REPORT NO. 427

INCREASE IN THE DOMESTIC DOLLAR-BASED REFERENCE PRICE FOR WHEAT FROM US$215/TON TO US$294/TON

The International Trade Administration Commission (ITAC) of South Africa herewith presents **Report No. 427: Increase in the domestic Dollar-based reference price for wheat from US$215/ton to US$294/ton.**

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Siyabulela Tsengiwe
CHIEF COMMISSIONER

PRETORIA

..23../..04../ **2013**

REPUBLIC OF SOUTH AFRICA

INTERNATIONAL TRADE ADMINISTRATION COMMISSION OF SOUTH AFRICA

REPORT NO. 427

INCREASE IN THE DOMESTIC DOLLAR-BASED REFERENCE PRICE FOR WHEAT FROM US$215/TON TO US$294/TON

Synopsis

Grain South Africa (Grain SA) applied for an increase in the domestic Dollar-based reference price of wheat from US$215/ton to US326/ton.

During its deliberations and in arriving at its recommendation, the Commission considered the application in the light of the information at its disposal and with due regard to food security in its full context.

High quality wheat is produced in South Africa although the country is not self-sufficient as far as wheat production is concerned. Domestic demand outstrips domestic supply by a substantive margin. South Africa has been a net importer of wheat as far back as the early 1990s and imports have increased steeply over recent years.

Currently, world wheat prices are relatively high. However, having taken into consideration the decreasing profitability and diminishing returns of the domestic wheat producing sector and its overall competitive position vis-à-vis foreign producers, the Commission found that the existing domestic reference price support for wheat should be increased from US$215 per ton to US$294 per ton by factoring in the latest price trends and cyclical movements in the global wheat price, the level of subsidisation; and transport costs.

It is the Commission's considered opinion that, into the future, South Africa will remain a significant importer of wheat.

Analytical projections at the Commission's disposal indicate that under the requested reference price of US$326 per ton, the domestic wheat price would increase, on average, by roughly 12% per annum over the next decade leading to an increase in domestic production of approximately 8% in the long run, far below the self-sufficiency level. Under the recommended reference price of US$294 per ton, the domestic price of wheat would increase on average by approximately 4% per annum, which will lead to an expansion of wheat production of between 2% and 3% in the long run. It is projected that bread prices would increase by approximately 1.6% per annum under a reference price of US$294 per ton and approximately 4.1% under a reference price of US$326 per ton.

The Commission found that there is no appreciable correlation between higher domestic wheat prices through an additional price support mechanism (self-sufficiency factor) and the expansion of wheat production, and that the ultimate cost of such support will be borne by the consumer, especially the poor. Agronomical factors such as soil (moisture) conditions and rainfall patterns play the dominant role in decisions affecting total plantings of wheat. It is unlikely that plantings of wheat will increase significantly as wheat is not an economically attractive option relative to other grains whose plantings have increased significantly over the last years.

In light of the foregoing, the Commission decided to recommend an increase in the domestic Dollar-based reference price of wheat to US$294/ton, based on the latest 5 year (2008-2012) average US No. 2 HRW (ord) Gulf settlement price calculated at US$294/ton plus an adjustment for a distortion factor of 10.5% (as per the OECD producer subsidy equivalent for agriculture) less the average ocean transport cost (over the latest 5-year period) of imported wheat to a South African port, of US$33/ton.

The recommended domestic reference price is calculated as follows:

Domestic reference price= World reference price + distortion – transport costs
i.e. US$ 294 = US$ 296 + US$31 – US$33

Given the domestic reference price of US$294/ton, the current 3-week moving average world reference price, and the existing R/$ exchange rate, the duty will remain at zero.

In terms of the current formula and the multiplier of 1.5, the duty on wheaten flour will also remain at zero.

Although the rate of duty will remain at zero, the level of protection (price support) would effectively be raised from the current US$215/ton to US$294/ton. Therefore, should prices fall below US$294/ton, a duty will be triggered to offset the effect of lower-priced imports.

The recommended price support would place the South African wheat producers on the same competitive footing as their counterparts abroad, would allow for a fair and reasonable profit for farmers, and would not have an undue price-raising impact on consumers.

The Commission recommends that the domestic Dollar-based reference price for wheat be increased from US$215 per ton to US$294 per ton. The resulting specific duty in terms of the variable tariff formula will remain at free of duty.

Adjustments to the level of protection will be based on quantum movements in the world wheat reference price as follows:

The difference between the 3-week moving average of the US No. 2 HRW (ord) Gulf settlement price (world reference price) and the domestic Dollar-based reference price of US$294/ton for wheat will be calculated on a weekly basis. If the 3-week moving average of the US No. 2 HRW (ord) Gulf settlement price shows a variance of more than US$10/ton from the existing level for 3 consecutive weeks, an adjustment to the tariff is triggered and a new duty will be calculated. The resulting dollar specific duty will be converted to Rand according to the Rand/Dollar exchange rate prevailing on the day that the adjustment is triggered.

The duty on wheaten flour is recommended to be maintained in the form of a specific duty at the level of 150% of the rate applicable to wheat.

THE APPLICATION AND TARIFF POSITION

Grain South Africa (Grain SA) applied for an increase in the domestic Dollar-based reference price of wheat from US$215/ton to US326/ton.

Grain SA is an autonomous specialist and non-profit organisation that represents around 3 400 commercial grain producers, as well as around 3 600 black developing producers. It is estimated that Grain SA's members produce nearly 80% of the total wheat produced in South Africa.

