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Rationing in the Fair Trade Coffee Market: Who enters and how?

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Abstract

The central component of the Fair Trade coffee system is a guaranteed minimum price to Fair Trade producers. This minimum price has generally remained above the price of the world coffee market, leading to a classical case of a price floor above the market clearing price in which quantity supplied exceeds quantity demanded. Of course, not all coffee producers can access the preferential price of Fair Trade; to sell in the Fair Trade coffee market a producer must obtain the certification of the Fair Trade Labelling Organizations (FLO). Nevertheless, the supply of Fair Trade coffee has consistently exceeded the quantity which Fair Trade Coffee buyers have demanded, requiring additional rationing mechanisms. This market reality has led Fair Trade coffee wholesale buyers to increasing demand high quality organic coffee from their Fair Trade coffee suppliers, a trend which has only gained momentum in the last five years. In addition, since 2004 the FLO has begun charging Fair Trade coffee organizations to both receive and to renovate the FLO certification.

This study addresses how the FT coffee system rations market access in a market reality where the quantity supplied by coffee producers that want to participate in the market exceeds the available contracts. This paper addresses two related questions. First, how the FT coffee system decides who receives the minimum price and who must sell to the open market? Secondly, what type of producers or organizations of producers are most likely to enter the current Fair Trade coffee system? The paper addresses these questions by analyzing the barriers and costs which producers' organizations confront to enter the current Fair Trade coffee market.

To answer these questions this paper examines the experiences of seven coffee organizations in the department of San Martín, Perú. Organized coffee cultivation has

emerged in San Martín in only the last ten years. As such, all of these organizations are young, having been established between 1998 and 2002. The experiences of this group range from one organization which has directly exported over 276,000 kg of Fair Trade organic coffee since 2004 to one cooperative which has failed to begin the FLO or organic certification processes.

For the FLO certification, producers have confronted the following barriers: coordinating the certification process, obtaining an export contract, and accessing financing for exports as well as to pay for the FLO certification. In the case of organic certifications, organizations have faced hurdles in the following areas: financing the three year certification process, providing the technical assistance to meet organic standards, and organizing an internal control system.

This study finds that it is the coffee market that determines who sells to the FT market. While the FLO certification is a creation of the FLO, the requirement by the FLO that soliciting organizations have an export contract is a reaction to a market reality. The demand by FT buyers for high quality coffee and organic coffee is a direct result of market forces. The producer most likely to enter the FT market is a producer with capital, a willingness to assume risk, and who is not remotely located.

The factors which determine if a producer becomes a beneficiary of CJ, however, are not his size, geographical location, or annual income. The principal factor is the entity to which the producer is connected. The capacity and competitiveness of that entity determines if a producer will pass the market's rationing mechanisms. For a producer's organization to promote the interests of its members it must have the capacity to compete in the coffee industry, FT or not. Included in this capacity are commercial contacts, knowledge of markets, ability to access capital, and experience in coffee processing, exporting, and quality control.

The FT movement should focus on creating or supporting the institutions and strategies that most effectively integrate small producers into the market, whether it is FT or other

coffee market niches. FT should not confine itself to working with producer's associations as the private sector has the capacity to efficiently integrate small producers into the market.

Even though many have aspirations for the FT movement to induce profound changes to the global economy, such aspirations should not prevent people from asking practical questions about how FT is actually working. Market tendencies, such as balancing the quantity supplied with the quantity demanded, govern the FT coffee market. Far from being a paradigm change, FT is a space in the market that represents an opportunity to promote development. The FT movement, therefore, should be evaluated by its efficiency and effectiveness as an engine of rural development.

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1. Introduction

From university cafeterias to supermarkets in the developed world, people are buying Fair Trade (FT) coffee¹ as a contribution to the welfare of marginalized producers in the developing world. While sales of FT coffee in Europe have stabilized, the North American and Japanese markets are growing rapidly. In fact, sales of FT coffee increased 26 percent to 24,222 Metric Tons in 2004 (FLO 2005).

In spite of its popularity, there are few analytical studies on the FT coffee market. One research project that has furthered understanding of the FT coffee system is the project of the University of Colorado's Fair Trade Research Group which authored the study, "One Cup at a Time: Poverty Alleviation and Fair Trade in Latin America" (Murray, Raynolds and Taylor 2003). While this work greatly furthers an understanding of the FT coffee system, it does not explore how to enter the FT coffee market.

This study addresses how the FT coffee system rations market access when the quantity supplied by coffee producers exceeds the available contracts. This paper addresses two related questions. First, how does the FT coffee system decide who receives the minimum price and who must sell to the open market? Second, what type of producers or organizations are most likely to enter the current Fair Trade coffee system? The paper addresses these questions by analyzing the barriers and costs to entry into the Fair Trade coffee market.

1.2 The Theoretical Background

In a free market, the price of a good is determined by the intersection of the supply and demand curves. The price at the intersection of these two curves is the market clearing price. At the market clearing price, all those who are willing and able to purchase the good will do so. Likewise, all those who are willing and able to supply the good will do

¹ This refers to coffee which has been certified by FLO-Cert, the certifying entity of the FLO.

so. A price floor set above the market clearing price, however, creates a surplus. In other words, producers will supply more than buyers are willing to buy.

