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LMC INTERNATIONAL

EU Sugar Reform

The LDC Proposal —

The Development Dimensions

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EU Sugar Reform: The LDC Proposal — The Development Dimensions

Under the Everything But Arms (EBA) initiative, the Least Developed Countries (LDCs) are scheduled to receive enhanced access for their sugar exports to the EU market, culminating in unlimited duty-free access from July 1st 2009. However, this concession looks set to coincide with reform of the EU sugar regime, which is expected to lead to significant price reductions in the EU market. The LDCs perceive a substantial reduction in the EU sugar price to be a severe impediment to the development potential of the EBA initiative. Moreover, such a reduction is also expected to pose a significant threat to the EU sugar industry, as well as the ACP sugar industries, many of which depend on the high price in the EU for their survival.

Therefore, in a bid to keep the price reduction to a minimum over the medium term, the LDC Sugar Group have put forward a proposal to the European Commission advocating the maintenance of an orderly market in the EU. Under the LDC proposal, access to the EU market would increase to 1.62 million tonnes per annum in return for remunerative sugar prices during an extended transition period. This measure is designed to reduce significantly the adverse consequences of a fall in prices in the EU on the LDCs.

KEY DEVELOPMENTAL BENEFITS OF LDC REFORM PROPOSAL

This study assesses: (a) the social development impact and (b) the economic development impact of the LDC proposal for the LDC sugar industries relative to the impact of the proposal made by the European Commission. These are described below. If the LDC proposal were to be adopted, the key benefits to LDCs, relative to the Commission's July 2004 proposal, are:

Social Development Impact:

- Increase in formal employment of 120,000-145,000 people, with multiplier effects extending into considerable indirect employment gains.
- Increased health, education and social welfare provision for workforce and their dependents.

Economic Development Impact:

- Increased investment of up to US\$775 million.
- Increased annual sugar production of up to 1.0 million tonnes.
- Increased export earnings of €300-€400 million per annum.
- Increased industry revenues of €300-€400 million per year.

The benefits of the LDC proposal do not extend just to LDC suppliers themselves. The LDC proposal has also received the strong support of the EU beet processing industry and the ACP group of producers.

THE POLICY REFORM OPTIONS

Because of the uncertainty that surrounds the outcome of EU policy reform, we have evaluated the LDC proposal and two versions of the July 2004 proposal from the Commission, against a benchmark (the Equilibrium Reform Option):

- **Benchmark: The Equilibrium Reform Option.** This reform option is a price-based solution, and is included in our analysis as a benchmark to be used for comparative purposes. From 2008, we assume that the quota system in the EU is abolished (for both sugar and isoglucose), and EU, ACP, LDC and West Balkan countries are granted free access to the EU sweetener market. The price in the EU would fall to around €400 per tonne of white sugar, and €305 per tonne of raw sugar (as explained in Chapter 4). An external tariff would be employed in order to prevent world market sugar from entering the market at a lower price.
- **The LDC Proposal.** As proposed by the LDC Group, LDC imports into the EU are assumed to be limited to 1.62 million tonnes, and are divided into two streams:
 - A first stream, which represents the current quota allocation, totalled 113,000 tonnes in 2003/04. This rises to 197,000 tonnes in 2008/09, and would be fixed thereafter.
 - A second stream, increasing by 15% per annum from a base of 466,000 tonnes in 2004/05 to 1.4 million tonnes in 2012/13. This will take the total quota allocation to around 1.62 million tonnes in 2012/13.

Even if the EU Commission opts to adopt the LDC proposal, prices in the EU will have to be cut, probably quite severely. This is due to pressures on the current tariffs resulting from the ongoing WTO Doha Round of trade negotiations. We have assumed that the EU intervention price would have to be cut by 20% from €631.9 per tonne to €505 per tonne. This price cut is based on the most likely scenario for WTO commitments following completion of the Doha Round, and assumes tariff reductions of 36%, with safeguard duties retained. Assuming that the raw sugar intervention price is cut by the same percentage, and that the refining aid is abolished, the raw sugar price would fall to €398 per tonne.

