

Statement

Of

American Cotton Shippers Association

On

2007 Farm Legislation

To

General Farm Commodities & Risk Management Subcommittee

Committee on Agriculture

U.S. House of Representatives

Washington, DC

April 26, 2007

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Joseph Nicosia
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Chairman Etheridge, Ranking Member Moran, and members of the Subcommittee, I thank you for this opportunity to appear here this morning.

I am Joseph Nicosia, CEO of Allenberg Cotton Co. of Memphis, Tennessee. Allenberg is a division of Louis Dreyfus Commodities. I appear here today in my capacity as Second Vice President of the American Cotton Shippers Association (ACSA). I am also a member of ACSA's Executive Committee and its Farm Policy Development and National Affairs Committees, and Chairman of its Committee on Futures Contracts. I am accompanied today by Neal P. Gillen, ACSA's Executive Vice President & General Counsel.

I have been involved in the merchandising and trading of cotton and cotton futures for over twenty-five years and I am fully familiar with all of the U.S. and foreign growths of cotton. In my appearance today, I will review why U.S. cotton is no longer competitive in the world market and what the Congress can and should do to enable the U.S. to regain the competitive advantage and market share it has lost this past year following the repeal of the Step 2 Program.

Interest of ACSA

ACSA was founded in 1924 and is composed of primary buyers, mill service agents, merchants, shippers, exporters and importers of raw cotton who are members of four federated associations located in seventeen states throughout the cotton belt:

Atlantic Cotton Association (AL, FL, GA, NC, SC, & VA)
Southern Cotton Association (AR, LA, MS, MO, & TN)
Texas Cotton Association (KS, OK & TX)
Western Cotton Shippers Association (AZ, CA, & NM)

ACSA member firms handle a substantial portion of the U.S. cotton sold in domestic markets as well as the bulk of the trade in the export market. Our significant involvement in the purchase, sale and shipment of cotton manifests our interest in the

adoption of sound farm legislation that would provide an adequate safety net for producers while providing domestic and export customers with an adequate supply of competitively priced cotton.

The U.S. Cotton Situation

The Step 2 Program masked the basic problems inherent in the cotton program. Since its repeal in August 2006, U.S. cotton is no longer competitive in the world market, which accounts for 75% of total U.S. cotton demand.

As the attached study by Informa Economics indicates, the current market situation for U.S. cotton is sluggish. Based on current sales and shipments, we can expect last year's export level of 18 million bales to decrease to approximately 13 million bales. Some in the cotton trade would argue that is an optimistic estimate since today's accumulated exports of 6.5 million bales are consistent with total annual exports in the 10 to 11 million bale range. Under either scenario we can expect carryover stocks to increase significantly from last year's level of 6.1 million bales to a level of 9 to 10 million bales. The result is likely to be continued lackluster prices. Since the Commodity Credit Corporation (CCC) loan has become the market of first, and not last, resort given the excessive premiums inherent in the price support loan structure (which pays loan premiums 6 to 8 cents above the CCC base loan level of 52 cents per pound), loan forfeitures are likely to continue.

Though this year's crop of 21.6 million bales is 10% less than last year's, the level of loan entries is similar – 18.25 million bales versus 18.07 million bales last year. 87% of this year's crop was placed under CCC loan and 10.6 million bales or about 50% remains in the loan at a cost to the CCC (storage and interest) approximating \$37 million each month.

Recommendations

We are in agreement with the industry to maintain the marketing loan and the use of certificates to facilitate moving cotton from the loan. This mechanism is critical to the well-being of all industry segments.

Given the rapid decline in U.S. mill consumption from 11.4 million bales in 1997 to an estimated 5 million bales in 2007 and our increased dependence on exports, the U.S. has no alternative but to be globally competitive. To do so requires a number of reforms in the cotton program – reforms that should either reduce or offset program costs, particularly those associated with maintaining stocks in the CCC loan. We proposed a number of changes in the program (attached to our statement) which are the subject of ongoing discussions within the industry.

On most issues, there is general agreement within the industry on what should be done. Along with the rest of the industry we are opposed to "Means Testing." One major difference of opinion within the industry regards the determination of the loan rate. The producers and the related ginner and cooperative segments do not favor returning the loan rate determination to a percentage of the market price as was the case from 1977 through 1996. We believe, as does the USDA, that this would serve to make U.S. cotton competitive in the world market. We urge the Subcommittee to consider this change.

Reform & Compete

The Subcommittee has critical choices to make at this time:

- Continue cotton on its current track of diminishing foreign market share and cycling cotton through the CCC loan at considerable costs to the taxpayer, or
- Make the following necessary reforms that would revive market share by:
 - Determining the price support loan rate on a percentage of a five-year Olympic average price;
 - Allowing the market and not the CCC to establish premiums; and
 - Permitting producers and holders of loan options to ship loan cotton prior to redemption. This will facilitate the movement of cotton throughout the year, reduce government storage expenses, and remove the incentive to hold cotton in hopes of favorable redemption later in the year.

In summary, by Congress providing us with the ability to compete, U.S. cotton demand should increase given:

- The reliability of the U.S. as a dependable supplier of quality cotton;
- USDA's superior cotton classification system;
- U.S. cotton's unique and efficient transportation infrastructure; and
- The U.S. industry's exceptional foreign promotion programs.

Again, thank you for the opportunity to present these views. I will be happy to respond to any questions you might have.

U.S. Cotton Program Recommendations

1. Maintain the marketing loan.
2. Authorize the holder of the 605 Option to Purchase to market the cotton prior to redeeming it from the CCC loan, provided that a form of security is posted to protect the CCC's collateral interest in the cotton in the event of forfeiture.
3. LDP/POP – Provide the producer with the option to fix the LDP/POP in any week within ten months following the module formation.
4. Loan program:
 - a. Maintain the base quality at 41434.
 - b. Maintain the current Adjusted World Price formula with the following exception: Discontinue using the CCC loan difference between 31335 and 41434 and utilize the previous marketing year's average market difference (as weighted by the seven growth area spot markets by total production volume) between these qualities. Each year on August 1st, USDA would revise the formula to reflect the prior year's value.

Revision of "1-to-1" Ratio – The **premium** for each quality better than 41434 would be set at 50% of the previous year's spot market difference from 41434 for that quality. The maximum premium for any bale would be the premium established for 31335, i.e. no bale would have a loan value greater than 31335.

The **discounts** would continue to be established using the 1-to-1 ratio between the previous year's loan discounts and the previous year's spot market discounts.

- c. For the 2006-7 crop, oppose revising the current methodology utilized by USDA in determining the Adjusted World Price (AWP) in the six-week transition period from old crop to new crop quotes, however, agree to consider this concept for future years.
- d. Eliminate Location Differences.
- e. Loan Terms FOB Truck All Charges Paid.
- f. Payment of Storage & Interest – Continue the current policy whereby charges for accrued interest and storage are not charged if the Adjusted World Price is below the loan, and whereby storage and interest are not fully charged until the AWP exceeds the level of the price support loan plus the accrued storage and interest: and, when the AWP exceeds the loan level, carrying charges payable at redemption should be determined by quality, including the coarse count adjustment when applicable.

In the event that USDA and/or the Congress changes this policy and requires the payment of storage and interest, then such charges should be deducted from the loan proceeds at the disbursement of the loan.

- g. Means Testing – Oppose any form of payment limitations or means testing. Understanding the global and national political realities recommend that the \$360,000 limitation, proposed by the USDA, be applied as an overall cap and not limited by the specific type of payment. This would allow a producer the flexibility to receive \$360,000 in either Direct, Loan Deficiency, or Counter-cyclical payments, rather than receive it piece-meal for each type of payment at levels lower than \$360,000.

- h. Loan rate determination – Should the loan be established at 85% of a 5 year Olympic Average price capped at 51.92 cents per pound, as suggested by USDA, this would increase a producer's risk to payment limitations on counter-cyclical payments. Therefore, the current counter-cyclical payment limit should be increased by an amount equivalent to the deduction (for each cent the loan is reduced the CYC limit increases by one cent). This is calculated by taking $1/13.73$ (current maximum CYC payment) or 7.28% and multiply by \$130,000 (the current maximum CYC payment limit), which would yield the producer an additional \$9,468.

- i. Support a Step 2 payment for domestic mills.

Committee on Agriculture
U.S. House of Representatives
Information Required From Non-governmental Witnesses

House rules require non-governmental witnesses to provide their resume or biographical sketch prior to testifying. If you do not have a resume or biographical sketch available, please complete this form.

1. Name: Joseph Nicosia
2. BusinessAddress: 7255 Goodlett Farms Parkway
Cordova, TN 38016
3. Business Phone Number: 901-383-5000
4. Organization you represent: American Cotton Shippers Association
5. Please list any occupational, employment, or work-related experience you have which add to your qualification to provide testimony before the Committee:
Chief Executive Officer, Allenberg Cotton Co.,
Louis Dreyfus Commodities
Director, Louis Dreyfus Corporation
6. Please list any special training, education, or professional experience you have which add to your qualifications to provide testimony before the Committee:
Member, Board of Governors, New York Board of Trade
Director and Founding Member of The Seam,
an electronic agricultural marketplace
7. If you are appearing on behalf of an organization, please list the capacity in which you are representing that organization, including any offices or elected positions you hold:
Second Vice President, American Cotton Shippers Association
Member, Board of Directors
Chairman, Futures Committee

PLEASE ATTACH THIS FORM OR YOUR BIOGRAPHY TO EACH COPY OF TESTIMONY.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2004.