The Fair Trade Labeling Organisations (FLO) establishes standards for FT coffee. The FLO sets the minimum price for Fair Trade coffee, which in the case of Arabic washed conventional coffee from South America is \$1.24/lb according to the 2004 Fair Trade Standards for coffee.² If the world coffee market price is less than \$1.24/lb, the FT minimum price functions as a price floor in which the quantity supplied will exceed the quantity demanded.

Since no entity exists to absorb the excess supply caused by an artificially inflated price, the FT coffee system must ration which suppliers have access to the FT price.

1.3 The Fair Trade Coffee Market

The theory behind FT was that higher prices could be given to producers or artisans by excluding unnecessary intermediaries. Initially, the FT coffee market grew rapidly in Europe, but currently the market appears to be saturated. Recent growth in the FT coffee market has occurred in Canada and the U.S. where the movement is younger. Nevertheless, the North American market will probably become saturated in several years (Lewin, Giovannucci and Varangis 2004).

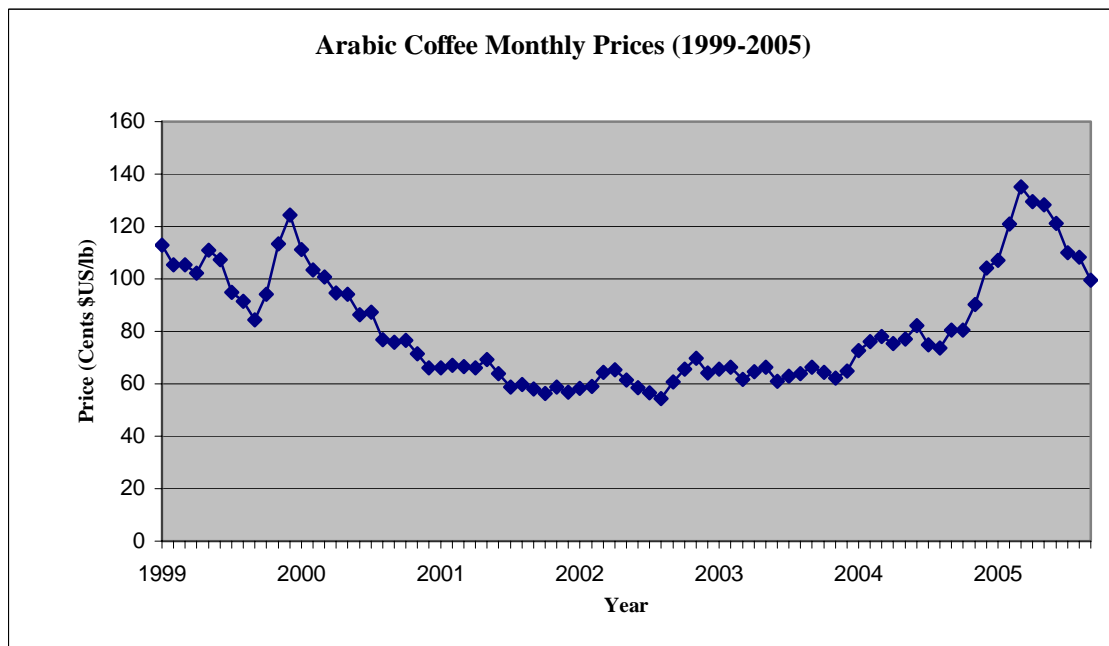
While concerns over future growth of FT coffee sales are relatively new, the imbalance between the supply of FT certified coffee and consumer demand has existed for at least ten years. Bob Thomson affirmed in 1995 that FT producers had a productive capacity of 250,000 MT of coffee for a demand of only 11,000 MT (1995). In other words, the FT market only purchased around 13 percent of the production of certified coffee producers' organizations. The imbalance between supply and demand was significant enough to

² This price includes the US\$.05 social premium given by FT.

cause the FLO to temporarily close their registry to new members in 2002 (Vizcarra 2002).

The experience of the coffee producer's association, APROECO, confirms this reality. When APROECO applied for certification in 2001, the FLO told the association that it already had 280 pending applications, but that it could prioritize APROECO's application if the association had a buyer (interview with Orlando Diaz³, September 10, 2005). Because the global coffee market suffered a profound crisis in the beginning of this decade, it is unsurprising that there were 280 applications before that of APROECO. At the end of 2000, coffee prices dropped from about US\$ 1.10/lb. to US\$.65 lb. Prices only began to rise in 2004.

Graph 1



Source: International Coffee Organization. Historic Data – Mild Arabica Monthly Averages. Elaboration by the author.

³ As a manager of the coffee export company PRONATUR, Diaz coordinated the certification processes for APROECO.

With an over-supply of FT coffee, the FT market increasingly demands organic coffee. The dual certification of FT and organic has allowed coffee organizations to differentiate their coffee in a saturated market. Between 1996 and 2000, exports of dual certified coffee (FT and organic) grew from 86.25 MT to 5,096 MT, an increase of around 5,800% (Raynolds 2002). According to FT fast facts available on the webpage of TransFair USA, approximately 85% of FT coffee sold in the U.S. is certified organic.⁴

2. San Martin, Peru and its Coffee Organizations

Peru's political system divides the country into 24 states ("departamentos"). The state of San Martin is located in north-central Peru with a total area of 51,253.31 square kilometers and a population of 743,668. Its economy is based in the production of rice, corn, bananas, coffee, yucca, the tourist industry, and a few agro-industries. Sixty-seven percent of the population lives in poverty while slightly more than a third lives in extreme poverty. These statistics exceed the national averages which are 48 percent for poverty and 26 percent for extreme poverty (Amresan 2002).

