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PIK CERTIFICATES AND CATTLE FEEDING

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Summary

The current Acreage Reduction Program has more benefits to the livestock producer than any of the earlier farm programs. It currently allows producers to obtain homegrown corn and sorghum at costs below the cost of production by covering the difference between the target price and the loan rate or the average market price, whichever is higher. However, to obtain the benefits of the program, the producer must have a good understanding of the program and know how to calculate the maximum (minimum) premiums to be offered (asked) for certificates to be traded. It also requires that the user know the relationships among the loan rate, posted county price and local flat cash price. It also means keeping an eye on the PCP and being ready to move when it is favorable.

Introduction

Of all the government programs designed for reducing feed grain production in the past 30 years, none have allowed the livestock producer to enjoy the benefits of the program as much as the use of PIK certificates. It is the purpose of this paper to explain some of the provisions of the 1985 Food Security Act and how a cattle feeder can use these to his benefit.

The idea of Generic Certificates, commonly called PIK certificates, was introduced in 1986 as a way of paying farmers for participating in the government's Acreage Reduction Program (ARP). They are now being used for other payments as well, such as Conservation Reserve Program (CRP), disaster payments and Export Enhancement Program (EEP).

Previous farm programs were designed to raise the income of grain producers by reducing the stocks available to the market and thereby increasing the market price. At best this was neutral to livestock producers and, in most cases, raised the cost of feeding livestock through higher feed prices. The current program is designed to provide increased income to grain producers while at the same time lowering the market price of feed grain. It frequently allows feeders to buy grain at prices below the loan rate, which was frequently near the minimum market price with previous programs.

Using Certificates

The way livestock producers obtain farm program benefits is to buy feed from the government at a price below the loan rate and often below the cash market price. The feeder can, in effect, sell his corn to the government at the loan rate and then buy it back using PIK certificates at the posted county price (PCP) which is also known as the redemption price. The way for a livestock feeder to maximize his return in this maneuver is to buy back at the lowest PCP. Because the PCP is highly correlated with the cash price, the best time to redeem corn will likely be during the harvest period. Thus, for the livestock farmer, the most likely time to use certificates will be immediately after taking out a loan on his grain at harvest. However, this program is controlled by government officials and they may have objectives in mind which may increase or decrease the frequency of profitable opportunities or move them to other seasons. This means cattle feeders need to keep a constant eye on the PCP and local flat cash prices and be ready to move when they are in his favor.

To illustrate how certificates can be used, suppose the going flat cash price of corn at the local elevator is $1.36 per bushel, the Commodity Credit Corporation (CCC) loan rate is $1.63, the posted county price of $1.20, and the cost of production is $2.75 per bushel. First, let's look at a producer who does not participate in the...
ARP. His cost of corn is $2.75 which is greater than what he can get for it in the market. Thus, he will need to charge his feeding operation $2.75 per bushel to cover his cost of raising corn, making his cost of corn for feed $2.75 per bushel.

The producer participating in the ARP can put the corn under loan and obtain $1.63 and then redeem the corn with certificates. The cost of redeeming the corn is the posted county price or $1.20. So, in effect he can sell his corn to the CCC at $1.63 and then buy it back for $1.20, picking up 43 cents on the transactions. Since the corn is now a purchased feed, its cost is $1.20. One should keep in mind, however, that it can still be sold on the cash market at $1.36. The wise cattle feeder will feed the corn only if he can get more than $1.36 by marketing his corn through his cattle. If the corn is redeemed with a purchased certificate, the cost of the corn is the value paid for the certificate. If the certificate above was purchased at a premium of 110% of face value, the corn would have a cost of $1.32 per bushel ($1.20 x 1.10 = $1.32). The difference between the cost of production and the loan rate, which is $1.12, is covered by the "deficiency payment" when participating in the ARP and should not be charged against the livestock enterprise. In addition to the loan and redemption profits, he is entitled to a deficiency payment. This is the difference between the target price, which approximates the cost of production, and the higher of the loan rate or the market price.

