Queensland Sugar Limited:

Supplementary Paper for the Federal Rural and Regional Affairs & Transport References Committee – Current & Future Arrangements for Marketing of Australian Sugar.

Supplementary submission

On 24 October Queensland Sugar Limited (***QSL***) provided an initial submission (Submission 16) to the Senate Rural and Regional Affairs and Transport Reference Committee (the ***Committee***) in respect of the Committee's inquiry into the current and future arrangements for marketing of Australian sugar.

QSL has now had an opportunity to review the content of the submissions made to the Committee by other stakeholders and wishes to comment on a number of issues raised and statements made in those submissions.

QSL is particularly concerned that Wilmar Sugar Australia Limited (***Wilmar***) has sought to mislead the Committee on a number of important issues. Wilmar has also made hypocritical and unsubstantiated allegations of QSL having conflicts of interest in operating the terminals while refusing to acknowledge the clear conflicts of interest Wilmar has in marketing grower economic interest sugar. QSL considers it is important to correct the record on those matters before the Committee makes its report.

The heart of the issue

The sugar industry is a complex one, with a long history and complicated contractual arrangements between industry participants, such that it can be hard for those without a long involvement in the industry to get to the nub of contentious issues.

But at its heart, the principal issue is that Wilmar is seeking to create a new single-desk for marketing of all raw sugar produced from cane in the Burdekin, Herbert River and Proserpine regions. Tully Sugar and MSF, who are in similar monopoly positions, have followed suit in their mill regions.

The only reason they can do this is because of the market power they possess as owners of monopoly infrastructure which practically prevents growers negotiating alternative arrangements.

The industry was deregulated with a view to removing monopolies and encouraging competition and innovation in marketing, but if Wilmar's behaviour is permitted that will never occur as most mills will face no competition for the provision of marketing services for as long as they are permitted to only acquire cane on the basis that the mill itself conducts the marketing of grower economic interest sugar.

QSL is therefore requesting the government to protect competition for marketing services to ensure that growers get to share in the benefits that deregulation was intended to bring.

Wilmar claims in its supplementary submission that it is still negotiating with growers. But it does not matter how many meetings or discussions are held, if Wilmar's position remains that growers can effectively 'take it or leave it' when it comes to Wilmar's anti-competitive marketing proposal (with leaving it effectively resulting in growers leaving the land).

If Wilmar and other mill owners (such as Mitr Phol and COFCO) sincerely believed they have a better proposition for growers they should not be concerned by the prospect of genuine competition.

Need for urgent intervention – the market failure is occurring now

A number of mills have made submissions indicating that government should not intervene where there is no existing marketing failure.

However, a market failure is occurring now and the existing regime has not been able to provide an effective response. The ACCC is still investigating complaints that have been made to it about breaches of the *Competition and Consumer Act 2010* (Cth) in May 2014 without any action having been taken to date.

As described in QSL's initial submission (Submission 16), due to the volatile nature of the global raw sugar market and foreign exchange rates, growers need to manage future seasons' price risk. One core way they currently do this is by having QSL or a mill enter into futures contracts before that cane has actually been produced.

Many growers would typically seek forward pricing for the 2017 season now. They are unable or unwilling to do this due to the uncertainty of future marketing arrangements.

Inability for growers to switch from producing cane

Some mill owners (Wilmar and MSF) have argued that they do not have market power due to the alleged ability of growers to switch the use to which they put their land. For the reasons set out in QSL's initial submission (Submission 16), particularly in relation to the approximately 5 year period for which a cane crop is planted, that is incorrect except potentially in the long term.

The Burdekin District Canegrowers submission (Submission 13 at page 5) provides a good summary of other key reasons switching to producing other products is not feasible – namely the damage switching crops would do to land valuation, financing arrangements and the returns obtainable for any alternative crop. It should be self-evident that if cane growers were to switch in material numbers to producing an alternative crop, the price achieved for the alternative crop will fall as supply increases (undermining the growers' ability to continue with the switch away from cane). As a result, switching as a response to misuse of market power by a mill is not realistic due to the likely negative adverse economic consequences for growers of doing so.

