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Ag Decision Maker
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A Business Newsletter for Agriculture

Vol. 6, No. 11 www.extension.iastate.edu/agdm September 2003

Price insurance for cattle producers

by John Lawrence, Director of the Iowa Beef Center and extension economist, 515-294-6290, jdlaw@iastate.edu

The Federal Crop Insurance Corporation's (FCIC) approved expansion of the Livestock Risk Protection (LRP) insurance policy for Fed Cattle and Feeder Cattle beginning June 2003. The LRP-Fed Cattle program is available in all counties in Illinois, Iowa and Nebraska. The LRP Feeder Cattle program is available in all counties in Colorado, Iowa, Kansas, Nebraska, Nevada, Oklahoma, South Dakota, Texas, Utah and Wyoming. Producers interested in LRP should contact a crop insurance agent and complete an application, which will be submitted through the approved insurance provider to FCIC.

What cattle are eligible?

Fed cattle are those that will be marketed for slaughter at the end of the insurance period and include cattle expected to grade select or better with a yield grade of 1-3. The insurance periods available range in approximately 30-day increments from 13 to 52 weeks. The maximum number of fed cattle that may be insured by any one entity in any one crop-year is 4,000 head.

Feeder cattle are those that will weigh 650-900 pounds and will be ready to be put into a feedlot for fattening at the end of the insurance period. Feeder cattle that are predominantly dairy or Brahma breeds are

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Handbook Updates

For those of you subscribing to the *Ag Decision Maker Handbook*, the following updates are included.

2002 Costs and Returns – C1-11 (2 pages)

2002 Costs and Returns by Economic Area – C1-12 (2 pages)

2002 Costs and Returns by Specialized Farms — C1-13 (2 pages)

2002 Crop and Livestock Costs – C1-14 (2 pages)

1993 – 2002 Trends in Efficiency Factors – C1-15 (2 pages)

1993 – 2002 Trends in Income and Returns – C1-16 (2 pages)

Please add these files to your handbook and remove the out-of-date material.

Inside . . .

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IOWA STATE UNIVERSITY
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not eligible for insurance. The insurance periods available range in approximately 30-day increments from 21 to 52 weeks. The maximum number of feeder cattle that may be insured by any one entity in any one crop-year is 2,000 head.

Producers must be able to verify ownership (at least the part insured) of the livestock insured to USDA employees upon request. Producers cannot take an offsetting position in the commodity futures market and there may be other limitations.

How to apply

To obtain coverage under LRP, producers must submit an application. Once an application is approved, the company will assign a policy number and the producer may activate coverage at any time by applying for a Specific Coverage Endorsement (SCE). More than one SCE may be purchased each year and different insurance periods and coverage prices may be elected. The RMA Web site that reports LRP premiums is: http://www3.rma.usda.gov/apps/livestock_reports/lrp_select_date.cfm

Contract details

Feeder Cattle Policy:

→ Settlement price is the CME Cash-Settlement Commodity Index price

→ Weight at end of the policy period in the 650-900 pound range.

→ Steers except for cattle identified as predominately dairy or Brahma breed.

→ Maximum head, 1,000 per endorsement and 2,000 head per year.

Fed Cattle Policy:

→ Settlement price is the USDA 5-Area Weekly Weighted Average Direct Slaughter Cattle price, Live Basis 35-65 percent Choice category.

→ Weight at end of the policy period in the 1,000-1,400 pound range.

→ Expected to grade Select or better and Yield grade 1-3.

→ Maximum head, 2,000 per endorsement and 4000 head per year.

The premium is determined by an equation incorporating the number of head, target weight, coverage price and level, premium rate, and the subsidy level. The example is for fed cattle, but the process is similar for feeder cattle (see box below).

The indemnity is based on target weight and head and the difference between the coverage price and the actual price at the end of the policy. If in the example above the USDA 5-Area Weekly Weighted Average Direct Slaughter Cattle price, Live Basis 35–65 percent Choice category price is $60, the difference is $5/cwt (coverage price – actual price). The indemnity is $5 × 550 cwt = $2,750 multiplied by the level of coverage which in this case is 100 percent. If 5 Area price was higher than the coverage price the indemnity would be $0.

Observations

It is expected that the cattle LRP will function the same as the swine LRP. One key difference between LRP and options on futures contracts is that the length of the coverage period and therefore the selling date is specified at the beginning of the coverage. For example, a producer may purchase coverage for 24 weeks to cover a feeding period. The policy will be settled 24 weeks from the date it was implemented regardless of whether the cattle are ready for market or not. The options have more flexibility

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Premium per policy =	Example
Number of head x target weight	50 × 11 cwt = 550 cwt
x coverage price (selected by producer)	550 × $65 = $35,750
x insured value (coverage, i.e., 100%)	$35,750 × 100% = $35,750
× premium rate (company website)	$35,750 × .013990 = $500 premium
× 1 – subsidy level (13%)	(1-.13) × $500 = $435 producer premium

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on when they are resold or exercised up to their expiration date.

