4-1-1980

Some Answers to Questions About Commodity Market Pools

John R. Dunn

Stanley K. Thurston

William S. Farris

adm - Yes

EC-509

SOME ANSWERS TO QUESTIONS ABOUT COMMODITY MARKET POOLS

John R. Dunn
Stanley K. Thurston
Cooperative Marketing and Purchasing Division
Economics, Statistics, and Cooperative Service
United States Department of Agriculture

and

William S. Farris, Extension Economist
Purdue University
West Lafayette, Indiana 47907

Market pools have become an increasingly important factor in the marketing of agricultural commodities in the United States. Many producers, particularly those of rice, dairy, fruits, and vegetables, are familiar with the market pool concept. However, to many producers, pooling represents a major change in traditional marketing practices and is not well understood.

Market pools provide options which producers may want to consider. A question and answer format is used to cover the various aspects of market pools, including an explanation of pooling and how it works, the advantages and disadvantages of pooling to producers, the pool marketing agreement, and some examples of market pools currently in operation.

Some Answers to Questions About Commodity Market Pools

John R. Dunn, ESCS, USDA
Stanley K. Thurston, ESCS, USDA
William S. Farris, Purdue University

What Is a Market Pool?

A market pool is a unique business arrangement between cooperative associations and their producer members. This arrangement is formalized by means of a marketing agreement between the cooperative and its members. The marketing agreement is a legal instrument which outlines the rights and responsibilities of both producers and their cooperative.

Instead of each producer individually marketing his commodity, the crops of many producers are combined in a market pool to be sold by the association's specialist or professional staff. The proceeds are divided among pool members with each member receiving the same average price for each unit of commodity delivered to the pool. Adjustments are often made to this average or pool price to reflect differences among pool members in commodity quality, transportation cost, or services rendered. The cost of operating the pool and any capital retains as determined by the association are deducted from the proceeds of the sale of the pool's contents.

How Does Pooling Differ From Buy-Sell Transactions?

In the usual buy-sell transaction, the producer does not give up his rights to the product until he agrees to a specific price and delivery arrangement. The price may be determined by a posted price on delivery, by a forward contract, or by a formula used in a price-later agreement. The producer receives payment in full on delivery, or, if the commodity is marketed under a price-later arrangement, on the day the commodity is priced. The producer, if a cooperative member, may also receive a

patronage refund based on the cooperative's earnings and his volume of marketings through the cooperative.

In a market pool, producers turn over the pricing and marketing decisions to the cooperative's management staff and agree to accept the average price of the pool after adjustments for quality and cost differences. In a typical pool, the producer receives an advance payment when he delivers his commodity. This payment is usually stated as a percentage of current market price or CCC loan rates if applicable. As the contents of the pool are sold, progress payments may be made. Once the pool is liquidated, operating expenses and capital retains are deducted and the remaining proceeds are divided among pool members in a final or equalization payment. Quality or cost adjustments made by the pool are usually handled in the final payment.

What Are the Types of Pooling?

There are two main types of pools, generally called seasonal pools and contract pools. Both types involve some form of volume commitment by producers, but differ in the degree of control over price retained by the producer.

The seasonal pool forms the backbone of most pooling operations. In a seasonal pool, the producer agrees to deliver some specified portion of his crop and to accept the adjusted pool price. The producer has little or no control over the price he receives under a seasonal pooling arrangement.

Contract pools are of two general types: The call pool and purchase pool. In a call pool, the producer retains some control over price by setting a minimum or reservation price below which his commodity may not be sold. Delivery of his committed volume is usually made prior to some fixed date early in the pooling period. In a typical purchase pool, the producer determines price by the timing of his delivery to the pool. The price he receives is usually the expected cash price on the day of delivery.

Contract pools, while having many of the characteristics of market pools, are not true market pools. In contract pools, producer prices are determined on an individual basis as in buy-sell transactions. In true market pools, exemplified by the seasonal pool, producer prices are an average determined by the joint sale of many producers' commodity. Contract pools are, in effect, marketing agreements that facilitate the pooling of expenses.

