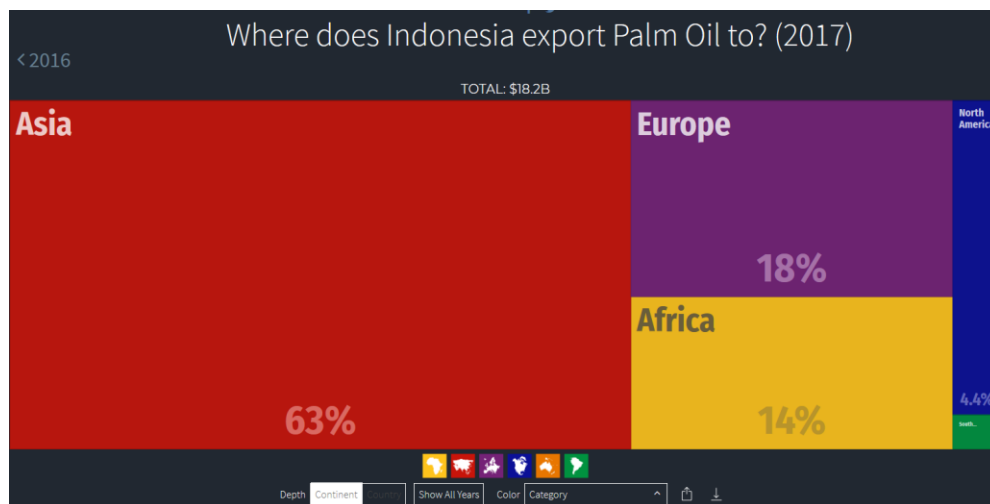


SPOTT Toolkit analysis in the Palm Oil sector of Indonesia

Report

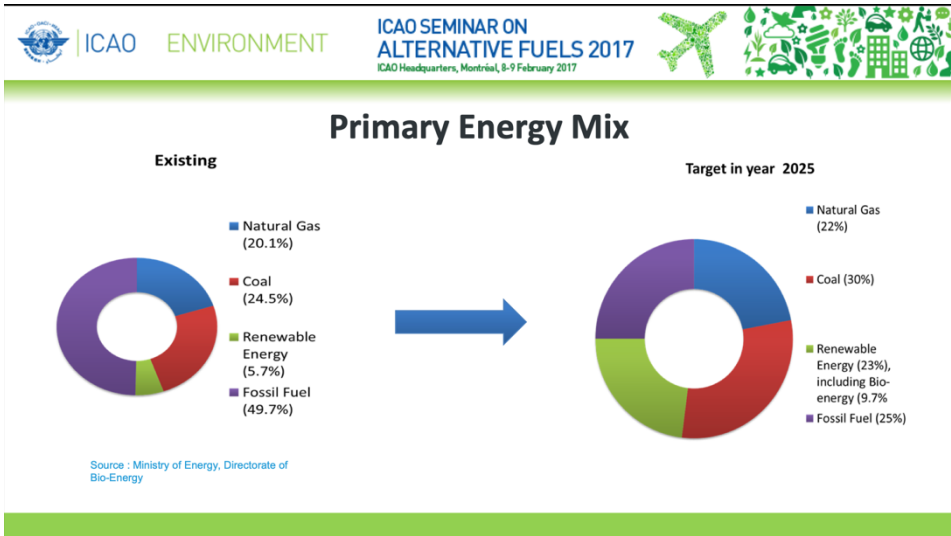
Where does Indonesia stand in general when we put it in the global context? With Indonesia's current population growth, the country will be the 4th largest economy worldwide by 2050. Taking a look at Indonesia's export volume of 190 billion USD, one can see a truly diversified economy. However, the two biggest portions are coal briquettes and palm oil (source: OEC). Out of all vegetable oils, Palm oil is the highest-yielding vegetable oil crop, making it the most preferred one. In terms of agriculture, palm oil is the most important industry of Indonesia contributing 2.5% of the nation's gross domestic product (GDP) (OECD).



