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Costs and Other Information on USDA's Commodity Certificates

Statement of
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Committee on Agriculture, Nutrition, and Forestry
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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss certain aspects of the U.S. Department of Agriculture's (USDA's) use of commodity certificates. Certificates are negotiable documents issued by USDA's Commodity Credit Corporation (CCC) in lieu of cash payments under certain commodity price-support and export promotion programs. They are issued in dollar denominations, and, with certain exceptions, they are "generic" in that they can be exchanged for any commodity under loan to, or owned by, CCC.

We focused our work on commodity certificates primarily on the costs to the government of issuing certificates instead of cash payments. However, because these costs depend in part on how the certificates are used, we also analyzed why certificates have been used as they have been by farmers and grain companies. As I will explain, certificate use is driven largely by the benefits they confer on the users. In addition, we looked into why certificates have traded for premiums--that is, prices exceeding their face value.

Mr. Chairman, before getting into the results of our analysis, I think it would be helpful to briefly discuss the background of certificates.

CERTIFICATES AND THEIR USE

The Food Security Act ~~of 1985~~ (P.L. 99-198) provided the Secretary of Agriculture with statutory authority to issue negotiable commodity certificates to make in-kind payments to eligible farmers who choose to participate in certain government price- and income-support programs and to companies that participate in USDA's export promotion programs. The Secretary used this authority to issue commodity certificates for a portion of CCC's program payments to both farmers and companies. For example, instead of receiving $1,000 in cash, a farmer receives a certificate with a face value of $1,000, which the farmer can exchange for $1,000 worth of commodities. The exchange prices of the commodities, referred to as posted county prices, or PCPs, are set by CCC on the basis of observed market prices.

Between April 1986, when certificates were first issued, and January 1987, CCC issued about $5.5 billion in certificates. Of this amount, about $4.1 billion represents price deficiency and land diversion payments to farmers participating in CCC's price- and income-support programs. Through February 1987, about $3 billion have been exchanged and the remainder are outstanding.

Farmers who receive certificates may exchange them for their crops under price-support loans, or, after a certain waiting period, exchange them for cash from CCC. Farmers may also sell their certificates to other farmers, grain companies, or any other interested buyers. Grain companies may in turn resell the certificates, or may exchange them for commodities owned by CCC.

CERTIFICATES WILL INCREASE CCC PRICE-SUPPORT LOAN OUTLAYS

The cost of certificates depends primarily on how the certificates are used, which in turn depends on existing market conditions. Although certificates can affect the budget in several ways, their greatest impact is on price-support loan outlays.

Consequently, we focused our effort on quantifying the effect of certificates on net loan outlays. Net loan outlays are a measure of the dollars loaned to farmers less the cash repayments made to CCC. We estimate that the $3 billion in certificates exchanged through February 1987 will increase CCC's net loan outlays by about $3.09 billion to $3.64 billion. Compared with the approximately $2.98 billion in cash program payment outlays that were avoided by issuing these certificates, this is a net increase in total CCC outlays of about $107 million to $653 million.

However, this increase will be offset to some extent by short-run commodity storage cost savings to CCC. While these are difficult to quantify, we estimate that these savings could be from about $169 million to $253 million. I will discuss the basis for these estimates later in my testimony.

Why loan outlays will increase

When certificates are issued, government expenditures are not initially affected because certificates, unlike cash payments, are not treated as budgetary expenditures. However, when certificates are exchanged for commodities, outlays for CCC's price-support loans ultimately rise. We estimate that this rise in loan outlays will exceed the reduction achieved by issuing certificates.

The rise in loan outlays happens for two basic reasons. First, net loan outlays rise directly as farmers place under loan, and then immediately exchange certificates for, crops that they would otherwise not have placed under loan. They use certificates in this way to benefit from the price-support loan program without having to incur the storage costs usually associated with that program. This increases net loan outlays.

Second, net loan outlays rise indirectly when farmers exchange certificates for loan commodities that they otherwise would have forfeited, or when grain companies exchange certificates for CCC-owned inventory. These uses of certificates tend to increase the supply of commodities in the marketplace. These increased supplies may cause commodity prices to decline; this effect has been most obvious for corn. Price declines, in turn, induce some farmers to obtain loans they would otherwise not have made or to forfeit commodities under loans that they would otherwise have repaid in cash. This also increases net loan outlays.

Available data do not permit exact measurement of the increase in CCC's net loans due to certificates. Our estimates are based on available data about market conditions, certificate use to date, and estimates about how the demand for certain commodities responds to price changes. In general, net loan outlays will rise more when market prices for some crops are well below their loan rates, as they are today, than when all market prices are at or above loan rates. If conditions change (for example, if corn export demand were to increase, raising corn prices), the cost effects of certificates used in the future could be smaller.

Factors that work to offset increased net loan outlays

While certificate use has increased outlays for the loan program, certificates will reduce CCC's short-run storage costs and may have helped avoid some transportation costs.

Certificates may have helped ease the Corn Belt storage crunch that USDA expected for the fall 1986 harvest. Farmers had a financial incentive to exchange certificates for corn that otherwise would have been forfeited to CCC. Because commercial storage in the Corn Belt was limited at that time, CCC may have transported forfeited corn to parts of the country where storage was available. However, because it is difficult to estimate just how much transportation would have occurred, it is difficult to quantify the savings.

Certificates reduce short-run storage costs when they are exchanged for CCC-owned inventory, for farmer-owned reserve loan collateral, or regular loan collateral that farmers would otherwise have forfeited to CCC. While we estimate that inventory reductions resulting from these certificate uses will ultimately be offset by an equal or almost equal amount of forfeited grain, there may be a span of several months between the exchanges and the certificate-induced forfeitures.

