

**Grain SA/Graan SA**

Office of the Chief Executive Officer/Kantoor van die Uitvoerende Hoofbestuurder

PO Box/Posbus 74087

Lynnwood Ridge/Lynnwoodrif 0040

Tel: +27 086 004 7246, Fax/Faks +27 (12) 807-3166



## **MOTIVATION FOR CHANGES IN THE LOCATION DIFFERENTIAL SYSTEM APPLICABLE TO WHEAT PRODUCTION IN THE WESTERN CAPE PROVINCE**

### **1. Background**

Grain South Africa (Grain SA) is a voluntary association of grain producers established to represent the interests of its members. Prospective members apply for and subscribe to membership and all members pay an annual membership fee. Members are organised into regions for which representatives are elected annually. Grain SA strives to be involved in all matters bearing on the wellbeing of the industry and to be consulted about policy issues relating to the industry. Grain SA is strongly apolitical and issues are dealt with on merit only and sound business principles without any party political consideration. Grain SA is run by producers for producers and structured to ensure members' democratic control over their elected office bearers. Policy decisions are taken democratically during congresses.

During the Grain SA congress held in 2006, members voted in favour of Grain SA management requesting the JSE and whoever else deemed necessary, to abolish the location differentials throughout the country. This mandate was reconfirmed several times over since that decision.

### **2. Demarcations of the motivation**

Grain SA submits this request with the following demarcations of the motivation.

2.1 The Commodity Derivatives Market provide a platform for price discovery and efficient price risk management and it is of utmost importance to Grain SA that this market functions efficiently to provide market participants with the ability to manage their price risk in the underlying physical market.

2.2 This motivation is aimed at the wheat marketing year of 2014/15 and beyond and involves the future contracts for wheat and the Western Cape Province (Swartland region and Southern Cape region (Ruens)).

2.3 Members of Grain SA in the winter rainfall production area adhere to the official mandate of Grain SA since 2006 which is that the differential system should discontinue.

2.4 Minority views of members were considered in Grain SA's democratic process in formulating our policies and viewpoints.

2.5 The impact of the removal of the differential system as requested needs to be evaluated after a period of two marketing years by an impartial party. The purpose is to evaluate the positive and negative outcomes of the request if accepted fully or partially and to implement corrective actions if needed. The corrective actions may include the reinstatement of differentials if needed.

2.6 The JSE make the final decision with respect to the requests in this motivation after consultation with the Advisory Committee, affected role players, the Financial Services Board and in consideration of any relevant South African legislation regarding competitiveness and commodity markets.

2.7 After removal of the differential system in the winter rainfall region, new initiatives in the free market are expected to replace the void created by the removal of the differential system with alternative and more acceptable solutions for price discovery and price information in the cash market.

2.8 It is acknowledged that the JSE is a highly successful profit driven company listed on the JSE and that the continuation and extent of the differential system may or may not be to the commercial interest of the JSE. It is accepted that the JSE exercises the necessary caution to sustain objectivity in this matter under supervision of the Financial Services Board.

2.9 Grain SA accepts that the final decision is vested in the JSE and that the advice of the Advisory Committee (either majority or minority) is subject to the JSE's final decision.

## **2. REQUEST: WHEAT CONTRACT 2014/15 AND BEYOND**

*Grain SA requests that the location differential between the points of delivery in the Western Cape and the Randfontein reference point should be discontinued. Secondly, the points of delivery in the Western Cape for the Randfontein reference point should also be deregistered. Thirdly, the location differentials between the point of delivery in the Western Cape and the Paarl reference point should be discontinued. Lastly, that the Paarl reference point is replaced by Cape Town (Harbour) as the reference point.*

The stated requests are motivated as follows and Grain SA proposes the following on behalf of producers in the winter rainfall region.

*2.1. The location differential between the points of delivery in the Western Cape and the Randfontein reference point should be discontinued.*

The daily supply and demand for long distance transport should determine the derived prices of wheat at the different Western Cape delivery points aimed for the consumer at Randfontein or somewhere else. The current differential distorts pre-season and other contract prices and decreases competitiveness and transparency in the cash market. Market role players including millers, traders and financiers rely on the differential to indicate the expected net producer prices.

