

REPORT NO. 542

**REVIEW OF THE DOLLAR-BASED DOMESTIC
REFERENCE PRICE AND VARIABLE TARIFF
FORMULA FOR SUGAR**

The International Trade Administration Commission (ITAC) of South Africa herewith presents **Report No. 542: Review of the Dollar-based domestic reference price and variable tariff formula for sugar.**



.....
Siyabulela Tsengiwe
CHIEF COMMISSIONER

PRETORIA

04 / 04 / 2017

REPUBLIC OF SOUTH AFRICA
INTERNATIONAL TRADE ADMINISTRATION COMMISSION OF
SOUTH AFRICA

REPORT NO. 542

**REVIEW OF THE DOLLAR-BASED DOMESTIC REFERENCE PRICE
AND VARIABLE TARIFF FORMULA FOR SUGAR**

Synopsis

The Minister of Economic Development directed the International Trade Administration Commission of South Africa (ITAC) in terms of Section 16(1)(d)(i) of the International Trade Administration Act, to evaluate and investigate a review of the Dollar-based reference price (DBRP) and variable tariff formula for sugar.

The directive entails the review of the DBRP and variable tariff formula for sugar, as set out below:

"The directive was made in view of the fact that wheat, maize and sugar are basic necessities used by South Africans, and that the country is still in the grip of a drought coupled with large exchange rate fluctuations over the last couple of months. I direct ITAC to urgently review the current formulae, in particular taking into account the impact on the price of bread, maize and sugar."

During its deliberations and in arriving at its recommendation, the Commission considered the information at its disposal, including comments, with due regard to food security.

The aim of the current variable tariff formula is to set a fair level of support that would encourage the production of sugar, which is able to compete against low priced imported sugar, without having undue adverse price raising effects downstream. The sugar industry is important to the economy of South Africa and Swaziland in the Southern African Customs Union (SACU) due to its substantial contribution to national employment, especially in rural areas, manufacturing and agricultural output as well as linkages to other sectors, which require a pricing system that does not render it unaffordable.

South Africa has experienced the worst drought in 2015 since the early 1980s. Domestic production of sugar declined by approximately 10 per cent from 2.3 million tons in 2013/14, to approximately 2.1 million tons in 2014/15. Reduced plantings and poor rains in the 2015/16 season resulted in an even lower sugar production level of 1.6 million tons, equivalent to a 23 per cent decline.

The impact of the drought was also evident in terms of a decline in export volumes. SASA submitted that surplus sugar that would generally be channelled to the export market has been channelled to the domestic market. It was further submitted that no

exports of sugar were expected for the 2016/17 season, as most of the output would be sold in the local market.

South African sugar production is projected to significantly recover from the drought conditions in the 2016/2017 production season, due to favourable climatic conditions. Sugar crop forecasts for the 2016/2017 season indicated that the industry would produce sufficient sugar to meet local demand and minimise exports. Together with the positive outlook on sugar production, maintaining the variable tariff formula with some changes in the variables will continue to encourage the production of sugar.

Total imports decreased, on average, by 48 per cent over the three year marketing period (2013/14 – 2015/16), which can be attributed to a constant increase in the average world price of sugar, coupled with the depreciation of the Rand. According to information at the Commission's disposal, SACU is a sugar surplus producer, which means that every ton of sugar imported displaces a ton of locally produced sugar into a distorted, low priced world market. In terms of imports, the SACU region's source of competitive pressure is imported sugar from Brazil that accounted for approximately two thirds of total imports during the 2015/16 marketing season, and India. A second source of sugar inflow is under the SADC Sugar Cooperation Agreement.

An analysis of the price cost structure for sugar producers was taken into account to ensure that the level of support in the form of DBRP is in line with the producers' production costs. It was found that the DBRP at US\$566/ton presents a level of support, which is in line with the industry's production cost and supportive of the development of the SACU sugar value chain without having an undue adverse effect downstream. Unlike the wheat sector, where the level of duty plays an integral part in the determination of domestic wheat prices, in the sugar sector, an import tariff has less impact on the local price of sugar.

The average cost of sugar production per ton in the SACU is comparable with the proposed reference price of US\$566/ton.

The Commission rejected SASA's request for an increased DBRP from the current US\$566/ton level to US\$812/ton or US\$837/ton, given the negative impact it would have on downstream users and consumers and as the requested levels were at considerable variance with production costs.

Simulations were conducted, to look into the possibility of switching to a Rand-based reference price and it was found that a Rand-based reference system would not have yielded a duty and would unlikely yield a duty or perhaps at only low rates due to the trajectory of the Rand. This would be unfair to producers against the background of imported inflationary pressures that dilute the supposed benefits of the lower Rand. The Rand/Dollar exchange rate catapults current prices to levels higher than the reference price. The reference price would have to be updated constantly to the most recent year based on almost yearly applications by the industry and this would be untenable.

A move to a simple *ad valorem* duty was considered and it was found that the tariff would lose the countercyclical feature provided by the current DBRP that triggers a duty when world prices are low and triggers lower or no duties when world prices are

high. The variable tariff formula is therefore better suited to the circumstances surrounding the production and trade of sugar as opposed to the normal *ad valorem* duties. Rapid response is required due to the frequency of the sharp peaks and troughs evident in the price cycles of sugar.

It was found that the introduction of a new variable of the Real Effective Exchange Rate Index would address the negative impact of exchange rate fluctuations. This new variable must be factored into the variable tariff formula to ensure that producers are protected against real cost pressures and foreign currency denominated intermediate input costs such as fertiliser and machinery parts and not benefit unduly from exchange rate fluctuations, by adjusting the duty with the Rand's Real Effective Exchange Rate Index as published by the South African Reserve Bank. The Real Effective Exchange Rate Index that will be factored in will support domestic sugar producers proportionally against a depreciating or an appreciating currency by adjusting the nominal Rand exchange rate for price differentials between South Africa and its most important trading partners. This would ensure that windfall profits or unnecessary additional protection to producers due to exchange rate fluctuations do not accrue to producers at the expense of food affordability.

Tariff protection must be complemented by addressing competitiveness constraints in sugar production. A long term drive towards improved productivity remains critical. A holistic view of its long term prospects is also required. This includes a number of reforms related to its revitalisation that must provide the critical incentives for reinvestment by the growers and the processors. This includes alternative uses of sugarcane for energy and potentially biofuels. According to information at the Commission's disposal, bioethanol and cogeneration of electricity have been placed on hold due to the perceived expense to the fiscus.

The Commission in its analysis found that sugar prices have been volatile over the past but, based on the Bureau for Food and Agricultural Policy (BFAP) impact analysis report in terms of the price effect of the current Dollar-based reference price and variable tariff formula on sugar, BFAP found that the impact of an import tariff has little impact on the local price of sugar. The Genesis Report (2013), also found that although sugar prices have been volatile over the past, its impact on food inflation in terms of the consumer price increases in sugar-containing products constitutes a relatively small proportion.

In view of the above, the Commission decided that the domestic Dollar-based reference price for sugar be maintained at the current level of US\$566/ton. The duty would place South African sugar producers and their foreign counterparts on an equal competitive footing and is in line with the producers' production costs whilst simultaneously being sensitive to the impact on downstream users as well as food affordability.

