CME Proposal for Heifer Delivery against the Live Cattle Futures Contract

Introduction
Recent feedback from the beef cattle industry and a recommendation from a heifer delivery focus group have prompted the CME to consider accepting heifers for delivery against the Live Cattle Futures contract. To this end, the CME has drafted an initial proposal for heifer delivery. The CME now seeks feedback from additional stakeholders in the Live Cattle contract, and the cattle industry at large, to gather final comments and input before making a decision as to whether heifers will be eligible for delivery. The comment period will last from the release of this proposal until January 28, 2014, after which the CME will make its’ final decision on heifer delivery. The CME invites firms and individuals to provide written feedback to the contacts listed at the end of this paper.

To facilitate understanding of factors considered in developing this proposal, this paper presents a background of the heifer delivery debate and a summary of arguments both for and against heifer delivery. Next, the CME’s proposal for the conditions under which heifer delivery would be accepted is presented. The CME welcomes additional feedback and presentation of any remaining issues not discussed in this paper.

Background
Since its creation, the CME Live Cattle futures contract has only allowed steers to be delivered against open futures positions. This was done due to beliefs that steers were a higher quality animal which brought premium prices to heifers. Furthermore, the reproductive cycle of heifers was perceived as placing additional risks and potentially inferior animals on the hedger receiving delivery. Therefore, in an effort to create and maintain the most fair and balanced futures contract, heifers were excluded for delivery. Although the topic of heifer delivery has been discussed several times, discussions and proposed solutions never progressed far enough to change contract rules to include heifer delivery.

In early 2012, several cattle industry participants and producer groups (including the NCBA) approached the CME Group requesting the inclusion of heifers for delivery. Following these requests, CME conducted an extensive analysis of the benefits, drawbacks, and challenges of allowing heifer delivery. The CME engaged many key stakeholders and participants in the Live Cattle Contract, including a focus group of cattle feeders, long hedgers, beef packers, and others in the industry to gather insight on the reasons for and against heifer delivery. Additionally, a survey was sent to over 60 cattle feeders, long hedgers, and beef packers to gather additional information on specific issues surrounding heifer delivery. The aforementioned groups provided many thoughts and insights on heifer delivery and a summary of their arguments is provided below.
Arguments for heifer delivery

- Heifers constitute a significant portion of cattle in commercial feedlots and are highly integrated into cash marketing channels (constituting nearly 30% of Federally Inspected cattle slaughtered in 2013 and 40% of negotiated cash transactions). The Live Cattle futures contract should reflect major trends in cash marketing of cattle which, in this case, would include accepting heifers for delivery.

- Heifers are typically lighter weight, more uniform, and higher yielding than steers and often have higher quality grades. Therefore, those receiving delivery of a load of heifers would not be receiving an inferior product.

- Including heifers for delivery would significantly increase the deliverable supply of the Live Cattle contract. For the 2013 calendar year, including heifers would have increased deliverable supply by 69%.
  - Increasing the number of cattle available to be delivered would potentially help convergence during times of tighter fed cattle supplies¹.

- Heifers are no longer marketed at prices lower than steers. In some cases, heifers are sold at a premium to steers. This equality across steer and heifer prices in the cash market indicates the inclusion of heifers for delivery will not be price depressive to the futures contract and may actually be price supportive.
  - Data shows heifers are, on average, sold at a $0.09/cwt. premium to steers on a live basis and a $0.21/cwt. premium on a carcass basis.
  - Further analysis suggests for 35-65% Choice animals during 2013, heifers were discounted $0.01/cwt. on a live basis and $0.63/cwt. on a carcass basis. For all grades in the USDA 5-Area negotiated trade reports, heifers were discounted $0.06/cwt. on a live basis and $0.12/cwt. on a carcass basis. All differences are statistically insignificant, indicating heifers are marketed at the same price as steers.

- The most recent Beef Quality Assurance audit showed only 1.4% of heifers (out of a 10,000 head sample) slaughtered in normal marketing channels were pregnant. This percentage is statistically insignificant and therefore, the chances of long hedgers being inadvertently “stuck” with pregnant animals is extremely low.
  - Because most cattle are on feed for between 90 to 180 days, pregnant heifers delivered against the Live Cattle contract would be entering their second or third trimester. At this stage of pregnancy, their pregnant status would be easily detected by the USDA cattle graders.

