



October 28, 2009

Responsible Management of the Sugar Program Requires A Quota Increase

Summary

The U.S. Department of Agriculture chose not to make adequate supplies of sugar available to the marketplace in 2008/09, causing refined sugar prices to remain uncharacteristically high. Ending stocks on September 30 were the lowest in relation to disappearance since the current sugar program was established in the 1981 Farm Bill, contributing to forecasts of even greater tightness of supplies in 2009/10.

Over the 26 years prior to 2008/09, USDA generally tried to strike a reasonable balance between the interests of sugar producers and sugar consumers. That has yet to happen with the current Administration, at least with respect to the size of the tariff rate quota (TRQ). (The Administration did act to create a new tariff line for high-polarity refined sugar, an action which has the potential to help balance supplies if actually used.) If supplies are kept tight by government policy during 2009/10, it will cost US consumers an additional and unnecessary \$2 billion on top of the normal burden imposed by the sugar program.

USDA should responsibly manage the sugar program by announcing a significant increase in raw and refined sugar import quotas in the coming weeks. The Secretary has the authority to do so, and the stock/use ratio remains the single best guide to how much of an increase to announce. The 15.5% target that industrial users have recommended in the past warrants an approximately 1.0-1.2 million short ton increase in raw and refined sugar import quotas in order to achieve additional imports of 850,000-1,000,000 tons.

Current situation

We begin the 2009/10 sugar marketing year with an official USDA supply-demand forecast that shows unprecedented tightness in the US sugar market. Market prices reflect that tightness, with wholesale refined sugar prices at 42 cents per pound, the highest monthly average level since the 1980 world sugar shortage. With the 2009/10 season now underway, one can reasonably ask what the next steps should be for USDA to responsibly manage the sugar program. Thus far, USDA has done the following:

- On September 1, announced that the Feedstock Flexibility Program (the subsidized sugar-for-ethanol purchases mandated in the farm bill) would not be in effect in 2009/10.
- On September 25, set the overall Allotment Quantity (OAQ) at a high enough level to insure that little if any beet or cane sugar stocks will be “blocked,” so that all domestically produced sugar can be marketed freely.
- In the same press release, established the tariff rate quotas at the minimum levels, as dictated by the 2008 Farm Bill. (The specialty sugar quota was set 75,000 metric tons above the minimum, as permitted by the legislation.)
- On September 28, announced the 2009/10 loan rates of 18.25 cents per pound of raw cane sugar and 23.45 cents per pound of refined beet sugar.

There is nothing in those announcements with which one can take exception. Indeed, in its September 25 release, USDA stated that it anticipates a need for additional sugar supplies during the current fiscal year. Such supplies can only come from imports. The test for USDA’s management of the sugar program is what comes next.

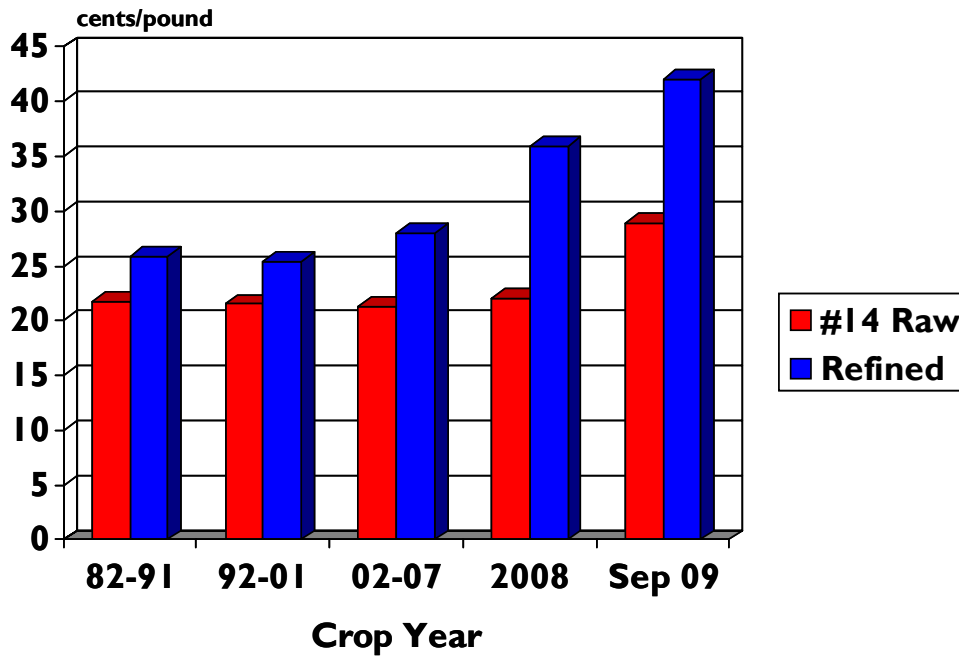
Past Program Management

The current price support loan program for sugar was established in the 1981 Farm Bill. When duties and import fees were unable to adequately support the price, the Reagan Administration launched the current import quota system via Presidential Proclamation No. 4941 on May 5, 1982. The 1982 crop year was the first full year covered by the new import quotas. For the 26-year period through the 2007 crop year, raw sugar prices averaged 21.57 cents per pound, and wholesale refined beet sugar prices averaged 26.18 cents per pound. The 4.61-cent differential between the two was roughly comparable to refining costs in cane sugar refineries.

