Improving Sustainable Development within Indonesian Palm Oil: The Importance of the Reward System

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ABSTRACT
Nowadays, standards play a central role in the governance of international business relations; palm oil is no exception. The focal issue of palm oil is sustainable processes of production and sourcing, thus multi-stakeholder initiatives such as the Roundtable on Sustainable Palm Oil (RSPO) set out the sustainability principles and standards, and manage the certification system (CSPO). Empirical evidence based on in-depth interview with various stakeholders in the Indonesian palm oil industry indicates that the development of the RSPO sustainability standards is perceived to be in favor of a particular interest group due to the asymmetrical power and unbalanced control structure of the stakeholders. Thus the powerful stakeholders are able to exercise imperative power over other stakeholders, to the extent that it actually contradicts the others’ interests. This paper puts forward the notion that a more equitable governance system should be developed through the introduction of the reward system on the CSPO transaction. The reward system can demonstrate the original motivation of the RSPO toward consensus among all stakeholders to equally contribute in the implementation of sustainability Principles and Criteria (P&C) and standards. Copyright © 2018 John Wiley & Sons, Ltd and ERP Environment

Introduction

In many developing countries, development in agriculture drives economic growth and offers a potential way out of poverty. Agricultural commodities not only fulfil the domestic basic need for food but also meet the demand of the global market by generating foreign exchange. The global demand for vegetable oil keeps increasing, not only due to food consumption but also for industrial uses such as cosmetics and biofuel. Global consumption of vegetable oil in 2016 was 184.1 million tonnes, of which palm oil accounted for 38.7 percent. Other significant contributors to the global consumption are soybean oil (27.9 percent), rapeseed oil (15 percent) and sunflowerseed oil.
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(8.5 percent) (Statista, 2017). In the case of the palm oil commodity, Indonesia is now the largest global producer and exporter; in 2016, Indonesia produced 34.5 million tonnes of palm oil (around 53.5 percent of global production) and exported 25.1 million tonnes at a value of US$ 18.1 billion (GAPKI, 2017). Indonesia in addition to Malaysia together account for 85 to 90 percent of global production and market, thus the two countries resemble a duopoly of palm oil. Therefore, palm oil in Indonesia is the most significant agro-industry.

Nevertheless, development in the agro-food industry also poses adverse impacts on environmental and social aspects. For this reason, standards are playing an important role in international trade of the agro-food industry. Standards in agricultural commodities mostly refer to food safety, health and diet, as well as the environmental and social impact of sustainable production processes. A certification and labeling procedure is generally used by large plantations and smallholders to inform buyers and consumers that they have met standards. Examples of certification in sustainable production are Fairtrade, Rainforest Alliance and UTZ. Within palm oil, standards and certification in production processes are administered by various international organizations including the Roundtable on Sustainable Palm Oil (www.rspo.org) and International Sustainability & Carbon Certification (www.iscc-system.org). Currently, the RSPO accounts for 11.97 tonnes or 21 percent of global certified sustainable palm oil (CSPO).

The research is aiming to understand the governance of global palm oil production network. More specifically this study seeks to address (1) how value is created and captured by actors within the network, (2) how power relations among actors in the networks involved in the standard setting are formed and (3) how global sustainable palm oil standards affect value creation and capture. The paper is organized as follows. The next section discusses the concepts and theoretical framework used for analysis. It explores the concept of sustainability and global governance, including power relations and value distribution among actors using the framework of the Global Production Network. It also discusses how data and information are gathered. The third section discusses results of this study. The last section concludes.

Conceptual Standpoint

In its early development, the concept of sustainability was popular in environment science, in which human activities affect the environment. It suggests that economic activities to seek human welfare also have an impact on the environment. The concept of sustainability differs among societies depending upon the context in which it is applied. For instance, sustainability in agriculture involves conservation of land resource without degradation and must be economically viable as well as socially acceptable (Brown et al., 1987). Therefore, sustainability refers to not only environmental but also economic and social pillars. In an attempt to address sustainability, the United Nations (UN) published the report Our Common Future to develop a global common perspective with respect to the earth’s future. The concept of sustainable development then emerged, focusing on economic and social development, and environmental protection to meet current needs without compromising future needs (UN, 1987). The concepts of sustainability and sustainable development may be divergent; however, the three pillars remain the same: environmental, social and economic, or what Elkington (1994) simply refers to as the 3Ps – planet, people, and profit. Since then, the term of sustainable development has been embraced by the UN in establishing the global development agenda, in particular the post-2015 Sustainable Development Goals (SDGs). The SDGs set 17 goals with 169 targets between the goals through a balance of the environmental, social and economic pillars of development (UN, 2015). The SDGs are not free from criticisms; some originate from the unrealistic attempt of SDGs to reconcile the three pillars (see for instance Brandi, 2017; Holden et al., 2017).

Since the 1990s there has been a paradigm shift in the global system of production, distribution and consumption of goods and services, in which the exchange among economic actors is governed and coordinated by transnational buyers and producers. Analytical frameworks, including the Global Commodity Chains (GCCs; Gereffi et al., 1994), the Global Value Chain (GVC; Gereffi et al., 2005; www.globalvaluechains.org) and the Global Production Network (GPN; Henderson et al., 2002; Coe et al., 2004; Coe et al., 2008; Coe and Yeung, 2019) are emerging to provide an understanding of the new global paradigm. The frameworks focus their analysis on the governance system: while the GCCs/GVC focus on inter-firm governance, the GPN includes all relevant sets of actors and relationships (i.e. intra-, inter- and extra-firm) to accomplish the exchange in goods and services. The term ‘extra-firm’
includes a broad range of institutions, including non-government organizations (NGOs), trade associations, consumer groups, government agencies and supranational organizations within the network.

