



## **Review of multi-peril crop insurance**

**Submission in response to IPART draft report**

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### **NSW Farmers' Association Background**

The NSW Farmers' Association (the Association) is Australia's largest State farmer organisation representing the interests of its farmer members – ranging from broad acre, Livestock, wool and grain producers, to more specialised producers in the horticulture, dairy, egg, poultry, pork, oyster and goat industries.

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## **Introduction**

NSW Farmers is Australia's largest state farming organisation representing the interests of the majority of commercial farm operations throughout the farming community in NSW. Through its commercial, policy and apolitical lobbying activities it provides a powerful and positive link between farmers, the Government and the general public.

The state of NSW is responsible for the production of almost a quarter of Australia's gross value of agricultural production and twenty percent of Australia's agricultural exports. Importantly the value of agriculture to the regional economies with almost one in thirteen employees in NSW regions directly employed in agriculture, fishing or forestry.

The NSW Government has recognised the competitive advantage that agriculture brings to the state's economy and its regions and has established the following initiatives to drive growth in the sector:

- The development of the Agriculture Industry Action Plan *Primed for growth: Investing locally, connecting globally*;
- The development of the Memorandum of Understanding with NSW Farmers; and
- The strategic vision of the Department of Primary Industries to grow the value of NSW's primary industries by 30% by 2020.

NSW Farmers welcomes the opportunity to provide the Independent Pricing and Regulatory Tribunal's (IPART) with feedback in response to its draft report into its assessment of multi-peril crop insurance (MPCI) incentive measures.

## **Background**

### ***Context of IPART Review***

Prior to the 2015 NSW Election, the NSW Liberals and Nationals entered into a Memorandum of Understanding (MOU) with NSW Farmers with the commitment of propelling the growth of agriculture as a major economic driver of the NSW economy, specifically through investment in regional NSW. As part of the MOU the Liberals and Nationals committed to developing multi-peril insurance as an option for farmers with the action of hosting a multi-peril insurance summit which was held in Sydney during November 2015.

The summit identified the following themes as areas for attention by government and industry to facilitate the development of a sustainable commercial market for multi-peril insurance for farmers:

- **Knowledge** - Ensuring farmers have the knowledge of how multi-peril insurance products operate to enable them to accurately assess and cost multi-peril insurance as a risk management option.
- **Data** – ensuring that insurance companies have access to sufficient data to be able to accurately price risk and develop improved multi-peril insurance products.
- **Incentives** – the development of government policies to incentivise access to multi-peril insurance products, noting its ability to contribute to the economic, social and rural development objectives of government.

- **Affordability** – opportunities to reduce both up-front and premium costs associated with multi-peril insurance noting that present costs are considered commercially prohibitive for farmers.
- **Leadership** – from the insurance and farming sector as well as Government.

***Government objectives in developing multi-peril insurance as an option for farmers***

NSW Farmers acknowledges the present review is being conducted using IPART's drought program evaluation framework following the terms of reference provided to IPART by the NSW Government. This requires IPART to focus narrowly on the investigation of the specified measures in respect to the:

- Intergovernmental Agreement on National Drought Program Reform; and
- Broader drought policy objectives.

Nevertheless, in addition to the value MPCl may provide to furthering drought policy outcomes, NSW Farmers believes other government objectives may also be addressed through well planned initiatives designed to facilitate the market for MPCl. These additional objectives include the Government's MOU commitment to propel the growth of agriculture as a major economic driver of the NSW economy, specifically through investment in regional NSW.

While the draft report identifies that other outcomes that may arise from a functional market for MPCl, such as facilitating the ability of farm businesses to undertake financial consolidation, these have only been evaluated in the context of drought policy. From the perspective of providing the NSW Government with a more holistic consideration, IPART's final report would be enhanced if other government objectives were specifically addressed.

