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# Flexible Cash Leasing of Cropland

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Agreeing on a cash rent can be a challenging task. Typically there is considerable uncertainty about what prices and yields will be in the upcoming year, and anticipating revenues is further complicated with the uncertainty of farm program payments, particularly in low income years when Congress may appropriate unexpected assistance. Attempting to determine a cash rent to apply for more than one year adds to the challenge. Also, adjustments to rent are required over time to remain current with changes in farm program provisions, production costs, productivity and prod- uct price levels.

The expected costs and revenues used to establish a cash rent will not likely be absolutely accurate, but it is possible to select a cash rent that is reasonably fair over several years, albeit high some years and low in others. Cash rental rates in Nebraska are frequently left unchanged with rates adjusted once every five years on average. This approach provides stable income for the landlord, which may be the primary objective in those agreements.

## Reasons For Flexible Cash Leases

For a number of reasons it may be desirable to have the cash rent adjust annually and perhaps reflect actual revenues and costs. For example, a fixed cash rent may be burdensome for the tenant when revenues are low. Also, the landlord may be interested in sharing the risk of low revenue if (s)he can expect a higher average rental income over time, or is particularly interested in helping the tenant with the risk associated with a cash rent.

One reason for infrequent adjustments may be that it is awkward or otherwise difficult to negotiate changes. An agreement that includes a mechanism for automatic adjustment may make it easier to implement needed changes, as well as accomplish some risk sharing. See NebGuide 99-1387, Cash Leasing of Cropland in Nebraska for further information on cash leases, including how to arrive at a cash rental rate.

A crop-share arrangement where the landlord and tenant share production costs and revenue in proportion to their cost contributions achieves a sharing of risk and results in an annual rental income that reflects yearly costs and revenues. However, a crop-share typically requires additional communication between the landlord and tenant and involves some joint decision making that constitutes material participation by the landlord, which has social security and tax implications. As a result, some crop-share agreements have been shifted to a fixed cash rent or to a net share arrangement.

Under a net share arrangement, the tenant pays all direct production expenses and the landlord receives a reduced share of the crop as rent, thereby reducing the communication and joint decision making necessary in a crop-share arrangement. See NebGuide 99-1355, Crop-share Leasing Patterns in Nebraska-1996 for more information on crop-share arrangements.

A flexible cash rent typically adjusts based on the crop price or yield, or on total revenue. Returns above operating costs such as seed, fuel and chemicals could also be used to trigger adjustments in a cash rent. A complication is farm program payments must be shared under some flexible cash rental arrangements, but go to the tenant under other agreements. The current rules for allocating farm program payments are discussed below.

## Advantages of Flexible Cash Leasing

- Financial risk is reduced for the tenant operator if the cash rent is lowered when revenues are low. The landowner can share in economic "windfalls" if the rent is adjusted upwards in those years when above-normal revenues are realized and if the arrangement qualifies for sharing farm program payments.
- Less communication and joint decision making are required than would be true of a typical crop-share lease, which results in possible social security and income tax advantages for the landlord.
- A flexible cash rent may better meet the objectives of the landlord and tenant than a cash rent, particularly if the landlord is willing to share the risk and the tenant is interested in reducing risk.
- Properly designed flexibility clauses can reduce the need for frequent renegotiation of cash leases and increase satisfaction with the rental arrangement.

## Disadvantages of Flexible Cash Leasing

- The landowner has more financial risk than (s)he would with a fixed cash rent.
- If the rent adjustment is based on yield, the landowner will need to trust the tenant to accurately measure production - similar to that under a crop-share lease.

- The tenant operator will typically share some of the "economic windfalls" from above-average years.
- Because flexible cash leases are not widely used in the state, there is lack of familiarity and experience with them.
- In the case of cropland parcels having multiple-crop enterprises, arriving at an adjustment mechanism involving prices and/or yields for two or more crops may be complicated.
- Establishing the initial framework for a flexible cash rent can be more difficult and time consuming than conventional leasing alternatives.

