Issue Brief
2024 #1

Swiss Platform for Sustainable Cocoa

THE COCOA PRICE – A KEY FACTOR FOR A LIVING INCOME FOR FARMERS

Perspectives and Solutions

April 2024

Key Messages

Farmers' incomes remain low: The historically high global market prices of cocoa fail to translate into higher incomes for cocoa farmers in countries such as Ghana and Ivory Coast who continue to struggle to gain a living income from cocoa farming. This despite government-led attempts to increase the incomes of cocoa farming households via a living income differential adopted since 2020.

Price volatility: Cocoa prices are highly volatile and influenced by many often unpredictable factors and global commodity exchange practices. Limited storage capacity due to financial constraints disproportionately disadvantages attempts by governments to reach favourable prices.

Sustainable procurement practices: Procurement practices such as sustainability premiums, direct sourcing and targeted technical support to farmers based on sustainability considerations and geared towards ensuring a living income for cocoa farming households have, when implemented effectively, great potential to improve the livelihoods of farmers.

Enabling government action: Producer countries can create enabling conditions for a living income by targeted supply management, agricultural output diversification as well as improved farm-gate prices.

The Swiss Platform for Sustainable Cocoa is committed to supporting farmers in attaining a Living Income, as laid out in its Roadmap 2030. This aligns with the United Nations' Sustainable Development Goals (SDGs) numbers 1 ("Zero Poverty") and 2 ("Zero Hunger"). Ensuring that farming families receive a living income (see info box on Living Income on page 2) is vital for sustainable cocoa production, as outlined in the Roadmap's emphasis on environmental and social sustainability.

To achieve this, the Platform advocates for cocoa prices to reflect farmers' efforts to apply sustainable farming practices, including tackling risks of child labour and deforestation.

The price cocoa farmers receive for their harvest is a key determinant of their income. A "favourable" or "fair" price is essential for them to be able to make a decent living from cocoa farming. Currently, an estimated 80% of farming families do not earn a living income, while internationally traded cocoa prices have reached historic highs (see figure 1). This underscores the complexity of cocoa prices, revealing that soaring market prices do not automatically translate into higher incomes for farmers.

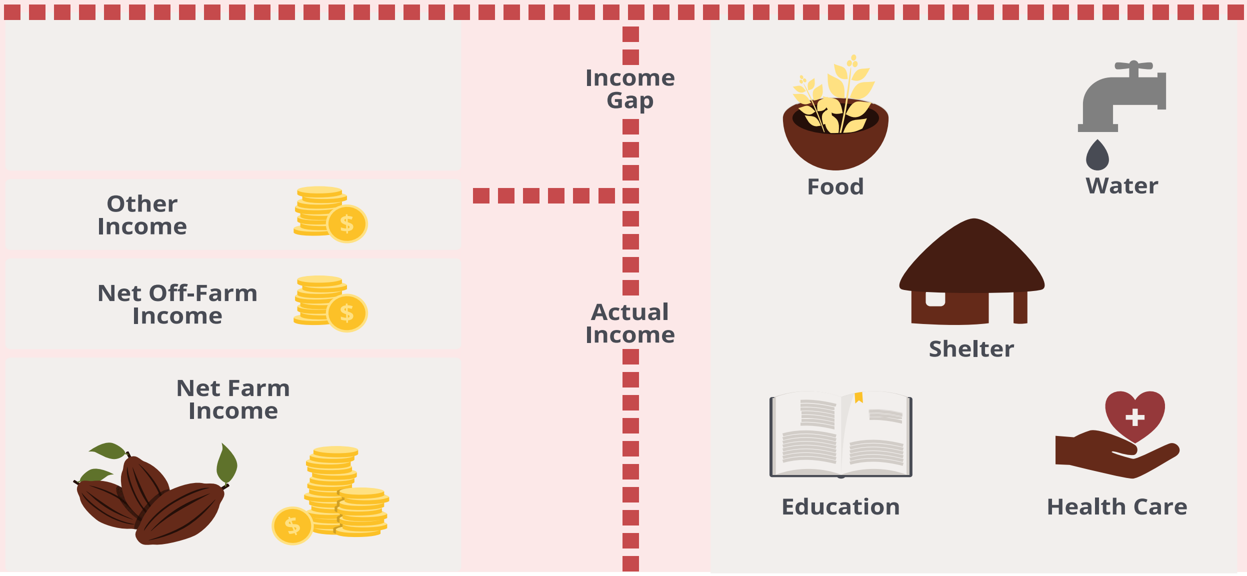
Several factors contribute to the challenges that cocoa farmers face in earning a living income. Alongside productivity and plantation quality, market access, and the size of the cultivated area, one important factor is the highly volatile cocoa price on the global market.

