Economic Impact of Contracting in the Fresh Fruit and Vegetable Sector

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Contract sales of produce are growing as the result of greater concentration in the retail supermarket industry, new value-added products by grower/shipper organizations, increased and often-surplus supplies and the entry of the 'club store' format into the retailing of fresh fruits and vegetables. What is the economic impact of contract sales on producers of fresh fruits and vegetables? Will contract sales continue to grow? What are the driving issues?

The primary market channels are the produce departments of supermarkets, retail grocers, mass merchandisers (i.e. Costco, Wal-Mart Super Centers, and Sam's Club), with food service distributors, both specialty produce and broadline, to a less degree.

The purpose of this report is to discuss fruits and vegetables that are utilized and marketed as fresh to consumers. It is important to recognize that government statistics use the word 'fresh' to refer to produce delivered as fresh by the grower to the next level in the distribution chain. This definition includes packaged fresh produce as well as fresh items for preserving, freezing or other processing.

Contract sales of fresh product are increasing

There are two significant categories of contracts: a supply contract from the fresh produce grower/shipper or shipper to the retailer or distributor, and production contracts between the grower and the shipper. The grower and the shipper may be the same economic unit.

Contract sales are growing.

Food Service Surveys.

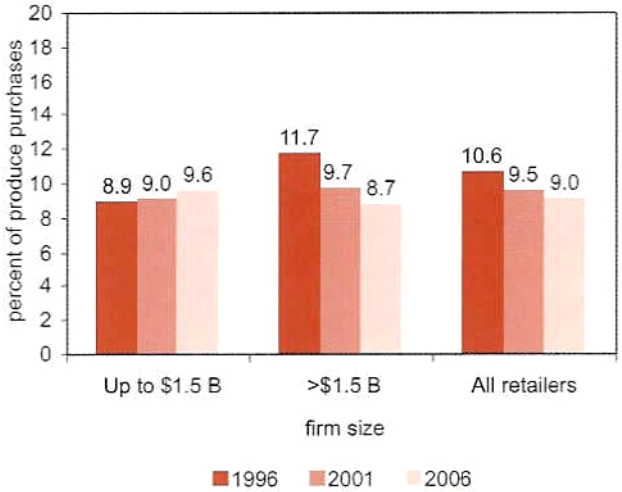
Transaction Method: Broadliners and Produce Distributors, 2002 and 2005

	Contracts		Open Market		Spot Buy	
	% of transactions					
	2002	2005	2002	2005	2002	2005
Broadliners	17%	27%	66%	58%	17%	15%
Produce Distributors	12%	21%	67%	62%	21%	17%

