

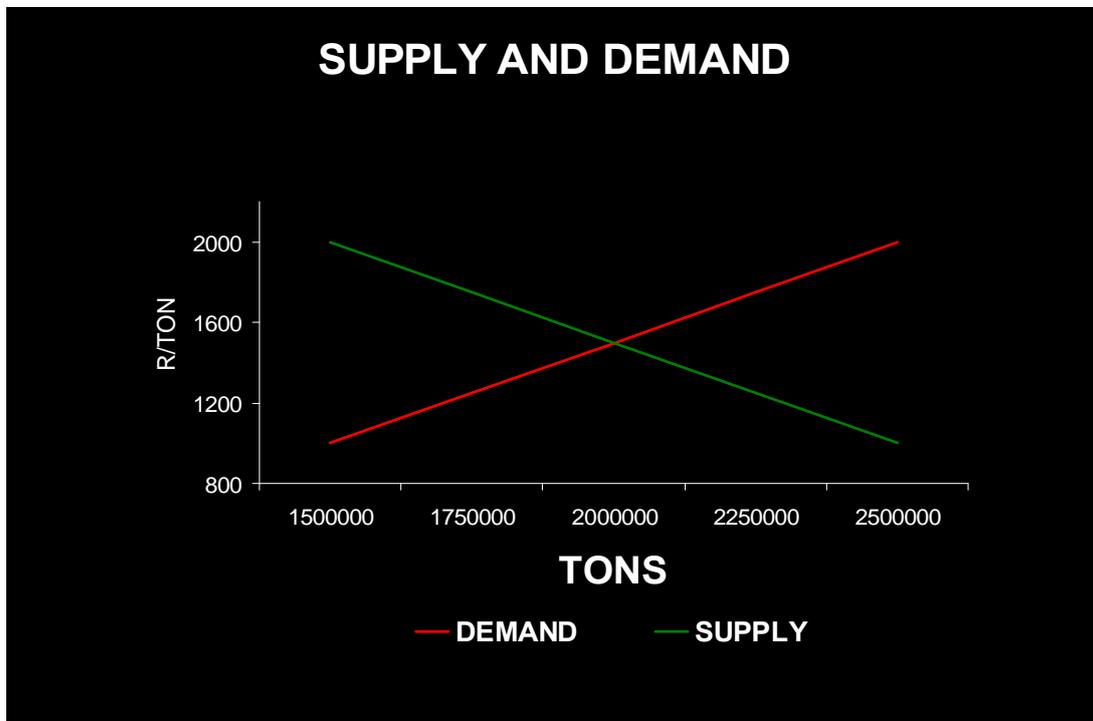
**ARE THE BAKERS BUTTERING THEIR BREAD ON BOTH SIDES?
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The bread price has recently been in the news quite regularly. Firstly because of the exposure of a bread cartel where the country's biggest millers and bakers were involved and secondly due to the steep increase in the wheat price that will take another bite out of the consumer's pocket. This places the whole value chain, from wheat production to the sale of bread, in the spotlight.

How does a cartel originate?

At the outset it is necessary to explain two economic principles in order to understand the process of price manipulation. The first is $\text{Profit} = \text{Income} - \text{Expenses}$. Profit is the difference between Income and expenses and can be increased by widening the gap between the two rather increasing sales volumes.

The second principle is that supply and demand in a free market system, will continually be fluctuating in order to establish the correct market price, depending on the existence of healthy levels of competition. This can be illustrated by the following graph:



