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Basic Marketing of Texas Cotton

Forward Contracts, Cash Sales, Marketing Pools and the USDA Loan Program

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Several basic marketing alternatives are available for cotton producers and may be of particular interest to new cotton producers in the northern Texas High Plains, the South Texas/Winter Garden boll weevil eradication zone and elsewhere. These alternatives include forward contracts, cash sales at harvest, marketing pools and U.S. Department of Agriculture (USDA) loan programs.

When choosing among these alternatives, growers should take into account the advantages and disadvantages of each as well as consider hedging with futures and options.

Forward Contracts

A forward contract is a legal agreement that specifies either the price or the basis for a quantity (either bales or acreage) and quality of cotton delivered by a future date. Cotton merchants use forward contracts to guarantee minimum supplies at an established price in order to make sale commitments to end users.

Forward contracts are not used in Texas as much as in other parts of the Cotton Belt (Table 1) because the contracting merchants face less production risk in the more stable production areas outside Texas, which is also why they tend to offer bale contracts in those regions. Because Texas has extreme variations in weather and production, most forward contracts are based on contracted acres and are offered more often during times of relative shortage.

Acreage contracts imply that the merchants share in more of the production risk. They may make up for this in the price/basis terms offered and in the late timing that contracts are offered during the season.

The terms of cotton marketing contracts are fairly uniform across the country. They are based on model contracts approved by the Texas Cotton Association and the American Cotton Shippers Association.

Considerations

The wisdom of the ages applies to forward contracts: *Read the fine print*. Contracts may or may not include disaster clauses, penalties for late delivery, yield limitations or other stipulations, so it behooves the grower to study them in detail.

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Table 1. Percentage of Planted Acreage of Upland Cotton Under Foward Contract, by Region, as of August 1, 1997, to 2006 and Planted Acreage, 2006 Crop[1].

States	Percentage of Planted Acreage Under Forward Contracts										Planted Acreage[2]
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	
Southeastern States	29	31	12	26	6	7	9	13	10	3	3,355
South Central States	30	34	6	11	6	3	4	*	11	9	4,205
Southwestern States (includes Texas)	12	13	2	5	5	-	1	4	3	2	6,800
Western States	23	30	1	4	*	*	*	*	-	-	580
United States	21	24	5	12	5	2	4	5	7	4	14,940

[1] Contracting estimates do not include cotton consigned to marketing organizations but do include cotton contracted with marketing organizations.

[2] June 2006, Agricultural Stastics Board, NASS, USDA

*Less than 0.5 percent

Another important question about any forward contract is its effect on the grower's legal ownership status ("beneficial interest," in USDA parlance) during the period that growers will also be participating in USDA loan programs. In general, growers want contract language that allows them to retain beneficial interest until after the grower applies for loan deficiency payments (discussed below).

Advantages

A major advantage of forward contracts is the ability to reduce price (or basis) risk by locking in a favorable price (or basis) when the opportunity exists in the market. Growers should recognize that this reduction in price risk is not free. The price/basis terms offered by the buyer are likely what is required to either bear the price risk or else hedge the buyer's position in the futures market.

Another advantage of early contracting is that it may enable growers to more easily secure operating loans.

Disadvantages

For growers, the drawbacks to forward contracting include:

- Contracts may not be offered at times when growers would prefer to lock in a price/basis.
- There is no transparent way to evaluate the terms of different contracts consistently (other than just hearsay or experience).
- Quality specifications are subject to the USDA's Commodity Credit Corporation (CCC) loan schedule of premiums and discounts. Research has shown that the CCC loan schedule overly penalizes Texas cotton in reflecting the true market value of quality differences.

Cash Sale at Harvest

A similar but simpler marketing alternative is to sell your cotton after harvest to a gin/broker, independent broker or larger merchant/shipper.

Advantages

The advantage of this approach is simplicity: There are no risks related to not fulfilling production contracts. There is also no basis risk to consider.

Disadvantages

When waiting to sell at harvest, the grower is fully exposed to price risk, basically bearing whatever the market happens to be offering at harvest time. Harvest-time prices tend to be lower, as shown in Figure 1 for the higher Lubbock cash prices in the months proceeding the December harvest time. This graph illustrates the advantage of forward pricing to take advantage of higher prices before harvest.

Like forward contracts, harvest-time cash sales contracts are also typically based on the CCC loan schedule of premiums and discounts, which has the aforementioned disadvantage for Texas cotton.

