LESSONS FROM THE HOG INDUSTRY'S EXPERIENCE WITH CONTRACTING

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The pork industry now has ample experience with both production and marketing contracts. We have seen both good and bad sides of these arrangements and, regardless of what any individual thinks of them, are convinced that they are part of the permanent landscape of animal agriculture. We firmly believe that correctly structured, negotiated contracts can serve all parties well in developing a closely coordinated pork industry that is competitive with any meat protein industry in the world. The point of debate at this point is whether these contracts have been structured to create win-win situations for contractors, growers and packers. The results to date are decidedly mixed.

The first and foremost idea that I want to get across today is this: Pigs are not chickens are not vegetables. Every product, even those which are close competitors such as pork and broilers, is unique and must be treated uniquely. Analysis or policies appropriate for one may be entirely inappropriate for another. It is paramount that we all keep this in mind. We in the pork industry are especially sensitive on this point since it seems that activist groups are incessant in their attempts to foist the problems of the broiler contracting system on the pork industry. The animals are different. The systems are different. The markets are different. The people are different. Treat us differently because we have fewer and different problems.

The second idea that I want to convey today is that while poultry production contracts embody marketing contracts, these two are still almost completely distinct in the pork industry. Yes, one can turn into the other when you think about a marketing contract really being another way to get someone to raise pigs for a processor. But pork production contracts have historically been initiated by a producer (sometimes a very large one, but a producer nonetheless) with sows who wants to grow pigs to market weight or grow more pigs. Conversely, marketing contracts have been initiated by either a producer or a packer with the explicit purpose to transfer pigs in a manner that guarantees shackle space and hog supply, respectively.

With this distinction in mind, I will address what I believe the pork industry has learned about production and marketing contracts separately.

Production Contracts

The number of hogs farrowed and finished under contracts has grown steadily over the past 20 years. There are good reasons for this growth. Production contracts:

- Are hardly ever lowest-cost production options. The major reason is simple: Contractors have to pay for the buildings again and again even after they are depreciated out. In addition, the geographic separation of contract sites and the need for supervision add administrative and logistical costs. Some of these are no doubt offset by economies of scale in genetics procurement, feed manufacturing and marketing but all of the data to date suggest that production can be done for less cost in owned buildings than in contracted ones. Contract production is cost competitive but not lowest cost.

- Are used effectively as a rapid expansion strategy -- This is a way to grow a business by accessing someone else's equity and credit line. It allows contractors to invest their money in the most productive asset, pigs, and entice someone else to invest in a less productive but less risky asset, buildings.
- Are an effective way to secure labor that has a stake in the performance of the operation. And this factor may get more important as labor supplies tighten, especially in the Midwest.
- Allow contractors to achieve the geographic dispersion needed to provide bio-security and spread environmental risk. In addition, contract facilities can place waste nutrients nearer to target cropland without requiring the contractor to buy large tracts of land. This adds value to the waste nutrients, frequently enough to generate positive contribution margin from these waste nutrients.
- Provide a diversification and entry opportunity for many rural families and do so while giving them much needed management support, access to modern genetics and market access.

I would classify the pork industry's experience with production contracts as widely successful. We have seen few of the problems that have been so widely publicized in the broiler industry, mainly because of the ease with which weaned pigs, feeder pigs and market hogs can be transported. Because of this ease, no contract grower is captive to a single contractor. This gives growers options to negotiate better contracts and keeps contractors honest and aggressive in their dealings with growers.

Pork contractors (especially the large ones) have invested much effort in building up reputational capital in areas where contract production is widespread. Virtually all of them count reputation as an asset that cannot be put at peril. There have been cases of default on production contracts but, to our knowledge, few of them have involved the large contractors whose every move is watched closely and publicized widely.

Finally, pork contractors, unlike broiler contractors, cannot afford to lose growers and their buildings because production decisions are made months in advance. The flow of pigs cannot be turned off in three weeks as can the flow of broiler chicks simply by deciding not to put eggs in an incubator. This longer planning horizon is also the reason for pork production contracts being much longer term agreements than what I consider the ridiculously risky flock-to-flock system prevalent in the broiler industry.

The lack of geographic monopolies on the part of contractors may not always be the case, especially if the mergers of 1999 continue. But the characteristics of the pork production system and the continuing need for high quality farrowing and finishing facilities suggest that contract growers of hogs are not as likely to become as captive to or as disposable by contractors as are their counterparts in the broiler industry. And, as of today, it doesn't appear that the one "surplus" facility that in essence floods the market has yet been built so the market for contract growers and barns remains generally tilted to the sellers' side.

Marketing Contracts

The real contribution of the pork industry to a "What have we learned" discussion is, no doubt, in the area of marketing contracts. NPPC is supportive of producers' rights to decide whether they need a contract to guarantee market access and manage price risk. We see contracts as a viable alternative for coordinating systems which neither the producer nor the packer want to vertically integrate and to make these systems competitive. We are also convinced that the first generation of marketing contracts, many of which are about to expire, are not fair enough to both sides to accomplish these goals.

First, a bit of history. Marketing contracts were developed by packers in response to producer requests. It was producers, not packers, who first proposed marketing contracts in an effort to guarantee access to slaughter capacity and, in many instances, to reduce price or cash flow risk. As a few packers responded, others quickly developed their own programs in order to prevent their competitors from tying up the supply of good, lean hogs. In the early days of market contracts quality was a key driver -- packers wanted to secure the best hogs.

