Managing Tough Times

Renegotiating Fixed-Price Hog Production Contracts

EXPERT REVIEWED

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Production contracts have become a popular mechanism for coordinating hog production. Some of these contracts are based on a fixed price for Segregated Early Weaned (SEW) pigs. Others are contractual arrangements to lease grow-out facilities on a fixed-price-per-pig basis or on cost-plus contracts. Large price changes can render such contracts untenable for one or the other party.

The fixed nature of the pricing on these contracts means that the contractor or the purchaser is taking all of the pig price risk. During periods of low market prices, the contractor may have a strong incentive to void or renege on the contractual commitment. Some form of negotiation or mediation is preferable, of course, to the costly and polarizing approach of litigation.

The fundamental flaw in many of these contractual arrangements is typically the risk sharing between the parties when the unexpected occurs. The contracts that are most likely to experience difficulty are ones that shift much or all of the uncertainty to one party. There are numerous unexpected events that might adversely affect contract performance including pig mortality, disease problems that interrupt the pig flow, or the death of a key employee or the owner of one of the businesses. In the current situation, the unexpected is low hog prices coupled with high feed costs.

Risk-Sharing Negotiation

How can equitable sharing of risk and returns be determined? What might be the basis now for negotiating a resolution between the contracting parties as an alternative to litigation?

One basic approach is to determine the total value of the resources used to produce the product involved, to determine the proportion of those resources contributed by each of the contracting parties, and then share the total revenue received by the sale of the product in the same proportion as the value of the contributed resources.

For example, let's assume that a producer has a contract on grow-out facilities that guarantees him a substantial economic loss, so he is considering default on the contract agreement. The owner of the grow-out facilities could sue if this were to occur, but he or she might find that recovery in such a set of circumstances could be costly. So the parties want an equitable resolution.

The first step is to determine what the value of the resources contributed by each party to the arrangement would be (for example, the contractor is contributing the feeder pigs, the feed, the veterinary services, etc., and the owner of the grow-out facility is contributing the buildings and his labor). Once the total value of the products and services contributed by each party is determined, the proportion of this total is calculated for each. Using fair market rates for all resources including labor, for instance, it might be determined that the contractor is contributing 55% of the resources used to finish the pigs and the owner of the grow-out facility is contributing 45% of the resources. These percentages are then used to allocate the amount of revenue received when the hogs are marketed.

In essence, this procedure attempts to allocate profits or losses in proportion to the value of the resources each party contributes to the production of the final product and thus provides some rationale for risk sharing between the parties.

Arbitration

The option of obtaining an arbitrator to help negotiate risk sharing or another acceptable resolution can also be used as an alternative to litigation. Maybe it is a banker or loan officer in whom all parties have confidence. Maybe it is an appraiser or a farm manager who has had experience in negotiating lease and other arrangements between tenants and landlords in livestock operations. It might be an Extension educator. The arbitrator should be well respected by both parties and relatively independent from them, both in personal and in business relationships.

Negotiating Long-Term Contracts Today

Fixed-price contracts negotiated in good times that don't allow for risk sharing when the unexpected happens will almost always result in conflict between the contracting parties. This doesn't suggest that contracting cannot be successful. What it does suggest is that for long-term success, contractual arrangements must include equitable sharing of not just the returns but also the risk.

Because it is almost impossible to write contracts that will anticipate all unexpected events, contracting parties today should: 1) recognize, up front, that the unexpected could happen and agree upon equitable sharing of the risk or the cost of unexpected events, 2) periodically review the arrangement so that the sharing of risk and rewards remains equitable over time, and 3) provide for binding arbitration or some other form of resolution if, as is sometimes the case, a conflict has developed and the parties can't come to agreement by themselves.

Contracting parties guided by the first two fundamental principles outlined above will be less likely to face the situation described in the third, because conflicts they cannot resolve together will be less likely to occur.

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REV 1/08