The initial duty on sugar will be calculated as the difference between the DBRP of US\$566/ton and the price of sugar on 19 October 2016, which amounted to US\$597.03/ton at an exchange rate of R13.97 to the US\$ adjusted for price differentials between South Africa and its most important trading partners using the published Real Effective Rand Exchange Rate Index as follows:

REFERENCE PRICE	
RSA domestic reference price	US\$566/ton
Minus: London No. 5 settlement price of sugar on 19 October 2016	US\$597.03/ton
Dollar duty on sugar	US\$0/ton
Rand duty on sugar before adjustment	R0/ton
Adjusted with the Real Effective Exchange Rate Index	R0 x 0.79 = R0/ton
Rand duty on sugar	0c/kg (equivalent to 0% <i>ad valorem</i>)

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

The difference between the 20 trading day moving average of the London No. 5 settlement price and the established reference price for sugar will be calculated daily. If the 20 trading day moving average of the London No. 5 settlement price shows a variance of more than US\$20/ton from the previous trigger level for 20 consecutive trading days, a new duty will be 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 and subsequently adjusted with the latest available real effective exchange rate index as published by the South African Reserve Bank.

The levels of duty may not exceed the bound rate of 105 per cent *ad valorem* for sugar.

The Dollar-based reference price should be reviewed on a three year basis. This would ensure that the DBRP is adapted to recent developments in the domestic and global markets.

1. BACKGROUND

1.1. Directive to review the Dollar-based domestic reference price and variable tariff formula for sugar

The Minister of Economic Development directed the International Trade Administration Commission of South Africa (ITAC) in terms of Section 16(1)(d)(i) of the International Trade Administration Act, to evaluate and investigate a review of the DBRP and variable tariff formula for sugar.

The directive entails the review of the DBRP and variable tariff formula for sugar, as set out below:

“The directive was made in view of the fact that wheat, maize and sugar are basic necessities used by South Africans, and that the country is still in the grip of a drought coupled with large exchange rate fluctuations over the last couple of months. I direct ITAC to urgently review the current formulae, in particular taking into account the impact on the price of bread, maize and sugar.”

The review was published in the Government Gazette on 22 July 2016 for a period of 4 weeks to solicit comments from interested parties.

1.2. The existing tariff dispensation for sugar

The current tariff dispensation for sugar, termed the variable tariff formula, was introduced by ITAC's predecessor, the Board on Tariffs and Trade (BTT), in September 2000. The BTT found that the average long term (10 years) international price for sugar (London No. 5 settlement price) of US\$300/ton was distorted to such an extent that it could not be accepted as a fair reflection of a normal world market price of sugar. Guided by the results of various studies regarding the effects of market intervention on the price for sugar, the BTT concluded that in order to establish a fair benchmark for a sugar pricing model, the long term average price for sugar should be adjusted upwards by 20%, to factor in distortions in the international sugar markets.

The BTT model found that the SACU industry would be competitive at an international price of US\$360/ton but would need protection should the international price fall below US\$360/ton. It was also found that over and above tariff protection, the industry also benefitted from natural protection in that sugar is an expensive product to transport. In view of the above, the BTT recommended a Dollar-based reference price (DBRP) system that provides for protection for the industry equal to the long term international price for sugar (then US\$300/ton), plus a distortion factor (US\$60/ton) less transport cost of US\$30/ton, which resulted in an initial DBRP of US\$330/ton.

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

The difference between the 20 trading day moving average of the London No. 5 settlement price and the established reference price for sugar is calculated daily. If the 20 trading day moving average of the London No. 5 settlement price shows a variance of more than US\$20/ton from the previous trigger level for 20 consecutive trading days, a new duty is calculated. The resulting Dollar duty is converted to Rand according to the Rand/Dollar exchange rate prevailing on the day that the adjustment is triggered.

Since the introduction of the variable tariff formula for sugar by the BTT in 2000, ITAC has maintained the use of the variable tariff formula to calculate the customs duty on sugar.

In 2009, the Commission investigated a potential increase in the DBRP for sugar, and recommended in Report No. 308 of 2009 an increase in the DBRP for sugar from US\$330/ton to US\$358/ton. It also recommended a new distortion factor and transport cost figure based on prevailing data. The Commission, in its last investigation regarding the DBRP for sugar, recommended in Report No. 463 of 2014 an increase in the DBRP for sugar from US\$358/ton to US\$566/ton, as well as a new distortion factor and transport cost figure based on prevailing data. This price support mechanism as per ITAC's Report 463 is based on the rationale that the duty would place

South African sugar producers and their foreign counterparts on an equal competitive footing whilst simultaneously being sensitive to food affordability.

The existing tariff position for sugar as at 19 October 2016 reads as follows:

Table 1: Current tariff position for sugar

Tariff heading	Tariff subheading	Description	Statistical unit	Rate of duty		
				EU	EFTA	SADC
17.01		CANE OR BEET SUGAR AND CHEMICALLY PURE SUCROSE IN SOLID FORM				
1701.1		Raw sugar not containing added flavoring or colouring matter:				
	1701.12	Beet sugar	Kg	free	free	free
	1701.13	Cane sugar specified in subheading Note 2 to this chapter	Kg	free	free	free
	1701.14	Cane sugar	Kg	free	free	free
1701.9		Other:		free	free	free
	1701.91	Containing added flavoring or coloring matter	Kg	free	free	free
	1701.99	Other	Kg	free	free	free

(Source: SARS)

As per the variable tariff formula, the level of duty introduced was 132c/kg when the recommendations of ITAC Report 463 were implemented on 04 April 2014. Subsequently, the duty triggered eleven times. Details of these triggers are as shown below:

Table 2: Variable tariff formula triggers after 04 April 2014

Date of trigger	Three week moving average world price at the time of trigger	Upward or downward trigger	Ad valorem equivalent
27/05/2014	US\$476.18	<i>Downwards</i> 132c/kg – 92.6c/kg	19%
25/08/2014	US\$432.92	<i>Upward</i> 92.6c/kg – 142.5c/kg	31%
06/01/2015	US\$389.46	<i>Upward</i> 142.5c/kg – 207.1c/kg	45%
21/04/2015	US\$365.37	<i>Upward</i> 207.1c/kg – 242.6c/kg	55%
23/09/2015	US\$344.05	<i>Upward</i> 242.6c/kg – 304c/kg	65%
09/11/2015	US\$391.70	<i>Downward</i> 304c/kg – 245.4c/kg	44%
04/02/2016	US\$417.70	<i>Downward</i> 245.4c/kg – 239.5c/kg	56%
27/05/2016	US\$473.33	<i>Downward</i> 239.5c/kg – 144.33c/kg	20%
11/07/2016	US\$544.21	<i>Downward</i> 144.33c/kg – 31.89c/kg	4%
26/10/2016	US\$597.27	<i>Downward</i> 31.89c/kg – free of duty (Implemented on 10/02/2017)	0%
15/12/2016	US\$519.42	<i>Upward</i> free of duty – 63.63c/kg	9%

(Source: ITAC)

At the core of the changes in the level of tariff support were movements in the world price of sugar. As can be seen in the table above, the declining world price necessitated an increase in the tariff to ensure that local sugar prices do not fall below the set domestic reference price. However, since November 2015, world sugar prices have been increasing, necessitating a reduction in the tariff.

The WTO bound rate for South African sugar is 105% *ad valorem*.

At the time of the WTO negotiations, South Africa's level of bound rates for agricultural products was deemed high. Subsequently, South Africa agreed to the introduction of Minimum Market Access rebates for certain agricultural goods, which allows for a specific percentage of duty free imports calculated as a percentage of the base year.

Under the SADC Trade Protocol, a provision for rebate of the full duty in terms of Schedule No. 4 to the Customs and Excise Act, 1964 exist with respect to raw or refined sugar imported from non-SACU SADC Member States. (Rebate provision under item 460.04/17.01/01.04).

2. INDUSTRY AND MARKET

2.1. International market

Sugar is produced in more than 100 countries and global production exceeded 160 million tons for 2015/2016 period as gains in Brazil and the European Union more than offset a decline in India. Brazil remains the largest producer and exporter of sugar, followed by the European Union, India, Thailand, Australia and China. South Africa only exports surplus sugar after satisfying the domestic market demand.

