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Email Responses on Harvest Price Option¹

Dear Recipient

Below are some of the emails responses to my AgManger posting on RA versus CRC, with the names and locations removed to protect the innocent. I then posted my response.

ART

Art,

The additional cost for RA (HP) vs CRC can be very different depending on many factors -

- 1. State and county*
- 2. unit type*
- 3. Crop*
- 4. regular or high risk ground*

Premiums are "all over the board". If I really found the right area, I could show maybe a \$20+ difference on high risk ground 85% corn. I can also find situations where RA (HP) is cheaper than CRC (some places on beans).

¹Prepared by G. A. (Art) Barnaby, Jr., Professor, Department of Agricultural Economics, K-State Research and Extension, Kansas State University, Manhattan, KS 66506, March 14, 2007, Phone 785-532-1515, e-mail – abarnaby@agecon.ksu.edu.

I have some people who have cheaper premiums with RA than CRC. Some enterprise units are cheaper with RA. If you are at a 70 or 75% level, the premium difference can be pennies...

I have been recommending RA if the premium difference is \$1 or \$2 dollars (it can be at the lower levels) and CRC if the premium difference is \$6, \$8 or \$15.

GRIP also got the 25 volatility and premiums came in 2 to 4 dollars cheaper - pretty good buy this year in my opinion.

Any other thoughts?

Crop insurance expert

More from another crop insurance expert.

Art:

Our customers are primarily in Nebraska. There are huge difference between counties and crops for CRC-RA.

In one county, the difference is around \$9/acre on 85% level with RA higher. For the 65% level, RA is \$.60/acre lower. In one of my other counties, the CRC at 85% is \$4.50 less, but \$.30 more at 65%. Another county has RA lower than CRC at all levels.

For soybeans, RA is almost all lower than CRC. For one County at 85%, RA is \$10.00 lower.

What am I saying about this? It depends on the cost difference and the customer. Other agents have stated that RA is always better. I prefer to explain how the coverage works and let the customer decide about the premium. Exceeding the \$5.56 cap will only pay if there is production loss of APH times level of coverage.

However, RMA needs to offer just one revenue product rather than CRC and RA. I have liked your approach on this issue. RMA works to make the consolidation to one revenue product very difficult.

Crop insurance expert

More from another crop insurance expert.

Art:

Not quite so fast. The premium difference between RA and CRC in Illinois is about \$15 per acre with the price advantage to CRC. Now I take the \$15 and go the market and cover that \$1.50. Also keep in mind that CRC settles with October average and RA with November average. There is a perceived price difference in those. Also using options the producer gets the price, not the insurance company. Take CRC and work the market.

Crop insurance expert

More from another crop insurance expert.

Art,

What about a producer who is buying GRIP HRO? If the price maxes out on GRIP at \$5.56 and continues to go to \$7 for RA, and the county experiences the same loss as the producer in yield, then GRIP HRO is actually a better option for him, even though there is a difference in price of \$1.44/bushel. Does this make sense for a producer who always has a better yield than the county?

Crop insurance expert

More from another crop insurance expert.

Art,

However, if you're comparing RA-HPO and GRIP-HPO the GRIP wins hands down. Because GRIP pays \$1.60 to every \$1 paid by RA, the corn price would have to be above \$11.50/bushel for the unlimited price factor of RA to outstrip GRIP payments.

Crop insurance expert

More from another crop insurance expert.

Art,

We were aware of that tool/option (\$5.50 December Call). However, at this time most clients don't want to spend more money and will wait until they see a price trending up before getting worried.

Crop insurance expert

More from concerned son.

Art,

My Dad farms in a county where yields are usually good, on the average in that area. He is considering dropping his crop insurance for this year.

My concern is the possibility of him losing a year's production data from his average. What exactly are his options as far as maintaining his production average, and do to the cost differential on this year's premium versus last year's, would RA without HPO be a viable alternative?

Thanks for the newsletters and updates!

Concerned son

More from a market expert.

Art

Corn prices will not go above \$5 because ethanol plants will shut down.

Marketing expert

Art's Response.

A note of thanks to all who sent in comments.

RA versus CRC. I did not expect this difference in premium between CRC and RA-HPO. The only difference in RA-HPO versus CRC is RA-HPO has the additional coverage of a \$5.56 yield adjusted Asian call. A yield adjusted Asian call with a \$5.56 strike is worth only a few pennies not dollars. However, CBOT \$5.50 calls are settled on a spot price, contain the right to exercise the option, and they are not adjusted for changes in yield, therefore CBOT calls have a lot more value. As a result it should be less expensive to get the upside coverage in RA than buying a \$5.50 call. However, purchase of a \$5.50 corn call will turn CRC into unlimited coverage similar to RA-HPO. This is the only alternative on grain sorghum in Kansas because there is no RA offer. The \$5.50 call may not be trading, so one would have to put in a bid to see if one gets a fill. A market order will get a fill (rather than a limit order).