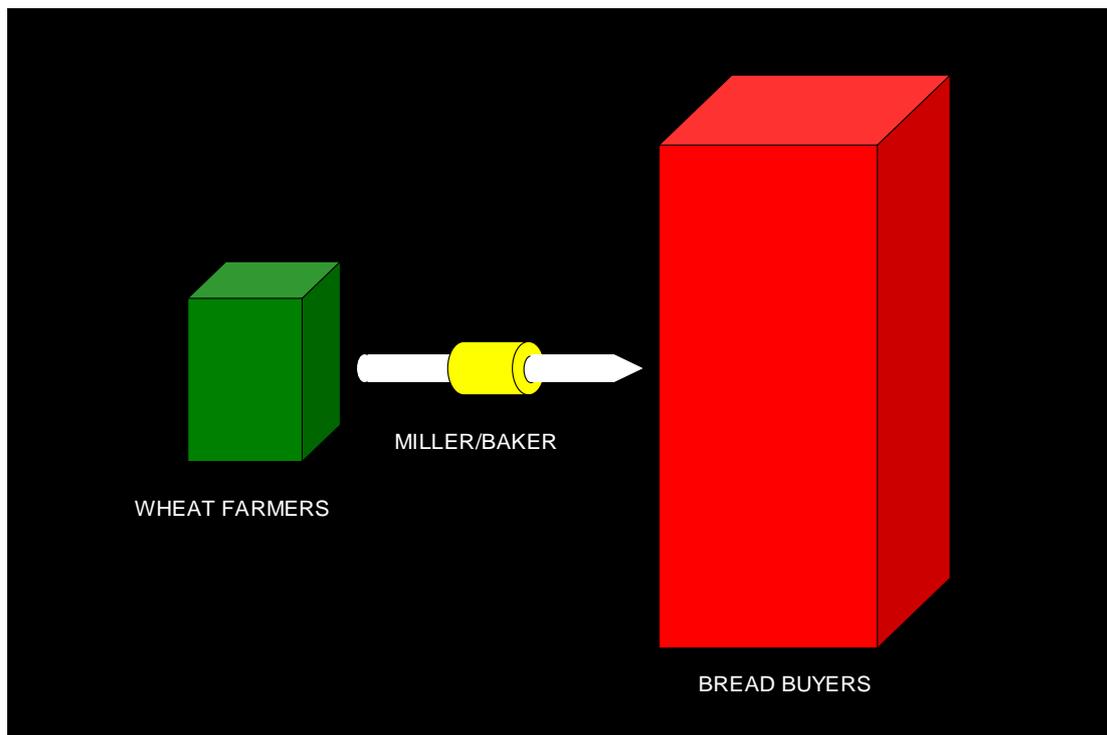
Where the supply is very high the price will be low because the seller must get rid of his product. A low price will discourage production and supply will gradually decrease. When the demand is high while the supply is low the price will be higher which in turn will result

in increased production. These opposing forces eventually find a point of equilibrium where supply and demand are more or less equal. The buyer and the seller meet each other at a price level where it is beneficial for both parties to partake in the transaction.

The aim of a cartel is usually to manipulate the price equilibrium artificially by way of mutual agreement. Cartels can be formed by buyers or sellers or by the middleman that buys products for resale. Cartels aim to peg the prices at higher levels than those determined by the normal market equilibrium in order to increase the gap between income and expenses, resulting in higher profits. Cartels can succeed where there are a limited number of role players in the market, where a direct link can be established between the supplier and the consumer and when it is an essential product for which no cheap alternative exists.

How could cartels originate between millers and bakers?

The product flow of wheat from the farm to the bread in the hand of the consumer is in many ways ideally suited for manipulation by a cartel. In the first place for most users it is an essential product without a ready alternative. This means that the demand is relatively firm and the price, whether high or low, would not really impact on the consumption. Secondly there are only a limited number of large millers/bakers via which the wheat can be channeled to the consumer. The chart below can illustrate this:

