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Negotiating Contracts in the Specialty Crop Industry

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Ladies and Gentlemen, is a pleasure to be here with you today. However, I wish it could be under better circumstances. The fact is the farm economy is in shambles. As you may notice this characterization is somewhat different to the USDA's conclusion that the farm economy is "reasonably stable". When government subsidies are factored out, the picture looks substantially different with net farm income eroding 20% over the past five years. When one considers that growing vegetables requires production costs approaching $1,800 per acre and only produces returns in the neighborhood of 5%, a 20% reduction in net farm income leaves razor thin margins in a high-risk world.

California once prided itself on being insulated from the commodity cycles associated with program-subsidized crops, utilizing diversification as a risk management tool. California boasts that it grows 350 different crops over its highly diversified geography and microclimates that offer exceptional soils, water and climate.

We have seen a profound change moving across the California landscape. One by one we have seen California's specialty crops succumb to over-planting, oversupply and eroding prices. Success or perhaps more accurately survival in this environment is reserved for those growers that:

1) Have the broadest diversification even extending to off-farm endeavors,
2) Are the most efficient growers, blessed with great soils, properly designed, implemented and mature business plans, solid financing and know how, or
3) Long-standing farm families that are willing to dip into their hard earned equity in hopes of surviving another cycle.

Farm Bill

A national debate is underway concerning the U.S. farm policy now that there is recognition of a wide spread breakdown in the agricultural sector and given the fact that President Bush was elected by rural America. The centerpiece of U.S. Farm Policy is the Farm Bill that is up for renewal. The current bill, known as the "Freedom to Farm" bill was a radical departure from those that preceded, going all the way back to the New Deal. It was thought that it was time that U.S. agriculture was weaned from government support. Those crops that received subsidies and the farmers that grew them were enrolled in a stepped down program that paid less each year over a seven year time period until all the crop acres were subsidy free.

During the adoption of this Farm Bill, vegetable growers from the west, including the CTGA, lobbied successfully for a "Flex Acres" provision that specified that acreage receiving a subsidy could not be used to grow vegetables. It was argued that supplying a subsidy to acres that were producing vegetables would distort those markets that had previously been free from a subsidized influence. It was also argued that a relatively small shift of program crop acreage into a specific vegetable crop would ruin the market by a near instantaneous over-supply.

Lo and behold the prophecy has become a reality. While we were able to keep the wolf away from the door for seven years, as program crops lost their subsidies and other major producing regions of the world did not, world prices plummeted. U.S. program crop growers began moving their freed-up acres into high margin crops. One by one growers have seen their specialty crops in California over-planted, ruining the supply demand balance and completely undermining the cornerstone of their risk management strategy.

California will play a prominent role in the U.S. Farm Policy debate. Policy that affects one sector of the Agriculture ultimately affects the whole of agriculture.

Producers of fruits and vegetables, especially for the fresh market, operate in an unusually risky economic environment. While theses farmers face the same sorts of production risk common to much of agriculture, they also produce a perishable commodity whose price is subject to unusually large fluctuations. While some of this variation in prices is predictable (e.g. seasonal variation), much of it is not, depending instead on unforeseeable shocks to both supply and demand. Indeed, price risk is particularly important for fruit and vegetable growers; dry beans, fresh pears, lettuce, fresh apples, grapefruit, potatoes and onions exhibit the greatest degree of price volatility of any agricultural commodities. Further, despite the great risk, no futures contracts or commodity insurance schemes exist for most fresh fruit and vegetable production.

Contracts

One important institution which does help to shield fruit and vegetable producers from both price and production risk are contracts, written between a producer and a "first handler," or intermediary who takes possession of fresh produce from the grower. Such contracts are of great importance for fresh produce.

Contracts are becoming a staple of the agricultural production and marketing system. In all, almost one-third of the crops and livestock produced and forty percent of U.S. fruit and vegetable production in 1997 were contracted according to the latest statistics available from the U.S. Department of Agriculture. That's more than double the amount of commodities produced under such agreements just a decade before.

In a recent article by Professor Ligon of UC Berkeley he points out the importance of contracts between growers and first handlers as being part of the process enabling "vertical coordination" in the food production chain. Vertical coordination is a general term used to signify ways of harmonizing the vertical stages of production and marketing. While the role that contracts play in coordination is no doubt important he points out that another important reason for the use of contracts is to reduce the degree of risk (in both price and production) that growers must bear, since an appropriately designed contract allows the first handler to share both sorts of risks with the grower. And while it may be presumed that first handlers do not wish any additional risk, this would be too simplistic. First handlers who contract with many producers can pool the risk and in addition to providing marketing services to the producer they also offer a measure of insurance. On balance, quality measurements observed, measured and utilized in the processing tomato industry, for example, help reduced price risk by providing a certain amount of trade-off to the growers for his performance in delivering quality to processors. Raw product quality <u>delivered;</u> helps assure a quality <u>finished</u> product.

The ability to transfer title to a vast quantity of fresh, red, ripe perishable tomatoes in a manner that shares the risk in a rational fashion is a major asset and should not be trifled with. As with any competitive advantage that we may have in business we need to make a commitment to make it better, keep it sharp and use it to the fullest.

Growers used to worry, that large corporation would vertically integrate, buying land, buildings and production capacity but as agricultural law expert Neil Hamilton puts it: **"Why own the farm if you can own the farmer?"**

First we had the **“marketing contract”** where a price is set for the crop before it is produced. The farmer retained ownership of the crop and any resources it took to produce it right up until delivery. Then we saw the **“production contract”** where the processors maintains more control of the product from beginning to end, including seed variety, ownership of the crop once the seed was in the ground, harvesting and hauling. Now, we are seeing **“risk sharing contracts”** that in fact becomes a way for risk to be shifted, with the momentum titled against the farmer side of the equation, says Lynn Hayes an attorney for Farmers’ Legal Action Group (FLAG). She continues, “Right now these contracts are written so that farmers have to either take them or leave them, maybe its time for farmers as a group to take the second option. She adds, “Farmers could just say no to these contracts in general until they can get the power to negotiate better agreements.”

