

Mr. Chairman and members of the committee, thank you for the opportunity to come before you and review the implementation of the peanut provisions of the Farm Security and Rural Investment Act of 2002 (2002 Farm Bill). I am pleased to be able to share information that the Department of Agriculture (USDA) has obtained from our experience in administering this program for almost four years, and to suggest what we see as important areas for attention. As you are well aware, an aim of the Congress over time in successive farm bills has been to make the commodity programs more market-oriented, i.e., to provide a safety net for producers while minimizing the influence of commodity programs on farmer production decisions and on markets. The 2002 Farm Bill altered the peanut program in that regard, from one characterized by marketing quotas and two-tiered price support to one more like the support programs of other commodities. Previously, marketing quotas limited the quantity of peanuts eligible for sale on the higher-priced domestic food market, while additional peanut production was directed to the export and crush markets.

The new peanut marketing assistance loan program provides support to all peanut producers through non-recourse marketing loans similar to that provided to producers of other commodities. This program allows peanut producers to place their production under loan at harvest when prices are typically low and receive benefits based on the statutory \$355 per ton average loan rate to help pay expenses at the time of harvest. Producers may wait until market prices move advantageously before redeeming the loan collateral and selling the commodity at a higher price. If subsequent market prices do not allow producers to repay the loan profitably, the grower may forfeit the loan collateral peanuts to the Commodity Credit Corporation (CCC) in satisfaction of the loan obligation. The producer also may repay the loan at a rate announced by USDA and market the peanuts previously placed under loan. Under the new program, peanut producers may grow any amount of peanuts and market them for food, export, or crush. Under the prior program, producers needed a marketing quota in order to sell the peanuts in the more lucrative food market. Price support under the previous program provided a high level of price support for peanuts used in domestic food and a much lower level of price support for peanuts to be exported or crushed. The two-tiered price support program operated as a tax on consumers, who paid a higher price for food peanuts than they would have without the program. As a result, taxpayer costs for the program were virtually nil, but high prices for peanuts restrained growth in food use. Historically, more than half of annual peanut production is used for food, with the remainder exported or crushed. The high quota support rate for food peanuts reflected this comparatively high value end use and illustrates a basic distinction between the food orientation of the US market and the oil and meal demand-driven world markets for peanuts.

The new peanut program also provides for fixed, decoupled payments of \$36 per ton to producers on farms for which a peanut base has been established and for market-based counter-cyclical payments to these producers with a maximum \$104 per ton annual benefit during periods of low market prices. These payments provide an additional safety net to producers when economic, or other conditions beyond their control, threaten the viability of their operations. An additional benefit that is required by the 2002 Farm Bill to be made with respect to peanuts, but not for other commodities, is the payment by CCC of storage, handling, and other associated costs, irrespective of the level of the loan repayment rate (LRR). While we have had few problems with the direct and counter-cyclical programs, one of the most

perplexing questions that has emerged is why the peanut marketing loan program does not function like the marketing assistance loan program for other commodities. That is, a very high proportion of the annual output is placed under loan; very little use is made of loan deficiency payments (LDP's). Our conclusion is that storage and handling payments encourage heavy loan placements and that holdover industry practices from the previous era are impeding price discovery, inhibiting more efficient operation of the program.

The Current U.S. Peanut Industry--Vibrant, Stronger, and More Competitive The changes Congress made to the peanut program with the 2002 Farm Bill have resulted in a more productive and economically efficient peanut industry. Producers, no longer constrained by the old marketing quotas, are now able to grow peanuts for any market. They are able to plant on more productive acreage. Shifts in plantings have contributed to higher yields and larger annual US peanut outturn. Peanut yields under the new program are averaging 13 percent higher than under preceding farm legislation. Domestic food use of peanuts, the largest peanut off-take category, has averaged 15 percent higher under the 2002 Act. The reduction in the support price for food-use peanuts from \$610 per ton to \$355 per ton has facilitated lower peanut prices for consumers. Increased peanut food product advertising and promotion by manufacturers has spurred consumer interest as well.