Produce in the Foodservice Industry, Freshtrack 2003, Table 2.2, p. 16

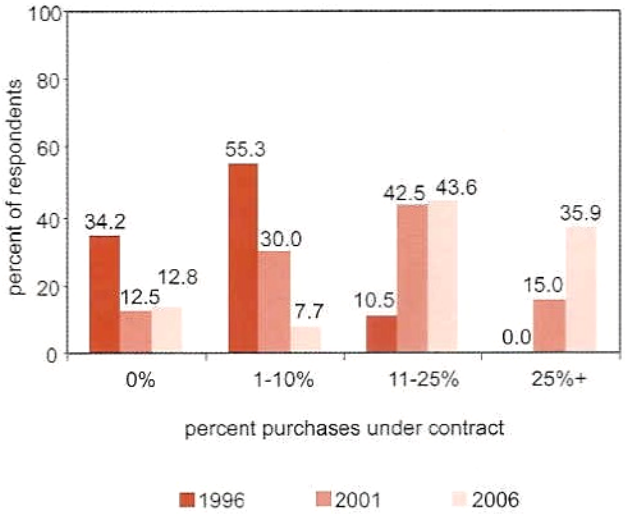
Retailer surveys from Fresh Track 2001

i. Percent of Produce Purchased through "Spot Buying" by Size and Year



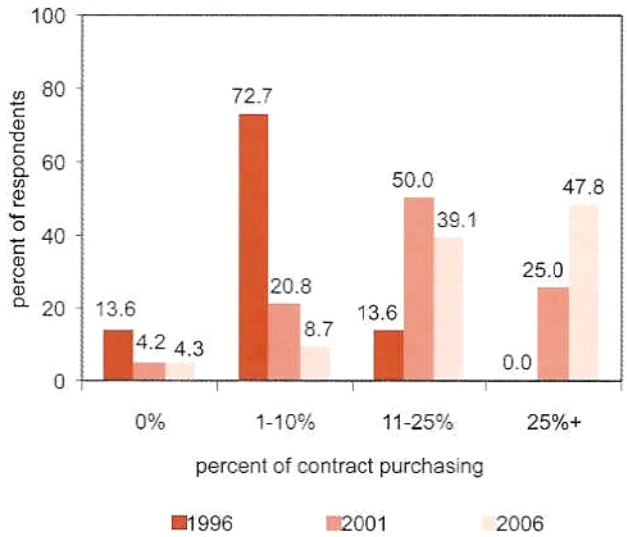
Supply Chain Management in the Produce Industry, Freshtrack 2001, Table 3.9, p. 24

ii. Retailers Use of Contract Purchasing: All Retailers



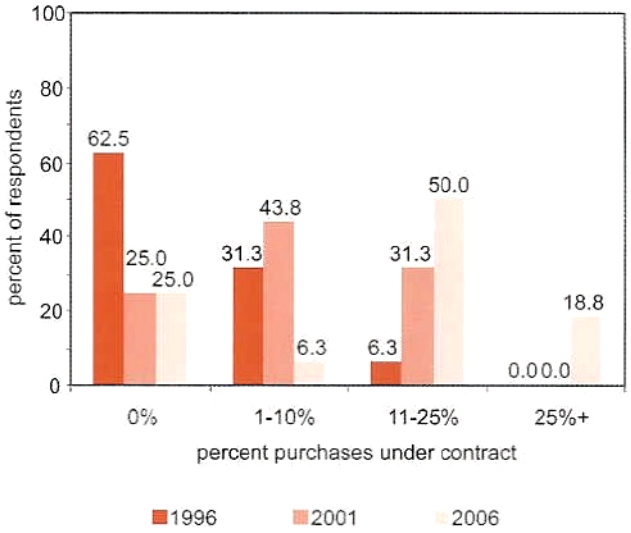
Supply Chain Management in the Produce Industry, Freshtrack 2001, Table 3.10, p. 24

iii. Use of Contract Purchasing: Retailers with Sales over $1.5 Billion



Supply Chain Management in the Produce Industry, Freshtrack 2001, Table 3.11, p. 25

iv. Retailers Use of Contract Purchasing: Retailers with Sales up to $1.5 Billion



Supply Chain Management in the Produce Industry, Freshtrack 2001, Table 3.12, p. 25

Contract characteristics

Contracts are typically unique to each customer and motivated by the customer. A contract establishes some type of volume arrangement (from a minimum to a fixed or variable volume within a range), some type of price arrangement (delivered or fob price), terms of payment, and possibly trade incentives, promotion allowances, quality, package, volume forecasts and other business incentives. The price may be a single price, or may have a range referenced to the commodity spot pricing exceeding defined high/low limits. The contract may also include retail-pricing schemes and merchandising requirements to assure product promotion and movement. There may be an act of God clause, limiting

the shippers' performance requirement in the event of a defined crop failure. The duration of the contract may be from a few weeks to multiple years.

One objective of a contract is to reduce transaction costs by removing short-term decisions for pricing and vendor selection. In some cases, notably with Wal-Mart Supercenters, the daily activity becomes inventory replenishment, the method of which is driven by computerization, increasing efficiency. Wal-mart created the term "VMI" – Vender Managed Inventory. The shipper is responsible for using Wal-mart's data and information to create orders and delivery schedules assuring full stocks. This is facilitated when the price is predetermined.

There are additional benefits. The grower/shipper has an assured market at a known price (or range) with a reliable forecast of volume. The retailer stabilizes the retail price and margin and reduces expenses and potential errors from changing retail prices. Stable retail pricing with determined promotions often results in increased demand and movement because consumers plan purchases when the price is stable and the supply consistent.

Produce sales contracts generally may be categorized in one of two ways: long term formal contracts for value-added or commodity type products. Bagged salads, cut fruit, and carrot sticks or chips are examples of value-added products, and bananas, potatoes, apples, and citrus examples of commodity products. Volume products with stable supplies are best suited to contracts. Produce with unpredictable and large short-term variance in supplies is more challenging. The berry category illustrates this type well.

The longer-term formal contracts for value-added products are likely to be complex and may include stocking requirements, shelf space definition, introduction and promotional incentives, and retail velocity requirements to avoid penalties and/or assure continued stocking. These contracts are written with few, if any, escape clauses and are reviewed by legal counsel. There is a reported shipper disposition that these contracts should be long term, for every negotiation, in six months or three years will result in lower margins for the shipper.

