



Risk and Disasters for Contract Producers

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Introduction

According to the 2002 Census of Agriculture, almost 47,000 U.S. farms produced \$31.5 billion worth of livestock under production contracts. The percentage of farm income from contract livestock has risen dramatically across the southern US, and accounts for more than half of all farm income in some states. The rising importance of production contracts creates a unique set of challenges for producers in managing the risk of natural disasters, and for policy makers developing disaster assistance programs for them.

Natural disasters have become a part of the normal operation of agriculture, and farmers who do not prepare for the inevitable hurricane or drought do so at great risk to their farms. Hurricanes Katrina and Rita were only two of the many disasters that have hit the southern US in recent years. The five gulf coast states, Alabama, Louisiana, Mississippi, Texas and Florida, all rank in the top ten states for disaster declarations.

The purpose of this publication is to describe the specifics of the disaster challenge faced by contract producers and the range of resources currently available to address these challenges. Our hope is to both assist farmers to make fully informed decisions and to assist policy makers and farm advisors in addressing farmer needs.

Understanding Marketing and Production Contracts

Marketing contracts focus on the commodity as it is delivered to the contractor, rather than the services provided by the farmer. They specify a price or a mechanism for determining the commodity's price, a delivery outlet, and a quantity to be delivered. The pricing mechanisms sometimes limit a farmer's exposure to price risks, and they often specify a premium to be paid for commodities with desired levels of specific attributes. The farmer retains control over major management decisions and hence retains more autonomy than is available under production contracts.

Under a production contract, the farmer provides services to the contractor, who usually owns the commodity under production. For example, contractors in poultry production usually provide chicks to the farmer along with feed and veterinary/transportation services. The farmer then raises the chicks to maturity, whereupon the contractor transfers them to processing plants. Contractors often provide detailed production guidelines, and farmers retain far less control over production decisions. The farmer's payment resembles a fee paid for the specific services provided, instead of a payment based on the market value of the product.

Nigel Key and James MacDonald, "Agricultural Contracting; Trading Autonomy for Risk Reduction." USDA Economic Research Service. *Amber Waves Volume 4 Issue 1*. February 2006. Pg 28.

Types of Disaster Losses for Contract Producers

While contract producers share the production losses that all farmers face in natural disasters, they also face a series of other, less common losses that can form a significant financial burden. Kinds of losses vary widely depending on the nature of the disaster and on the nature of the farm enterprise. Based on RAFI's experience, contract farm disaster losses can be roughly grouped into the following categories:

Production loss

The most obvious type of damage is the loss of current production. While a contract producer does not lose the value of the animals, they do lose their investment of time and inputs, in those animals.

Asset loss

Disasters often mean loss of equipment and structures associated with production. Following Hurricane Floyd, the national media showed photos of flooded hog production facilities. However, asset losses can be far less dramatic. In recent seasons we have seen high temperatures burn out generators, lightning strike and destroy computer controllers, and other damage that while less severe, is costly.

In field crop production there is generally little damage to the means of production, which is the land. Confinement livestock facilities are the means of production, and their destruction can have significant impact on both the farm assets, and the farm's capacity to generate income.

Post-disaster clean up and disposal of mortality

In production contracts, the farmer has responsibility for disposing of livestock mortality. In many situations disposing of dead chickens or hogs can be both costly and time consuming. On-farm disposal of livestock mortality has been shown to have long-term effects on the land and groundwater. In situations where the production facility is destroyed, clean up of the facility site can also be costly.

Loss of industry infrastructure or markets

In vertically-integrated industries such as contract livestock, disaster damage to other geographic areas can have a devastating effect on local production. Contract producers depend on a wide-spread system to provide inputs such as chicks and feed, and to receive the animals produced. Disaster damage to production or processing facilities miles away, even in neighboring states, can cause reductions in production or leave farmers with animals that cannot be processed or handled.

