Producing and Marketing Hogs under Contract
Michigan State University
Cooperative Extension Service

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There is increasing interest in hog contracting, due in part to the difficulty for many producers to obtain adequate financing. Contracting also is being used to coordinate pork production from genetics and nutrition to the retail meat counter. Currently, a small but growing percentage of hogs are produced, fed, or marketed under contract. It is estimated that about 14% to 16% are under production contracts, and a smaller percentage under marketing contracts.

Forward pricing (marketing) contracts for market hogs have been available from most major meat packers for a number of years. They are the most commonly used marketing contracts in the industry.

Production contracts for market hog finishing are relatively new but are increasing in the Midwest. However, they have been used for some time in portions of the Southeast where contract hog production is more widely accepted. Feeder pig production contracts are not as popular in the Midwest.

The following is an overview of the most common contracts in the pork industry.

Marketing Contracts

Market Hogs. The forward sale contract is a contract between a buyer (normally a meat packer or a marketing agent) and a seller (normally a producer), where the producer agrees to sell, at a future date, a specified number of hogs to a buyer for a certain price. The buyer normally will have taken an opposite position in the futures market to offset any price fluctuations between the signing of the contract and the delivery date. To cover margin and commission, the contract price offered by the packer may be lower than futures adjusted for expected basis.

Terms typically found in a forward contract include:

- The quantity to be delivered, with the minimum amount varying anywhere from 5,000 lb to 40,000 lb (40,000 lb equals one live hog futures contract).
- The date and location of delivery. The delivery date may normally be changed by mutual agreement. The seller may have the option of selecting the delivery date within a specified time interval.
- Acceptable weights and grades, including provisions for premiums and discounts.
- A description of the pricing mechanism, either fixed base price or formula price. Some contracts now price the hogs on a grade and yield basis to reward better producers who would otherwise be less inclined to contract.
- Provisions for non-deliverable hogs and unacceptable carcasses. The buyer normally deducts from the seller's receipts for unacceptable hogs and carcasses.
- Provisions outlining the credit requirements of the seller and inspection of the hogs by the buyer. The buyer may request to inspect the hogs while on the seller's premises.
- A provision dealing with breach of contract. Typically, the seller is liable for all losses incurred by the buyer when the seller is in breach of contract.

The producer retains all production risks, other than the selling price, under a fixed price forward sale contract.

A producer uses a forward sale contract to reduce the risk of price fluctuations and to lock in an acceptable selling price. While the forward sale contract allows the producer to lock in a particular selling price, it may cause him to miss out on greater profits if prices rise. Thus, the decision to contract must be based upon each producer's willingness or ability to bear the risk of price uncertainty. Some producers may be forced to contract due to a lack of diversification, indebtedness, or at the request of creditors, while other more financially stable or diversified producers may be in a better position to withstand the risk of price

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movements.

Price risk may be reduced by hedging in the futures market. A marketing contract may be preferred to hedging for the following reasons.

- Marketing contracts can typically be written for smaller sizes than the 40,000 pound Chicago Mercantile Exchange contract.
- A fixed price marketing contract locks in the delivered price. A futures contract hedge locks in the futures price, but the local price differential (basis) may still vary.
- A marketing contract does not require an initial margin or additional margin calls be paid should the price increase after the contract is signed.
- The marketing contract is typically made with a local marketing agent or packer rather than dealing with the Chicago Mercantile Exchange. However, unlike a futures contract, the producer is required to deliver the hogs to fulfill a marketing contract.

A floor price contract is a variation of the forward sale contract, however it is not as widely used as the forward sale contract. The seller agrees to deliver a specified number of hogs to a buyer at a future date and the buyer guarantees the seller a minimum price (the floor price) for his hogs. Usually, the seller receives the higher of the floor price or market price at delivery minus a discount. The discount compensates the buyer for the costs (options premiums and other variable costs associated with the contract) of providing the guaranteed minimum price. Both the forward fixed price contract and floor price contract reduce only the risk of hog price fluctuations. The producer must still bear the other risks associated with hog production.

