

## **Traceability and Regulation May 2024**

### **A View by Nicko Debenham of Sustainability Solutions Ltd**

#### **European Union Deforestation Regulation (EUDR) update**

The European Union Deforestation Regulation (EUDR) which entered into force on 29th June 2023 and will enter into application on 30th December 2024 prohibits companies from putting relevant products on the EU market unless they are deforestation-free and legally produced. It will also be illegal to export such products from the EU.

The EUDR applies to wood, palm oil, soy, coffee, cocoa, rubber, and cattle as well as most of their derivatives, which under cocoa applies to beans, products, and chocolate.

The final wording of the regulation was available in December 2022 with the original proposal to establish a regulation being put forward in 2018, so it has been in the pipeline for a long time.

#### **What is in the regulation?**

The regulation requires the operator, defined as the entity that places the relevant goods on the EU market, to issue a Due Diligence Statement (DDS) for each parcel that is crossing the EU customs border both for import and export.

Stating: "By submitting this Due Diligence Statement the operator confirms that due diligence according to the provisions of Regulation XXXX/XX was carried out and no or only negligible risk was found that the relevant products are not compliant with Article 3(a) they are deforestation-free since 31st December 2020 and 3 (b) they have been produced in accordance with the relevant legislation of the country of production."

This means this regulation is not just about deforestation, it is also about a far wider scope than its name implies.

Each DDS must state the Harmonized System code (HS code) of the product being placed on the market which for cocoa includes cocoa beans, products, and chocolate as follows, Annex I of the regulation states:

1801 Cocoa beans, whole or broken, raw or roasted

1802 Cocoa shells, husks, skins, and other cocoa waste

1803 Cocoa paste whether or not defatted

1804 Cocoa butter, fat, and oil

1805 Cocoa powder, not containing added sugar or other sweetening products

1806 Chocolate and other food products containing cocoa

Each DDS must be accompanied by polygons of all farm plots above 4 hectares and geolocation of 6 decimal places longitude and latitude of farm plots below 4 hectares that contributed to the parcel.

The DDS is created on the EU information system where the geolocations and polygons are uploaded. The relevant product has to be traceable to the farm plot.

Each EU member state is required under the regulation to create a National Competent Authority (NCA) to implement the regulation. The principle of the regulation is that it is based on the reversal of the burden of proof. Therefore, if you cannot produce evidence that there is no or negligible risk of deforestation having occurred after 31st December 2020 or that there has been illegality according to the relevant laws of the land production then the parcel and the operator are guilty.

The relevant legislation of the country of production means laws concerning the legal status of the area of production in terms of:

- Land use rights
- Environmental protection
- Forest related regulations
- Third parties' rights
- Labour rights
- Human rights protected under international law
- The principle of free prior and informed consent particularly in relation to indigenous people
- Tax, anti-corruption, trade and customs regulations

Each origin will be benchmarked for risk and categorized into low, standard, or high with 9% of all parcels from high-risk origins being inspected and also 9% of operators placing products from high-risk origins onto the EU market being inspected. The inspections for low are 1% and standard are 3%. It is highly likely that most cocoa origins will be categorised as high-risk.

It is also possible for interested parties like activist NGOs to submit a substantiated claim, backed with evidence, which the NCA is obligated to investigate. This will give the activist NGOs regulatory teeth that they have not had at their fingertips before.

A non-compliant parcel will be seized and/or potentially a fine of up to 4% of the prior year's turnover in the EU of the operator will be imposed. This changes the game in terms of liability in trade between counterparties where historically the risks would relate to contract delay or default and quality and weight loss, all of which would generate a relatively low percentage of the contract value. With EUDR, if a counterparty passes false data or data that proves non-compliance with the Bill of Lading for a relevant parcel, the potential loss is 100% of the contract value and possibly 4% of the importer's turnover within the EU.

An operator is obligated to carry out due diligence according to the requirements of Articles 9,10 and 11.

Under Article 9, the operator is obligated to collect information which they shall organise and keep for a period of 5 years from the date of placing on or exporting from the EU. Apart from the geolocations and polygons, there has to be adequately conclusive and verifiable information that the products are deforestation-free and also that the production of the relevant commodities has been conducted in accordance with the relevant legislation of the country of production.

Under Article 10, the operator is required to do a risk assessment at country level, regional level, and local level to establish that there is no or negligible risk of non-compliance.

Under Article 11, the operator is required to carry out risk mitigation which includes gathering additional data, carrying out surveys and audits, in addition to capacity building, particularly at the smallholder farmer level. Also, adequate policies, controls, and procedures with all decisions on risk mitigation procedures must be documented.

These clauses are all to ensure that at the time of inspection by an NCA, the operator can prove due diligence has been carried out for deforestation, illegality, and traceability.

### **Who does it apply to?**

Small and medium-sized enterprises (SME), defined as employing fewer than 250 people, with less than €50 million turnover, and less than €43 million balance sheet, have more limited responsibility under the regulation.