Many of the biggest mill owners also actually benefit economically from reducing the value of growers' crops and land, knowing that growers (typically individuals or family businesses) could not withstand that for any length of time and ultimately would be forced to sell up at a reduced price, with the only likely buyer being the mill itself. If that is thought to be alarmist, it is worth paying attention to the commentary of growers actually already facing this dilemma. In Queensland Country Life (page 16, 19 June 2014) a grower wrote the following about Wilmar's activities:

> We were initially told they don't want to be growers but are already the biggest land owners in our mill area and are well on the way to being the biggest growers. They refuse to sell any land, despite keen offers from genuine cane farmers.
> Cane farmers must not let the same thing happen to them as happened in the dairy industry.
> Lifetimes of hard work and enormous investments have been decimated by farmgate pricing (1$ a litre of milk) and land prices have reduced dramatically in that industry.
> This can happen to the sugar industry and Wilmar will then be able to snap up farms at reduced prices.
> It may not happen immediately but long term planning is the strength of these big companies and they are prepared to put in the time and effort to reap the rewards.

It should also be evident from commentary of that kind, that Wilmar is significantly overstating the risks of its mills being idle in the event a grower refused to supply cane (even ignoring for now how unrealistic that is for the reasons explained above). Even if a material number of growers were somehow able to switch to an alternative crop, Wilmar has a solid base volume provided by its own corporate cane farm production to guarantee continued throughput for its mills.

Consequently it is clear that mill owners' market power is not controlled in any way by a theoretical risk to the mill of the growers changing the use of their land and refusing to supply cane. The 5 year cropping period in particular means that many growers already have sunk investments related to the 2017 season (i.e. having planted a crop that will be producing in that and future seasons) when Wilmar, Mitr Phol and COFCO propose to impose new marketing arrangements and switching is economically unviable in any case.

Singapore-Australian Free Trade Agreement

Wilmar's submission (Submission 10) alleges that any government intervention runs the risk of contravening the Singapore-Australia Free Trade Agreement and triggering rights for compensation.

That is scaremongering without any legal basis. QSL would encourage the Committee to require Wilmar to substantiate its claim if it is going to be given any credence.

It is not being proposed that foreign investors (from Singapore or elsewhere) be treated any differently to other mill owners. No rights of Wilmar (or other mill owners) are proposed to be expropriated or nationalised.

Wilmar has never marketed export grower economic interest sugar. The Wilmar corporate group made its investment in the Australian sugar industry at a time when Sucrogen had no right to market any raw sugar intended for bulk export, let alone grower economic interest sugar, under its arrangements with QSL. Wilmar indicated at the time of making that investment that it had no current plans to change the existing QSL system. Any complaint now that a right to market grower economic interest sugar has been somehow 'taken away' is disingenuous and not credible.