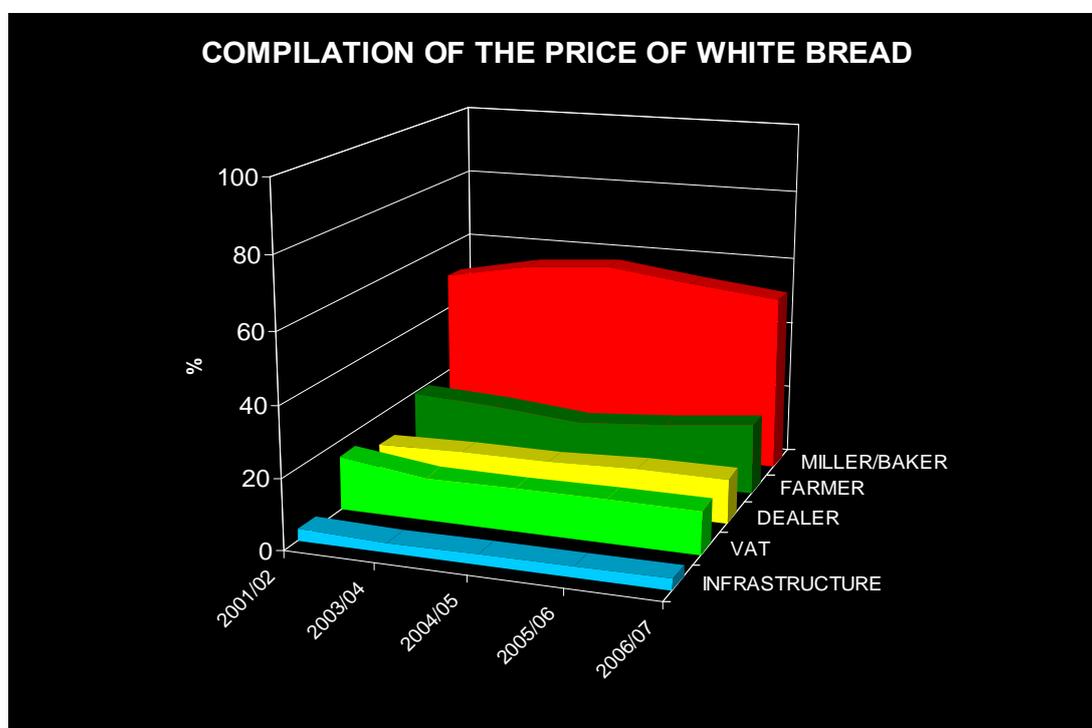


There are between 3000 and 4000 wheat farmers in South Africa while there are only four large millers who are also bakers: These are:

| | |
|-----------------------|--------------------|
| Pioneer Foods | (Sasko Sam/ Duens) |
| RUTO Mills ó Foodcorp | (Sunbake) |
| Premier Milling | (Blue Ribbon) |
| Tyger Brands | (Albany) |

On the other side there are millions of consumers who purchase bread. Although there are also a number of smaller millers and bakers, the big four controls possibly up to ninety percent of the wheat and the bread in the country.

The millers and bakers, as illustrated by the graph below, then also add by far the largest portion of the cost that contributes to the price of bread.



(Source: Chamber of millers)

The share of the millers/bakers in the price of white bread from 2001/2 to 2006/7 fluctuated between 50% and 58% while the share of the farmer in the same period fluctuated between 15% and 21%. In 2004/5 the share of the millers/bakers was 57.2% while that of the farmer was only 15.8% of the price of white bread.

