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Contracting—A Business Option for Many Farmers

Contracting has become a common business practice on farms of all sizes, producing a variety of commodities, and located in all areas of the country. In 1993, contractual arrangements accounted for $47 billion—almost one-third of the value of U.S. farm production. Contracting is an integral part of the production and marketing of livestock commodities such as broilers, turkeys, eggs, and milk. Most sugar beets and sugarcane, as well as many fruits and vegetables, are also produced under contract.

Agricultural contracts are arrangements under which farmers agree to deliver products of a specified quality and quantity to a contractor for a specified price or fee. Contracts generally stipulate who owns the product, pays for specific inputs, and holds the risk of loss, and when product ownership passes from one party to another. How much control a contractor has over production decisions varies, depending on the type of contract. As legal documents, contracts are enforceable in a court of law.

Farmers and contractors may use contracts for a variety of reasons. By bypassing open—and uncertain—markets, contracting can reduce participants' exposure to risk. Processors, and ultimately consumers, increasingly demand a uniform product of standard quality. Contracts are one vehicle that food processors and marketers are using to respond to consumer preferences. Contracts provide direct feedback to farmers on market preferences, and reward producers who respond.

Agricultural contracts are generally classified as either marketing or production contracts. A *marketing contract* is an agreement between a farmer and a buyer that specifies quantity, quality, price, and timing of the product to be delivered by the farmer. Under a *production contract*, a farmer receives a predetermined fee for raising products of a specified quality and quantity, with the contractor providing inputs and retaining ownership of the commodity throughout the production process. Of the total value of agricultural output covered by contracts, USDA's 1993 Farm Costs and Returns Survey (FCRS) found that 37 percent was under production contracts while the balance was under marketing contracts.

Production contractors typically bear a large share of production and price risk and earn most of the net income from the commodity's sale. Views of production contract arrangements are not all positive. Some feel that the loss of entrepreneurial capacity is perhaps the largest disadvantage to the farmer. To ensure a uniform product, production contracts specify the production practices and the types of inputs used. Good management is still needed, however, and many contractors reward skillful managers with bonuses. The farmer remains the judge of whether the tradeoff of income stability and a confirmed market is a fair exchange for a certain loss of independence.

Contract Use Varies By Farm Type & Size

Traditionally, U.S. farmers sold independently produced livestock or crops in an open market to the highest bidder among local marketing or processing companies or their agents. Over the past 40 years, farmers have become less dependent on this system of terminal markets and spot pricing to market their goods, and more reliant on agricultural contracts.

Contract-type arrangements are not new. As early as the 1920's, A&P, the chain retailer, developed a national buying organization to purchase fresh fruits and vegetables directly from farmers for its stores. Safeway and Kroger bought milk for their own processing plants directly from farmers or cooperatives before World War II. In the postwar period, many more chains became large enough to buy directly from farmers. The 1969 Census of Agriculture showed more than 156,400 farms, about 6 percent of all farms, using contracts for production or marketing of their agricultural commodities. By the 1993 FCRS, over 225,000, or nearly 11 percent of all farms, were using contracts.

Today, farms of all sizes and types are involved in contracting. Among livestock producers, poultry farms lead in use of contracts, with nearly 89 percent reporting use of contracts and about 86 percent of total production value produced under contract in 1993. Twenty-eight percent of dairy farms report use of contracts, representing 43 percent of the total value of milk production. Dairy farmers have long had verbal contracts with their processors or cooperatives, and most milk is produced under marketing orders, which set milk prices based on regionally determined formulas. Cattle and hog producers also reported use of contracts in 1993, although to a much lesser degree (about 11 percent of hog producers and less than 2 percent of cattle producers).

Some farmers are themselves contractors. For example, a farmer may contract with another farmer to complete a stage of production in the raising of livestock. The farmer, as contractor, can then specialize in a different stage of production, paying another producer to either provide young animals or finish the production cycle. Nearly 3,500 farms reported beef or hog production contracted out during 1993. These farms were predominantly livestock operations, where 85 percent of the $623,000 average gross cash farm income came from livestock sales.

