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Woods E. Eastland
President

April 24, 2000

COMMENT

Ms. Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Fax: 202-418-5521

Re: Proposed Amendment to the Cotton No. 2 Futures Contract Prohibiting Cotton Stocks Under Commodity Credit Corporation Loan From Simultaneously Being Exchange-Certified for Delivery on the Futures Contract

The Commission has asked for comments in regard to 3 questions: (1) whether the continuation of the practice of allowing certified cotton stocks to remain under CCC loan represents a threat to orderly trading and delivery in the futures market; (2) whether the proposal will reduce deliverable supplies to levels that would make the futures market susceptible to price manipulation or distortion; and (3) whether the proposal, by precluding the use of a method of financing that is commonly used in the cash market, is consistent with the requirements of section 15 of the Commodity Exchange Act.

1. Overview

The changes made to the CCC loan structure in 1986 were to assure that at all times U.S. cotton could be redeemed from the CCC loan at a level that would allow the redeemed bale to be sold in the domestic and international markets at a price competitive with cotton raised in other countries. The mechanism developed was to (1) determine the commercially quoted prices asked for the five cheapest growths of cotton CIF northern Europe for a bale of middling color, middling leaf, and 1 3/32" staple (31-3 -35),

(2) adjust this price by a moving average of inland and trans-Atlantic freight rates from a specific spot market location in the United States (3) adjust this price further by reducing it by the CCC loan rate difference between the loan value per pound of a 31-3-35 and a strict low middling color, strict low middling leaf, 1 1/16" staple (41-4-34). Thus the Adjusted World Price (AWP) is quoted for a bale of 41-4-34 quality, the base grade of the New York Cotton Exchange No. 2 contract. The CCC makes a non-recourse loan of a fixed amount per pound on a bale of cotton at a specific location. The loan can be redeemed at a "redemption price" which, when the AWP is below loan level, is the lower of (a) the AWP minus accrued storage charges, with interest waived, or (b) the base loan rate plus interest. The "redemption price" changes daily because it is the AWP minus accrued storage. The AWP can change only weekly, but storage accrues daily.

The program has worked amazingly well. The AWP is a Friday through Thursday average of the adjusted northern Europe prices, and is in effect for the following Friday through Thursday. Thus under this program the CCC offers a guaranteed minimum cash price for a specific bale (the base loan rate) and challenges the cash market to buy the bale away from the CCC by offering a cash price which accomplishes two tasks:

- (a) when added to the difference between the loan rate and the redemption price exceeds the loan rate plus accrued storage
- (b) when added to landing costs is less than or equal to competing prices for cotton grown in other countries. Landing costs include warehouse storage charges, interest, insurance, and freight. If the buyer wishes to purchase the bale and leave it in CCC loan stocks so that it continues to receive a waiver of interest and de facto payment of storage by the CCC, a price for a special option to purchase cotton in CCC loan stocks is negotiated and a form CCC-605 is completed and filed with FSA,USDA. In this type of purchase the cash price then is the special option to purchase price paid to

the holder of the bale in CCC loan stocks, and it plus the redemption price, plus landing costs must be less than or equal to competing prices for cotton grown in other countries. (a copy of form CCC-605 is attached.)

Only if (a) and (b) are both satisfied can the market find a willing buyer and a willing seller. The key to successful operation of the program is being free to act simultaneously. The person or entity upon whom market forces are acting either as a buyer or a seller must be free to establish the redemption price (the AWP minus accrued storage) on the same day that a cash price is accepted, in order to make sure that tests (a) and (b) are met. The only way for that to occur is if the bale is allowed to remain in the CCC loan, so that the redemption price is free to vary daily.

A good explanation of why CCC finds it necessary to waive interest and de facto pay storage for CCC loan bales is found in a USDA Decision Memorandum dated 6/12/96 (copy attached).

The remainder of this memorandum addresses situations that can occur when the AWP is below loan level.

2. The New York Cotton Exchange Proposal

The Exchange wishes to change its rules so that certified stocks no longer can be pledged to the CCC for a loan. Importantly the Exchange is unable to point to any instance in which the existence of certified stock in the CCC loan has been detrimental to the efficient operation of the futures market. This is important because the Exchange is trying to establish a rule for certification that varies from normal cash market practices at the delivery point, by restricting options for establishing the redemption price for certified bales that are not restricted for non-certified bales.

