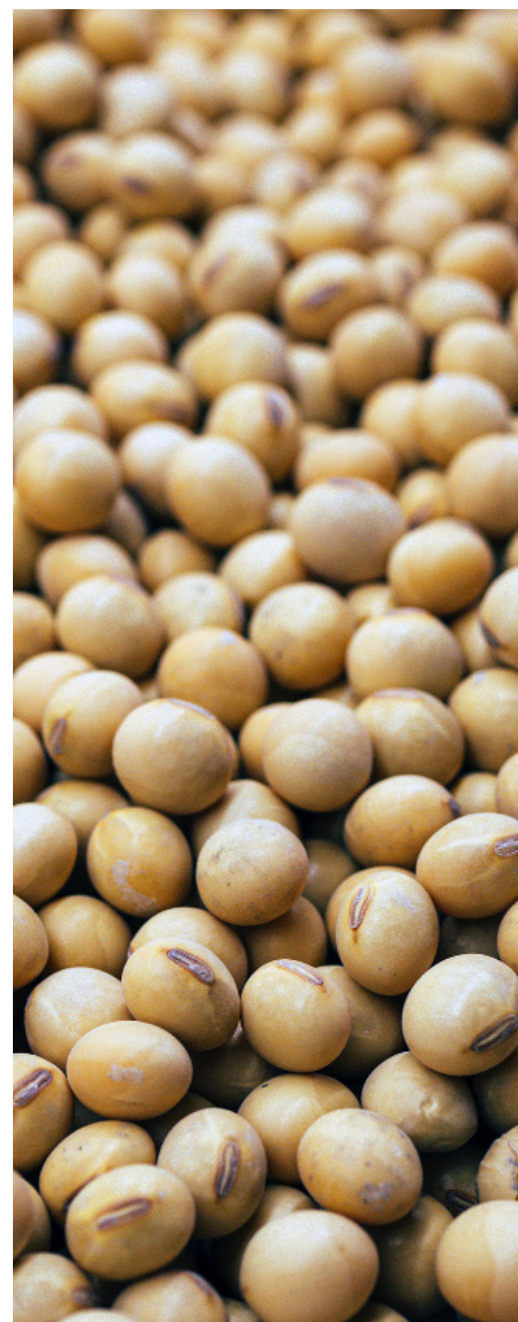


Exploring how commodity traders' strategies can influence the forest conservation effects of the proposed EU regulation on deforestation-free products

-Policy Brief-



Key findings and implications

This policy brief explores how commodity trader operations and strategies (e.g. sourcing decisions, expansion of traceability systems) may adapt in response to evolving European Union (EU) market requirements as proposed in the European Commission's regulatory proposal on deforestation-free products (EU-DR).

1 Implementing the due diligence requirements with existing suppliers appears as the most likely trader strategy in response to the EU-DR. Traders anticipate segregating their supply chains, with deforestation-free, legally produced, traceable volumes supplying the EU market, while non-compliant volumes will be redirected to other markets.

2 Costs and supply chain infrastructure and logistics are the key factors influencing traders' strategies for segregating their EU-DR compliant supplies. While segregation is expected to reduce the amount of deforestation attributed to EU consumption, the redirection of non-compliant commodities to non-EU markets may severely limit the EU-DR's impact on reducing total deforestation in producing regions.

3 It is expected that traders will also engage in other strategies to facilitate compliance, including adapting their supply base to source from low-risk suppliers. This could, in turn, lead to some producers, particularly smallholders, being excluded from the EU market.

4 Due diligence and full traceability under the EU-DR are perceived as challenging and costly and may result in a segregation of traders in the EU market, whereby traders well-positioned to comply with the EU-DR would supply the EU market, using fewer suppliers with sourcing from low-risk regions.

5 The EU-DR country benchmarking system appears unlikely to influence trader sourcing decisions, as key due diligence requirements (e.g., geolocational data) do not differ between high- and low-risk regions.

6 The EU could eventually lose leverage over the transformation towards sustainable agricultural supply chains if the EU's sourcing and market shares in certain regions are replaced by other demand markets with lower sustainability requirements.

7 As the segregation of EU-DR compliant supply by traders could severely limit the EU-DR's impact on reducing total deforestation in producing regions, complementary policies and local partnerships may be needed to both increase EU-DR effectiveness for forests as well as to mitigate negative impacts of the EU-DR on the livelihoods of smallholder farmers and on smaller traders.

