Livestock Risk Protection

What is it? Why does it matter now?

by Jimbo Mercer, Joe Kovanda & Jason Kraft, Compass Ag Solutions

Livestock Risk Protection, or LRP: Some cattle owners have heard the term. The word is finally starting to get around after the 2020 USDA overhaul that launched the program into relevancy. The most important point is this: Cattle owners can now set a price floor on calves (before they are even born) that is subsidized (therefore cheaper) and still lets the cattle owner participate in a higher market down the road. Cattle owners who have not yet considered using LRP would benefit by understanding how it works now.

Said another way: Cattle owners can now guarantee a worst-case scenario (price floor) — up to a year ahead of time — that does not limit their upside price participation. If the market improves, they can sell calves at higher prices realized in rallying markets. However, if the market goes down, they get a check that compensates them for the difference between that market price and the purchased LRP price floor.

Before diving further into exactly how LRP works, let's nail down some basics.

What is LRP?

- LRP is insurance that protects against a decline in the market price of cattle.
- It is expressed as a price in dollars per hundredweight (cwt.).
- Price protection coverage levels are offered daily after the futures market closes. The coverage cost (premium) to purchase each price protection coverage is also listed.
- LRP is published and backed by the USDA, but cattle owners access LRP through private insurance agencies.
- The protection cost (premium) is subsidized.
- LRP settles to a national average feeder-cattle price index, not the specific cash sale of a cattle owner's cattle (this is critical to keep in mind when learning how this tool functions).

How does LRP work?

Now that we have covered definitions, let's get into the mechanics. Coverage is offered and purchased per head, not by load lot or any other metric. One can purchase LRP on a single head if desired or an exact calf crop head count.

Cattle owners pay for LRP 30 days after coverage ends. This is a massive cash-flow advantage relative to traditional risk protection tools.

LRP is purchased through a licensed insurance agent. The prices offered do not and cannot change no matter who it is purchased from. Furthermore, only cattle owners can purchase LRP. A non-cattle owner cannot speculate on future cattle prices by purchasing LRP. Buyers of LRP must own the cattle, or they do not have an insurable risk and cannot purchase LRP.

To ensure LRP is tied to cattle and to remain in compliance with purchased LRP, cattle owners cannot ship the insured cattle more than 60 days prior to the LRP ending date.

There is some nuance to the timing components of LRP. Price protection coverage offers are published every day. Offers vary from coverage that ends three months into the future (shortest coverage offered) to coverage that ends at 12 months, and at one-month intervals in between.

For example, imagine it's midsummer, and consider the six-month coverage time frame. That LRP ending date happens to be Dec. 5. Tomorrow, the ending date for that six-month coverage will be one day later, Dec. 6; and the next day, it will be Dec. 7, and so on. There is usually one coverage option per month.

Another timing factor is the hours in which LRP can be purchased. The offers are published by 4 p.m. Central time on business days and are purchasable from that time through 9 a.m. the next morning.

Perhaps the most important LRP mechanic is how final settlement is established. Fed Cattle LRP settles to the USDA Five-Area Weekly Weighted Average Live FOB (Free on Board) Steer Average Price. Feeder Cattle LRP settles to the CME (Chicago Mercantile Exchange Inc.) Feeder Cattle Index. This means, with LRP, cattle owners can manage price risk separate from the cash sale of the cattle.

When LRP is purchased, whether

the market goes up or down, the cattle owner pays for the cost of the insurance. Consider Feeder Cattle LRP settlement as an example. On the ending date for the LRP coverage that was purchased, if the CME Feeder Index is at or above the purchased LRP floor price, the cattle owner will simply be billed the insurance premium cost in 30 days.

However, if the CME Feeder Cattle Index price on the ending date is below the purchased LRP floor, the cattle owner will receive a payment for the price difference, net of the insurance cost.

In both cases, the cattle owner sells the insured cattle separate from the LRP settlement. This allows for price risk management on cattle separately from the actual cash sale, and it even allows the cattle owner the flexible alternative to decide to retain ownership past the LRP ending date. This feature constitutes a huge advantage for navigating the substantial price volatility and uncertainty experienced in recent years.

PHOTO BY SHAUNA HERMEL

The cattle owner sells the insured cattle separate from the LRP settlement. This allows for price risk management on cattle separately from the actual cash sale.

How valuable is LRP?

Many people ask about LRP subsidy percentages, referencing how much they have increased. This is the wrong question, but it gets at the right idea. The subsidy percentage is arbitrary. Just like a grocery store, they can name whatever price they want on the presale item and then make it sound great because it's 75% on sale! In reality, the presale price was raised on the item by 150% before they posted the sale. What really matters is how much the same, or very similar, item costs at another store. To apply the analogy, the other store to comparison shop is the CME futures/options market, and the item is a bought put option on CME futures. It functions the same way as LRP; it is a price floor with an open top side. The best evaluations compare LRP's cost with that of a similar CME put option. This is the comparison used in the top row of Table 1, which quantifies subsidy amounts in dollars per head. In 2020 the USDA doubled the effective subsidy amount, and this launched LRP into relevance.

Why does LRP matter now?

Table 1 depicts the significant changes made to LRP, all of which favor the cattle owner's interests.

In summary, the USDA doubled everything good about LRP and took away some things that made it impractical. The USDA did not take great initiative to educate the industry on changes or clearly explain how LRP relates to actual cash cattle price risk. This article is meant to explain LRP in a way that is relatable and actionable for cattle owners.

Increased market volatility has many producers asking about how to manage volatility and price risk. LRP is a welcome, and now relevant, tool to answer these questions. For cattle owners who have never managed cattle price risk, LRP is the easiest, most straightforward tool for getting started. ▌

Editor's note: This article was commissioned for the *Angus Beef Bulletin*. Jimbo Mercer, Joe Kovanda and Jason Kraft are risk managers with Compass Ag Solutions, a dedicated cattle risk-management company. For more information visit *https://compassagsolutions.com/*.

Table 1: Significant changes made to Livestock Risk Protection

Old (before July 2020)	New (July 2020 forward)
Avg. feeder-cattle subsidy: $7 per head vs. CME equivalent Avg. fed-cattle subsidy: $9 per head vs. CME equivalent	Avg. feeder-cattle subsidy: $16 per head vs. CME equivalent Avg. fed-cattle subsidy: $18 per head vs. CME equivalent
Policy premium due at time of purchase	Policy premium due 30 days after endorsement ends
Cannot ship the insured head prior to 30 days from the LRP endorsement ending date.	Cannot ship the insured head prior to 60 days from the LRP endorsement ending date.
	Unborn steers and heifers eligible for feeder-cattle LRP
Annual limits: Feeder cattle: 6,000 head Fed cattle: 6,000 head	Annual limits: Feeder cattle: 12,000 head Fed cattle: 12,000 head

SOURCE: Compass Ag Solutions, 2022.