

Agricultural & Resource Policy Forum

Restoring Economic Health to Contract Poultry Production

C. Robert Taylor

The world is in the midst of a rapid restructuring and consolidation of the global food system. Consolidation and change have been both horizontal and vertical. Horizontal concentration has occurred from internal growth of firms, and from mergers and acquisitions of other firms competing in the same market. Vertical integration and development of vertical supply chains have occurred with agribusinesses expanding upward into processing, wholesaling, distribution and retailing, and expanding downward into farm inputs such as seed and chemicals.

The poultry industry, which vertically integrated in the 1950s, is often viewed as a model to be emulated in other industries. Yet, all is not well in the poultry industry.

This report examines trends in benefits to consumers, integrator returns, and profitability for contract poultry producers over the past few decades. Then policy issues surrounding the rapidly evolving global food system are addressed.

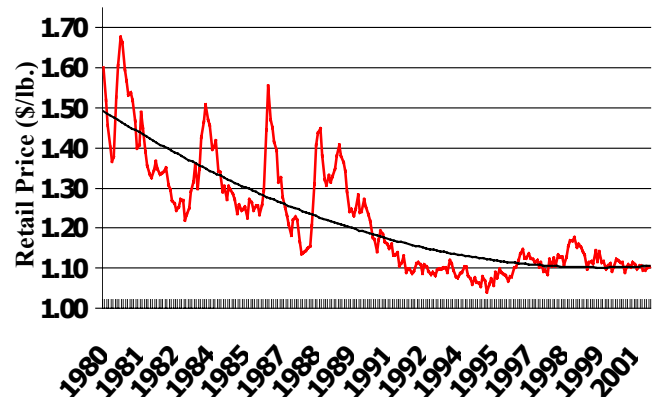
Consumer Benefits

Figure 1 shows the real (inflation-adjusted) monthly retail price of whole chickens since 1980. As can be seen, the retail price has declined substantially which reflects increased efficiency in broiler production and processing along with generally lower real feed prices. Most other poultry products, such as breasts, show a similar trend. Along with a decrease in the real retail price of poultry has come an improvement in both quality and consistency that has also benefited consumers.

Net Income to Producers

The Alabama Farm Business Analysis records for contract poultry producers provide cost and return figures based on actual farmer records analyzed with appropriate accounting practices. For the

Figure 1. Retail Price for Whole Chickens
 BLS data adjusted for inflation, with trend-line

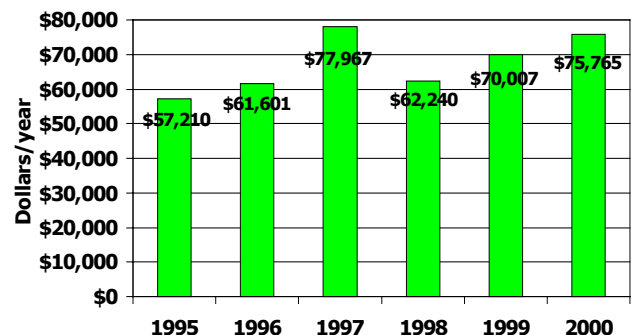


past six years, the inflation-adjusted returns above operating costs averaged \$67,465 per year standardized to four houses (see Figure 2).

Returns above operative costs are not indicative of profitability, however, because they do not include a charge for family labor or economic depreciation.

Figure 2. Average Returns above Operating Expense

Source: Alabama Farm Business Analysis Records for Poultry Operations
 Four 20,000 ft² Houses
 Adjusted for Inflation and Expressed in 2000 Dollars

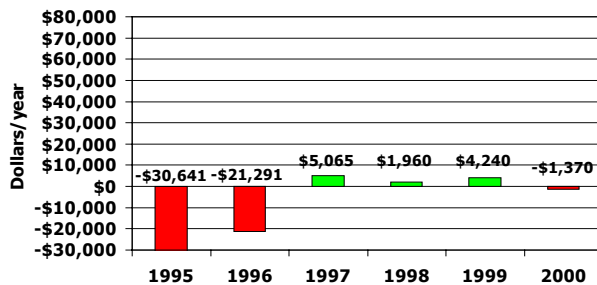


After accounting for economic depreciation and a very modest charge for family labor (\$6.50/hour with no benefits) and a modest return on equity (9%), the farm business records show that contract production resulted in a *loss* to management and risk bearing of \$7,006 for four houses (Figure 3).

Records from other impartial sources of information on profitability of contract poultry production in other states also show that profitability has decreased to the point where many contract producers have a poverty level of income. Only about one penny per pound more is needed for contract producers to earn a decent return.

