

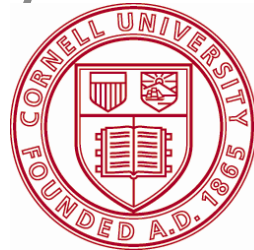
Ready to Get Off the Roller Coaster? “Tools” for Managing Price Risk



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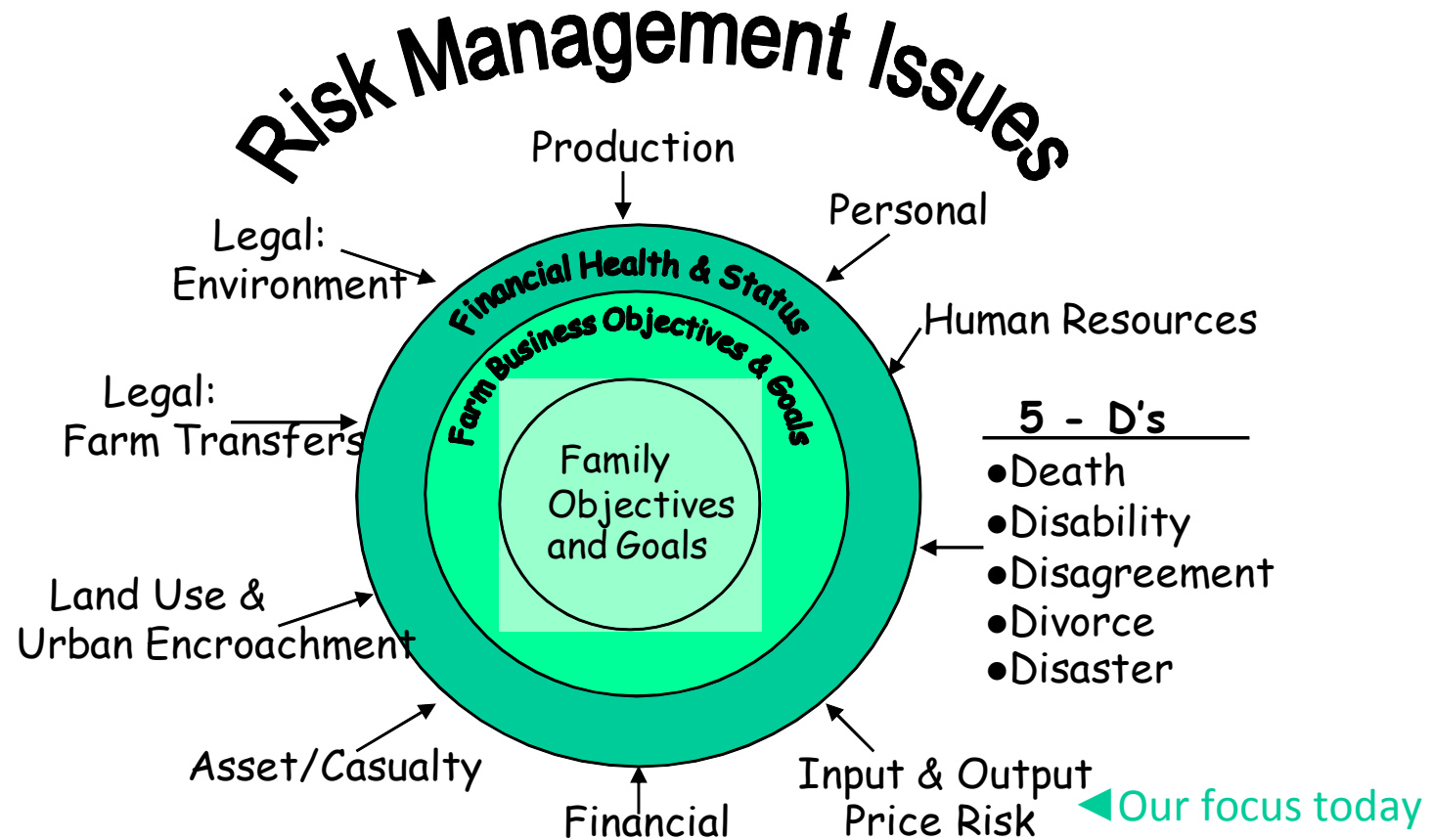
New York State Department of Agriculture & Markets



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PROTECTING THE CORE OBJECTIVES



Slide: courtesy of John Conway

Input and Output Price Risk

Profit =

(Quantity of output x price)

– (Quantity of input<s> x price<s>)

