CONTRACT FARMING AGREEMENTS EXPLAINED

INTRODUCTION

Contract Farming is a term used freely in today's farming world. It is often wrongly interchanged with: Share Farming; Contracting; Stubble to Stubble Agreements; and even what are effectively Rental arrangements. This document will outline the key principles and mechanics of a ***formal*** Contract Farming Agreement (CFA).

CFA's are a formal agreement between two parties:

1. **The Farmer** (Landowner / Occupier / Tenant)

   And

2. **The Contractor** (The person / Business which will ***physically farm***)

Contract Farming is different from hiring a contractor for single operations as the agreement will cover the ***whole*** farming operation. The Farmer will engage the services of the Contractor on certain terms and pay them according to a set formula via the agreement to carry out the work.

Contract Farming can be applied to ***all types of farming***. There are misconceptions that only arable land/farms can be contract farmed. This is not true. Livestock CFA's are becoming increasingly common and are not difficult to administer as long as good bookkeeping practices are in place.

WHO ARE THEY FOR?

Contract Farming Agreements must involve two separate parties who wish to work together. Once a Contractor is recruited a formal agreement is drafted and signed. Often the agreement is signed and never touched. Contract farming works on the basis of ***TRUST***. There must be a strong element of trust between both parties to ensure the agreement runs successfully.

WHAT SORT OF SITUATIONS DO THEY SUIT?

Landowners / Occupiers / Tenants

- Farmers who wish to retire from actively farming but wish to retain 'farmer' status.
- Farmers who have no family succession for their business but do not wish to sell or give-up their land.
- Farmers who wish to pull their capital out of farming and use it elsewhere.
- Landowners/Investors who wish to invest in land but do not wish to physically farm it themselves.
- Farmers who wish to bring in the next generation to the business in a low-risk way.
- Farmers who wish to step back from actively farming, but wish the retain their tenancy on the land/farm holding(s)
- Absent landowners who live away from the farm.

Contract Farmers

- Contract Farmers often have their own farming business which they wish to expand by contract farming.
- Young people/first generation farmers who are struggling to raise the capital to buy a farm or succeed with a tenancy application to farm in their own right.
- Businesses wishing to expand/grow without requiring significant amounts of capital.
- Established businesses looking to spread their overhead costs over additional land areas.
- Farmers who cannot afford to buy land.

RECRUITMENT FOR A CFA

Typically CFA's undergo a formal recruitment process whereby the opportunities are advertised (either publicly or by invitation only to a select number of candidates). The involvement of a third party consultancy firm is typically required in order to formalise the process, remove any bias, reality check the applications (long-term financial viability check to meet everyone's needs), and to draft the agreement.

Advertisements of Contract Farming opportunities should include:

- **Details of the farm:-** ownership; land areas; soil types; average field size; sheds / facilities / infrastructure available; details of any environmental schemes; livestock numbers; historic cropping.
- **What is the requirement of the applicant:-** track record in the sector/enterprise; current business details; accuracy of financial understanding; good references; a professional approach; ability to work with other parties.
- **About the agreement:**- Outline specific details of the farming policy; details of any employees; housing arrangements; any returns on invested capital needed as prior charges; typical shares of the surplus generated.

Applications for a CFA are similar to tenancy tenders. They require information on the applicant(s) history, qualifications, and most importantly business performance, both technically and financially. Sometimes a budget template may be supplied, sometimes not. The accuracy and detail provided in the budget will be scrutinised so they must be well presented; thought through; and be realistically deliverable.

The Farmer may wish to view the potential Contractors' current business to ensure what is on paper is actually happening. Unlike a tenancy, a CFA is a formal agreement between two businesses whereby one will effectively operate the business of another. So matching characters, objectives and an ability to work together is required, along with a high degree of trust is required to ensure success.

THE AGREEMENT

The actual agreement is a 30 page document which is legally binding between the Farmer; the Contractor and any Limited companies which either the Contractor or Farmer may trade under. The CFA is subject to the Law of Contract.