Loss of time

With annual row crops, disaster losses usually mean that the farmer starts over the following year. However contract livestock enterprises have multiple production cycles per year. Mortgage and farm financing are often predicated on a certain number of production cycles per year. Disasters often cause a significant delay in the return to production, reducing the number of production cycles in that year and cutting income beyond production losses.

Loss of resiliency

The loss of resiliency is often the least obvious, but can be one of the most insidious losses in a disaster situation. When faced with a disaster, a farmer's immediate reaction is often to do whatever it takes to get back into production. This often includes maximizing available credit, emptying savings and retirement accounts, using unsecured debt such as credit cards, and borrowing against all accumulated assets. This situation severely limits the farmer's ability to weather any future loss, either personal or weather related. In many cases, getting back into production requires going in to debt that will demand high levels of income to pay back, and any production loss in the following years, for whatever reason, can end the farm. Disaster losses frequently continue to affect farms three, five, or even ten years after disaster.

The Challenges of Production Contracts

The structure of production contracts and the nature of confined animal production create a series of challenges in planning for and addressing disaster losses.

Ownership of Production

The characteristic that defines the difference between production and marketing contracts is the ownership of the product. In almost all production contracts, the farmer does not assume ownership of the animal or crop, but is paid based on production while under their care. Companies generally provide chicks or piglets, feed and veterinary supplies, and compensate farmers based on the amount produced from those inputs.

Even without ownership the producer has significant investment in contract production through investment in facilities, labor, utilities, water and other inputs. Because the producer is compensated based on production rather than a set fee for service, the producer shares in the risk of the production.

Sharing in the risk of production but not in ownership is precisely what makes risk management and disaster assistance for contract producers problematic. Most disaster assistance and risk management programs address losses based on ownership, leaving contract producers without coverage.

Levels of Investment

Contract livestock producers often incur very significant investment debt in production facilities. Poultry houses frequently cost \$250,000 per house, with most producers investing in four or more houses. This million-plus dollar investment is usually production and even company specific, and cannot be paid for with other forms of production. Companies often require equipment upgrades that extend the level of investment and debt.

In much of agriculture, variable costs such as seed, fertilizer, labor or other inputs are the majority of the investment in the crop. With high levels of investment in facilities and without the investment in livestock ownership, variable costs are a relatively small portion of the contract livestock budget. Yet they are a very significant percentage of contract production budgets is ownership costs.

Multiple production cycles per year

Unlike most row crops, contract livestock production requires multiple production cycles per year. With high ownership costs, reductions in the amount of production have a direct impact on farm viability, often more directly than other types of agricultural production.

Vertical Integration

Under production contracts, the producer is locked in to a specific vertically-integrated “complex” that provides the required inputs and receives production. Independent producers have the opportunity to seek out alternate input suppliers and alternate markets for crops in the event some segment of that complex fails. Contract producers do not have that option, and therefore do not have as much flexibility in recovery.

Production scale

Vertically-integrated livestock production takes advantage of economies of scale by producing large numbers of animals in a relatively small space. The large volume of animals creates significant difficulties in both disposal of mortality and in finding potential alternative markets.

Large-scale production means that in a disaster, a farmer must dispose of thousands, even hundreds of thousands of animals rapidly, often at times when labor and funds are in short supply. Without proper handling, livestock mortality can quickly become a health and environmental hazard, so the public has a major stake in proper disposal.

Biosecurity

Recent attention to global outbreaks of high-pathological avian influenza has brought greater scrutiny to domestic livestock production and potential biosecurity vulnerability. The possibility of disease outbreaks and possible quarantine complicate disaster preparations, and reduce the options for addressing disaster losses. In the event of a disease outbreak, there will be greater emphasis on addressing livestock mortality disposal on-farm, without off farm transportation.

Animal disease situations also complicate definitions of losses. A farmer may be required to destroy animals based on a disease outbreak on a nearby farm, but may not have the disease on their farm. Or a farmer may lose production because of a distant disease outbreak. These indirect losses are difficult to categorize and address.