An operator is the entity that places relevant products on the market (incl. via an import) or exports them in the course of commercial activity. This definition also covers companies that transform one product of Annex I (which has already been the object of due diligence) into another product of Annex I. For example, if Company A, based in the EU, imports cocoa butter (HS code 1804), and Company B, also based in the EU, uses that cocoa butter to produce chocolate (HS code 1806) and places it on the market, both company A and B would be considered operators under the Regulation.

Operators placing on the market a product listed in Annex I that has not been subject to due diligence in a prior step of the supply chain (for example importers sourcing cocoa) are, regardless of their size, subject to the obligation of filing a Due Diligence Statement.

The regulation is designed so that the entity carrying the cocoa across the EU customs border is liable and they have to have carried out due diligence on all entities between them and the farm plot, including the farm plot itself. Therefore, any operator will want to ensure that there is contractual obligation in each step of the supply chain unless they are involved in every step.

## **The impact on cocoa**

Approximately 60% of the global cocoa crop crosses the EU customs border, some is re-exported but is still required to comply with EUDR. Even if a parcel is shipped via a third country (Malaysia, Singapore, Indonesia for example), traceability to farm plot is still required.

Cocoa has many HS codes to manage from beans, waste (shells etc), liquor, butter, cake, powder, and chocolate. Each of these are relevant products under the regulation.

This means that 60% of the global crop will have to be traceable to farm plots and have no or negligible risk of non-compliance to EUDR by the 2024/25 main crop (starting in October 2024) because anything crossing the EU customs border by 30th December 2024 will be subject to the regulation.

The sourcing of cocoa is split between direct and indirect or third-party supply chains. Direct means that the cocoa comes to the operator via aggregators in the origins where the operator has origin operations, and they have existing sustainability programs, including certification, where they have data on farmers and farms and traceability to aggregator. Indirect means the supply from shippers or international trade that is conventional with no data or traceability. The percentage of direct versus indirect is approximately 50:50. There is demand for directly sourced cocoa to go to destinations outside the EU because of other sustainability programs, so all of the directly sourced cocoa volume cannot be allocated to cover EUDR demand.

It is estimated that there will be a 25% shortfall of third-party supplied EUDR compliant cocoa. This is a significant percentage of the market that will struggle to be able to comply.

Many origins outside the loop of sustainability programs (that concentrate on Côte d'Ivoire and Ghana) will be starting from scratch to create the due diligence and traceability required to prove compliance. Demand for EUDR compliant cocoa is highly likely to exceed supply, especially in the third-party supply market over the next couple of years. This implies that there will be further complications in an already extremely volatile cocoa market which includes the possibility of a two-tier market for compliant versus non-compliant cocoa.

There are initiatives like ICE Cot, established by ICE (the cocoa futures market), to help try to maintain the tradability of cocoa by establishing an independent and regulated platform for shippers and operators to log data prior to a shipment and sale, so that information can be validated which will enable the passing of the data to a contracted counterparty at the time of a sale.

### **What is happening now?**

There is much political manoeuvring within the EU that is mainly an outcome of the EU Commission's inability to complete their required tasks in advance of the regulation entering into application. Risk benchmarking of each country has been delayed until after entry into application which means all countries will be considered standard-risk. If a country is rated low-risk they only need to collect data; standard or high-risk countries have to collect data, and assess and mitigate the risk. It should be noted that this delay by the Commission has therefore pushed low-risk country operators to have to do more work, at no fault of their own, pending the completion of the benchmarking.

The set-up of the information system is in the hands of the Commission. They established a pilot with multiple participants to test the system. It was far from successful. Particularly without having an API for operators to download DDS data directly to the system. After much negotiation, it was agreed that this would be added but with no clear time frame.

These challenges have led to a group of EU member states, under the influence of Austria, to call for the application date to be delayed. At this stage it is very difficult to predict, the only thing known is that if it is to be delayed the decision will not be until September or October 2024. With only one or two months before launch, prudent companies are advised to be ready and not rely on a delay being announced.

The regulation is a complex, product-related legislation only really seen in the EU under the European Union Timber Regulation (EUTR) in the past. As a result, there are multiple interpretations of the Articles and clauses. This is complicated by the seven very different supply chains from the relevant products from cocoa to cattle with rubber, palm oil, soy, timber, and coffee in the middle.

As stated earlier, prior to EUDR cocoa, could be bought under an FCC contract, destination EU, from a shipper and the concerns would be about contract default, shipment delay in a backward-dated market, weight loss and quality and other issues, all of which are risks that are relatively low percentages of the contract value. EUDR brings a 100% risk of contract value. If a counterparty gives data on a parcel that does not stand up to an NCA inspection, then the importer loses 100% (the parcel will be seized) and potentially receives a huge fine. This changes the game.

There is a lot of water yet to pass under the bridge, but one thing is certain, this will change cocoa sourcing forever.

### **June 2024 Instalment**

A detailed exploration of the UK Forest Risk Commodities Regulation (FRCR).