The HCDA Code of Conduct in Kenya:
Impact on transaction costs and risks

Yuca Waarts & Gerdien Meijerink
June 2010
This series is a result of the Partnership Programme between the Netherlands’ Ministry of Foreign Affairs Government and Wageningen UR.

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1 Introduction

1.1 Introduction
Despite the high potential for Ethiopia’s oilseed sector, it is generally felt that the value chain of sesame faces different challenges, including the adulteration of sesame with foreign materials or the mixing of sesame with different sources of varying quality, a lack of transparency among chain actors and the contract default of producers and/or buyers in some cases. In addition, transaction risks are mainly the result of problems caused by the behaviour of actors throughout the entire chain, lack of proper trade arrangements or coordination among chain actors and lack of capacity to accurately measure the quality standards of sesame and control problems related to theft and adulteration, have contributed to rising transaction costs.

Different types of institutional arrangements exist to organize transactions between buyers and sellers of agricultural products. Not only can buyers use spot markets to obtain products, they can also enter into contracts with individual farmers or groups of farmers. It is reasoned that in using contracts, transaction risks and costs are decreased for both buyers and sellers and access to markets is increased. Contracts can thus have advantages over spot markets.

Contracts are usually agreed upon by both buyers and (groups of) sellers. However, contract can vary widely in their specification. In the case of unequal power relations, the contract specifications may be unfavourable to the weaker contracting party (such as small-scale farmers). Kirsten and Sartorius (2002) put forward that “Contractual relations should be well managed and based on mutual trust. The perceived high levels of contract manipulation by agribusiness firms, distrust by farmers of the contractual relationship, and a perception of loss of autonomy have characterised contract farming in developing countries. Removing all elements of mistrust and establishing trustworthy relationships are important measures for success.” A national Code of Conduct (CoC) can be useful in managing contractual relations and develop mutual trust by setting certain ground rules for actors in the sector. Dispute settlement can be part of such a CoC.

A well-known example of a CoC can be found in Kenya, where the Horticultural Crops Development Authority (HCDA) has established a Code of Conduct (CoC) for the horticultural sector that is specifically focused on using written contracts as a preferred institutional arrangement. The CoC includes specific obligations related to contract farming and serves to reduce transaction risks by explicitly stating the behaviour and actions (i.e. conduct) to be expected from the parties involved in the horticulture sector, as well as the terms that should be included in written contracts.

As this CoC has such specific requirements for establishing written contracts, and contract farming in combination with a Code of Conduct can enable the exporter and its suppliers to minimize a number of risks, this could serve as a model for Ethiopia, where the Oilseeds sector is contemplating a CoC. This report investigates this question by analysing whether the HCDA Code of Conduct has indeed decreased transaction costs and risks for both exporters and farmers in Kenya.

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1 Eaton et al., 2008
2 Eaton et al., 2008
3 HCDA, 1995.
1.2 Research question addressed in this report
The main research question of this report is what the impacts are of the implementation of the HCDA Code of Conduct on transaction costs and risks for buyers and sellers from the horticultural sector in Kenya. We answer this question by evaluating the development and implementation of the HCDA Code of Conduct in Kenya, using information from the literature and information collected through interviews with relevant stakeholders in Kenya. Interviews were held with the HCDA Head Office and HCDA staff of two depots (stations). Furthermore, individual farmers and farmer groups were interviewed, focusing on relatively small-scale farmers. Also one broker, one small exporter and two large exporters were interviewed.4

1.3 Structure of the report
We start this report with reviewing contract farming and what transaction risks and costs this involves or reduces in the horticultural sector in Kenya. We use the framework described in Meijerink (2010). This sets the stage to discuss what role the HCDA plays in reducing specific transaction risks and costs involved in contract farming. Chapter 3 describes the history and functions of the HCDA and the Code of Conduct that was developed by the HCDA. In chapter 4 we detail the implementation of the HCDA CoC. In chapter 5 we draw conclusions and provide recommendations on how to use the HCDA CoC, or design and implement CoCs with similar objectives, as means to decrease transaction costs and risks in contract farming, for both farmers and exporters.

4 The information was gathered in November 2009.
2 Transaction risks and costs in contract farming and the role of the HCDA

In contract farming, both the buying party (contractor) and supplying parties (farmers) face various transaction risks. We discuss these using the framework detailed by Meijerink (2010) and try to answer two questions: (1) to what extent does contract farming reduce these transaction risks? And (2) how does the CoC reduce transaction risks of contract farming?

The framework distinguishes technical aspects linked to production and contractual aspects. It assumed that there are always behavioural aspects such as bounded rationality and opportunism\(^5\) that increase the transaction risk.

