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Sales of Livestock Insurance Scheduled to Resume

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Market Report	Yr Ago	4 Wks Ago	9/3/04
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight	$85.96	$82.26	$80.34
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb	110.09	137.60	134.40
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb	100.98	119.73	116.99
Choice Boxed Beef, 600-750 lb. Carcass	147.17	139.81	134.20
Western Corn Belt Base Hog Price Carcass, Negotiated	49.15	78.43	71.01
Feeder Pigs, National Direct 45 lbs, FOB	21.79	43.25	43.45
Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean	59.04	79.29	72.24
Slaughter Lambs, Ch. & Pr., 90-160 lbs., Shorn, Midwest	88.62	95.75	*
National Carcass Lamb Cutout, FOB	212.91	224.54	216.23
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Omaha, bu	3.49	3.35	3.21
Corn, No. 2, Yellow Omaha, bu	2.37	2.20	2.23
Soybeans, No. 1, Yellow Omaha, bu	7.92	5.70	6.24
Grain Sorghum, No. 2, Yellow Columbus, cwt	3.63	3.20	3.13
Oats, No. 2, Heavy Minneapolis, MN , bu	1.60	1.57	1.65
Hay			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton	113.50	115.00	115.00
Alfalfa, Large Rounds, Good Platte Valley, ton	65.00	62.50	62.50
Grass Hay, Large Rounds, Good Northeast Nebraska, ton	65.00	57.50	57.50

* No market.

USDAs Risk Management Agency (RMA) offered livestock producers in selected pilot states, including Nebraska, a new insurance product in 2003 called Livestock Risk Protection (LRP). It provided down-side price risk protection while allowing producers to take advantage of higher prices, similar to creating a floor price by purchasing put options. Premiums for LRP insurance changed daily and depended on current market prices and market volatility. Unlike put option premiums that change based on the current day's futures trade, LRP premiums were determined using the *previous* days futures and options prices. Since LRP could be purchased until 8:00 p.m. based on the previous day's prices, it created an opportunity for adverse selection by enabling producers to purchase price insurance after knowing how the current day's price changed. In cases where market prices decreased (increased) today, the same LRP insurance would be more (less) expensive tomorrow.

On December 23, 2003 at 4:30 p.m. (CST), USDA announced the first U.S. case of BSE. With the expectation that prices would decrease substantially, LRP purchased after that 4:30 p.m. announcement appeared to be a good buy. Producers recognized LRP as a way to obtain after-market price insurance based on prices established before the BSE announcement, and a substantial volume of the cattle LRP contracts written in Nebraska occurred that day between 4:30 p.m. and about 6:30 p.m. when RMA suspended sales.

Depending upon the specific insurance contract purchased late that afternoon, coverage prices for contracts purchased on December 23, 2003 and ending on April 20, 2004 were between $65-76/cwt for fed cattle. Interestingly, the price level when those LRP contracts ended on April 20 was over $85/cwt and no indemnities were paid on the December 23 contracts. However, RMA did not resume sales of LRP for fed or feeder cattle following the BSE event, and suspended sales of all cattle and hog LRP contracts at the beginning of the new crop insurance year (July 1, 2004) pending changes to the policy provisions.

After making changes to the policies, including addressing the potential adverse selection issue, RMA recently announced plans to resume sales of cattle and hog LRP contracts beginning October 1, 2004. First, RMA expanded the availability of hog, feeder cattle and fed cattle LRP to include Colorado, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, Nevada, North Dakota, Ohio, Oklahoma, South Dakota, Texas, Utah, West Virginia, Wisconsin and Wyoming. Nebraska was an original pilot state for fed and feeder cattle LRP, and had hog LRP insurance offered since November 2003. Additional changes were made to the feeder cattle contract. These changes included offering shorter insurance period lengths of 13 and 17 weeks (in addition to the 21, 26, 30, 34, 39, 43, 47 and 52-week periods previously available), and expanding sales to cover feeder heifers, dairy feeder cattle, Brahman feeder cattle and feeders weighing less than 600 lbs. Price adjustment factors were also implemented to account for the differences between feeder steer prices and prices of other types and weights of cattle.

Two significant changes were made to all LRP contracts in response to adverse selection and suspension of sales. First, producers will only be able to obtain coverage from approximately 5:00 p.m. to 9:00 a.m. (Central Time). Following the end of futures and options trade at 2:00 p.m. each day, RMA will calculate LRP insurance rates based on that day's trade and publish them on its website. Sales of LRP will end just prior to the next day's futures trading session. So, LRP insurance will only be available when the futures market is not trading.

A second change made in the LRP policy formalizes the process under which sales of LRP are suspended and resumed if large price moves occur in the market. Sales of LRP will be suspended for future sales periods if at least four contract months of the underlying futures contracts have a daily price change equal to the daily price limit for two consecutive days. Similarly, sales of LRP would resume when at least four contract months of the underlying futures contracts do not trade to the daily price limit for two consecutive days.

Other LRP policy provisions will be the same as in the pilot program offered last year. Details are available at www.rma.usda.gov or in NebFact 03-583 (http://agecon.unl.edu/mark/Papers/NF03-583.pdf). While insurance is limited to 2,000 feeder cattle, 4,000 fed cattle and 32,000 hogs per year per insured individual, LRP can be a useful price risk management tool for some producers. In addition to being able to insure as few as one head, it also does not require a brokerage account, margin money or commission to hedge price risk. Instead, producers purchase LRP through licensed crop insurance agents.

Hedging price risk with LRP is similar to creating a floor price using put options. However, the basis risk associated with hedging with LRP is different than when hedging using futures and options. Because LRP insurance is indemnified on a national cash price index, the relevant basis to consider is the difference between the producer's actual selling price and the national cash price index (rather than the producer's actual selling price and the futures price, as in the case of hedging with futures and options). Not only is this important when projecting expected hedged sales prices, but it also offers some reduction in basis risk because producers are no longer exposed to risk of changes between the futures price level and the national cash price index. Recent comparisons of the difference in basis risk when hedging with LRP and futures or options reveals a reduction in basis risk for swine LRP users, fed cattle LRP users when hedging heifers and feeder cattle LRP users when hedging heavier weight feeder steers and heifers. For complete details on basis risk when hedging with LRP, refer to Extension Circulars 04-833, 04-834 and 04-835, available at http://agecon.unl.edu/mark/ .

Whether hedging with LRP, futures, options or cash contracts, it is important to remember that each has its advantages and disadvantages. None of them however, including LRP, provides a "silver bullet" to create profit opportunities where they do not already exist. In other words, LRP, like other market-based tools, will not enable producers to create a hedged sales price above breakeven if their input costs (including purchased feeder animals) are too high.

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