Figure 1: Cocoa price development since 1994

What is a Living Income?

A Living Income is the minimum income that a cocoa farmer and their family need to meet basic needs (such as food, access to drinking water, shelter, education and healthcare) and maintain a decent standard of living. Cocoa farming is an important economic sector in many countries of the Global South, especially in West Africa, where most of the world's cocoa is produced. However, many cocoa farmers in these regions still struggle to earn enough to cover basic expenditures and provide for their families. Cocoa farmers are often compelled to sell other products and services, which also entail production and investment costs in order to secure a livelihood.

Figure 2: Living Income of Cocoa Farmers



The cocoa price between supply and demand

The price of cocoa is primarily determined by the forces of supply and demand in the global market. Cocoa, as other agricultural commodities, is traded on commodity exchanges in London and New York in the form of futures contracts, which determine what is generally understood as the "cocoa price". Futures contracts are agreements to buy or sell a commodity at a predetermined price at a specified time in the future.

Similar to other agricultural commodities such as coffee, sugar or soy, the price of cocoa is subject to considerable fluctuations. Crop volume, weather conditions, geopolitical factors, foreign exchange rates, consumer sentiment, as well as supply chain issues (such as outbreaks of diseases) contribute to the volatility of cocoa prices. In addition, market sentiment can shape perceptions of objective market conditions, and investment strategies as well as speculative behaviour of traders can acerbate price variability.

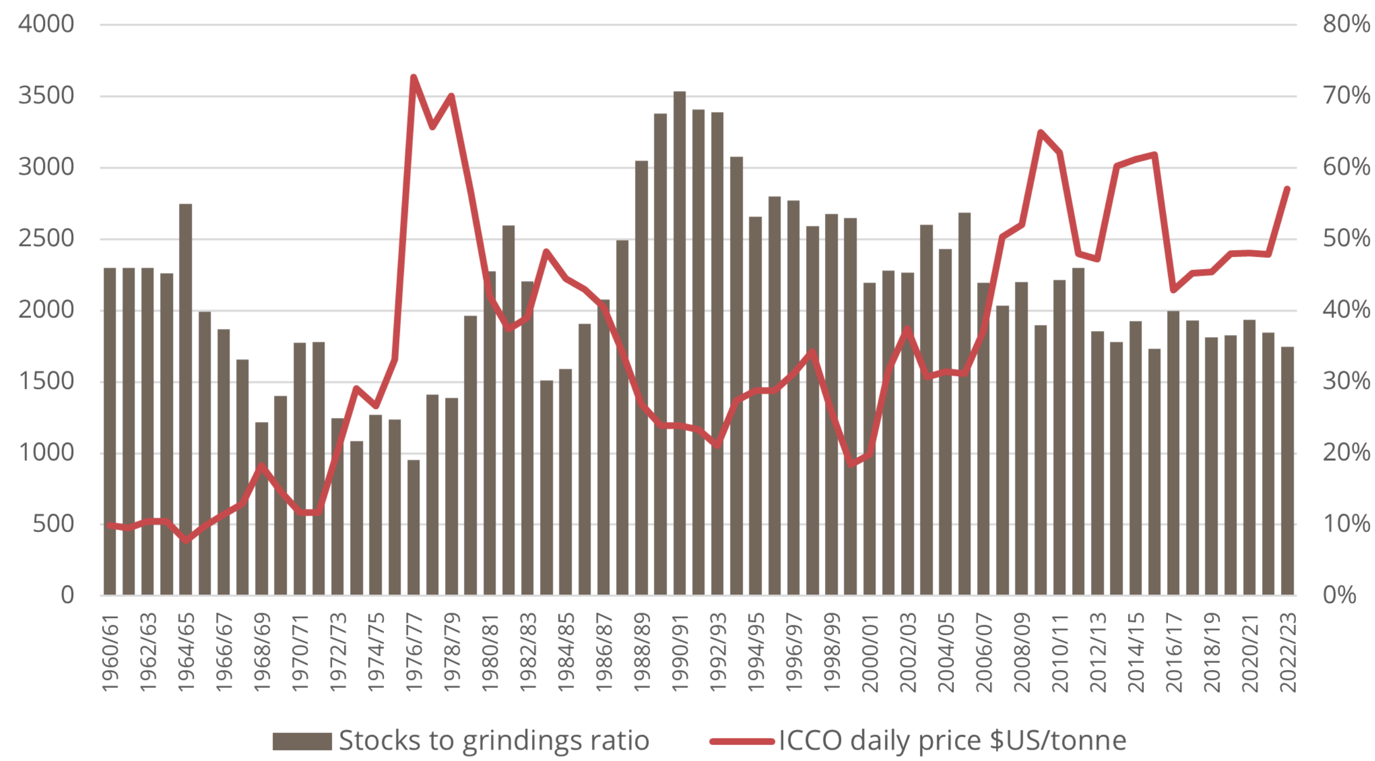
Stock levels have a substantial influence on the dynamic between demand and supply. Importing companies, which can afford to hold larger stocks, can navigate price fluctuations more easily and support the processing industry by guaranteeing a steady supply of raw materials. The main producing countries, on the other hand, have limited capacities in controlling the supply of cocoa and thereby influencing cocoa prices in their interests.

