

## The public and private regime complex for governing palm oil supply

### What scope for building connections and enhancing complementarities?

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#### Key messages

- The global palm oil value chain has grown in complexity over time as have the public and private regulations governing the sector. This influences stakeholder decisions along the palm oil supply chain and the territories where it is produced.
- Weak alignment between the many regulatory initiatives has given rise to a 'transnational regime complex' that is struggling to resolve effectively many structural performance issues that have long plagued the palm oil sector.
- Key performance issues facing the palm oil sector relate to pervasive land conflict and informality, yield differences between companies and smallholders, and a high carbon debt linked to emissions arising from deforestation and peatlands conversion.
- Different disconnects, complementarities and antagonisms characterize current governance. Building connections and enhancing complementarities are important ways to gradually reduce antagonisms.
- Complementarities have emerged among instruments with global reach, whereas disconnects persist especially within public regulations, between regulations and private standards, and between standards operating across different territorial scales.
- Several connections can be built by better linking existing regulations, and public regulations and private standards at different levels. These could arise by embracing approaches that look at both supply chain and territorial management.
- The main policy targets to achieve sustainability and inclusivity are: 1) limiting the expansion of palm oil in high-carbon forests and peatlands; 2) adopting mechanisms to enhance transparency and accountabilities; 3) creating conditional incentives to intensify palm oil supply, mainly of smallholder farmers; 4) adopting new approaches to facilitate the upgrade of smallholder production systems; and 5) legalizing tenure claims under different types of rights recognition schemes.

#### The challenges associated with governing the palm oil sector

One of the most pressing sustainability challenges in the tropics is the need to regulate oil palm expansion more effectively. Such regulation must mitigate the sector's negative environmental impacts from primary forests and peatlands conversion, while reducing the yield differences between large-scale plantations and smallholder oil palm growers (Sayer et al. 2012; Rival and Levang 2014). This is the case in Malaysia and Indonesia, which are the main suppliers of palm oil to the global market.

The main governance dilemma is that palm oil development leads to contradictory outcomes. On the one hand, the sector contributes fiscal and foreign exchange earnings to producer countries. It also supports the livelihoods of a large number of smallholders who have increasingly embraced this crop as their main source of income (Edwards 2015). On the other hand, oil palm expansion generates significant carbon emissions, particularly when planted in peatlands (Miettinen et al. 2013). It also contributes to biodiversity loss when production involves conversion of primary forests (Savilaakso et al. 2014; Vijay et al. 2016). This undermines governments' commitments to protect biodiversity and reduce greenhouse gas (GHG) emissions.

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Palm oil has benefited from increasing global demand for several reasons, mainly due to its fungibility; its use in the food, chemical, pharmaceutical and cosmetic industries, among others; and its comparatively high productivity in terms of oil yield per hectare. This makes it one of the most cost-competitive oil seeds on the global market (Rival and Levang 2014).

The rapid expansion of the sector has, however, increased the complexity of intra- and extra-chain governance. The sector involves a rising number of different stakeholders, whose interests often diverge. These actors range from downstream manufacturers and retailers to various types of producers, governments, banks, technical agencies and civil society players (Cramb and McCarthy 2016). With many of these actors involved in the promotion of sector standards, a 'transnational regime complex' has emerged (Overdevest and Zeitlin 2012). Myriad private standards such as certification systems, corporate codes of conduct and self-regulatory initiatives and public policies and regulations interact, both in concert and in conflict.

This regime complex ultimately aims to address three major sectoral performance issues, namely 1) persistent conflicts over land and benefit flows linked to industrial plantation expansion, 2) the large smallholder yield gap, and 3) the detrimental environmental impacts. The divergent stakeholder interests and perspectives on sector development and sustainability priorities have, however, given rise to tensions on appropriate mechanisms and pathways to address these performance issues. This, in turn, has created parallel, competing and overlapping regulatory instruments and institutions.

This absence of a coherent governance architecture tends to raise compliance costs for chain actors. In order to more effectively address the three main sector performance issues. There is significant room, however, for further exploiting possibilities for building connections and complementarities between state regulations and private standards to address those performance issues. While the analysis refers to the global palm oil sector, the main emphasis on the production side is Indonesia.