Shorter-term, less formal contracts are more typical for produce with erratic supply history, such as berries. A memorandum of agreement would be typical, not reviewed by legal counsel, and subject to adjustments as required. This is the type of agreement our company has with a number of customers. The motivator is the same, driven by the retailer to facilitate VMI strategies, stabilize retail price, and reduce buyer involvement in the process except when unusual circumstances dictate. The term is usually for six weeks to three months, seldom more than three months. These agreements retain more of the flavor of the historical produce trading environment between two responsible parties, are less formal, often not written, with no terms other than volume and price schedules, and may be subject to renegotiation in the event of unexpected supply changes. On-going business, the next agreement, is the result of satisfactory performance by both parties. The shipper's supply share of the product and product quality are important elements for equilibrium in these relationships, more than in the longer-term agreements.

Grower/Shipper Relationships

How does the shipper source product to assure fulfillment of contracts at acceptable margins or profits? Historically, the shipper has been the middleman between the retailer/food service distributor and the grower and is the organization bearing the direct risk of the contract. In many cases the lines are blurred due to backward or forward integration between grower and shipper. The blurring of the relationship results in a greater sharing of the sales contract price risk.

It may be the most efficient lowest risk supply for sales contracts is when the producer is fully integrated with the sales organization. This type of organization is increasing in numbers, often motivated to serve customers with contractual relationships. In the berry industry one of the top five shippers is the grower, growing in multiple districts to assure continuity of supply to fulfill contracts based on a season price based upon annual margin objectives. This model provides efficiency in sales contracting pricing and ease of sourcing product. The decision makers are a small number or may be one.

Non-integrated models pursue various arrangements from spot market purchases for 100% of produce needs to various combinations of spot and grower contracts. The grower contracts range from specific acreage, to specific quantities, to all the harvested quantities. The crop risk may range from 100% grower to 50/50 grower/shipper, to 30/70 grower/shipper, to 100% shipper risk. These arrangements are particularly used in the salad category, the largest value-added produce item(s). In order to avoid problems between packaged salad growers and shippers when lettuce prices soar, most fresh-cut lettuce processors have shifted to grower contracts with fixed price payments (per pound), and with a greater share of the crop financed by the shipper. With this method, the processors are assured of a stable ingredient cost regardless of the spot market price for lettuce.

Cooperative sourcing is an alternative. The cooperative supply agreements typically require delivery of 100% of the member's production. The cooperative manages contracted sales returns to assure equity of grower returns during various time periods. Fresh produce pool periods are typically daily to weekly and due to short-term market fluctuations, any period exceeding seven days is unusual. Assuring equity of grower returns often requires innovative methods as compared to the historical cooperative pooling methods. Our cooperative partners have been successful in moving forward contract sales, although management of returns is more intense than in short-term sales arrangements.

An illustration is the management of payments to the members of the cooperative. The cooperative manages the sales contract proceeds by paying the pool price, holding the overage/underage proceeds until the contract is complete. The balance at the conclusion of the contract is then dispersed to the impacted pools. It is important that the weekly pool payments are conservative, assuring positive net contract proceeds at the close of the contract for an additional payment to growers/members not a negative adjustment.

Long-term sales contract management requires intense management of the "lack of product" risk. The shipper must assure supply every day to the customer. This often requires growing relationships in geographically diverse growing districts to reduce the risk of crop failure during a similar time frame. There is evidence shippers' expansion to new growing districts has been at least partially motivated by contractual sales agreements to serve customers every day.

Impact on short-term prices

When the supply for a product with a high percent of contracted sales deviates from normal supplies the price deviation from normal is much greater than when there are no or few contracts. The spot price soars when supplies are tight and dives when they are long. The greater the proportion of contracted volumes the greater the price swings greater. This may motivate a grower to plant acreage gambling to hit it big.

When supplies are long and prices depressed many retailers have "special buy" programs to take advantage of the excellence value. These opportunities will be over and above the contracted sales and for the commodity type products with short shelf life like berries.

However, short supplies are not as readily remedied in that the retailer expects delivery of the contracted volume. The shipper with the contract must enter the spot market paying "almost any price" to assure delivery to customers. Unfortunately the high offers do not create more product. The result is a rise in the spot market to levels that make the non-contracted supply exceedingly valuable, tempting growers to divert production to the spot market to take the profit opportunity. These events are troublesome to all parties and motivate the shipper to further integrate into growing.