According to Indonesian Palm Oil Association (Gapki), about 50 million Indonesians depend in their everyday lives on palm oil and its derivatives, be it directly or indirectly, through multiplier effects the sector has created. Indonesia is the largest producer of palm oil, followed by Malaysia - both countries account for 84% of the world's palm production (OECD). This position as the global market leader makes Palm Oil Sustainability an extremely interesting topic and Indonesia a prime candidate for case studies. Given its importance for the country's development, this report is going to identify the weaknesses of the sector that prevents sustainability from flourishing in the industry. This will be followed by a SPOTT analysis which determines whether

companies see sustainability as a necessity and in what parts of the companies supply chains are being unsustainable and give room for improvement. Considering the size of the sector, once sustainable practices can be implemented, the country would take a significant step towards its national policy plan, which includes the SDGs.

First signs that the state sees a need to transform towards sustainability is the National Energy Policy (Government Regulation No. 79/2014) which was introduced in 2014 (Policy Ministry of Finance Indonesia, 2020). It focuses on re-establishing Indonesia’s energy independence by re-directing energy resources from export to the domestic market (Reuters, 2019). This translates into minimizing fossil fuel consumption and increasing the exploitation and consumption of renewables. An important initiative is the development of Biofuel, which is a fuel blend with a 30% bio-content of palm oil. This makes Indonesia the first country in the world, to introduce B30 to the market. As a result, the demand of palm oil increased (ICAO, 2017).



The arising conflict here is: if you expand palm oil, it requires land – this becomes difficult because of the moratorium, introduced by Jokowi, which prohibits the issuing of new land for plantations. Farmers and producers are therefore forced to produce palm oil more efficiently. Another example of the necessity to change shows the dispute of the Palm oil acceptance in Europe coming from Indonesia. Europe is one of Indonesia's main trading partner. After several Asian

countries, Europe is the second largest importer of Indonesian palm oil. In 2018, The European Parliament voted to ban the use of palm oil for the production of biofuels in the European Union (EU) by 2020, with the proclaimed aim to stop the deforestation of rainforests in mainly Indonesia and Malaysia. The EU reacted by banning imported biofuels. To counteract this, the Indonesian government imposed tariffs on products imported from Europe. This dispute could escalate into a trade war and place a far greater burden on the Indonesian economy. So far, this dispute is not really leading to a solution. If Indonesian producers want to remain their relation with its European customers, they should focus on extracting their resources in a more sustainable way and work towards having their palm oil certified as sustainable. Those and other factors which we will see throughout this report, will show, why the palm oil sector is so interesting but also important to analyze and rightfully implement the concept of sustainability within this industry.

1. The Palm oil sector

1.1. Political link – Where is the connection between the industry and the countries politics?

With a share of almost 65% of exports, about 25% of Indonesia's GDP and about 30% of the total government budget revenues, the extractive industry is one of Indonesia's most important industrial sectors (World Bank, 2014). The government earns most through tax income from companies claiming land. Given its relative high contribution to the national budget, politicians are tied to the interests of companies in this industry. Especially during election campaigns, this issue becomes an important topic. Nominations for elections are usually tied to money.

Candidates must secure the support of political parties that represent one-fifth of the seats in the local parliament. These parties demand high fees for their support. To escape the system, it is possible to run for office independently, but most candidates do not receive the required minimum signatures of voters before the deadline (The Guardian, 2019). This means: no money, no vote. So, politicians are usually supported by companies, or they themselves come from the private sector. In return for their financial support, corporate donors usually demand

government contracts, political influence or business licenses to extract more resources or acquire more land. The main problem becomes clear: politicians are addressing their own interests, which are in favor of the palm oil industry. One example on how corrupt elections fuel the sell-off of Indonesia's land resources is given by Rita Widyasari. She is a district chief from East Kalimantan province and was accused by the KPK of soliciting a 6 billion rupiah bribe for issuing a plantation license. Her mother is the largest shareholder in a company that has operated more than dozen coal mines in the district overseen by her daughter. Those bribes usually take place in the form of shell companies (Mongabay, 2017).

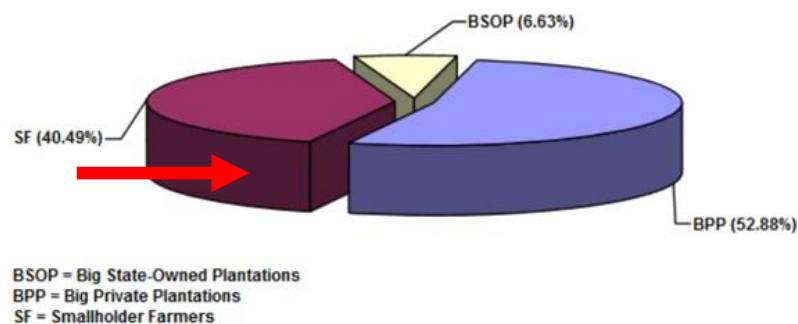
With the establishment of the KPK, much has already been done to combat corruption in politics. However, private sector interest in policy-making remains high due to the high presence of private sector politicians. Hence the system may be difficult to change and the shift towards sustainable palm oil may be impeded through political governance, that's why a push must come from the industry as well. Incentives by their customers like the European demand is therefore an useful tool to generate a rethinking of oil producers.

