

# **Managing Risk with an Alfalfa Production Contract**

prepared by

Dwight Aakre, Farm Management Specialist

Ron Haugen, Farm Management Specialist

Andy Swenson, Farm and Family Resource Management Specialist

North Dakota State University Extension Service

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Most commodities have three markets. They include seed stock, primary use and salvage market. For commodities that are relatively new to an area or are experiencing significant growth in production, the seed stock market can be a very strong market until the seed production overtakes demand by new entrants. Alfalfa production is well established throughout the country and as such this market is in a mature phase. For purposes of this paper we can ignore this market.

The primary use market is the market for which all producers aim. The primary market for some commodities is for human consumption. For alfalfa, this market is likely the dairy and horse market. This market, most years, will provide profitable returns to the producer.

When the quality doesn't meet the levels demanded by the primary market or there is surplus production, the salvage market becomes the outlet. This market prices the product low enough to encourage use of a lower quality product. It is unlikely this market will price the hay high enough to return a profit to the alfalfa producer most years. Only in times of extremely short supplies will this price cover costs of production.

Dairy represents the majority of the primary market and as such sets the market value at any point in time. Dairy producers have many alternative feeds which may substitute for some of the alfalfa that would ordinarily be fed if market prices dictate. This is the market at work allocating resources in the most efficient manner. Regardless of the price, the level of milk production per cow today necessitates only high quality alfalfa be used. Poor quality alfalfa is expensive in this use even if it is free because of the loss of production.

In general terms, quality dairy hay is: 1) 100 percent alfalfa, 2) baled dry enough to retain green color, 3) free of mold and dust, and 4) has a relative feed value (RFV) of 150 or more. The production goal should be to harvest '20-30-40' hay. This is hay with at least 20 percent protein, no more than 30 percent acid detergent fiber (ADF) and no more than 40 percent neutral detergent fiber (NDF).

## **What Does The Dairy Producer Want?**

The number one concern by dairy producers is quality, high quality as previously stated as well as consistency. Consistent quality allows for little disruption in the feed mix provided and enables the

producer to maintain milk production levels. Price is an important factor. Dairy production is a very competitive business and cost control is a fact of life. Price will determine how much alfalfa will be fed relative to substitute feeds. Some dairy producers prefer to contract alfalfa supplies for more than one year at a predetermined price. Contracting of this nature removes some of the risk of price volatility.

Delivery is another important consideration for dairy producers. Most dairy producers are not equipped to transport hay long distances. In addition, delivery times is also important. Time of day and day of the week may be a factor in having labor available. Delivering on an agreed upon schedule is also important to make sure the feed supply is uninterrupted. A dependable supplier is another factor the dairy producer is looking for. A supplier that can provide total needs is preferred over several suppliers. Dairymen generally prefer to make future purchases from someone they've dealt with in the past and know to be a reputable source.

### **What Does The Alfalfa Producer Want?**

Alfalfa producers are looking for a rotational crop that will contribute to the profitability of the farm business. This means a crop that will cover all costs, both direct and indirect. The indirect costs associated with alfalfa production are a greater portion of the total costs of production than for small grain or oilseed production.

Producers are looking for reliable buyers. They expect to be paid on time as agreed to when the purchase was made, whether it contracted for future delivery or in the spot market. Alfalfa producers prefer buyers that purchase consistently from year to year in order to be able to do long term planning. A buyer for all production is another concern of alfalfa producers. Since it is impossible in this part of the country to avoid rain damage to some of the seasons production, some of the crop will be unfit for the dairy market. Finding a buyer for the lower quality production is a concern of producers.

### **Price Discovery**

One of the biggest mental adjustments a new alfalfa producer must make is to adapt to producing and marketing a commodity without a focal point for determining price. The futures market serves this purpose for the major grain commodities. While the price on the futures market is not the same as the cash price received, there is a predictable relationship between futures market prices and cash prices. As a result there is universal knowledge of the markets estimate of value of these commodities. The same can not be said for alfalfa markets.