***Measuring social costs and benefits in the evaluation framework***

NSW Farmers believes that if the drought program evaluation framework is to operate successfully, a holistic approach to benefit cost assessment must be incorporated within the reviews undertaken by IPART. This includes careful acknowledgement and analysis of the social benefit that arises as a result of a proposed program and the opportunity cost of the decision to forgo the implementation of programs.<sup>1</sup>

NSW Farmers recommends that the potential social benefits and costs associated with the options to facilitate a commercial MPCl market be incorporated within IPART's final report.

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<sup>1</sup> See NSW Farmers, submission to the Independent Pricing and Regulatory Tribunal in response to 'NSW Drought Program Evaluation – Draft Report' (December 2015) 5,12.

## **Response to Draft Report**

### ***Findings on government support for multi-peril crop insurance***

#### **Draft finding 1**

Multi-peril crop insurance could play an indirect role in increasing crop farmers' self-reliance during droughts.

As outlined in our response to the issue paper, NSW Farmers specifically supports investigation into the design of MPCl products and the role of government to facilitate the development of a market for such products. However, in the context of an integrated approach to drought policy it is important to acknowledge that there are limitations to the role of insurance. Specifically, as a result of the systemic risk and moral hazard associated with the insurance of farm businesses in prolonged drought conditions, it is unlikely that MPCl policies would be made available in these circumstances or at least at premiums commercially affordable by these businesses.

NSW Farmers also cautions against any approach which would focus too closely on the availability of insurance markets as the solution to all of the economic and regional development problems created by drought. For example, proposals that would seek to reduce the assessment of whether a farmer has made reasonable steps to prepare for drought to the question of whether they have taken out a MPCl policy underestimate the range of drought preparedness strategies available to farmers.

Such an approach would be likely to distort risk management strategies towards insurance, regardless of whether it was the most appropriate option for that business. This in turn would stifle the development of innovation in the on-farm management of climatic risk.

In light of the above, NSW Farmers agrees with IPART's draft finding that a functioning market for MPCl would complement existing tactics available to farmers as part of their climatic risk management strategies. Specifically, NSW Farmers supports the potential of MPCl to:

- Promote farm business profitability in favourable seasons enabling enhanced financial consolidation;
- Facilitate appropriate seasonal financing of operations. This in turn reduces the requirement to fund working capital against land values, managing risks to farm business equity from production catastrophe; and
- Protect investment in cropping programs undertaken in the first year of a drought event, as well as necessary reinvestment in farming businesses during drought recovery stages against further climatic downturn or variability, such as flood or frost.

On this basis, NSW Farmers generally concurs with comments in the draft report that find government measures that facilitate the adoption of MPCl may meet the following objectives of the Intergovernmental Agreement on National Drought Program Reform:

- ‘assist farm families and primary producers adapt to and prepare for the impacts of increased climate variability’; and
- ‘encourage farm families and primary producers to adopt self-reliant approaches to manage their business risks’.

However, NSW Farmers disagrees with the limitations within the draft finding that MPCCI is only able to indirectly increase farmers’ self-reliance during droughts. This is due to the capability of MPCCI to protect a farmer’s investment in cropping programs that arise in the first year of a drought event and if drought relapses after an initial recovery stage.

An example of this may be observed when considering the different agronomic conditions across the different cropping regions of NSW that will impact the decision of whether a grain farmer will make the decision to plant or not.

Figure 1 displays the Seasonal Rainfall Zones of Australia. Farmers located in the Summer Rainfall Zone, particularly those in the Central North and the North West of NSW with heavier soils and enhanced moisture holding capacity, will make planting decisions based on pre-season rainfall and soil moisture. However, the ability to make a planting decision on pre-season rainfall and soil moisture is more limited for farmers located within the Uniform Seasonal Rainfall Zone in the southern half of NSW. This is particularly so in locations where soils are lighter and have lower capacity to hold moisture and farmers are reliant on in-season rainfall.



