LIVESTOCK RISK PROTECTION (LRP) INSURANCE

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Over the past couple of years we have seen tremendous volatility in the feeder cattle and feed grain markets as well. Of course the two are closely related. Corn prices have tripled over the past three years, and we have seen $10 to $15 per hundred moves in feeder cattle prices. Stocker operators are margin operators in that they hope to profit from the value of gain on cattle exceeding the cost of that gain. The difference in the buying and selling price significantly impacts the value of that gain. Beginning July 1, 2007 a new price risk management tool, LRP, became available in 17 additional states including the tri-state area. This makes a total of 37 states where the insurance is available.

The insurance is available for feeder cattle, fed or finished cattle and swine. At today's stocker conference we will only deal with feeder cattle and to a limited extent fed cattle. LRP allows one to set a floor selling price for cattle. It pays the producer if a Regional/National cash price index falls below a set price called the "coverage price." The insurance does not guarantee a cash price for the cattle, nor does it require the cattle be sold. LRP should be viewed as "price insurance" or as pickup truck insurance. One buys it hoping that it will not be needed, but that it is there in case prices crash. While LRP is designed to reduce price risk rather than enhance profit, there can be times when the market rises sharply, allowing one to buy LRP insurance at a coverage price which protects a profit on the cattle.

To be able to buy LRP insurance, the cattle must be in an LRP eligible state. Also the insurance must be purchased from a crop insurance agent who is licensed in the state where the cattle are located. It makes no difference where the owner of the cattle is located. In order to buy the insurance a producer must be properly enrolled. This may take a week to 10 days and carries no obligation to purchase LRP insurance. However, it must be done before one can buy the insurance. Crop insurance agents are listed on the Agent Locator Tool on the USDA Website at the following address http://www.3.rma.usda.gov/apps/agents/ . The insurance policy is only price insurance and covers no other loss or peril. There are limitations on the number of cattle which can be insured. For feeder cattle the limit is 1,000 head per specific coverage endorsement (SPE) policy or 2,000 head per crop year, i.e. July 1 to June 30. For fed cattle the limit is 2,000 head per SCE or 4,000 per crop year. The covered livestock are counted in the crop year when the coverage is purchased, so technically one could purchase coverage on 2,000 stockers in June and coverage on another 2,000 head in July. Cattle eligible for LRP include beef type and dairy type feeder steers and heifers including Brahman breeds. One must make basis adjustments for r cattle using historical basis information. This will be discussed later. For fed cattle, steers and heifers expected to weigh 1,000 to 1,400 pounds and grade Select or higher, Yield Grade 1 to 3 are eligible for the LRP insurance.

Actual Ending Value

The LRP insurance pays an indemnity if the coverage price purchased is above the Actual Ending Value (AEV). That Actual Ending Value is the Chicago Mercantile Exchange Feeder Cattle Index. It is the same index used to cash settle the feeder cattle futures. What numbers make up the index? It is a 7-day weighted average of USDA reported prices from a 12 state region: Colorado, Iowa, Kansas, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oklahoma, South Dakota, Texas and Wyoming. It includes prices from auctions, video & Internet sales and direct trades. We must note that it includes no cattle prices from the tri-state area, so a basis adjustment must be used to know the exact level of price protection one has purchased. For fed cattle, the Actual Ending Value is based on the 5-area weekly weighted average direct slaughter cattle price which is published each Monday. The 5 areas included are Texas/Oklahoma/New Mexico, Kansas, Nebraska, Colorado and Iowa/Minnesota. Again, if the Actual Ending Value is below the coverage price purchased, the LRP pays an indemnity.

Coverage Availability

Coverage is available from about 3:30 p.m. to 9:00 a.m. the following day. It is available on Saturday mornings until 9:00 a.m., but not Sunday, Monday and holidays. The insurance or coverage is initiated by purchase of a specific coverage endorsement (SCE) or policy. There is no limit on the number of SCEs. Producers have flexibility on the: timing of purchase of coverage, time period for which the cattle price is insured, i.e. the length of the SCE and the number of head covered. There are some days when the number of SCEs are limited for a given a ending date or time period, and some days there are a limited number of time periods or ending dates offered. The number of SCEs is intended to range from 70 percent to 100 percent of the futures price for the appropriate ending date. When purchasing coverage, the beef producer must keep in mind that this is a pilot program sponsored by the USDA Risk Management Agency (RMA). RMA pays the insurance commission to the insurance agents which is 5 percent. It also pays the administrative cost and subsidizes the insurance premium 13 percent. So the crop insurance agent is being paid less than they make selling crop insurance (15 percent). The insurance agent has the incentive to sell the higher coverage prices, because they earn a higher commission. In contrast to crop insurance, LRP insurance must be paid for up front. The check or payment must be good or future participation will not be allowed.

