PRO SUNERGY

August 6th, 2012.

Lessons from the 2006 EU Sugar Regime Reform

By Patrick H. Chatenay
President, ProSunergy (UK) Ltd

(ProSunergy provides strategic, investment and mergers-and-acquisitions advisory services worldwide for the sugar & ethanol industry.)

Executive Summary

As the next Farm Bill is being crafted in Congress, once again US Sugar Policy is under fire from industrial users who, together with "free market" fans, believe it would be best to open the American sugar market to foreign suppliers and let "the market" decide where prices should settle and where supplies should come from.

These arguments match those made by industrial sugar users and free market supporters in the European Union in the run-up to the 2006 reform of the EU's "Sugar Regime". By offering unfettered market access to many foreign sugar producers who can arbitrage the world market freely, the EU aimed to lower domestic prices significantly, improve the competitiveness of its food processing industries, moderate prices for the end-consumer and still enjoy a stable, safe supply of this essential ingredient.

Before the reform, EU sugar policy bore a rather close resemblance to US sugar policy (with, however, one important difference: the EU was dumping vast quantities of subsidized sugar onto the world market). It is worthwhile asking whether the promises made in support of reforming the EU's Sugar Regime were realized: economics not generally being an experimental science, it is good to check how contemplated policy changes fared elsewhere.

Six years on, it is possible to look at the results of the EU's 2006 Sugar Regime reform and learn some lessons.

The first lesson is that "liberalization" breeds supply uncertainty and price instability. After dropping 22%, bulk refined sugar prices in Europe are now some 10% above what they were before the reform. As any business manager will tell you, additional risk entails additional cost. Since the end of 2010, the EU sugar market has been characterized by high and volatile prices, and a shortage of supplies – thus mirroring world market gyrations. The sugar users who lobbied hard for the reform – companies such as Nestlé, Coca Cola and Kraft – are complaining just as loudly as before.

The EU is now realizing that the world market is a poor benchmark by which to set a proper sugar policy. Not only is it intrinsically unstable but it remains the outlet for heavily subsidized production, not least from the world's major exporter, Brazil, where half the sugarcane is sold onto government-controlled markets. Note also that in 2011 Brazil threatened to tax its sugar exports: is it safe to rely on the world sugar market?

The second lesson is the horrendous social costs attached to lower margins and to reduced domestic production. In the EU, 83 mills were closed, causing some 120,000 job losses and irreparable damage to the farming communities involved. Five EU member countries gave up sugar production entirely; five others more than halved production. Two traditional developing country suppliers shut down their industries – more will follow. In the remaining developing country suppliers, cost-cutting is shrinking investment and the provision of social services at the risk of destabilizing whole communities.

In the current public finance environment, another lesson is important: whereas the old EU Sugar Regime carried no cost to the general taxpayer, the reformed Sugar Regime is costing the public purse about 1.6 billion dollars[1] a year as grower support through beet pricing was transferred to the budget-financed Single Farm Payment. In addition, to soften the blow to developing countries of expected lower prices, an aid package of 1.4 billion dollars was agreed, and it may not be the last.

Last but not least, examination of the data doesn't support the assumption that lower sugar prices will be transmitted to the end consumer. The user industries and the retailers have pocketed the price drop. Even the European Court of Auditors concludes so after examining studies commissioned by the EU. Nor did lower domestic sugar prices cause a significant rise in sugar-containing processed product exports.

In short, the 2006 EU Sugar Regime reform implemented many of the ideas promoted by opponents of the current US sugar policy. At considerable cost to stakeholders and without any measurable benefit to the consumer, the European Union has thus put at risk the safety of its supply of sugar. Surely, there are lessons to be pondered here as American policymakers look to decide on the future of US sugar policy.

---

[1] For convenience, amounts in European euros (EUR) have been converted to US dollars (USD) at the rate of 1.2 USD to 1 EUR.

Agricultural Policies

Agricultural policy reform in the developed world is back. Both the United States and the European Union are in the process of reviewing their agricultural policies as the world struggles with the worst economic recession since the Great Depression[2].

