



# ERS *Report Summary*

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## The Role of Contracts in the Organic Supply Chain: 2004 and 2007

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Contracts are widely used for marketing agricultural products, particularly when buyers seek products with specific attributes. Economic research indicates that, under certain circumstances, both suppliers and buyers can benefit from using contracts. The production, handling, and marketing of organic products follow a distinct process, as specified by the National Organic Standards. For products to carry an “organic” label, their production and handling processes must be certified by an accredited third-party inspector. Retail sales of organic products have been increasing rapidly, and the market has faced periodic shortages of some organic products.

### What Is the Issue?

Contracts can be designed to provide suppliers with incentives to deliver products with attributes desired by buyers. Conditions in the organic sector suggest that organic handlers (i.e., processors, distributors, manufacturers, repackers), as well as their suppliers (i.e., producers or other handlers), may potentially benefit from contracts, given growth in demand for organic products, short supplies, and the need for certification. Previous research, however, has not investigated the use of contracts in the organic sector. Data from two Economic Research Service (ERS) surveys of certified organic handlers (or intermediaries) provide insight into the extent of contracting in the organic sector, the rationale for using contracts, and reasons for contract termination. Other key questions relate to specific terms of contracts, including whether buyers offer suppliers assistance, how quality is specified in contracts and then measured, how prices are determined, and the frequency of contract termination.

### What Did the Study Find?

In 2007, contracts were used chiefly to procure needed products, particularly those in short supply. The next factor leading to contract use is the desire to source products with specific quality attributes. Large firms were more likely to use contracts for procurement. Assistance offered by contractors to suppliers typically included transportation or technical advice on organic standards. Contractors rarely assisted suppliers with obtaining organic certification or with the transition to organic.

Exploring contract use for a group of 13 commodities, the analysis examines provisions on quality, organic certification verification, and pricing. Nearly all contracts required firms to provide evidence of organic certification. Most contracts included provisions regarding quality, with the most common provision being minimum quality standards. Best management practices, which can have a significant impact on final product quality, are specified in some contracts for

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nearly all products (except for nuts). Some contracts impose a penalty for low quality (typically in corn, soybean, and seed contracts, such as those used by farmers for raising crops), while others offer a premium for high quality (typically in milk, coffee, and wheat contracts).

Quality verification was an essential component of contracts, and the verification method depended largely on whether quality was observable. Grain quality has both observable and unobservable attributes, so verification consists of both physical observation and testing for specific attributes. Because the quality attributes for coffee and milk are largely unobservable, nearly all quality verification is done through testing.

The methods for determining contract-specified prices paid to suppliers vary by product. The market price for organic products was specified most often in contracts for apples/pears, coffee, and seeds. Quantity discounts were part of contracts for nearly all products, except for berries, and were most common in seed, wheat, rice, and tomato contracts. Flat prices were specified most often for onions/garlic, poultry, and grains. Flat prices that depended on the supplier's past performance were most prominent for seeds, coffee, apples/pears, berries, grapes, onions/garlic, and tomatoes.

### How Was the Study Conducted?

The analysis is based on data collected when ERS conducted nationwide surveys of certified organic processors, manufacturers, and distributors for 2004 and 2007 practices. The surveys were funded by a cooperative agreement with USDA's Risk Management Agency and were developed in conjunction with a group of organic stakeholders.