Figure 1: Australian Export Grains Innovation Centre 2016

Where a grain or oilseed farmer in NSW's uniform seasonal rainfall zone has MPCl, they would be eligible for indemnification for the variable costs of planting and any other crop management if crop failure should occur due to onset of drought conditions. In these circumstances MPCl will prevent the need to draw down on equity to fund these expenses, limiting the balance sheet deterioration created by a drought event.

This is particularly important as a result of industry wide structural adjustment within Australian agriculture towards aggregation of farm size to develop economies of scale. The process of land acquisition and necessary capital improvements associated with farm aggregation exposes businesses to higher levels of debt and associated debt servicing requirements. Consequentially this places limits on the ability of expanding farm businesses to convert operating surpluses into higher equity.

Additionally, the larger debt servicing requirements of an expanding farm business increases the business' exposure to de-capitalisation in the event of production catastrophe. As a result the ability to transfer the risk to the insurance market through MPCl will assist businesses that have recently expanded, but have not yet had the opportunity to undertake the necessary financial consolidation to withstand the impacts of production failure.

#### Draft finding 2

Multi-peril crop insurance is unlikely to displace government assistance, such as concessional loans and farm household support payments during droughts.

NSW Farmers agrees with the draft finding that MPCl is unlikely to displace the need for in-event assistance due to the fact that:

- Under the current one year terms of MPCl products, farmers will be unable to access affordable insurance during prolonged drought periods.
- The present multi-peril insurance product offering is limited across the agricultural industry. This not only precludes coverage for livestock businesses, but also for summer grains and horticultural crops from taking out multi-peril insurance. Further, as noted in the draft report, the livestock sector accounts for 80 per cent of Government expenditure on in drought event assistance.
- It would distort the market for drought preparation tactics if the mutual obligation of a farmer to be reasonably prepared for drought was limited to MPCl.

NSW Farmers is aware that some crop insurance providers are undertaking product development with the aim of offering multi-year MPCl policies. The development of these multi-year policies will provide benefit to farmers by providing them with an additional risk management tool to indemnify them from the financial losses across a multi-year period.

Even if multi-year policies were available, NSW Farmers continues to hold doubts over the ability of MPCl to be, in isolation, the most effective or efficient means of resolving the economic and regional development problems created by drought.

Low uptake probably due to high structural costs of multi-peril insurance

NSW Farmers agree with the draft report's conclusion that the high structural costs and the resultant impact upon the price of MPCl premiums is a major factor behind the low uptake of MPCl policies.

Farmers price the value of MPCl against other forms of risk management considering the cost and benefits. Specifically, with regard to MPCl, farmers are assessing the value of the foregone premium in respect of the insured amount; not on a per hectare basis.

Therefore, with regard to IPART's understanding that the cost of MPCl is falling based on the per hectare cost; NSW Farmers wonders if the product innovation claimed is the introduction of higher deductibles. Where higher deductibles are the reason behind lower MPCl premiums, the benefit of the policy is reduced to the insured amount reducing the perceived utility of the insurance in comparison to other risk management options.

As outlined below, NSW Farmers is not opposed to the proposal within the draft report to develop a program that subsidises premiums for MPCl policies as an option for Government to reduce the impediments to farmers taking up MPCl. However, in addition to the proposal to develop demand side initiatives, NSW Farmers recommends IPART undertakes analysis of potential Government initiatives to reduce the structural cost for the provision of MPCl products. This recommendation is made in the understanding that the administrative costs of offering MPCl policies in Australia could be as much as 50% more than the actuarial risk of the product.<sup>2</sup>

Without complementary measures that aim to reduce the structural cost of providing MPCl, NSW Farmers is concerned at the modelled reduction of farmers holding MPCl policies at the completion of the subsidy. This increases the possibility of a return to unsustainable adverse selection across the MPCl insurance pool, threatening the long term sustainability of the market.

Potential complementary supply side interventions that could be assessed includes adapting existing yield prediction models and the use of satellite and drone imagery so that they may be better utilised by insurers to undertake essential functions such as loss adjustment.