- **The July 2004 Proposal.** In this scenario, we have assumed that sugar prices decline to €421 per tonne and €329 per tonne for white and raw sugar, respectively by 2007, as proposed by the European Commission. However, the Commission propose a further review in 2008, after which the future course of prices is unclear. To take account of this, we have considered two possible outcomes:
 - *The price cut is maintained after 2008.* Prices are maintained at their 2007 level of €421 per tonne and €329 per tonne for white and raw sugar, respectively.
 - *A further price reduction after 2008.* In this scenario, prices fall further to their equilibrium level (explained above) of €400 per tonne of white sugar (€305 per tonne of raw sugar).

THE DEVELOPMENT POTENTIAL FOR LDCS

The welfare impact of these reform options on the LDCs will be manifested in many forms, with the LDC proposal providing the greatest benefits in terms of industry

revenue, export earnings, and perhaps most importantly, an increase in the number of people employed in LDC industries. This will impact positively on poverty alleviation, rural development and social welfare. In the following pages, we focus on the projected impact on:

- Key socio-economic indicators
- Investment levels
- Implied future production levels
- EU supply

1. Socio-Economic Indicators

Table 1 summarises the impact of the LDC proposal by demonstrating the additional contribution it is projected to make to three key indicators compared with the contribution under the two possible outcomes of the July 2004 proposal after 2008, based on a 10% rate of return.

Table 1: Impact of the LDC Proposal Relative to the July 2004 Proposal

	← July 2004 (Price Cut Maintained) →			← July 2004 (Further Price Reduction) →		
	Industry Revenue (€ millions)	Export Earnings (€ millions)	Total Employment (‘000 workers)	Industry Revenue (€ millions)	Export Earnings (€ millions)	Total Employment (‘000 workers)
IRR = 10%						
Congo DR	1	1	0	1	1	0
Ethiopia	-1	-1	0	77	77	23
Madagascar	2	2	0	2	2	0
Malawi	124	124	22	131	131	24
Mozambique	5	5	0	7	7	0
Nepal	21	13	73	21	13	73
Sudan	29	29	0	47	47	0
Tanzania	110	110	26	110	110	26
Zambia	3	3	0	6	6	0
Others	0	0	0	0	0	0
Total	293	285	122	399	392	146

Note: 1. Under the 10% IRR, Ethiopia would supply more sugar under the July 2004 proposal (assuming the price cut proposed by the Commission is maintained) than it would be allowed by its projected quota allocation. This more than compensates for the lower price that would be received in this scenario.

- The LDC proposal could boost the industry revenue of LDC sugar industries by almost €300 million per annum compared to the July 2004 proposal (assuming the proposed price reduction is maintained). This could be as much as €400 million per annum if prices fall further after 2008.
- Similarly, export earnings are projected to be almost €300 million higher under the LDC proposal than under the July 2004 proposal. If prices are reduced further this figure could rise to €400 million.
- In terms of direct employment, the LDC proposal is projected to create between 120,000 to 145,000 more jobs than the July 2004 proposal.

- The multiplier effects of increased direct employment and earnings will have further benefits on indirect employment and on the social welfare of workers, via education, health care provision and social provisions.

2. Investment Levels

The future level of investment in LDCs will be a key determinant of the quantity of sugar that will be supplied to the EU over the next decade. To assess this, we have examined the future incentives for each sugar industry to expand their production levels over the next decade. We have conducted our analysis based on two rates of return. These are:

- An internal rate of return (IRR) of 10% (reflecting an economic rate of return)
- An internal rate of return of 20% (reflecting a financial rate of return)

The required rate of return has a critical bearing on the outcome of the analysis. When evaluating the viability of potential investments, investors require a rate of return that reflects the level of risk associated with individual projects. Given the financial and political risks associated with investing in most LDCs investors, investors typically require far higher rates of return than in other markets. Investors concerns are amplified by the fragility of domestic and regional markets, which are often difficult to protect in the face of unpredictable tariff policy, the uncertainties associated with the granting of import licences, and informal trade flows. For this reason, knowledge that they have access to stable and secure markets, such as the EU, even if it is only for limited volumes as requested in the LDC proposal, provides some assurance to investors and their financiers, and acts to lower the rate of return that they require to commit funds to projects.