Pools may take a variety of forms based on the commodity and the markets involved. Variations may exist with respect to (1) duration of the pool, (2) number of commodities in the pool, (3) treatment of commodity grades, and (4) special characteristics of the commodity or its production.

What Are the Advantages of Seasonal Pooling?

1. Marketing decisions made at a specialized level

The pool's marketing specialists have one basic objective--to return the highest possible price to the pool patrons. They are able to devote full time to studying market conditions and developments. The marketing staff is attuned to both the desire of pool members and the needs of existing and potential buyers. They have the time to explore new markets and are able to take advantage of any new opportunity that arises.

2. Reduction of price risk

Since all pool members receive an average price for their commodity, the risk for an individual member of receiving a price lower than average pool price is eliminated. Losses from lower-than-average price sales are spread among all pool members, as are gains from higher-than-average price sales.

3. More orderly marketing and increased price stability

The combination of the crop volumes of pool members gives the pool's marketing specialist a great deal of flexibility in directing the flow of products from the farm to the point of highest return. Given an inventory of known size, the specialist is able to control the form, timing, transportation, and location of sales. He is able to tailor deliveries to meet the volume and quality specifications of large customers either in single sales or through long-term agreements. He can make sales or enter into sales agreements in advance of harvest if market conditions warrant. The selling of the pool's contents over the entire pooling period modifies the impact of temporary surpluses and reduces the effects of day-to-day price fluctuations.

4. Higher than marketwide average returns

While there are no guarantees, an adequately large,properly managed pool should provide for its members a higher price than the average received by non-pool producers. The pool's marketing specialist cannot be expected to consistently outguess the market; however, he should be expected to be aware of all marketing opportunities and to take advantage of as many favorable situations as possible. The advantages held by pools in obtaining higher prices are (1) a readily available large quantity of commodity, (2) access to and time to utilize more complete market information, (3) the ability to develop meaningful quality measures, and (4) a possible increase in market power. Large specialized customers are often willing to pay a premium for guaranteed qualities and quantities of supply. A pooling operation can provide these guarantees more easily than a normal buy-sell organization.

5. Improved quality control

By assuming responsibility for members' commodities early in the distribution

process, the pool is able to control the quality of its inventory more effectively. Improved quality control aids the pool's marketing in two ways, (1) by decreasing losses due to damage, and (2) by enhancing the pool's reputation as a supplier of quality products. Quality and variety specifications may be included in the marketing agreement which will improve quality control at the production level.

6. Promotion of unity of purpose among producers

The potential for higher returns from pooling commodities for a joint marketing effort underscores the benefits of producers working together to achieve a common goal. In so far as pooling increases producers' awareness of their market interdependency, an advance is made toward ensuring the future security of the family farm operator.

What Are the Disadvantages and Problems of Seasonal Pooling?

1. Delay in receipt of full payment

Pool members usually do not receive full payment for their commodities until the end of the pool period. Although a substantial portion of the payment may be received at or near the time of delivery, some producers may face a cash flow squeeze since the full value cannot be returned until the entire pool is liquidated.

2. Change in cooperative marketing philosophy

The transition from a buy-sell to a pooling approach to marketing involves making changes in operating procedures and marketing philosophy. Until these changes have been made, which may take some time, pool returns may not be satisfactory to producers.

Managers of both buy-sell cooperatives and market-oriented pooling cooperatives are interested in obtaining the highest possible prices for their members. Buy-sell managers are limited, however, in the extent to which they are able to seek higher prices. They must be able to provide bids to producers on any given day. They have no other alternative than currently available prices upon which to base their bids. They must orient their bidding procedures toward obtaining their necessary margin given market prices on a particular day. The pool manager does not have to make daily bids and concern himself with obtaining margins. He can coordinate his deliveries and storage to take advantage of prices over a much longer period of time.

3. Loss of marketing control by the producers

By turning over all marketing responsibilities to the pool specialist, the producer may miss an occasional opportunity to obtain a price higher than the pool average or than his neighbors! Of course, he may miss the opportunity of obtaining a lower price as well. Some producers may not wish to lose the satisfaction they derive from marketing their own products.