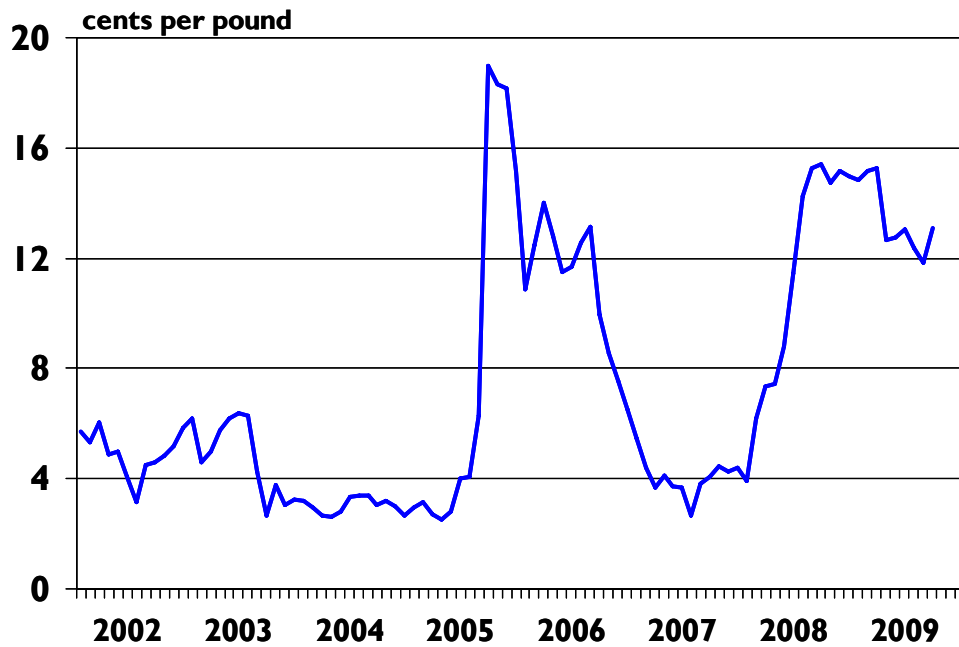
The chart below shows the average prices for the program’s first two decades, the 2002-2007 crop years, the 2008 crop year, and the most recent month, September 2009. For the 2002-2007 crop years, raw sugar averaged 21.33 cents and refined beet sugar averaged 27.99 cents. The 6.66 cent differential between the two – higher than the 4.61-cent long-term average cited above -- reflects a combination of higher energy costs, increased concentration in the sugar industry, the effects of Hurricane Katrina in 2005, and the February 2008 closure of Imperial Sugar Company’s Georgia refinery due to an explosion.

The margin between raw and refined sugar has been extraordinarily volatile in recent years, as illustrated in the second chart below. In 2005/06 the refining margin surged due to Hurricane Katrina, which damaged two cane sugar refineries. For the 2008/09 crop marketing year just ended, raw sugar averaged 22.07 cents and refined averaged 35.90 cents. Refined sugar prices were again unusually high due to the combination of a smaller beet crop, the continued closure of the Georgia refinery, and USDA’s decision not to increase the raw or refined sugar import quotas despite repeated requests by the Sweetener Users Association.

Average US Sugar Prices

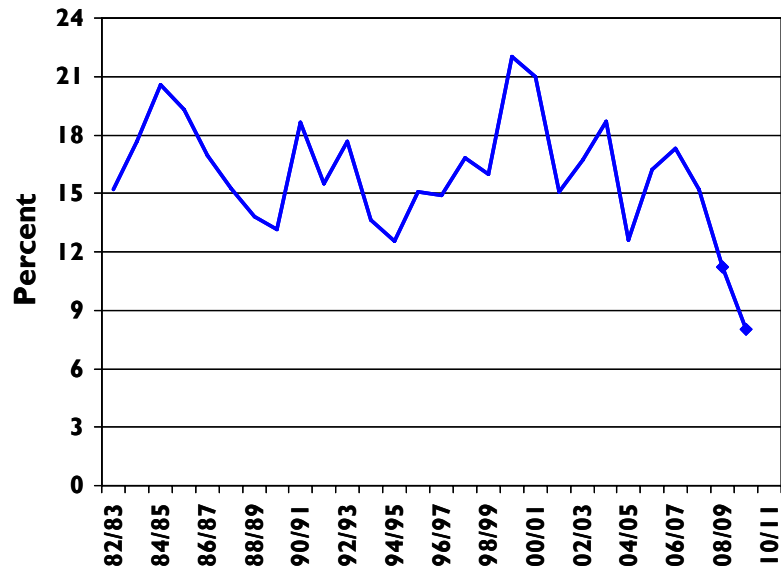


Spread Between Refined and Raw Sugar Prices



Sugar stocks at the end of the 2008/09 marketing year were the lowest in relation to consumption for the entire 27-year history of the current sugar program, as shown in the second chart below. They are projected to be even lower in 2009/10 – a stock/use ratio of just 7.9%.