The governance system will determine value creation, value enhancement (or upgrading) and value capture among actors involved within the network. Value can be created in various ways, including access to natural resources, technology, organization and relationships as well as brand (Kaplinsky, 2005). Due to these various forms of value, a single actor will not have access to all the scarce resources, thus the actors must specialize and work together to create value. Over time, value is enhanced through knowledge exchange and skill upgrading among actors within the network. Nevertheless, the extent of value enhanced, captured and distributed among actors strongly depends on power relations. Power relations will shape the flow of inputs, technology, information and knowledge among actors. Power refers to the ability of a single actor or some actors to influence the behavior of others within the network to perform a conduct according to a set of rules, even in a manner contradictory to the others’ interests (Coe and Yeung, 2015). Sources of power may be corporation (producers, buyers), collective (consumer groups, NGOs, trade associations) or institutional (government, supranational organizations). Although actors within the network depend on each other and work together to accomplish production, distribution and consumption of goods and services, power relations among actors are rarely symmetrical. Some actors take a lead in driving the network by using their power to set the rules of the game in order to condition the behaviour of other actors as well as to include or exclude actors. Therefore, a natural component of global governance is the potential use of asymmetrical power as a method to control other actors. The governance system including structure and power relations is embedded in specific society, network and territory. Societal embeddedness refers to social and cultural attributes of lead actors in the context of their home countries, for instance their sophisticated consumers and demanding market. Network embeddedness refers to the importance of connectivity or the degree of dependency of the actors upon the GPN. Meanwhile territorial embeddedness refers to the local, national and regional location of the GPN (Coe and Yeung, 2015).

Within current global governance, standards play a vital role to ease intra-, inter- and extra-firm coordination and to determine which corporations and actors are included or excluded within the networks. Standards are an accepted benchmark that provides information to buyers and consumers about goods’ or services’ quality specification and health and safety compliance, as well as their production and sourcing processes (Nadvi, 2008). In many global agrifood production networks, sustainability standards have been widely adopted and applied. Since the sustainability standards emanate from the network, they are mandatory for actors who insert themselves into the network. Those who are not engaged in the network still have a choice not to comply with the standards. Moreover, the sustainability standards within the network have evolved from private codes of conduct of transnational buyers and producers to rules of the game initiated within multi-stakeholder initiatives (MSIs). MSI-driven sustainable standards play a more and more important role in the mechanism of global governance (Cashore, 2002; Bernstein and Cashore, 2007; Eberlein et al., 2014; Ponte and Cheyns, 2013).

The MSIs appear promising due to the involvement of various actors (e.g. corporations, smallholders, consumer groups, NGOs, trade associations) within the production network at a global level, and use market-based incentive (i.e. market access) across corporation and national boundaries to implement the sustainability standards. Nevertheless, the legitimacy of the MSI-driven sustainability standard setting and effectiveness of the standards’ implementation by actors within the network requires deliberative democratic governance and a strong incentive system.

<table>
<thead>
<tr>
<th>Type of standard</th>
<th>Reward</th>
<th>Punishment</th>
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<tbody>
<tr>
<td>External institutions</td>
<td>-Quality standards (ISO)</td>
<td>-Fines, compulsory closure</td>
</tr>
<tr>
<td></td>
<td>-Informal standards promoted by civic society organizations</td>
<td>-Consumer boycotts; adverse publicity; campaigns</td>
</tr>
<tr>
<td>Internal actors</td>
<td>-Standards set by key links in the chain, which suppliers need to attain</td>
<td>Delisting as a supplier; swing-supplier status; lower prices due to checking of all incoming material</td>
</tr>
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Table 1. Incentive system in applying standards. Adapted from Kaplinsky and Morris (2001, p. 73) Figure 27: Sanctions and rule keeping.
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There is a wide array of theoretical and empirical studies discussing the legitimacy of MSIs in standard setting (see for instance Cashore, 2002; Bernstein and Cashore, 2007; von Geibler, 2013; Schouten et al., 2012; Martens et al., 2017). They point out important roles of the deliberative democratic qualities of standard setting processes, including inclusiveness (e.g. active participation of stakeholders, representation of various interests and perspectives), authenticity (e.g. open discussion and debate, deliberative communication) and consequentiality (e.g. institutionalization and implementation of standards). Furthermore, the aspects of deliberative democracy interlink and affect each other (Schouten et al., 2012).

Along with legitimacy, a weak incentive system and its enforcement may result in ineffective implementation and disappointing outcomes of standards (Kaplinksy and Morris, 2001). As shown in Table 1, the strong incentive system comprises not only punishment but also reward. Studies of organizational behavior have acknowledged that, aside from punishment, reward is also a useful tool to motivate members of an organization to act toward something wanted by the organization. Both kinds of incentive can promote cooperation among members of an organization and incentives should be more effective if the goals of those who administer incentives are perceived as aimed at enhancing collective interests, rather than their own interests. That is, incentives should be more effective to the degree that they are perceived as guided by cooperative motives (Balliet et al., 2011). Furthermore, the application of reward can be more effective than punishing or imposing stringent regulations and rules alone, especially when aiming to create long-term value (Verhezen, 2015). Therefore the effectiveness of sustainability standards is enhanced not only through punishment (e.g. sanction, penalty, ousted from the network) but also by reward (e.g. fixed long-term contract, price premium). The bottom line is that standards are not free from manipulation, vested interest, power struggles and opportunistic behavior in practices. They empower some actors to set criteria and to control their execution and monitoring and/or certification. Those who control standards have power over other actors within the network. Thus, standards affect the distribution of benefits and costs within the network (Ponte and Gibbon, 2005; Nadvi, 2008).