1.2. Market share distribution

It is important to have a general overview of the industry itself in order to solve following questions of who are the main actors, and who dominates the industry, who is the responsible one to address in order to achieve a transformation towards sustainable palm oil? Data from the Environmental and Forestry Ministry reports almost 15 million hectares of palm oil plantations in Indonesia in 2019. But who owns those plantations and who is responsible for the deforestation? The figure below displays the distributional share of palm oil plantations. It becomes clear, that the biggest share of Palm oil plantations are owned by the private sector. And only a minor part is actually state-owned. This implies, that even if the government would want to change the industry towards the better, it would need to do so in a in a non-direct way, through policy implementations in the private sector. However, as seen before, companies usually look for loop wholes in those policies and will continue their "business-as-usual" as long as possible. And as long as they are successful in avoiding those policies, they will not have any

incentive to deviate from their business-as-usual behavior. It therefore is importance to create those incentives for the private sector to change their behavior. The other part of the palm oil plantations is cultivated by more than 4 million smallholder farmers, employing more than 7 million laborers throughout its supply chain (Daemeter, 2015). The relationship between those main actors is that even though smallholder farmers own a major part of the plantations as well, they still do not have the knowledge and capacity to actually capitalize the palm oil themselves. They usually function as suppliers for bigger corporations. So even if the figure below gives the impression one should target the big corporations for reaching the aim of implementing sustainable practices in the industry, one should also take into account the smallholder farmers which mainly supply the big corporations.

Who Own the Palm Oil Plantations in Indonesia?



2. SPOTT Toolkit analysis

One way to pursue sustainable practices is with the SPOTT toolkit, that has been specially developed for tracking (un)sustainable practices of companies in the extractive industries. For the palm oil sector, 99 palm oil producers, processors and traders have been assessed in terms of public disclosure of their policies, operations and commitments to environmental, social and governance (ESG) best practices. Out of those 99 palm oil producers, 22 are headquartered in Indonesia. This assessment reveals public availability of a company's information which then should incentivize the implementation of good corporate practice for companies depending on

their ranking. Given this toolkit, one can analyze the companies' practices throughout their supply chain, coming to the following results:

Most companies have established clear sustainability policies, which apply to all their operations. However, only a small proportion of them address their policy to all suppliers, and these policies are usually limited to the company's operations only.

As for traceability on land banks and mapping, only 25% of raw materials can be 100% traced back to the original factory, while many companies (~70%) do not provide traceability figures. Some companies have a clear commitment to zero deforestation, and some extend their commitments to all their suppliers, but only a small proportion provide evidence to monitor deforestation.

In terms of peat, fires and GHG emissions, most companies reaffirm their commitment not to plant peat (~50%) and not to burn it (60%). However, the extension to their suppliers is somewhat less. And there is almost no real evidence of monitoring, which allows for illegal burning, canal building, and other degradational practices. Here is the thing, as is know the SHF supply a significant part of the sector. However, the companies that are assessed at SPOTT have been selected mostly according to the scope and scale of operations, namely those who are revenue-generated and land owned. These include the few SHF.

When it comes to the cultivation of palm oil plantations and the use of chemicals, only 35% of companies have committed to minimize the use of chemicals, including both pesticides and chemical fertilizers, and only 10% of those companies extend the commitment to minimize the use of chemicals to all their suppliers. These policies however are limited to the assessed companies itself which do not produce palm oil themselves but rather process the palm oil. Moreover, there are limited commitments and policies in place for their suppliers, implying limited traceability of the palm oil. However, without knowing where all the palm oil they source is coming from, companies cannot prove that it is being produced in compliance with their sustainability requirements, leaving their rank over all low (Asta group ranked 47th).