The problem is compounded by the use of USDA-Agricultural Marketing Service (AMS) spot market quotes as the means of price discovery, that is, the process or degree to which market prices reflect the value of a given quantity, quality, location and lot

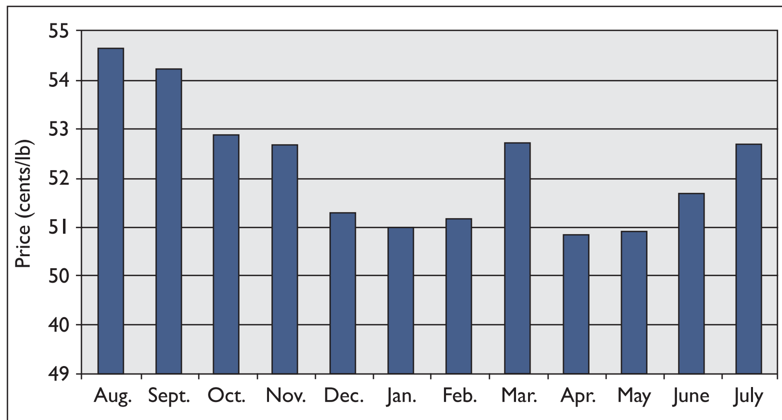

Figure 1. West Texas 41-34 Cotton Average Monthly Spot Price, 1995/96–2004/05.

size of a commodity. As with the CCC loan schedule, research in Texas indicates that USDA-AMS spot prices do not provide consistent, accurate or comprehensive valuation of the range of qualities of cotton across Texas. Thus, cash bids may not reflect the value of your quality relative to that of others.

Marketing Pools

Popular among Texas cotton growers, marketing pools are typically farmer cooperatives that provide, among other services, marketing services for the pooled production of the co-op members. More recently, private merchant companies have also organized marketing pools that are affiliated with that merchant company.

A 2001 article in Progressive Farmer listed 13 regional cotton marketing pools in the United States, but there are many smaller pools consisting of groups of gins.

Considerations

In considering marketing pools, growers should ask about the requirements and provisions for the level of production that must be committed, the pricing flexibility and any premiums offered for quality attributes.

For example, a marketing pool may offer growers a choice of a “seasonal pool,” in which the marketing pool makes all the pricing, hedging and farm program decisions, or a “call pool,” in which the grower has some choices.

Growers should also make sure that the pool they are considering is reputable and has financial integrity.

Advantages

The advantages of marketing pools are that in theory they have a stronger bargaining position in selling large volumes of cotton than would an individual farmer. Other significant advantages of marketing pools for growers are that pools are usually available and easy to use, guarantee market access and provide an average price received for the season (although the latter could also be seen as a disadvantage). In short, pools provide “a home” for cotton and free the growers from having to find and negotiate with buyers.

Marketing pools that are organized as grower cooperatives (as most of them are) have another legal advantage: They can place their cotton into the CCC loan program (discussed below), which creates storage advantages when markets prices are below the loan rate.

Finally, because there are many marketing pools available, they compete with each other as well as with local merchants. Growers should benefit from this competition in terms of either higher offers from local merchants or the best terms offered by pools.

Disadvantages

The main disadvantages of pools are like those of forward contracts. It is difficult to get marketing performance information from pools to be able to compare and choose among them.

Also, as with forward contracting, there is no free lunch. The marketing services will come at a cost, which may include agent fees, limits on pricing flexibility, limits on quality premiums or simply in getting an average price instead of being in the upper third.

USDA CCC Loan Program

The “cotton loan program” is technically part of the USDA’s marketing assistance program authorized by the 2002 farm bill. This loan program establishes a government floor or support price for cotton at the loan rate of 52 cents per pound. In the CCC loan program in previous decades, the USDA essentially bought up all cotton when prices were below the loan rate, effectively supporting grower prices at the loan rate.

The "loan rate" terminology exists because the program is designed as a financial operation: growers receive a non-recourse "loan" from the USDA valued at the loan rate times their bales of cotton, with the latter as collateral. If post-harvest market prices exceed the loan rate, growers can redeem their cotton, pay off the CCC loan (plus storage) and sell it. If prices are below the loan rate, growers simply forfeit their cotton to the USDA and keep the loan.

The implications of this were that the government collected large amounts of cotton when prices were low. Beginning in the 1980s, provisions were added to move this cotton directly to the world market while still maintaining the price support system.

Today (at least until the next farm bill in 2007), the cotton loan expands the domestic price support system by taking world prices into account. A British company called CotLook, LTD, calculates and publishes an index of world cotton prices called the CotLook A-Index (referred to by USDA as the Northern European price).

The A-Index is the average of the five lowest price quotes of the following world cotton descriptions (all middling grade, 1 3/32-inch staple length): Memphis Territory; California-Arizona; Mexico; Central America; Paraguayan; Turkish; Uzbekistan; Pakistani 1503; Indian H-4; Chinese Type 329; West African; Tanzanian; Greek; Syrian; and Australian.

The USDA uses the A-Index to calculate the official adjusted world price (AWP) each week. The AWP adjusts the A-index for the average cost differences of transportation and handling from the United States to northern Europe, and the average quality differences for U.S. base grade (strict low middling grade, 1 1/16-inch staple length) cotton. The AWP calculation as of August 3, 2006, is shown in Table 2.