Name: Joseph Nicosia

Address: 7255 Goodlett Farms Parkway
Cordova, TN 38016

Telephone: 901-383-5000

Organization you represent (if any): American Cotton Shippers Association

1. Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2004, as well as the source and the amount of each grant or contract. House Rules do **NOT** require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:

Source: None. I am also an employee of Amount: _____
Allenberg Cotton Co., which may
Source: have received federal grants or Amount: _____
contracts.

2. If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2004, as well as the source and the amount of each grant or contract:

Source: None. Amount: _____

Source: _____ Amount: _____

Please check here if this form is NOT applicable to you: _____

Signature: Joseph Nicosia

* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

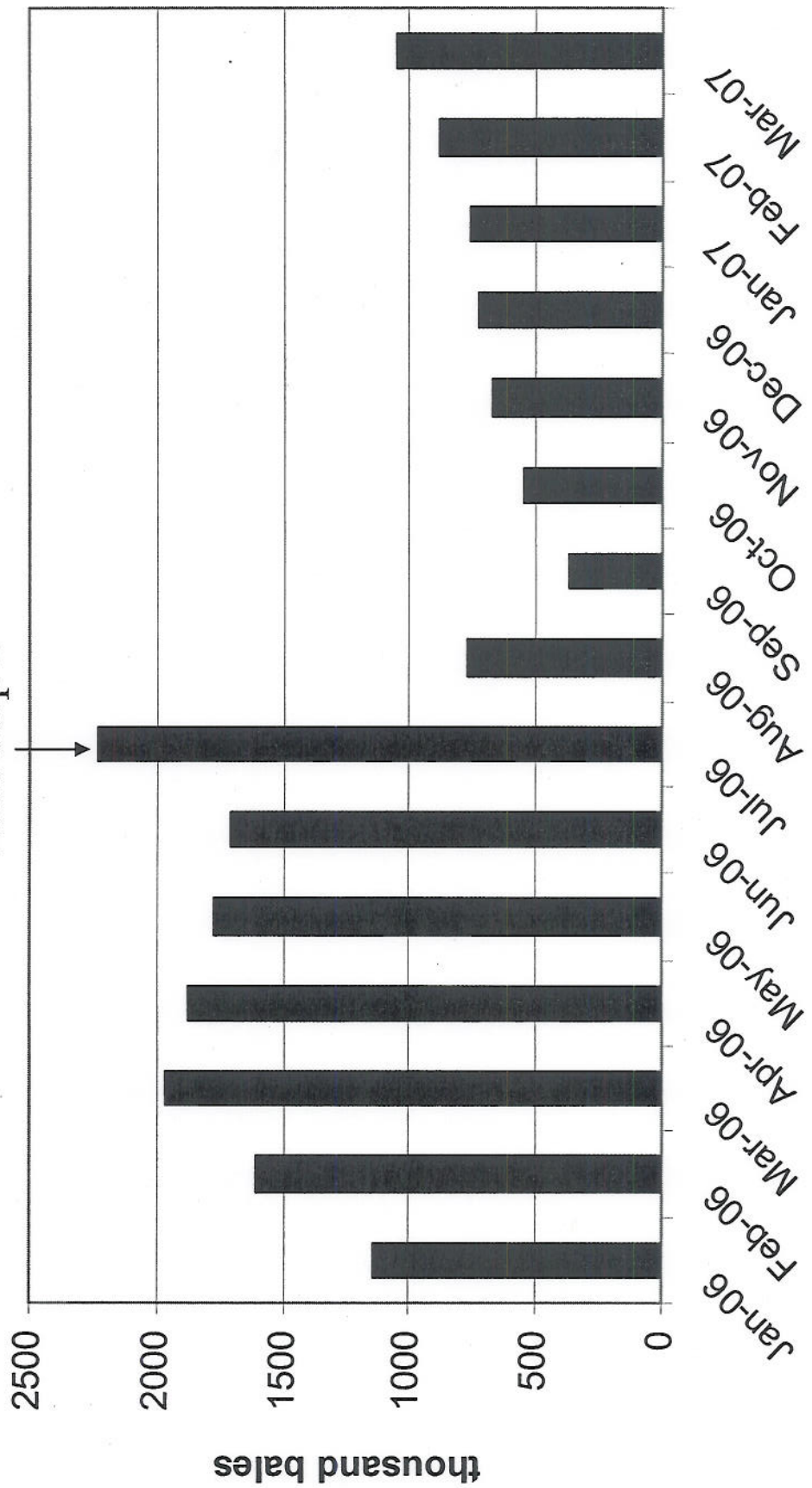
PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.

The US Cotton Situation Pending New Legislation

- Loss of Step 2 directly diminished the competitiveness of US cotton.
- Export demand for US cotton has fallen sharply.
- The US projected carryout is the highest since the 1985 Act began.
- The loan is the best market for many bales, and major forfeitures are expected.