Crop volume, weather conditions, geopolitical factors, foreign exchange rates, consumer sentiment, as well as supply chain issues contribute to the volatility of cocoa prices.

The precarious financial situation in Ghana, for example, forces the state-controlled export organisation Ghana Cocoa Board (COCOBOD) to buy and sell the cocoa in the same harvest year using a comparatively expensive so-called syndicate loan. To secure this loan, approximately 70% of expected harvest is sold through so-called forward sales contracts before the harvest.

Together with annual harvest surpluses or deficits, the so-called stocks-to-grindings ratio is an important parameter for pricing. This ratio is calculated by dividing end-of-season stocks

Figure 3: ICCO daily price for cocoa beans and ratio between stocks and grinding



What is a spot market?

Spot markets are marketplaces where commodities are bought and sold for immediate delivery or settlement, typically within a few days or weeks. In a spot market, commodities are traded based on the current market price.

The spot market enables immediate delivery or receipt at certified warehouses with clear quality specifications offered by the exchanges. While spot markets expose traders to price volatility, it also provides transparency in pricing and can help participants manage certain types of risks, such as sudden changes in supply or demand.

Ultimately, however, only a very small proportion of the global cocoa trade is physically settled on the spot market.

from the previous year by the estimated grindings for the current crop year. Daily cocoa prices are inversely correlated with stocks-to-grindings ratios (figure 3).

The commodity exchanges in New York and London determine the target price for individually negotiated futures contracts with specifications regarding quantity, delivery date and quality and allow both buyers and sellers to hedge their prices in advance, helping to offset the impacts of price volatility.

