REPORT NO. 333

INCREASE IN THE DOMESTIC DOLLAR-BASED REFERENCE PRICE FOR WHEAT FROM US$157/TON TO US$215/TON

The International Trade Administration Commission (ITAC) of South Africa herewith presents **Report No. 333: Increase in the domestic Dollar-based reference price for wheat from US$157/TON to US$215/ton.**

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Siyabulela Tsengiwe
CHIEF COMMISSIONER

PRETORIA

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REPUBLIC OF SOUTH AFRICA

INTERNATIONAL TRADE ADMINISTRATION COMMISSION OF SOUTH AFRICA

REPORT NO. 333

INCREASE IN THE DOMESTIC DOLLAR-BASED REFERENCE PRICE FOR WHEAT FROM US$157/TON TO US$215/TON

Synopsis

Grain South Africa applied for an increase in the domestic Dollar-based reference price of wheat, classifiable under tariff subheading 1001.90, from US$157/ton to US$260/ton. It requested that the domestic Dollar-based reference price of US$157/ton be adjusted by using the latest five year average domestic Dollar-based reference price of US$236/ton instead of the existing US$157 per ton. Furthermore, that this price be further adjusted by including a distortion factor (caused by subsidies) based on the relevant Producer Subsidy Equivalent for agriculture estimated at 10.27% as per the OECD, which leads to a domestic Dollar-based reference price of US$260/ton.

The Commission found that, in general, high quality wheat is produced in South Africa although the country is not self-sufficient by a considerable margin. The Commission considered the cost and price differentials between domestically produced wheat and that produced in the major wheat producing countries. It also considered that input costs have been on the rise and that major differences exist in the competitive position of the different wheat producing regions.

The Commission also found that low profitability and diminishing returns affect the long-term sustainability of wheat farming in South Africa and further investment in this field. In arriving at an appropriate level of tariff protection the Commission took into account both the low profitability of farmers and the impact on consumers, in particular the poor.

The Commission considered the competitive position of the wheat farmers within the wheat value chain and found that on both the input and output sides, farmers have little bargaining power and are price takers. On the input side compared to foreign producers, South African farmers are constrained by the high cost of inputs, especially fertiliser, while they have little pricing power as far as the price of their crop is concerned (this aspect requires an approach on several fronts, among them by the competition authorities).

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

The Commission took into consideration the fact that the wheat farming industry has been categorised as a distressed sector due to the recession.

The Commission found that the wheat sub-sector has the potential for increased investment and job creation, particularly given the abundance of unskilled labour.

The Commission found that, in the light of the structural changes that occurred in the supply and demand of wheat, a five-year average world reference price would be more appropriate than the existing ten-year reference price.

In view of the above, the Commission decided that the domestic Dollar-based reference price for wheat be increased from US$157 per ton to US$215 per ton based on the 5-year average US No.2 HRW (ord) Gulf price of wheat of US$236/ton, plus an adjustment for the distortion factor evident in the international wheat market of US$24/ton, less the average transport cost of wheat of US$45/ton.

The initial duty on wheat will be calculated as the difference between US$215/ton and the three-week moving average over the last two weeks in September and the first week of October 2009, which amounted to US$196/ton at an exchange rate of R7.41 to the Dollar, as follows:

Reference price	**US$ per ton**
RSA initial reference price	US$215
Minus: Three week moving average FOB US No.2 HRW (ord) Gulf	US$196
Dollar duty on wheat	US$19.00/ton
Rand duty on wheat	R140.74/ton

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$215/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 $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 applied for an increase in the domestic Dollar-based reference price of wheat, from US$157/ton to US$260/ton.

Grain South Africa is an autonomous specialist and non-profit organisation that represents 6 000 commercial grain producers and services up to 10 000 developing grain producers in South Africa. It is estimated that Grain South Africa's members produce nearly 80% of the total wheat produced in South Africa.