Data Collection and Analysis Methods

The conceptual framework of power, value and embeddedness of the GPN provides the basis for the empirical ground toward which this study is addressed: to understand the governance of the global palm oil production network. Since this study is exploratory in seeking in-depth insights into the governance system, including sustainability standard setting and implementation as well as power asymmetry among actors, it relies mainly on in-depth and detailed information provided by key actors within the Indonesian palm oil industry through interviews. In addition, this study collects quantitative data and public information through desk research (e.g. newspapers, websites) to put the interview results into the industry-level context. The participants in general were requested to share their experiences with regard to the implementation of sustainable palm oil standards and its challenges. Participants were selected based on personal contact and the snowballing technique, including Gabungan Pengusaha Kelapa Sawit Indonesia (GAPKI) and three plantations that were either RSPO members (i.e. ‘MS’ and ‘SM’) or not (i.e. ‘AG’). ‘MS’ is a subsidiary of Malaysian business group and was established in 1988. The corporation owns and operates 71 palm oil estates on a total area of 203 000 hectares of land located in Sumatra, Kalimantan and Sulawesi in Indonesia. It has crude palm oil (CPO) mills producing 771 272 tonnes per annum. ‘SM’ is a public Indonesian company, which was established in 1962 and sold its shares to the public in 1992. ‘SM’ manages palm oil estates with a total area of 138 400 hectares of land across the Sumatera and Kalimantan islands, in which the land includes estates operated by ‘plasma’ smallholders. The plantation has 17 mills to process fresh fruit bunches (FFBs) into CPO and then into oleochemicals and final goods as well (i.e. cooking oil, margarine, shortening). In 2015, ‘SM’ had started to build mills for producing biodiesel with a capacity of 600 000 tonnes per annum. ‘SM’ joined RSPO in 2005 and obtained CSPO for the first time in 2011. ‘AG’ is also an Indonesian public company, which was established in 1984 and sold its shares to the public in 1997. It manages a total area of 297 011 hectares of land (20 per cent is operated by plasma smallholders) spread through Sumatra, Kalimantan and Sulawesi. ‘AG’ also operates 31 mills to produce CPO and oleochemicals. Although ‘AG’ is not a member of the RSPO, the plantation takes responsibility to maintain environmental and social conditions by practicing sustainable business. As a public
company, ‘AG’ published its sustainability and corporate social responsibility (CSR) reports to its shareholders every year, even before the establishment of RSPO. To strengthen its commitment toward sustainable production processes, ‘AG’ enacted its Sustainability Policy in 2015, highlighting three principles: no deforestation, conservation of peatlands and respect for human rights. In implementing the policy ‘AG’ is technically assisted by the Consortium of Resource Experts (CORE). The CORE is a consultancy service focusing on sustainable commodity production and sourcing, comprising Daemeter Consulting (member of the RSPO), Proforest and the Rainforest Alliance. Other participants are one Indonesian environmental and human rights NGO (i.e. ‘YS’) and the RSPO’s Indonesia liaison office. ‘YS’ was established in 2007, focusing on environment and human rights issues, and is a member of the RSPO. ‘YS’ is concerned with social problems and the environment in Indonesia, particularly caused by the expansion and the large scale activity of palm oil plantations. ‘YS’ has a mission to develop the capacity of smallholders and local communities around palm oil plantations to use natural resources in a sustainable manner. ‘YS’ is involved in assisting smallholders to meet the P&Cs and standards.

The interview was conducted in Bahasa during 2016–2017 and the data is analyzed following these steps: (1) organizing field interview and field notes into readable narrative descriptions; (2) sorting data into themes (i.e. embeddedness, power and value) and sub-themes (i.e. societal and network embeddedness, collective and institutional power, value creation and capture); (3) examining themes and sub-themes for explanation and verification. This analysis process is likely to generate relationships and explanations of power relations and value capture within the global palm oil production network.

Since the detailed analysis of this study relies more on qualitative research, the author is well aware of the limitations of applying this approach. While a qualitative approach can provide detailed accounts and in-depth insights into the issues under investigation within palm oil stakeholders, the methods cannot produce quantifiable outcomes of the issues under investigation that can be generalized to the larger population of Indonesia’s palm oil industry (Yin, 2003; Bryman and Bell, 2003). However, the use of qualitative research in this study helps to provide a better nuanced and detailed understanding of the processes by which plantations adopt sustainable palm oil standards, and the consequences that arise from this for both empirical and theoretical considerations within the literature.

Results and Discussion

Embeddedness

The Indonesian palm oil industry consists of many actors and creates network relationships. The palm oil production network in Indonesia mostly consists of the upstream industry (i.e. plantations and processing mills producing CPO and palm kernel oil, PKO). The industry consists of large private plantations (57 per cent of the total area, 11.7 million hectares), smallholders (35 per cent) and large state-owned plantations (8 per cent). Some private plantations (including ‘MS’, ‘SM’ and ‘AG’) are members of national and international business groups (e.g. Wilmar, Sinar Mas, Astra, Sime Darby, Cargill). Smallholders are ‘independent’ or ‘organized’ by having supply chain arrangements with mills of large plantations. While most of the private plantations are members of the Indonesian Palm Oil Association (GAPKI), smallholders join the Indonesia Palm Oil Smallholder’s Association (APKASINDO). Both palm oil associations aim to promote and improve the global competitiveness of the Indonesian palm oil industry. GAPKI has a closer connection with the Government of Indonesia (GOI) in reformulating policies and regulations on the palm oil industry. For instance, GAPKI fully supports the implementation of Indonesian Sustainable Palm Oil Association (APKASINDO). The GAPKI has a mission to develop the capacity of smallholders and local communities around palm oil plantations to use natural resources in a sustainable manner. ‘YS’ is involved in assisting smallholders to meet the P&Cs and standards.