If the Exchange proposal were adopted, then the person or entity owning certified stocks that are otherwise loan eligible would have two choices: (1) redeem the cotton from the CCC loan before certifying the bale for delivery, or (2) not place the bale in the CCC loan at all. If choice (1) were chosen, the freedom to act simultaneously discussed in the above section is lost; risk is created that the return from redeeming the bale and selling it in the cash market will be less than if performed simultaneously; and the redeemer knows that to be made whole the cash market must go up enough at a minimum to offset the interest and storage charges accumulating on the bale after redemption. If choice (2) were chosen, the redeeming person or entity would still be able to receive a cash payment from CCC equal to the difference between the loan rate and the AWP, called a POP payment. However, the benefit of a zero interest rate and the payment of a sum equal to accrued storage charges would be lost. Referring to section 1 "Overview" above, if the Exchange proposal were adopted and choice (2) were chosen, the bale in certified stock would be non-competitive in the domestic and export market against a non-certified bale by the amount of accrued interest waived and storage de facto paid by the CCC.

The Exchange argues on page 3 of its presentation under "Role of Certified Stock" that for the futures market to function properly requires "the convergence of cash and futures at contract expiration." However, this argument is put forward in favor of a rule which, if adopted, would prevent cash and futures from ever merging when the AWP is under loan. The value of futures at contract expiration is the value of the certified stocks. The value of the certified stock, if the proposal is adopted, would be:

$$\text{Cash Price} + (\text{loan rate} - \text{AWP}).$$

The value of the non-certified stock in the cash market at the delivery point would be:

$$\text{Cash Price} + (\text{loan rate} - \text{AWP} - \text{accrued storage charges}).$$

(AWP) can never equal (AWP – accrued storage charges) unless the bale is stored in a warehouse charging zero storage. No exchange approved warehouse has a zero tariff.

Question 1:

Will continuation of the practice of allowing certified cotton stocks to remain under CCC loan represent a threat to orderly trading and delivery in the futures market?

History is the best teacher. Advantages in futures trading are always rapidly and brutally exploited, at great profit to one party. The Exchange does not point out one instance in which certified cotton stocks in the CCC loan has affected orderly trading and delivery. Nor can we. The logical answer is that there has been none because in reality there is no threat. The reason for that is that under current rules of the Exchange, the certified stocks and the non-certified stocks are affected equally each day by the same economic forces – the relationship of the cash price, the loan rate, and the redemption price. This is because the current rules allow the same options to certified stock as non-certified stock. The Exchange proposal would alter this.

Question 2:

Will the proposal reduce deliverable supplies to levels that would make the futures market susceptible to price manipulation or distortion?

The proposal, if adopted, will reduce deliverable supplies. It would raise the cost of certification, by assuring that the owner of certified stocks would lose benefits available to the cotton if it were not certified – the ability to have interest free financing and storage paid de facto by the CCC. Most importantly, this rule if adopted would do something that no other delivery rule of the Cotton Exchange now does: permanently devalue a certified bale in the cash market at the delivery point even if the bale were decertified and sold. The CCC waives interest only for the period of time the bale is in the loan. The redemption price is reduced by the amount of accrued storage only for the

number of days the bale is in the loan. The Exchange proposal would prevent these advantages from accruing while the bale is in certified stocks.

Bales in the loan and enjoying the loan's economic benefits can be sold to other parties such as cotton merchants by use of form CCC-605, and the subsequent owner can leave the bales in the loan and continue to enjoy these economic benefits. Thus under current Exchange rules the certified stocks can be sold to someone else before delivery and continue to be in certified stocks and CCC loan stocks, thus continuing to accrue these benefits; or, the stocks can be decertified and sold while still in the loan to another party. The key is that they can be in both the certified stock and in loan stocks. If this proposal is adopted and the bale is redeemed from the loan before certification, or never put in the loan, it must compete in the cash market with bales the buyer of which can continue to receive zero interest and storage paid de facto by the CCC. No one would argue that a bale of cotton on which the buyer must pay interest and storage has the same value to that buyer as a bale on which the buyer does not have to pay interest and storage.

