Guidance document on Fairtrade Coffee Standard Price Risk Management Strategies Issued January 2012

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Introduction

The new Standard for Coffee (April 2011) requires that producers and buyers agree on a price risk management strategy in case they sign an outright priced contract (requirement 5.1) or in case the producer fixes the price before the harvest starts (requirement 8.3).

This document, jointly produced by Fairtrade Standards Unit and Global Product Management Unit, provides some explanation on what a Price Risk Management Strategy is, and what it likely includes. We also detail other measures Fairtrade International are applying (beyond Standards) to help operators manage price risk, as well as prevent and mitigate defaults.

We provide this information as guidance to help explain the intent and requirements of the standard and to guide operator practice. This guidance however is not part of the Standard, and neither does it replace it. Operators will only be audited on the Standard, not on this Guidance Document. However, in case special measures (see page 6) are applicable, default operators will be requested to comply with these.
Contributions to the topic of risk management, questions and comments may be sent to FLO Coffee help desk coffeehelp@fairtrade.net to help develop best practice.

Background: What is a price risk?

In 2010-2011, NY C coffee prices rose from 150 to almost 300 USD cts / lb. This created severe disruption in the coffee market. Price volatility causes uncertainty and makes coffee trading very unpredictable. Fairtrade and other coffee supply chains are affected by this with significant potential for margin loss at both ends of the supply chain.

Every business has risks. Here we concentrate on the commercial risks (price) encountered by producer organisations (PO) selling Fairtrade coffee. Price risk management is about explicit tools and strategies designed and used by a PO to keep the commercial risks within reasonable limits, i.e. without putting the operations and survival of the organisation in danger.

Even if the PO is producer owned, at the moment of procuring coffee, the producers act as suppliers and their organisation as a buyer, so there is a commercial risk involved. This commercial risk exists at each stage in the supply chain, which can be short (producer – PO) or extensive: producer – primary level organisation – secondary level organisation – (private) exporter. The Fairtrade system for coffee is designed up to the level of exports and the Fairtrade price defined at the FOB level, after which the importer in the consuming country takes over the risk. The risk for the PO is essentially the difference in price and dynamics between the local market, where they purchase the coffee, and the international market, where they sell.

In summary the risk can be defined as follows:

- The PO buys the coffee, has it on stock and sells later. If the market drops it loses. This is called being long.
- The PO sells the coffee forward. If the market rises when it buys the coffee, it loses. This is called being short.

Coffee is often sold forward at a differential. A differential is the difference between the futures market (LIFFE London for Robusta, ICE New York for Arabica) and a particular grade or type of coffee.

The futures price can be hedged (price fluctuation for physicals offset by futures market), the differential cannot.

Price risk management: what does the Coffee Standard say?

The Coffee Standard has been revised, with the aim to reduce the price risk for producers, discourage speculation on both sides, and thereby reduce the risk of defaulting. Thus, the new standard:

- defines open contracts as the general rule:

  This allows PO to fix the price of the contract at the moment that the members deliver the coffee, thus avoiding the risk of price fluctuations between buying and selling.

- allows outright priced contracts only in certain cases[1]:

  This recognises that in certain cases, outright priced contracts make sense, but the standard limits the scope of these cases

- requires that a risk management strategy is put in place in case of outright priced contracts:

  This is to encourage PO and traders to be well informed about the risk they are taking, and to clearly identify and agree on ways to manage that risk.

- requires buyer's approval for fixing prices before harvest, and require a risk management strategy in place:

  This is to avoid that prices be set too early in the season, so as to reduce the price risk.

- limits fixed prices to one crop period:

  This is to avoid that prices are fixed for too long a period, which would increase the price risk.

What will the auditor check?

FLO-CERT auditors will check that all standards mentioned above are complied with.

Where it is stipulated that a risk management strategy needs to be in place[2], it is not up to the auditor to assess the content of the strategy and determine whether it is adequate or not, since the appropriate risk management strategy depends on each particular situation. The auditor will however check that buyer and seller have agreed in writing how the risks will be managed.

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[1] Exceptions are: outright price contracts are allowed when:

a) auction systems do not allow open contracts,
b) the PO already has the coffee in store
c) PO and buyers agree that it is mutually beneficial to have a fixed priced contract.