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Oil (ISPO) established by the GOI.1 The ISPO is a regulatory framework governing sustainability of palm oil businesses within Indonesia. The ISPO is sometimes referred to as Indonesia’s ‘legality (de jure) standard’, with its mandatory status for all palm oil plantations and smallholders.

Regarding the RSPO, GAPKI actively participated from its establishment in 2004 to represent Indonesian palm oil plantations on the executive board. Nevertheless, in 2011 GAPKI officially withdrew from the RSPO and joined the European Palm Oil Alliance (EPOA) as a full member in 2016. After GAPKI withdrew, the representation of Indonesia in the RSPO was taken over by the Indonesian Grower Caucus, made up of individual palm oil plantations.

Non-governmental organizations exert significant influence on the palm oil industry, including Indonesia. Concerning adverse effects of expansion of palm oil plantations on social injustice and environment degradation, some local NGOs have emerged, such as ‘YS’, Walhi (www.walhi.or.id) and Sawit Watch (www.sawitwatch.or.id), and along with international NGOs (e.g. Greenpeace Indonesia and WWF Indonesia) promote sustainable management of palm oil development in Indonesia. Of note, the NGOs have different backgrounds and strategies to reach sustainable palm oil in Indonesia, in some cases to oppose large plantations.

Some large plantations possess refineries to process CPO further to produce intermediate products (e.g. olein, stearin and fatty acid) and downstream products (e.g. oleofood, oleochemicals and biofuel). Nevertheless, the vast majority of Indonesian CPO goes through ports and shipments and enters importing countries by way of buyers, traders, processors and retailers (e.g. A. Reinsten & Sons, Britannia Food Ingredients, Aarhus United, Unilever, Nestle, Cadbury, Albert Heijn). In 2015, the GOI established the CPO Fund (BPDP-KS) to collect and manage imposition of export levies on CPO in order to encourage the development of the downstream industry (in particular biodiesel) and to promote sustainable palm oil businesses. Among CPO importing countries, there has been a shift in which emerging countries such as India and China have emerged as the largest importers. In 2015, export of Indonesian CPO to India and China accounted for 21 per cent and 13.3 per cent of a total of US$ 15.4 billion respectively. Meanwhile, the traditional export market of Indonesian CPO, i.e. the European Union (EU), contributes 13.8 per cent (see Table 2). Therefore, emerging countries are becoming major buyers of Indonesian CPO, and their imports are growing rapidly.

In general, the emerging market has distinct preferable characteristics over the traditional market. Standards are less significant in consumption and demand imports, while price plays a major role in their preferences. Standards are unlikely to be significant in value chains driven by China and India (Kaplinsky and Farooki, 2010). The interview results with GAPKI, ‘SM’ and ‘AG’ indicate that buyers in India and China do not require CSPO. The buyers are more concerned with competitive advantages of production and transportation cost, and product quality. Concern about cost and quality in buying preferences is aligned to the objective of their governments focusing on food security. Therefore, sustainability concerns in emerging countries are less important than other issues and the requirement for CSPO is less stringent. This buying preference may contribute to distribution of economic value creation among many, small and low capability palm oil plantations in Indonesia including smallholders.

In contrast, the EU is characterized by sophisticated consumers and a demanding market. The EU market demands not only cost-quality aspects of palm oil but also puts high concerns on sustainability standards. The EU market requires palm oil plantations to provide a certificate of their sustainable management toward employees, local

<table>
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<tr>
<th></th>
<th>2000</th>
<th>2005</th>
<th>2010</th>
<th>2015</th>
<th>CAGR (% per annum)</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>438.3</td>
<td>901.3</td>
<td>4 340.2</td>
<td>3 217.0</td>
<td>14.2</td>
</tr>
<tr>
<td>EU (Netherlands, Italy, Spain, Germany, UK, France, Belgium)</td>
<td>224.8</td>
<td>626.4</td>
<td>2 091.6</td>
<td>2 123.4</td>
<td>16.2</td>
</tr>
<tr>
<td>China</td>
<td>123.2</td>
<td>493.4</td>
<td>1 866.5</td>
<td>2 047.0</td>
<td>20.6</td>
</tr>
<tr>
<td>Pakistan</td>
<td>4.0</td>
<td>319.9</td>
<td>81.2</td>
<td>1 313.5</td>
<td>47.2</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>26.7</td>
<td>53.6</td>
<td>626.7</td>
<td>672.1</td>
<td>24.0</td>
</tr>
<tr>
<td>Others</td>
<td>447.7</td>
<td>1 693.</td>
<td>5 742.0</td>
<td>7 276.0</td>
<td>20.4</td>
</tr>
<tr>
<td>World</td>
<td>1 087.3</td>
<td>3 756.</td>
<td>13 469.0</td>
<td>15 385.2</td>
<td>19.3</td>
</tr>
</tbody>
</table>

*Table 2.* Export value of Indonesian CPO (in US$ million)

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The sustainability P&Cs clearly take into account the three pillars of sustainable development, thus the RSPO realizes that the viability of the palm oil business depends on healthy natural resources and ecosystems, and on the stability of just societies. Even more, the P&Cs are perceived as an important path to reach the SDGs. This is reflected in the memorandum of understanding between the RSPO and the UN that is aiming to raise global awareness of CSPO and to generate market demand for CSPO because the P&Cs and CSPO are playing a key role in preserving the earth’s ecosystem.

