

**GOVERNMENT RESPONSE TO  
THE FIFTH REPORT OF  
THE STANDING COMMITTEE  
ON AGRICULTURE AND AGRI-FOOD  
ON THE REVIEW OF THE  
*CANADA GRAIN ACT* AND THE  
CANADIAN GRAIN COMMISSION  
CONDUCTED BY COMPAS INC.**

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The Government would like to recognize the work of the Standing Committee on this report on the review of the *Canada Grain Act* (CGA) and Canadian Grain Commission (CGC) by COMPAS Inc. The work on this report represents a studied and reasoned approach to the issues presented in the COMPAS Inc. review. We congratulate the Standing Committee on working together to provide this unanimous report. The Government has studied the recommendations carefully and has the following response to the recommendations of the Standing Committee.

The Government recognizes that the CGC, at the centre of Canada's grain industry since 1912, is responsible for the development of Canada's grain quality assurance system which is valued and recognized around the world. As the Standing Committee noted, rapidly changing global and domestic markets for grain require that the CGC become a more flexible institution. In that light, the Government is developing proposals for change based on the valuable input of the Committee, the COMPAS recommendations, and other policy considerations.

The specific response to each of the Committee recommendations is as follows:

**Recommendation 1:**

**Mandate**

**The Standing Committee supports a redefined mandate of the CGC as more in line with the practical reality of the Canadian grain industry and it recommends that any eventual bill clearly protect the interest of grain producers.**

The Government appreciates the Committee's perspective on the need for the mandate of the CGC to reflect the practical realities of a modern Canadian grain industry, and that key grain producer interests are protected. The Government will carefully consider the ideas of the SCAAF report.

**Recommendation 2:**

**Governance**

**The Standing Committee recommends modern governance structure for the CGC's executive level and the appointment of a single President or CEO supported by three vice-presidents. The Committee also recommends that the CEO hold office during pleasure for a term of five years.**

**Furthermore, the Standing Committee recommends that, because of the intrinsic nature of the grain industry, a working knowledge of the industry should be a criterion, in addition to managerial and other skills, to be considered in the appointment process of a CEO.**

The Government appreciates the Committee's perspective on a sound and accountable governance structure for the CGC. The Government will carefully consider the ideas in the SCAAF report.

**Recommendation 3**

**Office of Grain Farmer Advocacy**

**The Standing Committee recommends the establishment of an independent Office of Grain Farmer Advocacy composed of six Commissioners deployed regionally. Furthermore, the Standing Committee recommends that the Office be permanent and be funded to perform adequately its role of defending, in the same manner all across Western Canada, the interests of all grain producers in disputes with other stakeholders, including the CGC itself. Finally, the Office should report directly to the Minister of Agriculture and Agri-Food.**

The Government agrees that the functions of communication, consultation, liaison, and complaint investigation are important to the operation of the Canadian grain quality assurance system. However, there is some question about whether creation of an independent office of Grain Farmer Advocacy would be the best means to ensure these needs are met. In particular, it is unclear how a government-funded advocacy office would co-exist with existing general farm organizations that advocate on behalf of grain and other farmers. The Government is considering how to meet the needs for adequate communication with farmers and effective consideration of farmer interests in disputes with other stakeholders, including the CGC.

**Recommendation 4**

**Inward Inspection and Weighing**

**The Standing Committee is in favour of optional inward inspection, and recommends sufficient funding so that the CGC can maintain efficient and timely services for both producers and smaller handlers who need such services for transactional purposes.**

The Government is aware of concerns of some stakeholders that mandatory inward weighing and inspection imposes unnecessary costs in some situations, whereas in other situations, stakeholders have said it is a valuable service. The Government is considering how to ensure that stakeholders can obtain inward inspection services, as well as binding grade and dockage arbitration, where necessary, while seeking to reduce any unnecessary regulations and costs.

