Agricultural Contracts and Risk Management

Rachael E. Goodhue
Agricultural and Resource Economics
University of California, Davis

Leo K. Simon
Agricultural and Resource Economics
University of California, Berkeley

A grower's risk management strategy must address a number of types of risk. Agricultural production is risky in a number of ways, including the quantity and quality of production and the costs and, in some cases quality and availability, of essential inputs, such as irrigation water. Agricultural marketing introduces additional sources of risk, including price risk and "placement risk" (defined as the risk of not finding a buyer for all or part of one's production).

Crop insurance is available for many commodities, which aids growers in managing production risks; crop insurance is now available for numerous specialty crops (see http://www.rma.usda.gov/policies/ for further information about crop insurance.) USDA is also expanding availability of revenue insurance programs; this risk management tool is described in the article, Managing Risk With Revenue Insurance, beginning on page 10. In addition, major commodities, such as corn, soybeans and wheat, have access to highly liquid futures markets, which offer the opportunity to hedge against marketing and production risks. Other commodities, and producers of value-added variants of major commodities, such as high oil corn, do not have this option.

Agricultural contracts are another risk management tool that is sometimes available to growers. In California, contracts are widely used. In some commodities the vast majority of production is grown and sold under contract. In others, contract production and the spot market co-exist, sometimes with major producer marketing cooperatives as well; marketing cooperatives are briefly reviewed in the article, The Power of Producer Collaboration, beginning on page 23. Producers can negotiate contracts individually or through cooperative bargaining associations; the benefits of bargaining associations are also reviewed in this article.

Agricultural contracts

Agricultural contracts between growers and buyers can be categorized in a number of ways. Contracts can be formal written documents, or informal verbal agreements. Under certain conditions, even the latter are enforceable in a court of law. Contracts can be individually negotiated between the grower and buyer, or one party, generally the grower, may be offered a "take it or leave it" contract by the buyer. In some instances, the latter may have been negotiated by a grower organization acting on behalf of all of its members. Contracts may be written for a single sale, for all sales over a specified time period, or may continue until either party chooses to terminate the contract. This final type is sometimes referred to as an "evergreen" contract. Marketing contracts specify only conditions regarding the sale of a commodity, such as its price, quantity, and quality. Not all conditions may be specified in a given contract. Production contracts specify at least one condition regarding the production of the commodity. For example, a list of permitted pesticides may be included. Generally, production contracts also include provisions regarding the sale of the commodity.

In addition to provisions determining prices, quantities and production methods, formal written contracts often contain a number of additional clauses regarding the relationship between the grower and the buyer. Sometimes referred to as "boilerplate", these clauses deal with issues such as procedures for addressing disagreements between the parties, and whether the parties are considered merchants under the Universal Commercial Code, and hence held to a higher standard of understanding of the implication of contractual specifications than are members of the general public. Other clauses include warranties, dispute resolution clauses, and *force majeur* clauses delineating conditions under which either party is released from fulfilling the terms of the contract,

Risk management benefits of agricultural contracts for growers

Agricultural contracts offer a number of potential risk management benefits for growers. Contracts may address various elements of marketing risk, including price risk, "placement risk", and quality compensation risk. Contracts also may address production risk.

First, a contract can specify a price or a price determination method for a grower's production. Depending on the price determination method used, this can reduce or eliminate the effects of price volatility on a grower's returns. Obviously, if a specific price is given then price volatility is eliminated for the production delivered under the contract. On the other hand, if the price is specified as the spot market price plus premiums or deductions based on delivered quality then the contract does not protect the grower from the volatility of the spot market, although his average price may be higher. The combined use of premiums and deductions may lead to greater price volatility than the grower would face on the spot market.

Second, a contract can guarantee a buyer for all or part of a grower's production. Especially for perishable commodities, reducing this "placement risk" can be an important benefit of contracting. Even when a buyer can ultimately be found, there is a risk that additional marketing costs will be incurred in order to find a buyer while the commodity is still saleable.

Third, a contract can lock in rewards for quality attributes produced by the grower, by specifying how quality is defined and measured, and by specifying price premiums and/or deductions for delivery of high-quality production. Contracts may in some instances lead to a reward for quality by specifying how quality is defined and measured when third-party grading systems do not exist, or do not addressed desired quality attributes or levels. In the absence of a contract, the grower may not benefit from producing high-quality output.

Finally, contracting may involve the buyer transferring knowledge to the grower regarding specific production techniques that improve output quantity or quality, or even regarding the production of a commodity that is new to the grower. This knowledge may reduce output volatility, in terms of quantity, quality or both. The grower may be able to apply this knowledge to his non-contracted production, further reducing his output volatility.

Risks of agricultural contracts for growers

While an agricultural contract can be a tool for managing marketing and production risk, it introduces a number of risks that do not exist when a grower relies on the spot market. These risks can be grouped into three categories: production and marketing risk, relationship risk, and contractual risk.

While an agricultural contract can reduce price risk, the associated cost of this reduction is that a grower loses the flexibility to exploit unforeseen marketing opportunities, and loses the ability to benefit from price spikes in the spot market. However, these considerations are unlikely to be important in most cases when a grower is considering a contract.

