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Producing and marketing hogs under contract

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Quick Facts

Although not widely used, contracts can reduce risk to producers in some instances.

A forward sale contract locks in the sale price of a specified number of hogs at a future date.

Producers also can work through agreements with marketing agencies that will sell pigs for the producer.

Other systems include hiring others to do production work, receiving a guarantee on the price for a market hog, custom feeding, profit sharing and leasing of breeding stock.

A contract is an agreement between two or more persons to do or refrain from doing certain things. Contracts have been used sporadically in recent years in various phases of producing and marketing feeder pigs and slaughter hogs. Many versions of contracts have been used. Extent of usage of particular contracts has varied widely over time and among areas of the country. Generally, however, only a small fraction of U.S. hogs have been produced or sold under contracts.

Forward Sale Contract

A *forward sale contract* is created when a contractor (usually a meat packer) agrees to pay a producer a specified price for a certain number of market hogs to be delivered at a future time. The packer typically sells on the futures market a quantity of hogs equivalent to that to be delivered under the contract at the time the forward price contract is negotiated with the producer.

Then as hogs are delivered under the contract, the packer offsets his futures position by buying back the futures contracts previously sold. By hedging, the packer largely transfers his price risk under the forward pricing contract. Large producers, of course, may engage in futures trading directly rather than using the forward pricing service provided by the packer.

Contract terms generally include the following:

- The number of barrows and gilts to be delivered. A minimum delivery may be required. Many forward sale contracts require delivery of at least 130 hogs, which is equivalent to one live hog futurés contract; but some contracts permit delivery of smaller lots, such as the number of hogs needed to fill one-half of a futures contract.
- Acceptable assortments of weights and grades, with provision for discounts for less desirable assortments.
- The specified base price for the acceptable assortments, or a formula price specification.
- Delivery date and location. Various provisions may apply. A buyer may have the privilege of selecting the day of delivery within a short period specified in the contract, or a buyer may require advance delivery notice by the producer; generally slight deviations in delivery time by mutual consent are permitted.
- Provisions concerning any partial prepayment or credit advanced by the buyer.
- Provisions concerning liens or security interests held by third parties and concerning the time and manner of final payment for the hogs.
- Provisions concerning breach of contract. If the seller does not fulfill the contract, penalties are specified.
- Duration of agreement. The contract may apply only to a specific lot of hogs or it may be automatically renewable over several years with new price agreements on each lot.

Acceptable contracts must have some advantages for both parties. Packers or marketing agencies use contracts to improve the scheduling and quality of their purchases. In-and-out finishers of feeder pigs (farmers, investors, and feed dealers) may use contracts to lock in profitable hog-corn ratios before they begin finishing the hogs.

Continuous producers may contract when they fear market price declines, or when they (or their creditors) feel that they should reduce price risks. Generally, producer interests in forward sale contracts is high when hog prices have been low for a prolonged period and wanes when hog prices increase. Producers also are attracted by a partial prepayment or credit advance in some contracts. Production risks (related to weather, disease, theft) remain with the producer under forward sale contracts.

When a farmer uses forward sale contracts to transfer price risks, this has its cost; the contracts protect the producer from disastrously low prices but they also may cause him to forego high prices during boom periods. Therefore, the final results may be more or less profitable than if the hogs had not been sold under contract.

Factors such as producer's risk-bearing ability and the degree of diversification of the farming operation determine whether he should contract. Thus, a specialized hog producer who could be ruined by extremely low hog prices might choose to sell a portion of his hogs under a forward sale contract even if this meant foregoing some possible profits.

The *floor price contract* is a version of the forward sale contract which has been used occasionally. The producer agrees to deliver to the contractor a number of hogs at a future date. The contractor in return guarantees the producer some minimum or floor price for his hogs. In some contracts, if the market price at delivery time is higher than the floor price, the producers get the higher of the floor or market price. In others, the producer receives the market price less a discount if the market price at delivery time exceeds the floor price.

The discount compensates the contractor for providing the price floor. Under this type of contract the producer shifts only part of the market risk to the contractor. Typically, the producer furnishes all production inputs and carries all the production risk under these plans.

Producers should keep in mind that floor price contracts and other forward sale contracts reduce the risk on only one

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variable—hog price. Thus feed prices, for example, could increase and wipe out an anticipated profit from a hog operation even if a floor price contract was employed.

Marketing Agreements for Feeder Pigs

Under these agreements, which are frequently used in selling feeder pigs, a marketing agency (often a feeder pig marketing cooperative) signs a contract with a pig producer agreeing to serve as the marketing agent. Typically, the contract between the producer and the marketing agency contains the following points:

- The producer agrees to market all pigs through the marketing agency.
- The contractor agrees to sell pigs for the producer for a fee. The time and place of marketing usually are specified.
- Producers often must follow specific management practices prescribed by the contractor relating to health, quality and weight of pigs marketed. Frequently, the producer also must certify that the pigs were farrowed on his farm, inspected for disease, dewormed, immunized against erysipelas and castrated.
- Field supervision and technical assistance usually are provided by the larger marketing agencies but not by local marketing associations.
- Advertising and educational programs are sometimes carried on by the contractor to increase demand for the pigs. The contractor also may pool feeder pigs into homogeneous groups to increase their sales value.