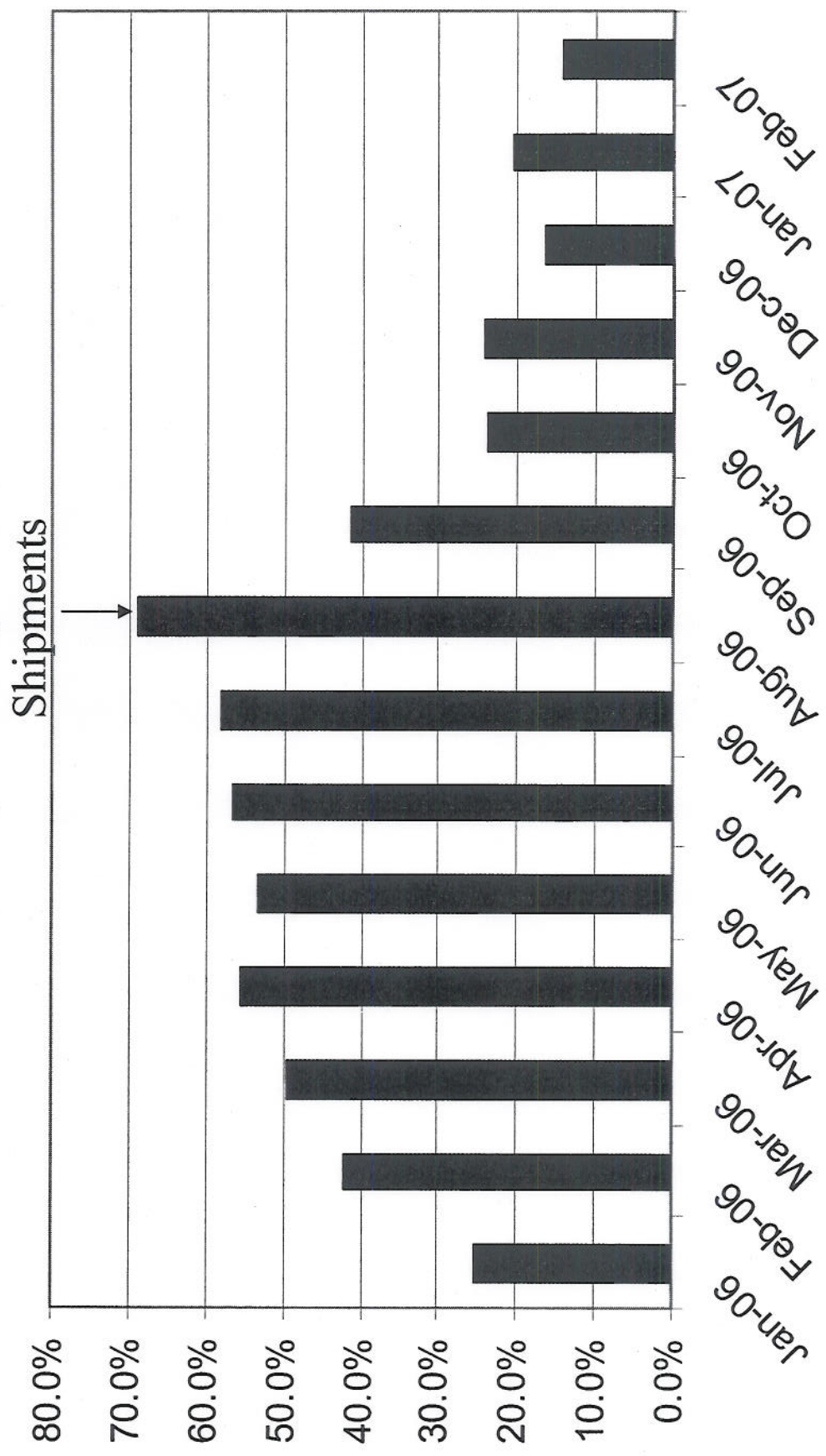
US Cotton Exports After Step 2

Last Month
with Step 2

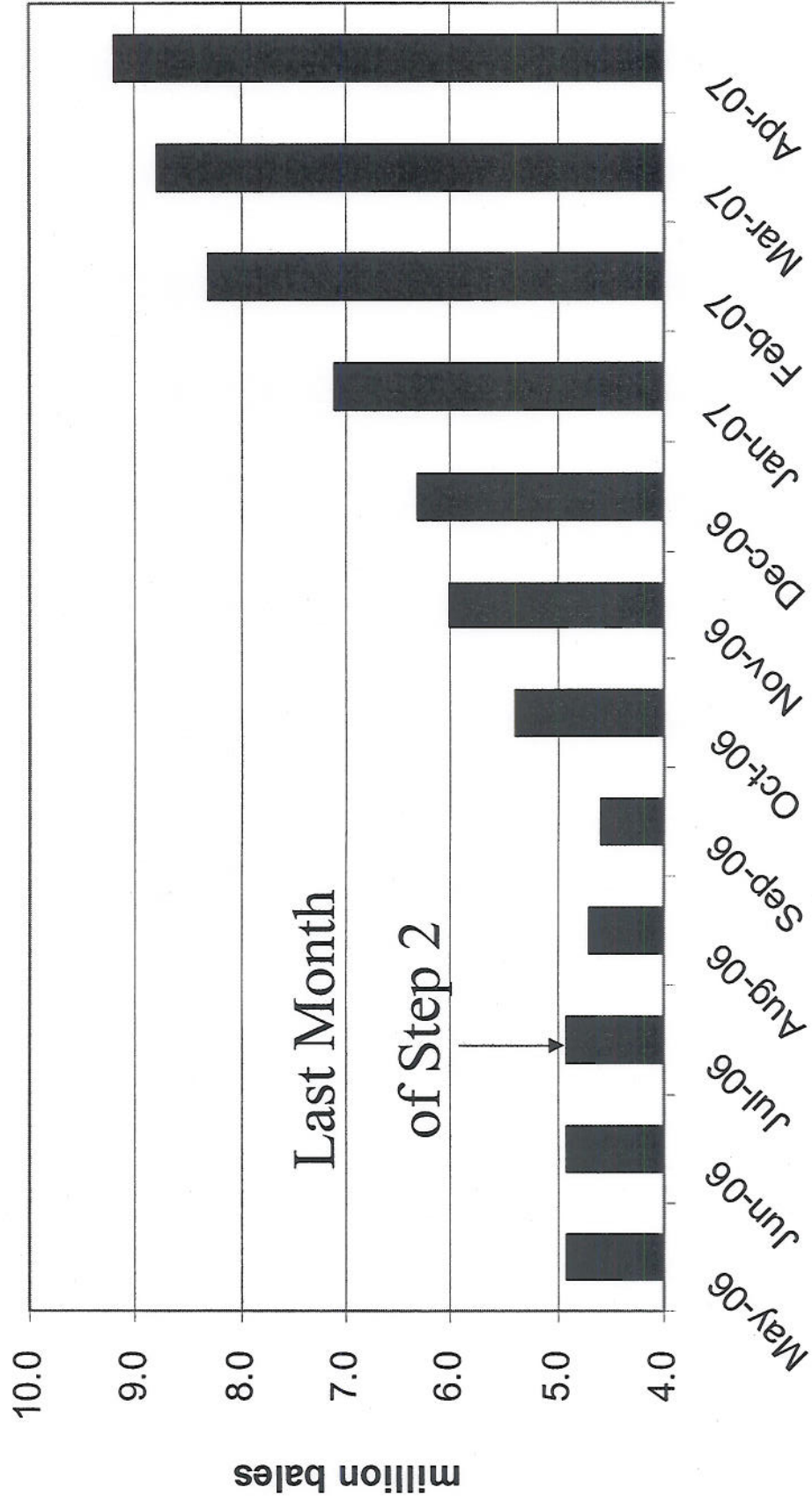


US Share of China Cotton Imports

Final Step 2 Cotton Shipments

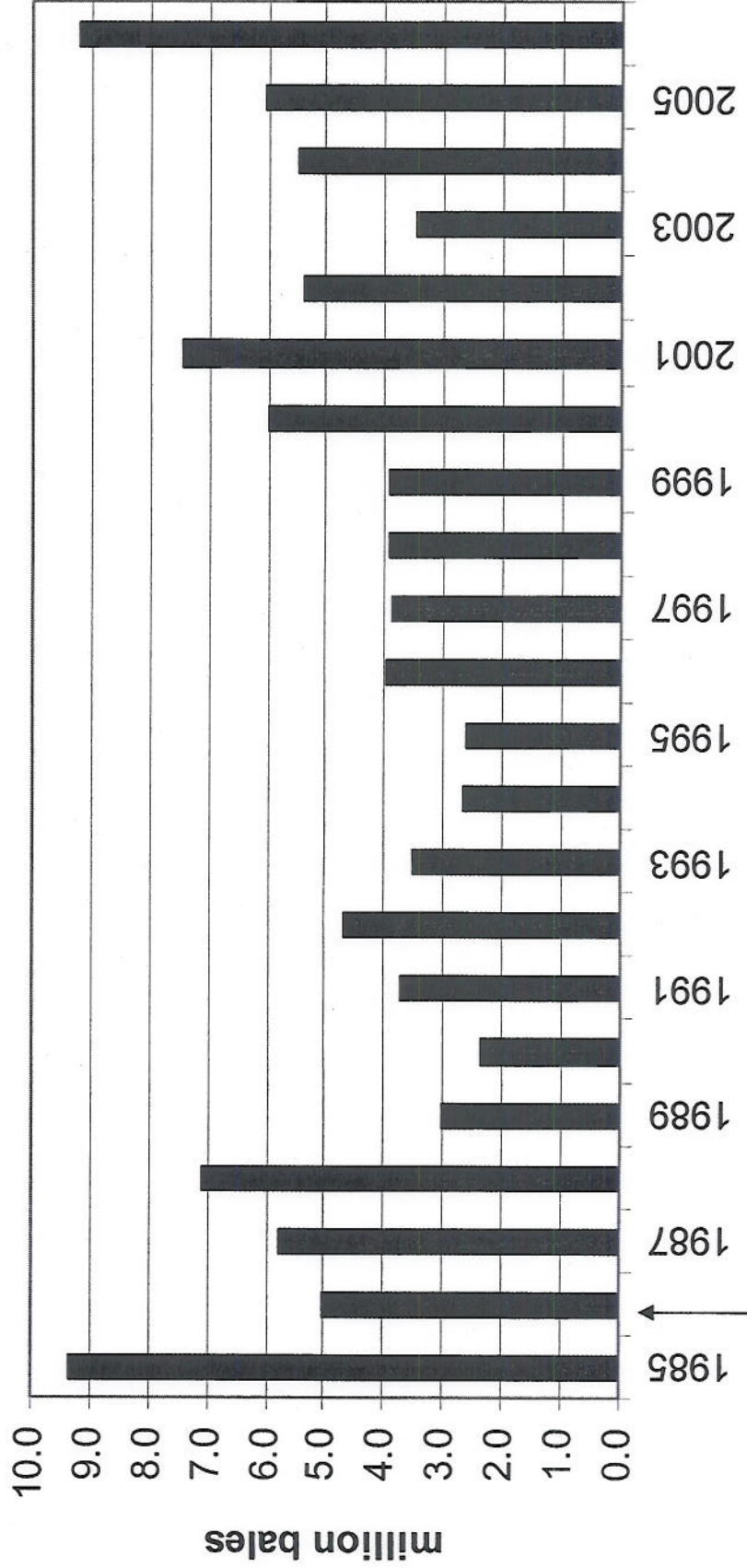


USDA Monthly Estimates of 2006/07 US Cotton Carryout



US Cotton Carryout Since the 1985 Act

USDA Estimates



1985 Act took effect

Four Key Objectives for Cotton Legislation

1. Calculate the loan rate based on Market Prices.
2. Lower Loan Premiums
3. Allow Loan Cotton to be Shipped Prior to Redemption
4. Maintain Current Payment Limitation Rules

An Evaluation Of The U.S. Cotton Program
Provisions And Potential Solutions To
Observed Problems

Prepared by

Informa Economics

For

American Cotton Shippers Association (ACSA)

The purpose of the Marketing Loan program is to provide the producer a level of support and provide a mechanism that allows cotton to move through the loan at competitive prices. The current cotton environment does not provide both a level of support for producers and allow cotton to move from the loan at competitive prices. The loss of Step 2 as a part of the three step competitive process has hampered the ability to move cotton from the loan to the market. Recognizing that fact, the American Cotton Shippers Association commissioned Informa Economics to provide an overview of the current Cotton farm program, provide an evaluation of its effectiveness and any recommendations for reform that might improve the program, keeping in mind that the goal of the US cotton farm program is to provide a minimum price guarantee for producers of cotton and provide a method of providing cotton in the market at competitive prices.

The market-clearing price for cotton is often at conflict with the established level of support because of the static nature of price supports and the dynamic nature of short-term market fluctuations.

Scope and Methodology

The methodology used in this abbreviated paper was to 1) review the current system, 2) gather opinions from informed sources from different segments of the industry delineating problems with the current program soliciting potential solutions, 3) aggregate that information and other information at our disposal to formulate possible solutions to the problems identified.

