

ESG Viewpoint

March 2016

Kwai San Wong, Analyst, Governance and Sustainable Investment

Slow transformation of the palm oil industry

- > Goal: Advance sustainable palm oil production practices along the entire supply chain
- > Engagement since: 2004
- > Sectors involved: Consumer staples

Key summary

- Palm oil can efficiently help feed the growing global population. However, unsustainable farming practices at palm oil plantations are causing a number of environmental and social impacts.
- A common standard to promote sustainability in the industry has been established but questions remain on its stringency and effectiveness of enforcement.
- Key challenges remain on how various parties including governments, growers, food manufacturers and non-government organisations (NGOs) work together to achieve a common goal.

Background

Palm oil is a common ingredient in many consumer products such as ice-cream, margarine, soap, cooking oil, noodles, biscuits and cosmetics. The high productivity of the palm – nearly six to seven times higher compared to other oilseed crops¹, as measured by the amount of oil produced per hectare – makes it a favourable crop in a world where an increasing global population meets with limited natural resources. In the past decade, palm oil has taken the largest market share in the global edible oil consumption² and about 50% of our daily

products today contain palm oil³. The importance of palm oil in our daily consumption has brought heavy scrutiny and attention to its growing practices, where palm plantations have long been accused of exacerbating climate change, causing biodiversity loss and creating social conflicts and loss of livelihoods.

The social and environmental impacts related to palm plantations

The recent prolonged forest fires in Indonesia have again put the impact of deforestation practices associated with palm and rubber plantations or paper and pulp forestry under the spotlight. Palm oil growers have received a lot of pressure from the public, the media and NGOs to improve their sustainability practices. Here we describe a number of social and environmental impacts of palm oil production:

Deforestation: The land footprint of palm plantations is significant. According to the Roundtable on Sustainable Palm Oil (RSPO), about 3.5 million hectares of forest – an area larger than the size of Switzerland – was lost to palm plantations in Indonesia, Malaysia and Papua New Guinea between 1990 and 2010.

Climate change: The practice of draining and converting peat lands into palm oil plantations has resulted in the loss of the most efficient terrestrial carbon store as peat lands can store

¹ CLSA data as at August 2014

² CLSA data as at August 2014

³ <https://www.rainforest-rescue.org/topics/palm-oil>

more carbon than all terrestrial biomass⁴. The method of 'slash and burn' to clear the lands for cultivation also exacerbates climate change.

Threats to endangered species: Deforestation causes the loss of habitat for some endangered species such as orangutan, Sumatran elephant, Bornean pygmy elephant, Sumatran rhino and Sumatran tiger⁵. Species such as orangutans are critical in the maintenance of the forests as they spread and germinate seeds.

Air pollution: Burning to clear lands for plantations in Indonesia causes air pollution as fires produce smoke and haze. The forest fires in Indonesia in the summer of 2015 produced a smoky haze which engulfed the nearby regions for months. Schools in Singapore and Malaysia were shut and air travel was suspended⁶. Six Indonesian provinces declared a state of emergency. An early estimate by the Indonesian government put its impact at a cost of 475 trillion rupiah (\$34 billion) to the economy.

Human rights concerns: Malaysia has a high number of migrant workers and roughly 25% of them work in mining, fishing, forestry and agriculture⁷. There have been allegations of workers being abused and exploited⁸.

Impact on local communities: Local communities could lose their livelihoods or be forcibly displaced to make way for plantations. Migrant workers are sometimes introduced to the communities which can cause conflicts.

Transforming palm oil production

In 2004, the Roundtable on Sustainable Palm Oil (RSPO) was formed to address the sustainability issues along the palm oil supply chain. The RSPO's mission is to:

1. Advance the production, procurement, finance and use of sustainable palm oil products;
2. Develop, implement, verify, assure and periodically review credible global standards for the entire supply chain of sustainable palm oil;
3. Monitor and evaluate the economic, environmental and social impacts of the uptake of sustainable palm oil in the market and;
4. Engage and connect all stakeholders throughout the supply chain, including governments and consumers⁹.

The RSPO has created the Certified Sustainable Palm Oil (CSPO) scheme where companies have to meet certain standards in order for the palm oil they produce to be certified. Buyers of certified palm oil are assured that growers have met eight principles – in essence the minimal sustainability requirements – defined under the scheme.

