Hog Production Contracts: The Grower-Integrator Relationship

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Introduction

As early as the 1970s there were some isolated hog production or marketing contracts in existence. During this era, such arrangements were limited and the overwhelming majority of hogs were produced and marketed by independent producers on open or "spot" markets. However, during the past 20 years the pork industry has evolved rapidly. Among the factors that have contributed to this rapid evolution are packer and large producer consolidation, the need to control pork supply and price volatility, and the need for pork to be of consistent high quality and competitive with other food protein sources. These conditions have led to the rapid expansion of contractual arrangements in hog production.

True "spot" market or unnegotiated sales of hogs now account for less than 15 percent of all U.S. hog sales (Grimes and co-authors, 2004). Recent National Agricultural Statistics Services data indicate that nearly 40 percent of the U.S. swine inventory is owned by large producers, but is raised by contract growers under a production contract (NASS, 2004). This trend is likely to continue. Other survey data indicate that large companies that produce over 500,000 hogs per year account for 40 percent of U.S. production (Grimes, 2004). Thirty eight percent of these companies indicate that contract production will be an important component of swine industry expansion in the future.

Marketing contracts are agreements by a producer to provide a specified quantity and quality of pigs or market hogs to a buyer at a specified price. Production contracts deal more specifically with the production and management of the hogs. In these arrangements, a contractor or integrator provides pigs or breeding stock, feed, and other services to a producer or grower who manages the hogs at his or her farm until the animals are ready for market or transfer to other farms. This publication will focus on the importance of integrator-contract grower relations in production contract arrangements, but some of the general principles apply to marketing contracts as well.

The Production Contract

Most production contracts include written terms for length of contract, terms for renewal, conditions for termination, and specific language defining which party is responsible for certain inputs of production, equipment and facilities, and required services in the production of pigs. The most common production contract is for raising finisher hogs from approximately 45 pounds to market weight (about 250 pounds). In hog finishing contracts, base payment terms are generally defined as a payment price per pound of weight gain with additional incentive payments based on added weight gain beyond a set end weight and improved feed efficiency (pounds of feed per pound of weight gain). Payment terms for contract nursery pig production (weaned pigs to about 45 pounds) typically focus on a base payment for weight gain in nursery pigs with a feed-efficiency incentive payment. Farrow-to-weaned pig contract payment terms are usually based on a set price for each acceptable quality pig produced plus incentives for each pig produced above some set level of pigs produced per sow in inventory. For example, incentive payments may be based on a bonus payment for each pig produced above 16 pigs per sow in inventory per year.

Agricultural economists and others who have studied contract production make it clear that a *written hog production contract is not an unlimited guarantee* (Zering, 1997). And, although production contracts are an effective way for swine growers to minimize hog-pricing and feed-cost risk, both parties bear some risk that the other party may not be capable of fully meeting the written terms of the contract. Ideally, contin-

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gency plans can be included in the written contract to minimize these types of problems. Including defined procedures in the contract to address unexpected problems generally helps reduce surprises or conflicts for both parties. Certainly production contracts are binding legal documents. However, even well written contracts should be considered a basic framework for a working relationship in the contract production of hogs (Zering, 1997). Ultimately, the ability of each party to communicate and work with the other effectively will determine the long-term success or failure of the contract production arrangement. Successful contract production occurs when the venture has consistent mutual benefit for both the grower and the integrator over an extended period of time.

The Poultry Experience

The poultry industry has been heavily dependent on production contracts for over 35 years. In many respects it has been an economic marvel to other agricultural industries as poultry production and consumption in the United States has climbed steadily since the early 1970s. However, the poultry system has not developed free of problems and challenges. Recent agricultural trade publications have presented cases of grower-integrator dissatisfaction. In some regions of the South, calls for increased legislation and government oversight of the integrator-contract grower relationship have taken place. It is reasonable to suggest that the swine industry should learn from the poultry experience. The goal should be adopting those things that are successful, but to avoid, or at least deal more effectively with, potential problems.

Detailed analysis of the issues and challenges in U.S. poultry grower-integrator relations has been reported (Jenner, 1997; 1998). These reports illustrate the complex nature of these types of problems. In some cases integrators feel that problems arise simply from the fact that inefficient growers become disillusioned and make public complaints that are damaging to the overall system. Even on a "level playing field" not every player will be highly successful and some of those who have sub-par performance may be the most vocal in their dissatisfaction. Related to this is the observation that many poultry growers and their integrators are very satisfied with their contractual arrangements. In these cases, both parties feel that mutual benefit exists in their contract arrangements and that growers who are constantly complaining are damaging the overall system.

Reports also indicate that some real grower-integrator problems can exist. Evidence of these problems include a large lawsuit settlement by Cargill with Florida poultry growers in 1996, a state legislative effort in Mississippi to increase communication between integrators and growers, and a published survey of Alabama poultry growers that indicated that some poultry growers were quite content with their contracts while others were very discontented. One clear message from the poultry experience is that a strong sense of trust between the grower and integrator must be established and maintained for long-term success. As suggested by Jenner, the potential to cultivate trust is greatest when neither party adversely influences the other party's performance. Some points that can impact this situation are defined in the written contract. But ultimately, each party's willingness to communicate openly and act consistently in a way that shows a good-faith effort to make the contractual arrangement work for both parties will dictate the long-term success of the production contract.