Astra Agro Lestari Tbk PT



Palm oil assessment

Total score: 36.6%

Quick facts:

Latest update: October 2019 | Next scheduled: October 2020

Established	1988
Parent company	Astra International
Landbank (oil palm)	291,000 ha
RSPO member?	No

> Sustainability policy and leadership	7 / 11	63.6%
> Landbank, maps and traceability	7.5 / 28	26.8%
> Deforestation and biodiversity	9 / 18	50%
> HCV, HCS and impact assessments	4.5 / 14	32.1%
> Peat, fire and GHG emissions	11.25 / 20	56.3%
> Water, chemical and pest management	4 / 22	18.2%
> Community, land and labour rights	19 / 46	41.3%
> Certification standards	0.75 / 15	5%
> Smallholders and suppliers	6.5 / 16	40.6%
> Governance and grievances	3 / 8	37.5%

Organisation:	14 / 40	35%
Policy:	36.5 / 79	46.2%
Practice:	22 / 79	27.8%
Self-reported:	21.3 / 79	26.9%
External:	0.8 / 79	0.9%
Certified:	0 / 79	0%

Other companies however try to excel in the rank, such as the Asian Agri Group, which is ranked 16th among all 99 assessed palm oil producers. Out of all Indonesian companies, which have been assessed, most of them show weaknesses in two categories: Water, chemical and pest management, as well as, Smallholder and suppliers. By going through the assessment in detail, it doesn't matter if higher up or lower down ranked, the companies have in common that they do not manage to provide and implement adequate policies in order to improve their assessment in those two categories.

Company Name	1	2	3	4	5	6	7	8	9	10	Overall Rank
Asian Agri Group	89%	65%	60%	90%	76%	47%	78%	69%	65%	67%	16
Eagle High Plantations Tbk PT	77%	63%	36%	38%	43%	35%	48%	37%	44%	44%	39
Sampoerna Agro Tbk PT	68%	50%	42%	46%	48%	28%	44%	57%	28%	47%	40
Dharma Satya Nusantara Tbk	27%	44%	41%	43%	25%	21%	38%	70%	35%	28%	46
Tunas Baru Lampung Tbk PT	18%	20%	25%	14%	21%	23%	31%	25%	13%	44%	59
GAMA Plantations	50%	13%	42%	29%	36%	7%	19%	0%	3%	0%	65
Royal Industries Indonesia PT	0%	0%	0%	0%	3%	0%	2%	0%	0%	6%	88
Siva Group	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	91

1	Sustainability policy and leadership
2	Landbank, maps, and traceability
3	Deforestation and biodiversity
4	HCV, HCS, and impact assessments
5	Peat, fire, and GHG emissions
6	Water, chemical and pest management
7	Community, land and labour rights
8	Certification standards
9	SHF and suppliers
10	Governance and grievance

Overall, the palm oil sector made stronger improvements in their commitments towards labor rights, when comparing assessments from 2017 and 2019. Almost half of all companies committed to the UN Declaration on Human rights and to respect all workers' rights. The overall extension of their commitment to all their supplier is relatively higher than in other criteria. Nevertheless, the social dimension in terms of Smallholder farmers and suppliers in general provides greatest room for improvement averaging only 23.7% among all companies. Only 40% of all companies actually commit to support smallholders but only six companies report time-bound action plans for all suppliers to be in compliance with their palm oil sourcing.

Half of the assessed companies report to have a whistleblowing procedure as well as a complaints system to open to all stakeholder. Every second company also commits to ethical conduct and prohibition of corruption, however, only every 4th company extended their commitment to their suppliers. The overall score can be broken down. Most of the public available information is self-reported. Some criteria are reported externally, i.e. through media coverage. Only a minor share is actually being certified, leaving all companies with a room for improvement and increasing their transparency.

In order to transform palm oil industry towards sustainable model supply chains require greater transparency, supported by responsible investment to encourage best practice. The overall average score is quite low, implying room for improvement. There is a need for bring the 'laggards' up to the standard of the 'leaders' and bring the whole sector to a higher level of transparency and sustainability.

One example of the relationships and dependence between MNEs and SHF shows the Asian Agri Group, which manages a total oil palm plantation area of 100,000 hectares. They partner with plasma SHF which are responsible for 60,000 hectares and independent SHF which are responsible for the other 41,000 hectares. So, smallholder farmers contribute to half of Asian Agri's total palm oil production. By analyzing the SHF business models, it is possible to see the link between MNEs and SHF and how they depend and interact among each others.