2.1 Transaction risks

2.1.1 Technical factors

**Asset specificity.** In contract farming, investments are often designed or located for a particular use or user (contractor) and have a lower value in the next best use (usually spot markets). Asset specificity may especially be important for horticultural crops that are specifically grown for export and thus do not have large numbers of buyers in the domestic market. If farmers invest in the production of such crops and cannot sell it to the contracted buyer, they will lose part of their expected revenues. Buyers may run similar risks. Contracted farmers may fail to supply the expected produce, while the buyer has made investments in cooling storage, transport, contracting a buyer (importer). Such risks are especially high when the buyer cannot source similar produce from other farmers.

**Frequency.** The frequency with which suppliers and buyers meet really depends on the type of horticultural produce. Most horticultural produce, however, is harvested on a regular basis, and the frequency of contact between farmers and buyer is relatively high, thus allowing for relationship and trust building.

**Uncertainty.** Horticultural crops, as all agricultural production, are affected by uncontrollable elements, such as weather. This will make concluding agreements or contracts difficult because renegotiating and adaptation might be required when unforeseen events emerge. Some horticultural crops are produced with inputs such as fertiliser, pesticides and irrigation water, which reduce the risk of crop failure. However, prices in both cases are volatile and cyclically fluctuating, which pose a transaction risk to farmers when they want to sell their produce after harvest. Contract farming with agreed prices may reduce these risks (partly).

**Performance measurement.** The extent to which this poses a transaction risk depends on whether the requirements of the production process or the produce specified in the contract are difficult to measure. This may differ per crop and per contract farming scheme. In some cases there may be very stringent requirements, such as Globalgap or organic farming, which involve

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\(^5\) In line with Williamson (Williamson 2005)
close monitoring of the production process. In other cases, there may be less stringent requirements. If the requirements are stringent, the transaction risks are also high. If, for instance, one farmer used the wrong type of pesticide in produce designated to adhere to GlobalGap standards, the contractor may run the risk of not being able to sell the entire contracted produce.

Coordination requirements. For horticultural crops in Kenya, the supply of inputs at the right time, of the right quality and right quantity are important. In general, high value horticultural crops require more inputs (such as irrigation water) and therefore have higher coordination requirements. If key inputs are not available, it may increase the risk of harvest failure (in terms of quantity or quality). Contract farming may solve this transaction risk by contracts that include the provision of inputs by the buyer.

2.2 Contractual risks

Contractual risks concern the risks and costs associated with finding suitable trading opportunities and trading partners, negotiating an agreement or contract and monitoring and enforcing this agreement or contract.

Contract farming can reduce search and information costs of finding a suitable partner and gathering market information. Instead of finding a suitable trading partner each harvest in spot markets, with contract farming, such partners need to be found only once, after which they enter into a contract for multiple growing seasons. The transaction risk of entering into an exchange with opportunistic trading partners is reduced, although in contract farming opportunistic behaviour is never completely absent. Having fixed prices and a guaranteed outlet within a contract reduces the transaction costs linked to gathering price and market information.

Contract farming does not reduce bargaining and decision costs immediately, because negotiating a formal contract between an exporter and a (large) group of farmers can cost quite some time. It may also not reduce the transaction risk of farmers of entering into an unfavourable contract with more powerful exporters. This is where a Code of Conduct for contract farming may reduce transaction costs (by offering example contracts) and transaction risks (by specifying reasonable terms for farmers). Once the contract has been established, the bargaining and decision costs for the following years will be substantially decreased, unless the contract is renegotiated.

If the produce in question has characteristics or requirements that are difficult to assess (e.g. MRI, organically produced), then the high transaction costs of getting this information makes exchange in spot markets impossible. Within contract farming, these costs are still high, but manageable. The supervision costs include monitoring farmers’ practices.

Enforcing other aspects of the contract, for instance timely delivery may constitute a real transaction risk within contract farming. In spot markets there are very few risks linked to enforcement, because inspection, delivery, payment are all executed ‘on the spot’. Exporters may reject part of the delivered product without transparent grading or wish to negotiate the price when the market price is low. Farmers may sell their crops to brokers when they offer higher prices than the contract price, which may affect the rest of the group because the exporter may end the contract with the entire group. Here again, the HCDA can play a role in lowering
transaction risks and costs by offering services with respect to contract enforcement and conflict resolution.

2.3 Experience of farmers, exporters and other traders in Kenya

The interviews we held with Kenyan farmers, exporters and other traders confirm our ideas on transaction costs and risks of spot markets, contract farming and the Code of Conduct. The Kenyan farmers we interviewed said their transaction costs had decreased when they turned to contract farming. The most important transaction cost which decreased with a contract was their cost of finding a trade partner, followed by the cost of supervision and enforcement because of decreased uncertainty in prices, sale, payments and income. Bargaining and decision-making did not always decrease with contract farming as negotiations over the terms in a contract may take up quite some time and effort, especially when group contracts are used.