### *2.1.1 Negative impact on the futures contract*

- The differential increases the risk of loss of volumes traded, loss of volatility and inactivity of the contract if determined incorrect. This almost always happen since the fundamental factors determining the supply and demand and cost of transport changes continuously during the 12 month period. During the past marketing year the very same location differential impacted on the volume traded for the wheat contract due to the fact that the location differential was announced too low at the beginning of the marketing year. When the location differentials are too low it is an opportunity for producers to deliver wheat on the JSE because the differential incentivises them to do so. On the other hand traders and end-users run the risk to pay too high a price that cannot be met by the physical transports costs which is higher than the published location differential. As a result volumes traded may decline together with a loss in open interest, volatility and a less sufficient contract.

### 2.1.2 Negative impact on cash flow of producers

- The location differential impacts directly on the price discovery of wheat and expected cash flow of producers in the cash market just before its announcement in September before harvesting.
- The location differential (determined annually) is with the exception of the diesel price (determined monthly), the main administered cost to be taken into account in the profitability of wheat production in the Western Cape Province. All the other costs such as fertilizer, chemicals, seed, reparations, crop insurance and other costs are affected by factors of supply and demand on a daily basis in the free market environment. The extent of the location differential compared to these cost items is shown in Figure 1 & 2.

**Note:** Futures prices may not increase to this extent at the delivery points in the Western Cape after the discontinuation of the differential but more importantly it is expected that the efficiency of the Cape contract and the differentiation of Cape wheat will improve in the market place. The same underlying fundamental factors of supply and demand and arbitrage opportunities between the Randfontein and Western Cape reference point will still exist but offers to producers will not be subjected to a Randfontein based administered differential.