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Table of Contents

1. Background	4
2. Strategies considered by traders	6
Cocoa	7
Palm oil	8
Soy	10
3. Predicted changes in global trade patterns.....	12
4. Implications.....	12
5. Conclusions	13



Xingu Indigenous Park territory border and large soybean farms in the Amazon rainforest, Brazil.

1. Background

At the end of 2021, the European Commission published a proposal for an EU Regulation to minimise EU market-driven deforestation and forest degradation (EU-DR). In the EU-DR, select agricultural commodities (cattle, cocoa, coffee, palm oil, soy, wood, and some related products) could only be placed on the EU market (or exported from the EU) if they are: (1) deforestation-free; (2) produced in accordance with the legislation of the country of production; and (3) accompanied by a due diligence statement. The latter is part of a mandatory due diligence system which requires operators and traders to collect information on the exact location and time of production and conduct risk assessments and mitigation measures. This is combined with a country benchmarking system categorising countries and subnational regions according to their risk of producing EU-DR incompliant commodities.

The EU-DR is believed to be a push forward in the transition towards sustainable, deforestation-free supply chains. However, its impact on forests will *inter alia* depend on commodity traders' responses along the commodity supply chains. For example, it is uncertain if traders would be able and willing to apply the EU-DR standards across their entire operations, or if they would divert non-compliant volumes towards other, less environmentally regulated markets. This market leakage as well as the potential dominance of less regulated demand-side markets may limit the EU-DR's impact on reducing forest loss. Hence, this policy brief explores possible strategies (Box 1) that traders in different supply chains could employ in response to the EU-DR due diligence obligations and the different factors (e.g., financial, logistical) influencing their decisions, as well as stakeholder perceptions of how global trade patterns may shift because of the EU-DR.

Box 1: Possible complementary trader strategies

- A. Implement the new due diligence requirements with existing suppliers
- B. Cease or reduce supply to the EU market
- C. Shift sourcing from higher to lower risk countries or parts thereof, as referred to in the EU-DR's envisioned country benchmarking system
- D. Substitute commodities or derived products covered by the EU-DR with those not covered
- E. Adapt the supply base to reduce supply chain risks
- F. Employ voluntary sustainability certification schemes to limit legality and sustainability risks

This policy brief focuses on three commodities imported by the EU and other markets: cocoa, palm oil, and soy (Table 1). They represent key drivers of deforestation in West Africa, Southeast Asia, and Latin America, respectively. We conducted semi-structured interviews during March-May 2022 with nine commodity trader representatives (three for each commodity) that are involved in genuine trading and in some cases are additionally performing processing and intermediary functions, and seven non-company commodity supply chain specialists (e.g., consultants and NGOs). Non-company respondents were included to better triangulate trader responses, as they would naturally advocate their own interests, thus gaining a more holistic appraisal of likely responses of actors to the EU-DR. We reference if the interview data came from traders or non-company respondents; when it came from both, we collectively refer to 'respondents'. While our small sample cannot be representative of the three commodity sectors, our interviews aimed to produce insight into how traders may adapt their operations to comply with the new due diligence obligations.

Table 1. Global production and import quantities (2018-2020 average in metric tonnes) of cocoa beans, palm oil and palm kernel oil, and soybeans, including share of the global production exported, and EU/UK/USA/China shares of the global imports.ⁱ

	Global production	Exported	Global imports	EU	UK	USA	China
Cocoa beans	5 629 355	73.1%	3 999 264	56.0%	2.8%	11.5%	0.7%
Palm oil & palm kernel oil	81 231 385	63.4%	52 662 982	18.4%	0.9%	3.6%	14.2%
Soybeans	344 841 605	46.5%	157 673 441	10.7%	0.5%	0.3%	60.2%

2. Strategies considered by traders

All traders stated an economic interest to further engage with the EU market, and therefore considered implementing the new EU-DR requirements with at least some of their existing suppliers, with little or no indication of ceasing or reducing commodity supply to the EU market or shifting their business to trade other commodities. However, due to various anticipated challenges across the sectors and producing geographies, all traders considered supporting strategies to facilitate compliance with the EU-DR (Table 2). These included adapting and restructuring the commodity supply base and supply chain infrastructure to ensure traceability and segregation of EU-DR compliant supply. Third party certification schemes do not appear as a key strategy for traders to facilitate compliance with the EU-DR. Costs are ultimately the dominant factor influencing strategy selection. In the following, sector-specific insights on potential strategies and their deciding factors are presented.