## **An evolving governance regime complex for palm oil supply**

A governance regime complex comprises a wide range of policies and regulations that are developed and implemented by state and non-state actors, or a combination of both, at different scales, from the global to the local levels (Gluck 2010; Margulis 2013). Figure 1 offers a stylized depiction of the transnational regime complex that governs the palm oil sector. The complex has implications for both the supply chain for palm oil and the landscapes where this tree-crop is produced. It involves a combination of state regulations

associated with diverse policy domains (i.e. finance, trade, fiscal, production and land), and private standards such as codes of conduct, sectoral standards, collective and individual pledges and commitments, and company policies.

The left side of the diagram depicts the different policies and regulations that shape oil palm development. These range from finance, trade and fiscal policies to production and land-related policies such as peatland restoration, land allocation and land tenure, and spatial planning. We do not elaborate on these regulations; a detailed assessment can be found elsewhere (Caroko et al. 2011; McCarthy et al. 2012; Daemeter Consulting 2015).

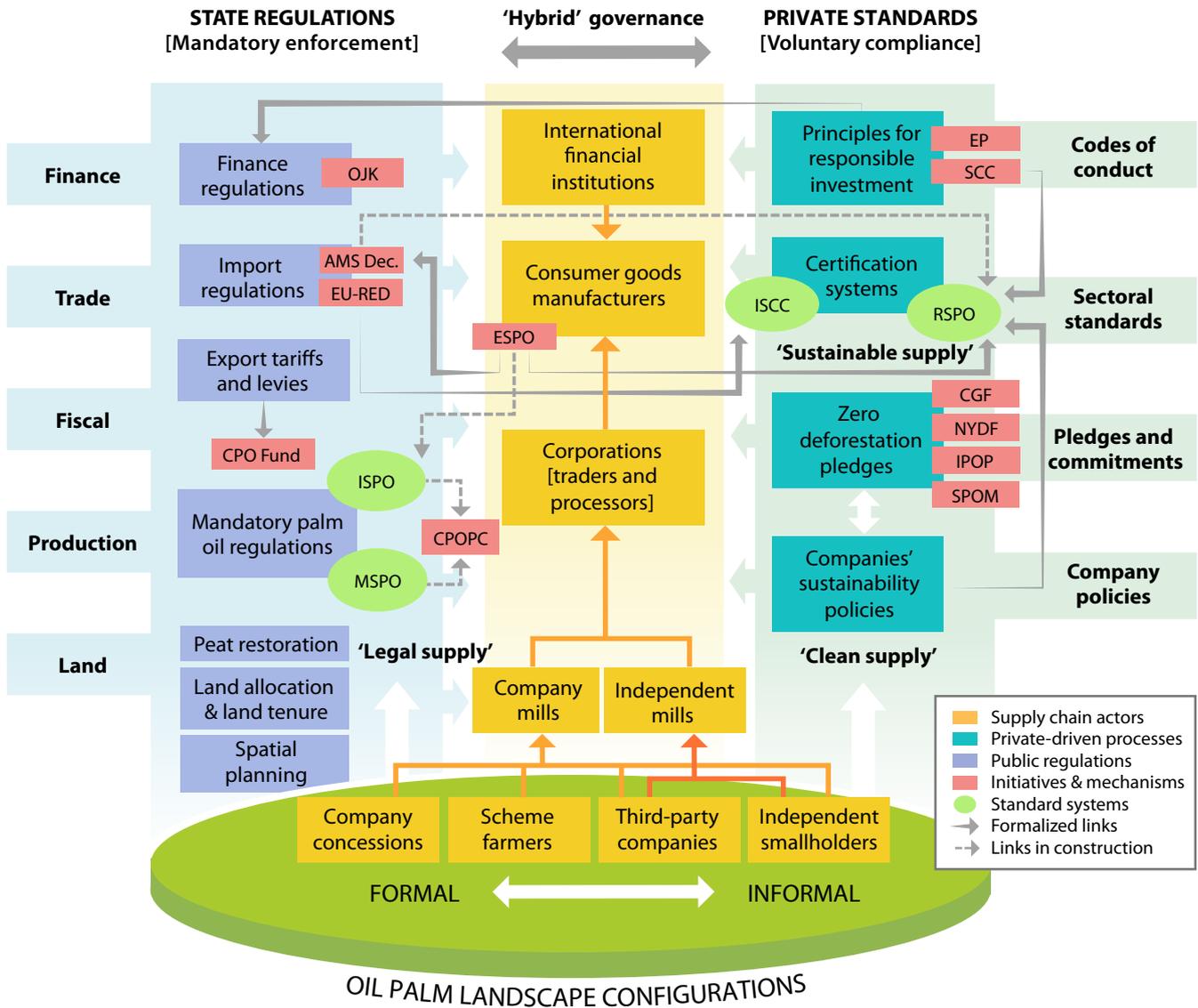
The right side of the diagram depicts the different private standards developed to govern the palm oil sector. These include voluntary certification systems, principles and codes of conduct, and self-regulatory initiatives. The latter have been growing in importance, and currently are a constituent part of the palm oil regime complex.