In March 2006, while school children enjoyed their classic American staple peanut butter-and-jelly sandwich, lunch providers' budgets benefited from the lowest March peanut butter prices in 20 years! In this regard, the new peanut marketing loan program has been tremendously beneficial. Working closely with the peanut industry, USDA has successfully established a market-oriented marketing loan program and facilitated the many accomplishments listed above. In short, producers, consumers, manufacturers and government are all doing their part to ensure the continued growth of this great industry. In evaluating the operation of the current program, it is important that four key factors are clearly understood:

- (1) price discovery limitations impede the estimation of an accurate LRR (also called National Posted Price [NPP]);
- (2) producers are not receiving the full benefits Congress intended from the marketing assistance loan program;
- (3) government paid storage and handling for peanuts placed under marketing assistance loans stimulate loan participation and creates rigidity in marketing; and
- (4) exports remain strong. Challenges with Peanut Price Discovery Price discovery is important to the administration of all CCC marketing assistance loan programs because it provides the requisite information for establishing an accurate LRR. The LRR allows for repayment of loans at levels that move freely in response to the dictates of supply and demand. The new peanut marketing assistance loan program established a loan rate of \$355 per ton. As with other commodities, the grower is guaranteed at least this price. If the price falls below this amount, the grower can receive the difference in the form of a marketing loan benefit or forfeit the peanuts to CCC. Finding price information with which to determine the LRR, not customarily a problem for other commodities with marketing assistance loan provisions, is a unique problem for peanuts. For example, corn producers have a combination of mechanisms that provide price transparency in the market. Corn producers throughout the U.S. have multiple marketing options, including selling to local elevators, feed lots, and ethanol plants.

Corn prices are openly reported on various market exchanges by many market price reporting services. In stark contrast, the comparatively small number of peanut producers in the U.S. has limited sales options, no market exchange, and limited market price information sources. When Congress changed the peanut program from a marketing quota program, it established a nonrecourse marketing assistance loan program in an industry without price discovery mechanisms. Previously, peanut market prices were largely determined by the program, and the peanut industry had little need for price discovery. Now that both peanut producers and USDA need farm-level market price information, very little exists. This is attributable to both the concentrated structure of the peanut industry and industry reliance on private contracts. Recent consolidations have resulted in a peanut industry with very few buyers. Market power is concentrated among shellers, leaving few alternatives to growers in marketing their peanuts. Industry concentration, coupled with previous marketing patterns, has facilitated widespread use of private contracting in the industry.

Private contracting, a holdover practice from the earlier program and the primary method of marketing peanuts, inhibits the availability of timely, transparently established market prices. Shellers and growers enter into individual contracts, often before planting. Private contracts provide little price information to USDA and impede the development of the sort of farmer stock cash market that would improve price discovery. If the industry could be encouraged to reduce its reliance on private contracts and instead trade on the cash market like other commodities, USDA could have access to the type of price information it needs to accurately determine the weekly NPP. However, incentives to continue the use of private contracts exist, with the most compelling incentive, storage and handling payments for peanuts under marketing loan, funded by taxpayers. Because private contracts (called option contracts) require growers to place peanuts under marketing assistance loan after harvest, they take advantage of storage and handling benefits, making the contracts more profitable than they were prior to the 2002 Farm Bill.

Available Peanut Price Surveys Provide Limited Market Information

One source of price information available to USDA for establishing the weekly NPP is the Agricultural Marketing Service (AMS) shelled peanut report. This report publishes shelled peanut prices for three types of peanuts, according to the different grades, by polling sheller representatives and peanut brokers over the telephone for prices on trades made during the previous week. However, a concentration of market power on the buying end lends itself to a more restrictive trading environment in which purchases cover peanut needs for extended durations of time, and where non-disclosure clauses written into large contracts prevent parties from sharing price information with AMS. AMS peanut price reporting and reliability is thus hindered by infrequent trades, low volume trades, and the potential for manipulation of prices through selective reporting. USDA's experience with using only AMS prices to establish the NPP was largely negative. When USDA first began its administration of the marketing assistance loan program in 2002, it relied only on AMS prices to establish the NPP. Within four weeks of the first announced NPP, the NPP had decreased 15 percent, from a level well above the loan rate to one which resulted in the payment of \$20-40 per ton in marketing assistance loan benefits. Over the course of the 2002 crop year, USDA paid \$50 million in marketing assistance loan benefits, even though other supply and use factors for the crop year suggested a robust market. USDA altered its NPP source data in response to this outcome by relying less heavily on AMS prices, and marketing assistance loan outlays have since

decreased.