Typical key areas covered under the Agreement are as follows:

1. **Duration** – this is important to define the beginning and end of the agreement- typical terms are 3-5 years.
2. **Responsibilities** of the Farmer and the Contractor in terms of the farming policy and any farm specific arrangements (such as environmental schemes).
3. **Indemnification** of employee responsibilities for the Farmer.
4. **Licence** for the Contractor to enter the farm.
5. **Remuneration** for the Contractor – amounts and timeliness of payment for the Basic Fee and the Balancing Fee.
6. **Subsidy Payments** – are they in the agreement or out the agreement? The Contractor will be made responsible to abide by cross-compliance rules.
7. **Responsibilities** for maintaining management accounts.
8. **Valuations** – often required for livestock CFA's to account for un-sold stock at the agreement year end.
9. **Insurance** responsibilities.
10. **Termination Notices** for both parties – the formal processes; the timelines; and the reasons for termination.
11. **Renumeration** dependant on the reason for termination of the agreement –
    a. Both parties may have to invest significantly to begin the agreement so sufficient renumeration must be in place should either party wish to end the agreement for no significant reasons.
    b. If one of the parties does not honour the agreement and defaults it, then a fair renumeration package should be in place for the non-defaulting party.
12. **Banking** – A separate business bank account (usually named the No.2 Account) should be opened by the Farmer, out of which the agreement should be run.
13. **Land Schedule** – field names/number/areas which are to be included within the agreement.
14. **The Net Return** – an outline of costs and expenditure which will be carried out under the agreement; go through the No.2 bank Account and will be used to calculate the divisible return.
15. **The Farming Policy** – typically related to cross-compliance, agriculture, and any specific environmental schemes.
16. **Schedule 4 Return on Capital (ROC) and Depreciation Charges** – this will be covered subsequently in this document.

RETURNS

The returns from a CFA for each party are made up of several constituents. The main aim is to provide incentive for good financial performance from the Contractor to drive a Divisible Surplus.

Contractors Basic Fee (CBF): This is paid to the Contractor to carry out the work and their obligations under the agreement. In arable agreements it is typically paid on a per hectare basis. The Contractor should not be making profit from the CBF, it should cover their costs for machinery and labour. The Contractors true profit should come from the Divisible Return.

Depreciation Payments: These are received by both parties if appropriate and are applicable to predominantly livestock CFA's. They are to recover the capital invested in any new buildings/infrastructure such as milking parlours, livestock housing, manure storage or silage pits. Depreciation payments are not typically included for arable CFA's, as the Contractors depreciation forms part of the CBF and the Farmer very seldom provides new Capital facilities for an all arable agreement.

Return on Capital (ROC): These are received by both parties if appropriate and again are applicable to predominantly livestock CFA's. The ROC reflects the opportunity costs of capital invested in any new buildings/infrastructure for the CFA. This would be a flat rate based on 50% of any expenditure made i.e. half-way through its life as it is depreciated, and the capital recovered by the agreement.

Net Return: This is all of the income from the CFA, minus the variable costs (inputs), minus the Contractors Basic Fee; minus any Depreciation or ROC payments made to either party.

Farmers Basic Return (FBR): This is the farmers return for providing the land, buildings, and infrastructure to the agreement. Often thought of as a 'rental equivalent' but should ***never be defined as such***. Often forgotten, the Farmer is not entitled to the FBR if the funds are not in the No.2 Account to be drawn out. It is simply an ***allocation of funds*** as technically the farmer would be paying themselves.

Divisible Surplus: Is the amount of money left after all of the above have been allocated for. This is shared out according to the terms of the contract. Typically the Contractor receives a major share (50-70%) in order to incentivise good performance.

The below Flow Chart outlines the calculation of the ***Divisible Surplus*** for a CFA.

Income
Crop sales, Straw
Milk income, cattle sales, cull sales
Basic Payment
Environmental Scheme income. Likely to be included long-term as affects farming productivity e.g. ELMS.