The outcome of the P&Cs encourages its members such as ‘MS’ to implement sustainable palm oil due to the positive effect on its business viability. The implementation of the P&Cs helps ‘MS’ in mitigating business risks and avoiding opportunity costs in doing business. ‘MS’ was once involved in appropriation of indigenous lands during its scale expansion, which led to a dispute with local residents. The land dispute originated from land cultivation title (HGU) overlap. Because there was no dispute settlement, the local residents took action by blocking access to the ‘MS’ mill and forced the corporation to halt the mill operation for weeks. In this incident, ‘MS’ lost a billion rupiahs.

Nevertheless, the implementation of the P&Cs also creates new challenges for Indonesian palm oil plantations due to an increase in costs. Obtaining the CSPO is not cheap; it consists of expenses for the RSPO annual membership fee, auditing processes (including administrative cost, accommodation and transport cost, and report writing cost) and a surcharge for the CSPO labeling. The RSPO annual membership fee is €2000 or US$ 2200 (€500 or US$ 550 for smallholders with areas of land of less than 500 hectares); the audit fee is between US$ 0.8 and US$ 5.0 per hectare in addition to preparation for the land audit, around US$ 13 per hectare. This surveillance audit is required annually. For a comparison, the Indonesian smallholders’ cooperative has spent at least 125 million rupiah or US$ 9615 for auditing processes (Pramudya et al., 2015). In addition, there is a surcharge for labeling the CSPO, including administration costs of US$ 3.0 per tonne plus a contribution to the RSPO of US$ 1.0 per tonne.

Business management and economics has taught us that as long as additional cost (MC) can be offset by its additional benefit (MR), the specific CSPO requirement in the palm oil business deal will be settled. In short, the CSPO should be technically feasible and economically justifiable to implement. This is highlighted by ‘AG’, which considers the CSPO based on a benefit–cost analysis; the additional costs of CSPO are simply compared with its additional benefits. In addition, ‘AG’ admits that CSPO is currently required by buyers from the EU but it is not specified by other buyers. Buyers from the emerging countries (e.g. China, India, Pakistan, Bangladesh, Russia) still prefer the cost-quality to the sustainability aspect of palm oil. Therefore, it becomes a matter of choice, i.e. which buyer and market will be served by ‘AG’. When the buyer and market demand CSPO it will certainly raise costs, and to do this ‘AG’ requires additional revenue; otherwise, it is not economically justifiable, let alone within the increasingly more stringent P&Cs. For this reason ‘AG’ has decided to embed into global palm oil networks (i.e.
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emerging market) with no specific requirement of CSPO, where the benefits and costs are still economically justifiable. This is not implying that ‘AG’ has no concern for a sustainable environment and ecosystem. ‘AG’ has realized for a long time that its palm oil business may negatively affect the ecosystem due to its natural resource intensive characteristic. In fact, ‘AG’ had adopted sustainable business practices in relation to the ecosystem and society; nevertheless, the EU buyers recognize only CSPO for sustainability standards of palm oil. For this reason, ‘AG’ perceives the P&Cs as skewed toward the perspectives and business interests of the EU buyer groups.

Power Relations

As its ‘roundtable’ suggests, the RSPO theoretically offers no dominant members and actors: each member has equal rights (i.e. every member has one vote), and decisions are made by consensus among the members. Therefore, the sustainability P&Cs and certification mechanisms are proposed in the context of harmonious interests, mutual benefits and existence of common objectives. In fact the RSPO membership comprises multiple stakeholders of palm oil businesses and each member has its own interests. Therefore, RSPO members are divided into various interest groups that may be much more in conflict than harmonious. Palm oil plantations may focus on the economic pillar (profit), NGOs are concerned with the environmental (planet) and social (people) pillars, while global buyers may be in between. In such a situation decisions are characterized by compromise rather than by consensus. Decisions on P&Cs and their dynamics will result from changes in the relative power balance of the interest groups. Therefore, the P&Cs may be completely beyond the influence of an individual member and its own will. It can therefore be expected that when progressive groups (i.e. NGOs advocated by green activists) win the power struggle, suitable conditions are created to reach more stringent sustainability criteria and standards.

Evidence demonstrates that the relations among interest groups within the RSPO, and hence its distribution of power, are asymmetrical. GAPKI withdrew its membership from the RSPO due to its resistance to an unwanted imposition by the other interest groups. GAPKI criticized the RSPO for being too much in favor of a group of non-producers (i.e. NGOs, investors, global buyers), comprising 70 per cent of the members. GAPKI states that the P&Cs are periodically raised on an ad hoc basis to fit goals of the group of non-producers. Asymmetrical distribution of power within the RSPO is due to this unbalanced composition of memberships. Asymmetrical power then skews the consensus on decisions in favor of the interests of the dominant group, thus propelling interest divergence and creating opportunistic behaviour for particular members. Powerful global buyers (e.g. Unilever) dominating the decision making is probably inevitable, since the buyers do most global palm oil transactions and govern the network. The buyers thus have both the incentives and the resources to influence other members within the RSPO in favor of their interests. For this reason, GAPKI had been urging equity in the RSPO’s decision making processes to have the spirit of a ‘roundtable’.

