REPUBLIC OF KENYA

MINISTRY OF AGRICULTURE AND RURAL DEVELOPMENT

Sessional Paper No. 2 of 2001

ON

LIBERALIZATION AND RESTRUCTURING

OF THE COFFEE INDUSTRY

REFORMS IN THE COFFEE BOARD OF KENYA,

COFFEE RESEARCH FOUNDATION

AND

PRIVATISATION OF COFFEE MARKETING SERVICES OF THE BOARD

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1.0 INTRODUCTION AND HISTORICAL BACKGROUND

1.1 Coffee was first planted in Kenya at Bura in Taita Hills in 1893 and thereafter, grown at Kibwezi, under irrigation in 1900, and at Kikuyu near Nairobi in 1904. There was no statutory control in terms of crop husbandry, processing or grading. The marketing of coffee was handled by individuals and through rudimentary institutions between 1900 and 1933.

1.2 Kenyan coffee was first exported in parchment and buni form to Britain in 1907. During the First World War, restrictions were introduced in the international shipment of coffee thereby discouraging coffee expansion. The Colonial Government allowed controlled planting of coffee outside the European settled areas in Kisii and Meru in the 1930's following the Devonshire White Paper Report of 1923.

1.3 On request of coffee farmers, the colonial government enacted the Coffee Industry Ordinance in 1932, and established Coffee Board (CB) in January 1933. The Ordinance was re-enacted in 1934 and amended severally later. The role of CB was regulatory and promotion i.e. licensing, inspectorate and promotion. In order to promote the consumption of Kenyan coffee in the world, the London Coffee Liaison Office was opened in November 1933. Since then CB remained the only body which controlled the coffee industry upto 1946.

1.4 In 1934, the Kenya Coffee Association was established which then established the Kenya Coffee Auctions to provide a mode of selling coffee. The liquoring department of CB was created in 1935. The first coffee auction was inaugurated on 25th September 1935 where 1,235 bags of coffee were sold at an average price of Kshs. 32.50 per 50 kg. bag. The present Kenya Coffee Auctions Ltd was formed as a private limited liability company in 1955, when it acquired Kenya Coffee Auctions.

1.5 In 1944, the Government acquired the Jacaranda Estate and converted it into a research station under the control of the coffee planters. This became the origin of the current Coffee Research Foundation (CRF), Ruiru which was initially funded by the national budget.

1.6 The Coffee Marketing Board (CMB) was established under the Coffee Marketing Ordinance No. 6 of 1946 and became fully operational on 1st July 1947 to cater for the coffee marketing activities with its functions being central warehousing, sale of coffee at central auction, liquoring and financing. Ordinance No. 26 of 1960 consolidated the two laws: the Coffee Industry Ordinance and the Coffee Marketing Ordinance into Coffee Ordinance, Cap 333 which commenced on 5th July 1960 when Coffee Board of Kenya (CBK) and CMB were established under the same law. Act 13 of 1971 abolished the CMB and consolidated the function of coffee marketing with the regulatory functions of the CBK.

1.7 The Native-Grown Coffee Rules, 1934 came into operation on 1st July 1934 and the African Grown Coffee Rules of 1945 and 1949 and the Native Lands Coffee Rules of 1951 amended these. Prior to 1952, coffee growing had been permitted for smallholder farmers in Meru and Kisii districts only. African coffee farming under co-operative societies which was restricted to Kisii and Meru districts expanded, and by 1952, there were 11,864 licensed African coffee growers with 3,038 acres under coffee. Crop husbandry standards were kept under strict rules.

1.8 During the state of emergency between 1952 and 1958, the implementation of the Swynnerton Plan gave high priority to expanding coffee planting mainly in Central and Eastern Provinces to contain African agitation for land in the white settled areas. But coffee planting was restricted to authorised persons only and for a specific number of trees.

1.9 As earlier stated, coffee research services undertaken by Ministry of Agriculture were funded through the national budget until 1963. In 1964, Coffee Research Foundation (CRF) was set up as a registered company having no share capital but limited by guarantee of CBK and Ministry of Agriculture. Since 1964, coffee research has been funded through the *ad valorem* planter's levy charged on coffee proceeds due to growers. Government subventions were also made available.

1.10 Between 1968-1970, the Government created the Coffee Development Authority to improve coffee development especially in small holder areas. However, the Authority did not last long after the establishment of a Field Services Department formerly known as Agricultural Department of CBK.

1.11 The CMB and the CBK as separate state Corporations controlled the industry between 1946 and 1971. They were merged into one State Corporation, CBK. Since then CBK has been controlling the industry up to the present. The reason for the merger of CMB and CBK was that the operational costs for running the two bodies had become increasingly high and unacceptable to farmers.

1.12 The policy of the Government between 1960 and 1970 encouraged formation of coffee co-operative societies for smallholder farmers. Expansion of coffee production and processing facilities within the co-operatives sub-sector between 1970 and 1980 made the co-operatives societies overtake the plantation sub-sector in terms of production. The plantations continued to lead with respect to productivity, that is, yield per hectare. It is also during this period that the coffee industry experienced a boom in 1976/77 due to severe frost in Brazil. The good prices led to informal cross border trade, induced farmers to expand area under coffee and rehabilitation of coffee farms. The increased production, in turn, led to severe congestion at the coffee factories particularly, in the co-operative sub sector.

1.13 Arising from these constraints, the Smallholder Coffee Improvement Project (SCIP I) and Second Coffee Improvement Project (SCIP II) were implemented in order to alleviate processing constraints, improve quality and increase production. The World Bank, Co-operative Bank of Kenya and Government of Kenya and co-operative societies co-financed both projects. The objective of the project was to increase the incomes of smallholder coffee farmers through increased coffee production and improved coffee quality. It also focused at increasing the foreign exchange earnings, employment creation and strengthening the institutional capacities of the key agencies participating in the project.

1.14 The Second Coffee Improvement Project (SCIP II) provided credit to the tune of 2.6 billion shillings to finance the implementation of Improved Coffee Payment System (IPS); Cherry Advance Payment System (CAPS); Farm Input Loans Scheme (FILS); Coffee Factory Development Scheme (CFDS); Training of farmers and staff from implementing agencies, and institutional support to the implementing organisations. However, due to the current low coffee production and depressed coffee prices farmers have difficulties in servicing these loans leading to high indebtedness by the farmers and coffee co-operative societies. The low production has also led to under-utilization of coffee pulping stations.

1.15 The reform process in the coffee industry should have started seriously in 1992. Due to delays in taking action, the process started in earnest in 1996 when the CBK initiated activities. The report of the Task Force on liberalization of the Coffee Industry, of 1996 was prepared by the Board members and coffee delegates. When it was submitted to the Minister in May 1996, a Technical Committee was appointed by the Minister to evaluate it. The Task Force's report did not address the issue of coffee marketing but the Technical Committee's report addressed the issue. It made recommendations to the Government, which led to formulation of the Coffee (Authorized Marketing Agents) Rules, which the Board did not implement. The Board did not also participate in the Strategic Study on Coffee carried out by

Price Waterhouse. The Study on the Strategies to Enhance Coffee Production, 1999 was commissioned by CRF and the CBK. The Ministry was represented but the report did not address the issue of coffee marketing. It confined itself to technical issues only. Many of the recommendations made by these studies have been incorporated in the new policy proposals.

2.0 THE ROLE OF COFFEE IN THE KENYAN ECONOMY

2.1 Coffee is important in the Kenyan economy due to its contribution to foreign exchange earnings, farm incomes, employment and food security. It is grown by the smallholder coffee farmers who belong to co-operative societies, registered small/medium coffee estate planters with less than twenty five (25) hectares and large coffee estates with more than 25 hectares. There are between 500,000 and 700,000 members of co-operative societies, about 2,000 coffee farmers in the small/medium estate category and about 200 planters with more than 25 hectares of coffee.

2.2 Coffee incomes have been invested in post-farm activities such as stocking farm inputs, food and grocery retail businesses, agro-processing and other informal activities that have played an important role in linking agriculture to the rest of the economy. The industry has significantly contributed to the economic development of the coffee growing areas and to the overall national economy. In addition, coffee is expected to play a major role in the country's poverty alleviation efforts because of its high multiplier effect.

2.3 Coffee was the leading export crop since independence to 1988. Between 1975 and 1986, it contributed over 40% of the total Kenyan exports value. After the 1987/88-production peak, the international prices fell sharply in 1989 and by 1992 coffee contributed less than 9% of the total export value. Following the policy changes to liberalize the industry in 1992, which allowed the sale of coffee in US dollars and improvement of the world market prices, the contribution of coffee, increased to 15% in 1995. Coffee earned about Kshs.107 billion, which is about 10% of agriculture's share of GDP between 1987/88 and 1997/98.