The applicant stated as reasons for the application that the wheat-producing industry was a sector in distress and that the current duty-free rating rendered the industry prone to global recessionary circumstances. In addition the ten year average FOB-price for Hard Red Winter (HRW) No. 2 wheat has risen to US$189/ton compared to the US$157/ton as applied in the existing tariff formula.

The applicant submitted that the existing tariff dispensation does not provide sufficient protection or encouragement and does not take into account the structural changes that have occurred in the global supply and demand of wheat. In addition, the industry has seen sharp increases in input prices such as for fuel and fertilizers. Wheat prices decreased since late 2008 and continued this trend during 2009 because of the global economic recession but not to the levels prevailing prior to 2006.

Grain SA requested that the domestic Dollar-based reference price of US$157/ton be adjusted by using the latest five year average domestic Dollar-based reference price of US$236/ton instead of the existing US$157 per ton. Furthermore, that this price be further adjusted by including a distortion factor (caused by subsidies) based on the relevant Producer Subsidy Equivalent for agriculture estimated at 10.27% as per the OECD, which leads to a domestic Dollar-based reference price of US$260/ton as illustrated in Table 1 below.

Table 1: Determination of the domestic Dollar-based reference price level and distortion

Oct-Sept	Annual average FOB (US$/ton)	5 year average FOB (US$/ton)	Plus 10,27% distortion factor
1999/2000	116		
2000/2001	134		
2001/2002	138		
2002/2003	157		
2003/2004	160		
2004/2005	147	**236**	**260**
2005/2006	187	**236**	**260**
2006/2007	226	**236**	**260**
2007/2008	373	**236**	**260**
2008/2009	246	**236**	**260**

(Source: Grain SA)

The application by Grain SA was published in the Government Gazette for comments by interested parties. Representatives from the primary and secondary wheat industry were also granted an opportunity 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	SACU	EFTA
10.01		**Wheat and Meslin**					
	1001.90	Other	Kg	Free	Free	Free	Free
11.01		**Wheat or meslin flour**					
	1101.00	Wheat or meslin flour	Kg	Free	Free	Free	Free

(Source: SARS)

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

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 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.

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 Board of Tariffs and Trade 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.

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). The gross value of wheat produced in the 2007/08 season was R4.7 billion which constituted around 12% of the total value of field crops and 4% of the total value of agricultural production in the same season. 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 around 2 million tons is locally produced and the rest imported from countries such as Canada, USA, Germany and Australia. South Africa exports around 120 000 tons of wheat to Kenya, Uganda, Malawi and Mozambique.

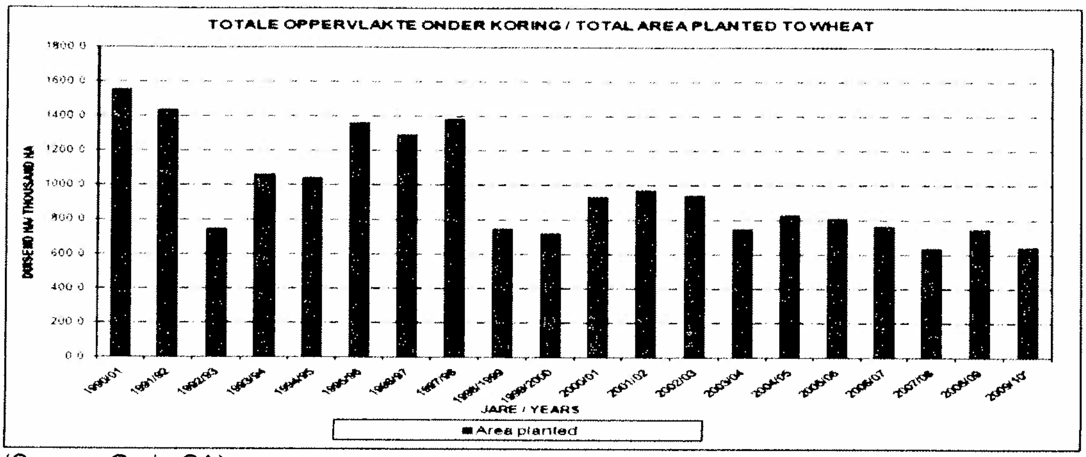
Around 98% of the local demand for wheat is used for human consumption whilst only 2% is used in the animal feed industry. Between 70% and 80% of the wheat used for human consumption is used for the baking of bread.

