AgEcon SEARCH
RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search
http://ageconsearch.umn.edu
aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

Interstate Trade in Market Milk

Annette M. Small*

Interstate trade has been a feature of the policy debate for several agricultural products in Australia, including wheat, eggs and dairy products. Interstate trade in market milk has been an on-going policy issue since the early 1970s, but has largely been prevented by informal agreements and threats of retaliation. Formal arrangements preventing free interstate trade are unlawful, being contrary to Section 92 of the Australian Constitution. Due to recent changes in the marketing arrangements for manufacturing milk, interstate trade in market milk now has the potential to rapidly deregulate the whole Australian dairy industry, with the consequent problems of resource dislocation and adjustment. The potential impacts of interstate trade in market milk are discussed below, commencing with a description of the background and situation as 31 December 1987.

Background and Current Situation

The dairy industry in Australia may be divided into two distinct sectors: milk for direct human consumption ("market" milk, accounting for 27 per cent of total milk production) and milk used for manufactured dairy products ("manufacturing" milk, accounting for 73 per cent of production). Approximately 40 per cent of manufactured dairy products are exported, with around 90 per cent of exported products being sourced from Victoria.

Separate marketing and assistance arrangements exist for market and manufacturing milk, although the arrangements for market milk also impinge on the arrangements for manufacturing milk and vice versa. Presently a significant price differential exists between market and manufacturing milk at farmgate, although this may be eroded by interstate trade. For 1987-88 the prices are forecast to be 18c/L and 36.1c/L for manufacturing and market milk, respectively (ABARE 1987).

The differential between market and manufacturing milk prices is maintained through the regulatory framework. The differential depends on the maintenance of separate markets for market and manufacturing milk within states and informal restrictions on market milk trade between states. In NSW all milk produced is vested in the NSW Dairy Corporation (NSWDC). Individual farmer shares of the high-priced market milk market in NSW are regulated through non-transferable farm supply quotas. One of the requirements for NSW quota holders is the consistent supply of milk throughout the year, resulting in a "deseasonalised" pattern of production.

In Victoria, regulation of market milk is performed by the Victorian Dairy Industry Authority (VDIA). In Victoria there are no farm held supply quotas and farmers share proportionally (according to volume of production) in the market milk returns.

On 1 July 1986 new national dairy marketing arrangements were implemented, providing assistance to manufacturing milk producers (the Kerin Plan). Broadly, assistance is provided to manufacturers (and ultimately farmers) of export product and is funded by a levy on all milk produced. This arrangement also provides implicit price support for domestically sold products as export returns plus assistance effectively sets the floor price on the domestic market. The underlying aim of the arrangements is to increase prices received by manufacturers from export parity to import parity. A detailed description of the Kerin Plan is provided in Davis, Burfitt and Small (1986).

One aspect of the Kerin Plan is the "comfort clause" which was included largely because of the potential threat of interstate trade in market milk. This clause was designed so that, in the event of disruptive practices in the industry, the collection of the all-milk levy could be suspended pending agreement within the Australian Agricultural Council (AAC),[1] and market support payments suspended. Accordingly, interstate trade in market milk has the potential to break down the marketing arrangements for manufacturing milk.

* Division of Marketing and Economic Services, New South Wales Department of Agriculture, Sydney. The views expressed are those of the author and do not necessarily reflect those of the Department of Agriculture nor the Minister for Agriculture.

1. AAC consists of the Commonwealth Minister for Primary Industry, State Ministers responsible for agriculture, and the Minister for Primary Production from the Northern Territory.