Agricultural policy is important. Since recorded history, no human society has dispensed with an agricultural policy and nations have vanished for lack of an adequate food supply. Today, multilateral institutions are publishing dire warnings about world food prices and availability. They forecast that prices will be higher and more volatile, and that the world will struggle to produce the 50% more food needed by 2050.

For a long time the US and the EU used opposite tools to promote and protect food supply. The US policy generally set prices at "market" levels and supported the farming community with direct financial tools, whereas the EU based its original Common Agricultural Policy on government-mandated high prices.

This wasn't as unreasonable as its seems: 16 years after the Second World War, Europe still lacked enough wheat, corn, meat, milk, sugar... What better way to promote investment in agriculture and output than to make it profitable? And, indeed, it worked… Too well: by the end of the 1980's, the EU was exporting more and more food. Because domestic prices were generally higher than world market prices, these exports had to be subsidized. As exports grew, the financial burden of subsidizing them expanded and the EU's trading partners understandably complained of unfair competition.

The EU abandoned mandated high agricultural prices not only to decrease export subsidies but also in order to make its food processing industry more competitive, to give its food processors access to agricultural products at lower prices. In the 1992 "MacSharry Reform" of the Common Agricultural Policy, reduction in administered support prices was compensated by direct payments to farmers. This began bringing EU agricultural policy tools in line with US tools and with the prevailing liberal economic approach to agriculture. The trend was amplified by the 2003 CAP reform and should be completed by the 2013 CAP reform currently being debated.

Whereas in 1991 nearly 30% of CAP expenditure was on subsidized exports and another 65% was spent on product-specific market support, by 2009 export subsidies amounted to less than 2% of the budget and decoupled aid to farmers represented over 60% of expenditure.

US and EU Sugar Policies

Sugar is one area where American and EU agricultural policies always were relatively close. The US and the former EU sugar policies both attempt to ensure domestic production of sugarcane and sugar beet by setting minimum prices and reserving market share; both seek to smooth price variations;

[2] The European Commission published its legislative proposal for the next Common Agricultural Policy (2013-2020) on October 9, 2011 and it is now being reviewed by the European Parliament; the US Senate passed a Farm Bill (2013-2018) on June 21st, 2012, and the House is currently contemplating its version.

both attempt to provide developing countries partners with a profitable export market.

Crucially, both sugar policies were conducted at no cost to the budget. In the case of the EU, the industry paid taxes on its domestic sales which paid for sugar export subsidies[3]. The net cost to the European budget was nil.

The fundamental difference with US sugar policy was that the EU quota system and sugar import policy[4] resulted in a systematic and large surplus which had to be exported. Whichever way one looked at it, having high domestic prices drive some 5 million tons of sugar onto a 45 million-ton world market was difficult to justify. In a context of multilateral trade liberalization, this would provide added impetus for reforming the EU Sugar Regime.

The EU reformed its Sugar Regime in 2006, aiming to drastically cut exports, to bring down domestic prices by 36%, to open its market to competition from imports and to improve the competitiveness of its sugar industry.

As the US Congress contemplates a new Farm Bill and debates whether US Sugar Policy should be changed, are there lessons to be learned from the 2006 EU Sugar Regime Reform?

Why reform the EU Sugar Regime?

The 2006 EU Sugar Regime Reform was driven by ideological factors but based upon legal constraints. Enshrined in the 2003 Common Agricultural Policy, the prevailing view was that support for agriculture was best provided by "direct, decoupled" subsidies, leaving the individual farmer to decide what to produce on the basis of market conditions. Crucially, this approach was compatible with World Trade Organization rules for which "direct, decoupled" payments are not – or are only minimally – trade distorting. But sugar beet and sugarcane production were still given support through a system of guaranteed prices and quotas. Moreover, administrative "simplification" called for all crops to come under a single set of policy tools. The sugar exception thus was seen as odd.

In addition, in 2001 the EU unilaterally decided to give duty-free access to its markets to all Least Developed Countries without any quantitative restrictions, on the basis of the theory that any trade is good for development. This became known as the "Everything But Arms" ("EBA") initiative[5]. Of the 49 beneficiary LDCs, at least 12 were significant sugar producers and a total of 23 were potential suppliers. Moreover, under EU rules these countries could send all their domestic production to the EU and cover their domestic needs with imports. Without a significant drop in its domestic prices for sugar, the EU market would have been flooded by imports.