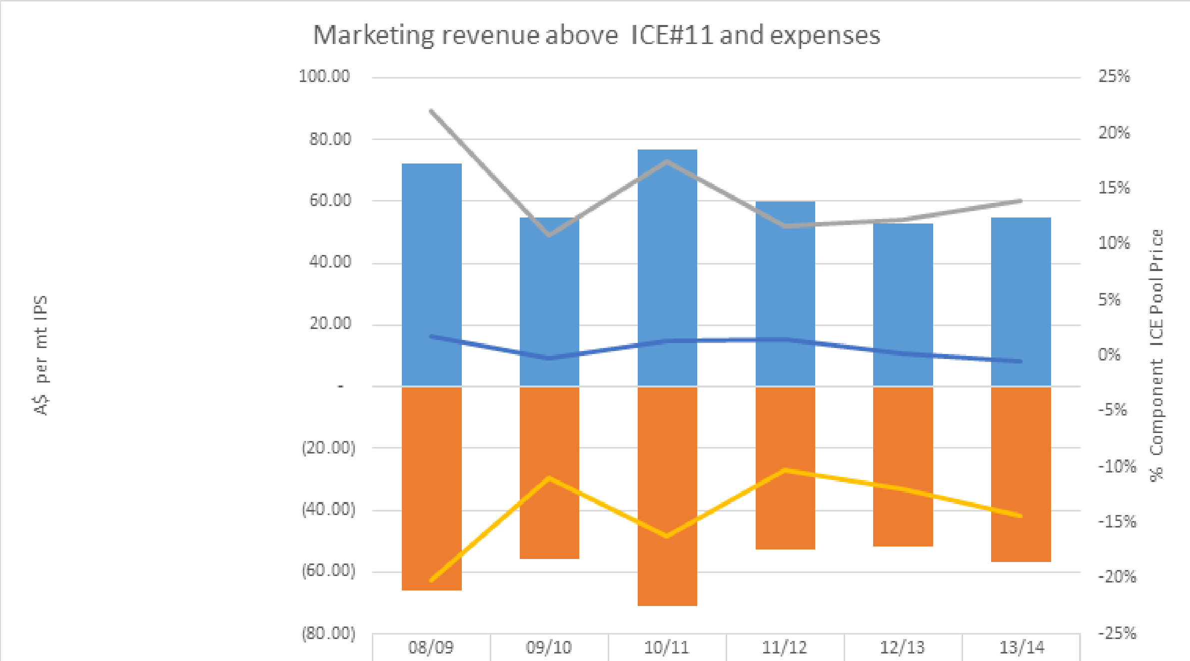
This is also not a sovereign risk issue. Australia has a deserved reputation for being an economy which has made significant pro-competitive reforms. That reputation has been enhanced, not damaged, by intervention where market failures have occurred or will occur with a view to ensuring dynamic market places continue across all of Australia's economy.

Government intervention in the current circumstances is responding to monopolists engaging in a new abuse of market power, as should be one of the core purposes of effective competition law regulation, not discriminatory re-regulation.

Grower returns as a percentage of ICE11 price

Wilmar's submission (Submission 10) and its supplementary submission states that the ICE#11 price makes up approximately 99 per cent of the net price for raw sugar. It appears to imply that, as a result, the marketing of raw sugar is therefore immaterial to the price growers receive. This is extremely misleading.

Even using Wilmar's figures, the percentage quoted is a percentage of a net price – after taking into account the 8% marketing revenue above the ICE#11 price and 7% marketing expense. Those two factors are clearly material in size. To give a better feel for the real magnitude of the marketing revenue above the ICE#11 price and expenses, they equated to approximately A$120million and A$118million in aggregate for QSL in the most recent season. As shown in the graph below, they equate to between $52.70-$76.74 of marketing revenue above the ICE#11 price and $51.68-$71.12 of expenses (per metric tonne international polarisation scale) respectively over the last 6 completed seasons.



	08/09	09/10	10/11	11/12	12/13	13/14
Expenses (B)	(65.97)	(55.96)	(71.12)	(52.47)	(51.68)	(56.62)
Marketing revenue above ICE#11 (A)	72.02	55.09	76.74	60.01	52.70	54.96
(A) as a% of ICE#11	22%	11%	18%	12%	12%	14%
(B) as a % of ICE#11	-20%	-11%	-16%	-10%	-12%	-14%
Net	2%	0%	1%	1%	0%	0%

Given how significant the amounts are, it should be evident that marketing performance and costs can have a substantial influence on the ultimate return achieved by growers. Without competition for the provision of marketing services the pressure to be efficient in the costs that are incurred and to achieve the highest marketing returns possible will cease to exist. This is the very justification for deregulation being introduced – yet the intended benefits of that deregulation will be clearly thwarted by Wilmar's anti-competitive actions, which will (if left unchecked) effectively create a new single desk for the Burdekin, Herbert River and Proserpine regions.