3. Smallholder farmer (SHF) Business models in the POS

Relation between SHF and MNEs is as following: those SHF who have the resources and the means to undertake the investments required are the first to participate in certification schemes but that the link between private standards and smallholder market participation also hinges on the preferences of retailers, manufacturers and importers as well as on the institutional context and support from national institutions. It is more burdensome for companies to source from many different smallholders rather than from a limited number of larger suppliers, in particular because of higher transaction costs, for instance due to monitoring compliance or the need to financially support the certification of smallholders.

In the following the smallholder farmers business models are explained and show how MNEs play a role in the palm oil production:

1. Independent Farmers

In order to qualify as a 'smallholder farmer' in Indonesia, farmer plantations must be less than 25 hectares (Ministry of Agriculture Decree No. 98/2013). Those kind of farmers, are considered independent, meaning they can sell their harvest to whomever they choose. However, in reality, they commonly sell to one agent in order to ensure buyer security of the harvest before yield loss and receive a viable return on their investment. Most of the SHF don't have the knowledge and skill to supply the market themselves or sometimes they are too small to do so.

If a SHF is large enough, they actually can be linked to the supply chain via local traders of mills. Those SHF tend to be local middle-class actors, they are relatively self-reliant and produce sufficient FFB per harvest to sell directly to a local trader or mill. Some indications imply they are a growing driver of deforestation and use fire to prepare land. Those business models are considered, usually when talking about SHF

While some farmers technically have a choice of where to sell their fresh fruit bunches (FFB) and freedom to manage their own plots independently, in reality, farmers are strongly affiliated with a limited number of company mills (generally 1-2 companies). This is owing to a combination of logistics and the need to sell FFB within a short time horizon post-harvest.

2. Koperasi

A group of farmers pools together to trade with mid-stream mills. Farmer groups can still manage a series of individual plots and work cooperatively only to trade or meet certification requirements. They will generally be free to trade with whomever; however, owing to logistics they will commonly only trade with 1-2 mills within the vicinity of their plantations.

The other few business models are more related to the private sector of owned plantations. Here the link between the MNEs and the SHF will be clear:

3. Company plasma schemes

The company forms an arrangement with several individual farmers. The company typically holds the farmer land title in return for initial investment loans to development oil palm plots. formal off-take agreement obliging farmers to sell their FFB to the company. Once plasma farmers fully repay their credit obligations to the company, they can opt to become fully independent. – However, this is rarely the case, and even if a farmer gets independent, they would still stick around the same company they have been supplying, because this is what they know and are used to.

4. Leased community-lands

This is similar to the previous model, but instead of the farmers managing their own plots, the company leases the land from the farmers and manages the plantation on their behalf. In this case landowner are treated as shareholders and providing a dividend for their stake in the plantation. The main problem here is, that communities give up their direct management control of their lands. In reality, the land is not maintained sustainably but the MNEs usually overuse the land and try to get the most out of it. Once the land is not producing enough harvest anymore, the land is given back to the farmers, leaving them with a depreciated asset and no steady income anymore.

Similar models are applicable for the State-owned plantations that are actually harvested by SHF

4. Certification process and its difficulties faced by SHF

The market share distribution as well as the following aspects make it clear, why including SHF into the certification scheme is essential – Smallholders (SH) account for 85% of farmers worldwide. In Indonesia, the SH are an essential element of the palm oil sector. They account for around 40% of cultivation area and 35% of production output. In the value chain of palm oil, SHF are on the bottom, meaning, including them in the certification systems for sustainable palm oil helps triggering to achieve more environmental sustainability in the downstream value chain. Certification can lead smallholders to improve their agronomic practices, thereby reducing small-scale negative environmental impacts, for example through the correct application of agrochemicals. It also holds the potential for economic benefits for smallholders, for instance through increased yields, quality of harvest and the knowhow flow which comes with it. As mentioned before, there are two types of SHF, namely scheme SH, who are contracted to a plantation company, and independent SH, who operate independently through all phases of production. Both types of SHF face slightly different degrees of challenges, when it comes to certifying their palm oil. On the smallholder level, independent ones often lack the knowledge to apply good agricultural practices, which represent a key challenge for certification. This limited knowledge, can reduce their yields and can be a compliance challenge and thus a barrier to certification. Additionally, many lack essential information about the certification process itself, and many did not even heard of the RSPO before. For scheme SH the challenges seem to be better coped with certification challenges, because they receive knowledge transfer and technical and organizational assistance from the affiliated companies. However, not all farmers affiliate with a company because they want to be their own boss and would not give up their land so easily, also because they can produce as they wish and fully can rely on their traditional knowledge instead of making compromises and eventually being exploited by their partners. Nonetheless, there is a knowledge gap which is partly attributed to a lack of training in the past. Independent smallholders usually do not receive any kind of training or extension services – they

