

## ***Contracting in the U.S. Beef and Pork Industries: Extent, Motives, and Issues***



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## ***Primary Source***



- Marvin Hayenga, Ted Schroeder, John Lawrence, Dermot Hayes, Tomislav Vukina, Clement Ward, and Wayne Purcell. *“Meat Packer Vertical Integration and Contract Linkages in the Beef and Pork Industries: An Economic Perspective.”* Iowa State University, May 2000.
- Financial support for the original study came from the American Meat Institute.

## ***Presentation Plans***



- Highlight the extent and motives for contracting in the U.S. pork industry
- Highlight the extent and motives for contracting in the U.S. beef industry
- Identify key (to me) contracting issues

## ***Contracting Motives***



- Contracting involves two consenting parties with potentially different motives
- Motives differ by type of contract
- Motives are interrelated and overlapping

### *U.S. Pork Industry: Extent*

- 1993 - Hog procurement by the largest packers - 13% contracts, 87% cash market
- 2001 - Hog procurement by the largest packers - 82% contracts, 17% cash market

### *Breakdown of Contracting by Type in 2001*

- Formula-priced contract based on cash market - 54%
- Fixed price contract based on futures - 6%
- Fixed agreement based on feed price - 16%
- Formula contract with window - 7%

### *U.S. Pork Industry - Producer Motives*

- Access to capital - favorable financing for growth
- Growth and expansion - manage environmental pressures and labor supply
- Margin assurance - cover costs, provide for a guaranteed minimum return
- Price risk management - price level, basis, floor, floor-ceiling

### *U.S. Pork Industry - Producer Motives*

- Higher prices - “sweetheart deals”
- Market assurance - shackle space with declining excess slaughtering capacity
- Reduced transaction costs - concentrate on production rather than haggling over price

### *Respondent-Packers' Motives, 2000*

- Secure more consistent quality 4.3
- Secure higher quality 4.0
- Assure food safety 3.8
- Improve plant scheduling 3.5
- Improve week-to-week supply/price management 3.5
- Reduce search costs 3.5

### *U.S. Pork Industry - Packer Motives*

- Supply assurance and coordination - plant utilization and coordination
- Quality assurance and control - consistent, high quality for branded pork products
- Food safety assurance - farm-to-retail management, tracking problems

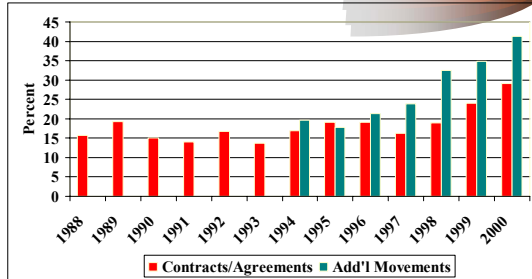
### *U.S. Pork Industry - Packer Motives*

- Price risk management - lay off risk assumed from producers
- Reduced transaction costs - manage procurement and input costs
- Lower prices - leverage contract purchases against cash market purchases

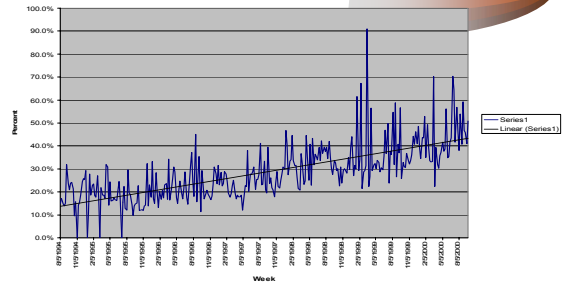
### *U.S. Beef Industry: Extent*

- Fed cattle procurement via contracts and marketing agreements by the four largest packers (GIPSA-USDA), 1988-98 - ranged from 13-20% annually
- "Additional movement" of fed cattle in the major cattle feeding states (AMS-USDA), 1994-2000 - increased from about 20 to about 50%

### Estimated Contracting of Fed Cattle, GIPSA vs. AMS



### “Additional Movement” of Fed Cattle, 1994-2000



### Respondent-Packers’ Perception of Producer Motives, 1999

- Receive a quality premium 4.0
- Secure a higher price 3.8
- Receive detailed carcass data 3.4
- Reduce price risk 3.3
- Facilitate obtaining financing 3.1

### U.S. Beef Industry - Producer Motives

- Access to capital - financing advantages
- Price risk management - managing basis risk
- Higher prices - from carcass merit pricing
- Market assurance - ensuring a “home” to reduce short-term price squeeze
- Reduced transaction costs - reduced haggling and frustration

### *Respondent-Packers' Motives, 1999*

- Secure more consistent quality 4.0
- Secure higher quality 4.0
- Assure food safety 3.0
- Improve plant scheduling 2.9
- Improve long run price risk 2.8

### *U.S. Beef Industry - Packer Motives*

- Supply assurance and coordination - plant utilization and coordination
- Quality assurance and control - consistent, high quality for branded beef programs
- Food safety assurance - managing food safety for large customers

### *U.S. Beef Industry - Packer Motives*

- Price risk management - managing costs and margins
- Reduced transaction costs - managing procurement costs
- Lower prices - leveraging "captive supplies" to lower cash prices

### *Contracting Issues: General Observations*

- Contracting involves two consenting parties with potentially different viewpoints and experiences (both with contracts and without them)
- Contracting issues are interrelated and overlapping
- Some issues may apply more to pork and beef but most are related to both industries
- Issues presented here are grouped somewhat arbitrarily (presenter prerogative)

## *Contracting Issues*

- Structure of Agriculture: Control vs. Independence
  - Who will control agriculture revisited
  - Defining “acceptable” control and independence
- Micro-Macro Conflicts: Firm vs. Industry
  - Is what’s best for me, best for the industry?

## *Contracting Issues*

- Risk Transfer
  - Good vs. bad contract clauses
  - Risk with contracting reduced?
- Returns and Potential
  - Consistent or inconsistent with economic theory?
  - Related to structure of agriculture issue

## *Contracting Issues*

- Deterioration or Disappearance of Spot Markets
  - Thinness, volatility, valid reference market
  - How thin is “too” thin?
- Consolidation and Market Power vs. Coordination and Efficiency
  - Ex post vs incipency question

## *Conclusions*

- Contracting is not new and the related issues are not new
- Contracting in agriculture is expected to increase for many reasons
- Agricultural economists need to be involved in the public dialogue

### *Economists' Role*



- Develop, clarify theoretical underpinnings for uniqueness (?) of contracting in agriculture
- Provide educational materials for producers and packers (micro/firm management)
- Identify pros, cons for firms and industries
- Estimate short/long run costs/benefits for industries, agriculture, and rural economy
- Provide objective input into the policy-making process