Table 2. Summary of perceived likelihood of different strategies (see Box 1) considered by traders. Green: likely strategy. Yellow: somewhat likely strategy. Red: unlikely strategy. *Argued that their current due diligence system fulfils EU-DR requirements. **Not a deliberate strategy but an expected outcome of the EU-DR.

		Strategies					
		A: Due diligence	B: EU-market reduction	C: Region shifts	D: Commodity substitution	E: Supply adaptation	F: Certification
Cocoa	Trader 1						
	Trader 2						
	Trader 3						
	Summarized non-company responses						
Palm oil	Trader 4						
	Trader 5	*					
	Trader 6	*	**				
	Summarized non-company responses		**				
Soy	Trader 7						
	Trader 8		**				
	Trader 9						
	Summarized non-company responses						



Cocoa

Strategy A: Traders likely to implement the new due diligence requirements with part or all of existing suppliers

All cocoa traders indicated that it is very likely that they will implement the new due diligence requirements with part or all of their existing suppliers, for two main reasons. First, traders perceived an already high level of traceability in their direct supply chains (e.g., one trader's sustainability programme that includes farm mapping and full traceability to the farm covered 90-95% of the direct supply chain in West Africa). Second, traders noted that the EU is a very important market. Cocoa imported to the EU represents the largest share of imports in global trade, and 56% of all cocoa produced is imported to the EU (Table 1). However, traders noted that the lack of an accurate database of polygon maps of individual cocoa farms and high percentage of cocoa sourced from indirect supply chains with less traceability (representing 40-60% of interviewed traders' supply) as key challenges. Non-company respondents expressed that large cocoa traders, with resources to implement new requirements, possess the leverage needed to create sustainable transformation in the sector, due to their combined large market share and strong relationships with producers.

Cocoa traders indicated that instead of implementing the due diligence requirements across all their supply chains, they would likely only do so for cocoa destined for the EU, US, and potentially UK markets, which currently represent the largest markets for cocoa. According to traders, this would not represent a significant change from the current operations, as these markets have a higher demand for sustainably sourced cocoa compared to other consuming countries. However, cocoa traders indicated that implementing the EU-DR due diligence requirements may further entrench the existing segregated supply chain, where cocoa not compliant with the EU-DR, including cocoa from hard-to-trace indirect supply, is used to supply domestic and emerging Asian market demand with lower sustainability requirements, to the extent that these markets are big enough to absorb the supply. On the other hand, non-company respondents predicted that in the long-term, traders would no longer segregate their supply chains, since they strive for sustainable transformations in their entire supply chain, as reflected in commitments made under the Cocoa and Forest Initiative, for example.

Given the concentration of the cocoa sector with few, large traders handling a majority of cocoa volumes, collaborative efforts among them could lead to considerable progress in addressing deforestation in the sector. These could include establishing collective traceability systems and common due diligence approaches and/or the use of national traceability systems such as those being developed by cocoa regulatory bodies in Ghana and Côte d'Ivoire, as proposed by traders.

Strategies C and E: Traders to adapt supply base to minimise risk

According to respondents, adapting the supply base to reduce risk and therefore reduce costs is a likely strategy for the cocoa sector. For example, respondents indicated that this could imply excluding high-risk suppliers (i.e., independent smallholders, indirect suppliers, those located near protected areas) from the supply chain and instead favour plantations, larger cooperatives, and larger farmers, which may be able to implement the due diligence requirements more easily. According to traders, these suppliers could also be more easily monitored.

Respondents indicated that shifting sourcing to lower risk regions (e.g., Latin America and areas with implemented jurisdictional approaches) may be another potential strategy in order to reduce costs arising from traceability in complex cocoa supply chains with many small cocoa suppliers. Traders suggested that this strategy may also help in meeting potential requests from clients. However, respondents thought that the strategy would unlikely be viable in the short to medium term, as cocoa-producing capacities remain limited in these countries.

Strategy F: Voluntary sustainability certification schemes mostly relevant for meeting client requests

According to respondents, traders are likely to continue to source cocoa produced under sustainability certification schemes, largely to meet client requests. However, they do not view certification as a means to facilitate compliance with the new requirements and perceive it as having a low impact-to-cost ratio. Instead, respondents anticipated that certification schemes will in part be replaced by implementing third party verification of their own trader-established standards.