Thus, the adoption of the LDC proposal could be expected to encourage investors to commit funds to projects within LDCs with a reduced rate of return. Table 2 presents a summary of the investment levels that are projected over the next decade under each reform option compared to our base case scenario (the Equilibrium reform option).

Table 2: Summary of the Projected Investment in LDCs (US\$ millions)

	Equilibrium	LDC Proposal	July 2004 Proposal (Price Cut Maintained)	July 2004 Proposal (Further Price Reduction)
IRR = 10%				
Total	1,521	+775	+271	+0
IRR = 20%				
Total	869	+165	+25	+0

Important points to note are:

- The LDC proposal has a notable positive impact on future investment levels in the LDCs.
- Assuming investments are made on the basis of a 10% rate of return, the adoption of the LDC proposal would lead to around US\$775 million of additional investment compared to the level of investment that would take place if the prices are reduced to their equilibrium level, and US\$500 million more than under the July 2004 proposal, assuming that prices are not cut further after 2008.

- If prices decline further to their equilibrium level after the review in 2008, the July 2004 proposal would not create any additional investment in LDCs when compared to the equilibrium reform option.
- If investors are willing to accept a 10% rate of return under the LDC proposal, against a 20% IRR requirement for the July 2004 proposal, the additional investment generated in LDCs would be over US\$1.4 billion.
- The LDC proposal provides full price stability during the time frame of the study, while the July 2004 proposal (regardless of whether prices are maintained or reduced after 2008) does not. The levels of investment projected in the scenario where the price cuts proposed under the July 2004 proposal are maintained after 2008 could overestimate the investment impact of this proposal, as they imply that prices will be stable. In reality, until there is clarity regarding the course prices after 2008, investors are likely to be unwilling to commit to major investments under the July 2004 proposal.
- The bulk of the investment made under the Equilibrium reform option is to meet demand in domestic and regional markets, rather than due to greater access to the EU market.

3. Implied Future Production Levels

Table 3 presents the impact of the investments presented in Table 2 on the level of sugar production in LDCs.

Table 3: Summary of Current and Future LDC Production Levels
(‘000 tonnes, raw value)

	Equilibrium	LDC Proposal	July 2004 Proposal (Price Cut Maintained)	July 2004 Proposal (Further Price Reduction)
Production (IRR = 10%)	5,182	+1,033	+284	+0
Production (IRR = 20%)	4,504	+193	+28	+0

- Under the LDC proposal, investors are more likely to accept a 10% return. Under this scenario, production levels could rise by more than one million tonnes when compared to the Equilibrium reform option, to 6.2 million tonnes from the current 2.8 million tonnes.
- Under the July 2004 proposal, investors are more likely to require a 20% return. Assuming the proposed price reduction is maintained, the increase in production when compared to our base case is less than one third of the increase projected under the LDC proposal.

4. EU Supply

The LDC supply response to the granting of enhanced access to the EU market can come from three principal sources:

- The diversion of existing world and regional market sales
- The diversion of domestic market sales

- The expansion of sugar production

The implications of these future production levels for the EU market are summarised in Table 4, which presents projected levels of LDC supply to the EU market under each policy option compared to our base case scenario, again based on an IRR of 10% and 20%.

Table 4: Future LDC Supply to the EU Market in 2015 ('000 tonnes, raw value)

	Equilibrium	LDC Proposal	July 2004 Proposal (Price Cut Maintained)	July 2004 Proposal (Further Price Reduction)
IRR = 10%				
LDC Total	742	+881	+345	+0
IRR = 20%				
LDC Total	535	+1,088	+88	+0

- Under the Equilibrium reform option and the July 2004 proposal, we estimate that LDC supply to the EU market would be limited to around one million tonnes or less in 2015.
- Under the LDC proposal, the LDCs would be willing to supply over 1.6 million tonnes under both IRR assumptions.