## Incorporating Flexibility in a Cash Lease Arrangement

A flexible lease arrangement involves several considerations not required in a cash lease. Typically a base rent is established and then an adjustment mechanism is added that may have trigger points. There are other considerations:

Scheduling payments can be complicated under a flexible cash lease. If, for example, a two-payment approach is used, which is typical for cash leases in Nebraska, and the total rent calculated at the end of the year is less than the first installment, is some of the first installment refunded or is no additional payment made? If the first installment is non-refundable, it, in effect, becomes a minimum cash rent.

The landlord assumes more risk under a flexible cash lease than with a fixed cash lease and, in principle, should receive a higher rent to compensate for the greater risk. This suggests evaluating the flexible arrangement over possible outcomes to determine the average rent.

In principle, farm program payments are divided based on the risk assumed. However, at the time of this writing Farm Service Agency (FSA) guidelines suggest that a bushel rent, where the tenant pays an in-kind rent of a fixed number of bushels, or a flexible cash rent adjusted based on price, are treated as a cash rent and all Production Flexibility Contract (PFC) payments go to the tenant. The PFC payments are to be shared, however, if the cash rent is adjusted based on yield or revenue.

The cash rent paid should reflect the income the land can produce net of all nonland costs. Therefore, if the flexing mechanism does not incorporate all the components of net income including input costs, the arrangement should be closely monitored and adjusted as needed.

Over 60 percent of the crop lease arrangements in Nebraska are annual agreements. A flexible cash lease potentially could be used for several years. Because of the added complications of a flexible cash lease, a written contract should be used, particularly if a multiyear agreement is reached. Ask your lawyer to review the contract and discuss the implications of establishing it in writing.

When trying to design a flexible cash rent, it is important to identify the objectives of the flexing arrangement:

- Is the primary interest in having a mechanism for making year-to-year adjustments? If so, agree on procedures to formulate expectations for the upcoming year and calculate a rental rate. If the primary interest is in having the rent for each year reflect the actual income generated that year, procedures will need to be agreed on for calculating that income and how the rent will be determined after harvest.
- Does the landlord have any minimum acceptable rental income? Recognizing the landlord must expect to receive something less than the fixed cash rental rate in poor years to be able to receive a higher rate in good years, is there some minimum rental income that the landlord would accept? No minimum is required if the landlord is willing to take whatever the calculated rent is for that year.
- What is the most downside risk the tenant is willing to accept? Is it expected that the tenant will be better off in the worst years than under a cash rent? If so, the flexing mechanism probably needs to be based on revenue as will be explained below.
- Both landlord and tenant will have to determine how much they expect to benefit (or are willing to pay) to adopt a particular flexing arrangement. This determination may be specific to each flexing arrangement.

An ideal flexing arrangement is one that is simple to implement and meets the objectives of both landlord and tenant within the limitations of the situation. The most detailed flexing mechanism would consider revenue (price times yield plus farm program payments) net of nonland costs of production, i.e. the residual return to land.

Typically, the risk of year-to-year variation in costs (replanting, irrigation energy, crop drying) can be absorbed by the tenant. However, trends in production costs certainly need to be reflected in the rental rate over time and if not built into the flexing arrangement then periodic adjustments will need to be made in the arrangement. The Extension Circular Nebraska Crop Budgets, EC 872 may be helpful in tracking changes in production costs over time. See NebGuide 1387, Cash Leasing of Cropland in Nebraska for help in calculating the residual return to land which will reflect production costs and projected returns.

A considerable portion of the yield risk can be insured through multiperil crop insurance and hail insurance. In fact, it may be more profitable for the tenant to assume the yield risk and pay the subsidized crop insurance premium than to shift that risk to the landlord. A multiperil crop insurance policy can be used to support a minimum rental payment as will be demonstrated below. Yield trends need to be reflected in the rental rate over time.

There is an additional consideration associated with flexing on yield. Current farm program rules allow a sharing of farm program payments only if the landlord assumes some of the yield risk. Since much of the income uncertainty faced at the beginning of the season can be related to the farm program payments, flexing the rent based on yield or revenue is usually a priority. Flexing on price alone is a possibility; but under current rules, the landlord would not be eligible for any of the farm program payments.