Approximately three quarters of sugar production is consumed in the countries of production. The balance is traded in the international sugar market, generally at prices below those supported by economic fundamentals. The distorted world sugar prices arise from interventionist measures adopted in a number of sugar producing countries. These measures, which have the effect of artificially increasing the supply of sugar to the world market, include producer and export support programs, market access constraints such as preferential quotas and special market arrangements, and are supported by high import tariffs.

In the Southern African Development Community (SADC), which comprises 15 member states, only 11 member states produce sugar with South Africa being the largest sugar producer in the region. There is an existing SADC Sugar Cooperation Agreement, which consists of two components, namely market access and areas of cooperation. The market access component allows non-SACU SADC surplus sugar producing countries, exposed to depressed world market prices, the opportunity to share in the growth in the SACU market. The cooperation component enables cooperation in the areas of research, training,

small holder development, infrastructure (including export facilities), customs administration and developments in the rest of the world, with the ultimate objective of creating an integrated and internationally competitive SADC sugar industry.

According to the United States Department of Agriculture (USDA)¹ Global sugar consumption for 2016/17 is forecast at a record 174 million metric tons (raw volume), exceeding production and drawing stocks down to the lowest level since 2010/11. Production is up 4 million tons to 169 million tons as gains in Brazil and the European Union more than offset the decline in India. With a growing international demand, imports are forecast to increase by 1.2 million tons. The rising pace of global consumption has been sustained by drawing from stock levels in recent years. Consequently, stocks are approaching what appears to be historically low levels. In fact, world raw sugar prices, after falling for over a year and bottoming at less than 11 cents per pound in August 2015, are trending higher to near 17 cents in May 2016. As prices react to high demand and as the Brazilian Real struggles to find equilibrium against the Dollar, market returns are needed to provide incentives for producers to meet the demand.

2.2. SACU sugar market

Table 3 below, reflects the estimated size of the SACU sugar market, which is represented by the South African Sugar Association (SASA) and the Swaziland Sugar Association (SSA). Import data has been adjusted to correspond with the industry marketing year, which runs from April to end of March.

Table 3: Estimated size of SACU sugar market

Year April -March	Total SACU sales Volume (Tons)	Annual growth rate of SACU sales (%) Volume (%)	Total SACU sales in terms of volume (Tons)		% share of sales to total SACU sales in terms of volume (Tons)	
			Imports	SACU Sugar industry	Imports	SACU Sugar industry
2012/13	2 458 731	16.7%	453 796	2 004 935	18.5%	81.5%
2013/14	2 313 406	-5.9%	462 224	1 851 182	20.0%	80.0%
2014/15	2 187 583	-5.4%	166 075	2 021 508	7.6%	92.4%
2015/16	2 095 600	-4.2%	113 343	1 982 257	5.4%	94.6%
Average	2 263 830	0.3%	298 859	1 964 971	12.9%	87.1%

(Source: SASA, SSA, SARS and ITAC calculations)

As shown in Table 3 above, the total SACU market for the 2015/16 period comprises of sugar supplied by South Africa, Swaziland, SADC producers who have quotas under the SADC Sugar Cooperation Agreement and all other imports.

As shown in Table 3 above, the average share of the SACU sugar industry's (producers) sales volumes was 87.1 per cent for the period 2012/13 – 2015/16, while imports represented approximately 12.9 per cent of the SACU

Available online: <http://www.fas.usda.gov/data/sugar-world-markets-and-trade> [May 2016 Report]

market during the same period. There was a decline in domestic producers' sales volume between 2012/13 and 2013/14, prompting the domestic sugar industry to file an application for an increase in the DBRP in 2014.

Subsequent to the implementation of ITAC Report No. 463 in 2014, imports declined from approximately 20 per cent in 2013/14 season, to approximately 5.4 per cent in 2015/16 marketing season, while domestic producers' sales volumes recuperated in 2014/15 season, increasing its share in the SACU market from 80 per cent in 2013/14 to 94.6 per cent in the 2015/16 season. The decline in imports could be as a result of higher import duties and the effect of a weaker Rand in the recent period. On average, the share of imports was recorded at 12.9 per cent between 2012/13 and 2015/16, with South African producers (SASA) enjoying the largest share of the market over the same period.

The domestic sugar industry's production volumes declined, on average, by approximately 3 per cent between 2012/13 and 2015/16. South African sugar producers exclusively accounted for the declines in the industry's production volumes with an average decline of 4.4 per cent, while Swaziland's production volumes marginally increased by 1.9 per cent during the same period. Due to the drought, production of sugar in South Africa decreased by 10 per cent and 23 per cent in the 2014/15 and 2015/16 seasons, respectively.

While the South African producers' production volume and capacity utilisation continued to decline since the 2014/2015 season, Swaziland's producers' production volumes and estimated capacity utilisation has shown an increasing trend during the same period. As a result, there has also been a corresponding decline and increasing trends in total sales volumes for South Africa and Swaziland, respectively, during the same period. On average, the domestic industry's capacity utilisation declined by 3 per cent during the period 2012/13 - 2015/16.

The domestic sugar industry's exports, on average, accounted for approximately 29.3 per cent of total sales, during the 2012/13 to 2015/16 seasons. The main export destination for South Africa's exports for the subject product is Sub-Saharan Africa, while Swaziland's exports have been destined for, amongst others, the EU and US markets. On average, the industry's total exports marginally declined by 0.4 per cent for the period 2012/13 to 2015/16. There was a significant decline in the domestic industry's exports between 2014/15 and 2015/16, declining by approximately 31 per cent and 56 per cent, respectively, during that period. The recent declines in export volumes may be as a result of the effect of the recent drought, which affected the production of sugar both in South Africa and Swaziland. The portion of surplus sugar that would generally be channelled to the export market is now being channelled into the domestic market.

According to information at the Commission's disposal, SASA only exported approximately 1 per cent of their output in the 2015/16 season. SASA also submitted that they are not expecting any exports for the 2016/17 season, as most of their output would be sold in the local market.

Information from the Swaziland Sugar Association (SSA)² indicated that Swaziland's sugar is largely sold to two main markets, namely SACU and the European Union (i.e. between 2013 and 2014 the sales were approximately in a 50:50 ratio). Other preferential markets exist in COMESA and the United States, but have not been utilised in recent years, owing to the relatively lower returns in those markets contrasted with a high-priced access to the EU market.