The misleading pricing and return comparisons Wilmar has included in its submission (as addressed further below) have also been a key part of trying to convince growers to enter its proposed marketing arrangements – demonstrating that, despite pretending it is insignificant, Wilmar itself clearly understands the importance of marketing cost and performance to the level of returns received by growers.

In any case, what is really important is not the proportion of net returns constituted by marketing revenues above the ICE#11 price and expenses, but the very high percentage such marketing revenues above the ICE#11 price and expenses form of cane farm profits (and therefore the ability and economic incentives for cane farmers to reinvest in the industry). What might seem like a small amount to a massive global agribusiness like Wilmar, is the difference between bankruptcy and economic viability for many family farms.

In addition if the figures quoted by Wilmar were to be used as a guide to the future, that involves a critical assumption that there will continue to be a connection between the cane price and the global raw sugar price (and relevant premiums). That is far from guaranteed, given that, whatever it may currently say about maintaining such a connection, Wilmar will have the future ability to dictate terms to its growers from a position of monopoly power (including potentially fixed dollar value farm gate pricing).

Open access to the terminals – QSL's track record and incentives

Wilmar alleges that QSL has a conflict of interest and that the terminals should be operated by a different entity that is not involved in marketing of raw sugar.

Firstly, Wilmar has not provided any evidence in its submission of it (or any other mill owner) being unfairly treated and QSL is confident that it will not be able to do so.

Secondly, Wilmar's allegation fails to take any account of QSL's nature as a not for profit company, with its members solely made up of industry participants and of it being required by its constitution to promote the best interests of the sugar industry. It is not in the position of mills involved in marketing (like Wilmar) – who must act in the best interest of their private owners – and who would have a real conflict of interest in operating terminals to which other mill owners (who are competitors in export markets) would seek access.

Thirdly, it also fails to take any account of QSL's track record. That QSL will continue to provide open access to entities that compete with it in export markets has already been proven for many years now. Each of the mill owners marketing their own economic interest sugar are being provided open access at cost and in previous years when some mill owners (most recently MSF) have not had a contract to supply raw sugar to QSL they have continued to receive open access at cost. MSF, which has had the experience in previous years of needing access to the terminals when not supplying QSL at all has made it clear in its submission (Submission 8 at page 9) that 'Overall these arrangements have worked well and have allowed MSF Sugar to export raw sugar in an orderly manner. MSF Sugar is not seeking any changes to these arrangements.'

Fourthly, to the extent that Wilmar's alleged concern is expressed as one relating to the information QSL will have access to as operator of the terminals, that fails to take account of the fact that:

- QSL can provide storage, handling and logistics services without the customer mill supplying it any information about the ultimate customer for the raw sugar (MSF is an example of a mill owner who deals with QSL in this way); and
- logistics operations of this nature are not confidential, as an international market information industry exists in which publicly available data regarding shipments is collated, cross-referenced with field information and on-sold to commodity traders. As a result, at practically the same time that QSL is notified of the vessel for a particular cargo the information nearly immediately enters the public domain through other sources.

The industry (with the apparent exception of Wilmar) supports QSL continuing to provide storage and handling services at the bulk sugar terminals. As Bundaberg Sugar Limited notes (Submission 12) 'there are overall benefits to the industry if the sugar terminals are … managed by QSL, given QSL have the equipment, software and resources to competently manage the terminals'. QSL and its predecessors have successfully managed the terminals since the separation from Sugar Terminals Limited (***STL***) and through that experience, and the economies of scale derived from having the same operator of all terminals, QSL is able to deliver the industry with:

- Lower costs than it would be anticipated any other operator would be able to achieve (particularly when any other operator would be expected to seek a profit margin for these services);
- Flexibility to outload raw sugar from a different terminal to that which raw sugar was delivered to and permitting 'two port loads' where there are reasons for doing so;
- Flexibility to manage and mitigate the adverse impacts of natural disasters which may prevent one or more terminals being used; and
- Quality management services (which ultimately assist in Queensland raw sugar having higher returns).