Although it may be the intent of the parties to arrive at a longer term rental arrangement, limited experience with a flexible cash arrangement may suggest proceeding with caution and starting with an annual agreement. After accumulating some experience with the flexing arrangement to

determine the rent on an annual basis, a shift to a multiyear arrangement can be made. We will also demonstrate how historical data can be used to check a proposed flexing arrangement.

## Flexing Mechanisms

The mechanics for flexing a cash rent require specification and collection of the data to be used as an indicator for change, e.g. price and/or yield or revenue, selecting a base for the indicator and a base rent, and specifying how the rent would be adjusted in relation to the indicator. We illustrate the development of a flex mechanism below where the objective is to have the rent reflect the actual income received that year:

1. Consider a farm that has a historical average yield of 100 bushels/acre and the tenant is considering 65 percent multiple peril crop insurance coverage. The loan rate is $1.80 per bushel so the worst crop revenue would be 65 percent of 100 bushel or 65 bushel at $1.80/bushel = $117/acre, assuming the insurance indemnity price exceeds the loan rate.

2. A $2.25 cash forward contract price is currently available for fall delivery and the announced farm program payment amounts to $25 per acre, which provides an expected revenue of 100 bushel x $2.25/bushel + $25 = $250 per acre. As a result, the landlord and tenant agree to use $250 per acre as the base revenue.

3. They agree a $60 fixed cash rent would be fair and that the landlord should expect to receive an additional $5 for a total $65 per acre rent for accepting the risk associated with a flexible cash rent. They decide since the base rent is 26 percent of the base revenue (65 , 250 = .26), the rent would be 26 percent of the revenue at all revenue levels.

4. A 26 percent landlord share of any farm program payments would be consistent with the rent determination, and it would be requested the payments be distributed between the landlord and tenant accordingly. The rent payable by the tenant would be calculated by taking 26 percent of the price times yield. The landlord's 26 percent share of the farm program payment would be paid directly to the landlord.

The flexing mechanism in our example is relatively simple. Expressing the mechanism in terms of a formula, the rent is calculated as a proportion (share) of revenue where the proportion is equal to the Base Rent divided by the Base Revenue, i.e. (Base Rent , Base Revenue) = $65 , $250 = 0.26 and the share formula becomes Rent = (Base Rent , Base Revenue) x Revenue = 0.26 x Revenue. The Calculated Rent is shown in *Table I* for the five levels of revenue listed.

An identical result would occur if the rent were determined by multiplying a revenue index times the Base rent where the revenue index is the actual revenue divided by the Base Revenue. The revenue-indexed rent formula is Rent = (Revenue , Base Revenue) x Base Rent.

Again, using a $65 Base Rent and a $250 Base Revenue, you can confirm that using the revenue index formula results in the Calculated Rent in *Table I*. For example, a $200

revenue results in a revenue-indexed rent of (Revenue , Base Revenue) x Base Rent = ($200 , 250) x $65 = $52. A third approach would be to add to or subtract an amount from the base rent according to the level of revenue. For example, consider the same base rent of $65 and Base Revenue of $250 and adjust the rent $13 for each $50 difference in revenue. The reader can again confirm that the result is identical to the Calculated Rent shown in *Table I.*

We have demonstrated how three apparently different mechanisms provide the same result. A difference in using a table versus a formula is a table will apply to revenue ranges and will result in step-wise adjustments in the rent. For example, the rent is $65 for a revenue range from 226 to 275 and the rent steps up to $78 for a revenue from $275 to $325. (See the Revenue Range column and the corresponding Calculated Rent.)

Therefore using the revenue range in *Table I*, a $270 revenue would result in a rent of $65 since the $270 revenue falls between $226 and $275. In contrast, the share-rent formula results in a rent of 0.26 x $270 = $70.20 and, likewise, the revenue indexed formula results in a rent of ($270 , 250) x $65 = $70.20. Note that the steps in the table can be made sufficiently small to virtually eliminate the differences between the table results and using one of the formulas.

