The New Zealand Dairy Industry
Executive Conference

Dairy Industry Deregulation - It's Time Has Come

Dennis Hussey
DIRECTOR
ACIL AUSTRALIA PTY LTD

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DAIRY INDUSTRY DEREGULATION - IT'S TIME HAS COME

1. INTRODUCTION

I feel privileged to address your annual conference. Very few get the opportunity of standing before the bosses of one of the biggest industries in New Zealand. However, I'll leave you to judge later whether it was a good idea to invite me.

I presume I've been asked to speak because last October ACIL's research on agricultural marketing regulation in New Zealand was published.

It may not have occurred to you that researchers have at least one thing in common with politicians - they don't like to be ignored. We are pleased when our work stimulates interest, debate and discussion, as this report has done.

However, and this has not come as a complete surprise to me, some reactions have just amounted to repetition of the shibboleths and myths that always surface when anyone dares question the status quo, or suggest it has fundamental flaws with serious future consequences. It's always easier, particularly in a political environment, to go for the spurious detail and the good one-liners than to face up to the principles and logic of the big picture.

I'll open my remarks by summarising the main findings of ACIL's work. I then want to pick up and challenge some of the responses in the debate which are generating more heat than light. I'll conclude with some observations about the challenge I think you must take up.

For you, the most important implications of ACIL's research are that current arrangements constrain your entrepreneurial endeavours, have perverse consequences when you are successful, and fail to measure superior performance satisfactorily. In a nutshell, you're unnecessarily constrained when trying to deliver what your shareholders expect of you.

2. COMPETITION AND SIGNALS

Essentially ACIL's work is about two issues - competition and commercial signals. In other words it is about the long-term and demonstrated benefits of competition and the inevitable downside of constraining it, and the crucial importance of non-distorted commercial signals to avoid getting out of kilter with the market.

ACIL believes your current arrangements constrain competition unnecessarily and disadvantage the industry in the process. That is, most of the asserted benefits of constraining competition are an anachronistic fiction in today's world, while the recognised costs of monopolies and constraints on competition continue to be incurred.

As managers of processing and marketing businesses you ride with considerable lead in your saddlebags because of these constraints on your entrepreneurial abilities. Your shareholders, of course, still expect you to perform miracles despite this handicap.

When you look at the dairy industry as a whole, the restrictions you have on export competition contrast curiously with the competition elsewhere in the industry. Much is said and done which shows industry participants recognise the benefits of competition.

The realities of competition are self-evident in your industry. The most immediate economic competitor for a dairy cow is another dairy cow. Dairyfarmers need only look to the next farmer to find their most immediate commercial competitor. It may or may not be another dairyfarmer. Dairy companies compete for suppliers wherever possible. If you can poach some suppliers from a neighbour it boosts your pride and,

hopefully, your bottom line. You are constantly seeking ways of delivering supplier payouts that are higher than the person sitting next to you.
If dairyfarmers genuinely believe that competing with each other, and with farmers in other industries, is counter-productive, then existing systems for controlling this competition are woefully inadequate. They should start where it's most obvious and closest to hand - down on the farm.

Of course, there is no suggestion that anyone in the industry wants all these competitive activities controlled. They are frequently argued, and rightly so, to be beneficial for the industry. Moreover, they're part of that commercial independence valued so highly by farmers.

But the same logic does not apparently apply to exporting. Arguments are advanced to say exporting is different. For the most part such a differentiation is a nonsense and I'll return to some of the particular reasons why later.

Let me turn to the other major issue - commercial signals or, more correctly, the distortion of commercial signals and the consequences. This is the so-called 'bundling' issue.

To me the logic is simple. New Zealand's dairyfarmers own the processing and marketing businesses you run. In aggregate your businesses represent a large capital investment and a significant slice of New Zealand's commercial sector. Let's assume, and I use that word advisedly, that you're profitable. The only way you can deliver that profit to your shareholders is through your milkfat payouts.

