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Fact sheet

Contract Growing: Is It for You?

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The green industry is the fastest growing sector of U.S. agriculture and accounts for over 11% of cash receipts for farm crops. The industry grew at a phenomenal rate of nearly 10% per year from 1986 to 1990. While the growth is still strong, it has slowed to a more modest 3% to 4% per year, reflecting a mature market. The growth of mass market sales has encouraged specialization and price competition. Large producers are expanding by vertical integration (expanding their economic base through the addition of value-added or pre-production processes) and mergers. Some of these large producers are offering contracts to other producers to supply products.

Advantages of Contracts for Producers

Several advantages of contracts for producers.

- Contracts are an easy way to enter the industry.
- A contract eliminates some market risk and uncertainty and makes it easier to obtain credit because the producer has a "guaranteed sale."
- With sales already assured, producers can focus on just growing, giving them some economic security and emotional stability.
- Having a contract limits price risk in a down market. Without having to worry that the buyer is searching for other suppliers, the producer can focus on being a low-cost producer.
- A contract also may provide a reliable cash flow.
- It may enhance long-range planning and makes it possible to allocate space in advance.
- Finally, the length of the contract may fit depreciation schedules on facilities and insure a less variable return on investment.

Disadvantages of Contracts for Producers

However, a producer should consider some disadvantages before entering into a contract.

- A contract gives the producer less market flexibility. The producer must deliver at the contract price at time of delivery.
- Penalties for non-delivery and not meeting quality standards may be imposed.
- Often a long-term commitment needs to be considered, possibly 3 years with one buyer, which eliminates competition for the product. A contract restricts or eliminates the producer's ability to market plants to another buyer, thus limiting upside potential in strong markets, and there is a risk of default by that single customer.
- A possible risk is that changes in input prices such as energy costs may not be accounted for in the contract.
- The contract may use a different pricing schedule than for plants purchased on the open market. The contract price will probably be lower than the average market price.

- Finally, if the contract is long-term , what happens at the end of the contract? Will you have to look for a new buyer?

Advantages of Contracts for Buyers

The buyer, too, has certain advantages with a contract, the most important being a consistent supply of high quality products. A contract secures long-term supply of product and may reduce procurement costs. The buyer has greater control over how plants are produced. The buyer may be able to secure high quality plants that are unavailable to the competition. The contract may be a strategic tool to use against competition. A contract offers vertical coordination from beginning to end, and the long-term cost of plants is the same or lower than open market prices. In other words, the buyer has taken control of more of the production process.

Disadvantages of Long-term Contracts for Buyers

Even a contract may not insure a consistent supply of plants to the buyer. It depends on the percentage of plants under contract. There is still a potential for quality problems. Because producers are obligated to the terms of the contract, it is harder for a buyer with a contract to adjust to changes in market conditions resulting from large price swings and structural changes. Because of the contract, a buyer may pay higher than market prices for plants in down markets than someone who is buying on the open market.

Considerations before Making a Contract

Before entering into a contract arrangement, a producer should seek a buyer who has a history of procuring plants similar to the type and quality being produced. The producer should consider the reputation and financial stability of the buyer.

The producer should ask questions. How long the buyer has offered contracts? Do other producers in the area have contracts with this buyer? What kinds of contract disputes have arisen, if any?

Characteristics of a Good Contract

You should retain an attorney before making contract negotiations. A good contract is clear and concise. It states the rights and responsibilities of both the producer and buyer. Terms should include quantity, quality standards, location for delivery, date of delivery, and price. The contract should include provisions for settling disputes and a possible escape clause. For example, consider whether the buyer has a right to inspect the plants and make possible changes and adjustments in buyer's buying program. Can the buyer cancel the contract? Are there provisions included for the producer to get out of the contract?

The contract also should spell out the duration of the contract; the method and timing of payment; the record keeping system to be used; sources of seeds, seedlings, and plants; the technical assistance provided by buyer (will the buyer send a representative to help you control insects and diseases or solve other production problems) and the specifications, if any, for production facilities.

Other considerations for producers to think about are the amount of buyer competition in the area, whether future expansion will be included in the contract, your lender's attitude toward contracts, and the long-term price outlook for your product.

In summary, check with your attorney regarding contract growing in your state. Carefully read that it includes procedures for dealing with disputes. Keep lines of communication open among you, your attorney, and the buyer.

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