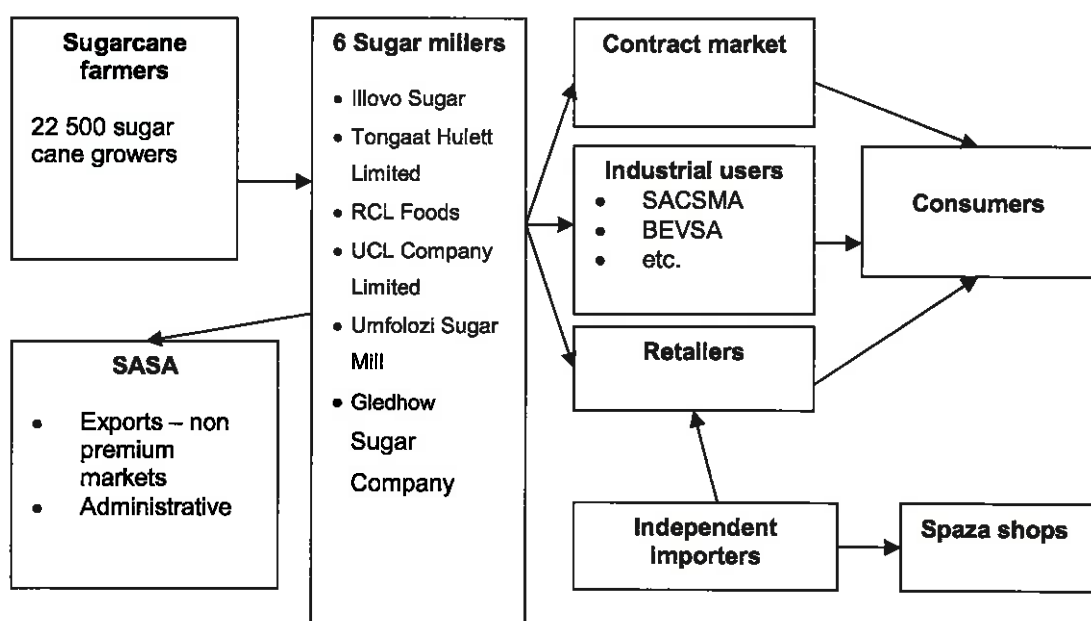
Swaziland's access to the EU market was on the basis of a duty-free quota-free market access provision of the Market Access Regulations, which was the interim instrument prior to the enactment of the Economic Partnership Agreement. This has provided Swaziland with an avenue to sell unlimited quantities of sugar to a higher-priced market in the EU, essentially diverting sales from the low-priced regional- and US markets. Through this access arrangement, Swaziland's exports to the EU have increased from 2006/07 to 2013/14. However, there has been a decline in SSA's sugar sales to the EU in recent years.

According to information at the Commission's disposal, SACU is a sugar surplus producer. In terms of imports, the SACU region's source of competitive pressure is imported sugar from Brazil and India. A second source of sugar inflows is under the SADC Sugar Cooperation Agreement.

2.3. Downstream sugar Industry

The South African sugar value chain is presented in Figure 1 below:

Figure 1: South African sugar value chain



² Sales data for SSA is available online at: <http://www.ssa.co.sz/industry-statistics/2013-12-11-06-16-55/sugar>

South African sugar is produced from sugar cane by approximately 22 500 registered sugarcane growers who annually produce, on average, 19 million tons of sugarcane from 14 mill supply areas. Approximately 21 110 are small-scale growers, of whom 12 507 delivered cane last season, producing 9.4 per cent of the total crop.

According to the South African Sugar Industry Directory³, there are approximately 1 383 large-scale growers (inclusive of 323 black emerging farmers) who produce 83.3 per cent of total sugarcane production. Milling companies with their own sugar estates produce 7.94 per cent of the crop.

On average, the South African sugar industry processes 19 million tons of cane in a season resulting in an average sugar production level of 2.3 million tons from the existing mill capacity of approximately 2.8 million tons per annum.

Four of the fourteen South African mills are owned by Illovo Sugar Ltd; four mills are owned by Tongaat-Hulett Sugar Ltd and three mills by RCL Foods. UCL Company Ltd, Gledhow Sugar Company and Umfolozi Sugar Mill each operate one mill. Two of the RCL Foods mills are located in the Mpumalanga province and the remaining mills are in the Kwa-Zulu Natal province.

The members of the South African Sugar Millers' Association Limited, which represent the interests of all sugar millers and refiners in South Africa, are:

- **Illovo Sugar Ltd** - operates four sugar mills in South Africa, one of which has a refinery and two have packaging plants. It has three cane growing estates and produces a variety of high-value downstream products.
- **Tongaath-Hulett Sugar Ltd** - operates four sugar mills in South Africa, two of which have packaging plants, a central refinery in Durban which has its own packaging plant, various sugar estates and an animal feed operation.
- **RCL Foods** - operates three sugar mills, two of which have refineries, a packaging plant, sugar estates, cane and sugar transport divisions and an animal feed division.
- **UCL Company Ltd** - operates a sugar mill, a wattle extract factory, two saw mills, a number of mixed farms and a trading division.
- **Gledhow Sugar Company (Pty) Ltd** - the mill produces refined sugar to EEC2 standard and supplies this sugar to the food and beverage industries in Southern Africa.
- **Umfolozi Sugar Mill (Pty) Ltd** – the mill refines and package high quality brown sugar for sale into the industrial and retail markets.

³ South African Sugar Industry Directory 2015, available online at <http://www.sasa.org.za>

Swaziland is the only other sugar producer in the SACU and has three main sugar cane growers, namely Simunye-, Mhlume- and Big Bend planters. The cane growers are aligned with their respective millers – i.e. Simunye-, Mhlume- and Ubombo mills. The operations of the Swaziland sugar industry are regulated by the Swaziland Sugar Association (SSA), which is the highest policy-making body and is a Council that comprises of members from the Swaziland Sugar Millers Association (SSMA) and members from the Swaziland Cane Growers Association (SCGA). Presently, the industry has approximately 130 registered sugar cane growers spread across the areas where the mills are based. Swaziland sugar cane production stood at 5 836 553 tons in 2015/2016 period, which resulted in a total industry sugar production level of 695 410 tons.

3. COMPETITIVE POSITION

According to information at the Commission's disposal, financial information pertaining to production costs provided by SASA was consolidated from information that was provided by the growers' and millers' associations. The figures were based on average costs, which were based on surveys conducted by the respective associations. According to SASA, all the actual cost price structures were audited, excluding the estimates for the 2016/17 period.

It was found that, on average, domestic production cost has increased from the 2013/14 to the 2015/16 marketing season. The main cost driver in the production of sugar is processing material, followed by direct and indirect labour costs. Amongst other cost drivers, maintenance cost also contributed to an increase in total production cost for the period 2015/16. According to information at the Commission's disposal, domestic sugar producers recorded a profit in the 2013/14 marketing season. However, for the period 2014/15 and 2015/16, domestic producers, on average, experienced a decline in profit levels and in some instances losses.

According to published, audited financial statements of JSE-listed Tongaat Hulett Ltd for the period 2014/15 – 2015/16 its sugar operations (SADC) realised an operation profit of R124 million in 2016 on a revenue of R11 382 million (1.09%), compared to an operating profit of R806 million in 2015 on a revenue of R11 621 million (6.94%). JSE-listed Illovo Sugar Ltd realised operating profit of R943.8 on revenue of R13 266.5 million (7.11%) in 2015 and an operating profit of R672.5 million on a revenue of R13 169.5 million (4.76%) in 2016.

The South African industry has recently been severely impacted by one of the worst droughts in history. From sugar production levels of approximately 2.3 million tons in 2013/14, poor rainfall in the rain-fed coastal and midlands areas resulted in a reduction in production levels to approximately 2.1 million tons in 2014/15. Reduced plantings and poor rains in the 2015/16 season resulted in an even lower sugar production level of 1.6 million tons. As a result, operational cost recovery for the industry has been increasingly challenging, where similar resources at escalating prices are required to process a crop.

According to SASA, prior to the drought and in addition to a challenging cost environment, the industry has been unable to pass the escalating costs of production onto consumers. Selling prices for a number of years, before and including the 2014/15 and 2015/16 seasons have lagged cost increases, which has been absorbed by the industry, by a significant factor. It was submitted that the industry has been unable to raise its prices due to the threat of deep sea imports. Measures such as Top-up rebates were implemented to discourage industrial users making use of imported sugar from 2013 to 2015. SASA submitted this to be indicative of the precarious state of the industry in this regard. SASA submitted that all sectors of the industry have applied rigorous austerity measures to cut the costs of the growing and processing of sugar as well as cutting costs in the administration of the sugar industry over this period.