mostly rely on their traditional knowledge. Also, meeting the certification requirements often causes additional costs, e.g. because SH needs more expensive inputs, such as high quality seedlings or additional equipment. Typically, the cost of certification exceeds the financial capital of small farmers. In particular, independent smallholders may not have access to longer-term credit because they lack a bank account or land ownership rights. The high kick-off costs, which usually include administrative fees for activities such as fresh fruit bundling, marketing, input procurement, etc., further complicate this process.

Lack of organisation is another obstacle to the independent certification of small farmers. A huge requirement of the RSPO is that farmers must come from groups. However, there is a lack of larger groups, which is a particularly critical obstacle to smallholder certification, as small groups lack human and financial capacity, which limits the portfolio of activities they can undertake. Larger groups offer better opportunities to develop economies of scale. In general, therefore, knowledge and finance appear to be the main obstacles that independent SHFs face in the certification process. However, if the SHF were to attempt to adopt RSPO standards, it would be extremely difficult to meet the following requirements.

1. Ownership rights

As a 'major must' for achieving certification, independent small- holders have to be able to demonstrate legal ownership of their land or their land-use rights.

2. Low- quality planting material

The use of inferior planting material is contrary to the State Seed Ordinance and significantly reduces yields. The problem is that there are no nearby distribution points for such certified planting material, or that farmers, in response to the price of such material, can look for alternative and non-certified sources, for example their own field crops. Most farmers obtain their seeds from vendors, neighbours and friends or informal nurseries which means that their origin and quality is unknown. Therefore, the price of the high-quality seed and planting material may be too high, but it may also not be available in rural areas.

3. Pesticides

According to RSPO, agrochemicals should not be used in a way that endangers health or the environment. Smallholder practices with respect to pesticide storage, application and empty container disposal often do not adequately consider the health and environmental risks: after emptying the containers, many of them simply dumped them on the plot. Others stated that they washed and resold the containers, while a few respondents indicated that they threw the empty containers into the river.

4. Documentation

RSPO requires smallholders to document certain activities related to their palm oil plot, for instance fertilizer application, pesticide use and yield. As the SPOTT traceability will show, that SHF do not document their farming activities, making it difficult to trace it.

- ➔ Informal ways on receiving seeds makes it impossible to define its origin.
- ➔ Documentation of palm oil impossible to track its origin

5. Conclusion

Various aspects must be taken into account when analysing and monitoring sustainability in the palm oil sector. There is a need to press for good governance at national level, to implement appropriate policies legally and to eradicate corruption at national level; the state must set a good example to the private sector. Instruments such as the SPOTT toolkit can help to analyse weaknesses in the palm oil production supply chain. All in all, most companies have formulated a clear policy and included it in their vision and mission statements. However, most companies fail to implement these policies. They fail to carry out monitoring and evaluation activities that would help implement these policies and ensure that the desired results are achieved. So they have policies to commit to zero deforestation, but most of their policies are not extended to all their suppliers and their value chain, but are limited to their own operations. But a manufacturer who produces biscuits, margarine or anything else is not directly involved in the deforestation

process. Many companies have also made progress in publishing sustainability reports, but what does sustainability mean in their context? Many sustainable practices have been kept very vague in their formulation, so it is difficult to say how sustainable they really are. (e.g. Unilever).

Most of the policies of these multinationals are also limited to their own operations. This means that they do not take their suppliers into account in their sustainable policies, so that although the companies operate sustainably, their suppliers are left out. Ultimately, the palm oil comes from their suppliers, and they should guarantee that this palm oil is produced in a sustainable way. Certifications such as the RSPO should also be improved, which would make their actions more transparent. The SHF business models help to understand why these weaknesses exist, usually because the larger companies have more power of the SHF, which are mainly dependent on these co-operations.