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Use of Risk-based Approaches in Sourcing and Reporting on Sustainable Palm Oil Procurement

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Executive Summary

Recently, more public attentions including governmental organizations go to palm oil sector, emphasizing the importance of palm oil companies to explain how they source their palm oil to make sure not contributing to deforestation, wildlife and peatland destruction and human exploitation. As many as palm oil companies understand this situation, there is no universal guidance on how to make sure companies can manage their risk and report their palm oil procurement. Realizing this situation, this report is trying to support palm oil companies to do more effective work to achieve sustainable palm oil procurement by introducing the "Use of risk-based approaches in sourcing and reporting on sustainable palm oil procurement".

Nature Economy and People Connected (NEPCon) launched NEPCon Sourcing Hub in 2018 to share information, risk data and tools to help companies to source responsibly. The NEPCon Sourcing Hub is a free source of credible, detailed and useful information for responsible sourcing of agro-commodities, to help the companies trading in forest impacts commodities, timber, palm oil, soy and beef understand their supply chains, and use a risk-based approach to reduce the negative social and environmental impacts of those supply chains.

Risk based approaches in sourcing and reporting on sustainable palm oil procurement report is designed to help companies in palm oil sector to do more effective and efficient risk assessment and mitigation in their supply chain. Once risks are identified, companies can mitigate the risks and avoid upcoming problems in their supply chain. Without carefully identifying risk, companies might fail to meet sustainable sourcing compliance in palm oil sector. Through this report, we give companies a guidance to do risk-based approach, including risk mitigation. A guidance on reporting on sustainable palm oil procurement is also provided here.

1 Introduction

To promote best practices in sustainability reporting around palm oil production in Indonesia, this report is developed as an initiative on sustainable palm oil reporting to support palm oil companies in Indonesia to have a good guidance and capacity to do reporting that is eligible internationally. This report is part of a series of three documents developed for palm oil companies to guide risk-based approaches in sourcing and reporting on sustainable palm oil procurement. Other documents are:

1. Strategic Approaches to Sustainability Reporting
2. What to Report and How – Considering Sustainability Metrics

The risk-based approaches and risk mitigation guidance in this report will help companies to better manage their risk and achieve sustainable palm oil procurement in more effective and efficient way. The guidance in this report is designed to be easy to follow by companies that are interested to conduct risk-based approach in their system and produce their palm oil procurement reporting.

Risk-based due diligence refers to the step companies should take to identify and address actual or potential risks in order to prevent or mitigate adverse impacts associated with their activities or sourcing decisions.

The UN Guiding Principles for Business and Human Rights (UNGPs) were endorsed unanimously in 2011¹. They make it clear that companies have a responsibility to make sure their activities do not harm and abuse. In many sectors, risk-based due diligence, as recommended by the UNGPs has emerged as a practical and effective way for companies to meet this responsibility².

This report consists of:

1. a short history of risk based due diligence initiated and developed overtime by international organizations and governmental policies, followed by
2. a trend in risk based approached globally, highlighting the necessity for companies to comply with current regulation for sustainable palm oil sourcing.

This report will also run through the main topic of:

3. risk-based approaches in palm oil sector, as well as giving an example of
4. what NEPCon has been analysing of global palm oil sourcing in NEPCon Sourcing Hub and what does it mean to conduct
5. risk mitigation for companies.

¹ United Nations Human Rights, 2011

² Global Witness, 2015

2 Risk-based due diligence in procurement – a short history

2.1 What is risk based due diligence?

The term due diligence is interpreted as a series of steps taken by a company to minimise the risk of sourcing and procuring oil palm and palm oil products that originate from illegal sources. The fundamental concept of exercising due diligence is to carry out the required actions to minimise the risk of sourcing illegally fresh fruit bunch of oil palm and palm oil products.

2.2 History of risk based due diligence in commodity supply chains

Risk based due diligence in supply chains was started from heavy concerns of human rights abuses, illegal logging, wildlife destruction that companies in several sectors be at risk of contributing to or being associated concerns. The Organisation for Economic Co-operation and Development (OECD) began to set up a risk based due diligence for mining and trade in minerals sector³. The European Commission also set out a strong commitment to combat illegal logging and the associated trade in illegally harvested timber through FLEGT Action Plan that was adopted in May 2003⁴, while the EU Timber Regulation came into force on March 2013⁵. Through “Action Programme on Forest” G8 ministers were also trying to address illegal logging. Moreover, the United States amended its Lacey Act in 2008 to include plants and plant products such as timber and paper⁶. Since 2012, Australia have had laws to combat illegal logging and promote the trade of legal timber products. These laws are set out in the Illegal Logging Prohibition Act 2012 and the Illegal Logging Prohibition Regulation 2012⁷.