More important considerations regard the interaction between an agricultural contract and production risk. First, contractual clauses specifying production practices may lead to more variable yields, and hence more variable revenues. Alternatively, they may cause lower yields. Depending on the price determination terms of the contract, this may lead to greater variability in revenues. Second, a contract may involve delivery obligations on the part of the grower. If his production is lower than anticipated, he may need to purchase additional output on the spot market in order to fulfill his delivery quota. On the other hand, the use of a delivery quota also limits the buyer's obligation to accept the grower's output. For the grower, this may lead to difficulty in placing any excess output with this or any other buyer, leading to placement risk for part of his production.

There are a number of potential sources of risk commonly grouped into the category of relationship risks. Here we focus on risks associated with compensation. There is a risk that the buyer may not pay for deliveries in a timely fashion, which can result in increased costs for the grower. While these are always risks with any type of sale, if a grower has delivery obligations under a contract he may not have the ability to cease deliveries if he is not paid for early ones. Another, more extreme case is the possibility that the buyer may go into bankruptcy. In this case, the grower may lose revenues for delivered product, or may face the need to find a new buyer for a product that may have been grown to the specifications of the bankrupt contracting buyer.

A contract specifies various aspects of the relationship between the contracting parties, which can reduce marketing and production risk facing the grower. On the other hand, contracts may introduce new risks as a result of common contract clauses, especially when the grower is offered a “take it or leave it” contract by the buyer. We refer to these risks as contractual risks. Contracts can include clauses that release one party from liability due to actions of the other part, clauses where one party warrants compliance with local, state, and federal laws and regulations, and clauses where one party warrants or explicitly does not warrant the quality of a product or its suitability for use in its intended purpose. We focus briefly on the risks of dispute resolution clauses and clauses that define farmers as merchants.

Dispute resolution clauses can introduce contractual risk regarding the financial outcome of a disagreement. The contract may require mediation or arbitration. While these procedures may be cheaper than filing a lawsuit if they are successful, they can also be more expensive, especially if they are unsuccessful and followed by a lawsuit. If binding arbitration is specified, the variability of the outcome for the grower is increased, because there is usually very little scope for contesting the arbitrator’s decision. In some instances, dispute resolution clauses require the grower to pay costs incurred by the buyer, in some cases regardless of which party prevails. Such clauses reduce the expected benefit of invoking the dispute resolution process, which in turn increases the volatility of contract returns.

While not a risk per se, contracts that note explicitly that growers are to be considered merchants may reduce the protection afforded by the courts when a grower seeks to declare all or part of a contract unenforceable, depending on the jurisdiction. A court may declare a contract provision “unconscionable”, and hence unenforceable. In general, a finding of unconscionability requires both that there was a procedural unfairness and that the provision drastically favors the party writing the contract. Compared to the general public, merchants are expected to have a greater understanding of the implications of contractual provisions due to their professional knowledge.

Buyers and contracts

No discussion of the role of agricultural contracts in risk management is complete without at least briefly addressing the interests of the buyer who contracts. It is important to remember that a buyer will not contract unless he perceives a benefit from doing so. An agricultural contract can serve as a risk management tool for a buyer, as well as for a grower. It can reduce price volatility. It can reduce “procurement risk”: just as a grower faces placement risk, a buyer faces the risk that he may not be able to obtain a sufficient quantity of agricultural output with his desired quality at his desired time. In cases where a buyer offers a “take it or leave it” contract to growers, he can benefit from reducing the financial risks associated with a contractual dispute through the inclusion of dispute resolution clauses, and reduce other financial risks through the inclusion of indemnification clauses.

Evaluating agricultural contracts as part of a risk management strategy
An agricultural contract may serve as a valuable tool within an individual grower's risk management strategy. However, its value is dependent on a number of interrelated considerations, and an evaluation of the risks and the returns must be conducted in order to ascertain whether or not the contract will be a useful risk management tool.

The evaluation should begin with the contractual provisions addressing price, quantity and production considerations. How is price determined? How will its behavior likely compare to the behavior of the spot price during the contract period? Is quality rewarded sufficiently to justify the cost of producing it? Does the contract provide a guaranteed home for all production, or only for a specified amount? What if total production is less than the delivery quota? Are there contract clauses regarding production? If so, to what extent do they deviate from your current practices? Does the buyer provide agronomists or other experts to aid you with adopting these practices? Consult your accountant regarding the financial implications of the contractual provisions.

In addition to the direct financial implications of the price, quantity and production specifications in the contracts, contractual risks and relationship risks should be considered. Regarding contractual risk, one should analyze carefully any contract before signing it, including an agricultural contract. As with any legal document, one should consult a lawyer before signing an agricultural contract.

In order to address relationship risk, consider researching the buyer. Are there any outstanding complaints or liens against the buyer? Can you speak with other growers currently contracting with the buyer? Are they satisfied with their experience? Request grower references from the buyer. In cases where the contract has been negotiated by a producer group on behalf of growers, request information from the producer group.

Many agricultural contracts are "take it or leave it" contracts offered by the buyer to growers. Perhaps the best guiding principle when evaluating a "take it or leave it" contract is that the buyer has written the contract to protect his interests; it is your responsibility to protect your own.

While agricultural contracts can offer significant benefits including the reduction of price, placement and production risks, they introduce new risks for growers. Fundamentally, risk reduction is never free. The benefits and costs of entering a contract must be evaluated on a case by case basis.