



### Other contract terms

Other important terms are included in these contracts. They require carcass merit pricing and may require that hogs be a minimum quality grade to qualify for the contract. Repeated delivery of sub-standard hogs is grounds for canceling the contract. Scheduled deliveries are also required. While some contracts allow the producer to commit only a portion of his or her production to the packer, others require that producers commit all production and the packer has first rights on any expansion. The contract may also require that genetic stock, nutritional practices, facilities and other production requirements such as the highest level of Pork Quality Assurance be approved. Contract lengths also differ, but are typically in the 5- to 10-year range to assure that prices have time to pass through both a high and a low range.

The contract may have a *no net gain* clause that keeps track of the price gains or losses under the risk-sharing provisions, and the contract must either continue or be bought out if either party has made a net gain. This assures that the producer and packer have the same long-run average price as in the open market, but without the highs and lows.

Provisions and price levels of long-term packer contracts are usually offered similarly to various producers at one time. However, the terms appear to have changed over time. Just as hog prices have declined in recent months, so have the attractiveness and availability of long-term contracts. The packer's bargaining position has improved. Contracts signed two to three years ago typically have higher price levels than the contracts offered today.

### Why producers use contracts

Producers that sign long-term packer contracts are typically looking to reduce risk either for their own benefit or at the request of their lender. Producers that are highly leveraged often find that the only way to acquire the necessary capital to expand is by reducing price risk.

Some choose these contracts so they can focus on production and worry less about marketing.

Before considering a long-term packer contract, producers must know their cost of production and quality of their hogs. Although lower risk activities often result in lower returns, the price outlook for the next five to seven years may favor some type of risk-sharing agreement for producers concerned about cash flow commitments.

### Why packers use contracts

Packers that sign long-term contracts are typically looking to secure a supply of high-quality hogs. They also have greater control over how the hogs are produced (genetics, PQA, etc.) and delivered.

Contracts are one more strategic tool that packers can use against their competition. They are able to secure high quality hogs that then are unavailable to competitors. However, it is doubtful that a packer can pay significantly more for hogs than his competitor for any extended time, and sell the pork at the same wholesale price. While some processors may have a brand name that can extract a premium price, most packers would have to absorb the difference until hog prices turn in their favor.

### Impact of contracts on market prices

What is the impact of long-term marketing contracts on open-market prices? Marketing contracts are relatively new in the hog industry, but formula pricing agreements and other *captive supply* mechanisms are more common in the fed cattle market.

While extensive research funded by the Packers and Stockyards Administration is underway on the cattle market, earlier research on the issue found a relatively small impact on market prices. At first glance, contracts take an equal amount of supply and demand out of the market. The remaining supply and demand would appear to be in approximately the same balance, resulting in similar prices.

To date, packers have contracted for a relatively small portion of their needs and must buy the remainder on the open market. While some people believe that packers will simply bid less for open-market hogs to offset higher prices paid on long-term contract hogs, the packers must stay competi-

tive in the open market. If they do not bid competitively, they will not buy enough hogs to run their plant efficiently, thus driving their cost per unit sold even higher. However, when short-run hog supplies are near packing plant capacities, such as during the large fall hog runs, packers do not have to bid as aggressively to acquire their needed supply. As a result, short-term price volatility may increase.

The long-run price impact of long-term market contracts will depend on the relative changes in supply and demand. If risk-sharing encourages producers to expand because there is less uncertainty about the prices, pork supplies will increase over time. However, contracts may improve communication between producers and packers and increase pork quality and plant efficiency, making pork a better value relative to poultry and beef. If so, pork demand may improve, offsetting some of the price impact from larger supplies. Although the full effect of long-term contracts on open-market prices is not fully known and additional research is needed, it is believed that they do not have a large impact at current levels of contracting.

### **Summary**

Long-term marketing contracts are used by producers and packers as a tool to compete in a rapidly changing industry. Risk-sharing has allowed producers to make the necessary changes to their operation with confidence so that the entire operation is not jeopardized by a short-term cash flow problem. Besides reducing risk for both parties, long-term contracts provide greater communication between producers and packers on product quality and safety.

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