Why Price Risk Management?

Andrew P. Griffith
UT Agricultural Economics

Cattle producers face a number of risks. Many of the risks are related to production practices, financial situations, input and output prices, changes in technology, policy development, and legal issues. Cattle producers, in general, are extremely effective in managing some of these risks while some of the risks are either overlooked or considered to be "unmanageable". Additionally, some risks are difficult to manage due to the availability of effective risk management tools, while other risks go unmanaged because producers are not aware of the risk management tools at their disposal.

Cattle producers tend to be effective at managing production risks. Production risks include herd health, nutrition, forage production, supplemental feed, etc. Many producers use established vaccination programs to reduce the incidence of adverse health conditions which is risk management. Similarly, some producers utilize a number of forages including cool and warm season perennial grasses as well as winter and summer annuals to improve the likelihood of having forage available more days out of the year. Production risks tend to be the risks producers are most effective at managing, because producers are comfortable addressing these risks and in general can see immediate results.

It can be difficult to manage some risks such as technological risks and policy risks. Many times there are technological advances or changes in farm policy that the producers' best risk management strategy is to adapt current resources to fit the advances and changes. Changes in technology and farm policy are prime examples of risk with few tools available to manage such risk. However, how one reacts to the change and adapts their resources is a part of risk management.

Thus far, the discussion has revolved around what producers do well and what they have limited control over. The hole in most producers' risk management plan is not what they have limited control over but rather not using tools for risk management that are available. There are multiple reasons one may provide for not using available risk management tools. Those reasons may include: 1) not being aware of the tool, 2) not knowing enough about how the tool works, or 3) the cost associated with using the tool.

Price risk management tools are underutilized by many folks in the cattle business. Most of the "big boys" in the cattle business use price risk management when making purchases and when marketing product, but most small producers do not utilize such tools. Before anyone says "the 'big boys' can afford to use price risk management because they are big," it would be appropriate to consider some of the price risk management alternatives.

Some price risk management alternatives are more appropriate for large producers while other alternatives are appropriate for small producers. Additionally, some cattle producers can utilize all price risk management alternatives effectively. The primary price risk management tools available to cattle producers are forward contracts, futures and options contracts, and livestock risk protection insurance.

Forward contracts may be one of the most familiar price risk management tools available to cattle producers when preparing to market cattle. Forward contracts can be structured in a number of ways, but the most common is a fixed price contract in which the price of a certain weight and quality of animal is determined today for future delivery of the cattle. One drawback to this strategy is that prices may improve before cattle are to be delivered, but the producer will not benefit from such price improvements.

Futures and options contracts are a fairly flexible way of managing price risks in cattle production. They provide ways of locking in a price similar to forward contracts as well as setting a price floor which allows a producer to capitalize on positive price movements in the marketplace. One drawback to futures and options contracts for most producers is that one contract is 50,000 pounds of feeder cattle or 40,000 pounds of fed cattle.

Since futures and options require such a large number of cattle, it is generally more appropriate for small producers to consider the use of livestock risk protection insurance (LRP). LRP insurance can be used to set a price floor for as few as one head of feeder cattle or fed cattle. Additionally, LRP is fairly easy to understand because it is insurance and most producers are familiar with paying insurance premiums as well as being familiar with how and why payments are received. LRP is an underutilized

tool in the cattle business. Producers should be considering its use with market volatility on the rise, even in a time of high cattle prices.