3.0 OBJECTIVES OF THE PROPOSED REFORMS

3.1 The Government intends to divest from business activities in accordance with the policy of liberalization and privatization. CBK Which is a state corporation regulates the coffee industry with regard to production, processing, marketing and export of coffee as stipulated in the Coffee Act, Cap 333. It also markets all coffee produced in the country on behalf of farmers. Initially, the regulatory and marketing functions were carried out by separate institutions. These multiple roles of CBK have tended to create conflict of interest and inefficiencies. It is therefore necessary to separate the regulatory role of the Government, which is done through the CBK, from the marketing function, which will be conducted by the private sector.

3.2 The overall objective of the policy changes is to introduce greater efficiency in the structure and institutional management in the coffee industry through redefinition of roles, elimination of conflict of interest between the institutions and staff rationalization at CBK and CRF. Also KPCU, District Co-operative Unions and Societies will be encouraged to review their staffing policies in order to improve on their operational efficiencies.

3.3 These actions will result in the reduction of costs, and thus enhance productivity and increased returns to the farmers. Since coffee belongs to the coffee grower until it is sold and he/she is paid for it, it is necessary to ensure that they get a fair return to their labour.

3.4 The removal of conflict of interest will be achieved through the separation of the regulatory and marketing roles currently undertaken by CBK. The marketing services of CBK will be privatized to be undertaken by licensed marketing agents including the proposed Kenya Coffee Marketing Agency (KCMA) which will have no Government representation. The current CBK will be restructured to perform the regulatory role only with majority grower representation. The Government representation will exist at reduced level. The elections of the members of CBK, CRF and the proposed KCMA will, in future, be held simultaneously. The election of persons to more than one national body or organization in the coffee industry will not be permitted.

3.5 The institutional changes will involve privatization of coffee marketing services through the establishment of a new body for the marketing function in competition with other marketing agents to be licensed by the CBK. The suggested name of the new marketing body is "Kenya Coffee Marketing Agency (KCMA)". KCMA will be a farmers' organization.

3.6 The legal framework will be harmonized with the policy changes. The harmonization of legal framework with the policy changes will culminate in the revision of the Coffee Act, Cap 333. The revision of the subsidiary legislation currently in operation will also follow. The main activity to be undertaken is the revision of the Coffee policy and the Coffee Act, Cap 333 and the subsidiary legislation made there under in order to determine key areas such as the:-

(a) licensing and registration of marketing agents;

(b) divestiture from Kenya Coffee Auctions Limited by CBK;

(c) institutionalization of the District Coffee Advisory Committee;

(d) the handling of the current CBK's fixed assets.

(e) the promotion of the local coffee roasting, value adding and consumption increased through promotion by roasters and marketing agents;

(f) revision of CRF Memorandum and Articles of Association in respect of election and composition of Board members. The representation on the CRF Board will be by direct elections and not from the Coffee Board of Kenya as is the practice at the moment;

(g) formation of the proposed KCPTA will include the determination of coffee volumes for each auction, and to make trading Rules in the NCE;

(h) promoting use of improved varieties e.g. Ruiru 11 and intensive cultivation methods to enhance coffee production and improved quality;

(i) rationalizing the statutory level coffee deductions from coffee proceeds to less than 10% without compromising services rendered to farmers;

(j) Promoting robusta coffee production through research on improved varieties e.g. Arabusta and extension services;

(k) Continuation by CRF to perform research work on coffee and be financed by growers through an ad valorem planter's levy; and

(l) Promotion of Kenyan coffee by Commercial Attaches in our Embassies abroad who will be enabled to gather market intelligence data in their stations, and which will be used to prepare our coffee trade promotion strategies.

4.0 COFFEE PRODUCTION

4.1.0 Current Status of Production

4.1.1 It is estimated that 162,470 ha are under coffee of which 75.5% is in the co-operative subsector and 24.5% in the estates. The highest production was achieved in 1987/88 when 128,926 metric tonnes of clean coffee were produced with co-operatives producing 65.5% and estates 34.5%. Coffee production declined to 56,159 metric tonnes of clean coffee in 1997/98. In 1998/99, production increased to 68,163 metric tonnes out of which, estates produced 58% and co-operatives produced 42 %.

4.1.2 The cost of coffee production has been rising against a sharp decline in prices making it difficult for coffee growers to break even. For instance, the average cost of producing a tonne of clean coffee by smallholder farmers increased from approximately Kshs.32,000 in 1991/92 to Kshs.64,000 in 1997/98, while for estates it increased from Kshs.72,000 to Kshs. 120,000 during the same period. Adoption of Ruiru 11, which would substantially reduce the cost of production, has been hampered by inadequate provision of seeds and seedlings.

4.1.3 Short term financing by Coffee Board of Kenya, commission agents, commercial banks and co-operative societies; SACCO societies provide crop advances or loans in kind towards coffee production and processing. The CBK sources its funds mainly through local and offshore bank overdrafts using coffee stocks as security. Financing schemes such as cherry picking and parchment advances are used to pre-finance the growers while they await the sale of their crop. Crop hypothecation is used as collateral for these credit schemes. The advances are recovered from coffee proceeds after sales. Currently, CBK has overdraft facilities with the local banks, which fluctuates between Kshs. 4 and 8 million depending on volume of business.

4.1.4 The financing schemes cater for short-term needs (working capital) but do not address the capital development requirements of the growers. Smallholder growers have limited access to commercial banks lending whose cost is too high and they require collateral. The co-operative societies borrow on behalf of their members who are sometimes unaware of the loans taken and loan recovery is not always restricted to those who benefit from the loans. There have also been incidences whereby farmers have evaded loan repayments through illegal cherry deals and splits of cooperative societies.

4.1.5 Under the Lome IV Convention African, Caribbean and Pacific (ACP) countries were considered for compensation by European Union (EU) for loss of export earnings on scheduled commodities whenever the commodity price fell below set thresholds. In this regard, Kenya was eligible for the stabilization of exports (Stabex) allocations from 1990 to 1993, which amounted to EURO 85,730,272. In 1999 Kenya was also eligible for Stabex allocation of EURO 39 million giving a total amount of EURO 124,730,272 equivalent to Kshs. 8,731,119,040. Adding interest earnings of Kshs. 3,310,986,891 gives a total of Kshs. 12,042,105,931 as at December 2000.

4.1.6 Initially the funds are deposited in GOK/EU Trust account in overseas bank and later transferred to local banks in designated currency. Coffee sub sector was allocated Kshs. 1,783,506,003. Of this, Kshs. 660 million was approved for on lending to coffee farmers through the Co-operative Bank of Kenya as a revolving fund. The amount was allocated to the following SCIP II components- Cherry Advance Payment System (CAPS) Kshs.190 million, Farm Inputs Loans Scheme (FILS) Kshs. 425 million, Coffee Factory Loans Scheme Kshs. 35 million and 10 million to the Kenya Coffee College at CRF. Disbursement of Kshs. 659,582,428 was realized. The amount in the revolving fund has now accumulated to about Kshs. 850 million. Kshs. 18,506,003 was spent on the Coffee Strategic Study.

4.1.7 Other allocations to the coffee subsector through other Ministries and institutions were as follows: Kshs. 375 million was allocated to Kenya Power and Lighting Company Ltd. through the Ministry of Energy for coffee factory electrification phase one. Of the Kshs. 375 million, only Kshs. 120 million has been utilized in phase one leaving a balance of Kshs. 255 million because of KPLC's low capacity to implement the project. An additional Kshs. 500 million for the second phase of electrification was to be availed on completion of the first phase. The tissue culture project at CRF has been allocated Kshs. 135 million; Roads sector Kshs. 1,312,000,000 of which Roads 2000 programme in 7 coffee growing districts was allocated Kshs. 700 million in phase one and Kshs. 600 million in phase II, and Kshs. 12 million for axle load control unit. Expenditure on Roads 2000 programme has been insignificant. Coffee quality improvement was allocated Kshs. 100 million but this amount has been reallocated; the Road Rehabilitation Fund was allocated Kshs. 600 million while allocation for matrix framework was approved at Kshs. 52.5 million. Most of these funds have been spent and the total allocation from 1990 to 1993 was about Kshs. 8.7 billion. There is a balance of about 6.6 billion that has already been reallocated. Tourism was allocated Kshs. 1,220,092,320 and a balance of Kshs. 1,103,850,000 may be available. Agricultural sector was allocated Kshs. 503,657,919 and economic management support was allocated Kshs. 2,611,160,343. Not all funds have been utilized and some Kshs. 6,664,000,000 could be available and be spent on agricultural sector and coffee sub-sector in particular if the necessary programmes and projects are mutually agreed upon with EU.

