POLICY MINUTE

The ABCs of LDPs and Marketing Loans

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This year's wheat harvest in Kansas has been reported as one of the best in many years, with excellent yields in many areas of the state. In fact, some producers may have harvested more wheat this year than they have the last two or three years combined.

Now that farmers have a large crop on hand, they are facing wheat prices that have fallen below the loan rate. As such, producers may want to carefully consider marketing loans or loan deficiency payments as part of their marketing decisions.

The marketing loan program is a complex program that offers producers both a source of low-interest credit and a safety net on market prices. Understanding how the marketing loan program works can provide some guidance on decisions and strategies for producers to consider.

A general discussion of the various issues with the marketing loan follows below. Program information is available from any local FSA office or from the FSA website at www.fsa.usda.gov under the price support program link (or directly at http://www.fsa.usda.gov/dafp/psd/). Direct links to specific program information are also listed in the Commodity section of the Policy section of AgManager at agmanager.info.

Marketing Loans and the Safety Net

The marketing loan program provides the foundation for the overall farm income safety net of loans, direct payments, and counter-cyclical payments. While direct payments and counter-cyclical payments are paid based on predetermined base acreage and payment yields, marketing loan benefits are tied to actual production and price.

The marketing loan is not actually a formal price support program, but rather an income support program tied to price. The marketing loan provides income support to producers in the form of loan proceeds at the loan rate. Producers can then repay the loan at the lower of the loan rate plus accrued interest or the posted county price (PCP) which is reflective of local market prices. Since the marketing loan can be repaid at market prices, commodities placed under loan can be redeemed and sold in the market even when market prices are below loan rate. Alternatively, producers can claim a loan deficiency payment (LDP), realizing the same benefits as under the loan, but without going through the actual loan process.

These features of the marketing loan program generally keep grain moving in the market instead of accruing in government stocks through loan forfeitures even when prices are below the loan rate. Thus, the marketing loan does not attempt to support market prices at the loan rate, but rather provides an income support to producers based on the loan rate.

Marketing Loan Mechanics

Marketing loan rates vary across every county in the country based on a complex relationship of national loan rate levels and local marketing patterns.

Using wheat as an example, the national average loan rate for wheat was specifically set in the 2002 Farm Bill at $2.80 per bushel for 2002 and 2003 and at $2.75 per bushel for 2004 through 2007. In implementing the loan rates, USDA established separate loan rates by county and by

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class of wheat. All counties in Kansas in fact have a separate loan rate for hard red winter wheat and soft red winter wheat while a handful of counties even have a published hard red spring wheat loan rate.

The loan rate for a given county for a given class of wheat is established relative to the national average loan rate adjusted for that county's marketing and basis patterns relative to the national average. Using 2003 loan rates in Allen County in Kansas as an example, the loan rate for hard red winter wheat is $2.86 per bushel while the soft red winter wheat loan rate is $2.39 per bushel.

Each county also has a separate PCP determined daily that is designed to be representative of current local market prices. The PCPs are established for each county based on the relationship of that county to two major terminal markets for each commodity. USDA releases a daily report of the previous day's observed prices at several terminal markets across the country. For winter wheat in Kansas, the relative markets are Kansas City and the Gulf of Mexico. These two terminal market prices are adjusted back to the county level by an established market differential that should be representative of local basis patterns to that market. The higher of these two adjusted prices is established as that day's PCP.

Table 1 provides a mathematical example of the calculation of the PCP, using data from July 10 for Allen County as an example. Daily PCP information can be found in an accessible database on the FSA website. A direct link to the database is provided in the Commodity Programs section of the Policy section of the AgManager website.

The relationship of the loan rate and the PCP in a given county determines the potential availability of either LDPs or MLGs. The two effectively provide the same income support, but work in separate ways. The potential LDP is equal to the loan rate minus the PCP if positive or zero if not. The LDP can be taken in lieu of a loan. Table 2 provides a mathematical example of the calculation of the LDP rate, again using data from July 10 for Allen County as an example. Daily LDP information can be found in another accessible database on the FSA website. A direct link to the database is also provided in the Commodity Programs section of the Policy section of the AgManager website.

Table 1. Posted County Price for Hard Red Winter Wheat, Allen County, July 10, 2003.

	Terminal Market	
	Kansas City (KCM)	**Gulf (GLF)**
	($/bushel)	
Reported Terminal Market Rate	2.99	3.40
Market Differential	-0.46	-0.73
Adjusted Market Rate	2.53	2.67
Posted County Price (higher of adjusted market rates)	2.67	

Table 2. Loan Deficiency Payments and Marketing Loan Gains for Hard Red Winter Wheat, Allen County, July 10, 2003.

	($/bushel)
Market Loan Rate	2.86
Posted County Price	2.67
Potential LDP or MLG (difference if greater than zero)	0.19

As an alternative to the LDP, a producer can place the commodity under a marketing loan, receiving proceeds equal to the loan rate. The marketing loan is available for a period of nine months and currently has an annual interest rate of two percent. Once the commodity is under loan, the producer has several options for repaying the loan. The most basic is that the producer can repay the loan at any time before maturity at the lesser of the PCP or the loan rate plus accrued interest. If, as in the example in Table 2, the PCP is below the loan rate, the producer can repay the loan at the PCP with the

accrued interest waived. The difference between the loan rate and the PCP is a MLG to the producer, effectively providing the same gain as if the producer took the LDP. Thus, the potential LDP or MLG shown in Table 2 is identical.

Marketing Loan Alternatives

Given the equivalence of the LDP and the MLG, it might seem that marketing loan program decisions are relatively simple and that distinctions between the two are trivial. However, there are various rules and situations that might strongly favor one versus the other.