Figure 3. Returns to Management & Risk

Alabama Farm Business Analysis Records for Poultry Operations
Four 20,000 ft² Houses
Adjusted for Inflation and Expressed in 2002 Dollars



Economic Depreciation

The silent and slow killer for profitable poultry production is economic depreciation. With a traditional bank loan on a dwelling or land, one normally obtains equity as the loan is paid off. With loans for poultry houses and equipment, however, little equity is earned because the houses and equipment have limited salvage value. The loan payments, therefore, approximate the true economic cost (including depreciation and interest) of a loan to a poultry producer.

Budgeting approaches to the returns from contract production often use unreasonably long depreciation periods not borne out by actual practices in the industry. For example, some budgets assume an economic life for poultry house equipment to be 12.5 years. Yet, a 1999 survey of 1424 growers in 10 states showed that 67% of growers had made at least one substantive improvement in the last five years, and 44% of the growers had made at least two (Farmers Legal Action Group, Inc.). Use of a shorter and more appropriate depreciation period may change the bottom line in a budget from profit to loss over the life of the operation.

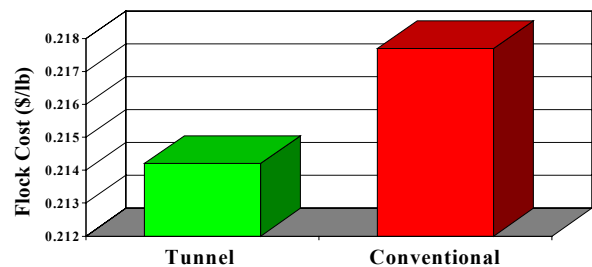
While loans are being paid off, cash flow is typically negative. After the loans are paid off, cash flow may be positive, but inadequate to recover earlier losses.

Deception

A question often asked is: “If returns are really so low, why are people lined up to become contract producers?” Although no detailed studies are available, it appears that there are four major reasons why people continue to be interested in becoming contract producers. First, there are few other job opportunities in areas where poultry operations are often located. Second, many potential producers do not understand that cost and return budgets may use unrealistically long depreciation periods. In the past, some producers have been strongly discouraged by integrators from making public their contracts and financial information. And there may be deception in the information presented to potential producers by some integrators in that not all costs are shown, or costs are underestimated. Third, many potential producers may feel that they can be above average, even though the payment system prevents more than half of them from being above average.

Fourth, the manner in which most integrators determine pay for individual flocks may result in declining pay as other producers adopt new, more efficient technology. This deceptive practice has the effect of shuffling an average producer with a conventional house down the pay scale in a subtle way. Potential new producers may not recognize this and thus may not account for it in profitability analyses.

Fig. 4. Average Flock Cost to the Integrator by Type of House



As an illustration of this deceptive practice, consider figure 4, which shows average flock costs to the integrator from a single weekly pay sheet. As can be seen in this figure, flocks in the tunnel houses generally have lower cost, which translates into higher pay for those growers. As more and more houses are converted to new technology (tunnel ventilation, in this case), a producer with a conventional house is shuffled down the pay scale.

Figure 5 illustrates pay for an average producer as other producers for the integrator adopt new technology. For this chart, it is assumed that contract (base) pay (without bonuses or discounts) is 4.5 cents/lb with a conventional house and 4.9 cents/lb with tunnel ventilation. Figure 5 is based on flock costs shown in figure 4. The left side of figure 5 represents all conventional houses, while the right side represents all tunnel ventilation houses. As houses are converted to new technology, expected pay moves from the left to the right. With all conventional houses, expected pay is 4.5 cents/lb. Movement toward the right on the chart occurs as more and more houses are upgraded to tunnel ventilation, the new technology. Because producers with conventional houses are shuffled down the pay scale as other houses are converted, the expected pay for the last conventional house (near the right axis) in the pool is only 3.7 cents/lb.

Fig. 5. Effect on Expected Contract Payment for an Average Producer As an Integrator's Houses Are Upgraded