Economic impact for producers

Sales contracts provide an assured market for production at a price agreed with the grower based on expected yields. Such contracts provide a hedge for crops with no futures market. They secure the sale for the company's production, removing opportunity for competitors to supply that particular customer. Although regular trading patterns develop between shippers and retailers, the contract assures the sale.

Retail prices stabilize. Price stability is important to consumers. There is evidence the consumer responds to the stable price by increased planned purchases and the demand curve is raised. This is good for growers.

Sales contracts increase distribution at retail stores and food service locations. The contract provides an established price, a promotional commitment, and definite supply for a determined period of time. The retailer will therefore incorporate the item as an every day stock item. The restaurant operator will add the item to the menu with confidence of supply and price. Known ingredient cost is especially significant for foodservice operators in building demand for produce items on their menus. Increased demand is positive for return on growers' resources.

Contracts reduce transaction costs for both the shipper and the customer. The surveys indicate daily or weekly price negotiation is diminishing and long-term price agreements more important. Order fulfillment and inventory management will become information and formula-driven accomplished by computers with few or no people involvement. The potential economic impact is not of the magnitude as raising the demand curve but important. How long before such transactions may be done in an offshore country with wages 20% of US wages? This would drive savings.

Sales contracts may erode grower/shipper margins as promotional allowances, stocking incentives and similar business development tactic costs are moved from the retailer to the grower/shipper. The grower/shipper involvement in marketing, supply and price management, promotions and demand impacting tactics argues for 'greater impact on determining one's destiny.' It is positive when the grower is motivated to take an active interest in the marketing of the product beyond the farm gate. Production planning will improve and be more responsive to the market.

The increased demand for stable everyday supply is impacting US growers and grower-based organizations such as cooperatives. The grower producing for a specific calendar window will increasingly be required to access the market through a shipper organization with year round agreements. The alternative is for the grower to expand production to fill the now void windows. This may require operations in districts significantly removed from the historical base. Similarly the grower-owned cooperative must find new sources to supply the full year. This objective is the one my career has focused on developing. Growers track record in producing the "year-round" supply to fulfill the demands of the customer is not good. Cooperatives have been slow to respond and often lag other shippers' engagement in twelve month sourcing. This reluctance has not been positive for growers' economics for it has stimulated another layer in the distribution channel to organize the twelve-month supply. Grower margins are reduced and others may enter the production of the product. Growers' economic results are improved when there are actions to organize twelve-month supply.

Growers may feel forced to move out of their traditional knowledge base for profitable growing when compelled to harvest over extended time frames. Long-term the grower will gain an economic advantage by sustained production diminishing the likelihood of the customer looking for other vendors.

Growers may experience an economic disadvantage when the spot price is sustained above the price of the contract for a considerable time due to events not anticipated or predicted. The opportunity for gain on 'hot' markets is removed.

As sales contract volume grows relative to total supply, the market for growers without agreements will be subject to greater price fluctuations, more boom or bust. The ease of entry into growing may be reduced by the contractual sales agreements and exit may come suddenly when a contract is lost to a shipper not needing the existing grower's supply.

Summary

Contracting will become the dominant procurement method for fresh produce. Although there are significant economic advantages, it is difficult to see grower margins increasing. Production will be concentrated in fewer hands. Efficiency will be derived by volume operations. The well managed large grower will grower. Smaller growers will be forced out. Shipper margins will be reduced by competitive pressure to increase volume, and reduce unit costs. The grower will bear this cost. Economic strength will move to the retailer and/or the shipper. The grower will counter by increasing volume to become more important to the shipper or will be come a shipper, controlling production over a

longer time, or combining with other growers, as in a cooperative model, to gain economic strength.

Shipper organizations will continue to seek grower agreements with fixed prices. Reduced risk results in reduced opportunity for gain. Pursuing a strategy of "no supply gaps" may increase total supplies, diminishing overall returns. On the other hand, as supply is concentrated in the hands of fewer shippers and/or growers this may reduce excess supplies by planting for the forecasted demand. This is positive. Shipper partnerships with the grower stabilize the grower's risk, but will minimize profit opportunities.

Sales contracts will diminish long-term margins both growers and shippers. There will be greater integration of grower/shippers and growth to obtain volume efficiencies to survive. The supply chain will become more tightly coordinated and those that cannot meet the volume, quality and food safety requirements will exit.

The most effective strategy to combat the buyer pressure resulting in diminished margins is for growers to organize to go to market with large proportion of the total supply. This should be thirty to forty percent. This is the most effective method for balance in negotiations in commodity products.