Current Federal Disaster Assistance Resources

Introduction

The federal government provides assistance to agricultural producers through a series of programs. Federal assistance is initiated through a disaster declaration, which can be made by the President or the Secretary of the Department of Agriculture.

There are three levels of federal disaster assistance programs. The first form of disaster assistance is federally subsidized **crop insurance**. Farmers sign up and pay for crop insurance at the start of the production season. Crop insurance participation and assessments are often used as the basis for participation in other disaster programs.

In addition to Crop Insurance, there are several **standing disaster programs**. These include the Emergency Loan Program and the Emergency Conservation Program. Standing programs have been created by Congress, and are usually the quickest programs to come into play following a disaster. While these programs are ongoing, they often require additional funding from Congress to be effective in a disaster.

In specific disasters, Congress often creates **ad hoc programs**. These programs are created and funded for each individual disaster, and are often adapted for the specific situations. Because they must be created each time, these programs can take as long as several years to get assistance to producers. They are also the most susceptible to the economic or political challenges of the time. Ad hoc programs include the Crop Disaster Program, the Livestock Indemnity Program and the Livestock Assistance Program.

These designations are important because they determine the amount of time and political action needed for the program to get funds into farmers' hands. While crop insurance benefits can be made available in a matter of days after disaster losses, ad hoc programs may take several years. Several programs to address losses incurred during hurricanes Katrina and Rita did not begin sign up periods until late 2007, over two years after the storm.

The program descriptions below are of recent disaster programs. Recent program history does not assure that these benefits will be provided in future disasters, but do provide precedents that can be drawn on to advocate for future benefits. Several programs have provided benefits to contract producers in the past, but are no longer structured to provide those benefits.

Specific information on current disaster programs, including eligibility and sign-up periods, is available on the farm Services Agency web site at www.fsa.usda.gov, under the heading Disaster Assistance Programs.

Crop Insurance

Federally-subsidized crop insurance is the core of agricultural disaster response and risk management. Crop insurance adjustments are the basis for determining benefits for other disaster programs and other programs can require crop insurance participation as a prerequisite for receiving benefits. Crop insurance can also be important to a farmer's access to credit by establishing assured income.

There is currently no federal crop insurance program that addresses losses to production contract producers. All crop insurance programs require ownership of the production in order to access insurance.

When first implemented, the Adjusted Gross Revenue – Lite crop insurance program provided insurance for production contract income. This pilot program bases insurance levels on whole-farm gross income and is available for 2008 in 37 states. However in 2006 the program guidelines were amended to disqualify production contract income.

We have seen individual farmers obtain private production insurance, but are not intimately familiar with these policies. Private policies would, however, tend to be more expensive without federal subsidy.

The Emergency Conservation Program

For disasters since 2005, the Emergency Conservation program (ECP) has provided cost-share assistance to contract farmers for mortality disposal and for the repair or disposal of damaged facilities. ECP is a standing disaster program that “provides emergency funding and technical assistance for farmers and ranchers to rehabilitate farmland damaged by natural disasters and for carrying out emergency water conservation measures in periods of severe drought.”

ECP provides a maximum of 75% cost-share. However the percentage of cost share is determined by the state and county committees based on available funds, and is often significantly lower than 75%. In order for the farmer to receive cost-share funding through ECP, actions must be approved in advance unless there is an emergency need.

The Livestock Indemnity Program

In recent years, the Livestock Indemnity Program (LIP) has been amended to include compensation for contract producers. This program covers losses due to livestock mortality, and provides a specific per-animal payment. The 2007 program provided \$0.12 per layer, or \$0.06 per broiler for contract poultry producers.

The LIP requires that livestock mortality “have died in an eligible county as a direct result of an eligible disaster event(s).” This requirement has proven to be a frequent challenge for farmers to receive benefits. For instance, farmers who had poultry production losses when generators overheated in the extreme conditions of the 2007 drought and high temperatures were denied benefits because the losses were due to equipment failures.

