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*With the Compliments of*

*The Hon.*

A handwritten signature in blue ink, appearing to be "R. Best".

*M.L.C.*

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## EXECUTIVE SUMMARY

### The NSW Egg Industry Will Have to Change

The egg industry in NSW will have to become less controlled and more market oriented.

There are a number of ways in which this can come about, ranging between two extremes:

- tightening up and policing absolutely the existing system of controls and regulations so they work exactly as intended, and then waiting for the system to collapse as a result of a build up in commercial and competitive pressures; or
- removing all controls and regulations overnight and forcing rapid and dramatic change immediately.

ACIL believes the case for making the industry more market oriented is overwhelming but considers there are good reasons for avoiding either of these two extremes.

The current industry arrangements are both complex and controversial. There are no 'easy solutions' or 'quick fixes'. The choice is between managed change with minimised disruption, or an unwinnable and costly fight to maintain the status quo (or minor variations of it). For many NSW egg producers an unrealistic hope that they can avoid change is likely to be the instrument of commercial death.

This review has developed an adjustment strategy which would allow the industry and the State economy to maximise the benefits from a more competitive egg industry. At the same time it ensures that those currently in the industry who have been abiding by the rules are able to maximise their opportunities for either:

- becoming well positioned to take advantage of the new environment as it develops; or
- leaving the industry in a commercially satisfactory manner.

This summary document presents a simplified explanation of the effects of the current arrangements, the reasons why change is essential, the options for achieving it and the recommended option. It concludes with a number of

questions which may well be asked about the impact of the recommended option, and answers to those questions.

### **The Current System Disadvantages Both Producers and Consumers**

The current controls and regulations act as a significant constraint on the ability of producers to maximise productivity and profitability because:

- they prevent or discriminate against the best use of existing and emerging production methods and technologies; and
- they discourage the development and exploitation of some profitable market opportunities.

It follows that they also disadvantage consumers, although it is probable that a proportion of the costs have been absorbed by retailers.

These deficiencies are at the heart of why the current arrangements result in continual commercial pressures, and unresolved public debate. They attempt to suppress normal and appropriate commercial behaviour in a number of areas.

In addition, ACIL has identified a number of other factors which indicate that change is essential. They are:

- the difficulties being experienced with non-compliance and the high costs and the damage to the industry's image of policing activities which are necessary to prevent it;
- the effect of levy arrangements in enhancing the competitiveness of producers operating outside the system or above their quota level (in other words, the levy system becomes an incentive for non-compliance);
- the fragile legal validity of some important elements of the current regulatory framework and their vulnerability to successful legal challenge;
- the desirability of instigating and managing appropriate change rather than having it eventually forced on the industry under circumstances where the outcome is less predictable and more likely to result in unintended outcomes; and
- the danger that some other State will move first and put the NSW industry at a competitive disadvantage because it is ill-prepared for a marked increase in competition.

### **The True Value of Quota to a Producer is Less than Today's Price**

A commercial egg producer needs to own quota. Quota determines how many hens can be run. Quota is tradeable with the farm or separately.

Quota has recently been trading for \$18-\$20 per unit. When allowance is made for the 'condition of licence' - currently 73 per cent of quota - this value is equivalent to about \$25 per laying bird.

In the market, quota value is determined by producers wishing to increase their existing level of production. The costs associated with such **additional** production are usually much less than **total** costs averaged over **total** production, because various overheads can be avoided. This difference probably exceeds 40 cents per dozen eggs. Obviously, not all quota is used for 'additional' production but it is that use which sets the market price for all quota which is traded. As a result, the market price of quota is higher than its true value across the entire industry.

In turn, this fact results in the value of the depreciable non-quota assets - principally hen housing and cages - being reduced. This is necessary to ensure that the market price of a total farm (quota plus other assets) being offered for sale will enable a return on the **total** investment sufficiently attractive to ensure a buyer.

The evidence is that this write down in the value of depreciable non-quota assets has already occurred extensively in the industry. The consultants estimate that the write-down in the value of shed and cage capacity is around \$6 per quota.

These considerations, combined with the high level of purchase of quota by existing producers, also suggest that the major beneficiaries of the quota system were those who were originally granted quota and who have since sold it and left the industry. The benefits are no longer 'owned' by the majority of existing producers and cannot be recovered.