San Martin is an appropriate region for this study. Coffee cultivation and the organization of producers has only emerged in approximately the last 10 years. As a result, these organizations have confronted the current barriers to entry of the FT market.

While several sub-markets exist such as FT conventional, FT organic, organic, and conventional, this study focuses on successfully entering the FT market. Because the majority coffee in the FT market is also organic coffee, gaining a significant space in the FT market requires an organic certification in addition to the FLO certification.

Of the seven coffee organizations in this study, four have the FLO certification and four have an organic certification. Also included is an association that has started the organic

⁴ TransFair USA is a member of the FLO, and is the only organization that audits Fair Trade transactions in the U.S.

certification process as well as an association that has yet to start any certification process. Starting with CAC Oro Verde, a description of each organization follows.

Cooperativa Agraria Cafetalera Oro Verde (CAC Oro Verde)

CAC Oro Verde was formed in 1999 through the project “Alternative Development Lower Huallaga” of the United Nations Drug Control Program (UNDCP). This UN project has supported Oro Verde through personnel, donations, and low-interest loans. Oro Verde started the organic certification process in 2000 and in 2002 about 200 members received the organic certification of Bio Latina. In addition, Oro Verde received the FLO certification in 2003 (interview with Hiderico Bocangle, Oro Verde general manager, October 7, 2005).

Asociación de Productores Agrarios del Valle del Alto Mayo (APAVAM)

APAVAM emerged from a USAID financed project that lasted from 1996 to 2000 and consisted of 47 associations. In 1998, 29 of these associations joined to form APAVAM. In 1998, the European Union established a trust fund of US\$ 120,000 (389,000 Nuevos Soles) in the Caja Rural San Martin (CRSM) to give credit to the producers who later formed APAVAM. In 2002, the Peruvian Ministry of Agriculture program “Innovations and Competitiveness for Peruvian Agriculture” (INCAGRO) started a three year organic coffee project with APAVAM. APAVAM, which had already started the organic conversion process, received the organic certification of the International Organic Crop Improvement Association (OCIA) in 2003 for 138 producers. APAVAM received the FLO certification in 2005 (interview with Heine Davia, president of APAVAM, October 20, 2005).

Asociación Distrital Agropecuario – Naranjos (ADISA)

ADISA was formed through local initiative in 2002. A year after its foundation, ADISA

became involved in the project Hivos/Rainforest Trading.⁵ This project placed the current general manager in the association and pays his salary. ADISA obtained the FLO certification in 2005. The association does not have an organic certification (interview with Alvaro Prada Guadalupe, manager of ADISA, October 20, 2005).

Asociación de Productores Cafetaleros Agrarios Selva Soritor (APROCASS)

Seventeen neighbors formed APROCASS in 2003. Excluding the indirect support of Rainforest Trading, APROCASS has operated without subsidies, depending on capital from membership dues (interview with Cesar Guerrero Diaz, president of APROCASS, October 20, 2005). In 2006, APROCASS started an organic conversion program with the support of the Peruvian Fund for Cooperation for Social Development (FONCODES) and the Inter-American Development Bank.

Asociación de Productores Orgánicos Cuenca Cumbaza (APOCC)

A project focused on agro-forest systems financed by Hivos created 33 Agrarian Producers Associations (APAs). APOCC was formed in 2001 using these associations. An INCAGRO project, “Organic Production of Coffee and Bee Honey,” allowed APOCC to receive an organic certification in 2005 (interview with Salvador Ruiz Garcia, vice-president of APOCC, October 25, 2005).

Asociación de Productores de Café y Cacao el Catimori de la Provincia El Dorado (APROCCC)

Eight producers’ committees established through local initiative formed APROCCC in 2002. APROCCC has had the support of several development projects executed by NGOs. In spite of this support, APROCCC does not have any certifications nor is it in any

⁵ Three organizations of this study, ADISA, APAVAM, y APROCASS, benefit from a project financed by Hivos and implemented by the coffee export company, Rainforest Trading. This project lasts from 2003 until 2006 and has a budget of 112,000 Euros to give technical assistance, business skills training, institutional development, and work with the participation of women in ten Peruvian coffee organizations.

certification process (interview with Sacaria Segundo Idrogo, November 15, 2005).

Asociación de Productores Ecológicos (APROECO)

APROECO was born out of external initiative in May of 1998. In 1999, the association developed a commercial relationship with the company Promoter of Natural Agriculture (Promotura de Agricultura Natural - PRONATUR). During this time, APROECO integrated new groups of producers into the association with the help of the German agency for international cooperation, gtz. APROECO entered the organic program of IMO Control in 1999 and received the certification in 2001. Since then, APROECO has obtained a variety of certifications, such as Bird Friendly and Sustainable (interview with Mauro Fernandez, president of APROECO, March 3, 2006).