The most important public regulation governing production activities within Indonesia is the Indonesian Sustainable Palm Oil system (ISPO), a mandatory standard launched in 2011. ISPO essentially bundles existing public regulations on palm oil production into one instrument. It is being revised to enhance its legitimacy. The Malaysian version, the MSPO certification standard, was introduced in 2013. In contrast to ISPO, the MSPO is voluntary. However, in February 2017, the Malaysian government announced a timeline for the mandatory implementation of MSPO by 2019.

To harmonize the two standards and stabilize the palm oil market, the Malaysian and Indonesian governments established the intergovernmental Council of Palm Oil Producing Countries (CPOPC) in 2015. The creation of CPOPC was part of a wider political attempt to reduce the influence of the Roundtable for Sustainable Palm Oil (RSPO) and other transnational initiatives (e.g. Indonesian Palm Oil Pledge). Other domestic initiatives to address sectoral performance include the establishment of the CPO Fund in Indonesia; CPO export levies subsidize biofuel production and support smallholders to reduce the yield gap (USDA 2015).

The fiscal and production policies co-exist with those regulations on land allocation and spatial planning. These policies have long tended to accommodate rather than obstruct private sector interests. To that end, they tend to facilitate access to state lands under forest concession or classified as conversion forests (Brad et al. 2015).

Spatial planning policies offer mechanisms for harmonizing land zoning and allocation at the national, provincial and district level. However, in practice these are rarely employed due to competing interests and bureaucratic and technical



**Figure 1. The palm oil sector transnational regime complex**

AMS Dec = Amsterdam Declaration, CGF = Consumer Goods Forum, CPO = Crude Palm Oil, CPOPC = Council of Palm Oil Producing Countries, EP = Principles, ESPO = European Sustainable Palm Oil, EU-RED = European Union Renewable Energy Directive, IPOP = Indonesian Palm Oil Pledge, ISCC = International Sustainability and Carbon Certification, ISPO = Indonesian Sustainable Palm Oil, MSPO = Malaysian Sustainable Palm Oil, NYDF = New York Declaration on Forests, OJK = Indonesian Financial Services Authority, RSPO = Roundtable on Sustainable Palm Oil, SCC = Soft Commodities Compact, SPOM = Sustainable Palm Oil Manifesto.

complexities. Indonesia made some concerted efforts to protect forests and peatlands to reduce carbon emissions in the context of national climate change commitments (Brockhaus et al. 2012). While this heralded a moratorium on primary forest and peatland conversion in 2011, forests within existing concessions and secondary forests were exempted. Thus the effect on curbing deforestation has been limited (Busch et al. 2015; Suwarno et al. 2016). In 2016, issues around peatlands management were more explicitly incorporated into policy by banning the expansion of oil palm in peatlands affected by fire, and creating mechanisms for restoring peatlands affected by forest fires.