Any reduction in deliverable supplies makes the futures market more susceptible to price manipulation or distortion. The USDA has available the quantity of bales placed under CCC loan whenever the AWP is under loan. For the 1999 cotton crop, the cotton produced on 98.7% of the harvested acres was eligible for the CCC loan. As of February 18, 2000, according to Farm Service Agency, Price Support Division, USDA, 4,238,201,000 pounds of upland cotton from the 1999 crop had been placed under loan. Using an average bale weight of 480 pounds, this totals 8,829,585 bales out of a 1999 upland crop of 16,257,000 bales of 480 pounds each. As the Exchange argues in its memorandum, the key to having a futures market free of manipulation and distortion is to have rules that permit cash and futures to converge at delivery. This rule, if adopted, when the AWP is under loan would prevent convergence from occurring.

Question 3:

Is the Proposal consistent with section 15 of the ACT?

I can not understand why the Exchange is proposing this rule change. The Exchange points to no instance of the futures market allegedly not functioning properly when certified stocks were in CCC loan stocks. The Exchange knows that its adoption would reduce deliverable supplies by significantly raising the cost of certification, and by permanently devaluing the value of a certified bale in the cash market at the delivery point. If anything, economic logic dictates that the proposal, if adopted, would make the futures contract more susceptible to manipulation and distortion.

As the resolution of the Exchange states, this recommendation came to the NYCE Board of Managers from the Cotton Contract Specification Committee, a committee composed of a chairman, one ex-officio member (the Chairman of the NYBOT Board) and 23 members: 9 cotton merchant executives, 8 floor members, 3 textile mill executives, 2 cotton marketing co-op executives, and 1 FCM. Cotton merchants, through operation of LSA's they own and/or manage, or by offering financial incentives to producers or co-ops to move their cotton to a delivery point warehouse, certify it for delivery, and put it in the loan before sale, can own certified stocks that also are in CCC stocks. (See Attached memorandum dated 5/21/93 acquired from CFTC under the Freedom of Information Act.) To do so through their LSA's they must meet many of the same regulatory burdens as co-ops.

The only reason in our opinion cotton merchants are still trying to have this Exchange rule approved is because they believe they can use it to gain a cash market advantage

over producers when the AWP is under loan. The AWP is under loan only in times of over-supply. By definition, in times of over-supply the cash market advantage swings to the buyer from the seller. In times of over-supply it is easier for merchants to drive the cash market down, widening their merchandising margin or lowering the cost to the end user. For cotton of deliverable quality, the cash market can be driven down only to a point that its discount to futures equals the cost of certification and delivery – any further and certification and delivery creates a greater return. The cost of certifying a bale for delivery is relatively constant year to year and within a year, and anyone can see that the proposed change would raise the cost of certification and delivery when the AWP is under loan – the time of oversupply. Thus if this proposal is adopted, cotton merchants will be able to drive the cash market lower in relation to the futures market than is now possible.

The least anti-competitive means of achieving the objectives, policies, and purposes of the Act is to refuse to approve the proposed change. If the Commission does refuse it will:

- (1) assure that the market forces acting upon the certified stocks are the same acting upon non-certified cotton of the same quality in the cash market at the delivery point
- (2) prevent the Exchange from adopting a proposal that would have the affect of causing the certified stocks to have a different value in the cash market at the delivery point than non-certified cotton of the same quality
- (3) assure that deliverable supplies are not artificially reduced by the Exchange's administrative action, and
- (4) leave unaltered the status quo in the cash market at and near delivery points.

By rejecting this Exchange proposal, the Commission will preserve the satisfactory level of economic performance which the New York Cotton Exchange's No. 2 contract has demonstrated over the years.

Respectfully submitted,

Staple Cotton Cooperative Association

By: Woods Eastland
Woods Eastland, President

WEE/bb

Attachments

CCC-605 U. S. DEPARTMENT OF AGRICULTURE Commodity Credit Corporation <p style="text-align: center;">DESIGNATION OF AGENT - COTTON</p>	1. COUNTY OFFICE NAME, ADDRESS & TELEPHONE NUMBER
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Items 1-10 must be completed.