GAPKI also had seen changes in the RSPO governance system, which is more and more influenced by extra-firm institutions including NGOs, nations and supra-national organizations (i.e. the European Commission). While corporations may be more concerned with the economic pillar of sustainability, the extra-firm institutions highlight non-economic issues, including environment, social, fair competition and political issues. The extra-firm institutions have made power relations within the RSPO more complex. The power tends to strengthen global buyers’ power in negotiation with palm oil producers in the implementation of P&Cs. In fact, the Indonesian palm oil industry is constantly accused of illegal deforestation, peatland clearance and forest fires, despite its membership of GAPKI and individual plantations (e.g. ‘MS’ and ‘SM’) in the RSPO. For instance, negative publicity once produced by Greenpeace resulted in a cancellation of purchasing contracts of Indonesian palm oil by Unilever and Nestle (Guardian, 2013). Other negative attention to palm oil is demonstrated by France, in which the French Green Party

2The third generation P&Cs or the RSPO Next are more stringent than the second generation: (i) banning planting palm oil on peatlands and other carbon-rich soils (pre-existing standards only banning the cutting of primary forests or those considered to be of high conservation value), (ii) requiring plantations to implement fire prevention policies (versus no requirement for plantations to have procedures in place to prevent fire on land they manage), (iii) reducing greenhouse gas emissions (versus less comprehensive reduction requirements), (iv) paying employees a living wage and committing to zero deforestation (versus only extensive planting on peatland) (Guardian, 2016).

Power asymmetry among members of RSPO is also raised by the Malaysian Palm Oil Association (MPOA) (Star, 2014) and Malaysian palm oil plantations identify increasing involvement of global NGOs such as World Wildlife Fund (WWF)-linked individuals and western green activists at all levels of the RSPO task force, committees and organizational set-ups. They boldly assert that the RSPO has turned into the ‘Trojan horse’ of the WWF (Star, 2014).
proposes to charge extra tax of €300 or US$ 330 per tonne of palm oil in 2017, which will increase to €900 or US$ 990 in 2020 and be progressively raised each year from 2021. This proposal is also known as the ‘Nutella tax’ because the tax is spread and supported by Italian buyer Ferrero (a member of progressive POIG). (Un)fortunately, the proposal has been rejected by the French Parliament (Reuters, 2016). Recently, the European Parliament has voted to ban the use of palm oil in biofuel due to its responsibility in global deforestation, including in Indonesia (Guardian, 2017). The negative publicity and sanctions will affect all stakeholders of the whole Indonesian palm oil industry including the P&C-compliant plantations and smallholders, although the accusation may only be true for a few palm oil plantations. This action will adversely affect the efforts of Indonesian palm oil industry toward the three pillars of sustainability. Since the power is distributed in an asymmetrical manner, to the disadvantage of GAPKI, then as the representative of Indonesian palm oil plantations GAPKI is uncertain if Indonesia even has a chance to obtain a better outcome of the RSPO decisions. CSPO, which was originally on a voluntary basis in the economic exchange system of producer–buyer relationships has transformed into a mandatory-like scheme through the asymmetrical power play of extra-firm actors over producers. Sustainable production is not originating from changes of behavior of plantations through the incentive system, but through the exercise of the power of global buyers, NGOs and state nations to enforce compliance on all Indonesian palm oil. Thus, GAPKI is now focusing on ensuring the success of ISPO implementation throughout the Indonesian palm oil industry.

Value Creation, Enhancement and Capture

Economic value is generated by the vast majority of Indonesian palm oil plantations through access to natural resources, because the Indonesian palm oil business focuses on the upstream industry. The upstream palm oil commodity provides lower value than the downstream products, thus its revenues and profits are highly dependent on production of FFBs and their market price. The price of palm oil is determined by global supply and demand, thus Indonesian palm oil plantations are clearly price takers with little market power (despite Indonesia’s status as the dominant global producer). Price taker status drives Indonesian plantations to lower costs to add value through mass production of FFBs, which is dependent on seedlings and land use. For this reason, some plantations are applying the extensification production system through expansion of palm oil estates. This production system is applicable particularly for plantations having a landbank. For instance, ‘MS’ still has about 77 000 hectares of spare land for new palm oil planting. This extensification system has raised concerns about the preservation of the ecosystem in Indonesia. Large plantations and smallholders may illegally grab forest land and indigenous local land to expand their palm oil estates, leading to deforestation and social conflicts. Even worse, the growers clear the forest to be planted by setting fires rather than zero burning techniques (i.e. cutting–chipping–stacking and leaving in situ to decompose naturally). Fires are often used to prepare land for planting because this technique is cheap and easy, thus the growers are able to save money and time. The cost of land clearing by fires is relatively low, about US$ 900 per hectare (Purnomo, 2015).

Other plantations are utilizing the intensification system by increasing the yield productivity of a given area of land through replanting using more productive seedlings. Palm oil is a perennial crop; trees potentially produce FFBs for 35 years. The productivity of trees reaches its peak between the ages of 9 and 18 years, and gradually declines thereafter. To retain the productivity of palm oil, the old trees are replaced and the estates are replanted with new seedlings. The seedlings typically need nearly 8 years to reach peak output capacity, thus the plantations have to consistently plan replanting schedules in order to sustain production. For instance, despite having a landbank, ‘MS’ prefers to conduct replanting about 7 per cent of the given area of 203 000 hectare per year. Other palm plantations such as ‘SM’ are even replacing the old palm trees with new high yielding seeds. ‘SM’ is able to use high yielding seeds because the corporation has been establishing a research and development subsidiary focused on producing high yielding palm oil seeds since 1996. The subsidiary is applying a tissue culture technology to generate high yield seedlings. The seeds have advantages of earlier FFB harvesting (at 24 months after planting) with a yield of 8–10 tonnes per hectare (compared with the national average yield of 3.5 tonnes per hectare) and the yield keeps increasing, to 28 tonnes per hectare between the ages of 3 and 8 years. This makes ‘SM’ easily comply with the P&Cs and achieve CSPO.