- Hardbone (animals over 30 months of age) animals can and do occur in both steers and heifers. Including heifers for delivery, therefore, does not change the risk of a long hedger receiving a hardbone animal.

¹ Note: CME analysis does not show a lack of deliverable supply or that deliverable supply needs to increase to improve contract performance or to meet CFTC requirements.
The 2011 Beef Quality Audit found only 1.2% of all carcasses to be of “hardbone” maturity. The BQA did not examine hardbone rates between steers and heifers but there is limited reasoning or other research showing the hardbone rate in feedlot heifers is higher than in steers.

- The time elapsed during CME Live Cattle deliveries for steers is less than the minimum time needed for heifers, once removed from the estrus suppression feed additive MGA, to begin estrus. Therefore, receivers of heifer delivery will not be faced with any detrimental effects of estrus.

Arguments against Heifer Delivery

- Nearly all commercial feedlots use the MGA feed additive to suppress estrus in feedlot heifers. The effects of removing heifers from MGA are so pronounced that MGA removal is sometimes used to synchronize the estrous cycle of heifers to be artificially inseminated. Thus, when heifers would be delivered against the futures contract, the receiver would take ownership of heifers primed to begin estrus within 12-24 hours.
  - While the elapsed time from when heifers are taken off feed, graded, and put back on feed by the receiver will likely be less than the time needed for heifers to show estrus, this does not account for the time until animals resume feed consumption. Cattle, having been removed from their feedlot pen, worked and graded at a stockyard, and transported to a new feedlot will incur significant stress and will likely not resume consuming feed immediately. This would increase the time heifers would be without MGA to such a point that heifers are likely to come into estrus.
  - Receiving heifers already in estrus or which will begin estrus soon after delivery places a financial burden on the long hedger. Estrus behavior will likely cause heifers to ride each other, posing welfare risks (falls, downer cattle, etc.) and may increase the likelihood of dark cutter animals. These factors mean the receiver of delivery will be marketing cattle in the future which, through no fault of the receiver, are of inferior quality.

- There is a higher chance of receiving cattle over 30 months of age (which will therefore be more heavily discounted) when receiving heifers than steers because heifers can be retained for a time as breeding animals and then culled before being placed on feed.
  - Due to the nature of the live grading process, there is a perceived increase in the risk of receiving cattle over 30 months of age. Receiving such cattle would mean the receiver will pay one price for the animals but will receive a lower price when subsequently marketing the same cattle in the cash market.

- If the receiving long takes delivery of an all-heifer load which has pregnant animals, animals over 30 months of age, or animals in estrus, the receiving long has no recourse by which to receive compensation for these negative characteristics. Therefore, the long will pay one price for the animals but receive a lower price when re-marketing the cattle in the cash market.
• The risk of receiving inferior cattle (animals in estrus, over 30 months or age or pregnant) will cause long futures position holders to exit the futures market before the delivery period. This will have a significant negative impact on both liquidity and convergence of the futures contract during the spot month.
• The futures market does not need to be an exact representation of the cash market to be an effective risk management tool. Because convergence, liquidity, and deliverable supply are all well-functioning currently, there is no need to add heifers and greater harm than good might be done by doing so.

Thoughts on Carcass-Only Heifer Delivery
From the above discussion, it is clear that carcass graded heifer deliveries are significantly simplified compared to live deliveries. A possible solution for heifer delivery, then, is to require all heifers to be delivered on a “carcass only” basis. However, the heifer delivery focus group and the CME identified several problems with this approach which make it impractical for implementation. Namely, times when Live Cattle deliveries are needed to bring convergence are likely the same times when beef packers are full and unable to accept CME delivery cattle. Thus, under a carcass only heifer delivery system, during times when heifer deliveries are needed to bring convergence packers would likely be unable to accept CME deliveries. In such cases, having heifer delivery becomes a useless feature of the contract. Additional comments on carcass only heifer delivery are provided in Appendix B.