Now farmers are as sensitive and responsive to prices as anyone in the economy. I remember being told by a stock buyer when working as a youth on a sheepfarm: "If you value your physical well-being, never stand between a farmer and a twenty pound note."

I therefore suggest to you that it is not very sensible to send a milk price signal to a farmer which incorporates the profits of businesses quite separate from the business of farming. No matter how it's explained or dressed up, you must expect a farmer to see that bundled return as being what the market is prepared to pay for the milk. But you know as well as I do that the payout is not what the market, certainly at the margin, is prepared to pay for it.

I see an increasing recognition in the dairy industry, and in other rural industries, that the traditional pooling of costs, and the pooling of different returns from different markets, is distortionary and not beneficial to farmers in the longer term. In many areas such pooling has been, or is being, abandoned.

Bundling is simply the pooling of different returns from different investments. The same logic applies - it is distortionary and something should be done about it.

Some have suggested that ACIL's logic is correct in principle but currently the size of the distortion is small and trivial. I see it as progress to have agreement on the principle and have confined the debate to matters of fact, and I shall present the facts as I see them in a moment.

These two factors, controls over exports when they are not necessary and when they constrain entrepreneurial activity, and the bundling of off-farm profits into the milk price, are causing major distortions in your industry. Conventional wisdom has it that your industry is the role model of success in primary products marketing. This view is based on the perceived success of your marketing activity - you sell all the milk that's produced and dairy farmers are still in business.

However, because of the misleading price signals, the dairy industry in ACIL's judgment is possibly the most distorted of all New Zealand's primary industries. Far from being the model people think they are, current arrangements could well be responsible for an even more serious misuse and misallocation of resources than was the case in the much-criticised meat industry. You will all remember what happened in the meat industry when regulations and controls, instead of the market, determined what could and could not be done past the farm gate.

3. SOME REACTIONS TO ACIL'S ANALYSIS

Since ACIL's work was published there has been extensive reaction and commentary on the analysis and conclusions. I see today as an opportunity to respond to some of these reactions and, particularly, to examine whether they stand up to scrutiny.

The following are the propositions I will cover:

- competitive exporting would disadvantage the industry because the world market is distorted and subsidised;
- competitive exporting would drive down prices because of weak selling;
- bundling is distortionary in principle but currently its effects are small;
- most large businesses bundle profits - the dairy industry is no different; and
- competition will turn dairyfarmers into peasants.

(i) A distorted and unfair world market

The first reaction I want to address is the cracked record: "New Zealand Incorporated has to sell into world markets that are corrupted by subsidies and protection." You cannot, it is said, be better off by having a so-called level playing field at home - that is, competitive exporting - while the world is so distorted, unfair and cruel.

There is no argument that many countries which are markets or competitive suppliers do some pretty ridiculous things which influence international demand and prices, and make profitable exporting more difficult for New Zealand. But, and this is the crucial point, this fact doesn't mean New Zealand or its dairyfarmers will be better off by constraining competitive exporting in response.

The international market distortions commonly discussed are of three types - tariffs, subsidies and quotas. It's necessary to examine these three distortions to trade from the perspective of whether they provide any logical justification for controlling competitive exporting. In doing this I use as my benchmark the proposition, which the Dairy Board has acknowledged as valid, that if the world were not distorted by those measures there would be no need or justification for controlling New Zealand exporting.

The first point to make is that tariffs only affect prices and they do this in the same way as normal market influences. Essentially, tariffs raise prices in the importing country, change the domestic supply and demand balance, and lower imports.

If, as is generally accepted, regulations are not needed when governments don't interfere with markets, then the same conclusion applies in the case of tariffs. Tariffs make profitable exporting more difficult. So does, for example, a market-induced devaluation of an importer's currency, or a seasonal surge in US milk production. Tariffs carry no particular implications for export regulation because they are just another price influence, however distasteful.

Statistics obtained from MERT show around 70 percent of New Zealand's dairy exports go to markets where there are only tariffs. What, therefore, is the logical justification for regulating exports to these markets?