[3] Taxes on sugar were "levies"; export subsidies were "restitutions".
[4] Largely as a result of the United Kingdom joining the EU in 1973, traditional suppliers of raw sugar from the Commonwealth had their sales to the EU protected by law under the "Sugar Protocol" which, alongside the Lomé and Cotonou agreements, linked the EU with the group of African, Caribbean and Pacific countries.
[5] Regulation (EC) 416/2001; for sugar, bananas and rice, a transition period including volume limits on LDC exports to the EU lasted until September 2009.

Finally, in April 2005 the WTO's Dispute Settlement Body found that EU non-quota sugar exports were "cross-subsidized" thanks to the high prices mandated on quota sugar. Until then, non-quota sugar had to be exported within the year at the producer's risk. Now, it was illegal to export non-quota sugar. The system had to be overhauled.

The 2006 Sugar Regime Reform

In July 2006, the EU introduced its Sugar Regime Reform. The reform sought to cut exports and domestic prices. To cut exports, the EU slashed domestic production: 5.2 million tons were removed from the sugar quota. To cut prices, the official refined sugar target price was reduced by 36%, from 631 to 404 EUR/t (760 to 485 USD/t).

The nature of the quota changed from a revenue guarantee to a right to sell on the domestic food market[6]. Indeed, the official price was no more an "intervention price" – the name of which suggests that the EU Commission would step in as needed and itself acquire unsold sugar – but a "reference price" – a price level which the Commission would generally aim for by adjusting the quota to demand.

Expectations

Observers and stakeholders favoring the 2006 reform mentioned many incidental benefits – apart from the evident compliance with the WTO panel ruling on subsidized exports.

By drastically cutting production, the reform would change the EU from being the world's second-largest exporter of sugar to being the world's largest importer of sugar. To those this worried, the Commission suggested that supply would remain plentiful by forecasting that some 3.5 million tons would quickly be made available by developing countries with preferential access.

The mechanism by which the quota was reduced was intended to concentrate sugar production in the most efficient areas and thus increase its average competitiveness. But initial financial incentives to abandon quota proved insufficient: only 2.2 Mt were "renounced" out of a targeted reduction of 6 Mt[7]. The Commission had to resort to threatening an across-the-board quota cut without any compensation and this resulted in efficient areas too giving up some production.

Despite their protestations to the contrary[8], the EU Commission also suggested that traditional developing country suppliers would be better off

[6] Quota sugar (13.3 million tons) can be sold in food uses; non-quota sugar (production ≈ 4.7 million tons) can only be sold domestically for "industrial" uses such as alcohol, ethanol, fermentation, pharmaceuticals and chemicals. If not, it can be exported (within the 1.4 Mt per year WTO limit) or carried-forward (and included in the next campaign's quota production).

[7] This target aimed jointly at sugar, at high fructose starch syrup and at inulin syrup. The gross total sugar quota abandoned actually came to 5.2 million tons.

[8] "The Commission's proposal does not take our situation into account in any way. It is completely at odds with EU development policy, the general objectives of the Doha Development Round, and the pursuit of the UN Millennium Development Goals." – Mr Kaliopate Tavola, Minister for Foreign Affairs and External Trade of Fiji. (2005)

with unlimited access to the EU market at a lower price than with the hitherto price guarantee given on limited volumes.

Of course, the industrial sugar users wanted the total abolition of quotas and pushed for duty-free quota-free access for LDC countries[9]. In short, nothing less than an open market: "Reform of the EU sugar regime will only be complete when both external and internal competition comes into play."[10] Though user industries had access to export restitutions on the sugar they used (the difference between the domestic and world market price for sugar was reimbursed to them upon proof of export of the sugar-containing processed product), they complained that "the present sugar regime and its artificially high prices are linked directly to job losses in the export side of the sugar using industry."[11]

Despite the maintenance of a domestic sugar quota, with the 36% drop in the reference price and the duty-free quota-free import regime for imports from some 76 developing countries[12], sweetener users may well have thought that they had "won the day". Indeed, from 2006 to the end of 2009, domestic EU sugar prices declined 22%.