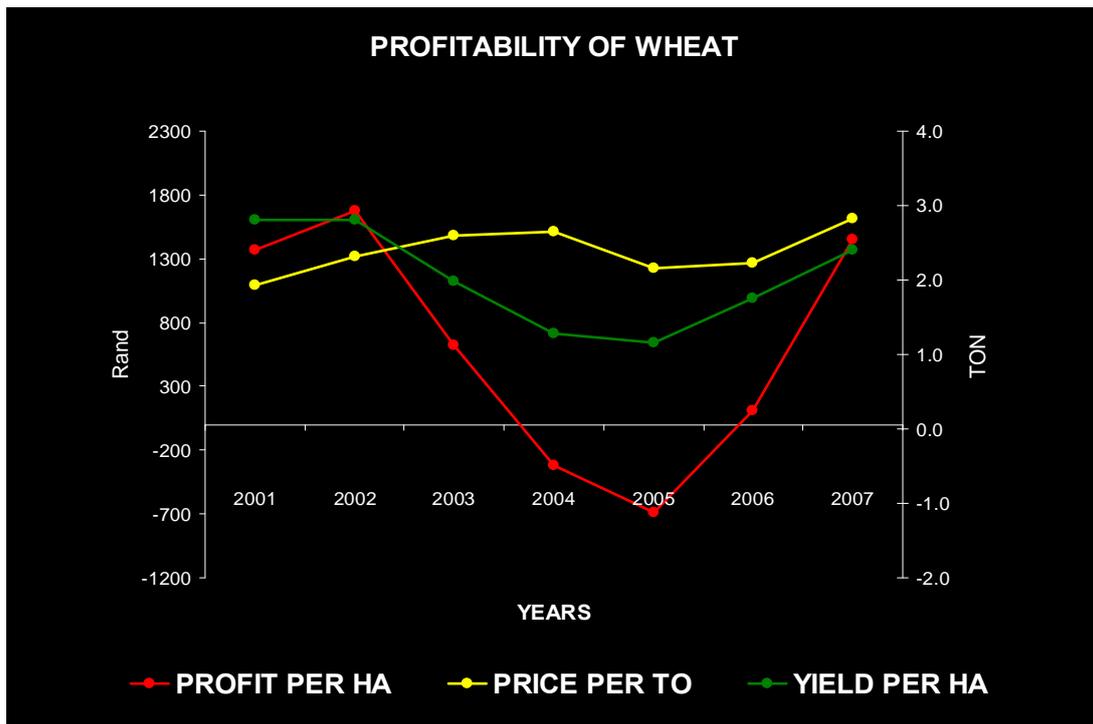
Almost the complete value chain of wheat to bread therefore at some stage flows through the narrow funnel of the four millers/bakers that at the same time adds the biggest portion of the cost to the price of bread. Only absolute self-control would prevent the four from forming a cartel that would be able to manipulate prices to both sides. The existence of the one leg, price manipulation to the consumer, has already been confirmed. The possible existence of the other leg is currently under investigation.

How does this affect the farmer?

The competition commission is going to extent its investigation to include the milling industry. It has therefore as yet not been established as fact that there has been price manipulation of farmers. It would however not be necessary for the milling industry to determine an agreed price for wheat. All that they had to agree on was that they would not pay local farmers more than what is being paid for cheap imported wheat. Whether this agreement exists or not, for the last 5 years, import price parity is what the milling industry has been offering local farmers for their wheat, despite decreasing local supply.

Despite various pleas from farmers, especially from 2004 to 2006, that the import parity price was lower than their input costs, Mr. Jannie de Villiers, general manager of the chamber of millers, on various occasions told the farmers in the eastern free state that this is how a free market system works and that local prices are based on import parity. He also argued that under the statutory price system, farmers were paid too much for their wheat in comparison to the quality. He also on numerous occasions added, with the necessary sarcasm, that the days of the old Wheat Board were over where six producer representatives calculated the wheat price and then submitted it to the two representatives of the milling industry for their approval.

During 2004, 2005 en 2006 wheat farmers in the Eastern Free State therefore produced wheat at a loss. Due to drought poor returns were realized which were not compensated for by a higher price due to the supply and demand inequality caused by imported wheat and the import parity price policy. The table below shows the profitability of wheat farmers during the period 2001 to 2007.



(Source: *Computus Bestuursburo*)

Up until 2002 the natural market forces of supply and demand were in play and it indicates price equilibrium. In 2003 the supply showed a sharp decline due to drought conditions while the demand still showed a steady increase. The wheat price did however not, as would be expected by supply and demand equilibrium, show a corresponding increase, as the millers increased the supply by way of cheap imported wheat. In 2004 and 2005 the millers who continued to import more and more cheap wheat further exacerbated this situation. Import prices also became the basis for local prices and the millers did not take of heed the production costs of local wheat. Instead of the market forces causing an increase in the price of wheat the price actually decreased in 2005.