Data from Three Associations

Organization	Surveyed	Avg. Production (qq)	Avg. Sale Price (US\$/qq)	Gross Income (US\$)	% Without High School Degree	% Of Crop Sold to Intermediaries
ADISA	73	43	78.81	3,389	75	59
APAVAM	105	42	64.48	2,708	78	90
APROCASS	95	57	68.66	3,921	87	66

Source: Base Line Reports for ADISA, APAVAM and APROCASS conducted by MEDA Consulting Group Peru as part of that organization's project with Novib (June 2005 – May 2006).

*qq refers to quintales, one quintal of “café oro” (export quality) equals 46 kilograms. A quintal of unshelled coffee (café pergamino) is equivalent to 56 kilograms.

Coffee Organizations of the Study

Organization	Est.	Current Members*	Certifications
Asociación Distrital Agroprecuario – Naranjos (ADISA)	2001	76	FLO
Asociación de Productores Orgánicos Cuenca Cumbaza (APOCC)	2002	70	Orgánica
Asociación de Productores Agrarios del Valle del Alto Mayo (APAVAM)	1998	300	FLO, Orgánica
Cooperativa Agraria Cafetalera Oro Verde (CAC Oro Verde)	1999	450	FLO, Orgánica
Asociación de Productores de Café y Cacao el Catimor (APROCCC)	2003	120	-
Asociación de Productores Ecológicos (APROECO)	1998	860**	FLO, Orgánica
Asociación de Productores Cafetaleros Agrarios Selva Soritor (APROCASS)	2003	111	-

*The numbers for “Current Members” are fluid as members constantly enter and exit the association.

**Only about 860 members of APROECO are coffee producers. The association also includes mango and banana growers.

Certification and Export Information

Organization	Certifications	Year	Certified Producers	Potential Volume of FT (qq)***	FT Exports 2004-2005 (qq)	Price (US\$/lb)	Buyer
ADISA	FLO	2005	63	1,890	1237.5	1.26	Globos Coffee
APOCC	IMO/Naturland	2005	68	2,040	0	-	-
APAVAM	FLO	2005	300	9,000	412.5	1.21	Globos Coffee
	OCIA	2003	133		412.5*	1.39	NJ Douek and

							Sons
APROECO**	FLO	2001	860	35,280	9,529	varied	varios
	IMO/Naturland	2001	860		17,896*	varied	varios
Oro Verde	FLO	2003	450	13,500	1,657.50	1.24	varios
	Bio Latina	2002	240		6105*	1.39	Hamburg Coffee Company

*FT Organic Coffee

**APROECO/PRONATUR has certifications in addition to those mentioned in this table.

***Estimate based on 2 hectares per producer and an average yield of 15 quintales per hectare.

3. The Fair Trade Coffee Certification

The FLO has four categories of standards: social development, economic development, environmental development, and labor standards. Each category has two levels of requisites, minimum and progressive. To achieve the certification, the applicant must meet the minimum requisites while showing progress towards meeting the progressive requisites. In the case of non-compliance, the FLO certification can be revoked. The notable minimum requisites of each category are the following:

Social Development

- The majority of members of the organization must be small producers.⁶
- The organization must have a democratic structure (members have control; annual reports exist; general assembly meetings take place; an administrative team exists).

Economic Development

- The organization must use the FT premium in a transparent manner in accordance with the decision of the general assembly and the requisites of the FLO.

- The organization has the capacity to export a quality product. Preferably the organization has already exported.

Environmental Development

- The organization must follow national and international laws with respect to the use of pesticides and the protection of natural resources.

Standards on Labor Conditions

- Involuntary work or the employment of individuals less than 15 years of age is prohibited.
- Employees of the organization must have the right to organize, work in a clean environment, and be remunerated at levels that are in accordance with regional averages (FLO 2004).

Four organizations in San Martin have the FLO certification, CAC Oro Verde, APAVAM, ADISA, and APROECO. The experiences of these organizations show the barriers and costs of the FLO certification process.

3.1 Key Barriers in the FLO Certification Process

The three principal barriers to the FLO certification are: coordinating the certification process; obtaining export contracts; and obtaining financing to buy coffee from members and pay the certification fee.

3.1.1 Coordinating the Process

To receive the FLO certification, an applicant must contact the FLO, coordinate the external visits, and meets the demands of the organization. APAVAM and ADISA benefited from the guidance and work of Miguel Alegria, the coordinator of the Hivos/Rainforest Trading project. In both cases, Alegria guided the associations through the certification process (interview with Miguel Alegria, October 20, 2005).

After Alegria provided the FLO with the general information that it required, he and the associations had to wait due to a backlog of applications at the FLO. At this point, the connection with Rainforest Trading became especially important. The manager of Rainforest Trading, Cesar Villanueva, assured the FLO that the company could find contracts for the associations. The FLO then ordered the external inspection of the associations and notified the associations of the information that the inspectors would need to see. See the appendix for a list of documents that the applying organization must present to the inspectors during the external visit.

Unlike APAVAM and ADISA, Oro Verde has an administrative team of four persons: a manager, an administrator, a marketing person, and a certification and quality control supervisor. The general manager, Hiderico Bocangel, coordinated the FLO application process (interview with Hiderico Bocangle, September 7, 2005).