Customs duties payable on the importation of value added wheat products are 25% *ad valorem* for bread, pastries, cakes, etc. and 20% *ad valorem* for pasta related products.

The applied rate of duty for wheat flour is also zero. The mandatory fortification of wheat flour based on a unique formula as per the 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 to wheat in South Africa has decreased since the 1990's.

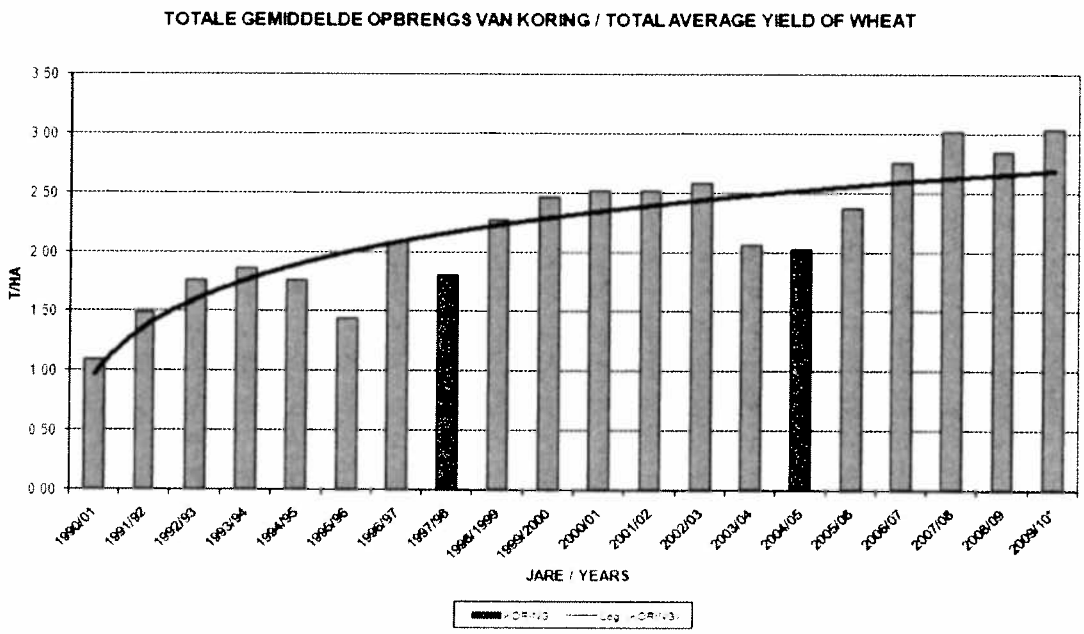
Figure 1: Total area planted to wheat



(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.