Because both policies settle against the target number and weight, there is no production risk protection. The Feeder Cattle LRP settles against the Chicago Mercantile Exchange (CME) index price and will still have basis risk. ***The Fed Cattle LRP settles against the 5 area price and will provide some degree of basis price protection.*** If a producer sells at the end of the policy, the basis risk would be the amount of difference between his/her actual price compared to the 5 area price. Secondly, basis risk may result due to weather risk if the cattle are delayed or marketed earlier than the policy end date that was picked at the beginning. Finally, many Iowa producers would have cattle that grade better than 35-65 percent Choice and may have a positive basis compared to the target price.

How does LRP compare to Options?

Both put options and LRP provide price protection at prices below the current futures market price, but allow the producer to take advantage of higher prices if they occur.

Tables 1 and 2 show the options and LRP premiums and expected floor price for a range of protection levels based on September 15 quotes. For February marketings (Table 1) the LRP coverage level is very close to the expected floor price with options and at lower premiums. The LRP premiums are subsidized 13 percent which may explain part of the difference. In the April marketings (Table 2) the LRP had lower coverage than options. Premiums were lower, but so is the coverage. For about the same premium ($1.70 v. $1.93) options will buy a $2.65/cwt higher floor ($72.20 floor with a $72 put compared to a $69.55 floor with the LRP). Obviously, this example is for one day and the relationships may change based over time, with time to maturity, and how closely they match a particular marketing date.

Table 1. February Marketings Costs and Expected Floor Price for Options and Livestock Revenue Protection ($/cwt)

Strike Price	Option Premium	Expected Floor	LRP Premium	Coverage Level
80	3.50	74.40	2.39	74.21
78	3.03	72.87	1.73	72.77
76	2.20	71.70	1.32	71.13

Table 2. April Marketings Costs and Expected Floor Price for Options and Livestock Revenue Protection ($/cwt)

Strike Price	Option Premium	Expected Floor	LRP Premium	Coverage Level
76	3.15	74.75	1.93	69.55
74	2.25	73.65	1.43	67.98
72	1.70	72.20	1.07	66.30

To repeal or not repeal the rule against perpetuities *

by Neil E. Harl, Charles F Curtiss Distinguished Professor in Agriculture and professor of economics, 515-294-6354, harl@iastate.edu

The new century is rapidly coming to be dominated by two developments—terror ism and the realization that the universal dismantling of important institutional structures can have devastating long-term consequences. The latter point has been dramatically made by the Enron debacle, the Andersen accounting fiasco, the Global Crossing bankruptcy, the Tyco problems and the general distrust at all levels of aggressive business strategies and tax shelter schemes. The message in all of this is critical: we should be very, very careful in dismantling important institutional constructs in the euphoria of the moment.

That's what makes the argument that states should repeal the Rule Against Perpetuities appear out of touch with reality. Those urging repeal have dusted off the thread-bare and largely discredited arguments that the venerable Rule Against Perpetuities is no longer needed and should be jettisoned.

What the argument's all about?

The basic issue is how long property can be tied up in trust. The Rule has come to stand for the proposition that interests in trust must vest, if at all, not later than 21 years after the last to die of a class of lives in being at the creation of the interest in trust. As a practical matter, that has tended to impose a maximum term of 100 to 125 years for property to be held in trust. Complete repeal of the Rule removes the limits on how long property can be held in trust. With repeal, assets could be tied up 500 years, 1,000 years, indeed forever. Professor Lewis Simes, a well-known legal scholar of his era articulated two reasons for the Rule in contemporary society—

"First, the Rule Against Perpetuities strikes a fair balance between the desires of members of the present generation, and similar desires of succeeding generations, to do what they wish with the property which they enjoy... In a sense this is a policy of alienability, but it is not alienability for productivity. It is alienability to enable people to do what they please at death with the property which they enjoy in life. As Kohler says in his treatise on the Philosophy of Law

> 'The far-reaching hand of a testator who would force his will in distant future generations destroys the liberty of other individuals, and presumes to make rules for distant times.'"
> "But in my opinion, a second and even more important reason for the Rule is this. It is socially desirable that the wealth of the world be controlled by its living members and not by the dead. I know of no better statement of that doctrine than the language of Thomas Jefferson, contained in a letter to James Madison, when he said: 'The earth belongs always to the living generation. They may manage it then, and what proceeds from it, as they please during their usufruct.'"