Overview Of Current Cotton System

Currently the cotton program cycles nearly all of US cotton production through the loan with the marketing loan program that began with the 1985 Farm Bill to remedy a situation similar to the one currently experienced. Producers put cotton in the Commodity Credit Corporation (CCC) loan at a fixed price, 52.00 for base quality 41434 (SLM 1 1/16). The loan program has a schedule of premiums and discounts to account for quality differences based on Agricultural Marketing Service (AMS) classification. Producers repay the loan at the lesser of the amount loaned plus carrying charges (storage and interest) or the Adjusted World Price (AWP). The AWP is a formula derived value based on international prices for 31335 landed in foreign ports. The landed prices are discounted by costs to transport US cotton to those ports and a quality differential to make the quality equal to the US base. The loan program has a schedule of premiums and discounts to account for quality differences. The loan must be repaid or forfeited nine months following the month of initiation. The CCC pays storage charges and interest on the cotton if the redemption rate is less than the base loan value and pays all or that portion of the carrying charges above the redemption rate when AWP is at or above the base loan rate.

Producers may bypass the loan by opting to take a Loan Deficiency Payment (LDP), which is the difference in the AWP and the base loan rate. The producer establishes the LDP on the day that he chooses to bypass the loan.

Producers may sell their cotton while it is in the CCC loan program if they have a contract that ensures they have not lost beneficial interest in the cotton. That transaction

is referred to as an option to purchase. A payment arrangement is made with the producer for the option to purchase the producers' cotton from the loan.

The loan program administered by the CCC has a schedule of premium and discounts established by FSA. The loan has an established base of 52.00 cents for SLM 41434. The premium and discount schedule is designed to ensure the cotton farmer receives a support price for the cotton based on several characteristics important to end users of cotton. The premium and discount schedule is updated each year primarily by formula, but with some adjustments if necessary, that is based on a one to one simple average of the seven spot markets for the prices collected from August to February as one portion, the other being the previous year's loan differences. The 2007 premium and discount schedule was released on April 10, 2007.

Producers receive a countercyclical payment when the average price received by the producer is less than the target price now set at 72.40 cents. The maximum payment is 13.73 cents. A direct payment of 6.67 cents is a part of that calculation. The balance is made up if the average price received is low enough to collect the payment.

This year producers will be required to pay compression charges and any excess storage over an amount determined by formula during the loan period upon forfeiture. The CCC also has allowed a transfer process this year to allow shippers to consolidate cotton for better efficiency.

Producers are subject to a payment limitation of \$360,000. Loan redemptions with generic certificates are not counted against that limitation.

The Survey

We conducted a limited telephone survey to ascertain what were perceived problems with the cotton program. We asked what are the three biggest problems and what are the two most critical parts of the program to keep.

We spoke to different segments of the industry: merchants, cooperatives, industry associations, producers, and communication specialists. We also spoke to several branches of USDA; AMS, FSA and CCC personnel to clarify procedures and better understand how the current system works.

We did not provide responses from which the respondents could choose. The responses for the biggest problems were less varied than we thought they would be. There was however, a distinction that an opinion was based on that individual's position in the marketing channel.

There were three problems that were most frequently offered by our participants. The loan premium problem, that was either first or second by each respondent except one. Inability to pay equity was the second most and general lack of demand was the third problem.

When asked what was the most critical program provision to keep, the most often mentioned was certificate redemptions and then storage credits. The problem mentioned

the second most often was payment limits. It is interesting to note that nearly all respondents came from a position assuming the marketing loan was a given.

The survey, small as it was, confirmed that the problems identified by the American Cotton Shippers Association are shared across the spectrum of the industry with whom we spoke.

Some of the problems identified by ACSA, their proposed solutions, and Informa Economics' analysis are as follows :

Maintain marketing Loan:

The marketing loan has been a good method for moving cotton into the international market and has been emulated in many other commodities. It is clear that many respondents in our survey and others that assumptions are made that the marketing loan is effective and clearly that is assumed as the other topics are discussed. We recommend that the government keep the marketing loan. We also recommend certificate redemptions remain a part of the marketing loan.

Loan program suggestions

a. Maintain base quality at 41434:

We agree in principle but research more extensive than conducted here might yield a result that can accomplish the same objectives. Absent that scenario we agree with the conclusion to maintain the base loan at 41434.

b. Maintain the current Adjusted World Price formula with the following exception: Discontinue using the CCC loan difference between 31335 and 41434 and utilize the previous marketing year's average market difference (as weighted by the seven growth area spot markets by total production volume) between these qualities. Each year on August 1st, USDA would revise the formula to reflect the prior year's value.

We agree that the full difference of the weighted spot market average in the AWP calculation will help keep US cotton competitive.

Revision of the "one-to-one" Ratio - The premium for each quality better then 41434 would be set at 50% of the previous year's spot market difference from 41434 for that quality. The maximum premium for any bale would be a premium established for 31335, i.e., no bale would have loan value greater then 31335.

We agree that the calculation is skewed to result in increased premiums because the one to one calculation treats all cotton in the US equally when that is not the case. California upland cotton carries a much larger premium and constitutes only a fraction of the total production in the US. See the example of weighted spot market and loan calculation.

The discounts would continue to be established using the "one-to-one" ratio between the previous year's loan discounts and the previous year's spot market discounts.

This method will serve to stabilize the discounts over time. The competition between the spot market and the CCC loan tends to decrease the discounts the same way the premiums are increased.

- c. For the 2006/07 crop, oppose revising the current methodology utilized by USDA in determining the Adjusted World Price (AWP) in the six-week transition period from old crop to new crop quotes, however, agree to consider this concept for future years.

We do not see the transitional calculation as critical at this juncture and has the potential to be disruptive and agree that the topic should be revisited.

- d. Eliminate Location Differences

The location differences are based on Group 3 mill location and the modern transportation costs do not warrant a continuation of the location differentials.

- e. Loan terms FOB Truck All Charges Paid.

Added costs and major discrepancies in the charges make a uniform policy desirable. Though difficult to quantify the different terms hamper the movement of cotton.

- f. Payment of Storage and Interest – Continue the current policy whereby charges for accrued interest and storage are not charged if the Adjusted World Prices is below the loan, and whereby storage and interest are not fully charged until the AWP exceeds the level of the price support loan plus the storage and interest; and, when the AWP exceeds the loan level, carrying charges payable at redemptions should be determined by quality, including the coarse count adjustment when applicable.

In the event that that USDA and/or Congress changes this policy and requires the payment of storage and interest, then such charges should be deducted from the loan proceeds at the disbursement of the loan.

The storage credits are an integral part of the marketing loan. Storage would follow the cotton and defeat the purpose of the AWP redemption process. We are strongly in favor of maintaining storage credits.

- g. Means Testing – Oppose any form of payment limitations or means testing. Understanding the global and national political realities recommend that the \$360,000 limitation, proposed by the USDA, be applied as an overall cap and not limited by the specific type of payment. This would allow a producer the flexibility to receive \$360,000 in Direct, Loan Deficiency, or Counter-cyclical payments, rather than receive it piece-meal for each type of payment at levels lower than \$360,000.

Informa Economics is unable to analyze the impacts of means testing because it is a social rather than an economic issue. Government estimates of cost savings need to be compared with social impacts to render an objective conclusion on this subject.

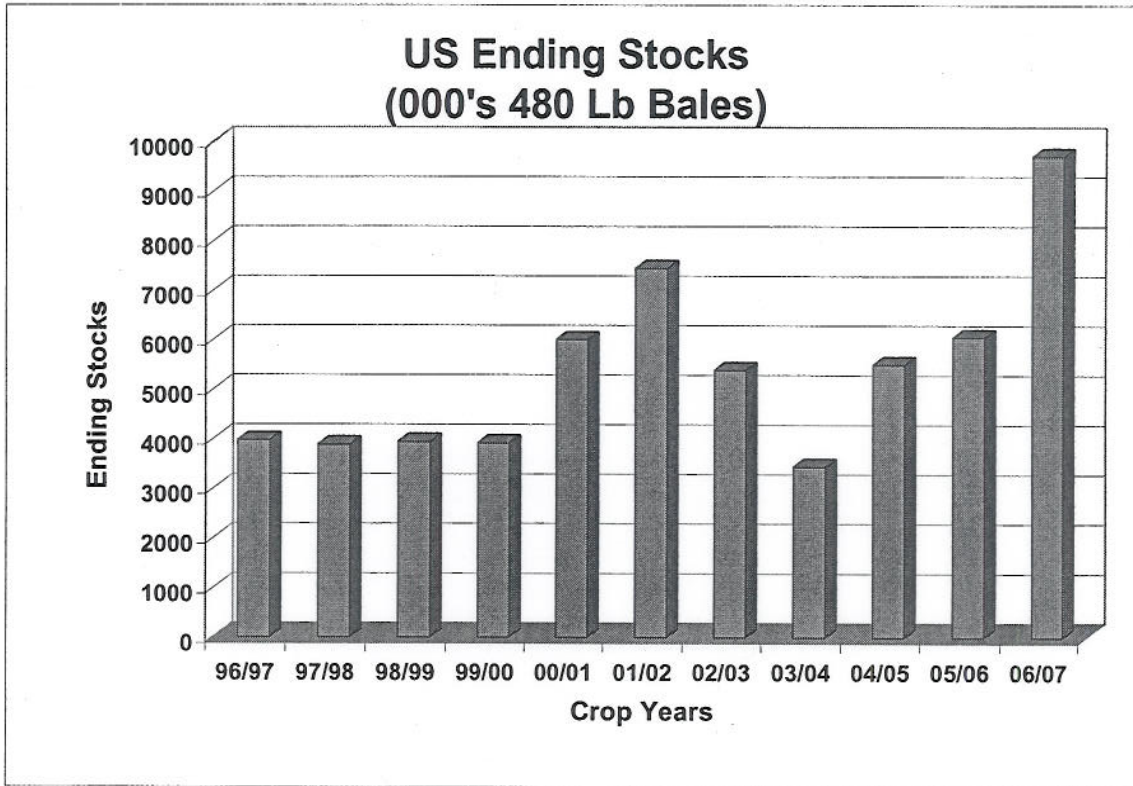
- h. Loan rate determination – Should the loan be established at 85% of a 5 year Olympic Average price capped at 51.92 cents per pound, as suggested by USDA, this would increase a producer's risk to payment limitations on counter-cyclical payments. Therefore, the current counter-cyclical payment limit should be increased by an amount equivalent to the deduction (for each cent the loan is reduced the CYC limit increases by one cent). This is calculated by taking 1/13.73 (current maximum CYC payment) or 7.28% and multiplied by \$130,000 (the current maximum CYC payment limit), which would yield the producer an additional \$9,468 per each one-cent production.