A change in USDA policy in August 1987 makes the above process more secure for the cattle feeder. Corn producers can now "lock in" the PCP on the day they apply for a commodity loan. This protects the PCP during the period of time it takes for the CCC to conduct a lien search on the corn. Before the policy change, the producer had to wait for a lien search to be completed and the loan granted before the corn could be redeemed. In the meantime the PCP could move higher, increasing the cost of redeeming the corn. With the policy change, prices can be locked in and the risk of potential loss (or potential benefit) due to price changes is eliminated. Once a producer locks in a PCP, he is obligated to follow through. A failure to take out the loan and then redeem it will result in damages payable to the CCC equal to the difference between the loan rate and the PCP, which was the expected profit on the day the agreement was made.

Another provision that helps the cattle producer is that wet corn can be put under loan. This means that the producer who puts wet corn in the silo or in air-tight storage can obtain a loan from the CCC. He must redeem the corn immediately with certificates or substitute dry number 2 corn in its place. If it is redeemed with certificates, he picks up the difference between the loan rate and the PCP, assuming the value of the certificate at 100%. If substitution is used, the benefit is the difference between the loan rate and the market price of corn given in place of the wet corn. The producer using this "wet corn" provision must prove the actual amount of wet grain available for loan. This can be done by using a CCC approved facility, certified scale tickets or have an ASCS official measure it. Any measuring by the ASCS will be done at the farmer's expense. The amount of wet corn will be converted to dry corn basis for determining the amount of the loan.

If dry corn is substituted, free stocks of eligible quality must be used. They may have been under loan earlier and PIKed back from the CCC. However, any grain that has been substituted can not be redeemed with certificates. It can only be redeemed with cash or forfeited to the CCC. Thus, by using substitution, a producer will be obligating his storage facilities for the term of the loan.

The Certificate Market

When using certificates to redeem needed corn, it may be necessary to buy them. In other situations, it may be more profitable to sell them. It all depends on the market conditions at the time the decision is to be made. Therefore, it is necessary to know how to calculate their value in use as well as know their market value.

Certificates are traded at a premium expressed as a percentage of face value such as 107%. This means a $1000 certificate would sell at $1070. Certificate values change daily. (The going values are available daily in the MARKETS program on AGNET for 15 East River South Dakota markets.) Their value fluctuates with the number of certificates available and the profitability of PIK-and-roll. "PIK-and-roll" refers to the process of using generic certificates to redeem a commodity under loan and then selling it immediately in the cash market. "PIK-and-hold" refers to redeeming a commodity and then holding it for sale or use later. Generally, people engaged in PIK-and-roll try to redeem their grain and sell it on the cash market the same day. They are interested in maximizing the difference between the PCP and the local flat cash price. PIK-and-hold maneuvers occur when the PCP is considered low and the producer is expecting an increase in the flat cash prices. The practice here is to redeem the grain and then hold it for more favorable cash prices. Thus, the person using PIK-and-hold generally is speculating in the cash market.
The livestock producer should be viewing his redemption process as buying feed and therefore seek a low PCP. Because of the different goals of different users of certificates, it is possible to have both low certificate premiums and a low PCP. When and if this occurs, it is ideal for the cattle feeder needing to redeem more corn. Of course, there is no guarantee that this will be the case. During this past year fluctuations have been wide enough to make it profitable for those needing certificates to buy them when premiums were low and hold them until needed. Because the ASCS will buy back untraded certificates at face value during the last 90 days of their lives, it has established a floor under certificate values at 100%. Also, supporting the low end are those who will buy them for speculation on the bet that their values will increase.

Buying Certificates

Cattle feeders need to know how much they can afford to pay for a certificate to avoid making costly mistakes. One thing in their favor is that they can usually pay more than a grain farmer seeking to redeem a commodity for sale in the cash market. To determine the maximum value that can be paid for a certificate, first determine the price of the next best source of corn and divide it by the PCP. This next best source will usually be the cash market but may be the cash redemption price for corn. If the next best source is to buy in the cash market, then the cost of the corn delivered to the farm divided by the PCP will give the maximum premium that can be paid for a certificate to redeem the corn under loan. This same value will be the minimum premium that should be demanded for any certificates put up for sale. Note: if there are any other costs in addition to the price of the corn, such as out-charges at the elevator or trucking, these should be added to the price paid for the corn before dividing by the PCP.

