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THINKING ABOUT COUNTER CYCLICAL PAYMENTS

The reaction to the surprisingly small production numbers for this fall's corn and soybean crop are still being digested. One of the topics that market strategists are rethinking is how the new counter cyclical payments program will fit into the marketing plan this fall and especially what price vulnerabilities or opportunities are created by this new program. Recent changes in the August 12 wheat supply and demand updates from USDA will illustrate the price vulnerabilities that could face corn and soybean producers this fall.

First the quick review. Counter cyclical payments are made when the 12 month (marketing year) national average price received by farmers falls in a range between the national loan (on the low side) and the target price minus the direct payments on the high side. For wheat these boundaries are $2.80 per bushel (national loan) and $3.34 per bushel ($3.86 target minus $.52 direct payment). The vulnerability arises because the level at which an individual prices may be substantially different than the national average price for the entire marketing year.

Look at what happened to wheat on August 12 when USDA raised their estimate of the average farm price for the 2003 to 2004 marketing year by 30 cents per bushel. On July 9 a central Illinois elevator's wheat bid was $2.90 per bushel and the mid-point of the USDA's estimate of the average farm price was $3.10 (range $2.80 to $3.40). An individual who priced their wheat on this date near harvest would net $2.90 from the market and have an anticipated counter cyclical payment of an additional $.24 per bushel ($3.10 minus $3.34).

As of the August report, however, the USDA increased their estimate of the mid-point of the average farm price estimate for the 2003 to 2004 crop to $3.40 (range $3.10 to $3.70). An individual who sold out of the field would net $2.90 from the market, but now have no anticipated counter cyclical payment. It is important to note that this potential loss of 24 cents per bushel of counter cyclical payments has nothing to do with USDA, but rather with market forces that can quickly change farm prices, and the manner in which Congress decided to calculate the counter cyclical payments.

What are some implications for corn and soybeans? Counter cyclical payments for corn will be made if the average farm price falls in a range from $1.98 to $2.32. The mid-point of the August USDA price range is $2.20 per bushel (range $2.00 to $2.40). This would suggest 12 cents of counter cyclical payments. If market prices for corn should prove bearish this year, counter cyclical payments could increase to as much as 34 cents per bushel, and if the price pattern proves more bullish than the mid-point of current USDA estimates, the counter cyclical payment could fall to zero.

For soybeans, counter cyclical payments will be made if the average farm price falls in a range of $5.00 to $5.36 per bushel. The mid-point of the current USDA price estimate for the 2003 to 2004 marketing year is $5.05 (range $4.55 to $5.55). This would suggest a 31 cent per bushel counter cyclical payment at this time, near the maximum of 36 cents per bushel.

For corn, anticipated counter cyclical payments are already reasonably small. The most that can be lost is 12 cents per bushel if subsequent prices rise, with the possibility that they could increase to 34 cents if the average yearly price falls to $1.98 or less.

On the other hand, the potential price impact per bushel on soybeans is larger. Anticipated counter cyclical payments are already near a maximum with the potential they could drop to zero. Thus, the incentive to attempt to protect soybean counter cyclical payments may be larger.

Unfortunately, there are not market solutions to offset these uncertainties created by the mechanism of payments under the current farm program. However, as a starting point, here are three strategies to ponder. First, most producers will strive to do their best job of pricing their corn and soybeans with no follow-up strategy to attempt to outguess the counter cyclical payments. A second strategy would be to diversify pricing throughout the marketing year, so that an individual's price received would be reasonably close to the season average in their area. Finally, those who price substantial portions of their crops around harvest or early in the marketing year could follow-up by buying futures or call options on a portion of their crop sales. The difficulty here is that rising futures may reasonably protect losses of counter cyclical payments, but falling futures cannot be offset in gains of counter cyclical prices beyond their maximum.

Other option strategies such as vertical call spreads could also be used, but each strategy has its complications. Therefore, those who alter their pricing strategy to use futures and options to attempt to protect counter cyclical payments clearly need to understand the implications if futures prices should rise or fall.

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