As reason for the application, the applicant stated that the existing free of duty rate, in terms of the variable tariff formula, does not provide sufficient protection or encouragement for the wheat industry. It was submitted that the current rate of duty is based on a domestic Dollar-based reference price of US$215/ton, and does not encourage farmers to invest in planting wheat, as it does not favourably compete with other grain crops, i.e. maize and soya beans.

Grain SA requested that the domestic Dollar-based reference price of US$215/ton be adjusted by using the latest five year average US No. 2 HRW (ord) Gulf wheat price of US$288.31/ton and that this price be further adjusted by including a distortion factor (caused by subsidies) based on the latest relevant Producer Subsidy Equivalent for the Agriculture sector, estimated at an average of 10.35% as per the OECD, resulting in US$318.15/ton as illustrated in Table 1 below.

Table 1: Determination of the 5 year average US No. 2 HRW (ord) Gulf wheat price and distortion

April-March	Annual	5 year average	Plus 10.35 % distortion factor	FOB price plus distortion (5 year)
2007/2008	323.95	288. 31	29.84	318.15
2008/2009	297.92	288.31	29.84	318.15
2009/2010	224.99	288.31	29.84	318.15
2010/2011	278.17	288.31	29.84	318.15
2011/2012	316.50	288.31	29.84	318.15

Ocean transport cost is considered natural protection due to South Africa's geographic distance from the countries of origin. Transport costs from the Gulf ports to South Africa add an additional protection to tariff protection and should be deducted to determine the level of the price disadvantage experienced vis-à-vis the landed costs of imports. Therefore, Grain SA calculated the average ocean transport cost at US$36.95/ton. This should be deducted from the FOB price including the distortion factor, resulting in a figure of US$281.20/ton.

Grain SA further motivated for the inclusion of a self-sufficiency factor in the calculation of the domestic Dollar-based reference price. The motivation for this is based on the fact that during the years 2000/01-2002/03, South Africa was able to supply between 93% and 97% of the domestic demand in wheat for commercial consumption. Since 2002/03 the self-sufficiency in wheat decreased to 47% in 2010/11. Grain SA is of the view that South Africa has the potential to produce substantially more wheat if it is more profitable to do so.

Grain SA's calculation of the self-sufficiency factor is based on the price differential ratio of the respective increases in the price of bread compared to that of wheat over the period 2008-2011.

Grain SA submitted that the price differential ratio of 1.158 indicates that the increase in the price of bread exceeded the increase in the price of wheat by roughly 16%. The domestic production of wheat declined by 34.9% over this period, Grain SA therefore submitted that a self-sufficiency factor of 1.158 should be factored into the tariff formula.

Grain SA therefore requested that the wheat reference price be calculated as follows:

Description	**US$/ton**
5 year USA HRW #2 FOB price	288.31
Plus: Distortion factor (10.35%)	29.84
Sub total	**318.15**
Less: Average sea freight	-36.95
Sub total	**281.20**
Plus: Self-sufficiency factor (1.158)	44.43
Suggested reference price	**325.63**
Rounded off to:	**326**

In order to enhance the consultative process and inject transparency, ITAC initiated the formation of task teams to present their views on the application, consisting of representatives from the SACU primary and secondary industries, the Department of Trade and Industry (**the dti**), the National Agricultural Marketing Council (NAMC) and the Department of Agriculture, Forestry and Fisheries (DAFF).

The application by Grain SA was published in the Government Gazette for comments by interested parties. Representatives from the primary and downstream wheat industry were granted opportunities to present their positions orally to the Commission.

The currently applicable tariff position for wheat and wheat flour is shown in Table 2 below.

Table 2: Current tariff position for wheat and wheat flour

Tariff Heading	Tariff Sub-heading	Description	Statistical Unit	Rate of Duty			
				General	EU	EFTA	SADC
10.01		Wheat and Meslin					
	1001.9	Other:					
	1001.91	Seed	Kg	Free	Free	Free	Free
	1001.99	Other	Kg	Free	Free	Free	Free
1101.00		Wheat or Meslin Flour					
	1101.00.10	Brown wheaten meal produced by the milling of whole grains	Kg	Free	Free	Free	Free
	1101.00.90	Other	Kg	Free	Free	Free	Free

According to the WTO's Minimum Market Access (MMA) requirements, South Africa is currently obliged to allow the importation of 100 000 tons of wheat at a rate of duty not above a maximum of 14.4 per cent ad valorem. The bound rate for wheat is 72 per cent ad valorem.

A provision for rebate of the full duty in terms of Schedule No. 4 to the Customs and Excise Act, 1964, exists with respect to wheat imported by Botswana, Lesotho, Namibia and Swaziland (BLNS countries). The rebate provision under item 460.02/1001.90/01.06 reads as follows:

"Wheat (excluding durum wheat), in such quantities and at such times as the Director-General: Agriculture may allow by a specific permit: provided that such permit shall be issued under such conditions as may be agreed upon by the Governments of the Republic, Botswana, Lesotho, Swaziland and Namibia: Provided further that wheat and wheaten flour obtained from such wheat cleared in terms of this rebate item, shall not be removed to the area of Botswana, Lesotho, Swaziland or Namibia."

The continuation of the wheat rebate is imperative to ensure the long-term survival of the BLNS milling industry and also to allow consumer access to competitively priced wheaten products, due to the fact that most of these countries either do not produce wheat or produce it in insufficient quantities to satisfy domestic demand.

THE EXISTING TARIFF DISPENSATION FOR WHEAT

The current tariff dispensation for wheat, termed the variable tariff formula, was introduced in 1999 at the recommendation of the then Board on Tariffs and Trade (BTT). The domestic Dollar-based reference price of wheat was set at a level of US$157/ton, equal to the average long-term international price for wheat (using the then latest 10 year average US No. 2 Hard Red Winter (ord) Gulf wheat prices).