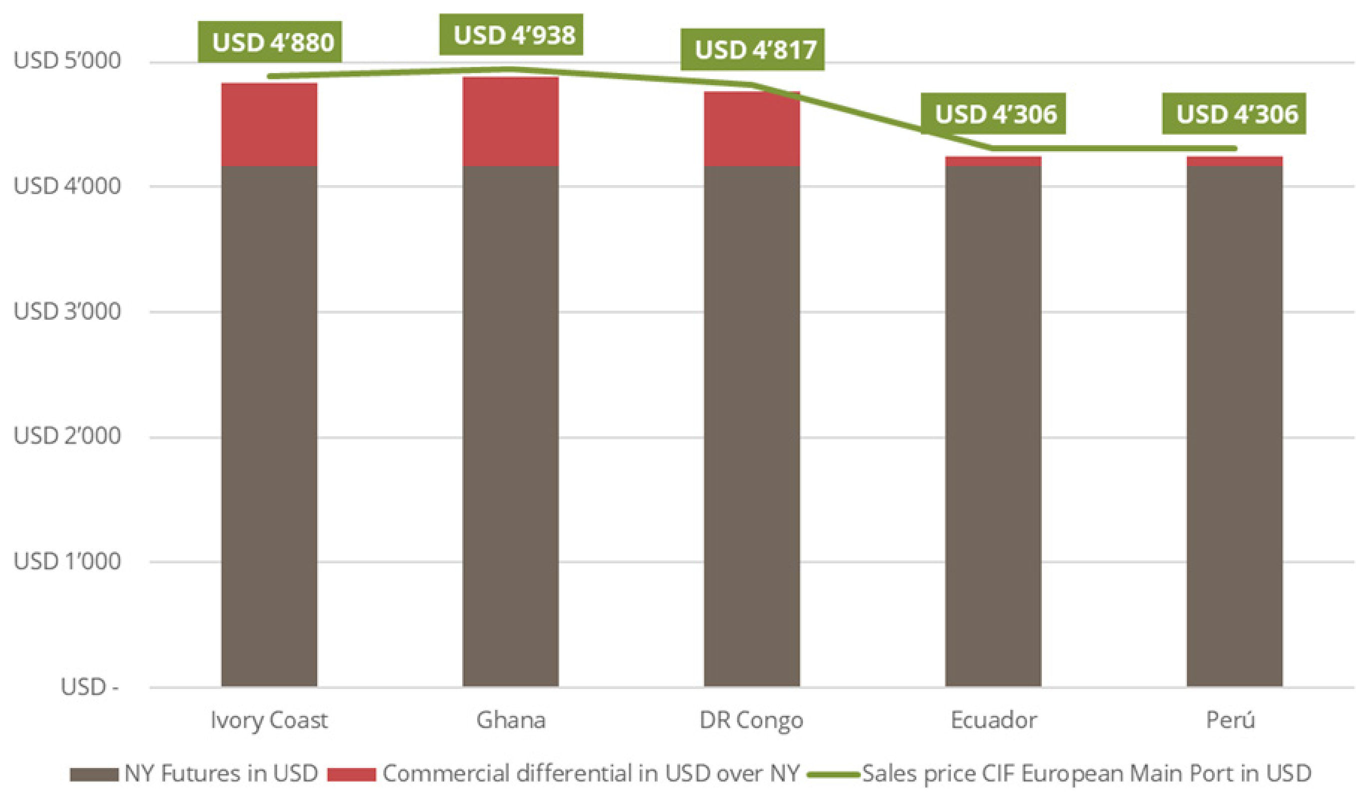
The price that is ultimately paid by importers to exporters is determined in individual purchase con tracts between two trading partners. In addition to the market price as a benchmark price, the following factors also determine the import price of cocoa, i.e. price at the European main port or CIF (Cost, Insurance and Freight) Europe:

Country differential

The country or commercial differential is an additional premium paid for cocoa from a particular country based on the quality of the cocoa (fat content, size, purity or flavour). If the quality is low, a price deduction is applied instead. The reference values for the country premium are traditionally determined in the contractual discussions between buyer and seller.

Country premiums fluctuate considerably depending on the country and harvest year. Examples of current country premiums for Ghana, Ivory Coast, Peru, Ecuador and Congo can be found in figure 4 below.

Figure 4: Cocoa prices paid (CIF Europe, December 1, 2023)



Living Income Differential (LID)

The Living Income Differential was introduced by Ghana and Ivory Coast in October 2020 to increase farmers' income. A premium of USD 400 per tonne of exported cocoa beans is intended to increase the farmers' share of the sales proceeds. However, the LID, which has been levied since the 2020/21 cocoa harvest, has led to an unintentional reduction in the country premiums for the two countries.

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While the intended effect of the LID was to increase prices received by farmers (country premiums plus LID), it appears to have cancelled out the benefits of the country premiums for the cocoa harvests between 2020 – 2023. In the current 2023/24 cocoa harvest, however, the large harvest deficits in West Africa have again resulted in country premiums that were significantly higher than the LID of USD 400.

Figure 4 compares the prices paid for cocoa at the main European port on 1 December 2023 (delivery on 1 March 2024). The LID for Ghana and Ivory Coast is already included in the red-coloured country premiums.

