SLOW TURNAROUND for the WHEAT INDUSTRY

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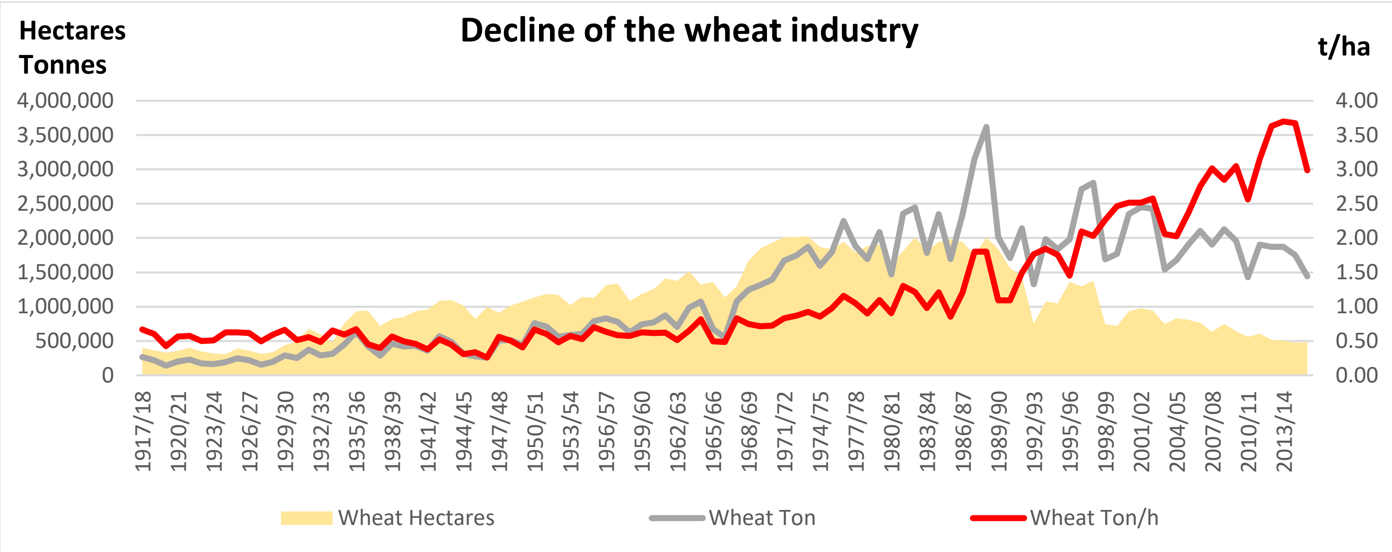
In 2014/2015 about 723 million tonnes of wheat was produced world-wide which constituted about 36% of all grain production globally. During the same year, South Africa produced 1.8 million tonnes of wheat (less than 0.5% of the global production) of which 64% occurred in the Western Cape, 24% in irrigation areas and 12% under dry land conditions in the Free State.

Overall the hectares planted to wheat in South Africa have dropped and so has the total production. However, the local demand for wheat as a food crop increased significantly during thew past two decades. Recently the country imported more than 1.5 million tonnes of wheat, passing the critical limit of importing more wheat than it produces. Although there is an increase in irrigated wheat hectares and consequently yield, the dryland wheat production in South Africa has declined substantially and continues to do so.

Numerous reasons for the decline are mooted, but the reality is that a structural change occurred in the wheat market when producers realised that soybean and maize crops (both with new technology and genetics) give better returns. In addition to this, the doubling of soybean crushing capacity in South Africa from 600 000 to 2 102 000 mt between 2012 and 2014 has spurred local plantings and opened up a market gap for additional soybean hectares. This is especially true in the Free State where rainfall is lacking at critical times of the wheat growth stage due to a seasonal shift in rainfall or climate change. It is an indication that wheat, in the future, may only be grown in the Western Cape and under irrigation. By 2014 irrigated wheat already covered about 21% of the total wheat area, and produced 41% of the total crop.



It was a collective decision of the players in the grain industry to come together and discuss action plans to revive the wheat industry. The whole industry is in dire straits, not just farmers. However, the starting point is with the producers. If producers cannot produce wheat sustainably, the entire wheat industry remains under pressure. Stakeholders can come together to make plans to support the profitability of producers, but then, money is just shifted around along the value chain.