The lower loan rate would help cotton move into the lower priced export market though a decrease in the loan rate could discourage cotton production. We agree that a lower loan rate should be offset with a proportional increased countercyclical payment because of the potential lower price received by the producer.

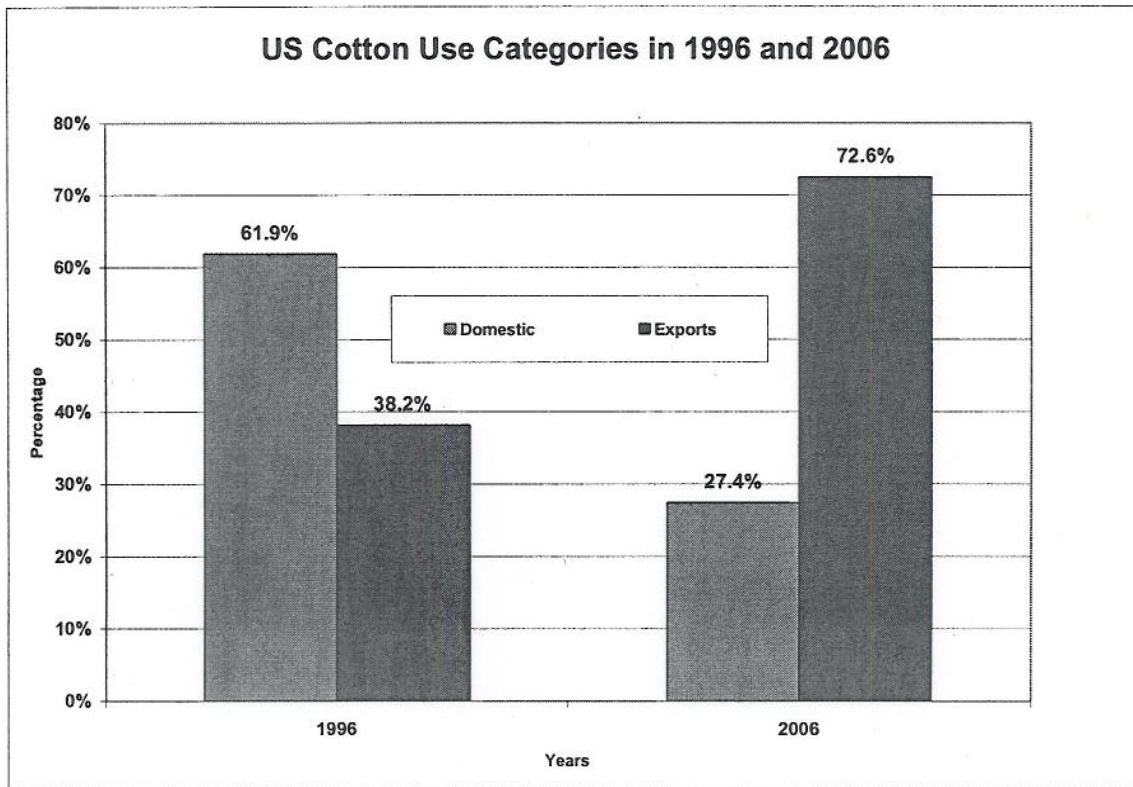
Current Cotton Situation

US Cotton Demand Is Now Predominately The Export Market

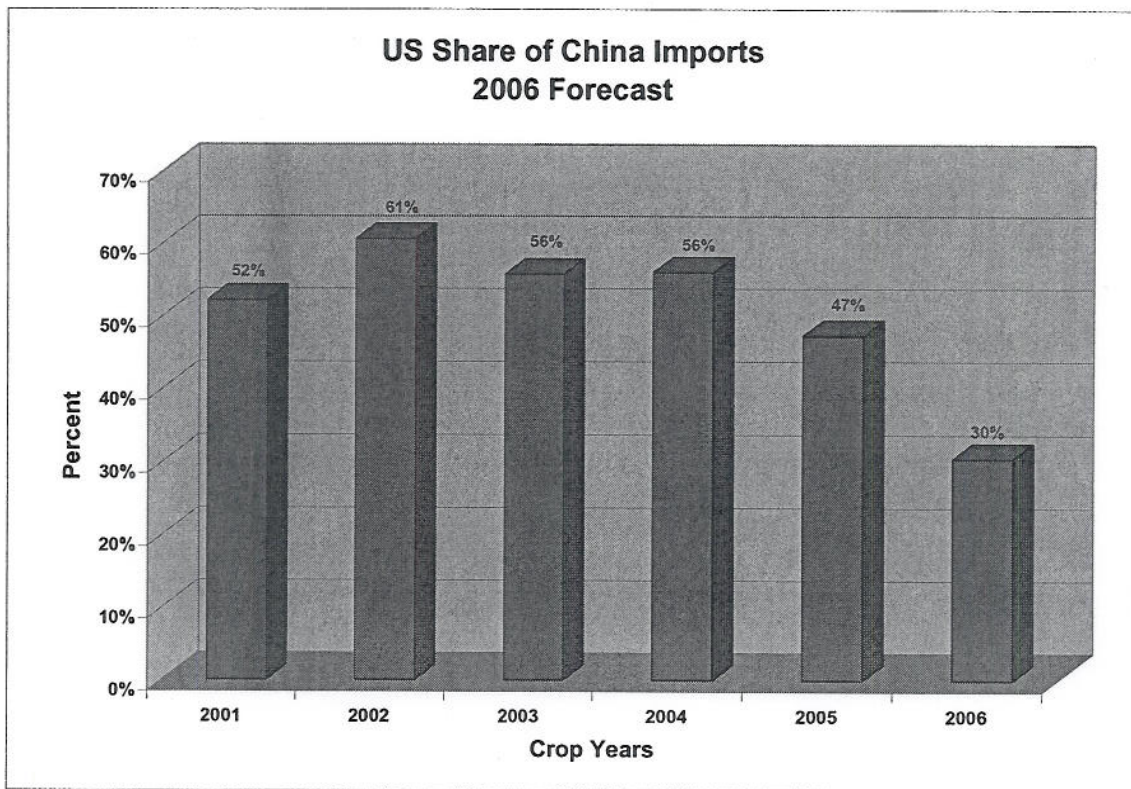
The cotton fundamentals are currently characterized by oversupply, with the US supplies unable to be offered competitively in the international market. Production has improved significantly with increased yields and higher quality cotton. The US is now producing the quality of cotton that the world demands but export sales are falling well short of our increased production creating a surplus of cotton in the US. This is the third consecutive year of increasing ending stocks. We are currently anticipating ending stocks of 9.7 million bales, the largest since 1985. The costs of storing the cotton is staggering. Storage and interest on those stocks is about 34.5 million dollars per month that will have to be paid by someone. Currently it looks like that someone will be the CCC because much of the cotton in the loan will be forfeited due to the inability of US cotton to be competitive in the world market.



US cotton demand has shifted rather dramatically in the last ten years and exports are increasingly more important. In 1996 domestic mill use was 62% of US cotton demand and exports were only 38%. In 2006 the situation is reversed domestic mill use is expected to be about 27% and exports at 73%. The outlook for 2007 includes smaller domestic mill use to about 20-21% of US cotton usage.

