

## Contracting in the Poultry Industry

Business coordination has become an important method of organization of agricultural production in numerous commodity areas—fruits and vegetables for canning, livestock feeding, and dairy production and marketing to name a few (USDA, 1996). Contracts are an integral part of the production of broilers, turkeys, and eggs. The poultry industry is often cited as a model of the organization that may come to characterize much of U.S. farming in the future.

Broadly speaking, a contract is a written or oral agreement between parties involving an enforceable promise to do or refrain from doing something in return for a monetary consideration. Besides specifying quality requirements, contracts can also dictate prices and quantities. The form of the contract, specific provisions, degree of control, and other terms can vary greatly between farmers and among contractors. Contracts have become an integral part of the production and marketing of poultry products, including broilers, turkeys, eggs, and breeding stock (Lasley, 1983; Lasley, Henson, and Jones, 1985). For poultry, contracts are agreements between farmers and companies (or other farmers) that specify conditions of producing and marketing chickens and other poultry products. By specializing in the various phases of production, contracting can reduce participants' exposure to production or price risk.

We identify two types of contracts—marketing and production contracts. For more information about marketing and production contracts see *Farmers' Use of Marketing and Production Contracts* (USDA, 1996) which examined the use of contracts on all U.S. farms. That report provided some specific detail about the nature of contracts, with processing vegetables and broilers as examples, using data from the 1993 survey. Here, we examine broiler contracts in somewhat greater detail.

### Factors Influencing Use of Contracts

Contracting can be an effective way to manage the risks presented by the market. Farmers benefit by having a guaranteed market, price, or access to a wider range of production inputs, allowing them to concentrate their management efforts on a particular part of the production process. Because most contract arrangements reduce risks in comparison with traditional production or marketing channels, income is more stable over time. Farmers receive a steady cash

flow received from contract fees, giving them a safe position from which to conduct business. They also benefit from technical advice, managerial expertise, market knowledge, and access to technological advances (such as proprietary genetics) not otherwise available (Doye, Berry, Green, and Norris, 1996).

Processors and other entities enter contracts to reduce the risks and uncertainties in the production and marketing process by controlling input supply, improving response to consumer demand, and expanding and diversifying their operations (Kolmer, Kirtley, Smith, and Porteus, 1963). The incentive is the expectation that their profit opportunities are improved by controlling the quality and quantity of their products, thereby enhancing their market position. The poultry industry has been a leader in product quality, standardization, and identification, while smoothing seasonal supplies and expanding market share. Contracting has been key to achieving a higher level of product consistency. Broilers have been produced under contract since mid-century, and today, 85 percent of chickens are grown under contract. Most of the remaining chickens are grown on farms owned and operated by the integrator (Manchester, forthcoming).

When contracting began, broiler contracts had a per-bird payment or a simple per-pound fee (Aho, 1988; Doye, Berry, Green, and Norris, 1996). Today, contracts usually provide three types of compensation for grower services: (1) the base payment, (2) an incentive or performance payment, and (3) the disaster payment. The base payment is a fixed fee per pound of live meat produced. The incentive payment is a percentage of the difference between average settlement costs of all contractor flocks during a specific period and costs associated with the individual grower. Settlement costs are obtained by adding chick, feed, medication, and other customary flock costs divided by total pounds of live poultry produced (Vukina and Foster, 1996).

Contracts usually provide for incentives and penalties for management of the flock. Growers are penalized when their cost per pound of live meat produced is above the average cost per pound for the pool of growers. For below-average settlement costs (above-average performance), the grower receives a bonus (Vukina and Foster, 1996). Extremes in the costs per pound of live animal produced are typically removed from the calculation of average costs per pound. Thus, all other growers are not rewarded or penalized

because of the actions of just one grower. Different contractors use different methods to calculate incentive payments. Vukina and Foster note that some contracts include a payment mechanism that considers the differences between average market price and average variable cost. As prices decline, this mechanism transfers some market price risk from the integrator to the grower. The overriding concern is to give growers incentives to manage the poultry enterprise in a way that maximizes net returns to the integrator. The integrator has an incentive to support successful growers. The grower then attempts to maximize net returns within the constraints of the contract. Finally, contracts often provide causality clauses that compensate the grower in cases of natural disaster, such as for a flood, excessive heat, fire, or for damage or loss of potential production.