The survival of the local wheat industry is important for grain handling and storage companies who form an important link in the value chain between the producer and the processor. Most of these companies are Agbiz Grain members and the storage of grain is their primary business. They support the efforts of the Wheat Forum to save the domestic wheat industry and have been working with the other industry role players in this regard since 2014.

A free market system is of primary interest for Agbiz Grain members. Other important principles are a profit driven approach as well as returns on capital that is put at risk. Agbiz Grain members are demand sensitive and their needs must be taken into account in all value propositions. They held numerous meetings to find solutions to the challenges of the local wheat industry and reported back to the Wheat Forum every time regarding its members' response to the proposals of other stakeholders and potential solutions Agbiz Grain can contribute to the process.

The issue of the revival of the wheat industry was addressed for the first time when there was a meeting of the WHEAT FORUM working group for Trading on 15 October, 2014 to discuss proposed changes to the wheat grading regulations.

PROPOSAL 1 Amendment of the wheat grading regulations

Proposal to alter wheat grading regulations	**Agreement or argument against**
Delete the definition of cultivar list	NO. Production should be limited to approved varieties. Imported varieties that can meet the value chain requirements are placed on the list.
Delete the definition of wheat	NO. Provision must be made to distinguish between, e.g. bread wheat and durum wheat, and therefore the correct definition of bread should refer to *Triticum aestivum* and not only the Genus *Triticum*, because it would include various grasses.
Introduce a super grade with 13 percent protein	YES. A super grade is acceptable to the storage industry, but we do not see the usefulness of this if the millers purchase mostly B2 wheat. Producers will spend their money on nitrogen fertilizer to boost the protein content to 13% since the wheat price is then slightly higher, while buyers prefer B2 (wheat with 11 to 12% protein).
Lower the minimum hectolitre mass (HLM)	NO. According to the SAGL harvest quality report, the average hectolitre mass for all grades over the past five seasons, was 80 kg/hℓ. We suggest that HLM for all the grades rather stay as is and the Super Grade has a HLM 79 or 80.
Lower the minimum falling number	NO. According to the SAGL harvest quality report, the average falling number, was as follows for the last five seasons: B1 - 379; B2 - 384; B3 - 371; B4 - 353; UT - 340 If the average falling number already exceeds 300 seconds, there is no reason to now lower it to 200.
Introduce a new class for White Wheat	MAYBE. White wheat is not currently grown commercially in SA. The silo industry will not be able to handle and store white and red wheat separately at all silos. If specific growing regions are identified where white wheat is planted exclusively and the silos in that area handle only white wheat, the production and storage of these two types of wheat will be viable in South Africa.
Increase the maximum percentage field fungi infected wheat from 2% to 5%	NO. The fungus that causes gray brush ends in wheat develops toxic byproducts during storage, although such mycotoxins have not yet been identified. It would pose a food safety hazard if the maximum percentage allowable deviation was increased to 5%.
Increase the maximum percentage screenings of 3% to 5%	NO. For the past five seasons, the average percentage screenings for Grade B1 to B4 have been well below the maximum permissible deviation for the various grades. Screenings are not a problem. There is no justification to adapt the maximum percentage screenings to 5% for grade B1 to B4, as this would entail additional costs for handling and transport.

Given the current market structure this proposal for white wheat and a Super grade will clearly lead to financial benefits for local grain producers and it is therefore in line with the purpose of the "wheat revival" exercise. Although the implementation of this proposal will have an impact on the business of the storage operators and will demand some system and equipment changes, Agbiz Grain members agree that they will be able to accommodate such changes and therefore support the proposal.

Comments:

- The industry should take note that import parity will remain the price determining factor for South African wheat. The end users of wheat will make clinical and rational calculations and, as a standard practice, will thus not pay more for local wheat than imported wheat. The proposed changes to the grading regulations will not change that.

- The net benefit for wheat producers under the proposed new grading system will ultimately be determined by what happens to the estimated import parity and its effect on the JSE wheat prices. It is expected that the net weighted effect of this proposal will be negotiated in the spread between import parity and the JSE price.

- The proposed introduction of a super grade impacts all silo owners in the same way. The expected impact will be determined by the usual quality profile in each production area.