Less, Variable Costs
Feed, Vet/Med, Livestock Sundries, Fertiliser, Seed, Sprays, Lime, agronomy etc

Less, Overheads
Water, Electricity, Property Repairs, Office Costs, Bank Interest

Less, Contractors Basic Fee
Contractor's Basic Fee (for providing all labour and machinery costs)

Less, ROC & Depreciation Charges
Depreciation on any new fixed infrastructure
Return On Capital Charges on capital employed in livestock, machinery, and new investment/infrastructure

Net Return

Less, Farmer's Basic Return

Divisible Return

xx% to Farmer
(Minority share)

xx% to Contractor
(majority share)

EXAMPLE ARABLE CFA

The below shows an example ***DIVISIBLE SURPLUS*** calculation/budget for an ***Arable CFA***.

Note for this example there is no Depreciation or ROC as the agreement is for land only.

YEAR End 30/09/2022

Example Arable Business

ARABLE FARMING CFA
DIVISBLE RETURN SCHEDULE

OUTPUT

Crop	Hectares	Yield T/ha	Price per tonne (£)	TOTAL £/ha	TOTAL £/crop
Winter Wheat	100.00	9.00	185	1,665	166,500
Spring Beans	50.00	4.00	215	860	43,000
Linseed	50.00	2.50	400	1,000	50,000
Clover Grass Ley	10.00	40.00	25	1,000	10,000
WW Straw	100.00	3.70	55	204	20,350
				0	0
Total Hectares:	210			**Total Income (£):**	289,850

Crop	Hectares		Variable Costs £/ha	Total Variable Costs (£)	Total Gross Margin per crop (£)	Gross Margin £/ha
Winter Wheat	100.00	@	620	62,000	104,500	1,045
Spring Beans	50.00	@	315	15,750	27,250	545
Linseed	50.00	@	360	18,000	32,000	640
Clover Grass Ley	10.00	@	240	2,400	7,600	760
WW Straw	100.00	@		0	20,350	204
0	0.00	@		0	0	0
				Total Crop GROSS MARGIN:	**£191,700**	
	BASIC FARM PAYMENT £/ha:		**£160.00**	**Total BPS:**	**£33,600**	

FIXED COSTS		£/Ha	Total £
Contractor's Basic Fee		**296.52**	62,269
Grain storage charges	To be agreed		7,718
Electricity			0
Professional Fees			1,800
Insurance			1,000
Lime			750
Miscellaneous			600
Agronomy			1,890
Water & Drain Rates			800
Sundry/Contingency			2,000
Bank Interest			4,800
		Total Fixed Costs:	**83,627**

NET RETURN:	***Equals Total Gross margin plus BPS Less total fixed costs***		**£141,673**
FARMER'S BASIC RETURN (£/Ha):	**@ 235**	**Total:**	**£49,350**
TOTAL DIVISIBLE RETURN:	***Equals Net Return; Less Farmers Basis Return***		**£92,323**

DIVISIBLE RETURN	Percentage	Total (£)
Farmer	30%	£27,697
Contractor	70%	£64,626

TOTAL RETURNS

	Basic Fee		Divisible		Total Return	£ / Ha	£/ac
Farmer	£49,350	Plus	£27,697	=	£77,047	£366.89	£148.48
Contractor	£62,269	Plus	£64,626	=	£126,896	£604.26	£244.54

Figure 1: Example Arable CFA Budget

EXAMPLE DAIRY CFA

The below shows an example ***DIVISIBLE SURPLUS*** calculation/Budget for a ***Dairy CFA*** with the relevant charges broken down.

Contractors Basic Fee - Breakdown	
	£
Salary	38,000
Labour	30,000
Machinery Repairs & Spares	15,000
Fuel & Oil	10,000
Vehicle Tax & Insurance	3,000
Contractors: Silage	25,000
Contractors: FYM / Slurry	10,000
Contractors: Other	10,000
House rent	9,000
	150,000