Estimates for the period 2016/17 have been provided, and this indicated that sugar producers expected production cost as well as its selling prices to increase. However, profit levels were expected to recover from previous levels, in the 2016/17 season.

According to information at ITAC's disposal, imports of sugar for the 2013/14 marketing period amounted to approximately 462 000 tons. Imports of sugar for the 2014/15 marketing period declined significantly by 64 per cent to approximately 166 000 tons. In the 2015/16 marketing period, imports of sugar continued to decline as sugar imports were recorded at approximately 133 000 tons. On average, imports of sugar into the SACU region decreased by 48 per cent over the three year marketing period (2013/14 – 2015/16). The decrease in the level of sugar imports into the SACU region can be attributed to the constant increase in the world average price of sugar and the depreciation of the Rand.

The majority of imports into the SACU region originated from Brazil, which accounted for approximately two thirds of total imports during the 2015/16 marketing season. While the average price of sugar imported from Brazil remained relatively constant over the three year marketing period (2013/14 – 2015/16), the level of imports decreased by 55 per cent over the same period. In addition, while imports from India and Thailand accounted for 3 per cent of total imports in the 2015/16 season, these imports experienced a similar decreasing trend in both the quantity as well as the average price per ton.

With regard to imports from the rest of the world, all other importing countries individually had an average import share of less than 1 per cent for the 2013/14–2015/16 marketing seasons. However, the combined imports of sugar from these countries increased by 2 per cent, while the average price per ton increased by 13 per cent over the same period. These countries had a combined total import share of approximately 29 per cent in the 2015/16 marketing season.

4. ESSENTIAL ISSUES PERTAINING TO THE REVIEW

The essential issues according to the policy directive include: the effects of drought; food inflation (sugar prices); exchange rate fluctuations; and the relationship between the cost of production and the level of protection.

4.1. The effects of drought

South Africa has experienced the worst drought in 2015 since the early 1980s. From sugar production levels of approximately 2.3 million tons in 2013/14, poor rainfall in the rain-fed coastal and midlands areas resulted in a reduction in production levels to approximately 2.1 million tons in 2014/15. Reduced plantings and poor rains in the 2015/16 season resulted in an even lower sugar production level of 1.6 million tons. In the SACU as a whole, sugar production has declined from 2.9 million tons in the 2013/2014 season to approximately 2.3 million tons in the 2015/2016 season as a result of poor rains which culminated in reduced plantings. The impact of the drought was also evident in terms of a decline in export volumes. SASA submitted that surplus sugar that would generally be channelled to the export market has been channelled to the domestic market. It was further submitted that no exports of sugar were expected for the 2016/17 season, as most of the output would be sold in the local market.

The Association of Southern African Sugar Importers (ASASI) submitted that local producers do not have sufficient stock and even with higher rainfall levels, it would take an additional season to recover. In terms of ASASI's estimates, there would be a shortage of at least 200 000 tons of sugar.

The Beverage Association of South Africa (BEVSA) submitted the following relating to the effect of the recent drought conditions:

- Carry over stock from the 2015 sugar season might be sufficient to meet the 2016 demand but this will fully deplete regional stocks;
- There would be a production deficit for the period 2017 to 2020, which was estimated at over 800 000 MT;
- The production deficit would require the importation of sugar into SACU in order to meet the estimated demand; and
- The duty on sugar is an unnecessary cost barrier during periods where a supply deficit is expected.

The South African Sugar Association (SASA) submitted that the drought has had a significant impact on cane and sugar production. Cane production in the 2013/14 season was just over 20 million tons. The impact of the drought in the 2015/16 season resulted in a 35 per cent reduction in cane production levels to just over 14.8 million tons. Sugar production has also reduced significantly by more than 31 per cent over the same period. The impact of the drought was expected to persist in the 2016/17 season, with estimates marginally down from the 2015/16 season. As at April 2016, cane production for the 2016/17 season was estimated to be 14 236 937 tons while sugar production was estimated at 1 561 804 tons. Based on weather predictions, it

was expected that the 2017/18 cane crop would show improvement. SASA further submitted that in the 2015/16 season, the South African sugar industry produced sugar in excess of the domestic demand. As mentioned previously, SACU is generally a surplus producer of sugar. Therefore, the sector was able to channel surplus sugar that was destined for the export market for use in the domestic market. SASA also estimated that sugar will not be exported during the 2016/17 season but would be channelled into the domestic market to satisfy local demand. According to sugar crop forecasts for the 2016/2017 season, the industry estimated that sufficient sugar would be produced to meet domestic demand.

The Swaziland Sugar Association (SSA) submitted that the drought reduced the industry's production levels by approximately 24 per cent, from 695 000 tons in 2015 to a projected 526 000 tons in 2016. The effects were expected to continue into the 2016/17 season but the quantum of such effect was not known. It was further submitted that despite a reduction in the level of production, it was estimated that there would be sufficient sugar available to supply in the South African and SACU requirements over this period. SSA submitted that as a surplus sugar producing region, the only impact of the drought was in terms of reducing export availability.

The Commission, in its analysis of the effects of the drought, was of the view that the drought had a negative impact on domestic sugar production. The Commission found that the industry has been severely impacted by one of the worst droughts in history. Sugar production in the SACU declined from approximately 2.9 million tons in the 2013/14 season to approximately 2.3 million in the 2015/16 season.

The recent drought resulted in a decline in export volumes of sugar both from South Africa and Swaziland. It was submitted that surplus sugar that would generally be channelled to the export market was being channelled to the domestic market. SASA submitted that it only exported approximately 1 per cent of their output in the 2015/16 season and it was expected that there would be no sugar exported during the 2016/17 season. Sugar crop forecasts for the 2016/2017 season indicated that the industry would produce sufficient sugar to meet local demand.

4.2. Food Prices

Sugar is used in the manufacture of a variety of downstream products. The production of domestic sugar has been declining in recent years exacerbated by drought conditions, which negatively affected food production and consequently consumer prices. Since sugar is used in a variety of downstream products, it was challenging to measure the impact of the increased sugar prices based on a specific product, hence the impact would be measured in terms of sugar prices rather than prices of specific food items containing sugar.

ASASI submitted that local sugar price increases ranged between 6.5 per cent and 27.5 per cent for the period 2014 – 2016. Other stakeholders submitted

that the actual weighted average sugar price has consistently increased over the past three years. The Consumer Price Index (CPI) also indicated an increasing trend in the price of sugar for the past three years, with the sugar price at CPI exceeding general CPI in 2016.

SASA cited the Genesis Report of 2013, which contended that a change in the price of sugar has a relatively small impact as a cost driver of sugar-containing products. Furthermore, SASA submitted that according to Clause 161(a) of the Sugar Industry Agreement of 2000 (SIA 2000), the Council of the South African Sugar Association periodically reviews and adjusts the notional local market price of sugar. Changes in the notional price have been constrained by the threat of imports as well as duty-free imported competition from Southern African Customs Union and the Southern African Development Community. The industry's production cost increased over time, however, not at the same rate as the increases in the notional local market price for sugar, threatening industry sustainability. Price suppression and a failure to recover production costs remain critical challenges to the South African industry.

SSA submitted that the sugar price is highly volatile, with the London No. 5 price ranging from a low of US\$330.60/ton in August 2015 to a high of US\$571.70/ton in July 2016 during the 3 year period from August 2013 to July 2016. The price was, however, US\$388.30/ton at the beginning of August 2013 and US\$528.40/ton at the end of July 2016. During the 3 year period, the price of sugar realized a standard variance of US\$52.30/ton, which is deemed to be a very high variance for the price of a commodity product.