Then, in December 2010, the unexpected, the unthinkable, the incredible happened: the world market price FOB surged above the domestic EU price! But the reform was to have other unintended consequences, some of them not at all to the liking of the sweetener users.

Social Costs

Because of the need to reduce production drastically, the reform entailed significant social costs.

The sugar industry ceased entirely in 5 member countries[13] and was cut by over half in 5 member countries[14]. The number of sugar beet-processing factories in the EU dropped by 44%: the closure of 83 sugar beet factories caused the loss of some 20,000 industrial jobs directly. Indirectly, it is estimated that an additional 100,000 jobs were affected by these factory closures[15]. All these jobs were located in the countryside, where little or no alternative employment can be made available. Also, the number of sugar beet growers dropped from about 300,000 to 160,000[16].

In its 2010 report on the reform, the European Court of Auditors notes that "The abandonment of sugar beet production and the closing down of factories have an important direct and indirect impact on the agricultural community and regions concerned including a significant number of job losses." [17]

---

9 Committee of Industrial Sugar Users (CIUS), "Reform of the EU Sugar Regime", Brussels, March 2004
10 "CIUS Remarks on WTO Negotiations and Sugar" – April 2006
11 "CIUS Position Paper Autumn 2005"
12 67 ACP countries and 9 LDCs which are not members of the ACP Group
13 Ireland, Latvia, Slovenia, Bulgaria & Portugal; a combined drop in sugar production of some 430,000 tons
14 Italy, Greece, Hungary, Spain & Slovakia; a combined drop in sugar production of some 2,300,000 tons
15 Source: "Companies' Social Responsibilities" – 8th Implementation Report (October 28, 2011) – CEFS & EFFAT.
16 Source: CIBE; CEFS Statistics
17 European Court of Auditors, Special Report n°6, "Has the Reform of the Sugar Market Achieved its Main Objectives?" §103

Developing countries too suffered. Faced with the prospect of much lower revenues, St Kitts and Nevis, and Trinidad, traditional developing country suppliers, gave up sugar production entirely despite a 350-year association with the industry. Other traditional suppliers to the EU, such as Fiji, are unlikely to survive long. It should not be forgotten that, whereas the EU's direct decoupled Single Farm Payment scheme was extended to sugar beet as compensation for the expected decline in beet prices, no such safety net is available to sugarcane growers in ACP countries and LDCs.

To meet expected lower EU price levels, traditional developing country suppliers had to cut costs. The case of Swaziland illustrates well what happened next: EU prices dropped just as sugarcane costs grew; indebted small holders were squeezed, caught in "debt bondage"; maintenance of assets such as irrigation equipment suffered; investment was curtailed. In short, competitiveness was eroded. Seeking to cut costs, sugarcane millers reduced the number of permanent positions and outsourced jobs. Job losses were thus compounded by less favorable employment conditions. As a result of the EU reform, millers have reduced expenditure on non-core social services to their rural communities: "these include housing for teachers at government schools…, closure of clinics and business loans for women and training centres, village health workers and school buses…" Programs to combat AIDS and HIV have been weakened; prostitution has increased[18].

The cost of a "more competitive" EU food industry to some of the planet's most vulnerable people has been high.

Concentration & Competition

Concentration in the EU sugar industry increased significantly as some groups left the business and others amalgamated. Whereas, in 2005, the five largest EU sugar groups controlled about 50% of supply, including imports, today they account for some 85% of total supply. This worries the Commission and client industries; both see such a trend as threatening competition. But it is a direct consequence of the reform: indeed, the economics of the industry mandate concentration in order to reach higher efficiencies.

Without doubt the reform has increased the industry's average competitiveness as the Commission intended. Average sugar production per factory has increased 50% since 2006, and average campaign length grew from 90 to 125 days. Many of the highest-cost beet areas have abandoned the crop and average yields have grown by over 10%. But the largest relative competitive effect has come from the increase in the world market price for sugar, itself largely driven by the appreciation of the Brazilian real and a 40% increase in Brazilian cost-of-production. Thus the increase in the EU's relative competitiveness has little to do with the reform itself.