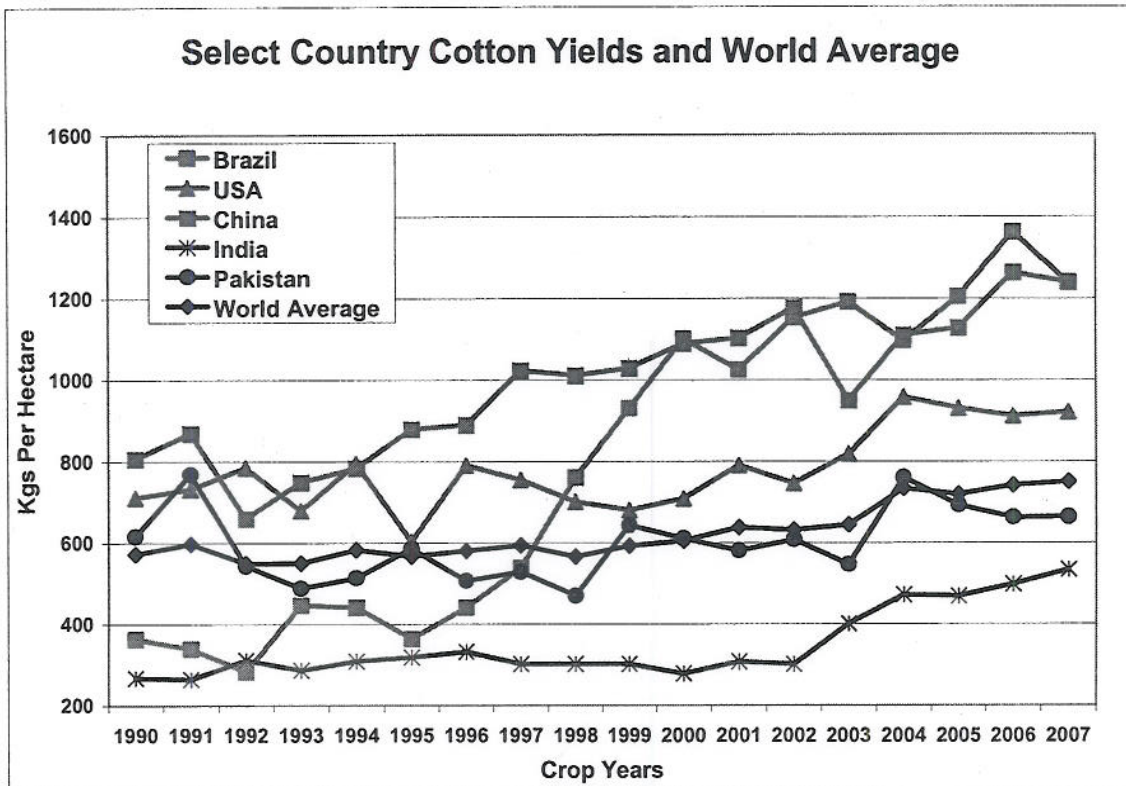


The dramatic shift has been due to the strong competitive advantage of the Asian textile industry. This year Asia is expected to consume about 83% of world cotton mill use compared with about 65% in 1996. The US domestic market is expected to consume about 4% compared with about 13% in 1996. The US cotton market is now heavily dependent on the export market and if the industry is to survive it must do so in an international rather than domestic environment. China particularly has a rapidly expanding textile industry and the US has supplied 50% or more of their raw cotton imports four of the past five years. Last year the US slipped to about 47%. However during the current season, the US is forecast to do only 30% and will have to sell and ship at least another 1.4 million bales to make that forecast. The US is currently about 17% of China imports compared to 40% last year. China is the largest importer in the world comprising some 44% of the world imports last year and 22% average of the past five years. China is a low cost buyer so our prices have to be competitive.



Foreign Export Competition Increased in 2006

A major increase in Asian production accompanied their mill use growth. The major growers in Asia are India, China and Pakistan. Pakistan has had a rather stable production level over the past several years, but they are beginning to expand plantings of genetically modified (GMO) seeds this year and they may begin to see the yield increases that India has experienced. India is a double-edged sword regarding US exports. They have about 25% of the world area devoted to cotton but until recently have had meager yields. The introduction of GMO seeds in India has increased their yields 65% since 2002. Production has gone from 10.6 million to 21.0 million bales in that period. Exports consequently have increased from essentially nothing (56,000 bales) to about 5.0 million bales. India has taken exports from the US because of proximity and price. Indian prices have been at or near the cheapest in the world nearly all year. Other growers have been competitive but the addition of India as an exporter has created additional difficulty for US shippers.



Export Sales Are Anemic

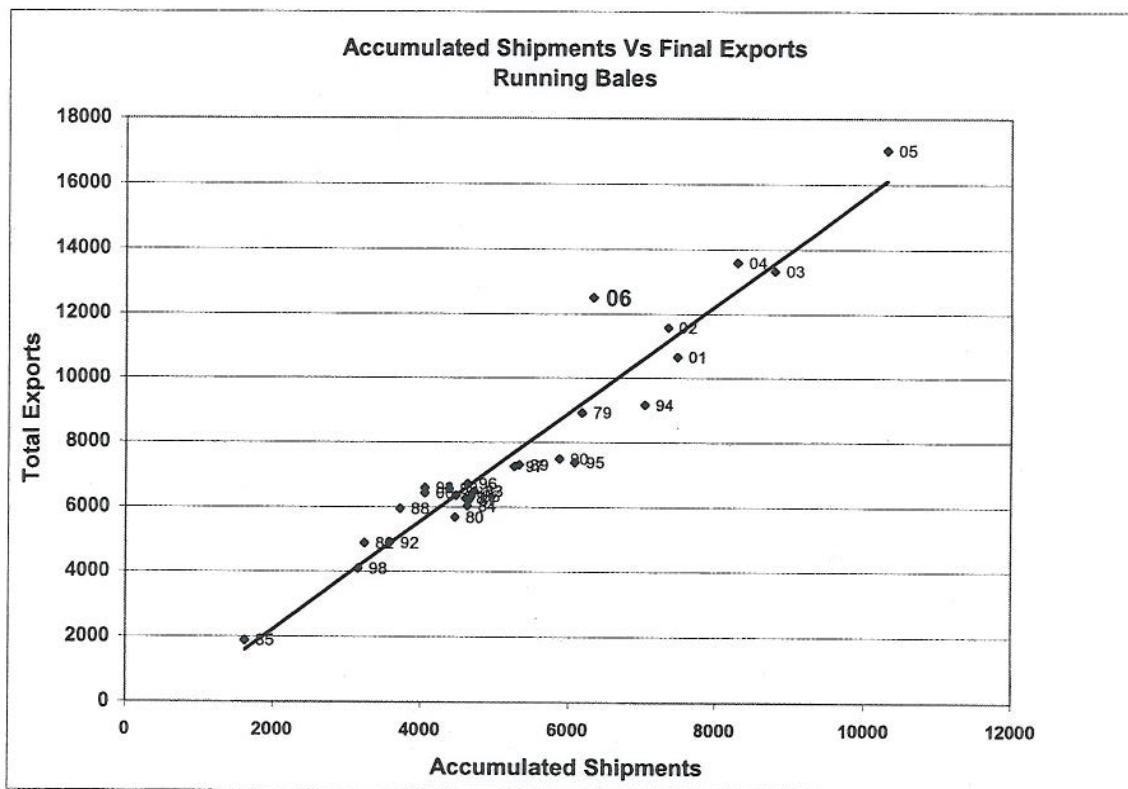
Export sales are now about two thirds of what are historically associated with a 13.0 million bales export season. The graphic Accumulated Shipments VS Final Exports indicates an export total more consistent with about 10.0 million running bales or about 10.4 million statistical bales. We think China will come in later in the year to perhaps boost shipments near or perhaps slightly above 13.0 million bales, however at this point that does not look likely. Shipments in the 37th week or April 12, 2007 of the marketing year were 273,000 bales (including Pima) and far short from the 386,000 running bales a week now needed to reach 13.0 million statistical bales. The end result is that ending stocks are likely to be at a 20 year high.

The loss of Step 2 is believed by many to have inflated 2005 exports at the end of the marketing year. That anomaly is responsible at least for a part of the problem being realized particularly early in the season. However, that feature was temporary because the hangover from the large sales was expected by most, including us, to have disappeared by late October or November.

Most thought that the Chinese government would release TRQ's in the same fashion as they had in the past though the Chinese had telegraphed earlier that the government would be taking a more active role in managing (read micromanaging) the country's cotton trade. They commented that TRQ's would be better timed and be more incremental in nature to help stabilize internal prices. We, like most others, underestimated the extent and the impact of that decision. China has reduced cotton

imports this year on the order of 40% so far and indications are that they are still not in the market aggressively for US cotton. US share has dropped to about 17% currently compared to just over 40% last year at the same time. The US lost share because the AWP/futures spread was not adequate to coax the cotton out of the loan without the help of Step 2. The silver lining in that cloud is that if China decides late in the year to buy a large volume of cotton before new crop harvest they will have to come to the US because the US has the largest available supply.

The situation can be summed up as a difficult environment with loan prices higher than the world competition and the inability to be competitive without Step 2. A slightly higher than "normal" A Index also allowed foreign competitors to undercut the US export price. The marketing loan has served the industry well but the absence of Step 2 has created a problematic situation. The US must find ways to operate the marketing loan to again be competitive in the international market.