4.1.8 The EU requires the National Authorizing Officer, who is the PS Treasury to allocate the funds through mutually agreed programmes. The money has been banked in local banks. The Ministries of Finance and Planning and National Development, Agriculture and Rural Development, are working out modalities of utilizing the remaining funds with emphasis on supporting the coffee sub-sector.

4.1.9 In the co-operative sub-sector, coffee production is influenced adversely by the poor quality of coffee co-operative society management and the extent of squabbles within its membership, unlike in the estates which are either individually managed or managed through management agents.

4.2.0 Constraints to Production

4.2.1 (a) Currently there is limited access to credit and the cost of borrowing is high. The requirements by the commercial banks for security have been major impediments to accessing finance by the coffee growers. The high cost of irrigation and farm inputs prices have adversely affected coffee production leading to the high costs of production being experienced now. There are no long- term financing arrangement in the industry, particularly for the smallholder coffee growers.

(b) The requirement for a licence before establishment of coffee farm or approval by CBK before uprooting of coffee has tended to discourage potential growers from going into coffee farming. A number of neglected coffee farms or estates exist because of the bureaucracy involved in obtaining approval to uproot coffee and put the land to alternative uses.

(c) Coffee growing has been restricted to gazetted coffee zones only.

(d) There is low availability of Ruiru 11 seeds and seedlings, which are disease resistant and thus reduce cost of coffee production by about 30% because of reduced use of agrochemicals. Multiplication of Ruiru II seedlings has been hampered by seed provision and delays in putting up tissue culture laboratory as well as lack of private sector participation.

(e) Robusta coffee production in Coast, Nyanza and Western Provinces has been hampered by lack of financing for research, unavailability of seedlings, and marketing constraints.

(f) Other problems include coffee co-operative societies mismanagement, agitation for splits of coffee co-operative societies into small uneconomic units, and farmers' lack of information on the provisions of the new Co-operative Societies Act (No 12 of 1997). Others are inadequate appreciation of the implications of liberalisation process, and farmgate sales of cherry, buni and parchment coffee that have tended to promote coffee thefts and general insecurity in the coffee areas.

(g) There is inadequate and uncoordinated extension service.

4.3.0 <u>The Current Policy in Production and Proposed Changes:</u>

4.3.1 There are short term financing arrangements for coffee production now. Coffee co-operative societies, rural SACCOs, millers, commission agents, management agents and marketing agents will be required to finance or facilitate financing the coffee industry in the areas they participate in.

4.3.2 Contract coffee farming will be encouraged, through the observance and enforcement of contractual arrangements. Contract farming will involve millers who will finance coffee growing and also provide extension services to their contracted farmers. This will include technical advice on primary processing and other advisory services in addition to receiving the coffee crop and buni, hulling and grading as well as classifying coffee. The change of contract will be registered with the Board. CBK and the Courts will enforce the contracts. The financiers' costs on crop advances will be secured through execution of agreements between the growers or their agents. The millers may hypothecate coffee/crop up to the approved percentage for grower to secure crop advance or loan, which must be recovered by the marketing agent on behalf of the miller/commission agent. Alternatively, the grower's proceeds will be forwarded through his miller/commission agent who would deduct his crop advances and pay him his dues.

4.3.3 The role of the miller/commission agent in financing growers through contract farming and guaranteeing farmers loans/advances and also guaranteeing buyers of crop deliveries for spot sale through marketing agents/brokers or for futures contracts through private treaty provided that the sales are registered with the

CBK, will go along way in financing coffee production. The miller would also mill the crop, grade it and classify the coffee before sale through the auction. He should recover his expenses, loans/advances with assistance of the marketing agent.

4.3.4 This means that marketing agent/broker would only borrow funds only to finance coffee stocks carried over to the next crop year provided he is instructed to do so by the grower and his financier who would therefore release coffee stocks to him otherwise the grower and his financier would finance stocks. Many marketing agents, including KCMA, may rely on the millers for the warehousing of coffee and would only ensure that coffee is properly warehoused and correctly classified by the millers and possibly counter check classification.

4.3.5 It is proposed that the current requirement for a licence before establishment of a coffee farm or approval of CBK before uprooting of coffee which tended to be restrictive in nature be removed. A grower, who wishes to grow or uproot his/her coffee, will be required to register with his co-operative society, in case of small holder growers or directly with the Board, in case of estate grower for statistical purposes.

4.3.6 The current requirement, which restricts coffee growing to the gazetted zones, will be done away with. It is proposed that a grower will be free to plant coffee without being restricted to coffee gazetted zones only. Growers will, however, need to seek the advice of CRF on the recommended coffee varieties to plant in their respective agro-ecological zones and also register the planted area.

4.3.7 There will be promotion of planting improved varieties e.g. Ruiru 11 and intensive cultivation methods to enhance coffee production and quality.

4.3.8 There is potential in Robusta coffee production in Coast, Nyanza and Western Provinces and production will be increased through research on improved varieties e.g. Arabusta backed by good extension services.

4.3.9 Extension services currently provided by MOARD, CBK, commercial millers, CRF and the co-operative movement should be co-ordinated by MOARD. MOARD will be responsible for the policy initiatives and formulation, overall quality assurances, promotion of development, pest and disease control, provision of extension services and information thereby ensuring efficiency and healthy competition in the industry. It will therefore co-ordinate the services and create enabling environment for growth and development by giving general direction of production and research agenda. The millers and commission agents will be involved in extension and advisory services in the industry. There will be no extension services or milling services provided by the marketing agents but they may provide advisory services in the areas they are involved. Specialized extension staff may be hired by various agencies according to their need but the Government will be responsible for overall extension policy in the industry. Extension services will be co-ordinated by the Ministry, which is responsible for policy and promotion of coffee among other enterprises. CBK will be a regulator and will prosecute offenders hence can only give advisory services. Many players (commission agents, millers, co-operative societies, regulatory body, marketing agents) in the industry will provide certain aspects of information-delivery to the industry but the Government will have the overall responsibility to ensure correct and adequate extension services delivery to coffee farmers. However, the Ministry will still require adequate budget to play its role effectively.

4.3.10 The Co-operative Societies Act, (No. 12 of 1997) will be reviewed and harmonized with the policy reforms in co-operative sector and other sub-sectors of agriculture.

4.3.11 Using tissue culture techniques and expanding vegetative propagation of seedlings will enhance multiplication of the disease resistant Ruiru 11 variety. Encouragement of private investors in seedling multiplication, particularly vegetative propagation and tissue culture will be done under close supervision by CRF.

4.3.12 Ruiru 11 is a hybrid. The flowering of its parents takes place for a very short time when cross-pollination is made. The amount of seed available is therefore limited. The distribution of Ruiru 11 is made by a committee of CRF/CBK in accordance with the demand and availability of seedlings. About 73,000 seedlings are produced annually. With the introduction of tissue culture technique, more seedlings will be produced. The tissue culture project is funded from stabex funds at Kshs. 135 million. Tissue culture would require the use of orthodox shoots, which are also limited. The technique will help in multiplication of seedlings. New varieties are also on the pipeline including robusta types. If Government votes for a definite budget for coffee research as well as improvement in budgetary allocation for agriculture, a lot will be achieved. Private sector will be encouraged to participate in the multiplication of seedlings under CRF supervision and registration by CBK.

5.0 COFFEE PROCESSING

5.1 Current Status of Processing

5.1.1 Coffee processing is done in two stages: primary and secondary processing. Primary processing is undertaken at the coffee factory and involves cherry sorting, pulping, pre-grading into three categories (firsts, seconds and lights), fermentation, washing and sun drying of wet parchment.

5.1.2 The cost of processing cherry has increased over the last ten years due to the high costs of electricity, fuel, and labour and factory repairs/maintenance. For instance, the cost of processing one kilogram of cherry increased from Kshs. 3/85 in 1989 to Kshs 6/80 in 1999, an increase of 77%.

5.1.3 The law allows growers with ten or more acres under coffee to own private pulping stations. The ten acres requirement was administratively reduced to five acres by the Board. This has resulted in proliferation of many pulping stations and hand pulpers, which do not observe or maintain the required quality standards.

5.1.4 Secondary processing is carried out by millers and involves parchment hulling followed by polishing, sorting and grading. Spillage of parchment coffee during the milling process often occurs such coffee is bulked and sold as sweepings.

5.1.5 The milling process is fully liberalised and is undertaken by private and commercial millers. A private miller is the owner of the coffee parchment he/she mills while commercial miller engages in parchment milling for profit.

5.1.6 The entry of additional private and commercial millers increased the milling capacity from 140,000 metric tonnes in 1993 to 230,000 metric tonnes by the end of 1996. The increased milling capacity against a background of low coffee production has reduced milling utilisation to 30% in 1997/98 improving to 43 % in 1999/2000.