Complying with the P&Cs should provide benefit through value enhancement of Indonesian palm oil. In the macro-level analysis, the value enhancement or upgrading can be detected by considering a combination of unit
price (e.g. export value divided by volume) and market share (e.g. export value to a particular market/total world) (Kaplinsky and Readman, 2005). The P&Cs and CSPO are enhancing value for Indonesian CPO when there is an increase in market share, despite rising unit price (due to the P&C compliance costs).

Comparing the Indonesian export of CPO to the EU market and emerging markets (e.g. India, China, Pakistan and Bangladesh), as shown in Table 3, demonstrates that there is no significant unit price difference between the two markets. In addition, the market share of Indonesian CPO in the EU is declining, which indicates disadvantages of the EU market for Indonesian CPO. It appears that Indonesian palm oil exporters are adding value through export market expansion by offering the cost-quality rather than the sustainability aspect. This may be true in particular for the RSPO non-members such as ‘AG’, which is expanding into new emerging markets including the Middle East, Africa and Iran in anticipation of negative sentiment of the EU toward Indonesian CPO. The data on unit price also indicates that global buyers (in particular the RSPO members) in the EU provide little reward for the plantations complying with the P&Cs in term of price premium. The absence of rewards is also highlighted by the GAPKI. This may be due to the voluntary basis for palm oil plantations to implement the P&Cs. The RSPO seems to have overlooked the fact that the implementation of the P&Cs is costly. With no increase in price in purchasing contracts from EU buyers, all costs are born by the plantations. On the other hand, the EU buyers are most likely to generate higher benefits through an increase in their brand value and corporate reputation perceived by consumers. Therefore, the governance system between various interest groups within the RSPO takes on a zero-sum game where the costs of plantations equal the gains of global buyers. In other words, there is a wealth transfer from plantations to global buyers. By forcing the Indonesian palm oil business into P&C compliance through punishment rather than reward, the industry may cover the rising costs while fixing the purchasing price through scale expansion (may cause deforestation), lowering workers’ wages and labor standards, or reducing the profit margin. In this situation, a tradeoff between the 3Ps of sustainability is likely to take place. The conflicting nature of the three pillars has been highlighted by scholars both conceptually and empirically (see for instance Holden et al., 2017; Brandi, 2017).

In addition, Indonesian NGOs have raised concerns about the effectiveness of the P&C implementation by palm oil plantations and smallholders, and the certification processes. The certification process is perceived as a rubber stamp, as expressed by ‘YS’, which is currently helping independent smallholders to prepare for the certification processes of the P&Cs. ‘YS’ has a sense that the objective of the certification process is for the sake of the CSPO label rather than changing behaviour of smallholders toward sustainable production of palm oil. This is because the certification process is mostly a document-based audit. Thus when there is a violation of the P&Cs, the auditor only requires documentation about the issues of violation along with a plan document on how the issues can be settled, not a comprehensive resolution. ‘YS’ presents a case of conflict between a large plantation that is a member of the RSPO and local residents at its palm oil estate. Because there was no real resolution of the conflict, the plantation finally sold the estate to another palm oil plantation, which is not a member of the RSPO. By getting rid of the conflict the plantation retains compliance with the P&Cs, although the conflict itself still exists.

**Table 3.** Unit price (in US$/kg) and market share (% of total export) of Indonesian CPO

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<tr>
<td></td>
<td>Unit price</td>
<td>share</td>
<td>Unit price</td>
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</tr>
<tr>
<td>India</td>
<td>0.27</td>
<td>40.3</td>
<td>0.35</td>
<td>24.0</td>
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<tr>
<td>EU (Netherlands, Italy, Spain, Germany, UK, France, Belgium)</td>
<td>0.25</td>
<td>20.7</td>
<td>0.35</td>
<td>16.7</td>
</tr>
<tr>
<td>China</td>
<td>0.28</td>
<td>11.3</td>
<td>0.36</td>
<td>13.1</td>
</tr>
<tr>
<td>Pakistan</td>
<td>0.27</td>
<td>4.0</td>
<td>0.38</td>
<td>8.5</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>0.28</td>
<td>2.4</td>
<td>0.37</td>
<td>4.1</td>
</tr>
<tr>
<td>World</td>
<td>0.26</td>
<td>100.0</td>
<td>0.35</td>
<td>100.0</td>
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In the emergence of the MSI-driven standards, scholars have identified the drawbacks of the MSIs’ governance system resulting in low sustainability outcomes. Scholars pointed out a legitimacy problem within the MSIs that is contributing to the disappointing outcome and impact. They see the governance system of the MSIs including the RSPO contradicts some aspects of deliberative democracy, thus they suggest applying deliberative democracy in improving the governance system of the MSIs (Schouten et al., 2012; Martens et al., 2017). For instance, the inclusive nature of deliberative democracy reflects on not only equal rights (every member has one vote) but also representation of various interest groups, particularly in decision-making processes.

In fact, the source of the problem in the RSPO is from the various interest groups, which conflict with each other rather than running harmoniously. This reflects on the decision of the RSPO to raise the level of sustainability criteria and standards, a.k.a. RSPO Next. This third generation of the P&Cs has been criticized by not only the group of palm oil plantations but also global NGOs. The group of palm oil plantations claims that RSPO Next is too stringent and is very much skewed toward the goals of the global environmental NGOs. On the other hand, the NGOs are criticizing the RSPO for failing to strictly apply its P&Cs and leaving palm oil plantations free to destroy the forests (Greenpeace, 2013). Therefore, Greenpeace International and WWF International established the Palm Oil Innovation Group (POIG). The conflict between the different interest groups has been escalating, thus challenging the legitimacy of the RSPO.