Also, the use of a shelled price is not appropriately matched to the loan program, which is based on grower product, or in-shell peanuts. Such use would necessarily imply a minimum processing margin for shellers guaranteed by taxpayers. Including available international peanut prices in the NPP calculation is deemed inadvisable since the reporting companies do not provide information on volumes traded, indicate whether the reported prices are quotes or actual transactions, or detail the sources

of their price information. Further, trading companies do not update prices often enough, are inconsistent with their updates and have a stake in the reported price levels. USDA contracted with independent professional economic analysts to study the peanut market and make recommendations for setting the NPP. They rejected the use of prices from international sources in setting the NPP and recommended that USDA focus on domestic prices. The only dependable source of price information on peanuts at the farm level is reported monthly in the National Agricultural Statistics Service (NASS) Agricultural Prices report. The NASS report is a paper survey that captures volumes traded and prices received for farmer stock peanuts, including option prices paid to farmers. However, NASS only reports a single price that encompasses all types and does so only once a month, which may reflect a 4-8 week lag in actual transaction prices. USDA Peanut Price Discovery Efforts In attempting to overcome these deficiencies, we have made several attempts to engage the peanut industry in cooperative efforts to obtain more accurate and timely price information. USDA efforts to enhance price discovery began in July 2003 when USDA established its Interagency Peanut Task Force to review the price discovery process. USDA assembled staff from nine agencies in the Department. The Task Force determined that the most critical component in a successful marketing loan program is accurate and timely price information. Furthermore, the Task Force said that price discovery in the peanut sector has been complicated by a lack of transparent, consistent and market-oriented transaction data. Contributing to the lack of transparency is the small and highly consolidated structure of peanut buyers.

USDA followed up on the task force findings with a meeting of all industry segments in October 2003 to discuss challenges related to price discovery and to solicit their input in developing solutions. USDA sought to improve upon the NASS price series by increasing the frequency of the NASS survey from monthly to weekly. The peanut shelling segment of the industry stated its preference for the use of AMS and/or international prices for establishing the weekly NPP. At least one of the major peanut shellers declined to participate in a weekly survey. In 2004, USDA contracted with an independent economic consulting firm to develop a methodology for calculating the NPP. The resulting analysis focused on the use of domestic prices to establish the weekly NPP, specifically AMS shelled prices. Based on USDA's previous experience with this method, USDA continued its use of prices from multiple sources to establish the NPP. Subsequently, USDA undertook to determine potential marketing assistance loan outlays using the methodology recommended by the independent contractor during the period when USDA experienced the only significant level of forfeitures under the new program. Beginning in late February 2005, the third party estimation of the NPP dropped below the loan rate, and the spread between this hypothetical NPP and the actual NPP widened over time.

Marketing assistance loan outlays using the third party NPP were estimated to total \$42 million from February to November 2005. Actual marketing assistance loan benefits paid during this period were \$7 million. Assuming that payment of \$42 million in marketing loan gains would have prevented forfeiture of 106,000 tons (4.9 percent of production) during the period, the monetary loss to USDA resulting from these forfeitures only added \$6 million to USDA outlays. In January 2005, in response to interest from the New York Board of Trade (NYBOT) regarding the feasibility of adding peanuts to its exchange, USDA hosted a meeting between representatives of the peanut industry and experts on futures markets from the Commodity Futures Trading Commission (CFTC), Chicago Board of Trade (CBOT), Economic Research Service (ERS), and NYBOT. Presenters discussed the criteria necessary for a successful futures market. The outlook for the peanut industry was mixed. Representatives of CBOT and NYBOT stressed that the level of interest and participation in a futures market during its first month would likely determine its ultimate success.