Even though the futures price in New York provides an important orientation, the different country premiums for cocoa from Ghana (plus USD 708), Ivory Coast (plus USD 660) and Congo (plus USD 565) as well as the lower valued cocoa deliveries from Peru and Ecuador (plus USD 80 each) lead to significant price differences among countries.

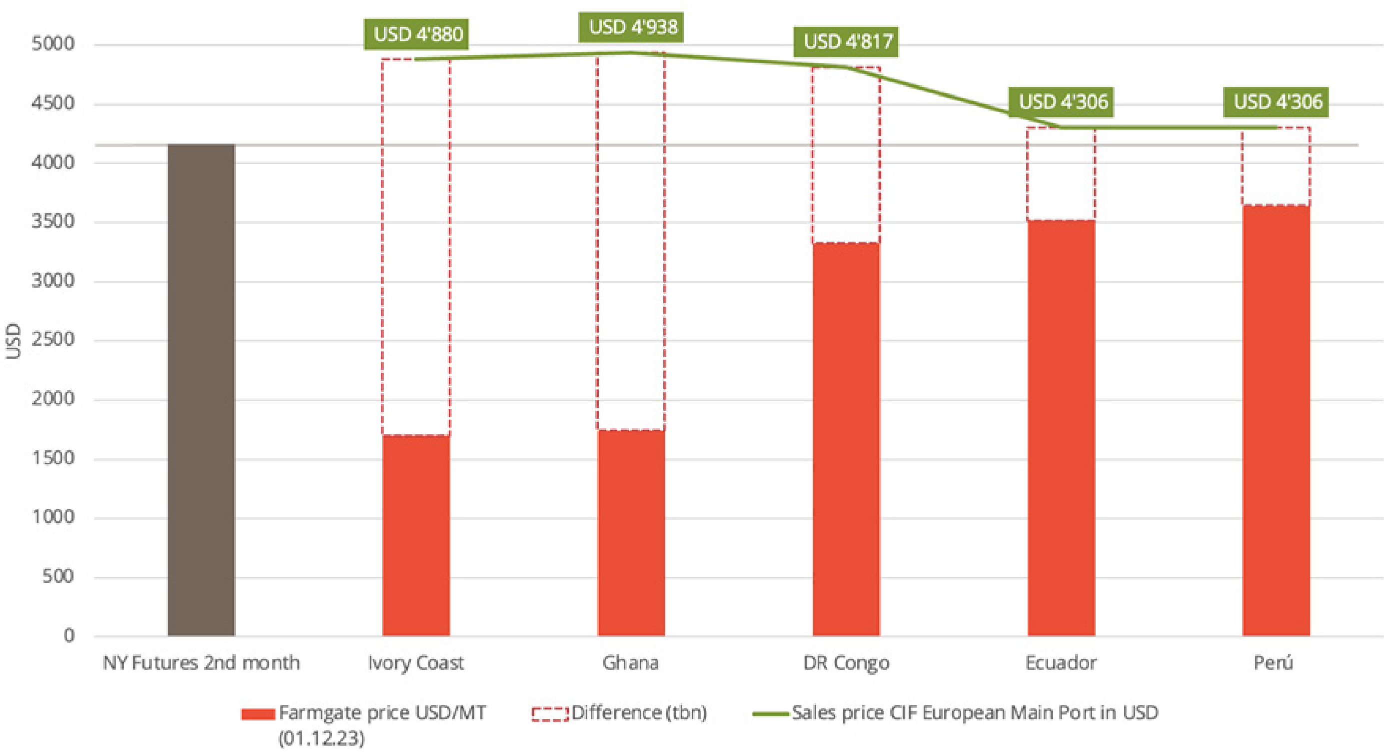
What price does the farmer receive?

The so-called farm-gate price is the price paid to farmers by a cooperative or other intermediary and does not correspond to the price stipulated in individual purchase contracts.

Figure 5 highlights the enormous differences in farm-gate prices that exist between different countries of origin. In the current 2023/2024 harvest, the farm-gate price ranges between 40% to 90% of the market price.

