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CASH SETTLEMENT FOR FEEDER CATTLE

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Summary

The change in the feeder cattle futures contract from physical delivery to cash settlement should not affect a producer's net price for his feeder cattle. For those producers who hedge or use the cash forward contract, the main impact is in the basis. Now, a smaller basis (by about $3) should be used compared to what the producer used prior to cash settlement.

Under the old delivery procedure, once a producer used the futures market as a hedge (sold a futures contract), there were two alternatives--either buy back the contract or delivery. If the contract was not "bot" back (offset), delivery was required. Now, if a contract originally sold is not offset, cash settlement is automatic. No further action is required by the user.

(Key Words: Cash Settlement, Futures, Feeder Cattle.)

Introduction

A major change recently was made by the Chicago Mercantile Exchange in the feeder cattle futures contract. The contract now is under cash settlement, which means that delivery of the physical product (feeder cattle) no longer is possible. That change went into effect with the September, 1986, contract.

The change was made for several reasons. The problems associated with delivery of feeder cattle are eliminated. That includes both the uncertainties and disputes associated with delivery and the costs incurred in the delivery process. Also, the cash settlement process will promote a more stable, predictable cash-futures price relationship. That relationship is called the basis. A more stable and predictable basis makes hedging a more useful tool for the user.

Since only a small percentage of producers use the futures market, it may appear that the change won't affect many feeder cattle producers. However, the change has a greater impact than first might be expected. In addition to the impact on those who use the futures market to hedge, there is an impact on producers who use cash forward contracts and also on those who use the futures market as a forecast of future prices. The purpose of this report is to describe the settlement procedure and its impact on feeder cattle producers.

Definition

Cash settlement is an alternative to the current Feeder Cattle physical delivery settlement procedure. An average of actual cash market prices of feeder

cattle, known as the U.S. Feeder Steer Price or USFSP, is the final settlement price which will be used for feeder cattle. (The USFSP is license from Cattle Marketing Information Services Inc., a nonprofit corporation known as "Cattle-Fax".) That price will be applied on the last day of trading, which is the day of maturity of the contract. All positions remaining open at contract expiration are settled in cash based on this final settlement price rather than by delivering or receiving feeder cattle.

Contract Difference Between Cash Settlement and Physical Delivery

There are three major differences in the contract specifications used to arrive at the cash settlement price from those used for physical delivery. First, the cash settlement price is based on sales of feeder steers weighing between 600 and 800 lb rather than the current 575 to 700-lb weight range. The weight range has been expanded to include a broader group of feeders produced throughout the U.S.

Second, the cash settlement price is based on sales of feeder steers which will grade 60 to 80% Choice when fed to slaughter weight. The physical delivery contract had somewhat tighter grade specifications.

Third, prices of cattle included in the USFSP are from numerous locations in 27 states. When physical delivery was possible, delivery, when made, was to be at one of 11 acceptable delivery sites in only 10 states. Therefore, the cash settlement price is based upon a larger number of locations from a greatly expanded area.

Determination of Final Cash Settlement Price

Cattle-Fax obtains auction prices and direct sale prices for 600 to 800 lb feeder steers selling in 27 states in the four geographic regions of the West, the North, the Central and the Southeast. South Dakota is in the West region along with North Dakota, Montana, Wyoming and Iowa. The North Dakota price and the South Dakota price are combined into a single price for the two states.

There are five basic steps used in calculating the USFSP.

(1) A price is calculated for the auction cattle sold in each state or state group.

(2) A price is calculated for the direct sale cattle in each state or state group.

(3) Prices obtained in (1) and (2) are combined into a single price for each state or state group.

(4) A price is calculated for each of four regions by averaging the prices of all states in each region.

(5) Finally, these four regional prices are combined into a single national price--the USFSP.

The USFSP is published daily. The final cash settlement price is an average of the USFSP for the last day of trading and the preceding six-day period.

The cash-settled contract will terminate trading on the last Thursday of the expiration month. However, if a holiday falls on any of the four weekdays prior to that Thursday, trading will terminate on the first prior Thursday that is not a holiday and is not so preceded by a holiday.

Impact of Changes on Prices

As the maturity date of a contract approaches, and that is around the 20th day of the contract month, cash and futures prices tend to converge. When delivery was possible, the convergence price level was close to the cash price at major acceptable delivery locations. Now, under cash settlement, the convergence price level will be close to the USFSP price. The convergence price level now will be lower than under the system where delivery was possible. There are several reasons for that lower price.

First, since physical delivery is not required, there are no costs of delivery. Prices on the futures market will not be "bid-up" to cover that cost. Second, the wider weight range, especially the inclusion of heavier animals and the looser quality grade specifications, will cause a lower price under the cash settlement system. Third, prices collected from historically low-priced areas will not be adjusted. The result will be a lower price under cash settlement than was true with delivery.

Estimates of the impact of the above changes have been in the range of $2 to $5 per hundredweight. Generally, a price reduction in South Dakota of $3 per hundredweight appears likely.

Impact on Producers

A lower price on the futures market as a result of the above changes does not mean lower feeder cattle prices. The changes, nonetheless, are important.

Certainly, users of the feeder cattle futures market should be aware of the change. First, they no longer will deliver against the contract. Second, they must note that the "new" price quoted on the futures board represents a slightly different entity than was represented under physical delivery and that the price is lower. Again, this does <u>not</u> mean that the producer ends up with a lower price. Rather, it means that a smaller basis should be used. If under physical delivery, the producer subtracted $3 from the futures price to arrive at a localized price, now no deduction is necessary. Or, if under physical delivery a producer was able to add $3 to the futures price (his local market is an extremely good one, his animals are much lighter than those described in the contract or other reasons could enable the producer to do that), now a $6 figure could be added to arrive at a localized price.

The same concept applies to producers who use the cash forward contract. In general, cash forward contracts involve the determination of a price in one time period with product delivery in another. In most cases, the cash forward contract price is based upon the futures market and usually involves a deduction from the futures market quote. With the new method of price determination for the futures contract, a smaller deduction (or a bigger add-on) should be used. For example, a producer decides in March to forward contract his calves for Fall delivery but wants to decide on price now. If the futures market for feeder cattle is used to arrive at that price, a smaller figure (say $3 smaller) should be subtracted from the futures price now than would have been subtracted under the physical delivery system.