Auction markets for hay and straw have developed in recent years. These serve as price discovery for localized areas but the area for which these prices apply is limited. Sales are limited to the commodity actually on site. The lots for sale are often relatively small. Auctions do serve to bring together buyers and sellers. These transactions may lead to further sales and purchases and serve as a benchmark for price and quality.

Transportation costs can often distort reported prices for hay. Due to the bulkiness of the product as

well as the relative low price, transportation cost constitutes a relatively high percentage of market value. Distance becomes a significant factor in hay markets. Quoted prices may or may not have transportation included. Therefore it is important for the seller to determine the net price received for the crop. For the buyer, it is the total cost, hay plus transportation, that determines the cost.

### **Finding A Buyer**

Unlike commodities such as feed grains, it is necessary to inform potential buyers that a supply of alfalfa exists and its location. Details on price, quality, type of package, delivery and any other factor that enhances the demand for this hay must be made known to potential buyers. Sellers will incur this marketing cost and needs to be included when determining net selling price. As with advertising for any product, the goal of the seller is to convince potential buyers that the hay you have for sale is the best buy available.

### **What To Cover In A Contract**

Producing alfalfa based on a contractual agreement between producer and buyer is a means of reducing the risk each party is exposed to. A contract provides some certainty regarding price, size of sale and continuity from one season to the next for the alfalfa producer. For the buyer, a contract provides some assurance of price, quality, availability, delivery and reliable source of supply from one year to the next. Factors that should be addressed in a contract include:

- 1) Price needs to be addressed. This should include a base price for a stated quality hay along with a schedule of adjustments to the base price for differing qualities. One method of adjusting the price for quality would be to increase or decrease the price a specified amount for each point the Relative Feed Value is above or below the target value.
- 2) Quality should be identified as to the target quality for which the base price applies. All factors that will be used to determine quality should be in the contract. Regardless of price adjustments, there generally is a minimum acceptable quality and this needs to be specified. It is also important to identify when and how quality will be sampled and tested.
- 3) Quantity that both buyer and seller will be obligated for should be specified. Detail the terms that will apply to a shortfall in production as well as production in excess of the minimum. In the event of a short crop, some producers may choose to purchase the hay necessary to meet the contract minimum in order to keep a favorable, long-term contract.
- 4) Weighing procedure should be specified in the contract. Typically every load is weighed individually. Weighing at a certified scale should be specified. The contract may include details regarding weighing practices such as how often the empty truck is weighed.
- 5) Storage is another factor that should be covered. Who will be responsible for storage? This is determined by time of delivery. Who is responsible for cost of storage? Normally that is the party

in whose possession the hay exists, however a payment for storage may be a factor to consider.

- 6) Delivery responsibilities need to be covered in the contract. Who is responsible for delivery and is the cost of delivery included in the sale price or a separate charge? When is delivery to be made? Is it at the convenience of either buyer or seller or on a specified schedule outlined in the contract? What responsibilities does the buyer have at delivery?
- 7) Payment. When and how will payment be made? The seller likely would prefer payment ahead of delivery due to the high cost of transportation relative to the value of the commodity. The buyer typically prefers a payment schedule that is more in line with the stream of income derived from feeding the hay. However this method leaves the seller with considerable risk of non-payment. Specifics regarding payment need to be clear in the contract.
- 8) Type of Package should be specified. This seems obvious but sometimes overlooking basic details creates big problems later. Most producers are likely geared up to produce one type of bale and the same applies to the ability to feed hay on the part of the buyer.
- 9) Length of Period Covered by Contract. The contract needs to specify the termination date of the agreement and procedures for renewing and terminating the contract.

## Summary

Production contracts may be used to reduce the risk associated with marketing alfalfa or other hay production. A contract allows for both the producer and buyer to specify details regarding the factors that are important to each of them. This may be used for both physical characteristics of the product and the services provided by both parties.

Details that should be in the contract depend on what is important to the parties involved. This paper provides a start in identifying some of the factors that should be included and the concerns surrounding those factors. Additional specifications should be included if both parties are in agreement. A contract signed before the product is produced increases the chances that both parties will realize the results they intended.



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