### **Egg Corporation 'Losses' are Paid for by Producers**

Despite considerable effort the NSW Egg Corporation has constraints on its commercial flexibility and ability to maximise opportunities.

The Corporation's 'losses' derive mainly from the requirement to pay producers an equalised price for all eggs of similar class, despite variable market conditions on both domestic and export markets. They also arise from the inability of the Corporation to apply its considerable capital investment, which has very low levels of utilisation for parts of the year, to the processing of products which are not egg based. Third, it incurs considerable administrative costs, especially in policing the current arrangements.

Producers face an inherent conflict in that they want the equalised price maximised and they also want the Corporation's 'losses' to cease. Under current arrangements, the two are linked and producers cannot simultaneously meet both their objectives, without missing profitable market opportunities.

When the Corporation incurs losses net producer returns are reduced, through the levy arrangements.

The Corporation will have extreme difficulty in becoming and remaining 'profitable' while operating under its current constraints, even if changes are made to allow it to be more commercial.

### **The Wholesale and Retail Price of Eggs Reflects the Costs of Regulation; Consumer Choice is Reduced**

The consultants are convinced that the regulations have added significantly to the wholesale price of eggs - if for no other reason than to cover the additional production costs identified in this review. Some of the increased costs are absorbed by retailers (especially given the highly competitive retail food market in Sydney), but a significant proportion are being passed on to consumers.

Also important is the fact that the controls and regulations reduce consumer choice in many ways. Consumers do not have access to ungraded eggs, pullet eggs, and variations in packaging for which there would be variations in costs. Consumers are not permitted the option to trade-off quality and price if they wish. It is far from certain that consumers would object to seasonal fluctuations in prices. Such fluctuations characterise many of the staple foods they buy (such as potatoes and meat) and most products, including eggs, have substitutes.

## The Costs of the Current Arrangements Far Outweigh the Benefits

The consultants have quantified some of the more important economic effects of the current arrangements in NSW:

- the cost of capital tied up in quota is equivalent to about 13 cents per dozen eggs; for an industry with a net farm income of around 12 cents per dozen and an operating profit of 5 cents per dozen, this is a hidden cost of real significance;
- hen levies and licence fees currently average about 27 cents per dozen; this predominantly reflects the cost of 'equitably' managing the disposal of surplus eggs; in an unregulated market, such a surplus would be reflected in lower prices rather than higher costs and would not be equalised over all production;
- quantifying the cost of restricting hen numbers is not possible with available information; however, benefits being foregone can be identified; a producer with spare cages and labour available could benefit by 3 cents per dozen by extending the laying life of hens through moulting; running single age flocks, actively discouraged by the current minimum quota age, could yield an extra 4 cents per dozen compared with the continuous production system;
- if the Corporation were able to source additional eggs (over and above domestic demand for shell eggs) from the lowest cost producers, net benefits in excess of 2 cents per dozen across total production are very likely;
- cost reductions would flow from the Corporation being able to use its plant and equipment over a wide range of activities, in particular for the processing and production of non-egg products; and
- the regulations are resulting in transfers from consumers/retailers of at least several cents per dozen and possibly as high as 20 cents per dozen.

Overall, it is probable that the increased producer returns generated by the regulations have been largely dissipated through increased financial costs incurred by the current producers. In other words, current producers are essentially 'paying' via higher costs for the 'benefits' they are receiving via higher prices. Any consumer benefits of the regulations are likely to be outweighed by the transfers, via the egg price, to producers.

The consultants are led to conclude that the present regulatory arrangements are difficult to justify. There is a clear case for seeking to reduce the costs through changes to the current controls and regulations.

### **Objectives and Priorities for a Lower Cost and More Competitive Industry**

Given that change has to occur in the industry, it should aim to achieve:

- the creation of an environment in which commercial decisions of producers more closely align with the minimisation of the industry's production costs;
- the creation of an environment where all operators have clear commercial incentives, as well as the flexibility, to better match their supplies to market demand;
- a reduction in the cost of funds tied up in quota and the consequential distortion in the market values of depreciating non-quota assets;
- improved utilisation of the industry's productive assets; and
- a reduction in the administration, policing and non-compliance costs associated with the present arrangements.