USDA's Ratio of Ending Stocks on Sep. 30 to Total Use



Quota Authority

The Food, Conservation and Energy Act of 2008 included language in the sugar title that attempts to limit the Secretary of Agriculture's ability to increase import quotas. In brief, the Secretary is required to start the quota year with TRQs at the minimum WTO levels. Before April 1, an "emergency shortage of sugar" can be addressed by increasing the raw sugar quota for reassignment of marketing allotment deficits to imports or to maximize use of refining capacity. There is no restriction on how soon after the initial announcement such an increase may occur.

Once use of refining capacity is maximized, the Secretary can increase the refined sugar TRQ. On or after April 1 he can increase quotas without there being an "emergency". (The farm bill language is attached as an appendix.)

It is our view that the Secretary still has ample and clear cut authority to increase TRQs at any time, either through tariff headnote language or how he defines "emergency".

Additional U.S. Note 5 to Chapter 17 of the Harmonized Tariff Schedules of the United States (HTSUS) provides the details for implementing the sugar quotas to which the United States committed in the Uruguay Round. Section (a)(ii) of that note states the following:

“Whenever the Secretary believes that domestic supplies of sugars may be inadequate to meet domestic demand at reasonable prices, the Secretary may modify any quantitative limitations which have previously been established under this note but may not reduce the total amounts below the amounts provided for in subdivision (i) hereof.”

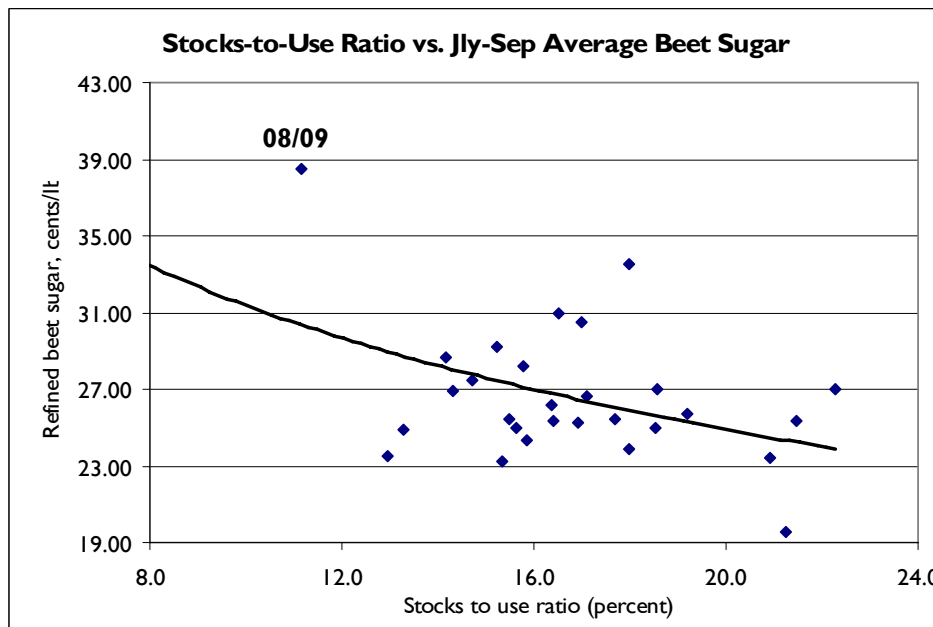
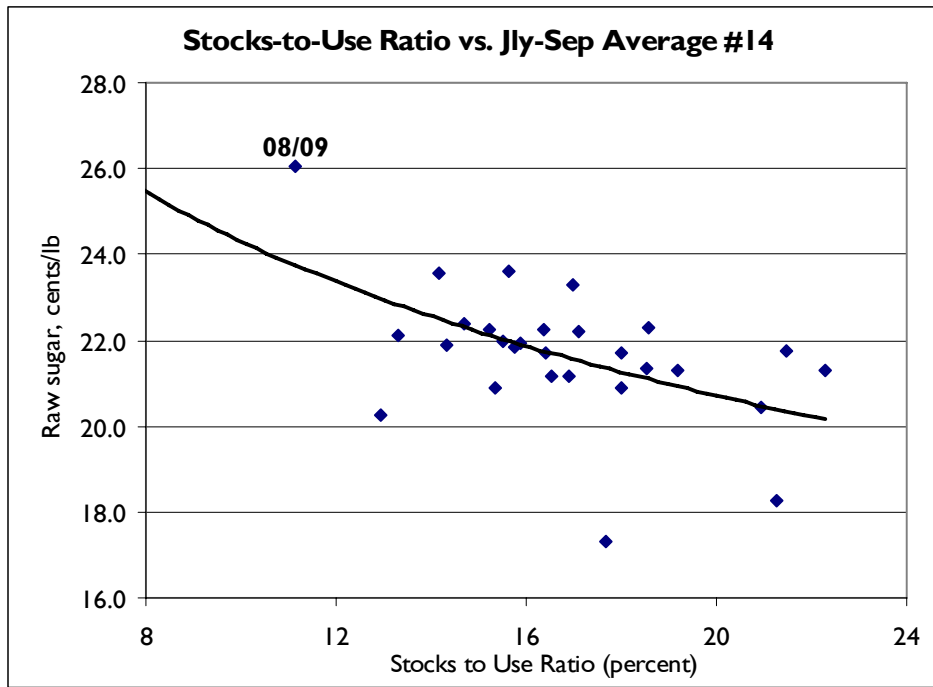
This condition for a TRQ increase would appear clearly to be met; it is difficult to argue that the highest refined sugar prices in over a quarter-century, coupled with nearly unprecedented refining margins, represent “reasonable prices” under any normal understanding of that term. Moreover, nothing in the farm bill repeals or amends the HTSUS headnote language. The farm bill describes those circumstances in which the Secretary *must* increase the TRQ prior to April 1, but does *not* prevent his use of the headnote authority to increase quotas in other circumstances. Even if that were not so, there would be ample scope within the farm bill language itself to consider current market conditions – with their record-low projection of ending stocks – to constitute an “emergency shortage” and hence to require a TRQ increase.

