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## Beef Alliances: A Basic Economic Overview<sup>1</sup>

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The use of marketing structures other than the open market has become more widespread in agriculture. One such alternative marketing structure is the beef alliance. Beef alliances use contracts and incentive structures to link stages of production and/or to create a marketing organization. Links are created between entities that are under separate ownership to help coordinate the efforts of those entities.

Alliances are a relatively new marketing structure within the cattle industry. Some Florida producers have begun to participate in various types of alliances, but many producers are still left wondering how alliances work. This paper discusses the economics behind alliances and how they differ from the vertical integration found in the poultry and pork industries.

### Economic Rationale

There are several different types of alliances, but every alliance is a form of vertical coordination. Vertical coordination links various stages of the production process through any form of agreement or ownership. Loosely speaking, forward contracting is a form of vertical coordination. Vertical integration is the extreme opposite 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 a broiler from "peep" to packaging.

Why would people wish to vertically coordinate? The answer is simple yet complex. The potential for reduced costs and/or higher market prices are just two reasons people vertically coordinate. The ways in which costs are reduced may not be very clear. In a vertically coordinated market, contractual arrangements will predetermine who the buyer and the seller are. By predetermining the market, buyers in a contract no longer have to take the time to search for inputs. Additionally, buyers can coordinate with their suppliers the inflow of product in a way that allows the buyers to operate more efficiently. In the case of packing plants, 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 beef alliance participants remains uncertain.

The contracts may also stipulate rules for payment. In the cattle industry, we see these rules outlined as pricing grids. These arrangements create an alignment of incentives. Producers in different stages of production begin to share the same goals.

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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 that consumers desire, the consumer is more likely to pay a premium for that product.

## Pricing Grids

Pricing grids are a key component of the alliance and must be studied carefully before making the decision to participate in an alliance. A producer can significantly increase profitability if his cattle match well with the pricing scheme. However, a mismatched herd-alliance pairing could leave the producer very disappointed.

What is the source of premium dollars? There are several sources for the premiums paid in the pricing grids. The most obvious is the savings gained from the discounts paid to poorly grading cattle. However, alliances also attempt to create a market niche in which the goal is to produce a product consumers desire and for which they are willing to pay a premium. The additional revenues from these premiums then filter back through the pricing grids. For example, beef packers may be willing to pay a higher price to ensure a more stable flow of animals through the system.

Information transfer and quality control are two other benefits of a coordinated market. Part of the reason the poultry industry is vertically integrated and the swine industry is highly vertically coordinated is tied to these two issues. Information is transferred in several ways. In an open market, information stops at the price paid. Thus, sellers have only the incentive to get the highest price possible. In a vertically coordinated market, it is easier to reward high quality animals and discount low quality animals. Presumably, producers will respond to these incentives and strive for the ultimate goal to market nothing but high quality animals.

The pork industry is similar to the poultry industry but with different ownership structures. Vertical coordination has created a slightly different

structure where packers either farrow or contract the farrowing of piglets. The piglets are then sold to a producer who "grows them out", or the piglets may be ownership retained by the company and produced as in the poultry case. If the piglets were sold, the company then, by contract, buys back the "finished" hogs. Contracts will stipulate again what should be fed and when it is fed.

In both the poultry and swine industries, the cost of information transfer has been internalized. The packers control the genetics and know the output quality associated with those genetics. Vertical coordination also allows for an increased level of information transfer. Packers can better track carcasses to give further feedback, ultimately to cow-calf producers, on the quality of the carcass. New technology is beginning to allow that information to be animal-specific. Thus, the consumer's preferences can be transferred more efficiently to the critical early stages of production.

## Should You Participate?

The question remains, is a beef alliance right for you? The answer lies in what your goals are. It is important to understand the mission of the alliance. What product niche is it trying to fill? Can my cattle fit into that niche? Those are just the beginning questions. Matching your herd to an alliance is key to avoiding losses from discounts on cattle that do not match the alliance goals. The returns for cattle that grade well in the grid are high, but the losses for poorly grading cattle are just as high or higher. So there is considerable added risk in income variability. However, much of that risk can be overcome through intensive management of the production cycle.

Producers who are willing to invest the time in management and production of animals that fit into a grid of choice will likely do well in an alliance situation. Smaller producers who cannot produce the loads of cattle desired in the program may not be in a position to participate to their full benefit. However, several small producers may be able to coordinate efforts within an area. This would be considered horizontal coordination. The cooperative is the most familiar example of horizontal coordination.

## Management and the Alliance

Success in an alliance is controlled by the level of herd management a producer can, or will, put into the production process. Since incentive structures are performance based, the producer will not benefit fully from vertical coordination without active herd management. Poor management will leave the producer at risk of increased losses because of the severe discounts and number of poorly performing cattle. It is also important for the producer's herd to match its genetics and goals with an alliance that will mutually benefit all participants. Only a producer who closely manages the herd can adequately assess the potential match up of his herd with an alliance program. 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.

## References

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