Exporters face similar risks as farmers. The exporters we interviewed indicated that one of the most important risks related to contract farming was opportunism: farmers may decide to sell their contracted produce to a broker who offers a higher price. See for more detailed information from the interviews Appendix 2. Other risks experienced by the exporters included farmers not implementing the contract out of lack of knowledge (e.g. use of pesticides etc.) resulting in a lower supply or a supply with the wrong quality. But exporters have found ways to decreasing these risks: not only do they usually have an agronomic or technical officer who works directly with the farmers to build their knowledge on certain aspects of production, they also only enter into contracts with groups or individuals of which they are certain that they can deliver the right product on time after conducting a risk assessment. This can be seen as additional transaction costs to reduce transaction risks.

The exporters said that transaction costs are much higher in a situation where they would not use contracts. They mention also the search and information costs; it takes a lot of time and effort for exporters to find good farmers that deliver products of good quality on time. Bargaining and decision costs are usually relatively low as they use standard contracts and until present, enough farmers can be found to close a contract with. Supervision and enforcement costs can be high in contract farming. As it costs such a lot of time to find good farmers, exporters usually guide their farmers well, including the appointment of a technical officer who works with the group. In this case, these transaction costs may be lower than without using contracts.

Besides farmers and exporters, the HCDA has also mentioned transaction costs and risk they have encountered in contract farming. Their input overlaps the experience of the farmers and exporters entirely. More information on their experience can be found in Appendix 2.

3 The development of the HCDA Code of Conduct

3.1 What is the HCDA?

The Horticultural Crops Development Authority (HCDA) is a state corporation under the Kenyan Ministry of Agriculture, 'with the responsibility to develop, promote, co-ordinate and facilitate the
horticultural industry in Kenya’. The HCDA was established by an order under the Agriculture Act, in 1967.7

HCDA’s mandate is ‘to regulate the horticultural industry through licensing and application of rules as prescribed under the Agriculture Act8 and is run by a board of directors from both public and private sectors9. Levies and fees charged on produce produces the main revenue for the HCDA.

3.2 Why was HCDA created and what are its functions?
The HCDA was established to regulate the horticultural industry and coordinate the activities within the sector.10 Originally, the HCDA was given the ‘authority to fix prices, regulate trade, and operate processing facilities and market horticultural goods’11. To meet those objectives, infrastructure including pack houses and cooling stations was established. However, because progress was slow, exporters had already established their own pack houses with cooling facilities by the time the HCDA infrastructure was finished. Therefore, the objective of regulating the industry by organizing the collection and auctioning of produce at the pack houses etc. could not be met.12

In 1986 therefore, the HCDA withdrew its buying and selling functions from the market.13 One of the reasons for changing HCDA’s functions was that the government aimed to increase the role of the private sector in economic growth.14 Price controls were eliminated, as ‘Kenya’s external trade policies are designed to create an environment conducive to promoting its products in international markets’.15,16 Even though there were plans to abolish the HCDA import and export licensing in 2005/200617, the HCDA still grants licenses to exporters and foresees to continue to do so.

The functions of the HCDA have changed through time by several amendments of the HCDA order under the Agriculture Act. The last change of the HCDA order occurred in 199518 to give the HCDA the mandate of ‘revitalizing the horticultural industry’.19

HCDA currently performs the following tasks:
- Granting licenses to exporters;
- Witnessing (countersigning) contracts between buyers and sellers, including arbitration;
- Providing cooling, packing, and transport facilities through HCDA depots (stations);

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6 HCDA, 2009a.
7 Agricultural Act, Legal Notice No. 231 Cap 318 Par. 6(1).a
8 HCDA, 2010a
9 EPZA, 2005
10 HCDA, 2009. Personal communication.
11 EPZA, 2005
12 HCDA, 2009. Personal communication
13 EPZA, 2005
14 WTO, 2000
15 WTO, 2000
16 EIU, 2005
17 EIU, 2005
18 1995 Export Order. L.N. No. 230
19 EPZA, 2005
• Providing demand-driven technical support to farmers, about quality, the introduction of new crops and post-harvest activities. HCDA does so in cooperation with extension workers of the Kenyan Ministry of Agriculture (MoA);
• Establishing linkages between farmers and markets, linking buyers and sellers;
• Organizing stakeholder meetings in regions to link farmers to exporters, agro chemical providers, banks etc. HCDA also organizes fairs for certain crops (e.g. the avocado fair on 29/11/2009 which included participation of Kenya Agricultural Research Institute and universities);
• Providing advisory and marketing services to stakeholders.

3.3 Contracts as a requirement to obtain an export license; the 1995 export order
If a company wants to receive an export licence, it needs to enter into a formal written contract with its suppliers (e.g. farmers) and communicate this to the HCDA. The HCDA then can become a 'witness to the contract' and act as an arbitrator when required. This requirement is described in the 1995 HCDA export order. The following obligations are also laid down in the export order:
• the HCDA should be informed about details on the growing of horticulture products for export ('source of produce, types of crops and approximate amount, duration of production and indicative prices to be offered to farmers').
• It is not allowed to pay to producers a price lower than a certain minimum price (reference is made to minimum prices per area);
• Exporters need to observe minimum export prices as indicated by the authority;
• Exporters need to strive to attain the highest quality and ensure that all produce for export is pre-cooled;
• Finally, ‘any production schemes so sponsored shall be regulated by contract’.

