Guidance document on Price Risk Management of the Fairtrade Coffee Standard

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Introduction

The Fairtrade Standards Unit and Global Product Management (GPM) team published a guidance document on Price Risk Management (PRM) when the previous Standard for Coffee was launched in April 2011. With the new Coffee Standard published in July 2021, the guidance document was also updated, considering the new standard and changing circumstances in the context of the Fairtrade coffee market.

The new Coffee Standard requires that the producer organisation and the buyer agree upon a price risk management strategy in writing (requirement 2.2.1, 2.2.2 and 4.5.1).

We provide this information as guidance to help explain the intent and requirements of the standard and to guide practices for Fairtrade's partners. 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, certified customers are requested to comply with these.

Contributions to the topic of risk management, questions and comments may be sent to Fairtrade International Coffee Help Desk coffeehelp@fairtrade.net to help develop best practice.

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Background: What is a price risk?

The world market price for coffee has been well below the Fairtrade Minimum Price for extended periods ever since the launch of the first Fairtrade seal in 1988. During these periods, the price risk for Fairtrade contracts are relatively easy to manage, but when the price spikes risk management becomes an important issue for both Fairtrade buyers and sellers. This is particularly valid for Arabica coffee.

Fairtrade certified small producer organisations (SPOs) are producer owned, but bear a commercial risk when they buy from their members. The risk for SPOs is essentially the difference in price and dynamics between the local market, where they purchase the coffee, and the international market, where they sell. The Fairtrade coffee business has some special characteristics, due to its pricing system (price defined at the FOB level in US dollars, the Fairtrade Minimum Price), that require specific measures under certain circumstances.

Fairtrade buyers often hedge the price risk at the futures market, but many SPOs lack the knowledge and resources to do the same. SPOs often depend upon physical price risk management tools like the Price to be Fixed at Seller's Call (PTBF) in the contract linked to the procurement of the coffee. Fairtrade buyers and SPOs need tools and strategies to manage the risk and coordinate the same.

The price risk consists of the following components:

- The base price risk of the futures market - London for Robusta, New York for Arabica.
- The differential risk - the difference between the futures market and a particular grade and origin of coffee.
- The Forex risk – the fluctuation of the exchange rate between the US dollar and the local currency.

What is the impact of price risk?

SPOs often sell coffee forward to seize sales opportunities and because they need sales contracts as collateral for external finance. With a PTBF clause the risk is limited, but with fixed prices before the harvest (a *short* position) the risk is that the market price goes up, which will reduce their margin and even generate a loss. If they cannot bear the loss, the consequence may be that they default on their commitments with the buyers and their lenders and eventually lose their market and source of finance.

The main risks for the buyer are delays or defaults on shipments and in their turn default with their clients and / or having to buy more expensive coffee to substitute the defaults, taking a loss and potentially losing clients.

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If this happens on a large scale it may generate supply issues for the Fairtrade market and create reputational damage. Roasters and retailers may lose their trust in Fairtrade and decide to drop the seal. This risk is larger for Fairtrade than for other certifications, because of the Fairtrade Minimum Price in combination with fixed price contracts, when the market price suddenly spikes.

Price risk management: what does the Coffee Standard say?

The aim of the new Coffee Standard is to reduce the price risk for producers, discourage speculation on both sides, and reduce the risk of making a loss and defaulting on the contract. Thus, the new standard:

- defines open contracts with a PTBF clause as the general rule (requirement 2.2.1):
  This has been the keystone in PRM for SPOs since the start of Fairtrade labelling. It allows SPOs 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 fixed-price contracts only in certain cases[1]:
  This recognises that in some countries open price contracts are not permitted, and that in certain cases, fixed-price contracts make sense, but as an exception to the general rule and not as a common practice.

- requires that a risk management strategy is put in place in case of fixed-price contracts:
  This is to encourage SPOs 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, 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 requirements 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

[1] Fixed-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.
d) ‘Price-to-be-fixed’ is against the national law

the appropriate risk management strategy depends on each particular situation. The auditor will check that the buyer and seller have agreed in writing how the risks will be managed.

However, a simple sentence in a contract e.g. that the contract price will be reviewed if the market price goes up or that the SPO will buy options to cover the price risk, is not sufficient. The buyer is bound to the general rule of open contracts with a PTBF clause, making an exception to that rule requires that the buyer checks that the SPO has the capacity to implement a proper price risk management strategy. The buyer will have to show evidence to the auditor that this capacity check took place, for example, with copies of emails or other written proof of the conversation and the precautions that are in place with a date and the names of the participants in this agreement.

