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Contracting in Organic Grains

This document is based on the results of producer, marketer and processor surveys administered as part of the marketing study being conducted by the Project on Organic Agriculture in the Department of Agricultural Economics. The objective of the study is to examine the issues, opportunities and challenges in organic grain marketing and to provide insight to the organic grain industry on what can be done to improve the organic marketing system for the benefit of all participants. These papers are designed to provide industry participants with a brief summary of this information. This document is one of a series that will constitute the complete marketing study.

1. Introduction

Contracts are an important aspect of marketing for organic producers, marketers and processors. The objective of this paper is to describe the nature of contracts used to buy and sell organic wheat, oats, flax and lentils.

A survey was undertaken, as part of the University of Saskatchewan Project on Organic Agriculture, which attempted to find out the state of contracting in organic grains. Questionnaires were mailed to 90 organic grain producers randomly picked from across Saskatchewan. The sample included producers from 4 Certification Bodies (OCIA, Pro-Cert, COCC and SOCA[1]). The membership of OCIA is divided into 8 chapters, of which 5 participated in the study.[2] The sample yielded 37 producer respondents that answered the questions relating to organic costs. Five grain marketing companies and 6 grain processing companies also answered questions regarding organic grain contracts.

This paper is divided into three sections. The different types of contracts used in organic grain marketing and their prevalence are first described. The effect of contract choice on the price that producers received and other characteristics is then presented. The satisfaction that producers have with contracts is then discussed. Resources for producers to learn about contracting are provided in the last section.

2. Contracts in Organic Grain Marketing

Contracts are used in transactions for three main reasons (Zawada 2003):

1) to provide certainty
2) to help avoid and/or settle disputes
3) to balance the risks

Although contracts come in many forms, there are two major types of formal contracts used in organic grains: the delivery contract and the production contract. A brief description of each type of contract is provided below. For a more thorough description, please read *A Farmer's Guide to Production Contracts in Saskatchewan*, and *Grain and Seed Contracts for Farmers*, both published by the Agriculture Institute of Management in Saskatchewan (AIMS).

<u>Delivery Contract</u>

A delivery contract specifies the time, place, quality, quantity and price of a transaction. The delivery contract is usually made after the grain has been harvested, although time between signing the contract and delivering can vary. A contract for delivery within a 30 days is often called a *spot market contract*. A

[1] OCIA – Organic Crop Improvement Association
COCC – Canadian Organic Certification Cooperative
SOCA – Saskatchewan Organic Certification Association

[2] Of the three excluded OCIA chapters, one was excluded because it did not certify organic wheat producers, one could not be successfully contacted, and one declined to participate.

contract for delivery beyond 30 days is often called a *deferred delivery contract*.

Production Contract

Like a delivery contract, a production contract requires delivery of product at a future time. A production contract is distinct because it is typically made before the product has been grown, usually in the spring. Since quantity is unknown at the time the production contract is made, the contract will typically apply to the quantity produced from a particular piece of land, or from seed provided by the buyer. The buyer may be given the right to monitor the farmer's field and bins to ensure that the buyer receives all of their production or some minimum amount of production. A production contract may include a price that is dependent on the resulting quality of the grain. The time frame for delivery may also be specified in a production contract.

Contracting by Producers, Marketers and Processors

Producers were asked by the survey to provide details about each sale of organic grain that they made between 2000 and 2003. The percentages of producer sales using production contracts and deferred delivery contracts are given in the first column of Table 1. Producers used production contracts in sales of organic wheat, flax and lentils, but not in sales of organic oats. Deferred delivery contracts were used in about ten percent of producer sales for all four organic grains.

Organic marketers and processors were asked to provide the percentage of their purchases and sales that are made using forward contracts[3]. The responses of marketers and processors are given in the second and third columns of Table 1. Marketers and processors contracted between a third and a half of their wheat purchases and sales, and about a third of their flax purchases and sales. Marketers contracted about a quarter of their lentil sales. Marketers forward contracted about 10 percent of their oat purchases, and none of their oat sales. Processors, on the other hand, forward contracted about a third of their oat purchases.

Overall, the results show that production contracts and deferred delivery contracts are used in many sales of organic grains. However, the majority of organic sales occur through the spot market.

Table 1: Prevalence of Different Forms of Contracts, Wheat, Oats, Flax and Lentils (% of sales)

Group:	**Producer Selling**	**Marketer Buying**	**Marketer Selling**	**Processor Buying**	**Processor Selling**
Contract Type: Time Period:	Production Contract / Deferred Delivery Contract 2000-2003	Forward Contract[3] 2001-2002 average		Forward Contract[3] 2001-2002 average	
Wheat	20% / 10%	35.5%	47.5%	47.5%	42.5%
Oats	0% / 10%	10%	0%	30%	42.5%
Flax	18% / 12%	27.5%	40%	36%	-
Lentils	15% / 9%	25%	29%	-	-

Source: Organic Producer, Marketer and Processor Surveys

[3] A forward contract is a contract in which a price is agreed for commodities to be delivered at a future date, and includes deferred delivery contracts and production contracts.