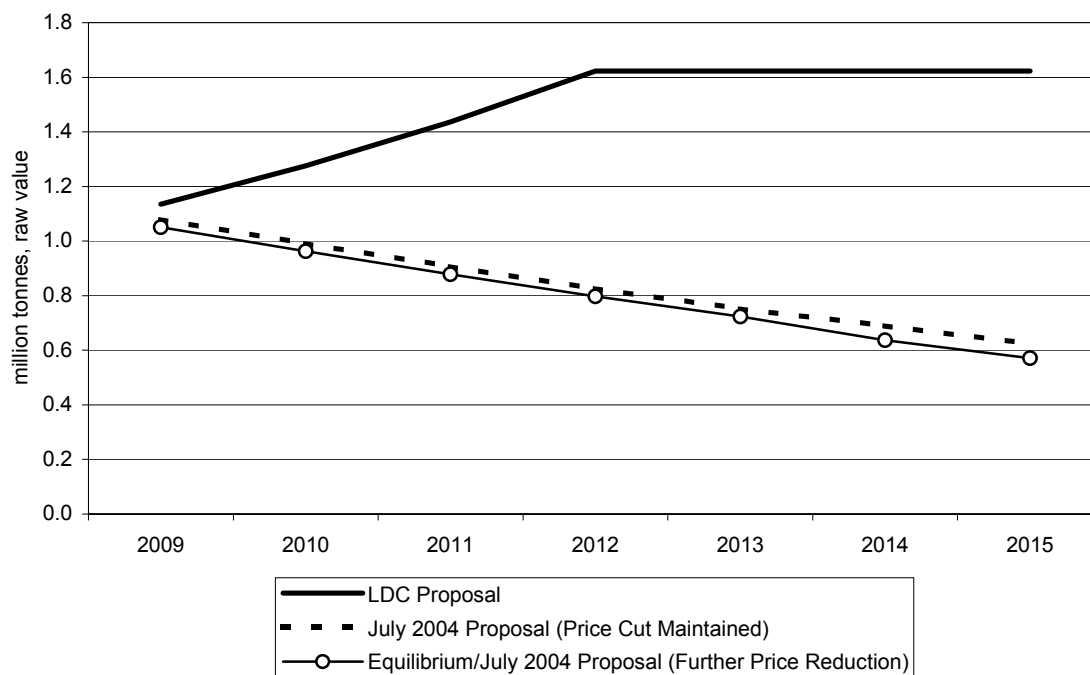
So far, the analysis in this chapter has looked at the incentive for the LDCs to supply sugar to the EU in 2015. However, it would be wrong to assume that the quantity of LDC sugar sold to the EU will be static over time. In reality, movements in LDC sugar supply will be dependent on two factors:

- The timing of any investment.
- The future growth expected in domestic and regional markets.

For the purposes of our analysis, we have assumed that investment in all scenarios takes place prior to the granting of unlimited access (under the July 2004 proposal) in 2009, thereby allowing investors to capture fully the benefits accruing from EU access. Diagram 1 presents the projected evolution of EU supply over the next decade on the basis of a 20% internal rate of return.

- The diagram highlights the increased supply of sugar (and, therefore, development potential) that would be stimulated by the LDC proposal.
- One of the key benefits of the EBA agreement is the stimulus that it provides to current investment in the LDCs, in order to have capacity in place to reap the benefits of future access. In the future, this capacity may be used to supply growth in the domestic sugar market. The level of LDC supply is projected to fall over time under the larger price cuts associated with these reform options. This is because, at this level of price reduction, domestic market prices in the LDCs are almost always more attractive than the EU market. Consequently, as domestic markets grow, increasing amounts of sugar are diverted away from the EU towards the domestic markets.