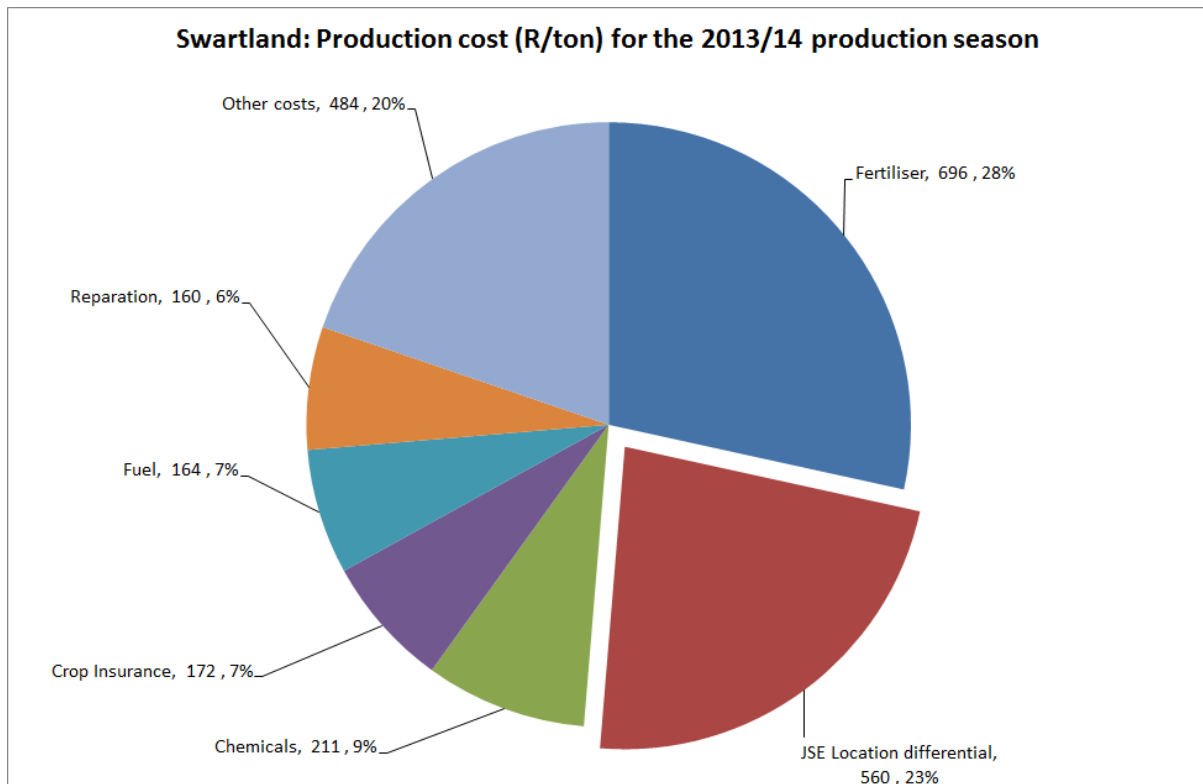


Figure 1: Swartland: Production cost (R/ton) for the 2013/14 production season

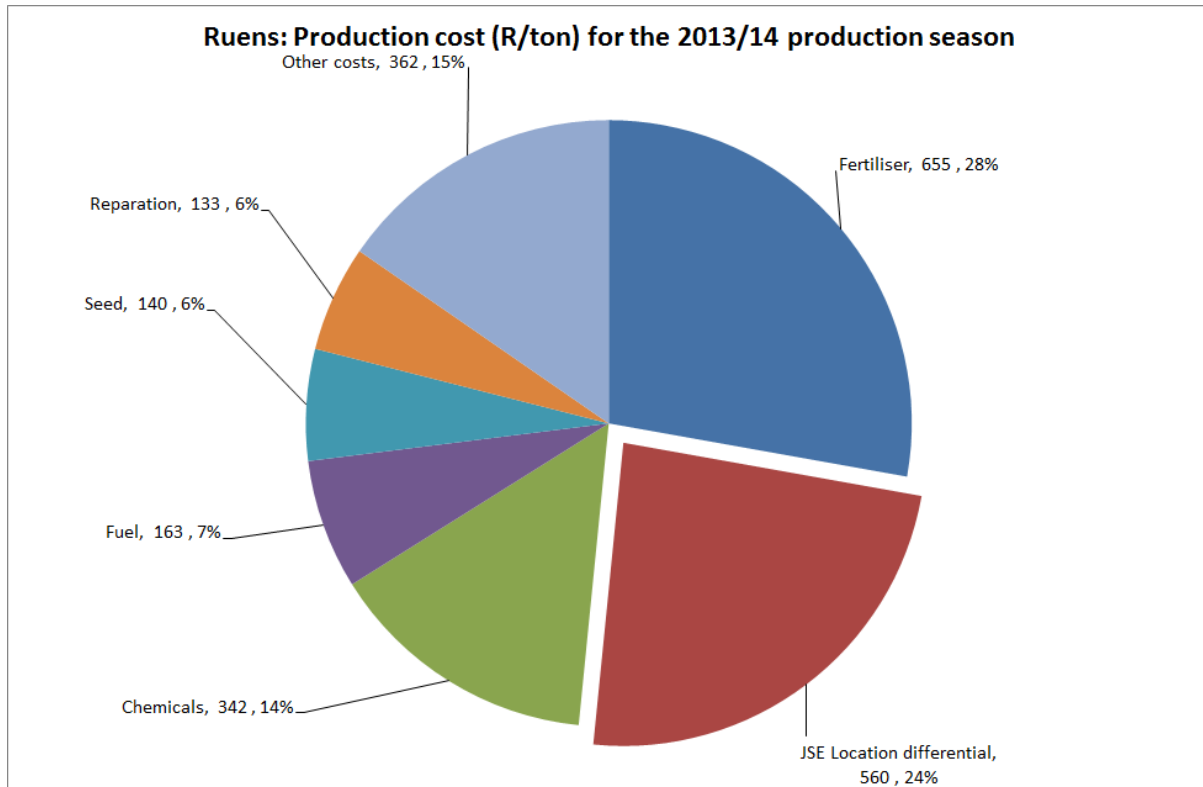


Figure 2: Southern Cape (Ruens): Production cost (R/ton) for the 2013/14 production season

### 2.1.3 Limits transparency in cash market prices

- The differential system is majorly directional to the derived net producer wheat cash market and pre-season prices at the delivery points for the Paarl contract. The differential is an important but undesired component which is used extensively in contracting net producer prices with producers by millers and buyers of wheat.
- The free market system is partially bound by this phenomenon and is undesired by producers who accepts price risk and who desires a functional free market with minimum intervention.
- The futures market is leading the cash market in South Africa while a mature cash market leads the futures market values in the USA. The differentials on the futures market supports this phenomenon and limits the development of the cash market in South Africa to lead prices in the market place.

### 2.1.4 Adverse to the supply and demand factors of transport and changes in basis

- The cost of rail and road transport fluctuates on a daily basis but the differential system does not account for the impact of changes in the basis rendering it impossible for producers to share in the opportunities presented by changes in the basis. These opportunities are captured by traders and are seldom passed on to producers.
- Annually the differentials are announced just before harvest thus impacting negatively on the expected cash flow of wheat producers. This year the increase in the wheat differentials between the Western Cape and the Randfontein reference point amounts to 33% compared to the year on year price of diesel which increased by 21% only.
- The previous value of the location differential was determined as R420/ton indicating a sufficient supply of road transport to justify lower transport costs. A year later the situation changed with the demand of long distance bulk transport to Namibia and Zimbabwe tightening, resulting in higher than normal increases in the domestic demand for long distance transport.