5.1.7 After milling, coffee is graded in a process which involves separation of clean coffee beans by sizes into six grades namely: AA, AB, PB, E, C, T and a seventh grade, TT, which is light in density, is obtained by blowing pressurised air through the bigger beans.

5.1.8 After grading clean coffee by sizes of the beans, it is classified by liquoring in order to assign the classification standards. Kenyan coffee is classified into ten classes. The high quality coffee falls into class 1 to 6 while lower quality beans falls in to classes 7 to 10. Coffee is auctioned in the Nairobi Coffee Exchange by grade and class, which determines the prices fetched. The standards of classification have helped maintain the unique character of Kenyan coffee in the world market.

5.1.9 The liquoring criterion used for classification of coffee is important as it determines value of coffee. This should be as fair as possible. The growers' agents will also liquor coffee to counter-check what millers have classified. The organoleptic method is the only way applied presently. Research is being undertaken at CRF to investigate whether or not this process can be done scientifically. At present, several liquorers are involved in this process at the milling stage, at the marketing agent's level, and at the buyers/dealers level. The regulatory body may also counter-check in case of disputes. All liquorers will be expected to confirm the cup quality but the grower may appeal against the decision if he is not satisfied and demand a repeat to be made.

5.2.0 Constraints in Coffee Processing

5.2.1 Poor state of roads causes delays in cherry and parchment deliveries to factories and mills.

5.2.2 High coffee processing costs have resulted in reduction of coffee returns.

5.2.3 Lack of declarations of the quantities and proceeds realized from sale of sweepings have always caused suspicion and controversy in the industry. The policy of CBK is that all sweepings should be declared but millers have not always declared sweepings otherwise sweepings are usually sold and the proceeds paid to the growers.

5.2.4 Although the law stipulates that a grower who owns ten acres or more under coffee can be licensed to construct and operate a pulping station, those with five, or more acres have been licensed without amending the law. This has led to a proliferation of pulping stations, some of which are hand pulpers. This change has further led to farmgate cherry sales and increasing incidences of cherry and parchment thefts.

5.2.5 There are withholdings of parchment coffee for unnecessary long periods by millers leading to quality deterioration, lower prices and delayed payments.

5.2.6 Perceived high milling losses (conversion ratio of parchment to clean coffee) lead to misunderstandings.

5.2.7 High transportation costs of buni to the mills.

5.3 <u>Current Policy on Processing and Proposed Changes</u>

5.3.1 The issue of high primary processing costs will be addressed through flexible staffing arrangement by co-operative societies adjusting staff numbers to production levels. The review of taxation and tariffs on the diesel and electricity used in processing cherry will be undertaken.

5.3.2 There is need for staff rationalization in the co-operative societies that will have to be addressed by the members. They have to address the requirements of the Co-operative Societies and the labour laws including child labour. The members will take costs of hiring staff into account. Presently, co-operative societies deduct between 11% and 76% of the gross proceeds. A large portion of this deduction is used to meet personnel costs. If Co-operative Societies are to reduce their costs to between 11% and 15%, then members will have to determine the terms of personnel and numbers as well as determine materials needed to process coffee in order to keep costs down. In order to reduce costs to farmers, Parliament may fixe their margin to between 15% and 20% and then members will have to rationalize staff numbers and intermediary organizations. They may do away with unions and also base their operations at the factory level as the first stop. The Co-operative policy will be made clear on these issues. The co-operative societies will rationalize the numbers of permanent staff and casuals by for example hiring essential permanent staff only and casuals during peak periods.

5.3.3 The hiring of children under the age of eighteen years for commercial labour in the coffee farms will be controlled and discouraged except where educational programmes involve family/household units.

5.3.4 Coffee pulping stations are licensed by the CBK. Currently, a grower who owns ten acres or more under coffee can be licensed to operate a pulping station. It is proposed that CBK continue licensing pulping stations after ascertaining ownership of ten acres of mature coffee. However, farmers who pull out of co-operative societies are required to clear their liabilities (if any) with their co-operative societies before being licensed by CBK.

5.3.5 Commercial processing of cherry as well as trading in cherry, parchment or buni among members of coffee co-operative societies or estate owners will not be allowed. However, arrangements may be made by the co-operative society or estate owner whenever its/his pulping station breaks down to have coffee pulped by another on cost recovery basis.

5.3.6 The policy re -emphasizes that private coffee pulping stations will be restricted to ten 10 acres (4 ha) where there are Co-operative Societies and five (5) acres (2ha), where there are no Co-operative societies. Although this would appear to be discriminatory and over 2000 growers, with 5 acres and above, have been licensed by the Board, the policy stops licensing those growers with less than ten acres of coffee. There is no advantage for small private factories as they dismantle the co-operative societies. These small estates have been carved from the Co-operative Societies areas and also subdivision of large estates. Five (5) acres of mature Ruiru II coffee, when well managed can produce about 120,000 kg of cherry, which can be processed by one disc factory. The Board will license such farmers in areas where there are no co-operative societies. The policy discourages poor processing methods or smaller units including hand pulpers in all areas.

5.3.7 Accountability of coffee sweepings and other coffee by-products will be enforced by the CBK and where such by-products generate income, such revenue will be passed on to coffee growers. Commercial millers will be required to account for sweepings and by-products to the growers through their marketing agents who serve the grower who contracted the miller.

5.3.8 Coffee millers will account for milling losses and sweepings to farmers. CBK, as a regulatory body, will monitor and supervise the exercise through periodic returns received from millers. The returns on sale of by-products (joint product) or free issues to farmers will also be made. The millers will be required to minimize milling losses as well as declare them. The sweepings, which amount to about 250-300 tonnes of clean coffee per year, will be reduced. Currently CBK operates a sweeping's bank account from where farmers are paid. Such an account opened by a marketing agent will be properly monitored by CBK in future to ensure payments to farmers are made in accordance with the rules to be made.

5.3.9 The milling losses for heavy coffee (P1) may be between 15% and 20% while medium coffee (P2) realizes between 25% and 29%. But light coffee (P3) has recovery ratio of between 35% and 40% and buni gives 50% to 60%. In all cases the recovery ratio depends on the efficiency of the machine and the quality of coffee. CBK will publish the milling losses for each mill and the growers will be educated on this issue. The rules will specify the obligations of the millers so far as milling losses are covered.

5.3.10 Every licensed coffee miller will be required to mill all parchment coffee in his possession on first- in first-out basis but not more than 60 days after receipt from the grower and thereafter forward the milled coffee (clean coffee) to the marketing agent within forty-eight hours after milling or such time as may be agreed with the farmer and his marketing agent.

5.3.11 The Rural Electrification Programme will be enhanced in order to reduce factory-operating expenses hence, reduce processing costs. There will be close liaison with the Ministry of Energy, Ministry of Finance and KPLC particularly in regard to Stabex funding of the programme.

5.3.12 CBK will provide in the print and electronic media information on the performance of millers with respect to milling losses and other related charges such as transportation, handling, drying etc. Growers will be educated on the conversion ratio and encouraged to take their parchment coffee for sampling by independent expert in this area to enable them to know the expected conversion ratio after milling.

5.3.13 Investors will be encouraged to install coffee mills close to the growers and also co-operative societies will be encouraged to invest in mills or buni hullers.

5.3.14 Management of the coffee produce cess is not uniformly managed in all coffee growing districts. The practice that is most commonly used is for allocation of 80% of the cess funds to the growers' cess committees while 20% is passed on to Local Authorities. Although the growers are not happy with the portion that goes to the Local Authorities, there was consensus to adopt the ratio. The growers cess management committees are chaired or led by the CBK delegates. The system has worked well in some places whereas in others, there has been incidences of cess mismanagement. The produce cess committees will therefore be institutionalised and their operational modalities spelt out. The 80% portion will be managed by coffee growers' organisations (districts roads cess committees) in the coffee growing areas and applied to improvement of factory access roads. The Agriculture Act Cap. 318 and the Local Government Act Cap.265 will be amended to provide for the provisions and for effective management of the cess. Good accountability of the cess money will be achieved through enforcement of transparent and accountable procurement procedures in addition to annual audits of the cess funds.

6.0 COFFEE MARKETING:

6.1.0 Current Practice in Coffee Marketing

6.1.1 Coffee marketing involves a sequence of stages, namely, primary and secondary processing, grading, classification, warehousing, selling and exporting. In normal circumstances, coffee is sold weekly through the central auction system at the Nairobi Coffee Exchange (NCE). CBK prepares samples for the coffee to be included in the auction.

6.1.2 These samples are then passed on to brokers and dealers to facilitate the preparation of coffee auction catalogues and participation at the auction. It has been argued that "there are too few buyers" at the central auction making collusion easier and minimising competition.

