting their exports.

Countering export subsidies

The argument that an Australian single export desk for wheat is required because export markets are distorted by grain subsidies paid to European and US producers is weak. Wheat prices may be distorted, but this of itself does not give Australia market power. What is required is some restriction on arbitrage between export markets.

AWB Limited has negligible power to counter export subsidies of rival exporting nations, in the sense of forcing the United States or the European Union to cease subsidising exports. A single desk (or, for that matter, Australian taxpayers) simply does not have the means to match such policies; nor indeed, is it guaranteed that such a strategy would succeed in having the subsidies withdrawn. In recognition of the limitations and potentially large costs of such an approach, Australia has formed bargaining coalitions within the multilateral trade negotiation framework (the Cairns Group being the principal example) to push for agricultural trade policy reform.

AWB Limited may have the capacity to engage in a discount war with a rival in one export market with a view to increasing or maintaining market share. But the conditions necessary for such a policy to generate net benefits for wheat growers are stringent. Net benefits can accrue only if profits gained subsequent to discounting exceed losses incurred while discounting. In practice, with the ever-present threat of competition from other suppliers, it may prove impossible to maintain such gains in market share without also maintaining discount prices.

A related suggestion is that the single desk allows AWB Limited to divert exports away from markets subsidised by the United States and European Union to unsubsidised markets. However, this process of diverting supplies from lower-priced to higher-priced markets is just the arbitrage which occurs under competitive exporting — neither a single desk, nor any other form of control of export quantities, is required. Unless arbitrage is restricted, over time, higher prices received in the unsubsidised markets will tend to be pushed down to the prices received in subsidised markets.

Is a single desk necessary to capture premiums arising from market power?

Given the number of significant exporters and producers of wheat internationally, and the erosion of buying monopolies, the Commission considers it unlikely that Australia possesses sufficient market power in world markets to justify continuation of the export monopoly.

Nonetheless, if it can be demonstrated to the Committee that arrangements in some particular markets are such that Australia faces restricted competition from rivals and that higher than normal returns are available to Australian exports on a continuing basis, it may make sense to put in place mechanisms to capture this benefit. However, this would not require a monopoly over *all* Australian exports via the single desk.

For example, auctioning of limited export rights to supply markets where premiums are clearly available would allow the premium to be captured while allowing competitive selling to all other markets, including the Australian domestic market. The premium, captured in the tender bid, could be distributed to all producers directly (for example, as an annual cash payment apportioned according to the value of production) or used for activities which potentially benefited all producers (for example, research and development). Auctioning of export licences has the advantage of transparency (because the size of the expected market premium is revealed). Moreover, compared with an allocation of a licence or a single desk, the most efficient seller(s) are likely to win the export right.

Several Australian agricultural industries already have targeted mechanisms in place that are designed to extract premiums in quota-restricted markets (for example beef, dairy, Queensland barley). These models could be considered for the wheat industry if any premium markets are identified.

‘Earned’ export premiums

Other suggested benefits of the single desk include higher export returns attributable to specialised marketing services (including the provision of customer credit) and a long-term commitment to develop markets for ‘Australian’ brands. These are arguments for the common *marketing* of exports, rather than monopoly control over exports as such.

In the Commission’s view, these arguments carry little weight. An inference seems to be that competition would result in spot selling of low quality, homogeneous wheat. On the contrary, competitive markets do not generally result in under-provision of customer services, or of market or variety development. Indeed, in the absence of the single desk, it might be expected that there would be more tailoring and development of products and markets and provision of ancillary customer services to meet consumers’ needs. The Australian cotton and wine industries provide relevant examples of industries that undertake significant amounts of market development and value-adding, without recourse to monopoly marketing.

Some services provided by the AWB might not be provided, or provided to the same extent, in a competitive market. These include services that are not profitable and activities which generate benefits that a private provider could not fully capture:

- it is possible that AWB Limited may offer services that are not profitable. Pressure on the AWB to improve efficiency and pass on cost savings to wheat growers has increased in recent years (through opening of the domestic market, some relaxation of the export monopoly, and demutualisation and

corporatisation). Nevertheless, the absence of many of the normal market constraints on performance (the lack of competition and the compulsion on growers to invest in and export via the AWB) may allow some inefficiencies to persist; and

- some services provided by the AWB may generate industry-wide benefits. For example, promotion of generic ‘Australian’ wheat, or generic wheat research. Marketers in a competitive market may not promote ‘Australian’ wheat or undertake generic research to the same extent as the AWB if competitors can benefit (free of charge) from their expenditure. This does not mean that they will not promote their own Australian ‘brands’ or varieties or undertake research and development, but they may be less inclined to undertake ‘generic’ expenditure from which rivals might also benefit.

