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Potato Marketing — Processor Contracts

Dramatic changes have been experienced in the form in which potatoes are consumed by the U.S. public over the period 1956 to 1973. In 1956 less than 14% of the per capita consumption of potatoes was in their processed form. By 1973 over 54% of potatoes were consumed in this manner.

The rise in consumption of processed products has been paralleled by an increase in pre-season contracting by processors, especially of the fall crops.

Processing, particularly of dehydrated and frozen products, traces its origins to World War II when food with greater storability was needed to maintain the diets of our service men. The increase in the use of processed products, however, can be traced primarily to the fast food services such as the drive-in restaurants. Processed product use by the institutional trade (hotels, restaurants, schools, hospitals) is also important.

In recent years we have witnessed considerable expansion of processed potatoes into retail outlets for consumption in homes. Perhaps one of the most important traits of processed products today is the fact that a consumer can rely on consistent and known quality. Incentive clauses that have become a part of pre-season contracts have encouraged the production of high quality potatoes that yield good processed products.

The big increase in processing has been primarily in the form of frozen and dehydrated products. These operations have concentrated in the Pacific Northwest and to a lesser extent in Maine. Recently they have been expanding to other fall-producing areas. Generally, these are large processing operations; they use pre-season contracts extensively.

The potato chip industry has also experienced slow but fairly steady growth as a market for potatoes. Unlike the dehydrated and frozen potato processors, however, potato chippers are scattered throughout the country and their plants are primarily located near major consumer markets.

Potato chippers have also used contracts for many years but these contracts have not reached the degree of refinement that is found in the other processor contracts. This is probably accounted for in large measure by the wide dispersion of chipping operations and the relatively

small size of most chip processors. Since the basics remain the same, this publication centers attention on the processor contracts for dehydrated and frozen potatoes.

Benefits of Contracts

The contracts being used today represent many years of refinement based on the experience of buyers and sellers alike. Mutual benefits to both parties are basic to contracting negotiations and the contracts that are developed.

Processor Benefits

1. A known supply. Processors normally contract for a substantial portion of their raw product needs through the use of pre-season contracts. They rely on the open market for the rest in the hope that they may be able to attain a more favorable (lower) price through the open market. This, of course, hinges closely on the magnitude of the production in a given year. Since a known supply is contracted, a processor can plan his sales of finished product. He can also arrange for the needed labor force and plan his production schedule with a reasonable degree of certainty.

2. A known price. As a result of contracting for a substantial portion of his anticipated needs the processor knows his price. He will not be subject to the fluctuation often found in the open market. It also gives him a clear picture of how much he must charge for the finished product and in this manner aids sales planning.

3. Specifications. The pre-season contract also enables the processor to specify the type and quality of potatoes he will need to yield the finished product he anticipates selling. He also attains a degree of control over the production practices which a grower follows.

Grower Benefits

Growers, too, benefit from contracting potatoes.

1. An assured outlet. Contracting assures the grower of a market for that portion of his production which is covered by the contract. It enables him to focus attention on production practices required to produce the best quality product to meet contract standards and specifications.

2. A known price. Since the contract specifies the price that will be paid, most often on a sliding scale based on

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quality, the grower does not need to worry about the price fluctuations that often occur in the open market. Nevertheless, while the known price is a definite plus in years of heavy production, he foregoes the higher prices that usually accompany short crops. Areas where contracting is commonplace and quite extensive have experienced greater price stability than have those areas where a small proportion of the crop is covered by contracts.

3. Access to credit. Since a market is assured at a known price, many credit agencies are more willing to grant needed credit to farmers who have a contract for at least a portion of their production. The credit agencies have a clearer concept of farm needs and possible receipts. Consequently, they are more willing to advance needed funds because there is an assurance that their loan will be repaid.

4. Known specifications. The specifications are spelled out in the contract so the grower can focus on production practices that will yield a crop most nearly conforming to the contract. Ideally, this enables him to take advantage of the various incentives included in the contract.

5. Storage. Many processors now operate their plants 10 months or more per year and need a supply of raw products arriving at the plant throughout the operating period. For this reason clauses are included in the "storage contracts" which reimburse the producer for the added risk of storing the crop for 2 to 10 months or more. These payments enable the grower to rent or build his own storage and to take advantage of the additional payments for extended storage. In these instances, the **risk** of storage falls on the producer. Of necessity close attention needs to be given to the storage conditions and the condition of the potatoes during the storage period.

