

Contract Farming : Hold up and Asset Specificity

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--Phenomenal change in Indian agriculture in the last five decades.

-- The change – technological (green revolution) and institutional innovation – in credit, inputs, extension and marketing.

-- Contract Farming is one such institutional innovation

What is contract farming/vertical coordination?

--Contract farming is a system in which agricultural commodities are produced and supplied to a particular buyer mostly processors under pre negotiated arrangement about price, quantity and quality.

New Agricultural Policy 2000, "private sector participation will be promoted through contract farming and land leasing arrangement to allow accelerated technology transfer, capital inflow and assured marketing of crop production."

Contract farming is followed for many agricultural and horticultural crops in India.

Several Corporate houses – small, big transnationals are involved

3

Partial List of Companies Following Contract Farming

S.No	Company	Crops	State
1	Global Greens	Gherkin, baby corn, paprika	Karnataka, AP
2	Sterling Agro Products	Gherkin	Karnataka
3	Ken Agri Tech	-do-	-do-
4	Green Agri Pack	-do-	-do-
5	Unicorn Agro Tech	-do-	-do-
6	Golden Sluis	-do-	-do-
7	Bharat Copper Cutting Works	-do-	-do-
8	Koelman India Ltd	-do-	-do-
9	Vishal Natural Products	-do-	-do-
10	Suguna Poultry	Broiler	TN, AP
11	Pioneer	Broiler	TN
12	Sri. Venkateshwara Hatcheries	Broiler	AP,TN
13	Swathi Hatcheries	Broiler	TN
14	Marico	Safflower	Maharashtra, MP
15	Pepsico	Chillies, Basmati, Goundnut	Punjab
16	FritoLay(Pepsi)	Potato	Punjab, UP
17	Satnam Overseas	Basmati	Punjab
18	Escorts	Basmati	Punjab
19	Rallis	Basmati, Wheat, Fruits and Vegetables	Punjab, UP, MP, Maharashtra, Karnataka
20	EID Parry	Paddy (Branded rice Ponni)	TN

4

21	AM Todd	Mint	Punjab
22	Appachi Cotton Mills	Cotton	TN, Karnataka
23	Super Spinning	Cotton	TN
24	Rasi Spinning Attur	Cotton	TN
25	Vardhman	Cotton	Punjab, TN
26	Sami Labs	Medicinal Plants and Herbs	TN AP Karnataka
27	Dabur	-do-	AP, Himachal, UP MP, Haryana
28	Hexagon, Theni, TN	-do-	TN
29	Nandan Agro Farms (P) Ltd Hyderabad	-do-	North East
30	Himalaya International Ltd	Culinary Herbs (Dill, Basal and Thyme)	HP
31	United Breweries	Barley	Punjab
32	Jain Irrigation	Onion	Maharashtra
33	Mc Cain	Potatoes	Gujarat
34	Wimco	Poplar	Haryana, UP
35	Ion Exchange Enviro Farms Ltd	Organic products of banana, pineapple, papaya, wheat, basmati, cotton,	TN, MP, Gujarat, Haryana, Maharashtra
36	AV Thomas ?	Vanilla	Kerala
37	Prime Bio Products	Cotton, Maize Sunflower	Mostly TN, small presence in Karnataka
38	Century AgroTech	Jatropha	TN
39	Golden Fries Ltd	Potato	TN
40	Mahindra Subhlabh	Many crops	Maharashtra, Punjab
Source: Press statements, WebPages of the companies Note: Some may be pilot projects, others may be very small operations, while some others are third party			

5

Fundamental question is – produce internally or externally i.e. depend on the market

Between vertical integration and spot market exchange – long term contractual arrangement

Land legislations, high cost of production – hinders vertical integration or corporate farming

Possible only in plantation crops like tea, coffee, rubber etc

Our focus here is on spot market and contract farming

6

Transaction cost

In open market the firm has to incur search and information cost

Availability, quality etc

Bargaining and decision cost

Risk of procuring inferior materials

Market failure

Market failure occurs for goods – idiosyncratic in nature

Benefits are transaction specific

Need Assurance -- recurrent demand

7

Opportunism

Ex post advantage i.e after the investment had been made

Opportunistic behaviour – not honouring the contract

Contract farming – opportunistic behaviour is a major problem

More so in asset specific investments

Asset specificity – physical, site, temporal

8

Eight case studies

Gherkin in Karnataka
Boilers in Tamilnadu
Coleus in Tamilnadu
Mint in Punjab

Wheat in Uttar Pradesh
Safflower in Maharashtra
Tomato in Punjab
Cocoa in Kerala

9

Asset Specificity

Relationship would be smooth—firm and the farmer are locked in asset specific investments

Alternative use of the investment is smaller than the specified use.