**Recommendation 5**

**Contracting Out**

**The Standing Committee supports pilot projects in contracting out services for grain inspection, but recognizes the absence of strong factual data on the advantages and the costs. In that context, the Standing Committee recommends that Agriculture and Agri-Food Canada take advantage of the first three years of the CGC reform to conduct a cost-benefit analysis on contracting out services.**

The Government considers that inspection and weighing services performed by CGC employees have played a considerable role in enhancing the marketability and reputation of Canadian grain. With this in mind, we need to be cautious to ensure the benefits of any changes in the weighing and inspection services are greater than the costs this may impose on the system. The Government agrees that a cost-benefit analysis should be conducted to assess the advantages and costs that would be associated with contracting out these services. Contracting out would be considered if it is determined that contracting out is in the best interests of Canada's grain quality assurance system and the participants in the grain sector.

**Recommendation 6**

**Funding**

**In order to offer a benchmark for a cost-benefit analysis on contracting-out**

**services, the Standing Committee recommends that the Canadian Grain Commission receive adequate funding to improve its services, particularly regarding the flexibility on authorizing overtime when specific delivery conditions are required to satisfy foreign buyers and protect Canada's reputation.**

The Government has considered the issues of funding that have resulted in challenges for the CGC in meeting its legislated mandate in the past. The Government is considering ways to ensure that the CGC is adequately funded to provide its services both to the Canadian public and to participants in the grain industry.

**Recommendation 7**

**KVD, Monetary Penalties**

**The Standing Committee recommends that kernel visual distinguishability (KVD) be abandoned, and be replaced by a system based on farmer's declarations or affidavits supported by science-based mechanisms of quality control. The Committee also recommends that farmers' declarations be coupled with producer and industry monetary penalties to be introduced in the Canada Grain Act.**

The Government agrees with the Standing Committee that the elimination of KVD is a desirable outcome. However, it is important that changes be introduced in a measured way to ensure that the consistent quality of Canada's grain exports can be assured. The CGC has been working towards this objective for several years and will eliminate KVD as a variety registration criterion and segregation tool for the minor western wheat classes by August 1 2008 as part of the Wheat Quality Assurance Strategy.

The Minister of Agriculture and Agri-Food has asked the CGC to prepare a report, by December 31, 2009, including an evaluation of the minor class experience, a progress update on the development of technology and the evolution of process verification and declaration systems, and a work plan towards the complete removal of KVD by a target date of 2010.

**Recommendation 8**

**Research**

**The Standing Committee supports the proposed increase, to about \$40 million, for R&D funding in the grain industry, and also supports a separate**

**appropriation for the Grain Research Laboratory (GRL). Furthermore, the Standing Committee recommends that the government conduct a study to determine if the GRL would be better located, and become more independent, under Agriculture and Agri-Food rather than under the Canadian Grain Commission.**

The Government agrees that research is important to ensure that Canada's grain sector can continue to meet the needs of changing international and domestic markets. The research conducted by the GRL on qualities for end uses of grains, in monitoring grain quality and safety, and in technologies for measuring grain quality and safety factors are essential to meeting these needs. Accordingly, the Government agrees that adequate funding for the GRL is needed to meet the specific needs of the grain quality assurance system. It also considers that the specific role of the GRL in meeting the needs of the grain quality assurance system suggest that the GRL should remain as a part of the CGC. However, the Government is currently assessing the potential for co-location of the GRL and AAFC research facilities and will examine the funding of research in the grain sector overall within the context of AAFC's science and innovation strategy in order to provide for coordination and cooperation of research between the GRL and AAFC.

**Recommendation 9**

**Funding**

**The Standing Committee recommends that the government review all the CGC infrastructure costs, including costs related to overtime and other individual services necessary for commercial transaction, and establish which ones may deserve to be defrayed by the taxpayers of Canada, so as to ensure the long-term sustainability of these services.**

The Government values the many public benefits of the services of the CGC. The Government is working on a sustainable funding solution for the CGC which will recognize that some CGC activities serve the public interest and this could be used a basis to determine what should be publicly funded.