Over the past decade, self- and co-regulations initiated by the private sector have gained prominence, partly in response to increasingly stringent procurement standards of consumer goods manufacturers (CGMs). RSPO, established in 2004, involves third-party compliance monitoring of adherence to their standard. This covers primarily the aforementioned first (land) and third (environment) performance issues. Although it is the most widely adopted private standard, RSPO has yet to become an industry standard (Morley 2015). Adoption has been prevalent among large well-resourced corporate groups. Smaller producers face financial, technical and legal barriers to compliance (Brandt et al. 2015).

Another certification system increasingly adopted is the International Sustainability and Carbon Certification (ISCC). This was established in 2010 to certify crude palm oil (CPO) sold to the European Union (EU) biodiesel market. The EU forces suppliers selling CPO to EU biodiesel markets to be certified under an EC-accredited certification scheme, which is mandated under the EC's Renewable Energy Directive's (RED). In April 2017, the EU signaled its interests to apply more stringent sustainability criteria to imports of all palm oil entering the EU market, not simply palm oil from the biodiesel sector.

Since 2013, many large chain actors have made ambitious pledges to fully eliminate deforestation from their supply chain, mostly by 2020. The zero deforestation movement is driven primarily by large CGMs. They created pressures for upstream actors (e.g. traders and processors) to build systems to delink their supply from deforestation.

Many European governments are also committed through the 2015 Amsterdam Declaration to ensuring that all palm oil traded within their markets is certified by 2020. To that end, industry platforms have been established in Belgium, Denmark, France, Germany, Italy, Norway, The Netherlands, Sweden and the United Kingdom. In 2015, the Dutch government began hosting the European Sustainable Palm Oil (ESPO) initiative to support implementation of these commitments and to harmonize activities across the different national platforms.<sup>3</sup> In 2016, Norway became the first country to apply zero deforestation commitments to all public procurement activities (Gaworecki 2016).

Financial services providers play an important role in the expansion of plantations and processing and refining capacity. Some of the major international financial institutions (IFIs) provide financial services to palm oil actors. Lending to the sector is increasingly subject to adherence to the Equator Principles (EP) and for some banks sector-specific Environment, Social and Governance (ESG) criteria. IFIs are increasingly being held to account for social and environmental misconduct of their clients. As a result, risk mitigation strategies strongly underlie recent momentum behind more explicit ESG integrations (Stampe and McCarron 2015).

The development of common standards is also beginning to emerge. The Banking Environment Initiative (BEI), the finance platform, developed the Soft Commodities Compact whose responsible lending guidelines now incorporate numerous RSPO criteria. These changing norms and practices by IFIs have also prompted the Indonesian Financial Service Authority (OJK) to formulate the Sustainable Financial Roadmap. The latter sets a pathway for integrating responsible lending practices from international banks into the operations of eight of Indonesia's largest commercial banks (Pramudya et al. 2016).

Some of the private-sector initiatives described above have not been received well by the Indonesian and Malaysian governments, especially the zero deforestation commitments. The Government of Indonesia appeals to the concept of legal deforestation (i.e. forest areas classified for conversion can be suitable for deforestation). It accused six major corporate groups of cartel practices for attempting to coordinate their zero deforestation commitments through the Indonesian Palm Oil Pledge (IPOP). The government threatened to investigate the companies through the national anti-monopoly agency, thus forcing IPOP disbandment in mid-2016. In parallel, it created the CPOPC and announced the strengthening of ISPO.

These actions can be interpreted as a government strategy to undermine the legitimacy of private sector commitments and platforms in order to re-establish the primacy of public regulations, as well as state enforcement authority. In light of these events, corporate groups announced they will continue pursuing their commitments individually. Multi-stakeholder efforts to develop a common set of zero deforestation definitions and principles is ongoing through the High Carbon Stock Approach (HCSA) initiative. In late 2016, this initiative announced plans to merge the two streams (the HCS+ and the HCS Approach). In 2017, an HCSA toolkit that merges the two approaches will be finalized and all major corporate stakeholders are expected to adopt it (HCSA 2016).