However, sheller representatives expressed reluctance to commit to serious participation in a futures market in its formative stages. USDA's most recent meeting with all segments of the peanut industry occurred in November 2005. USDA reviewed the status of the marketing assistance loan program, explained its reasons for not relying solely on AMS prices for establishing the NPP, and recommended program improvements. The key recommendations were for a weekly NASS farmer stock price survey by type and for shortening the loan period to require loan maturity no later than June 30. Major industry participants showed little interest in either proposal. USDA convened its Peanut Interagency Task Force in January 2006 to perform an internal review of the NPP calculation. The Task Force affirmed the NASS farmer stock price as the best indicator of the market and recommended that USDA continue its existing method of establishing the NPP until better price information becomes available. USDA continues to pursue the establishment of a weekly NASS farmer stock price survey by type. During March 2006, NASS met individually with shellers to solicit their participation in a weekly survey. USDA considers the more frequent update on farmer stock prices imperative to successful operation of the marketing loan program.

The benefits of full participation in this survey include 1) more timely and accurate farmer stock price information for the industry and USDA, 2) reduced lag between NASS farmer stock price updates, and 3) differentiation of farmer stock prices by type. Access to prices by type will allow for a more precise repayment rate. It may also result in a lower repayment rate for runner peanuts, which make up 80 percent of US production.

Because NASS combines prices for all types, it may at times include prices for comparatively high-valued types. It is readily apparent that access to timely and accurate price information is essential to successfully operating the marketing loan program in the manner Congress intended. One possibility for ensuring that USDA has the information it needs to operate the marketing loan program is for Congress to require industry participation in a price survey should the industry continue to refuse to participate voluntarily. Without this price information, the result will be unnecessarily high loan forfeitures when the NPP is set artificially high, or overpayment of marketing loan benefits when the NPP is set too low. Peanut Option Contracts The use of option contracts, which require peanuts to be placed under a marketing assistance loan, hampers the development of a reliable NPP. Since the new program, these contracts

almost always set the sheller price based on the USDA-determined LRR2. Through option contracts, shellers offer producers a premium, or option payment, above the LRR in exchange for the right to redeem the grower's marketing loan (marketing assistance loans are required under the contract) at a time of their choosing and then process the peanuts. Because a large portion of all peanuts are marketed in this manner, option contracts have precluded the emergence of a cash market, resulting in little "arms length" price discovery.

This, in turn, severely limits the amount of market price information available to USDA for use in establishing the NPP. This has resulted in a circular situation. Contracting precludes availability of broadly-based, representative price information with which to establish the NPP, but the sheller contract "price" depends upon that very same USDA-set price. This situation is very different from other commodities, where price information and buyers are widely available. Option contracts base sheller prices on the NPP and provide authority to the sheller the right to redeem a grower's peanuts. Option contracts require peanut growers to take a marketing loan at harvest, when the producer receives payment for the peanuts of \$355 per ton (the loan rate) plus any option payment from the sheller. When this occurs, a producer's role in peanut marketing virtually ends, because through the option contract, the producer has authorized the sheller the right to repay the marketing loan when the sheller so chooses at the prevailing NPP. When the repayment rate is less than \$355, shellers simply obtain the peanuts they redeem at a lower cost. The removal of producers from the loan redemption decision eliminates the producer role in ensuring fair market value. By taking producers out of the mix, buyers may be able to obtain loan commodities at below true market value, with the difference funded by taxpayers through excessive marketing loan benefits. This may explain sheller reluctance to reveal market price information to USDA.

