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Bio-Fuels

Situation Update

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Report Highlights:
The South African government has approved a Bio-fuels Industrial Strategy for the country, but has excluded corn as part of the strategy. The exclusion of corn comes amid concerns over food security and fears of price increases. Bio-fuel production targets have also been reduced from 4.5% to 2% of total motor fuel consumption. The strategy elicited strong negative reactions from industry and agriculture groups and, in response, the government signaled that there may be some flexibility in the policy.

Includes PSD Changes: No
Includes Trade Matrix: No
Annual Report
Pretoria [SF1]
[SF]

Executive summary

The South African cabinet approved the bio-fuels industrial framework strategy seven months after the target date. Concerns over food security and the crops to be used were the main reasons for the delay in approving the strategy. The approved strategy differs radically from the draft strategy and the South African government has scaled back plans for an ambitious bio-fuels roll-out. Corn as a feedstock for ethanol production was excluded amid concerns over food security and fears of price increases. The new strategy recommends sugar cane and sugar beet for bio-ethanol production and soy beans, canola and sunflower as feedstock for biodiesel. The bio-fuels production target was also lowered from 4.5%, as proposed in the draft, to 2%. The blending target for bio-fuels is set at 8% bio-ethanol and 2% biodiesel.

The public release of the strategy brought about a strong negative reaction from key agriculture and industry groups. The Minister of Agriculture and Land Affairs has now suggested that the policy may have some flexibility with regards to corn.

$1 = Rand 6.73 (12/12/07)

Introduction

In December 2005 the South African cabinet approved the development of a bio-fuels industrial strategy and the establishment of a Bio-fuels Task Team. The Task Team included 12 national government departments chaired by the Department of Minerals and Energy. The team had to develop the strategy, investigate the establishment of a bio-fuels industry in South Africa and report on the financial implications involved.

A year later cabinet approved the Draft Bio-fuels Industrial Strategy compiled by the task team and released it for consultation. The draft, based on a detailed feasibility study, proposed a 4.5% inclusion of bio-fuels in the total motor fuel consumption to achieve 75% of the country's renewable energy target by 2013. The strategy was based on the national blending specifications of 8% for ethanol (E8) and 2 % for biodiesel (B2). Corn and sugar (ethanol), as well as soybean and sunflower (biodiesel) were chosen as inputs. This was based on existing crop production patterns but other crops were also being considered. Technical specifications for bio-fuels were also developed.

The draft strategy proposed a mandatory blending of bio-fuels with petroleum-based fuels. This included a proposal that the existing fuel levy exemption for biodiesel be extended to bio-ethanol based on the energy content. A hedge fund similar to the Equalization Fund was proposed to deal with oil price variations. The proposal was that during periods of high international crude prices the bio-fuels producers would pay some money back to the National Treasury and during times of low crude prices the producers would then receive some government support.

The final policy document was to be presented to Parliament in May 2007, putting the industry on hold as the viability of the whole bio-fuel industry depends on government policy and assistance. However, this date passed without a policy as deliberations continued until the recent unveiling of the current policy.

The approved Bio-fuels Industrial Strategy

On December 5, 2007 the South African cabinet approved a national Bio-fuels Industrial Strategy. The Bio-fuels Industrial Strategy is driven predominantly by the need to address issues of poverty and economic development. The focus of the strategy is therefore the promotion of farming in areas that were previously neglected by the apartheid system and areas of the country that did not have market access for their produce; most of these areas are in the former homeland areas.

However, the approved strategy differs radically from the draft strategy and the South African government has also scaled back plans for an ambitious bio-fuels roll-out, citing concerns over food security and the effect of climate change on the agricultural sector. According to the strategy the focus will be on new and additional land and will require only about 1.45% of arable land in South Africa (currently 14% of arable land, mainly in the former homelands, is underutilized).

The move deals a hefty blow to hopes that the bio-fuels strategy would substantially reduce South Africa's dependence on imported oil and that bio-fuels utilization would form the cornerstone of the government's strategy to reduce greenhouse gases under its Kyoto commitments. Hopes were also dampened that a bio-fuels industry would enable agricultural development in South Africa, create thousands of new jobs and grow the rural economy, thereby realizing a major social development objective of the government.