More than 40 percent of the 6,000 farms reporting livestock contracted out in 1993 had replacement breeding stock raised by another farm operation. Among the most common were dairy operations contracting for replacement heifers. Egg producers also often contract with other farms to raise layers.

While large commercial farms account for most of the value of products sold under contract, almost half of the 225,000 farms with marketing or production contracts in 1993 were small commercial farms (sales between $50,000 and $249,999). These smaller farms produced about 24 percent of total contract value of farm products.

The largest contract users among crop commodity farms are fruit and vegetable growers; 36 percent of farms specializing in the production of fruits or vegetables used some form of contracts in 1993, producing more than half the total value of production of fruits and vegetables. About 30 percent of the value of cotton production was also produced under contract. Other crop farms used contracts, although at much smaller rates. The largest of these is corn production, for which 13 percent of the total value of output was under contract.

Larger farms are more likely than other farms to use *production contracts.* Twenty-one percent of farms with production contracts had sales of $500,000 or more. Large farms accounted for 69 percent of the value under production contracts.

On the 44,000 farms with production contracts in 1993, sales averaged $485,000, but gross cash income for these farms averaged only $149,200, reflecting the contract fees received by operators. Under production contracts, while sales reflect the full value of the product, farmers receive a predetermined fee, not a share of sales, for raising contracted products.

Three-quarters of farms with production contracts were producing livestock commodities, primarily poultry. Livestock farms accounted for more than 90 percent of the total value of products sold under production contracts.

Under *marketing contracts*, while the farmer receives all of the income generated by production, expenses for the business are usually higher than under production contracts because the farmer pays more of the expenses. Marketing contracts, found on 186,000 farms, were more common than production contracts. However, farms with marketing contracts had lower average sales ($225,700).

Although farms of all sizes used marketing contracts, large farms (gross sales more than $500,000) reported almost half of all marketings. Farms with gross sales of less than $250,000 comprised 80 percent of the farms producing under marketing contracts, but accounted for only 33 percent of the total value of production. Seventy percent of farms using marketing contracts in 1993 were classified as crop farms (fruit and vegetables, 20 percent; corn, 11 percent; cotton, 3 percent; other crops, 36 percent). These crop farms accounted for 56 percent of the total value of commodities marketed under contract.

The mix of crop commodities comprising most of the value of marketing contracts for farms with the smallest contracts (less than $100,000 marketed) included field corn, soybeans, peanuts, almonds, and wheat. Milk, cattle, and turkeys were the most often reported livestock commodities for a similar marketing contract size. Under the largest marketing contracts

Marketing vs. Production Contracts

Marketing contracts refer to verbal or written agreements between a grower and a buyer—generally a food processing and/or marketing company— that set a price (or pricing mechanism) and determine an outlet for a specified quantity of a commodity before harvest or before the farmer markets the commodity. Most management decisions remain with the grower, who retains product ownership during the production process. The contractee assumes all risks of production, but shares price risk with the contractor.

Marketing contracts can take many forms, including:

- forward sales of a growing crop, where the contract provides for later delivery and establishes a price before delivery;

- price setting after delivery based on a formula that considers grade and yield; and

- pre-harvest pooling arrangements, in which the amount of payment received is determined by the net pool receipts for the quantity sold.

Since the farmer incurs the costs of production, the farmer retains the income generated from sale of the commodity.

Production contracts involve paying the farmer a fee for providing management, labor, facilities, and equipment, while assigning ownership of the product to the contractor. The contract specifies in detail the production inputs supplied by the contractor, which may be a processor, feed mill, or another farm operation or business. The contract also specifies the quality and quantity of the particular commodity. Because the contractor controls the amount produced and the production practices, the contractor often dominates the terms of the contract.

Advantages of production contracts for farmers include the sharing of production and marketing risks with the contractor and the availability of financing—either directly from the contractor or indirectly through other lenders who are more assured of loan repayment under this arrangement. Farms can have both marketing and production contracts.