This study has demonstrated that Indonesian palm oil plantations and smallholders are confronted with the conflicting nature of the economic, environmental and social aspects of sustainability. The current incentive system of the RSPO relies mainly on punishment, and this is perceived as aimed at enhancing particular interest groups rather than collective interest of the RSPO. Therefore, it is crucial to improve the incentive system through a balancing of reward and punishment in order to be more effective in changing the behavior of palm oil plantations and smallholders toward sustainable production. A price premium or a long-term purchasing contract should be introduced for sustainable palm oil. A price premium for the CSPO transaction is not uncommon in the concept of economic and business exchange (e.g. due to the existence of relationship specific investment, product differentiation or positive externalities). A price premium indicates that costs of the CSPO are distributed equally between plantations, buyers and consumers of palm oil. Thus the reward will be perceived as guided by cooperative motives among various interest groups within the RSPO, due to the contribution of all RSPO members to sustainability issues. The reward shares the idea that the behavior of plantations and buyers is motivated to maximize their self-interest value creation, enhancement and capture. The asymmetrical power and unbalanced control structure among members of the RSPO cannot be ignored; however, powerful actors including global buyers and environmental NGOs can achieve sustainable development in the palm oil industry by offering rewards rather than by breaking ties. The withdrawal of GAPKI from the RSPO is not the end of relations, but it is a stepping stone toward more equitable governance under the spirit of mutual benefits and interdependency to achieve long-term sustainability in the context of profit, people and planet.

Nevertheless, the efforts toward more equitable governance of the RSPO through a stronger incentive system pose a challenge, in particular when the powerful stakeholders posit the harmony between environmental, social and economic pillars, thus the 3P sustainable goals can be reconciled with little contribution from them. There will be a lack of participatory process balancing interests of various groups in the P&C development and implementation. The participation of palm oil plantations in the P&C development and implementation is motivated by a positive individual economic cost–benefit analysis. With lack of participation, the legitimacy and the outcomes of the sustainability standards are questionable.

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4 In 2013, Greenpeace and the WWF together with progressive palm oil stakeholders (e.g. Ferrero, Danone) established the Palm Oil Innovation Group (http://poig.org/). POIG has developed higher standards (than RSPO Next) for socially and environmentally responsible palm oil production, including human rights and labor (see the POIG Charter).
Sustainable palm oil

Concluding Remarks

Although sustainability standards of palm oil are advocated by the MSIs such as the RSPO, its implementation by palm oil plantations and smallholders and its outcomes are hindered by the asymmetrical power exercised by a particular interest group (e.g. global buyers and NGOs). The power of global buyers originates from their knowledge of complex home market preferences, while the NGOs represent consumers’ concerns on environmental and social issues. Thus both actors can provide market access for the plantations. Asymmetrical power skews the collective interests of sustainability P&C and standard development in favor of a powerful group of buyers—NGOs (plus state nations), thus the standards are not reducible to plantations’ business strategy but rather reflect the negotiated settlements that arise from the conflicting nature of economic and environmental interests. Consequently, the asymmetrical power can create opportunistic behavior of the powerful group in creating, enhancing and capturing value. Because of this, palm oil plantations in Indonesia perceive CSPO to pay off less, and the governance system of the RSPO is unable to correct the misbehavior of unsustainable plantations.

Given the conflicting nature of the 3P sustainability and the existence of asymmetrical power among the RSPO’s members, the paper suggests creating a more equitable governance system through an introduction of reward in the incentive system. The paper develops the logic of the reward system to motivate palm oil plantations and smallholders to implement sustainability P&Cs and standards from studies of organizational development. It is more effective to combine reward with punishment to stimulate behaviors toward what is wanted by organizations. In addition, a reward in terms of a price premium is not uncommon in economic transactions involving relationship-specific investment, product differentiation and generating positive global externalities for CSPO. The reward system is required to demonstrate the original motivation of the RSPO toward achieving consensus among members in the implementation of the sustainability P&Cs and standards.

In the context of the popularity of the MSIs in countering unsustainable production of agricultural commodities, it may not be the best way to govern sustainability standards. Despite a voluntary basis, the legitimacy of the MSIs seems promising due to a mixed representation of and participation by cross-sectoral stakeholders. In fact, the MSIs deal with diverse perspectives and motivations, conflicts of interests and power asymmetry between the stakeholders. These may result in a paradox: the MSIs are willing to include various stakeholders while at the same having exclusionary effects (i.e. favoring some stakeholders over others). The MSIs should shift their focus from a platform of sustainability standards to a process used to achieve sustainability outcomes. Facilitation toward a process may assist the MSIs to deal with these dynamics and encourage various stakeholders to achieve long-term win–win benefits based on mutually desired outcomes. The facilitation includes a participation of various stakeholders in open discussions and a representation of conflicting interests in decision making. As this paper suggests, the reward system should be also introduced to facilitate the implementation of sustainability standards.

The MSIs may gain de facto legitimacy through various stakeholders’ membership; nevertheless, they should fit within a broader governance ecosystem, including the de jure legal system on which the stakeholders stand. The MSIs are not isolated from local and national contexts, thus their principles and standards are embedded in the local and national rules and practices. MSIs’ principles and standards should align and comply with national regulations and policies in order to obtain a greater acceptance and effectiveness in implementation. A contradiction in standards and incompatible certification system between the MSIs and national regulations implies complexities and additional compliance costs in their implementation. The outreach of MSIs (e.g. the RSPO) depends on the extent to which their voluntary standards synergistically reinforce mandatory national standards (e.g. the ISPO).

References


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