As indicated in the previous chart, the contribution of the miller/bakers to the cost of bread increased in 2004/5 to 57.2% while that of the farmer decreased to 15.8%. This coincided with a period when the wheat price was the lowest in seven years and farmers suffered a loss of R693/ha on their wheat farming operations.

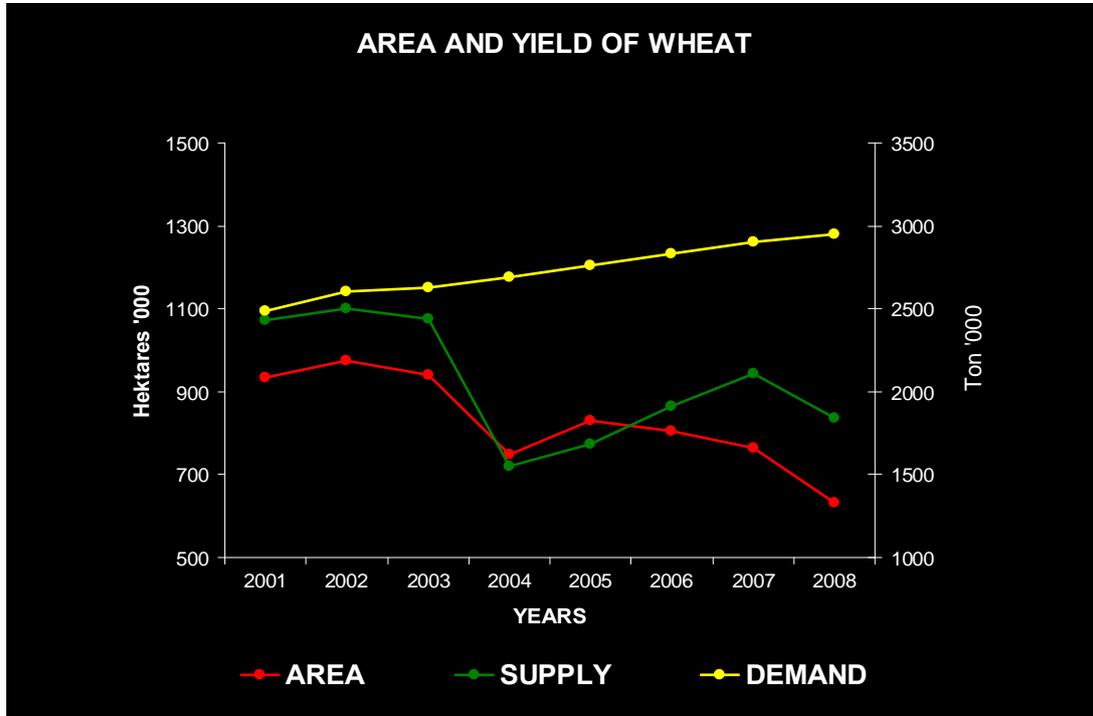
Local prices were initially depressed by poor quality wheat from Kazakhstan and later by better quality Argentinean wheat. South African wheat, which is of high quality, was mixed in with low quality overseas wheat to improve the baking capability of imported wheat. Local farmers however only received an import parity price for their better quality product. The result of the message from the millers, packaged in the free market principles, was therefore that local farmers did not have any incentive to continue producing wheat.

Could the Government not intervene?

In 2005 Grain SA requested government on behalf of the farmers to implement an import tariff on grain at the maximum level of 72% as allowed by the *World Trade Organisation*. This was turned down on two occasions and the reason was probably that cheaper bread was considered more important than tariff protection for farmers. A 2% *ad valorem* tariff was implemented as alternative that at the time provided protection to the value of about R30/ton for locally produced wheat. This small tariff did not have any effect in the protection of local farmers against cheap imports. The government could have intervened but chose not to and should therefore to some extent also accept responsibility for the high price of bread.