However, if it were considered appropriate to promote a national brand or trademark, this could be funded via an industry levy scheme — single-desk marketing is not required. Similarly, quality licensing might be considered necessary to prevent ‘contamination’ of the export trade by inferior exports where consumers are unable to differentiate between Australian exports prior to purchase. (The Australian wine and meat industries, for example, have in place quality control mechanisms for exports, but marketing is not centrally-controlled.) Generic product or market research could also be financed by an industry levy. Several Australian industries have in place targeted levy schemes to promote industry research and development (for example, the cotton industry has a voluntary levy scheme).

Lower costs for producers?

The issues paper asks whether the single desk generates cost savings in areas such as financing grower returns, freight, storage and shipping. In some cases the AWB provides services itself. In others, it acts as an agent, buying services from other providers (including other commodity traders). It may be the case that there are economies of scale or scope in services provided by the AWB. It may be able to negotiate lower shipping rates due to volumes exported. But a protected monopoly is not generally required to promote the organisational structure capable of exploiting efficient economies of scale and scope — large firms can also evolve in competitive markets, driven by the incentive to reduce costs. Indeed, in the absence of competitive pressure, the monopoly seller may be a less efficient provider (or buyer) of services than competing providers.

In addition, some economies of scale generated by compulsory marketing of a generic commodity may not be cost-effective if they are achieved at the expense of variety or product characteristics that consumers value. If this is the case, any lower

costs arising from economies of scale achieved through compulsory aggregation of the commodity must be balanced against forfeited price premiums.

Some people suggest that, in the absence of a single desk, individual growers would be forced to manage their own risk, raise their own finance and market and transport their own produce. This is not so: they would face a wide range of choices for these services, including continued provision by AWB Limited. For example, they would be able to buy services provided by specialists who can exploit global economies of scale and scope. Because these providers (AWB and others) would be competing with each other to provide services, cost savings would be passed on to Australian producers. Importantly, wheat producers would only choose to sell through other traders if they received a better return — in other words, the claim that the AWB's monopoly generates cost savings for growers would be put to the test. If the AWB is the most efficient provider, growers would continue to trade through the AWB and its dominant position (and scale and scope of operations) would not be affected.

Risk management

The AWB has emphasised its access to relatively cheap finance as a major advantage of single-desk selling. Finance is raised to meet interim pool payments to growers or to invest in storage and other facilities. The protected monopoly status of the single desk may serve to reduce its financial risk to lenders and thus deliver lower debt costs, resulting in savings which can be passed on to growers. However, though financiers might reasonably conclude that a business with a regulated monopoly is a better risk than a business operating in a competitive environment, it does not necessarily follow that it is in the interests of growers or the nation.

Debt costs of AWB Limited might also be lower to the extent that wheat growers are compelled to bear levels of price risk which, in a more competitive market, they might prefer to shift. Thus while interest rates paid to credit providers might be lower with a single-desk monopoly, producer returns can fluctuate with market conditions and the performance of the single desk. Producers may save on finance costs of the single desk, but at the cost of bearing a higher level of risk than some might prefer (or at the cost of covering that risk by another route).

Grower control of marketing?

Current wheat marketing arrangements had their genesis in the voluntary grower cooperatives established in the early 1900s. A major objective was, and continues to be, producer control of marketing in order to avoid exploitation by 'middlemen' and

processors. However, commodity producers can only be exploited if they do not have a choice of buyer.

The compulsory cooperative model supported by many wheat producers, by restricting competition, may be less efficient and deliver lower returns to growers than competitive arrangements. Without clear identification of shareholdings and profits, producers cannot assess whether an SMA is performing efficiently or whether its assets are earning an adequate return. In addition, a cooperative SMA is reliant on producer equity, which may place it at a disadvantage *vis-à-vis* investor-controlled corporations which can raise funds from the market.

These issues have been addressed to some extent in the wheat industry by corporatisation and privatisation of the AWB, with explicit allocation of shareholdings to wheat producers. This should allow better monitoring by growers-cum-owners of the performance of AWB investments and returns to commodity production. Moreover, by unbundling dividends and commodity payments, producers should be better able to compare commodity prices paid by the AWB and those paid by commercial marketers. This should place additional pressure on the AWB to improve efficiency and pursue profitable marketing opportunities.

However, as long as producers effectively are locked into ownership of the AWB, normal market constraints on and signals regarding company performance do not operate. There is a proposal to allow public listing and trading of certain classes of AWB Limited shares which will introduce additional competitive pressures and inevitably create tensions between shareholder and grower interests. Ultimately, it would be desirable to allow wheat growers to choose how they hold their assets. This would not necessarily mean an end to producer control — this will depend on producers and whether they consider they can obtain a better return from investment in activities other than AWB Limited.

Growers may be concerned that the removal of the single desk status of the AWB would reduce shareholder value. This outcome is possible only if the AWB's monopoly generates higher dividends (or grower returns). However, if the monopoly were allowing inefficiency and discouraging innovation, its removal could open up profitable opportunities which in turn could increase shareholder wealth. Experience of deregulation in other industries (for example, Queensland grains) and countries (for example, South Africa) suggests that the incumbent SMA, reconstituted as a private corporation, typically becomes a major player in a deregulated market, providing marketing, risk management (including voluntary pools) and other services to growers, albeit on a purely voluntary and commercial basis. In addition, the AWB would only lose market share if some Australian wheat producers considered that they could obtain better returns by using alternative marketing arrangements.