Countries such as Peru, Ecuador and Congo have significantly higher farm-gate prices than Ghana and Ivory Coast despite lower CIF prices. As a result, Peruvian and Ecuadorian farmers receive double the price than farmers from Ghana and Ivory Coast do, despite prices being paid by importers are almost 10% higher for the latter two.

Figure 5: Farm-gate price and sales price (reference date: December 1, 2023)



The enormous differences, which have become even more pronounced in Q1 of 2024 due to the further price hikes, can be explained, among others, by the fact that Ghana and Ivory Coast concluded comprehensive forward sales before the start of the harvest and therefore at much lower prices.

While both Ghana and Ivory Coast have recently (Q1 2024) made a step in the right direction by increasing farm-gate prices, gaps remain large. Significantly lower farm-gate prices for farmers in Ghana and Ivory Coast follow a long-term trend, which remained unchanged even with the introduction of the LID in 2020.

Several factors contribute to these differences in farm-gate prices. In the Ivorian regulated system, an elevated tax burden on cocoa as well as state-financed support measures for cocoa farmers have led to sensibly discounted farm-gate prices.

Significantly lower farm-gate prices for farmers in Ghana and Ivory Coast follow a long-term trend, which remained unchanged even with the introduction of the LID in 2020.

In Ghana, the state authority COCOBOD plays a central role in managing the supply chain. Farmers benefit from seamless quality control, subsidised means of production, agricultural advice, and other support services. However, there is no reliable evidence to date that these support measures respond to the needs of cocoa farmers and compensate for the significantly lower farm-gate prices compared to other countries of origin.

Efficient national marketing and support models have a considerable influence on farm-gate prices and thereby on the income of farming families.

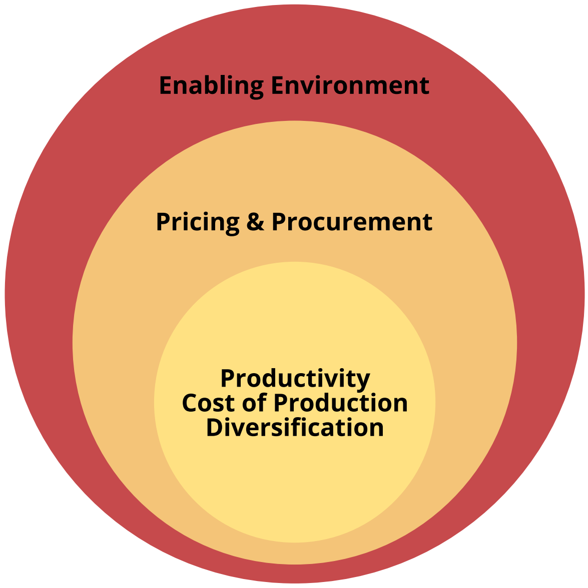
From a farmer's perspective, it is important that farm-gate prices, support measures (plant material, fertiliser, advice, etc.) and fiscal measures must be properly balanced. The low farm-gate prices in West Africa compared to other countries present an insurmountable obstacle for cocoa farmers to earn a Living Income.

What favourable price and procurement practices exist?

There are various ways to help cocoa farmers earn a Living Income. In principle, this requires the efforts of all supply chain actors and other stakeholders involved. The Cocoa Platform's Roadmap 2030 pursues a holistic approach in which all relevant influencing factors are to be considered.

The Living Income Community of Practice (LICOP) stipulates that, in addition to price and procurement practices, other key factors are harvest yield, the size of the cultivation area, cultivation costs, other sources of income and good framework conditions.

Figure 6: Key Factors for a Living Income



The price and procurement dimension in focus here is largely characterised by the unpredictable forces of supply and demand on the commodity exchanges and the unequal storage capacities of different market players.

Coordinated control of the cocoa price among importers is, however, considered difficult given existing antitrust obstacles, inherent problems of collective action and the competitive environment among trade and industry players.

However, a meaningful commitment to more favourable cocoa prices for farmers is possible despite the uncontrollable interplay between supply and demand. Companies have ample room of manoeuvre to link their procurement practices to a series of sustainability criteria relating to climate, child labour, deforestation, biodiversity, education and income. Sustainability has a price tag.

Sustainable procurement practices can take various forms and can be adapted to the priorities and possibilities of each company. Below we present four different model types of sustainable pricing and procurement practices, which are also pursued by individual member companies of the Cocoa Platform.