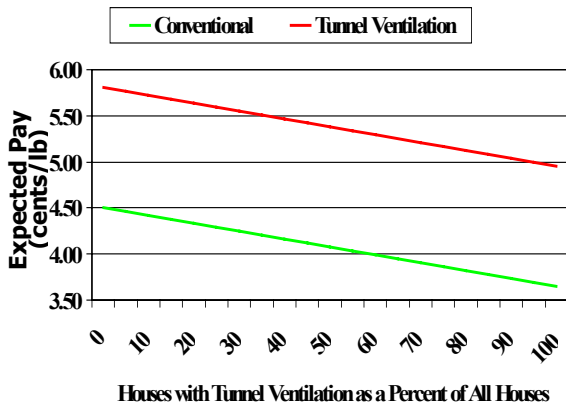


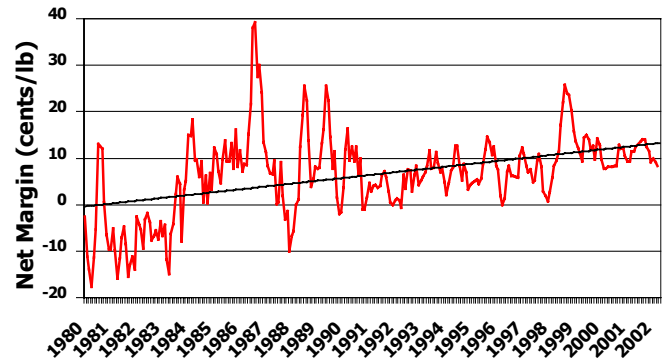
Figure 5 also illustrates the pay for an average producer who adopts the new technology. Even though the contract pay is assumed to be 4.9 cents/lb, the expected pay for the first house in the pool to convert to the new technology is 5.8 cents/lb (not 4.9 cents/lb) because flock costs are lower with the new technology. Thus, houses with the new technology tend to be at the top of the pay scale, while houses with conventional technology tend to be at the bottom of the pay scale.

Budgeting approaches for contract production universally use a fixed price—such as 4.5 cents/lb—in examining the profitability of contract production. Accounting for the declining pay, such as that illustrated in figure 5, will change the profitability, often dramatically so.

Integrator Returns

Figure 6 shows USDA monthly data on the net margin for broiler integrators. As can be seen, the overall trend is upward.

Figure 6. Estimated Monthly Net Margin for Broiler Integrators
Net Margin is the Wholesale Price *minus* Wholesale Production & Processing Cost
USDA data with trend line, adjusted for inflation



Agribusiness firms often publicly present numbers showing very low percentage returns, but these are typically returns on gross sales. A more appropriate way to compare various industries is by comparing the rate of return on equity, not the rate of return on sales. Public information is not available on many poultry integrators, but the three largest integrators (Tyson's, Gold Kist, and Pilgrim's Pride) return¹ on equity averaged 16% for the last three years, and this was with one of the firms showing substantial losses in two of the three years.

In contrast, the consensus of actual records and realistic budgets for contract poultry production now show a zero return to equity after subtracting a very modest amount for labor, management and risk bearing. The persistence of this disparity in returns for contract producers and broiler integrators raises fundamental fairness issues.

Economic System Design

Vertical integration may result in benefits for consumers in terms of lower priced, higher quality and more consistent quality meat. However, vertical integration combined with horizontal consolidation may also lead to an imbalance of economic power that will harm both consumers and contract producers.

For vertical integration with contract production, to work efficiently, effectively and with some semblance of

¹ Return is defined as the operating margin from financial statements.

fairness, two basic conditions must exist. First, there must be rigorous competition between the vertical supply chains. As the number of vertical supply chains dwindles through consolidation and as joint ventures with other firms increase, competition may be softened or, in the extreme, eliminated by collusion.

The second condition necessary for a vertically integrated system with contracting to work well is to have a balance of economic power in contracting. An imbalance of economic power favoring the large vertical corporation over the contract producer is undesirable, as is an imbalance of economic power favoring the producer over the corporation.

As industries integrate vertically, traditional commodity markets may disappear as occurred with vertical integration of the poultry industry in the 1950s. Now there is no viable farm-level market for broilers. Without markets, the “invisible hand of the market” which is widely viewed as leading to efficient resource allocation, can theoretically be replaced by equally effective and efficient “price discovery” or “contract terms discovery” in contracting in a vertically coordinated system. But for price discovery to occur, there must be a balance of economic power. And there must also be contract transparency and public reporting of contract terms.

Unfortunately, there is an enormous imbalance of power in contracting, to the benefit of the integrator. Returns to contract production—actually the lack of returns—give new meaning to “dismal” economics. With the growing economic power imbalance in contracting, contractors have effectively transferred income to themselves while transferring risks to producers.

Summary

Farm business records show that contract producers who once had acceptable income from their poultry operations now put up a few hundred thousand dollars of equity, and borrow several hundred thousand more to hire themselves at minimum wage with no benefits and no real rate of return on their equity. Yet integrators continue to earn 10-25% rates of return on equity.

Consumers have benefited tremendously from vertical integration, as have many poultry integrators. However, contract poultry producers have been left behind with a poverty level of subsistence.

In the first substantive decision interpreting the Sherman Antitrust Act, Justice Peckham wrote²:

“[I]t is not for the real prosperity of any country that such changes should occur which result in transferring an independent business man . . . into a mere servant or agent of a corporation . . . having no voice in shaping the business policy . . . and bound to obey orders issued by others.”

Yet, the lack of enforcement of antitrust legislation in the decades since Justice Peckham’s ruling has resulted in contract poultry producers becoming exactly what antitrust laws were intended to prevent; namely, the contract producer has been transferred into a “mere servant of a corporation.” Or, as some have said, contract producers are serfs—with a mortgage.

The economic health of poultry production can be restored by balancing the economic power between contract producers and integrators, by establishing transparency in contracting, and by eliminating deceptive features of some contracts. Economic viability would be restored to contract production if producers received only a penny per pound more.

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² From Carstensen.