In the case of export subsidies, the logic and conclusions are identical. Subsidised exports alter prices in importer markets. As with the tariff logic, this is not a sustainable justification for controls over New Zealand exporting.

This leaves quotas which can be different. The key issue with quotas is whether New Zealand can obtain any or all of the premiums or economic rents that quotas generate. As ACIL's report explains in detail, the answer depends on the precise nature of the quota. Many quotas are designed to make sure the exporter cannot get the rents.

Moreover, where some or all of the rents are available to exporters, it doesn't necessarily follow that statutory controls are needed to capture them. Many markets for industrial products - like steel and cars -

are subject to quotas and voluntary restraint agreements with exporter rents being captured by voluntary industry cooperation.
Statutory control over exporters will only be required in exceptional circumstances where there are large benefits and where controls are the only way to capture them. In ACIL's view only the United Kingdom butter market, and only for the time being, meets this test. Some other smaller quota markets are unlikely to deliver benefits large enough to justify the costs of controlling exporting. However, this judgment can be tested in the ongoing debate.

So, we have a situation where it's agreed that if overseas governments didn't interfere there would be no justification for controlling New Zealand dairy exports. The industry would not need regulations to compete successfully in a market influenced only by normal market forces.

The logic I have just been through shows that, as far as New Zealand exporting is concerned, tariffs and subsidies are akin to normal market forces. In addition, many quota markets are unlikely to deliver benefits sufficient to offset the costs of controls.

This leaves only the UK quota. It's nonsense to suggest you need wall-to-wall controls over exporting just to harvest this rent.

Therefore, the argument that "the rest of the world is distorted and not a level playing field" collapses as a justification for current export regulation. To conclude otherwise is erroneously to believe that distortions which make profitable exporting more difficult can be countered by controlling exporting. It might be recalled that the logic I am advancing was eventually accepted, by most farmers among others, as reality in the policy debate over New Zealand's import controls.

(ii) Competitive exporting results in weak selling

A frequent response to suggestions that more competition be introduced into exporting is that lots of beneficial market power flows from a united, regulated front on the export scene. I question this proposition.

So-called 'weak selling' is a tempting and attractive explanation for producers to grab when they want to blame marketers for unacceptable prices. In my view, however, the weak selling argument, and the proposition that single sellers deliver a country market power, are predicated on some pretty naive views about how the market place actually works.

No-one has yet explained why profit-maximising marketers would want to, or could, engage in persistent weak selling. Logic and commercial reality suggest that persistent weak sellers would go out of business. Better performers would pay farmers better prices and drive such incompetents out.

In ACIL's report we demonstrate, using the unfortunate example of the kiwifruit industry, that statutory monopoly exporters are the only marketers able to get away with weak selling on a persistent basis. Of course, the board in question preferred to call it strategic marketing.

The second missing explanation is how the 'NZ Incorporated' approach can control the behaviour of commodity suppliers in the home market or from third countries, or stop consumers from switching to substitute products if prices are raised above competitive levels. Even where New Zealand likes to claim it has a sizeable market share, there is no way you can prevent responses from producers or consumers if New Zealand attempts to behave like a monopolist.

It is widely accepted that effective market power comes through brands and the reputation and customer loyalty that goes with them. However, even if we go to outstanding examples like Anchor or Coca Cola, there are limits on how much extra commercial advantage, either in market share or in price, a brand can extract. One of the realities of commerce is that demonstrable success quickly attracts competitors, imitators and substitutes.

The New Zealand dairy industry is justifiably proud of its progress in branding and product differentiation. The Dairy Board says that over 60 percent by volume, and more by value, of your dairy exports now fall into this category. While this leaves a significant proportion of your trade still in commodity lines, that proportion is falling slowly.