- Cancellation of the B4 grade and the introduction of a Super grade will increase the number of grades that some silo owners will have to manage. Agbiz Grain members have indicated that they will, in most cases, be able to handle it - given that the rest of the system remains the same.

- However, silo operators have indicated that in some cases they will only be able to handle Super grade in specific areas because of the structural composition of certain silos. This could mean that all points of delivery will not be able to accommodate Super grade. Wheat producers will then be forced to travel longer distances to deliver wheat of a specific quality at a particular silo dedicated to be that class or grade of wheat.

PROPOSAL 2: Cancellation of the R100 / mt discount applicable to the delivery of foreign origin wheat on JSE

This arrangement between the supply and demand side of the wheat market in no way affects the silo operators and thus the storage and handling industry does not have a strong view in favor or against the proposal.

Comments:

- Although the introduction of a discount was originally initiated by the buyers, this discount also protected the South African wheat producers, because it contributed to the relative import parity level. However, this argument applies only to traders who bring wheat into South Africa and in particular on the imported wheat which is not sold prior to importation. The argument does not apply to the imports that are done directly by processors. Taking away the R100 discount is expected to change the value of inputs into the calculation, leading to a decline in the local import parity reference. Thus, this proposal is expected to have a negative impact on domestic producers and it is therefore contrary to the purpose of the wheat revival effort.

- Dealers will benefit from this proposal if a much more direct price relationship between imported and domestic wheat is established, and many more trading opportunities will be created. This proposal is expected to lead to more wheat deliveries of foreign origin on the JSE, as well as a much more direct relationship between domestic and imported wheat prices. It is clear that traders will directly benefit from this proposal. The benefit to the local producer is not clear.

- Given the fact that a lower import parity level is expected as a result of this proposal, local millers will also benefit when purchasing wheat on the domestic market.

- This proposal could stimulate the local cash market as more doubts about the quality of the JSE delivered wheat (due to imported wheat deliveries) will force local buyers to pay more premiums in the local cash market. However, this argument assumes that JSE deliveries must be made less attractive to local buyers, in an effort to stimulate the local cash market.

- It is clear that the beneficiaries of this proposal are the traders and processors, while the producers will probably be in a net negative position. It is therefore surprising that this proposal was discussed and forms part of this wheat revival exercise if the focus is solely on the improvement of the local wheat farmer's situation.

- The JSE announced in February 2016 that it will continue with the R100 origin discounts applicable to the supply of wheat from specific origins.

- For the period 1 October 2016 to 30 September 2017 there will be NO origin discount on wheat from the following countries:
    - US Hard Red Spring wheat (Dark Northern Spring and Northern Spring)
    - No. 3 or better Canadian Red Western Spring Wheat,
    - Australian wheat (Hard, Prime Hard, Prime Standard White and White)

- Wheat from the following countries will still be subject to a R100 per ton discount:
    - Argentina
    - US Hard Red Winter wheat
    - German wheat (Type A or B)
    - Ukraine

PROPOSAL 3: Changing the price difference between wheat grades

Agbiz Grain chose not to participate in the consideration of this proposal, because it is clearly an issue that can and must be driven by the free market and dictated by demand. It is not something that should be determined by players in the value chain. The value of wheat grades (i.e. the price difference between grades) are important as they contribute more to the wheat value chain costs than the total storage costs in most cases (R145/mt). However, this proposal seems to be in favor of the wheat producers. The net benefit for the wheat producer will depend on the price differences between grades as well as the extent to which the market will discount the change in grade through the spread between the JSE wheat prices and import parity. The net effect of this proposal will also be affected significantly by other negative commercial aspects. Even if this consensus is a legal consensus is Agbiz Grain believes that the net benefit, if any, to local grain producers will be only marginal.

Comments:

- This proposal means that the local wheat producers will be penalised with a lower price difference between grades for lower quality wheat, but if all other factors remain the same, this will benefit local producers.

- This price offer by buyers will also have to be tested in a JSE price vs. import parity level market environment.

- Income related to grain blending and upgrading contributes to the revenue streams of storage providers and subsidizes their cost structures. This proposal would lead to a decline in revenue and that would necessitate commercial storage operators to increase existing tariff structures.

