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Flexible Cash Leases: Some Additional Considerations

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Market Report	Yr Ago	4 Wks Ago	8/27/99
Livestock and Products, Average Prices for Week Ending			
Slaughter Steers, Ch. 204, 1100-1300 lb Omaha, cwt.	$57.75	$64.89	$65.55
Feeder Steers, Med. Frame, 600-650 lb Dodge City, KS, cwt.	71.25	80.17	84.97
Feeder Steers, Med. Frame 600-650 lb, Nebraska Auction Wght. Avg.	*	78.00	86.32
Carcass Price, Ch. 1-3, 550-700 lb Cent. US, Equiv. Index Value, cwt.	94.90	99.61	102.19
Hogs, US 1-2, 220-230 lb Sioux Falls, SD, cwt.	33.53	34.50	34.25
Feeder Pigs, US 1-2, 40-45 lb Sioux Falls, SD, hd.	*	*	22.06
Vacuum Packed Pork Loins, Wholesale, 13-19 lb, 1/4" Trim, Cent. US, cwt.	98.10	110.75	100.85
Slaughter Lambs, Ch. & Pr., 115-125 lb Sioux Falls, SD, cwt.	79.38	81.35	81.25
Carcass Lambs, Ch. & Pr., 1-4, 55-65 lb FOB Midwest, cwt.	165.00	177.00	182.00
Crops, Cash Truck Prices for Date Shown			
Wheat, No. 1, H.W. Omaha, bu.	2.51	2.97	2.73
Corn, No. 2, Yellow Omaha, bu.	1.64	1.75	1.59
Soybeans, No. 1, Yellow Omaha, bu.	5.06	4.26	4.28
Grain Sorghum, No. 2, Yellow Kansas City, cwt.	1.76	3.27	3.07
Oats, No. 2, Heavy Sioux City, IA , bu.	*	1.18	1.09
Hay, First Day of Week Pile Prices			
Alfalfa, Sm. Square, RFV 150 or better Platte Valley, ton.	*	82.50	97.50
Alfalfa, Lg. Round, Good Northeast Nebraska, ton.	55.00	*	65.00
Prairie, Sm. Square, Good Northeast Nebraska, ton.	70.00	*	55.00

* No market.

In the February 24, 1999 issue of this newsletter, John Cole discussed the idea of flexible cash leasing and described some examples for adjusting cash rents. Several of us have continued to discuss the flexible cash lease and have further explored its application. Part of our interest in flexible cash leases has been due to the relatively infrequent rate at which cash rents are adjusted (an average of once every 5 years in Nebraska) and a shift that has been taking place from crop-share rents to fixed cash rent. Some of what we have discovered in looking more closely at flexible cash leasing is shared below.

A fixed cash rent provides a stable income for landlords which may be a primary objective in those agreements. However, for a number of reasons, it may be desirable to have the cash rent closely reflect actual revenues and costs on an annual basis. For example, a fixed cash rent may be burdensome for the tenant when revenues are low and the landlord may be interested in sharing the risk of low revenue in exchange for a higher average rental income over time.

A reason for infrequent adjustments in cash rent may also be the effort that is required 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.

A flexible cash rental arrangement is an alternative to a crop-share arrangement that can accomplish the sharing of risk between the landlord and tenant. A flexible cash rent typically adjusts based upon the crop price and/or yield or may be flexed based on total revenue including farm program payments. Returns above operating costs such as seed, fuel and chemicals could also be used to trigger adjustments in a cash rent. An advantage of the flexible cash rent over a typical crop-share is a flexible cash rent does not require the landlord to share in input costs or production decisions and, therefore, does not constitute material participation by the landlord.

However, scheduling payments can have an added complication under a flexible cash lease. If, for example, a two-payment approach is used as is typical for cash leases in Nebraska, and the total rent calculated for the year is less than the first installment, is some of the first installment refunded or just no additional payment made? If the first installment is non-refundable, it in effect, becomes a minimum cash rent.

Also, at the time of this writing a flexible cash rent adjustment based upon price or a bushel rent 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 upon yield or revenue. We will consider below how these payments might be shared.

The rule that farm program payments would all go to the tenant if the rent is adjusted based on price alone may be considered a disadvantage. Also, the tenant may experience greater risk with a price-only adjustment, since prices (and rent) could be high when yields are low. If the rent is adjusted according to yield, some of the farm program payment would go to the landlord. Using the base rent as a percent of projected revenue at the base yield, it would likely be accepted by FSA as a reasonable allocation of farm program payments.

Adjusting rent based on yield alone has the advantage of not requiring collection of price data. However, similar to using price alone to adjust rent, using yield alone has the risk that a high yield (and high rent) may coincide with a low price. Adjusting rent based on revenue will guarantee revenue and rent move together while other methods may not. Whatever the mechanism that is being considered, it is advisable to consider either a range of situations that might be expected to occur or to see how the mechanism would have performed in past years before adopting any procedure.

Setting Prices and Yields

Key to any flexing arrangement is the 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.

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.

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 yield 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 dockage, 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.

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