Storage cost savings are difficult to quantify because we do not know what this average time span may be. We also do not know how long CCC-owned commodities exchanged for certificates would have remained in CCC inventory in the absence of certificates. Assuming that about 6 months storage was avoided, we estimate savings of about $169 million; assuming 9 months of avoided storage raises this estimate to about $253 million. However, the actual storage savings could be more or less than these amounts.

CCC's future storage costs will be reduced only if, in the long run, certificates ultimately reduce CCC-owned inventory. We believe that such a reduction, if it occurs, will not be large. This is because we believe that the quantity of CCC-owned inventory exchanged for certificates will not be much greater than the additional quantity that will ultimately be forfeited to CCC as a result of certificates. Certificates are likely to cause a significant inventory reduction only if they decrease commodity prices enough to stimulate more consumption. There is some evidence that certificate use has led to lower corn prices; however, the effect of certificates on other commodity prices is not clear.

Why outlay effects may be delayed

In addition to affecting the size of budget outlays, certificates may also affect their timing. Substitution of certificates for cash payments can shift outlays from one year to the next. This is because certificates, issued instead of cash payments, cause current-year outlays to be lower than they would have been otherwise. However, increased loan outlays attributable to the certificates may not occur until much later. Two factors account for this delay.

First, certificates are not always used immediately after they are issued. Most of the offsetting increase in loan outlays will not occur before the certificates are exchanged. If certificates are not exchanged until the fiscal year after they are issued, then most of the increase in net loan outlays will occur in the following year, not the year of issuance. In this way, total outlays will be shifted from one year to the next.

Second, there may be a time lag between the increased quantity of commodities brought on the market by certificate exchanges and a resulting decline in the market price. Additional time may pass before farmers respond to lower prices by obtaining loans that they would otherwise not have obtained, or by forfeiting loans they would otherwise have repaid in cash.

POTENTIAL BUDGETARY CONTROL ISSUE

Under current budgetary reporting procedures, certificate amounts are not included in the budget's outlay totals at the time of issuance, even though they ultimately have effects similar to outlays. This may lessen the usefulness of the budget and its reported outlay amounts to the Congress in its budget-related deliberations and actions. The proper budget treatment of certificates is a complex and technical matter, but one that the Congress may wish to study further.

HOW FARMERS BENEFIT FROM COMMODITY CERTIFICATES

When farmers obtain price-support loans from CCC, they are obligated to store the loan collateral, at their expense, during the loan term, which can be up to 9 months. The cost of storing the crops in effect reduces the farmers' financial return from the loan program. For example, a farmer who obtains a loan of $1.84 for each bushel of corn would not realize a return of $1.84 per bushel if he or she forfeits the corn at the end of 9 months; the return would be $1.84 per bushel minus the cost of storage.

Certificates change this situation. Specifically, eligible farmers can now take out price-support loans and immediately exchange certificates for the loan crops at posted county prices. In this way, farmers obtain the full return from the loan program because they avoid the storage costs.

Certificates also give farmers more flexibility in marketing their crops. After benefitting from the loan program, farmers may temporarily keep their crops to take advantage of possible price increases. Farmers doing this of course risk a price decline. In addition, farmers who exchange certificates for their price-support loan collateral may also profit by marketing their crops at prices higher than the exchange prices established by CCC. While it attempts to set these prices to reflect market prices, CCC occasionally sets these values below actual market prices.

Finally, some farmers have enhanced their incomes by selling their certificates at premiums to other farmers or grain companies.

HOW GRAIN COMPANIES BENEFIT FROM CERTIFICATES

Certificates have given the grain industry greater access to CCC-owned grain at market prices. Thus, grain can be more readily obtained when and where needed. Certificates have also enabled grain companies, like farmers, to profit when they can exchange certificates for CCC-owned commodities that are worth more to them than the prices established by CCC.

Finally, grain companies may profit by serving as intermediaries in trading certificates. Several large grain companies told us that they actively buy and sell certificates. In addition to receiving commissions on purchase and sales transactions, according to the companies, they use certificates as marketing tools to bring grain business to their facilities.

Grain companies were reportedly involved in helping farmers take advantage of a specific CCC loan program provision. This provision allows farmers facing storage problems in their locality to obtain a loan, not on the crops they harvested locally, but on an equivalent quantity of the same crops located in a part of the country where storage is available in commercial facilities. In such cases, the farmer's grain is said to have been "substituted."

Because posted county prices vary among localities, some farmers could benefit more from certificates by first substituting their loan grain, then exchanging certificates for the grain. In some situations this practice was so profitable that farmers could buy certificates from grain companies at a substantial premium and still come out ahead financially. USDA ended this practice on October 31, 1986. We plan to issue a separate report on this matter later this year.

WHY CERTIFICATES HAVE TRADED AT PREMIUMS

As I stated earlier, some farmers as well as grain companies have been willing to purchase certificates at prices exceeding their face value. It is important to note that, in and of themselves, premiums paid for certificates do not cause government costs to increase.

As with other negotiable goods, the price at which certficates trade depends upon two factors: the supply of certificates available to be traded and the demand for certificates by farmers, grain companies, or other parties. The supply of certificates available for trade depends upon the amount CCC issues as well as the recipients' willingness to trade. Certificate demand--and the recipients' willingness to trade--is driven by the benefits they provide to farmers and the grain industry, as I have just outlined. Both the supply and demand for certificates can change over time. Because of the benefits certificates provide, farmers and others have been willing to buy them at premiums.

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This concludes my prepared statement. I will be glad to answer any questions you may have.