- It should be noted that the internal surplus removal activities in the Western Cape are financed and motivated by the price difference between grades, amongst others. This includes the financing of:
    - double handling costs associated with blending
    - transport costs to inland silos as part of the upgrading effort
    - wheat premiums paid in the Western Cape
    - upgrading related to post-season incentives as paid by many silo owners
    - the practice of natural upgrades at delivery points where producers recognized for better grades than what is actually delivered.

- Thus, in calculating the net effect of these so-called price concessions in favour of the producers, it is important to also take the associated negative aspects into consideration.

- The silo operators are of the opinion that these price differences in grade should be determined not by a mutual agreement between demand and supply-side, but by market forces. To put this in perspective - the industry wants to make a decision regarding a cost element in the value chain which is much higher than the average storage and handling costs in the value chain. Agbiz Grain is of the opinion that the actual value of protein and hectolitre mass for the processors must be determined by independent analysis or research. This can lead to a larger or smaller difference in grade price, but then this decision is at least motivated by an economic rationale.

- This proposal would be detrimental to the Western Cape processors because of the negative impact on Cape premiums and surplus removal operations in that area.

- The net effect of this proposal on South African wheat producers will be neutral to marginal.

- Agbiz Grain is also of the opinion that the proposals may be in conflict with legal requirements of Section 4 of the Competition Act. The article prohibits parties in a horizontal relationship from fixing a purchase or selling price or any other commercial aspects. Article 10 of the Competition Act, however, states that the Competition Commission could be approached to release parties from this restriction, especially if an agreement or practice is aimed at making changes in productive capacity that are needed to stop the deterioration of an industry. We therefore recommended that the Competition Commission immediately be approached in terms of these proposals.

- While Agbiz Grain members will work together in such a process and support the outcome, it should be borne in mind that any change in the grade price differences (up or down) will lead to a structural change in the local grain market. The net benefit for the wheat industry is expected to be marginal.

PROPOSAL 4: A minimum grade guarantee on the receipt of JSE wheat with zero compensation for the outloading of higher grades

Agbiz Grain considers this proposal in a positive spirit and as supportive of the efforts that contribute to industry's commitment to local wheat production. Agbiz Grain also fully understands and respects the needs expressed by the processors.

Due to structural realities, the storage industry will, unfortunately, not be able to accommodate this proposal fully. We believe that a complete rethink of the JSE wheat contract may be needed to ensure that the unique nature of the South African grain market and the available infrastructure are taken fully into account in the structuring of a standardised futures contract.

Comments:

• In light of the reduced price for grade differences, this proposal represents significant operational, commercial and risk implications for storage operators.

• In the proposed new dispensation, benefits for producers will be affected negatively:

  - Natural upgrading at the delivery points will change
  - All forms of producer sharing of the upgrading income will change
  - Grading will be very strict if minimum grades must be guaranteed
  - Better grading equipment (more accurate) will need to be acquired by storage operators with huge cost implications
  - Higher risks, capital utilization in the business and structural requirements will lead to significantly higher handling and storage costs as well as the fee for JSE receipts
  - The available space for wheat storage will change as a result of the requirement to keep all grades separate
  - Structural constraints and the requirement of separate storage for all the different grades of wheat will result in grade specialisation at specific silos. This may imply higher transport costs for producers if they have to transport their grain further in order to deliver to the nearest facility which focuses on storing the grade of wheat which they have produced.

- Given the growing volumes of barley in some areas, it is expected that the proposed new system will result in wheat hectares being replaced with barley.

• The proposal implies a system with much better business transactions for traders and processors, namely guarantees without paying for it and free upgrades.

• The value of this proposal for the wheat producer, on the other hand, is vague and undefined. Whatever this undefined benefit for wheat producer is, it is important to explain the measurable negative aspects, as evidenced by statistics:

- Less than 20% of silo receipts are up- or downgraded
- Only between 2% and 3% of wheat outloaded on JSE certificates are downgraded and, in most cases, it is not because a silo operator planned to exercise this option, but rather the result of a dispute
- Experience shows that over 50% of all upgrades are due to the owner’s request and not as a result of the silo operator's decision.