Ten years on, the RSPO has undoubtedly improved sustainability in the palm oil industry and has achieved tangible progress. In its 2015 annual review, the RSPO-certified area has grown from about 125,000 hectares (ha) in 2008 to about 3 million ha¹⁰ in 2015. A 2012 report¹¹ by the World Wildlife Fund (WWF) cited a number of benefits such as improved community relations, lower staff turnover, reduced accident rate and increase in productivity of smallholders. Uptake of the CSPO was approximately 50% in 2015 so there is no issue with the supply of sustainable palm oil.

However, like other certification systems, whether the CSPO scheme achieves its intended mission largely depends on the ambitions of the scheme, the strength of its sustainability criteria, and the ongoing monitoring and review of progress and results. In June 2015, a number of US companies and global investors wrote¹² to RSPO raising their concerns that the current CSPO standards do not address some critical issues such as protection of High Carbon Stock forests and peat lands. The RSPO does not have a strong record of enforcement and there were incidents where the auditors provided fraudulent assessments to cover up the violations of the RSPO standards.

In response to criticisms raised by various stakeholders about the existing weak standards, the RSPO launched an enhanced set of voluntary standards called RSPO NEXT. Some criteria have been strengthened including banning plantations on peat land and requiring companies to have procedures in place to prevent fire on land that they manage.

While we acknowledge the weaknesses of the RSPO standards, we believe that asking companies to join the RSPO and engaging the RSPO to improve their standards is a pragmatic approach to improving sustainability along the palm oil supply chain. In addition, we believe traceability is a vital component to improve sustainability in the palm oil industry so that palm oil buyers, traders and producers are able to trace their sources of palm oil to specific plantations. Full traceability requires all supplies of fresh fruit bunches – both grown by the supplying company and by its third parties – to be RSPO-certified. Having

⁴ "Environmental and social impacts of oil palm cultivation on tropical peat", RSPO, Nov 2013

⁵ <http://www.worldwildlife.org/stories/endangered-species-threatened-by-unsustainable-palm-oil-production>

⁶ <http://www.theguardian.com/world/2015/oct/26/indonesias-fires-crime-against-humanity-hundreds-of-thousands-suffer>

⁷ <http://theoilpalm.org/briefing-palm-oil-and-labour-rights/>

⁸ <http://www.wsj.com/articles/palm-oil-migrant-workers-tell-of-abuses-on-malaysian-plantations-1437933321>

⁹ <http://www.rspo.org/about>

¹⁰ First nine months in 2015

¹¹ "Profitability and Sustainability in Palm Oil Production", World Wildlife Fund, Mar 2012

¹² <http://www.ceres.org/files/rsपो-letter>

traceability is important because it will help these parties to monitor and honour their sustainability commitments i.e. no deforestation and no plantations on peat lands.

Apart from strengthening environmental and social criteria, the RSPO should also focus on enhancing traceability along the supply chain, as the current standards only require traceability to the mills.

Lack of available traceability information, ambiguity in and even lack of land rights by smallholders, and corruption are some examples of obstacles to full traceability. It is worrying that, according to HSBC, only a few companies that have pledged to become 100% CSPO compliant have traceability pledges¹³, and these traceability pledges are not sufficiently ambitious. Traceability is key to ensure proper implementation of sustainability practices at palm oil plantations.

Engagement action

For a number of years, we have been engaging a number of companies in the palm oil supply chain, including **Golden Agri-Resources, Sime Darby Group, IOI Group, Wilmar International, Daewoo International Corporation, Unilever and Procter & Gamble (P&G)**. We have been pushing for better sustainability management.

Examples of our engagement recommendations to growers include:

- Committing to implement the RSPO principles;
- Formulating policies and programmes to protect High Conservation Value and High Carbon Stock forests;
- Developing an effective mechanism to engage with local communities;
- Strengthening and disclosing environmental and social impact assessments and adopting a human rights policy which is on par with international standards;
- Encouraging food producers to source only sustainable palm oil, ideally from segregated supply chains. From our experience, buying companies have not made much progress in demanding segregated palm oil. Without a concerted push by buyers, development of segregated palm oil is not going to take off.