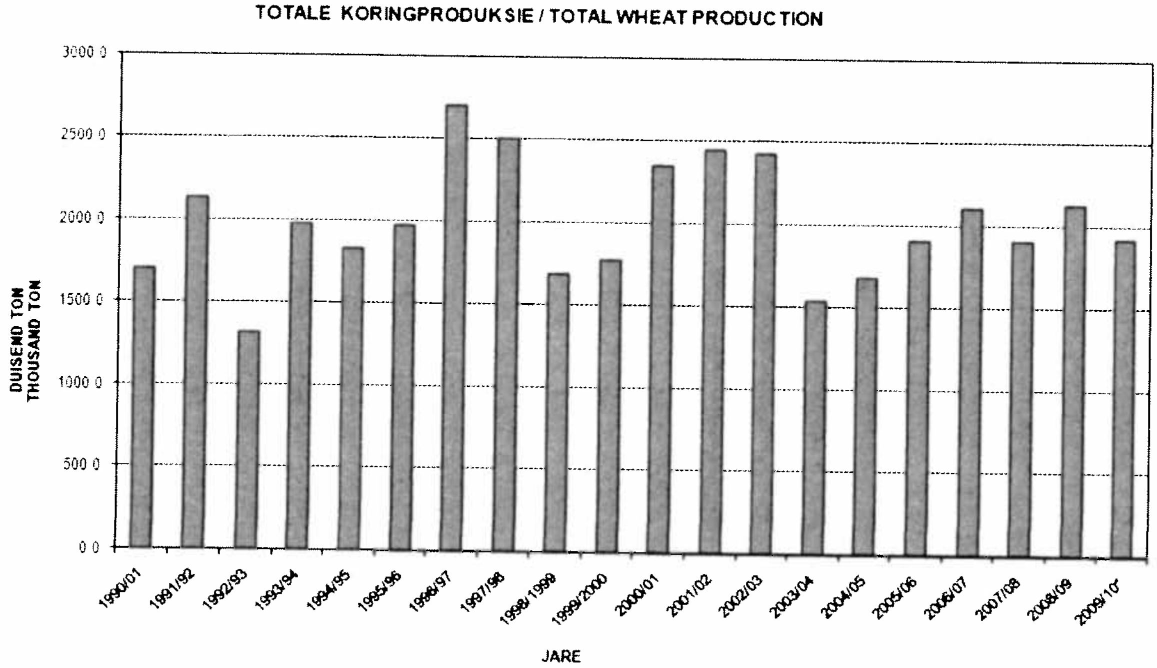
Figure 2: Total average yield of wheat



(Source: Grain SA)

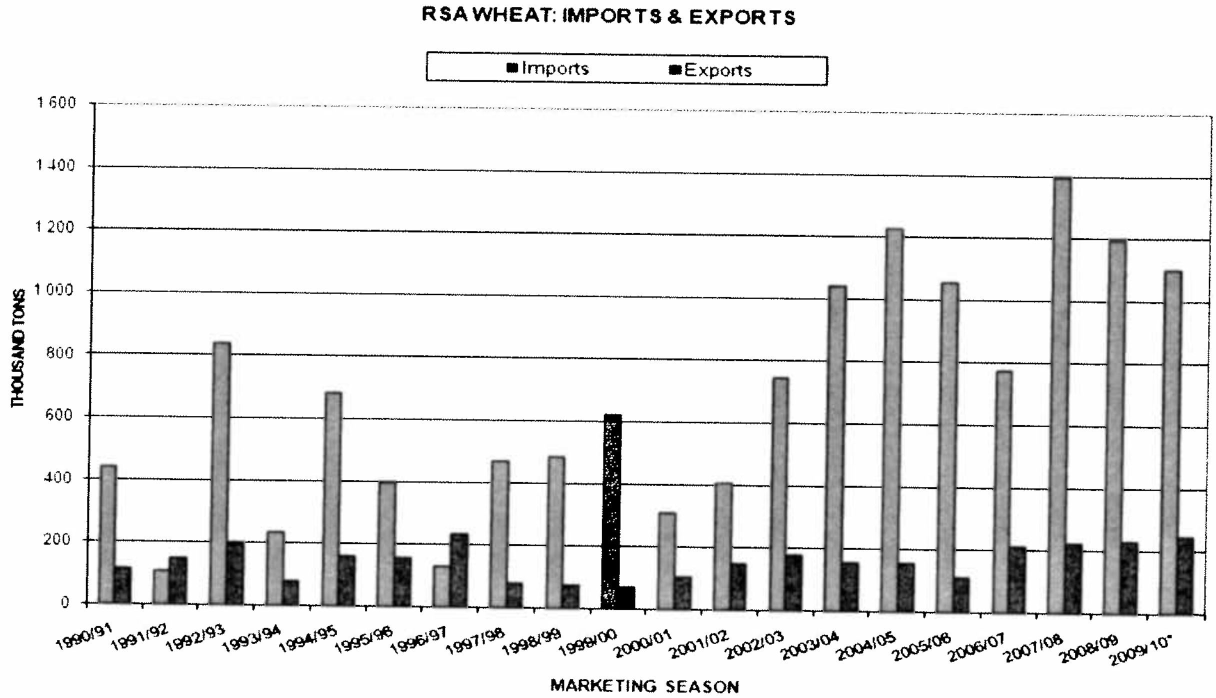
Total wheat production has varied (illustrated in Figure 3 below), whilst the demand for wheat has been increasing leading to an increase in wheat imports (illustrated in Figure 4 below).