6.1.3 Coffee is sold or auctioned at the trading floor of the Exchange. About 45 auctions are held during the coffee year, beginning in October when the first crop becomes available. This is followed by a break over Christmas and the New Year. The main crop becomes available from the end of February. A second break occurs at the end of July.

6.1.4 The auction system is transparent, competitive and rewarding in terms of premium prices for quality coffee. It also offers the best system of price discovery to farmers. At the central auction, dealers buy coffee through competitive bidding. Auctioneers subsequently invoice the successful bidder who in turn remits payments within seven days to CBK. CBK pays the growers directly or through the commission agents.

6.1.5 Coffee offered for sale is warehoused by CBK, which also regulates the sale programme and decides on the qualities and quantities to be offered at every auction. The reserve price is pegged on the basis of world market prices and is adjusted by a premium to reflect the unique quality of Kenyan coffee. The auctioneers, in consultation with the planters, set the reserve price. However, forces of supply and demand in the auction determine the actual sale price. The coffee auction is presently operated under the rules of the Mild Coffee Trade Association of Eastern Africa (MCTA).

6.1.6 Presently, CBK remits coffee proceeds to farmers who are on direct payment system within 7 days after receipt from dealers. The other farmers receive their payments through their agents. In future, marketing agents will be required to pay growers or their agents within 7 working days from prompt date.

6.2.0 **Constraints to Marketing**

6.2.1 There is limited competition at the central auction because of the few dealers who participate in any one auction.

6.2.2 It is only CBK, which determines when each lot is to be auctioned.

6.2.3 Warehousing of clean coffee before auction is controlled by CBK.

6.2.4 Local consumption of coffee is low due to high retail prices and limited promotion.

6.2.5 Promotion of Kenyan coffee in the new and emerging markets has been inadequate.

6.3.0 Current and Proposed Policy Changes in Marketing

6.3.1 The marketing function involves warehousing of coffee; classification by liquoring; preparation of sale catalogues; and auction of the coffee; receiving the coffee proceeds and remitting proceeds to growers after the requisite deductions. These functions are all done by CBK. The objective of the policy changes in coffee marketing will be to introduce competition by allowing participation by more marketing agents. The proposed changes will include: -

(a) The industry will retain and strengthen the Central Auction System. The central auction conducted at the trading floor of The Nairobi Coffee Exchange (NCE) is managed and administered by the Coffee Board of Kenya. It is proposed that this role be handled by an association comprising of members from growers, coffee grower's organizations, millers, marketing agents, brokers, auctioneers, dealers and warehousemen. It is proposed to form an association to be called "Kenya Coffee Producers and Traders association (KCPTA)."

(b) The functions of the proposed KCPTA will include the determination of coffee volumes for each auction and to make trading rules in the NCE. Kenya Coffee Producers and Traders Association (KCPTA), which will also formulate regulations to govern their operations, will supervise the auctioneers. The regulations will be in harmony with the provisions of the Coffee Act. MCTA will be advised accordingly.

(c) The Board will license and register marketing agents, millers, brokers, dealers, warehousemen, auctioneers, buyers, packers and roasters. The licensing and registration of marketing agents will be done in a similar manner on the basis to be specified in the rules whereby particulars of each one of them will be supplied to the Board in order for the Board to keep statistics on the players in the industry.

(d) Any commercial coffee miller who wishes to operate as a marketing agent will be required to incorporate a separate company for the purpose of marketing coffee. No miller will be a marketing agent.

6.3.2 Coffee growers will have the option of selling their coffee in any one-coffee year through either the proposed Kenya Coffee Marketing Agency (KCMA) or any other marketing agent.

6.3.3 Auctioneers, who will be licensed brokers, will also be registered by the Board for purposes of selling coffee at the trading floor of Nairobi Coffee Exchange. The marketing agents, in consultation with the growers, will appoint them.

6.3.4 The marketing agents may also double as the auctioneers/brokers appointed by growers through marketing agency contracts registered by the Board. The grower may revoke or change the appointment of marketing agent in writing. The Board will register such changes and advise all parties concerned.

6.3.5 The brokers will function as auctioneers or marketing agents as explained above. The broker's work is to negotiate the purchase or sale of coffee between growers and buyers.

6.3.6 KPCU is a farmers' organization and will continue to be a milling agent that may also finance coffee production. KPCU's warehouses that are now sublet to CBK will still be available for warehousing coffee by KPCU. It may also rent space to other millers who are able to hold coffee stocks. Others may be rented to coffee dealers who need such facilities. Likewise, CBK may own warehouses that may also be available for renting to millers or dealers.

6.3.7 <u>First Option for the Coffee Growers</u>

(a) A coffee grower will appoint a marketing agent of his/her own choice through "a marketing agent contract". The contract will be registered with the Coffee Board of Kenya. The Board will enforce the smooth operations of the contracts between the growers and the marketing agents.

(i) The marketing costs will be direct costs and will be negotiated between the grower and the marketing agent and should not exceed 0.6% of the gross coffee sales. The grower will pay 0.4% and the dealers 0.2 % to the marketing agent making a total of 0.6% of gross sales proceeds as the proposed brokerage/marketing fee, excluding the auction fee.

(ii) To safeguard the grower's coffee, the marketing agent will provide a bank guarantee to the Coffee Board of Kenya. The marketing agent's guarantee will be US$ 12 million on the upper limit or any other figure fixed by the Coffee Act. While the amount of guarantee should be affordable, it should also safeguard farmer's coffee and money, as it will not be acceptable that farmers incur losses. Based on 45-50 weekly auctions, the amount of coffee sold per week will be worth about US$ 8 million (being the value of 40,000 bags at US$200/bag) shared by a number of marketing agents. That upper limit will be a maximum of 40,000 bags worth US$ 8 million covered by the guarantee of US$ 12 million being one and a half times the value of coffee. The lower limit will be 3,500 bags of coffee worth US$ 0.7 million covered by a guarantee of US$ 1.0 million. The quantities of coffee handled by the marketing agents will be between the two limits provided the guarantee given by each marketing agent will be one and a half times the value of coffee he sells. The guarantee will be registered by the Board. The object is that all marketing agents should pay farmers their dues and where they fail the Board will fall back to the bank guarantee.

(iii) Dealers will remit coffee proceeds to the marketing agents who shall pay the growers within 14 working days from date of sale less the statutory deductions and other charges such as milling costs, warehousing costs, insurance costs and auctioneering expenses.

(iv) Conditions for registration and licensing of marketing agents will ensure that high integrity; honesty and competency are complied with before a licence is issued by the Board.

6.3.8 Second Option for Coffee Growers

(a) A new body will be established under the law to undertake marketing of coffee and remission of growers' payments. The marketing body may be registered as "Kenya Coffee Marketing Agency Limited (KCMA)". The proposed Agency will be incorporated under the Companies Act Cap. 486 and will be limited by shares and the coffee growers will be the shareholders.

(b) The proposed KCMA will be a coffee growers' organisation, registered as a marketing agent responsible for the marketing functions like the current CBK. KCMA may own warehouses but it will not mill coffee. KCMA, as a marketing agent, may appoint an auctioneer to sell coffee or it carries out that function itself as an auctioneer under the auspices of KCPTA. KCPTA will not auction coffee but it will set Rules and guidelines that will govern the operations of auctioneers/brokers at the trading floor of the Exchange.

(c) In order to have smooth transition in transferring the coffee marketing function to KCMA and other marketing agents, there will be sufficient transition time for the CBK to dispose of coffee stocks, pay growers their dues, and take a decision on CBK's assets and liabilities. CBK will clear liabilities and thereafter carry out staff rationalisation. The transitional period will be 5-6 months to 30th June 2001.

(d) The Government will refer the details on assets and liabilities of the CBK and formalities of forming a new company to a technical expert.

(e) The marketing expenses will be met by charging a marketing fee of upto 0.6% from the gross coffee sales. Essentially, fees payable to marketing agents, by dealers and growers would be a reduction in the price of coffee payable to farmers. The fees has now been revised, consolidated and fixed at 0.6% for both KCMA and other marketing agents. Rebates should be paid to coffee growers during times of high coffee production and high prices.

6.3.9 <u>The Functions of KCMA and other marketing agents</u>

(a) The marketing agent will:

(i) ensure that coffee is warehoused and classified properly and also prepare sale catalogues;

(ii) auction and receive the coffee sale proceeds and pay farmers direct after deducting the statutory levies and other charges;

(iii) order for delivery of coffee to designated warehouses by millers,

(iv) receive from the millers and deliver coffee samples to central trade sample room of the exchange;

(v) set the reserve price in consultation with grower;

(vi) monitor the sale of the coffee at the central auction;

(vii) disclose to the grower the selling price at the auction; and

(viii) deal with other matters pertaining to the transaction.

