Price Risk Management for Cow-Calf Producers: Part 5

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Cow-calf producers use various strategies to manage price risk, including futures and options. Livestock Risk Protection (LRP) is a type of livestock price insurance that typically costs less than a put option. The focus of this article is the LRP guarantee (also referred to as "liabilities"), which is the level of revenue (or calf income) that is guaranteed by LRP.

The holder of any insurance product receives compensation for damage (i.e. your roof blows off) or other losses, which is called an indemnity. LRP pays out an indemnity when the actual market price is less than the producer-selected coverage price. A LRP indemnity effectively covers the revenue loss that can be attributed to this price decline. The producer would select a coverage price and target weight to determine the LRP guarantee: coverage price times the target weight.

LRP indemnities are the difference between the actual and coverage price times the producer-selected target weight. Target weights must be within a specific range that is based on the specific type of LRP feeder cattle endorsement selected. For example, 'unborn steers and heifers' must have a target weight less than 600 lbs. The indemnity makes up the difference between the guarantee and actual revenue. In other words, the indemnity is designed to bring the producer's revenue back up to the guaranteed level when prices drop.

Why does a producer need to consider the guarantee, in addition to the coverage price? First, understanding how the guarantee is calculated can help a producer understand sources of risk that LRP does not cover. In addition to the examples in the previous paragraph, prices for feeders that are above or below the target weight might be different from LRP actual prices, such as price divergence between 600 lb. and 800 lb. feeders. Second, knowing the value of the guarantee can help a producer better understand the amount of income at risk from price declines and the potential value of LRP to their operation. Third, estimates of expected revenue based on the LRP guarantee might be valuable for a lender, potentially leading to additional credit being extended or more favorable terms.

The LRP guarantee is a measure of the income that LRP can protect for a cow-calf operation. In the next article in this series, we will discuss the historic frequency and magnitude of indemnities that LRP would have provided for spring-born calves.

For more information, please contact the local K-State Research and Extension Office

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