PART A - LOAN AND AGENT DATA

2. PRODUCER'S NAME AND ADDRESS	3. AGENT'S NAME AND ADDRESS	4. OFFICE HOLDING WAREHOUSE RECEIPTS
5. MATURITY DATE	6. LOAN NUMBER	7. CROP YEAR

PART B - DESIGNATION OF AGENT FOR LOAN REDEMPTION

THE UNDERSIGNED PRODUCER(S) ("PRODUCER") hereby authorizes the agent identified in Item 3 or, if applicable, the subsequent agent identified by endorsement on the reverse side of this form, or the execution of a Form CCC-605-2, to redeem all or a portion of the cotton pledged as collateral for the loan identified in Part A. The Producer agrees that no other Form CCC-605 has been or will be executed with respect to such cotton. If this form covers all the warehouse receipts pledged as security for the loan as described in Part A, mark "all" in Item 8. If this form is for only some of the warehouse receipts pledged as security for the loan, mark "see attached Form CCC-605-1, or other list" and enter the bale receipt number(s) in numerical order on Form CCC-605-1 or other list properly dated and signed by the producer. Attach CCC-605-1 or other list to this form.

8. LOAN QUANTITY APPLICABLE TO THIS AGREEMENT: ALL <input type="checkbox"/> See attached Form CCC-605-1 or other list <input type="checkbox"/>	9. NUMBER OF BALES
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Title to the cotton shall, without a sale thereof, immediately vest in CCC upon maturity of the loan. CCC shall have no obligation to pay for any market value which the cotton may have in excess of the amount of the loan. CCC may sell, transfer and deliver the cotton or documents evidencing title thereto at such time, in such manner, and upon such terms and conditions as CCC may determine, without demand, advertisement, or notice of the time and place of sale. CCC does not guarantee that the cotton subject to this agreement will be permitted to be redeemed at a level lower than the original loan level if the producer has exceeded statutory payment limitation amounts. In addition, CCC does not guarantee that the cotton subject to this agreement will not be redeemed by anyone other than the designated agent or that the warehouse receipts representing the cotton will not be released to anyone other than the designated agent.

10 A. SIGNATURE OF PRODUCER	DATE	10 C. SIGNATURE OF PRODUCER	DATE
10 B. SIGNATURE OF PRODUCER	DATE	10 D. SIGNATURE OF PRODUCER	DATE

PART C - DESIGNATION OF AGENT FOR LOAN EXTENSION FOR 1995 AND PRIOR CROP YEARS - ONLY

With respect to the loan identified above, if the Producer has executed Part B of this form, the undersigned Producer does also hereby appoint the agent identified in Item 3 as the Agent to act on behalf of the undersigned Producer to extend the loan identified above when extensions are authorized by CCC for 1995 and prior crop years. The Producer understands that if the cotton is forfeited to CCC after the extended period, the producer, not the agent will be required to pay to CCC; 1) all storage costs on the extended loan from the day after the original maturity date through the forfeiture date; and 2) a handling fee of \$1.00 per bale. Such Agent is authorized to appoint another person to act as said Agent for the undersigned Producer. The designation of such other person shall be accomplished by endorsement on the reverse side of this form or the execution of a Form CCC-605-2.

11 A. SIGNATURE OF PRODUCER	DATE	11 C. SIGNATURE OF PRODUCER	DATE
11 B. SIGNATURE OF PRODUCER	DATE	11 D. SIGNATURE OF PRODUCER	DATE

12. REMARKS

NOTE These statements are made in accordance with the Privacy Act of 1974 (5 USC 552a) and the Paperwork Reduction Act of 1995, as amended. The authority for requesting the following information is the Agricultural Act of 1949, as amended, the Federal Agriculture Improvement and Reform Act of 1996, the Commodity Credit Corporation Charter Act, as amended, and regulations (7 CFR 1427). The information will be used to determine who may repay cotton loans, or who may extend cotton loans when extensions are authorized. Furnishing the requested information is voluntary, however, without it assistance cannot be provided. This information may also be provided to other USDA agencies, IRS, Department of Justice, or other State and Federal law enforcement agencies, and in response to orders of a court magistrate or administrative tribunal. The provisions of criminal and civil fraud statutes, including 18 USC 286, 287, 371, 641, 651, 1001; 15 USC 714m; and 31 USC 3729, may be applicable to information provided.