Figure 3: Total wheat production



(Source: Grain SA)

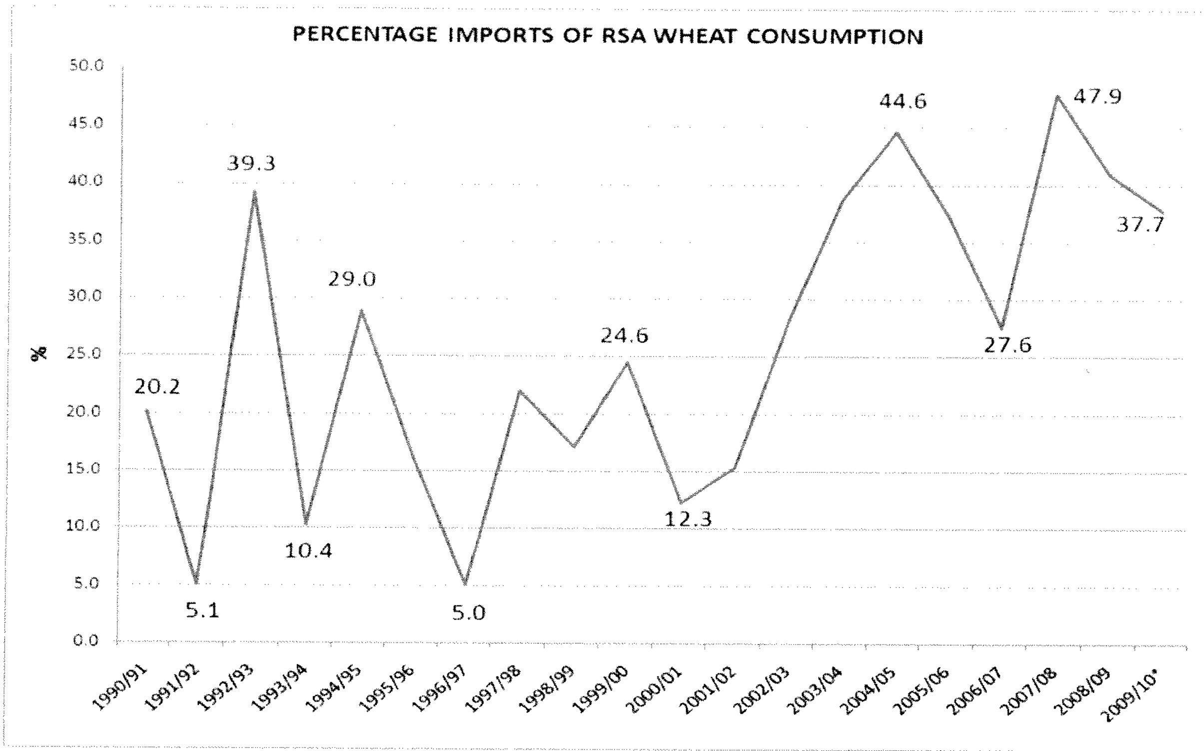
Figure 4: RSA wheat imports and exports, showing a large trade deficit.