4. Inadequate pool size

Inadequate volume is often a problem for new pool operations or pools without substantial supply commitments from members. To significantly increase the returns from marketing members' products, the pool must control a large enough volume to supply the needs of large commercial and export customers. Lacking adequate volume, the pool has few, if any, marketing outlets that are not available to the non-pool cooperative. Per unit administration costs are high when the pool is small.

5. Loss of some short-term marketing opportunities

Because a primary strategy of a market pool is to minimize the effect of wide price fluctuations and to reduce short-term selling options in favor of long-term agreements, the pool may not be able to take full advantage of unexpected price increases.

6. Producer misunderstanding of need for capital retains

Many pools retain a portion of their payments to meet the future capital needs of the cooperative. Unless this need is thoroughly explained to members, capital retains may appear to be a non-productive expense that lowers the producers' net returns.

How Are Pool Payments Determined?

The following example is presented to demonstrate how payments to pool members may be determined (Display 1). In this simple pool, there are three members who produce one commodity of three grades. Each grade is treated as a separate sub-pool for the purpose of calculating payments, even though the commodity grades may be commingled (blended) for selling purposes. The deliveries of each member are tabulated by grade in the first section of Display 1. Producer Able delivered 2,000 bushels of grade 1, 4,000 of grade 2, and 8,000 of grade 3. Upon delivery, the pool member receives an advance payment of $1 per bushel regardless of grade. The pool manager then sells the contents of the pool, obtaining the highest prices available. As the contents are sold, the pool receives money from which an interim payment of $.50 per bushel is made. When the pool's contents are completely sold, an average unit sales price for each grade may be calculated on the basis of actual sales. Subtracting the per unit advance and interim payment from the average price results in gross final payments per unit for each grade.

Display 1. Example of member pool payments

Receipts from	Bushels of Grade 1	Grade 2	Grade 3	Total
Able	2,000	4,000	8,000	14,000
Baker	9,000	3,000	1,000	13,000
Charles	6,000	7,000	4,000	17,000
Total	17,000	14,000	13,000	44,000

Payment Schedule for Grades	$ per bushel		
Advance payment	$1.00	$1.00	$1.00
Interim payment	.50	.50	.50
Operating expense	.05	.05	.05
Capital retain	.03	.03	.03
Net final payment	.57	.45	.30
Average price received by pool	$2.15	$2.03	$1.88

Member payments

Able:	Advance payment	14,000 x	$1.00 =	$14,000
	Interim payment	14,000 x	.50 =	7,000
	Final payment-grade 1	2,000 x	.57 =	1,140
	Final payment-grade 2	4,000 x	.45 =	1,800
	Final payment-grade 3	8,000 x	.30 =	2,400
	Total payment			$26,340

Average price received ($26,340 ÷ 14,000) $1.8814 per bushel

Baker:	Advance payment	13,000 x	$1.00 =	$13,000
	Interim payment	13,000 x	.50 =	6,500
	Final payment-grade 1	9,000 x	.57 =	5,130
	Final payment-grade 2	3,000 x	.45 =	1,350
	Final payment-grade 3	1,000 x	.30 =	300
	Total payment			$26,280

Average price received ($26,280 ÷ 13,000) $2.0215 per bushel

Charles:	Advance payment	17,000 x	$1.00 =	$17,000
	Interim payment	17,000 x	.50 =	8,500
	Final payment-grade 1	6,000 x	.57 =	3,420
	Final payment-grade 2	7,000 x	.45 =	3,150
	Final payment-grade 3	4,000 x	.30 =	1,200
	Total payment			$33,270

Average price received ($33,270 ÷ 17,000) $1.9571 per bushel

The pool cost $2,200 to operate. To cover these operating expenses, a $.05 per bushel deduction must be made. In addition, a $.03 per bushel retain is withheld to cover the pool's need for capital. After all deductions have been made, the net final payment per bushel for each grade is determined. Each producer will receive a net final payment of $.57, $.45, and $.30 for each bushel of grade 1, 2, and 3, respectively, that he delivered to the pool.