Direct procurement with a focus on quality, proximity, and long-term trading relationships

Direct sourcing is undertaken by some companies that are willing to pay significantly higher prices than the world market price in order to guarantee a certain quality of their product. The resulting long-term contracts and close relationships with cocoa farmers provide these with stability and security.

The comparatively high price allows them to utilise natural resources sustainably so that they can be preserved for future generations. In return, the importer or processor receives cocoa of the highest quality and benefits from a reliable and secure supply chain.

Industry Example: Max Felchlin's FAIR DIRECT CACAO model

An example of this practice is Swiss manufacturer Max Felchlin AG, whose FAIR DIRECT CACAO model and Felchlin Sélection guidelines combine aspects of sustainability, transparency, and quality. Felchlin pays the farmers a high premium if the cocoa has a certain quality and is traceable. Key criteria of the FAIR DIRECT CACAO Guidelines are:

- Annual calculation of the average price compared to the average world market price (20% - 60% higher than the world market price),
- Regular contact and visits to partners and cocoa farmers on site,
- Direct deliveries without intermediate trade and additional margins,
- Quality controls both before and after delivery to Felchlin,
- Firmly defined regions of origin and therefore a single origin cocoa with a complex and unique flavour profile.

The label model

Sustainability premiums such as those offered by labels such as Max Havelaar Fairtrade, Rainforest Alliance or organic, generally contribute positively to the income of farming families. However, the impact assessments regarding their effectiveness are not always conclusive, particularly when considering the associated cost of certification.

By complying with and evaluating a range of sustainability (social, environmental and economic) criteria, a higher price is paid to farmers, mostly through cooperatives or trading companies.

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For Fairtrade, the premium paid to the partner cooperative is USD 240 per tonne of cocoa beans; for Rainforest Alliance, at least USD 70 per tonne is paid to the farmer, plus additional individually determined contributions for training, administration and targeted investments.

In addition to these minimum premiums, higher sustainability premiums are also paid depending on the willingness of buyers. There are also numerous other premium models on the market that reward farmers' sustainability efforts.

Dual certification has a demonstrably significant price effect, whereby the combination of Fairtrade and organic is particularly widespread and leads to premium payments of up to USD 500 per tonne to the cooperatives.

However, of these premiums only a small proportion (approx. 30%) is paid out in cash to the farmers. Companies of the Cocoa Platform that often strive for dual certification are Stella Bernrain, Pronatec, Chocolats Halba and Maestrani.

Closing the income gap through additional living income premiums

Sustainability premiums can also be made dependent on the cost of living or production costs of farmers and be calculated on this basis to guarantee a Living Income. Benchmark studies are used to calculate reference values for a Living Income that best reflects local living conditions. Reliable data is available for Ghana and Ivory Coast. These studies calculate

Industry Example: HALBA's Sankofa Sustainability Project

In late 2020, Swiss chocolate producer HALBA launched in collaboration with Swiss retailer Coop and Fairtrade Max Havelaar the Sankofa sustainability project in Ghana.

Through this pilot project, 377 cocoa farmers who implement dynamic agroforestry receive an additional payment alongside the Fairtrade premium to help them achieve a Living Income.

The pilot aims to expand the payments to additional Fairtrade cocoa farmers in the Ghana cocoa supply chain, enabling more farmers to benefit from a supplement and a Living Income in future.

the difference between the actual income and the estimated living income of farming families in order to determine the necessary differential.

Building on Fairtrade certification, individual companies therefore go one step further and pay cocoa farmers an additional premium on top of the Fairtrade premium, which is intended to reduce the Living Income gap. Thanks to the additional payment based on the Living Income Reference Price (LIRP), cocoa farmers are better able to achieve a living income and a decent standard of living.

The LIRP calculated by Fairtrade International is currently at USD 2,120 and USD 2,390 per tonne for Ghana and Ivory Coast respectively. This price is regularly re-calculated based on basic assumptions regarding household size, land size and harvest. In the current 2023/24 harvest season, the Living Income Differential for Ghana is USD 316 per tonne, in 2022/23 it was USD 895 per tonne, and in 2021/22 USD 355 per tonne.