As noted in QSL's initial submission, QSL is willing to have access to the terminals be subject to a regulatory regime. QSL has nothing to fear from such a regime, as it already provides open access on more favourable terms than would typically be imposed by a regulator in any case.

QSL only requests that any regulatory regime that is implemented is light handed for as long as QSL is the operator as it would prefer that there is a limited regulatory burden, given the compliance costs would effectively be passed on to the mills that QSL provides these services to (and indirectly the growers that supply them), when there is no evidence of any current issue in parties obtaining access from QSL on fair terms.

If a mill owner (without the constitutional and not for profit requirements applicable to QSL) were to operate a terminal which both it and other mills needed access to, QSL appreciates that there would be a greater need for regulatory intervention. Even if a terminal is currently only used by one mill, that mill becoming the operator may create a structural barrier to entry to any potential future independent mill development in a region which would deliver raw sugar to such a terminal. In respect of the only other foreseeable alternative operator, STL, it should be noted that, while it has no involvement in marketing, it can be influenced by major mills (through their substantial shareholding – through both mill owner and grower shares), has no experience in operating the terminals and will still have the usual economic incentives privately owned monopoly infrastructure providers do (to raise prices).

Ultimately all terminal operators other than QSL will impose greater costs on the sugar industry unless they continue QSL's practice of providing storage and handling services on a cost recovery basis.

Title to cane is not a licence to abuse market power or prevent competition

Wilmar notes in its submission numerous times that it currently obtains title to the cane acquired from growers (and therefore has title to the raw sugar it produces), as if that is somehow a complete answer to the current issues.

No one is disputing that those are the current contractual arrangements between growers and mill owners in relation to title. However, as noted in the initial QSL submission (page 7), the 'resulting separation of legal and economic interests is a creature of contract and not the only possible outcome of such negotiations.'

The fact that this was the model adopted following deregulation reflects the monopoly market power of mill owners and the fact that at the time it was agreed CSR (as it then was) was not forcing its provision of marketing services on growers who did not want to sell it cane on that basis.

There is not some intrinsic right of a mill to be delivered cane on the basis it gains title to cane and can market the raw sugar produced in any way it wants.

In particular, there are numerous examples of markets where providers of processing services do not always receive title (including, just taking examples from agribusinesses, some cotton gins, milk processors and abattoirs), such that competition for the provision of marketing services for the relevant processed product can still occur.

Title does not automatically infer a right to market the raw sugar on any terms a mill owner desires – particularly where:

- as Wilmar's submission recognises on pages 16-18, growers have an economic interest in the price mill owners receive for raw sugar (an economic exposure that has been a common feature of the industry throughout its history);
- the mill owner has conflicts of interest and the opportunity to engage in arbitraging and profit-shifting transfer pricing such that grower's have no transparency or certainty as to the price obtained for the raw sugar produced from their cane. For example, in Wilmar's case growers have genuine concerns about:
  - non-arms length price for sales to Wilmar's foreign owned refineries;
  - Wilmar favouring its international trading operations to grower economic interest sugar for sale opportunities (and other issues like market access, freight, storage and handling capacity, credit exposure etc);
  - Wilmar favouring its supplier economic interest sugar to grower economic interest sugar for sale opportunities (and other issues like market access, freight, storage and handling capacity, credit exposure etc);
- the mill owner, in Wilmar's case, is refusing to deal with growers on any contractual basis which does not give them the right to market the raw sugar; and
- the clear purpose of that behaviour by Wilmar is to prevent competition for marketing services (with both QSL and other sugar traders), such that in future it will be able to set the terms on which cane is acquired free from any competitive constraint.

By way of analogy, the mill owner is in a position akin to that of a manager of a managed fund – responsible for managing the economic performance of the grower's investment in the cane crop, but is completely unwilling to:

- provide the sort of transparency fund managers are required to (including through product disclosure statements); or
- give growers a choice contrasted with fund managers who have to compete to attract investment.

