Alternative approaches to achieve a living income:
A roadmap for flexible premiums

Bonn, 25 April 2017

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Publisher:
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German Press Law (V.i.S.d.P.): Martina Schaub

Cover Photo: Nestlé / Flickr.com

Many valuable comments and proofreading: Antonie Fountain (VOICE)

I want to thank Evelyn Bahn, Johannes Schorling, Arjen Boekhold, Femke Lotgerink and Sven Bergau for their comments and shared experiences.

Content

Introduction

SÜDWIND is conducting a research on alternative business models for the cocoa value chain. The preliminary results concerning inclusive business models, insurance systems, contract farming and flexible premiums will be presented at a workshop organised in cooperation with INKOTA on 16 May 2017 in Bonn.

Due to the present crisis in the cocoa sector conclusions based on these preliminary results were already summarised in the "Cocoa Barometer Consultation Paper: Raising Farm Gate Prices. Approaches to Ensure a Living Income for Smallholder Cocoa Farmers".[1] This paper describes questions concerning interventions to increase the farm gate price for cocoa by setting minimum prices, policy interventions, flexible premiums et cetera.

This new paper published by SÜDWIND explains in more details how a Flexible Premium model could work. It provides chocolate and cocoa companies a concrete option to take their responsibility to protect the first producers in their supply chain from unwanted price volatility; to ensure the farmers receive a sufficient income; and to ensure the companies are compliant to their requirements of due diligence within the framework of the United Nations Guiding Principles on Business and Human Rights (UNGPs).

Cocoa farmers in a permanent crisis

The cocoa sector is in a crisis. High volatility and inflation-adjusted decreasing prices over the last decades have reduced the attractiveness of cocoa production for farmers. Most of the farmers live below the poverty line. The debate on how to calculate a living income is still ongoing, not only for cocoa but also for other agricultural and industrial sectors. It is a challenge for the cocoa industry to come to results as soon as possible.

According to the United Nations Guiding Principles on Business and Human Rights (UNGPs), companies are responsible for human rights violations within their value chains. The introduction of a living income is a precondition for farmers to be able to avoid human rights abuses on their farms, as well as to ensure that their own human rights are not violated. Without a living income many of the problems within the sector cannot be solved.

Many stakeholders in the cocoa value chain have known this for years. They also know that additional to an increase of productivity per hectare and diversification of production, farmers need a decent price for their cocoa to support a living income. All participants of the value chain are aware that ageing farmers have to invest in ageing plantations to secure a sufficient supply for the future.

The ongoing harvesting season 2016/17 illustrates a high-risk for farmers. Many projects run by companies, NGOs, donor organisations and governments have invested in the cocoa sector. Within months from the beginning of the harvesting season on 1 October 2016, cocoa prices declined by roughly 30%. The stakeholders of the sector know that this price decline has a much higher impact on the income of farming families then all their combined investments.

The minimum price systems in Ivory Coast and Ghana have delayed the impact of the price decline to farmers. But there are rumours that many traders already were paying a lower farmgate price during the last months, at least in the Ivory Coast. On April 1st, the cocoa regulation body of the Ivory Coast had to reduce the farmgate price from 1100 CFA to 700 CFA for the mid-crop. There are doubts that the CCC will be able to increase the farmgate price at the beginning of the next season from this bottom line of 700 CFA. The Cocobod in Ghana is still struggling to avoid a reduction of the real farmgate price. The institution might be able to keep the

[1] See: http://www.cocoabarometer.org/Download_files/Raising%20Farm%20Gate%20Prices%20Cocoa%20Barometer%20Consultation%20Paper%20170419.pdf

nominal farmgate price stable for the next season but for farmers there will be a reduced real price due to the high inflation rate.

In all countries with a non-regulated market the farmgate price for cocoa has already declined with the world market price.

Comparable to company owners, farmers will only invest in new production capacity if there is at least a high probability that the investment pays off, especially for crops such as cocoa, that need years to reward investments. Therefore, the stabilisation of regionally adapted cocoas price on a certain level could have a major impact on livelihoods of farming families and future cocoa production.

