Testimony of

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Mr. Chairman and members of the committee, we appreciate the opportunity to review the operation of the sugar program authorized by the Farm Security and Rural Investment Act of 2002 (2002 Farm Bill). We are pleased to share our experiences administering the sugar program for the past four years and also to offer observations on the changing business environment in which the program operates, particularly as Congress begins to consider appropriate policies for the next Farm Bill.

Overview of the Sugar Program

During several Farm Bills over the years, Congress has restructured the various commodity programs to make them much more market-oriented. The sugar program is a notable exception. Due to high budgetary costs experienced with the previous program, Congress, in the 2002 Farm Bill moved the sugar program in the opposite direction by authorizing supply controls (marketing allotments for individual companies) to reduce the risk of forfeiture of sugar pledged to the Commodity Credit Corporation (CCC) as collateral under the price support loan program.

The sugar policy pursued today consists of several interrelated programs that require the Department of Agriculture (USDA), rather than the marketplace, to attempt to balance available supply with domestic demand. One of those programs, mandated by the 2002 Farm Bill, is the price support loan program for processors of sugarcane and beets. The specific support price is set by statute. Processors pledge the sugar as collateral to receive a loan at the support price. The borrower then may either forfeit the collateral to USDA's Commodity Credit Corporation (CCC) in complete satisfaction of the loan obligation, or redeem the collateral and sell it into the market at a higher price. Thus, the borrower is always assured of receiving at least the support price.

At the same time, USDA is directed to maintain a price sufficient to prevent loan forfeiture. The 2002 Farm Bill requires the sugar program to be administered, to the maximum extent possible, with no budgetary cost (i.e., "no net cost"). Rather, the cost is shifted from the taxpayer to the users of sugar. Price is determined by controlling the supply relative to the demand. Domestic supply is controlled by a marketing allotment program while foreign supply (imports) is controlled through the application of tariffs and tariff-rate quotas (TRQ's), authorized by the Harmonized Tariff Schedule. Imports are required each year to comply with our international trade agreements/commitments, but these amounts may be increased above the minimum as needed to mitigate domestic supply shortfalls. These mechanisms are used to realize a domestic price that sufficiently exceeds the mandated support price to avoid loan forfeitures by cane and beet processors.

The 2002 Farm Bill established the support prices (loan rates) for processors of domestically grown sugarcane at 18 cents per pound and 22.9 cents per pound for refined sugar from beets. Unlike most other commodity programs, the processed product is supported rather than the farm commodity – sugar beets and sugarcane. This is because cane and beets, being bulky and perishable, are not viable loan collateral though their value is directly determined by the market price of sugar. Processors use the loan

proceeds to finance preliminary payments to growers and generally place about a quarter of their output under loan.

To discourage forfeiture of loan collateral, the price must be kept sufficiently high to enable the processor to fully repay the loan, accrued interest, and expected marketing costs (interest is forgiven should the loan collateral be forfeited). Thus, the *effective* support level (and therefore the domestic market price floor) is considerably higher than the statutorily determined loan rate. For Fiscal Year (FY) 2006, the *minimum* raw sugar market price to prevent forfeiture is about 20.80 cents a pound (Florida), while the corresponding *minimum* refined price is about 24.20 cents a pound (Midwest). This is in contrast to the corresponding loan rates of 18.0 and 22.9 cents per pound, respectively.

The ability to control sales of domestically produced sugar to achieve the minimum price is provided by current law through the imposition of marketing allotments. If the industry produces more sugar than USDA determines the market can use at an acceptable price, marketings are restricted and storage of the surplus is the responsibility of processors.

At the beginning of each fiscal year, USDA establishes an overall allotment quantity (OAQ) intended to balance the domestic supply plus required imports with market requirements. It then continually monitors the sugar market fundamentals – consumption, stocks, production, and imports – with formal reviews each quarter and adjustments to the OAQ during the year as the market requires. The 2002 Farm Bill allocates the total OAQ to the beet (54.35%) and cane (45.65%) sectors. Any shortfall (inability to supply) must be reassigned, first to CCC and then to imports rather than to the other sector, a complicating factor at times in program administration.