Relationship of domestic prices to stock/use ratio

Having decided to increase sugar quotas, the Secretary has to determine the tonnage. Historically, the criterion used by the Department has been the ratio of stocks to use. Experience has shown that a ratio somewhere in the 15-16 percent range results in prices that are high enough to prevent forfeitures of sugar serving as collateral for Commodity Credit Corporation loans to producers under the price support program, but not so high that they penalize consumers. For a number of years USDA’s unofficial minimum target was a 14.5% ratio. The Sweetener Users Association has for years recommended 15.5% as the appropriate floor. For the 26 years through the 2007 crop year, the end result was a ratio below 16% eleven times and above 16% fifteen times, as sugar growers and processors tended to over-produce in response to the favorable support level. That tendency has been constrained by the marketing allotment system in more recent farm bills.

The two charts below plot the logarithmic relationships between the stock/use ratio and prices for raw and refined sugar. There are outliers in both directions, but the 2008/09 result is one of the more obvious ones.

The statistical fit of these lines is not the best. It is particularly unclear what market prices will actually do when the ratio falls below 12% because that has only happened once. Note that the “x” (horizontal) axis starts at the projected 8% stock/use ratio for 2009/10. If that were actually to be how the year ended up, it is highly unlikely that the third quarter price would be as low as the indicated intercepts of the lines with the “y” (vertical) axes. (In fact, prices are above these implied levels even today, at a significantly higher stock/use ratio.) Eight percent is a one-month supply and would not be sufficient to ensure orderly marketing of sugar to U.S. consumers.



Implications of the merging of the US and Mexican sweetener markets

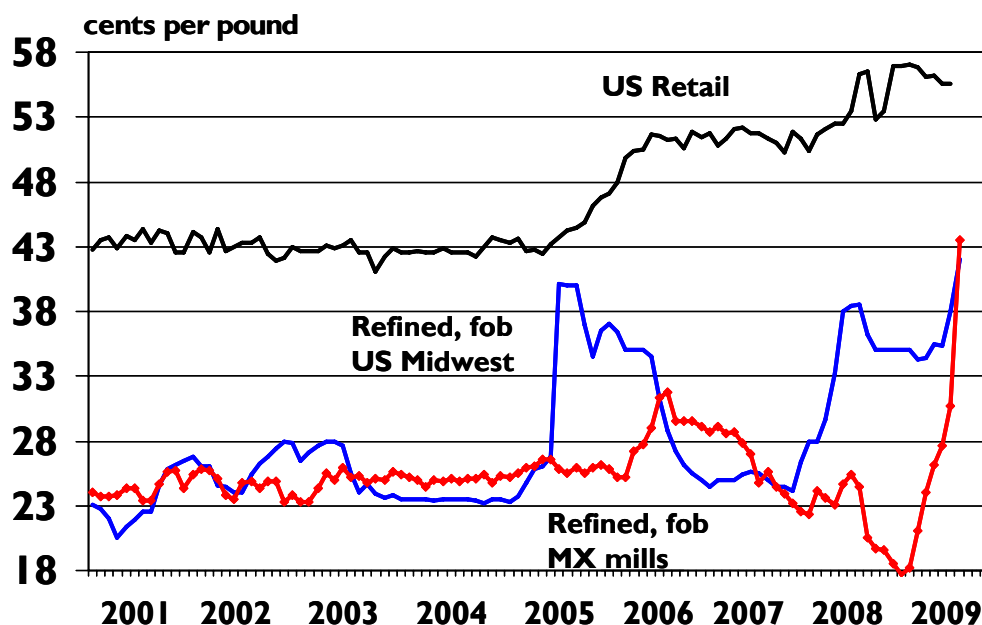
The elimination of barriers to sugar and corn sweetener trade between Mexico and the United States has important implications for the management of the US sugar program. Since either country is free to authorize increased imports, the relevant government officials from both

