

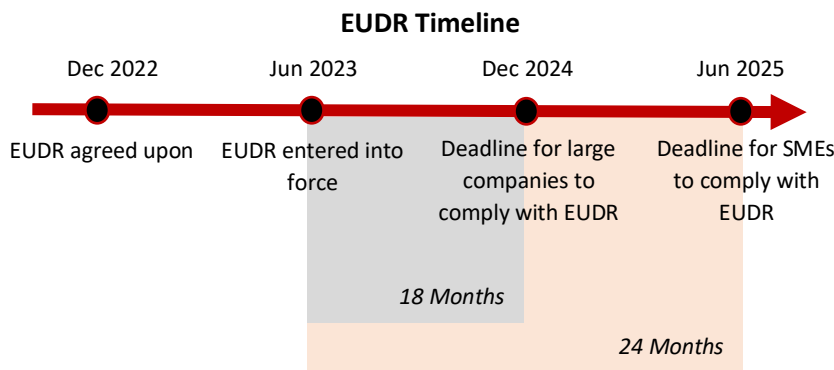
Implications of the EU’s deforestation-free law for Indonesia

European Union (EU) regulation on deforestation-free products (EUDR)

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The EUDR came into force on 29 Jun 2023, that mandates companies placing certain commodities on the EU market to screen their global suppliers through mandatory deforestation and forest degradation due diligence frameworks. A key driver is that the EU is a major consumer of commodities associated with deforestation and forest degradation for agricultural land expansion. The six commodities covered by the regulation are (i) palm oil, (ii) cattle, (iii) soy, (iv) coffee, (v) cocoa and (vi) timber and rubber, as well as derived products such as beef, leather, chocolate and furniture. The EUDR aims to increase the consumption of deforestation-free products, limit the EU’s impact on global deforestation, and reduce EU-driven greenhouse gas emissions and biodiversity loss. Under the EUDR, companies that export or place these commodities on the EU market must prove that the products originated from land that has not been subject to deforestation or forest degradation after 31 Dec 2020. All relevant companies will need to conduct strict due diligence to ensure that the products comply with regulations including those surrounding human rights, or face penalties for non-compliance. There is a transition period of 18 months from 29 Jun 2023 for large companies to comply with the EUDR, while small enterprises will have up to 24 months to adapt.



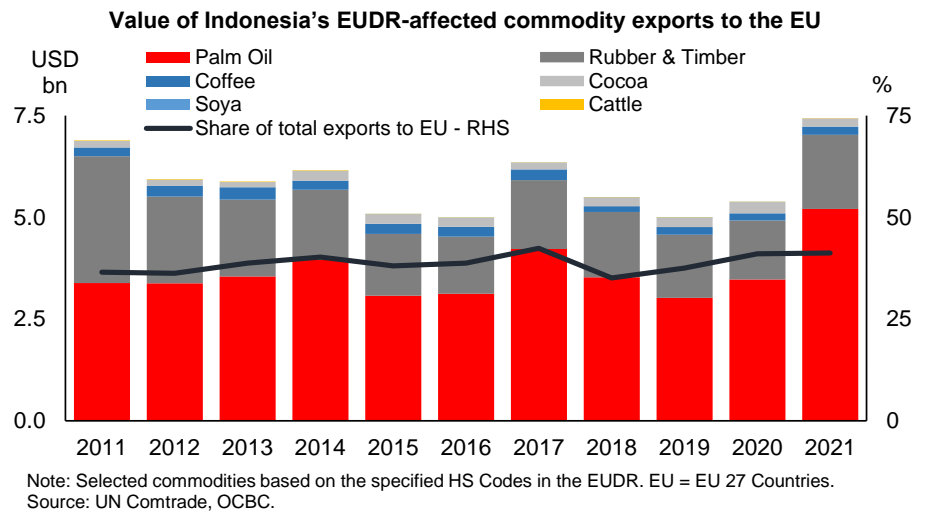
The EU estimates that there will be a reduction of at least 31.9 million metric tons of carbon emissions annually from the EU consumption and production of the targeted commodities, that translates to at least EUR 3.2 billion of economic savings annually.