What does a price risk management strategy look like?

It is good practice for SPOs to have proper risk management strategies and tools in place for all their commercial operations. The Standard for Coffee requires that a risk management strategy as explained in the previous section.

This document provides some guidance on tools and strategies for both SPOs and traders to manage price risks.

A) Price Risk Management for Traders

Most first buyers of Fairtrade coffee are traders, who often manage the price risk through hedging[2] on the futures market as a main tool, both their own and the price risk of their clients. But other general practices such as shared cost structure, solutions based on harvest results, and any clause relating to the responsibilities of the producer organization and the buyer – as mentioned in the Coffee Standards should be utilized whoever helpful to clarify the price risk management plan.

The new Standard for Coffee does not allow fixed-price contracts as a regular practice, nor to impose the cost of hedging upon the producer organisation and in case the producer organisation agrees with a joint price risk management strategy with the use of options, the buyer needs to check they are in the capacity to implement such strategy.

Nevertheless, the pressure from roasters on traders to offer fixed prices for a longer period and the difficulties to hedge the price risk around the Fairtrade Minimum Price exist and traders need to manage this with practices keeping within the spirit (or intentions) of Fairtrade's ultimate goal of improving farmer livelihoods).

In case the SPO is not able or willing to use hedging tools, there are various good practices that traders can use to manage the risk between themselves and the producers:

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

- Requirement 2.2.1 (in case of an fixed-price contract)
- Requirement 2.2.2 (in case the producer fixes the price before the harvest starts)

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1. Make an analysis of the market situation and an assessment of the risks and of the capacity of suppliers to handle these risks, also especially when the market becomes more volatile. Discuss the results of their analysis with producers and define together best possible price risk management strategies.

2. If the SPO agrees upon fixed-priced contracts, issue these shortly before the harvest starts. Buyer and producer can agree upon fixed-price contracts for the following shipments before a specific deadline (even before the First Notice day or B/L date), for example once the coffee has been procured. This price risk on fixed-prices over a limited time and volume is lower and easier to manage. Once the harvest is in full-swing, risks due to short positions can be covered relatively fast. If both sides want to secure a certain volume and define shipment months, one might want to start with a letter of intent and express a firm commitment from both sides. The actual contract could be issued close to the harvest start when the market situation is clearer.

3. In case the market spikes, buyers can make an assessment on “risk of default” by checking with producers what their short / long position is in relation to their target for the harvest. A high percentage of fixed-price contracts in times of sudden market volatility represents a significant risk that producer organizations could find themselves in the position of selling at a loss, which is the number one cause of contract default. We must remind ourselves that supply chain disruption is a huge risk for everyone involved, and buyer and seller should increase their communication and adopt a more flexible approach in time of extreme market volatility.

4. When a joint price risk management strategy is established, the price level at which the risk can become critical is to be defined. A copy of the joint strategy should be included.

B) Price Risk Management for Producers

In order to have a proper risk management strategy in place, SPOs need some basic structures and tools:

1. The harvest plan should have at least two different scenarios with different price levels, adapt the plan mid harvest if necessary.

2. Make a harvest forecast based not only on historical figures, but also on field visits. It is important to consider the historical commitment of the members selling coffee to their organisation. Monitor the progress of the procurement against the targets in the forecast, update it mid harvest and adjust if necessary.

3. Work out a price policy and a price risk management strategy, how procurement prices will be established and how contracts will be negotiated and fixed, who takes what decisions. Have this endorsed by the board and the members.

4. Keep proper tools and records to monitor performance and update these at least monthly. Define key indicators: yield, quality, costs, prices, differentials, stock position, short / long position, liquidity, projected profit / loss at the end of the harvest.

5. Regularly monitor market tendencies, ask buyers and analysts what their analysis of the market is.

6. Read contracts carefully before signing, make an assessment of the potential risks, ask the buyer if a certain concept is not understood and ask to change a clause if necessary.

7. Spread sales over the harvest and different markets, look for an average price that allows competitiveness and creation of a margin, without taking too many risks.

8. Base the price risk management in the first place on physicals, open forward sales contracts to be fixed as the coffee is procured. Do not speculate, put limits on how much volume can go short or long and what the limit is for fixing contracts.

9. Only engage in the use of options if understood how they work, what the costs and risks are, and if it fits in the budget. Ask for support on how to manage options from buyers and other people with experience.

Where to find advice on how to manage price risks?

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

Questions may also be directed to the usual contact within the Fairtrade system. Producers may contact their Producer Network. Traders and licensees may contact their Country Labelling Initiative / Certifier or the Coffee Help Desk.