GRAIN CONTRACTING: KNOW THE FINE PRINT

Frayne Olson, PhD
Crop Economist/Marketing Specialist
NDSU Extension Service
ND Agricultural Experiment Station
Dept. of Agribusiness & Applied Economics
Why do farmers and grain buyers contract?
Why Study Contract Provisions?

- Contract provisions vary considerably across different commodities.
- Contract provisions vary considerably across companies within the same industry.
- Contract provisions change every year.
- There is a concern that some farmers focus on contract price and don’t study the other contract terms.
Key Functions of a Contract

• Divide Value
  • Price is only one element of value.

• Divide Control Rights
  • Who has authority to make decisions concerning actions which influence value?

• Divide Risk and Uncertainty
  • Who is exposed to the outcome(s) of various adverse events?
Economic Considerations

• Any transaction must be a (potential) “win-win” proposition.

• Considerations which are of greatest importance when the contract terms or transaction provisions are designed, agreed upon and executed.
Legal Considerations

• Considerations which are of greatest importance when the contract terms or transaction provisions must be verified by an independent third party and/or disputes must be resolved.
Dividing Value from Exchange

• Assigns a price or pricing formula.
  – Fixed Prices
  – Price relative to specified futures market

• Specifies time and location for exchange.

• Specifies timing of payments.
  – Lump sum
  – Sequential over time
Dividing Control or Decision Rights

• Who is responsible for making decisions which impact value?

• Crop Contract Examples:
  – Choice of seed varieties
  – Choice of herbicides or production practices
  – Choice of deliver locations and timing
Dividing Risk & Uncertainty

• All contracts are *incomplete*.
• Contracting parties cannot anticipate all possible events.
• What does the contract specify?
• What do we do if something happens which is not included in the contract?
Dividing Risk & Uncertainty

• The longer the contract duration, the greater the uncertainty.

• Measurement of key quantity and quality characteristics can create challenges.
  – Objective Measurement vs. Subjective Measurement
  – Can measurement be verified by an independent third party?

• Price variability
Options for Unexpected Conditions

• Execute the contract.

• Renegotiate or amend the contract.

• Utilize arbitration or mediation.
  – May be included in the contract.

• Bring into the court system.
General Classes of Crop Contracts

• Marketing Contract
• Production Contract

• Definitions are very broad and there is not a clean division between the two.
General Classes of Crop Contracts

• Marketing Contract (purchase agreement)
  – Focus is on establishing price, quantity, and quality for a specified commodity to be delivered in the future.
  – Producer (seller) has wide discretion concerning production practices.
  – Typically used for crops already produced.
General Classes of Crop Contracts

• Production Contract
  – Establishes price for a specified commodity which is to be produced and delivered in the future.
  – Buyer includes provisions concerning appropriate production practices.
Contracting Systems

- Processor → Grower:
  - Grower delivery directly to processor

- Processor → Grower (local delivery):
  - Grower delivery to local elevator, with re-delivery to processor

- Processor → Elevator → Grower:
  - Grower contracts/delivers to local elevator, with re-contract/re-delivery to processor
Key Contract Considerations

• Quantity:
  – All production on specified acres.
    • Full Production Contract
  – Fixed production on specified acres.
    • Partial Production Contract
    • Example: Max. of 1,000 lbs./a. (first units)
  – Specified number of bushels, pounds or tons of production.
    • Example: 12,000 bu. of malt barley
Key Contract Considerations

- Quantity:
  - If fixed quantity, how will production shortfall be covered?
  - Can production from another field be delivered?
  - Can seller deliver another individual’s (ex. neighbor’s) production?
  - Are service fees charged if buyer must fill contract shortfall?
Key Contract Considerations

• Quantity:
  – If fixed quantity, how will contract over-run be handled?
  – Is there a “right of first refusal”?
    • Usually requires written authorization.
  – How will contract over-run be priced?
  – Are there fees for re-delivery?
Key Contract Considerations

- **Act-of-God Clause (Force Majeure):**
  - Provides seller and buyer an exit provision due to drought, flood, fire, pests, strikes, etc.
  - Does not excuse poor management.
  - Seller usually required to deliver available production.
  - Seller must give notice to buyer in writing, usually within 10 days of event.
Key Contract Considerations

• Act-of-God Clause (*Force Majeure*):
  – How is prevented plant handled?
  – Is replant of another crop allowed?
  – Are multiple fields (land tracts) treated individually or jointly?
Key Contract Considerations

• Quality Specifications:
  – Min. standards should be detailed.
    • USDA (FGIS) Standards
    • Buyer Specific Standards
    • MRL – this is an emerging issue!
  – Objective measurement criteria recommended.
  – Be cautious of “visual inspections”.
  – Act of God clause usually does not apply to quality issues.
Key Contract Considerations

• Quality Specifications:
  – Quality specifications for rejection or price adjustments.
  – Price adjustments (premiums and discounts) usually determined at time of delivery.
  – What happens if delivery is delayed?
Key Contract Considerations

• Quality Specifications:
  – Is quality averaged across all deliveries or applied to each load?
  – How long does buyer save samples after delivery for re-testing?
  – Should seller save samples?
  – Can seller deliver production from another individual (ex. neighbor)?
Key Contract Considerations

• Quality Specifications:
  – Buyer's options for dealing with quality variability:
    • Blend
    • Clean or Sort
    • Segregate
    • Reject
Key Contract Considerations

• Time of Delivery
  – “At Harvest” – When does harvest begin and end?
  – General period – “First half October”
  – “Buyer Call” – at buyer’s discretion; seller usually provided with delivery window.

• Are storage payments made?
Key Contract Considerations

- **Delivery Location (FOB)**
  - The local elevator.
  - The processor’s facility.
  - Designated receiving site.

- **Will this impact harvesting efficiency or conflict with other farm operations?**

- **Will this impact on-farm storage capacity?**
Key Contract Considerations

• Time of Payment
  – After contract is fulfilled and all deliveries have been made.
  – Can be different from delivery dates.
  – May be split or sequential payments.
  – By accepting payment, seller is agreeing that contract is fulfilled.
Key Contract Considerations

• Dispute Settlement:
  – Mediation – A neutral third party reviews dispute and renders opinion, but is not binding.
  – Arbitration – A neutral third party reviews dispute and renders binding resolution.
Key Contract Considerations

• Dispute Settlement:
  – Use the court system.
  – Who pays dispute settlement fees?
  – What damages can be included?
    • Difference in price, plus fees
    • Lost business activity
    • Punitive damages
Key Contract Considerations

• Counter Party Risk
  – What happens if one of the parties does not fulfill their contractual obligation?

• It depends upon the cause – Examples:
  • Large scale quantity or quality shortfall
  • Changing market conditions
  • Insolvency and/or Bankruptcy
  • Breakdown in sequential sales
  • Purchased by another company
Key Contract Considerations

• Reputation is important!
  – Are you easy to do business with? (timely and flexible)
  – Are you firm, but fair?
  – Some buyers include contract provisions that may not be enforced, but are included to add “teeth” to the contract.
  – All buyers interviewed had a list of farmers they would not do business with again.
QUESTIONS & COMMENTS?

Frayne Olson
Dept. of Agribusiness & Applied Econ.
NDSU Dept. 7110
P.O. Box 6050
Fargo, ND  58108-6050
701-231-7377
frayne.olson@ndsu.edu
http://www.ndsu.edu/cropeconomics