The issues paper also raised the question of whether use of foreign traders is likely to remove wealth from Australian rural areas. Australian wheat growers presumably would sell to a foreign trader only if they received higher returns than they would from the AWB or other Australian buyers — in other words, only if they were better off. This would increase rural wealth, not reduce it.

3 Potential costs of single desk marketing of wheat

In broad terms, there are two main sources of potential costs of the AWB single desk: higher domestic prices for wheat and lost opportunities and inefficiency within wheat marketing itself.

Higher domestic prices?

Some domestic users of wheat (for example, the pigmeat industry and food processing sector) and rival marketing organisations suggest that, despite deregulation of the domestic wheat market, AWB Limited continues to enjoy an advantage in the domestic market by virtue of its export monopoly.

To some extent this may merely reflect habit on the part of wheat producers and a reluctance to experiment with alternative traders. Such attitudes are likely to wane over time. However, the export monopoly could provide AWB Limited with some scope to extract higher returns from the domestic market because, unlike its potential competitors in the domestic market, it can spread risk and costs over both export and domestic markets. AWB Limited may thus be in a position to offer a higher net return to growers (for a given world price). (If this is the case, it suggests that large scale, rather than an export monopoly as such, is efficient and could be expected to emerge in a competitive market.)

In addition, if wheat pool payments continue to ‘bundle’ some returns to marketing activities and investments with returns to commodity production, growers may be reluctant to forgo such returns on their (compulsory) investments by selling to other marketing organisations.

To the extent that AWB Limited can use its monopoly export powers effectively to discourage growers selling to the domestic market via other traders, it could dominate the domestic market, and possibly raise domestic wheat prices above world prices. This might increase returns to wheat producers somewhat but, in turn, would disadvantage downstream processors (especially those who compete internationally) and, possibly, final buyers. In this case, an increase in wheat grower returns is paid for by domestic users through higher prices. The net effect on

national income is likely to be negative, reflecting reductions in domestic wheat processing and consumption.

Impact on wheat industry performance

The current export monopoly may impair long-term performance of the wheat industry in several ways:

- compulsory pooling and averaging arrangements (which are an inevitable part of the process of aggregation which occurs under the single desk) limit recognition of product quality and other valued product characteristics, tending to reward lower-valued products at the expense of higher-valued products, and discouraging the more efficient and innovative producers. AWB Limited today recognises several product grades and varieties but it cannot emulate a dynamic market outcome, as evidenced perhaps by the significant increase in demand for containerised export permits via the WEA; and
- without competition in the range of activities provided by AWB Limited to growers and customers, there is no guarantee that these services are provided efficiently and are giving the best-possible returns to wheat growers. While changes in the AWB's structure may 'unbundle' production and marketing income streams, thus exposing the efficiency of the AWB's activities to a greater extent, wheat growers continue to be denied the opportunity to export independently, and to arrange and select the most efficient transport, handling and shipping providers.

Importantly, the AWB single desk effectively precludes development of alternative market structures — for example, informal and formal integration between growers, marketers and processors, and direct relationships with customers. It also may inhibit the development, and export, of Australian marketing expertise, including by the AWB itself.

It is impossible to quantify these potential effects because they involve lost opportunities. Yet the costs of a lack of flexibility and dynamism may be very large and are likely to be increasing. There have been important changes in the production technology of agricultural products, the relationship between the agricultural sector and the downstream processing sector and in customers' requirements for agricultural products. This is underlined by pressure from many wheat growers who see opportunities in being able to deal directly with customers.

4 Conclusion

As noted at the outset, this submission has not attempted to quantify the costs and benefits of single desk arrangements but, rather, to set out a framework for evaluating those costs and benefits. In the Commission's view, application of this framework suggests that it is unlikely that the current wheat export marketing monopoly generates net benefits for Australia or, indeed, wheat producers themselves. The fundamental reasons for this assessment are that:

- the current lack of choice for wheat growers is likely to be impairing efficiency and innovation within the industry; and
- most if not all of the potential benefits of the AWB's single desk could be achieved under competitive selling arrangements combined with, if necessary, targeted mechanisms which could promote industry-wide activities and exploitation of export premiums in identified markets.

A desirable outcome of this review, therefore, would be to limit compulsory arrangements to those markets or activities where benefits of compulsion can be demonstrated to outweigh the costs, and to allow competition in all other markets and activities.

In the Commission's view, the introduction of greater freedom of choice for those wheat producers who wish to explore alternative marketing, risk management, transport and handling arrangements would promote the performance of the wheat industry and contribute to wealth creation in rural areas. Those producers who do not wish to change current practice would be free to continue to use (and continue to own) AWB Limited, as their service provider and agent of choice.