**Recommendation 10**

**Independent Arbitrator**

**The Standing Committee supports the concept of an independent arbitrator**

**(appointed by the Minister of Agriculture and Agri-Food), and recommends that the government consider amalgamating the functions of the arbitrator in the Office of Grain Farmer Advocacy. Further, the Standing Committee recommends that the government reevaluate the level of responsibility a reformed CGC should carry in the future.**

It is important that stakeholders concerned with the rulings of the CGC be confident that their concerns are considered fairly and efficiently. The Government is carefully considering the SCAAF recommendations. However, with respect to the office of Grain Farmer Advocacy, it is not clear that the objective of a fair and efficient consideration of complaints would best be handled by an office dedicated to advocating for one part of the industry.

**Recommendation 11**

**Payment Security Program**

**The Standing Committee recognizes the necessity of contractual security and supports the concept of a clearinghouse, or other models such as the Ontario's Grain Financial Protection Program. However, the Standing Committee believes that such an important risk management tool requires further investigation and therefore recommends that the federal government report back to the Standing Committee, prior to the tabling of a new grain legislation, on the various models that could be implemented for protecting grain farmers.**

As requested a report on the various models to protect producers from nonpayment for delivered grains has been prepared by CGC and AAFC staff and is appended to this response. While recognizing the importance of contractual security in the grain sector, the Government believes that, like other agricultural sectors, the grain industry can develop cost-effective and appropriate mechanisms for producer payment security.

**Recommendation 12**

**Producer Cars**

**The Standing Committee recommends that the Canadian Grain Commission facilitate and maintain access to producer cars, and that CGC inward**

**inspection on producer cars be maintained.**

The Government agrees that producer cars are an important option for producers to ship their grain. The current *CGA* provides mechanisms for the *CGC* to facilitate and maintain access to producer cars. The Government is considering how to ensure that stakeholders, including producer car shippers, can obtain inward inspection services, as well as binding grade and dockage arbitration, where necessary, while seeking to reduce any unnecessary regulations and costs.

## **PRODUCER PAYMENT SECURITY MODELS IN THE AGRICULTURAL SECTOR**

### **INTRODUCTION**

The Standing Committee on Agriculture and Agri-Food (SCAAF) tabled its “Report on the Review of the *Canada Grain Act* and the Canadian Grain Commission Conducted by COMPAS Inc.” in Parliament on December 5, 2006. Recommendation 11 of this report states that:

The Standing Committee recognizes the necessity of contractual security and supports the concept of a clearinghouse, or other models such as the Ontario’s Grain Financial Protection Program. However, the Standing Committee believes that such an important risk management tool requires further investigation and therefore recommends that the federal government report back to the Standing Committee, prior to the tabling of new grain legislation, on the various models that could be implemented for protecting grain farmers.

This document addresses SCAAF’s request by providing an overview of producer payment protection mechanisms (referred to by SCAAF as contractual security mechanisms). Over the past decade the security program for western grains has been studied and consulted upon extensively by the Canadian Grain Commission (CGC), producer groups, and the grain industry. The current CGC security program consistently emerged as the mechanism with the most stakeholder support.

While this report does not contain an exhaustive list of potential models, it encompasses models that have been considered by the CGC for western grain, as well as a sampling of mechanisms used for other agricultural commodities and other jurisdictions.

### **Payment protection mechanisms**

Broadly speaking, producer payment protection mechanisms fall into four general categories:

- Security based – companies buying commodities are required to post security with a licensing body to cover liabilities to producers
- Insurance based – either producers or buyers pay an insurance premium
- Fund based – a fund is created by contributions from producers, buyers or both to cover liabilities
- Clearinghouse model – a third party guarantor that provides settlement services and ensures that both buyers and producers (the sellers) are able to meet their contractual obligations

Within each category there are many combinations of sub-options with respect to: who pays

(producers, government, industry); who administers the program (federal government, provincial government, producers, industry); level of coverage or guarantee; and whether the system is voluntary or mandatory.

## **SECURITY BASED MECHANISMS**

A security based mechanism requires companies who purchase a commodity from producers to post security with a licensing body to cover their liabilities to producers. This security may be in a number of forms including: a bond, a letter of credit, payables insurance, cash, or trust account. In the event of a default or other failure to pay by the purchaser, the licensing body may then use this security to compensate the producer.

