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Falling Short on Contracted Insurance Bushels

Many Iowa farmers combine pre-harvest crop marketing strategies of contracted corn and soybeans committed to delivery with revenue protection crop insurance coverage. In 2012 it is estimated that 90 percent of all insured acres of corn and soybeans statewide are covered by Revenue Protection insurance policies.

Drought damage is an insurable loss under these Revenue Protection policies. Should a yield loss occur in 2012, it will be paid at a rate equal to the average Chicago Mercantile Exchange (CME) futures price during the month of October, if this average price exceeds the February average price of $5.68 per bushel for corn (December contract) or $12.55 per bushel for soybeans (November contract). The loss is equal to the crop insurance approved yield (actual production history or APH) times the level of guarantee purchased, minus the actual yield.

Insurance Unit

Remember, should a loss occur the indemnity payment on a farm-level product, the insurance will be settled based on actual harvested production over the entire insurance unit. Many farmers elected enterprise units rather than optional unit coverage in 2012 to receive a lower premium. This means that all production of that insured crop for that farmer will be combined with production from their other farms in the county to determine the potential indemnity payment.

Even fields that are declared a complete loss will be combined with any harvested acres in the same insurance unit to calculate the final yield. For example, if an insured unit of 100 corn acres had 30 acres on a separate farm that were declared a complete loss, and the remaining acres averaged 90 bushels per acre, the average yield for the unit would be (70 acres x 90 bu. / 100 acres) = 63 bushels per acre.

Indemnity Payments

The loss is equal to the crop insurance approved yield times the level of guarantee purchased, minus the actual yield. So, if the approved yield on the unit was 150 bushels per acre, and an 80 percent guarantee was purchased, the guaranteed yield would be 120 bushel per acre, and the loss would be (120 bu. – 63 bu.) = 57 bushels per acre. Assuming a Revenue Protection (RP) policy and the December corn futures price averages $7.50 during the month of October, the indemnity payment would be (57 bu. x $7.50) = $427.50 per acre.

Shortfall on Contracted Bushels

The concern is that the drought will be so severe in certain parts of Iowa that some farmers might have contracted more bushels for delivery than they will harvest. Using this example, let's say a farmer using Revenue Protection coverage decided to contract for delivery the entire 12,000 bushels (100 acres times 120 bushel per acre guarantee), but only 6,300 bushels were produced.

Such a strategy for contracting 100 percent of the guaranteed bushels for delivery is rare, as there is always the risk of a positive harvest basis (since the indemnity payment uses the higher of the February or October average of the December corn futures price).

So the farmer is 5,700 bushels short of fulfilling their contract. The average forward contract cash price was $5.50 per bushel with delivery to the local elevator in October. The December corn futures price was $6 per bushel the day the contract was initiated. Let's say the December corn contract price averages $7.50 per bushel in October. Remember, in this scenario an indemnity payment of $427.50 per acre is anticipated. This means that the farmer will be receiving an indemnity payment reflecting $7.50 per bushel for any bushels below their 120 bushel per acre guarantee.

However, the indemnity payment won't likely be received until after the crop is harvested and the usual evidence of actual production is collected and submitted to the crop insurance agent. With the backlog of claims, the farmer should not expect to receive their indemnity payment until later in November or perhaps December.

Work with your Grain Merchandiser
Once the farmer realizes that all the bushels contracted cannot be deliver, he should work with the grain merchandiser on a strategy to make up the shortfall in bushels or pay the replacement value of those bushels. The solution will vary by grain merchandiser and whether a cash forward or hedge-to-arrive (HTA) contract was used. Generally, the farmer would have the option of buying out the missing bushels at the current market price.

Given adequate notice, the merchandiser will attempt to replace the contracted bushels by purchasing bushels elsewhere. However, the farmer that contracted those bushels should still expect to pay the replacement value for those bushels. That is the difference between the CME futures price at the time the contract was initiated subtracted from the CME futures price at the time of settlement. In addition, a small cancellation fee will likely be charged. So, if the CME price at the time of the contract for corn was initiated was $6 per bushel and the futures price at settlement is $7.50 per bushel, the difference is $1.50 per bushel + .10 service fee = $1.60 bushel replacement value.

Since the harvest price for revenue protection losses will be known approximately Oct. 31, settlement for the replacement value of undelivered bushels should be negotiated at that time regardless if bushels were to be delivered at a later date. Since the farmer will likely have other bushels to be delivered to this grain facility, the merchandiser will simply subtract the replacement value of $1.60 per bushel from the total sales receipts.

Delaying settlement beyond early November leaves the farmer in a speculative position for those bushels that they were unable to deliver. Should the futures price move even higher beyond this time frame, the replacement cost would increase. Regardless, the need to work with your grain merchandiser is critical should you fall short on contracted bushels.