For the sake of illustration, let's continue with the example on page 1. Suppose a feeder needs another 5000 bushels of corn for his cattle and he is considering the following three options (in addition to redeeming his corn under loan with certificates): (1) pay off the CCC Loan with cash, (2) buy the needed corn at the local elevator and (3) buy corn from his neighbor at the going cash price. Assume that 11 cents of interest has accrued to the CCC loan. Therefore, if he chooses to redeem that corn with cash, the interest must be paid, bringing the cash redemption price to $1.74 ($1.63 + $.11). The flat cash price at the local elevator is $1.36, but there is a 15-cent out-charge and 6 cents freight to the feedlot. This brings the price to $1.57, which is better than redeeming the loan with cash. A third alternative is to buy corn from a neighbor at the local flat cash price plus trucking of 6 cents and 5 cents additional labor for a total of $1.47. Obviously buying from the neighbor is the lowest priced of these three alternatives.

To determine the maximum price you can pay for a certificate to redeem your corn under loan, divide the cash price to be paid ($1.47) by the PCP ($1.20) which is equivalent to 122.5%. Thus, the most you should pay for the $6000 worth of certificates needed to redeem the 5000 bushels is $7350 ($6,000 x 1.225 = $7350). If the premium is greater than 122.5%, the buyer would be ahead to buy the needed corn from his neighbor and leave the sealed corn in storage, forfeiting it to the CCC if necessary. To summarize:

| Cash redemption of loan: | $1.63 + .11 = $1.74 |
| Buy at elevator: | $1.36 + .15 + .06 = $1.57 |
| Buy from neighbor: | $1.36 + .06 + .05 = $1.47 |
| Maximum certificate value: | $1.47 x 100% = 122.5% |

Certificate value needed to redeem 5000 bushels: $1.20 x 5000 = $6000

Maximum total value paid for $6000 face value of certificates: $6000 x 1.225 = $7350

Suppose the same conditions exist as in the example above except the possibility of buying from a neighbor is out. Now, the next best alternative is to buy from the local elevator. This will cost $1.57 delivered to the farm. The maximum value that can be paid for a certificate is now $1.57 divided by $1.20 or 130.8% of face value.

The same analysis applies to redeeming the sealed corn with cash. Redeeming corn with cash requires that the loan be paid plus interest. When certificates are used, the interest is forgiven, so when evaluating this alternative, accrued interest must be added to the loan value before dividing by the PCP.
It may be possible this crop year (1987-88) for the PCP to rise above the loan rate plus interest. If it does, then it will be cheaper to redeem with cash and sell any certificates you may be holding. This condition existed much of the summer of 1987 for soybeans and oats. The probability of this occurring in the corn and sorghum markets is not very high but not impossible.

In all of the above examples, it was assumed that the flat cash price and the cash redemption price were above posted county price. This need not be so. If the flat cash price plus the out-charges and freight are below the PCP, then it is cheaper to buy in the local cash market. If this condition is caused by an abnormally high PCP, then it may pay to wait for it to return to a normal level. If, on the other hand, it is due to an abnormally low cash price, it may be wise to take advantage of the cash price and then PIK and roll the sealed corn when price relationships change. The same reasoning will apply to a condition when the PCP is above the cash redemption price. In either case, examine the situation carefully and move on what appears to be the most profitable.

Some Tax Implications

After a great amount of confusion, hopefully the tax implications regarding certificates is now settled. The confusion was only for those farmers who elected to treat CCC loans as loans. Those who declared loans as income when received were not caught up in the confusion.

As word of background, on March 2, 1987, the IRS issued a retroactive ruling stating that any commodity under loan which was redeemed with certificates was to be considered "sold" at the time it was redeemed and the amount of the sale, which would be the same as the loan rate, was to be considered as gain at that time. Then, when the commodity was actually sold, the seller would have gain equal to the difference between the redemption price (PCP) and the cash price received. For livestock feeders, this meant that the value of the corn fed would be a tax deductible expense when the cattle are sold. Consequently, thousands of farmers filed erroneous tax statements prior to the ruling.