The obligation of using written contracts is also mentioned on the HCDA website, which states that required are ‘written contracts with farmers for supply of produce of a certain quality and standard, unless you are producing the export crop yourself.’

According to the export order, a company license will be cancelled when a company does not comply with these rules. In reality, however, licences are rarely cancelled, but according to the HCDA, in the future the export order may be enforced more often. The reason for the current practice of not cancelling licences could be that the legal notice (1995 export order) was never enacted into law. The 1995 export order thus lacks a solid legal basis.

3.4 The HCDA Code of Conduct
After the 1995 export order was finalized and communicated, the HCDA developed a Code of Conduct (CoC) in 1996 with key stakeholders, ‘to enhance business relations between buyers and

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20 Legal Notice No. 231 Cap 318 Par. 6(1).a
22 HCDA, 2010b
23 HCDA, 2009b
24 We found this out by screening the laws that came into effect in 1995 and afterwards. We have asked the HCDA to confirm this, but until present we did not receive any response to our queries.
a sellers, and to use it as a framework to stay in check with the sector'. The HCDA presents the Code of Conduct as ‘an agreement between the buyer of fresh horticultural produce and the seller or grower of the produce’. The HCDA sees the CoC as a memorandum of understanding between buyers and sellers and as a guideline for the buyer and seller to develop a legally binding contract. This is in line with the 1995 export order, to which the CoC often refers, which specifically obliges exporters to enter into contracts with their suppliers.

The HCDA CoC spells out specific contract terms that should be included in written contracts between buyers and sellers of horticultural produce. These contract terms are similar to the obligations stated in the 1995 export order. Thus even though a company does not use the CoC, it is required by the 1995 export order to use formal contracts and to adhere to certain practices that are presented as contract terms by the CoC (see Box 1). Using the CoC is however voluntary, so the exporters can use different contract terms to suit their individual needs.

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26 HCDA, 2010c
27 HCDA, 2010c
Box 1: **Text of Contract guidelines of the HCDA Code of Conduct**

*Buyer obligations: exporters or processors should:*
- Relate to specific outgrower groups under a contract
- Provide reasonable extension services
- Try and relate directly to their outgrowers (and not allow their workers to appear like they are the owners of the company).
- Respect each other and not try and poach from areas that other exportersprocessors have developed schemes (Business Ethics).
- Endeavour to establish means and ways of financing their groups e.g. through existing programmes-KREP, CDF, etc and also try and encourage groups’ self financing.

*Dual obligations: buyers and seller should:*
- Be loyal to each other in the spirit and terms of the contract
- Have mutual co-existence
- Involve when drawing up contracts
- Have knowledge on the effective use of pesticides.

*MoA, HCDA & NGO’s obligations*
- MOA as a witness will ensure that all parties abide to the contract regulations and provide sufficient support to both parties
- HCDA as a witness will monitor the activities of both parties
- Other NGOs working directly or indirectly with horticultural farmers will collaborate with MOA, HCDA, and the local administration in guiding both sellers and buyers

*Essential elements of the contract should include:*
- Quantity and quality of produce to be supplied.
- The responsibility of seed and other inputs
- Generally accepted production practices
- Record keeping
- Harvesting, irrigation and training dates and conditions
- Agreement on harvesting and post-harvest practices
- Packaging supply and procedures
- Conditions of collection and delivery
- Middlemen and other intermediaries
- Multiple contracts
- Rejected produce
- Payment terms and mechanisms
- Penalties
- Duration of the contract
- Termination clause
- Natural calamities and non-commercial risk.

Source: HCDA, 2010

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28 HCDA, 2010c
29 Constituency Development Fund
30 The clarification we received from HCDA on this issue is as follows: “This means that two parties should work amicably for the gain of each other. By each party playing their roles as stipulated, the growth of the two is achieved”
31 HCDA clarified this issue. It means that the Ministry of Agriculture of the HCDA should be involved as witnesses in contract signing.
4 The implementation of the HCDA Code of Conduct

4.1 HCDA roles in implementing its Code of Conduct

The HCDA performs various tasks in implementing the CoC.