## Disconnects, complementarities and antagonisms

The state regulations and private initiatives constitute a regime complex characterized by disconnects, complementarities and antagonisms with respect to their objectives and strategies in relation to enhancing palm oil's sustainability. These are summarized in Table 1.

The palm oil regime complex suffers from major internal disconnects. First, in the finance realm, there is a lack of correspondence between OJK, international banks and efforts by the CPO Fund to support responsible lending and smallholder access to finance. Second, in the trade realm, import policies adopted by consumer countries such as EU-RED and ESPO are not aligned to standards developed by producer countries (ISPO and MSPO), but rather to international standards (RSPO and ISCC). Third, in the fiscal policy realm, national revenues generated from palm oil-related land and income taxes and export levies are not targeted to help major producing districts promote the uptake of sustainable practices. Fourth, there is a lack of harmony between procurement requirements under the private standards ('sustainable supply' under RSPO and ISCC certification, and 'clean supply' under corporate zero deforestation policies), and between these and the 'legal supply' under ISPO and MSPO. Fifth, there is lack of coherence between national and sub-national sustainability policies. For example, the Indonesian government

<sup>3</sup> <https://english.eu2016.nl/documents/publications/2016/04/14/declaration-of-amsterdam>

**Table 1. Disconnects, complementarities and antagonisms in the global palm oil sector**

Levels	Disconnects	Complementarities	Antagonisms
<b>Finance</b>	Public funds (e.g. CPO Fund) are not completely aligned with attempts to support responsible lending for stimulating the adoption of ISPO standards by smallholder farmers	Policies adopted by international financial institutions are being internalized by domestic commercial banks in Malaysia and Indonesia, stimulated by state regulatory bodies	Formal processes in the banking system to support ESG integration conflict with widespread practices by domestic banks and informal local lenders
<b>Trade</b>	Import policies adopted by consumer developed countries do not rely on state mandatory system standards adopted in producer countries (i.e. ISPO and MSPO)	Consumer countries adopt import policies that rely on voluntary system standards (i.e. ISCC, RSPO) to verify that supply originates from sustainable sources	Transnational consumer goods companies set market constraints (i.e. deforestation-free supply) that conflict with expansion goals of national states and companies
<b>Fiscal</b>	Palm oil taxes collected are only partially channeled to support sustainable supply in the main producing districts	CPO Fund targets resources to support increases in smallholder yields under approaches endorsed by companies	Local authorities use informal ways to capture economic rents from plantations through granting of permits
<b>Production</b>	Different types of standards and methods linked to 'legal' (ISPO), 'sustainable' (RSPO, ISCC) and 'clean' supply (company pledges) are developing to segregate the different types of palm oil supply	Private sector adopts codes of conduct and sustainability policies that rely on RSPO certification, and in some cases makes more ambitious efforts toward delinking their supply from deforestation	State regulations contradict private sector attempts to comply with zero-deforestation pledges, mainly with regards to the attempts to set aside HCV and HCS areas within granted oil palm concessions
<b>Land use</b>	There is a lack of correspondence in the methods adopted for setting aside conservation areas between the national and provincial levels	Increased attention in land use regulations to methods and criteria developed by private standards to protect forests and peatlands	Land, finance and service provision transactions that occur informally tend to make state and company efforts to regulate illegal supply more difficult

CPO = Crude Palm Oil, HCS = high carbon stock, HCV = high conservation value, ISCC = International Sustainability and Carbon Certification, ISPO = Indonesian Sustainable Palm Oil, MSPO = Malaysian Sustainable Palm Oil, RSPO = Roundtable on Sustainable Palm Oil.

is opposed to the use of High Conservation Values (HCV), a method developed under RSPO. Interestingly, some sub-national governments try to incorporate it into their provincial regulations.