Using the wheat price data at the time, this particular dispensation was deemed to better suit the circumstances surrounding the production and trade of wheat than the normal *ad valorem* import duties that are in place for most other products.

The BTT also recommended that the tariff protection on wheaten flour be in the form of a specific duty at a level of 150% of the rate applicable to wheat and that this tariff be adjusted when the tariff on wheat is adjusted. The Board was of the opinion that the milling industry was exposed to disruptive competition from subsidized products to the same extent as the primary industry and therefore recommended that the protection on wheat flour be linked directly to that applied to wheat. The conversion factor of 150% was based on the world average for conversion of wheat to wheaten flour of 1:1.5 i.e. wheat flour is 1.5 times more expensive than wheat. In *ad valorem* terms, the duty on wheat flour is approximately the same as that for wheat.

The Commission, in the last review of the domestic Dollar-based reference price for wheat, recommended in its Report No.333 of 2010, an increase in the domestic Dollar-based reference price from US$157/ton to US$215/ton, factoring in adjustments to account for the distortion factor (caused by subsidies) and transport costs.

Adjustments to the level of protection are based on movements in the world wheat price and are made as follows:

The difference between the 3-week moving average of the US No. 2 HRW (ord) Gulf settlement price (world reference price) and the domestic Dollar-based reference price for wheat is calculated on a weekly basis. If the 3-week moving average of the US No. 2 HRW (ord) Gulf settlement price is lower than the domestic reference price and shows a variance of more than $10/ton from the previous trigger level for 3 consecutive weeks, an adjustment to the tariff is triggered and a new duty calculated. The resulting dollar specific duty is converted to Rand according to the Rand/Dollar exchange rate prevailing on the day that the adjustment is triggered. If the world reference price is above the domestic reference price, no duty is triggered.

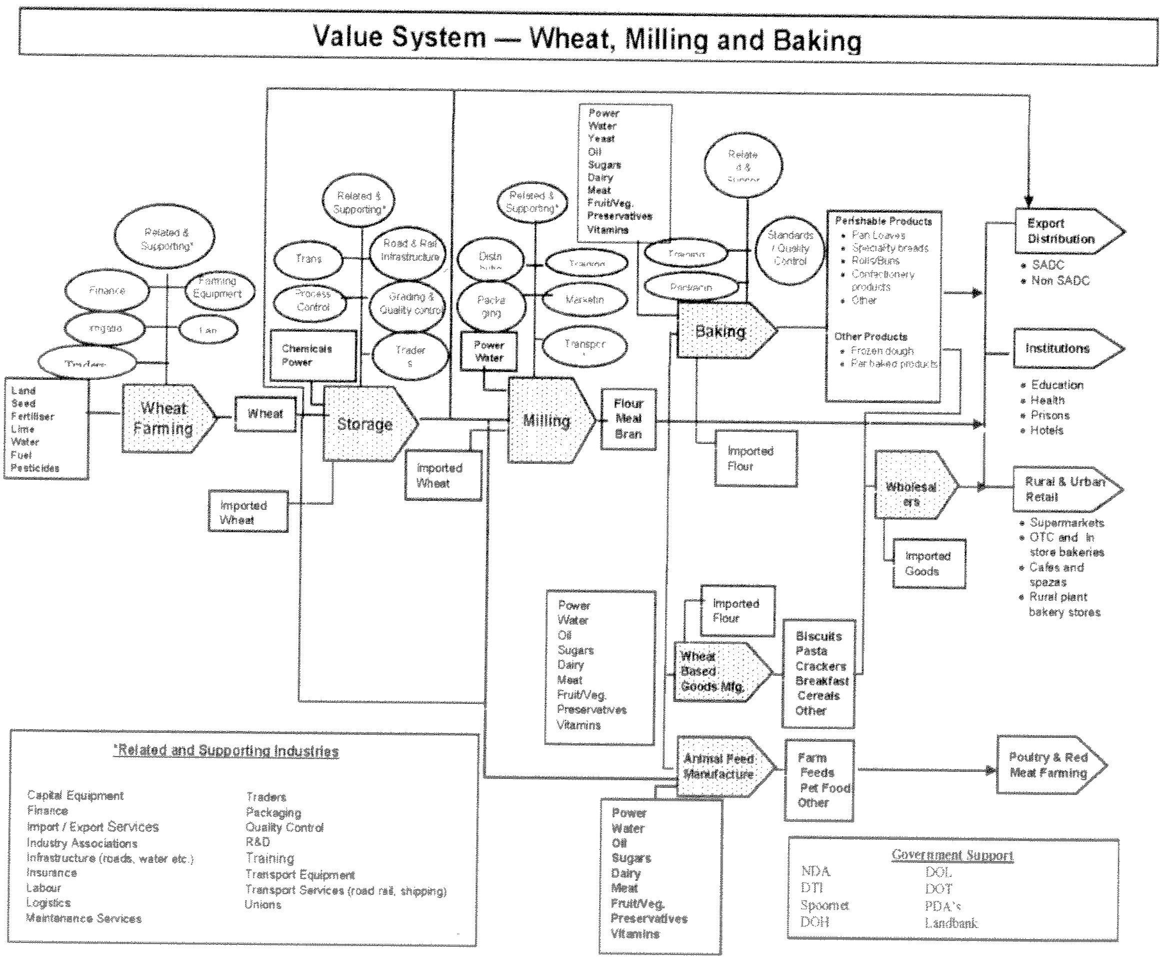
INDUSTRY AND MARKET

The wheat industry is the second biggest field crop industry in South Africa, after maize. Wheat farming in South Africa is concentrated in the Free State (summer rainfall region) and the Western Cape (winter rainfall region). According to an analysis conducted by the Department of Agriculture, Forestry and Fisheries, published in 2012, wheat contributed approximately 11% to the gross value of field crops in the 2011/2012 season. The average annual gross value of wheat for the past five years, up to the 2011/2012 season, amounted to R4 185 million, compared to R17 985 million for maize, which is the most important field crop. South Africa is responsible for around 98% of the wheat produced within SACU. The total demand for wheat in SACU is around 3 million tons of which less than 2 million tons is locally produced and the rest is imported from countries such as Canada, the USA, Germany and Australia. South Africa exports around 120 000 tons of wheat to Kenya, Uganda, Malawi and Mozambique.