**HCDA as reviewer of the 1995 export order and the Code of Conduct**

Because the HCDA created the Code of Conduct with key stakeholders, it is the body that reviews the CoC when required. A new review is expected\(^{33}\) because the HCDA believes that the 1995 export order contents no longer correspond with recent developments in policymaking and the changed dynamics in the horticultural industry. Although the pathway and details of this review are not clear yet, it is indicated that the intention is that the industry will become streamlined.\(^{34}\)

**HCDA as promoter of the Code of Conduct**

The HCDA promotes the use of the CoC by exporters and farmers. Not only does the HCDA disclose information about the CoC on its website, it also organizes meetings to communicate and discuss the CoC. An example is the meeting the HCDA organized with all exporters in July 2009 to discuss contract issues and how to discourage the practice of side-selling (or ‘poaching’). Afterwards, the HCDA sent out information to relevant target groups about the agreements made during the meeting.

Most exporters are supposed to be aware of the CoC and its requirements, although it may be that new exporters who have just started their business are not. During our interviews, some exporters said they regarded the stakeholder meeting in July 2009 as informative but do not necessarily expect to comply with the gentlemen’s agreement made during the meeting. Some of them have expressed the opinion that their first priority is to continue to do what is best for their company, which is not necessarily always in line with the interests of the entire industry.

Some farmers have been trained on the CoC and on how to deal with buyers by the HCDA. Through these trainings and advertisements, the HCDA encourages farmers not to farm without contracts. Most farmers we spoke to, however, have not heard of the HCDA CoC, and remain unaware of the functions of the HCDA or MoA.\(^{35}\) One of the reasons why so few farmers know about the CoC is that the HCDA depots are responsible for large areas in which huge numbers of farmers are active. They can only reach more farmers in their area with more staff. Currently the HCDA does provide farmers with various kinds of support, but only when farmers file a request for such support.

**HCDA as the verifier of contracts to grant export licenses**

As we mentioned earlier, exporters need to enter into written contracts with suppliers and provide the HCDA detailed information on where they source their products, how much and of which quality etc. If the HCDA receives this information, its technical officers verify the correctness of the information received from the exporters. The reason for this check is that the HCDA would like to verify whether the farmer(s) who supply the exporter really exist to ensure traceability of the

\(^{33}\) HCDA, 2009b.
\(^{34}\) HCDA, 2009b.
\(^{35}\) HCDA, 2009b.
products. When the information is correct, and when written contracts indeed exist, the export license is given to the exporter.

This verification should take place every three years when a licence is renewed. The HCDA verification procedure would thus enforce the 1995 export order requirement of having a written contract. The EU, however, has stated that verification only occurs when a new exporter applies for an export licence and that normally, inspections do not take place when an export license is renewed. Exporters have also indicated that providing information of only a few contracts can be sufficient to obtain an export licence. Besides the contracts shown to the HCDA, they can then source produce from farmers unknown to the HCDA, with or without written contracts. This practice currently does not result in exporters losing their export licence. Another way to circumvent the obligation of a written contract is that the exporter does not mention the real quantity exported on the export licence.

This implies that the HCDA is not aware of all transactions that take place between exporters and their suppliers (producers) and that it does not receive information on all contracts closed between exporters and farmers.

**HCDA as witness to contracts**

The HCDA can, just as the MoA, take a specific role in the execution of contracts, namely in being a witness of the contract for both parties, and to arbitrate when required. The HCDA only countersigns a contract when a buyer or seller asks the HCDA to do so. Usually however, companies do not seek the HCDA as a witness because they prefer to use lawyers to step in when there is a conflict with a farmer (group). Because farmers often do not know about the functions of the HCDA or about the CoC, they rarely ask the HCDA to have their contracts (counter)signed. As a result, the HCDA indicated that they generally countersign very few contracts, although details of the number of countersigned contracts is not available. This differs between depot, however. In one depot we found that 80% of all exporters in the area have asked the HCDA to become a witness to the contract.

The HCDA can play different roles in arbitration. Not only can the HCDA arbitrate when an exporter refuses to pay or delays the payments to producers, but they can also assist when farmers do not plant on time or plant at all after receiving seed on credit from the exporter.

Many farmers are organised in Self Help Groups, which are registered at the District Departments of Social Services (DSS). One problem with ensuring that such farmer groups deliver according to the contract is that contracts with Self Help Groups cannot be enforced because this organizational form is not a legal entity that can be taken to court. In comparison, associations or cooperatives can be taken to court. Therefore the HCDA can be useful as a vehicle for arbitration when conflicts arise between exporters and Self Help Groups. But many of transactions occur either without written contracts with exporter, with a contract but without having the HCDA or MoA as a witness, or through spot market types of transactions with brokers. In these cases it is difficult for HCDA to arbitrate when disagreements between parties arise.

The HCDA says that the contracts they receive to witness are occasionally based on the CoC, but more often the exporters do not follow the CoC. One of the future ambitions of the HCDA is to

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36 HCDA, 2010b.  
37 EC, 2007  
38 Eaton et al., 2008
check all contracts with regard to specifications therein. However, currently this is not possible because not sufficient staff is available to do so. The voluntary nature of the CoC also leads to the HCDA not to seeing or witnessing all contracts between exporters and farmers. One way to improve this situation is that the HCDA uses its power to withdraw export licences.

