APAC Agricultural Policy Analysis Center
The University of Tennessee

PolicyPennings by Dr. Daryll E. Ray

# In theory contracting reduces farmers' risk but not always in practice

The current financial crisis has spread its devastation far and wide. We have all read about the problems created by risky behavior on the part of some of our most-trusted financial institutions: reduced consumer spending including a drop in demand for automobiles, new homes and even chickens.

Suddenly farmers, who signed contracts with integrators as a means of reducing their risk, find themselves with cancelled contracts and no income to pay the mortgage on their chicken barns. A number of those with cancelled contracts mortgaged everything they had to get into or expand what they thought was a steady, relatively safe business. Today many of them face bankruptcy.

The present problems cannot be laid only at the feet of the financial crisis. The meteoric increase in grain and oilseed prices between the fall of 2006 and the summer of 2008 played a significant role in this crisis.

After years of extremely low prices, grain and oilseed farmers were breathing a sigh of relief as the price of their commodities rose above the cost of production. What looked good for crop producers was a disaster in the making for poultry, dairy and livestock producers as they saw their feed costs go through the roof. Dairy farmers were hit by a double whammy: much higher feed costs and a large reduction in milk prices. Many dairy farmers will not be in business at this time next year.

In the case of poultry, growers typically do not sell the output produced nor do they pay for the feed. The cost-price squeeze occurs one step up from the farmer producer, at the integrator level. But the result can be just as devastating to producers. Take what has happened at Pilgrim's Pride.

The combination of lower poultry demand, higher feed costs, and a relatively large debt load pushed Pilgrim's Pride over the edge and they filed for bankruptcy. As part of their reorganization plan, they began to close their less profitable plants, leaving the farmers who grew chickens for them without a contract.

Because the growing areas for the various poultry plants tend not to overlap each other, when a plant closes the farmer often does not have an alternate market for 200,000 chickens several times a year.

Other poultry producers saw the number of "turnarounds" reduced. When an integrator decides to reduce production, the integrator might not close a plant but rather reduce the number of birds processed by the plant.

A producer may be notified that instead of growing 5 batches of broilers one-after-another in a year's time, he will only be delivered 4 batches of chicks per year. Often 4 turn-arounds pay the producer's out-of-pocket expenses but no money is left to pay for his own labor, management and other costs.

This situation points out some of the problems that are an inherent part of industrial farm animal production. In a given area, a single integrator has monopoly control of the local market. Farmers, who have a contract dispute with the integrator or farmers whose contract is cancelled or modified during an economic downturn, may still owe the bank $500,000, but they have no alternate market. They are at the mercy of a single integrator.

Nationally, in addition to Pilgrim's Pride, there are two other major poultry integrators, Tyson Foods and Perdue Farms. With their market power, it would be very difficult for an independent to purchase a closed plant and make a go of it. In addition, because the three top firms control a major share of the national broiler production, they have little incentive to sell a closed plant.

The purpose of closing a plant in a time of oversupply is to reduce production and stabilize the price they receive for their broilers. Selling a closed plant and allowing the supply to remain on the market defeats one of the purposes of closing the plant.

Because of market concentration in the production of broilers, the integrators are able to capture the bulk of the profits generated by the industrial-scale production of chickens. According to a Los Angeles Times article "Farmers provide half the capital in the industry but earn only 1% to 3% on their investments, versus more than 20% for integrators in boom times, the National Contract Poultry Growers Assn. said" (http://www.latimes.com/news/nationworld/nation/la-na-chickens13-2009apr13,0,2407745.story).

While individual producers have signed contracts to reduce their risks and stabilize their income, they also have tied their prosperity to decisions made by the integrators.

*Daryll E. Ray holds the Blasingame Chair of Excellence in Agricultural Policy, Institute of Agriculture, University of Tennessee, and is the Director of UT's Agricultural Policy Analysis Center (APAC). (865) 974-7407; Fax: (865) 974-7298; dray@utk.edu; http://www.agpolicy.org. Daryll Ray's column is written with the research and assistance of Harwood D. Schaffer, Research Associate with APAC.*