Typically, producers operating under marketing agreements supply all production inputs. Sometimes the price producers receive for pigs under the agreements is determined by a formula relating feeder pig values to market hog prices. But normally under marketing agreements the producer accepts the market price for pigs. Therefore, the producer generally shifts little or no production and market risk to the contractor under these arrangements.

Selling practices vary. A local association may have periodic auctions in rented facilities. Larger marketing agencies may use tele-auction or a network of selling agents to market the pigs.

Producers who use these marketing agreements generally believe that the grading and other marketing services, and the technical assistance with breeding stock and production practices, are worth the fees paid to the contractor.

Putting-Out Systems of Hog Production

Feed dealers, investors, packers, farmers and other business people often are interested in owning and producing hogs but do not wish to furnish the facilities or labor. Contracts permit such operators to put out hogs with producers who are willing to furnish the facilities and labor. In some cases, feeder pigs are produced by one set of contractees and are then transferred for finishing to another set of contractees.

These contracts vary considerably in name and precise terms. Generally, the producers—the people doing the actual farrowing or finishing—receive a payment that is very close to a piece wage and rent plus some sort of incentive for a job well done. Sometimes the payment is partially related to market prices, but usually the persons providing the major inputs take all the price risk.

Major versions of putting-out contracts include 1) fixed or guaranteed payments, 2) custom feeding and 3) profit-share.

Guaranteed payment contracts. These contracts, which are used for feeder pig production and market hog finishing, guarantee a producer a specific payment per head regardless of the market price.

A guaranteed payment contract for finishing market hogs may provide that the farmer furnish the buildings, equipment, utilities and labor, and that the contractor supply the feeder pigs, feed, veterinary services, transportation and supplies. The contractor also would prescribe management practices to be followed. The object is to add 160 pounds (72.5 kilograms) of gain or more to each pig. The farmer might be guaranteed some fixed payment such as 2 or 3 cents per pound of gain for his contribution. A contract may provide bonuses or penalties depending upon production performance. For example, one contract provides bonuses if hog death losses are kept under 4 percent and feed conversion is 3.5:1 or better.

Custom feeding. The commercial custom feedlot is a larger, commercialized version of the producer who feeds hogs owned by others. Essentially copies of cattle custom lots, these rather new enterprises ordinarily provide more services and management, mantain greater independence and achieve higher returns than a small producer feeding for a single owner.

Profit-share contract. The producer is paid a percentage of the net receipts from sale of market hogs under this type of contract. The producer and contractor (typically a feed dealer) in a profit-share contract may divide the profit 90-10, 75-25, or 50-50, depending upon inputs furnished. Normally, the profit is defined as hog sales proceeds minus the contractor's costs (on a retail basis) of pigs, hog feed, medication, interest, taxes, veterinary expenses, miscellaneous and overhead costs.

The producer provides the facilities and labor for his share of the profit. The contractor normally stipulates that definite managerial and marketing practices be used. Typically, he also requires that his own feed, pigs and equipment be used. His gain or loss depends upon the profitability of the enterprise and what he gains from the markup on feed, pigs, and equipment. The producer and contractor share price risk and production risk under this type of contract.

Contractors putting out hogs have varying motives. A nonfarm investor seeks good returns without becoming involved in owning facilities or in the day-to-day labor of production. A feed dealer or manufacturer may seek the same goals as the investor, and also extra feed sales. A packer may have the investors' goals as well as valuing his own ability to schedule hog supplies for slaughter.

Producers signing these contracts achieve more certain returns, trading off larger possible profits in boom periods against loss prevention in low price periods. These producers, who may lack the ability to finance production on their own, may be willing to accept lower average returns than an independent producer.

Breeding Stock Leasing

The contractor furnishes the producer with breeding age gilts and/or boars under a breeding stock lease. The rent paid by the producer for the breeding stock may be either a specified number of hogs or an equivalent amount of money at designated times. Few of the leases permit a producer to retain any offspring for breeding purposes. Some require the producer to sell pigs farrowed to the contractor.

A producer operating under a breeding stock lease receives an income from the sale of hogs that is directly related to market prices. And typically, the producer supplies or rents all inputs. Therefore, the producer carries all market risks and most production risks except those related to death loss on the leased boars and gilts. Breeding stock leases have helped some new, undercapitalized producers to get started in hog production with good quality breeding stock and management assistance.

Breeding stock leases have declined considerably in popularity and are seldom used currently.

Characteristics of a Contract

- The contract should be in written rather than verbal form. It should be clear, concise and complete without being unduly long.
- The contract should be explicit about the rights, duties, and responsibilities of the people involved, and should contain at least the following provisions: names of parties, description of the property involved, duration of contract, how the contract is to be renewed, how much and in what manner payment is to be made or profits shared. If you don't fully understand your obligations under a contract, it is a good idea to consult an attorney before signing it.
- Production contracts and breeding stock leases are more complicated than the forward sale and marketing contracts because the contractor's property is entrusted to the farmer's care. Many questions must be anticipated and answered in a production or breeding stock lease contract. For example: How are death losses to be shared? Who pays the taxes and insurance on the hogs? Who pays for the marketing costs? When will you be paid for hogs sold or services provided under the contract?