To address labour issue, Modern Slavery Act has also been created in the UK⁸ and Australia⁹.

³ OECD, 2013

⁴ European Union, 2004

⁵ EU FLEGT, 2013

⁶ Forest legality Initiative, last reviewed in 2019

⁷ Australian Government Department of Agriculture and Water Resources (date unknown)

⁸ UK Legislation, last reviewed in 2019

⁹ Australian Legislation, 2018

3 Trends in risk-based approaches: Potential future legislative requirements for palm oil

Oil palm grows well in tropical countries with minimum care, and the oil from the palm nut is very versatile, thus provides income for many sectors. In 2018 itself, investors on palm oil has not only been private sectors that directly involve in palm oil supply chain but vary from electronic companies and banks.

Despite bringing efficiency and profit, its production has been an ongoing controversy. Palm oil has been strongly associated as one of the causes for deforestations in tropical countries, that it threatens exotic animals like the orangutans in Southeast Asia or that is associated with land grabs and human rights abuses when it's grown in large plantations. These things led to consumer's concern brought up by several NGOs such as Greenpeace and Rainforest Action Network among others, demanding sustainable palm oil supply chain. Not only as ingredient for consumer products, palm oil efficiency for biofuel has heavily brought controversy and legislation changes in several countries, noting EU decision to reduce palm oil import to come. As a consequence of heavy controversy of palm oil production, banking and other financial sectors that are willing to make investment or to finance palm oil companies have also started to keep an eye of how palm oil is sourced. They start to require due diligence for applying funding.

To make sure palm oil is produced sustainably, efforts are being made by governments, companies and civil society organizations on different fronts and at different levels to enhance the palm oil sector's performance. Commitments to sustainability made by major palm oil companies have been accompanied by a more aggressive sustainability discourse by governments, and many civil society organizations have begun to play a new role as facilitators in the implementation of standards by companies, or as intermediaries between private and public actors.

In Indonesia, the government have made important efforts to respond to the global climate change agenda, resulting in a moratorium on new licenses to develop primary forest or peatlands, which in practice the implementation needs further enforcement. Major corporations have also been trying to comply with Indonesian Sustainable Palm Oil (ISPO), among other ways to prove their commitments towards sustainable sourcing in palm oil.

Recent resolution on Palm Oil by European Parliamentarians put forward a number of policy proposals on Palm Oil imports into Europe. One of them was a 'FLEGT-style' (Forest Law Enforcement, Governance and Trade) regulation for Palm Oil¹⁰. With this legislation adjustment and more attention to ensure sustainability on palm oil supply chain, risk-based approach will be crucial for companies working for this commodity.

¹⁰ European Parliament, 2017 & The Oil Palm, 2017

4 A risk-based approach to palm oil procurement

A risk-based approach is centered on a high level of transparency in supply chains, as well as detailed risk analysis of source areas and supply chains enabling identification of the key risks. Risks may relate to legal, environmental, social or other types of risks that are relevant for the company when sourcing commodities such as palm oil. The main core of implementing risk-based approach by company is to mitigate problems that may come.

The risk-based approach process includes 4 key steps (See Figure 1), which are:

1. quality management
2. manage supply chain
3. risk assessment, and
4. risk mitigation

Robust information is essential to each of these steps:

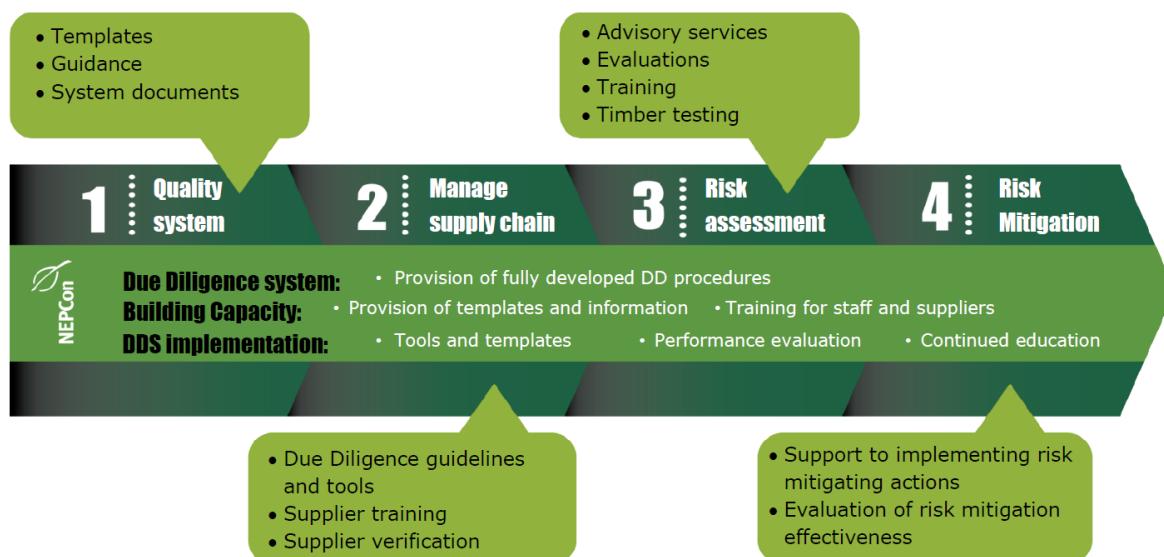
For **step 1 and 2**, a company needs information about the structure of its supply chain, the sources of material, suppliers and trade routes. The company will also need an information management system to keep track of it all.

For **step 3** to identify potential supply chain risks, the company needs to understand the wider context of the country of origin in terms of legal requirements and socio-economic structures. In addition to the context, the company also needs to assess what risks could occur in their supply chain. When the company understand the context and potential risks at a national level, the company needs to determine if the risks are in fact relevant for its specific supply chain.

For **step 4**, a company needs information about what actions to take to effectively avoid or manage risks in a supply chain. This may include knowing which documents are required or which authorities to contact to confirm compliance.

In short, below is step-by-step risk-based due diligence mechanism:

Figure 1: Due Diligence Process



4.1 NEPCon develops and uses ResponsibleSource Programme as risk-based approach

A robust risk management system is necessary where upstream buyers/users of forest impact commodities do not have a 100% certified segregated supply chain. Responsible sourcing of commodities and a due diligence system must start from the beginning of the supply chain, i.e. at the farm/production level. Though risk assessment and mitigation of risk is an important step in responsible sourcing, this should not be the only focus. In addition to providing a clear approach to risk assessment (and access to risk assessment data via the [Sourcing Hub](#) and other sources), the ResponsibleSource Programme contains requirements for other aspects of responsible sourcing and production of commodities. This include requirements for quality assurance systems, policy and commitments, stakeholder engagement, supplier verification as well as farm- level engagement and action – based on risks. The ResponsibleSource Programme enables a systematic analysis of palm oil supply chains, from farm establishment through processing and transport to the end user with respect to CSR issues.

The ResponsibleSource Programme of NEPCon creates a framework within which NEPCon offers to support companies in achieving their sustainability goals through different types of activities, tailored to the needs and objectives of the company itself. A central component of the ResponsibleSource programme is a risk-based approach to sourcing.

The ResponsibleSource verification and certification services is structured as a modular approach – allowing organisations to select which areas of responsible production and sourcing should be included in a certification assessment.

The ResponsibleSource approach, as defined in the ResponsibleSource Standard, is suitable for palm oil supply chains. the standard structure is centered around some key benchmarks for making ethical supply chain commitments, as well as criteria for management of systems, such as:

- Setting commitments
- Defining scope
- Stakeholder engagement
- Responsibilities and competence
- Access to information
- Procedures and systems
- Risk management
- Performance monitoring
- Remediation
- Positive impact
- Reporting and disclosure
- Communications and claims

5 What we know so far: risks associated with palm oil from Indonesia

NEPCon has developed the Sourcing Hub risk assessment on palm oil among other important commodities such as beef, soy and timber. The risk assessments result for palm oil in NEPCon's Sourcing Hub website covers assessment from major producing countries such as Indonesia (Sumatra, Kalimantan, West Papua), Malaysia (Peninsular, Sabah, Sarawak) and Ghana. It is a database that collates all the information that NEPCon has gathered from its certification and risk assessment work over the years from countries producing palm oil. Its risk assessment cover 82% of world-wide palm oil production. NEPCon Sourcing Hub is free, online database that you can check here: <https://www.nepcon.org/sourcinghub/palm-oil>

Below are the steps to access the database:

1. Go to the website and select palm oil;

Once you are in the Sourcing Hub website, you can select palm oil among other commodities there (e.g. beef, soy, timber).