Topic-specific, production-independent premiums

Increasingly, companies seek to support farmers financially and with training to enable them to grow crops other than cocoa to diversify their income. In this way, the farmers' resilience can be strengthened. Often, topic-specific, production-independent premiums are linked to specific sustainability goals of the supply chain partners.

The most common incentives relate to climate and environmental services, as well as child labour risks. In some cases, the incentive systems are designed independently of cocoa production volumes to allow for a more inclusive distribution of premium payments.

Industry Example: Nestlé's Income Accelerator Programme

The Income Accelerator Programme aims to tackle child labour risks by incentivising and supporting change in cocoa farming households and to help them towards a living income. It does so through cash incentives and technical support across four areas: cocoa farm productivity, child education, agroforestry, and additional incomes. Womens participation and gender equality is another key focus.

The programme aims to reach an estimated 160,000 farmers in Nestlé's global supply chain. Through direct, mobile cash transfers of up to EUR 500 per year, farming families are thus remunerated for their efforts regardless of the respective production volume. Nestlé and its partner KIT will regularly report on progress.

Such procurement practice models are promising and can provide valuable guidance to other market players depending on their size, focus and strategy. However, they are not a guarantee for achieving a Living Income for farmers.

Interested cocoa manufacturers and producers are therefore recommended to first measure the existing Living Income gap in their respective supply chains by consulting available literature or to conduct a brief assessment in cooperation with supply chain partners. Based on the identified gap, feasible targets and measures can be defined, including different income drivers such as price, income diversification, productivity increase, cost of production and enabling conditions.

For additional guidance, interested parties can consult the recently published Position Paper by DISCO on Procurement Practices or contact the Platform's Coordination Office directly.

Conclusions

Despite the many obstacles identified in this issue brief, the strategic goal of a Living Income for all cocoa farmers deserves the utmost attention. This requires the efforts of all supply chain actors and engagement with additional stakeholders, including governments and civil society.

In the spirit of shared responsibility, the Swiss Platform for Sustainable Cocoa calls on all member companies to commit to ensuring a Living Income for farming families. The shaping of sustainable procurement practices with a positive influence on the cocoa price plays a central role. Based on the presented models of sustainable pricing and procurement practices, and by assessing existing Living Income gaps, the following measures are considered to be particularly effective:

Sustainability premiums that include a substantial surplus over the world market price are important sources of income for farmers and can have a stabilising effect for farming families, especially when farm-gate prices are low. Elastic premiums that are based on current world market and farm-gate prices and that are geared towards the strategic goal of a living income can substantially strengthen this effect.

Long-term, trust-based trading relationships give farming families security and stability and allow companies to ensure the desired quality and high traceability of goods. Cooperation on an equal footing with partner cooperatives are a central element of a long-term, trust-based trading relationship.

Targeted investments to strengthen the resilience of farmers to promote good and climate-friendly production methods and to develop other sources of income. In contrast to traditional premiums, the corresponding incentives can be independent of the production volume to reach the poorest farmers and link to sustainability impacts such as climate and child protection.

However, pricing and procurement practices of companies are only one part of the solution. Measures should also be taken by the governments of producing countries to ensure a Living Income for farming families and thus a sustainable cocoa value chain. In the area of price, the following measures should receive special attention:

Increasing the farm-gate prices through lower fiscal burdens on farming households and increased efficiency in the local management of the supply chain. The extent and impact of the subsidised support measures (plant material, fertiliser, advice, infrastructure, marketing, etc.) should be adapted to the needs of the beneficiaries and be easier and more transparent to navigate.

Strengthening the storage capacities of producing countries increases their negotiating power and thereby their influence on pricing. For this to happen, however, the financial situation needs to be improved, and would probably have to be secured in the short term through loan agreements with development banks. Greater financial leeway would also reduce dependence on forward sales contracts that secure costly loan agreements with commercial banks.

Reduce supply and strengthen the resilience of farmers through diversification. By consistently diversifying local agriculture through the promotion of products other than cocoa, producer countries can reduce the dependence of the rural economy on cocoa. Diversification strengthens both the resilience of farming families and the local economy, and prevent the re-emergence of the risk of over-supply of cocoa and thereby drives up the price of cocoa.