countries have an incentive to talk to each other and take into account what is happening on both sides of the border.

From July through October, Mexico does not produce sugar, and consumption needs have to be met either by drawing down stocks or by imports. During the autumn, the United States has the potential to be a natural supplier to Mexico because it is the peak US production period for both beet and cane sugar.

By unduly limiting imports and forcing market prices higher, USDA has foreclosed that possibility for this year. US refiners and beet processors could have been selling significant quantities of sugar in Mexico, just as Mexico sold significant quantities to US customers earlier this year. Mexican sugar companies actually committed too much sugar to the US market over the past year, leading to ever tightening supplies as the summer wore on. Sharp increases in domestic sugar prices in August and September forced the Mexican government to turn to increasing quotas for imports from the world market.

US & Mexican Refined Prices

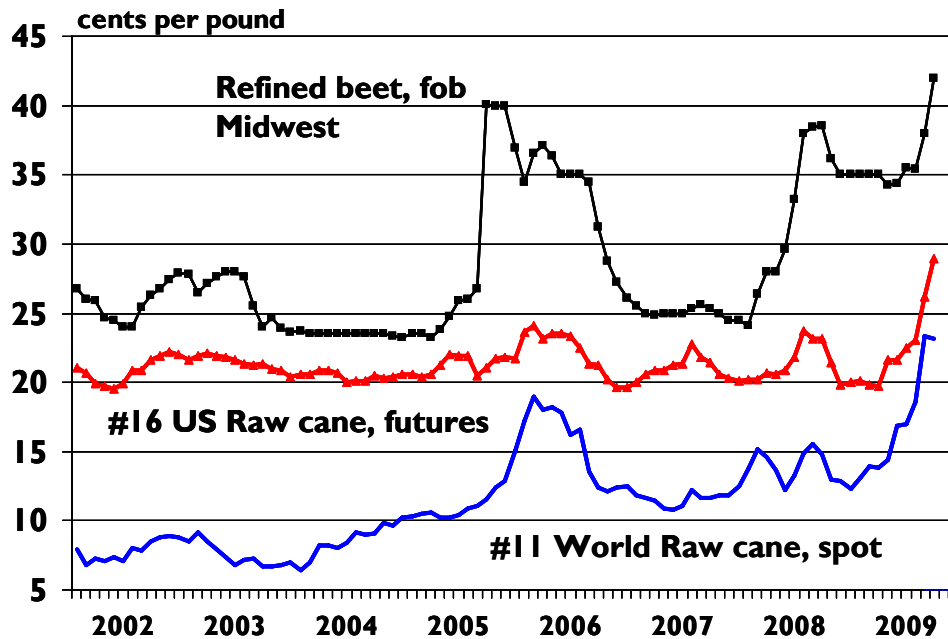


Implications of high world market sugar prices

The price situation in both Mexico and the United States has been exacerbated by rising prices in the world sugar market due to adverse weather in both India and Brazil, the world's two largest sugar producing countries. The world price for raw sugar has risen from the low teens last spring to about 23 cents per pound in September. World refined sugar prices were 3 cents

higher at about 26 cents, which would result in a landed price in the United States of less than 30 cents if imports were permitted.