The Commission, in its analysis, found that sugar prices have been volatile over the past. However, the Commission considered the price impact analysis report conducted by the Bureau for Food and Agricultural Policy (BFAP) which established that the import tariff has little impact on the local price of sugar. According to the Genesis Report (2013), although sugar prices have been volatile over the past, its impact on food inflation in terms of the consumer price increases in sugar-containing products constitutes a relatively small proportion.

The Bureau for Food and Agricultural Policy (BFAP) conducted an impact analysis in terms of the price effect of the current Dollar-based reference price and variable tariff formula on sugar production and the sugar price. BFAP found that:

- The equilibrium pricing conditions in the sugar industry differ significantly from the maize and wheat industries. This industry follows a single channel marketing system, which is based on a division of proceeds and a surplus removal scheme to maintain local prices in the market.
- The local sugar price (notional price) is set by the industry. The local price is set above the world price and therefore surpluses are exported at a loss. At its peak, the sugar industry exported more than 1.4 million tons of sugar per annum.

In terms of the effect of the current sugar price tariff on consumer food prices it was submitted that:

- The mere fact that the sugar industry operates under the current Sugar Act, implies that the import tariff has little impact on the local price of sugar.
- Compared to maize and wheat, the global sugar market is considered to be heavily influenced by a combination of policies and market interventions, implying that the world price of sugar does not give a true reflection of global supply and demand dynamics.
- The local sugar price (notional price) is set above the world price and all local sugar is sold at this price. After the local demand has been met, any surplus sugar is exported to the world market at a loss. The Sugar Act determines that the total revenue that is earned by the sugar industry is divided between the growers and the millers based on a formula.
- The structure described above implies that if more sugar is imported, a higher volume of sugar also has to be exported at the lower world price.
- Apart from tariff implications, the newly introduced sugar tax may reduce the domestic use of sugar, due to higher costs, which implies that more sugar will have to be exported at lower world prices, reducing the recoverable value for producers.
- The world sugar market is characterised by a wide range of government interventions, policies and support mechanisms (not only directly in the sugar market but also in the form of subsidies in the bio-ethanol market that result in major distortions in the world market and a price that is generally depressed by surplus production).
- The current duty protects South African producers from this distorted global market. The majority of sugar that enters South Africa comes from within the SACU region (Swaziland) at free of duty.
- Contrary to the maize and wheat industries that are not regarded as labour intensive, approximately 75 000 workers are employed in the sugar industry.
- The sustainability of the sugar sector does not rest on import tariffs alone. A holistic view of its long term prospects is also required. This includes a number of reforms related to its revitalisation that must provide the critical incentives for reinvestment by growers and the processors.
- This includes alternative uses of sugarcane for energy and potentially biofuels. Bioethanol and cogeneration of electricity have been placed on hold due to the perceived expense to the fiscus.

4.3. Exchange rate fluctuations

In determining customs duties for sugar using the existing variable tariff formula, the difference between the current moving average international sugar price and the DBRP (both denominated in US Dollars), results in a Dollar specific duty, which is converted to Rand according to the Rand/Dollar exchange rate prevailing on the day that the adjustment is triggered. Therefore, changes in exchange rates play a crucial role in the quantum of the duty. Over the past two years the R/\$ exchange rate showed a weakening of 60% to the US\$, as shown in the graph below:



As a result of the weakening Rand/Dollar exchange rate and the impact this had on the calculation of the applied sugar duty, concerns were raised that the current variable tariff formula does not take into account extreme exchange rate variations, which may result in unnecessary additional protection to producers due to these fluctuations.

BEVSA stated that the depreciation would have a material impact on the level of the duty payable in the local currency (other factors remaining constant) and could unduly increase the local price of sugar. It could be argued that in instances of material currency devaluation, this devaluation effect should be taken into account when the level of the tariff is determined.

SASA submitted that the current variable tariff formula, coupled with the volatility in the exchange rate could have a significant impact on the level of the tariff. A significant depreciation of the Rand therefore offers added levels of protection. However, SASA further cautioned that it should be taken into account that a number of key inputs in the production of sugar i.e. fertilisers and chemicals are imported and would be subject to the same currency volatility.

SSA said that the exchange rate must be treated, as is the case currently, as an exogenous variable. It was also submitted that the exchange rate is used to determine the conversion on the applicable date.

Certain interested parties submitted that the DBRP be substituted with a Rand-based reference price in order to minimise the effect of a devaluating currency, which affords excessive levels of protection to the domestic industry when global sugar prices are low.

The Commission considered the fact that when there is a sharp decline in the value of the Rand this may result in overprotection. While the Commission noted that since 2014 to early 2016, the international prices of major input costs such as crude oil and fertilizer have been declining, the weakening in the R/\$ exchange rate diluted advantages that the local sugar producers would have had in potential lower input costs as far as fuel and fertilizers are concerned.

Based on simulations conducted on the possibility of switching to a Rand-based reference price, it was found that a Rand-based reference system would not have yielded a duty and would unlikely yield a duty or only at low levels due to the trajectory of the Rand. This would be unfair to sugar producers against the background of imported inflationary pressures that dilute the supposed benefits of the lower Rand. This would expose domestic sugar producers to low priced and subsidized imports. The Rand/Dollar exchange rate catapults current prices to levels higher than the reference price. The reference price would have to be updated constantly to the most recent year based on almost yearly applications by the industry and this would be untenable.

The Commission therefore concluded that a new variable should be introduced into the tariff formula in the form of the Real Effective Exchange Rate (REER) Index published monthly by the South African Reserve Bank. This index takes into account price differentials between South Africa and its 20 most important trading partners. Adjusting the triggered duty by the REER, would ensure that sugar producers are protected against real cost pressures and do not benefit unduly from exchange rate fluctuations. This adjustment should bring stability to the system during periods of exchange rate fluctuations or a sustained depreciation or appreciation of the Rand.

4.4. Relationship between the cost of production at farm level and the tariff regime

The variable tariff formula is intended to sustain and encourage the domestic production of sugar in the SACU. Therefore, in establishing the level of the DBRP, production costs are taken into account in order to ensure that the DBRP is comparable to the domestic producer's production costs, which would support the viability of domestic sugar production. There was a concern that the variable tariff formula does not take into account movements in sugar producers' production costs.

In analysing the relationship between domestic producers' cost of production and the proposed DBRP, SASA was requested to submit average production costs for the 2013/14, 2014/15, 2015/16 as well as estimates for the 2016/2017 production years.

An analysis of the cost structures provided showed that for the 2015/16 season, the total production cost of sugar exceeded the average selling price of sugar resulting in a loss situation. This loss situation was exacerbated as a result of rebates offered by SASA to downstream users of sugar, which ultimately resulted in a net loss.

Estimates for the period 2016/17 were provided, and they indicated that sugar producers expected production costs to increase in the 2015/16 season. However, profit levels were expected to recover from previous negative levels realised in the 2014/15 and 2015/16 seasons to a positive estimate for the 2016/17 season. The improved profit outlook was based on an expected increase in the selling price of sugar in the 2016/17 season. This increased selling price is expected to offset increases in sugar producers' production costs.

The Commission took into account the domestic cost of sugar production in determining a level of protection. It was found that the DBRP of US\$566/ton presents a level of protection, which is in line with the industry's production cost and supportive of the development of the SACU sugar value chain without having an adverse effect downstream. Unlike the wheat sector, where the level of duty plays an integral part in the determination of domestic wheat prices, in the sugar sector, an import tariff has less impact on the local price of sugar.