(Source: Grain SA)

As illustrated in Figure 5 below, the percentage of wheat imports peaked at 47.9% of RSA wheat consumption in the 2007/08 season and is estimated at 37.7% for the 2009/10 season.

Figure 5: Percentage imports of RSA wheat consumption



(Source: Grain SA)

COMPETITIVE POSITION

An analysis of the production costs of wheat farming in South Africa shows that domestic wheat farmers are burdened by relatively high cost structures in comparison to the major wheat producing regions in the world.

The competitive position of the wheat farmer within the wheat value chain is such that on both the input and output sides, farmers have little bargaining power and are price takers, exemplified on the input side by the high cost of fertiliser inputs and exacerbated by the imperfect competition within the fertiliser industry, and on the output (wheat milling) side by a similar lack of competition amongst the millers and the bakers. Contrary to the import competition experienced by the wheat farmers, the wheat millers experience virtually no import competition.

The Commission also noted the practice by wheat millers to mix different qualities of wheat to control costs (for instance high quality domestic wheat with lower quality imported wheat). Thus low profitability and diminishing returns affect the long-term sustainability of wheat farming in South Africa and further investment in this field.

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 further adversely affecting the competitive position of domestic wheat producers.

COMMENTS ON THE APPLICATION

The application attracted comments from various role players within the wheat industry. Comments were received from the National Department of Agriculture, Forestry and Fisheries (DAFF), the National Agricultural Marketing Council (NAMC), Pioneer Foods, Tiger Brands, Foodcorp, Agri Northern Cape, Transvaal Agricultural Union, Sentraal-Suid Co-operative, NWK Ltd (North West), GWK Ltd, Eendekuil Agricultural Union, Grain SA Commercial farmers, Profert (Pty) Ltd, Oos Vrystaat Kaap Operations Ltd (OVK), Vrystaat Kooperasie Beperk (VKB) and the Ministry of Agriculture of Botswana.

Generally, interested parties indicated support for an increased level of protection for wheat but not to the level requested by Grain SA. Some respondents objected to the request for a change in the ten-year reference period to the five-year reference period requested by the applicant as it would have the effect of a very high increase in the tariffs. There was general agreement that a distortion factor should be taken into account. However, the Ministry of Agriculture of Botswana objected to the application due to the price-raising impact on consumers.

The Department of Agriculture Forestry and Fisheries (DAFF), submitted that the department had noted that the current domestic Dollar-based reference price has been at the same level for too long despite sharp increases in input costs, that developed countries subsidized their wheat producers to counteract the increasing production costs while South African wheat producers do not have the luxury of receiving such forms of support, and that imports of wheat into SA have increased by 79% between the 2006/07 and 2007/08 marketing years, indicating that South Africa has increased its dependence on wheat imports.

The DAFF submitted that an increase in the domestic Dollar-based reference price from US$157 to US$260 is too steep and might have major implications on prices of bread and other wheat–based products. But it was also submitted that leaving the status quo would have a negative impact on the sustainability of the local wheat producing industry.

The National Agricultural Marketing Council (NAMC) is in support of the application by Grain SA. The NAMC took cognisance of the potential negative impact of the increase in the customs duty on wheat, but is of the opinion that the socio-economic benefits to regional economies and producers outweigh such negative impacts, especially in the light of government's rural economic development and employment creation objectives, and the fact that the international wheat market is distorted due to support afforded by the US and the EU to their wheat producers.

NAMC submitted that the profitability of wheat production in SA is under severe pressure due to increasing input costs and the unfair international playing field due to subsidies and support provided to producers in countries such as the US.

The NAMC commented that the consumer welfare impact will be relatively small if expressed as a percentage of final household expenditure should the duty on wheat be increased as requested by Grain SA. However, the positive impact on producers would be significant if expressed in terms of net farm income, while there are also significant benefits for regions that produce winter cereals.