Table 2. Adjusted World Price of Cotton as Determined by USDA, as of August 3, 2006.

A-Index of World Prices	60.35
Adjustment to U.S. Location and Grade	-15.93
Adjusted World Price (AWP)	44.42
U.S. Average Loan rate	52.00
Loan Deficiency Payment Rate (LDP = Loan-AWP)	7.5890

The AWP then reflects the value of U.S. cotton on the world market—that is, roughly what a foreign buyer would bid for U.S. cotton. The loan deficiency payment (LDP) calculated above is roughly the difference between the USDA loan rate and what the grower would get by selling it on the world market. (The LDP is sometimes called a "POP" payment by growers; "POPing your cotton" means applying for an LDP.)

The current cotton loan program is designed to keep the 52-cent support price effective, so when world prices are low, the program pays the LDP to sell growers' cotton on the world market instead of putting their cotton in the loan program.

The LDP shrinks to zero in years when the A-Index of world prices is high enough to result in an AWP in the mid-50s or higher. Conversely, the LDP increases as world prices (and hence the AWP) falls below 52 cents per pound.

If world prices are low, growers have several alternatives to receive payments:

1. **Forward contract before harvest, and apply to the USDA for an LDP while still maintaining beneficial interest.**

   A producer retains beneficial interest in a quantity of a commodity if he or she has control of the commodity, risk of loss and title to the commodity. For loans, a producer must retain beneficial interest in the commodity from the time of harvest through the date the loan is redeemed or CCC takes title to the commodity. For LDPs, a producer must retain beneficial interest in the commodity from the time of harvest through the date the LDP is requested.

   Once beneficial interest in a commodity is lost, the commodity remains ineligible for a loan or an LDP even if the producer regains control, risk of loss and title.

2. **Apply for an LDP (while still maintaining beneficial interest) during the harvest period, then sell the cotton.**

   New cotton producers should carefully note that cotton in the loan does not require payment of storage costs if market prices are below the loan rate. Free storage costs in those circumstances means that cotton in the loan will be more attractive to merchants. Therefore, when prices are

below the loan rate, if you take the LDP and opt out of the loan before you've sold your cotton, you may get lower bids for your cotton than you otherwise would have. Furthermore, you will have to pay storage.

[The term "equity offer," also known as "selling equities" should not be confused with so-called "equity contracts." Merchants use equity contracts to bid for cotton before it is put into the loan.]

3. **Forgo the LDP, store the cotton under the USDA loan program and receive the loan rate (and the obligation to pay storage and accrued interest).**

The first two alternatives require that growers monitor weekly LDP rates and make sure that their forward contracts or cash sales do not disqualify them from applying for the LDP.

The third alternative offers three choices for cotton in the loan:

- Forfeiture to the USDA (in which case the grower keeps the loan value less any storage and accrued interest)
- Redemption, or taking the cotton back out of the loan, paying off the loan at the loan rate (plus accrued interest to that point) or the AWP, whichever is lower, and selling it on the world market
- "Selling equities," that is, making an equity sale to a merchant

The first choice would generally be made only as a last resort. The second choice would generally be made if the AWP was less than the loan rate plus accrued interest costs. In that case, the grower would realize a net gain, which is called a marketing loan gain (MLG). The MLG incentive is exactly that of the LDP: to move U.S. cotton into the world market.

Regarding the third choice: The practice of merchants offering equity bids offered to growers is common, especially in West Texas. Merchants calculate equity offers based on the estimated MLG, trends in United States, world prices and the time remaining until expected loan redemption by the merchant.

Growers with cotton in the loan should evaluate any equity bids to their expected MLG under Choice 2.

Eligibility

Marketing assistance loans and loan deficiency payments have several eligibility requirements for the producer or the commodity or other commodity program provisions. One important concept already mentioned is beneficial interest.

In addition to maintaining beneficial interest, the cotton pledged as collateral for a non-recourse loan must satisfy the USDA's minimum grade and quality requirements. Also, the sum of marketing loan gains and loan deficiency payments for all crops during a crop year is limited to $75,000 per person. **Your local USDA-FSA office has the final word on eligibility requirements.**

For more details on how these programs work, see the USDA bulletin at http://www.fsa.usda.gov/pas/publications/facts/nonrec03.pdf.

Hedging with Futures and Options

Futures and options allow you to build on the advantages of all of the basic cotton marketing alternatives discussed above. With forward contracting, cash sale at harvest or marketing pools, you are ultimately locked into a price and will generally be unable to take advantage of upward price movements.

There are basic marketing strategies with futures and options, such as purchasing call options that allow you to take advantage of future price increases with no other obligation. For more information, visit http://trmep.tamu.edu/cg/list.htm.

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