Contract Farming Checklist

A tool for reflection on critical issues in contract farming arrangements in developing countries

Investors that plan to work with contract farming in developing countries face opportunities and risks. Investment proposals are frequently based on optimistic assumptions without thoroughly analyzing the probabilities that things may go out of hand. In this checklist we list issues that you need to resolve and anticipate when embarking on contract farming. Further information is available in the *"Sense and Sensibilities in Contract Farming: tool for reflection on critical issues in contract farming arrangements in developing countries"*.

Contract
- Be aware that most contracts cannot be enforced by justice or police
- Check whether smallholders clearly understand their obligations and rights
- Define the way to settle future disputes

Farmers
- Get the right farmers from the start; not everyone is willing or able to specialize on a commercial crop
- Check whether there is a real business case for the farmer; comparing it with crop alternatives and other markets
- Start small and expand a contract arrangement that has proven to work
- Induce self-selection of farmers, working with groups and internal control systems

Groups
- Be aware that may groups do not have an economic orientation
- Check if existing farmers' organisations can help you start the contract farming
- Be aware that group leaders do not always represent group interests

Prices
- Define a transparent way to translate (international) market price into contracted farm-gate prices
- Explore how production risks can be distributed between contractor and farmer
- Reward quality and provide a market for second grade
- Define a levy on farm sales to cover training and certification costs

Services
- Make sure you are able to deliver your services, as it provides a perfect argument for default or side-selling
- Link input credit with other services to motivate pay-back
- Create goodwill by service provisioning additional to the contract
- Prevent side selling through investing in chain coordination

Social embedding
- Check the attitude of other chain actors towards your investment
- Cross-check information of your partner with other sources and informants
- Use local development organisations, but with caution

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Sense and Sensibilities in Contract Farming

A tool for reflection on critical issues in contract farming arrangements in developing countries

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Investors that plan to work with contract farming in developing countries face opportunities and risks. The investor provides a market outlet and often some inputs and training services to farmers; the farmers promise the investor a regular supply of a quality product in a pre-harvest contract. A properly designed contract farming arrangement can create important wins for both farmers, investors, input dealers and service providers. Contract farming often implies shorter, direct chains between farmers and companies. This is often essential for traceability and quality upgrading. However, contract farming is still quite exceptional in developing countries and many investors face severe problems in making the win-win arrangement work. How can you make a contract relation that creates benefits for the farmers and the company, and that is resilient to the forces of opportunism, competition and obstruction by other stakeholders? In this paper we highlight some issues that are important in most contract farming relations. Investors and development organisations thinking about establishing contract farming should check carefully whether their plans and projects are robust enough to handle these issues. It helps to refine strategies to source products from smallholder farmers in developing countries and make it a worthy collaboration for all.

The PSI (former PSOM) program supports the establishment of many contract farming arrangements in developing countries. Dutch development organisations such as ICCO are also involved in facilitating contract farming. In 2008 more than twenty of these arrangements have been reviewed by the project advisors, searching for tips that could help new applicants. This guide presents the lessons learnt as a tool for reflection for prospective investors in contract farming.

Key issues to reflect on before starting a contract farming arrangement

Investment proposals are frequently based on optimistic assumptions of win-win and the maintenance of cordial relations, without thoroughly analyzing the probabilities that things may go out of hand. Every situation is different, hence it is impossible to come up with standard guidelines that automatically will lead to a successful contract farming arrangement for all parties involved. Instead, we identify the key issues that you need to resolve and anticipate when embarking on contract farming.

> ***"In the absence of established relationships between both sides, such as those based on blood or friendship and in the absence of a capable legal system, there is a significant risk that one or both sides may decide to exploit the relationship for short term gain in the absence of concrete signs of long-term commitment and incentives"***

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Contract

The unbearable lightness of contracts

In most developing countries contracts cannot be enforced by justice or police. The amount involved with default by each farmer is usually too low to legitimize expensive legal action. And courts and police are often so bureaucratic or corrupt that a fair outcome of a legal procedure is not guaranteed. A contract farming arrangement needs an alternative mechanism to ensure compliance.

Common understanding?

Check whether the contractual obligations have been understood by the farmers. Smallholders and companies often do not 'speak the same language'. Issues like traceability, and quality certification will be new to the farmers. Do farmers really have a good understanding of their obligations and rights as described in the contract? Check whether farmers have really understood the crucial elements of your message; a lot of technical words may not exist in the local language. Anticipate future problems by explaining the arrangement in detail to all stakeholders involved. Several certification systems state it as the responsibility of the buying company to ensure that the small producers understand the terms of the contract, like the obligation to provide the contract in a language that the small producers can understand, and to give a verbal explanation of the contract before having it signed.