Since 1996 commodity prices have reached all time lows, and agribusinesses have continued to consolidate. Many farmers regard this consolidation as the major reason for the economic distress at the farm gate. In response, Congress has provided billions of dollars in agricultural relief to farmers and has introduced a number of proposals that would effectively change the way agribusinesses, including farmer cooperatives, participate in the marketplace.

We must be extremely cautious on how we approach legislation to toughen agricultural antitrust laws. After all, it is The Capper-Volstead Act that provides the critical exemption to the Sherman Anti-trust Act that allows farmer cooperative members in general and Bargaining Cooperative grower-members in particular the advantage of joining together and discussing price and terms of trade.

Benefits of Bargaining Association

The French have a very interesting saying, “An old pot still cooks good soup”. As we continue the national Farm Policy it is important that we not lose sight of the tools that have worked well for us as we attempt to prepare ourselves for the future.

As the CEO of an Agricultural Bargaining Cooperative, I often find that the activities and benefits derived from this type of Cooperative are not well understood. However, with the extreme pressures mounting in the farm sector we are seeing growers of a wide variety of crops show a high degree of interest in Cooperative Bargaining Associations and the benefits they provide for their grower members. Simply put, a Bargaining Cooperative is the exclusive bargaining agent for price and terms of trade for the sale of grower members’ production. In the late 1920's Congress recognized the relative strength large buyers of agricultural commodities had over small farmers and provided an exemption, whereby growers can freely join together to strengthen their marketing ability. There are five distinct and fundamental benefits growers receive by being members of a Cooperative Bargaining Association:

1. **Market Power.** Growers are able to achieve a measure of economic equality by joining together. Supply-side agriculture may be the closest model to perfect competition because there are a large number of small firms that cannot influence the price with individual action. On the other hand, buyers of farm commodities are larger and fewer and tend to dominate prices and terms of sale for the commodities they buy.
2. **Control of Timing.** As the exclusive bargaining agent for its members, a Cooperative Bargaining Association has the ability to influence the timing of negotiations. This is of particular importance for growers of annual crops that are eager to make plans and begin planting. Bolstered by strong bargaining laws, processors are required to meet with Bargaining Associations at reasonable times and for reasonable periods of time with the genuine desire to reach agreement.
3. **Market Intelligence.** Cooperative Bargaining Associations provide professional intelligence and marketing information necessary to contribute to a comprehensive price discovery process. The Bargaining Association provides growers with the latest prices and market information, previously only available to the largest corporations. A Bargaining Association has the ability to research a wide variety of factors that influence negotiations that would be out of reach of most individual growers.
4. **Securing a Home.** Terms of Trade become an integral part of the final agreement when a Cooperative Bargaining Association is involved. Because of their desire for a contract, individual growers often overlook or trade away critical terms of sale, quality deducts, rejects, time of delivery or inspection criteria. Bargaining Associations negotiate terms of trade in Master Agreements that become the standard for all industry participants.
5. **Close the Deal.** Bargaining Associations have the authority to approve contracts and close the deal. Membership agreements between the Associations and growers stipulate that growers can only sign contracts with processors that have been approved by their Bargaining Association.

National Bargaining Legislation

U.S. Farm Policy needs to strengthen the National Bargaining laws so that all growers will have the opportunity to sell their crops for a fair and reasonable price. The 2002 Farm Bill needs to include provisions to strengthen National Bargaining Law, more specifically to amend the Agricultural Fair Practices Act of 1967. California and several other states have adopted public policy that supports growers freely joining together to bargain for a fair price for the sale of their commodities. The laws were enacted in the 20's when buyers of agricultural commodity had far greater marketing strength than individual farmers. By joining together growers had the opportunity to begin to match to some degree the marketing power of buyers. To assure that both parties respect the public policy, bargaining laws have been enacted in the more progressive states, California included. These laws prohibit Unfair Trade Practices, require Good Faith Bargaining, include some type of dispute resolution mechanism, and provide for enforcement.

Unfortunately, the existing Agricultural Fair Practices Act of 1967 is flawed and has fallen into disuse.

First and foremost, the AFPA does not compel good-faith bargaining by handlers. In fact, Section 5: Disclaimer Clause, implies that handlers are not required to deal with bargaining associations. This is directly in conflict with the purpose and statement of policy underlying AFPA. The Disclaimer Clause should be eliminated. Second, both the Disclaimer Clause and the lack of a duty to bargain in good faith under AFPA undermines growers' ability to bargain in states that do not have bargaining legislation, including states where potatoes, poultry and many other commodities are grown. Another major deficiency in the AFPA is the lack of a dispute resolution mechanism. Without this effective tool, growers are always left with the handler's last "take it or leave it" offer.

We feel that the Administration's earlier draft AFPA legislation, while adequately addressing enforcement provisions, falls short of providing growers the self-help legislation that is desperately needed in farm communities across the country. However, proposed AFPA legislation while not perfect, goes a long way to ensuring growers' rights as contemplated by the Capper-Volstead Act.

Consolidation in the processing, distribution and retail sectors is clearly tipping the scale in favor of big business versus the individual grower. The need for growers to be able to secure a fair and reasonable price for their products has never been more pressing. While bargaining legislation requires a minimum investment it requires a commitment to the public policy that farmers should have the right to receive a fair price for the commodities they grow. We feel this is a critical component of U.S. Farm Policy.