Figure 2: Breakdown of a Contractors Basic Fee for a Dairy CFA

Capital Item	Opening Value/Investment	ROC on the Average Value @ 10%	Write-Off Period	Depreciation Charge
Farmer				
Parlour, buildings, infrastructure	540,000	27,000	25 years	21,600
Total:	**540,000**	**27,000**		**21,600**
Contractor				
Machinery & Equipment	60,000	6,000	5 years	12,000
300 cows @ £1,100/hd	330,000	33,000	N/A	N/A
200 Heifers @ £500/hd	100,000	10,000	N/A	N/A
Total:	**490,000**	**49,000**		**12,000**

Figure 3: A Capital schedule for a Dairy CFA which determines the Depreciation and ROC payments

Contract Farming Budget - An Established Year					
		Litres:	1,800,000		
		Hectares:	150.00		
		Livestock Units:	300.00		
		L.U./ha:	**2.00**		
Income		**Total (£)**	**p/l**	**£/Ha**	**% of Total**
Milk		540,000	30.00	3,600	86%
Calf Sales		42,000	2.33	280	7%
Cull Sales		45,000	2.50	300	7%
	Total Income	**627,000**	**34.83**	**4,180**	**100%**
Variable Costs					
Purchased Feed					
Cow Concentrates & Minerals		110,000	6.11	733	18%
Calves/Replacements		30,000	1.67	200	5%
Minerals		6,000	0.33	40	1%
	Total Purchased Feed	**146,000**	**8.11**	**973**	**23%**
Vet/Med		25,000	1.39	167	4%
AI		12,000	0.67	80	2%
Fertiliser & Lime		22,000	1.22	147	4%
Seeds & Sprays		3,200	0.18	21	1%
Forage Sundries		5,000	0.28	33	1%
Bedding		16,000	0.89	107	3%
Livestock Sundries		14,500	0.81	97	2%
	Total	**97,700**	**5.43**	**651**	**16%**
Parlour Expenses					
Consumables/Dairy Chemicals		9,000	0.50	60	1%
Service & Maintenance		3,000	0.17	20	0%
	Total Parlour Expenses	**12,000**	**0.67**	**80**	**2%**
	Total Variable Costs	**255,700**	**14.21**	**1,705**	**41%**
	Gross Margin	**371,300**	**20.63**	**2,475**	**59%**
Overheads					
Power & Labour					
Contractor's Basic Fee		150,000	8.33	1,000	24%
Electricity		14,000	0.78	93	2%
Total Power & Labour		**164,000**	**9.11**	**1,093**	**26%**
Depreciation					
Contractor - Machinery		12,000	0.67	80	2%
Farmer - New Investment		21,600	1.20	144	3%
Total Depreciation & Leasing		**33,600**	**1.87**	**224**	**5%**
Sundry Overheads					
Water & Rates		250	0.01	2	0%
General Insurance		3,000	0.17	20	0%
Office & Phone		200	0.01	1	0%
Advice & Professional Fees		2,000	0.11	13	0%
Miscellaneous		2,500	0.14	17	0%
	Total Sundry Overheads	**7,950**	**0.44**	**53**	**1%**
	Land & Property Repairs	**15,000**	**0.83**	**100**	**2%**
Rent & Finance					
Bank Charges & Interest		300	0.02	2	0%
Farmer ROC - Investment		27,000	1.50	180	4%
Farmer ROC - Livestock		0	0.00	0	0%
Contractor ROC - Machinery		6,000	0.33	40	1%
Contractor ROC Livestock		43,000	2.39	287	7%
	Total Finance	**76,300**	**4.24**	**509**	**12%**
Total Overheads		**296,850**	**16.49**	**1,979**	**47%**
Net Return		**74,450**	**4.14**	**496**	**12%**
Less, Farmer's Basic Return		**30,100**			
Divisible Surplus		**44,350**			

Figure 4: Example Dairy CFA Budget

Returns Summary				
Farmer's Return				
Farmer's Basic Return		30,100	*Rental Equivalent*	
Divisible Return %	40%	17,740	*Share of Divisible Surplus*	
ROC		27,000		
Depreciation		21,600		
Total		**96,440**		
Contractor's Return				
Contractor's Basic Fee		150,000	*To cover costs of power and labour*	
Divisible Return %	60%	26,610	*Share of Divisible Surplus*	
ROC		6,000		
Depreciation		12,000		
Total		**194,610**		

Figure 5: A Returns summary for the Dairy CFA Example

THE FLOW OF MONEY THROUGH THE NO.2 ACCOUNT

Under a CFA, both parties will run their own separate business through their own bank account, carrying out the administration of their own VAT claims and income tax returns.