According to the strategy the bio-fuels industry in South Africa will be developed in phases, with the first phase from 2008 to 2013. After this initial five-year period, which will be known as a "pilot stage", bio-fuels production and its impact on agriculture would be assessed and evaluated and targets would then be reviewed.

One significant disappointment for corn farmers in South Africa is the exclusion of corn as feedstock for ethanol production. The use of corn was excluded amid concerns over food security and fears of price increases. Concerns over food security and the crops to be used was also the main reason for the delay in approving the strategy.

The new strategy recommends sugar cane and sugar beet for bio-ethanol production and soy beans, canola and sunflower as feedstock for biodiesel.

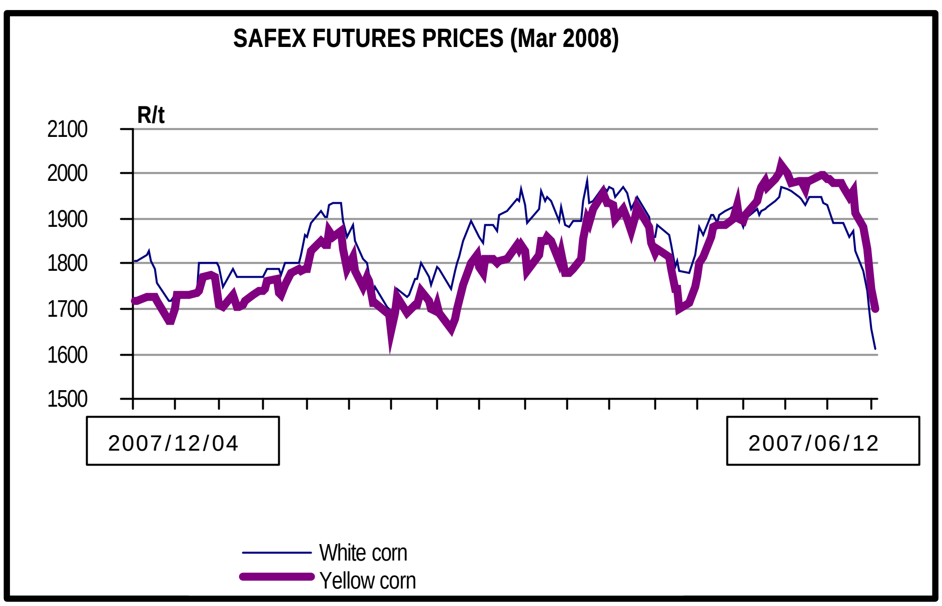
The disappointment for corn famers is understandable as they were from the very beginning involved in the formulation of the draft bio-fuels industrial strategy and made contribution to it. South Africa's potential to produce corn surpluses in a "fairly stagnant" domestic market is well documented and an additional outlet for corn was welcomed. This is in contrast to oilseeds where there is a chronic shortfall necessitating imports exceeding the oilseed equivalent of more than a million tons a year.

Corn producers reacted with dismay to the decision to exclude corn from the strategy, saying it would have the opposite of its intended effect. Grain SA chairman Neels Ferreira said the exclusion of corn at any stage of the bio-fuel industry's development was a mistake, and that it would not ensure food security or decrease domestic food prices. "Farmers may switch to other crops, which could threaten food security. The economic reality is that farmers will plant what is profitable; whether it goes to ethanol or food is immaterial. If South Africa produces a corn surplus, farmers will plant alternative crops or nothing at all, as happened in the previous season. It is that which could be a threat to food security." warned Ferreira.

Monsanto was among the many agricultural sector players who also criticized the decision by South Africa to exclude corn from its bio-fuels policy, saying it would hurt farmers and deal a blow to the government's land reform policy. "We in the agricultural sector want to say to government that we are willing to assist with agricultural matters. Big international agribusinesses, like Monsanto, invest in the country and its economy, and government must realize that we are here to stay. For that reason we have to map the future together. Using corn for bio-fuels would allow the government to settle black farmers on farms through its land reform policy with a big demand for corn that they could plant. Now government has put a lid on all this." said Kobus Lindeque, managing director of Monsanto for sub-Saharan Africa.