Around 98% of the local demand for wheat is used for human consumption and 2% is used in the animal feed industry. Between 70% and 80% of the wheat used for human consumption is used for the baking of bread.

Customs duties payable on the importation of value added wheat products are 25% *ad valorem* for bread, pastries, cakes, etc. and 40% *ad valorem* for pasta-related products.

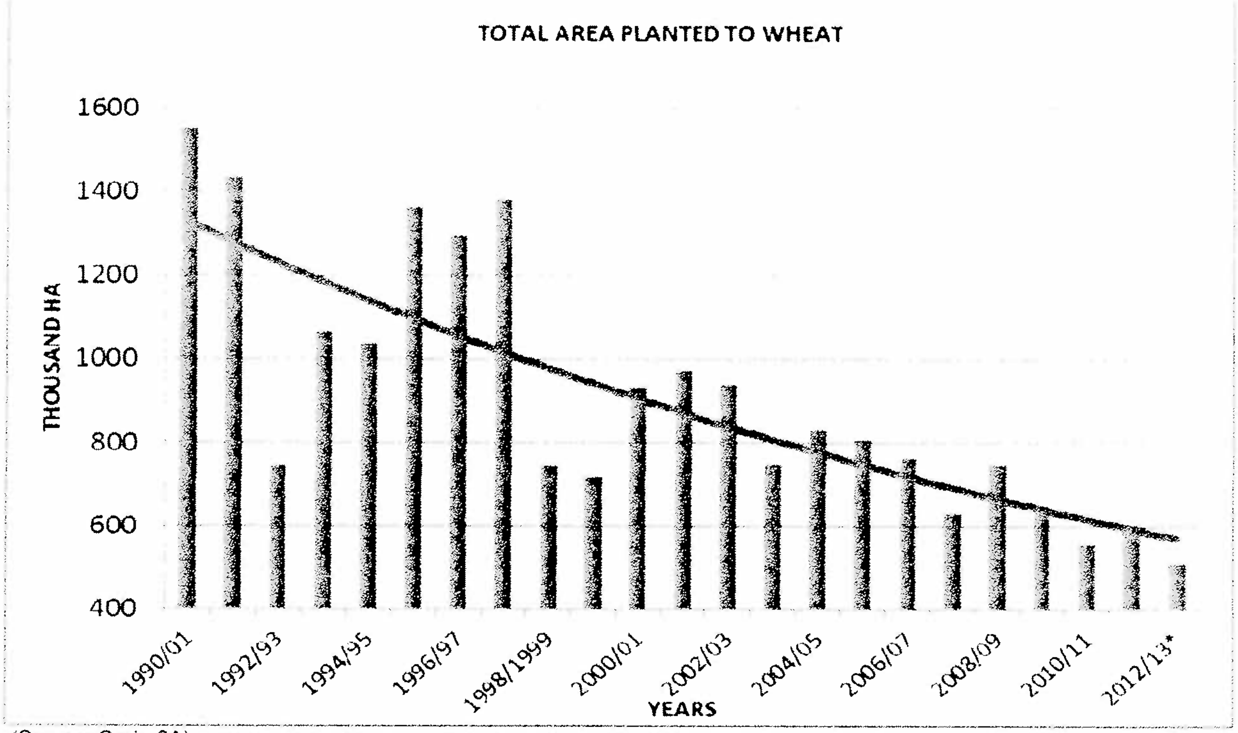
The following diagram provides an illustration of the wheat value chain:



The applied rate of duty for wheat flour is also zero. The mandatory fortification of wheat flour based on a formula as per the unique South African specifications, limits the viability of importing wheat flour, as does the fact that an easily spoilt product such as wheat flour is not ideally a product tradable over long distances and climate zones.

As can be seen from Figure 1 below, the area planted with wheat in South Africa has decreased since the 1990s.

