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# Economics Newsletter

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## Cash Settlement for Feeder Cattle

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### 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.

Since only a small percent of producers use the futures market, it may appear that the change won't effect 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 newsletter is to describe the settlement procedure and its impact on feeder cattle producers.

### DEFINITION

Cash settlement is an alternative to physical delivery. 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 licensed from Cattle Marketing Information Services Inc., a non-profit corporation known as "Cattle-Fax".) That price will be applied the day of maturity of the contract. All positions remaining open

at contract expiration are settled in cash based on this final settlement price.

### 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 pounds rather than the current 575 to 700 pound weight range.

Second, the cash settlement price is based on sales of feeder steers which will grade 60 to 80 percent 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 pound feeder steers selling in 27 states. 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 state group. The daily USFSP is obtained by averaging process involving prices from all 27 locations.

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.

### IMPACT OF CHANGES ON PRICES

As the maturity date of a contract approaches (around the 20th), 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 settle-

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ment, 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. They no longer will deliver against the contract. Also, 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 not mean that the producer ends up with a lower price. Rather, it means that a smaller basis should be used. For example, if under physical delivery, the producer subtracted \$3 from the futures price to arrive at

a localized price, now no deduction is necessary.

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. Usually a deduction is involved. 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.

### CONCLUSION

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.

One final comment. 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.