- Crude oil prices increased and the exchange rate weakened resulting in higher than expected transport costs.
- It is also important to note that the difference between the prices of the Randfontein contract and the Paarl contract is only about R460/ton instead of the R560/ton published by the JSE. It is expected that by the time that the new announcement on differentials are made that the difference between the Randfontein and Paarl wheat contract prices should match the new differential. Figure 3 indicates that this is not the case as expected which results in animosity about the reflection of the announced differentials compared to the difference between the Randfontein and Paarl reference points.

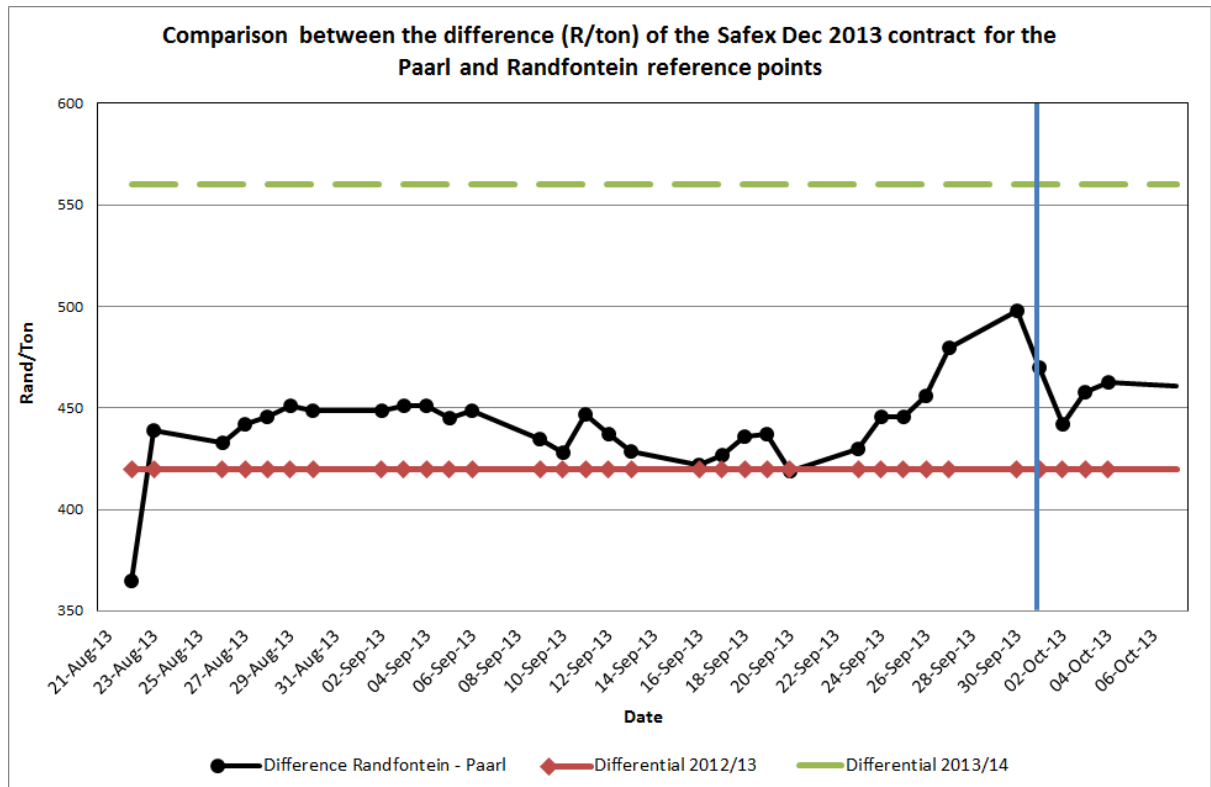


Figure 3: The published location differential compared to the difference in price between the Paarl and Randfontein contract (Source: Grain SA, 2013)

- The volume of wheat transported by rail between Paarl and Randfontein is minimal and the quote by Transnet Freight Rail is R609/ton which is higher than the differential of R560/ton. It is expected that the cost of rail should be more economical than road transport. Differences in the % out loading of wheat on rail and road may not be a true reflection of changing outloading percentages at the different delivery points during the course of the new marketing year.
- The return load factor used in the formula is disputable as the return loads on long distance freights especially between the Western Cape Province and Randfontein is very difficult to determine accurately and it may also be subject to seasonal changes in the demand for road transport.