There are no easy or totally satisfactory solutions for achieving these important objectives. However, delay or fiddling at the edges will only make the inevitable processes of change even more painful at some time in the future.

### **Modification Versus Removal of the Regulations**

It would be possible to make some modifications to the existing controls and regulations to overcome some of the unfavourable consequences. The consultants have considered those options but they are not favoured for a number of reasons:

- most create additional opportunities for circumventing the intentions of the regulations, increasing non-compliance and policing costs, and most would add to administrative costs;
- some of the options for making the Corporation more efficient and profitable would take it into areas of commercial activity inappropriate to a statutory body established for the benefit of the egg industry;
- removing all regulatory responsibilities from the Corporation - consistent with clarifying its objectives and making it more commercial - would mean that the separate regulatory body to be

- created would need extensive resources to monitor and assess the industry and its markets; and
- past modifications and adjustments and their limited success suggest that treating symptoms instead of fundamental causes is unlikely to provide lasting solutions; some of the major costs would remain and the industry would be ill-equipped to handle major change if initiated by another State.

### **The Recommended Option is to Make the Industry More Market Oriented in a Planned and Phased Manner**

The consultants do not see merit in giving further transfusions to an ailing patient - the modification option. Equally, an immediate dismantling of all existing controls and regulations is not favoured because of its potential disruptive and costly effects.

What is recommended is a set of changes which will move the industry over a defined and relatively brief time period to a more open and market oriented structure without the worst effects and consequences of options at either of the extremes.

The recommended option has considerable detail but is predicated on a few basic mechanisms. They are:

- the use of a transition period to create an environment where participants, current and prospective, can recognise, and position themselves to take advantage of, the commercial gains arising from a more market oriented industry;
- access for existing licenced producers to a well structured and commercial body involved in egg handling, processing and marketing and with the market power to compete effectively with buying entities and large new entrants;
- the encouragement of 'coalitions' of producers during the transition period to enhance their ability to compete and to take advantage of more cost efficient production systems;
- continued support for the price of domestically sold shell eggs during the transition period while encouraging the sourcing of additional eggs from lowest cost producers;
- opportunities for those who wish to leave the industry to do so in a considered and commercially reasonable manner; and

- ensuring compliance during the transition period to enable the longer term benefits to be equitably and efficiently set up and distributed.

### Key Features of the Recommended Option

The following are the key features and elements of the recommended option:

- all the recommended changes will be embodied in appropriate legislation; this would mean no amendment to legislation would be needed to modify the plan once underway;
- there would be a two year transition period from the date of effect of the legislation - equivalent to approximately 30 months from the date of announcement;
- the date of effect of the legislation and the commencement of the transition period would coincide with:
  - the removal of the 100,000 quota ceiling per producer;
  - the creation of a new Egg Industry Licensing Committee being the sole body responsible for regulation setting and compliance during the transition period;
  - the creation of a producer Co-operative with each licenced producer holding a share in proportion to quota holding on day of announcement; these shares would be immediately saleable to other producers if desired;
  - the creation of a new Company, holding the current assets of the Egg Corporation but with no vesting power; initially this Company would be owned 60 per cent by the producer Co-operative with the remaining 40 per cent being allocated to licenced producers in proportion to their quota holding on the day of announcement; this 40 per cent would immediately be tradeable and, subject to the endorsement of the Company's board, the Company would seek public listing on the Stock Exchange; the requirements of corporate law would be the only restriction on the company's activities; and
  - the removal of all restrictions preventing open competition in the market for eggs and egg based products, although there will effectively be some restrictions during the transition period, as discussed below; abolition of all statutory grading requirements for shell eggs;