While the specific contract terms vary from company to company, most broiler contracts outline the division of responsibility for providing inputs and compensating growers (Gallimore and Vertrees, 1968). The grower cares for the chickens, and usually provides land and housing facilities, utilities, labor, and other operating expenses, such as repairs and maintenance. Depending on the contract, the farmer may also be responsible for manure disposal and chicken house cleaning. The contractor provides chicks, feed, veterinary supplies and services, management services or field personnel, and transportation for the birds to and from the farm. Rogers (1979) reports that feed is the largest expense and one of the most critical inputs in poultry production. Bird costs are the second largest expense, followed by labor and overhead costs, with energy costs being of minor importance. Expenses for fuel and litter can be shared or paid by either party, depending on the nature of the contract. Occasionally, the contractor may compensate the farmer for some fixed costs, such as insurance, or provide financing for capital purchases. Contractors make many significant production decisions, such as the capacity and construction of the technological unit (chicken house), the technology of production, size and optimal rotation of flocks, genetic characteristics of the birds, and specific feed ingredients.

With contracting, receipts from farm production are distributed to nonfarmers, with the contractors receiving the larger share of receipts from production (Lipton, 1997). Because contractors typically own the poultry, they bear a large share of production and price risk and earn most of the net income from the

commodity's production. Farmers may benefit from contracting by expanding their operations more rapidly than otherwise possible, perhaps with less debt and fewer financial risks.

Not all aspects of contract arrangements are viewed positively. Harris (no date, pages 110-113) asserts that contracting reduces entrepreneurial capacity by removing opportunities for human capital development through decisionmaking. Rather than buying inputs and supplies of the quantity and quality desired and from anyone who offers them at the best price, farmers respond to conditions stated in the contracts. Under contracts, many production practices are specified to bring a uniform product to market. Practices specified may include schedules of feeding, construction of buildings, and the types of inputs used. However, since the farmer is the flock caregiver, there is still room for good management, and most contractors reward skillful managers with bonuses.

Kolmer et al. (1963) indicate the possibilities of exploitation when there is unequal bargaining power. Farmers may be placed in a position to accept an unattractive distribution of risk and profit or to go out of production. Ideally, the division of gains or losses should be based upon the relative amount of inputs supplied by the different parties. Farmers, while free from uncertainty of receipts because income is fee-based and contractually determined, have little opportunity to profit from rising markets. The more coordinated a production process, the less flexible are the possible management decisions. Poultry producers invest in single-use chicken houses on the expectation of continuing contracts. If the contract is rescinded, the producer may be left with liabilities that cannot be repaid and assets that cannot be converted to other agricultural uses (*Progressive Populist*, 1996).

That some activities are closely coordinated does not guarantee efficient production and marketing. Contracting is a tool that farmers and contractors use because of profit incentives. The farmer is the judge as to whether the tradeoff of income stability and a confirmed market is a fair exchange for a loss of independence (Harris, no date). Contracts should clearly note who owns the product and holds the risk of loss in the crop or livestock, and when, if at all, ownership passes from one party to another. More information about contracting on broiler farms and for other commodities can be found in *Farmers' Use of Marketing and Production Contracts* (USDA, 1996).

### **Farms with Poultry Production Contracts**

Our data show that 52 percent of almost 50,000 farms with poultry or egg production in 1995 reported the use of a production contract, including contracts for broilers, turkeys, other poultry, and hatching and table eggs. The value of poultry and eggs produced under contract on those farms accounted for 85 percent of the total value of all poultry and egg production. Farmers without contracts tend to be large owner-integrated operations, or independents providing poultry and poultry products to local markets. Broilers accounted for almost half the value of all poultry production under contract. The remaining value was distributed among eggs, turkeys, other types of chickens, and other poultry.

We examined the financial structure and other characteristics of farms that reported broiler production to understand farm operations that contract. While some farms may produce poultry for sale in the cash market, or through a marketing contract, our data are too sparse to make reliable estimates for this group. We limited our investigation to broiler producers, as these farms represented most poultry production, and the survey provided an adequate sample for detailed analysis. Broilers are chickens raised specifically for meat and are ready for processing approximately 6-1/2 weeks after hatching.