AgriLIFE EXTENSION
Texas A&M System

Hedging Cattle with an LRP Policy

Overview

- Livestock producers have always had to manage in uncertain environments.
- Price uncertainty is as common an issue as uncertain rainfall patterns for Texas cattle producers.
- Livestock Risk Protection (LRP) policies were introduced by the Risk Management Agency (RMA) of USDA to provide single peril, price risk insurance.
- Policies can be purchased for feeder cattle, fed cattle and lambs.
- In many ways LRP policies are similar to Chicago Mercantile Exchange (CME) put options.
- LRP policies can be effective hedging tools for livestock producers.

Basics of Hedging

- Hedging is the process of trying to secure an attractive or acceptable price now for a commodity that will be produced or marketed some time in the future.

Futures Selling Hedge

- A futures selling hedge involves selling one or more futures contracts as a proxy for a sale to occur in the future.
- Several characteristics of a futures selling hedge have discouraged many producers from using it.
  - If a producer sells a futures contract and futures prices increase, margin calls will be required to assure the commodity broker that the producer will have the financial resources to re-purchase the higher priced contracts. These margin calls are difficult to plan for when creating cash flow projections.
  - Producers are also discouraged from using a futures selling hedge because they may miss a potentially higher net price if the overall market increases.

Hedging With a Put

- A put establishes a price floor and protects the buyer against lower prices.
- It gives the buyer of the put the right, but not the obligation, to sell a specific futures contract at a fixed price on or before the expiration date of the put.
- The use of a put option in lieu of a futures selling hedge offers producers two main advantages:
  - The financial obligation associated with the put is met as soon as the initial premium is paid, and if prices increase, the producer will be able to participate in the market rally. If the futures market rises above the strike price, the option will be allowed to expire worthless and the producer's net price will be the increased cash market price less the option premium paid. If futures prices drop below the selected strike price, the producer can use the increased value of the option to supplement the reduced cash price received for the calves sold.
  - Producers have long felt that options have three distinct drawbacks. Put options can be relatively expensive, especially when a significant portion of the total premium is associated with the time value of the put. At times, light trading may mean that a seller for an option at the desired price cannot be found. In other cases the competitive open trading for options may mean that option prices have changed before a producer can get his option bought at the desired price.

LRP Policies

- LRP policies are single-peril insurance policies intended to protect against a price decrease in the overall market.
- After completing the policy application, producers select a coverage price, endorsement length, and the specific number of head and expected target weight of the cattle to be sold.
- The coverage price is a percentage of the expected ending value. These values and the associated rates are based on the current day’s closing futures prices, volume and volatility, and they correspond to different endorsement lengths.
- Endorsement lengths are in increments of about 30 days and can range from 13 to 52 weeks, though they are seldom available for more than 34 weeks into the future.
- If, at the ending date of coverage, the actual end value has dropped below the selected coverage price, the producer will need to file an indemnity claim within 60 days.

LRP Policies *cont.*

- It is crucial for producers to understand that the ending value of the LRP contract is not the cash price received or a closing futures price as of the end date of the policy.
- The LRP feeder cattle policy uses the Chicago Mercantile Exchange (CME) feeder cattle price index as the actual end value. This cash-settled commodity index is a mathematical calculation that averages the headcounts, weights and prices from numerous livestock sales across the nation to determine its settlement price.
- The LRP fed cattle policy uses a weekly weighted average of the slaughter cattle prices in five areas, as reported by the Agricultural Marketing Service. This creates a slightly different basis calculation from traditional basis calculations.

Advantages of LRP Policies

- They provide coverage in months when CME contracts are not available.
- They instill confidence that the policy can/will be purchased at the rates quoted by RMA on their Website.
- All LRP premiums are tax deductible.

Table 2. Calculation of Minimum Net Selling Price for Feeder Cattle to be Marketed in May, 2008.

Coverage/strike price ($/cwt)	$107.90 (99.9%)	$108.00
Less: Producer paid premium ($/cwt)	$4.0025[1]	$3.10
Expected basis ($/cwt)	$ -2.00	$ -2.00
Commission and interest ($/cwt)	$0.1270[2]	$0.2427
Minimum expected net sales price ($/cwt)	$101.77	$102.66

LRP Disadvantages as a Hedging Tool

- LRP policies cannot be purchased for coverage periods less than 13 weeks. This could be problematic if prices increased dramatically 60 to 90 days before the intended sales date and a producer wanted to put a price floor under his cattle at those higher levels. The fact that LRP policies are seldom offered for coverage periods of more than 34 weeks may also limit their usefulness relative to CME futures and options, which have contract months listed for nearly a full year.
- Another potential disadvantage of trying to hedge your expected price with an LRP policy could be the limited number of coverage prices available for each end date of coverage. This becomes more of an issue as the end dates of coverage become more distant. Often only one or two coverage levels may be available for a specific end date, and in all cases the coverage level is less than the expected ending price. This may limit a producer's ability to buy LRP coverage at the desired levels at the time cattle are purchased or placed on pasture/feed.

Marketing Strategies

- LRP policies should be viewed as another tool available to livestock producers.
- The policies perform best when used for the right task, and can be disappointing when used for a function they were not designed for.
- Producers should identify their marketing or risk management objectives, risk tolerance and cost parameters, and combine that with their own market outlook and production schedule before implementing an marketing plan.
- LRP policies could be used for the following purposes:
    - Establish a minimum average sales price.
    - Insure against a catastrophic event by routinely purchasing LRP coverage at low coverage levels.
    - Scale-up LRP coverage on a limited number of head at a time if the market seems to be trending upward, as opposed to rolling hedges forward.
    - Combine LRP policies with a CME option contract to create a spread or window strategy.