If anything the issue is more critical, as the grower's investment in the cane crop is likely to be their primary source of income (which is unlikely to be the case for most beneficiaries of funds invested with fund managers).

Wilmar's misleading pricing comparisons

Wilmar's submission misleadingly asserts on (Submission 10, page 28) that:

> Averaged over the 2012 and 2013 seasons, Wilmar's net sugar price including premiums was A$45 per tonne higher than growers received on average under the QSL system. Contributing to this result, Wilmar achieved marketing premiums that were approximately 60 per cent higher than QSL, equivalent to $11 per tonne of the net sugar price.
> If growers had achieved the same sugar price as Wilmar, they would on average have received a cane price more than $4 per tonne higher, resulting in an increase of more than 50 per cent in average farm gross margins.
> This means a typical Wilmar grower producing 10,000 tonnes of cane would have made an additional $40,000 per year over the last two years if they had received the same sugar price as Wilmar.

These statements are already the subject of an ongoing investigation by the ACCC (for misleading and deceptive conduct which contravenes the Australian Consumer Law) and should be given no credence.

The Wilmar statements are principally misleading because they fail to disclose:

- the pricing risk profile under which Wilmar was operating;
- the pricing timelines Wilmar utilised; and
- how the Wilmar risk profile and pricing timelines materially differed from those applicable to QSL.

By way of background (to assist in understanding why a failure to disclose those factors is misleading) the price growers receive under the existing QSL system is a function of 3 major inputs: the sales price QSL achieves with the end customer; pricing of the raw sugar (entering into of hedges and futures contracts); and an allocation of QSL's costs. In addition, there are mechanisms in the existing cane supply arrangements and raw sugar supply agreements for pricing decisions to be effectively controlled by individual growers and mill owners. A substantial volume of pricing is directed in this way.

Different growers have different risk appetites and accordingly adopt different pricing decisions (in terms of the extent to which they hedge exposure to the sugar price by 'forward pricing' raw sugar in respect of future seasons). As a consequence, any weighted average of QSL outcomes does not reflect the outcomes for individual growers (with individuals who have achieved higher and lower outcomes than Wilmar claims it can achieve) and is not a reasonable indication of the 'overall' success of marketing and pricing decisions that QSL itself controls.

The issue with these statements is therefore that Wilmar is comparing pricing results achieved through very different means with very different risk profiles (in QSL's view, selectively picking two seasons in which a high risk Wilmar strategy may have succeeded without properly explaining the differences in the risk profiles involved, and selectively excluding the 2011 season when QSL had a very successful year in terms of returns to mill owners and growers).

In particular, Wilmar does not disclose that, in the 2012 and 2013 seasons Wilmar references, Wilmar was marketing a smaller volume of raw sugar through a 'committed pool' under the QSL raw sugar supply agreement (such that Wilmar had high certainty of the quantity it was marketing and limited volume risk to deal with). That is a significant contrast to the larger volume QSL was marketing which included a large proportion of raw sugar from the high production risk 'harvest pool' (involving significant volume risk as variability in production is first deducted from the harvest pool).

In addition, Wilmar's statements are also misleading and deceptive because:

- they give (and are intended to give) the overriding impression that Wilmar will always outperform QSL's marketing (a claim which Wilmar cannot substantiate and QSL disputes);
- they do not explain that Wilmar's volume was disproportionately marketed in respect of the 2013 season (in a factor of about 7:2) whereas QSL's volume over those 2 seasons was more even (and the global raw sugar market was obviously different in those two seasons such that any weighted average across those seasons is not a reasonable comparison);
- based on other information Wilmar provided to growers with these statements, it appears to QSL that the QSL results were calculated by not including the revenue QSL makes from 'other origin' (non-Australian) sugar (which is rebated to mills and therefore part of the calculation of the cane price achieved by growers) whereas QSL suspects that the Wilmar pricing reflects arbitraging activities using 'other origin' sugar; and
- in calculating the additional cane price that would allegedly have been achieved, the statements do not explain how Wilmar's costs of marketing and overhead were allocated (which would necessarily be different to how QSL costs are allocated due to the greater extent of international trading that Wilmar is involved in).