Value of Indonesia’s commodity exports affected by the EUDR

As Indonesia is the world’s leading palm oil exporter and a major supplier of rubber, timber, cocoa and coffee products, approximately USD 5.9 billion¹ of

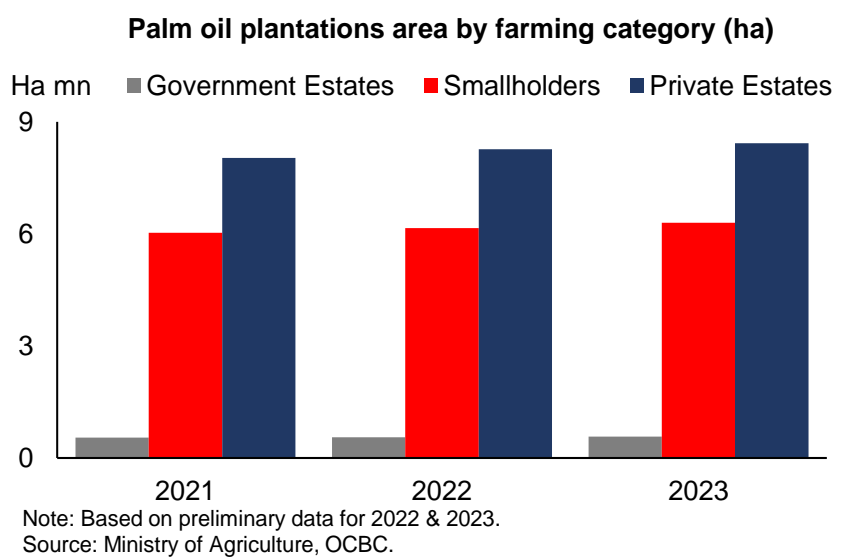
¹ Average value of annual exports of commodities covered by the EUDR to the EU from 2017 to 2021.

Indonesia’s annual exports are expected to be affected by the EUDR. While this constitutes only ~2.9% of Indonesia’s total global exports, it contributes up to ~40% to the country’s total exports to the EU. More importantly, both the nominal export value and its share of total exports to the EU have been on an upward trend since 2018.



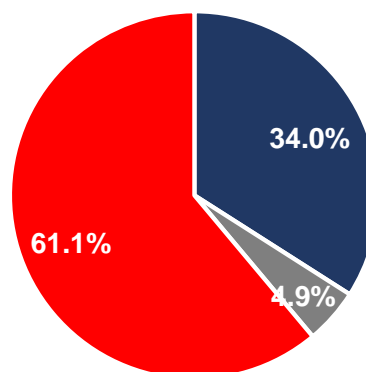
Impact on Indonesian palm oil: Increased costs but decreased climate risks

A key driver of deforestation in Indonesia is the large-scale conversion of forests into agricultural land e.g., palm oil. The EUDR is expected to largely affect around 15 – 17 million smallholders and small-scale farmers of palm oil in Indonesia, as they may not have sufficient resources to comply with the regulatory requirements.



Palm oil production by farming category (tons)

■ Smallholders ■ Government Estates ■ Private Estates



Note: Based on preliminary data for 2022 & 2023
Source: Ministry of Agriculture, OCBC.

These smallholders contribute to 34% of palm oil production for domestic and international markets. As a result, the Indonesian government is lobbying for the EU to recognise its locally recognised palm oil sustainability standards, i.e., Indonesian Sustainable Palm Oil (ISPO) certificates and Roundtable on Sustainable Palm Oil (RSPO), for export to the EU market.

However, there are also challenges with integrating smallholders into the sustainability palm oil supply chain, due to barriers such as lack of technical knowledge, limited access to planting materials and financing. There are existing efforts such as the smallholders training programme to support small-scale farmers in gaining access to financing, replacing ageing palms and managing their plantations while meeting certification standards.

The EUDR may spur greater government support for smallholders in capacity building and financing, as well as efforts to build on existing sustainable certification schemes like ISPO and RSPO to meet international regulations. This can increase the implementation of more innovative agriculture technologies for more productive palm oil production and lower the exposure to climate risks with decreased deforestation and forest degradation.