Despite these disconnects, complementarities between regulations and initiatives are emerging. First, in the finance realm, progress by financial institutions in adopting responsible lending policies is encouraging major commercial banks in Malaysia and Indonesia to begin doing the same. Second, related to trade, is the increasing use of voluntary standards (i.e. RSPO, ISCC) by consumer countries to verify their national imports originate from sustainable sources (e.g. national initiatives under ESPO, EU RED). Third, the CPO Fund has explicit targets to support adoption of improved production practices by smallholders, which are also being discussed under RSPO and endorsed by major corporations. Fourth, the private sector has made efforts to develop and adopt industry-level codes of conduct and sustainability policies drawing heavily on RSPO and evolving zero deforestation norms. Fifth, government has tried to strengthen ISPO regulations more explicitly by further improving the current set of criteria and indicators, as well as introducing third-party monitoring, thereby increasingly converging with those of private standard systems.

There are several antagonisms between regulatory initiatives as well. With regards to finance, the emergence of a formal process in the banking sector to upscale ESG integration tends to conflict with domestic banks and informal lenders that finance expansion of non-sustainable palm oil. In the trade realm, the commitment of transnational CGMs to deforestation-free sourcing policies, and emerging EU attempts to impose sustainability criteria in legally binding trade agreements, conflict with sector expansion goals of both governments and companies in producer countries. The third antagonism relates to the fiscal realm, and the informal capture of economic rents by local governments; formal taxes collected at the national level rarely reach local governments that are best placed to promote upgrading on the ground. The fourth antagonism, in the production realm, is associated with compliance requirements of private standards that involve setting aside conservation areas through HCV or HCS approaches within oil palm concessions, which are not recognized by statutory law. Finally, a major source of antagonism is the clash between the formal and the informal segments of the oil palm economy that manifests in informal land transactions. It becomes difficult to support and regulate smallholder production since a portion of independent smallholders lack formal claims to land and remain illegal. This

threatens to further alienate smallholders from the formal (sustainable) economy and undermines the effectiveness of initiatives that aim to promote upgrading of smallholder production systems.

## Ways ahead: Building connections and enhancing complementarities

The complementarities are not yet effective to reverse the structural sector's performance issues. The persistence of disconnects and antagonisms limit the impact of measures to advance sustainability. We argue that a 'hybrid approach' mixing state- and private-driven initiatives and mechanisms, at different levels, offers an opportunity to build bridges and complementarities. We offer insights into the types of hybrid mechanisms that could be developed to better connect state regulations and private initiatives. In so doing, they could trigger more effective actions to tackle the sector's key performance issues.

Some policy targets to achieve sustainability and inclusivity are listed here and elaborated below: 1) limit the expansion of palm oil in peatlands, and in primary and secondary forests defined as high-carbon forests; 2) adopt mechanisms to enhance transparency and accountabilities, particularly in systems to allocate lands, grant permits and oversee concessions' performance; 3) put in place conditional incentives to support intensification of oil palm production, particularly for smallholders; 4) build new approaches to facilitate the upgrade of smallholder production systems; and 5) legalize tenure claims under different schemes of property rights' recognition, either collective or individual. Looking for connections may support a policy agenda that embraces multiple simultaneous objectives.

*Limiting the expansion of oil palm in high-carbon forests and peatlands:* public regulations banning the expansion of palm oil in high-carbon forests and peatlands associated to large- and medium-scale plantations and smallholder lands, including those in which conversion rights were granted, can complement "No Deforestation, No Peatlands and No Exploitation" policies adopted by companies. The previous moratorium policy has been more or less followed by actors issuing permits. However, additional rule should be applied to further prevent the allocations of areas with high carbon stocks or secondary forests to plantations, despite the functional status of the areas as convertible forest areas.

Recently issued regulations by the Ministry of Environment and Forestry apply stricter criteria such as minimum level of water surface and peat hydrological maps. These will likely be effective in limiting the expansion of plantations on peat. However, those regulations should be combined with the 'regardless of depth' criteria used by some companies when opening a new oil palm plantation. Yet, as a way to enhance credibility in the system, Indonesia needs a real-

time concession and land-use monitoring system that all stakeholders could use to oversee what happens in practice.

