Contract farming: Some fundamentals to be considered in contract design

Contract farming agreements are forward contracts specifying the obligations of two business partners: the sellers' (farmers') promise to supply and the buyers' (processors'/ traders') promise to off-take agricultural produce as agreed. With regard to substance, form and the process of concluding such arrangements, farming contracts are quite variable: they may be established in verbal or written form; they may be concluded by individual farmers or by farmer groups; the description of obligations may remain quite vague or be reasonably specific; the arrangements may be based on renewable seasonal negotiations or on long-term business relations; the specifications may be based on case by case negotiations or on a sub-sector code of practice. Whatever process applied or contents itemised, to ensure sustainability, successful farming contracts have to be designed in a way that promises benefits to both contract parties.

Given the diversity of produce features and geo-climatic situations, business cultures and entrepreneurial capacities, socio-economic structures and business environments, it is obvious that there is no one-size-fits-all blueprint for designing farming contracts. Furthermore, experience shows that a farming contract is not worth the paper it has been written on if there is no trust between farmers and buyers.

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Trust is decisive for the willingness to honour agreements and for reducing moral hazard problems such as diversion of inputs or side-selling (often in response to poaching by competitors), unduly imbalanced negotiating power or biased rejection practices. **Contract farming is a business, in which farmers and buyers share risks and benefits.** For making contract farming a sustainable business, the following principles have to be acknowledged:

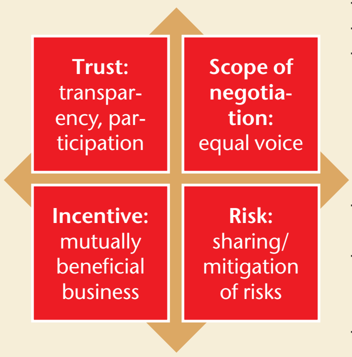
- **Trust:** appreciate that trustful relations are the foundation for success and that trust builds on fair give-and-take relations and open communication;
- **Scope of negotiation:** understand that farmers need to have an equal voice in contract negotiations and conflict settlement;
- **Incentive:** recognise that farming contracts are clear-cut commercial agreements that can sustain if both parties realise a cost-benefit 'plus';
- **Risk:** realise that contract farming bears risks requiring arrangements for sharing and minimising risks of conjoint investments according to the capabilities of contract partners.

Business principles and basic elements for designing contract farming agreements

Legal elements:
- Freedom to contract: it is the free decision of farmers and buyers to conclude a contract and negotiate contract details
- Good faith: the honest intention of both parties not to cause damage to each other can be trusted
- Termination: the conditions of contract expiry need to be specified
- Force majeur: in case of unforeseeable/ exceptional situations, a non-performing party can be exempted from liability
- Performance: both contract parties are bound to realise their obligations as specified
- Non-performance/ compensation: consequences for any party's failure to meet obligations are to be specified
- Dispute settlement: agreement on ways to settle contractual disputes (mediation, arbitration, prosecution)

Farmers' obligations:
(individual farmers or farmer groups)
- registration (name, acreage, etc.)
- product quality
- cultivation practices (e.g. Good Agricultural Practice – GAP)
- supply volume (incl. share to be supplied to buyer and share to be freely used/ marketed by farmers)
- supply date/ calendar
- record-keeping (probably as annex: detailed GAP, list of tolerable pesticides, etc.)

Business principles:



Buyers' obligations:
- name, location, etc.
- off-take volume
- embedded services (inputs, extension, market information, certification support, packaging material, credits)
- field monitoring/ spot checks
- quality control mechanism/ grading criteria
- feedback on performance/non-performance

Pricing specifications:
- production costs/ farmer margins
- flexible or fixed rates
- quality premiums or deductions
- costs for inputs/embedded services and cost recovery details

Marketing specifications (responsibilities/arrangements):
- harvesting/ grading/ packaging
- rejection criteria/ tolerance levels
- collection infrastructure/ procedures
- transport organisation

Payment specifications:
- mode (e.g. cash/ in-kind, individual/ group transfer)
- timing (e.g. down-payment, staged payment, payment on delivery)
- records of deliveries/ payments