In summary, the contract does offer the grower advantages from the standpoint of planning his overall production schedule and planning possible storage of the crop after it is harvested. He also has a clearer picture of how potatoes may compare with an alternative crop.

Basics of a Contract

A contract in its simplest terms is merely an agreement by a seller to sell and a buyer to buy a given good or service for an agreed-upon price. Many contractual arrangements are actually completed over the telephone. This will often work well if the two parties know and respect each other, and if the period is for a relatively short term.

For longer term contracts, particularly as is the case with potatoes where one buyer is involved with many different sellers, a written agreement is important. Changing circumstances over time often lead to difficulties when verbal agreements are relied upon. Furthermore, even if one or the other party to the contract is not present at time of final delivery, written contracts remain binding.

Basically, a contract has these provisions:

1. Parties to the contract (buyer and seller).
2. Date of the contract.
3. Quantity of product contracted (cwt, tons, barrels, acres).
4. Specifications (variety, grade, etc.).
5. Price per unit.

6. Terms of payment.
7. The point and method of delivery.
8. Time of delivery.
9. Storage agreements, if applicable.

The more refined contracts, common to potatoes, usually expand on one or more of the above items. Most of the expansion is with items 4 through 9 and these are examined in further detail in succeeding sections.

Types of Contracts

Two general types of contracts are usually available for potato producers. Most but not all of the processors offer producers their choice of one or the other type.

The Harvest Contract

This type of contract provides for delivery of the potatoes at harvest time to the processing plant or to storage specified by the processor. A grower operating under this type of contract has no concern with the storage; his potatoes are graded upon delivery from the field. Harvest contracts are used extensively in newly developed areas where the farmer wants to concentrate his finances on developing new production facilities rather than storage facilities. They also have an important place in some of the older areas where storage facilities may be run down or obsolete and the grower has no desire to build new storage.

The Storage Contract

Storage contracts are also made available to growers by most of the processors. These contracts provide for additional payments to growers above the base price for storing the potatoes over an extended period of time. The premiums are increased on a weekly, bi-weekly, or monthly basis. Some processors offer a different rate schedule depending upon the type of storage the grower is providing. Storage payments serve the dual purposes of extending the period over which potatoes will be delivered to the processor and also serve to compensate the grower for additional risk and investment he has in providing storage.

Specifications

Specifications included as a portion of the contract often constitute the central part of the bargaining negotiations that are involved. Growers may regard the base price in the contract as the central theme for the whole negotiation process. However, in a speech for the Oregon Potato Growers Conference in January, 1974, Haakon (Hank) Thomsen pointed out that often the "nickels and dimes" of other portions of the contract negotiations yield greater returns to the grower than a small increase in the base price might yield. Hence, it is appropriate to look at some of the other specifications:

1. Certified Seed. The State of Washington requires that all seed imported into the state be certified or higher grade. Contracts in most other growing areas specify that the seed either be certified or approved by the processor. Such seed is relatively free from disease and also assures that the variety will be as specified. For these reasons, certified seed would also be expected to produce better yield than would non-certified seed.

2. Production Practices. Contracts also have specifications relating to various production practices followed during the course of producing the crop. Normally these include such items as the use of pesticides, fungicides, and records of the amounts of these materials used and the times they were applied.

3. Field Inspection. Access to fields by processor representatives is often included. This can benefit both buyer and seller because the representative has expertise that enables him to offer suggestions which may prevent losses. Processor representatives are usually able to give reliable estimates of what production will ultimately be received from the field. Field sampling also gives an idea of the size and maturity of the crop which in turn can aid harvest decisions.

4. Harvest provisions. At harvest, the time of ultimate pay-off is more nearly at hand. Better contracts include clauses relating to disasters or inability to perform on the part of either the buyer or the seller. This is a highly desirable clause because it offers protection to both parties. Natural disasters can occur which would prevent the grower from delivering on his contract. In this case, a disaster clause will greatly reduce, if not eliminate, his liability to deliver under the contract. Conversely, disaster clauses offer protection to the processor-buyer in the event he encounters strike or a fire or some similar calamity.