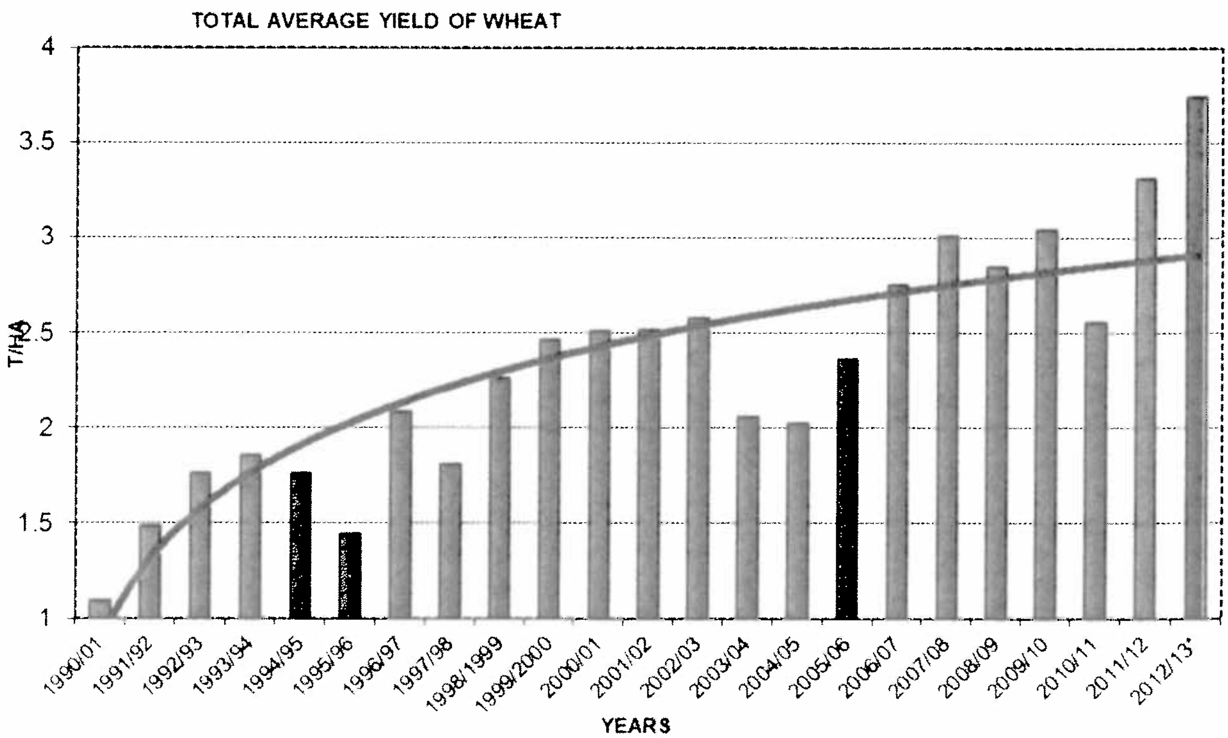
Figure 1: Total area planted to wheat



(Source: Grain SA)

However, as can be seen from Figure 2, the total yield per hectare of wheat has been increasing. This means that productivity has been on the rise as a result of reforms in the sector.

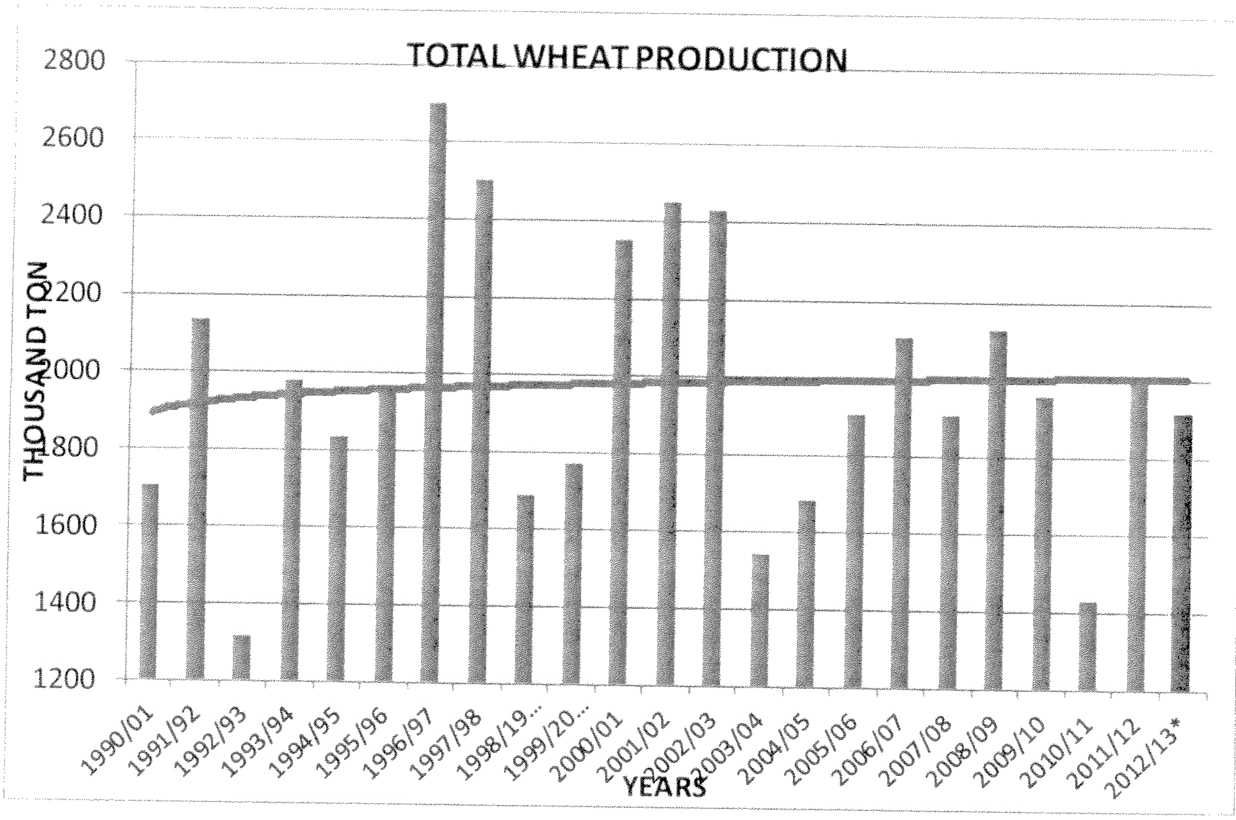
Figure 2: Total average yield of wheat



(Source: Grain SA)

