GRAIN LICENSING AUTHORITY

SUBMISSION TO THE ECONOMIC REGULATION AUTHORITY

FOR THE REVIEW OF THE GRAIN MARKETING ACT 2002

FEBRUARY 2008

Scope

This submission from the Grain Licensing Authority (GLA) attempts to highlight the issues it has experienced whilst administering the *Grain Marketing Act 2002* and operating the licensing scheme for bulk exports of barley, canola and lupins. This submission does not seek to build a case for or against deregulation but does explain the issues which the GLA would like to see investigated in the pending review and why. Most of the issues have been listed in the Issues Paper released by the Economic Regulation Authority (ERA). This submission also includes some specific recommendations and considerations for any potential future licensing scheme.

The GLA have identified the following main issues for investigation:

1.0 The prescribed grain status of lupins, canola and barley

2.0 The intent of the Act in protecting the single desk or main export licence (held by Grain Pool Proprietary Limited – GPPL) versus protecting pools, including the appropriate level and type of pooling

3.0 Information provided by the current main export licence holder, GPPL and evidence of price premiums due to market power

4.0 Transparency of GLA decisions

5.0 Potential impediments for Special Export Licence (SEL) Holders in accumulating grain and executing licences

If the ERA review recommends retaining any form of licensing system then the following issues need to be addressed:

6.0 Export controls (scope and definition) and offences applicable under any potential future licensing system

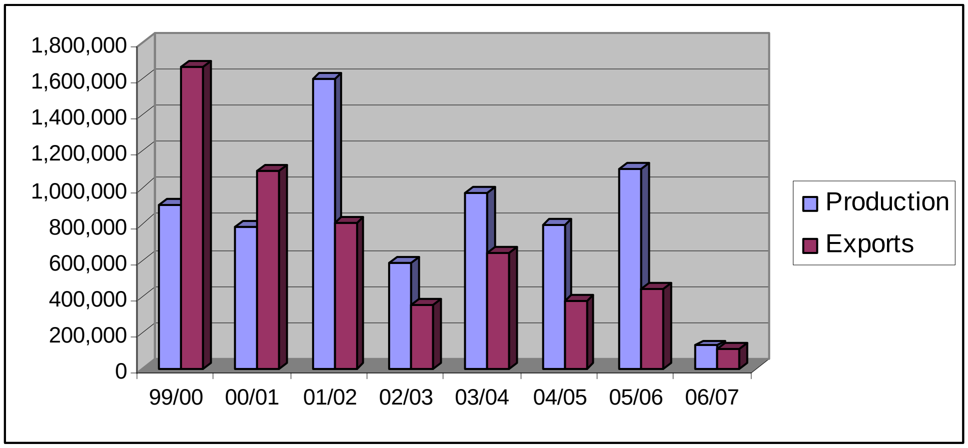
7.0 The appropriate fees and charges for licences under any potential future licensing system

1.0 Prescribed grain status of lupins, canola and barley

1.1 Lupins

Western Australia's lupin production has been declining in recent years and despite being the world's largest producer of lupins, exports have declined significantly since 1999/2000. If there was a return to normal seasonal conditions and fertiliser (nitrogen) costs continued to increase, it is possible that farmers may increase their lupin production once again.

Figure 1. WA lupin production vs exports



Note: Export may be greater than production where stock has been carried from a previous season of production

Source: ABARE Commodity Statistics and DAFWA Agrifood Infonet

At present, the majority of lupins produced in Western Australia are used on farm as animal feed, sold domestically or shipped in containers. There are some small groups emerging in the business of growing and marketing Western Australian lupins. Western Australia's main export markets for lupins are the European Union (EU), South Korea and Japan. In the feed markets, lupins can be easily substituted for other high protein feed sources such as soybean meal.

There have been only two applications for lupins both of which were approved however there were no shipments under these licences.