On October 13, 1987, after much Congressional pressure, the IRS revoked this rule and issued a new one in its place. With the new ruling, a farmer is taxed on the difference between the loan rate and the PCP at the time he redeems the commodity with certificates. He then must claim the total amount of the sale as gain when the commodity is sold. For the cattle feeder, this means he can not deduct the value of the corn fed as a cost when the cattle are sold, but it also means he does not pay income tax on the corn when it is redeemed. Thus, it is the same as would be the case if he did not participate in the government program. So as things stand at the time of this writing, the farmer who treats CCC loans as loans has the following conditions: (1) generic certificates are considered income in the year received, (2) when a commodity under loan is redeemed with certificates, the taxable income is the difference between the loan rate and the PCP, and (3) when the redeemed commodity is sold, the full amount of the sale must be considered gain. For the farmer who declares the loan as income when received, item 1 above holds as stated above, 2 when the commodity is redeemed, no tax liabilities are incurred, and 3 when the commodity is sold, only the difference between the cash price received and the PCP must be declared as gain.

Participation in the Government Acreage Reduction Program

Sometimes livestock producers believe they can not afford to participate in the government program because they need all of their crop for feed. This belief is due to a misunderstanding of the farm program and the market system. The farmer-livestock feeder who stays out of the government program has higher costs for his homegrown feed grains because the government is not picking up part of the production costs through deficiency payments. In 1987, the government is covering approximately $1.20 per bushel of corn production costs. Thus, nonparticipation results in significantly higher corn feed costs, nearly $50 for raising a calf to slaughter weight.

Another misunderstanding is the high cost of attempting to be self-sufficient by nonparticipation in the ARP. A fear of a poor crop resulting in an insufficient supply of feed is another deterrent to participation. The current farm program allows a feeder to buy corn and milo at prices below the cost of production. Thus, it may be cheaper to buy feed, even in a short crop year, than to produce it without participation in the government program. If a particular farmer has a poor crop, such as hailed out, he can buy corn in the market cheaper than he can raise it without government help.
In the case of a general short supply, the market price could rise above the average cost of production. If one is in the area where production is scarce, the cost per unit of production will also rise, most likely faster than the market price, so nonparticipation is not an advantage in that situation. If one is in an area where production is near normal, there should be no shortage for a particular farmer whether in or out of the program.

**Glossary**

**ARP.** Acreage Production Program. The current name for the government program used to reduce acreages in production.

**ASCS.** Agricultural Stabilization and Conservation Service.

**Cash Redemption Price.** The price at which a CCC loan can be redeemed with cash. This will include accrued interest.

**Generic Certificate.** Commonly called PIK certificates. These are negotiable instruments used by the ASCS to make partial payments to farmers who participate in the government farm programs. They are also used as payment to exporters to encourage exports of farm commodities.

**CCC.** Commodity Credit Corporation. This is the organization that makes nonrecourse loans to farmers who participate in the farm programs.

**CRP.** Conservation Reserve Program. The current long-term program to take marginal and highly erodible land out of production.

**Deficiency Payment.** The difference between the target price and the higher of either the loan rate or the average market price.

**Flat Cash Price.** The cash price quoted by the local cash market.

**IRS.** Internal Revenue Service.

**PCP.** Posted County Price. This is the price at which a commodity under loan can be redeemed with certificates. No interest is charged when this is used.

**PIK and Hold.** The process of using generic certificates to redeem a commodity used as security for a nonrecourse loan with the CCC and holding it for an increase in the local flat cash price or holding it for to be fed.

**PIK and Roll.** The process of using generic certificates to redeem a commodity used as security for a nonrecourse loan with the CCC and selling it immediately in the cash market. Typically the person doing this tries to maximize the difference between the PCP and the local flat cash price.

**Spot Price.** The price actually received in the cash market when a product is delivered and sold.

**Target Price.** The government's estimation of a fair price which will cover all economic costs of production.

**USDA.** United States Department of Agriculture.