If a grower's yield exceeds the guaranteed bushels in either contract, the Asian calls that are built in to CRC and RA-HPO expires worthless even if the market increase by \$2. But if farmers knew they were not going to have losses, then there would be no reason to buy crop insurance.

Growers that do not want to pay the premium for RA-HPO or purchase of the \$5.50 December call are self insured for prices above \$5.56. I would not recommend purchase of RA or GRIP without the HPO or HRO. Higher prices will reduce indemnity payments and under some condition could be less than the APH (MPIC) indemnity payment.

Last year RA-HPO on corn paid less than CRC because RA-HPO is based on the November average closing prices verses October average closing prices of December CBOT corn. In an efficient market this will average out over the long run and the revenue products are rated based on this assumption of an efficient market.

GRIP Coverage. GRIP depends on the RMA expected county yield. In Kansas, we have many cases where the RMA expected county yield is 5-20% lower than the 20 or 30 year average county yield. This suggests negative technology and that makes no sense. Unless the RMA expected county yield is higher than the 20 year average county yield it is not a good buy. To put GRIP on my list for consideration, I want to be in a county where the RMA expected county yield exceeds the 20 year average corn yield by at least 20%, 10% for soybeans, 7% for milo and 5% for wheat. Also in some counties yields are not separated by irrigated versus dryland corn yields and in some counties GRIP is based on harvested acres rather than planted acres. For many Corn Belt counties, GRIP is a good offer especially when compared to the RA/CRC rates but don't assume the rest of the country looks like the Corn Belt.

Dropping coverage because of higher premium makes no sense. Before one drops ones coverage, I would consider GRIP or GRP. With the subsidy level there are very few farmers that will not come out ahead. So if one really believes that one will not suffer a crop loss then by purchasing GRIP/GRP the grower would have a payment, if county yield is lower, and a crop too. I am not sure that is true, but otherwise why would farmers drop their coverage?

GRIP is a put option on expected county revenue and GRP is put option on expected county yield and both have a yield basis risk. My understanding is that agents have been able to maintain APH records if farmers shift to GRIP/GRP.

If the reason your Dad is dropping his coverage is because the premium is higher, then that makes even less sense. Assuming he thinks there is some chance of loss then he is cutting the coverage on an asset that is worth double the value of a year ago. I would at least want the \$100 CAT contract to maintain my place in line for any disaster aid funding.

Higher price risk. The story is the same. If farmers don't want to add the call to their CRC or GRIP, then they are self insuring the risk above \$5.56. Because there is no carryover, any production problem will likely send the market higher. If there is real damage, such as 130 bushel national yield (similar to 2002) rather than a 154 bushel trend yield, then the market needs to increase to ration out the available supply. If we were to get a 1988 drought, then all bets are off.

One does not start or shut down an ethanol plant without cost. In addition, the DDGs are often leaving the plant straight to feed bunks on site. One does not easily change feeding rations on cattle. Therefore, it is possible that plants will operate in the short run with a loss. More likely higher corn prices would shut off the building of new plants. However, shutting down plants will also depend on the price of ethanol and gasoline. Below is a figure and comments by Kastens and Dhuyvetter on the tradeoff between gasoline prices, mandates, ethanol subsidies, and corn prices.

Art:

Mandates are proxied by ignoring the difference in energy content of ethanol and gasoline. Since, ethanol's generally been trading about \$0.50/gal above gasoline, this indicates a) capture

of the \$0.51/gal subsidy and b) folks are still ignoring BTU differences (i.e., our mandate proxy). So, it is the red line that is most appropriate for today, the lavender line if ethanol politics suddenly disappeared (see figure below).

TKastens

If there is no corn crop damage in the Corn Belt, then I would expect prices to drift lower, but I do not expect the bottom to fall out of the market. If there is no crop loss then with the benefit of hindsight, farmers didn't need to buy crop insurance but farmers don't know the outcome when they sign up for crop insurance.

We would need two bumper crops to drive prices to there former levels because I would expect farmers to hold on to corn with the expectation that demand would catch-up with supply. However, in the future we could see a change in public policy on ethanol mandates and subsidies. It is also possible the current higher prices will encourage expansion of the ethanol and/or corn production in the rest of the world.

An email from a happy camper.

Art,

I love the way you think!

Not sure if I ever shared this with you or not, but in the early 90's, Dr. Ed Rister at Texas A&M turned me on to your initial studies of MPCCI coupled with Put Options as a risk management tactic for producers. That nearly took me back to the farm in Beloit. I was intensely intrigued with your work and then more so when CRC came about and so on. Since that initial introduction to your work, I don't think I've meaningfully disagreed with your risk management approaches in all the years since. Kind of scary...!

Hope all is well with you. Keep up the good work!

Grain Merchandiser

I don't get many of these emails, so what can say but thanks!

ART

