

# Livestock Risk Protection Insurance for Cattle: A New Price-Risk Management Tool

By Matthew M. Larson, Graduate Student  
Darrell R. Mark, Extension Agricultural Economist  
H. Douglas Jose, Extension Agricultural Economist

## What is Livestock Risk Protection?

Livestock Risk Protection (LRP) insurance offers single-peril price-risk protection to feeder and fed cattle producers. Cattle producers are able to protect against declining cattle prices by purchasing an insurance contract with a specified coverage price. If cattle market prices fall below the specified coverage price, an indemnity is paid to the producer. Because the LRP contract is market-based, coverage prices and premiums change daily. Although LRP offers price level protection, producers using LRP are still exposed to basis risk. Thus, successful use of the contract by producers will require knowledge of local basis.

LRP is a revenue insurance program that is reinsured and subsidized by the Federal Crop Insurance Corporation (FCIC). LRP was initially offered as a pilot program for swine in 2001. In June 2003, LRP was expanded to include feeder and fed cattle in selected states. The cattle LRP contracts, in some respects, are similar to put options.

## Feeder Cattle

The feeder cattle pilot program will be offered in Colorado, Iowa, Kansas, Nebraska, Nevada, Oklahoma, South Dakota, Texas, Utah, and Wyoming. Steers that are expected to weigh between 650 and 900 pounds at the end of the insurance period are qualified to participate in the LRP program. Feeder heifers and Brahma cattle (over 50 percent Brahma breed) do not qualify for LRP. Feeder cattle producers select insurance periods of 21, 26, 30, 34, 39, 43, 47, or 52 weeks, depending on when the cattle are expected to be marketed. The feeder cattle pilot program allows producers to insure up to 2,000 head of cattle per year (LRP insurance year is July 1 to June 30) with a limitation of 1,000 head of cattle per Specific Coverage Endorsement (SCE). Producers

are able to select coverage levels between 70 and 95 percent. The Chicago Mercantile Exchange (CME) feeder cattle price index is used to measure cash feeder steer prices and then compare to the coverage price to determine whether an indemnity will be paid.

The feeder cattle LRP insurance contracts, while similar to put options, offer advantages to producers not available with futures options or futures contracts. First, a CME feeder cattle futures contract is based on 50,000 pounds or 67 head of 750-pound feeder steers. For producers with a smaller number of cattle, LRP can be used without over insuring (any number of cattle less than 1,000 head can be insured per SCE). Thus, producers with smaller herds could find the most benefit from LRP. This group of producers could be sizeable. In 2002, 75 percent of Nebraska's 22,000 beef cow/calf operations had fewer than 100 head.

Another advantage to LRP insurance contracts is that 13 percent of the premium is subsidized. Another subsidy covers the administration of the insurance contracts and agent commission.

## Fed Cattle

The fed cattle pilot program will be offered in Illinois, Iowa, and Nebraska. Steers and heifers that have an expected quality grade of select or higher and a yield grade of 1 to 3 at harvest qualify for the LRP contract. At the end of the insurance period, the fed cattle must be marketed for slaughter and weigh between 1,000 and 1,400 pounds. Fed cattle producers are able to select insurance periods of 13, 17, 21, 26, 30, 34, 39, 43, 47, or 52 weeks, and can insure up to 4,000 head of cattle per year (LRP Insurance year is July 1 to June 30) with a limitation of 2,000 head of cattle per SCE. Fed cattle producers select coverage levels between 70 and 95 percent. The five-area weighted average price reported by

USDA's Agricultural Marketing Service (AMS) is used as the cash fed cattle price and then compared with the coverage price to determine whether an indemnity will be paid.

The fed cattle LRP contract is subsidized by FCIC like the feeder cattle contract. A difference between the LRP contract and the CME Live Cattle futures contract is that LRP covers both steers and heifers (CME futures contracts only allow delivery of steers).