[2] The Standard mentions that a risk management strategy needs to be in place in the following requirements:

- Requirement 5.1 (in case of an outright priced contract)
- Requirement 8.3 (in case the producer fixes the price before the harvest starts)

What does a price risk management strategy look like?

It is good practice for PO to have proper risk management strategies and tools in place for all their commercial operations. As mentioned above, the standard requires that a risk management strategy be in place at least in certain cases.

The section below provides some guidance on what tools and strategies are likely needed to manage risks, and what a risk management strategy usually includes.

A) Price Risk Management Tools

In order to have a proper risk management strategy in place the PO needs some basic structures and tools:

1. A clear definition as to who takes decisions on sales, price fixing and defining purchase price, and how & when these decisions are made.
2. A clear definition of who bears the risks (takes the loss) at different stages of the supply chain/process.
3. A policy on sales, price fixing and purchase price that has been endorsed by the board or the AGM and / or a signed agreement with a group of farmers regarding a specific commercial operation or sales contract, where type of coffee, volume, price, delivery and sanctions in case of defaults (incompliance) are laid down.
4. A shortfall policy which clearly states the criteria by which contracts will be honoured in the event of coffee shortage Contracts should be fulfilled in a manner that is fair and equitable to all outstanding contracts, giving priority to contracts that are pre-financed and to long established customers. Evidence of the policy and its application must be presented to FLO-CERT on request.
5. Clear registers of purchases and sales where the status of each batch or contract is recorded in detail (including price, quantity, quality, producer, order number, etc).
6. Regular updates from co-operative members of coffee stocks available/non available to ensure accurate forecasting of stocks.
7. Registers and / or regular reports defining the position (short / long) of the PO, both in physical (coffee received and contracted) and in futures (coffee bought and sold, i.e. with a price attached to it).
8. Updated registers of costs and margins and tools or regular reports on profit - loss forecasts over the full harvest. Market tracking information on NY C prices – via ICE website https://www.theice.com/FuturesUSReportCenter.shtml or LIFFE Robusta prices http://www.liffe-data.com/ and local market prices and NY C differentials (where possible).

9. Monitoring tools for crop yields and crop quality to ensure availability for contractual commitments and in the event of dispute (for example cupping results, and storage of samples (both representative and pre-shipment samples).

10. A harvest plan or strategy that takes into account changing market scenarios and permanent monitoring of market trends.

11. Clear agreements with buyers on how to manage the price fixing in case the PO takes a position (goes long or short).

12. Contracts with the term 'Replace' added to the usual terms and conditions should be considered very carefully before signing as PO may not have sufficient coffee of that grade to replace and failure to deliver at the agreed/specified quality has severe financial penalties in the event of a disagreement over quality. For advice in this regard contact coffeehelp@fairtrade.net.

B) Price Risk Management Strategies

In order to manage Price risk a PO can use a series of strategies:

1. Back to back operations, i.e. fixing sales contracts as the coffee is received from the producers and paid by the PO.

2. First and second payment. This approach depends on a high level of loyalty from PO members particularly in a speculative market. The PO members bear the risk; the PO deducts the costs and other contributions from the average sales price. The first payment must be substantially below the market price.

3. Sales in consignment. The PO members keep the ownership and bear the risk, deciding when to sell the coffee. The PO processes and exports the coffee and fixes the contracts when the producers decide to sell (a kind of deferred back to back operation).

4. Firm internal agreements with PO members that they will deliver against a price fixed before the harvest, embedded in a series of measures that limit the risk: long term track record and commitments with members Investments, services, etc.), substantial quality premiums above regular commercial differentials, a large volume that permits averaging prices at a level, a level of income that covers the basic needs of the farmers who sign the contract.

5. Hedging the price risk on the futures market through futures contracts and / or options. The risk of the price fluctuation at the time of buying and selling is compensated by operations on the futures market. Very few PO have a futures account to hedge the risk, if not managed properly against physical stocks, managing futures and options can increase the risk. Margin calls for futures contracts may require substantial financial liquidity.

A strategy based only on a verbal or written agreement between PO and producers regarding pre-harvest fixing of forward contracts will not be considered sufficient price risk management by FLO-CERT.