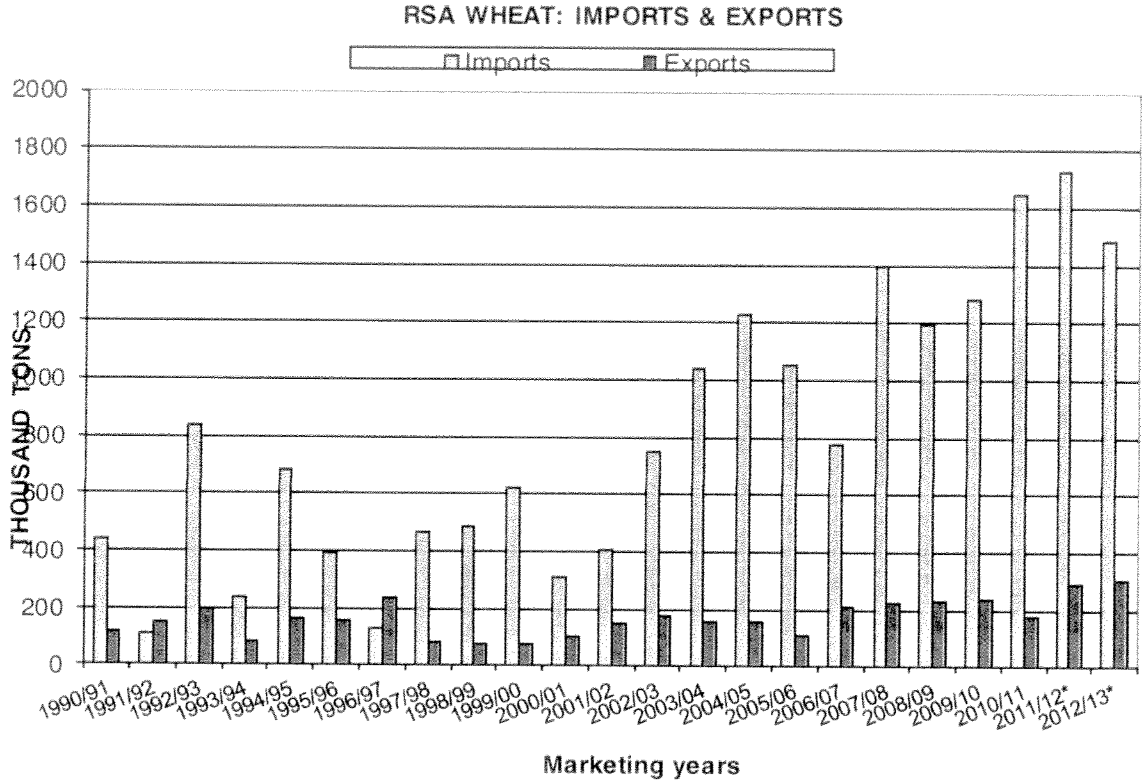
Total wheat production has varied (illustrated in Figure 3 below), whilst the demand for wheat has been increasing leading to an increase in wheat imports (illustrated in Figure 4 below).

Figure 3: Total wheat production



(Source: Grain SA)

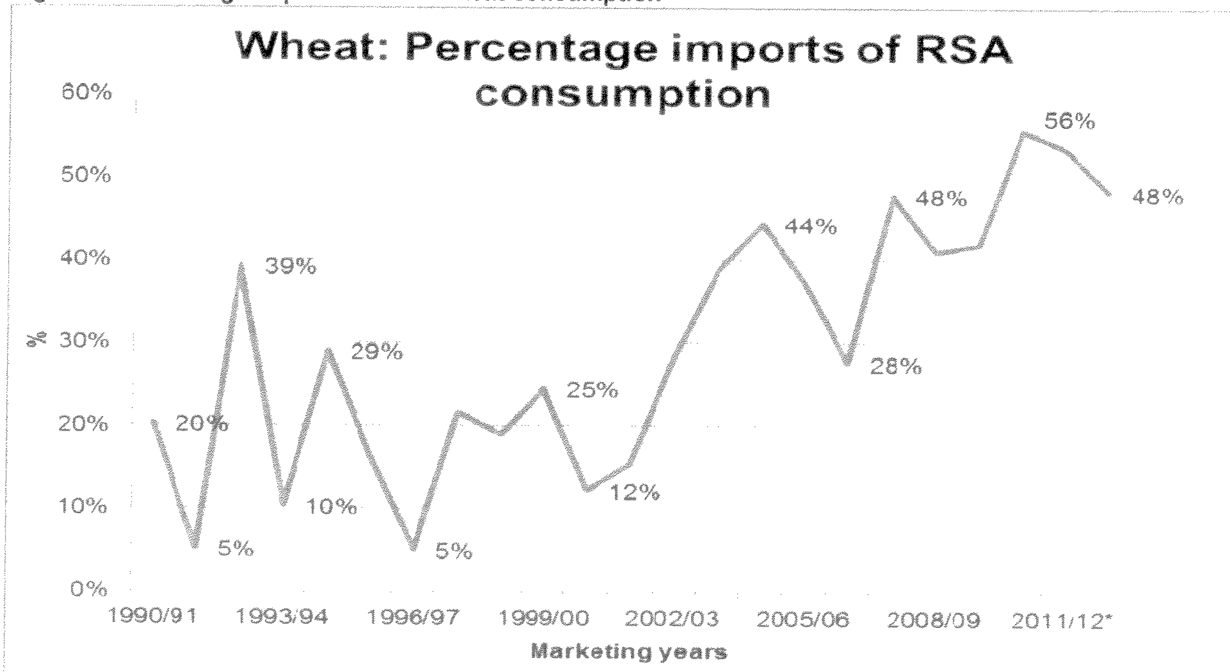
Figure 4: RSA wheat imports and exports, showing a large trade deficit



(Source: Grain SA)

As illustrated in Figure 5 below, the percentage of wheat imports peaked at 56% of RSA wheat consumption in the 2011/12 season and is estimated at 48% for the 2012/13 season.