What consequences does price fixing have for the consumer?

The obvious detrimental effect for the consumer is the consumer will pay an artificially higher price while the farmer probably received too little for his product. The underlying detriment is however that a serious distortion existed in the market over the medium term that had a very serious detrimental impact on prices. Market forces cannot be held down for a long period and must let off steam. This can be explained by the following graph:



(Source: Agricultural abstracts)

The total wheat cultivation in South Africa decreased from 974,000 hectare in 2002 to 632,000 hectare in 2008. With this the supply drastically decreased since 2004. Where the

local supply of wheat in 2003 could nearly satisfy the total demand, large quantities had to be imported since 2004 when the supply decreased in line with the decrease in hectares planted. From a high of more than 2 million hectares wheat planted in 1973, only 31% remained in 2008.

South Africa has the potential to fully satisfy the local demand for wheat, but even this year with one of the highest crops per hectare, there is a shortage of more than one million ton, due to inadequate hectares planted. Consequently this shortage must be imported at high prices in the face of a worldwide shortage due to unfavourable climatic conditions in most wheat producing countries.

In addition to the international shortage, South African infrastructure is also not equipped to handle a sudden inflow of 1 million tons at the harbours and to quickly transport it to the millers. These delays in deliveries result in additional costs being added. Further bad news is that bread prices will rise even more due to cheap Argentinean wheat not being available that has to be substituted with US wheat that is R400 to R500 more expensive.

What is so wrong with price manipulation?

In the long run the market forces always triumph. That is why cartels are not sustainable and only cause damage for which the consumer ends up paying. If local wheat farmers this year with the support of a price incentive, planted the same number of hectares as in 2001 (974,000), then there would have been, measured at the actual yield of this year, a total production of 2,9 million ton which is sufficient for the local demand. It would not have been necessary to import wheat at a price in excess of R3800,00/ton. An export parity price of R2451/ton as calculated by the South African Grain Information Service would then probably have been applicable to local wheat, with the corresponding effect on the bread price.

For the country as a whole R3,8 billion of foreign currency will flow out of the country due to the fact that wheat had to be imported while we have the capacity to produce it locally. This is equivalent to two large power stations and the price that the country is paying so that four large milling companies could make a million or two more in profit.

Cartels with the objective of manipulating prices are in the first place for obvious reasons against the law (Competition Act of 1998). In the second place, the correction of artificially depressed prices results in serious financial losses to the consumer. Even when guilty parties are fined, the consumer eventually finances these fines.

In the case of Tyger Brands they were fined R99 million. This entails only 4% of their milling and baking turnover, 8% of their operating income from food sales and 4% of the net profit of all its activities. Hopefully the damage to their reputation is much greater than the monetary impact of the fine.

What can the wheat farmers expect?

The shortsighted policy of the miller/bakers to buy cheap imported wheat at the peril of local wheat farmers caused considerable damage to the South African wheat industry and

the economy of the country as a whole. It is quite staggering that this approach had to be further supported by the price manipulation on bread.

Wheat farmers can now have the last laugh at the expense of the millers, and it can be expected that significantly more hectares will be planted with wheat in the coming season due to the current high prices, even though a lagging effect should be expected as potential wheat producing land is currently planted with summer cultivars. Wheat farmers will now be able to farm wheat very profitably but this should rather be a period of restoring confidence in the market. The bigger supply due to more hectares being planted will result in the price equilibrium being found at a lower level in 2009 with a resulting decrease in the bread price. The milling industry will then have to keep their side of the deal by following a "Buy South African" approach rather than suppressing the South African market with lower overseas prices if circumstances again change in their favour. In this way the consumer can be supplied of bread in a sustainable manner.

Bethlehem
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