Agricultural Economy

(more than $600,000 marketed), cotton, potatoes, strawberries, walnuts, grapes, onions, and tomatoes represented more than 95 percent of the value of crop commodities. The large-contract livestock commodities were predominantly milk, eggs, and cattle, with a marketed value nearly double that of crops marketed by the large-contract crop farms.

Beyond their importance as a source of income, marketing contracts usually provide for multiple payments, which may extend beyond one calendar year. In 1993, 40 percent of marketing contracts were structured to carry total compensation across calendar years. This is often helpful to farm operators in managing cash flow; many operations are not diversified and have only one commodity enterprise.

The Variety of Production Contracts

In most production contract, the contractors pay directly for inputs, supply the inputs, or reimburse the producer for expenses required to grow the commodity under contract. The contrast between production contracts for broilers and those for processing vegetables illustrates some of the differences in contract terms, including the extent of production and managerial control the contractor holds, the size of fees paid to the farmer, the amount of inputs supplied by the contractor, and ownership of the commodity.

Broiler contracts are the most widely publicized livestock production contracts, although contracts have covered fed cattle and hogs for many years. Of the more than 32,000 farms with livestock production contracts in 1993, about 14,000 had single broiler contracts (one contract only). Broiler production was the primary activity of nearly all these farm businesses, with 40 percent having no additional farm enterprises. The total value of broilers raised on these single-contract farms varied considerably. Nearly one-third of the farms had contracts valued at $300,000 or less during 1993, while 20 percent had contracts valued at $600,000 or more.

While the specific contract terms vary from company to company, most broiler contracts designate the division of responsibility for providing inputs and compensating growers. The grower usually provides land and housing facilities, utilities, labor, and other operating functions, such as repairs and maintenance, manure disposal, and chicken-house cleaning. The contractor provides chicks, feed, veterinary supplies and services, management services or field personnel, and transportation. Either party pays for fuel and litter, or they share expenses, depending on the nature of the contract. In 1993, farmers provided, on average, 11 percent of the cash expenses on single-contract broiler operations.

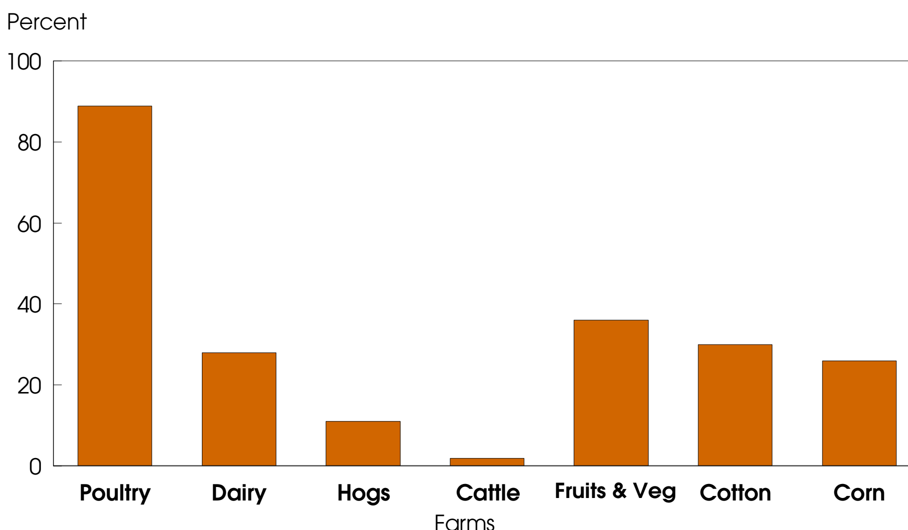
Contractors usually own and operate hatcheries, feed mills, and/or processing facilities. The contractor may pay some fixed costs, such as insurance, or provide financing for capital purchases. Contractors make the most significant production decisions, including size and rotation of flocks, genetic characteristics of birds, specific feed ingredients, and the capacity of the chicken house. Broiler contracts usually provide three types of compensation for grower services: the base payment, an incentive or performance payment, and the disaster payment, which covers lost production from natural disasters.