Dispute settlement

Contracts should explicitly indicate the way in which future disputes will be settled: outside the court through some other 'impartial' dispute settlement system. Arbitration can be done by a specially formed council with representatives of all involved stakeholders or by the local authorities. When they co-sign each contract, farmers will be aware of this social control and the arbiters may increase their commitment as problem solvers.

> One company selects farmers who fall under one chief. The area chief is present during all negotiations, and signs contracts as a witness and arbiter.

Farmers

Get the right farmers from the start!

Ensure that the right farmers are contracted. Many farmers in developing countries are producing for family consumption and, therefore, not everyone is willing or able to specialize on a commercial crop. Farmers might be interested in the services or credit in the scheme but unable to deliver on time and with consistent quality. As farmers have multiple occupations and pressing social needs of a large family network, many of them may be unable to meet the contract whenever some small hurdle crosses their path. Farmers will have to face this reality before agreeing on the contract farming arrangement. You can help them to get a clear and realistic picture of the benefits but also check with them the responsibilities and risks of signing.
Some companies have developed procedures to select the farmers based on criteria like land size, land ownership, yields or educational level. Others use references from the past, like performance in existing or past micro-credit schemes. Various investors developed a working relation with a local NGO or existing farmer groups, and made these co-responsible for the selection of farmers. Some

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companies ask for a collateral of the farmer before starting the contract arrangement (e.g. a bag of maize). By doing so, only committed farmers will start working with the contractor.

> A green pepper export company pays a local NGO a fee depending on the performance of the farmers that they have proposed to him. Doing so, he uses the multiyear experience of the NGO to select farmers and avoids future contract default.

> Together with traditional, religious and political leaders, a company made a shortlist of 50 potential contract farmers. These were all interviewed and a selection was made of farmers for a 5 day training course. 85% of the farmers passed the test and their farms were visited. A final selection was made based on a combination of all these elements.

Put yourself in the farmers' position!

The offer of 'markets, services and credit' is tempting for everyone who struggles to make a daily living. Especially, access to input credit will attract many farmers. Farmers often have a memory of former projects that gave loans that they never had to pay back completely. This has undermined their credit discipline and some farmers may therefore accept a contract without taking default seriously. You need to examine carefully with the farmers whether your proposal, including the potential benefits and risks, is beneficial to them. Hence ensuring that they will be able to reimburse credit or meet the contract. Local banks and micro-finance organisation often have experience in these kinds of calculations and can help you check the deal you plan to offer the farmers.
Even the poorest farmer will analyze his opportunity costs: Which other crops can he produce? Or what other work can he do? How much money will he get for this? Or how will this help the family with food security? How about the risks involved? Your contract farming proposal will have to compete with these other alternatives in the decision making process of the household.

> Who is the farmer? Is it the person who attends your meetings? The person who will carry out the work? Most contracts are signed by the head of the household, while much of the work may be carried out by women and children. Have you checked whether they can/will implement the conditions set in the contract?

Get the right number at the right time

You will need a minimum quantity of produce to make your business profitable, or at least break-even. Yet every person with contract farming experience will advise you to start with a manageable number and scale up later! Make sure the arrangement works before major upscaling. And analyze the implications of a gradual start for your investment plan and financial projections!

Induce self-selection!

Once the initial group of farmers is performing well, you may use these as the nucleus of growth. Especially in organic production, social control on compliance is key. Certification of each smallholder is too expensive. Group certification has been developed as a solution. It is a cost-efficient quality certification procedure: when one farmer does not comply, the whole group looses the organic or GlobalGAP certificate. The group needs an internal control system and has to explain, train and support the group members. Farmers gain ownership of the logic behind the quality attributes and registration requirements.

> One contractor mentions that he only accepts new farmers who are recommended by two farmers already involved in the scheme.

Groups

Farmers' organisations

Most investors work with organized groups of producers. Many work with existing groups or cooperatives with a proven trajectory in marketing transactions. Others coordinate with farmer organisations with a more social developmental focus but are keen to use them only as an entrance point. They subsequently select farmers within that wider group who can respond to the demands of a contract farming relation. This selection is crucial when working with organisations that were set up with totally different objectives than agricultural production or marketing.