Now, two important points concerning market power and export regulations arise from these considerations. The first is that if the best approach to establishing market power and avoiding weak selling is branding and product differentiation, then would it not be sensible to provide maximum room for this to occur? Regulation of entry and blocking the ideas, innovations and capital of new entrants, as well as existing players, is inconsistent with achieving this goal.

Secondly, if branding protects you from the terrors of weak selling and the price-only competition of the commodity trade, then there is no justification or need to control non-commodity exports.

Where does all this leave us? Clearly you must conclude, at the very least, that there is no logical justification for controlling at least two-thirds of New Zealand's dairy exports. Furthermore, restrictions on entry to the non-commodity parts of the industry will merely retard the rate at which you move away from commodities. Movement away from commodities is seen by all as essential to future commercial success.

(iii) Bundling distortions are said to be small

As I noted earlier, there is agreement that ACIL's conclusions on the distortions caused by bundling are correct in principle. However, the Dairy Board says that currently the distortions are very small and the industry will do something about them in the future when it's necessary.

The key point to keep in mind when looking at the size of the distortions and their consequences is the way dairyfarmers react to the payout you deliver. It is the only signal they have on which to base their milk production decisions. It is imperative that they are not misled about what the market will pay for their milk, particularly where significant production expansion or dairy conversions are planned.

Therefore, when it comes to estimating the size of the distortion, the question to ask is: How accurately does the payout tell dairyfarmers what the market is prepared to pay for additional milk? The extent to which the actual payout differs from this market return is a measure of the distortionary element.
In ACIL's report we set out estimates of the amount of milkfat return which is not derived from the sale of New Zealand dairy products at normal market prices. The ACIL estimate is at least 85 cents/kg of milkfat compared with the Board's estimate of 5 cents.

The two major reasons why the Board's estimate is so low is that it does not include the UK butter quota premium and it includes profits from only non-dairy commercial activities. ACIL's estimate includes the UK premium and profits from all commercial processing and marketing activities.

According to the Board, the UK premium is just compensation for subsidised European Community exports in other markets. While this may be correct, the source of the premium is irrelevant to this argument. The point remains that dairyfarmers are being misled about what other markets are paying - markets where their milk will be sold if they use the payout as a signal to change production levels or mixes. Distribute the premium to dairyfarmers by all means, but not in a payout which farmers use as a market price signal.

The distortion is far from trivial. ACIL has estimated the UK premium at $125 million per year. We know of no published estimate of the premium and the fact that this estimate has not been challenged reinforces our belief that it may be conservative.

The same logic applies to the profits from your processing and marketing businesses. By including them in the payout you are misleading the farmer into thinking they are part of the price the market is paying for milk. Clearly they are not. When the Board includes in its estimate of 5 cents only profits from non-dairy commercial activities it is acknowledging the bundling principle but then not applying it correctly. People in the industry must insist on an open debate about the figures and the analysis.

(iv) But all businesses bundle - don't they?

A number of people have suggested that bundling is a common feature in the corporate world. Dryden Spring said recently that the dairy industry is no different from many integrated businesses where returns from different activities are combined into a single profit stream.

Conventional integrated businesses often do deliver a consolidated profit stream. However, the dairy industry does not. It delivers a consolidated residual revenue stream and delivers it as though it were what the market is paying for milk. There is a world of difference between the two situations.

The key to the difference can be found by examining how the recipient of the payment perceives and responds to the payment.

When a conventional business delivers a consolidated profit in the form of a dividend, the recipients' investment decisions are influenced but not any particular production or consumption decisions. In the dairy industry, by contrast, you take the consolidated profit from a range of off-farm investments and deliver it as part of the price signal which influences decisions about producing milk.

Let me illustrate this point by taking, as an example, a dairyfarmer who, in addition to the farm, has three other investments - shares in Fletcher Challenge, a block of flats in the city, and the dairy company/Dairy Board investment. Put simply, if FCL's dividends rise, the farmer will not put on more cows; if the farmer can raise the rent on the block of flats this will not be seen as a reason to put on more cows; but if the profits from the off-farm dairy investments rise, the payout *will* rise and this *will* be seen as a reason to put on more cows.