Table 1. SEL applications and licences for lupins

No. of applications	Tonnes applied for	No. of SEL's granted	Tonnes granted	Tonnes shipped
2	80,000	2	80,000	0

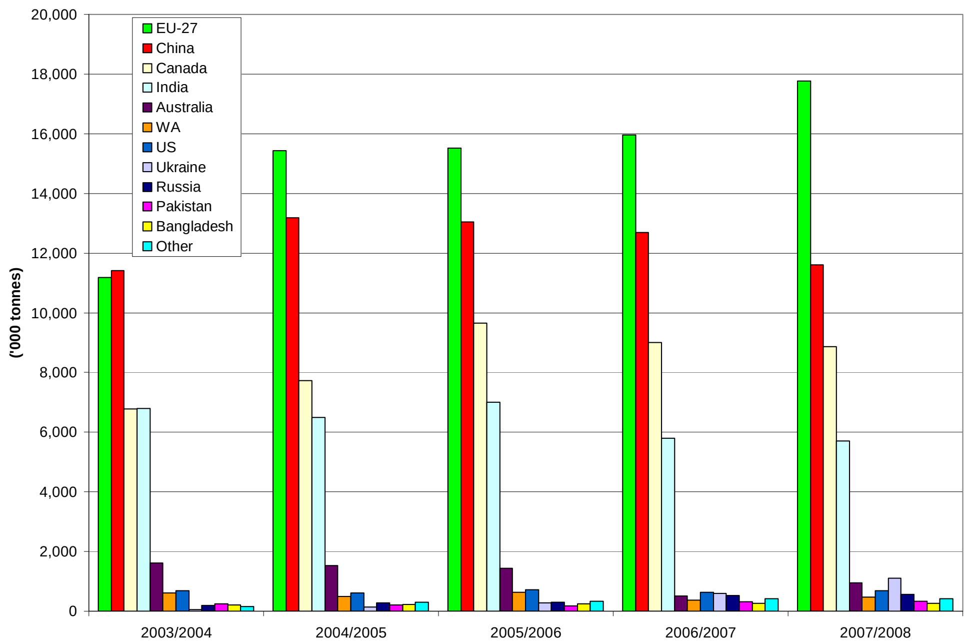
Source: Grain Licensing Authority 2008

With decreasing exportable surpluses from Western Australia and the fact that lupins can be easily substituted for other high protein feed it would seem, at present, unnecessary to retain controls on the bulk exports of lupins. If production were to return to past levels of up to 1 million tonnes per annum then opportunities would arise for industry to establish supply chains into the niche export markets.

1.2 Canola

When comparing Western Australia canola production to the rest of the world, figure 3 below highlights that the EU, Canada, China and India are the major canola producers in contrast to Australia and Western Australia which are very small producers.

Figure 3. World canola production



Source: USDA – FSA PSD online (2007) *Production, Supply and Distribution Online*

In terms of trade, Western Australia is also relatively small on the global scale. Canada is the largest exporter of canola in the world, accounting for over 75 per cent of global trade during the last five years. Australia's share of recent global canola trade has varied from 22 per cent in 2003/04 to a low of 5 per cent in 2007/08. Western Australian contribution to global canola trade has ranged from 5 per cent in 2006/07 to 11 per cent in 2003/04.

The major importers of canola are Japan, Mexico, China and Pakistan. These four countries have recently averaged 77 per cent of world canola imports. An estimated trade matrix based on a 5 year average is presented below.

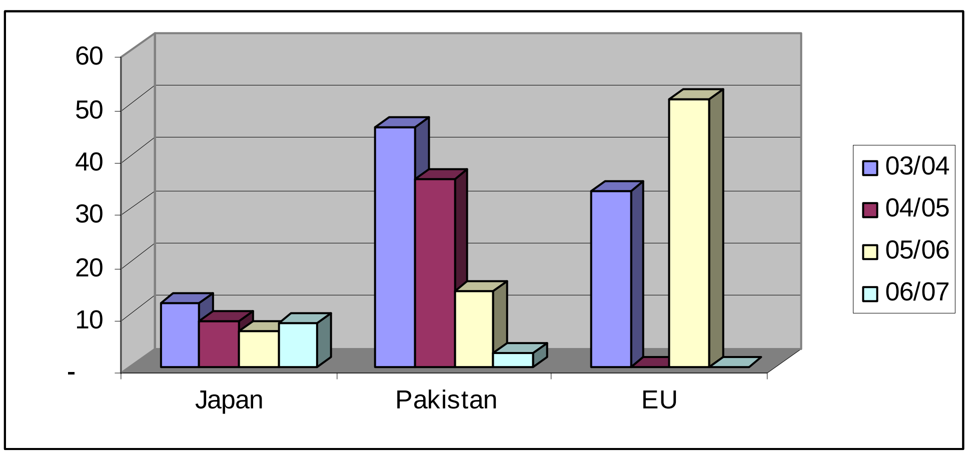
Table 2. Canola trade matrix (percentages)

