Managing Tough Times

Pork Contracting Considerations

EXPERT REVIEWED

Ken Foster

Agricultural Economics

Purdue University

Vertical coordination in the pork industry will continue to increase for many reasons. Producers who are unable to secure the credit they need to continue to operate independently may find contract production the most profitable option left to them, even though it may not pay the full ownership costs. Some producers with stronger balance sheets will be looking for risk management strategies that generate a stable (although probably lower on average) income. Other producers will choose to vertically align their operations because they fear that access to markets will be limited in the future.

This publication provides some information to assist those who are considering some sort of pork production or marketing contract.

Advantages of Contracting

Farmers have different skills, expertise, financial positions, and attitudes toward risk. What is right for one individual may not be right for another. Thus, some of the advantages discussed below will not apply to all farms. That is, coordinated production and marketing are not for everyone.

Producer Risk Reduction: In Production Contracts, much of the market price risk is assumed by the contractor.

Producer Capital Requirement Reduction: In Production Contracts, the contractor provides some of the inputs (often feed and animals). This reduces the operating cost budget of the grower and may increase his/her ability to obtain financing for the swine facility.

Producer Cash Flow: As contracts become more contractor-dominated they tend to provide more regular payments to the producer. However, if the contract payments are not sufficient to cover costs, then this advantage is of little consequence.

Producer Idle Resource Utilization: On some Indiana farms there are unused facilities and/or labor. If the producer receives a return from a contract that exceeds the additional cash costs, then this surplus is a return to the idle resources. All parties need to be aware that older facilities will eventually become obsolete, and there may come a point in time when the contract is not profitable.

Guaranteed Market Access: Having a place to sell hogs is a concern for some due to the concentration in packing and the use of more captured supplies. “Shackle space" guarantees could be a strong incentive to enter into a Market Contract.

Lower Costs: Marketing Contracts can lower costs by reducing haggling between parties, improving accessibility of superior technology, and/or by reducing input costs through volume buying.

Disadvantages of Contracting

There is no free lunch involved with contract production. Each advantage requires that someone bear a cost. Below is a general discussion of some disadvantages of contracting.

Producer Control Reduction: Contracts typically reduce the producer's involvement in management decisions. This may be as minimal as determining the type and timing of medications or as drastic as complete loss of control over day-to-day management and marketing decisions.

Producer Record Keeping Requirements: Most contractors will require some additional record keeping by the producer.

Potential for Disease: In order to fill a producer's buildings, the contractor may find it necessary to co-mingle groups of hogs from several sources.

Facilities Under-Utilization: Unless the Production Contract specifies otherwise, the contractor has discretion to either leave the facilities idle or not fill them to capacity.

Producer Returns Limitation: Producers who enter into Production Contracts generally have more stable incomes but at a lower level. This is like paying an insurance premium to avoid bad outcomes.

Low Equity Building Potential: Because swine buildings have few profitable alternative uses, the producer is in a vulnerable bargaining position once the building is erected. As a result, some Production Contracts do not provide sufficient payments to build substantial equity over time.

Additional Considerations for Contract Growers

Because of the legal nature of contract production, producers should examine carefully any agreement and consult an attorney. The following are some commonly overlooked considerations that should be addressed in writing a swine production contract.

- Are Livestock Quality and Health Status Stated?
- Is Feed Quality Guaranteed?
- Are the Amount and Timing of Payments Clearly Defined?
- Are Performance Incentives Realistic and Properly Rewarded?
- Is a Contract Termination Clause Included?
- Is the Contractor[1]s Financial Position Divulged?
- What Are the Implications of Bankruptcy?
- Does the Contractor Agree to Follow Any Risk Management Strategies?
- Who is Liable, and Who Insures?
- Are Management Control Parameters Clearly Defined?
- Is the Division of Expenses Defined?
- Are Capacity Utilization Guarantees Included?
- Is the Contract in Writing, and Is It Legally Binding?
- What Are the Procedures for Conflict Resolution?
- Does the Contract Include Periodic Renegotiation of Terms?

Future of Contracting in the Pork Industry

There are strong economic incentives for increased coordination at various levels of the pork industry. Consequently, it is inevitable that Indiana pork production will be highly coordinated, and contracting will be a part of this. Periodic downturns in the profitability of pork production will accentuate the movement toward coordination. As independent investment exits, it will be replaced primarily by coordinated investment.

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