Profits are often either made or lost at harvest time. Practically all contracts have clauses which can result in rejection of the lot if bruising is too great. Bruises certainly reduce the usefulness of potatoes to the processor-contractor. Hence, virtually all contracts include provisions for incentives or discounts depending upon the proportion of bruised potatoes in the lot. This is discussed further in the section on settlement price.

5. Sell or store. In some but not all instances, grower holders of storage contracts have important decisions to make at harvest time. If the processor agrees, growers may deliver direct from the field or put their potatoes into storage. For example, a given lot of potatoes may not have desirable storage characteristics at harvest time. It could be saved if delivered direct from the field. Gains to grower and processor would then result.

Delivery

Most contracts include stipulations relating to hauling the potatoes from grower storage or fields to the delivery point. These provisions vary considerably from one contract to another but are still worth consideration.

If, for example, a grower is operating under a harvest contract, he needs to know how many additional trucks will be required to deliver to the processor's storage besides those needed to deliver to his own storage. Allowances for hauling can also have a decided impact on the ultimate profitability of the crop. These allowances vary considerably from one contract to another. In the case of storage contracts, the hauling rates need to be considered since they may be sufficient to enable the grower to retain year around hired help and still keep them profitably employed. If the allowance is insufficient to allow compensation for labor and equipment he is better off to have the processor take care of the delivery from storage.

Clauses relating to inspection, weighing and grading constitute another important aspect of delivery. This is a critical part of the whole process and a point where disagreements may arise because ultimate pay-off is usually tied to the grade delivered. Most contracts provide for grading to be conducted by impartial federal-state inspectors. The contract should spell out very clearly how inspection, weighing and grading will be handled.

Contracts also include clauses relating to tare. Dirt, rocks, cull potatoes and other debris increase the costs of handling, so there is often a provision for rejecting the load or for discounts if tare exceeds a certain amount. Unusable material has to be separated during processing and this increases cost of handling. This is the reason for discounts. Incentives may be included for less than normal tare.

Usually there is provision for refusal of a lot if the portion of diseased potatoes is higher than a specified amount. Removing the diseased potatoes also increases cost of handling for the processor.

Maturity and storage conditions appear to affect the specific gravity (solids) and the incidence of "sugar ends". These factors affect the fry color of the finished product particularly in the case of french fries and also affect appearance and desirability for the ultimate user. Many contracts, therefore, provide for incentives or discounts depending on specific gravity and incidence of sugar ends. In most instances, the tests for solids and sugar ends are conducted by company representatives subject to fry color charts developed by USDA.

Settlement Price

Although base price is often the primary concern of the grower when he signs the contract, the factors already discussed may be of equal or greater importance. The final settlement price, not the base price, represents the culmination of the year's efforts and the moment of truth.

Virtually all contracts specify a base price, but analysis is needed before one can compare one contract with another or even know what one contract will yield. For example, it would appear that a different base price is involved with the illustration in Fig. 1. The stated base price for processor 1 is \$1.70 and for processor 2 is \$1.75. Both contracts call for the base of 25% 10-ounce of larger potatoes.

When these contracts are placed on the same footing—that is 50 percent U.S. 1—both call for \$1.75 per cwt. Both call for an upward adjustment as the percentage of U.S. 1 in the lot of potatoes increases. This adjustment, however, is at a somewhat different rate for the two contracts. In the case of processor 1, the downward adjustment falls off rather sharply when percentage of the U.S. No. 1's drops from 25 to 20%.

The two contracts differ considerably when the percent of U.S. 1 drops below 20%. Processor 1 leaves prices subject to negotiation between buyer and seller but could reject the potatoes outright. Processor 2 would take them at \$1.30 per cwt if they drop below this amount, but are otherwise acceptable.

Wide variation is also obvious in the allowance for more than 25% 10-ounce and larger potatoes. This con-

stitutes an incentive clause and encourages production of larger potatoes. There is a sharp downward adjustment in both instances if the potatoes fail to meet the 25% 10-ounce or larger requirement. The base price of both these contracts is stated in terms of U.S. No. 1 and U.S. No. 2 with the different percentages shown in the charts.

Some contracts arrive at the base price by stating an amount for the U.S. No. 1 and a lesser amount for the U.S. No. 2. They specify the percentage of U.S. No. 1 required for the base. Similar charts can be prepared to show the incentives and discounts for this type of contract.