Interstate trade in market milk has largely been confined to the supply of Victorian milk to the border regions of NSW and to the Mallee of South Australia; South Australian milk to Broken Hill; and northern NSW milk to the Gold Coast of Queensland (IAC 1983). The incidence of further interstate trade has been moderated by negotiation and the threat of retaliation and/or legal contest. However, since the 1970s there has been "an uneasy truce which could explode at any time" (Haberfields 1983). In 1985-86 Midlands Milk Ltd (Shepparton) successfully challenged the NSWDC's efforts to contain interstate trade. It was ruled that the NSWDC was acting in an unconstitutional manner and, as was ruled in 1975, health and hygiene were no longer sufficient cause for trade prevention.[2]

During 1987 the issue of interstate trade in market milk re-emerged. On 10 April 1987, shipments of packaged milk, equal to approximately 1 per cent of the Sydney market, commenced for a period of 30 days. This milk was sold by Jewel Food Stores (NSW) at a discount of 9c per 2 litre container.

The immediate impact of this trade was the invocation of the comfort clause by the NSW Minister for Agriculture. The request for the suspension of the market levy was subsequently withdrawn, following a temporary agreement between the NSWDC and the VDIA. Two temporary and partial solutions were implemented:

(1) an agreed access arrangement for the supply of bulk milk, equal to 1 per cent of the NSW market (over and above the previously negotiated access), for a period of 90 days; and
(2) a committee was established to determine a long run solution to the issue.

In August 1987, during the 90 day reprieve period, Midlands Milk and Jewel Food Stores recommenced trade in market milk for discount sales. This action again led to the invocation of the comfort clause by the NSW Minister and subsequent withdrawal of the request at the required meeting of AAC, on 2 October 1987.

During this period it was decided by the NSW and Victorian Ministers to extend the arbitrary level of access to 5 per cent, conditional upon no further interstate trade. However, Midlands announced on 31 October its intention to continue to trade with Jewel Food Stores.

Discussions have taken place between the Victorian and NSW industries resulting in rejection of the Ministerial agreement. Instead, NSW has proposed offering access to the Victorian industry via a contract for a six-month period with a possible six-month extension.

Following the second invocation of the comfort clause the NSW Dairyfarmers Association (DFA) and the United Dairyfarmers of Victoria (VDU) also negotiated an extended share of the NSW market milk market for Victoria. This agreement contained three main features:

(a) the VDIA would be offered 5 per cent access to the NSW market after 5 years, effected through the purchase of NSW surrendered quota;
(b) complementary State and Commonwealth legislation would be required to collect a further levy on market milk, in an attempt to remove the financial incentive for interstate trade; and
(c) the Kerin Plan would be modified to place an upper limit on export support.

While these agreements represent a move toward more rational sourcing of market milk, there are five broad problems:

(i) The access levels granted were arbitrarily determined and do not necessarily reflect an "efficient" level of market access.
(ii) The financial incentive for interstate trade will not be removed. Based on 1986-87 production and pricing levels, 5 per cent access represents a gain of $540 per Victorian farm per year.
(iii) The requirement for complementary State and Federal legislation is not likely to be seen as expedient to the Federal government and may be open to challenge under Section 92.
(iv) The proposals will not relieve the significant consumer transfers involved with existing regulation.
(v) The proposals do not allow for changes to the present quota arrangements for sourcing market milk in NSW. As such, the significant cost savings available to NSW farmers from seasonal production would not be realised.

More recently, the Victorian Minister for Agriculture announced new legislation aimed at removing the incentives for interstate trade for Victorian processors. Broadly this legislation requires that all milk purchased for supply of any market milk market must be paid for at the farmgate market milk price. Prior to this legislation, Victorian processors wishing to

2. North Eastern Dairy Co. Ltd v. Dairy Industry Authority of New South Wales, (1975) 7 *Australian Law Reports* 433.

engage in interstate trade were able to source milk directly from farmers and pay a price negotiated between the farmer and the processor. It is likely that this price would have fallen within the bounds set by the state average price for market and manufacturing milk. While this legislation will reduce the profit margin available to processors and/or retailers from interstate trade, it is unlikely that it would be eliminated. As such, interstate trade may be expected to continue.