2. Select a country for details;

In this stage, you will see an overview map of countries that produce palm oil. Just select the country you want to find out more. The risk assessments only cover main producing countries; Indonesia, Ghana and Malaysia.

3. Find the risk assessment result and more information;

In the main page, you can see overall score of the risk assessment and more information of the methodology, risk assessment result and risk mitigation when you scroll down.

Risk assessment methodology for palm oil on Sourcing Hub was constructed based on several elements, such as applicable laws and regulations, legal authority, legally required documents or records, sources of information, overview of legal requirements, description of risk, risk conclusion (low or elevated) and control measures and verifiers. Figure 2 below shows more detailed categories used for developing risk assessments.

Figure 2: Palm Oil framework considers social, environmental and legality risk across 7 categories and 19 sub-categories



For more detailed information on how to use Sourcing Hub for risk-based due diligence, please visit this link: <https://www.nepcon.org/library/how-use-nepcon-sourcing-hub-due-diligence-process-presentation>

5.1 Overview of the results of the NEPCon's Sourcing Hub palm oil risk assessments in Indonesia

Based on NEPCon's palm oil risk assessments result for Indonesia, Indonesian palm oil industry is dominated by large-scale private enterprises and smallholders, with government-schemes only playing a modest role. Private enterprises produce roughly half of the palm oil and smallholders produce around 40%.

Major ecological threats from palm oil plantations are deforestation, biodiversity loss, and carbon emissions resulting from land use change and forest fires. The disregard of indigenous rights by the palm oil production sector is also an area of high concern. It is reported that a high number of palm oil farms operate under illegal land tenure and licensing schemes, using forced labour or child labour among other business and legal risks. The biggest underlying threats are corruption and weak enforcement of the law.

The risk assessments in Indonesia comprise four main issues such business issue, social issue, environmental issue and conversion issue in three main producing areas; Sumatra, Kalimantan and West Papua.

Business Issue

In Sumatra, there is a risk of insecure land tenure. Many different claims to the same land can be legal depending on what law, regulation or decree is used for justification. This means the same development on the same location can be both legal and illegal depending on one's legal point of reference. There is also a risk that the land title is not officially registered. Land tenure tensions are most intense in areas where land conversion has been most severe and/or where there has been a legacy of bad practice. Another issue is illegality and corruption in the issuance of relevant plantation licenses. This includes issuance of license in areas not zoned for agriculture, allowing palm oil companies to commence development without proper licensing, and failure to enforce remediation of illegality.

Tax evasion in relation to the payment of royalties and fees, value added taxes and income and profit taxes is also an issue due to the existence of plantations illegally operating without the required HGU license, and thus operations avoid having to pay land and building tax. Furthermore, half the land area in Indonesia is not officially registered and thus production on non-registered land is not currently being taxed. Most companies in Indonesia do not report their income to the Director General of Tax to evade payment of tax. Tax evasion is also done by stating a false amount of income, resulting in payment of a lower amount of tax.

Regarding business issues in Kalimantan, there is a risk that land title is not officially registered and/or removed from indigenous traditional lands illegally or through unjust processes. Approximately 50% of the land area in Indonesia is not officially registered. Furthermore, the local government of Kalimantan has systematically used the legal framework to prioritize private palm oil development over indigenous claims to land and land-conflicts are frequently reported from Kalimantan. That relevant licenses are issued illegally due to corruption. This includes issuance of license in areas not zoned for

agriculture, allowing palm oil companies to commence development without proper licensing, and failure to enforce remediation of illegality. Moreover, tax is being evaded due to corruption. Tax evasion in the palm oil industry is often times due to the existence of illegally operating plantations, which operates without the HGU license and thus operations avoid having to pay land and building tax. It is also linked to transfer pricing, meaning limiting tax liability by shifting profits to lower taxed regions through subsidiaries. Another risk in relation to tax is deliberately wrongful filling of tax forms by large corporations. In addition, general enforcement in tax related issues in Indonesia remains weak while levels of corruption remain high.

Lastly, in West Papua there is a risk of local government of Papua using the legal framework to prioritize large-scale palm oil development over indigenous claims to customary rights. Furthermore, the risk with land tenure relates to the fact that half the land area in Indonesia is not officially registered. Another issue is illegality and corruption in the issuance of relevant plantation licenses. Local governments are actively inviting companies to come to Papua and providing them with permits for plantation development. These permits are reportedly often on customary land, in several cases local villagers have been forcibly removed by the authorities. Moreover, tax evasion due to the existence of illegally operating plantations, which operates without the HGU license and thus operations avoid having to pay land and building tax. Furthermore, half the land area in Indonesia is not officially registered and production on non-registered land is not currently being taxed. Most companies in Indonesia do not report their income to the Director General of Tax to evade payment of tax. Tax evasion is also done by stating a false amount of income, resulting in payment of a lower amount of tax.

