

Contracting In U.S. Agriculture: Lessons For Tobacco

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U.S. Contract History

- ◆ Contracts Have Been Around Since The Early 1900's
- ◆ Well Developed As A Farm Production & Management Tool By The 1960's
- ◆ Rapid Increase In Contracting And Vertical Integration Termed "Industrialization Of Agriculture"
- ◆ Today's Food System Demands Uniform Quality, Minimal Seasonality, More Value Added In Processing And Distribution

Common U.S. Contracts

Production Contracts

Production
Management
Contracts

Resource
Providing
Contracts

Cash
Forward
Contracts

Basis
(Difference)
Contracts

Marketing Contracts

Production Contracts

- ◆ Contract To Produce A Specific Quality And Quantity Of A Specific Commodity
- ◆ Contractor Usually Owns The Commodity And Makes Most Of The Production Decisions
- ◆ Grower Provides A Service And Other Fixed Inputs For A Fee, Less Than Full Market Value
- ◆ Grower Reduces Production And Price Risks

Production Management Contracts

- ◆ Specify Inputs Supplied By The Contractor
- ◆ Detailed Production Practice Requirements
- ◆ Specify Amount To Be Produced
- ◆ Specify Terms For Compensation
- ◆ Specify Grading Standards



Resource Providing Contracts

- ◆ Grower Usually Provides Fixed Assets And Labor, Contractor Provides Animals
- ◆ Contractor Retains Ownership Of The Stock
- ◆ Contractor Determines Size, Rotation, Genetic Characteristics Of Flock / Herd
- ◆ Specify Compensation, Which May Be Based On Performance Relative To Pool



Characteristics Favorable For Production Contracts

- ◆ Production Requires Specialized Inputs And/Or Complex Production Technologies
- ◆ End Product Must Meet Rigid Quality Levels And Possess Uniform Characteristics
- ◆ Historical Problems With Over/Under Supply
- ◆ Centralized Management Is Feasible
- ◆ Commodity Is Highly Perishable

Marketing Contracts

- ✦ Contract For A Known Quantity And Quality Of Commodity For A Negotiated Price
- ✦ Grower Responsible For Management And Production Decisions
- ✦ Grower Supplies And Finances All Or Most Of The Production Inputs
- ✦ Grower Receives Largest Share Of Total Value Of Production
- ✦ Grower Assumes Production Risks But Reduced Price Risk

Cash Forward Contracts

- ◆ Establish A Price And Provide For Delivery Of A Certain Quality At A Specified Time
- ◆ May Contain Provisions For Setting A Price At A later Date
- ◆ “Flat Price” Contracts Are Common
- ◆ May Include Premiums Or Discounts For Quality



Basis (Difference) Contracts

- ◆ Price To Be Determined By Applying A Specified Difference (Basis) To A Particular Futures Contract Price
- ◆ Assures The Grower An Outlet While Allowing Gains Or Losses In Futures Prices
- ◆ Grower Bears Risk Of Price-Level Variation Until Crop Delivery



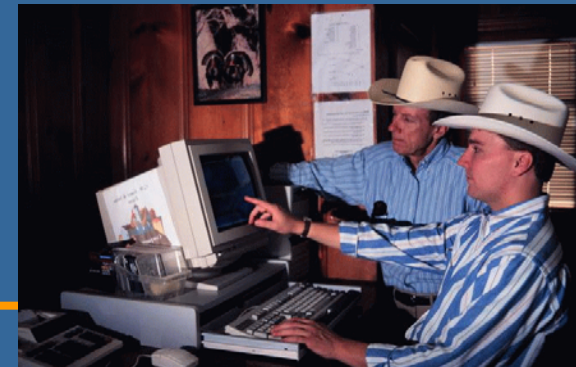
Other Marketing Contracts

- ◆ Delayed Payment Contracts
- ◆ Delayed Price Contracts
- ◆ Minimum-Price Contracts
- ◆ Hedge-To-Arrive Contract