Federal agencies may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. Public reporting burden for this collection of information is estimated to average 15 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate, or any other aspect of this collection of information, including suggestions for reducing this burden, to the Department of Agriculture, Clearance Officer, OIRM (OMB No. 0560-0074), Stop 7630, Washington, D.C. 20250-7630.

This program or activity will be conducted on a nondiscriminatory basis without regard to race, color, religion, national origin, age, sex, marital status or disability.

CCC-605 (Reverse) (01-29-97)

ENDORSEMENTS

THE TRANSFEROR/ENDORSER MUST COMPLETE THE RELEVANT INFORMATION FOR EACH TRANSFER. FAILURE TO COMPLETE THE INFORMATION RENDERS THIS CCC-605 VOID.

Endorsement transfers both functions specified in Parts B and C, if applicable, and the transferor agent's authority is extinguished.

13. BY ENDORSEMENT:

A. _____
 (Name of agent)

does hereby transfer the functions specified in Part B and, if applicable, Part C:

TO _____
 (Name of subsequent agent)

BY _____
 (Signature of agent)

D. _____
 (Name of agent)

does hereby transfer the functions specified in Part B and, if applicable, Part C:

TO _____
 (Name of subsequent agent)

BY _____
 (Signature of agent)

B. _____
 (Name of agent)

does hereby transfer the functions specified in Part B and, if applicable, Part C:

TO _____
 (Name of subsequent agent)

BY _____
 (Signature of agent)

E. _____
 (Name of agent)

does hereby transfer the functions specified in Part B and, if applicable, Part C:

TO _____
 (Name of subsequent agent)

BY _____
 (Signature of agent)

C. _____
 (Name of agent)

does hereby transfer the functions specified in Part B and, if applicable, Part C:

TO _____
 (Name of subsequent agent)

BY _____
 (Signature of agent)

F. _____
 (Name of agent)

does hereby transfer the functions specified in Part B and, if applicable, Part C:

TO _____
 (Name of subsequent agent)

BY _____
 (Signature of agent)



United States
Department of
Agriculture

Farm
Service
Agency

AG Code 0512
P.O. Box 2415
Washington, D.C. 20013-2415

DECISION MEMORANDUM FOR THE UNDER SECRETARY FOR FARM AND FOREIGN AGRICULTURAL SERVICES

FROM: Grant Buntrock
Administrator

SUBJECT: Warehouse Storage Charges - Cotton Marketing Assistance Loans

ISSUES:

1. Should the Commodity Credit Corporation (CCC) continue to be responsible for warehouse storage charges that accrued during the term of the cotton loan if the cotton is forfeited to CCC in satisfaction of the loan amount?
2. Should CCC continue the current policy of paying accrued warehouse storage charges on upland cotton loans that are repaid at the Adjusted World Price (AWP)?

BACKGROUND:

The "Federal Agriculture Improvement and Reform Act of 1996" (the 1996 Act) provides for nonrecourse marketing assistance loans on upland and extra loan staple cotton. The provisions of the 1996 Act differ from the "Agricultural Act of 1949" (the 1949 Act) in that the 1996 Act does not include the stipulation, "the Secretary shall, upon presentation of warehouse receipts reflecting accrued storage charges of not more than 60 days, make available to producers nonrecourse loans for . . . cotton produced on the farm . . ." This stipulation has been interpreted to mean the Secretary had the authority to obligate funds for accrued warehouse storage charges incurred prior to and during the loan period.

Cotton is required to be ginned, classed and placed in an approved warehouse before it is eligible for a loan. Standard cotton industry practice is to allow the storage to "follow the cotton;" that is, the warehouse storage charges accrue on the bale and are paid by whomever removes the cotton from the warehouse, usually the buyer. Often, the farmer has no direct contact with the warehouse. However, according to most rules for trading cotton the buyer reduces the sales price to reflect warehouse storage charges that accrued prior to purchase. More specifically, the producer is responsible for the accrued warehouse storage charges through the date the buyer takes title to the cotton.