Peanut Storage and Handling Payments Another major factor that negatively affects loan program operations is the provision requiring CCC to pay storage, handling, and associated costs for loan peanuts through the 2006 peanut crop year. These benefits are generally not available to the producers of any other covered commodity, although cotton producers may receive credit for storage (not handling) when the loan repayment rate falls below the loan rate. Paid storage and 2 Through option contracts, the per ton price received by peanut growers is the loan rate (\$355) + option. However, the per ton price paid for peanuts by shellers is the loan repayment rate (a variable price less than or equal to \$355) +option. For this reason, it is peanut shellers, rather than peanut growers, who are subject to changes in the LRR handling exacerbates problems with price discovery and precludes the NPP from fulfilling its intended role. Like marketing loan gains, option contracts shift most of the storage and handling benefit (\$48 per ton on average) to peanut shellers at the expense of taxpayers. We suggest that this is an unintended result and that Congress intended the peanut marketing loan program to work similarly to programs for other commodities, with the benefits going to producers. Storage and handling payments create a strong incentive to continue use of option contracts and place an abnormally large share of peanut production under loan. In 2005, 95 percent of production was pledged as collateral for CCC marketing assistance loans. By comparison, a normal rate of loan placement for cotton ranges from 50-80 percent, while the rate of loan placement for corn ranges from 10-15 percent. The heavier use of the marketing assistance loan for peanuts relative to cotton may stem in part from the unique provision for peanut storage and handling charges, regardless of the level of the repayment rate.

Cotton producers who are in a position to capture a marketing loan gain may incur storage payments if cotton prices rise above the loan rate. They thus have a higher risk of adverse price movements and an increased incentive to cash in on these benefits in a timely manner through redemption of loan collateral. In contrast, this incentive does not exist for peanuts, which is evident in the rate of peanut loan collateral redemptions. Because peanut shellers do not run the risk of losing storage and handling payments with an adverse price movement, shellers redeem loans as their needs prescribe. This reduces the effectiveness of the LRR to influence loan collateral redemptions and increases USDA's risk of forfeiture. Statistical analysis suggests no correlation between the levels of the weekly loan repayment rate and peanut loan collateral redemptions. This is in sharp contrast to the experience with other commodities.

In addition to impeding the operation of the marketing assistance loan program, paid storage and handling have proven expensive. Since 2002, larger peanut production and increasing shares of peanut production pledged as loan collateral have escalated USDA costs associated with peanut storage and handling. Prior to enactment of the 2002 Farm Bill, the Congressional Budget Office estimated that peanut storage and handling would cost \$74 million over fiscal year (FY) 2003-2007. Actual FY 2003-2005 expenditures plus USDA projections for FY 2006-2007 suggest total outlays for peanut storage and handling of \$509 million, nearly seven times the estimate. The decision by Congress to terminate peanut storage and handling support after the 2006 crop will help the industry to adapt to the new program and function in a manner more consistent with other commodities.

The industry will have a reduced incentive to negotiate option contracts and place large portions of production under loan. Price discovery mechanisms, such as a farmer stock cash market, will likely be more robust, thereby improving market information to producers and to USDA. Producers use the loan program. Currently, nearly 100 percent of crops placed under loan lock in the minimum price of \$355 per ton. The elimination of storage and handling payments will help USDA manage the peanuts under a marketing assistance loan by encouraging loan collateral redemptions in response to market conditions, rather than program provisions. Loan Duration Our experience also suggests an additional adjustment that would improve effectiveness of the peanut marketing assistance loan program.

Shortening the term of the marketing assistance loan to no more than six months, with maturity by June 30 each year, would mitigate market conflict between "old" and "new" crop peanuts. June 30 was the date at which old crop loans were terminated under the previous program and this encouraged the movement of peanuts from one crop into the market prior to harvest of the next crop. Peanut Exports Most of the criticism of USDA's administration of the peanut marketing assistance loan program focuses on the determination of the NPP. Some in the industry argue that the NPP is too high to allow the domestic industry to compete in the export market. However, we suggest that these arguments fail to recognize the fundamental changes made to the program by the 2002 Farm Bill. The program was changed from a two-tiered price support program, which distinguished between the domestic food market (with a high support price) and the crush and export markets (with a much lower support price), to a single price program. The NPP is intended as a market-clearing mechanism for all peanuts, regardless of end use. As such, the NPP reflects the combined value of all end uses, as revealed by the market price, and does not seek to direct peanuts to one market over another, as in the previous