Figure 5: Percentage imports of RSA wheat consumption



(Source: Grain SA)

COMPETITIVE POSITION

The South African wheat producers supply wheat of high quality with excellent intrinsic characteristics in terms of its milling and baking qualities which compares satisfactorily to international quality standards. The good quality of domestic wheat is the result of more than two decades of strict wheat cultivar release criteria. A new wheat cultivar must comply with these pre-determined quality criteria before it can be released and sold to producers for cultivation. These release criteria for wheat cultivars ensure that South African wheat will be of a high quality standard in international terms. Although openly determined by industry interests, the cultivar release criteria are dominantly influenced by the consumer (millers and bakers).

Domestic wheat producers follow world trends and implement new production technologies, precision-farming methods, and better production practises, such as crop rotation, increased wheat production under irrigation, conservation and minimum tillage practises to keep abreast of modern production techniques. Producers revise their production methods at frequent intervals and adjust cultivation practises as new technologies and information are released.

An analysis of the production costs of wheat farming in South Africa shows that domestic wheat farmers are burdened by relatively high cost structures such as high fertiliser costs, in comparison to the major wheat producing regions in the world, and agronomic factors such as soil conditions and rainfall patterns.

The profitability of wheat production has been decreasing as the gap between the producer price and the production cost is decreasing especially for farmers in the Southern and Western Cape regions.

On the global front, the distortionary impact of agricultural subsidies on the global supply of wheat has a depressing effect on wheat prices, adversely affecting the competitive position of domestic wheat producers.

The international production costs for wheat in 2011 are shown below. Whereas the South African northern regions lie at the lower end of the scale of production costs per ton, farms in the Western Cape are high cost producers.

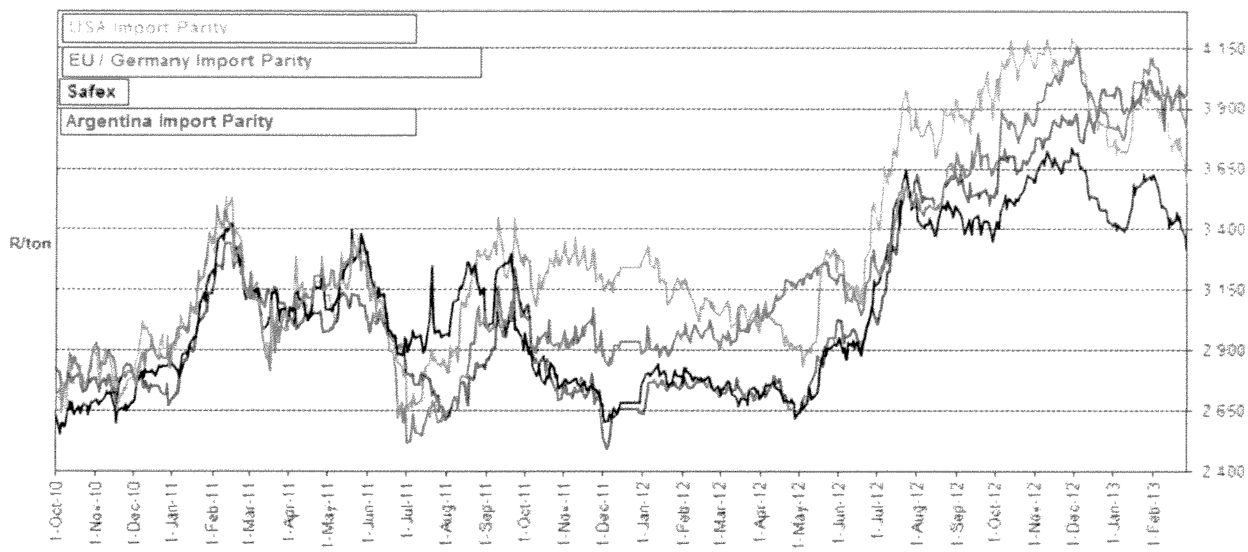
Table 3: Comparison of international wheat production cost in 2011

	Argentina	USA	Germany	Australia	Canada	RSA Dry land	RSA Irrigation
Yield (t/ha)	4.17	3.7	7.62	2.54	3.14	2.3	8.37
Cost per ton ($)	150	172	227	204	182	347	194

Source: BFAP, 2011 and www.agribenchmark.org

As can be seen from the graph below, the South African Futures Exchange (SAFEX) price for wheat tracks the import parity price for wheat:

PRICES OF WHEAT DELIVERED IN RANDFONTEIN



COMMENTS ON THE APPLICATION

The application attracted support from various interested parties within the wheat value chain, namely wheat producing organisations such as agricultural unions and agricultural cooperatives.

A number of organisations objected to the application, in particular:

The National Chamber of Milling, a representative of millers of wheat, in its objection submitted, inter alia, that food security, i.e. availability, affordability, and safety, does not consist of self-sufficiency alone, and that in South Africa affordability is the more important constituent of food security; the logic of fostering wheat production on marginal lands for food self-sufficiency is unsound and runs contrary to the notion of comparative advantage; substantial wheat market price increases and historical wheat duties have not encouraged increased wheat production; and that wheat in their opinion is not an economically attractive cropping option relative to other choices that farmers have, be it crop or livestock alternatives.

Pioneer Foods (Pty) Ltd, one of the biggest millers of wheat submitted, inter alia, that the application and new self-sufficiency mechanism is not supported; that there is no correlation between higher market prices and expansion of wheat production; that South Africa will remain a significant net importer of wheat; and that an increase in the price of wheaten flour will result in significant price increases for bread, pasta, biscuits, rusks, breakfast cereals and other value-added products, which will ultimately affect the consumer.