Improve access to capital for farmers

NSW Farmers disagrees with the conclusions made in the draft report with regard to current high levels of equity, resulting from increasing land values, reducing concerns that farmers need alternative means, such as MPCl, to access capital.

Analysis undertaken by the Australian Farm Institute into the risks faced by Australian farmers drew the conclusion that for medium-sized broadacre farms it was no longer appropriate to utilise historical views of equity levels as a measure of long term financial

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<sup>2</sup> OECD, *Thematic Review on Risk Management: Australia* (Working Party on Agricultural Policies and Markets, 19 November 2010), 21.

viability.<sup>3</sup> This finding was based on the fact that farm consolidation has led to increased accumulation of debt and debt servicing requirements which will impact long term on the ability of farmers to access capital from the banking sector.

Further, as newer forms of capital seek to partner with Australian agriculture, such as joint ventures between family farms and international funds, MPCl will provide the assurance to these investors that the production risk Australian agriculture faces from drought will not result in capital losses. This could result in greater competition from capital to invest in agriculture, providing the on-farm investment in productivity necessary to ensure Australia's international competitiveness in global commodity markets.

Lastly NSW Farmers is hopeful that with increasing maturity in the market for MPCl, opportunities to secure short term working capital against the insurance product will develop. This would in particular assist farming businesses in the drought recovery stage that have undergone a fall in equity due to prolonged absence of income and face reluctance from financial institutions to extend further working capital. This impedes the ability of a farming business to utilise recovering conditions and fund debt reduction and financial consolidation through a successful crop program.

This would not only facilitate farm business recovery, but also the recovery of the regional economy through the purchase of necessary farm inputs.

#### Encourage additional structural adjustment in the agricultural sector

For the reasons in the above response to Draft finding 1,<sup>4</sup> NSW Farmers believes that a functional market for MPCl will assist in facilitating the continued trend to aggregate land agricultural holdings to develop greater efficiencies of scale.

### ***Upfront Premium Subsidy***

#### Draft finding 3

An upfront subsidy complies with the drought framework

As outlined above, NSW Farmers is not against the Government introducing an upfront subsidy for MPCl policies along a similar manner proposed within the draft report. In considering the benefits of the proposed program, CIE estimated that if the average MPCl premium cost between \$22 and \$30 per hectare, by the conclusion of the program between 9 and 16% of grain farms will hold MPCl policies. Conversely, the conclusion of the program is estimated to result in the level of insurance dropping to between 7 and 11%.

As a result, NSW Farmers is concerned at the ability of the proposed subsidy to develop lasting change in the market place without complementary measures to reduce the structural cost of providing MPCl.

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<sup>3</sup> Mick Keogh, 'Including risk in enterprise decisions in Australia's riskiest businesses' (Paper presented at the 56<sup>th</sup> Annual Conference of the Australian Agricultural and Resource Economics Society, Fremantle, February 2012), 2.

<sup>4</sup> See page 7.

Lastly, NSW Farmers believes IPART should consider whether control options are necessary within the proposed subsidy program to minimise potential perverse outcomes, such as increases to the cost of MPCl premiums.

### ***Five-year stamp duty***

#### Draft finding 4

A five-year stamp duty waiver on insurance premiums does not comply with the drought framework, because it would not be effective in achieving its objectives. In addition, it is not complementary with the upfront premium subsidy, which would be more effective in achieving the same objective.

Despite the NSW stamp duty for crop insurance already being levied at a concessional rate, NSW Farmers agrees with the argument put by others at the public hearing that it is not consistent to offer a subsidy to enter into MPCl, while at the same time retaining the disincentive of stamp duty. Therefore NSW Farmers disagrees with draft finding 4.

### ***Farm Business Skills Professional Development Program***

#### Draft finding 5

The NSW Farm Business Skills Professional Development Program does not comply with the drought framework, but can be redesigned by removing the overlap between it and the Commonwealth Managing Farm Risk Program

#### Draft recommendation 1

That the NSW Farm Business Skills Professional Development Program be redesigned to exclude the preparation of financial and production data from being eligible for a rebate.