This sliding scale approach can also be applied to the storage provisions, the hauling provisions and the provision for solids and sugar ends.

This analysis shows that the stated base price is not likely to be the final settlement price. If the lot of potatoes is exceptionally good, final settlement price may be above the stated base price. Alternatively, if the producer has a bad lot of potatoes, the price could fall substantially below the base price or the lot could be rejected. It is, therefore, obvious that one has to look beyond base price to estimate what he may ultimately receive for a given lot of potatoes.

A grower's production history can provide a good means for estimating probable returns. This involves the following steps:

1. Prepare a chart similar to those in Fig. 1, using information from your contract.
2. Determine the percentage of U.S. #1 normally produced to find where you fit on the base line.
3. Determine historical output of 10-ounce and larger potatoes to find where you will come out above or below the base line.

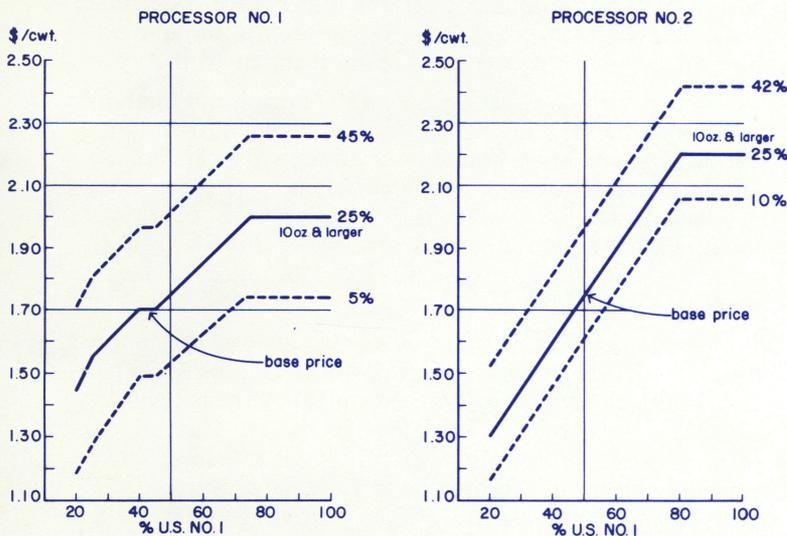


Fig. 1 - Sliding scale of prices on two potato contracts, based on percentage of U.S. No. 1 and percentage of 10 ounce and larger.

This reveals a probable or expected base price, based on delivered weight less tare.

4. From this point you can move to the following calculations:

base price	_____
+ allowance for tare	_____
+ allowance for bruises	_____
+ allowance for specific gravity (if applicable)	_____
+ allowance for sugar ends (if applicable)	_____
+ allowance for hauling less cost	_____
+ allowance for storage less cost	_____
= expected payment per cwt or ton	_____

Payment Terms

Payment terms can constitute an important part of the "nickels and dimes" to which Mr. Thomsen referred in his speech. At first glance, this may appear of limited importance. For example, one contract provides for: 1) \$1 per cwt 2 weeks after final delivery and inspection; 2) 50% of the balance 30 days after final delivery and inspection; and 3) the balance 60 days after final delivery and inspection. Assuming the final settlement price is \$4 per cwt and interest at 10%, then the added interest cost is:

- \$.0154 per cwt for 2 weeks on \$4.00 outstanding
- .0123 per cwt for 16 days on \$3.00 outstanding
- .0123 per cwt for 30 days on \$1.50 outstanding
- \$0.0400 per cwt. added interest cost following delivery.

If the yield of usable potatoes is 300 cwt per acre, payment on this basis would constitute an additional cost of \$12 per acre to the grower.

In summary, this discussion emphasizes that base price is just one of many factors that influence the profitability of potato contracts. Those involved in contract negotiations give considerable attention to these other clauses. Growers must also consider the whole contract in making a determination of whether to sign.

Attention to quality is important. Quality is at the heart of the price incentives and discounts included in present contracts and may become more important in the future. Quality is the key to the final settlement price; base price serves only as a starting point. Processors use quality as an important criterion of whether or not they will offer a contract to a grower or whether they will move to other growers or even other areas. It is a key to a healthy and growing industry. Finally, quality influences consumer acceptance, the ultimate reason for producing potatoes.

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