In the rush, many mismatches between producer goals and contract features were created. Many producers who, after the slaughter capacity problems of the fall of 1994, were concerned about having a place to sell pigs signed contracts that included price risk management when they neither wanted nor needed that feature. Others signed formula contracts that they erroneously believed would affect the average price received enough to offset the risk posed by price variation. Still others signed contracts, which put floors under prices and included a "ledger" feature that they believed would never get too large and would self-liquidate over time. So they believed!

All of these contracts were written buy the packers. Some had terms that were somewhat negotiable. Others were strictly contracts of adhesion or "take it or leave it" deals. As with any contract, the party that wrote these (i.e. the packers) made sure that their interests were taken care of. Many terms gave them unilateral power to change everything from quality standards to delivery to the pricing matrix itself. All were predicated on "historic" hog cycles and price levels and this doomed them to problems in a market like that of late 1994 through 1999.

So what have we learned. Quite a bit and most of it has not been pleasant. Here are the highlights:

- History doesn't always hold OR make sure you look at ALL of history. Did anything really suggest $10 hogs in the fall of 1998? No. But nothing really suggested that hog prices would stay in the $35 to $60 range of the '80s and early '90s either. If all of history is considered, the possibility of lower priced hogs was clear. Was it "probable" in today's world? Again, no. But probability distributions theoretically contain every possible outcome, including positive and negative INFINITY. Never think it will never happen. The result of this narrow view of history is huge ledger balances that may never be repaid. The lesson is for producers and packers to consider the full range of possible outcomes and develop adequate contingency plans. These are, at least in theory, long-term and supposedly win-win relationships.
- Producers should match contract provisions to their critical needs. If market access is the key issue, then agree to supply hogs to packer A in turn for packer A agreeing to take your hogs on a timely basis and leave price risk management up to the separate parties. The lesson is for producers to carefully analyze what is actually needed and negotiate for only those features. The arrangements must be win-win or no deal.

- Be wary of any contract clause that gives one party (usually the contract writer) the unilateral power to change a contract provision. The ability to change business relationships is needed but the changes should be the result of negotiation, mediation or, as a last resort, arbitration. Our experience with packers changing weight discount ranges, leanness premiums and a host of other items at their own whim has been entirely negative and will probably be played out in more than a few courtrooms over the next few years. The lesson here is to carefully review contracts and develop alternative to the unilateral change provisions. Change is often a necessity, but leaving the decision in one parties hands is a recipe for disaster. The need for change should be a signal for renewed negotiation and, if a mutually acceptable decision cannot be reached, possible mediation or arbitration.
- Provide for changes in government services and information. A main source of unhappiness with contract performance has been packers' decisions regarding base prices after the USDA-AMS changed their price reporting system in 1999. And at least one packer chose to use a reported price that was clearly in the packer's favor in spite of ample data demonstrating a method of mimicking the discontinued "Iowa-Southern Minnesota Practical Top" price report. The only recourse to producers to react to what they consider was a breach of contract was to breach the contract them selves and sell hogs on a $20 cash market. Some recourse! The lesson here is to include the possibility of information changes in the contract and spell out how such changes will be handled. Again, negotiation, mediation and/or arbitration are all possible courses of action.
- Be very careful about narrowing the market that serves as the base for a large percentage of the contracts in force. Many of today's contracts use the Iowa-Southern Minnesota 10:30 a.m. report to price a given day's purchases or deliveries. So, the price of all of these contracted hogs is determined by purchases occurring before 10:00 a.m. on a given day. In addition, a good portion of the contracts is priced at the midpoint of the range of prices reported at 10:30 a.m. These contracts are priced on an even narrower set of hogs -- the highest and lowest priced lots sold before 10:00 a.m. on a given day. As the base market is narrowed more and more, the more open to manipulation it becomes. And when producers have tried to take an active role and report the prices they receive to AMS, many have found it impossible to get a bid on their hogs before 10:00 a.m. but easy to get bids at higher prices after the 10:30 a.m. report. We believe it is blatant manipulation but we also admit it was our own "collective" doing that made it possible. The lesson here is to be careful about the scope of the price determining market. One of the best features of the impending Mandatory Price Reporting system is its inclusion of a prior day report that will include ALL of the hogs purchased by plants which slaughter over 100,000 head per year. These data, since they are on such a broad set of hogs, will be practically impossible to manipulate. Furthermore, the records and enforcement provisions of the Mandatory Price Reporting Act promise to make the data accurate and hold packers accountable for such accuracy.

So what should the response be? Regulation is a possibility but not one that we are extremely fond of. Standardized disclosure requirements would reduce confusion and facilitate comparisons and competition. The catalog of contracts required by the Livestock Mandatory Price Reporting Act of 1999 will help producers be aware of what is available to them.

But the most important action to be taken is for producers to learn more and be more vigilant about their business dealings. It is unbelievable the number of producers who admit that they never had their attorney review the marketing contract that they signed. It is shocking how many producers never read the contract themselves. This is just lousy business practice that must end in today's more sophisticated world. The courts will not likely remain sympathetic forever to producers who do not follow sound business practices.

We at NPPC have recently assembled a committee of experts to review marketing contracts and write what we believe to be a much-needed and valuable addition to the pork producers' decision-making arsenal. NPPC's Guide to Marketing Contracts will be publicly available for the first time in two weeks at the National Pork Industry Forum in Kansas City. It covers many of the issues I have discussed today and demonstrates the performance of the various marketing contracts over recent years. It is not meant to be legal advice but is meant to stimulate what we believe to be the correct and necessary questions that producers should ask themselves and any packer who offers a contract.

I appreciate the opportunity to discuss these issues with you today and hope that you better understand the pork industry's experience and education regarding contracts. I look forward to responding to any questions.