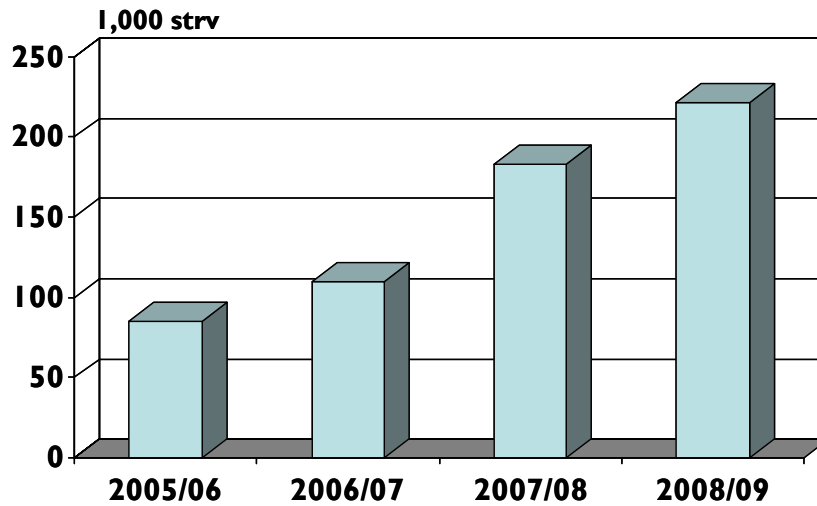
World and US Sugar Prices



The US price for raw sugar has also risen sharply as US refiners have been forced to compete for available quota supplies. The nearby January futures price is now over 33 cents per pound. The problem is that the US sugar quota effectively gives the foreign supplier a free put option to sell to the United States at the US support price – normally about 20 cents per pound at port of export. Whenever there is a big rise in world market prices, with nearby prices higher than deferred months, quota holders that sell to both the United States and the world market have an incentive to first try to capture the high world market price while it is available because they can always get at least 20 cents for a US sale later in the season.

Refiners need 400,000-500,000 tons of raw material per month. Domestic cane sugar production does not really get underway until mid-October and then it takes time to move the sugar to refineries. With low beginning stocks, a high world price, and an increasingly unreliable quota supply base, US refiners have had to bid aggressively for quota sugar. During 2008/09, 19 of the 39 quota-holding countries (besides Mexico) shipped no sugar to the United States. This year the European Union's Everything But Arms initiative giving 26 of the least developed sugar producing countries duty-free and quota free access to its sugar market could further undermine fulfillment of US quotas. Quota shortfalls have been rising each year, as shown in the chart below. The trend is even more remarkable than it looks because the quota was 1.7 million metric tons in 2005/06 and 1.3 million the following year, compared to 1.1 million metric tons in the last two years, so if expressed in percentages, the chart would show an even sharper uptrend. How high shortfalls for 2009/10 will go in a strong world market is anyone's guess.

Raw Sugar Quota Shortfall



One thing should be clear to USDA from this discussion. When there is a tight world sugar market, one cannot assume that six months from now there will be uncommitted sugar readily available for sale to the United States. If other buyers have locked in sales at prices above the normal US support level, there may simply not be sugar available from some holders of US quota. Therefore, it is important that USDA act promptly to increase US sugar import quotas to signal quota countries that they should reserve appropriate quantities for the US market.

Refining capacity utilization

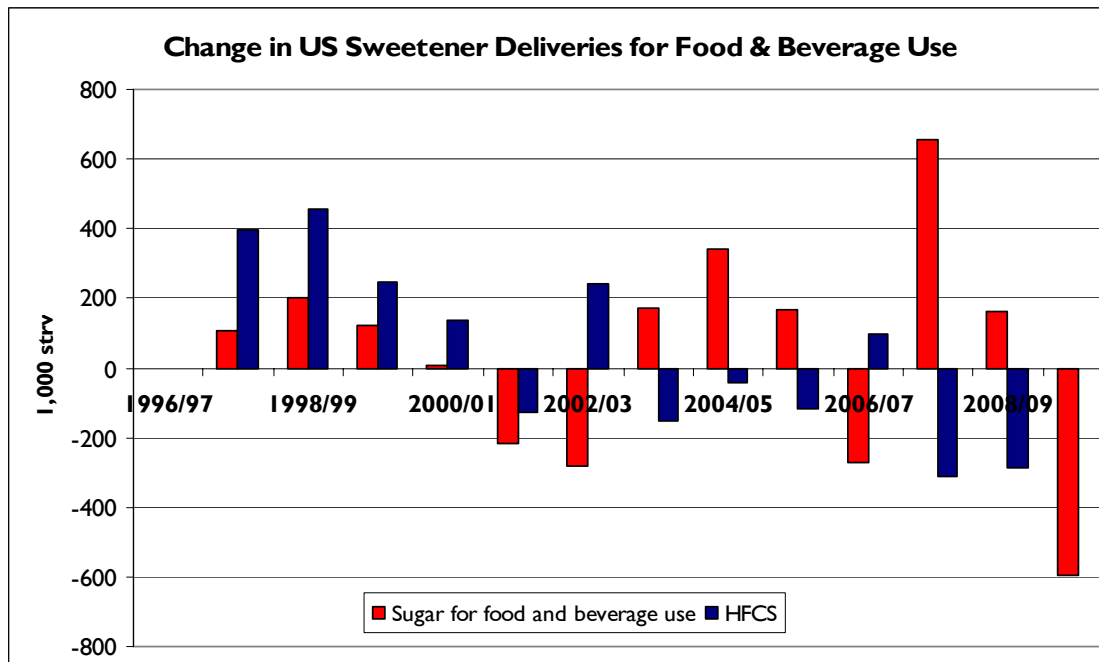
The United States has the refining capacity to handle a significantly larger volume of imported raw sugar. Rated capacity for the 8 remaining large cane sugar refineries totals about 6.6 million strv (assuming 330 operating days), or about 550,000 strv (short tons, raw value) per month.