Effect of Production Contracts on Price, Payment and Trucking

The effect of production contracts on the price received by producers, the days between delivery and payment, and the decision of who pays for trucking is presented in Table 2. Prices received by organic producers decreased when using production contracts for organic wheat, flax and lentils. This result suggests that organic producers tend to receive lower prices when they use production contracts with buyers instead of selling after the grain is harvested. This effect is especially strong in the case of organic flax.

In the sample, payment took about twice as long for all organic flax and lentil sales as it took for sales of organic wheat and oats. Wheat and flax production contracts resulted in quicker payment compared to the average. In contrast, lentil production contracts resulted in slightly longer payment times.

Buyers paid for trucking most often in sales of organic wheat and oats, and least often in sales of organic lentils. Buyers of wheat and flax tended to pay for trucking slightly more often in production contracts than in delivery contracts. In contrast, lentil buyers paid for trucking less often when under production contracts.

The effect of production contracts on oat transactions could not be measured, since none of the producers in the survey used an oat production contract.

Overall, these results highlight that production contracts can affect some of the characteristics of organic producer sales. The difference in price is the most notable effect, with production contracts having a negative effect on prices for organic wheat, flax and lentils. This result is similar to that of a study by Weleschuk and Kerr (1995), that examined the effect of marketing strategy on prices for conventional lentils, canary seed and mustard from 1988-89 to 1990-91.

Satisfaction with Contracts

Producers were asked to rate their satisfaction with contracts on a scale of 1 to 5, where 1 was poor and 5 was excellent. Producer's rated contracts with an average of 3.3 out of 5, which indicates that they found contracts satisfactory on average.

A few producers also felt that production contracts resulted in waiting longer to deliver. A few producers also were concerned when they could not keep their grain screenings. No producers claimed that contracts helped to avoid or settle disputes or balance risks between them and their buyers.

Table 2: Effect of Production Contract on Price, Payment and Trucking

Grain	**Price ($/tonne)**		**Days between Delivery and Payment**		**% of Sales where Buyer Pays for Trucking**	
	Average, All contracts	Effect of Production Contract on price ($/t)	Average, All contracts	Effect of Production Contract on days to pmt	Average, Delivery Contract	Average, Production Contract
Wheat	291.05	-9.82*	24.5	-3.7*	78%	90%
Oats	253.64		21.2		79%	
Flax	851.10	-54.94*	44.7	-27.8*	67%	78%
Lentils	1060.00	-46.94	49.6	2.5	59%	50%

Source: Organic Producer, Marketer and Processor Surveys
*Measured using OLS Regression technique

Processors and marketers were asked for the reasons that they forward contract organic grains. They said that they forward contracted in order to ensure price, quantity and quality. Production and deferred delivery contracts can be used by marketers and buyers in order to hedge against sales commitments to downstream buyers. No processors or marketers claimed that contracts helped to avoid or settle disputes or balance risks between them and their buyers.

Implications and Conclusions

The results of the surveys suggest that production contracts and deferred delivery contracts are commonly used in wheat, flax and lentil marketing. These contracts are used in response to a desire by producers to ensure demand and a desire by marketers and processors to ensure both supply and demand.

Despite producers' common use of these contracts, producers tend to be dissatisfied with the price that they receive and the terms of the contract. On the other hand, processors and marketers speak much more favorably about using forward contracts in their purchases and sales. The difference in satisfaction between producers and their buyers suggests that either producers do not understand the benefits of contracting, or they bear a disproportionate share of the disadvantages. In the long run, either of these problems can lead to an underinvestment by producers (Weleschuk and Kerr 1995).

One possible solution to the dissatisfaction of organic producers with contracts may be to provide information in order to help producers understand the benefits of contracts. There can be a significant advantage to farm operators in being able to lock in a price for their products that provides a reasonable return. Producers must also realize that a forward contract, on average, will result in a lower price compared to selling on the spot market. The buyer must receive a return on bearing the risk of prices changing between the time the contract is made and delivery at the future date. However, it is important that marketers and processors continually evaluate and improve their contracts wherever possible in order to improve contract prices and other contract terms.

It is important to note that conventional buyers who use forward contracts have the option of offsetting price risk by hedging on the futures market. Since there is no futures market for organic crops, organic buyers do not have this option, which may also explain the lower prices received by producers when using forward contracts.

References and Resources

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