It is therefore debatable whether the implementation of this proposal will lead to any notable benefit to the local producer. Agbiz Grain members, however, considered the issue and agreed to request the JSE to conduct an independent investigation to determine the actual value that buyers place on these requirements. This proposal involves the listing of a second JSE wheat contract with the grade guaranteed JSE Silo Certificate specifications. The premium buyers are willing to pay for this grade guaranteed contract will be transparent and market-related. This exercise will also indicate the real interest in guaranteed grades and reflect the value thereof. The premium for such a grade guaranteed contract will also motivate (or demotivate) storage operators to increase their offering of guaranteed silo receipts in the market.

Obstacles to consensus

The main issue that was an obstacle is the requirement that a minimum grade 100% is guaranteed upon receipt of the JSE wheat plus the additional condition that there will be no compensation when higher grades are unloaded. The storers find it very difficult to comply with this because they work with a biological product and varying climatic conditions - no grain is identical; no year's grain quality is the same. In addition, the grading regulations allow that a variance in protein determinations on grading instruments at dispatch and receipt – they may differ by 0.3% (up or down, which means, in total, there is a 0.6% tolerance). This can easily result in a wheat consignment being one grade higher or lower.

Some Agbiz Grain members believe that this arrangement can disturb normal market forces and that an agreement in this regard will lead to standardization of matters that should actually be determined by competition in the market. However, Agbiz Grain members respect the request from industry and the importance of a minimum quality guarantee for processors.

Against this background, the Agbiz Grain members agreed to individually make available to the market, minimum quality guaranteed silo receipts. Such tools are not standardized in the industry and therefore competitive in nature. The issuing of requirements and other related conditions will be determined by each individual agri-business, as and when possible under its unique circumstances. A prerequisite for this contract is that it is structured in such a way as to provide every service provider to complete the essential elements of the agreement (cost, volume constraints, application procedure, duration, transferability, grade etc.) in line with their own preference.

This requirement is important because of the highly diverse nature of storage operators’ infrastructure, business conditions and different seasonal realities. Agbiz Grain members all agreed to a new JSE Silo Certificate with such a Guaranteed Grade (GG). The JSE also approved the concept and presented the procedures for implementing such a GG to the industry in February 2016. Although the implementation of this proposal is not expected to directly and significantly contribute to the welfare of the wheat producer, it is assumed that local processors will appreciate the grade guarantees to such an extent that the local wheat price will receive support in the cash market compared with the relevant import parity level.

Summary of the effect of the initial proposals on the various role players

Effect of action plan on all role players				
	R100/JSE delivery	**Grading – Super grade**	**2% grade price differential**	**Guaranteed grade contract**
Import parity prices	Reduction	JSE Neutralises	JSE Neutralises	Spread smaller
Storage operators	Neutral (storage usage)	Practical challenges	Great financial impact	Great financial impact
Traders	Opportunity for arbitrage	Relatively neutral	Relatively neutral	Lower risks
Processors	Beneficial	Neutral	Negative, Manageable	Beneficial
JSE	Neutral (more deliveries?)	Neutral	Neutral	Neutral (more deliveries?)
Producers	Negative	Some negative; Others positive	Neutral Marginally positive	Neutral

Summary of the financial impact of all proposals on grain storage and handling companies

Financial impact of initial proposals on grain handling and storage companies						
Proposal	**Admini-stration**	**Systems develop-ment**	**Risk**	**Adapability of model**	**Financial sacrifice**	**Investment**
Removal of R100 / ton discount	None	None	None	None	None	None
Changes to wheat grading regulations	Yes	Yes	Yes	None	Yes	Yes
Change of price difference between wheat grades	Yes	Yes	Yes	Yes	Yes	None
Guaranteed Grade silo receipt	Yes	Yes	Yes	Yes	Yes	Yes
Proposals from other stakeholders						
Cultivar Development	Yes	Yes	Yes	None	None	Yes
Endpoint Royalty System	Yes	Yes	Yes	None	Yes	Yes
Proposals from grain handling and storage companies						
Listing of second JSE contract	Yes	Yes	Yes	None	Yes	Yes
Wheat moisture concession	Yes	Yes	Yes	None	None	Yes
Financing solutions	Yes	Yes	Yes	None	Yes	Yes
Align industry with processors	Yes	Yes	Yes	None	None	Yes
Production Practices	Yes	Yes	Yes	None	None	Yes
Reconsider all the elements of the JSE wheat contract	?	?	?	?	?	?