Feeder Pigs. Typically, feeder pig marketing contracts are between a marketing agency, often a cooperative, and a pig producer, where the marketing agency agrees to market the pigs for the producer in exchange for a fee.

A marketing contract might contain the following provisions:

- The producer agrees to market all pigs through the marketing agency.
- The marketing agency prescribes specific management practices to be followed by the producer. These may relate to the weight at which the pigs are to be marketed, health of the animals, and immunization against diseases.
- Many larger marketing agencies will pool feeder pigs into homogeneous groups to increase their marketability and will provide technical assistance to the producer.

Producers are essentially hiring marketing expertise to enhance their market prices and minimize the time and effort of locating buyers for their pigs.

Production Contracts

To expand more rapidly their own production, many larger producers use contract production as a way to hold down risk and capital required.

Investors, feed dealers, farmers, and others often are interested in producing hogs, but are unwilling or unable to provide the necessary labor, facilities, and equipment. Therefore, they search out producers who are willing to furnish the labor and equipment in exchange for a fixed wage or a share of the profits. The resulting contracts, between owner and producer, vary considerably in form and responsibility of each party involved. These contracting arrangements are attractive to young or financially strapped producers and would-be producers who do not have the capital to invest in a herd, and for producers with underutilized facilities.

Feeder Pig Finishing Contracts

There are three basic types of hog finishing contracts offered, each with variations on payments and resources provided.

Option 1: A fixed payment contract guarantees the producer a fixed payment per head as well as bonuses and discounts based on performance. Under a fixed payment contract for finishing hogs, the producer normally provides the building and equipment, labor, utilities, and the necessary insurance. The contractor supplies the pigs, feed, veterinary services and medication, and transportation. The contractor usually provides a prescribed management system and supervises its conduct. The contractor, as the owner of the hogs, does the marketing. The producer often receives an incoming payment based on the weight of the feeder pigs when they come into the producer's facilities. For example, $5 for a 30 lb pig and $4 for a 40 lb pig. The remainder of the producer's payment is made when the hogs are sold. The method of calculating base payment varies by contract. Some contracts offer a fixed dollar per head regardless of the weight gained. Other contracts pay a fixed amount per pound of gain based on pay-weights in and out of the facility. Others pay a fixed amount per head per day spent in the facility.

Most contracts contain bonuses for keeping death loss low and improved feed efficiency, as well as penalties for high death losses and unmarketable animals. Producers should have control over factors that impact their bonuses and penalties. For example, the right of refusal on obviously unhealthy pigs, or to negotiate a more lenient bonus schedule for multiple-source pigs. Contract payment methods typically range from a low base payment with high incentive bonuses to a high base with relatively low bonuses.

Option 2: Directed feeding by a cooperative or feed dealer that contracts with a producer to finish-out hogs. The contractor's objective when entering into a directed feeding contract is to increase feed sales and secure a reliable feed outlet.

The contractor provides the feed and some management assistance and typically directs the feeding program. The contracting firm often will purchase the feeder pigs, in which case profits from the sale of the hogs are shared as discussed below; or it will help the producer obtain financing to purchase the pigs. The producer agrees to purchase all feed and related services from the contractor and is responsible for all costs of production. The producer receives all proceeds for the sale of the hogs minus any outstanding balance owed to the contractor.

Option 3: In a profit sharing contract, the producer and contracting firm divide the profit in proportion to the share of the inputs provided by each party.