In the "member payment" section of display 1, total member payments are calculated. Each member received $1 and $.50 per bushel in advance and interim payments. Final payments were found by multiplying the number of bushels in each grade by the net final payment amount for each grade.

The above example assumes there will be no change in grade nor loss in weight from the time the commodity was delivered to the pool to the time of sale, and that all premiums and discounts are reflected in the grade prices. An actual pool would likely be much more complex and could be operated in a variety of ways. For example, quality premiums or discounts could be added or deducted in the advance payment, instead of waiting until the final payment. In practice, a commodity such as grain would be commingled, which generally results in a higher average grade than when grades are stored separately.

What Is Contained in a Pooling Agreement?

A pooling agreement, often called a marketing agreement, is a legal document, signed by the producer member and a pool representative outlining the rights and responsibilities of both parties. While pooling agreements vary in content, most have the following elements in common:

1. Producer commitment

The pooling agreement will outline the extent of a member's commitment to

deliver his crop to the pool. This commitment may be in terms of a percentage of the producer's total production, a specified volume, or all of the crop from a specified number of acres. Occasionally grade or variety specifications are made, as are limitations on acceptable forms of on-farm storage.

2. Cooperative commitment

With the pooling agreement, the cooperative commits itself to seeking the highest possible price for its members products while keeping per unit administration costs to a minimum. To aid the cooperative in fulfilling its responsibilities, the pooling agreement usually grants the pool's management the authority to establish grading, classification, handling, storing, financing, testing, and selling practices.

3. Duration of the agreement

The pooling agreement will state the period for which the agreement is in force. Special circumstances under which early termination of the agreement is allowed may be stated. The time period of specific pools may be included. Provisions are generally made for the way in which pool carryover, the crop remaining unsold at the end of the pool period, will be disposed.

4. Qualifications for membership

The agreement may state specific qualifications that a producer must meet to become a pool member. Such qualifications may deal with type of operation or location.

5. Payments to producers

The pooling agreement may outline the payment procedure to members. Typically, provisions are made for advance, progress, and final payments. A specific method of determining the size of the advance payment may be included. The pool may be given the right to obtain funds for advance payments by using the pool's contents as collateral for some type of loan.

6. Financing the pool

The pooling agreement usually contains provisions for financing the pool. A method of allocating expenses among members and deducting for expenses is often specified. A maximum amount to be withheld as a capital retain is frequently stated on a per unit basis.

7. Other provisions

The pooling agreement may contain a number of other provisions covering a variety of topics. These include penalties for breach of agreement by either party, identification of creditors and claims, conditions for renewal of the agreement, and limitations of the agreement.

How Are Pools Affected by Price Support Programs?

The provisions of the Commodity Credit Corporation loan program permits qualified cooperatives to obtain loans on wheat, feed grains, soybeans, rice, honey, and cotton on behalf of their producer members. To qualify, the cooperative must meet specific requirements of a bona fide cooperative including having a market agreement with producers and operating a system of pooling. The system of pooling may involve a seasonal or contract pool. To qualify for support loans, the pool must include

only those commodities eligible for the program. This "cooperative provision" of the price support loan programs permits cooperatives to obtain loans on eligible commodities for member-producers. Funds from these loans may be used to make advance payments to members after they deliver their products. Without this special provision, a price support loan could not be obtained on a commodity committed to a pool.

What Are Some Examples of Existing Pools?

The following are three examples of pooling operations currently in existence. The three associations, Riceland Foods, Inc., Calcot, Ltd., and FAR-MAR-CO, Inc., operate both a seasonal pool and a contract pool. These pools have been reasonably successful, as their long-run results indicate. Each has experienced, however, an occasional bad year when volatile market conditions led to lower-than-average returns. This can and does happen to every marketer from the individual producer to the most professionally operated pool since prices in the future are never known with certainty. The long-run success of any pool is dependent upon a high quality management staff and continued support by members who are willing to stay with the pool in good years and bad. Movement of the decision-making prerogatives to the specialized marketing level of a pooling operation can result in producer returns higher than in a buy-sell operation.