Some employees of the big cocoa and chocolate companies are well aware of these problems. They know that to improve the living conditions on the cocoa plantations in West Africa the level of farmgate prices has to be predictable and needs to be significantly higher than it is presently.

Presently, there is no mechanism for companies to do what is necessary: pay a price that guarantees a living income.

Fixed premiums

Premium systems have been established widely in the cocoa sector by standard setting organisations. Fairtrade has a fixed premium of 200 US-Dollar per ton conventional cocoa; farmers and their organisations that are certified by UTZ or Rainforest Alliance/SAN have to negotiate the amount of the premiums with their buyers. Over the past years, premiums have had a very limited effect on the income of farmers. The decline of the world market price within the last months has not been accompanied by increasing premiums. Thus the premium has not been able to buffer the steep decrease of the cocoa price, let alone ensure a living income. The same is true for fixed premiums paid by companies in their own cocoa sustainability programmes.

Flexible premiums

Flexible premiums can be negotiated directly as a private sector agreement between farmers or their organisations and cocoa buying companies. These negotiations could take place on a regional level, avoiding an unworkable global one-size-fits-all level. Additionally, as the negotiations happen between a single company and a farmer/farmer organisation, there is no conflict with competition laws.

Shared risks

Within a flexible premium system, the risk of price volatility can be shared between farmers and companies. The amount of risk that is shared can also be adjusted where necessary. The cocoa buying company and a cooperative agree on an upper limit. If the farmgate price exceeds this level, the company pays no premium. If the price falls below that level, the amount of the premium is increased step-by-step. The more the price decreases, the higher the premium rises, until a minimum farmgate price level is reached. When the minimum farmgate price, which can be fixed at a level to guarantee a living income, is reached, the increase premium becomes equal the decrease in farmgate price.

In short: the crucial parameters for the level of the premiums would be

- the upper limit, beyond which no premium is paid;
- the percentage of a price decrease, which is covered by the company;
- a minimum price level, which can be fixed to guarantee a living income.

Below there are two examples of how should a model could work. Model 1 with an upper limit of 2,500 US-Dollar, a 50% shared risk, and no minimum price. Model 2 with an upper limit of 3,000 US-Dollar, a 50% shared risk, and a minimum price of 2,500 US-Dollar.

Flexible premium model, data in US-Dollar						
Model 1				Model 2		
World market price	Premium	Farmgate price		World market price	Premium	Farmgate price
2,500	0	2,500		3,000	0	3,000
2,400	50	2,450		2,900	50	2,950
2,300	100	2,400		2,800	100	2,900
2,200	150	2,350		2,700	150	2,850
2,100	200	2,300		2,600	200	2,800
2,000	250	2,250		2,500	250	2,750
1,900	300	2,200		2,400	300	2,700
1,800	350	2,150		2,300	350	2,650
1,700	400	2,100		2,200	400	2,600
1,600	450	2,050		2,100	450	2,550
1,500	500	2,000		2,000	500	2,500
1,400	550	1,950		1,900	600	2,500
1,300	600	1,900		1,800	700	2,500
1,200	650	1,850		1,700	800	2,500
1,100	700	1,800		1,600	900	2,500
1,000	750	1,750		1,500	1000	2,500

Model 3 shows, that the fixed minimum price in the two most important cocoa countries, Ivory Coast and Ghana, could facilitate the implementation of flexible premiums. In both countries the minimum price is usually fixed at the beginning of the harvesting season. This minimum price can serve as a stable baseline for the calculation of the premium. Using the farmgate price paid at the beginning of last harvesting season the model shows that companies can decide on the amount of the premium and they have a direct impact on the farmgate price. Depending on to the calculation of a living income they can decide what they want to add to the fixed minimum price.

If the company would for example fix the farm gate price on 2500 US-Dollar, they can react if the national minimum price (Model 4) changes.

