



www.agmanager.info
abarnaby@agecon.ksu.edu
(785) 532.1515 (phone)
(785) 532.6925 (fax)

RISK ASSESSED MARKETING

G.A. "Art" Barnaby Jr.

Copyright 2004. All rights reserved. Contact Art to be added to e-mail list

Disclaimer: This web page is designed to aid farmers with their marketing and risk management decisions. The risk of loss in trading futures, options, forward contracts, and hedge-to-arrive can be substantial and no warranty is given or implied by the author or any other party. Each farmer must consider whether such marketing strategies are appropriate for his or her situation. This web page does not represent the views of Kansas State University.

Why Would Any One Pay Extra for HPO Added on to RA? ¹

Art,

Why wouldn't I want to buy Revenue Assurance (RA) without the Harvest Price Option (HPO) for the floor protection knowing that I am leaving the upside on the table when I can save \$3 or more an acre? It would seem to be that this would be a much better vehicle than MPCI. I am getting mixed reviews when I mention it but for some that have bought low levels of coverage in the past just for the bottom side protection are thinking that it is a great alternative to better use the dollars that they will spend.

Crop Insurance Agent

Dear Agent

The ending stocks of USA corn and world wide stocks have been shrinking the past 4 years. If the new crop yields are below average that will tighten supplies even more. USA soybean supply has also tightened up and there is continued concern about rust in Brazil. It is also raining and causing harvesting problems in Brazil. The news is very bullish and that always makes me nervous, but do growers really want to pass on these prices to save some premium dollars?

There is a 50% chance of higher prices based on today's market assuming the market is efficient. If buyers and sellers of grain believed that prices will be lower then there would be more sellers and the price will fall. If the market is controlled by speculators (I heard this one in Brazil) then

¹Prepared by G. A. (Art) Barnaby, Jr., Professor, Department of Agricultural Economics, K-State Research and Extension, Kansas State University, Manhattan, KS 66506, February 27, 2004, Phone 785-532-1515, e-mail – abarnaby@agecon.ksu.edu.

growers should sell their crop and take the speculators' money because they have no room in their Chicago apartment to store grain! They will have to get out of the market by selling at some point in the year.

I always ask farmers who are not going to buy the harvest price option, why not? They often tell me they expect prices to be lower at harvest. If they really believe their own price forecast then they should sell everything because it will only be cheaper at harvest (some farmers I talk to are making preharvest sales).

The "floor" in RA is based on soybean prices that are 78 cents out of the money and the insurance deductible. If there is no chance of prices increasing why not sell the whole APH or buy puts on the whole APH? RA insured soybean growers who select 75% coverage and produce an average yield (the most likely outcome) would need prices to fall by more than 32% to trigger RA payments because the RA price election is out of the money. **Assuming 75% RA coverage soybean prices would need to fall from \$7.50 to \$5.04 to trigger an RA payment with an average yield!**² Because these are futures prices that would mean cash prices would be below loan rates at harvest time! The numbers are smaller but similar for feedgrains and spring wheat. Why would anyone give up these prices to save \$3 on insurance?

Many farmers expect higher prices if they suffer a yield loss and the HPO would then payoff. Because of the government program the worst outcome is low yields and higher prices. Because this is a grower's greatest risk it would make more sense to buy HPO and drop the revenue coverage (RMA does not sell RA-HPO without the revenue coverage). If growers forward sell then the loss of the yield combined with higher prices puts them in a worse financial position and they will need the extra cash from HPO to cover cancellation penalties, loss of option premiums, margin loses, seed, fertilizer, chemicals and other production expenses.

When I ask growers if prices will be lower at harvest they almost always say yes. Then I ask with that forecast why don't you sell the whole crop and always I get two responses. 1. I might not produce the crop and 2. the price might go higher! Both are insurable risk. The RA-HPO will replace lost bushels at harvest time prices and one can cover the sales with calls in case prices go higher. Many growers don't want to waste their money on premiums so they don't make the sale because they are uncomfortable with these two risk and they absorb the price drop. At least the lower prices will reduce their income taxes!

I would agree that if one were going to drop their HPO it makes more sense with high prices than low prices but the catastrophic risk is higher prices combined with no yield. Ask me in

²For example, a grower with a soybean APH of 50 bushels and he/she purchases 75% RA coverage would have a minimum revenue guarantee equal to 50 bushels times 75% coverage times \$6.72 for a total of \$250. Then take the \$250 and divide by an average yield of 50 and the result is \$5.07 per bushel. November soybean futures would have to fall below \$5.07 before this example grower would receive any RA indemnity payment with an average yield. Growers in most markets will generate revenue below their "minimum" revenue guarantee because their cash price for an average crop will be less than the futures price.

November and I will give you the correct answer. If there is no yield damage then it is very unlikely that grower will collect from RA and they should have bought no insurance.

In some cases growers will find the RA rate cheaper than MPCI. The premiums per acre may be higher but that is caused by the higher RA price election and the RA has more dollars of coverage per acre. So even though growers “know” prices will be lower by harvest but they are not going to sell before harvest, then I would agree this group should buy RA over MPCI.

Those growers that may want to preharvest sell but want nothing to do with a commodity broker then their local elevator can probably help them. Many elevators offer open basis contracts so the grower can lock in the basis later (one would expect the basis to be weak in a forward contract bid). Growers with little experience preharvest selling but decide to sell some of their crop to their elevator before harvest should buy RA-HPO because of the unlimited liability and they will not use options. Also growers would not want to aggressively sell before they get their crop planted because the coverage for prevented planting is much lower.

I would suggest growers need to put their market plan on paper. If they are not unwilling to preharvest sell, then that fact should be clearly stated and list their post harvest price objectives. However, if they are willing to preharvest sell then they need to write down their preharvest price objectives. If growers don't create a written marketing plan (it will fit on the back of envelope) then they won't sell any bushels when (if) the market reaches their price objective. Without a written plan grower are always holding for 25 cents more only to store the crop and sell it for the loan rate. Growers also need to write down how they are going to cover yield loses. Growers who have forward priced their crop and it fails are in the same financial position as a Chicago speculative trader; neither have bushels to offset their futures and options.

The only thing I know for sure is that growers will have to sell the crop sometime. They can not store it for ever, although a few growers have tried to store that long. Doing nothing does not eliminate the risk; it only means the grower is turning down today's offer in the hope of a better offer tomorrow. If a grower doesn't want risk then don't plant the crop! Once growers have planted the crop they have yield and price risk unless they are willing to pay premiums to pass some of the risk.

ART