		Importers			
		Japan	Mexico	China	Pakistan
Exporters	Canada	78	85	45	23
	Australia	21		41	48
	Ukraine				0
	United States	<1	5		
	EU	1	11	14	28
	Russian Federation			<1	
	Other			<1	<1

Source: UN Comtrade Data reported by Foster and French

Economically speaking, a seller would need to have at least 40 per cent market share to be able to exert market power, according to the Australian Competition and Consumer Commission (ACCC). Figure 2 below shows that even if a single desk seller had access to the entire exportable Western Australian canola crop, it would not be able to consistently maintain a 40 per cent market share in any of Western Australia's key markets.

Figure 2. WA canola market share in key markets (%)



Source: DAFWA 2008, USDA FAS Online 2008

The current main export licence holder, GPPL has in the past claimed that it can extract a premium for canola in Japan and Pakistan through the use of its 'single desk'.

The GLA has since its inception, commissioned a number of reports by independent consultants to investigate this matter. Below is a summary of conclusions from those reports.

One of the reports for canola into Pakistan concluded the following:

- *In the Pakistan market, Australia has an ongoing long term supply role.*
- *The 60-70 per cent of Australian canola produced outside of Western Australia is all freely exported into world markets.*
- *GPPL use a trading house, as its preferred partner to sell into Pakistan. In its marketing to Pakistan, GPPL does not deal directly with local buyers. GPPL claim this is to avoid counterparty risk.*
- *GPPL is hopeful that it will develop Pakistan as a market where additional premiums are available.*
- *Freight and quality premiums will be available against some competing origins and freight premiums will be available against other Australian States.*
- *If special export licences were granted for the export of canola to Pakistan, then Western Australia would still be able to achieve a similar volume of canola into this market.*

The report could not conclude that any 'single desk' marketing premiums are available.

For canola into Japan the following observations were made:

- *There does not appear to be further growth in the Japanese market, therefore all other origins entering Japan will be forced to buy entry into that market by displacing Canadian seed through discounting of price.*
- *In Japan there are now two groups controlling nearly 80 per cent of the market. Mergers are likely to continue and lead to some further rationalizing of the market in the form of plant closures and the construction of more modern and larger capacity facilities.*
- *Canadian Canola FOB prices are the same to all destinations and show no specific premium exists in any market other than the origin freight advantage.*
- *Canola is a global market place. In today's markets we can see just how volatile prices can be. In Canada, the market operates openly and prices are discovered daily to the benefit of the grower. There is true competition in the market between the buyers and daily events that bring price volatility. The variety of contract options that the Canadian industry provides, offers flexibility to the farmer and allows them to make sound marketing decisions.*
- *It would appear to be logical that Western Australia, which clearly finds its price direction from open market prices in Canada, should also consider opening the market up to increased competition. There is very little doubt that when a farmer has something to sell, his options are better where there are more buyers than sellers.*

- *The main benefit presented in support of single desk selling is the ability of single desk sellers to extract a price premium from the exercise of market power.*
- *However, the existence of a price premium depends upon a crucial assumption of the existence of a highly oligopolistic market structure - that is a market structure dominated by a few firms in which these firms are able to control information and the flow of substitutes. If anything, the market place for canola appears to becoming more, rather than less, transparent as is evidenced by the very thin margins available from trading and the increasing reliance by traders to extract margins from a offering a range of services and quality specifications.*
- *Most importantly, there is a contradiction involved with the exercise of market power by an organisation that seeks to develop close relationships with its end users to extract price premium on the basis of service and quality provision, as the two would appear to be mutually exclusive.*
- *It would appear that the GPPL's single desk selling powers provides little or no scope to achieve a premium when selling canola from the exercise of market power. Other 'benefits' of the single desk such as ensuring quality, savings by shipping C&F and year-round supply can be achieved without the single desk.*

In addition to these reports, there were also the independent assessments of price premiums due to market power conducted by Advance Trading Australia in 2006, Storey Marketing Services in 2005 and Farm Horizons in 2004. These all concluded that due to the highly competitive nature of the international grain market and GPPL's relatively small market share in most key canola markets, it was unlikely GPPL would be able to exert market power.