Deforestation risks in other sectors

Apart from palm oil, other monoculture plantations such as timber plantations also contribute to deforestation in Indonesia. Mining activities are also another major driver of deforestation in Indonesia, especially nickel mining as Indonesia has large nickel reserves and is the world's largest nickel producer. With the growing electric vehicles (EVs) sector, the demand for nickel is also expected to increase as nickel is a critical component of EV batteries.

The list of commodities covered under the EUDR is expected to be regularly reviewed and updated while it considers new deforestation drivers and emerging trends. Therefore, it is possible that the scope of commodities may be expanded in the future to include more commodities associated with deforestation such as nickel.

Resistance from commodity-producing countries

Indonesia is amongst several commodity-producing nations that export commodities covered under the EUDR to the EU. 17 countries signed a letter of concern to be involved in the drafting of implementing rules, as there are concerns over many small-scale farmers across Asian, Latin America and Africa who are not able to comply due to high costs and technical complexity. The 17 countries are Argentina, Brazil, Bolivia, Ecuador, Ghana, Guatemala, Honduras, Indonesia, Colombia, Malaysia, Mexico, Nigeria, Ivory Coast, Paraguay, Peru, Thailand and the Dominican Republic. These discussions will be crucial to trade relations between EU and affected commodity-producing nations.

What's next?

1. Risk classification of supplying countries

The EU will determine levels of low, standard and high risk for the supplying countries, which are dynamic and can change over time depending on country developments. Countries assessed as low-risk will be subject to simplified due diligence processes, while high-risk countries will be subject to more comprehensive checks e.g. satellite images. There are concerns that Indonesia may be labelled as a high-risk country that can lead to greater scrutiny on Indonesia's supply chains and additional regulatory burden.

2. Increased operational costs to commodity-producing countries and potential delays in trade negotiations

Countries exporting the affected commodities to the EU will be faced with increased compliance costs associated with tracing complex supply chains, such as new technologies and administrative processes. They are required to provide documents and certificates of traceability to European partners, which increases long-term operational costs of exporting to the EU. To support compliance to EUDR, the EU may provide financial and technical support to some of the supplying countries.

The enforcement of the EUDR is expected to slow down the advancement of free trade agreement negotiations between the EU and Indonesia. On 31 May 2023, Indonesia and Malaysia delayed trade talks with the EU to seek fair treatment for palm oil smallholders that will be greatly affected by the EUDR.

3. Alternative export markets

The EUDR is likely to transform trade and supply chains across commodities associated with deforestation. Companies who cannot comply with the EUDR while keeping their businesses sustainable may seek alternative export markets. Indonesia is considering the diversion of palm oil exports to Africa in place of Europe. This decision will depend on the EU's receptiveness to Indonesia's locally-recognised palm oil sustainability standards, as well as supporting smallholders in exporting to the EU.

Coordinating Minister of Maritime and Investment Affairs, Luhut Binsar Pandjaitan, suggested a gradual shift of palm oil exports to Africa, while Eddy Martono, Chairman of Indonesia Palm Oil Association (GAPKI) emphasised the growing opportunities to increase exports to China.

4. Watching developments from the Ad Hoc Joint Task Force

Indonesia, Malaysia and the EU have agreed to establish an Ad Hoc Joint Task Force (JTF) to address concerns about the EUDR. The Ad Hoc JTF aims to establish dialogue and workstreams related to EUDR implementation through identifying practical solutions and approaches. The Ad Hoc JTF aims to conclude its work by the end of 2024, but may extend if mutually agreed upon. The first meeting took place in Jakarta on 4 Aug 2023, with the next meeting scheduled for end Nov 2023.

The formation of the Ad Hoc JTF is a positive first step towards addressing the structural challenges within the industry, particularly pertaining to the livelihoods of smallholders through the sustainable transition. If executed successfully, the Ad Hoc JTF can lay a strong foundation for Indonesia, Malaysia and the EU in future sustainability policy initiatives and partnerships.

Sources: Antara, Biodiversity and Conservation Journal, European Commission, Indonesia Palm Oil Association, International Union for Conservation of Nature, Reuters, Roundtable on Sustainable Palm Oil, S&P, The Straits Times

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