#### 2.1.5 Objectivity of the JSE

- The extent of an efficient differential system is of commercial importance to the JSE (and other roleplayers) in the market as it facilitates trade and trade volumes and therefore ties to annual turnover achieved.

- The JSE announces the location differentials annually and the very fact that the JSE is listed on its own exchange renders the JSE as being potentially subjective on matters like these. The JSE is therefore an important market player and it is in the JSE's commercial interest that the location differentials to be announced, reflects reality.

#### 2.1.6 Financing of wheat production in the winter rainfall region

- The variability of the Safex wheat price in relation to the exchange rate and FOB-prices is less than the case is for maize prices. Maize prices fluctuate according to supply and demand between import and export parity while wheat tends to stay near import parity because South Africa is a net wheat importing country. The view that the location differentials are needed because it creates more certainty on the net producer prices of wheat and therefore the financing of production may be less true for wheat producers than for maize producers.

#### 2.1.7 Wheat quality and regional supply and demand

- The annually announced fixed differential that support the delivery of wheat on the Randfontein contract does not reflect the dynamism of the regional fundamental supply and demand factors for wheat and desired wheat quality at delivery points. This may change within days in the Western Cape production areas (Figure 4 & 5).

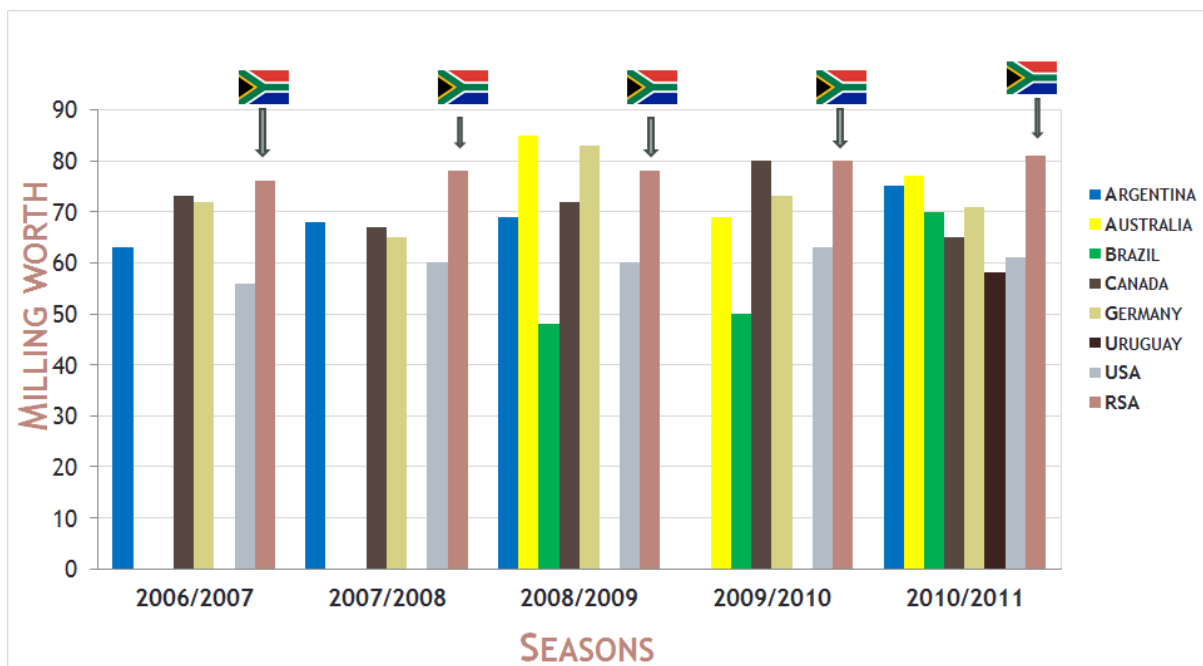


Figure 4: Milling worth values of imported wheat as well as RSA wheat over five seasons (Source: SAGL, 2013)