Palm oil

Strategies A and B: Traders to implement the new due diligence requirements for the EU market demand only

Respondents thought it appears likely that most traders will aim to implement the new due diligence requirements with existing suppliers, but only among those supplying the EU market demand. This will reinforce an already existing segregated global palm oil supply chain, where Europe currently receives a major share of the global sustainably certified palm oil volume, with 90% of the EU's palm oil imports being sustainably certified in 2020.ⁱⁱ While traders claimed that their current due diligence systems were sufficient to meet the new EU-DR requirements, respondents noted potential challenges to compliance. First, they argued that traceability to the plot level will be difficult to implement, particularly for those with a large

number of small suppliers. Traders expressed concern that under Indonesian policy, farm geolocation data cannot be shared with third parties. Second, traders also highlighted logistics and supply chain infrastructure that are ill-adapted for compliance, e.g., a single shipment of palm oil is usually from hundreds of mills, making due diligence information logistically difficult to maintain across the supply chain, and factories are not currently built for batch or segregated shipments.

Respondents indicated that these challenges and the potentially high investment costs to overcome them may result in a reduction of palm oil trade with the EU (Box 2). Respondents argued that for some traders these costs could be prohibitive, and they could instead turn to supply markets with less demanding sustainability requirements, such as India and China. If so, respondents found that the EU might become a niche market and could lose its leverage to collaborate with producing countries, such as Indonesia, on sustainability improvements.

Box 2: Potential cost increases as a result of the EU-DR

Respondents predicted that the EU-DR is likely to result in cost increases for the provision of the three commodities to the EU market. Respondents from the cocoa and palm oil sectors perceived that the required collection of traceability information (e.g., mapping all suppliers and their geolocation data) will be a major cost driving factor. In the cocoa sector, traders estimated the cost of a traceability system to be equivalent to between 0.5% and 2% of recent cocoa price per ton (\$2248 per ton).ⁱⁱⁱ This is consistent with findings from a 2020 study on the costs of implementing physical traceability and zero deforestation criteria for soy and palm products in the French animal feed sector that estimated additional costs for consumers would be between 0.09% and 0.6%.^{iv} Further, respondents from the palm oil and soy sectors referenced logistics and supply chain infrastructure that are ill-adapted for EU-DR compliance (e.g., commodity processing facilities that are not built for segregation) as other central cost driving factors inhibiting the operation of economically efficient, segregated supply chains. For instance, one trader estimated that segregation of soy into smaller volumes of EU-DR compliant soy could require transporting it with smaller Handymax instead of larger Panamax vessels, which could increase freight prices by up to 35-40% per vessel, resulting in total prices up by 5% or \$400-500M per year.

Respondents predicted differently how the costs associated with EU-DR compliance might be distributed in the supply chain (e.g., among producers, traders, and EU consumers), but traders were suggested most frequently, followed by consumers and producers. Additional studies are needed to develop a better understanding of the full impact of the EU-DR on different supply chains, incremental costs, and price increases.

Strategies C and E: Traders seek to source from lower risk suppliers

According to respondents, adapting the supply base to supply the EU market with palm oil from lower risk suppliers (e.g., some large plantations) and providing non-EU markets with higher risk supply (e.g., from most smallholders), appears to be the most likely strategy to facilitate EU-DR compliance. Traders favoured this strategy because of insufficient levels of traceability from smallholders, the predicted high costs of traceability in complex supply chains with a high number of suppliers, and their ownership of fixed assets (e.g., large plantations). Respondents asserted that this could result in a shrinking of the supplier base including through the exclusion of smallholder suppliers. However, non-company respondents expect that organised (RSPO) scheme smallholders (e.g., those contracted by larger plantations as outgrowers) could remain in the EU-supply chain.

Respondents expressed that shifting the sourcing region is seen as possible, however less likely than other strategies, as full traceability is also lacking in candidate low-risk regions. However, they claimed there could be a reduction of sourcing for the EU market from Indonesia and increased sourcing from Latin America, where palm oil production is not yet perceived as a significant direct driver of deforestation. According to non-company respondents, traders' sourcing strategies are unlikely to be influenced by the EU-DR country benchmarking system and its related incentives, as traceability requirements are the same in high- and low-risk areas. Instead, respondents indicated that shifting sourcing regions is more likely to occur when there is a lack of fixed assets owned by companies in existing sourcing regions, and lower supply chain complexity and higher levels of traceability in other regions. Further, traders noted that shifting the sourcing area may also be determined by traders' client demands (e.g., to focus on low-risk regions) and potential product marketing advantages when sourcing from low-risk regions.