Flexible premium model, data in US-Dollar						
Model 3				Model 4		
National minimum price	Premium	Farmgate price		National minimum price	Premium	Farmgate price
1,900	100	2,000		1,900	600	2,500
1,900	200	2,100		1,900	600	2,500
1,900	300	2,200		1,900	600	2,500
1,900	400	2,300		1,900	600	2,500
1,900	500	2,400		1,900	600	2,500
1,900	600	2,500		1,900	600	2,500
1,900	700	2,600		1,900	600	2,500
1,900	800	2,700		1,900	600	2,500
1,900	900	2,800		1,900	600	2,500
1,900	1,000	2,900		2,100	400	2,500
1,900	1,100	3,000		2,100	400	2,500
1,900	1,200	3,100		2,100	400	2,500

Model 3 (continued)				Model 4 (continued)		
National minimum price	Premium	Farmgate price		National minimum price	Premium	Farmgate price
1,900	1,300	3,200		2,100	400	2,500
1,900	1,400	3,300		2,100	400	2,500
1,900	1,500	3,400		2,100	400	2,500
1,900	1,600	3,500		2,100	400	2,500

Front-runners

Some smaller companies, such as Taza, Ingemann, and Tony's Chocolonely, already work with flexible premiums based on farmgate price developments. Though there is not much information publicly available. Taza and Ingemann work in Latin America and process high quality cocoa to high quality and high-priced chocolate. Tony's Chocolonely works in Ghana and Ivory Coast through the supply chain comparable to this of the big chocolate producers on the world market.

Requirements

Much like in many other models to improve the situation of farmers, a very important requirement to implement flexible premium systems is a transparent and stable value chain. From the perspective of the buying companies it is essential that farmers are organised, and that their organisations, whether as cooperative or another business model, are capable to sign contracts, communicate the impact of these contracts to the members, and guarantee the implementation of the contract. In other agricultural sectors, such as coffee production, farmer organisations already have experiences with contracts which include penalties in case of non-conformity. Without such penalties there is a high risk that companies pay high premiums in times with low prices but will not receive much cocoa in times of high prices due to competitors who offer only a few cents more per kilo to the farmers: Contractual fidelity is essential for the implementation of flexible premium systems.

Therefore, such a system needs transparency within farmer organisations and the capability of the management to convince the members to fulfil all contracts. This is a high entrance bar especially in the cocoa sector in West Africa.

Experiences in other crops show that not only farmers or their organisations sometimes do not fulfil contracts; companies often violate contracts, too. To balance the power asymmetry between on the one hand small-scale farmers and their often weak organisations and on the other hand the large (often multinational) companies, governments should strengthen flexible premium systems by implementing supporting policies. This should include regulations which protect farmers and their organisations against infringements of contract by companies. Additionally, the government should implement policies and regulations to support the farmer organisations.

Reliable strong organisations could form platforms on regional, national or even on international level. By this, they could develop to an important factor not only to foster the implementation of flexible premiums, but also to generally support farmers to balance the power asymmetry in the sector.

Another crucial point for farmer organisations is to diversify their trade even within a flexible premium system. Experiences from other crops with different inclusive business models show that farmers and their organisations have to avoid becoming dependent on one customer. Furthermore, there needs to be transparency within the contracts with the farmer organisations on which level and how prompt premiums have to be adjusted if the world market price changes. If there are too many changes on short notice the premium system might get non-transparent and it could be difficult for the farmers to understand the developments.

Problems for front-runners

The payment of premiums that is significantly higher than the amount paid by companies for certified cocoa or cocoa coming from their own projects can lead to unwanted side effects. Farmers could for example buy cocoa at the market price from other farmers and sell them as own cocoa to profit from the premium. Therefore, once again, significant transparency is needed. Buyers of the cocoa could for example support cooperatives to measure the exact size of the fields of the members. Based on the field size and the average productivity, the potential amount of the harvested cocoa per farmer can be calculated. If a cooperative for example produced an average 1,000 tonnes of cocoa during the last years the contract on flexible premiums could be limited to these 1,000 tonnes to avoid the smuggling of cocoa from non-member farmers into the value chain. As mentioned in the previous chapter, the competence of a cooperative to be transparent and communicate with their members will be an important factor.