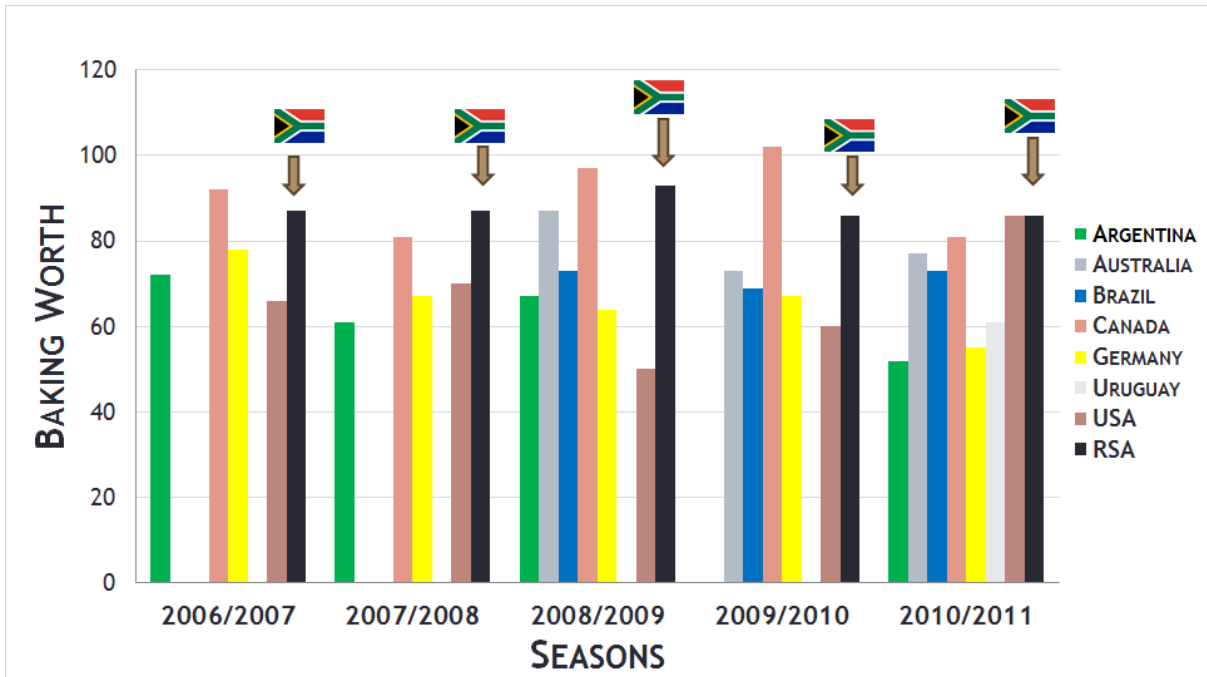


Figure 5: Baking worth values of imported wheat as well as RSA wheat over five seasons (Source: SAGL, 2013)

### 2.1.8 Importance of Western Cape Province increase as share in production area and production increase

- The share of the area planted and production of wheat in the dry land production areas of the Free State and other areas declines while the production in Western Cape sustain their levels of area planted and increased production justifying a more efficient and supported wheat contract in the Western Cape (Figure 6 & 7).