Strategy F: Certification viewed as less relevant, but could be leveraged to facilitate compliance

Traders viewed certification as a less relevant strategy because it will not be recognized by EU competent authorities as demonstrating compliance with the EU-DR. However, traders identified how certification systems could be leveraged to facilitate compliance. The Malaysian MSPO system that requests farmers to have an MSPO license to be able to sell the palm fruits to the mill, for example, could facilitate registrations of smallholders and thus help overcome the problems related to requiring traceability through geolocations. This model could then be adopted in Indonesia.



Soy

Strategies A and B: Traders intend to implement the new due diligence requirements with existing suppliers, but EU market for soy might shrink

In 2018, only 11% of soybeans and soybean meal production from Brazil – the main country of origin of imports to the EU – was exported to the EU.^{v,vi} Despite this relatively small soy demand in the EU, respondents indicated that in order not to lose their existing market shares, traders anticipate implementing the new due diligence requirements with their existing suppliers. However, they predicted that most traders would face substantial difficulties in implementing the new requirements, especially in Brazil, for several reasons. Traders argued that there would be a need to segregate potentially low volumes of EU-DR compliant soy. According to respondents, logistics and supply chain infrastructure (e.g., warehouses, export facilities) are not currently designed to operate with these smaller volumes, and therefore segregating EU-DR compliant soy would jeopardize cost efficiency. Moreover, according to traders, acquiring and maintaining all required due

diligence information along a segregated supply chain from individual plots to collection and re-distribution sites, such as warehouses, and finally onto ships poses great logistical, and even legal challenges.

While traders did not deliberately consider ceasing or reducing supply to the EU market, these challenges may result in a reduced supply of soy to the EU. Non-company respondents thought traders could charge more for EU-DR compliant soy, which in turn might increase general prices and shrink the EU market over time.

Strategies C and E: Traders anticipate increased sourcing from the US to meet EU soy demand

Given the various challenges, respondents expect traders may adjust supplier networks in current sourcing areas and are likely to shift sourcing regions. Respondents argued that a small number of traders could adapt their supply base in their current sourcing areas to ensure that the EU is supplied with soy only from EU-DR compliant farmers, particularly those owning fixed assets (e.g., warehouses and export terminals) that allow them to adapt their supply chains more efficiently to segregation as well as those with an already high level of traceability in their supply chains. In 2020, 92% of directly sourced soy from the Brazilian Cerrado by six major traders was traceable to individual farms.^{vii} The harder-to-trace indirectly sourced soy accounts for 12-42% of all soy sourced from South America.^{viii}

Traders noted that some fixed assets (e.g., warehouses and export facilities) are shared through joint ventures, making them less flexible to adapt, and to do so, would ultimately lead to large losses in economic efficiency. Thus, for others, it may be more cost-effective to shift sourcing regions, with reduced sourcing from Brazil and increased sourcing from the US and, to a lesser extent, Argentina. However, respondents expected that this supply would not be able to fully replace Brazilian supply for several reasons, including lower production quantities per year, limited growing seasons, lower protein content in soy, insufficient processing capacities (e.g., for soy crushing), and country legal challenges (e.g., data privacy rules).

Strategy F: Traders believe certification schemes will lose importance

Non-company respondents perceived using voluntary certification schemes as unlikely, while traders indicated that certification could be a potential strategy, with a preference for company-own certification (possibly verified by third parties). This is because, similar to the cocoa sector, traders perceive third party certification as overly costly. Traders further predicted that the use of certification schemes in countries like Brazil could decrease because of the EU-DR, for two reasons. First, they expected that European feed compounders will not be willing to pay for certification premiums in addition to EU-DR compliance costs and second, the demand for certified soy could collapse if the EU, as the main market for certified soy, reduces its sourcing from Brazil.



3. Predicted changes in global trade patterns

In each of the three commodity markets, but especially in global soy and palm oil trade (where EU market shares are lower than for cocoa), traders suggested that implementation of the EU-DR could entrench market segregation of suppliers: traders well-positioned to comply with the EU-DR would supply the EU market, using fewer suppliers with sourcing from low-risk regions. In the case of soy, traders indicated that large traders might reshuffle their EU and non-EU market shares depending on the new EU-DR compliant comparative cost advantages. For palm oil, traders thought that especially small and medium sized traders could become entirely excluded from the EU market, and instead exclusively supply non-EU markets with less requirements for sustainability.