The chart below shows actual meltings of raw sugar the last five years, and there have been a few months when they exceeded 500,000 tons or about a 91% capacity utilization rate. Thus 6 million tons is probably a reasonable expectation for what the cane refining industry can comfortably handle in the course of a year. In addition to the large refineries, there is additional ability around the country to process Mexican *estandar* (which generally needs further refining before use in most U.S. food products) or imported raw sugar, perhaps adding another few hundred thousand tons to capacity estimates.

Working off of USDA's October *World Agricultural Supply and Demand Estimates* (WASDE), the amount of new raw sugar available to refiners in 2009/10 is approximately as follows:

Domestic production	3,325,000
Raw sugar TRQ	1,150,000
Other program	400,000
Mexico	330,000 (assuming 1/3 enters as refined)
Total	5,205,000 strv.

sweetened beverages beyond traditional soft drinks, and the trend of food and beverage manufacturers switching from HFCS to sugar in response to some consumers' negative perceptions of HFCS as an ingredient. The chart below, showing the annual changes in deliveries of both sweeteners, provides some insight into the net effects of recent trends.



Up through 2000/01, demand for both sweeteners was rising. In 2001/02, demand for both fell for reasons that are obscure. Demand for sugar declined further the next year while HFCS bounced back. Since then, the two have always moved in opposite directions, but with sugar in a generally increasing trend and HFCS in a generally decreasing trend. Domestic deliveries of sugar gained ground from 2001/02 to 2005/06 despite the fact that net imports of sugar in products were rising by an average of 100,000 strv per year.

Since 2005/06, net imports of sugar in products have been falling 100,000 strv per year, and yet sugar deliveries declined 271,000 tons in 2006/07 in the aftermath of Hurricane Katrina. In the two most recent years, sugar deliveries have been up significantly despite the negative product import trend and much higher wholesale prices, and HFCS use has been down.

For 2009/10, USDA is forecasting that the amount of corn used to produce HFCS will be up less than one percent. If HFCS exports to Mexico rise in response to higher sugar prices in that market, the implication is that domestic U.S. HFCS sales would be lower, not higher, unless imports from Canada pick up significantly.

Our conclusion is that HFCS is in a downtrend due to the change in consumer preferences and the 100% price increase since 2004/05. We think that sugar imports from Mexico will not decline as much as USDA is expecting because firms that have developed commercial

relationships over the last couple of years will be trying to maintain them once the new Mexican cane harvest begins. The Mexican government's apparent willingness to authorize substantial import quotas will also help to keep a certain amount of Mexican sugar available to the US market. We have raised our forecast of imports from Mexico to 700 tmt, down only 50% from the 2008/09 level. One outstanding question is what portion will be estandar going to US refineries, and what portion will be refined and/or estandar going directly or indirectly to US end users. In 2008/09, at least one third went for refining.

Factoring in the economic recovery now underway, and the likely continued decline in net imports of sugar in products due to the rise in world market prices, we expect that total sugar deliveries will be down only marginally at 10,750,000 strv, which is 375,000 tons above USDA's forecast. That makes a big difference in any calculation of import needs for the marketing year.

US Sugar Balance (1,000 strv)

	2005/06	2006/07	2007/08	2008/09	2009/10
Beginning stocks	1,332	1,698	1,799	1,660	1,315
Production					
Beet	4,444	5,008	4,721	4,184	4,650
Cane	<u>2,955</u>	<u>3,438</u>	<u>3,431</u>	<u>3,324</u>	<u>3,350</u>
Total	7,399	8,446	8,152	7,508	8,000
Imports					
Quota entries	2,588	1,624	1,354	1,370	1,225
Other program	349	390	565	307	350
Other	506	66	701	1,400	710
Mexico	<u>420</u>	<u>60</u>	<u>694</u>	<u>1,397</u>	<u>700</u>
Total	3,443	2,080	2,620	3,077	2,285
Total availability	12,174	12,224	12,571	12,245	11,600
Disappearance					
Deliveries	10,341	10,135	10,773	10,900	10,750
Exports	203	422	203	130	200
Miscellaneous	<u>-68</u>	<u>-132</u>	<u>-65</u>	<u>-100</u>	<u>0</u>
Total use	10,476	10,425	10,911	10,930	10,950
Ending stocks	1,698	1,799	1,660	1,315	650
CCC stocks	0	0	0	0	0
"Blocked" stocks	0	50	0	0	0
Free stocks	1,698	1,749	1,660	1,315	650
Stock/use ratio (%)	16.2	17.3	15.2	12.0	5.9

A 15.5% stock use ratio applied to our use estimate implies an ending stock target of 1.7 million tons, about double what USDA is projecting and more than a million tons above our own forecast. To get another 850,000-1,000,000 tons of imports, the announced quotas for raw and

refined sugar would have to be at least 1.0-1.2 million tons higher than the initial USDA announcement. Exact numbers would depend on the mix between raw and refined.