- during the transition period:
  - the Egg Industry Licensing Committee would set a level of base quota assessed to be just sufficient to satisfy peak domestic demand for commercially produced shell eggs at current price levels;
  - the age for quota purposes would be reduced to 19 weeks;
  - for each farm, the level of base quota would be interpreted as an intended control over numbers of eggs produced, with scope for varying the condition of licence to reflect the particular production system being used;
  - the Committee would further approve the issue of secondary quota, on a quota weeks basis, as an integral part of contracts let exclusively by the new Company for the supply of eggs for processing and export purposes; there would be tight controls on these contracts, but the basis for pricing would be strictly commercial;
  - other commercial enterprises would be free to develop egg processing activities, based on the availability of surplus shell eggs produced out of base quota away from peak demand periods, but would not have access to secondary quota for the duration of the transition period;
  - a levy would continue to be payable to cover the administrative costs of continued regulation, but not to fund price equalisation; this levy could be assessed in relation to quota held or could be applied at the hatchery level; and
  - tight policing would be maintained for the duration of the transition period, but clearly predicated on the objective of removing the need for such policing at the end of that period; and
- at the end of the transition period, quota restrictions would cease and the Egg Industry Licensing Committee would lapse.

The ownership structure of both the Company and the Co-operative would afford a very high level of protection against takeover, while affording a facility for significant external capital injection should the owners so choose. In essence, the current ceiling on quota ownership would be translated into a broadly comparable ceiling on ownership of shares in the Co-operative.

During the transition period, producers would be encouraged to make an assessment of their future in the industry and to act on this assessment against the backdrop of:

- greatly expanded incentives and flexibility: to develop their enterprise and their markets; to seek out mutually beneficial coalitions of interests in respect of production, grading, processing and marketing; to select production systems on the basis of maximum profitability per dozen, or per kilogram, of eggs rather than on the basis of optimal utilisation of quota;
- a high level of market power through the Co-operative and the Company in which it has a majority shareholding - a Company with established sources of supply, major retail outlets and distribution networks;
- clear market signals as to the true market return from expanding production beyond the level dictated by base quota;
- a continuing market for production quota, partly driven by the demands of existing producers and potential new entrants to the industry to position themselves in respect of both sources of supply and of markets during the transition period; and
- a new market for the equity held in the new Company, both directly and through shares in the Co-operative.

Beyond the transition period, the industry would be fully market oriented, but with the advantages of established coalitions of interest, with associated sources of supply, markets and processing facilities, owned by and reflecting the aspirations of existing producers. These interests would be exposed to competition, but could expect to have available to them defences based on size economies, established distribution networks and a product range and brand names already well positioned in the marketplace.

#### **Questions Likely to Arise Regarding the Recommendations**

Finally in this summary document, in an effort to clarify the recommendations and their impact on the various participants in the industry and over time, a series of likely questions are posed and then answered briefly.

##### **Q.1 *Why Have These Recommendations Been Made?***

- They directly and efficiently attack the main recognised sources of unnecessary costs imposed on the industry by the present regulations;

- they recognise and preserve the significant investment made in the industry by existing licenced producers;
- they increase incentives and flexibility; and
- they remove the need for indefinite and stringent policing of an elaborate and highly intrusive set of regulations.

Q.2 *Why Were Other Options Rejected?*

- No other option could so successfully achieve the objectives;
- modification of the status quo would maintain high costs and policing requirements and would remain unstable;
- immediate deregulation could entail severe losses for existing producers and costly and inefficient disruption in the industry; claims for compensation could be expected.

Q.3 *What Industry Changes Would Occur Immediately on Enactment of the New Legislation?*

- The Egg Corporation would cease to exist and a new Egg Industry Licensing Committee would be formed;
- the Corporation's assets would be transferred to the new Company, owned by existing licenced producers (both directly and through the new Co-operative);
- producers would receive 'base quota', in proportion to their existing quota, and could compete to supply additional eggs through a 'secondary quota' scheme administered by the Committee;
- producers could expand production or sell quota and leave the industry; new entrants could emerge; the ceiling on quota ownership would cease.

Q.4 *What Circumstances Would the Industry Face at the End of the Transition Period?*

- Remaining production controls would be removed and the Licensing Committee be abolished.
- Industry would have lower costs of producing eggs and a capacity to draw eggs from least cost sources;
- 'coalitions' of producers, with links to marketing and processing facilities, would have formed;
- some producers would have left, others would have entered;
- a facility would remain for levying the industry for R&D and related purposes.