Heifer Delivery Proposal
Stemming from the recommendation of the Heifer Delivery Focus Group and comments from members of the cattle feeding and beef packing industries, the CME Group is proposing accepting heifers for delivery against the Live Cattle contract beginning with the August 2015 contract listing. Under this proposal, heifers would be deliverable against Live Cattle Futures contracts but subject to added eligibility requirements. These additional conditions are included to enhance the fairness of the contract to all market participants. The conditions for heifer delivery are outlined below with rulebook chapters that would be impacted included in parenthesis.

• Heifers will be deliverable at par value with steers (10103.B.4 and 10103.C.5).
• Heifers will be subject to the same yield, quality and age specifications as steers (10101).
• Delivery loads must be all-steers or all-heifers and noted as such on the delivery tender (10103.B.4.a, 10103.C.5.a, 10104.A).
• No individual heifer may weigh less than 1050 or more than 1350 pounds (10103.B.4.a & b).
• Discounts for hardbone and dark cutter carcasses are based on USDA 5-Area Weekly Weighted Average Direct Slaughter Cattle – Premiums and Discounts report (10103.A, 10103C.5.e).
• Heiferettes, cows and bred heifers are not deliverable for live deliveries and any such animal will be removed from the load (10103.B.4.a).
  o If one or more animals are deemed to be pregnant by the USDA live grader, a penalty of $1.00/cwt. will be applied to the entire par delivery unit (40,000 pounds) (10103.B.8).
USDA graders shall determine which animals are deliverable (10103.B.4.a & b, 10103.C.5.a).

Parties tendering an all-heifer load will be required to sign two affidavits: the Progestin Feeding Supplement Affidavit and the Open Heifer Protocol Affidavit (10103.B.2, 10103.C.3).

- The Progestin Feed Supplement Affidavit (Appendix A) requires all pens of delivered heifers to be fed an estrus-suppressing progestin feed additive for a minimum of 30 consecutive days before delivery. Additionally, the affidavit requires this progestin to be made available to the delivery heifers no more than 21 hours before 9:00 AM on the delivery day. This would require deliverers to feed a progestin feed additive to heifers after 12:00 noon the day before delivery.

- The Open Heifer Protocol Affidavit (Appendix A) requires the delivering feedlot to administer an approved pregnancy prevention protocol to all heifers intended to be delivered against the Live Cattle Futures contract after being placed on feed in the delivering party’s feedlot and not less than seven (7) days before delivery.

The CME Group stresses that these are not final rules and welcomes additional feedback from the industry. Feedback from the industry is encouraged following the release of this proposal until January 28, 2014. Following the conclusion of the comment period, the CME will make a formal, final decision regarding heifer delivery and prepare any necessary filings with the CFTC along with a final notification to the marketplace. If you or your firm has additional comments which are NOT reflected in the above summary of arguments, please submit your comments in writing to:

Jack Cook, Director, Commodity Research and Product Development, jack.cook@cmegroup.com;

Matt Herrington, Manager, Commodity Research and Product Development, matthew.herrington@cmegroup.com;

Thomas Clark, Director, Commodity Business Line Management, Thomas.clark@cmegroup.com;

Dave Lehman, Managing Director, Commodity Research and Product Development, david.lehman@cmegroup.com.
Appendix A – Proposed Affidavits for Heifer Delivery

Live Cattle Progestin Feeding Supplement Affidavit

***This Affidavit is only required for tendered deliveries of heifer cattle***

Whereas an affidavit is deemed by the Chicago Mercantile Exchange, Inc. (“CME”) as a record of production practices, I attest through firsthand knowledge, normal business records, or producer affidavits, that these heifers being tendered for delivery on the CME Live Cattle Futures contract were administered a CME approved estrus-suppressing progestin protocol for a minimum of 30 continuous days before the scheduled delivery date. Furthermore, I attest these heifers had this same estrus-suppressing progestin made available to them no longer than 21 hours before 9:00 AM on the day of delivery.

I attest that the records reflecting feeding practices for all heifers delivered against the CME Live Cattle Futures contract are available for inspection for the sole purpose of compliance with an audit from CME and that these records will be maintained for one year from the date of delivery.