If you want dairyfarmers to make sensible investment decisions you must change your method of delivering off-farm dairy investment profits in a way that conforms to the conventional business model. That means delivering those profits to the dairyfarmer in the same way as other investment returns are delivered.

Farm decisions should not be influenced, and normally are not influenced, by returns from non-farm investments.

(v) Competition means we'll all be peasants

"Open up marketing to competition and New Zealand's dairyfarmers will be ripped off by all and sundry, particularly multinationals, and driven into peasantry" - or so it is said.

This pretty emotive scare tactic totally ignores the way competitive markets actually work. When you look at the dairy industry from the farmer to the consumer, the competitive battles are not up and down the chain but within each segment. This is why I said earlier that the most important economic competitor for a dairy cow is another dairy cow.

In all industries, and dairy is no exception, suppliers are not competing with marketers. Rather, suppliers are competing with other suppliers and marketers are competing with each other for sales, and for the all-important suppliers.

It is because markets work this way that dairyfarmers would be the beneficiaries, not the victims, of processor and marketer competition. The circumstances where the dairyfarmer is in danger of being ripped off or given a poor deal are those where this competitive process is blocked - as it is at present in industries like kiwifruit and dairy.

If you allow buyers of milk to compete they will have to entice farmers to supply. How can you make money from a dedicated processing plant if you don't have milk supplies? If you try to frighten or starve the farmer out, would that not encourage new entrants who will treat their suppliers in a more commercially sensible manner? If there are more entrants - big and small, bearing in mind that in most industries business of all sizes can be and are profitable - will these additional entrants not provide farmers with the benefits of competition? How can this competitive process rip anyone off?

In the longer term, and that's what really matters, farmers can also produce other things. Farmers constantly adapt their enterprise mix and change enterprises in response to changes in profitability. We often underestimate their inclination and capacity to make such adjustments. I certainly wouldn't want to be a shareholder in a processing company that stupidly forced all its suppliers to switch to beef, asparagus or cut flowers, and be left with a dedicated facility and no milk.

Producers are getting over the bogey of the rapacious middleman, as we have seen with the welcoming attitude to the opportunities Heinz is bringing to New Zealand. It is time the old fears were dropped in other parts of the primary sector which are presently closed off to competition.

4. STRUCTURAL CHANGE - NOT DISMANTLING - IS NEEDED

To obtain the benefits of competition and remove the distortions of bundling does not require any wholesale dismantling of existing business structures in the dairy industry. In fact, it would very likely be counter-productive to do so.

What is needed is reconstruction of ownership so that investments are held and returns received in a manner similar to the conventional corporate model. Unnecessary restrictions on competition should also be removed.

ACIL's recommendations are that the Dairy Board be corporatised and tradeable shares be given to dairy farmers. Whether the current ownership structure of dairy companies needs to be changed should be up to their current shareholders. Farmers will have to decide whether, in a more competitive environment and with a corporatised Board, the cooperative business structure is in their best interests. There would certainly be no restrictions on alternatives.

It is asserted that if tradeable shares were issued in the off-farm dairy industry businesses this would result in outside ownership and exploitation of farmers.

The first and most obvious point is this: How can an investor (dairyfarmer) be worse off if the current return is simply split into two components, with the added benefit that it is no longer distortionary?
If dairyfarmers are unhappy with the idea of freely tradeable shares, there are means of limiting the shareholding to farmers only or maintaining majority farmer ownership. Such alternatives have their disadvantages, which are discussed in the ACIL report, but they are feasible.

Perhaps what I find most fascinating about fears of a mass sell-out is the implicit assumption that farmers would want to sell investments that are said to be very successful and considered so important by them. The implication of this fear of a loss of ownership and control is that farmers are not capable of making investment decisions which are in their best interests - the decisions need to be made by someone else and enforced on all.

