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Forage Risk Management, Livestock Risk Protection and Livestock Gross Margin Insurance Relatively New Products to Help Ranchers Cope With Financial Risk

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After record high prices for most beef cattle categories last spring, prices have weakened as cattle producers face substantially increased financial risks as production costs increase and the drought lingers. Increased demand for corn has resulted in sharply higher prices for corn, consequently higher feed costs. Higher feed/energy costs and slightly increased cattle feeder supplies are impacting weakening cattle markets relative to last spring. It appears unlikely that these increased costs will be reduced in the near term. As a result, cattle producers should plan to contend with higher costs and higher market risk and find alternatives to help manage increased financial risk.

The Federal Crop Insurance Corporation (FCIC) and USDA's Risk Management Agency (RMA) supports three insurance products to help livestock producers manage the risk: The Livestock Risk Protection Insurance ((LRP), the Livestock Gross Margin for Cattle (LGM) Insurance Program and the Rangeland, Forage Risk Management Insurance programs. These insurance programs are generally considered income protection policies: the LRP provides insurance protection from downward price movements in feeder and fed cattle markets: the LGM provides protection from an expected decrease in expected gross margins (gross income less feed costs) and the pasture/forage insurance program provides income protection from reduced forage production as a result of reduced rainfall (rainfall index program). **NOTE:** The Livestock Risk Protection Insurance ((LRP) for Feeder Cattle will be covered in this brief article.

Livestock Risk Protection Insurance (LRP)

LRP for Feeder Cattle offers cow-calf producers, stocker and backgrounding operators the opportunity to purchase insurance against a decline in the Chicago Mercantile Exchange (CME)

Feeder Cattle Index. After a successful launch of the program, the LRP was halted in December '03 after the discovery of bovine spongiform encephalopathy (BSE) in the U.S. The program was re-authorized in 2004.

The program is similar to buying a **PUT** (option to sell a futures contract and thereby establishing a price floor for the feeders) in the feeder cattle futures market, without having to buy contracts in 50,000 pound increments as sold in the Chicago Mercantile Exchange (CME). Producers may buy an LRP insurance contract only on the number of head they actually own, which may be fewer head than would be required for a CME contract. For example, if a full CME feeder contract represents about 80 head (50,000 lbs divided by 625 lb/hd average) but if the producer only has 50 steers then he/she would be able to purchase LRP on just the 50 steers. While the LRP contract is similar to buying a **PUT** option contract, this is an insurance contract. Once purchased it can not be cancelled as can be done with a put option by selling the put.

LRP insurance coverage is currently available for 13, 17, 21, 26, 30, 34, 39, 43, 47 and 52 week coverage durations. Coverage is limited to 1,000 hd per policy or 2,000 hd per producer per contract year with coverage levels ranging from 70% up to 95% of the expected end value of the cattle.

The LRP insurance contract does not guarantee the producer a cash price, but establishes an expected end value. The actual end value is based on the CME Feeder Cattle Index. The CME index changes daily and represents the weighted average daily index cash price of 650 to 849 lb cattle being sold across the U.S. Currently, while May '07 feeder cattle futures contracts were trading at about $106/cwt on Tuesday (3-6-07) when this article was prepared, the CME index was $99.52/cwt. So, purchasing a May '07 **PUT** with a strike price of $106/cwt for about $2.65/cwt would **not provide** better protection than a 13 week LRP contract with a coverage price of $109.78/cwt with a premium costs of about $1.30/cwt ($1.497 less 13% government subsidy) (See table 1 and example).

Example

If a producer places 100 steers weighing an average of 600 lbs in a retained ownership enterprise on March 6, 2007 and pulls them off 13 weeks later on June 4, 2007. At 1.25 lbs/day gain, the steers should weigh 707 lbs by June 4, 2007. The producer estimates projected breakeven costs at $90/cwt. Table 1 provides an example summary of the LRP coverage price, premium rate and ending value, based on the March 6, 2007 USDA's-Risk Management Agency Report when this article was prepared.

Table 1: Coverage Prices, Rates, and Ending Values[1] **March 6, 2007 Report**						
Endorsement Length (wks)	End Date	Expected End Value	Coverage Price	Coverage Level	Rate	Cost Per CWT
13	June 4, 2007	117.786	$109.780	$0.9320	0.013637	1.497
13	June 4, 2007	117.786	$107.580	$0.9134	0.010051	1.081
13	June 4, 2007	117.786	$105.380	$0.8947	0.006221	0.656
13	June 4, 2007	117.786	$103.180	$0.8760	0.005458	0.563
[1]Only 4 examples of over 50 options available						

Based on the LRP rates and ending values for the first 13 week contract in table 1, the premium for the 100 head stocker example would be $911.72 (100 head x 7 cwt equals 700 cwt; times coverage price of $109.78/cwt equals $76,846 times 0.013637 rate equals $1,047.95; less government subsidy ($1,047.95 times 0.13 equals $136.23). This would amount to about $1.30/cwt in premium costs ($911.72 divided by 700 cwt).

With a coverage price of $109.78/cwt, if on June 4, 2007, the CME Feeder Cattle Index settled at $100.00/cwt, the producer would be eligible for an indemnity payment equaling $9.78/cwt ($109.78 less $100.00) and receive an indemnity payment of $5,934.28 (700 cwt times $9.78/cwt less the premium of $911.72).

NOTE: Two factors are used to determine if an indemnity payment is due; the insured estimated weight of the feeders and the CME index on the ending date of the policy. Sales date and/or higher or lower actual pay weight is not taken into account to determine an indemnity payment.

For more information on premium costs go to RMA homepage: www.rma.usda.gov or, go directly to www.rma.usda.gov/apps/livestock_reports/