In view of the findings above, the GLA has little evidence of price premiums due to market power. With the existence of a transparent and liquid forward market for growers to utilise there appears to be little justification to support single desk marketing for canola.

1.3 Barley

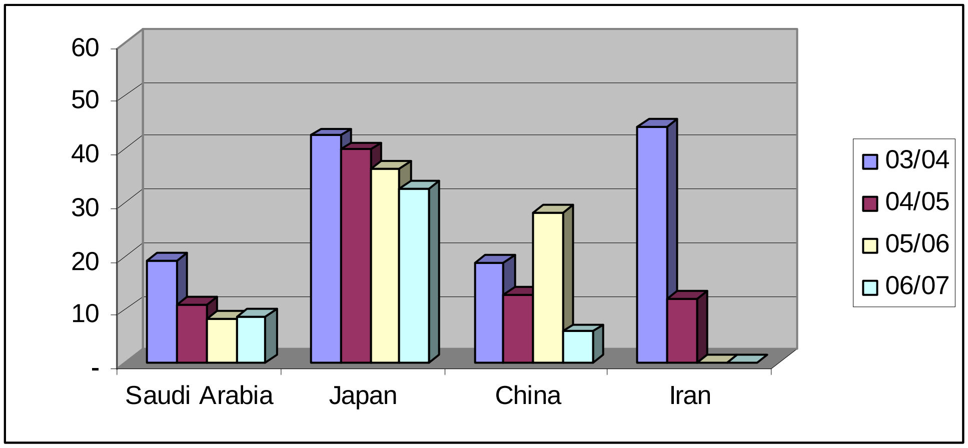
Western Australia's main markets for barley include Japan (feed and malting), Saudi Arabia (feed) and China (malting barley).

The three independent assessments on price premiums due to market power indicated there is potential for price premiums for Western Australian feed and malting barley into Japan.

Japan consumes approximately 1.65 million tonnes of barley per annum and there is no indication that it will show a significant increase in the near future. On the contrary, some decline is expected as Japan's cattle population shrinks.

Western Australia consistently supplies one third of Japan's total barley imports, but has rarely supplied over 40 per cent of Japan's total imports. Western Australia's market share for barley Japan has ranged from 32 per cent to 42 per cent in recent years. The majority of barley supplied is for feed purposes.

WA barley market share in key markets (%)



Source: DAFWA, 2008 and USDA FAS Circular Series FG 09-09, Sept 2007.

Japanese markets are highly regulated through the Simultaneous Buy and Sell (SBS) system. The SBS system was introduced in 1999 for feed barley and in 2007 for barley used for human consumption (i.e. malting barley). It limits the number of companies allowed to export to Japan and can serve to inflate prices relative to other markets. GPPL has excellent access into the Japanese market through long established relationships.

Given that GPPL holds a sizeable and consistent market share, is subject to less competition through Japanese regulation, and has good market access there is potential for GPPL to exert market power and extract price premiums.

GPPL therefore place high importance on the Japanese markets by maximising the quantity (feed and food grade) it supplies. This means that in smaller production years they limit supplies to other markets such as Saudi Arabia.

The GLA has commissioned independent reports on feed barley to Saudi Arabia and the conclusions from the most recent report prepared in 2006 are presented below:

- *The Saudi Arabian barley represents about 52 percent of the world feed barley trade. In times of surplus barley, all roads lead to Saudi Arabia.*
- *Saudi Arabia is an extremely flexible and price conscious market. They source barley from all origins and on average buy about 6 million metric tonnes per annum.*
- *The import subsidy to control domestic prices is an important factor as to when and from which origin Saudi Arabia import barley. When the combination of subsidy and world price reflect an attractive barley price compared to other feed stocks large purchases of world price barley will take place.*
- *Due to their geographical location, Europe and Eastern Europe have more options for barley destinations than do the other major exporters like Australia, Canada and the United States of America (USA).*
- *Statistics suggest that the EU 25 and Eastern Europe are the most consistent suppliers into the Saudi feed barley market.*
- *For Australia, Canada and Australia, the Saudi Arabian market is extremely important because of its capacity to take large vessels and thus to level the playing field on freight costs. In a surplus market all must compete into this market.*
- *There is little evidence of single desk power in Saudi Arabia. All barley origins do business in Saudi Arabia, and there are very large annual volume variations for the two single desk shippers, Australia and Canada. For example, over a five year period, Australian exports have ranged from a low of 2.5 percent (203,000 tonnes) of Saudi imports to a high of 58.9 percent (3,119,000 tonnes). The cumulative average from 2001 to 2005 is 22.5 percent.*
- *In times of surplus, both Australia and Canada need to be price setters to attract market share.*
- *If third party licenses were not available through the GLA, Western Australia would be the only single desk seller into Saudi Arabia (apart from South Australia). The Canadian Wheat Board sells most of the barley destined to Saudi Arabia via Canadian based or multinational trading companies.*

The GLA has also conducted a cash price analysis for barley to determine whether Western Australian barley prices have increased or decreased, in comparison to other States of Australia, since the commencement of GLA operations in 2003.

The analysis was based on a regression analysis model, incorporating prices offered from 2000/01 to 2002/03 seasons (before GLA) and 2003/04 to 2006/07 seasons (after GLA).Variation attributable to seasonal (annual production) and weekly conditions were removed.

For feed barley, the analysis showed that Fremantle cash prices significantly increased by an average of $11.32 per tonne more than Adelaide cash prices.

A South Australian port should be considered a good comparison for prices in a regulated market versus prices in a deregulated market. South Australia is the most similar to Western Australia in terms of the high proportion of grain exported and for the time period analysed, South Australia barley marketing was still operating under a single desk arrangement.

South Australian barley marketing is now virtually deregulated, but it would be too early to tell what impact the change has on cash prices offered to farmers in South Australia compared to those in Western Australia.

For malting barley, the cash price analysis showed that prices in Western Australia declined significantly less than any of the other States, with a difference of $11.40 per tonne between Fremantle and Adelaide prices.

Western Australia's main market for malting barley is China. The most recent market analysis commissioned by the GLA on the Chinese market for malting barley is presented below:

- *Australian malting barley has gained a good name in China; and on average, Australian malting barley has historically occupied a majority (60%) of the China import market. Prospects are good for Australia to substantially expand its export of barley to China in the years ahead. This may be tempered by seasonal availability.*
- *Chinese imports of malting barley have increased dramatically reflecting the reduced domestic production together with a robust 5-6 per cent annual increase in beer consumption.*
- *Continued beer demand growth combined with lack of ability to expand domestic production of malting barley and high import tariffs on malt would indicate that the outlook is for continued strong growth in imports of barley for malting purposes.*
- *The ability of any single seller to compete in such an environment will be governed by their ability to be consistently price competitive against suppliers from other origins.*
- *To increase market share in China, consideration should be given to offering high quality technical training, which highlight the benefits of Australian malt barley varieties.*
- *In order to maintain its international market share, Australia needs to produce an extra 1.5 million tonnes of malting barley by 2010. Meaning, by 2010, markets will exist for Australian production of around 3.7 million tonnes of malting barley per annum.*
- *Historically, the Chinese barley trade has been government controlled and monopolized by COFCO. COFCO was the first to introduce Australian barley into China. Although COFCO lost its monopoly of barley import in 1995, they are still the biggest malting barley buyer in China.*

- *China's malting barley market is now free and open. Australia, Canada and France are China's main suppliers of malt barley. In addition, China has also imported malting barley from USA, New Zealand, Spain, Britain, Denmark and South Africa.*
- *Australia is a price taker as the returns for malting barley are determined by the market. Whilst there is short-term opportunity for price control due to seasonal supply considerations, this opportunity would be open to all sellers because of market transparency.*
- *GPPL claim to only sell malting barley quality as opposed to feed to maintain good relationships, continued market access and better returns for growers*
- *It appears that GPPL exports to China have been direct to end users but also to trading houses. They do not sell to Northern China. These factors would make it more difficult to exert market power.*
- *There is little evidence that GPPL actively promote West Australian malting barley in China in comparison to the Canadian Wheat Board (CWB) for example.*
- *In a free market, growers have absolute control over the timing of sales, the degree of finance they are prepared to bear, risk assessment, and ultimately the income they receive for their production – in short it is the international trader who assumes the majority of the risk. A regulated marketing system however forces this risk onto the producer.*
- *Malting barley is increasingly becoming a "specialty crop" as maltsters continue to tighten the quality specifications and demand a higher level of quality control through the supply chain. Growth in contracting malting barley directly with producers will continue to provide less price transparency on the world market.*