5. A POSITIVE AND AGGRESSIVE APPROACH IN A RAPIDLY CHANGING WORLD

I'll conclude my remarks with some observations about the future and a few consequential challenges that I think you must take up.

I would start by saying to you with all the sincerity I can muster, and in the vernacular of today's youth - "get real". The world is changing rapidly and neither the dairy industry nor New Zealand will be well served by having the experience, innovativeness and enthusiasm of your best performers constrained because unjustified fears about competition, distorted markets and multinational ogres are cultivated and allowed to persist.

I suggest you start by looking at what is happening around you in New Zealand. Every day seems to bring forth further evidence that the process of exposing New Zealand entrepreneurs to what the best the world has to offer in terms of expertise, innovation, capital and competition is, in turn, bringing out the best in New Zealanders.

Ask logically and clinically whether your industry really is any different. Do the arguments you hear, and sometimes subscribe to, really stand up? As business executives do you really believe you need a regulatory cocoon to compete successfully when demonstrably most other industries do not?

I have talked to sufficient people in the dairy industry to believe that many of you do feel constrained entrepreneurially and would like to be able to have a go at beating the best in the world. I reckon it's about time you stood up to be counted.

When you look at the international scene, stop being so preoccupied with all the so-called nasty things stupid countries do. You are allowing a few who have a vested interest in maintaining controls to use the trade distortion myths, and fears of peasantry, to divert your attention and that of your shareholders from the main game.

Today's world is about internationalising businesses in a deregulating environment. The pace of these changes is quickening and they are not going to cease. Forget what politicians around the world say they may or may not do, and look at what is really driving international change.

The global village is at hand. National borders are becoming less and less significant. Expertise and capital are moving to where the prospective returns look best. The smart countries are encouraging these flows and not trying to stop them. The only thing world class entrepreneurs can't shift is the land base - but then there's plenty of that in the world. That's why you hear increasingly of investors who look quickly at New Zealand's agriculture, grimace at its anachronistic regulations, and fly on to South America. The idea that New Zealand can act like a monopolist in a world of open borders and intensifying international competition is totally naive.

Do not let the opportunities and benefits of joining the international food industry slip through your fingers. Is the small size of your business, or even New Zealand as a whole, really a disadvantage or a cause for concern? Look around in nature and in business - Fox Terriers are not extinct even though they live in the

shadows of the odd Great Dane. Never forget that two advantages the Fox Terrier has are that it moves faster in small spaces and has its mouth closer to the food dish.
Let me make two final and very general points about the consequences of trying to regulate commercial behaviour. They reinforce my conclusions about the futility of trying to preserve the old ways.

First, any industry that calls on the legislators to help it control, discipline and direct commercial activities which are normally sorted out in the market place should expect to be regularly examined, challenged and pressured by all and sundry who think they have a good idea or would like to have a go. Since the regulations prevent them from using the market place to test whether they are any good, they will turn and continuously pester you and the politicians who gave you the protection.

Secondly, regulated environments of the dairy industry type slowly build up pressures for change. I see evidence of this in your industry.

Such pressures are not unique to regulated environments. Look what General Motors and IBM are now having to do because they were tardy in responding to change. However, they are now being forced to adjust and will undoubtedly survive, albeit in a different form. The problem with regulated industries (and command economies) is that the pressures can stay hidden and bottled up for many years. Then changes become unavoidable as a consequence of a full scale crisis.

You are engaging in self-deception by believing that there is nothing to worry about. Much of the information you use to convince yourselves that you are travelling well tells you lots of things about activity but very little about true performance. The international environment is changing and you are not changing with it - certainly not fast enough. Those bundling pressures are building up and you are not taking them seriously enough.

An analogy that comes to mind concerns the scientifically agnostic gentleman who did not accept that the law of gravity meant you needed a parachute when jumping from a great height. He jumped from the top of the Empire State Building without one. As he passed the 25th floor an observer leaned out and asked how he was going. "Not a problem in the world," he said, "so far."