The Animal Feed Manufacturers' Association (AFMA) submitted in its objection to the application, that the proposed increase in the wheat tariff would eventually be passed on to consumers, which are already taking economic strain; and that the low wheat production levels are not due to low protection, but rather to structural problems leading to a situation where farmers choose to rather plant maize or soya due to relative price-ratio factors.

The Ministry of Trade and Industry in the Republic of Namibia submitted that it supported the application, provided that the rebate facility for the importation of wheat by the BLNS countries is maintained.

The Ministry of Trade and Industry in the Republic of Botswana objected to the application for an increase in the domestic Dollar-based reference price for wheat as this would lead to higher prices for consumers. It should however be noted that Botswana and the other BLNS countries can import wheat duty free under the BLNS wheat rebate.

FINDINGS

During its deliberations and in arriving at its recommendation, the Commission considered the application in the light of the information at its disposal and with due regard to food security in its full context.

High quality wheat is produced in South Africa although the country is not self-sufficient as far as wheat production is concerned. Domestic demand outstrips domestic supply by a substantive margin. South Africa has been a net importer of wheat as far back as the early 1990s and imports have increased steeply over recent years.

Currently, world wheat prices are relatively high. However, having taken into consideration the decreasing profitability and diminishing returns of the domestic wheat producing sector and its overall competitive position vis-à-vis foreign producers, the Commission found that the existing domestic reference price support for wheat should be increased from US$215 per ton to US$294 per ton by factoring in the latest price trends and cyclical movements in the global wheat price, the level of subsidisation, and transport costs.

It is the Commission's considered opinion that, into the future, South Africa will remain a significant importer of wheat.

Analytical projections at the Commission's disposal indicate that under the requested reference price of US$326 per ton, the domestic wheat price would increase, on average, by roughly 12% per annum over the next decade leading to an increase in domestic production of approximately 8% in the long run, far below the self-sufficiency level. Under the recommended reference price of US$294 per ton, the domestic price of wheat would increase on average by approximately 4% per annum, which will lead to an expansion of wheat production of between 2% and 3% in the long run. It is projected that bread prices would increase by approximately 1.6% per annum under a reference price of US$294 per ton and approximately 4.1% under a reference price of US$326 per ton.

The Commission found that there is no appreciable correlation between higher domestic wheat prices through an additional price support mechanism (self-sufficiency factor) and the expansion of wheat production, and that the ultimate cost of such support will be borne by the consumer, especially the poor. Agronomical factors such as soil (moisture) conditions and rainfall patterns play the dominant role in decisions affecting total plantings of wheat. It is unlikely that plantings of wheat will increase significantly as wheat is not an economically attractive option relative to other grains whose plantings have increased significantly over the last years.

In light of the foregoing, the Commission decided to recommend an increase in the domestic Dollar-based reference price of wheat to US$294/ton, based on the latest 5 year (2008-2012) average US No. 2 HRW (ord) Gulf settlement price calculated at US$294/ton plus an adjustment for a distortion factor of 10.5% (as per the OECD producer subsidy equivalent for agriculture) less the average ocean transport cost (over the latest 5-year period) of imported wheat to a South African port, of US$33/ton. The latter adjustment is necessary as tariff protection for the wheat industry should be considered in line with the principles upon which tariff protection for other agricultural industries is granted, i.e the difference between the domestic price and the landed price is the level of the price disadvantage experienced by the domestic industry (should the domestic price be higher than the landed price) and this disadvantage is expressed as a percentage of the export price to determine the level of the tariff. Transport costs from the Gulf ports to South Africa add an additional protection of approximately US$33/ton to tariff protection and should be deducted to determine the level of the price disadvantage experienced vis-à-vis the landed cost of imports.

The recommended domestic reference price is calculated as follows:

Domestic reference price= World reference price + distortion – transport costs
i.e. US$ 294 = US$ 296 + US$31 – US$33

Given the domestic reference price of US$294/ton, the current 3-week moving average world reference price, and the existing R/$ exchange rate, the duty will remain at zero.

In terms of the current formula and the multiplier of 1.5, the duty on wheaten flour will also remain at zero.

Although the rate of duty will remain at zero, the level of protection (price support) would effectively be raised from the current US$215/ton to US$294/ton. Therefore, should prices fall below US$294/ton, a duty will be triggered to offset the effect of lower-priced imports.

The recommended price support would place the South African wheat producers on the same competitive footing as their counterparts abroad, would allow for a fair and reasonable profit for farmers, and would not have an undue price-raising impact on consumers.

RECOMMENDATION

The Commission recommends that the domestic Dollar-based reference price for wheat be increased from US$215 per ton to US$294 per ton. The resulting specific duty in terms of the variable tariff formula will remain at free of duty.

Adjustments to the level of protection will be based on quantum movements in the world wheat reference price as follows:

The difference between the 3-week moving average of the US No. 2 HRW (ord) Gulf settlement price (world reference price) and the domestic Dollar-based reference price of US$294/ton for wheat will be calculated on a weekly basis. If the 3-week moving average of the US No. 2 HRW (ord) Gulf settlement price shows a variance of more than US$10/ton from the existing level for 3 consecutive weeks, an adjustment to the tariff is triggered and a new duty will be calculated. The resulting dollar specific duty will be converted to Rand according to the Rand/Dollar exchange rate prevailing on the day that the adjustment is triggered.

The duty on wheaten flour is recommended to be maintained in the form of a specific duty at the level of 150% of the rate applicable to wheat.

[22/2012]