Further problems could result from the social implications of paying extra premiums. If farmers for one community get a significantly higher premium than farmers and neighbouring communities this could lead to social tensions. This problem can be reduced if flexible premiums are implemented on a broad range within certain regions.

Chain of custody

A critical factor for the implementation of flexible premiums is the question: who pays the additional costs. The premiums need to be part of the contracts along the value chain. This requires transparency about the farmgate prices which is the benchmark for the calculation of the premium. Similar to the premiums already paid for certified cocoa, premiums could be passed through the value chain. In the end, prices for chocolate and other products made from cocoa will have to increase to cover the costs.

The fixed premiums would lead to a business environment in which companies pay different premiums to different cooperatives which will complicate the trading system. To facilitate such a system governments or regulation bodies which are responsible for the cocoa sector like the CCC in the Ivory Coast and the COCOBOD in Ghana could serve as guarantors. Another possibility would be to involve the FCC in the process is a guarantee of contract. Government controlled institutions or the FCC could for example set up model contracts in which companies and farmer organisations only have to fill in the figures they agreed on.

How is the premium transferred to the farmers?

The passing on of the premium along the value chain might be the easiest way to cover costs; however, it comes with a serious problem. Many actors in the value chain usually add a certain percentage as a profit margin on the turnover. As such, the increase of the cocoa price from the farmer could lead to a significantly higher price for chocolate on the shelf in the supermarket of which the additional premium paid to farmers is only a small part. A solution to this could be that companies who produce chocolate don't include the premium in their usual pricing system. Instead of passing the premium along the value chain, they would transfer the money directly to the farmer organisations. The existing systems of the standard setting organisations and of some company projects could help to learn about how to set up such a system. This would also allow stable and reliable long-term relationships between all participants of the value chain, from the farmers to the chocolate producers. This might sound presently challenging, but some chocolate companies are already working on long-term connections to farmers. As such, it could be part of the way to sustainable cocoa sector many companies are following anyway. Presently, only a part of the farmers is organised. Therefore, it is crucial to support the not yet organised farmers to set up strong organisations.

In the future, the cost for transferring the money to farmers could decrease significantly in the future due to alternative banking systems. Many stakeholders in the cocoa sector, including some of the big companies and standard-setting organisations, have set up a lot of pilots and projects to transfer money via mobile phones. This new technological approach can facilitate a system of flexible premiums.

Knowledge transfer

The pros and cons of such a system should become part of the curricula of all trainings in the cocoa producing regions. These trainings for farmers and employees of cooperatives form the base for the knowledge transfer about the positive and negative sides of flexible premiums. This knowledge would give farmers and their organisations the opportunity to decide if they want to work within the system of flexible premiums. If they decide that they want to work with such a system farmer organisations need support in setting up agreements with companies. Such support could come through trainings, too.

The required transparency could be supported at least in Ivory Coast and Ghana, as both countries already fix a minimum price. In other cocoa producing countries the situation is more complex. On the other hand, many companies and many farmer organisations and single farmers already have experiences with flexible systems, as some cocoa already is traded with differentials depending on the cocoa quality. This is specifically true for cocoa from Central and Latin America and other regions of Fine Flavour Cocoa.

No panacea!

Flexible premiums will not be able to overcome all the problems of farmers in the value chain of chocolate. Many challenges, which farmers face, are not touched by such a system. This includes the access to affordable inputs, organising the unorganised farmers, access to financial services, sufficient extension services, clearly defined land rights, support to diversify production, the setting up of well-functioning farmer organisations, et cetera. Furthermore, governments have to invest into rural infrastructure, education, healthcare and other essential elements to support a living income. Additionally, collaboration on international level is needed to avoid overproduction. Another important role of the government is to guarantee a rule of law which protects farmers and companies and to set up a legal framework for prospering cocoa sector.

Contracts between farmer organisations and companies also face challenges due to the high asymmetry of power. These are similar to issues experienced in inclusive business models like contract farming and outgrower schemes in other crops.

Nevertheless, flexible premiums could be a tool to increase farmgate prices on short notice, which should lead to a living income. This increase could strengthen the position of farmers and give them the breathing space to look for more holistic solutions.