Characteristics Favorable For Marketing Contracts

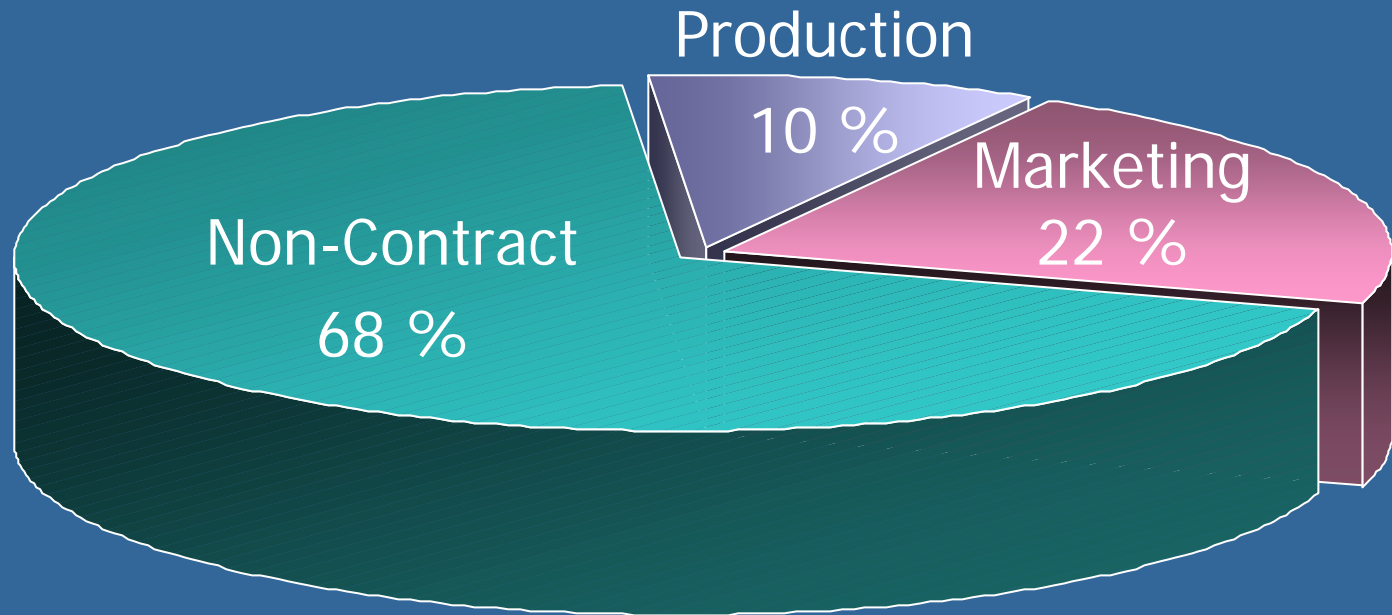
- ◆ Works Well With Commodities That Have Highly Developed Markets
- ◆ Difficulties With Over-Contracting Arise If Yields Are Highly Variable
- ◆ Useful For “Localizing” Regional Or National Prices Or Markets