### **Example 1: The current CGC payment security system**

Under the *Canada Grain Act (CGA)*, companies which purchase western grain from grain producers are required to be licensed by the CGC and to post security (in the form of a bond, letter of credit, payables insurance, cash or certified cheque deposits, or trust accounts), to cover expected liabilities. In the event of a bankruptcy or a failure to pay, the CGC may realize on the security to compensate the producers.

Currently, the following formula is used to estimate the appropriate level of security for a new license applicant (primary elevators, process elevators, and grain dealers):

$$\frac{\text{Annual planned purchases (\$)} \times 90 \text{ days}}{365 \text{ days per year}}$$

- Where 90 days is the time period for which a liability potentially remains outstanding and eligible for security protection.
- Company plans, practices and processes limiting producer purchases, causing prompt producer settlements, etc. are taken into consideration in fixing security requirements.

Although the aforementioned formula is used in estimating the appropriate level of security for a new licensee, the level of security is ultimately negotiable between the CGC and the license applicant or licensee.

Once licensed, the CGC fixes the amount of security to be provided by a particular licensee on the basis of monthly liability reports. The CGC usually requires \$1 of security for every \$1 of reportable liabilities. The CGC conducts risk-based or periodic on-site audits to monitor that liability reports have been completed properly. There is no legal requirement for licensees to keep their liabilities under their posted security. There is no way for a producer to opt out of security coverage, even if the producer is a shareholder of the licensee or chooses not to participate.

The annual cost of the licensing and security system to industry and producers is approximately \$4.1 million (based on 2004-05 figures). This cost is incurred by industry but indirectly by

producers. With 107 licensees as of January 2006, the CGC held approximately \$138 million in security (this amount fluctuates), in the form of bonds and letters of credit. Companies also incur costs associated with providing monthly liability reports and annual audited financial statements (though this latter requirement can be waived).

It is estimated that in the 2005-06 crop year, approximately \$6 billion in producer deliveries were shielded with financial protection afforded through CGC licensing and security. More directly, during the seven year period from 1999 to 2006, producers received \$5.8 million in direct compensation from the CGC through security posted by licensees that became unable to meet their payment obligations. During the same period, there were two cases where security was inadequate: in one case producers were paid \$0.51 per dollar of losses and in the other \$0.28 per dollar.

### **Example 2: Québec Agricultural Marketing Board**

The Québec Agricultural Marketing Board provides a payment security system based on a licensing system which includes provision of a bond. This system is used for all agricultural products in Québec including grains. The licensees pay the cost of bonding. The bond is 30% of the mean value of the four biggest months of buying by the firm with a minimum bond level of \$10,000 (\$50,000 for new buyers). The value is fixed by the Board and the volume is determined by the volume of grain handled the previous year. The level of coverage is 100% unless total claims exceed the level of the bond. This system provides coverage if producers are to be paid within 14 days, but does not provide coverage if the producer accepts a longer payment period.

### **Example 3: Dairy Farmers of Ontario Credit Program**

Dairy Farmers of Ontario (DFO) is the marketing organization for milk and cream shippers in the province. The DFO has established a credit program as a means to protect milk and cream producers by minimizing credit losses. Processors pay for the program directly, although there may be some indirect costs incurred by producers.

The DFO has authorized Agricorp to perform financial duties related to the program on its behalf. Processors must provide quarterly financial statements and year end financial statements so that they may have their credit assessed by Agricorp. New processors may submit an interim financial statement in order to qualify for the credit program. Every processor must file with Agricorp.

A processor is assigned a credit score based on the financial statements they have filed. If the processor meets a minimum credit score, they are not required to post security with the DFO. If the processor does not meet the minimum credit score, they must post security with the DFO. The DFO accepts cash deposits, commercial security bonds, corporate guarantees, and irrevocable bank letters of credit as forms of security. The maximum amount of security required by the DFO is equal to the processor's highest two consecutive months' purchases of milk. The DFO may require additional security to be posted if a processor no longer meets the minimum credit requirements or if existing security falls below the minimum amount required.