Another issue that, according to the NAMC, should be considered is the potential impact of an increase in the wheat tariff on consumer inflation. It was noted that the overall weight of bread and cereals in the Consumer Price Index is 3.08, of which bread contributes 1.56. The weight of bread in the expenditure basket for low income households is 4.59 which, according to the NAMC, is relatively low. It was thus submitted that, although an increase in the tariff on wheat would result in a higher bread price, ranging between 2% and 5.8%, the impact would be marginal in terms of overall expenditure by households.

NAMC also considered the trade balance for primary agricultural products, of which the single largest contributor to the value of primary product imports is wheat. The value of wheat imports increased by 262.8% between 2006 and 2008, and 99.05% between 2007 and 2008. It was submitted that the expansion of local wheat production would result in a decline in imports, and hence an improvement in the primary agricultural product trade balance.

The three biggest South African wheat milling companies, who responded to the publication, namely Tiger Brands, Foodcorp and Pioneer Foods objected to the request for a change in the ten-year reference period to the five-year reference period requested by the applicant, stating that the ten-year period would even out the volatility in the international price of wheat.

Premier Foods, one of the biggest wheat flour milling companies in South Africa requested that the duty on wheat be an *ad valorem* and not a formula duty.

The Ministry of Agriculture 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

In its deliberations and in arriving at its recommendation, the Commission took into account, although not exclusively, the following factors:

- The domestic demand for wheat is 3 million tons and the supply is 2 million tons, implying a supply shortage that can be filled by increasing the domestic production of wheat.
- In general, high quality wheat is produced in South Africa although the country is not self-sufficient. South Africa has been a net importer of wheat for more than a decade and the gap has widened over recent years, causing a huge trade deficit in wheat.
- There has been a sharp increase in wheat imports since the 2007/08 season.
- The cost and price differentials between domestically produced wheat and that produced in the major wheat producing countries, as well as the SAFEX pricing regime for wheat that tracks import parity prices. It also considered that input costs have been on the rise and that major differences exist in the competitive position of the different wheat producing regions.

- Low profitability and diminishing returns affect the long-term sustainability of wheat farming in South Africa and further investment in this field. In arriving at an appropriate level of tariff protection the Commission took into account both the low profitability of farmers and the impact on consumers, in particular the poor.
- The competitive position of the wheat farmers within the wheat value chain is such that on both the input and output sides, farmers have little bargaining power and are price takers. On the input side compared to foreign producers, South African farmers are constrained by the high cost of inputs, especially fertiliser, while they have little pricing power as far as the price of their crop is concerned (this aspect requires an approach on several fronts, among them by the competition authorities).
- On the global front, the distortionary impact of agricultural subsidies on the global supply of wheat has a depressing effect on wheat prices further adversely affecting the competitive position of domestic wheat producers.
- The fact that the wheat farming industry has been categorised as a distressed sector due to the recession.
- The wheat sub-sector has the potential for increased investment and job creation, particularly given the abundant unskilled labour.
- The impact of the increase in the wheat tariff recommended by the Commission would lead to a moderate increase of approximately 2.5% in the price of bread, based on the assumption that the full effect of the duty will be passed on. The Commission could not support the applicant's request which would have resulted in an immediate increase in the duty to approximately 47.42 c/kg equivalent to 33% *ad valorem* with a concomitant appreciable increase in the price of bread.