European raw sugar refining has been weakened as capacities have increased (in part on the basis of the Commission's own forecasts of raw sugar imports) whilst raw sugar imports for refining have fallen. A number of reasons explain this fall: increases in direct sales of imported raw and

[18] "Trade, Aid and Rural Development – EU sugar policy and the experience of Swaziland" – Ben Richardson, University of Warwick – ECDPM discussion paper n°133, July 2012 – page 19

refined sugars; bad weather and sugarcane processing incidents in preferential supplier countries; exporter arbitrage against local and world prices (both of which became more attractive as the domestic EU price decreased at first).

Market Instability

At the end of 2010, in 2011and in 2012, the European market showed signs of being under-supplied. Industrial users complained bitterly of being unable to buy sugar. In October 2010, the chief executive of England-based R&R Ice Cream Plc said "we can't buy sugar in the EU because there isn't any."[19] In March 2012, the Committee of European Sugar Users stated that "supply tightness has led to unforeseen shortages in the European food manufacturing sector, causing disruptions in factories such as temporary closures, line stoppages and transfer of production outside the EU."[20] The main cause of this shortage was, of course, the original reform decision to cut domestic EU production. Added to this was the fall in available sugar from preferential suppliers as the latter struggled against bad weather, incident-prone industrial operations and increases in their own domestic demand.

The Commission had to take exceptional measures to release non-quota sugar and to attract additional imports. But those measures were implemented just as world market prices surged past domestic EU prices and sugar became scarce: the EU had lost control over its supplies and prices.

It is not only supply that is more volatile, price is too. The domestic EU market is now exposed to the vagaries of the world market. Instead of falling structurally, EU prices are now about 10% above those of 2006. Why? Because major producing countries experienced bad weather, because the Brazilian currency revalued, because the cost of producing sugarcane exploded, because developing country demand increased, etc.

Even the EU industrial users of sugar are complaining: "EU sugar users have seen an increase of 40% in sugar price within the last year, leading to significant financial instability for many food manufacturers across Europe, particularly SMEs [Small and Medium Enterprises]. This situation is not acceptable."[21] Not acceptable, but both the instability and the level of prices in the EU are direct consequences of what the industrial users were – and still are – advocating.

For the European Court of Auditors, to depend upon third-country preferential exports "entails greater uncertainty in the supply of sugar to the EU market."[22] It may be useful to remind those who believe it is acceptable to entrust supplies of key food ingredients such as sugar to foreign suppliers that, from April to October 2011, the Brazilian government repeatedly threatened to tax sugar exports so as to favor domestic ethanol production.

---

[19] Bloomberg, "Sugar Shortages Extend Across Europe as Global Glut Expands: Commodities" by Isis Almeida & Rudy Ruitenberg, October 19, 2011.

[20] BloombergBusinessWeek, "EU Sugar Users Seek Bigger Supplies on Sweetener Shortage" by Isis Almeida, March 15, 2012

[21] CIUS President Robert Guichard, Press Release, 18 June 2012.

[22] European Court of Auditors, Special Report n°6, "Has the Reform of the Sugar Market Achieved its Main Objectives?" §59(b)

Taxes or even bans on food exports are not unknown and one should be wary of putting a country's food supply at risk of such intervention.

Have retail prices for sugar and sugar-containing products fallen? The data shows not. For example, from a base index of 100 in 2005, Eurostat data shows that cocoa, chocolate & sugar confectionary producer prices increased to 120 in 2010, whilst the price for sugar beet dropped to 75. Any windfall benefit derived by sugar users seems to have disappeared.

Indeed, for the European Court of Auditors, "studies carried out on behalf of the Commission indicate that reductions in the price of bulk sugar are unlikely to be passed on to the final consumer. In the case of processed products, which account for over two thirds of the sugar consumption, most of the cost savings due to price reductions will be added to the profit margin of industrial producers; in the case of the retail sugar price, which accounts for the remaining one third of consumption, price transmission is affected by the concentration of distribution networks."[23]

Have exports of sugar-containing products suddenly grown? The data shows not. The amount of sugar exported in processed products is stable: between 2005/06 and 2010/11, it grew by 12% overall. But then EU exporters can use an Inward Processing Relief mechanism to supply sugar for their processed products: a reduction in domestic prices is indifferent to export competitiveness[24].