Value Of U.S. Agricultural Production Under Contract

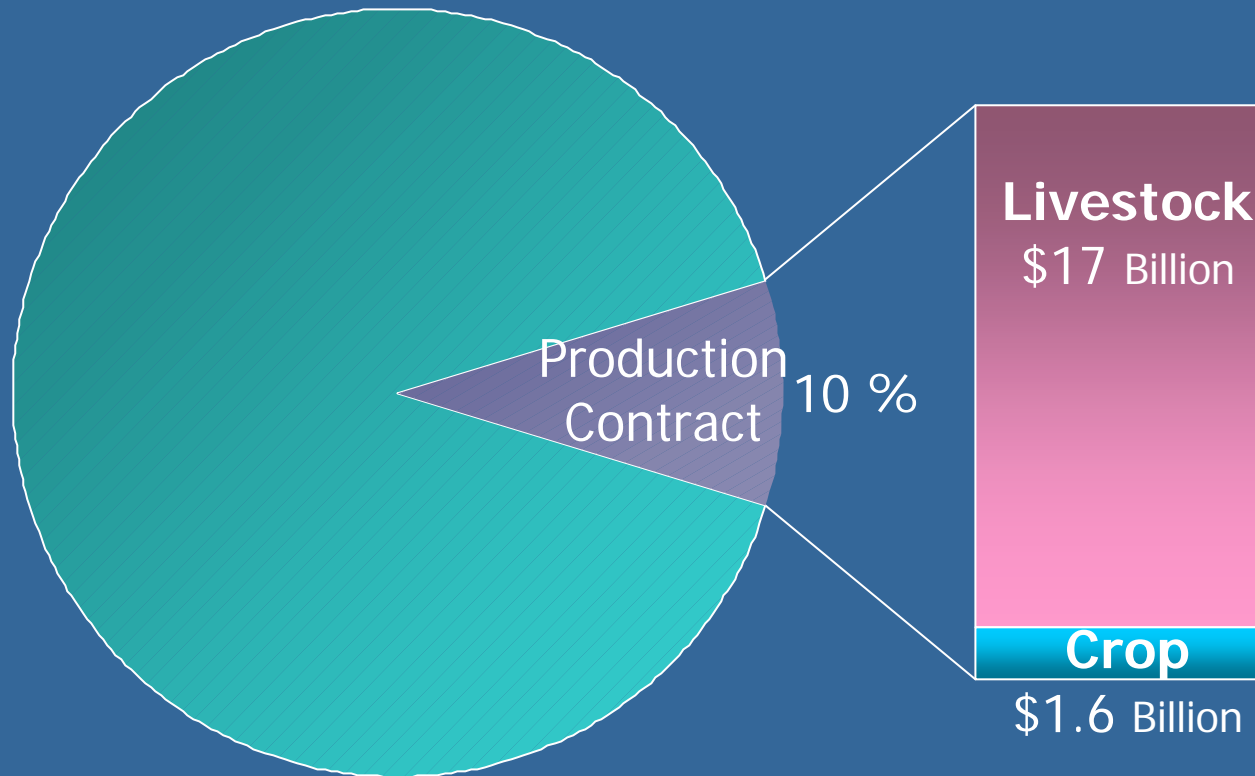
Commodity	Share of Contract Production (%)	Share Produced Under Contract (%)
Vegetables, Fruit, Nursery	23	47
Dairy	21	48
Poultry	20	89
Cattle, Hogs, Sheep	18	19
Corn, Soybeans, Wheat	7	7-12
Cotton	3	33
Peanuts	2	65