If the processor's payment on account is more than one business day overdue, the DFO has the right to realize the security of the processor. If the processor was not required to post security with the DFO and has been late two or more times within a year, the processor will be asked to provide security to the DFO.

### **INSURANCE BASED MECHANISMS**

Insurance based mechanisms involve the payment of an insurance premium, by either producers or licensees. Premiums are determined by the risk classification of the licensee to which producers sell their product.

An insurance based system uses actuarial computations of premiums (since premiums are based on actual liabilities). Available security is equal to outstanding aggregate risk at all times guaranteeing that the buyers pay the lowest cost for their security. With insurance programs that offer 100% coverage, banks do not require additional working capital as collateral, leaving more cash for licensee working capital.

#### **Example 1: Proposed Special Crops Insurance Plan (SCIP)**

In 1998, federal legislation was passed enabling implementation of SCIP for special crops produced in western Canada. Under this program, all elevators and dealers licensed by the CGC would have collected a levy of \$0.38 per \$100 of special crops sales from producers, upon delivery of their grains, to fund a plan to protect producers if the company to which they delivered were to default on their payment obligations.

The program was to be administered by the CGC and underwritten by Export Development Canada. The levy was composed of both an insurance premium and administration costs and the coverage of the insurance plan was to be 90%. The collection of levies was to be mandatory, but producers who chose to opt out would have automatically received rebates.

Ultimately, although producers did support security for grain transactions, this program was not implemented as the projected level of producer participation was insufficient to make the insurance instrument actuarially sound.

#### **Example 2: Insurance payables tool, underwritten by Export Development Canada (EDC)**

EDC has traditionally offered contract bonding services to Canadian exporters who are required to post bonds or secure surety (in the form of standby irrevocable letters of credit or letters of guarantee or surety bonds) guaranteeing their bid, performance or other obligations as part of their contracts with foreign buyers. EDC offers a Performance Security Guarantee (PSG) and Surety Bond (re)Insurance (SBI). A PSG is issued directly to the bank, covering 100% of losses if a foreign buyer calls or makes a demand against an irrevocable letter of credit, or letter of guarantee for any reason. Under SBI, EDC reinsures a surety company for 100% of the bond liability exposure of a surety bond issued by a surety company on behalf of the exporter for the benefit of the buyer. This is usually done through a surety company licensed in the proper jurisdiction.

Recently, EDC began applying its contract bonding services in a unique manner by

collateralizing the security tendered by licensees to the CGC, provided the licensees are exporters (as defined by EDC). This service frees up collateral that is normally required to support the issuance of the security instruments.

EDC's bonding services do not result in the replacement of bonds or letters of credit or guarantee or the manner in which they are posted by licensees with the CGC. Under the PSG and SBI, a licensee would still post letters of credit or guarantee and bonds, respectively, with the CGC. The CGC, rather than the foreign buyer, would realize on the security when a licensee fails to meet its payment or delivery obligations to producers.

Licensees must qualify to participate in either of these programs. EDC looks at a number of factors before agreeing to provide coverage:

- Managerial, technical and financial capabilities
- Acceptable contract terms
- Acceptable bonding and guarantee instruments
- Current conditions and economic outlook in the buyer's country, as well as the buyer's profile
- Acceptable Canadian exports of goods and services or other significant benefits to Canada

Pricing is based on a number of factors including policy liability and duration, exporter risks, and other contract-specific risk factors. Coverage is capped by the insurance policy - if a licensee exceeds the cap, producers will not receive full coverage.

Some CGC licensees have already availed themselves of these services. However, this insurance tool is untested since no company defaults have occurred since these instruments became available.

### **Example 3: Insurance payables scheme, brokered by AON Reed Stenhouse**

AON Reed Stenhouse, an international insurance broker, has developed a payables insurance policy that is acceptable to the CGC as an alternative to a bond or letter of credit as a form of security.