To the above two reasons, a third can be added. It is an article of faith that economic growth is maximized if resources are subject to the forces and pressures of the market. Prices emanating from free, open and competitive markets are the best way to allocate resources and to distribute income if economic growth is to be maximized. Without question, repeal of the Rule would tend to insulate assets from the market. Over time, this could be a highly significant factor and would almost certainly slow economic growth. With the trust assets shielded from market forces, widespread ownership of assets in such dynasty trusts would almost certainly reduce the rate of economic growth. That could easily amount to 0.2 to 0.3 percent per year—with the damping effect possibly increasing over time.

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For example, assume a couple with two children place $1,000,000 of property in trust in 2003. Further, assume the state in question is one of the dozen or so states that have repealed the Rule. What could be the consequences of setting up the trust to last forever?

- Fast forwarding to 2503, 500 years from now, our two beneficiaries would have increased to 3.4 million (based on projections by the Joint Editorial Board for the Uniform Probate Code) assuming current fertility levels.

  As the Joint Editorial Board for the Uniform Probate Code has stated—

  > "Over time, the administration of such trusts is likely to become unwieldy and very costly.
  >
  > "Government statistics indicate that the average married couple has 2.1 children. Under this assumption, the average settlor will have more than 100 descendants (who are beneficiaries of the trust) 150 years after the trust is created, around 2500 beneficiaries 250 years after the trust is created and 45,000 beneficiaries 350 years after the trust is created. Five hundred years after the trust is created, the number of living beneficiaries could rise to an astounding 3.4 million."

  And that's only 500 years. In 1,000 years, it would clearly be unmanageable.

  As the period of trust life lengthens, with millions of trust beneficiaries, a situation would be created where trust-owned property would be perceived in a manner similar to government-owned property. It would resemble the way beneficiaries view the social security trust fund, for example.

- The trust, perhaps in 2003, would be administered in some place like Sioux Falls, South Dakota. But with the dramatic consolidation in banking and among trust companies, the trust might eventually be managed in Beijing or Jakarta or Hong Kong. Not everyone is comfortable with that.
- As the centuries pass, it would lead to enormous economic power in the hands of banks and trust companies. That is obvious, with beneficiaries limited in terms of their right to participate in management decisions. Remember, trusts aren't like corporations with perpetual life where shareholders have and can (and do) exercise their rights.

  Some argue that much of the family wealth is in 401(k) plans and IRAs and those are already managed by financial institutions. That's correct—but all qualified plans require a minimum distribution beginning after a beneficiary attains age 70½. Therefore, pension and profit-sharing accounts *cannot* be held in economic hostage forever.

  This country was not based on dynasties. Indeed, this country was founded, in part, on the notion of open access to assets, not on the idea that property owners could tie up property forever.

  Part of the drive to repeal the Rule was based on the belief that the generation-skipping transfer tax is less advantageous when the Rule limits the period in which property can be placed in trust to lives in being plus 21 years. The combination of repeal of the generation-skipping transfer tax, repeal of the federal estate tax and repeal of the Rule Against Perpetuities would lead not only to dynasty trusts; it would lead to a separation of the legal ownership from equitable ownership of property to a degree we've never seen in this country.

In conclusion

The Rule Against Perpetuities was developed for good reason; those underpinnings to the Rule haven't changed in the centuries since the Rule was first articulated.

Many opponents of repeal are supportive of efforts to permit the reasonable accomplishment of educational and other objectives of property owners. Indeed, many are willing to lend support to proposals that would assure a trust duration of 150 years. That should be long enough to permit rational planning even with regular increases in life expectancy for at least the next few years.

Ag Decision Maker goes electronic

Like the print version, this decision-oriented agricultural business Internet site is designed for farmers, lenders, farm managers, agriculture instructors and others. It provides up-to-date information from agricultural economics at Iowa State University and other Midwest universities and institutions.

The Internet site is located at http://www.extension.iastate.edu/agdm. The online version offers a number of interactive tools not available in the print publication. To stay current, you can request to be notified each month by email of new information that is being posted on the web site. The Internet version is free. Four types of information are offered on the site:

Newsletter articles

This section is updated monthly and provides analysis and insight into many of the issues facing modern agriculture. Also newsletter articles published during the last three years are available.

Decision files

More than 160 Decision Files provide information and analysis for finding solutions to many of the decisions facing farmers and agribusinesses. Each decision file can be printed or read from your computer screen.

Decision aids

Many of the decision files have decision aids (spreadsheets) for on-line computation. Just enter your figures into the spreadsheet to analyze your individual situation and save the analysis as a file on your computer.

Teaching activities

Many of the decision files have teaching activities for use in high school classrooms. Students can complete the teaching activity from information provided in the decision files and save or print the document and provide it to their instructor. Teachers can access a restricted area of the site to get answer keys.

The monthly print publication will still be available for a fee. Those interested in subscribing to the print publication should contact Trece Lonneman at (641) 923-2856 or via e-mail at trece@iastate.edu.

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture. Stanley R. Johnson, director, Cooperative Extension Service, Iowa State University of Science and Technology, Ames, Iowa.