Typically, the producer provides the facilities, labor, utilities, and insurance for his/her portion of the profit. The contracting firm normally purchases the pigs and is responsible for all feed, the veterinary services, transportation, and marketing expenses. Over the duration of the contract, the contractor's costs are charged to an account. This account balance is then subtracted from the sale proceeds to determine the profit. The contracting firm often will use its own feed and provide management assistance. The producer is normally guaranteed a minimum amount per head as long as death loss is below a set percentage. For instance, depending on contract terms,the producer may receive $5/head if death loss is 3% or less and $3/head if death loss is over 5%. The producer receives this payment regardless of whether a profit is made. The contractor's return depends upon the profit made on the sale of the hogs and the gain received from the markup on feed, pigs, and supplies provided.

Through contracting, producers are able to achieve more stable returns, trading the possibility of large profits for the assurance of a more reliable return. Many producers enter into contracts because they either lack the capital or they do not wish to tie up a large amount of capital in hog production.

Feeder Pig Production Contracts

Feeder pig production contracts come in several forms.

Option 1: The producer provides everything but the breeding stock and bids what he is willing to produce a feeder pig for, based on production criteria such as pigs weaned per litter, etc., with discounts and bonuses based on a target level. Most of the production risk is retained by the producer.

Option 2: A contractor provides breeding stock, feed, management assistance, and supervision, and pays the feeder pig producer a flat fee for each pig. This fee varies according to pig weight and current production costs. In this example most of the risk falls on the person providing breeding stock, feed, and management.

Option 3: The contractor provides breeding stock, feed, facilities, and veterinary costs. The producer provides labor, utilities, maintenance, and manure handling. A fee for each pig produced and a monthly fee for each sow and boar maintained is paid to the manager. This option fits owners who no longer want to be actively involved in production, but have a good manager with limited cash willing to take over the operation.

Option 4: A shared revenue program with revenues divided in proportion to inputs provided. One example would be where the producer supplying facilities, veterinary care, utilities, labor, and insurance would receive a negotiated percentage of gross sales in return for his/her share of production costs for each pig sold. The feed dealer would receive a certain percentage based on his/her share of the total inputs. The remaining percentage would go to the breeding stock supplier and the management firm that supplies computerized records, and consultations. Negotiated percentage shares should be based upon inputs provided and risks borne by each participant.

Farrow-to-Finish Contracts

While base-payment plus bonus contracts are offered in some regions, many farrow-to-finish contracts are on a percentage basis to reflect the relative inputs supplied by each person or firm.

Option 1: The producer supplies facilities, labor, veterinary care, utilities, and insurance for an appropriate percentage of gross sales based on input costs. The feed retailer supplies feed, standard feed medications, and receives a predetermined percentage of returns. The capital partner and breeding stock supplier get another percentage. The management firm receives a percentage for supplying computerized records services and management consultation.

Option 2: The current hog inventory is purchased outright by a limited partnership and it will supply sow replacements. The producer supplies facilities, labor, utilities, veterinary costs, repairs, and manure disposal. The feed retailer provides feed and standard feed medications. A management agency supplies production and marketing guidance. Each of the contract participants receives a percentage of the proceeds when hogs are marketed. The remaining percentage is split between the limited partnership and the general partner for managing the partnership.

Option 3: The contractor provides breeding stock, feed and a prescribed system of management. The producer provides facilities, labor, utilities, insurance and disposal of manure. The producer receives fees per head or per pound of hogs marketed plus possibly additional compensation for farrowing and feeding efficiency.

Breeding Stock Leasing

The popularity of breeding stock leases has declined in recent years and presently they are seldom used. Many contractors were dissatisfied with the care of the breeding herd and sometimes were unable to collect their payments from producers. One lease involves a payment-in-kind for the use of breeding stock. This lease is particularly attractive to producers with limited capital but ample feed, facilities and labor to produce hogs. The producer pays all production costs and pays the breeding stock owner, for example, one market weight hog per litter.

Characteristics of a Good Contract

The relationship of producer and contractor are generally more complex and interdependent for production contracts than for marketing agreements. Hence, production contracts need to be evaluated with special care. When considering contract production, contractors and producers need to evaluate each contract on its own merit. Each party should look for a contract that best fits its operation and management capabilities. Both parties must know their cost of production to make an informed decision. Simply signing a contract will not necessarily improve efficiency or insure a profit. It is doubtful that producers will receive a bonus for feed efficiency better than 2.9 if they have been only achieving 3.5 on their own, for example.