Value of Contract Agriculture



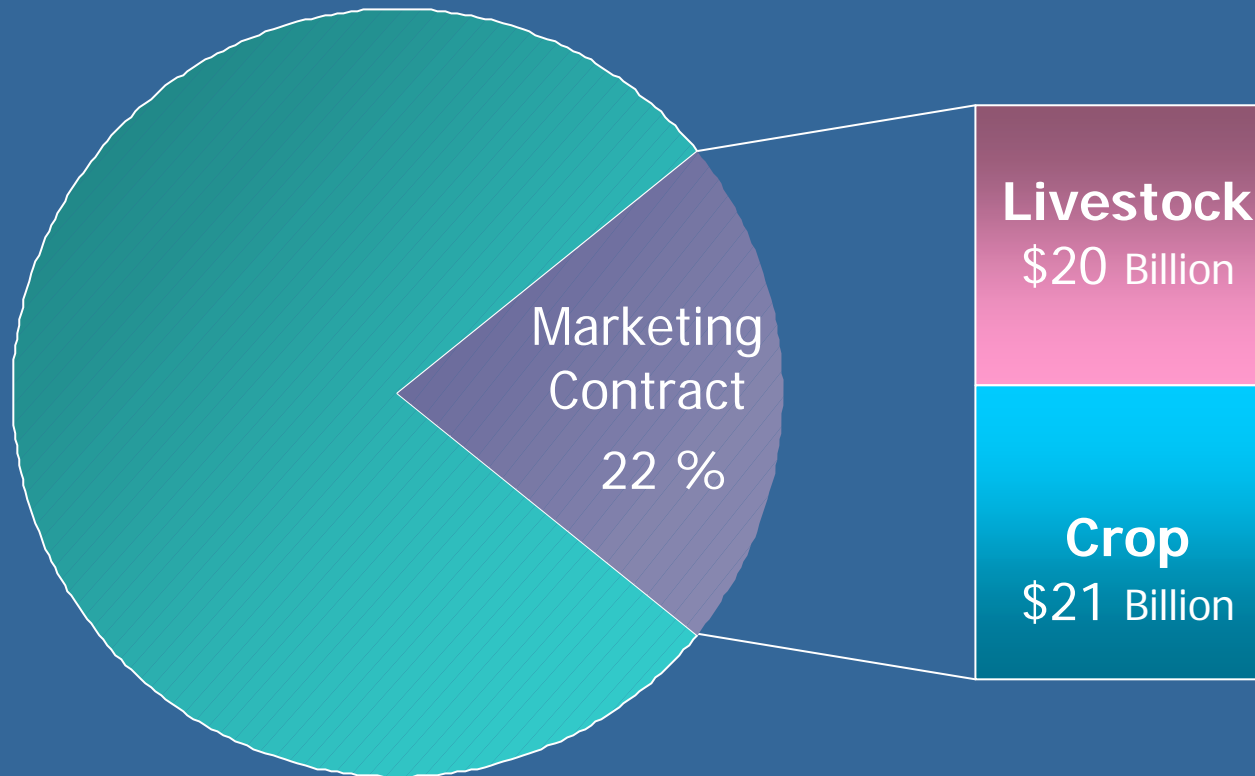
All Agriculture: \$192 Billion

Value of Production Contracts



All Agriculture: \$192 Billion

Value of Marketing Contracts



All Agriculture: \$192 Billion

Potential Pros And Cons: Producer Perspective

Advantages

- ◆ Risk-Shifting
- ◆ Guarantee Market Access
- ◆ Improve Efficiency
- ◆ Access To Capital
- ◆ Technical/Managerial Advice
- ◆ Cash Flow Management
- ◆ Income Stability

Disadvantages

- ◆ Limits Entrepreneurial Capacity
- ◆ Reduced Independence
- ◆ Risk Of Termination
- ◆ Investment Risk
- ◆ Could Weaken Open Market Price Signals
- ◆ Relative Performance Problems

Potential Pros And Cons: Contractor Perspective

Advantages

- ✦ Input Supply Control Without Vertical Coordination
- ✦ Ensure Timeliness & Quality Of Commodity Deliveries
- ✦ Improved Response To Consumer Demand
- ✦ Control Over Production Methods

Disadvantages

- ✦ Leads To Concentration Of Decision Making
- ✦ Reduces Diversity In Products
- ✦ Reduces Diversity In Production Practices

Potential Pros And Cons: Consumer & Community Perspective

Advantages

- ◆ Uniform Products On Market
- ◆ Reduced Price Volatility
- ◆ Improved Response To Consumer Demands

Disadvantages

- ◆ Inputs Supplied By Contractors Rather Than Local Retailers
- ◆ Marketing Channel Control Distributed Away From Local Markets
- ◆ Reduced Product Diversity & Entrepreneurial Capacity

Production Contract Elements

- ◆ Length Of The Contract
- ◆ Conditions For Contract Termination And Renewal
- ◆ Payment Determination
- ◆ Quality Considerations & Measurement
- ◆ Conditions For Delivery And Marketing
- ◆ Responsibilities Of Each Party
- ◆ Independent Contractor Status

Trends In Contracting

- ◆ Expected To Further Increase Use Of Production Contracts For Hogs
- ◆ Farms Organized As Partnerships Or Corporations Twice As Likely To Contract
- ◆ Marketing Contract Use On Farms Outnumbers Production Contract Use 4 to 1
- ◆ Average Sales On Farms With Production Contracts 10 Times Greater Than Cash Sales
- ◆ Tobacco ???

? Tobacco Contracts ?

- ✦ Contract Production Could Provide Manufacturers With The Specific Qualities They Need
- ✦ Over Time, Growers Would Have Incentive To Increase Tobacco Quality
- ✦ Growers Are Likely To Earn Price Premiums For Tobacco With Certain Quality Characteristics
- ✦ Growers Would Bear Contract-Specific Risks
 - Risk Of Growing Tobacco That Doesn't Meet Quality Standards
 - Risk Of Not Having Contracts Renewed
- ✦ Role Of The Program Under Contracts Unclear