In some countries, it is mandatory to work through semi-governmental farmer groups. Generally, this is the case in countries where marketing boards provide some services and take a percentage of the turn-over. Sometimes the quality of their service provisioning can be negotiated with these organisations, e.g. to organize training within the contract scheme. Often, however, it must be considered as a sort of tax payment and expectations to use these organisations to create services for or trust with the farmers will be in vain.

It is recommended to discuss with farmer organisations the possibility of forming crop/contract specific subgroups as part of their organisational structure. Instead of creating parallel organisations, dependent on the contract scheme, these existing farmer organisations can give a 'licence to operate' and support in conflict resolution.

When a strong farmers organisation is in place, working with these organisations will lead to more stable and sustainable relationship with the farmers; 'peer pressure' among farmers will ensure more compliance with quality standards and prevent side selling; farmer organisations can help so that all farmers understand the contract conditions.

Farmer organisations need income to pay for organisational expenses. They normally generate income from input or output marketing, or the provisioning of training services. Membership fees are rare. If you want to make use of a farmer organisation, you need to help them in finding ways to make them economically sustainable.

> One investor allowed the groups to generate income by deducting one shilling per kilo from the season's crop. Half of this one shilling is used in a community development project of the farmers' choice while the other half is used to cover the group administration and crop collection expenses.

Trust the leader!?

Some investors have contracts with the chair person of a farmers' group. Especially in larger schemes, direct communication with individual farmers is not feasible and indirect communication through group leaders is necessary. However, these leaders have not always emerged in a context of free choice: election may have been an arena of fraud or patronage, or is a representation of the oppressive relations in society, like women subordination or ethnic discrimination.

Though a contract farming arrangement will be unable to change these underlying social structures, it is important to check if alternative management models can be used that are more efficient and fair. Establishing a council explicitly including delegates from female headed households or other disadvantaged groups and empowering them on the technical and management issues, will better guarantee that their points of view are considered in the discussion.

> An exporter had signed a contract with the chairperson of a farmer's organisation. The contract specified all the details: But when the farmers did not deliver the produce on the agreed time, the company staff talked to the producers and discovered that they were unaware that any contract had been signed and they did not agree with the terms of the contract.
> Another exporter paid the farmers through the account of the farmers' organisation and the chairperson and treasurer 'emptied the bank account'. They were expelled from the organisation but the exporter had to spend a lot of efforts to rebuild the relationship and restore trust with the producers.

Prices

What market price?

Many schemes use a minimum price with a surcharge based on the level of 'prevailing market prices'. This is often necessary as the scheme has to offer at least the price of the competitor. However, there is never only one market or one competing trader. A reference market will have to be stipulated in the contract. Many countries have price information systems that can be used to compile prices or price indices.
As world market prices can be volatile, difficult to predict and hard to explain to local farmers, a sheet with a price table relating commodity exchange derived international prices to local farm prices increases transparency and may avoid tensions around pay day. Additional advantage is that it stimulates a more market oriented attitude of the farmers.

The merits of risk and benefit sharing

Several companies state that they bear all price risks because of the fixed farm gate price agreed with the farmer. It is recommended to have a pricing system that transfers some of the price risk to the farmer to increase the market orientation.
On the other hand, weather and plague risks in developing countries are high and farmers generally bear the bulk of that production risk. It is worthy to explore if both risk factors can be better balanced between the farmer and the contractor. Together with the farmers possible risk management strategies can be devised.
Also, credit risk can be distributed between farmers and contractor. A price surcharge can be explicitly linked to it: when default is low, contracted prices go up.

> A contractor wants to establish a joint venture with farmers as shareholders. "Currently all losses are borne by the company. In future when farmers take up shares in the company, profits and losses will be shared amongst them as shareholders."

> An exceptional case: a seed potato company mentions that he compensated farmers for loss due to heavy rains. He paid the farmers for the time and inputs they invested. And, this is also the exporter who has hardly any problems with side selling, even at a point in time when his buying price was much less than the local price.

Reward quality!

Additional to prices, other mechanisms can be used to stimulate compliance. Several companies mentioned that they give a bonus to farmers if they produce more than anticipated or a higher quality product. This also promotes the market orientation of the farmers.

Unacceptable quality?

The contractor usually only wants to buy high quality products. However, in farming there will always be second grade. Instead of returning the second grade to the farmer and make him or her sell and spoil the local market, a better option is often to accept it with a differential price and sell it outside, e.g. selling damaged fruits to a juice maker in the city. A low local market price for second grade is a powerful disincentive for farmers to grow the specific crop.

Payment for training and certification

For farmers to meet the required quality criteria, it is often necessary to get training. They need to learn and understand the quality selection process. Many companies collaborate with NGOs or government extension workers to train farmers. However, certain crops need specific technical know-how that is not easily available that, initially, can only be provided by the investor.

