

RIGHT RISK NEWS

Risk Strategies for Managing Drought

DATES TO REMEMBER

Acres Reporting
- November 15th

RI-PRF Coverage
December 1st, 2021 for 2022
crop year coverage

For more information see:
<https://www.rma.usda.gov>
<https://www.fsa.usda.gov>

Drought is a major concern for many agricultural producers throughout the country on a regular basis. Establishing a risk strategy for managing drought can pay tremendous dividends during times of uncertainty.

A risk strategy starts with goals and objectives and a plan of action for using available resources to achieve those goals and objectives. Of course, the goals and objectives for a drought management strategy should be consistent with the overall goals and objectives for the operation. For example, a cattle



producer with a management objective to improve herd genetics should include information from their herd improvement plan in a strategy for managing drought so decisions regarding animal sales are consistent with that plan. The strategy for managing drought can then properly inform culling and sales decisions throughout the drought event.

Another important point to keep in mind, is that goals and objectives for the drought management strategy should be prioritized. The severity of droughts vary widely in intensity, length of time, and geographic scope.

Prioritizing goals and objectives as a part of establishing a strategy for managing drought leads to a more effective implementation of the strategy. Thinking through ahead of time which goals and objectives are the highest priority and which are the lowest will provide needed clarity when tough decisions inevitably arise, should the drought intensify to the point that not all can be achieved.

Drought is a threat to many types of agricultural enterprises. Risk management strategies are generally designed to do one of four things: (1) avoid the risk; (2) transfer the risk outside the business; (3) control the risk within the business; or,

(4) accept the risk as a part of doing business. Avoiding exposure to drought risk in agriculture is difficult unless irrigation water is bountiful, completely unregulated and free. Similarly, accepting the risk of drought as a part of doing business does not make a lot of sense unless the potential impacts of drought are extremely low, you live in an area where drought rarely occurs, or the cost of control are too high to outweigh the benefits. The two main strategies for managing drought risk are to either transfer risk outside the business or control it within the business.



How Much Risk is Right for You?



Transferring Drought Risk

Transferring drought risk outside the business is usually accomplished with insurance. For example, a crop insurance contract may protect revenue or yield. The insurance contract provides protection, depending upon the coverage level selected at the time of purchase, if a drought occurs and yields are negatively impacted. In exchange for a premium payment, the insurance transfers some potentially bad outcomes from drought to an insurance company that can better tolerate the risk.

Pasture forage production risk associated with drought can be transferred outside the business through a Pasture, Rangeland, Forage (PRF) insurance contract. PRF is a precipitation index insurance designed to protect against deficits in precipitation on perennial forage intended for use under livestock grazing or haying. The PRF rainfall index is based on precipitation data from the National Oceanic and Atmospheric Administration Climate Prediction Center (NOAA CPC). It is a group insurance policy based on grids roughly 17 miles by 17 miles.

The insurance provides producers with the opportunity to insure 70 to 90 percent of the Expected Grid Index Precipitation across a series of two-month intervals within the rainfall coverage period for each year. The signup deadline for PRF insurance is December 1. Producers interested in obtaining PRF insurance coverage for the 2022 calendar year should contact a crop insurance agent soon to begin the application process.

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Controlling Drought Risk

Risk strategies with the goal of controlling risk are focused on managing either the probability of outcomes, the impact of outcomes or both. Managing the probability of drought is possible only in the context of choosing where the operation is located geographically, while taking into account alternative area's drought susceptibility. As a result, the focus of most drought risk management strategies is usually on managing the impact of drought if it does occur. Controlling the impact of risk is accomplished in three main ways: (1) diversification, (2) increasing the capacity to bear risk with extra reserves or (3) maintaining flexibility in order to reduce the impact of a bad outcome or increase the benefits of a good outcome.

For example, diversification by growing more than one crop or operating a farm with both crop and livestock enterprises is one method for reducing the impact on the overall operation when drought occurs. Selection of enterprises with diverse time periods of drought sensitivity will reduce the impact on the operation for all but the most severe long term drought scenarios, even though all enterprises may be affected by a drought.

Cattle producers are also known to diversify by having both a breeding herd enterprise and a yearling/stocker enterprise. This is an example where diversification introduces flexibility to the operation. Grass resources can be shifted from the yearling/stocker enterprise to the breeding herd by selling the yearling/stockers or placing them in a feed yard if a drought occurs and grass production is far below normal. This flexibility gives the operation the ability to maintain the size of the breeding herd and, thus, reduce the long term impact of the drought on ranch income.

Many ranchers increase their capacity to bear risk by stocking below full stocking rates or stocking conservatively. For example, if the ranch stocks at 90 percent of the average carrying capacity of the range, a drought would need to decrease grass production by more than 10 percent before it would impact the ranch in a significant way. Another option is to keep extra hay reserves on hand to supplement the cattle if range conditions deteriorate because of drought. Of course, keeping extra hay on hand or light stocking rates costs money and constitutes a risk premium paid by the ranch to reduce the risk of drought much like an insurance premium.





Some people hold extra reserves in a way that introduces flexibility to convert the extra capacity into revenue when it is not needed, thus, lowering the cost to reduce the impact of drought. An example, could be a meadow that can be grazed or hayed depending upon precipitation and growing conditions. The flexibility to switch to producing hay from the meadow introduces the potential to generate positive hay sales in the good years and partially offset the cost of maintaining the extra reserves.

Drought management strategies can vary widely depending upon the enterprises and resources available to the operation.

Most people acknowledge a desire to maximize returns and minimize risk as two of their primary objectives. Undoubtedly, preserving the land for future production is also on the list of priorities. Financially, increasing equity over time is another common objective managers work to achieve. With these objectives in mind, along with the many production objectives that represent the means of achieving them, a producer can begin the process of mapping out a good drought management strategy.

Drought Management Strategies

Strategies for managing drought should include an inventory of resources and a plan of action for utilizing those resources in the event a drought occurs. It is also important to identify the timing of decisions necessary to implement the plan of action effectively. Creating a list of decisions that need to be made today and those that can be made later, along with a description of when later might be is an important aspect of an effective drought management plan. For example, as mentioned above, PRF insurance decisions for the 2022 calendar year must be completed by December 1, 2021. Similarly, stocking decisions are best made at the beginning of the grazing season. Timing of other decisions, such as which animals to sell or pull from the range, will vary depending upon the situation but likely come much later in the season and only come into play if a drought actually occurs.

Establishing a strategy for managing a drought takes commitment and a willingness to address issues before they become a problem. However, it is work that can pay tremendous dividends for years to come by informing good decision-making that keeps the operation headed in the right direction even during the stressful years where drought creates tough operating conditions.

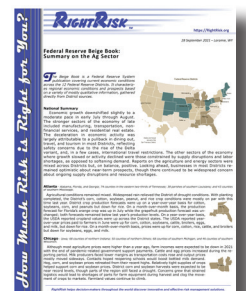


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NEWS RELEASE - SEPTEMBER 28 | RIGHTRISK

Federal Reserve Beige Book Summary on the Ag Sector

Economic growth downshifted slightly to a moderate pace in early July through August. The stronger sectors of the economy of late included manufacturing, transportation, nonfinancial services, and residential real estate. Reports on the agriculture and energy sectors were mixed across Districts but, on balance, positive. Looking ahead, businesses in most Districts remained optimistic about near-term prospects, though there continued to be widespread concern about ongoing supply disruptions and resource shortages . . .



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HIGHLIGHTED PUBLICATION: ENTERPRISE RISK ANALYSIS

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How much risk is right for you and your operation?



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