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Some ABCs on Commodity Loans and LDPs

Roger Selley

University of Nebraska-Lincoln, RSELLEY1@UNL.EDU

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The objective of the loan rate has been to provide eligible producers the equivalent of a minimum price. When the market price remains below the loan rate a non-recourse loan accomplishes this objective by allowing the producer (borrower) to forfeit the grain provided as security and cancel a loan that was made at the loan rate. The grain must be in storage under loan for 9 months before forfeiture is an option. The net result with forfeiture is the producer realizes the loan rate (accrued interest is forgiven) less storage costs. The marketing/promotion assessment is also deducted from the loan proceeds, as is a loan service fee plus any bin measurement fees. If the market price rises above the loan rate the producer can repay the loan at anytime, plus accrued interest and market or feed the grain.

Instead of securing a non-recourse loan, the producer can opt for a direct payment called a loan deficiency payment or LDP. The LDP is designed to accomplish the same minimum price objective as the non-recourse loan by allowing the producer to apply for a LDP that is the difference between the loan rate and the current market price. As long as the producer sells the grain at the same market price used in determining the LDP, the loan rate will be realized.

For several years now, the non-recourse loan has provided producers with an opportunity to be assured of the loan rate for grain, while storing the grain in anticipation that prices will rise to cover interest and storage costs and more. The only major downside risk is that farm storage has the additional risk of spoilage.

Instead of securing a commodity loan the producer can take their LDP at harvest, for example, and store their grain in anticipation that prices will rise to cover storage costs and the interest that could have been realized (or saved) from an earlier sale, the farmer realizes the gain without any loan service fees (and if fed, the marketing/promotion assessment is avoided). Say the
market price is 25 cents below the loan rate when the LDP
is secured. If the grain is later sold at a price above the
loan rate, the producer will realize the market price plus
the LDP of 25 cents, less the cost of holding the grain. If
however, the producer sells the grain at a market price
below the price used to determine the LDP, the proceeds
will fall short of the loan rate. For example, a market price
of $1.60 and a loan rate of $1.85 will result in a LDP of
$.25. If the producer takes the $0.25 LDP and later sells
the grain at $1.40, only $1.65 in total is realized. If the
producer had taken the commodity loan for $1.85 and
delivered the grain against the loan, (s)he would have
realized the loan rate regardless of how low the price. The
lower the price the worse the outcome when taking the
LDP and later selling the grain. TAKING AN LDP
WITHOUT SELLING THE GRAIN CANCELS THE
MINIMUM PRICE GUARANTEE OFFERED BY
THE COMMODITY LOAN. Taking a LDP without
selling the grain increases the opportunity to profit but it
also exposes the producer to maximum downside risk.

To facilitate the determination of the LDP, a local
price called the posted county price or PCP is announced
each day by the FSA. The PCP is calculated using a
differential (basis) and terminal prices specific to each
commodity and location. The LDP is the county loan rate
less the PCP announced for that county for that day.

Since individual local prices frequently differ from the
PCP, that difference can be utilized to enhance profits.
One reason for the difference in the PCP and the local
price on a particular day is the PCP for today is based on
the market price for the previous day. Also, there may be
a lag between the adjustment of the differential used by
the FSA to determine the PCP and the local elevator's
adjustment in the basis.

Perhaps the simplest and least risky strategy to utilize
the LDP when the market is below the loan rate has been
to sell grain on an up market day and take the LDP the
same day. Since the LDP is based on the previous day’s
market price, the producer realizes the loan rate plus the
difference between the sales price and the PCP. A narrowing
of the local basis (the difference between the local
price and major terminal market prices) by an elevator can
provide a similar opportunity to realize more than the loan
rate, if the cash sale and LDP transaction is completed
before the FSA has made a similar adjustment in the
differential used in determining the PCP.

In addition to being used to calculate LDPS, the PCP
can also be used to repay an outstanding commodity loan.
When only non-recourse commodity loans were available,
producers could benefit by repaying a loan when the
market price exceeded the loan rate but would forfeit the
grain if the market price remained below the loan rate.
Now producers can benefit by repaying a loan at the PCP
when the PCP is below the loan rate plus interest, and sell
the grain at a market price that is above the PCP, thereby
realizing a few additional cents per bushel. Producers also
have the option to “lock in” a PCP for 60 days and repay
the loan at that rate during that period. The grain need not
be sold, but if sold the loan can be repaid at the “locked in”
PCP if the money is received during the 60 day period.

The strategies discussed above depend only on the
volatility of prices and recognition that the PCP has lagged
in its adjustment with changes in the market. They are also
strategies that are possible only when the PCP is below the
loan rate.

The LDP can also be used to enhance profits where
prices are above the loan rate and are expected to fall
below the loan rate. For example, the last 3 years have
provided opportunities to forward price grain above the
loan rate and subsequently pick up an LDP when prices
dropped below the loan rate. A LDP can be taken anytime
after harvest and prior to transfer of title of the grain. The
risk of this strategy is failure to produce the grain (or
storage losses) and profit foregone if prices rise above the
cash forward price. Some elevators offer minimum price
contracts, which provide the opportunity to sell at the
market price if the price rises above the minimum contract
price prior to delivery.

Maintaining eligibility for the price support program
is of particular concern when delivering grain. Producers
need to check with the FSA office if any transfer of
ownership is being considered. Delivery of grain to a local
elevator or feedlot requires the completion of a CCC-709
Field Direct Delivery Form prior to movement of the grain
to maintain eligibility for a LDP. The same applies to
grain to be cut for silage or grain to be fed to livestock.

Care is also required when certifying grain in storage
that is to be placed under loan. Contrary to past provisions,
FSA does not allow for over-run, so bushels removed from
a bin under loan will not be eligible for price support if it
exceeds the bushels certified and the deadline to apply for
a LDP is passed. Using past records of grain removed from
a bin can be more accurate than measuring corn in the bin.

In summary, always keep in mind a commodity loan
and taking a LDP are first of all alternatives for realizing
the price support. As indicated above, each have their
advantages and disadvantages and taking a LDP without
pricing the grain at the same time negates the price
guarantee. An additional consideration that could be
important in deciding which to use is the $75,000 payment
limitation on market gains from loans and LDP transac-
tions. Producers have the option to repay a loan at the PCP
using a commodity certificate that can be purchased at the
FSA office. Market gains realized when utilizing a com-
modity certificate exchange are not counted in the $75,000
limitation while all other loan and LDP payments are
included in the $75,000 limit.

Roger Selley, (402) 762-4442
Extension Economist
South Central Research & Extension Center