In the case of APROECO, PRONATUR managed the certification processes for all the certifications of the association/company.⁷ APROECO/PRONATUR already had an organic certification when it applied to the FLO. PRONATUR's financial manager, Miguel Reyes Custodio, emphasized that the association's organic program helped the organization in the FLO certification process (interview, January 27, 2006).

APROCCC is the only organization of this study that has not started any certification process. Sacarias Segundo Idrogo, an association representative, explained that APROCCC has no information on the FT market (interview, November, 15, 2005).

3.1.2 Obtaining Contracts

To obtain the FLO certification an organization needs export contracts. In the case of ADISA, Rainforest Trading, who supports the association through the Hivos project, sent

⁷ Most of the certifications are in the joint name of APROECO/PRONATUR.

samples of coffee to importers and obtained a contract with Globos Coffee (interview with Alvara Prada Guadalupe, October 20, 2005).

Rainforest Trading also obtained a buyer for APAVAM. Prior to its relationship with Rainforest Trading, APAVAM spent two years with an organic certification without a contract. APAVAM contacted Cocla and Cepicafe, two large Peruvian coffee cooperatives, looking for a contract. These cooperatives told APAVAM that they lacked contracts for much of the coffee that their own members produced (interview with Heine Davila, October 20, 2005).

The UN project provided Oro Verde with financing and personnel which allowed the cooperative to export conventional coffee in 2001 and 2002. As a result, Oro Verde had already exported conventional coffee when it applied to the FLO. Certified International, which had purchased conventional coffee from Oro Verde, provided the intent to purchase document for the FLO inspection (interview with Hildebrando Cardenas Salazar, Oro Verde sales manager, September 7, 2005).

The general manager of PRONATUR, Jan Berhard, had commercial contacts in Europe from his work in the coffee export company, PERCOF. Berhard obtained APROECO's FT contracts, which was made easier by APROECO's organic certification (interview with Miguel Reyes Custodio, January 27, 2006).

The experiences of APOCC and APROCASS underscore the difficulty of obtaining export contracts without the support of an entity with commercial experience. APOCC has searched for buyers since 2003 and has yet to sell its coffee as an association (interview with Salvador Ruiz Garcia, October 25, 2005). APROCASS paid an advisor, sent samples of its coffee to Mexico, and went to Lima to look for buyers. As an association, APROCASS has only sold 100 quintals of coffee when Rainforest Trading needed coffee to fulfill a contract (interview with Cesar Diaz Guerrero, October 20, 2005).

3.1.3 Financing

An applying organization needs money for the FLO certification, US\$ 3,200 in the case of an organization of less than 500 producers. The organization also needs cash to buy coffee from its members to honor export contracts. The FLO requires that FT importers offer 60 percent of the value of a FT contract to the supplying organization so that the organization can buy coffee from its members. It is generally accepted, however, that members will not supply their coffee to the organization if they are not paid in full.

Financing for the Purchase of Coffee from Members

To purchase its member's coffee ADISA received a forward payment of 60 percent of its contract with Globos Coffee. Miscommunication between the association's manager and producers concerning prices and payment times allowed ADISA to collect the coffee of its members with only 60 percent of the payment (interview with Alvaro Prada Guadalupe, October 25, 2005).

APAVAM also received a forward payment of 60 percent. Unlike ADISA, APAVAM needed the remaining 40 percent to collect its members' coffee. The association borrowed US\$ 40,000 (S/. 135,000) from the CRSM using the assets of the president and manager of the association as collateral (interview with Americo Arevalo, business manager of the CRSM, January 3, 2006).

Collecting coffee from its members presents a problem for ADISA and APAVAM as FT associations. According to both the general manager of ADISA and Miguel Alegria, an increase in conventional coffee prices harms the associations because they cannot collect coffee to honor their contracts (interview with Alvaro Prada Guadalupe, October 20, 2005 and Miguel Alegria, January 3, 2006). Due to quality standards and processing costs the associations' members often prefer to sell to the local market. The local market buys all of a producer's coffee, the good and the bad. The FT market, however, demands coffee of higher quality than that of the conventional export market. Each 300 grams of

FT coffee can only have five defects while conventional coffee for export can have between 20 and 30 defects. As a result, the association needs to start with a greater quantity of raw material to fill a container. The second reason is that the association has to process its coffee for the FT market. Processing costs are reflected in a lower price paid to members. Even though the FT market always pays a five cent premium above the conventional market price, because of quality standards and processing costs the organizations sometimes cannot offer a competitive price to its members (interview with Miguel Alegria, January 13, 2006).

With respect to financing, Oro Verde has had short-term loans from the United Nations of around US\$ 100,000 a year to buy coffee from its members (interview with Hiderico Bocangle, October 14, 2005).

While APOCC and APROCCC are not in FT, their experiences highlight the importance of financing to buy and sell coffee as an association. Both associations lack such funds. APROCCC was only able to buy and sell 400 quintals⁸ of coffee because Rainforest Trading loaned the association US\$ 3,000 (S/. 10,000) for a week (interview with Sacarias Segundo Idrogo, November 15, 2005).