SOYBEANS

Riceland Foods, Inc., Stuttgart, Arkansas, operates both a seasonal pool and a "purchase" pool for soybeans. Riceland receives soybeans from producers through member local cooperative elevators and processes soybeans into oil and meal products at their three plants. Distribution is made to domestic and export markets.

The seasonal pool and purchase pool require a contract or marketing agreement whereby the grower agrees to deliver a specified quantity of soybeans to the pool. Under the seasonal pool, an advance payment is made at the time of delivery which is equivalent to the support level (or an amount determined by the board if the support is not applicable). Subsequent payments may be made to members during the marketing year. The final payment is made in September after the seasonal pool is closed on July 31.

Under the purchase pool, three pricing options are available to producers. With the three options, the producer may choose to price his soybeans contracting forward prior to harvest, by or at the time of delivery, by accepting the daily bid price on the day of delivery, or by making delivery and establishing a basis to be applied to the futures price on a date to be determined later by the producer. The producer may receive an additional refund at the end of the year based on net savings.

Over the 14 years ending in 1977, the seasonal pool averaged $.19 per bushel over the purchase pool and $.28 per bushel over the Arkansas average price. From 1972 through 1977, the seasonal pool averaged $.32 per bushel over the purchase pool and $.36 per bushel over the Arkansas average price. In 11 of the 14 years the seasonal pool paid more than the purchase pool. (Precise comparisons should include the time value of money).

COTTON

Calcot, Ltd., Bakersfield, California, operates both a seasonal pool and a call pool for cotton. The producer signs a membership and marketing agreement and agrees to deliver all his cotton to the association. All the producer's cotton is placed in the seasonal pool unless the producer states he wants some or all of his cotton to go into the call pool. The producer must designate how many bales will go into the call

pool by March 1, prior to planting. Approximately 60-65 percent of Calcot's volume is marketed through the seasonal pool.

When the producer places cotton in the call pool, he must sign a supplemental call pool agreement and state that he will establish a sales call price prior to May 31, in the year following harvest. If no price is established by May 31, Calcot will establish the sales price. An advance payment is made in both the call and seasonal pools. The amount of this payment depends upon the borrowing rate for cotton, either from the government or from private lending institutions. Primary retains are withheld from the advance payment. Progress payments are made on both pools about three or four times each season. The final payment for both pools is made the end of September, just prior to the next crop year's harvest.

In most years, the seasonal pool has brought producer greater returns for his cotton. During the 1971-1977 period, the seasonal pool returned to producers in the San Joaquin Valley an average of $17.26 per bale more than the call pool. For the same years, Calcot's seasonal pool returned an average of $25.60 per bale more than the state average. (Precise comparison should include the time value of money).

WHEAT

FAR-MAR-CO, Inc., Hutchinson, Kansas, and its membership initiated a seasonal pool program called PROMARK for the 1976 wheat crop. In 1976, more than 15,000 producers committed 1.13 million acres of wheat to the seasonal pool which amounted to 32.7 million bushels. A total of 359 local cooperatives approved the program. Pool wheat is delivered to local cooperatives for disposition by PROMARK management.

Dual marketing agreements are required--one between each producer and his local cooperative and an overall agreement between each local cooperative and FAR-MAR-CO. A producer may sign up any portion of his acreage. He receives a price advance upon

delivery to the local cooperative elevator. The advance for the 1976 crop was $1 per bushel. Grain is marketed by PROMARK management who receive direction from an advisory committee. A marketing committee provides market analysis for the advisory committee.

The final 1976 pool price paid producers under the PROMARK program was higher than the daily market price in approximately 75 percent of local cooperative districts. The 1976 pool price generally exceeded the price received by non-pool producers by 15 cents per bushel or more according to PROMARK management. The 1977 pool prices paid to producers were about even with average daily cash prices. (Precise comparison should include the time value of money).

NEW 4/80