> One company has a partnership with a local university to provide training but stressed that it is necessary to complement this with 'on-the-job training' of farmers. You have to be in the field when farmers are working.

Farmers are seldom aware of the costs related to training and supervision. Former state extension systems and current donor support have eroded the willingness to pay for training services and the 'money for quality-concept'. During start-up, training costs are often subsidized through donor subsidies. But after some years these costs will have to be incorporated in the cost structure of 'normal business'. Complete transparency on your service costs is good but can be painful, especially when international training or certification costs are high compared with the revenue for the farmer. Instead of deducting real costs from the final price paid to the farmers, you may better apply a fixed percentage on the gross transactions of the farmers. During start-up this will create only limited funding, but it has the advantage that after the 'subsidy fall-out' you will not have to change your payment system. Generating a training fund opens the opportunity to evaluate the quality of the service delivery paid by through the fund with the farmers. When the farmers complain about the services of your staff, you can give them the opportunity to contract higher quality service providers using the training funds.

Services

Why would the farmers trust you?

Farmers often see foreign companies as the latest in a row of intruders in their environment. They have to decide whether they will take the risk to invest their resources to produce for you. They often have a lively memory perceiving cheating by traders and authorities. Farmers may want to check the credibility of the company. Are you going to deliver the services you promise, and pay the price you offer? Transparency on the background and performance of the company is often needed to make the social environment receptive for the contract farming arrangement and build trust. Gossip can undermine the loyalty of the farmers, the service providers and the local authorities.

> Two contractors mentioned that, although the processing factory was not yet ready, they already purchased the crop of the farmers at harvest time. The companies felt that this was extremely important to show their commitment and build trust with the producers.

Are you able to deliver yourself?

Often farmers need additional training and inputs in order to produce consistent good quality produce that meets all the standards. Do you have enough qualified staff who can train farmers in time, and monitor the application of agronomic practices?

> Contractors that have own fields often overestimate their own staff's training capacity. Just when the farmers need on-the-spot-training to combat diseases, the contractors' fields have the same problem and need all the available time of the field staff: the moment he can provide the training is only after the damage is already done.

Do you have enough staff trained in grading procedures and quality control? If you have agreed to provide inputs, are you able to deliver the right quality at the required time? Your inability to deliver on your promises may have an impact on the productivity of the farmer, and will definitely have a huge impact on the trust that the farmer has in you. It provides the perfect argument to legitimize default.

> One investor in poultry stressed the responsibility of the company: any failure on the company's part will affect the trust and motivation of farmers to meet their obligations. "One day late with chicken food means that 200 chickens will disappear through side-selling….."

Input credit

Input credit is often intimately related with contract farming. Credit can be paid back with the harvest. However, it can also induce side-selling, especially when the credit is a high proportion of the payment.

Most companies have as their only sanction to remove farmers from the contract scheme if they wilfully do not reimburse the credit, or in case of side selling. This sanction will be effective if the farmers perceive real benefits of the input credit for the next crop cycle, or that that they will loose 'embedded' economic or social benefits in the period after the loan repayment.

Another security is asking for collateral. Small collateral with a high symbolic or personal value, such as a bag of food or a bicycle, is often more effective than collateral related with land or houses. The smaller items can effectively be taken in case of default, while the larger one need trial and justice and cannot be seized easily.

> One company realized that while they rightfully seized collateral of those farmers who did not meet their obligations, it damaged their reputation as if they snatched from the poor.

Investors brought up other experiences on the issue of loans:

- One mentioned that they do not provide loans to farmers as they find it too risky. It is easy for the farmer to tell the company that his crop was stolen; seed did not germinate, etc.
- Others do give loans, but regularly visit the farmers and know exactly what is being produced.
- A third category of companies makes a deal with a Bank or Micro Finance Institute. These provide the loans and also ensure repayment. This is often the preferred option because in this way everyone can stick to its core business and investors don't have to perform conflicting roles: build good relationships with farmers and policing at the same time.

Create goodwill!

Goodwill is the lubricant for overcoming hurdles in the contract arrangement. Unforeseen problems will always appear. However, getting it right from the start can reduce a lot of troubles. Generally smallholders do not count on long term benefits of a chain partnership, but are very responsive to concrete benefits in the short term.

Goodwill enhancing activities do not have to be very difficult or expensive. Examples are: provision of educational grants or transport facilities to farmers' children; emergency funds for health or funeral costs; or access to entertainment events (cinema, soccer!), etc. Local NGOs are often particularly good in identifying social services adapted to the problems of households in rural areas.