There are two obvious ways for USDA to proceed: a large sugar TRQ increase now followed by a review of the situation in January, or a return to the tranche system, used from 1996/97 to 1999/00, under which fixed amounts are pre-authorized to enter at various dates unless the WASDE ending stock/use projection is above a specified level (15.5% the last time the method was used). In the case of the first approach, the sensible thing for USDA to do is to increase TRQs now by enough to result in an additional 600,000 tons of actual imports (recognizing the likelihood of shortfalls that will shrink actual imports below any announced amount), and then review the situation again in a few months. In the case of the tranche approach, the initial amount could be lower because trade assessments of the outlook would permit exportable supplies to be lined up on a contingent basis.

Pending litigation against genetically-modified sugarbeets provides another reason for USDA to act soon. It is too early to predict the ultimate outcome of the lawsuit, but impacts on 2009/10 supplies or new-crop plantings – if any – would be much more likely to subtract supplies from the market than to add to them.

Conclusion

The total supply of sugar currently available to US consumers and food and beverage manufacturers is totally inadequate. Based on current supply and demand forecasts, the United States will need an additional 850,000-1,000,000 strv of third-country imports, i.e., other than from Mexico. In view of the tight world market situation, prompt announcement of increases in the raw and refined sugar TRQs is required if retail and industrial consumers are to have any assurance that the sugar will actually be forthcoming.

Failure to act in a timely manner risks locking in high sugar costs for consumers and for food and beverage manufacturers for another year. When government policies contribute to wholesale refined sugar prices at 42 cents per pound instead of a more normal 32 cents (given the world market situation), that additional dime on 10 million tons of refined sugar consumption is equivalent to a \$2 billion tax on consumers, in addition to the underlying consumer costs that are always associated with the US sugar program.

Appendix: Excerpt from 2008 Farm Bill

(j) *ADMINISTRATION OF TARIFF RATE QUOTAS.*-Part VII of subtitle B of title III of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1359aa) (as amended by subsection (i)) is amended by adding at the end the following:

"SEC. 359k. ADMINISTRATION OF TARIFF RATE QUOTAS.

"(a) ESTABLISHMENT-

"(1) IN GENERAL-Except as provided in paragraph (2) and notwithstanding any other provision of law, at the beginning of the quota year, the Secretary shall establish the tariff-rate quotas for raw cane sugar and refined sugars at the minimum level necessary to comply with obligations under international trade agreements that have been approved by Congress.

"(2) EXCEPTION.-Paragraph (1) shall not apply to specialty sugar.

"(b) ADJUSTMENT. -

"(1) BEFORE APRIL 1.-Before April 1 of each fiscal year, if there is an emergency shortage of sugar in the United States market that is caused by a war, flood, hurricane, or other natural disaster, or other similar event as determined by the Secretary-

"(A) the Secretary shall take action to increase the supply of sugar in accordance with sections 359c(b)(2) and 359e(b), including an increase in the tariff-rate quota for raw cane sugar to accommodate the reassignment to imports; and

"(B) if there is still a shortage of sugar in the United States market, and marketing of domestic sugar has been maximized, and domestic raw cane sugar refining capacity has been maximized, the Secretary may increase the tariff-rate quota for refined sugars sufficient to accommodate the supply increase, if the further increase will not threaten to result in the forfeiture of sugar pledged as collateral for a loan under section 156 of the Federal Agriculture Improvement and Reform Act of 1996 (7 U.S.C. 7272).

"(2) ON OR AFTER APRIL 1.-On or after April 1 of each fiscal year-

"(A) the Secretary may take action to increase the supply of sugar in accordance with sections 359c(b)(2) and 359e(b), including an increase in the tariff-rate quota for raw cane sugar to accommodate the reassignment to imports; and

"(B) if there is still a shortage of sugar in the United States market, and marketing of domestic sugar has been maximized, the Secretary may increase the tariff-rate quota for raw cane sugar if the further increase will not threaten to result in the forfeiture of sugar pledged as collateral for a loan under section 156 of the Federal Agriculture Improvement and Reform Act of 1996 (7 U.S.C. 7272)."

(k) *PERIOD OF EFFECTIVENESS.*-Part VII of subtitle B of title III of the Agricultural Adjustment Act of 1938 (7 U.S.C. 1359aa) (as amended by subsection (j)) is amended by adding at the end the following:

"SEC. 3591. PERIOD OF EFFECTIVENESS.

"(a) IN GENERAL.-This part shall be effective only for the 2008 through 2012 crop years for sugar.

"(b) TRANSITION.-The Secretary shall administer flexible marketing allotments for sugar for the 2007 crop year for sugar on the terms and conditions provided in this part as in effect on the day before the date of enactment of this section."