APROECO does not intervene in the buying or exporting of its coffee. Members deliver their coffee individually to the warehouse of PRONATUR in Moyobamba, and the company pays them in full (email from Orlando Diaz, December 16, 2005).

Payment of the FLO Certification

Members of ADISA received loans of US\$ 180 to US\$ 450 (S/. 600 to S/. 1500) from the CRSM. From this amount, US\$ 75 (S/. 250) went to the association to pay for the FLO certification (interview with Alvaro Prada Guadalupe, October 20, 2005). This loan was

⁸ A quintal of exportable coffee (café oro) is 46 kg while a quintal of pergamino coffee (unshelled) is 56 kg.

made possible by a donation of US\$ 48,000 from the Consulting Group to Assist the Poor (CGAP) to the CRSM specifically for credit to small coffee producers.⁹

The members of APAVAM were to contribute US\$ 15 (S/. 50) for the FLO certification. APAVAM, however, confronted the free-rider problem as most members chose to let someone else pay and still reap benefits. Only 20 members contributed. For the remainder of the payment, the association borrowed US\$ 2,800 from the CRSM using the association's president's house as collateral (interview with Heine Davila, October 20, 2005). This loan was also made with resources from the CGAP donation to the CRSM.¹⁰ APAVAM also has had steady income of US\$ 350 to US\$ 450 (S/. 1,200 to S/. 1,500) a month from the trust fund from the European Union (interview with Americo Arevalo, January 3, 2006).

Oro Verde and APROECO were fortunate to apply to the FLO before it charged for the certification, a practice which started January 1, 2004 according to the webpage of the FLO regional office for Ecuador and Peru.

APROECO has not directly paid for any of its certifications. PRONATUR assumes these costs which the company integrates into its cost structure. These costs are transferred to the association in the form of lower prices to members (email from Orlando Diaz, December 16, 2005).

In the cases of APOCC and APROCASS, the certification payment of US\$ 3,250 (€ 2,500) has been a major barrier. Neither APROCASS nor APOCC have such funds (interviews with Salvador Ruiz Garcia, October 25, 2005 and Cesar Diaz Guerrero, October 20, 2005).

⁹ "Buyer and Supplier Credit Linkages: Pilot Funding Application," prepared by the personal of the Caja Rural San Martín.

¹⁰ "Sixth Month Status Report" from the Caja Rural San Martín to CGAP.

The FLO certification process restricts access to the benefits of the FT market. The supply and demand statistics previously discussed show that the barriers to the FLO certification are too low to put supply more in line with demand. As a result, another barrier has emerged, an organic certification, which will be analyzed after a brief discussion of the economy of scale in the coffee export market.

Summary – FLO Certification

Organization	Coordination	Contracts	Financing
Oro Verde	Professional Manager	Support from UN, trade fairs, management team	UN donation, low interest loans to buy coffee, export commissions
APAVAM	Miguel Alegria	Hivos/Rainforest Trading project	Loan from the CRSM - assets as guarantee, Trust fund from EU
APROECO	PRONATUR	PRONATUR	PRONATUR
ADISA	Miguel Alegria	Hivos/Rainforest Trading project	CGAP donation through the CRSM, member contributions, confusion

4. Economy of Scale in the Export Market

The experiences of these coffee organizations in the FT market show that an economy of scale exists in the coffee export market. As export volume increases average export costs decline. In 2005, the five largest producers' organizations of Peru exported 77% of all coffee exported through producers' organizations.¹¹ One producer's organization exported 44% of all coffee exported through producers' organizations. To a point, if an entity exports one container or ten containers, fixed costs such as managers remain unchanged (personal communication with Cesar Villanueva, former manager of Rainforest Trading, February 14, 2006). The manager of APAVAM noted that the

¹¹ See appendix for a summary of exports prepared by the author.

association had elevated export costs in 2005. APAVAM could have exported five or six containers without having to hire more personnel (personal communication with Mario Agustin Altamirano, manager of APAVAM, March 4, 2006). In other words, APAVAM operates at an inefficient level. In the end, the cost of this inefficiency is passed on to member producers.

An organization also needs a significant export volume to pay for professional personnel. Once an organization has specialized personnel it can obtain more contracts, increase its scale, and continue to lower average costs. Oro Verde had the benefit of financial support from the United Nations to sustain its professional team. The cooperative's administrator believes that after six years Oro Verde can only cover 70 percent of its costs with its current income stream (interview, September 7, 2005). The quality control supervisor, Teofilo Biengolda, said that the cooperative needs an annual export volume of around 15,000 quintals to be sustainable – more than double the cooperative's current volume (interview, September 7, 2005). While Oro Verde's specialized personnel allowed the cooperative to enter export markets, the current export volume does not generate sufficient income to sustain the management team.

5. Organic Certification

To sell organic FT coffee an organization must have an organic certification in addition to the FLO certification. Various entities that are internationally known and accepted offer an organic certification, such as Bio Latina, OCIA, and IMO Control. In most cases, the organic certification process takes a minimum of three years and follows these general steps:

- After expressing interest to a certifying entity, the applying organization supplies the information that the entity requests.
- The applying organization ensures that a request form and contract exist for each producer, affirming that the producer wants to convert to organic production and will abide by the certifying entity's standards.