The 2002 Farm Bill also includes a "trigger" on total imports. This "import trigger," is set at 1,532,000 short tons raw value (STRV). If imports for human use are estimated to exceed this amount, then domestic marketing allotments to control supply could be suspended. Without allotments, processors could market all their sugar or place it under loan and forfeit it to CCC, receiving at least the effective guaranteed price (thereby contravening the "no net cost" provision). USDA has not suspended sugar marketing allotments authorized under the 2002 Farm Bill.

The tariff rate quota (TRQ) is an integral part of the sugar program although it is not authorized as part of the 2002 Farm Bill. The World Trade Organization (WTO) *minimum* TRQ for raw cane sugar is 1,231,497 STRV, and for refined sugar is 24,521 STRV, a total of 1.256 million STRV. Whenever the Secretary of Agriculture "believes that domestic supplies of sugars may be inadequate to meet domestic demand at reasonable prices", the TRQs may be increased. The U.S. Trade Representative (USTR) allocates the *raw* sugar TRQs to supplying countries based on their share of imports into our market during the period 1975 to 1981. In recent years, the *refined* sugar TRQ has been allocated by USTR in part to Canada (51%) and Mexico (14%), and the rest to all exporters on a first-come, first-served (global) basis except for a small portion reserved for specialty sugar (recently increased specifically for organic sugar).

USDA also administers a re-export program that permits refineries and sugar-containing product manufacturers to import tariff-free sugar at world market prices and then export it as either refined sugar or an ingredient in a sugar-containing product. Over a period of several months, this has no net effect on the domestic sugar supply.

Carefully regulating the amount of foreign sugar allowed to enter the domestic market is a critical aspect of program operation. The minimum domestic price typically is well above the world market price, making ours a highly lucrative market to which access is sought by all exporters.

Program Operation Since 2002

The current version of the sugar program was developed in part based on experience with the previous program, which ended with the 2002 Farm Bill. That program resulted in a huge market imbalance and USDA acquisition of 1.1 million tons (about 13% of annual output) of sugar under the price support program at a cost of some $445 million. The imposition of marketing allotments in the 2002 Farm Bill reduced the possibility of such significant forfeitures of loan collateral but did not eliminate them entirely. Upcoming changes in the structure of the global sweetener market again make large forfeitures of price support loans a distinct possibility.

The new program is highly prescriptive, containing many rigid, and sometimes contradictory, rules that greatly increase the complexity of program administration. Even so, from the beginning of the new program in May 2002 through July 2005, the domestic market was rather tranquil and operation of the program was relatively smooth (see Chart 1). However, this belied the growing strains due to technological, policy, economic, business and other changes occurring throughout the industry and the broader global environment.

The growing difficulty for a government agency to be able to manage the sugar market became readily apparent in FY 2005 and continues. FY 2004 had ended with the general perception that the sugar market in FY 2005 would be amply supplied if not oversupplied. Beet processors still were raising the possibility of forfeiture well into the spring of 2005. FY 2005 began with small forfeitures of CCC sugar price support loans largely due to anomalous circumstances, and it ended with major market disruptions due to suppliers' inability to meet contractual commitments resulting from adverse weather affecting the beet harvest and, soon thereafter, hurricanes reducing the sugarcane crop and closing two cane refineries in the South.

In August 2005, the Red River Valley suddenly and unexpectedly began rationing deliveries as growers experienced field losses due to excessive soil moisture and anticipated new supplies did not materialize. This had the effect of creating enormous uncertainty across the market. Then, only days later, on August 29, 2005, Hurricane Katrina struck Louisiana disrupting sugar refinery operations. With the sugar supply abruptly disrupted and reduced, USDA responded by increasing the domestic marketing

allotment allowing immediate entry of so-called "blocked stocks" and expanded allowable imports so that an additional 384,725 tons became available to the market by the end of FY 2005. Subsequent monitoring of market conditions resulted in further increases in the OAQ of 580,000 tons, releasing all deliverable refined beet sugar stocks into the market (cane sugar stocks already had been exhausted). The raw and refined sugar TRQ's were increased, allowing an additional 174,700 STRV to enter in FY 2005.

The August and September 2005 weather events immediately and severely damaged refined sugar supplies and clearly indicated the cumbersomeness of quickly obtaining refined sugar meeting the specifications of most manufacturers. The Harmonized Tariff Schedule defines refined sugar as having a polarity (sugar content) over 99.5 percent. However, many domestic manufacturers have such specific needs that much sugar from the world market meeting this requirement (polarity above 99.5) still must undergo further refining before use. Increases in the refined TRQ tend to be filled by nearby suppliers who can technically meet import specifications, but not the more stringent requirements of many product manufacturers. USDA does not have a trade-compliant way to satisfactorily meet acute domestic industry needs for such high quality imported refined sugar.