Also, carefully scrutinize the examples used to demonstrate cash flow or producer returns. Unless otherwise stated these are only examples and not guarantees. Producers should consider the impact on cash flow and debt repayment if payments are less than projected. Is there a guarantee of contract length if new facilities or other major capital expenditures are required to obtain the contract? Most contracts guarantee a stated number of turns (groups of hogs) or are in force for a stated length of time. Few, if any, guarantee the number of hogs that will be put through the facility in a set time, say one year. Facilities that sit idle during an unprofitable period in the hog cycle may profit the contractor, but disrupt the producer's debt repayment schedule.

Before considering the details of a contract, one should first consider the reputation and financial stability of the company or individual with whom the contract is to be made. For instance: How long has the company been in business? What has been the company's financial success? How long has the company offered contracts? Do other producers in the area have contracts with the company? Does the company fulfill the terms of its contracts?

Because little can be done after the fact to correct the problem, both parties should be encouraged to gather financial information about the other. This may be best handled on a document separate from the production contract. Problems and risks can arise for both the owner and the feeder due to financial failure of the other. Remember that:

- Except for the right to remove the hogs, the hog owner is an unsecured creditor of the feeder. The owner has little chance in recovering losses resulting from excessive death loss.
- The feeder has a statutory lien on the hogs, but this lien is subject to all prior liens of record. This means that the

owner's secured creditors can remove the hogs without paying the grower. Once the hogs are removed, the grower has an unsecured claim for his contract damages which is probably uncollectible.

- It is possible for the grower to receive first lien on the hogs if the owner and his/her creditors are willing to give the grower a lien subordination.

At a minimum:

- The contract must be in written form and must be clear and concise.
- The contract should clearly define the rights and responsibilities of both parties involved.
- The contract also should contain the following: number of pigs involved, names of both parties, duration of the contract, method and timing of payment, and definition of who shall supply certain inputs.
- A contract should be thoroughly read and understood before it is signed. Enlisting the advice of a lawyer, farm management specialist, or business consultant is helpful and often essential when evaluating contracts.
- The contract should contain an arbitration clause. Such a clause removes any disputes from the court system. The contract also should define how the arbitrators are chosen.
- Complete records of inventories, deaths, purchases, and sales should be maintained and open to both parties.

Other possible contract provisions would include:

- The right of the owner to inspect pigs at any time.
- Designation of responsibility for purchasing and marketing.
- A procedure for refusing delivery of unhealthy or poor quality pigs.
- The basis for compensation of feed and non-feed costs.
- Acceptable weight ranges for incoming feeder pigs and outgoing market hogs.
- A procedure to use if failure of payment arises.
- The means and timing of communication by producer to owner when a death loss occurs.
- Who assumes the risk of death loss.
- The extent of the producer's responsibility for care of the pigs and record keeping.
- Designation of who will provide insurance and how much coverage.
- The brand and quality of feed and supplement that is required if any, and who is responsible for ration formulation.
- How and when the contract may be terminated by either party.

The key to feeding or producing hogs under contract is finding the type of contract that will allow each individual to profit most from his/her skills, resources, and ability to bear risk associated with hog production. This strength may be record keeping, producing with a low mortality rate, or an ability to maximize herd feed efficiency. Whatever the case, producers should make certain that the contract will reward them appropriately for what they do best.

Once the best contract type has been found, the written contract itself should be carefully read and understood. The responsibilities of both parties should be clearly spelled out and understood as should procedures for dealing with possible disputes. While a well written contract is essential to successful contract production, it is also important that both parties are professional and willing to work out any problems that arise. A contract can never be so complete that every possible problem is anticipated. Individuals interested in contract production should check laws regarding contracting in their state.