Gaps in Federal Programs

The Emergency Conservation Program provides funding for losses associated with mortality disposal and repair of production facilities. The Livestock Indemnity Program provides compensation for mortality losses. While these programs are crucial, they do not address a series of other types of disaster losses associated with contract production.

In recent experience, the greatest uncompensated disaster loss is the loss of time. Most disaster programs are designed for commodity crop production with a single production cycle per year. In contract livestock production the time needed for disaster recovery before production can resume often extends long past the customary two-week layout and results in significant income losses beyond production losses or damage to production facilities. This down time can be caused by either the time needed for the farmer to clean out and repair the production facility or the need of the company to repair and restore infrastructure.

The financial structure of contract production increases the importance of these losses. With a high percentage of production costs being from ownership and debt financing, reduced production income is not offset by a reduction in variable costs to the same extent it would be in other agricultural production.

Addressing livestock disease outbreaks

In the spring of 2007, Jim and Randy White added a four-house poultry contract to their farm. Jim looked to a poultry contract to bring his son, Randy, into his farming operation without having to go after more land. Randy received a beginning farmer loan with a

federal guarantee to put up four poultry houses, and Jim co-signed. The loan for four houses was just over \$1 million. The annual loan payment is made in installments that coincide with the five flocks guaranteed by the contract.

The houses had the latest technology, including computer-run feeding and ventilation and an alarm system to alert Randy if something were to go wrong.

The high temperatures and drought of the summer of 2007 were hard on the Whites, and they had to check the poultry houses frequently for heat. In late August, as temperatures hit the high 90's for a record number of days, an evening thunderstorm moved through the area. Lightning struck the center house, and knocked out the computer for two of the houses. It also shorted out the alarm system. With record temperatures, the 40,000 birds in each house were dead.

In past disasters, some poultry companies have chosen to compensate farmers for lost flocks based on their production averages. This, however, differs between companies and sometimes between areas within the company.

Several disaster programs have addressed the direct disaster losses faced by contract producers in recent years, but these payments have been added to ad hoc programs and are not consistent.

In 1999, the Livestock Indemnity Program was amended to provide \$10 million in payments for contract producers.⁴² The result was LIP-CG, a LIP program specifically for contract growers.⁴³ LIP-CG was repealed in 2003.⁴⁴

Disaster bills for the 2005 hurricanes authorized LIP payments to contract producers for poultry mortality, Emergency Conservation Program payments to contract producers for mortality disposal and for repair or clean up of poultry houses, and Livestock Compensation Program payments for feed and pasture losses to both owners and cash lessees.⁴⁵

Production contracts, characterized by a separation between product ownership and product production, now dominate three of the top five crops in farm receipts in North Carolina. Farmers with current production contracts, especially poultry and hog contracts, experience disaster losses as loss of production income, costs associated with disposal of livestock mortality, costs associated with repair of facilities, and costs from disaster caused delays in production. These farmers continue to have little in the way of disaster assistance and no federal crop insurance. While production contracts are most prevalent in hogs and poultry, they are starting to be seen in other products as well.

⁴² P.L. 106-113 Appendix V, Title I, Chapter 1, 113, stat. 1501 (Nov. 29, 1999)

⁴⁴ 68Fed. Reg. 61,324, 61,325 (2003)

⁴⁵ Emergency Supplemental Appropriations to Address Hurricanes in the Gulf of Mexico, Pub. L. No. 109-148, Division B, Title I. (December 20, 2005) with regulations at 7CFR part 701, May 26, 2006. The Emergency Agricultural Disaster Assistance Act of 2006, enacted June 15, 2006 as Title III of the Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Recover Act of 2006, Pub. L. No. 109-234. A fact sheet on the 2006 Livestock Indemnity Program is available on the FSA web site at http://www.fsa.usda.gov/Internet/FSA_File/lip2_06.pdf.