EU Sugar Producers and Financial Market Regulation

Presentation to the Expert Group on agricultural commodity derivatives and spot markets
3rd October 2013

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Overview

• Introduction
  • About CEFS
  • About Südzucker
  • About Sugar

• Sugar Markets
  • The World Market of Sugar
  • The EU Sugar Market
  • Futures Markets for Sugar

• Financial Market Regulation
  • Risk Management
  • Applications of Financial Instruments
  • Implications of Regulation
CEFS represents the activities of European sugar manufacturers and refiners (approx 60 companies across 20 Member States).

Beet sugar is produced in 19 Member States by 109 factories (supporting 180,000 indirect and direct jobs and 170,000 beet growers).

European produced sugar guarantees secure sugar supplies at reasonable prices for European consumers.
About Südzucker Group

- Sugar beet growers are major shareholders
- 17,900 employees
- € 7.9 billion annual revenues
- Sugar production: 4.9 million mt
- Leader in the European sugar market
- Member of the German MDAX
- More than 175 years of tradition
Südzucker Group: Segment Overview

**Sugar segment**
- 29 sugar factories and 3 refineries in the EU, Bosnia-Herzegovina, and Moldova

**Special products segment**
- BENEÔ
  - Functional food ingredients
  - Freiberger
    - Frozen & chilled Pizza
  - PortionPack Europe
  - Starch

**CropEnergies segment**
- Bioethanol
  - 4 production sites in Germany, UK, Belgium, and France

**Fruit segment**
- Fruit preparations
  - Fruit juice concentrates
  - 41 production sites worldwide
Worldwide sugar production is 175 M mt. 80% comes from sugar cane and 20% from sugar beets. White sugar produced from beet or cane is the same.

The predominant commodity traded on the world market is semi-finished cane based “raw sugar”.

About Sugar
Raw Material
The World Market of Sugar

World Sweetener Consumption
(Mmt of sugar equivalent)

Million metric tons

Year

2005

2010

2015

2020

Cane Sugar

Beet Sugar

HIS

HFCS
The World Market of Sugar

• Global sugar production about 175 M mt
• The largest sugar producers are
  • Brazil, India, EU, China, Thailand, USA, Mexico
• The largest sugar consumers are
  • India, EU, China, Brazil, USA, Russia, Indonesia

• Global sugar trade about 53 M mt

Source: USDA 2013, Rabobank
Sugar Deficit and Excess Countries

Location of the world sugar importers and exporters

- **Net exporters**
- **Self sufficient**
- **Producing importers**
- **Net importers**

Source: LMC International
Top Global Sugar Exporters

Brazil 50%

Thailand 14%

Australia 6%

Mexico 3%

Guatemala 3%

EU-27 3%

Colombia 1%

Cuba 1%

UAE 1%

India 1%

Other 17%

Source: USDA 2013
Sugar Market Regulation

Regulation and support measures in all important sugar markets around the world (importing and exporting countries)

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<th>SUGAR SPECIFIC</th>
<th>Australia</th>
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Source: LMC International
The World Market of Sugar

Top 10 Global Sugar Exporters

Exports in Mt raw value (2012/13)

- Brazil: 29.30 Mt
- Thailand: 8.50 Mt
- Australia: 3.40 Mt
- Guatemala: 1.66 Mt
- Mexico: 1.61 Mt
- EU-27: 1.50 Mt
- Colombia: 0.88 Mt
- Cuba: 0.85 Mt
- UAE: 0.75 Mt
- India: 0.60 Mt

Markets regulated by Sugar Market Organizations, Import tariffs, Sales programs, etc.

Source: USDA, LM C International
Causes of Volatility in the Sugar Market

• **Nature of agricultural commodities:**
  - Long planning-production-sales cycles – cycle of sugar much longer than most other agricultural commodities (beet sugar: up to 30 months)
  - Lagged supply response
  - Low elasticity of demand (aggravated by biofuels)
  - Stock ratios
  - So prices need to react strongly to restore equilibrium

• **Shocks:** Natural, financial, energy, political,...

• **Interdependencies:** Ethanol, Energy, ...

• **Sugar is historically one of the most volatile soft commodities**

• **Volatility is the reason for regulation and vice versa**
Causes of Volatility in the Sugar Market

• Planning-production-sales cycle (sugar beet):
  • Decision: summer 2013 (wheat or beet)
  • Sowing: spring 2014
  • Yield: summer/autumn 2014
  • Processing: until January 2015
  • Sale: until end 2015
  • Total: 2.5 years between decision and last sale of sugar

• Sugar cane:
  • Perennial plant
  • First yield between 9 to 24 months after planting
  • Sugar cane can be harvested up to 8 times
A small change in quantity leads to a large change in market price.
Sugar Market Volatility

Extreme price movements occur always on the upside
The EU Sugar Market
The Common Market Organisation (CMO)

EU sugar consumption: 18 M mt

**Status Quo (since 2006):**

- Quota system with minimum beet prices
  - Minimum beet price of 26.29 €/mt
  - Reference price for white sugar of 404 €/mt
  - Production covers roughly 85% of EU consumption (quota)
  - Limited production of isoglucose under quotas
  - Additional measures/ import tenders possible

- External protection
  - Imports from ACP/LDC without tariffs
  - Additional tariff-free imports from countries with FTAs (Peru, Costa Rica...)
  - TRQ/ CXL: Imports with preferential duty (98 €/mt) for limited quantity
  - Tariffs for raw (339 €/mt) and white sugar (419 €/mt)