An Example

Assume last October 70 calves had been purchased which were to be sold at 700 pounds in mid-January after a short backgrounding period. A total weight of 49,000 pounds was to be sold. After examining the coverage prices available on October 15, a price of $107.97 is selected for which the premium will cost about $1.56 per hundred. Other coverage prices ranged from $111.97 to $97.97. As a general rule, I prefer to spend about $1 per hundred for insurance, since in most cases you hope you do not need it. The SCE has an ending date of January 14, 2008. The value which we wish to insure is 49,000 pounds times the $107.97 coverage price or $52,905. The insurance rate is .014411 or $762 ($52,905 X .014411). We can deduct from this the 13 percent subsidy or $99, leaving a net premium cost of $693 ($762 minus $99), or $1.35 per hundred ($693 divided by 490 hundredweights). The beef producer will then be paid an indemnity if the CME feeder cattle index falls below $107.97 on January 14, 2008. It is important to know as nearly as possible what level of price protection one has. Since the feeder cattle index is not based on prices in the tri-state area, a basis adjustment should be made to determine the actual level of protection. For purposes of this example, a negative $3 basis will be used to adjust the coverage price. This is taken from historical basis data on truck loads of cattle selling on video sales and auction markets in Tennessee. Producers located further north would likely have basis less negative or more positive. The recent increase in trucking rates has made most prices in our area lower relative to the CME feeder cattle index. Please note that the computer software used by crop insurance agents attempts to take into account differences in coverage prices based on sex, weight and breed (beef, Brahman, or dairy). These adjustments make no difference in the outcome. Furthermore, they do not take the location factor into account. I suggest using the heavier weight feeder steer (over 600 pounds) and making adjustments using actual basis estimates to know as accurately as possible what the floor price is. Also be aware that the insurance has nothing to do with the sale price of your cattle, only the CME index and the SCE or coverage price purchased.

As it turned out on January 14, 2008, the CME feeder cattle index is $98.01, while our coverage price is $107.97. The producer is due an indemnity for the difference or $9.96 per hundred ($107.97 minus $98.01). The total indemnity is $4880.40 (490 hundredweights times $9.96). If we assume the cattle were sold for $3 per hundred less than the CME index, they brought $95.01 or a total of $46,555 (490 X $95.01). Adding the indemnity we get $51,435 and minus the insurance cost of $663 leaves a net proceeds of $50,772. Assuming we sold exactly 49,000 pounds, the net price is $103.62. Of course like other forms of insurance, if the CME feeder steer price index does not go below the coverage price on the ending date, you do not collect anything on the policy.

Important Details

Upon the insurance company's request or request of any USDA employee, the insured must provide documents verifying ownership of the cattle. Needless-to-say the working relationship and trust between the insurance agent and producer is very important. Ownership of the cattle must be maintained until 30 days before the ending date of the SCE. If any portion of the insured cattle are disposed of prior to the last 30 days of the coverage, then that portion of the coverage will terminate, no indemnity will be paid for that portion, and there will be no refund of premium for that portion. Production factors may necessitate selling before or after the SCE ending date. The LRP insurance only has value on the ending date of the SCE. Selling cattle before or after the ending date may have risk or reward depending on the Actual Ending Value on the ending date. Two examples which could easily occur are to sell the cattle say 25 days before the ending date for a low price, only to have the CME feeder cattle index rise above the SCE on the ending date resulting in no indemnity being paid. The second example would be to have the CME feeder index below the coverage price on the ending date resulting in an indemnity being paid, then sell the cattle at a later date on a higher market. Other scenarios would give varying results, but the important thing to remember is to not dispose of the cattle more than 30 days before the ending date of the SCE or coverage will be lost.

If an indemnity is due you, the insurance company will issue a letter of probable loss. The producer must file a claim form within 60 days. The indemnity will be paid within 60 days of submission of the claim form. The indemnity is taxable on a cash basis and applies to the tax year it is received. The premiums paid are tax deductible. It is reported that some lenders may prefer LRP over futures or options to cover loan collateral. They like the fact that the producer cannot cancel the coverage, and that they can take a security interest in the contract.

Sales can be suspended when at least 4 of the underlying CME live cattle futures contracts settle at the daily price limit for two consecutive days. Sales will be resumed when there have been two consecutive days without there being 4 or more of the underlying CME Live Cattle futures contracts settling at the daily price limit. Sales may also be suspended if an event occurs during or after trading hours deemed to significantly change market conditions on which LRP for that day was rated. These might include news reports, USDA announcements, or other events.

Summary

LRP is a relatively new price risk management tool available to cattle producers. It is intended to be price insurance not price enhancement, though circumstances may result in price enhancement. Cattle must be located in a LRP eligible state and insurance must be purchased from an insurance agent licensed to sell insurance in the state where the cattle are located. **You must be enrolled ahead of time to participate.** There is no obligation if you enroll. The outcome of LRP can be affected by the price level and actual basis. LRP does not guarantee a cash price. Sales can be suspended if markets trade the limit on consecutive days, or USDA may suspend sales if some significant event occurs which might affect the markets. LRP protects against a negative change in the CME cash price index. It does not guarantee the basis nor cover any other peril. Livestock ownership must be maintained up to 30 days before the ending date. Once set, LRP prices and premiums are guaranteed for that day, i.e. from 3:30 p.m. until 9:00 a.m the next day. The reason insurance is purchased to protect against an unexpected occurance. Information on Livestock Risk Protection insurance can be found at www.rma.usda.gov/livestock and at http://livestockinsurance.unl.edu .