## I. Example of Cash Rent Flexed on Revenue.

| | *Revenue* | | |
|---|---|---|---|
| *Level* | *Range** | *Calculated Rent* | *Adjusted Rent* |
| $150 | *Below 175* | *$39* | *$29* |
| 200 | *176-225* | *52* | *47* |
| Base 250 | *226-275* | *Base 65* | *Base 65* |
| 300 | *276-325* | *78* | *83* |
| 350 | *Above 325* | *91* | *101* |

* Determined by finding the midpoint between the revenue levels.

## Modifying Calculated Rents

We have shown how different mechanisms can be used to arrive at the same rent. We will now consider why and how we might modify the rent from the Calculated Rent in *Table I.* For example, the tenant may be interested in reducing the rent more rapidly as revenue drops in exchange for a more rapid increase in the rent as revenue increases above the base. The table above could be modified accordingly. For example, the Adjusted Rent in *Table I* was derived by subtracting $5 from the Calculated Rent in the first step down from the Base Revenue, $52 - $5 = $47 and by subtracting $10 from the

Calculated Rent in the second step down, $39 - $10 = $29. Rent on the upside is adjusted by adding $5 to the Calculated Rent at the first step up, $78 + $5 = $83, and adding $10 at the second step up , $91 + $10 = $101.

The Adjusted Rent would provide the tenant more protection on the downside in exchange for adjusting the rent more on the upside. As already suggested, a reasonable approach on the farm program payments would be a landlord's share specified as the Base Rent divided by the Base Revenue or 26 percent in our example.

Another way *Table I* could be modified would be to not adjust rent beyond a certain revenue range, for example, placing a minimum on rent. The landlord may be interested in establishing a minimum income and the tenant may find that crop insurance will enable the tenant to comfortably meet a minimum rental payment even when yields are low. Another alternative modification would be to leave rent unadjusted until revenue varies outside a given range, for example, leaving the rent at $65 per acre as long as revenue remains between $200 and $300 and using the table to determine the rent outside that range.

This latter approach may be appropriate where the tenant is comfortable with the risk of a fixed cash rent within a range, but would like the rent to be adjusted downwards if revenue is below that range. The landlord would be compensated by increasing the rent when revenue is above that range. The mechanisms described above could be used in the same fashion where the rent is adjusted in response to price or yield.

## Separate Flex Mechanism for Price and Yield

The mechanism could be complicated by making adjustments to revenue based upon separate mechanisms for price and yield, for example, adjusting rent $5 from the Base Rent for each 10 cent change in price from the Base Price and further adjusting the rent in proportion to the yield relative to the Base Yield. To illustrate, use the $2.25 cash forward price in our example as the Base Price and the 100 bushel historical average yield as the Base Yield. If the actual price is $2.65 ($.40 above the Base Price indicating a $4 increase from the Base Rent) and the actual yield is 60 bushels, our adjustment mechanism using a $65 Base Rent would result in a rent of ($65+$4) x 60 bushels , 100 bushels = $41.40. Alternatively, if the actual price is $1.85 ($.40 below the Base Price indicating a $4 reduction from the Base Rent) and the actual yield is 86 bushels, our adjustment mechanism would result in a rent of ($65-$4) x 86 bushels , 100 bushels = $52.46.

The actual crop revenue in both cases is approximately the same, the farm program payment plus 60 bushels at $2.65/bu=$159 or 86 bushels at $1.85/bu= $159.10, yet there is more than $11 difference in the calculated rent, $52.46 versus $41.40 (assuming the farm program payment going to the landlord would be the same in both cases). However, it would appear desirable to arrive at the same rent for the same revenue regardless of how the revenue is achieved. As illustrated, using separate adjustment mechanisms for price and yield is more complicated and may not be as effective as an adjustment

mechanism based on revenue alone. Whatever the mechanism adopted, it is recommended that the mechanism be tested using either possible outcomes or using historical data.