Survival of both parties—closely linked – contract – self enforcing

Some examples

- certified seed production
- gherkin
- broiler chickens
- coleus

10

Gherkin

New Crop– introduced in the country in the early 1990s

Consumers – Europe, Russia, North America, Japan

Companies organise production after getting firm orders

As the crop is new seed has to be supplied by the company

Importers insisted on use of pesticides permitted in those countries

To ensure the use of right kind of pesticide company supply them

Processing should be done within 10 hours of picking

No local market so all the production is supplied to the contracting company

Company's commitment is heavy due to supply of seed and pesticide

Fulfill the obligation to overseas clients.

11

Coleus

Is a medicinal plant found in the wild

Belongs to the mint family

Used for pickles and in ayurvedic medicines

Sami Labs, Bangalore

U.S. subsidiary Sabinsa

Several patents in US

Patent for Forslean

Extract from the plant – coleus forskholii

Forskholin causes weight loss, helps to increase lean body mass

Sabinsa supplies forslean to major pharmaceutical companies in the US
4000 acres (2300 TN, 1000 Karnataka and 700 acres in AP)

Organize production through Intermediary

Sami labs is the sole purchaser farmers have no alternative but to supply.

As Sami labs has to supply to its overseas client it cannot afford to fail its₁₂ commitment so purchases all the produce from the farmers

Broilers

- Survival of hatcheries
- Affected the layer farming
- Broiler chicken rearing not popular because of volatility of the market
- Idea of a feed mill owner with some farmers
- Integrated Approach
- Decentralization of rearing
- Supply of day old chicks, fee, medicines
- Lift the birds after six weeks
- Growers paid on the basis of feed to meat conversion ratio

13

Mint in Punjab

AM Todd US based multinational a leading supplier of mint oils

Supplies to food, beverages and cosmetic industry

Supplier of intermediate product

Entered India in the mid 90s and chose Punjab

For the farmers the crop fits well in the crop cycle

Paddy, Potato and Mint

Volatility of price, exploitative nature of the trade

Chose contract farming

AM Todd better price, prompt payment

Returns better than other crops at the time of the year

AM Todd commitment to it clients

Farmers alternative channel unreliable

14

Safflower in Maharashtra

Marico industries – health and wellness segment

Saffola positioned as healthy oil

Developed a niche market

A near monopoly of Safflower oil in the organized sector

Safflower minor crop little public research

Farmers switched to more remunerative crop – area declined

Imports from Brazil and Mexico – high landed cost and uncertainty

15

Marico promoted the crop

Entered into contract agreement with the farmers

Pre negotiated price

When the crop system was introduced

Crop failure in Brazil and Mexico

Safflower available was cornered by traders for exports

Higher price lured the farmers

Before the company could react it lost the crop

Abandoned the arrangement – Revising the strategy for procurement

Farmers behaved opportunistically – alternative channel offered higher price

16

Tomatoes in Punjab

Pepsico entered India on the condition of investing in agro processing

Tomato was identified by the company

Improvement on yield, solid matter, prolong processing days

Entered into contract farming with the farmers

Pre negotiated price

Open market price higher – farmers' diverted the crop

Havoc in the co planning and processing schedule

Eventually the plant and scheme was abandoned

17

Cocoa in Kerala

Multinational chocolate manufacturer promoted cocoa cultivation in the 70s

Pre negotiated price – assurance of good returns

But the company reneged on the commitment when the tree started to yield

Reason international prices crashed

Company could source from anywhere

Farmers – ruined because of long term crop

Gestation period – economic life quite long

Opportunistic behaviour by the company

Farmers suffered because of asset specificity

No alternative buyers – floated their own cooperative

One case of integration

18

Wheat in Uttar Pradesh

Rallis leading input manufacturer (pesticide)

Threat from spurious pesticide

Kisan Kendras (Farmers' centres)

Extension services to the members

Integrate input supply and output marketing

Supplied seed and fertilizer

Not an agro processor – contacted leading processor – made the Kisan Kendras procurement hub

Initial effort was in wheat in Uttar Pradesh, Fruits and Vegetable in Karnataka

Open market prices went up only 60 percent procurement by Rallis

Not able to fulfill the commitment to the clients

Abandoned the contract farming

19

Gherkin, Coleus, Mint ,Broiler chicken

Both the farm and the farmers are locked in a specific relationship

The investment made in the asset is specific to that transaction

As both the farmers and the firm are hostage to each other the contract is self enforcing

*In case of
Wheat, Safflower, Tomato*

The farmers had alternative channels the crops were not specific to the relationship to the company

In case of cocoa

The firm tried to hold up the farmers for a lower price as it was a monopsony in cocoa

Farmers' response was to integrate forward into chocolate manufacturing₂₀

Thank You

21



22



23