(b) Thus the marketing agents will receive coffee from millers who will deliver it to designated warehouses and then prepare sales catalogue, prepare to release coffee to the dealers who have purchased and paid for it.

(c) The advances/loans will be taken into account so that, sales do not take place below the due price, otherwise loans/advances may not be recoverable. In appointing the auctioneer, the due regard of the growers' and their financiers' wishes will be taken into account in order to safeguard farmers' and the miller's investments.

(d) The marketing agents will receive coffee sales proceeds from dealers and pay growers directly or through the appointed miller/commission agent who may have entered into loan agreements with the grower. However, the marketing agent will deduct statutory deductions from coffee proceeds and remit to the designated authorities not later than seven days from the prompt date as specified in the catalogue.

(e) Before the sale of coffee the grower, the miller and the marketing agents will agree upon the period of delivery of coffee to designated warehouses. The arrangements should be such that there will be guarantee for the recovery of the loans/advance in accordance with agreements signed by the parties and registered by the Board.

(f) The marketing agent will explore other alternative market opportunities i.e. futures, options, international tendering and private treaty subject to registration with the Coffee Board of Kenya when applied. In such instances, the futures price will take into account the value of the coffee crop including costs of production and processing. Kenya will, while maintaining its market share in the traditional markets, develop new markets in the new and emerging markets of Eastern and Central Europe and the Far East, Northern and Southern African countries and the COMESA region. Thus, the marketing agent will develop new marketing strategies for penetrating the emerging markets of the afore said regions.

(g) The marketing agents will actively undertake coffee promotion activities in the traditional and emerging markets. Promotion materials will be developed and used for targeting these markets according to their consumer market profiles. Special emphasis will be placed on the emerging speciality/gourmet market, which is a niche for top quality Kenyan coffee.

(h) The marketing agent will co-ordinate and facilitate sale of coffee at the Nairobi Coffee Exchange and effect the payment of statutory deductions to the authorities and organisations and remit promptly the net proceeds to coffee growers.

(i) The marketing agent may also be required to borrow funds to finance the coffee stocks carried over to the next crop year provided he is instructed to do so by the grower and his financier.

(j) Since coffee belongs to the farmer, the Co-operative societies, Sacco's and marketing agents may only finance the farmer to the extent that they may hypothecate the crop to secure advances to meet certain payments/obligations. At the society level, the management committee of the co-operative society may borrow money and pass it on to the farmers or carry out farmers' operations. It is envisaged that not more than 20% of the gross value of the coffee they produce per year will be borrowed. At the miller's level, the miller may not hypothecate more than 15% of the gross proceeds from the crop he handles. The marketing agent, who may borrow to finance only carry-over coffee stocks, and pay the farmers directly or through their agents, not more than 7.5% of the gross coffee sales or the actual value of coffee stocks as instructed by the grower and his financier. In this way, over- borrowing will be avoided and the farmer will be assured of his payments because about 63% of the crop will remain uncommitted/un-hypothecated.

(k) The marketing agent will develop specific and tailor-made promotion and marketing strategies for Kenyan coffee. These include encouraging branding, value adding, speciality markets and organic markets.

(l) The marketing agent will conduct research relevant to coffee marketing.

6.4.0 <u>Composition of the proposed KMCA Board</u>:

6.4.1 The election and composition of KCMA Board will be guided by its Memorandum and Articles of Association. It will provide for electoral process and zones for representation in the Board. The proposed KMCA Board members will be elected directly from the grassroots. The electoral areas will be reviewed based on coffee production levels and hectarage.

6.4.2 The elections to KCMA Board will be based the criteria establishing electoral zones/areas to ensure that coffee growers are equitably represented on coffee geographical basis. The Memorandum and Articles of Association will have these provisions so that directors of the company represent the coffee growing areas and coffee growers.

6.4.3 The Board of KCMA will comprise 11 members as follows:-

(a) seven members from the co-operative societies elected by growers/shareholders; and

(b) four members from the estates sub subsector elected by growers/shareholders.

7.0 PAYMENT SYSTEM

7.1.0 Current Payment System

7.1.1 There are currently two methods of payment: pool and out of pool (direct) payment systems. Under the pool system, the growers are paid in a series of interim payments before receiving the final payment. All the coffee proceeds in a coffee year are aggregated and averaged to determine the final rate of payment. Although this system shields growers from the risks of price fluctuations, growers who produce high quality coffee are paid the same price as those producing low quality coffee.

7.1.2 In the direct payment system, the grower is paid by prices realized in the auctions. Over 90% of the growers have opted for direct payment system.

7.1.3 Coffee is sold in US dollars at the auction and growers are also paid in US dollars. Growers are paid by classification in accordance with value of the coffee.

7 1 4 The direct payment system introduced two payment accounts: Member's Payment Account (MPA) and Society Operating Expenses Account (SOEA). The coffee societies, at an AGM, pre-determine the proportion to be credited into each account. For most of the coffee societies the ratio is 80% and 20%, respectively.

7.1.5 Various charges and deductions are effected from the coffee receipts at source (CBK) namely, presumptive income tax of 2% (now abolished by the Finance Act 2000), coffee produce cess 1%, marketing costs of 3%, milling charges at US $ 59-110 per metric tonne of parchment or 1% to 3%, ad-valorem levy of 3%, commission agency fees 1.5% and auctioneer's fee of 0.13% to 0.2% and the co-operative societies operating expenses range between 10% to 76%.

7.1.6 Computerization of some of the coffee societies' Payment Calculation Requests (PCR) has facilitated faster processing of farmer's payment.

7.2.0 Constraints in Payment Systems

7.2.1 Currently there are two payment system: out of pool and pool systems. This operation is laborious and very often-misunderstood leading to delayed payments because of the long chain.

(a) Presumptive Income Tax now abolished is unfair to the small producers.

(b) Numerous and high deductions leading to low payment rates.

(c) Lack of computerization at society level.

(d) Pooling of accounts at Co-operative Society level.

7.3.0 <u>Proposed Policy Changes to improve Payment System</u>

7.3.1 The proposed policy changes in coffee payment system will include: -

(a) Rationalising the statutory deductions from coffee proceeds by reducing them to less than 10% without compromising services rendered to growers. The proposed deductions will be as follows:

(i) ad valorem levy to be collected by CBK not exceeding 1% of gross proceeds;

(ii) ad valorem levy to be collected by CRF not exceeding 2% of gross coffee sales proceeds,

(iii) County council crop cess of 1% of gross sales proceeds to be utilized by County Councils and District Cess Committees at the ratio of 20% and 80%, respectively.

(iv) other fees such as the milling charges of US$ 59-110 per tonne or 1% to 3% depending on the price of coffee will be limited to up to 1% of gross sales;

(v) auctioneer's fees of 0.13 -0.2% charged now would be reconciled with future marketing charges, which should not exceed the proposed 0.6% proportionately apportioned to producer 0.4% and 0.2% to dealer.

(vi) commission agency fees of 1.5% will be rationalized with milling and marketing charges.

(b) The reduction of the payment chain through direct payment to the grower by the marketing agent will be achieved when marketing agents make all statutory deductions and remit one cheque direct to farmers' bank accounts opened on the basis of coffee factories. The other cheque in respect of Co-operative Society's expenses will be sent direct to the Society's bank account. The officials of the Society will not be expected to delay payments to the growers thereafter. The matter will be publisized to the concerned farmers so that they may demand their payments when the funds have reached their bank accounts.

(c) On the rationalisation of deductions from coffee proceeds received at the society level by the co-operative societies, it is recommended that the deductions be fixed by co-operative society's annual general meeting preferably at 15% of the gross amount of money received at that level. The Co-operative Societies' deductions will be based on principles of 80% and 20% of net proceeds going to farmers and co-operative society, respectively. The co-operative societies should aim at 15% being the maximum deduction. Law may fix this percentage in future.

8.0 REGULATION OF THE INDUSTRY:

8.1 The restructured Coffee Board of Kenya will regulate the industry.

8.2.0 Composition of the restructured CBK

8.2.1 The Coffee Board of Kenya will comprise 15 Board members as follows:

(a) eight members elected from co-operative societies at a meeting convened by the Minister, to represent the interest of the smallholder growers representing specified zones;

(b) three members elected by the plantation growers at a meeting convened by the Minister to represent the interests of coffee plantation including small and medium plantation growers, representing a specified zone;

(c) one member elected by the directors of the coffee trade at a meeting of the directors of the registered trade organizations convened by the Minister;

(d) the Permanent Secretary in the Ministry responsible for agriculture;

(e) the Director of Agriculture;

(f) the Commissioner for Co-operative Development;

(g) the Managing Director appointed by the Board who will be an ex-officio member of the Board and Secretary to the Board.