The Swine Growers Perspective

Contract growers typically have large capital investments in specialized swine buildings and equipment (Figure 1). Meeting the fixed costs to operate such facilities has a major impact on the profitability and net returns to the grower's financial and management investments (Harper and co-workers, 1991). The contract grower must also be responsible for environmental regulations associated with manure management and mortality disposal and their associated costs. Under this situation, it is easy to understand that contract growers do incur economic risk and consequently are under pressure to achieve optimal throughput with their facilities. They also are justified in their desire to have a reasonable opportunity to achieve incentive bonus payments for better feed conversion, lower death losses, or more pigs produced per sow in inventory.

Growers recognize that contracts allow them to avoid much of the feed and hog price risks associated with the hog business. But they also recognize that they face other types of business risk. Such risks include increases in interest costs on debt, changes in fuel or utility rates, and even legal risks associated with environmental regulations or nuisance complaints against the operation.

Like all agribusiness people, contract growers must be profit motivated. Because they bear financial risk and face economic pressure to optimize net returns, it

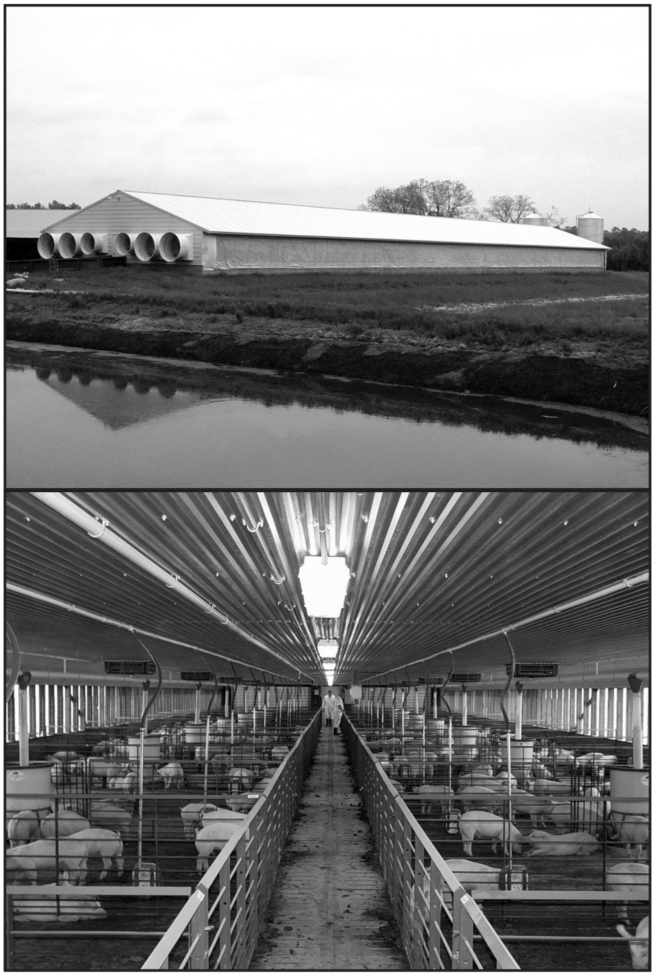

Figure 1. Contract growers have substantial economic investment in specialized swine barns and facilities.

is reasonable that they have certain expectations in the operation of their contract. These expectations may include, but are not limited to the following.

- That they are given the opportunity to have barns fully stocked to their design criteria.
- That "down time" between pig groups is consistently held to a minimum time.
- That health and general quality of the weanling pigs, feeder pigs, or breeding stock placed on the farm is sufficient to allow a reasonable opportunity for performance bonuses when good pig husbandry and management are applied.
- That the quality and consistency of the feed delivered is sufficient to allow the animals to perform near their genetic potential when good pig husbandry and management are applied.
- That communication with the serviceman and other representatives of the integrator is frequent, open, sincere, and helpful as they work to achieve optimal performance from their pigs or breeding herd.
- That the contract production arrangement can continue on an extended basis so that debt service or financial returns to management can be successful for the long term.

The Swine Integrators Perspective

Like the grower, the integrator faces financial risks and economic pressures. Risk exposure includes such things as potential increases in grain, soybean meal, or other feed ingredient prices; changes in pig marketing prices or schedules; and changes in labor, management, transportation, and other variable costs in the operation of company farms. In addition, the integrator faces financial risk associated with disease or other factors that decrease pig performance and efficiency, either on company farms or on contract-grower farms.

The integrator is under economic pressure to meet the demands of a significant payroll for workers, fieldmen, and management. Additionally, most integrators must meet the expenses associated with operating a fleet of trucks, a centralized feed mill (Figure 2), and in many cases, establishment and operation of company farms that may provide pigs or breeding stock to contract-grower farms.

