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# Some ABCs on Commodity Loans and LDPs

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August 30, 2000

# Cornhusker Economics

Cooperative Extension

Institute of Agriculture & Natural Resources
Department of Agricultural Economics
University of Nebraska – Lincoln

## Some ABCs on Commodity Loans and LDPs

| Market Report | Yr Ago | 4 Wks Ago | 8/25/00 |
|---|---|---|---|
| ***Livestock and Products, Average Prices for Week Ending*** | | | |
| Slaughter Steers, Ch. 204, 1100-1300 lb Omaha, cwt. | $65.55 | $65.66 | $65.83 |
| Feeder Steers, Med. Frame, 600-650 lb Dodge City, KS, cwt. | 84.97 | 94.50 | 82.00 |
| Feeder Steers, Med. Frame 600-650 lb, Nebraska Auction Wght. Avg. | 86.32 | 107.12 | 99.95 |
| Carcass Price, Ch. 1-3, 550-700 lb Cent. US, Equiv. Index Value, cwt. | 102.19 | 103.30 | 101.74 |
| Hogs, US 1-2, 220-230 lb Sioux Falls, SD, cwt. | 34.25 | 47.50 | 45.00 |
| Feeder Pigs, US 1-2, 40-45 lb Sioux Falls, SD, hd. | 22.06 | 40.60 | 41.20 |
| Vacuum Packed Pork Loins, Wholesale, 13-19 lb, 1/4" Trim, Cent. US, cwt. | 100.85 | 126.70 | 115.75 |
| Slaughter Lambs, Ch. & Pr., 115-125 lb Sioux Falls, SD, cwt. | 81.25 | 82.75 | 74.13 |
| Carcass Lambs, Ch. & Pr., 1-4, 55-65 lb FOB Midwest, cwt. | 182.00 | 185.00 | 168.00 |
| ***Crops, Cash Truck Prices for Date Shown*** | | | |
| Wheat, No. 1, H.W. Omaha, bu. | 2.73 | 2.82 | 2.99 |
| Corn, No. 2, Yellow Omaha, bu. | 1.59 | 1.42 | 1.49 |
| Soybeans, No. 1, Yellow Omaha, bu. | 4.28 | 4.27 | 4.42 |
| Grain Sorghum, No. 2, Yellow Kansas City, cwt. | 3.07 | 2.79 | 2.73 |
| Oats, No. 2, Heavy Sioux City, IA , bu. | 1.09 | 1.26 | 1.18 |
| ***Hay, First Day of Week Pile Prices*** | | | |
| Alfalfa, Sm. Square, RFV 150 or better Platte Valley, ton. | 97.50 | 125.00 | 110.00 |
| Alfalfa, Lg. Round, Good Northeast Nebraska, ton. | 65.00 | 67.50 | 77.50 |
| Prairie, Sm. Square, Good Northeast Nebraska, ton. | 55.00 | 75.00 | 77.50 |

* No market.

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 prices will rise. If prices do 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

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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 transactions. 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 commodity certificate exchange are not counted in the $75,000 limitation while all other loan and LDP payments are included in the $75,000 limit.

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