8.2.2 The membership of CBK includes both the Permanent Secretary and the Director of Agriculture. The former is the Accounting and Authorized Officer of the Ministry while the latter is the head of the technical department of the Ministry.

8.2.3 There is complete de-linking of CRF and CBK. Therefore, the membership of Director of Research to CBK has been removed. However, the Board can always invite the Director of Research at CRF for consultations.

8.3.0 Functions of the restructured CBK

8.3.1 The Board will be a regulatory body whose functions will be to: -

(a) promote coffee production, processing, marketing and the industry generally;

(b) register and regulate growers, pulping stations, millers, commission agents, marketing agents, buyers, brokers, roasters, packers, warehousemen, coffee nurseries owners and auctioneers;

(c) license pulping stations, millers, exporters, coffee nurseries owners, warehousemen, auctioneers, marketing agents, buyers, dealers, roasters and packers. It is important to license coffee exporters because they are the final players in the marketing chain. Coffee being a valuable commodity, it is important for the Board to monitor its movement from the farms to the export market and the final form of its export i.e. clean coffee for obvious reasons. Also transit coffee will be monitored as this could be confused with Kenyan coffee. Where thefts take place, it will become easy to hold stolen coffee, when found, before exports are made. Since coffee belongs to farmers until it is paid for, the activities of many players should be monitored to avoid losses to the farmers.

(d) provide advisory services as related to coffee production and quality enhancement;

(e) collect, collate and analyse data, maintain database on coffee, document and monitor coffee through registration of any person dealing in coffee;

(f) research into, investigations of, and all matters relating to the coffee industry including training;

(g) represent Government, if so directed, in coffee international conferences e.g. International Coffee Organisation (ICO) and Inter-African Coffee Organisation (IACO);

(h) make rules and formulate policies in the industry (including rules on electronic-commerce) in consultation with the Government and stakeholders;

(i) In case of disputes in the Industry, the Board will arbitrate when the parties refer the matter to it. If the matter is not resolved, then they may appeal to the Agricultural Appeals Tribunal specified in the Agriculture Act or move to the High Court. The Co-operative Tribunal will also deal with matters affecting co-operative societies operating in the sub sector.

8.3.2 CBK will be financed through a levy of upto 1% of gross proceeds from the sales of clean coffee. The CBK's budget will be prepared by the Board, and approved by the Ministries of Agriculture and Finance annually. It is proposed that the levy should not exceed 1% of gross sales proceeds. The Minister would issue a Legal Notice to determine the level of ad valorem levy between 0% and 1%. For example, if the budget is Kshs. 150 million he may fix the ad valorem levy at 0.75% if projected gross sales are Kshs 20 billion. The law will specify that the levy will not exceed one per centum of the gross proceeds.

9.0 COFFEE RESEARCH FOUNDATION:

9.1.0 Current Coffee Research:

9.1.1 Currently, the Foundation is managed by a Board of Directors composed of five nominees of the Coffee Board of Kenya and one representative each from the Ministry of Agriculture, Kenya Agricultural Research Institute and the University of Nairobi, Faculty of Agriculture, as specified in its Memorandum and Articles of Association.

9.1.2 The principal objective of the CRF is to promote research and investigate all problems relating to coffee and such other crops and systems of husbandry as are associated with coffee through out Kenya including productivity, quality and suitability of land in relation to coffee planting, and on matters ancillary thereto.

9.1.3 The Foundation has expanded the research disciplines over the initial entomological and mycological studies to cover coffee agronomy, plant physiology, plant breeding, soil fertility, plant nutrition, and agricultural engineering and agricultural economics.

9.1.4 Over the years, CRF has developed and updated technologies aimed at enhancing coffee yields, coffee quality and production. In pursuit of this, it has, from time to time, commissioned studies to analyse specific problems in the industry and to suggest remedial measures.

9.1.5 For instance, a study carried out in 1989 analysed the then prevailing production costs and coffee prices. In 1996 CRF was involved in preparation of the report of Task Force on liberalisation of the coffee industry while in 1999 a study was carried out which detailed the strategies to enhance coffee production in Kenya.

9.1.6 Other services provided to growers by CRF include the following: soil and leaf analysis; coffee planting materials; pesticide analysis; field evaluation of pesticides; field advisory services; training in coffee matters through the Kenya Coffee College and provision of literature on coffee.

9.2.0 Future Research:

9.2.1 Research is a dynamic and responsive process that must keep up with the changing circumstances in the farming environment. The Foundation is currently focusing on organic coffee production, molecular methods of selection for improved varieties, and use of tissue culture and biotechnology for multiplication of new varieties. It is also working on development of indigenous pesticides, integrated pest management, soil and water management, high density plantings, inter-cropping methods, irrigation methods for smallholder farms and development of field management practices. Other areas suggested for future research on long term basis include breeding for resistance to bacterial blight of coffee, selection for drought tolerance and marketing systems.

9.3.0 Financing of Research:

9.3.1 The main source of funds for coffee research is ad valorem levy, which is deducted from coffee proceeds by CBK. Currently CRF receives about 70% of the 3% ad valorem levy (approximately 2% of the ad valorem levy) from CBK to meet the cost of research. The funds are supplemented by internal revenue, which varies from year to year within a range of 10 to 25% of the CRF annual budget.

9.3.2 The level of funding CRF will be based on the same ad valorem levy, which will not exceed 2%. At present the levy of up to 2% is what farmers are agreeable to give CRF. For example, a CRF budget of Kshs. 250 million, the Minister may fix the levy at less than 2% depending on the volume of coffee and its value. At one time CRF had a budget proposal of Kshs. 500 million but got Kshs. 203 million only from CBK.

9.3.3 The funds will be remitted directly to CRF, by the marketing agents and not through CBK as at present.

9.3.4 CRF is a farmers' organization and will remain a parastatal being a company guaranteed by the Ministry and the Board. It's accounts, like those of CBK will be tabled in Parliament.

9.3.5 The Government or donor agencies have in the past provided additional funds from time to time. Government has had little input in the past but the Ministry could budget for coffee research if Parliament approves this action because the current source of funding is not adequate to finance all the research projects.

9.4.0 <u>Proposed policy changes</u>

9.4.1 The Foundation will amend its Memorandum and Articles of Association in line with the changes, which relate to the election and composition of the Board members.

9.4.2 The members of the Foundation's Board will be elected directly from the grassroots.

9.4.3 There will be nine electoral areas for the election of the Directors.

9.4.4 Five of the electoral areas will be allocated to co-operative growers and the other four to the plantation growers.

9.4.5 The Board will consist of 13 members:-

(a) five members from the Co-operatives sub subsector elected by growers;

(b) four members from plantation subsector elected by growers;

(c) Director, Kenya Agricultural Research Institute.

(d) one member being Dean of Faculty of Agriculture in a public University offering courses in agriculture. The member will be selected by and from among the Deans of the Faculties of Agriculture. They will come together to elect one of their kind on rotational basis.

(e) Director of Agriculture;

(f) Managing Director, Coffee Board Kenya;

(g) The Director of Research at CRF will be an ex-officio member and Secretary to the Board.

(i) The Chairman will serve a maximum of two terms of three years each.

(ii) The Board members will retire annually by rotation and will be eligible for re-election.

10.0 OTHER COFFEE SUB-SECTOR INSTITUTIONS /ORGANIZATIONS

10.1.0 The Mild Coffee Trade Association of East Africa (MCTA):

10.1.1 MCTA is a voluntary association of coffee dealers, brokers, warehousemen, millers, and commission agents in East Africa. The association's rules and regulations facilitate trade in both arabica and robusta coffee in East Africa. The number of members of the Association is 120. To be a member of MCTA one pays a membership fee of Kshs. 30,000/= and annual subscription of Kshs 15,000/=. The coffee growers and growers organisations are not members of MCTA. It is proposed to form Kenya Coffee Planters and Traders Association to take care of Kenyan interests including growers.

10.2.0 The Co-operative Bank of Kenya Limited

10.2.1 The Co-operative Bank of Kenya was formed in 1968.The Bank is the main supplier of credit to the agricultural sector and to smallholder coffee growers in particular. The Bank has 229 branches and 4 agencies throughout the country with a concentration in the high potential areas. It is registered under the companies Act and licensed under the Banking Act. The Bank is supervised by the Central Bank of Kenya and must conform to guidelines and directives issued by the Central Bank of Kenya. The provisions of the Co-operative Societies Act relate mainly to the bank's ownership structure and its relation to the co-operative sector.

