ONA REPORTS

published in

THE FLORIDA CATTLEMAN AND LIVESTOCK JOURNAL

May - 2002

Beef Alliance Economics 101.01

Dr. Tom Anton
University of Florida
Range Cattle Research and Education Center

For questions or comments regarding this publication contact
Dr. Tom Anton

Alliances are a new marketing structure in the cattle industry. While some Florida producers are beginning to participate in alliances, many producers are still wondering how alliances work. This article will discuss the economics behind beef alliances, and how they differ from the vertical integration found in the poultry and pork industries.

There are several types of alliances, and each is a form of vertical coordination. Vertical coordination links stages of production through any form of agreement or ownership. Loosely speaking, forward contracting is a form of vertical coordination. Vertical integration is the opposite extreme of vertical coordination from forward contracts. Vertical integration occurs when one entity owns more than one stage of the production process. For example, Perdue Farms, a vertically integrated company, owns their broilers from peep to packaging.

Why vertically coordinate? The answer is simple, yet the motivations are complex. The potential for reduced costs and/or higher market prices are just two reasons. The ways in which costs are reduced may not be very clear. In a vertically coordinated market, contractual arrangements will predetermine the buyer and the seller. By predetermining the market, buyers no longer have to search for inputs and can coordinate with suppliers the inflow of product to more efficiently operate. For beef packers, it allows them to avoid costly down time. For the seller, the contract takes away the uncertainty of finding a sale market. However, unlike the poultry and pork industries, the final market price paid to alliance participants remains uncertain.

Contracts may also stipulate rules for payment, such as pricing grids in the cattle industry case. These arrangements create an alignment of incentives allowing producers in different stages of production to share the same goals. Information transfer between stages becomes less restricted. Ultimately, the system allows consumer preferences to efficiently reach the most critical stages of the production chain. Efficiently transferring consumer preferences through the production chain allows for production of desired products. By producing a product which consumers desire, the consumer is more willing to pay a premium for that product.

Pricing grids are a key component of the alliance and must be studied carefully before making the decision to participate. A producer can significantly increase profitability if his/her cattle match the pricing scheme, but a mismatch could be very disappointing.

Where do the additional dollars come from? There are several sources for premiums paid in pricing grids. The most obvious is savings from discounts paid to poor quality cattle. However, alliances also create a market niche for products which consumers will pay a premium. The revenues from premiums then filter back through the pricing grids. Finally, additional savings can be obtained by stable flows of animals through the system.

Part of the reason the poultry industry is vertically integrated and the swine industry is highly vertically coordinated is tied to information transfer and quality control. In an open market, that information stops at the time of sale. Thus, sellers have only the incentive to get the highest price possible when cattle are sold. In a vertically coordinated market, it is easier to reward high quality animals and discount low quality animals. Presumably, cattle producers will respond to incentives and strive to market high quality animals.

In the poultry and swine industries, the cost of information transfer has been internalized. Packers control the genetics and know the quality of products associated with the genetics. Vertical coordination allows for an increased level of information transfer for beef packers to track carcasses and give feedback to cow-calf producers and feedlots on the quality of carcass. New technology allows information to be single animal specific, and consumer preferences can be transferred more efficiently to the early stages of production, e.g. the cow-calf operation.

Alliances are likely to be a significant part of the future of the beef industry. It will be important for producers to understand these programs and opportunities they offer. In future issues, I will discuss in more detail the types of alliances, their pros and cons, the management issues, and how current marketing channels can be and are being used in the various alliance structures.