Social Issue

In Sumatra, Kalimantan and West Papua, there is a risk that some companies do not register all employees, preventing these workers from getting a social security card and the required medical coverage and insurance. Forced labour, child labour and debt bondage has proved to be a pervasive issue in the Indonesian palm oil sector, ultimately affecting the legal employment of many palm oil workers and company compliance with the ILO Fundamental Conventions. Another issue is Indonesia's health and safety requirements are breached by palm oil producers. The use of safety equipment is not common in Indonesia, and thus in many cases employees do not use safety equipment despite companies providing it. Supervisors and managers are also commonly known not to wear safety equipment; with a reported lack of enforcement or incentives to use it. Additionally, there is a lack of systematic reporting on occupational accidents and diseases by palm oil plantations. Moreover, indigenous and traditional peoples' rights are not upheld. The lack of security for indigenous peoples is a pervasive concern throughout Indonesia and especially in Kalimantan. Under the Law No. 39/2014 on Plantations, companies are effectively prohibited from retaining forest within their plantations and local authorities are prohibited from issuing permits where 'adat' communities have customary rights. Despite this change, continued cases of abuse, corruption, and strife persist against traditional and indigenous communities by both palm oil companies and the government.

Environmental Issue

Regarding environmental issues in Sumatra, Kalimantan and West Papua, there is a risk that palm oil plantations are not complying with the relevant environment regulations and are not obtaining the legally required environmental licenses. There are numerous cases of companies not conducting an Environmental Impact Assessment (AMDAL), which per the law, companies would not then be able to obtain an Environmental License nor a concession license. But in practice these companies are managing palm oil concessions and have obtained a concession license without following the due process. These cases usually involve bribery and/or weak enforcement by the authorized person from the local government; and natural ecosystems along the boundaries of protected areas and high conservation value areas are being cleared to establish palm oil plantations. Sources indicate that several palm oil companies disregard the relevant laws including those connected to locally protected areas (Kawasan Lindung Setempat) and/or palm oil companies operating without land tenure, proper operating licenses etc. Particularly in West Papua, there is also a lack of official publicly available maps and data on palm oil concessions.

Conversion Issue

Regarding conversion issue in Sumatra, Kalimantan and West Papua, there is a risk that natural forests or ecosystems are cleared for the establishment of palm oil plantations. One of the biggest drivers of deforestation in Kalimantan is due to the growth and establishment of oil palm plantations. It is not illegal to convert forest to oil palm in Indonesia; however, the Presidential Instruction No. 8/2015 suspends the granting of new palm oil licenses in primary natural forest and peat lands. In West Papua, peatlands are often the main target of clearing land by burning. The instruction directs several ministries and government agencies to take the necessary steps per their respective authority to implement the instruction; however, the instruction is not legally binding.

Another issue is, fire is being used to clear natural ecosystems/forests for the establishment of palm oil plantations. Particularly, Kalimantan is known as a hotspot for forest fires and there has been recent detection of fires activated within palm oil concession areas as indicated on the Global Forest Watch Fires mapping platform. Many palm oil farmers still consider clearing land by fire a traditional farming practice and this has not been effectively counter acted by existing fire mitigating policies due to a lack of the resources and expertise in many districts and villages.