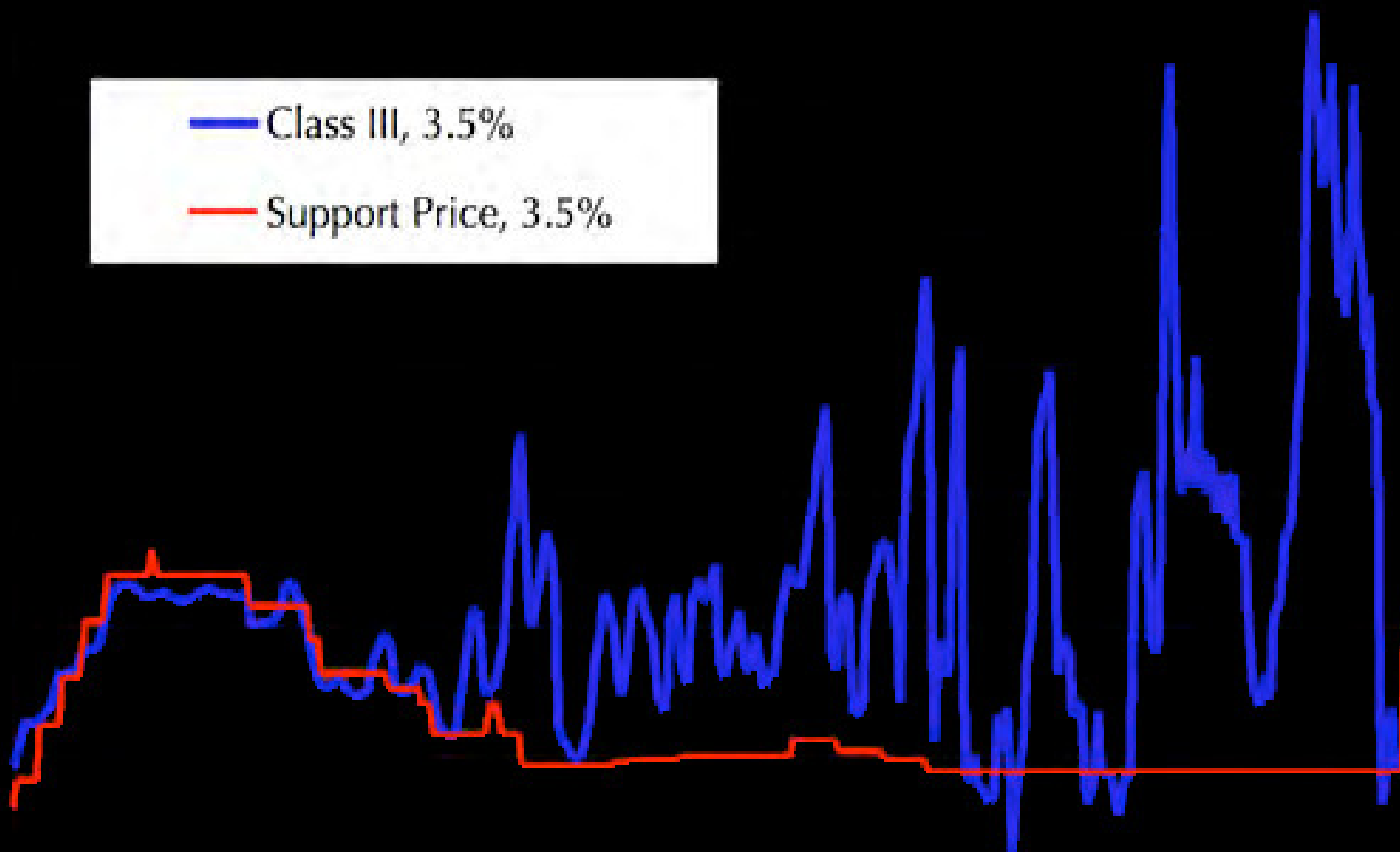
Profit

- **the margin** between value of production and cost of production.
- affected by prices both on the input and output sides

To protect profit – need to assure prices of both products and inputs

— Class III, 3.5%

— Support Price, 3.5%



Tools for Price Protection

- Forward contract
- Group purchases
- Hedging
 - Futures
 - Options
- Cooperative/Handler Risk Management Products
- Some crop insurance products
 - Crop Revenue Coverage
 - Livestock Gross Margin
 - Adjusted Gross Revenue

Forward Contract

- Cash market agreement in which a seller agrees to deliver a specific cash commodity to a buyer sometime in the future at a predetermined price. Also referred to as a long-term purchase agreement

Group Purchases

- Producers working together to collectively negotiate a price for inputs

Hedging

- Buying or selling a futures or options contract for protection against the possibility of a price change in the physical commodity or ingredient one is planning on buying or selling.
- Resources for understanding commodity futures and options:
 - <http://agmarketing.extension.psu.edu/Commodity.html>
 - Winning the Game Workshop – March 1- Batavia contact Cathy Wallace to register.