5. THE REVISED DBRP AND VARIABLE TARIFF FORMULA

The current tariff dispensation for sugar, referred to as the variable tariff formula, was introduced in 1999, with the aim to set a fair level of protection that would encourage production of sugar, which is able to compete against low priced imported sugar, without having undue adverse price raising effect downstream. The formula sets a floor-price referred to as the Dollar-based reference price (DBRP), which represents the minimum price at which the local producers are able to produce sugar. When the price of imported sugar is lower than the DBRP (i.e. due to depressed international prices), for a specified time, an import duty is levied based on the difference between the DBRP and the low import price. It is countercyclical in that it affords protection when international world prices are low and no duty is levied when international prices are above the DBRP.

In terms of the relevance of the current variable tariff formula and DBRP, ASASI submitted that the current reference price is not relevant as the current duty resulting from the DBRP that was recommended by ITAC in its Report No. 463 is way above the duty that was approved (i.e. 123.4c/kg) and the duty that would have been approved if SASA's request for a higher DBRP (i.e. US\$764.34) was granted. ASASI further submitted that the current exchange rate and duty makes it absolutely impossible to import.

BEVSA submitted that whilst they do not have any concerns regarding the constituent components of the formula, they believe that there is no

mechanism to ensure that the recommended DBRP remains relevant over time.

SASA submitted the following in response to the relevance of the formula:

- The variable tariff formula duty remains a relevant mechanism for protection of the local sugar industry. According to SASA, the variable tariff formula takes into account subsidised global commodity production and trade dynamics, and offer local producers a level of protection from distorted world market competition.
- The principle of the mechanism is to be reactive to the volatile world sugar price, taking into account changes in the exchange rate that would impact the cost of imports. The variable tariff formula used for sugar, since the increase in the DBRP in April 2014, has resulted in triggers with varying levels of duty.
- The protection afforded to the South African industry by the variable tariff system has clearly been reactive to changes in a distorted global market, and has gone some way to curbing imports from a residual and subsidised world market. On this basis, the formula for sugar remains relevant to the sustainability of the local industry.
- While the government has considered alternative tariff systems, such as *ad valorem* or a specific duty, the industry is of the view that the variable tariff system is the most efficient. By comparison, a specific duty, expressed in Rand per ton of sugar, would fail to address the volatility in world sugar markets, or the impact of the changing exchange rate, unless set at a high level and reviewed frequently. Determining an appropriate level could be very difficult in a volatile world market.
- The *ad valorem* tariff would result in a duty levied on sugar on the basis of its value. This type of tariff offers high protection when the world price is high and low protection when the price is low and therefore would not cater appropriately in a volatile world market. In terms of South Africa's WTO commitments, there is a bound rate of 105% *ad valorem* on sugar meaning the duty levied should not exceed 105% of the invoice price of the sugar imported.
- Therefore, a change from the current variable tariff formula to a specific duty or an *ad valorem* regime would potentially expose the sugar industry and would not react to changes in the distorted world market.

SASA requested that the DBRP for sugar be increased from the current US\$566/ton level to US\$812/ton or US\$837/ton. These increased levels were based on either the 4-year or 5-year average London No. 5 world sugar price, coupled with a distortion factor that SASA submitted would be better aligned with current conditions as well as factoring in the transport cost variable, which remained at the same level as the one SASA submitted in its 2013 application

for an increase. SASA indicated that the increased DBRP level would protect the domestic sugar industry against low priced imported sugar, taking into account inflationary changes as well as exchange rate volatility. The Commission considered that the 4-year or 5-year average world sugar price is not in line with the industry's production cost. The Commission also considered that the distortion factor provided by SASA was calculated using the weighted average cost for high cost beet sugar, which is not produced domestically, and cane sugar production, which resulted in a higher distortion factor. The Commission did not consider SASA's request for an increased DBRP favorably, given the negative impact it would have on downstream users and consumers and as the requested levels were at considerable variance with production costs.

In order to take into consideration recent economic developments, SASA was requested to provide data on the average London No. 5 sugar price per year, covering a 10 year period from 2005/06 to 2015/16. The average annual prices were calculated taking the daily closing prices from the London Mills Commodities (LMC) International and High Fructose Syrups (HFS) production cost reports (Quarter 2 of 2016). It should be noted that the data only reflects the distortion in the cost of producing cane sugar, which includes a return on capital employed in the field and factory⁴.

Table 4 below presents a summary of various scenarios considered by the Commission in the calculation of the DBRP. The calculations presented in the table below follow exactly the same methodology as the current variable tariff formula based on the latest available updated data [i.e. year(s) average FOB + distortion – average transport costs].

Table 4: Determination of the domestic Dollar based reference price level

Year (April - March)	Average annual London No.5 FOB Settlement price US\$	Weighted average world cost of production US\$	Distortion Factor (%)*	FOB +Distortion	Transport cost US\$	Calculated Reference Price US\$
2006/07	399	389.6	0%	399.00	31	
2007/08	312	401.6	29%	401.55	31	
2008/09	358	477.5	33%	477.50	31	
2009/10	558	482.0	0%	558.00	31	
2010/11	639	487.3	0%	639.00	31	
2011/12	678	520.1	0%	678.00	31	
2012/13	555	541.8	0%	555.00	31	
2013/14	475	531.7	12%	531.67	31	
2014/15	424	506.5	19%	506.46	31	
2015/16	382	451.9	18%	451.90	31	
Averages						
10 years	478	479	11.18%	531.42	31.00	500.42
5 years	503	510	9.94%	552.76	31.00	521.76
4 years	459	508	12.42%	516.00	31.00	485.00
3 years	427	497	16.56%	497.71	31.00	466.71

Source: LMC, SASA and ITAC calculations

*Negative distortions are converted to zero

Having considered the information presented in Table 4 above, the Commission found that if the domestic DBRP for sugar is maintained at the current level of US\$566/ton, this level would place South African sugar

⁴ Note: Capital costs include depreciation and a return on capital employed (LMC, 2016)

producers and their foreign counterparts on an equal competitive footing thereby stimulating production whilst simultaneously being sensitive to the impact on downstream users as well as food affordability. Maintaining the DBRP at US\$566/ton present a level of support, which is in line with the industry's production cost and is thus supportive of the development of the SACU sugar value chain without having an undue adverse effect downstream.

As per ITAC Report No. 463, the DBRP level of US\$566/ton was calculated using the 4-year average annual London No. 5 FOB sugar settlement price which was US\$558/ton. To create a fair trading environment, a distortion factor of 7 per cent (US\$39/ton) was added and transport costs of US\$31/ton was deducted, which resulted in a DBRP of US\$566/ton.

Using data received from SASA, and introducing a new variable to the formula to be discussed below, the 20-day moving average price of sugar on 19 October 2016 was US\$597.03/ton and the corresponding exchange rate was R13.9679. The applicable duty on sugar, using the DBRP of US\$566, is calculated as follows:

$$\begin{aligned}
 & \text{Reference price – 21 day moving average London no.5 FOB} \\
 & = \text{US\$566} - \text{US\$597.03} \\
 & = -\text{US\$31.03} \times 13.9679 \text{ (Exchange rate on 19 October 2016)} \\
 & = -\text{R } 433.42/\text{t} \\
 & = -\text{R}433.42/\text{t} \times 0.79 \text{ (adjusted by the real effective exchange rate} \\
 & \qquad \qquad \qquad \text{i.e.79/100 for July 2016 as published on the SARB} \\
 & \qquad \qquad \qquad \text{website using its published base year, which is} \\
 & \qquad \qquad \qquad \text{currently 2010)} \\
 & = (-\text{R}342.40/ 1000\text{kg}) \times 100 \\
 & = -34.24\text{c/kg} \\
 & = 0\text{c/kg (zero duty)}
 \end{aligned}$$

Based on the DBRP of US\$566/ton, the rate of duty on sugar would therefore remain at free of duty. This implies that, if prices of sugar should fall below US\$566/ton a duty will be triggered to offset the decline in international sugar prices. The *ad valorem* equivalent of the applicable duty on sugar would remain at free of duty.