Atradius underwrites the payables insurance which will insure against licensees not meeting their payment and delivery obligations to producers. A claim against the insurance may be triggered in two ways: either when a licensee becomes insolvent and has outstanding obligations to producers, or when the licensee defaults on its obligations. The policy has been written to be consistent with all aspects of the current security program:

- 100% coverage (no co-insurance and no deductible)
- Applies to all grains covered under the CGA
- Covers only grain for which a CGC-authorized document has been issued
- Does not exceed 90 days security limits
- Gives CGC 60 days notice in writing of the cancellation of the policy for a specific

- licensee
- Gives a 6 months discovery period to receive claims against the insurance effective the date the insurance was terminated
- Must be issued by surety company, insurer or financial institution that is acceptable to the Government of Canada (Zurich is on the eligible list)

To participate, each licensee must provide financial information as part of the application and qualification process. Tabis Trade Services (TTS) is used to monitor obligations by licensees; licensees require computerized accounting software system in order to download and report activity and transactions to TTS.

Premiums are risk rated, ensuring licensees of the lowest possible price. Each licensee is covered at a cost commensurate to its creditworthiness, volume of business and loss history. Pricing can be computed daily, weekly, monthly or annually and paid in estimated monthly installments in advance.

### **FUND BASED MECHANISMS**

Fund based mechanisms involve the development of a fund for accumulating contributions from licensees and producers, or a combination of both. There are varying models for the control of these funds including control by a board or by a government agency. The fund may have a financial backstop (e.g. government or bank). Typically, fund contributions start at a particular level and are expected to decrease over time, unless significant failures and payouts occur.

#### **Example 1: Ontario Fund Model (Grain Financial Protection Program)**

Authority for the Grain Financial Protection Program was created under the provincial *Grains Act*, to create a mandatory system where contributions are collected on all sales of designated crops (corn, soybeans, canola, and wheat). It is mandatory that all grain dealers and grain elevators be licensed under this provincial legislation.

AgriCorp, a crown corporation, delivers the program as well as crop insurance and revenue insurance. A board appointed by the provincial Minister of Agriculture oversees the program funds (separate funds for each of the crop types). Producers contribute to the fund via a check-off upon delivery of grain to licensees. The check-off varies by commodity but ranges from \$0.02 - \$0.50 per tonne for the fund (actual check-off amounts are greater than this as an additional portion of money is collected for research which is transferred to the producer associations). The coverage in case of non-payment by licensees ranges from 90 to 95%.

A Financial Responsibility Review Committee (FRRC) maintains transparency and integrity in the process by confirming the risk profile of licensees through analysis of financial statements. The total costs for administration of the funds and for the licensing activities are estimated at \$350,000 to \$400,000 annually. This does not include compliance and bonding costs incurred by licensees.

A producer must claim within 30 days from the date of payment default. Agricornp is initially notified regarding claims and if the situation is not rectified, the Fund Board is notified. If large failures and producer claims are made on a fund, and insufficient resources are available, the board can borrow from the provincial government for a specified amount. If claims exceed both the fund and the amount that can be borrowed, claim payouts are either prorated or the payments are spread over an extended time period. To date, this situation has not occurred.

**Example 2: Alberta Livestock Producer Check-Off Program**

The livestock industry in Alberta operates on a check-off program, requiring producers to pay a small levy per head of livestock sold to establish a fund which provides farmers with an 80% level of payment protection. The levy is currently set at \$0.05 per head of livestock sold. Livestock dealers are required to obtain a license from the Alberta government. Before receiving a license, dealers are required to post security with the provincial government. The Minister of Agriculture for Alberta has the power to set the amount of security required, and can at any time request financial information from the applicant in order to aid him in this process. The level of security is established in relation to the declared volume of sales expected or realized by the individual dealer or agent.

The *Livestock and Livestock Products Act* allows for farmers to be placed ahead of any other creditors in the event of bankruptcy by a dealer. Further protection is provided to the farmer by the fund established by the levies collected.

A farmer who sells livestock to a licensed dealer and does not receive full payment for the product they delivered due to default must notify the fund administrator, Livestock Identification Services (LIS), as quickly as possible. When LIS is satisfied that default has occurred, it can use the security posted by the dealer to make the payment to the farmer. In the event that the security posted does not cover 80% of the sale price, LIS forwards the claim to the Livestock Patron's Review Tribunal (LPRT). The LPRT then decides whether to pay the claimant from the fund. If the LPRT determines the farmer is eligible for payment from the fund, the farmer will receive a maximum payment that, together with the amount the farmer received from the initial security, equals 80% of the sale price.