The policy based on the 1949 Act is if the cotton is forfeited to CCC in satisfaction of the loan, CCC shall be responsible for any storage charges that accrued during the term of the loan plus up to 60 additional days of storage charges that accrued before cotton was tendered to CCC for loan. For warehouse receipts showing accrued storage charges in excess of 60 days as of the date of tender to CCC, the gross loan amount is reduced for each month of unpaid storage or a fraction thereof in excess of 60 days.

**DECISION MEMORANDUM FOR THE UNDER SECRETARY FOR FARM AND
FOREIGN AGRICULTURAL SERVICES**

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For all other loan commodities the producer is responsible for prepaying the storage charges through the maturity date of the loan or making arrangements with the warehouse operator for the payment of storage charges through the maturity date of the loan. In situations where the producer does not make arrangements for storage to be paid through the maturity date, such storage charges are deducted from the loan proceeds.

Because the 1996 Act language regarding cotton loans is now the same as for grains, it can be argued that payment of warehouse storage charges for cotton is not authorized. However, the Conference Report states, "To continue to achieve the objectives of minimizing forfeitures, the accumulation of stocks, and government costs while promoting competitive marketing in domestic and international markets, the Managers expect the Secretary to extend the provision of current regulations governing entry into the marketing assistance loan and establishment of the repayment rate for the marketing assistance loan. The Managers recognize that the regulations vary by commodity and expect the Secretary to continue to establish regulations which reflect differences in normal commercial practices for the affected commodity."

The Office of the Inspector General (OIG) criticized the policy on cotton warehouse storage charges in an audit dated July 1994 and in subsequent communications with the Farm Service Agency (FSA). OIG believes that CCC payment of cotton warehouse storage charges under the marketing loan is inconsistent with treatment of other commodities, unnecessary to achieve competitiveness, and might actually delay loan redemptions. In response to OIG's concerns, FSA prepared a decision memorandum, which was signed by the Under Secretary on June 28, 1995, requesting guidance with regard to a potential policy change. The Under Secretary's decision was to await the outcome of the 1996 farm legislation.

The 1949 Act stipulates that if the Secretary determines that the prevailing world market price for upland cotton is below the loan level, the Secretary shall permit a producer to repay an upland cotton loan at a level that is the lesser of:

1. the loan level determined for the crop; or
2. the higher of:
 - A. the loan level determined for the crop multiplied by 70 percent; or
 - B. the prevailing world market price for upland cotton (adjusted to U.S. quality and location) as determined by the Secretary.

**DECISION MEMORANDUM FOR THE UNDER SECRETARY FOR FARM AND
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The 1996 Act stipulates that the Secretary shall permit a producer to repay nonrecourse marketing assistance loans for upland cotton at a level that is the lesser of:

1. the loan rate for the upland cotton; or
2. the prevailing world market price for upland cotton (adjusted to U.S. quality and location) as determined by the Secretary.

Note: The prevailing world market price determined and adjusted in accordance with 7 CFR Part 1427.25 is the AWP that is announced weekly by the Secretary.

In a move to make U.S. cotton more competitive in world markets, USDA in 1988 began allowing upland cotton loans to be repaid as follows:

1. When the AWP was below the loan rate, loans could be repaid with cash at the AWP and CCC would pay all the accrued warehouse storage charges and forgive accrued interest.
2. When the AWP was above the loan rate but by less than all accrued storage charges and interest, loans could be repaid with cash at the AWP and CCC would pay only enough of the accrued warehouse storage charges and forgive only a portion of the interest so the cotton could be repaid at the AWP where the cotton was stored.
3. When the AWP is above the loan rate by an amount equal to or more than the accrued warehouse storage charges and interest, loans could only be repaid with cash at an amount equal to principal plus accrued interest. Thus, CCC would not pay any of the accrued warehouse storage charges or waive any of the accrued interest.

Note: The amount of interest waived and the amount of warehouse storage charges paid by CCC are not subject to the payment limitation provisions.

In 1989, USDA again revised its policy on upland cotton loan repayments. This change was to improve the competitiveness of U.S. cotton by encouraging the timely movement of the cotton into the market. USDA determined that upland cotton loans would be repaid as follows:

1. If the loan is repaid during the initial 10-month loan period, the repayment would be determined in the same manner as in 1988.