6. COMMENTS

Comments were received from Tiger Brands, Coca-Cola, The Beverage Association of South Africa (BEVSA), The South African Sugar Association (SASA), The Association of Southern African Sugar Importers (ASASI), Little Green Beverages (Pty) Ltd, Woolworths (Pty) Ltd, Pearl Island Trading 714 (Pty) Ltd, Tongaat Hulett Starch, Snackworks (Pty) Ltd, Swaziland Sugar Association (SSA) and South African Breweries (SAB).

7. FINDINGS

The aim of the current variable tariff formula is to set a fair level of support that would encourage the production of sugar, which is able to compete against low priced imported sugar, without having undue adverse price raising effects downstream. The sugar industry is important to the economy of South Africa

and Swaziland in the SACU due to its substantial contribution to national employment, especially in rural areas, manufacturing and agricultural output as well as linkages to other sectors, which require a pricing system that does not render it unaffordable.

South Africa has experienced the worst drought in 2015 since the early 1980s. Domestic production of sugar declined by approximately 10 per cent from 2.3 million tons in 2013/14, to approximately 2.1 million tons in 2014/15. Reduced plantings and poor rains in the 2015/16 season resulted in an even lower sugar production level of 1.6 million tons, equivalent to a 23 per cent decline.

The impact of the drought was also evident in terms of a decline in export volumes. SASA submitted that surplus sugar that would generally be channelled to the export market has been channelled to the domestic market. It was further submitted that no exports of sugar were expected for the 2016/17 season, as most of the output would be sold in the local market.

South African sugar production is projected to significantly recover from the drought conditions in the 2016/2017 production season, due to favourable climatic conditions. Sugar crop forecasts for the 2016/2017 season indicated that the industry would produce sufficient sugar to meet local demand and minimise exports. Together with the positive outlook on sugar production, maintaining the variable tariff formula with some changes in the variables will continue to encourage the production of sugar.

Total imports decreased, on average, by 48 per cent over the three year marketing period (2013/14 – 2015/16), which can be attributed to a constant increase in the average world price of sugar and the depreciation of the Rand. According to information at the Commission's disposal, SACU is a sugar surplus producer, which means that every ton of sugar imported displaces a ton of locally produced sugar into a distorted, low priced world market. In terms of imports, the SACU region's source of competitive pressure is imported sugar from Brazil that accounted for approximately two thirds of total imports during the 2015/16 marketing season, and India. A second source of sugar inflow is under the SADC Sugar Cooperation Agreement.

An analysis of the price cost structure for sugar producers was taken into account to ensure that the level of support in the form of DBRP is in line with the producers' production costs. It was found that the DBRP at US\$566/ton presents a level of support, which is in line with the industry's production cost and supportive of the development of the SACU sugar value chain without having an undue adverse effect downstream. Unlike the wheat sector, where the level of duty plays an integral part in the determination of domestic wheat prices, in the sugar sector, an import tariff has less impact on the local price of sugar.

The Commission rejected SASA's request for an increased DBRP from the current US\$566/ton level to US\$812/ton or US\$837/ton, given the negative impact it would have on downstream users and consumers and as the requested levels were at considerable variance with production costs.

Simulations were conducted, to look into the possibility of switching to a Rand-based reference price and it was found that a Rand-based reference system would not have yielded a duty and would unlikely yield a duty or perhaps at only low rates due to the trajectory of the Rand. This would be unfair to producers against the background of imported inflationary pressures that dilute the supposed benefits of the lower Rand. The Rand/Dollar exchange rate catapults current prices to levels higher than the reference price. The reference price would have to be updated constantly to the most recent year based on almost yearly applications by the industry and this would be untenable.

A move to a simple *ad valorem* duty was considered and it was found that the tariff would lose the countercyclical feature provided by the current DBRP that triggers a duty when world prices are low and triggers lower or no duties when world prices are high. The variable tariff formula is therefore better suited to the circumstances surrounding the production and trade of sugar as opposed to the normal *ad valorem* duties. Rapid response is required due to the frequency of the sharp peaks and troughs evident in the price cycles of sugar.

It was found that the introduction of a new variable of the Real Effective Exchange Rate Index would address the negative impact of exchange rate fluctuations. This new variable must be factored into the variable tariff formula to ensure that producers are protected against real cost pressures and foreign currency denominated intermediate input costs such as fertiliser and machinery parts and not benefit unduly from exchange rate fluctuations, by adjusting the duty with the Rand's Real Effective Exchange Rate Index as published by the South African Reserve Bank. The Real Effective Exchange Rate Index that will be factored in will support domestic sugar producers proportionally against a depreciating or an appreciating currency by adjusting the nominal Rand exchange rate for price differentials between South Africa and its most important trading partners. This would ensure that windfall profits or unnecessary additional protection to producers due to exchange rate fluctuations do not accrue to producers at the expense of food affordability.

Tariff protection must be complemented by addressing competitiveness constraints in sugar production. A long term drive towards improved productivity remains critical. A holistic view of its long term prospects is also required. This includes a number of reforms related to its revitalisation that must provide the critical incentives for reinvestment by the growers and the processors. This includes alternative uses of sugarcane for energy and potentially biofuels. According to information at the Commission's disposal, bioethanol and cogeneration of electricity have been placed on hold due to the perceived expense to the fiscus.

The Commission in its analysis found that sugar prices have been volatile over the past but, based on the Bureau for Food and Agricultural Policy (BFAP) impact analysis report in terms of the price effect of the current Dollar-based reference price and variable tariff formula on sugar, BFAP found that the impact of an import tariff has little impact on the local price of sugar. The Genesis Report (2013) also found that although sugar prices have been

volatile over the past, its impact on food inflation in terms of the consumer price increases in sugar-containing products constitutes a relatively small proportion.

8. RECOMMENDATION

In view of the above, the Commission decided that the domestic Dollar-based reference price for sugar be maintained at the current level of US\$566/ton, due to the fact that the duty would place South African sugar producers and their foreign counterparts on an equal competitive footing and is in line with the producers' production costs whilst simultaneously being sensitive to food affordability as well as the impact on downstream users.

The initial duty on sugar will be calculated as the difference between the DBRP of US\$566/ton and the price of sugar on 19 October 2016, which amounted to US\$597.03/ton at an exchange rate of R13.97 to the US\$ adjusted for price differentials between South Africa and its most important trading partners using the published Real Effective Rand Exchange Rate Index as follows:

REFERENCE PRICE	
RSA domestic reference price	US\$566/ton
Minus: London No. 5 settlement price of sugar on 19 October 2016	US\$597.03/ton
Dollar duty on sugar	US\$0/ton
Rand duty on sugar before adjustment	R0/ton
Adjusted with the Real Effective Exchange Rate Index	$R0 \times 0.79 = R0/\text{ton}$
Rand duty on sugar	0c/kg (equivalent to 0% <i>ad valorem</i>)

*Calculation as at 19 October 2016

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

The difference between the 20 trading day moving average of the London No. 5 settlement price and the established reference price for sugar will be calculated daily. If the 20 trading day moving average of the London No. 5 settlement price shows a variance of more than US\$20/ton from the previous trigger level for 20 consecutive trading days, a new duty will be 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 and subsequently adjusted with the latest available Real Effective Exchange Rate Index as published by the South African Reserve Bank.

The levels of duty may not exceed the bound rate of 105 per cent *ad valorem* for sugar.

The Dollar-based reference price should be reviewed on a three year basis. This would ensure that the DBRP is adapted to recent developments in the domestic and global markets.