It is good practice for PO to have proper risk management strategies and tools in place for all their commercial operations. The FLO Coffee standard requires a risk management strategy agreed between buyer and seller in case of an outright priced contract or price fixation before the harvest. It is not up to the auditor to determine whether the strategy complies with the above, which is merely indicative, but to observe that buyer and seller have agreed in writing how the risks will be managed.

What is the impact of price risk?

Being short in physical (the coffee) is common, as PO often sell forward and use the sales contracts as collateral for external finance. Being short on the futures market, i.e. having fixed the contract price before the coffee has been received, is a risk. A default (non compliance) on a contract that has been hedged (the buyer sold a contract on the futures market at the moment that the PO fixed the price of the coffee), means a double risk for the buyer: a commercial risk on the coffee that needs to be substituted and the risk of a price fluctuation on the futures market. The latter can be a substantial risk and both need to be covered by the party that defaulted on the contract.

> Example: A contract is fixed at 180 cts/lb, the buyer sells a futures contract. By the time the coffee needs to be shipped, the market is 280. In the case of a default the buyer will not only have to substitute the contract with other coffee (which may be more expensive or may not be available, so the final buyer may charge a penalty for the default), but will also have to buy a futures contract at 280 to roll back his position, at a loss of 100.In case of a default the PO and the buyer have to come to an arrangement: both can agree to roll over the contract to the next season (the price risk and differential risk are for the account of the PO) or they can agree upon a ”wash out” of the contract (the PO pays the cost of the substitution, a possible penalty and the cost of rolling back the position at the futures market in case the contract has been fixed and hedged; the latter can also produce a positive balance).

How to mitigate impact?

The standard stipulates that a PO must inform the buyer 2 months before shipment date about a possible default, when it can reasonably know whether the coffee will be available or not. This gives the buyer the opportunity to look for an alternative and propose a settlement of the default with the PO that will limit the damage for both.

In general it is recommended to communicate and resolve these issues as soon as possible, as solutions are more difficult to find at the end of the harvest and rolling it over into the next harvest may increase the financial risk to both parties. In case the contract has been pre-

financed by a separate lender the latter needs to be involved in the settlement of the default to arrange repayment of the loan.

What to do in case of defaults?

In the minority of cases, where defaults have already occurred, Fairtrade International will apply special measures to help resolve these contracts. Default operators will thus be required to supply additional information on Fairtrade contracts and the contracting process to FLO-CERT. Failure to comply with such requests may result in suspension.

Special Measures for default operators, include:

1) Producers must engage with traders to try and resolve FT default contracts before signing new FT contracts in the following season. They can do this independently or via FLO mediation but they must demonstrate they are actively seeking resolution of outstanding contracts.

If default operators can not demonstrate they are actively seeking contract resolution then FLO-CERT will apply the following:

2) **a)** If a Pre-financed contract is defaulted, future delivery must be fulfilled at the earliest opportunity. Pre-financed contracts take priority over any other new contracts.

b) Default operators under special measures are required to supply a list/record of Fairtrade coffee contracts to FLO-CERT for monitoring purposes.

c) Default operators may request the assistance of the Fairtrade International to help resolve contract issues via coffeehelp@fairtrade.net. However FLO mediation does not replace formal arbitration via the standard coffee industry bodies ie: Green Coffee Association contract or European Contract for Coffee, in the event that contracts are not resolved.

d) We encourage any operator who has experienced a default to contact the FLO Coffee Help Desk (coffeehelp@fairtrade.net) for advice within 60 days of non-deliver date to assure best support.

Thereafter the service may refuse to mediate. The mediation team includes FLO Global Product Management, Legal Advice and external expert coffee advice.

Where to find advice on how to manage price risks?

Free confidential advice regarding risk management and Fairtrade coffee contracts is now available via a Fairtrade International sponsored Coffee help desk (coffeehelp@fairtrade.net).

Questions may also be directed to your usual contact within the Fairtrade system. Producers may contact their Liaison officer or Producer Network. Traders and licensees may contact their Country Labelling Initiative / Certifier or the GPM product responsible Lee Byers: l.byers@fairtrade.net