- The organization establishes an Internal Control System (ICS) to monitor and document the activities of each farm.
- The certifying entity visits the organization to verify its information and to visit a sample of producers.
- After the external visit, the organization receives the results and recommendations of the visit.
- If producers fulfill the certifying entity's requirements each year, they will be eligible for the organic certification after the time specified by the certifying entity.¹²

5.1 Key Barriers in the Organic Certification Process

The organic certification process, like that of the FLO, presents difficulties for the applying organization. The three most notable barriers are: fulfilling the requirements of organic production; paying the certifying entity; and establishing an adequate ICS.

5.1.1 Fulfilling the Requirements

Unlike the FLO certification, the organic certification requires significant changes in how a producer manages his farm. A coffee producer must gradually bring farm practices inline with the certifying entity's norms. Periodic visits by field technicians who educate participating producers and evaluate their progress facilitate such changes.

Many producers withdraw from organic programs due property transfers, migration, and unwillingness on the part of producers to change production methods. In three of the four organizations studied, only around 70 percent of the producers who started an organic program successfully finished it.

¹²This summary comes from the webpage of IMO Control and Naturland as well as a document from Bio Latina (Priego 2002).

Organic norms require a Processing Center (*Centro de Beneficio*) to properly manage the water and pulp that comes from shelling, washing, and fermenting coffee. Most producers in San Martin lack such a structure, and therefore, have to construct one.

Materials for the Construction of Processing Center (US\$)¹³

Material	Unit Costs	Quantity	Total Cost
cement	6.50 /bag	5	32.5
brick	0.15 /brick	70	32
tube (4")	3/tube	5	5014
tube (1")	4.50 /tube	10	45
labor	4.50 /day	6	27
Total			151.50

Source: Costs provided by Teófilo Beingolda Ayalo, the quality control and certification supervisor for Oro Verde. Elaboration by author.¹⁴

Heine Davila estimated that each producer APAVAM invested US\$ 150 (S/. 500) in a Processing Center (interview, October 20, 2005). This amount coincides with the cost estimate provided by the quality control supervisor at Oro Verde.

5.1.2 Paying the Certifying Entity

Unlike the FLO certification, the organic certification takes around three years. An external visit, with its own cost, is required each year. The box below shows the costs of one visit of IMO Control to APOCC.

Bill from IMO Control for a group of 70 coffee farmers (2005)

¹³ This cost does not include tin for the roof as Oro Verde planned to use palm leaves. This estimate assumes that the producer has a machine to remove the fruit from the coffee bean, which typically costs around US\$ 100. Nor does the estimate include solar plastic to dry the coffee beans.

¹⁴ The original costs were converted from Nuevo Soles to US\$ at a rate of 3.35 S/. per U.S. dollar.

Activity	N° days	US\$./Day	Total US\$
Inspection of production and ICS	5	220	1,100
Travel time, (to and from the project site)	1	220	220
Preparing reports and follow up	1	220	220
Certification costs, IMO for the EU			400
Bank transfer costs			60
Administrative costs			20
Participation in international travel costs (33%)			143
Food, lodging and minor expenditures			241
Inspecting payment 2005			1,200
Total			3,604

Source: Archives from the project “Producción de Café orgánico y Miel de Abeja en Sistemas Agroforestales en San Martín”, Centro de Desarrollo e Investigación de la Selva Alta (CEDISA).

The cost per day per inspector depends on how many days the inspector needs to visit the selected farmers. Farms that are more dispersed and inaccessible require more time to visit which translates into higher inspection costs (interview with Gerardo Medina, inspector for IMO Control, OCIA, and Rainforest Alliance, March 3, 2006).

5.1.3 Internal Control System (ICS)

All organic certifiers require that an organization maintains an Internal Control System (ICS). An ICS consists of committees responsible for monitoring member farms. The ICS must be established and have conducted an official internal visit prior to the first external inspection.

The following table summarizes the experiences of the four organizations with an organic certification.

Summary – Organic Certification

Organization	Internal Control System	% that fulfilled standards	Financing
Oro Verde	Organized by field technicians from the UN	76%	Donations from the UN, export commissions
APAVAM	Organized by field technicians from ADEX, IDACA	71%	Donations from the EU, USAID, INCAGRO, loan from the CRSM
APROECO	Organized by field technicians from PRONATUR	80-90%*	PRONATUR
APOCC	Organized by field technicians from CEDISA	62%	Donation from INCAGRO, CEDISA, and member contributions

*This is an estimate made by the financial manager of PRONATUR.

The following graph shows the costs incurred by four organizations in the payment for three years of external inspections, three years of technical assistance, and an investment of US\$ 150 for each member's Processing Center.

Summary of Organic Certification Costs (US\$)

Organization	External Cost	Technical Assistance	Investment in Processing Center*	Total Investment per Assoc.	Investment per Member
Oro Verde	5,580	114,000	34,091	153,671	683
APAVAM	4,824	100,709	28,485	134,018	1,008
APROECO	18,373**	96,000	150,000	264,373	307

APOCC	8,531	52,674	10,448	71,653	1,024
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*The estimate of US\$ 150, excludes the cost of a machine which removes the pulp from the coffee bean.