To illustrate the need to test any system, consider the following historical distribution of yields that is used to flex the cash rent based on yield:

The Years column in *Table II* shows how many years each yield was achieved. The Yield x Years column when summed helps calculate the total number of bushels produced on an acre over the 15 years. Dividing the total bushels by the number of years gives the average yield of 2,565 bu/15 years = 171 bu. Using a base rent of $125 and adjusting the rent in proportion to the yield relative to the 171 bushel average results in a rent with a 95 bushel yield of $125 x 95 bu , 171 bu = $69 and similarly for the other yield levels. Multiplying each of the rent levels times the number of years and summing in the Rent x Years column and dividing by the number of years shows the average rent would have been $1876 , 15 years = $125, i.e. the base rent selected. However, if the landlord wants a minimum of $100 rent, the average rent would be $128 as illustrated in the Adjusted Rent x Years column.

The Adjusted Rent x Years column is identical to the Rent x Years except a $100 rent is substituted for any year the calculated rent falls below $100. The total rent that would have been paid over the 15 years would be $1,916 resulting in an average of $1,916 , 15 years = $128/acre. If the target is for the rent to average $125 with a $100 minimum, the base rent will have to be reduced to $122 as the reader can confirm. Note that if the landlord has agreed to a target $125 average rent with no minimum (s)he would be expected to accept a lower target average rent in exchange for the protection provided by a minimum rent.

## Table II. A Historical Distribution of Yields and Proposed Flexing Rules.

| *Yield* | *Years* | *Yield x Years* | *Rent* | *Rent x Years* | *Adjusted Rent x Years* |
|---|---|---|---|---|---|
| | | (bu) | | | |
| 95 | 1 | 95 | $69 | $69 | $100 |
| 125 | 1 | 125 | $91 | $91 | $100 |
| 165 | 3 | 495 | $121 | $363 | $363 |
| 175 | 4 | 700 | $128 | $512 | $512 |
| 185 | 3 | 555 | $135 | $405 | $405 |
| 195 | 2 | 390 | $143 | $286 | $286 |
| 205 | 1 | 205 | $150 | $150 | $150 |

*Table II* also illustrates some important points about characterizing field history. Note that the most frequent yield was 175 bushels (4 years out of 15) and that the yield

exceeded 175 bushels more often than it fell below 175 bushels while the average yield is 171 bushels, demonstrating the most frequent outcome is not the average outcome. Using only three to five years of historical yields could dramatically affect the results of the evaluation depending upon the years selected. Therefore, more years are preferred to less and caution should be taken not to look at the most common situation, but to average over a range of years.

Introducing ranges with a fixed rental rate or using more complicated formulas further demand a careful evaluation of the projected outcome. Using a historical period for the evaluation of an adjustment mechanism is recommended and adjustment can then be made for yield trend or change in price level.

We also caution the reader to be aware of the fact that it is possible to increase the tenant's risk when switching from a fixed cash rent to a flexible cash rental arrangement. We refer specifically to the risk of more frequent or more extreme low income years (income net of rent) than would be experienced with at fixed cash rent. The problem that can result when flexing rent on price or yield alone is the rent may be high when revenue is low. In fact where yields are generally good in a geographic area, prices are more likely to be depressed and vice versa. We will further illustrate the use of historical data to check a possible rental agreement using *Table III* below:

## Table III. Evaluating Rental Alternatives using Historical Yield and Prices.

| *Yield* | *Price* | *Revenue* | *Revenue-$60 Rent* | *Rent* * | *Revenue-Rent* |
|---|---|---|---|---|---|
| bu/acre | $/bu | $/ac | $/ac | $/ac | $/ac |
| 79 | $2.48 | $196 | $136 | $65 | $131 |
| 101 | 2.31 | 233 | 173 | 61 | 173 |
| 76 | 3.23 | 245 | 185 | 85 | 161 |
| 129 | 2.00 | 233 | 258 | 52 | 206 |
| 118 | 2.28 | 269 | 209 | 60 | 209 |
| 118 | 2.55 | 301 | 241 | 67 | 234 |
| Averages: | | | | | |
| 103.5 | $2.48 | $250 | $190 | $65 | $186 |