4.2 Exporter experience in using the HCDA Code of Conduct

Exporters' views vary about using the HCDA CoC. Exporters that are new in the industry find the CoC useful in drafting contracts. But when companies grow and become more experienced, they usually have their own legal officer or hire lawyers to draft or check their contracts. Such lawyers normally do not use the CoC as a contract format.

We have been given the opportunity to compare several contracts provided to us by the HCDA which include the terms of the HCDA CoC. We find that the contracts differ in specifics between the exporters but that the general terms agreed upon are quite similar. The contracts contain almost always the terms that are required by the CoC. One difference, a cause of concern to the farmers, is that the CoC describes that when natural calamities occur, 'the affected party(s) should be held harmless for non-performance'. In the contracts we have studied, this clause has not been included, resulting in the farmers to take the risk when natural calamities occur.39

However, actual practices around written contracts also differ from the terms advocated by the CoC: i) in the CoC it is stated that a farmer can produce different crops for multiple exporters. However, in several contracts we have seen it is stipulated that farmers cannot sell anything to another exporter; ii) in several contract the fact that the HCDA or MoA can become a witness to the contract is not discussed; iii) the collaboration with NGOs already working with the farmers is not included in contracts or exchange relationships.

Side-selling to non-contract parties ('poaching') is a concern to the HCDA and therefore mentioned in the CoC. The CoC states that buyers are not allowed to poach. This practice is also a concern to exporters who may experience that their contracted supply is not being met because of side-selling. The reality is that exporters often buy from brokers when demand is high and supply is low. These brokers may convince contracted farmers to sell their produce to them instead of their contracted buyer by offering high prices. So even though poaching is a concern to exporters, exporter demand creates, often indirectly, poaching practices.

There are more examples that indicate that exporters do not use the CoC guidelines. Exporters generally want to be able to govern their own contracts without the HCDA controlling the way they operate their contracts. This results in export companies not informing the HCDA about all the contracts they close, nor about the produce they buy on spot markets (e.g., from brokers) to export. Although this is against the 1995 export order, the HCDA cannot enforce the order because it has not been enacted into law.

4.3 Farmer experience in using the HCDA Code of Conduct

As has been mentioned above, only few farmers know about the Code of Conduct or have been trained in the use of the CoC. The ones who have been trained by the HCDA on its CoC said that their negotiation power had increased compared to earlier situations when dealing with exporters.

39 HCDA, 2010
We talked to only one farmers’ group that had experience with a written contract witnessed by the HCDA. The members of the group indicated that the risk of natural calamities was not reduced with the contract; in case of a crop failure, the farmers were held responsible. Risks were not shared between farmers and exporters. The contract did reduce the risk of opportunistic behaviour of the exporter because of the complaint form that was part of the contract. The contract also specified the prices that farmers would receive for their produce, which reduces the risk of price fluctuation and the standards and procedures related to rejection of products.

4.4 Applicability of HCDA CoC to sesame contract farming in Ethiopia

There is much interest in Ethiopia to use contract farming as an arrangement to buy high quality sesame and to offer stable and fair prices to farmers. Although experience with contract farming is increasing, it is currently still limited. Nijhof (2010) lists 8 more or less-established contract farming arrangements, varying from organic sesame to fruit juice. To what extent can the HCDA CoC experience be useful to contract farming in Ethiopia?

Nijhof (ibid) asked Ethiopian farmers and exporter/processor companies what the critical issues are for managing contracts. Table 1 shows the results, which indicate that for farmers price and payment are important issues. This may entail a transaction risk, if the company does not pay a good price on time. These issues are less important for the companies, although they realise it is important for the contract farming to succeed. For both parties the mutual understanding of the contract is important, and this is where a HCDA type of CoC may play a beneficial role.

For both parties, specification of input and quality aspects are very important. These are specific to the produce, and may differ for each crop; i.e. there will be important differences between sesame and passion fruit. A HCDA type CoC will not be able to play a role here, unless it focuses on one crop type (e.g. horticultural crops, or oilseeds)

Table 1: Ranking elements related to the key issue ‘managing contracts’

<table>
<thead>
<tr>
<th>Sub issue</th>
<th>Critical to farmers</th>
<th>Critical to companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>Guaranteed price (***)</td>
<td>Guaranteed price (*)</td>
</tr>
<tr>
<td>Time of payment</td>
<td>Payment directly at collection (***)</td>
<td>Payment directly at collection (**)</td>
</tr>
<tr>
<td>Method of payment</td>
<td>Payment in cash, inputs or goods (***)</td>
<td>Payment in cash, inputs or goods (*)</td>
</tr>
<tr>
<td>Duration of contract (payback investment)</td>
<td>Long term relation(**)</td>
<td>N.A.</td>
</tr>
<tr>
<td>Mutual understanding of the contract</td>
<td>Speak the farmers' vocabulary (***)</td>
<td>Contract realistic and clear, mutual understanding (***)</td>
</tr>
<tr>
<td>Specification and guidance on input</td>
<td>Clear coordination and guidance (***)</td>
<td>Clear coordination and guidance (***)</td>
</tr>
<tr>
<td>Clear specification of quality aspects</td>
<td>Transparent criteria/reward for higher quality (***)</td>
<td>Transparent criteria (***)</td>
</tr>
</tbody>
</table>