**DECISION MEMORANDUM FOR THE UNDER SECRETARY FOR FARM AND
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2. If the loan is repaid during the optional 8-month extension period, the repayment would be determined in the same manner as 1988, except that the redeemer of the loan would also be required to pay all interest and warehouse storage charges that accrued during the extended period.

Note: If the loan is extended, CCC pays the accrued warehouse storage charges through the original maturity date. Storage charges that accrue during the extended period are considered the responsibility of the producer. If cotton is forfeited to CCC at the end of the extended period, CCC will collect the storage charges that accrued during the extended period from the producer.

When the decision was made to make the producer responsible for the storage during the 8-month extension, CCC proposed requiring producers to prepay storage through the extended maturity date. Comments received on this proposal were:

1. It would lower the net loan to producers causing financial hardship and difficulty in obtaining financing.
2. Cotton would be forced into the market when it may not be needed, thereby, lowering prices and increasing price volatility.
3. Any agreement that provided that the warehouse would not hold CCC responsible for the charges during the loan period would hinder the warehouse in borrowing working capital.
4. Independent warehouses would be placed at a disadvantage relative to cooperative warehouses, since the latter can absorb the charges by discounting the member's distribution of earnings.
5. Because "storage follows the cotton" warehouses have traditionally accepted delivery of cotton from gins and charged buyers for storage at the time the cotton is shipped. Warehouses generally do not have direct contact with producers, nor would they know at what point buyers should assume responsibility for storage from the sellers. Warehouses would have particular difficulty processing unused balances of prepaid amounts in order to make refunds. Warehouses are not equipped to handle the paper work involved in implementing the proposal.

OPTION 1:

Continue the current provisions for obtaining a cotton loan and the policy for paying warehouse storage charges when upland cotton loans are repaid at the AWP.

**DECISION MEMORANDUM FOR THE UNDER SECRETARY FOR FARM AND
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PROS:

- Encourages repayments and minimizes forfeitures.
- No additional expenditures are placed on the producer.
- Makes U.S. cotton more competitive in world markets.
- Maintains the current level of CCC outlay exposure.
- Consistent with the Conference Report accompanying the 1996 Act.
- Consistent with cotton industry practice which allows the warehouse storage charges to follow the bale.

CONS:

- The 1996 Act does not specifically authorize this policy.
- Does not reduce the current level of CCC outlay exposure.
- Provides an incentive for placing cotton under loan solely for 60 day storage credit.
- Provides a program benefit not available to producers of other commodities.
- Inconsistent with OIG's opinion.

OPTION 2:

CCC shall not require prepayment of warehouse storage charges; however, the producer shall agree that if such cotton is forfeited to CCC in satisfaction of the loan, the producer shall reimburse CCC for all warehouse storage charges which have accrued on such cotton before the cotton was tendered for loan.

If the loan is repaid, CCC will pay all or a portion of the warehouse storage charges which have accrued on the cotton during the period the cotton has been tendered for loan if the sum of loan principal plus accrued interest and storage charges exceeds the AWP.

PROS:

- Encourages repayments and minimizes forfeitures.
- Lowers CCC outlays. if cotton is forfeited.

**DECISION MEMORANDUM FOR THE UNDER SECRETARY FOR FARM AND
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- Lowers CCC outlays, if redeemed at the AWP.
- Removes incentive for placing cotton under loan solely for 60 day storage credit.
- Makes U.S. cotton competitive in world markets.
- Consistent with cotton industry practice that allows warehouse charges to follow the bale.
- Consistent with the Conference Report accompanying the 1996 Act.

CONS:

- Inconsistent with OIG's opinion.
- Minimal increase in producer's net expenditures if cotton is forfeited.
- Provides a program benefit not available to producers of other commodities.

OPTION 3:

CCC shall not require prepayment of warehouse storage charges; however, the producer shall agree that if such cotton is forfeited to CCC in satisfaction of the loan, the producer shall reimburse CCC for all warehouse storage charges which have accrued on such cotton through the maturity date of the loan.

