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NF96-280 Hog Cash Contracts Advantages and Disadvantages

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Hog Cash Contracts
Advantages and Disadvantages

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NebFact NF96-267, *Hog Cash Contracts*, discussed the provisions and specifications for cash forward contracts. This NebFact will cover the possible advantages and disadvantages of traditional and long-term cash forward contracts for hog producers and for buyers (most often a packer). A traditional cash forward contract is defined as a contract for a onetime or possible several onetime deliveries of butcher hogs over some time period to the same buyer or to a different buyer. The long-term cash forward contract (also called a marketing agreement) is defined as a three- to seven-year slaughter hog contract with the same buyer.

Advantages of Traditional Cash Contracts

- Quantity is agreed to by sellers and buyers
- Seller determines price
- Locked-in price; the negotiated price does not change but premiums and discounts may adjust the price received
- Usually understandable contract terms

Disadvantages of Traditional Cash Contracts

- Finding a buyer willing to offer a contract at the price desired
- Reduces market flexibility
- Commodity must be delivered in full
- Net price for contracted hogs may be lower than hedged price (because basis adjustment used by buyer turns out to be greater than actual basis, hogs are delivered in a non-futures contract month, etc.)
- Price received does not increase in a rising market

The decision to use a traditional forward cash contract revolves around the current and expected future directions of market prices, the volatility of the market and how soon a market direction change is expected. A cash forward contract fits a marketing plan best when the producer is in or expects a down or declining market.

Long-Term Hog Contracts

Long-term cash hog contracts include the provisions of traditional cash contracts along with additional price risk sharing and other variations. For example, most long-term contracts establish a floor price, but if the market rises the producer can share in the higher prices. Nebraska hog producers considering a long-term cash contract should check Nebraska laws and statutes to insure compliance. A producer should seek expert advice and consult with an attorney before entering into a long-term contract. The following points outline the advantages and disadvantages of long-term cash contracts for producers and buyers (most often a packer) for market hogs.

Advantages of Long-term Hog Contracts for Producers

- Guarantees place to market hogs
- Carcass information – kill sheet and updated historical record is provided to producer after each lot of hogs slaughtered – should provide data and excellent record of herd genetics
- Incentive to be low-cost producer, especially on contracts where a price floor is involved
- Focus on production and worry less about marketing
- Enhances ability to obtain long-term financing, if other areas of the hog enterprise are in good shape
- May provide more reliable cash flow, enhancing long-range planning
- Potential may exist for lender to consider the reduced risk by lowering interest rates or equity capital requirements
- Length of contract fits well with depreciation schedules on facilities and can insure a less variable return on investment over the productive life of the investment
- Frees management time for use in production and other financial matters.
- Limits price risk in down market
- Can benefit from higher prices on a price window or cash-flow contract
- For emotional stability

Disadvantages of Long-term Hog Contracts for Producers

- Length of commitment, usually three to seven years to one buyer
- Long-term commitment eliminates competition for producer's hogs
- Producer loses some independence
- Restricts or eliminates producer's ability to market hogs to alternate packer if that is advantageous
- Risk of changes in input prices may not be accounted for in contract, i.e. corn price increases but price window is not adjusted
- May use different premium/discount schedule for hogs purchased on open market
- Loss of flexibility in the marketing decision
- Penalties for non-delivery
- Limits upside potential in strong markets
- Likely the long-run average contract price will be lower than the average market price for the same time period

Advantages of Long-term Hog Contracts for Buyers

- Consistent supply of high quality hogs
- May reduce procurement costs

- Secures long-term supply of hogs
- Greater control over how hogs are produced (genetics, Pork Quality Assurance, etc.), less variability, likely more uniform or consistent quality hogs
- May be a strategic tool to use against competition
- May be able to secure high quality hogs that are unavailable to competition
- Vertical coordination
- Longer term cost of hogs is same or lower than open market prices

Disadvantages of Long-term Hog Contracts for Buyers

- May not insure consistent supply of hogs, depends on percent of hogs under contract
- Some potential for quality problems, contract hogs and open market hogs may have wide quality differences
- Harder to adjust to changes in market conditions because of large market hog price swings and hog industry structure changes
- Pay higher than market prices for hogs in down markets

Characteristics of a Good Contract

The producer should seek a buyer that has a history of procuring hogs similar to the type and quality being produced. The producer needs to consider the reputation and financial stability of the buyer. The producer should ask questions like: how long has the buyer offered contracts? Do other producers in the area have contracts with this buyer? What kinds of contract disputes, if any, have arisen?

At a minimum, the contract must be written clearly and concisely. It must state the rights and responsibilities of both the producer and the buyer. The terms of the contract must cover the basic elements of a market hog cash contract, including quantity, weights, grades, location for delivery, date of delivery and price. Other details like duration of the contract, method and timing of payment, record keeping system, sources of seed stock, how contract changes are made, how disputes are settled and any other specific contract terms, specifications and conditions should be covered in detail. A well written contract should keep the lines of communication completely open between the producer and the buyer.

Other Considerations for Producers

- Will future expansion be included in contract?
- Right of buyer to inspect hogs
- Possible changes and adjustments in buyer's buying program
- Can buyer cancel the contract
- Amount of buyer competition and slaughter capacity in area
- Provisions for the producer to be able to get out of contract
- Your lender's attitude on long-term contracts
- Long-term price outlook for hogs

Current Situation

It appears that currently Nebraska and most Midwest packers have contracted for a relatively small portion of their market hog needs and must buy the remainder on the open market. Packers must buy enough hogs to run their plants efficiently. This tends to keep packers competitive in the open market. At different times of the year, historically spring and fall, packers may not need to bid as aggressively for larger short-run supplies of hogs, but during the winter and summer, there is strong competition for available supplies. As a result, short-term price volatility may increase. The long-run price impact of long-term market contracts will depend on the relative changes in supply and demand. If risk-sharing encourages producers to expand because there is less uncertainty about prices, pork supplies likely will increase over time. However, contracts may improve communication between producers and packers and increase pork quality and plant efficiency making pork a better value relative to competing meats. If so, pork demand may improve, offsetting some of the price impact from larger pork supplies. Although the full effect of long-term contracts on open-market prices is not fully known, it is believed that recent price impacts are small at current levels of contracting.

Summary

A producer considering a long-term cash contract should be knowledgeable, check the law or consult with an attorney regarding contracting in Nebraska. If the decision is made to enter into a long-term cash contract, the contract should be carefully read and understood. All responsibilities should be clearly spelled out and agreed to by both parties as should procedures for dealing with possible disputes. No contract is so complete that all possible problems can be anticipated. It is important that both parties are professional and the lines of communication are open.

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