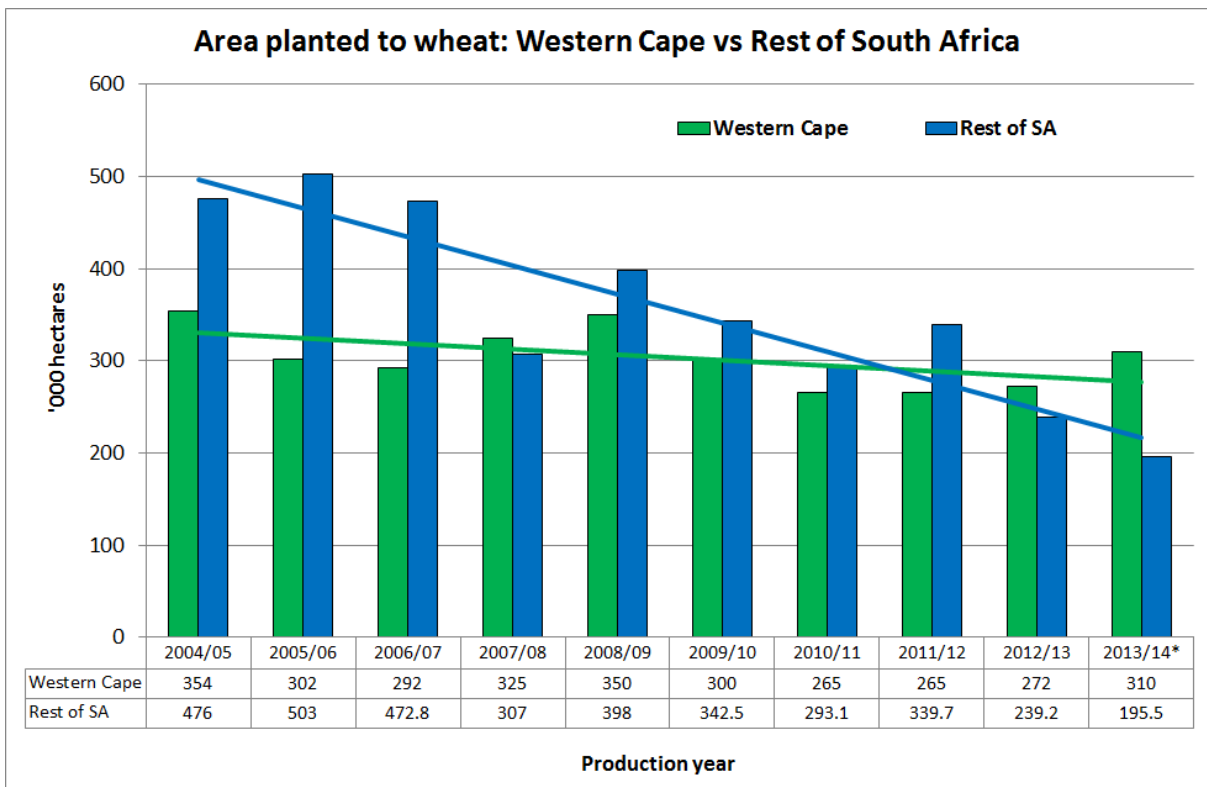


Figure 6: Area planted to wheat: Western Cape vs rest of South Africa

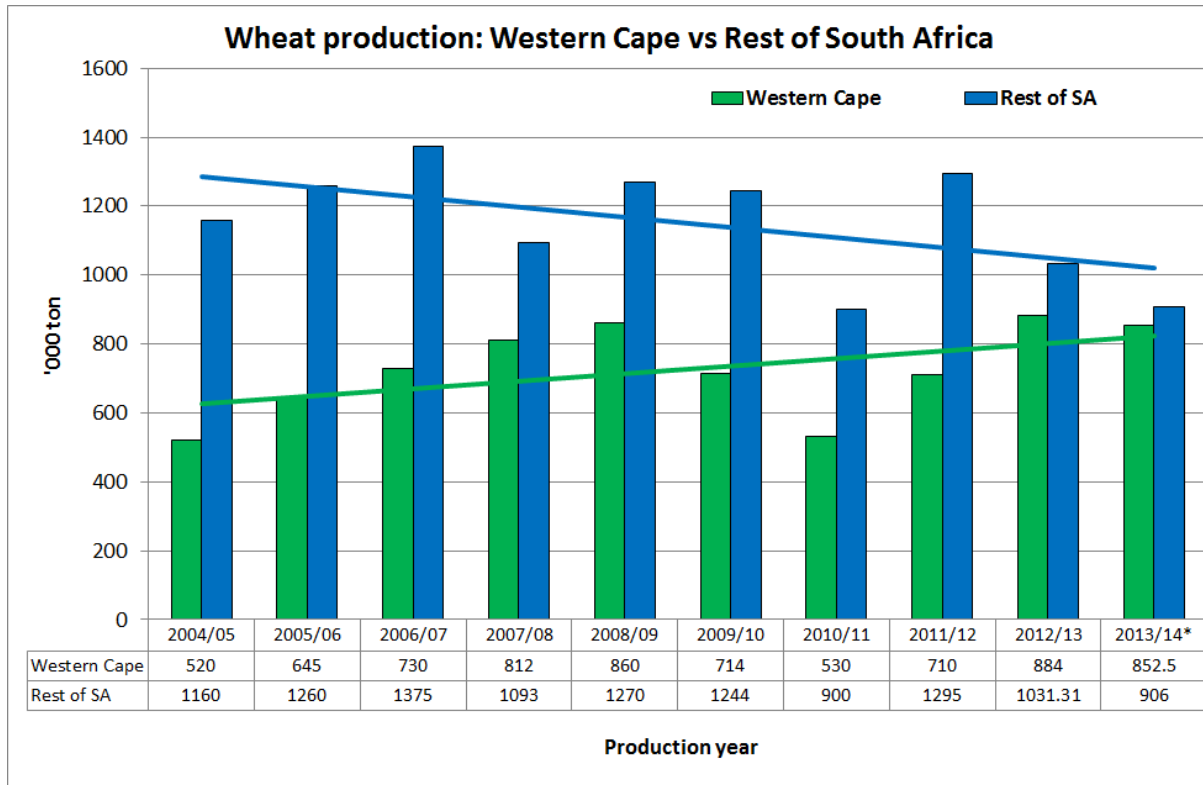


Figure 7: Wheat production: Western Cape vs rest of South Africa

**2.2 The points of delivery in the Western Cape for the Randfontein reference point should be discontinued.**

Thus, the delivery of wheat from the different delivery points in the Western Cape should not be allowed for the Randfontein reference point. The delivery of wheat in the Western Cape should only be possible at the Paarl reference point. Increased participation and liquidity is expected for the Paarl reference point.