Diagram 1: LDC Supply to the EU Market, 2009-2015 (Assuming IRR = 20%)



THE IMPACT ON EU SUGAR PRODUCERS

Table 5 lists the EU beet sugar producers that are expected to remain operational, on a full cost basis, under each reform option.

- By maintaining prices at a higher level, and maintaining a managed market, the LDC proposal offers many EU beet sugar producers the possibility to continue production. Indeed, our results show that, with the exception of Finland and Italy, all the major EU producers would be able to maintain production with a 20% reduction in prices.

Table 5: Future EU-25 Beet Sugar Producers, Basis Full Costs

← LDC Proposal →		July 2004 Proposal (Price Cut Maintained)	July 2004 Proposal (Further Price Reduction)	Equilibrium
Austria	Sweden	Austria	Austria	Austria
Belgium	United Kingdom	Denmark	Denmark	Denmark
Denmark	Czech Republic	France	France	France
France	Hungary	Germany	Isoglucose	Isoglucose
Germany	Poland	Portugal	Sweden	Sweden
Greece	Latvia	Sweden	UK	UK
Ireland	Lithuania	UK		
Netherlands	Slovakia	Czech Republic		
Portugal	Slovenia	Hungary		
Spain				

- Under the July 2004 proposal, only nine industries would be able to cover their full costs of production, with many industries having to operate on a cash cost basis in order to survive. In an environment of quota transferability, this should lead to a shift in production towards a small number of lower cost producers.
- Under the July 2004 proposal with a further reduction in prices, there is the potential for isoglucose (in a quota-free environment) to erode significantly the share of the EU sweetener market held by the EU beet sugar producers. On a full cost basis, only a handful of industries are projected to survive.

THE IMPACT ON ACP COUNTRIES

Much as the LDC proposal will maintain beet industries across most of the EU, so will it maintain sugar supplies from a wider range of producers among the ACP group of countries. Table 6 presents the ACP countries that would supply the EU in future under the three reform options.

The table reveals that seven industries will be able to maintain production under the LDC reform proposal, while only three will continue supplying sugar under the July 2004 proposal with further price reduction. Moreover, a key issue that will need to be addressed for the ACP access arrangement in future is the possible reallocation of quota from countries that cease production. If total quota were to be maintained at current levels, and this quota were to be re-allocated among the seven producers listed in Table 6, these low cost sugar producers would benefit significantly from the LDC proposal.

Table 6: Future Non-LDC ACP Suppliers to the EU Market, Basis Full Costs

LDC Proposal	July 2004 Proposal (Price Cut Maintained)	July 2004 Proposal (Further Price Reduction)	Equilibrium
Belize	Belize	Guyana	Guyana
Congo	Fiji	Swaziland	Swaziland
Fiji	Guyana	Zimbabwe	Zimbabwe
Guyana	Mauritius		
Mauritius	Swaziland		
Swaziland	Zimbabwe		
Zimbabwe			

KEY CONCLUSIONS

- Our analysis indicates that LDCs, both for the group as a whole, and each individual country, would be better off with a transitional arrangement where prices are maintained at a higher level, in terms of investment level, industry revenue and export earnings.
- The adoption of the LDC proposal would help to encourage the future development of LDC sugar industries by:
 - Encouraging sustainable investment, with considerable financial and welfare returns for LDCs.

- Creating price stability until at least 2015, thereby providing an investment perspective to investors and financiers that is not provided by the July 2004 proposal (which creates price uncertainty after 2008).
 - Providing the opportunity for the EU to introduce a clear schedule for the reduction of prices in the EU market beyond 2008.
 - Providing LDCs with an attractive, secure market in which to sell their sugar, allowing them to develop their industries in advance of growth in their domestic/regional markets.
- The LDC proposal would stimulate investments at lower rates of return than the alternative reform options. This is because knowledge that they have access to the EU market at stable and remunerative prices for a part of their output, would offset some of the risks associated with supplying often fragile domestic and regional markets.