QSL understands from Herbert River growers that, when Wilmar representatives were challenged about the misleading nature of these claims in meetings with growers, it was expressly acknowledged by Wilmar representatives that Wilmar may not have been comparing 'apples with apples'.

To put an end to this sort of behaviour, QSL proposes the introduction of new regulations or an industry code requiring entities offering marketing services to Australian growers (including where they are seeking to acquire cane on condition that they or an entity they nominate is to do the marketing) to disclose previous pricing outcomes, with sufficient details provided (including in relation to risks and marketing strategy) to give the growers the same levels of transparency investors receive when choosing a managed fund.

Wilmar's misleading statements about the 2010 season

The Wilmar submission (page 28) and supplementary submission (page 8) make a number of statements regarding the results of the 2010 season which appear intended to give the misleading impression that the outcomes were attributable to poor marketing or risk management performance by QSL. Wilmar fails to disclose that the crop was not just impacted by 'persistent rains' or hedging activities but mill owners like Wilmar contributed to the financial consequences suffered by all mills and growers by failing to update their crop estimate until excessively late in the crushing season despite the evident likelihood of the adverse weather conditions continuing.

QSL understands that Wilmar remains in dispute with numerous grower groups about that season, many years later due to alleged discrepancies between the representations provided to growers by Wilmar about the way in which cane prices would be calculated in those circumstances and the way that it ultimately sought to pass on costs to the growers. That aptly demonstrates the hypocrisy of Wilmar now calling for 'transparency' from others by reference to the 2010 season.

It should also be noted that despite its current claims, Wilmar was only too happy to recognise the economic interest of growers so that they bore approximately two thirds of the costs allocated to Wilmar in respect of the 2010 season.

Arbitration

While QSL has a preference for commercially negotiated agreements, it is convinced that an important part of the grower choice regime being sought by many industry participants is the ability to resolve the terms on which cane is supply to a mill by arbitration where the parties fail to reach agreement.

Arbitration is a common method for resolving terms where one party has monopoly power (as demonstrated by the common 'negotiate-arbitrate' model of access regulation of monopoly infrastructure). Without the potential to refer the terms to arbitration, it is difficult to see how the mill owner's market power will not be reflected in substantially unbalanced terms for the delivery of cane where a mill owner chooses to misuse its market power.

A negotiate-arbitrate regime would also allow the government to regulate in a light handed and less prescriptive way that would only involve intervention in circumstances where the parties were unable to reach agreement (and would not, in practice, impose any regulatory burden on mill owners that were not misusing their market power).

In addition, none of the mills who oppose use of arbitration have provided any convincing reason for why it should not be adopted.

QSL therefore, echoes its recommendation in its initial submission, that arbitration of the terms on which growers deal with mill owners should be part of the recommended reforms.

Conclusions

Having reviewed the submissions of other stakeholders, QSL continues to consider that there is a need for government intervention either by introduction of a statutory grower choice regime or a third party access regime in respect of the crushing services of mills.

QSL considers that a number of statements made to the committee by other stakeholders have been quite misleading, and that the clarifications provided in this supplementary submission will assist in providing a more accurate picture of the current circumstances of the industry.

The need for government intervention exists now as a market failure has already occurred.

Mill owners (most evidently Wilmar) are using their market power to create a new single-desk for marketing of all raw sugar produced from cane in growing regions surrounding their mills.

QSL requests urgent assistance to protect Queensland cane growers from an abuse of monopoly power by Wilmar and any other mill owners which are seeking to prevent competition for the marketing of grower economic interest sugar.