A farmer can choose to opt out of the additional coverage provided by the LPRT by providing the LIS with a declaration of withdrawal. The farmer must then submit a written application to the LIS every year indicating the total amount of livestock sold to licensed livestock dealers in

order to receive a refund of the levies paid for that year. Although farmers who opt out and are affected by default would not receive the additional coverage provided by the LPRT, they are still protected up to the level of posted security of the licensed dealer.

The fund was initially paid for by the Alberta government, but since 1998 has been self-supporting. Operations of LIS are funded partially by fees collected for services, such as inspection, and partially by the Alberta government.

### **Example 3: U.S. Perishable Agricultural Commodities Fund**

The U.S. Perishable Agricultural Commodities Act (PACA) establishes a combination of measures to ensure against nonpayment by dealers or brokers for perishable commodities. PACA prescribes that trade of any produce in any form received by a dealer or broker is regarded under law as a “trust” placing the value of these goods ahead of all other creditors in the event of bankruptcy or other non-payment. The trust is preserved simply by adding an appropriate paragraph to the invoice. This allows producers to be at the top of the list in terms of creditors in the case of bankruptcy. Dealers and brokers are required to be licensed through PACA and, while a bond is not generally required, the PACA allows the Secretary of Agriculture to require a bond from a licensee for a range of reasons such as previous bankruptcy.

In addition to these mechanisms, a fund held by the US Treasury receives all fees prescribed under PACA and interest earned on account balances. The fees deposited in the fund include licensing fees and complaint filing and handling fees, and penalty fees for non-compliance with related regulations or late payment of license fees. This fund is then used in cases of insolvency or bankruptcy where the bond and the regular bankruptcy proceedings do not cover the payment owed to a producer. An industry estimate of the likely payouts from the fund over the past ten years is approximately US\$150 million.

### **CLEARINGHOUSE MODEL**

In sectors other than primary agriculture, a clearinghouse is a widely used business risk management practice which provides a set of unbiased standardized contracts as well as rules and regulations for successful transactions and default parameters. Although no clearinghouse exists for primary agriculture at this time, the Western Barley Growers Association is currently developing the Agriculture Commodity Clearing House.

A clearinghouse requires both the buyer and the producer (the seller) to pay for transactional security up front by charging transaction fees and requiring both parties to post margins. A margin is a part-payment of collateral to cover contractual obligations and protect against potential loss. The clearinghouse guarantees each transaction, so in the event of a default by one of the parties, the counterparty would still receive the full amount they were owed. For producers, this implies they would always receive full payment for the product they deliver, regardless of the buyer’s financial standing, provided all other contractual terms are met. Participation by both buyers and producers is optional, on a transaction by transaction basis.

An initial margin must be posted before transactions can be registered with the clearinghouse. The initial margin is often a letter of credit issued by the buyer or producer’s financial institution. Once a buyer and producer each agree to the terms of a contract and register a transaction with the clearinghouse their position becomes open and subject to daily price fluctuations. The clearinghouse then monitors the transaction until delivery. Depending on their positions, when the price of the underlying commodity moves the buyer or producer will have to post additional margin money with the clearinghouse, where it is held until the execution of the contract.

Margin calls serve to keep the trade in balance relative to the current market, providing incentive for buyers and producers to fulfill the terms of the contract. For example, if the price of the commodity has risen since the establishment of the contract, there would be incentive for the producer to violate the terms of the contract in order to take advantage of the higher current market price. However, by requiring the producer to post additional margin money to account for the price increase, the clearinghouse has offset this risk.

In the event of a default by one of the counterparties, the clearinghouse will use the margin posted by the defaulting counterparty to cover the losses incurred. If the margin is not sufficient to cover all losses, the clearinghouse will use reserve funds to fully compensate the affected member. Revenues generated by the clearinghouse provide the backstop fund. Additionally, a clearinghouse will normally have a line of credit with a financial institution to use when necessary.

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