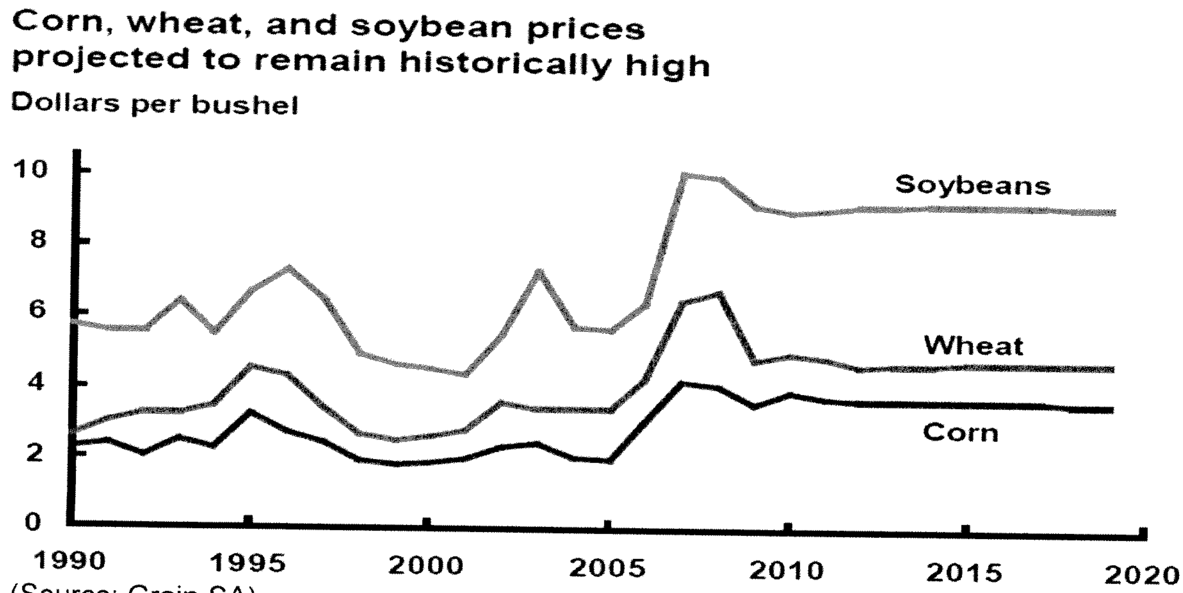
The Commission considered the application in the light of the above factors, although not exclusively, and decided to recommend an increase in the domestic Dollar-based reference price of wheat to US$215/ton, based on the latest 5 year (2004/05 -2008/09) average FOB price (US$/ton) calculated at US$236/ton plus an adjustment for a distortion factor of 10.27% (as per the OECD producer subsidy equivalent for agriculture) less the average ocean transport costs (over the latest 5-year period) of imported wheat to a South African port of US$45/ton to arrive at the average landed price of wheat. The latter adjustment is made to adjust for the natural or geographic protection that wheat producers enjoy in order not to overprotect or over compensate the industry causing serious adverse effects downstream.

The recommended domestic reference price is calculated as follows:

Domestic reference price= World reference price + distortion – transport costs
i.e. US$ 215 = US$ 236 + US$24 –US$45

The Commission found that, in the light of the structural changes that occurred in the supply and demand of wheat, a five-year average world reference price would be more appropriate than a ten-year reference price as recommended by the BTT. The graph below illustrates the structural effect.

Figure 6: Structural changes in the price of grains and oilseeds



(Source: Grain SA)

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 the farmers, and would not have an undue price-raising impact on consumers.

The recommended domestic Dollar-based reference price of US$215/ton will be yielding an immediate duty of 14.07 c/kg equivalent to approximately 10% *ad valorem*. The duty on wheaten flour is recommended to increase to 21.10c/kg (also equivalent to approximately 10%).

RECOMMENDATION

In view of the above the Commission decided that the domestic Dollar-based reference price for wheat be increased from US$157 per ton to US$215 per ton based on the 5-year average US No.2 HRW (ord) Gulf price of wheat of US$236/ton, plus an adjustment for the distortion factor evident in the international wheat market of US$24/ton, less the average transport cost of wheat of US$45/ton.

The initial duty on wheat will be calculated as the difference between US$215/ton and the three-week moving average over the last two weeks in September and the first week of October 2009, which amounted to US$196/ton at an exchange rate of R7.41 to the Dollar, as follows:

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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$215/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.

[20/2009]