6 Supporting risk mitigation: Giving your customers what they want and need

Risk Mitigation

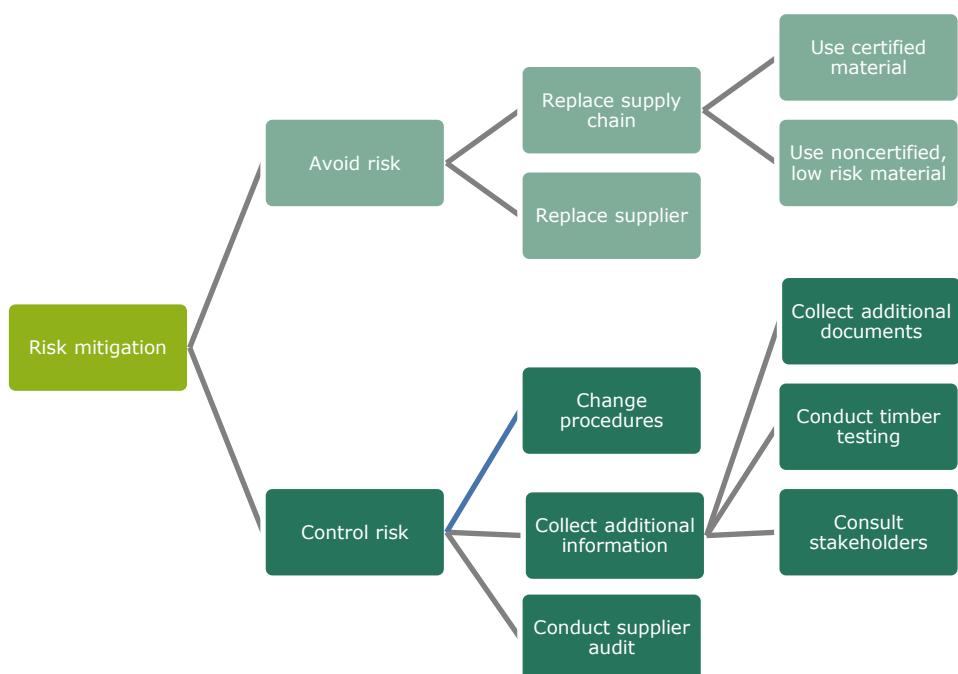
The process of mitigating risks builds on the result of the risk assessment. Any risks that have been identified as not being “specified” (non-negligible) during the risk assessment, shall be mitigated according to the following procedures:

1. Identify risk mitigation actions

Once it has been verified that the underlying non-compliances giving rise to risks do exist in the supply chain, the next step is to identify suitable risk mitigation actions. We seek to identify and select actions that are most effective in addressing the specified risk. The appropriate mitigating measures depend on the type of potential legal non-compliance in question. Some types of non-compliances can be verified by field visits to the harvesting sites (e.g. inspecting the borders of the harvesting unit, workers’ use of personal health and safety equipment, level of soil damage). Others can be verified based on document control (such as custom declarations forms, payment of royalties, work permits etc.). In some cases, a combination of different control measures may be required to ensure proper risk mitigation.

There are two broad groups of mitigation action that may be employed: risk avoidance and risk control (see Figure 3). It is impossible to outline all risk mitigation actions but Figure 3 details the most common actions we utilise as part of our due diligence process.

Figure 3: Risk Mitigation Options



2. Obtain Consent from Suppliers

For suppliers that supply material or products which cannot be confirmed to be low risk, the supplier or sub-supplier shall provide written consent to support the organisation in implementing necessary risk mitigating actions.

3. Plan and Record Risk Mitigation Actions

We record all planned mitigating actions to keep track of risks and their current mitigation status. The plan to mitigate risks shall contain the following minimum requirements:

- a. List of all identified risks for each relevant product.
- b. Action to be taken to mitigate all applicable risks. This shall include a description of the relevant steps that we will take to mitigate the specific risk identified.
- c. Timeline for when the mitigation action shall be completed.
- d. Identification of position(s) responsible for the mitigating actions.
- e. Status of the mitigation (updated on a regular basis).
- f. Additional comments or follow up required.

4. Implement Risk Mitigation Actions

Once we have planned the mitigating actions, we move to manage and oversee their execution. Conducting an audit of organisation within the supply chain may be necessary to mitigate risk. This may require designing and implementing a verification audit programme, which includes auditing suppliers at the forest-level (forest management organisation) or within the supply chain (sawmills, traders, factories).

5. Evaluate the Effectiveness of Risk Mitigating Actions

Once risk mitigation actions have been implemented, we evaluate their effectiveness on a regular basis. It is integral to verify that the mitigation actions that we have implemented have been effective in mitigating the identified risk. Verification is conducted on a regular basis to ensure that the risk does not recur in the future.

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About NEPCon

NEPCon (Nature Economy and People Connected) is an international non-profit organisation that works to build capacity and commitment for mainstreaming sustainability. For almost 25 years, we have worked to foster sustainable land use and responsible trade in forest commodities. We do this through innovation projects, capacity building and sustainability services.

We engage in innovation projects and initiatives that drive and support nature conservation and sustainable land management around the world. These activities range from donor-financed, international projects to capacity building and own-financed non-profit activities.

We have supported the establishment of over 100 protected areas. We make our risk assessments, tools and other information freely available. To date, we have evaluated forest legality in more than 60 countries.



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