Considerations in a Crop Production Contract

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A 1997 Agricultural Resource Management Study (ARMS) found that nearly one-third of the value of domestic agricultural crops and livestock was produced and marketed under contract. A 2000 survey by Grimes and Plain found that 75% of hog marketings were through a non-cash pricing mechanism. For live cattle, there are weeks in which nearly 100% of the fed cattle marketed are priced through a previously negotiated contract. The 1997 ARMS study found that nearly 60% of total hog production value was produced under a production contract. As for crops, the 1997 ARMS study found that marketing contracts accounted for less than 10% of the value of production for each of the corn, soybean, oats, milo, and sunflower crops. Over 30% of cotton and rice marketing was through contractual arrangements according the survey. One area of increased interest in contracting has been crop production contracts, primarily for specialty grains.

Here, we try to provide a brief overview of contracting considerations.

What Is a Contract?

A contract is a written or oral, legally binding agreement between at least two parties to do or refrain from doing something. Another way of thinking about a contract is as a set of rules outlining the expectations and responsibilities of both (all) parties involved in an exchange. For example, a production contract to produce high oil corn between a contractor (entity offering the contract) and contractee (entity accepting the contract) may be as simple as specifying that the contractee plant a certain variety of corn and, upon harvest, deliver a specified quantity to a previously designated location.

So Why a Contract?

Processors of grains and oilseeds for food, industrial, and feed use realize the value of sourcing inputs of known quality to reduce acquisition costs or enhance value to the end-user. Since processors are able to enhance profitability by using specialty grains/oilseeds, they are willing to pay a premium to guarantee the quality and quantity to meet their needs.

The premium is typically a payment for quality and quantity attributes above a conventional grain price the contractor pays to the contractee. The contractee requires a premium because of the added costs of producing and marketing the crop. Typically, seed is more expensive for specialty crops. Also, production of specialty grains requires more management by the contractee to make sure that the level of quality and quantity is obtained. This outcome can be achieved via two methods: by specifying the details of the production process, or by simply paying based on the quality of the delivered product. The method used will depend on the nature of the production process and the desired quality characteristics. If the desired outcome can be controlled by specifying the input/production decisions, then including those specifications in the contract may be the most effective method for guaranteeing output quality. On the other hand, if the output quality is highly variable, then simply paying based on the output characteristics may be the most effective approach.

Marketing Considerations with a Production Contract

Typically the production contract specifies one of two types of delivery of the grain/oilseed. A harvest delivery requires delivery of the crop at harvest. A buyer’s call delivery requires
delivery of the crop during a window of time specified in the contract. This window typically begins at the end of the harvest season and may be months in length. The contractee then stores the grain/oilseed until he receives a phone call informing him that he has a specific period of time to deliver it to a specified location. Very short time periods for delivery can cause logistical problems for producers.

Most production contracts leave the base price risk in the hands of the contractee. Assume a contractee has signed a contract to deliver 5,000 bushels of high oil corn to a local elevator. The contract will typically state that the premium will be paid on a per bushel basis determined by the level of oil content in the corn. For the harvest delivery option, the contractee has a good idea of the time period in which the corn will be turned over to the contractor so traditional risk management strategies apply. The buyer’s call requires storage of the crop and makes using risk management strategies such as futures/options more difficult because of delivery date uncertainty. As the time window of buyer’s call widens, more uncertainty surrounds which futures/options contract month to use. Longer storage periods can cause grain/oilseed quality issues and adds to the opportunity cost of storing.

Other Considerations
Specialty crops must be segregated. The producer may end up storing 5,000 bushels of specialty corn in a 10,000-bushel bin where 10,000 bushels of conventional grade corn could have been stored.

There is also a tendency for specialty crop contracts to have more stringent grade requirements than conventional crops, i.e., moisture, foreign material, etc.

Some contracts will specify that the per bushel premium will be paid only up to a specific level of per acre production. That is, if the contract specifies the premium will be paid on up to 150 bushels per acre on 50 acres, then the contractor is not obligated to pay a premium on production over 7,500 bushels. Of course, these production contracts will be most attractive to producers who can achieve a production level close to the target specified in the contract.

More Information
The Missouri Farm Bureau has two publications titled “Checklist for Grain Production Contracts” and “Checklist for Livestock and Poultry Production Contracts” that are available upon request or by going to their web site at www.mofb.org/.