** NB

*** (Very important) : Crucial for successful Contract Farming
**  (Important)   : Important for Contract Farming
*   (Less important)  : Less important but needed for Contract Farming
There is thus a role, albeit a relatively small one, for a HCDA type of CoC in Ethiopia in providing contract models and conflict resolution. However, it is still an open question whether such a CoC should be a voluntary standard, or a regulatory standard. When a CoC becomes official, its usefulness depends whether the regulatory bodies will actually implement and enforce it. In addition, stakeholders (companies and farmers, farmers’ representatives or cooperatives) also need to be convinced that they will benefit from such a CoC. Otherwise they may avoid using the CoC, especially when enforcement is low. Having sufficient staff at relevant governmental institutions to inspire, advocate, inform and enforce the CoC is therefore a requirement for its effective uptake.

The CoC can also be developed as a voluntary standard. In this case, it should be in the interest of relevant stakeholders to use the CoC. Ways to make a CoC accepted include multi-stakeholder consultation processes, and information campaigns. Such activities can be implemented by the sector itself, relevant governmental institutions, societal organizations and research institutes.
5 Conclusions and recommendations

5.1 What is the impact of the HCDA CoC on transaction costs and risks?
Entering into contracts can lower transaction costs and risks both farmers and exporters compared to buying and selling through spot markets, especially for produce that have specific requirements (such as organic, Global-Gap certified).

The HCDA CoC has the potential to reduce transaction costs in the contracting phase by offering model contracts. Instead of putting much effort in developing (fair) contracts, exporters and farmers can use existing models. The HCDA can also play a role in reducing transaction risks and costs in the enforcement phase, because it can function as a conflict resolution body. However, few farmers know of the CoC and therefore do not use such knowledge in contract negotiations, and the fact that most exporters do not use the CoC even though they are all aware of it, leads us to the conclusion that the HCDA Code of Conduct currently has a negligible effect on transaction costs and risks for buyers and sellers in the horticultural sector in Kenya.

5.2 Recommendations for the HCDA and other parties wishing to promote the CoC
We envisage two routes that the HCDA can follow to implement the Code of Conduct. The first route is to ensure that the 1995 export order is enacted into law. This will enable the HCDA to enforce the closing of contracts, which includes the possibility to withdraw licences from exporters that do not comply with the order. When the export order would be enacted into law, more staff will be needed at the HCDA to verify the contracts, and to train farmers and farmer groups on the use of the CoC. This strategy would, when successful, give the HCDA the possibility to regulate the export of horticultural products.

The question is whether the Kenyan government is willing to take this route. Based on the information we gathered, we conclude that it is not a priority for the Kenyan government to increase the regulatory function of the HCDA. In contrast, the Kenyan government wishes to stimulate the role of the private sector in the economy, to create an internationally attractive trade environment and to abolish several licences, among which the HCDA export order license. Such policy ambitions do not match with the HCDA being given a more regulatory function.

The second route would be for the HCDA to convince the exporters of the need to use the CoC as a guideline for their contracts, and to submit information about all their transactions so it can be verified by the HCDA. In combination with extensive training of farmers on the CoC, with the aim of increasing their capacity and potentially also their bargaining power, this could be another strategy to properly implement the CoC in Kenya. Although this would require additional HCDA staff for verification activities, training and extensive communications with exporters, it would be a more acceptable route, because it can be seen as providing service to Kenya’s profitable horticultural sector.
### 6 Appendices

#### 6.1 Appendix 1: Transaction risks and costs encountered by farmers in Kenya

<table>
<thead>
<tr>
<th>Nr</th>
<th>Farmers</th>
<th>Transaction risks</th>
<th>Transaction costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Individually owned farmer. No contract. Sometimes verbal agreement.</td>
<td>- no confidence in contracts because they are not rewarding (payments low now)</td>
<td>- input credit</td>
</tr>
<tr>
<td></td>
<td>No knowledge on HCD A CoC</td>
<td>- finding markets for tomatoes</td>
<td>- trust: grading and rejects</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*MP > CP*
2

Farmers group with individual contracts.

- security
- fixed price is good
- weekly payments
- rejections.
Grading at Nairobi not in production area.
- The exporter keeps to the contract
- opportunism: side selling when MP > CP*
- risk reduced of being left with products with contract
- costs of seeking information on new buyer (distance is far)
- collection of produce always in time, even in low season
- with broker: uncertainty of sale or collection
- negotiation of prices
- negotiation on seed provision in contract
- contract is cheaper than spot market or broker transactions: time, costs,
- risk of natural calamities not reduced with contract

- complaint form to reduce opportunism of exporter

- rejects

- fixed prices in contract

- you know the expected income to be earned.