Therefore, the integrator must also be motivated by profit. The objective in establishing a production contract is to achieve an expected level of pig production in a cost effective manner. The integrator's intent is to pay the grower for management and services in the production of the pigs and for the transfer of facility maintenance, mortality disposal, and manure management

Figure 2. Operation of a large, centralized feed mill and a truck fleet for hauling feed and live hogs represents significant production costs for the contract integrator.

responsibilities to the grower. However, the reasonable business expectation is that payment for these services will still leave opportunity for return on investment. Reasonable expectations of the integrator may include but are not limited to the following.

- That the grower will provide properly maintained facilities in sanitary condition for housing the pigs on a consistent basis.
- That ventilation, heating and cooling, penning, feeding, and watering equipment be maintained and operated to promote efficient pig performance.
- In the case of contract sow farms, that skillful breeding-herd management is carried out on a consistent basis for a high level of reproductive performance.
- That the grower will provide regular daily care and management of the contracted pigs and that health or other management problems will be promptly addressed in an effective manner.
- That access roads leading to the barns, feed bins, and hog loading facilities are well maintained and allow for delivery and pick-up of feed and pigs under all weather conditions.
- Growers will communicate openly with fieldmen and other integrator representatives concerning many potential or existing problems with the contract pigs so that viable solutions can be reached.

Making the Production Contract Work

There is no universal policy on the best approach to maintaining good contract grower–integrator relations in the swine industry. However, some general principles do apply.

From the onset, avoid or eliminate false expectations. The best time to determine what a contract can and cannot provide is before the contract is signed. Both parties should not expect things that the contract arrangement cannot deliver. Pro forma statements of potential costs and returns for a contract production farm should be drawn up based on realistic data and experiences. Potential growers should critically evaluate the contract and potential financial returns on investment and management. Integrators should be willing to provide reference contract growers whom potential growers can contact for information to help them make decisions. Likewise, potential growers should be willing to provide references and information to the integrator if such information is requested. Careful evaluation before the contract is established will determine if the relationship is truly feasible and help prevent false expectations between grower and integrator.

Understand the other party's perspective. As described previously, both the grower and the integrator are driven by economic forces to have certain expectations from the contractual arrangement. Some of these expectations may be addressed within the written contract but some may not. However, each party should make an effort to understand the other's reasons behind the expectations. Doing so will improve trust and cooperative spirit, improving the chances of long-term success in the contract.

Communicate openly, honestly, and with a common goal. The importance of good communication in contract production cannot be overemphasized. Open dialogue conducted in a professional manner should occur regularly between the contract grower and the integrator representative, typically the integrator fieldman (Figure 3). In this manner, problems can be identified early and viable solutions applied. It is not a matter of if problems will occur but rather how quickly will they be identified, communicated, and addressed. Effective communication that involves both talking *and listening* is important in addressing these problems. Ultimately, the goal when addressing these problems should be to arrive at a solution that is beneficial to both the grower and the integrator.

Respond to open communication with appropriate action. Open communication is critical, but responding to dialogue and problem identification with appropriate action is equally important. Failure to take proper

Figure 3. Open, honest, and frequent communication between the integrator's fieldman and the contract grower is essential for long-term success in contract swine production.

action to deal with problems after they have been discussed can lead to the impression that one or both parties are good at rhetoric but weak on their ability to actually solve problems. This weakens trust and cooperative spirit within the contractual arrangement.

Be willing to terminate the contract relationship if it absolutely won't work. This is a difficult statement to make because contract termination may create serious financial problems, especially for growers with a major capital investment in facilities. However, the reality is that in rare situations a contract arrangement simply does not work and cannot be repaired. When faced with this situation, integrators and growers should strive to minimize losses for the other party when a contract must be terminated (Zering, 1997).

Summary

Contract production has become increasingly important in the U.S. swine industry. Credible surveys indicate that most hogs produced in the country are under some type of contractual arrangement, and nearly 40 percent are produced under a production contract. Production contracts are a means of transferring business risk and defining production responsibilities within an integrated pork production system. In this system a swine integrator provides pigs or breeding stock, feed, and other services under a contract to growers who are responsible for housing and managing the pigs during one or more production phases and for collection, utilization, and disposal of manure and other waste products. Payment terms for the grower are written into the contract and typically include base payment prices for each pig or pound of pig growth with incentive payment schedules for better feed efficiency and productivity. While many important terms and conditions are written into the contract, it should be recognized that a hog production contract is not a risk-free guarantee for either party.

Swine growers and integrators should strive to avoid or eliminate false expectations from the production contract. Each party should attempt to appreciate the other party's perspective. Both face specific economic pressures and business risks and have sound reasons to be motivated by profit. Within this framework, growers and integrators should strive to have regular communication that is open and professional with the common goal of improving conditions for both parties in the contract. Communication and dialogue should be followed up with prompt action to deal with problems and improve efficiencies. All of these actions will help foster a sense of trust and teamwork between the grower and integrator. Practical experience has demonstrated that long-term contract production success occurs when the venture has benefit for the grower and the integrator. Finally, it should be recognized that in some rare cases the contract arrangement does not work and cannot be repaired. In such situations, the parties must be willing to terminate the relationship.

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