10.2.2 The Co-operative Bank of Kenya will review its position with regard to registration and operations to be able to revert to its original role of a development Bank under the Co-operative Societies Act. It will review its lending policies to the coffee industry. The Co-operative Bank of Kenya is an essential institution as a farmers' bank although it is licensed and operates under the Banking Act. It is recommended that it operates under the Co-operative Societies Act since the majority of the shareholding is held by the Co-operative societies. The vision and mission of the Co-operative Bank will be focused on agriculture, and if the Parliament approves, the Bank would be the farmers' bank to finance agriculture along with the Agricultural Finance Corporation. If agreeable to the Government, Parliament can amend both the Banking Act and the Co-operative Societies Act in order to provide for a strong Co-operative Bank, which will be a farmers' Bank. The Bank will address these issues. In the past it has financed the agricultural sector to the tune of Kshs. 5.6 billion.

10.3.0 Union Banking Sections (UBS) and Rural SACCOs Co-operative Societies

10.3.1 Many coffee growers now have substantial savings in the UBSs and rural SACCOs, which provide financial services to individual smallholder coffee growers within membership of co-operative societies. The rural SACCOs are based on ownership and shareholding from members of primary societies in the area. Currently, there are 78 rural SACCOs spread throughout the country. In total, the coffee based UBSs and rural SACCOs serve more than 600,000 growers with savings and credit services. They operate both from banking halls in rural and urban centres situated in the coffee growing areas, and from mobile service units at society and factory levels close to grower's location. Credit given by UBSs and rural SACCOs is mainly in form of seasonal production loans or as welfare loans for social expenses (e.g. school fees, medical bills, etc.) In addition to the credit for individual growers, a few UBSs advance some credit to societies for various purposes.

10.3.2 There are over 500 coffee co-operative societies with 853 coffee factories and a membership of over 500,000.

10.4.0 Kenya Coffee Growers Association (KCGA (1991)) and Kenya Coffee Growers Employers Association (KCGEA).

10.4.1 The white settlers formed the KCGA in 1934 and helped to establish the Kenya Coffee Auctions, KPCU, research stations, and other institutions like Coffee Board of Kenya and Coffee Marketing Board. Because of politics between 1947 and 1959, it changed its name in early 1960s to become Kenya Coffee Growers Association registered under the Trade Unions Act, Cap 233. By 1989, it had 640 members who were estates and co-operative societies. It was banned in 1989 but the members petitioned in the High Court in 1991 and the court order was issued in 1997. The Association became operational in January 2000.

10.4.2 Currently, KCGA (1991) has 253 members comprising 163 coffee estates and 90 co-operative societies as at November 2000. After the ban in 1989, some members formed the (KCGEA) which was registered as a trade union in January

1992. It addresses labour matters and like the KCGA (1991), general matters of interest in the coffee industry. This Association has 78 members growing coffee in 9,200 ha. The two Associations are aligned to Federation of Kenya Employers (FKE). KCGEA is an affiliate of KFE while KCGA (1991) is non-affiliate.

10.4.0 Millers:

10.4.1 The milling of coffee has been undertaken by KPCU, which was established in 1937. Until 1994 KPCU milled 98% of coffee with the balance being milled by the estates. From 1994, coffee-milling activity was liberalised with licensing of three commercial millers to compete with **KPCU Ltd.** These are **Thika Coffee Mills Ltd., SOCFINAF Mills** and **Gatatha Farmers C-operative Society Ltd.** in addition to private miller called **Kibubuti Estates.** Private miller mills his own coffee while commercial miller engages in the coffee milling business on behalf of farmers.

10.5.0 Coffee Auctioneers/Brokers:

10.5.1 The Kenya Coffee Association (predecessor of KCGA) formed the Kenya Coffee Auctions in 1935. The present Kenya Coffee Auctions Ltd was formed as a private limited liability company in 1955 with 30,000 nominal shares and acquired Kenya Coffee Auctions. The issued shares are 3,000 of which CBK owns 65% and J.C. Valentine 35%. The Kenya Coffee Auctions Ltd. was the only auctioneer up to 1997, when four more auctioneers namely, Munene Coffee Brokers and Consultants, Cereals and Coffee Ltd.; Ridge Coffee Brokers and Horizon Coffee Brokers were licensed to offer competition in the sale of coffee in the auction hall. This company has been involved in the business of brokerage/ auctioneering coffee as a monopoly until 1997. It now sells about 95% of the coffee at the auction while the other four auctioneers handle about 5%.

10.5.2 CBK will divest from KCA Ltd. KCA Ltd will revert to its owners, CBK having disposed of its shares in the company. While CBK was the legal marketing agent for the coffee growers, it usually entered into a 3-year contract with KCA Ltd as its sales agent, broker and auctioneer. Presently KCA Ltd sells 95% of coffee in country. CBK's shares in KCA Ltd will not be transferred to KCMA. CBK will sell its 65% shares to J. C. Valentine, resign from KCA Ltd or pursue dissolution of the company and share its assets, if any, and then forgo about Kshs. 5 million dividend annually. KCMA will have its own auctioneer or carryout the work itself as auctioneer. KCPTA will co-ordinate the work in the auction hall to ensure the present monopoly is removed and that there is competition.

10.6.0 Coffee Roasters and Packers:

10.6.1 CBK used to have a chain of Coffee Houses until mid 1990s when the coffee houses were sold to the private sector. To date Kahawa No.1 and Kenya Coffee House Blend (KCHB) are brands of coffee sold by CBK. This business will be discontinued. Coffee roasting is organised under the auspices of the East African Coffee Roasters Association (EACRA) and the roasters are licensed by the CBK. EACRA members are free to introduce to the market their own coffee brands. Currently, there are various coffee brands owned by the members of the Association. Domestic consumption of coffee is low due to limited promotion.

11.0 TRAINING AND HUMAN RESOURCE DEVELOPMENT IN THE COFFEE INDUSTRY:

11.1.0 Universities

11.1.1 The degree and postgraduate training programmes in general agriculture are offered in the public and private universities. University of Nairobi, Egerton University, Moi University, University of East Africa at Baraton, Jomo Kenyatta University of Agriculture and Technology offer undergraduate and postgraduate programmes in agriculture whereas diploma and certificate training are undertaken at Bukura Agricultural College and Kilifi Institute of Agriculture, respectively.

11.2.0 Kenya Coffee College (KCC):

11.2.1 The college is situated at the Coffee Research, Station Ruiru. It was built in 1993 with assistance from the World Bank through the Second Coffee Improvement Project and has a capacity of 110 students. Currently, the college offers short courses in coffee to extension officers, farm managers, factory managers, society management committees, nursery managers, Co-operative Education and Publicity Officers (CEPOs), secretary-managers and coffee growers. The College is planning to offer certificate and diploma courses when its charter is finalised with the relevant Universities offering courses in Agriculture.

11.3.0 The Co-operative College of Kenya (CCK):

11.3.1 The Co-operative College of Kenya was established as a division of the Co-operative Development in 1970 but it was made an autonomous training institution established by an Act of Parliament in 1997. It offers certificate and diploma courses in co-operative management and other short courses in various disciplines in co-operative management. The College has a capacity of 240 students. It is hoped that the running of the College will be on self-sustaining basis so that its operations would not adversely affect research programmes.

12.0 MANAGEMENT OF TRANSITIONAL PERIOD

12.1 To ensure smooth transition without disrupting operations of the industry, it is proposed that Coffee Board of Kenya continue to perform the present functions during a transitional period until the "appointed day" which will be defined as 1st July 2001. The Coffee Act Cap.333 will be amended to provide for all the policy changes including licensing of marketing agents. Therefore, when the Bill becomes law, CBK will cease marketing of coffee on the appointed day.

12.2 Transitional time during which CBK will have disposed of stocks and paid farmers and other liabilities will be 5-6 months. It is noted that in the past, changes were made in the industry in month of July. e.g. 1934, 1945, 1947, 1960, 1971. This time round it should take place in July 2001 as the appointed day.

12.3 The Ministry will refer the incorporation of the proposed KCMA to a technical expert so that the modalities of its formation are worked out.

12.4 The CBK will restructure and review the staff establishment and determine the personnel requirements. A technical expert will be engaged to look at the current staff establishment and propose optimum staffing levels for the restructured Coffee Board of Kenya.

12.5 The modalities of forming the proposed "Kenya Coffee Producers and Traders Association" will be worked out by the Industry so as to become functional before the appointed day in order to take over the running of the central auction when CBK relinquishes its marketing roles.

13.0 CONCLUSION:

13.1 The various planned actions outlined in this paper, after their implementation, will result in efficient and effective operations of the institutions in the industry with adequate counter-check systems. The existing constraints and problems when fully addressed through the new policies will lead to better decision-making processes by farmers and other stake holders involved in the industry. The Government will continue to support the industry by creating enabling environment in a liberalised economy.