As production risks are usually quite high, the facilitation of crop diversification next to the contract target crop is a good strategy to build goodwill and to support food security. For example offering farmers access to (cash-paid) post-harvest storage or processing services for other crops that are not under the contract.

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A contractor announces: In June we roll out the first farming pension fund in West Africa. We hope to develop more tools to link the farmer in the program and therefore reduce side selling. The pension fund is one of them.

The fatal attraction of side selling

The nightmare for investors is to discover that, after all your investments and support in contract farming, the farmers sell their produce to another buyer. Especially buyers who have not invested anything can easily offer a higher price to farmers. Contractors may deal with this problem at two levels by working on improved chain coordination:

- Horizontal coordination: e.g. establish a Code of Conduct with other buyers
- Vertical coordination: invest in a good relationship with your contract farmers.

Here are a few more tips that have worked for others to build trust with farmers:

- Make sure that you are regularly in touch with farmers so that you know the produce on their fields and their problems.
- Farmers need money on the spot: make prompt payments!
- Be transparent and honest with your price: create and reinforce a collective memory of the company paying a higher price when local market prices were low.

Social Embedding

Deal with the vested interests!

The contract farming scheme will change the local context. Check which actors are already involved in the production, processing and sales of the product. Which actors in the chain, critical for success of the contract farming arrangement can be contacted to get an idea of their possibilities and constraints and their attitude towards your investment? If you know the vested interests that are threatened or feel obstructed by your investment beforehand, you may find proper ways to reduce these frictions and improve 'public relations'. Often government or donor programmes work on 'your' commodity and have a lot of information on the sector as well as the chain actors involved.

Does your local partner really know?

Joint ventures are often deals by foreign investors with 'local' professionals or traders that live in the big city. These local partners do not necessarily know the details of local rural social reality. They can make up things and present you a picture that does not correspond with reality. Several examples show that the Dutch partner sometimes thinks too optimistically that their local partner is able to 'do everything' in his/her country. You can be very lucky in finding a trustworthy, entrepreneurial trader. But does that make him automatically a good manager and a good farmer and a good trainer?

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A joint venture was set up to build and run a processing factory. The local partner proposed to set it up in 'his home village' as it would be easy to assure sufficient labour as "people in the rural areas always look for money". However, the work in the factory was rather tough and salaries low and people preferred to work on their fields rather than in the factory! The processing plant would have functioned very well in urban areas with abundant unemployed people but risks to become a 'white elephant' in a remote village.

NGOs: crucial for success or a nuisance?

Many companies make use of the knowledge, experience and relationships of NGOs with farmers. Some are even qualifying this collaboration as crucial for the success of contract farming. NGOs have experience with farmer groups and often they spend a lot of time in the field with farmers. Potential synergy of working together in design and implementation can be high.
However, others are complaining that because of NGO programmes it is difficult to introduce 'economic projects' with real cost structures. Both parties, NGOs and investors, should be aware that their interests do not necessarily match.

- "Farmers need to understand the difference between an investment project with export to Europe and a development project."
- "Farmers want to be paid a price that does not reflect market reality. NGOs are the cause of this unrealistic expectation because they have been giving handouts, have overpriced certain products thereby distorting commercial orientation."
- "Existing groups can be a social mobilization structure. It requires "upgrading" to meet economic challenges. Make sure farmers understand that this is business."

Final check: do you still have a business case?

Now that you have gone through all these elements,

- Do you still have a viable Business Case? Can you cope with the risk factors?
- And what about the farmers – do they also have a Business Case? Imagine their perspective: is contract farming under your conditions a good option for them?

Buying from spot markets and paying the product after the harvest is a far more easy way of procuring products from farmers than establishing contract farming arrangement, with forward sales and embedded service provisioning. Only use contract farming when you are quite sure that it will work out well.
Contract farming is a promising way to generate more stable value chain relations and is often a necessity to meet traceability requirements. It is an increasingly important but challenging business. If you plan to establish a contract farming arrangement: prepare yourself well to anticipate future problems!

Good further reading

For further reading on legal considerations on contractual design and enforcement, see FAO (**http://tinyurl.com/fao-legal-issues**) For many examples of contracts see FAO (**http://tinyurl.com/fao-contracts**)

In Kenya there is a Code of Conduct for parties entering into contract farming arrangements for horticultural produce. See Kenyan Horticultural Crop Development Authority (**http://tinyurl.com/hcda-code**)