Total value of birds removed from the 14,000 single-contract broiler farms averaged $445,400. The average annual fee received was $53,500, or about 12 percent of the value of birds removed. This represents the 1993 amount received by growers for all types of compensation as stipulated in their particular contracts.

Although most production contracts are for livestock commodities, 11,700 farms reported at least one crop production contract in 1993, and nearly half these farms had contracts for processing vegetables. Processing vegetables include snap beans, cabbage, sweet corn, cucumbers, lima beans, sweet peas, spinach, and tomatoes and are destined for canning, freezing, heating, or drying.

Under production contracts for processing vegetables, contractors usually pay only for seed and custom services such as harvesting or hauling. Contractors provided seed to nearly 80 percent of the farms with a single production contract for processing vegetables. Some operations received custom planting services, which included seed. Custom hauling (reported by 70 percent of contract producers of processing vegetables), and fertilizer and chemical applications (reported by 60 percent) were the other two inputs most often supplied.

Nearly 90 Percent of Poultry Farms Use Contracts



Farms identified by the commodity that accounts for at least 50 percent of their total value of sales.
Source: Farm Costs and Returns Survey, USDA, 1993.

The contractor usually stipulates the amount to be produced, along with detailed requirements regarding production practices, grading standards, and terms for compensating the grower. Growers, particularly in California and Washington, commonly negotiate through a bargaining association representing several producers.

ERS estimates the average total value of processing vegetables removed under contract at $103,000. Fees received by producers during 1993 averaged $72,400, which represented about 70 percent of the total value removed. Expenses provided by contractors averaged $13,000. Most of the farms had other enterprises, making it difficult to partition operator expenses to vegetable production.

A Cost-Benefit View Of Contracting

Farmers use contracts to increase their income stability. Because most contractual arrangements reduce risks in comparison with traditional production or marketing channels, a contracting farmer's resulting income tends to be less variable over time. Farmers benefit by having a guaranteed market and price, as well as access to a wider range of production inputs and technological advances. They can also concentrate their management efforts on a particular part of the production process.

Processors use contracts because they need uniformity and predictability to suit consumers, but they also benefit from lower costs in processing, packing, and grading. The consumer can probably buy chicken or vegetables at a few cents per pound lower as a result of these savings from contracting arrangements by processors.

Data Sources

Data for this report come from USDA's 1993 Farm Costs and Returns Survey (FCRS), an annual survey which collects information on farm income, expenses, and operator characteristics. USDA administers the survey each spring in the 48 contiguous states through personal enumeration. The sample size of the FCRS in 1993 was approximately 12,000 farms and ranches.

The target population of the FCRS is operators associated with farm businesses representing agricultural production across the U. S. A farm is an establishment that sold or would normally have sold at least $1,000 of agricultural products during the year. Farms can be legally organized as proprietorships, partnerships, family corporations, nonfamily corporations, or cooperatives.

Data are collected from only one operator per farm, the one who makes most of the day-to-day management decisions. This one-farm/one-operator survey design yields good financial information for the farming business. However, it limits information about income and equity sharing when more than one operator is involved. Data on other stakeholders, such as contractors and share-rent landlords, who provide inputs to the farm and receive income from production, are also not included in the FCRS, except as reflected in other data on the farm business.

How the benefits and costs of contracting are distributed to the larger community has not been quantified. Consumers may see the concentration of control in production contracting leading to less competition and higher prices. Contracting may not necessarily lead to concentration of production on fewer farms—data show that farms of all sizes use contracts. It does, however, lead to concentration of decision-making and to less diversity in products and production practices. While diversity presents problems of its own, contracting that fosters product homogeneity makes agricultural communities more vulnerable to decisions made outside the community.

The trend toward contracting is part of a general shift in entrepreneurial functions within agriculture. Most concern about this shift centers on resource control in agriculture and the impact of those that control resources on producers, suppliers, price, and income at various stages of the production and marketing process.

Contracting, on the one hand, leads to the weakening of open-market price signals and a lessening of independence for the family farm. On the other hand, greater use of contracts could lead to more efficient production, less dependence on government assistance, and greater global competitiveness.

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