In addition, according to respondents, Latin America appears to be the region that could experience the most shifts in sourcing patterns linked to all three commodities, for three reasons. First, respondents predicted that Brazil might see a reduced EU soy demand if the traders supplying the EU shift sourcing to the US, yet traders indicated Brazil might also continue to increase its soy trade share with China. Second, respondents noted that Brazil and other Latin American countries such as Colombia are already seeing larger investments in cocoa production, which they predicted to continue in the future. Third, respondents thought that the share of trade of Latin American palm oil to the EU might increase if the implementation of the EU-DR results in traders reducing palm oil sourced from Indonesia and Malaysia.

4. Implications



Traders likely to segregate their EU-DR compliant supply chains

Respondents perceived compliance with the EU-DR as challenging and costly for traders, with costs and supply chain infrastructure and logistics considered as the key factors influencing traders' strategic choices. To minimise cost increases and achieve compliance in the most economically efficient way, respondents suggested that traders would likely segregate their supply of EU-DR compliant commodities to the EU from other markets, as opposed to applying new market requirements across their supply regardless of destination market. For example, respondents indicated that segregation could be achieved by reorganising existing supply chain infrastructure and changing logistics. To the extent this trader strategy comes to dominate, it would severely limit any hoped-for forest-conserving effect of the EU-DR in commodity-producing regions.



EU-DR could lead to a segregation of traders

Respondents believed that potential high compliance costs with the EU-DR could lead large traders to reorganise their EU and non-EU market shares, depending on which traders face comparatively lower costs to comply with the EU-DR. Specifically, respondents thought those that face lower compliance costs could increase their EU market shares while others might exit the EU market and increasingly supply non-EU markets instead. Further, respondents suggested the compliance costs could become altogether prohibitive for small and medium-sized traders, which could then abandon the EU market. As a result, traders argued that the implementation of the EU-DR could entrench a segregation of traders engaged with the EU market.



Traders' sourcing strategies unlikely to be influenced by EU-DR country benchmarking system

The envisaged EU-DR country benchmarking system and its related incentives appear unlikely to influence trader sourcing strategies because key information requirements (e.g., plot of production geolocation data) would be the same in high- and low-risk regions. Changes to traders' sourcing strategies instead appear related to traders' ability to provide geolocation data, availability of commodity volumes compliant with the EU-DR, and expected compliance costs. Traders anticipate using the risk rating if clients explicitly request commodities sourced from low-risk regions (e.g., for marketing purposes).



Smallholder growers' access to the EU market faces uncertainty

Respondents thought that the EU-DR's requirements related to full traceability to the plot of production appear challenging and costly, which might in turn push traders to cease sourcing the EU market with smallholder-grown commodities, favouring instead larger plantations. Similarly, traders expressed a preference for cooperatives over independent smallholders for the EU supply. Respondents suggested that smallholders could instead then come to increasingly supply markets not demanding deforestation-free commodities.



The EU potentially at risk of losing leverage over sustainability efforts in commodity producing countries

Non-company respondents perceived the EU-DR as disincentivising traders' support for high-risk areas, including ongoing engagement with farmers and in landscape approaches. Traders also thought that there could be a reduction in sustainability certification, as it is not recognised by the EU-DR. Moreover, traders believed that for some commodities, the EU's sourcing and market share in certain regions with a higher deforestation risk could be replaced by other markets with lower sustainability requirements. As a consequence, the EU could be at risk of losing leverage vis-à-vis the transformation towards sustainable agricultural supply chains and production in producing countries. This danger might be mitigated if the EU-DR is implemented with accompanying supportive policies and local partnerships, and if other demand markets (incl. Asian markets) over time introduce similar regulations.

5. Conclusions

In principle, the EU-DR could increase a sense of environmental responsibility among commodity producers and traders, as well as a consciousness among EU consumers. It may also set a good example for other markets to implement similar regulations in the future, beyond the like-minded efforts being undertaken in the US and the UK. However, in the short to medium term, flexible markets may respond by increasing segregation, widely reallocating commodities to markets with less stringent requirements – to the extent these are big enough to absorb higher risk commodities. This would severely limit any forest-conserving impact from the EU-DR. Complementary policies and local partnerships may be needed, both to increase EU-DR effectiveness for forests and to mitigate the EU-DR policy impacts on the livelihoods of smallholder farmers and on smaller traders.



Endnotes

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