Procter & Gamble case study

Our engagement with P&G on this issue goes back to 2006 when it announced plans to increase its sourcing of palm oil. We spoke with them more recently following its release of palm oil sourcing standards in 2015. As one of the largest palm oil buyers globally, P&G has been relatively late in publishing clear targets in this area. It plans to achieve full traceability of its palm oil supply chain. It aims to ensure that all suppliers adhere to zero deforestation and peat land development by 2020. It has started assessing supplier plans for implementing standards established by the RSPO. We encouraged clearer disclosure on how P&G intends to drive adoption of RSPO standards throughout the supply chain via audit regimes and intervention procedures. Furthermore, we pressed the company to commit to adopting enhanced standards that are currently developed within the RSPO framework, which are designed to address shortfalls in the certification regime for sustainable palm oil. While P&G's 2020 goals appear to be aligned with these updated standards, the company has not yet set this as a public goal.

Trip to Malaysia and Indonesia

In 2015, we went to Malaysia and Indonesia to meet with companies and NGOs to understand the latest challenges and progress in achieving sustainability in the palm oil industry. We met with Sime Darby, the world's biggest CSPO producer since 2010. We visited Sime Darby's plantation field in Carey Island in Malaysia to get a first-hand experience of what a RSPO-certified plantation looks like. It cited that the sustainable plantation practices make the palm oil produced in Carey Island of a higher quality than those produced by ordinary practices.

In our view, Sime Darby is a leading company in the palm oil industry to tackle sustainability issues. The company already has the supply chain capability to deliver segregated CSPO to European buyers, but was disappointed by the lukewarm demand for segregated CSPO in Europe. We are encouraged to see that Sime Darby has invested significantly in sustainable palm oil, but we have not seen a proactive push by the company to encourage buyers to buy segregated palm oil. We believe Sime Darby could further co-operate with European buyers in order to push them to strengthen their commitment to buy fully segregated sustainable palm oil.

In Indonesia we met with the Indonesia Palm Oil Pledge (IPOP) and Golden Agri-Resources (GAR) to discuss the controversies over palm oil plantation due to the air pollution caused by the land clearance fires. We heard from IPOP, an organisation formed in late 2014 to promote sustainability in the palm oil industry in Indonesia and improving traceability along the supply chain.

¹³ "Does sustainability matter?", HSBC, Nov 2013

We also discussed with GAR how it is going to react to the Indonesian government's recent request that major palm oil companies who signed the IPOP should exempt smallholders from the IPOP 'no deforestation commitment' believing that it could jeopardise the country's palm oil industry. This is because IPOP could exclude small-to-medium suppliers who do not have the required sustainability practices. Small scale farmers account for about 40% of palm oil plantations in Indonesia and they often overlook sustainability practices in their plantation. The forest fire in November set off a blame game and it is still unclear who should be responsible.

In addition, we heard that when the government assigns an area for development, companies like GAR should not set aside that area for preservation. This is now not only a sustainability issue but also a political issue and it is unclear how this will progress going forward. We were disappointed that the Indonesian government appears to be asking these companies to go back on their pledge, but we were encouraged that GAR is going to stand by its no deforestation commitment and will not buy palm oil from mills which cannot give full traceability data on their fruit bunches, a key step to ensure no deforestation. The company stated that this is a pure business decision.

Verdict

Sustainability issues along the palm oil supply chain have been gaining traction in recent years, not least because of the scale of environmental problems associated with palm oil production. The haze in South East Asia is becoming an annual phenomenon. Consumer boycotts are gaining traction against products with palm oil and against companies that engage in unsustainable agricultural production. The RSPO has served as a platform to bring different stakeholders together to ensure sustainable palm oil production. However, its standards, monitoring and enforcement need to be strengthened in order for sustainability in the palm oil industry to have meaningful progression.

In general, we expect palm oil growers to set ambitious commitments, to have a strong implementation of the RSPO standards, to develop a group-wide approach towards the protection of High Carbon Stock forests, and to develop effective mechanisms to engage with local communities and multi-stakeholder dialogue to persuade smallholders not to use the practice of 'slash and burn'. For food producers, we expect the companies to source palm oil only from sustainable sources and to have full traceability along its palm oil supply chain. Rather than just buying CSPO, food producers should actively seek information on sources and origins of the CSPO. We expect them to invest in their supply chains, help suppliers to build up the necessary infrastructure to record traceability information, and identify and address obstacles to traceability.

Going forward, we will continue to engage all players along the palm oil supply chain, as the responsibility of sustainability should be borne by everyone. Our future engagement focus will also be on buyers who can have transformational impacts on growers including those from the emerging markets which already comprise over half of the global palm oil consumption.

¹⁴ <http://www.reuters.com/article/indonesia-forests-idUSL4N11L3HZ20151006>