- standard contract with no negotiation

- finding buyers difficult when no contract

- great distance to markets

- transpor:
  t: produce picked up by exporter

- input credit. Inputs less expensive

- price better

- getting volumes to market

- discount inputs as a group

- always pick up throughout the year, otherwise they
Grou

HCD
A witne
ss to the contr
act

selling would not sell

assurance to receive payment

spreading risks by selling to multiple markets

- finding brokers would otherwise be difficult
- export crops receive higher price than locals.

5 Farmer Group

Knowledge of HCD A CoC

- working with a contract gives stability and security compared to working with brokers

- speculation was proving losses, P higher now.

- side selling takes place; risk of losing contract

- MPs in area known easily

- finding the buyer
- they negotiated the contract
- the contract has remained the same
- now they want to renegotiate the price
- no contract, no market

- grader employed by the farmers

- sometim
es rejects

- stability for households

- bank accounts and bank loans because of contract

- complaint system for problems

*MP: Market Price. CP: Contract Price*
### 6.2 Appendix 2: Transaction costs and risks encountered by exporters and one broker in Kenya

<table>
<thead>
<tr>
<th>No.</th>
<th>Buyers</th>
<th>Transaction risks</th>
<th>Transaction costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Exporter</td>
<td>Reasons using contracts:</td>
<td>- find farmers to supply them</td>
</tr>
<tr>
<td></td>
<td>Large company</td>
<td>- reliability and security for exporter and farmer</td>
<td></td>
</tr>
<tr>
<td></td>
<td>He knows of the HCD A CoC</td>
<td>- trust important, otherwise no commitment</td>
<td>- assessment of risk when speaking to new groups</td>
</tr>
<tr>
<td></td>
<td>Their contract has same form at as HCD A CoC</td>
<td>- contract s keep off competitors</td>
<td>- probation time first period, then longer contract</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- farmers can plan income and its expenditure</td>
<td>- discipline in payment and keeping farmers: expensive to keep recruiting farmers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- farmers not sticking to contract? Yellow and red card, then cancellat</td>
<td>- input credit</td>
</tr>
</tbody>
</table>
- groups have by-laws ensuring contract commitment.

- Large companies

He knows of the HCD A CoC.

HCD A has a copy of the contract.

- contracts for security of supply with large scale individual farmers and many (groups of) small scale farmers.

- input credit and technical support to facilitate supply.

- contract against side selling, but side selling still occurs.

- grading at the farms, but check in Nairobi.

- enforcement of contract.

- when MP* is high then brokers come in, when MP is low, they disappear.

- there are always middlemen for farmers to sell to.

- getting smallholders to comply with contract takes time and effort and costs.
3 Exporter
Small company that just started
Used HCD A CoC as example for his contract

- accountability
- ability to implement contract
- no side selling
- avoid areas with lots of brokers
- risk spread by working with different groups

4 Broker.

He knows of the HCD A CoC

- MP>CP in 6 of 12 months
- side selling when MP>CP
- rejects with exporter s, he does not reject but takes the risk of not
- regular contact with group, employee d agronom ist
- not difficult to find markets
- gives input credit also
- negotiations with farmers and exporter s
- market
selling everything for the highest price

- exporter may decrease the CP when MP<CP

- payment in cash upon delivery. Farmers need cash

- freedom to supply

- brokers strategically buy from farmers to get a good price.

- trust between broker and farmer needs to be built up

*M: Market Price. CP: Contract Price*
### 6.3 Appendix 3: Transaction costs and risks encountered by the HCDA

<table>
<thead>
<tr>
<th>HCDA</th>
<th>Transaction risks</th>
<th>Transaction costs</th>
</tr>
</thead>
</table>
| Head Office, Sagana Depot and Machak u Depot | - Contracts: fixed price. MP > CP* = losing money  
- Farmers sometimes do not abide with contract  
- with contract: collection security  
- that the exporter does not pay  
- transport arranged  
- contract length (too) long e.g. 6 months for new product; difficulty.  
- price uncertainty covered with contracts. But sometimes MP > CP. Then farmers not | Price with broker sometimes higher  
- payments quicker with broker  
- negotiations lead by exporters  
- bargaining power farmers is low. Contracts can differ between groups |
satisfied

- demand is low, exporters do not come to pick up contracted produce

- inputs credit in contract

- collection security

- payment security → credit availability increases

- side selling when MP>CP

*MP: Market Price. CP: Contract Price
7 References


Nijhoff, Hans. 2010. 'It takes two to tango': Critical contract farming issues for linking up small-scale Ethiopian farmers with the world market. Wageningen, The Netherlands: CDI, unpublished.