Q.5 *Why is a Two Year Transition Period Proposed?*

- It is an integral part of the arrangements;
- it would support the mechanism for producers to form and develop 'coalitions';
- it would provide the industry with a finite period of 'controlled competition', during which producers could assess their options; and
- it reflects the consultants' judgement as to the time necessary to achieve these changes in an orderly manner without being so long as to encourage complacency.

Q.6 *Why Should a Co-operative be Formed of Current Producers?*

- It would ensure that all producers have access to market power through a co-operative with a controlling interest in an established processing and marketing company;
- its majority shareholding in the Company would afford the Company a high degree of takeover protection, while enabling the injection of new and outside equity; and
- it would provide a model for the development of other producer coalitions.

Q.7 *Would Producers be Required to Use the Co-operative and the Company?*

- No; they would be free to supply markets directly or through any other agents; and
- a facility would exist for valuing, buying and selling shares in the Co-operative.

Q.8 *How Can We Be Certain That the New Company will be Valuable and Successful?*

- The Company will commence with valuable assets in the form of capital items; experienced staff; established markets and distribution networks; and recognised trade names and associated goodwill;
- the Company would be free of the regulatory constraints (particularly on pricing and requirements to receive) responsible for Corporation losses;
- during the transition period, it will enjoy advantages over potential competitors, including access to secondary quota and the economies associated with large scale processing and marketing; but

- its ultimate success will depend on the quality of its management.
- Q.9 *Would the Company be Listed on the Stock Exchange as a Public Company?*
- This would be a decision for the Company's management; it is probable that listing would be sought to enable an equity injection.
- Q.10 *What is the Significance of Having Two Classes of Quota?*
- The current one class quota system creates significant difficulties in targeting potentially profitable but lower priced markets;
  - some efficient producers with access to spare cage capacity could supply additional eggs profitably at a price well below that needed for reasonable profit for the industry as a whole; and
  - the transition period can be used to develop systems for sourcing eggs and supplying markets on a fully commercial basis, without undermining the price of domestic shell eggs.
- Q.11 *How Would the Profits Derived from Secondary Quota be Distributed?*
- Any additional profits would accrue to the Company and hence to all existing producers; and
  - The benefits would be greater because of the facility to seek eggs from lowest cost sources.
- Q.12 *How Would the Relative Positions of Licenced and Unlicenced Producers be Affected?*
- Unlicenced producers currently receive many of the benefits of regulation without incurring the costs of financing quota, payment of levies etc;
  - under the recommended changes, this competitive edge would be removed;
  - unlicenced producers would receive no equity in the Company or the Co-operative;
  - during the transition period, licencing restrictions would continue to be enforced;
  - unlicenced producers could tender to supply eggs for processing and would be free to develop their enterprises at the end of the transition period on the basis of their true efficiency and competitiveness;

- licenced producers with surplus hens would receive equity only in proportion to their quota, not the number of hens.

Q.13 *Would There Be a Continuing Need for Policing?*

- During the transition period, yes, but not thereafter.

Q.14 *Would Producers Be Disadvantaged by the Recommendations?*

- Producers would be offered a range of new commercial opportunities, increased flexibility and scope for cost savings; most would benefit from these changes;
- some existing producers can be expected to leave the industry, but with the option of selling all or part of their asset package (farm, shares in the Co-operative, shares in the Company and quota); and
- new entrants would seek to position themselves in the industry with a planning horizon extending beyond the transition period.

Q.15 *Would Distributors Be Disadvantaged?*

- the initial Company structure would preserve the present Corporation distribution requirements, although existing trends away from Corporation sales of shell eggs may intensify;
- the proposals would create new distribution opportunities, including for non egg based products.

Q.16 *Would Consumers Benefit?*

- Yes; cost reductions would be shared between producers, retailers and consumers;
- prices may be less stable, as with fruit and vegetables, but consumers would also benefit from a wider choice of product, grading and packaging.

Q.17 *What Would be the Implications for Other States?*

- During the transition period, there should be no immediate implications for shell egg markets; NSW would become a more competitive supplier of egg products;

- at the end of the transition period, there would be a major threat to the sustainability of the current arrangements in other States; and
- other States would have approximately 30 months to plan for this; seeking to increase barriers would probably not withstand legal challenge.