*Certifying sustainable palm oil to enhance transparency and accountabilities:* making progress in narrowing the gaps between mandatory and voluntary sustainability standards would certainly facilitate progress to prompt the uptake of sustainability standards, particularly under some contentious issues. These could include, for example, criteria for protecting high-carbon and biodiverse forests, and acknowledging local social claims to ameliorate land conflict. Supporting certification can be a way to enhance transparency under independent monitoring and verification systems, and make companies accountable to a set of agreed sustainability criteria. Transnational processes and consumer countries should support a process of progressive harmonization rather than imposing their own criteria for sustainability, and do so in ways that include the views of all stakeholders. The current effort on strengthening the ISPO seems to be in line with this. It is intended to improve the certification system by giving the right to make decisions to a certifying body, by introducing independent monitoring systems and by improving the criteria and indicators for sustainability. There is ample room in the palm oil sector to follow the path and learn lessons from the timber sector in setting the Forest Law Enforcement, Governance and Trade (FLEGT) and Indonesia's timber legality assurance system (SVLK), to increase the credibility of the ISPO system.

*Building conditionalities to foster intensification of palm oil supply:* fiscal resources originating from palm oil production and trade should be reinvested. At least part of this investment should address one of the major performance issues that is reducing the yield differences between smallholders with respect to large-scale plantations. A major step has been the creation of the CPO Fund to channel resources to stimulate biodiesel supply and smallholder intensification. Yet more is needed to improve the targeting of the resources and effectiveness in achieving expected outcomes. These could be improved by building some conditional incentive systems for allocating these resources based on performance compliance. For example, these resources could target programs for supporting the upgrade of smallholder plantations under criteria defined by existing sustainability standards such as ISPO. Even more, subsidies to expand biodiesel supply to the domestic market should prioritize as recipients those companies that comply with regulations (such as ones that prescribe to allocate or develop 20% of the concessions in collaboration with local communities) and that apply preferential sourcing from independent smallholder farmers. In addition, fiscal policies could also transfer public financial resources to districts that are conditional on the compliance of some previously agreed social and environmental performance criteria at the jurisdictional level.

*Establishing innovative approaches to upgrading independent smallholders' production systems:* companies' efforts to put in place traceability systems ensuring that supply from second- and third-party suppliers comply with sustainability practices should be reinforced. As well, sub-national governments could enhance the sustainability of palm oil supply within their jurisdictions. It is important to extend support to independent smallholders so they can access high-yielding hybrid seedlings and inputs, as well as affordable investment and operational capital to improve their production performance, while adopting more sustainable practices.

There are different initiatives from nongovernmental organizations, in alliances with companies, and with support from development and commercial banks, often under the umbrella of jurisdictional approaches. More of those efforts are needed. Learning from what has already been done can address a major challenge, which is to scale up those efforts. To that end, local governments can get involved in scaling up, for example, by formulating regulations for supporting these initiatives. Some regulations could improve spatial planning and set up extension services, while others could improve accessibility and availability of inputs, and enforce input standards.

*Legalizing legitimate tenure claims under collective and individual schemes:* the regularization of smallholder farmers in state forestland has to be seriously considered, particularly in established agricultural areas where deforestation occurred long ago. This would facilitate channeling public resources to independent smallholders. It would also help them uptake improved practices and certify their operations under existing certification schemes, such as ISPO. In frontier areas, dominated by land speculation, where apparent land concentration occurs, investigation of illicit land trading practices and fraudulent formalization is clearly needed to prevent further expansion.

Given the complexity of the topic, eligibility criteria would need to determine what lands could be regularized without further exacerbating negative environmental impacts. The government needs to accelerate efforts through agrarian reform and social forestry programs to legalize smallholder land tenure and give secure ownership and use right over plantations that were built on forestland. However, it is important to understand the diversity of smallholders. Thus, land regularization programs have to be adapted to local conditions, and reverse rather than foster social inequalities.

In conclusion, the opportunities for building connections between public regulations and private standards and initiatives offer the possibility of a more holistic approach to addressing productivity, legality and sustainability issues. This is urgently required to enhance the effectiveness of the governance complex, while gradually reversing persisting antagonisms.

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