Date: ________________

Name (please print): ____________________________________________

Signature: ______________________________________________________

Feedlot Name: __________________________________________________

Address: ________________________________________________________

City, State, Zip: _________________________________________________

Telephone, including area code: (_____ ) ________________________________

A copy of this Affidavit must accompany each Certificate of Delivery tendered and shall be considered part of the Certificate of Delivery. A Certificate of Delivery will not be accepted without a complete, legible, and signed copy of this Affidavit, dated as of the date of tender.
Live Cattle Open Heifer Protocol Affidavit

***This Affidavit is only required for tendered deliveries of heifer cattle***

Whereas an affidavit is deemed by the Chicago Mercantile Exchange, Inc. (“CME”) as a record of production practices, I attest through firsthand knowledge, normal business records, or producer affidavits, that

1) These heifers being tendered for delivery on the CME Live Cattle Futures contract were given a CME approved pregnancy prevention protocol (PPP) after being placed in the feedlot of the party tendering this Certificate of Delivery.
2) This CME approved PPP was not administered within 7 days of issuing the Certificate of Delivery.
3) These heifers have not knowingly been exposed to a bull following the administration of the PPP.

I attest that the records reflecting production practices for all heifers delivered against the CME Live Cattle Futures contract are available for inspection for the sole purpose of compliance with an audit from CME and that these records will be maintained for one year from the date of delivery.

Date: ________________
Name (please print): ________________________________
Signature: _______________________________________
Feedlot Name: ______________________________________
Address: ________________________________
City, State, Zip: ______________________________________
Telephone, including area code: (_____) ____________________________

A copy of this Affidavit must accompany each Certificate of Delivery tendered and shall be considered part of the Certificate of Delivery. A Certificate of Delivery will not be accepted without a complete, legible, and signed copy of this Affidavit, dated as of the date of tender.
Appendix B – Analysis of “Carcass Only” Heifer Delivery

During focus group discussions and other conversations about heifer delivery, two options for “carcass-only” heifer delivery were discussed. The first was to require all CME approved slaughter facilities to guarantee space for heifer deliveries. The second was to have the tendering short first secure the needed space for heifer delivery with a CME approved packer. The CME and other individuals questioned about carcass-only heifer delivery identified several significant concerns with the proposed scenarios. These concerns are outlined below. Because of these issues, the CME is not recommending or proposing carcass-only heifer delivery.

Scenarios for Carcass Only Heifer Delivery:

1. **Require CME approved slaughter facilities to guarantee slots for heifer carcass delivery**

   Concerns:
   
   a. Most often, deliveries occur when futures are premium to cash and cash is weak because packers have adequate supplies and/or no available kill spaces. If packers were required to process any tendered heifer deliveries, the requirement would force them either to reschedule non-CME delivery cattle or to process additional cattle beyond their optimal slaughter number. Both scenarios impose a cost on packers and it is likely most packers would avoid these costs by terminating their status as a CME delivery location.

   b. Some have suggested that packers could agree to take the heifers at an indexed price. If this price was higher than cash, lower than futures, and above the cost of replacing/substituting CME cattle for already scheduled cattle, then we could reasonably expect to see high volumes of deliveries and a packing community that is reimbursed at a rate below their cost of rescheduling cattle. Again, such a scenario would likely lead to packers withdrawing from the CME delivery process.

2. **Require delivering shorts to acquire kill slots before issuing a heifer delivery tender**

   Concerns:
   
   a. Under the scenario where futures are premium to cash and kill slots are not available, the prerequisite for tendering a load of heifers (acquiring kill slots) would prevent heifer tenders from being issued. The inability to issue tenders would create barriers to obtaining convergence between cash and futures markets. While steers could still be tendered and delivered to create convergence, one of the primary reasons for considering heifer delivery is to increase deliverable supply in the Live Cattle contract. If heifers could not be delivered when needed to encourage convergence, it would negate any benefit of including heifers for delivery.

   b. If shorts are required to acquire kill slots before tendering it may create opportunities for packers to manipulate markets. By not issuing kill slots (even if slots are available), packers could theoretically keep cash prices lower than futures and prevent convergence.