The GLA is of the view that for barley, there is potential for price premiums due to market in Japan, but such premiums are much less likely to be extracted from Saudi Arabian and Chinese markets. Given the increase in cash prices that Western Australian growers have received for their barley in comparison to South Australian growers, it is also clear to the GLA that partial deregulation has benefited Western Australian growers.

2.0 The intent of the Act in protecting the single desk or main export licence (GPPL) versus protecting pools, including the appropriate level and type of pooling)

Whilst the one of the purposes of the Act is to increase competition, the ministerial guidelines issued for the GLA, indicate that is not to be done at the expense of the benefits of single desk marketing. More specifically the GLA are required to protect any price premium that can be leveraged by the existence of the main export licence holder, through its ability to control and manage the market place.

The guidelines also state that the GLA should protect the State's reputation as a grain exporter and take into account other factors such as the main export licence holders marketing strategy and ability to enter into and supply long term agreements before making decisions on whether to grant a special export licence.

The GLA had initially interpreted single desk or main export licence to mean the operation of the traditional pooling systems.

Over the past 18 months in particular, there has been a trend by farmers to sell an increasing proportion of prescribed grains for cash.

It also appears that GPPL are moving away from providing the traditional pooling options that growers were accustomed to and that the GLA assumed the Act was intended to protect. The traditional harvest pools which were open to everyone for the whole season have become less common as premium and contract pools are introduced. Contract pools are short-term fixed tonnage pools, not necessarily open to everyone and can close at any time without prior notice, in order to protect the price for growers who committed to the pool early in the season. This type of pooling seems to be in contradiction with the original propositions put forward for the benefit of pooling and a single desk approach which was to hold grain in pools for up to 18 months, until the opportunity arose to exert market power and extract a premium. The benefit of this was that over the life of the pool, the average price and returns for growers would be higher.

The GLA has protected the main export licence by declining SEL applications that may have a negative impact on GPPL's pool marketing strategies and ability to supply on long term agreements.

Given the main export licence incorporates GPPL's cash trading entity, Agracorp, who is not required to apply for an SEL (because all grain is lawfully owned by GPPL), it is difficult for the GLA to ascertain to what extent it can protect pool returns to growers. In a market where the majority of grain is sold for cash, it would be reasonable to suggest that the GLA could potentially end up protecting one cash trader against all others.

The review of the Act should investigate whether the purpose of the *Grain Marketing Act 2002* or any future legislation that might be introduced is to protect the main export licence (GPPL) irregardless of whether it markets grain using pools or whether it is to protect pools (a definition of a pool would be needed) and the subsequent market power and price premiums that single desk holders claim they can extract from running these pools.

3.0 Information provided by the current main export licence holder, GPPL and evidence of price premiums due to market power

The main export licence holder, GPPL, provides market reports to the GLA that summarise its main export sales and give a general overview of its marketing strategies. The information provided does not provide conclusive evidence that price premiums are being achieved.

This has meant the GLA has had to use other means to determine the potential for price premiums due to market power.

The GLA has in the past commissioned three independent assessments of the existence of price premiums due to market power. Advance Trading Australia in 2006, Storey Marketing Services in 2005 and Farm Horizons in 2004 all concluded that due to the highly competitive nature of the international grain market and GPPL's relatively small market share into most key markets, it was unlikely GPPL would be able to exert market power. As per Section 1.3, the assessments did, however, suggest that there may be some potential in the Japanese feed barley market.

Whilst the combination of information from various sources has been sufficient for the GLA to function, the GLA feels that to improve the decision making process, access to more detailed information is required.

Any future legislation should consider specifying the information to be provided by the main export licence holder and include actionable consequences or penalties for non compliance.

4.0 Transparency of GLA decisions

Some parties might argue that to improve the transparency of a licensing process, applicants should be able to determine their chances of a successful application. The Act is highly subject to interpretation and with new and different factors being taken into account as the grain marketing environment changes over time, the system may be considered somewhat subjective.