Public Finances

The EU sugar regime is not budget-neutral anymore. Each hectare growing sugar beet benefits from the direct decoupled payment scheme. As the beet and sugar price reduction transferred some 1.8 billion dollars per annum from farmers to food processors and retailers, the general taxpayer picked up a tab of some 1.6 billion dollars per year, as sugar beet acreage was added to the EU's general "direct, decoupled" farm support subsidy.

Further, over the decade an expected 2.4 billion dollars in lost revenue for developing countries with long-standing preferential access to the EU was offset by a 1.4 billion dollar aid package[25]. This package was intended to improve ACP country sugar industry competitiveness or to finance diversifications. With few exceptions such as Mauritius, implementation of this aid package has proved difficult. It has been delayed by administrative complexities and, sometimes, incompetence. Generally, it has not yet had the intended effects. The damage done to small island economies, for example in the Caribbean, may require additional financial transfers in the future to prevent regional instability and security failures.

[23] European Court of Auditors, Special Report n°6, "Has the Reform of the Sugar Market Achieved its Main Objectives?" §63

[24] Inward Processing relief is a procedure by which a food processor can import a commodity at world market prices to use in the production of items which will be exported.

[25] The Accompanying Measures for Sugar Protocol countries ("AMSP")

Lessons for the US

When observing the EU sugar reform from the US, it must be remembered that a fundamental driver in the EU was to cut exports. Since it neither creates nor subsidizes exports, US sugar policy doesn't result in additional world market distortion: that reason to reform is absent.

The main lesson from the reform of the EU sugar policy has to be that, by letting imports determine the ultimate availability of sugar, the EU has lost control over its supply of this essential food ingredient. With preferential imports no longer subject to quantitative controls, the domestic EU market is subject to world market uncertainties. The EU food market now depends heavily on the world market. Imports supply some 20% of the sugar needed. Thus price and supply instability have come to the EU market.

At a time of scarce government finances, another important lesson is that the EU sugar policy went from being budget neutral to costing hundreds of millions to the public purse.

Lower domestic producer prices have caused income transfer away from farmers and developing countries towards food processing companies without any measurable effect on consumer prices, employment or processed food exports.

Though increased efficiency of the EU sugar industry was achieved, it has come at a high social cost, with additional industry concentration, and sugar industries in developing countries have suffered from the lack of certainty offered by a less predictable EU market.

The EU experience of sugar policy reform carries warnings which US policymakers should heed when contemplating how best to improve US sugar policy.

Patrick Chatenay

*(**Patrick Chatenay has been involved with the sugar industry since 1985**, when he joined Saint Louis Sucre, at that time the second-largest sugar and ethanol producer in France as Director for Economic Analysis.*

In 1990 he was appointed to Saint Louis's Executive Board where he was in charge of strategic analysis, data processing and management accounting, and where he served until he left the company in 2008.

As part of his responsibilities for Saint Louis he acted as Assistant Managing Director of Azucarera Ebro, the largest Spanish sugar producer, and as a board member of IANSA, the Chilean sugar producer and food processor.

From 2003 to 2008, Patrick researched investment opportunities in the Brazilian sugar/alcohol industry for the Südzucker Group, following its acquisition of Saint Louis in 2000.

He holds a Masters in econometrics and a B.A. in English from the University of Paris, a Diploma in public administration from the Political Science Institute of Paris and an MBA from Columbia University in New York.

Patrick has wide international experience. Although born in Geneva, Patrick lived for the first seven years of his life in New York City. Since then he has lived, studied or worked in places as far apart as Washington DC, Pittsburg, Paris, Madrid, São Paulo and Port-Vila (Vanuatu).

In 2008, he founded ProSunergy which provides strategic advice and implementation services for the world's sugar, renewable energy and bio-fuel industries.

Patrick and his wife, Véronique, live in England and have two children: Margot, 21, and Victor, 18.)