Futures Contract

- A contract traded on a futures exchange for the delivery of a specified commodity at a future time. The contract specifies the item to be delivered and the terms and conditions of delivery.

Options Contract

- Within the futures industry, this is a contract that conveys the right, but not the obligation, to buy or sell a futures contract at a certain price for a limited time.
 - **Put option**—gives the option buyer the right to sell (go “short”) the underlying futures contract at the strike price on or before the expiration date of the option.
 - **Call option**—gives the option buyer the right to buy (go “long”) the underlying futures contract at the strike price on or before the expiration date of the option

Cooperative/Handler Risk Management Products

- Risk management tools offered by cooperatives, handlers or dealers that utilize futures and options contracts to lay off the risk of customers without the customer needing to engage directly in the futures or options markets.
- Producers pay a fee for the protection to the originator of the contract.

Crop Insurance products

- Crop Revenue Coverage
- Adjusted Gross Revenue (and Lite)
- Livestock Gross Margin – Dairy

Crop Revenue Coverage

- Provides **protection against a decline in market prices as well as a shortfall in production**. The **guarantee is in dollars** and a loss situation occurs when the dollar value of your production falls below your dollar guarantee.
- Can choose among levels of coverage ranging from 50 to 85 percent of crop revenue.

Adjusted Gross Revenue

- Protection against low revenue from natural causes and market fluctuations
- Covers income from agricultural commodities, as well as income from animals, animal products, and aquaculture species reared in a controlled environment
- Uses Schedule F income as a base
- Provides insurance for multiple commodities in one product

Livestock Gross Margin - Dairy

- New risk management tool for dairy producers
- Newly approved, federally reinsured, dairy insurance program through the USDA crop insurance program
- Provides protection against unexpected declines in gross margins (market value of milk minus feed costs) on target quantity of marketed milk, **WITHOUT Forfeiting Increased Profits.**
- Enrollment periods occur the last business Friday of each month and end at 9 P.M. the next day

Prices Used - GM

“Milk Income Minus Feed Cost”

Milk prices = **Class 3, Chicago Board of Trade**

Feed prices = **Chicago Board of Trade**

(All feed is converted to Shelled corn
(energy) & Soymeal (protein) equivalents)

Or default costs

HOW It Works:

- 1. Expected GM is determined for a future time period**
- 2. Expected GM is compared to actual GM for selected time period**
- 3. Claim is paid when actual is less than expected GM**

Time Periods

- Twelve, twelve month insurance periods each calendar year
- Any or all expected milk of the last 10 months of each insurance period can be insured (insured months within an insurance period must be consecutive)
- Maximum milk enrollment – 240,000 Cwts. annually

Expected Gross Margin
Oct. 08 GM Purchase for Sept. 09

“Milk Income Over Feed Cost - ”

Milk = 1 cwt. X \$ 15.36 ----- = \$ 15.36

Feed - USDA/RMA Ratios or Actual Producer Records

Corn .014T.(1/2 Bu.) X \$ 4.48 bu.- = \$ 2.24

Soymeal .002T.(4 lbs) X \$ 285.47 T.= \$ 0.57

Total Feed Cost----- \$ 2.81

Expected Gross Margin(milk – feed)----- \$ 12.55

(All feed is converted to Shelled corn (energy) & Soymeal (protein)
equivalents unless USDA/RMA ratios are used)

Actual Gross Margin

Oct. 08 GM Purchase for Sept. 09

“Milk Income Over Feed Cost - ”

Milk = 1 cwt. X \$ 12.08----- = \$ 12.08

Feed - USDA/RMA Ratios or Actual Producer Records

Corn .014T.(1/2 Bu.) X \$ 3.10 bu. = \$ 1.55

Soymeal .002T.(4 lbs) X \$ 245.27 ton = \$ 0.69

Total Feed Cost----- \$ 2.24

Actual Gross Margin(milk – feed) -----\$ 9.84

Must use same methodology for feed cost calculation (default or actual) as was used to calculate the Expected Gross Margin .

Insurance Loss Payment (Indemnity)

Oct. 08 GM Purchase for Aug. 09

“Milk Income Over Feed Cost - ”

Expected Gross Margin --- \$ 12.55

Actual Gross Margin ----- \$ 9.84

Ins. Payment (Indemnity) \$ 2.71

@ 0 deductible

Why Manage Price Risk?

- Price fluctuation cycles are expected to be steeper and shorter for the foreseeable future
- One strategy is to self-insure by riding the price cycle
- For many farms the financial risk is too great during a down cycle – these farms must insure
- There are many tools available to manage risk. I challenge you to learn about the tools and utilize those that will benefit your farm business.