Typically for these agreement's, a ***separate bank account*** is set up at the bank of the Farmer; and in the name of the Farmer/Farmers business. Then all transactions relating to the agreement will be paid from and into this ***No.2 Account***.

All income and expenses related to the CFA will pass through the No.2 account. Some are simply used for the calculation for the Divisible Return. It is wise that if the Farmer carries out the bookkeeping for the Agreement, that a representative for the Contractors business checks invoices are correct prior to payment.

EACH PARTY'S ROLES AND RESPONSIBILITIES

The Farmer

1. Ownership and management of the farm account from which the contract agreement would trade, providing the working capital (overdraft) if needed. It is important to remember that in years where there may be deficits created, the cost sits with the farmer.
2. Responsible for maintaining accounting records, detailing all items that relate to the Contract Farming Agreement separate to other farm business / estate activities.
3. Organisation of putting in place relevant insurance for public liability, business interruption, crops in transit / crops in store, produce and deadstock, and buildings etc.
4. To be responsible for claiming the Basic Payment and for retaining all records required for Cross-Compliance under the Basic Payment Scheme (see below the Contractor's responsibilities).
5. Responsible for providing the Contractor with all the management information for the stewardship options to ensure on-going compliance with the scheme and the options chosen.
6. The reward for the Farmer will be made up of: -
    a. Farmer's Basic Return to cover the provision of land
    b. Farmer's Share of Divisible Surplus – Minority Share of the Surplus from the business after all costs and the above charges are paid.

The Contractor

1. Provision of all labour and management for the farming operation.
2. Provision of all machinery and power costs – i.e. provide the machinery required on the farm and pay for all fuel, machinery repairs and sub-contractor costs. In return, the contractor receives a 'Contractor's Basic Fee' to contribute towards these costs (including own labour and depreciation). It is important that the Contractor's Basic Fee does not reward for any profit to ensure sufficient incentivisation to farm the land to a high standard to maximise returns for both parties via the Divisible Surplus.
3. Jointly responsible for organising input purchases/sales with the Farmer and providing all invoicing/sale information to maintain accounts and sufficient trading records.
4. Responsible for completing and maintaining all field records, N plans, sprays records etc.; and any other information required to ensure compliance with Cross-Compliance. To then be provided to the Farmer for them retain ahead of any inspection.
5. Be responsible for maintaining the farmland in the same condition as it was at the commencement of the agreement. This includes annual ditch cleaning and maintenance, as well as hanging existing gates that may become damaged over time. Typically, drainage and ditch maintenance would be charged in addition to the Contractor's Basic Fee, as property repair costs.

6. The reward for the Contractor will be made up of: -
    a. Contractors Basic Fee to cover the provision of all labour and machinery, including depreciation.
    b. Contractor's Share of Divisible Surplus – Majority Share of the Surplus from the business after all costs and the above charges are paid.

RISK

Under a CFA the Farmer is assuming a certain amount of risk with regards to income. If there is a bad year, the Contractor must always receive their income first and the Farmer may not be able to draw down their First Charge or Share of the Divisible Surplus.

The essence of a CFA is that the Farmer remains the proprietor of the Farming Business and is involved in the management and the decision making. Under the agreement the Farmer purchases the services from a Contractor including an element of management. But to ensure the Farmer continues the business of farming it is important not all management decisions are left to the Contractor. The Farmer must draw up the farming policy, attended regular management meetings and sign cheques from the No.2 Account.

FINAL WORDS

To conclude, a Contract Farming Agreement is something which can be adaptable to suit a wide range of situations across the agriculture sector. In order to be successful they need to be:

1. Formally administered
2. Have a high element of trust between parties
3. Be driven to perform financially whilst respecting the non-financial goals of key stakeholders