program. The NPP does not distinguish peanuts by end use or destination. In addition, this ignores the long-term downward trend for peanut exports that began in the early 1990s. Prior to the 2002 Farm Bill, U.S. peanut exports began to decline due to increasing competition with China and Argentina. China produces 14 million metric tons (MT) of peanuts each year, while US production is 2 million MT. China has doubled its exports since the mid 1990s and improved quality. Total 2005 crop peanut exports from China are projected at 950,000 MT; U.S. 2005 crop peanut exports are projected at 234,000 MT. While a large portion of China's export increase has been to markets that previously did not import large quantities of peanuts, China has still managed to increase market share in nearly every market, including the European Union and Mexico. In both Europe and Mexico, this increased share of sales by China has come at the expense of Argentine and US peanuts. Since 2002, U.S. peanut exports have stabilized to a consistent annual rate of around 250,000 short tons. This figure remains on par with many of the years leading up to the 2002 Farm Bill and does not indicate a loss of exports resulting from the 2002 Farm Bill or the level of the loan repayment rate.

Imports into the domestic market lend little support to the suggestion that the NPP is set too high. U.S. peanut imports have fallen 90 percent since 2001 and now comprise less than 1 percent of total use. As of March 31, 2006, imports from Argentina, our principle supplier, totaled less than 7 percent of the annual tariff rate quota that opened April 1, 2005. Put another way, 93 percent of the allowable peanut import quota remained unfilled last year.

If the NPP was set too high for domestic peanuts to remain competitive, U.S. processors would likely be importing more peanuts. USDA estimates that even a sharp reduction in the peanut LRR will capture few additional exports at a sizeable cost to US taxpayers. A reduction in the repayment rate from the 2005 season low (to date) of \$330 per ton to approximately \$260 per ton will likely only generate 60,000 short tons of additional exports and would add \$161 million to the cost of the marketing assistance loan. This amounts to a taxpayer cost of \$2,683 per additional ton of export. Were USDA, as requested, to intentionally reduce the repayment rate to a level that would capture additional exports, it would likely present World Trade Organization (WTO) concerns.

Marketing loan gains are subsidies for the purposes of the WTO Agreement on Agriculture and the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement). As such, they qualify as amber box support and count toward the total U.S. support limit of \$19.1 billion per year. In addition, the SCM Agreement provides that no country should cause, through the use of any such subsidy, serious prejudice to the interest of another country. When the perceived effect of a subsidy is significant price suppression, price depression, or lost sales in an individual market or in the world market, the WTO may rule as it did in the upland cotton case brought against the United States by Brazil that a subsidy creates serious prejudice. Intentionally reducing the loan repayment rate for peanuts under USDA's marketing assistance loan program for the purpose of facilitating the export of peanuts could give rise to claims of serious prejudice under the SCM agreement. A successful challenge in the WTO on that basis would ordinarily require the U.S. to withdraw the measure or its impermissible effect. Failure to do so would then permit the complaining party to seek trade retaliation commensurate with the degree and nature of the adverse effects determined to exist.

For Consideration...

First, allow peanut storage and handling benefits to terminate with the 2006 peanut crop. This will help the peanut marketing assistance loan program adjust to more normal placement and redemption patterns. It will induce peanut loan redemptions and will likely reduce loan placements and industry dependence on option contracts. To the extent that it reduces the use of private contracts, it will improve price discovery and could foster a cash market for farmer stock peanuts, thus rendering mandatory price reporting unnecessary.

Second, establish June 30 as the date marketing assistance loans for peanuts mature each year. Under the prior peanut program, handlers cleared loan peanuts from warehouses by June 30 to ensure that storage facilities were available before the next crop's harvest began. The threat of peanuts perishing will be less of a problem under such an arrangement. Earlier maturity also will require redemption or forfeiture of peanut loan collateral at an earlier date, and thus reduces conflict that arises when "old" and "new" crops are marketed simultaneously. And third, collect a weekly NASS farmer stock peanut price to provide USDA with dependable, timely, and accurate price information for estimating the market price and setting the LRR. If this option fails, we recommend exploring an incentive-based or mandatory price reporting system.