Andrew Makenete, President of the South African Bio-fuels Association commented that the government's bio-fuels strategy flew in the face of logic. Makenete said that the association will meet with the Minister of Agriculture and other Cabinet Ministers to discuss the issue. "Corn presents the greatest opportunity. Its exclusion came to us as an absolute surprise and shock. In discussion with the task team that compiled the strategy, corn's exclusion had never been proposed" he said. He also commented on the fact that the crops singled out for bio-ethanol production namely, sugar beet and sugar cane, would require the greatest utilization of water and were thus "surprising" starting points in a country where water was not in abundant supply.

South African corn futures tumbled on Friday on follow-up selling after Thursday's news that government policy has excluded corn in the production of bio-fuels (see graph). However, corn prices have recovered slightly and March white corn is now trading at R1700/ton (US$253/ton).



The corn industry will also be losing out on huge planned new investments and developments. The plan of Ethanol Africa to build eight corn-to-ethanol plants across South Africa's main corn-growing areas at a cost of approximately R8bn ($1.2bn) is now something of the past. Each plant would have had an annual capacity of 160 million liters of ethanol, 10 million liters of bio-diesel and 120,000 tons of oil-cake, which was to be used for stock feed.

However, the Industrial Development Corporation (IDC) and Central Energy Fund (CEF), both government owned, are at relatively advanced stages in setting up two bio-fuels projects at a investment of more than R3.2 billion ($0.5bn), with the first production set for early 2009. One of the projects will be near Cradock in the Eastern Cape and the other near Hoedspruit in Mpumalanga. The plan is for the Eastern Cape project to use sugar beet to produce about 90 million liters of bio-fuel annually, and the Mpumalanga venture to make 100 million liters of fuel from sugar cane.

In addition, the IDC and CEF are also looking into the production of 150 million liters of bio-fuel made from sugar cane in Pondoland, which spans KwaZulu-Natal and the Eastern Cape.

Another key point of the strategy is the lowering of the bio-fuels production target from 4.5%, as proposed in the draft, to 2% (or approximately 400 million liters). The motivation for the drop in target was again concerns over food security and rising food prices. The blending target for bio-fuels is set at 8% bio-ethanol and 2% biodiesel.

The government also poured cold water on expectations that it would help subsidize bio-fuels production. Stakeholders have argued that bio-fuels production would not be economically viable without incentives. With the revised strategy, the fuel levy exemption (a product as oppose to a producer incentive) for biodiesel would increase from the current 40% to 50% and bio-ethanol would maintain its 100% exemption. A fixed margin price will be introduced as a producer support mechanism. To specifically ensure the use of underutilised land from the former homelands, a fixed margin scheme will only apply to litres produced from feedstock grown on this underutilised land.

In a surprise move the Minister of Agriculture and Land Affairs invited Grain South Africa, Agri SA and NAFU on December, 13 2007, to discuss the decision by Cabinet to exclude corn in the Bio-fuels Industrial Strategy. According to FAS/Pretoria sources the Minister said to the meeting that it was not the purpose of Cabinet to exclude corn produced in surplus from the bio-fuel industry and that it is still possible to continue discussions in this regard with Cabinet. To further the process at this stage, it is the responsibility of the Industry to provide the Minister with the necessary arguments in order to convince Cabinet to include corn in the Bio-fuels Industrial Strategy. The most important argument to be conveyed is that the creation of new markets for the surplus production capacity above current demand would contribute positively to food security.

Comment

The strong reaction by agriculture and industry groups to the bio-fuels strategy illustrates the significant interest by these groups in bio-fuels, both as a business venture and as a means to address critical social and political objectives. The

Minister's surprising invitation to the agriculture groups to discuss the government's decision may signal the policy does have some flexibility. For potential investors, however, the Minister's comments might also be viewed as injecting an element of uncertainty back into South Africa's bio-fuels outlook.