Incentives for Interstate Trade

Under the existing dairy marketing arrangements and price structures there are incentives for farmers and retailers to engage in interstate trade. For Victorian farmers the incentive is the existence of a major, premium priced market in close proximity to Victoria. In contrast to NSW, the supply orientation of the Victorian industry is toward manufacturing milk for export. Market milk accounts for only 12 per cent of total Victorian production and 20 per cent of revenue while in NSW, market milk accounts for approximately 65 per cent of sales by volume. The residual 88 per cent of total production in Victoria is sold as manufacturing milk, earning approximately 18c/L at the farmgate (gross of the all-milk levy). The ability of the Victorian industry to supply milk to the NSW market and thereby initially increase total returns, is a significant incentive for interstate trade.

There are also incentives for retailers to instigate or co-operate in interstate trade. Currently, supermarkets account for approximately 25 per cent of retail liquid milk sales in NSW and receive an administered margin for profit. The remining 75 per cent of sales is split between vendors (40 per cent) and small shops (35 per cent). Milk is seen as a high turnover item for supermarkets, attracting customers on a daily basis. The ability to offer discounted milk and thereby increased market share of both milk sales and total supermarket sales, is likely to be a significant incentive for interstate trade. Further, the participation in trade outside of the regulated pricing and margin structure for liquid milk may result in an increase in the profit margin available to retailers (even in the presence of retail price discounting).

The incentives to Victorian farmers to engage in interstate trade will remain while the price differential between market and manufacturing milk remains significant. Four factors are important in assessing the future price differential. First, the outlook for world dairy markets remains reasonably depressed with significant levels of stocks in the major trading nations and stagnant world demand for most manufactured products. This will continue to be reflected in low manufacturing milk prices at the farmgate.

Second, although the farmgate price for market and manufacturing milk increased for 1985-86 and 1986-87, this was largely the result of the "windfall gain" from the significant devaluation in the Australian dollar. Any improvement in the Australian currency, which has been forecast for the medium term by the Australian Bureau of Agricultural and Resource Economics (see O'Mara, Crofts and Coote 1987), will have a downward impact on Australian farmgate prices for manufacturing milk.

Third, the supplementary support levy for butter and cheese payable under the Kerin Plan is to be gradually removed. This additional support would be currently reflected in the manufacturing milk prices. Fourth, the administrative price setting arrangements for market milk are likely to result in continued increases in the farmgate price for market milk. It is therefore unlikely that the current significant differential for market and manufactured milk will narrow in the medium term and thus the incentives for interstate trade will remain.

Price Determination in a Deregulated Market

In the event of a collapse of the Kerin Plan or an increase in the levels of interstate trade, it is likely that the prices for both market and manufacturing milk would decline from present levels. Although the Kerin Plan provides explicit price support for exported products, it also provides implicit support for domestically sold product through the setting of floor prices.

Further, in the absence of price support for manufactured products, there would be a greater incentive for Victorian dairy farmers to participate in interstate trade. The subsequent increase in competition would erode the present market milk premiums in NSW and, assuming retaliation by NSW farmers, in Victoria.

While it is generally agreed that price declines would be inevitable, several alternative price levels have been assumed by various industry participants. The major determinant of price declines will be the level of competition which eventuates on the domestic market for both market and manufacturing milk.

In the absence of the Kerin Plan and with

competitive trading, the range within which price will settle will theoretically extend from a ceiling price equal to current price levels, to a floor price equal to export parity for both market and manufacturing milk (about 10c/L). However, even with a relatively intense level of competition, price is unlikely to decline beyond import parity levels (about 13c/L) for manufacturing milk. For market milk, the final price is likely to include a margin for transport and a small premium for quality and hygiene (13c+7c+2c/L). At current levels of production, the average price in NSW—that is, total revenue received from market and manufacturing milk sales divided by total production—would therefore decline to 19c/L.