* Rent = (Price/$2.48) x $65/ac

Table III compares a fixed cash rent of $60 per acre to a price-flexed cash rent using a $65 base rent. For comparison purposes, the rent was subtracted from the revenue each

year and the years were ordered from low to high net revenue. Table III illustrates how flexing can be counter productive if, for example, one of the objectives of flexing the rent is to reduce the risk to the tenant. In particular, the three worst net revenue years are as bad or worse under the price-flexed rent. The reader can confirm that a rent flexed on revenue does a better job of protecting the tenant, for example, using a revenue flexed rent formula of rent = (revenue , $250) x $65 for the worst revenue year in Table III results in a rent of ($196 , 250) x $65 = $51 and a net revenue of $196 - 51 = $145 in contrast to a net of $136 with a fixed rent and $131 under the price-flexed rent.

A final note on the results in Table III: Multiplying the average yield by the average price results in 103.5 bu. x $2.48/bu = $256 in contrast to the average revenue of $250 in Table III. The difference is a result of prices tending to be low when yields are high and vice versa. The caution is to calculate revenue as an average whenever possible rather than calculating revenue from average yield x average price.

## Setting Prices and Yields

Key to any successful flexing arrangement is the base data to be collected and its use. How the price is to be set will need to be specified, including location of the price quote and the day(s) and week(s) to be used. Given the volatility of prices, using prices over several weeks may be considered, although additional effort will be required to collect the data. The procedure for using the data can also be complicated. Examples include: an average of the highest four mid-week prices over the months of October through December or the midweek prices for the four weeks following of harvest of the crop.

It is probably not desirable to set the rent based on an isolated peak in prices and an average over a long period may understate the true pricing opportunities that have existed. Again evaluating the procedure that is selected using historical data will be desirable.

Under a flexible cash rent the landlord will not be able to directly benefit from the price protection provided by the loan rate since the landlord does not receive any grain that is eligible for loan even if the rent is paid in kind. Therefore, when the market price falls below the loan rate, consideration should be given to replacing the loan rate for the market price if the market price is used in determining the flexible cash rent. The tenant will be eligible for the loan rate or loan deficiency payments on all of the bushels produced under the flexible cash rental arrangement as long as all other requirements are met.

If the objective is to determine a rent prior to the cropping season based upon projected prices, yields or revenue then cash-forward prices for fall delivery and a historical yield adjusted for any trend should serve the purpose. A historical average price or projected long-term price would be needed to establish a base for year-to-year adjustments in cash rent. Where the rental rate will be adjusted according to the income actually secured that year, the current year fall delivery cash forward prices could be used to establish a base

price. A historical yield adjusted for trend and the expected farm program payments could also be used to establish a base.

A decision will be needed on how to specify the actual yield to be used for flexing the rent. The tenant could be expected to assume the drying cost and any discounts in which case a moisture-adjusted yield could be used. Establishing the yield could be done using scale weights or bin measurements, for example, but the acceptable procedure should be agreed upon beforehand. Also, keep in mind the rent each year would depend upon the crop(s) grown unless it is agreed to determine the rent from a single crop that will be grown on some of the parcel each year.

## Summary

While conventional cash leases may be rather "generic" in nature, the flexible cash lease represents more of a "designer" type of lease. It is most beneficial to the parties involved when it is designed around their objectives and on leasing outcomes on which the landowner and the tenant operator mutually agree. Moreover, since it is unique and likely specifies several steps that need to be written into an agreement, it is recommended that it be reviewed by an attorney.

The various approaches previously discussed can serve as a starting point in building a flexible cash lease arrangement. But it should be recognized that deliberate involvement and negotiation will be needed by both parties. However, the landowner and tenant who are willing to work together in designing a flexible cash lease and then refining it over time may have considerably more opportunity to satisfy their mutual objectives than they would with a fixed cash rent.

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