The draft report finds that the Farm Business Skills Professional Development Program (Farm Skills Program) fails to comply with IPART's drought evaluation framework on the basis that the assessment found overlap between it and the Commonwealth's Managing Farm Risk Program (MFRP). In line with the terms of reference provided to IPART, the draft report recommended that the program be redesigned to remove this overlap. In expounding the outcome of the proposed redesign the draft report stated:

The rebate would only be available in relation to professional development activities.<sup>5</sup>

NSW Farmers argues that it is neither necessary to excise the entire scope of the professional services component of the Farm Skills Program to remove the overlap between it and the MFRP, nor is it desirable.

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<sup>5</sup> Independent Pricing and Regulatory Tribunal, 'Review of multi-peril crop insurance incentive measures: Assessment against the drought program evaluation framework' (Draft Report, July 2016), 69.

With regard to the first of these concerns, discrete differences exist between the professional services that may be funded by the Farm Skills Program and the MFRP. As outlined within the draft report, the Farm Skills Program rebates costs incurred with the obtaining of professional services to prepare a farm business and/or drought plans. While the support of an application for insurance or a loan is one of the outcomes the program guidelines specifies may be met from the development of a farm business plan or a drought preparedness plan, this is not the only outcome proposed. Instead the guidelines state the objective of these plans is to serve a much broader purpose of supporting 'the productivity, profitability and viability of the farm business'.<sup>6</sup>

The Commonwealth Managing Farm Risk Program (MFRP) provides eligible farming businesses with a one-off rebate for expenses incurred when:

- Undertaking an assessment required by an insurance provider;
- Compiling historical farm financial performance and production data; or
- Preparing an analysis of insurance options in the context of a whole of farm risk assessment specific to the business.

However, it remains a condition of the program that the applicant *must* apply for a new insurance policy that will assist with the management of drought and other production and market risks to be eligible for the rebate.

As the draft report has already noted, the Farm Skills Program may not be used towards costs incurred in the cost of an insurer auditing information and is instead focused on obtaining professional services to assist in farm wide business planning. Secondly because a rebate under the MFRP is only available where the farmer has made an application for a multi-peril styled insurance produce, it cannot be used to undertake more strategic drought risk management planning. Therefore in considering the limitations already placed on both programs it is arguable that there is no overlap. This includes instances where funding under the Farm Skills Program is used to develop a farm business/drought management plan and the development of that plan analyses the benefits and costs of MPCl compared to the other drought risk management tactics.

Additionally, the outcomes of the NSW Government's Multi-Peril Insurance Summit support the retention of the professional services component due to positive impact on the uptake of MPCl. The summit identified farmers' lack of familiarity with MPCl products compared to other drought risk management tactics as a barrier to adoption. Solutions identified to overcome this barrier by the summit included facilitating the ability to undertake a complete business risk analysis and to develop better understanding of the cost benefit of multi-peril insurance.

Further with regard to broader drought policy, the review of the West Australia Drought Pilot made the recommendation that governments 'have a role in providing support for

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<sup>6</sup> NSW Department of Primary Industries, Rural Assistance Authority, 'Farm Business Skills Professional Development Program Guidelines' (November 2015) p 10.



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strategic farm business planning'.<sup>7</sup> This was made both on the general basis of the impact of education and skill level as a driver of productivity and the specific public good benefits derived from education in the farm sector. Further, in considering the Farm Planning program rolled out as part of the pilot, the Review proposed that the assistance government provides should enable flexibility in delivery and incentives to implement and regularly review their business' strategic plan.

ENDS

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<sup>7</sup> Keogh, M., Granger, R. and Middleton, S. 'Drought Pilot Review Panel: a review of the pilot of drought reform measures in Western Australia' (September 2011, Report for the Department of Agriculture Fisheries and Forestry, Commonwealth of Australia). 37.