Overall, the challenges of the past several months have clearly illuminated several deficiencies in the 2002 Farm Bill's rigidly structured sugar program.

Considerations for the Future

The domestic sugar market once could be rather effectively isolated from influences outside our borders. This enabled domestic price to be maintained well above prevailing world market price through the use of border measures. However, that is increasingly less possible. At the same time, recent events have pointed up vulnerabilities in the current sugar program. The rapidly changing industry and broader business environment very likely will bring even more pressures, suggesting that new approaches to sugar and sweetener policy may need to be examined. Otherwise, the program, as now structured, could well become impossible to operate within the current statutory specifications.

Some factors that merit consideration as the Congress contemplates sweetener policy for the future are briefly characterized below.

Changing Structure of the Domestic Industry

The U.S. sweetener market is the largest and most diverse in the world, both in terms of consumption (including high fructose corn syrup) and sugar imports. The United States also ranks among the top five global sugar producers and is one of the few countries with significant production of both sugarbeets and sugarcane.

Sugar production has been relatively stable in recent years averaging about 7.7 million STRV while utilization has grown to about 10.4 million STRV. Even so, the domestic sugar industry has been undergoing considerable structural change. In the production

sector, the number of operations continues to decline but with a corresponding increase in size. The most recent Census of Agriculture (2002) shows beet and cane operations to have declined to 5,980 from 8,136 in the previous Census (1997). Beet operations declined from 7,057 to 5,027 while cane operations fell from 1,079 to 953. Average beet acreage harvested per farm rose from 205 to 272 and for cane from 825 to 1,027.

Other parts of the industry have been characterized by rapid integration and consolidation. For instance, all sugar beet processing facilities, which can be considered fully integrated, now are cooperatively owned by producers. Likewise, 10 of the 15 cane processors now are cooperatively owned. In addition, cane farmers, through vertical integration, own over 70 percent of the refining business. Combined, beet and cane farmers now account for 84 percent of domestic refined sugar production, with 58 percent of the market share controlled by two companies. These changes have resulted in the closing of four beet processing facilities, five cane processing facilities, and two cane refineries since the inception of the 2002 Farm Bill.

Shifting Competitiveness of the SCP Industry

Structural change also has been occurring in other parts of the industry, some related to the economic effects of the sugar program. Evidence indicates that the domestic sugar containing product (SCP) industry has lost competitiveness vis-à-vis foreign manufacturers and is shifting to off-shore production as a result of domestic sugar prices being kept well above world prices. This in part is reflected in the amount of sugar imported in sugar-containing products, which reached 1.15 million STRV in FY 2005, outpacing exports of sugar in products by 573,000 tons. The loss in U.S. market share in the SCP business has been increasing since 1996, when imports and exports of sugar-containing products were nearly balanced.

A recent Department of Commerce study found that many SCP manufacturers have closed or relocated to Canada, where sugar prices average less than half of U.S. prices, and to Mexico, where prices average about two-thirds of U.S. prices. Sugar costs appear to be a major factor in relocation decisions for the confectionery industry, in particular where high domestic sugar prices represent a larger share of total production costs than labor. The study also suggested that for every one sugar growing or harvesting job saved through high U.S. sugar prices, nearly three confectionary manufacturing jobs are lost.

The Changing World Market

Another recent development is the significant structural change altering some long-enduring trends in the world sugar market. One of the more notable changes is the reform of the European Union's sugar regime under the Common Agriculture Policy (CAP). The EU long has been a major supplier of sugar to the world market and a contributor to longstanding low market prices. While the reform does not alter the structure of the EU production quota system, and quotas will not be tradable between countries, internal prices will be lowered by 36 percent. According to most analysts, these

program changes will result in some five million tons less sugar going onto the market each year, resulting in a significant boost in prices.

In fact, the EU could become a net importer, since its commitments to import sugar from its traditional suppliers could exceed its permitted (subsidized) exports. The EU also faces the prospect of potentially unlimited imports under the "Everything-But-Arms" (EBA) protocol, which permits a group of least developed countries duty and quota free access after 2009. The EU plans include compensation for traditional suppliers for the price cuts. But it is likely that many of these former colonies will reduce or cease sugar production, as has already occurred in St. Kitts.