- Export limited to 1.35 M mt/year (WTO ceiling)
The EU Sugar Market
The Common Market Organisation (CMO)

What will change after 30th Sept 2017:

• Quota system will end in 2017
• No more minimum beet price

Consequences:

• Volatility of quantities causes volatility of prices for beets and sugar
• Markets for isoglucose and sugar will have to rebalance leading to a potential surplus of sugar in Europe
• Stronger dependence on world market developments
• Export limitation is expected to end
• General framework (crisis mechanism) needs to be realised
Futures Markets for Sugar

- Futures markets address price volatility and not quantitative volatility
- Futures markets are necessary to hedge price volatility
- As domestic sugar markets are heavily regulated around the world there are futures for both domestic and world markets
- Domestic futures markets cover local price developments
Futures Markets for Sugar

• Global sugar trade about 53 M mt

• World market futures
  • USA: ICE Sugar No. 11
    Raw cane sugar delivered to 30 locations around the world where cane sugar is produced
    Open Interest about 74% of world trade
    (39 of 53 M mt)

  • EU: Nyse Liffe Sugar No. 5
    White sugar delivered to 41 locations around the world where white sugar is produced
    Open Interest about 7% of world trade
    (3.5 of 53 M mt)

Sources: Rabobank, ICE, NYSE EURONEXT
Futures Markets for Sugar

• Futures for domestic markets

  • USA: ICE Sugar No. 16
    Raw cane sugar delivered to 5 locations in the US all duties paid
    Open Interest about 7% of total US sugar production (16% of cane sugar)
    (0.56 out of 8.2 M mt)

  • China: Zhengzhou Commodity Exchange
    White sugar delivered into exchange-appointed delivery warehouses
    Open Interest about 50% of Chinese sugar production
    (7 out of 14 M mt)

  • India: National Commodity and Derivatives Exchange
    White sugar delivered into exchange-appointed delivery warehouses
    Open Interest about 2% of Indian sugar production
    (0.62 out of 27.4 M mt)

Sources: USDA, ICE, CZCE, NCDEX
Sugar companies are affected by financial market regulation like any other company in respect of managing financial risks (liquidity, interest rates, FX, asset management, ...)

Sugar companies use commodity markets (spot and derivatives) on procurement and on sales side

**Use of sugar derivatives:**

- Raw sugar procurement for sugar refineries
- Export of white sugar on world market
  - Total EU sugar production (2012): 17 M mt
  - Export: 1.35 M mt
  - White sugar futures for hedging (estd.): 0.25 M mt
Risk Management

Südzucker Group Market Price Risks

Financial Risks

Interest rates
- Long term
- Short term

Foreign Exchange
- Financing/Investment
- Operational: Purchase and sale of goods and services in foreign currency

Commodities Risks

Raw materials
- Sugar beets
- Raw sugar
- Grains

Energy
- Hard Coal, Brown Coal
- Nat Gas, Oil
- CO₂

End products
- Sugar
- EU & World Market
- Ethanol
- Starch
Applications of Financial Instruments

**Use of Derivatives:**

- **Financial underlyings**
  - FX forwards (OTC)
  - IRS, Cross-currency Swaps (OTC)

- **Commodities**
  - Energy Swaps, CO$_2$ (OTC)
  - Wheat futures
  - Corn futures
  - Raw sugar futures
  - White sugar futures
Südzucker AG’s risk policy has always been that the use of derivatives for speculation purposes is strictly forbidden. Their application is limited to hedge operations.
Financial Market Regulation
Implications for Sugar Producing Companies

- MiFID II/ MiFIR

- Position limits
  Exemption for positions for hedging purposes
  Positions of sugar producers can be quite large relative to total Open Interest

- Definition of Financial Instruments
  Commercial contracts can have a lot in common with derivatives. They should not be treated as financial instruments
  This will be increasingly important when the CMO changes in 2017
  Are commercially motivated FX-forwards Financial Instruments?
  (At least not in the UK - FCA)
EMIR – administrative burden

- Clearing obligation for Non-Financial Counterparties
  Does anybody know more than 10 NFC+ in Europe? (BaFin: Germany none)
  But each company in Europe being counterparty in a derivatives transaction
  needs a process to check thresholds (hundreds of thousands of companies)
- Intragroup transactions should be out of scope
  - Clearing obligation
  - Reporting
  - Clearing threshold double/ triple counting!
- General reporting obligation for NFC- unnecessary (e.g. Dodd-Frank)
- EMIR regulation on company level
  - Risk mitigation techniques
  - Implementation legislation – mandatory external audition
Financial Market Regulation
Implications for Sugar Producing Companies

• MAD/ MAR

• Art. 6, 7 and 9: Prohibition of insider dealing
  As designed today MAR could prevent hedging of market price risks if sugar producers cannot act on derivatives markets using commercial information

• Sugar companies have a presence in many locations around the world and gather public as well as non-public information from their normal commercial activity. This information should not be considered as inside information.
Financial Market Regulation

Concluding Remarks

• Market regulation for financial companies is necessary and valuable
To improve market transparency, reduce counterparty risk, systemic risk and risk of market abuse

• Volumes of companies from the real economy are insignificant for financial markets

• Implementation of EMIR regulation should be adapted to Non-Financial Companies

• Regulation creates new hubs of information
Details about each market participants derivatives positions are concentrated in a few Trade Repositories.
Data security of Trade Repositories is crucial – information leakage can ruin in particular financial companies.
Thank You!