The average price which will eventuate in NSW will be determined by the percentage of market milk supplied by Victoria and the proportion of market and manufacturing milk produced in NSW. In the event of a significant decline in price, a number of NSW farmers would leave the industry, reducing the total production of milk in NSW, and increasing the proportion of total production sold as market milk. This would have a positive impact on the average price in NSW.

The final price which will be determined in the absence of the Kerin Plan will also be related to the price paid for manufacturing milk in Victoria. The concept of "rational sourcing" is dependent on the ability of the Victorian industry to supply the NSW market milk market during months of deficit production in Victoria. As a consequence, the supply of milk to NSW will further reduce the availability of milk for processing in Victoria during winter. This is likely to result in two impacts. Firstly, Victorian processors will need to compete for the available supplies of surplus milk through increasing price. Currently, Victorian processors pay producers winter incentive payments to encourage production during the traditional "off-season". To attempt to maintain production, prices would need to be increased. This would increase the average manufacturing milk price in Victoria and therefore the price for market milk during these months. Second, Victorian processors will need to continue to rationalise their present operations, in an attempt to improve capacity utilisation and efficiency (*cf.* Small 1986).

The preceding discussion has assumed that, in the event of the collapse of the Kerin Plan, market milk premiums will not be maintained. In the event of the "orderly" introduction of rational sourcing, however, the current premium structure may be preserved. While some reduction in the average price paid in NSW may occur due to some loss of market share of the market milk supply in NSW, this may be off-set by subsequent declines in production, in response to the lower average price. In this situation, the retail price for market milk would be unchanged and the level of consumer transfer currently occurring would be maintained. Further, the incentive for interstate trade outside the administered system would not be removed because the differential in farmgate prices would not narrow significantly.

Conclusions

During 1987 the issue of interstate trade in market milk re-emerged as a major policy issue for the Australian dairy industry, with the potential collapse of the marketing arrangements for manufactured milk products. While initially this would affect the export sector of the industry, the resulting increases in competition in both the domestic manufactured products and market milk sectors would lead to a significant erosion in prices paid at the farmgate. While potentially this could result in a decline in prices to export parity levels, it is likely that prices will settle at higher levels than this. The final prices paid will ultimately depend on the level of competition in both milk markets and the declines in supply which would result.

The present incentives for interstate trade arise from the significant differential between market and manufacturing milk prices at the farmgate. In the absence of reform to the present arrangements for sourcing market milk, it is likely that the incentives for interstate trade will continue in the medium term.

Despite intensive negotiations at all levels of the dairy industry, no effective long run solution to the "problem" of interstate trade has been developed. This is because, to date, the solutions have not been aimed at removing the incentive for "disruptive" trading, that is, the existing significant price differential. However, an effective long term solution will depend on intensive economic, agronomic and animal research, and continued co-operation between all sectors of the dairy industry.

References

AUSTRALIAN BUREAU OF AGRICULTURAL AND RESOURCE ECONOMICS (1987), "Dairy Products", *Quarterly Review of the Rural Economy* 9 (4), 390-392.

DAVIS, D., BURFITT, T. and SMALL, A. (1986), "Dairy Industry Marketing Arrangements—background, costs, farm management implication", *Commodity Bulletin* 15 (4), 16-25.

HABERFIELDS MILK PRODUCTS LTD (1983), Submission to the 1983 Inquiry into the Dairy Industry, Sydney, mimeograph.

INDUSTRIES ASSISTANCE COMMISSION (1983), *The Dairy Industry*, Industries Assistance Commission Report No. 333, Australian Government Publishing Service, Canberra.

O'MARA, P., CROFTS, B. and COOTE, R. (1987), "Prospects for exchange rates and interest rates: implications for farmers", *Quarterly Review of the Rural Economy* 9 (4), 440-448.

SMALL, A. (1986), Structure, concentration and costs of production for the Australian dairy processing sector, Paper presented to the Australian Agricultural Economics Society Annual Conference, Adelaide, February, mimeograph.