This will be necessary for three reasons:

- To stimulate the liquidity of the Cape contract
- To enable the difference between the Cape contract price and the Randfontein price to reflect the true free market discount between, as it will differ over the season.
- The Western Cape regional supply and demand will then automatically reflect in the price difference including differences in production conditions.

**2.3 The location differentials between the delivery points in the Western Cape and the Paarl reference point should be discontinued.**

The daily supply and demand for shorter distance transport should determine the derived prices of wheat at the different Western Cape delivery points aimed for the consumer at Paarl or somewhere else. The current differential distorts pre-season and other contract prices and decreases competitiveness and transparency in the cash market. Market role players including millers, traders and financiers rely on the differential to indicate the expected net producer prices. This is for the same reasons as listed under point 2.1

**2.4 The Paarl reference point needs to move to Cape Town.**

This request follows in case the discontinuation of location differentials between delivery points in the Western Cape and the Paarl reference point in the Western Cape is not approved by the JSE.



Malmesbury is a main consumption area for wheat but wheat is produced throughout the Western Cape and this is needed for the consideration of the reference point.

- As the milling activities in Paarl moves from Paarl to Malmesbury Cape Town will be a more ideal reference point and fair to all role players in the market.
- Since the Western Cape nowadays imports more than 135 000 tons of wheat (SAGIS,2013) annually it means local wheat competes with imported wheat. Import parity comparisons based in Cape Town harbour is simplistic to calculate, easy to understand and transparent.

According to the CEC the Western Cape produced 530 000 tons of wheat in 2010/11. SAGIS reported that the Western Cape Province processed 498 195 tons of wheat and imported 137 637 tons of wheat. The % of the wheat crop processed in the province aims at 81% for 2010/11.

During 2011/12 the Western Cape produced 710 000 tons of wheat. A number of 676 709 tons were processed in the Western Cape which equals 75% of production. The Western Cape imported 135 640 tons of wheat in 2011/12.

Therefore, the Western Cape imports of wheat as percentage to produced varied between 19% and 25% and should be enough to justify the Cape Town Harbour as a valid reference point.

**Note:** Principle: The removal of location differentials renders the need for a reference point obsolete. Similar to the soybean contract, the factors of supply and demand including those related to imported wheat and Cape wheat destined for export during years of surplus will determine the price of the Cape futures contract. This price will not be associated with any delivery point in the production area or centre of consumption but will purely be determined by supply and demand. As soon as this is implemented the price of the Cape contract will be priced lower in the market in order to accommodate the potential distances between the different delivery points from where wheat can be allocated and the main centres of consumption in the Cape. Cash market prices is expected to remain intact. Actual transport costs will play a part in the newly discovered futures price. Information and knowledge on transport cost and cash market prices as well as historical basis information will then in future be important for pricing decisions.

## Conclusion

The straining impact of the location differentials on the full development of the free cash market in the Western Cape Province is not acceptable to Grain SA. The differentials are a non-statutory announced intervention by the JSE supported by stakeholders in the industry without consensus by all stakeholders in the industry. Producers are for one opposed to the differential system while other role-players in the market seem to be unaffected and indifferent by the impact that the discontinuation or continuation of the differential system will have on their own businesses. However, these influential members of the supply chain still reserve the unqualified position to take authorisation on the concern of producers.

The differential system, as practised by the JSE, impacts negatively on the full development of the free market (physical (forward and cash market) and also limit competition and price discovery. The price of wheat at a specific delivery point relates to a number of factors and not only to the annually announced location differential or transport costs. These factors include quality differences, locality, volumes available and in demand, import substitution and many other factors.

The proposals as set out above will also increase the liquidity of the Cape-wheat contract. It will also increase the overall usage of the wheat futures contract as a price risk management tool.

The free market environment will introduce market mechanisms to improve the transparency of forward and cash market and transport prices.