A producer actually has several options to consider in the marketing loan program, but it is important to remember that these decisions can only be made while the producer has beneficial interest in the commodity. Beneficial interest is defined by FSA as control of the commodity, risk of loss, and title to the commodity. Essentially, a producer gains beneficial interest in the commodity when it is harvested and loses beneficial interest in a commodity when it is delivered to the market for sale, including delayed pricing.

For a producer with no storage, they have beneficial interest in the commodity only until they deliver it to market at harvest for sale. For a producer with available on-farm or commercial storage, they can retain beneficial interest in the commodity as long as they keep it in storage.

1. <u>Loan Deficiency Payment</u> - A producer can take a LDP in lieu of a loan on any day, as long as they have maintained beneficial interest in the commodity. If a producer has no storage, they can file with FSA for a field direct LDP, taking the LDP, if available, for the day on which the commodity is harvested, delivered, and sold to the elevator. The amount collected as a LDP is subject to payment limits.

2. <u>Marketing Loan</u> - A producer can take a marketing loan on the commodity in storage as long as they maintain beneficial interest. From that point, there are several options.

a. The loan can be repaid with cash anytime before maturity at the lower of the loan rate plus accrued interest or the PCP. Here too, there are a few possibilities.

i. The loan can be repaid at the loan rate plus accrued interest. If the loan rate plus accrued interest is less than the PCP, then the repayment rate would simply be the loan rate plus accrued interest and there would be no MLG and no interest waived.

ii. The loan can be repaid at that day's PCP. If the PCP is below the loan rate, the interest is waived and the difference between the loan rate and the PCP is realized as a MLG subject to payment limits. If the PCP is equal to or above the loan rate, but below the loan rate plus accrued interest, some or all of the interest is waived, but no MLG is realized.

iii. The PCP can be locked in once for a period of 60 days, and, anytime during that 60 days, the loan can be repaid at the locked-in PCP. If not, the locked-in PCP expires and on day 61 or later, the loan can be repaid at that day's PCP. In either case, repayment then works just as in 2.a.ii above which can result in a MLG subject to payment limits.

b. The loan can be repaid with generic certificates at that day's PCP. Generic certificates can be purchased from the government on a dollar-for-dollar basis and then can be used to repay the loan at the PCP. This provides the same result as in 2.a.ii above, with waived interest and a potential realized gain (loan rate minus the PCP), but the gain is not considered a MLG and thus is not subject to payment limits.

c. The loan can be held until maturity and the commodity forfeited to the government. This option essentially provides the same gain to the producer as in 2.a.ii and 2.b above when the PCP remains below the loan rate. Here too, any realized gain (loan rate minus the PCP) is not considered a MLG subject to

payment limits. However, with the availability of generic certificates as in 2.b above, storing the commodity under loan until maturity simply to avoid payment limits is not necessary and is generally not preferable.

Marketing Loan Strategies

Given the various alternatives, there are a few basic strategies that producers can consider based on a producer's storage situation and based on their marketing plans and expectations.

If a producer has no long-term storage available, either on-farm or commercial, then they are generally limited to only the potential LDP. If the commodity is delivered at harvest directly from the field to the elevator for sale, then the producer must apply for a field-direct LDP before making delivery. If the producer has short-term storage available at the elevator (such as free storage for a period of several days or weeks), then the producer may be able to claim an LDP on the commodity in storage before having to sell to the elevator. But, if they lose title to the grain, such as with an immediate sale or even a deferred pricing contract, then they no longer have beneficial interest in the commodity and would not be able to claim a LDP.

If a producer plans to store the commodity before selling, then taking out a marketing loan is generally worthwhile. Even if the price of the commodity is above the loan rate, taking out a loan provides low-interest access to funds equal to the loan rate, reducing the opportunity cost of storing the commodity for later sale. And, if the price of the commodity is at or below the loan rate, then the marketing loan potentially provides an interest-free loan as well as a chance to take advantage of future price movements.

The marketing loan program also provides two methods by which a producer can effectively make marketing decisions after the fact, taking advantage of price movements after they occur.

First, remember that the daily PCP is based on the previous day's terminal market prices. Thus, when a major market move occurs and prices rise sharply on a given day, then that day's market prices are higher while that day's PCP continues to reflect the previous day's lower prices. Thus, it is possible to claim a LDP or to redeem a loan and earn a MLG that is effectively based on the previous day's lower prices and then sell the grain at the current day's higher prices. This one-day lag in the PCP results in a one-day window during which one can observe price movements before having to make a pricing decision.

Second, for commodities put under loan, the opportunity to lock in a PCP for 60 days effectively provides a 60-day window to observe price movements before having to make a pricing decision. This 60-day lock-in works much like an option contract. If prices rise during the 60-day period, the daily PCP would also generally rise, but the locked-in rate remains fixed. Thus a producer could take advantage of a price rally during the 60-day period by repaying the loan at the lower locked-in PCP and selling the grain at the higher market prices.

If on the other hand, prices fall during the 60-day period, the daily PCP would also generally fall. Thus, the locked-in PCP would be higher than the current PCP. However, the producer can allow the locked-in PCP to expire, and as early as day 61, the producer could repay the loan at the now-lower PCP.

In sum, the marketing loan, and particularly the 60-day lock-in on the PCP, provides the producer an opportunity to benefit from a general rise in prices while being protected from a general fall in prices. And, with the availability of generic certificates, the benefits of the marketing loan do not disappear once the payment limit of $75,000 per person per year for LDPs and MLGs is reached.

This benefit of the marketing loan program may not be worth anything more than a low-interest loan when prices are above the loan rate. But in times when prices are at or below the loan rate, the benefits of the marketing loan program can be substantial.