The GLA advises applicants in advance of each season (through its operating procedures) of the factors that will be considered and the weighting given to certain to assessment criteria. However, because of the commercially sensitive nature of the information provided by GPPL and SEL applicants in relation to a specific application (ie market destination, end customer, marketing strategy, pricing etc) and the fact that the analysis is not conducted until the applications and information is received from all relevant organisations, it is not possible to guarantee an applicant whether or not they will be successful.

The GLA believes that the assessment criteria does adequately reflect the purpose of the Act but the purpose is not only to maximise the benefit of market competition as stated in the ERA Issues Paper but also to protect the benefits of a single desk. One issue is that the benefits of a single desk are debatable and not clearly defined in the Act.

5.0 Reasons for volumes exported under SEL's being significantly less than the volumes granted by the GLA

The GLA cannot explain with any certainty why there is less grain being exported than what is being granted since it does not know the volumes being acquired by the marketers or the volumes being sold domestically.

As per the GLA annual report for the 2006/07 season, SEL holders have cited in addition to poor seasonal conditions for that season, the following on-going impediments to shipping under their licences:

- Restrictive nature of the licensing system (i.e. limiting destinations/buyers means that there is increased risk of a deal not coming to fruition);

- CBH storage and handling fees and charges (i.e. export accumulation fees);
- Lack of options for swap stocks (GPPL own the majority of the grain in the CBH system but don't have an economic imperative to swap it);
- Cost of stock swaps (only marginally cheaper than the export accumulation fee).

CBH maintain that it is in their best interest to provide high standards of service to all of their customers and that pricing of services is related to the costs.

The GLA are not in a position to either substantiate or reject these claims but feel these should be thoroughly investigated by the ERA. If any of these factors prevent marketers from accumulating, storing and out-loading grain under the same conditions as any other marketer such as the GPPL, it might be considered anti-competitive behaviour, in which case the Act would not be having the intended effect.

6.0 Export controls and offences under the Act

Under Section 23 of the *Grain Marketing Act 2002* it is an offence to buy prescribed grain for export in bulk without a licence. It is practically impossible for the GLA to determine whether or not grain has been bought without a licence because even if it was bought with the intention of exporting it in bulk, the owner can maintain that the intention was to sell to the domestic market, the main export licence holder (GPPL) via the traders pool or to another SEL holder.

Under Section 24 of the *Grain Marketing Act 2002* it is an offence to export prescribed grain in bulk without a licence. Whilst the GLA has been able to extract information from other government departments and CBH Ltd to determine whether there has been a breach, the legislation does not specially provide the GLA with powers to access or instruct another agency to provide this information.

7.0 Special Export Licence application and annual licence fees

Most applications received by the GLA are for 35,000, 50,000 or 60,000 tonnes of grain which is one bulk shipment depending on the size of the vessel. The sliding scale structure does not relate to shipments sizes nor to the cost of assessing an application which is the same regardless of the number of tonnes applied for.

As long as the fee amount still serves to ensure that only marketers who are financially resourced to pay growers and are committed to export will actually apply for licences, it would not seem necessary to retain a sliding scale structure for application fees. One flat fee in the range of $15,000 to $20,000 might be more appropriate and would (based on previous operating expenditure) cover the cost of the SEL application process.

The $500 annual licence fee does not cover the cost involved in actually issuing a licence, amending a licence, managing the feed back process, ensuring licence conditions are met and coordinating the grain quality testing regime.

It has become more common for SEL holders to request amendments to their existing licence and since each request has to be processed and considered by the members there are costs involved. Costs are higher when a change in market destination or end users is requested. Often the GLA has to decide whether the changes are significant enough to warrant a new application.

The grain quality testing regime was introduced amid claims that sub-standard quality grain was being exported and serves as a tool for the GLA to monitor exporter performance and protect the State's reputation as a grain exporter however it also has costs. An annual licence fee of approximately, $2,500 would more adequately reflect the real cost involved.

The GLA also believes that the annual licence fee should apply to one shipment of grain per production season. Therefore if a licence is granted early in the season, or more than one year before the shipment occurs, the licence holder would only be required to pay one fee as opposed to one every financial or calendar year (part or whole) that the licence is held for.