Discontinue the policy for paying accrued warehouse storage charges when upland cotton loans are repaid at the AWP.

PROS:

- Higher net loan amounts to producers.
- Encourages repayments and minimizes forfeitures.
- Lowers CCC outlays if cotton is forfeited.
- Lowers CCC outlays if redeemed at the AWP.
- All commodities are treated similarly.
- Consistent with OIG's opinion.
- Consistent with cotton industry practice that allows warehouse charges to follow the bale.

**DECISION MEMORANDUM FOR THE UNDER SECRETARY FOR FARM AND
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- Consistent with normal trading rules which provide for the seller to be responsible for storage charges until title is passed.

CONS:

- Makes U.S. cotton less competitive in world markets.
- Inconsistent with the Conference Report accompanying the 1996 Act
- Sizeable increases in producer expenditures if cotton is forfeited.

OPTION 4:

CCC shall not require prepayment of warehouse storage charges; however, the producer shall agree that if such cotton is forfeited to CCC in satisfaction of the loan, the producer shall reimburse CCC for all warehouse storage charges which have accrued on such cotton through the maturity date of the loan.

If the loan is repaid, CCC will pay all or a portion of the warehouse storage charges which have accrued on the cotton during the period the cotton has been tendered for loan if the sum of loan principal plus accrued interest and storage charges exceeds the AWP.

PROS:

- Encourages repayments and minimizes forfeitures.
- Lowers CCC outlays, if cotton is forfeited.
- Lowers CCC outlays if redeemed at the AWP, relative to current program provisions.
- Does not lessen the U.S. cotton competitiveness in world markets.
- Consistent with cotton industry practice which allows the warehouse charges to follow the bale.
- Consistent with normal trading rules which provide for the seller to be responsible for storage charges until title is passed.
- OIG concerns are partially addressed.

CONS:

- Sizeable increases in producer's net expenditures if cotton is forfeited.

DECISION MEMORANDUM FOR THE UNDER SECRETARY FOR FARM AND FOREIGN AGRICULTURAL SERVICES

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- Inconsistent with the Conference Report accompanying the 1996 Act.

RECOMMENDATION:

We recommend Option 2.

DECISION BY THE UNDER SECRETARY:

Approved

✓ Option 2

Disapproved

Discuss with me

Date

6/12/96

Reviewed by

Eugene Moos

Eugene Moos

Under Secretary for Farm and Foreign Agricultural Services

Phillip Sharp
Program Specialist, State and County Operations
U.S.D.A. - Agricultural Stabilization and Conservation Service
Washington, D.C.
202-720-7988

5/21/93

Mr. Sharp is the author of the letter of August 21, 1992, to Clyde Davidson of Allenberg Cotton, signed by Thomas A. VonGarlem. Allenberg and others have relied upon this letter as evidence that merchants can not take advantage of the possibility of having cotton simultaneously certified for delivery and under CCC loan.

According to Mr. Sharp, merchants ARE PERMITTED to make certification of cotton for delivery on the futures contract a condition of the option to purchase on Form 605: such a condition may not be a condition of sale of the cotton by a producer.

The answers in the letter in question are to be read literally. Bids for cotton options to purchase may be on any basis, including offering different prices for cotton in different locations and in different statuses with respect to futures certification. Merchants may offer more for the option to purchase cotton that has been certificated for delivery on the futures contract, though they may not direct that such cotton be certified or pay for such certification AFTER they have acquired the option.

The keys are the timing of events and control of the rights involved. Producers may put cotton in any position acceptable for purposes of the loan program, including having it certified for delivery in a delivery point warehouse, and have it under loan, as long as all of these actions are complete prior to the granting of an option to purchase to a merchant. The CCC's interest in the cotton as collateral for the loan must remain unimpaired and be acknowledged (on Form 605) to be superior to the interest of the merchant. Also, the option must expire on the earlier of the date of maturity of the loan or the date of redemption (the producer must retain this right) and allow the CCC to take sole and unencumbered possession of the cotton upon forfeiture of the cotton under the loan. (The reason for these provisions is the Julien bankruptcy in which the CCC lost a substantial amount of money because it did not retain a superior interest in cotton simultaneously under loan and subject to options to purchase.)