Another major development in the world sugar market is the growing role of renewable fuels from sugarcane as petroleum prices continue to be record-high. This already is having a perceptible influence on the world sugar market and, as more and more sugar producing countries explore ethanol production, could have a considerable long-term impact.

Continuing pressure on world energy prices is expected to divert more sugarcane, chiefly Brazilian, into ethanol production, which would tend to boost sugar prices. While the world price is expected to remain below the current domestic support price, increasing demand for ethanol and firmer world prices could reduce the incentive to supply the U.S. market should our production again be adversely affected by weather or other factors.

In 2005, Brazil was the world's largest producer and exporter of both sugar and ethanol, with 18.5 percent of the world's sugar production and 37 percent of world sugar exports. Likewise, Brazil produces 36 percent of world fuel ethanol production and exports 47 percent of the world total. Brazil's current sugarcane crushing capacity of over 400 million tons at 347 mills is expected to expand by 105 million tons capacity (another 70 mills) within the next four years to meet future demands.

Trade Agreements/Market Access

The future prosperity of the domestic farm sector and food industry is highly contingent upon gaining greater access to more and more global consumers in growth markets. Recognition of this has spurred the pursuit of both multilateral and bilateral trade agreements to provide that access.

As the U.S. continues to seek expanded opportunities for our farmers and ranchers in the international markets through free trade agreements, trading partners in turn request increased access to the U.S. sugar market, especially as long as our domestic price substantially exceeds the world price.

The minimum import access required by U.S. trade commitments in 2002—under the WTO and in the North American Free Trade Agreement (NAFTA)—was 1.256 million tons. By 2008, U.S. total trade commitments could increase to 1.388 million tons [up to 120,000 tons attributed to the Central America-Dominican Republic Free Trade

Agreement (CAFTA-DR), and up to 12,000 tons attributed to the United States-Peru Trade Promotion Agreement (Peru TPA), assuming both are fully in force]. Any access for sugar under other free trade agreements that are under negotiation (Colombia, Thailand, SACU, etc.) would be additional. In addition, elimination of customs duties on Mexican sugar imports on January 1, 2008, as provided in the NAFTA, could mean increased imports in some years, as well.

Denial of further access to our sugar market very likely will lead to denial of access by our trading partners to some U.S. agricultural and food products, precluding a comprehensive agreement.

NAFTA Implementation

On January 1, 2008, full implementation of the NAFTA eliminates all customs duties for sweetener trade between Mexico and the United States. Market forces will determine adjustments in the sweetener production and processing sectors of both economies. The most immediate policy question, however, concerns the impact this will have on the ability of both countries to operate a sugar program that provides a premium market. Significant quantities of Mexican sugar coming into our market would mean exceeding the "import trigger" of 1.532 million short tons, suspension of marketing allotments, and likely considerable forfeitures and substantial program costs.

In the long run, relative costs of production, transportation and other market factors will determine where sugar crops are grown and processed following elimination of customs duties on sweeteners trade after January 1, 2008. Over time, prices for sweeteners in the United States and Mexico would be expected to equilibrate. If the loan program is left intact, market prices could fall below the forfeiture level, causing sugarcane and sugar beet processors to forfeit loan collateral to CCC and the U.S. sugar program to support the price of sugar to both U.S. and Mexican producers.

This likely would not be a politically acceptable outcome, thus suggesting that alternative approaches will need to be explored. One alternative the United States will not consider is any reopening or renegotiation of the NAFTA. As noted above, with respect to new trade agreements, any attempt to limit the long-agreed to access to our sugar market for Mexico will frustrate the expectations of our corn, bean and dairy farmers that have waited 14 years for the elimination of Mexico's barriers to their products

Conclusion

The formulation of a sustainable safety net for American sugarcane and sugar beet producers in the future must consider the challenges presented by the rapidly changing domestic and international environment. Sugar program administration has become increasingly difficult within the past year and is not expected to get any easier. Direct federal management of the nation's sugar supply has always been a difficult proposition at best. The development of an appropriate policy for 2008 market conditions and beyond will require foresight and innovative thinking.

Chart 1

U.S. and World Sugar Prices