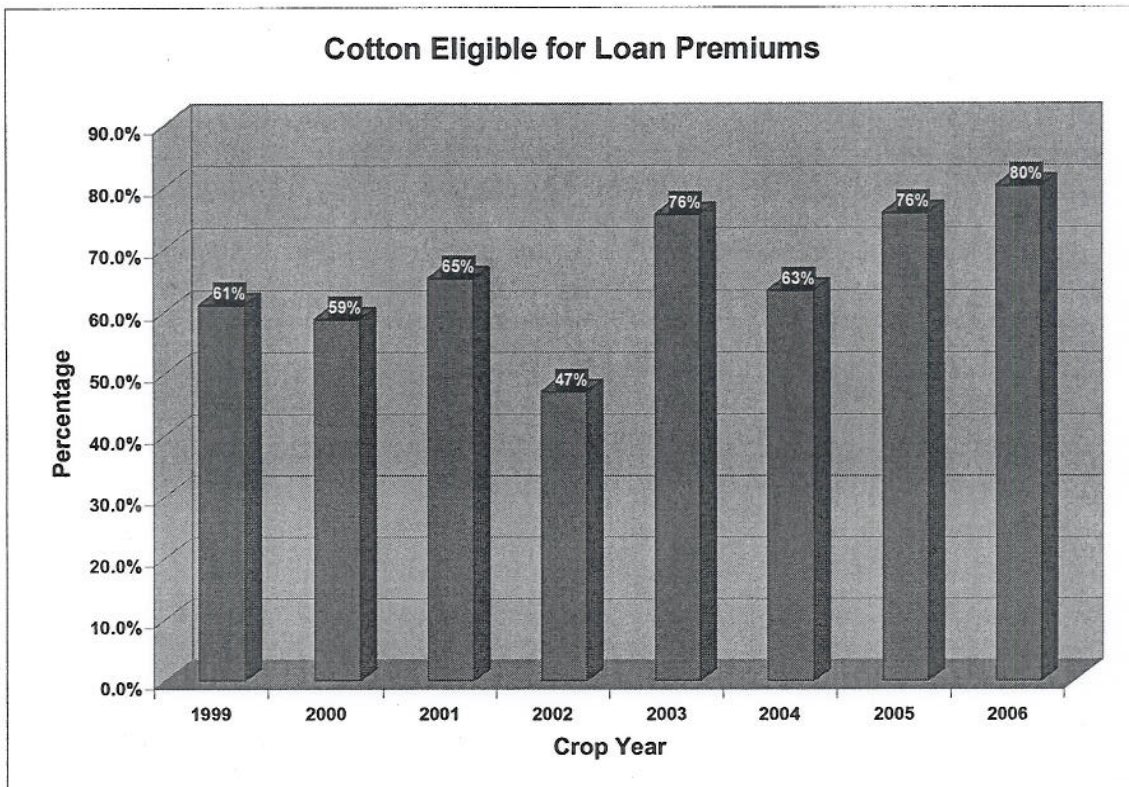


Problems

Cotton Continues To Move Into The Loan Program – And Stay

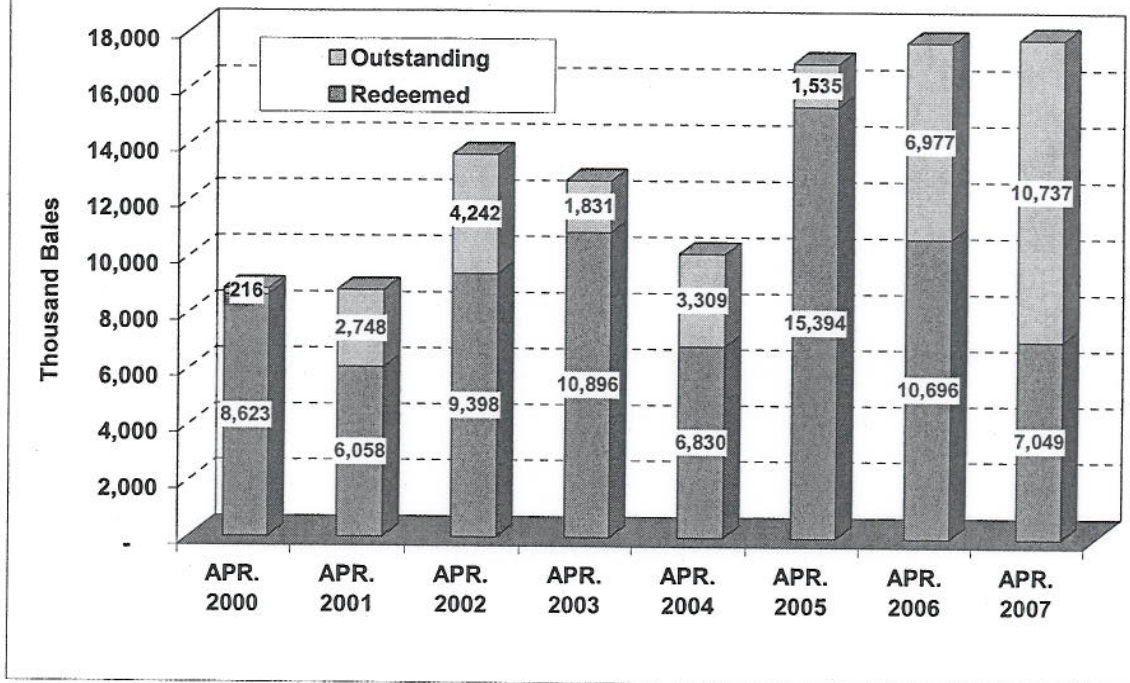
Cotton goes into the loan because it is the best bid for the producer. Also premiums paid on the loan schedule are higher than the market pays so the farmer opts for the best prices. The loan program was intended to be a safety net and a sale of last resort not the primary market for farmers. The marketing loan program is designed to move the cotton through the loan not have it become CCC inventory. The most recent AMS classing

report indicates about 80% of the production this year will be eligible for a loan premium based on grade, leaf and staple. There was about 76 % last year that was eligible on the same criteria.



The graph shows that the amount outstanding is about 54% more than the same time last year. One must go back to 1989 to find a March monthly number approaching 2006 and that was large at 9.043 million bales. The farmer is making a sound economic decision to put the cotton in the loan rather than market it for a lower price.

Cotton Under Loan and Redemptions



The cost to carry (storage and interest) 10.7 million bales is a bit over \$37 million dollars a month. One can see that the amount of outstanding loans this year is dramatically larger than in past years. Expectations are that the loan costs for this year will exceed 200 million dollars and the average time in the loan is expected to be over 4-months, the highest we have seen in several years. We could not find accurate numbers for the average time cotton stayed in the loan past 2002.

Crop Year Months	
2002	2.04
2003	3.08
2004	1.91
2005	2.95
2006	4.2-4.5

Like 2006, both 2004 and 2005 had over 17 million bales put under loan, however the situation was different. In 2004 the US had 11.6 million in export commitments and in 2005 it had 14.3 million bales committed for export. This year the US had commitments of only 8.956 million bales at the end of March and on April 12 only 10.1 million bales in total commitments, still 14% behind the previous two-year average. There were better prospects for that cotton leaving the loan because of the higher level of commitments. The current prospects are that a great deal of the cotton will be forfeited.

Cotton is leaving the loan slowly largely because of a problem that wasn't paramount until Step 2 was repealed. The Step 2 payment allowed the cotton loan premiums to be overcome by providing a cushion to pay an equity price to entice cotton out of the loan. Table A uses the current premium schedule. We mentioned earlier that a high

percentage of cotton going into the loan is eligible for premiums due to the better job producers are doing with production and quality. It is good for the industry to have the higher quality cotton that is desired in the international markets but the current premiums in the loan are greater than the US market outside the loan will pay and far above international quality premiums.

Table A

Crop year	2000	2001	2002	2003	2004	2005	2006	2007
Middle of January	2001	2002	2003	2004	2005	2006	2007	2008
Base loan	51.92	52.00	52.00	52.00	52.00	52.00	52.00	52.00
Premium (31335)	2.60	2.85	2.80	3.25	3.55	4.30	4.65	4.80
AWP (Base)	50.76	29.12	43.46	62.54	36.16	43.15	44.25	44.25
Memphis Spot	58.46	32.09	50.46	69.99	42.67	52.68	50.70	50.70
Step 2	1.76	0.00	5.78	1.47	4.25	3.37		
Producer Revenue								
+ Base loan	51.92	52.00	52.00	52.00	52.00	52.00	52.00	52.00
+ Premium (31335)	2.60	2.85	2.80	3.25	3.55	4.30	4.65	4.80
Sum	54.52	54.85	54.80	55.25	55.55	56.30	56.65	56.80
Merchant Cost								
+ AWP (Base)	50.76	29.12	43.46	62.54	36.16	43.15	44.25	44.25
+ Premium (31335)	2.60	2.85	2.80	3.25	3.55	4.30	4.65	4.80
Rule 3 to Rule 5	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.00
+ Step 2	-1.76	0.00	-5.78	-1.47	-4.25	-3.37	0.00	0.00
Net	56.00	36.47	45.08	69.02	40.26	48.98	53.90	54.05
Merchandizing Costs	5.24	7.35	1.62	6.48	4.10	5.83	9.65	9.80
Memphis Spot	58.46	32.09	50.46	69.99	42.67	52.68	50.70	50.70
Implied Equity 31335	2.46	-4.38	5.38	0.97	2.41	3.70	-3.20	-3.35
Implied Equity w/o Step 2	0.70	-4.38	-0.40	-0.50	-1.84	0.33	-3.20	-3.35
The negative equity was irrelevant because there was adequate cotton outside the loan.								