### **How Livestock Risk Protection Works**

As indicated earlier, LRP is a single-peril price-risk contract. To protect against downside price risk with the LRP contract, producers select a coverage price (minimum sale price), which is based on a percentage coverage level (between 70 and 95 percent) of an expected end value. For example, if the expected end value of feeder steers after a 21 week period was \$84.55/cwt, a coverage level of 92 percent would yield a coverage price of \$77.79/cwt ( $\$84.55/\text{cwt} * 92$  percent). If, at the end of the 21-week period the CME feeder cattle price index is higher than \$77.79/cwt, no indemnity is paid. However, if the index is lower than \$77.79/cwt, an indemnity equal to the difference between the coverage price and ending value of the CME feeder cattle price index is paid. The cost for this insurance based on July 2003 market prices was about \$1.15/cwt. Suppose that the CME index ending value was \$76.29/cwt. In this case, a \$1.50/cwt indemnity would be paid. The minimum sale price (\$77.79/cwt) would be achieved by selling the feeder cattle for \$76.29/cwt in the cash market, plus the \$1.50/cwt LRP indemnity. If the producer sold the feeder cattle for more than \$76.29/cwt, a price higher than the insured minimum sale price would result. However, if the feeder cattle were sold for less than \$76.29/cwt in the cash market, the net price received would be less than the insured minimum sale price. Thus, basis, or the difference between the CME index and actual cash market sale price, is critical when using LRP to manage price risk. Because LRP does not guarantee basis, it is important for producers to understand and anticipate the basis in the markets in which they sell cattle.

The fed cattle LRP works similarly; however, the AMS five-area weighted average price is used as the ending value, rather than the CME feeder cattle index.

### **How to Enroll in Livestock Risk Protection**

Before producers are able to purchase LRP insurance, they must register with a certified LRP agent. To do so, they must submit an LRP application, a Substantial Beneficial Interest (SBI) form, and an LRP disclaimer form. The application form determines if producers are eligible to purchase LRP insurance and lists the conditions of acceptance in the LRP insurance program. The SBI form establishes eligibility (verifies that the producer has ownership of the cattle), accounts for insurance limits, and determines the number of

cattle that will be insured by the producer. The statements on the LRP disclaimer include specific regulations and rules regarding the collection of indemnity payments to which producers must agree. Any crop insurance agent can become certified to sell LRP insurance. A list of certified LRP agents is available online at <http://www3.rma.usda.gov/apps/agentslpi/>.

Once the application is accepted, producers purchase LRP coverage by filing a Specific Coverage Endorsement (SCE) with a certified LRP agent, who then verifies the number of cattle that will be insured. With the SCE filing, producers establish the coverage level, price, premium, and length of coverage. The SCE must be filed between 7 a.m. and 8 p.m. Central Time, Monday through Friday, (excluding federal holidays).

The prices for the LRP program change daily, so the premium for the insurance coverage is established at the time of purchase (filing the SCE). Current prices for the LRP pilot program are available online at <http://www.rma.usda.gov/tools/>.

At the end of the selected insurance period, if the coverage price is greater than the cattle price reported by USDA-AMS (fed cattle) or CME (feeder cattle), an indemnity payment is paid to the producer. To receive the indemnity payment, producers must submit a 04-LRP-Claim Form within 60 days of the ending date of the insurance contract. Payment is based on the actual ending value determined by the AMS or CME reported prices. The indemnity payment will be paid within 60 days after the 04-LRP-Claim Form is submitted to the insurance agent. The actual ending values can be found online at [http://www.ams.usda.gov/mnreports/lm\\_ct150.txt](http://www.ams.usda.gov/mnreports/lm_ct150.txt) (fed cattle) and <http://www.cme.com> (feeder cattle), or at the RMA Web site. If the coverage price is less than the cattle price reported by AMS or CME, no indemnity payment is paid to the producer.

### **What LRP Means for Cattle Producers**

The LRP insurance program reduces the downside price risk for cattle producers, but it does not eliminate all risks. The LRP insurance program does not cover sickness or death of the cattle or the possibility of rising feed costs. Further, producers are also subject to basis risk (the risk that basis declines relative to their forecast used to create their expected minimum sale price).

The value of the LRP insurance contracts to cattle producers will depend on the premiums for the contracts relative to other risk management tools, including put options. Certainly, however, the LRP program provides another choice for price risk management, and may be especially useful for producers with small operations.

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