One can readily see in Table A that the implied equity for 31335 was either small or negative without the Step 2 payment. The charge for Rule 3 to rule 5 is estimated for the first five crop years. We are told that the charge was incrementally higher over the years but were unable to secure actual numbers. The two rules, FOB warehouse (Rule 3) and FOB car/truck, compression paid (Rule 5), has generated problems for the industry and distorts pricing across the country. Compression charges range from \$9.25 per bale in some areas of Texas to zero cost in North Carolina. Adjusting loan terms from Rule 3 to Rule 5 would make the trades more transparent and eliminate some dubious activity that is sometimes associated with the charges.

Table B illustrates the impact of regional weightings on the premiums in the loan schedule. They also show the impact on the theoretical equity. We have calculated what

the premiums would have been with the previous loan rate and 50% of the regional weighted spot market premiums. The theoretical equity moves higher.

Table B

Crop year	2000	2001	2002	2003	2004	2005	2006	2007
Middle of January	2001	2002	2003	2004	2005	2006	2007	2008
Base loan	51.92	52.00	52.00	52.00	52.00	52.00	52.00	52.00
Premium (31335)	1.15	1.34	1.08	1.67	1.85	2.11	1.89	1.73
AWP (Base)	50.76	29.12	43.46	62.54	36.16	43.15	44.25	44.25
Memphis Spot	58.46	32.09	50.46	69.99	42.67	52.68	50.70	50.70
Step 2	1.76	0.00	5.78	1.47	4.25	3.37		
Producer Revenue								
+ Base loan	51.92	52.00	52.00	52.00	52.00	52.00	52.00	52.00
+ Premium (31335)	1.15	1.34	1.08	1.67	1.85	2.11	1.89	1.73
Sum	53.07	53.34	53.08	53.67	53.85	54.11	53.89	53.73
Merchant Cost								
+ AWP (Base)	50.76	29.12	43.46	62.54	36.16	43.15	44.25	44.25
+ Premium (31335)	1.15	1.34	1.08	1.67	1.85	2.11	1.89	1.73
Rule 3 to Rule 5	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.00
+ Step 2	-1.76	0.00	-5.78	-1.47	-4.25	-3.37	0.00	0.00
Net	54.55	34.96	43.36	67.44	38.56	46.79	51.14	50.98
Merchandizing Costs	3.79	5.84	-0.10	4.90	2.40	3.64	6.89	6.73
Memphis Spot	58.46	32.09	50.46	69.99	42.67	52.68	50.70	50.70
Implied Equity 31335	3.91	-2.87	7.10	2.55	4.11	5.89	-0.44	-0.28
Implied Equity w/o Step 2	2.15	-2.87	1.32	1.08	-0.14	2.52	-0.44	-0.28
The negative equity was irrelevant because there was Adequate cotton outside the loan.								

This is an effective system for calculating the premiums that will help move cotton from the loan because it would provide the opportunity for an equity that did not exist before.

The discounts in the spot market are behaving as one might expect. They are in competition with the loan so they are continuing to decrease in the spot market or the producer will choose to put the cotton in the loan. We therefore agree with the proposal to leave discounts at "one-to-one" ratio. We submit two examples to illustrate the point. Note the discounts have narrowed from 2004 to 2007.

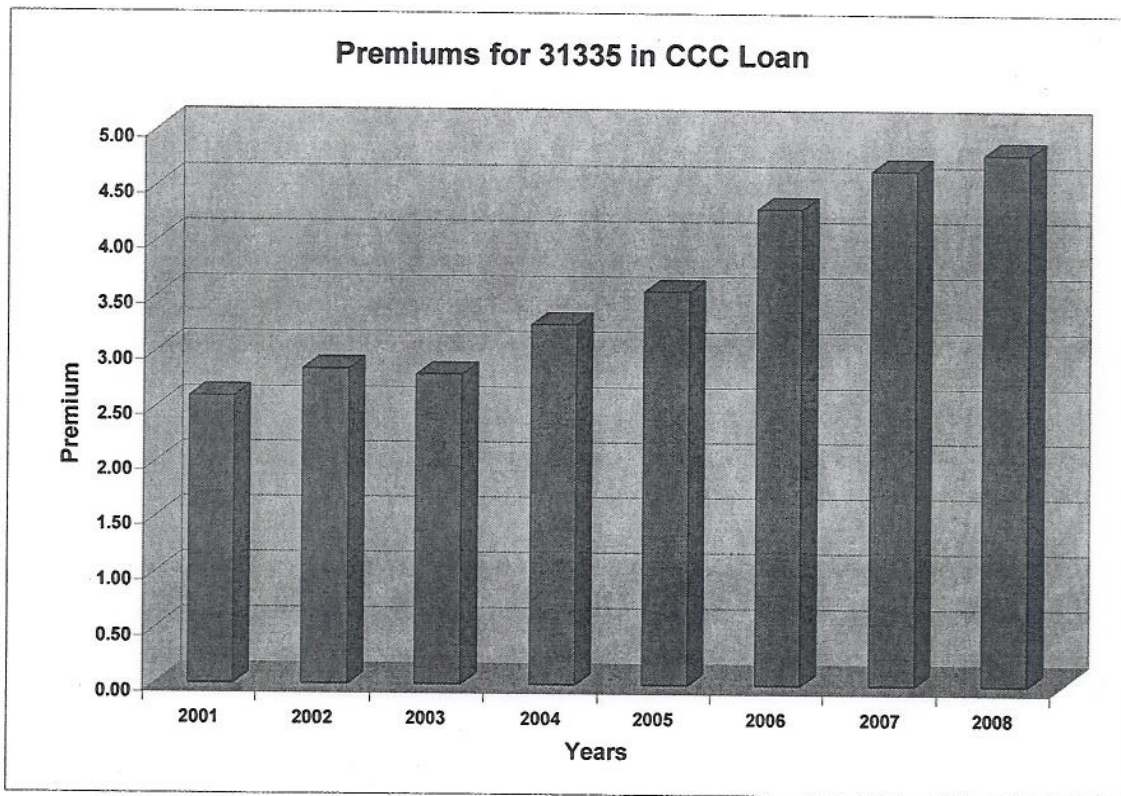
Discount in CCC Loan Schedule

Quality	2007	2006	2005	2004
51433	-340	-345	-350	-385
41531	-420	-425	-425	-500

An integral part of the marketing loan is storage credits. Even the deduction of storage from the loan proceeds would be passed to the buyer trying to get the cotton out of the loan. Should the USDA decide not to pay storage, within two months, in a moderately competitive environment, US cotton would be priced out of the market. Therefore, storage credits should be maintained.

Location differentials in the loan were practical when US mill use was over 60% of US demand but they serve no practical purpose in today's export oriented container driven market. Location differentials do nothing to enhance the marketing of US cotton nor do they make an appreciable difference to the value chain.

One of the problems we note is the method of calculating the premium. The reported spot market trades in 2005 constituted only about eight percent of US production. Therefore, the size of the sample is suspect as an efficient guide because it must compete with loan premiums. If the cotton is not competitive in the spot market (low premiums), then, it will go into the loan. The premiums will nearly always be the same or greater in the spot market in that scenario. The simple average one to one ratio alone is not effective.



The increase in cotton production of high-grade cotton should, by the dictates of supply and demand, either begin to stabilize or even weaken simply because of their increased availability. The premiums are curiously increasing as the quantity was increasing. The premium for 31335 has increased 85% since 2001. One solution would be to find another method of calculating the premiums by utilizing an internationally recognized source for international values. We know of, but are not familiar with the history or

accuracy of the International Cotton Association's (ICA) monthly *Value Difference Circular*, nor do we have time or resources in the time frame of this study to evaluate it. However, an international source for evaluating differences would be preferred because so much of the US demand is in the world market and it is there that the US cotton must compete. In the absence of an international benchmark or if that course is ineffective or impractical, one action that would provide a measure of aid to the system is to improve what we now have. An improvement to the method would be to weight the quotations by production regions. The calculations are a bit skewed and the alternative of weighting would be to adjust that by matching the regions production with the price in that region could help adjust that inefficiency. That system would serve to reduce the premiums that are now presenting problems. An example will illustrate the point:

31-3-36 Spot Market Regions	Simple Avg Premium	Production	Percentage	Weighted Premium
Southeast	220	4968	24%	52
N. Delta	351	4895	23%	82
S. Delta	351	3350	16%	56
ET/ OK	420	2170	10%	43
W TX	561	4160	20%	111
Desert SW	810	660	3%	25
SJ Valley	1134	770	4%	42
AMS Aug-Mar Avg	552	20973	100%	412