**The external cost for APROECO is based on a bill for an external inspection by IMO Control of 660 producers in San Martin. That rate was applied to 860 producers for APROECO.

7. Conclusions

- The FT market is a niche in the larger coffee market. Market forces determine who enters the FT market.
- A producer with capital, a willingness to assume risk, and who is not remotely located is most likely to enter the FT market.
- More important than the characteristics of the producers, however, is the competitiveness of the entity (producer's organization or company) that links producers to the market.
- While FT eliminates market intermediaries in some cases, FT does not eliminate the functions that intermediaries perform. Producers will not earn more if their association or cooperative performs these functions less efficiently than other market actors.
- For a producer's organization to promote the interests of its members it must be competitive in the coffee industry, FT or not.

In the introduction, this study asked how the FT coffee system decides who receives the minimum price and who must sell to the open market. The answer is that the coffee market determines who sells to the FT market. While the FLO certification is a creation of the FLO, the requirement by the FLO that soliciting organizations have an export contract is a reaction to a market reality. The demand by FT buyers for high quality coffee and organic coffee is a direct result of market forces. Furthermore, excluding

subsidies, market actors such as banks determine which organizations are worthy of credit, which is needed to enter the export market and pay for certifications.

The second question in the introduction was what type of producers or organizations are most likely to enter the Fair Trade coffee system. The answer is a producer with capital, a willingness to assume risk, and who is not remotely located. Producers need capital to invest in their association. In addition, entering the market involves risk; there are producers who have invested in a certification and an association and still have not received contracts and, therefore, benefits. In the case of organic coffee, producers will probably only receive benefits from the conversion to organic cultivation in the fourth year. Indeed, no direct benefits are guaranteed. The cost of an external inspection and the cost of maintaining an internal control system as part of an organic program also increase when producers are scattered in remote areas.

The factors which determine if a producer becomes a beneficiary of FT, however, are not his size, geographical location, or annual income. **The principal factor is the entity to which the producer is connected. The capacity and competitiveness of that entity determines if a producer will pass the market's rationing mechanisms.** PRONATUR and Oro Verde have integrated many producers into the FT coffee market. The members of APROECO (PRONATUR) and Oro Verde are similar to those of the other coffee organizations of this study in terms of location and socio-economic status. The factor which differentiates successful coffee organizations from the rest is the presence of personnel specialized in production, certification, and marketing/exporting of coffee – in other words, the business of coffee. Oro Verde has these capacities. While APROECO lacks these capacities, it has a strong alliance with an entity that has them, PRONATUR.

In spite of technical and financial support, the only coffee organization in San Martín that has solidly established itself in the FT market is CAC Oro Verde, which until 2005 received support from the UN. CAC Oro Verde is also the only coffee organization in San Martín that has a professional management team. APROECO appears to have firmly established itself in the FT coffee market. In reality, however, APROECO does not

involve itself in the sale of its product or in the internal monitoring of its member's farms. PRONATUR undertakes these tasks. If APROECO were to lose its connection with PRONATUR, the association would struggle (interview with Mauro Fernandez, March 3, 2006).

The theory behind Fair or Alternative Trade was to give producers higher prices by excluding intermediates. While FT has eliminated intermediates in some cases, FT has not eliminated the functions which those intermediates perform. Intermediates invest capital and assume risk to buy and transport coffee from remote areas to storage centers. Export companies coordinate contracts, volumes, and export logistics. Eliminating these intermediates does not eliminate these labors. Eliminating intermediates will not generate greater earnings for producers if a producer's association conducts these tasks less efficiently than the individuals or companies that previously conducted them. To the contrary, an inefficient association may cause a producer to earn less than if he had sold his coffee to the local market.

For a producer's organization to promote the interests of its members it must have the capacity to compete in the coffee industry, FT or not. Included in this capacity are commercial contacts, knowledge of markets, ability to access capital, and experience in coffee processing, exporting, and quality control. Also, a significant volume is needed to lower average export costs. The most successful entities are those with their own human resources (professional personnel) as opposed to those managed by producers who depend on development projects and the advice of the NGOs that implement them.

9. Recommendations

- FT should identify strategies to link new organizations without a commercial history or collateral to sources of short-term capital so that these organizations can buy and sell coffee.

- The FT movement should focus on creating or supporting the institutions and strategies that most effectively integrate small producers into the market, whether it is FT or other coffee market niches. FT should not confine itself to working with producer's associations. As shown by the case of PRONATUR, the private sector can efficiently integrate small producers into the market.
- Research is needed that explores the degree to which FT has improved living conditions for participating producers over time. To merit the investment of funds from international cooperation, FT should do more than maintain the status quo.

In conclusion, even though many have aspirations for the FT movement to induce profound changes to the global economy, such aspirations should not prevent people from asking practical questions about how FT is actually working. Market tendencies, such as balancing the quantity supplied with the quantity demanded, govern the FT coffee market. Far from being a paradigm change, FT is a space in the market that represents an opportunity to promote development. The FT movement, therefore, should be evaluated by its efficiency and effectiveness as an engine of rural development.

Appendix

1. Abbreviations

ADEX – Association of Exporters (Asociación de Exportadores)

APA – Agrarian Producers Association (Asociación de Productores Agrarios)

CEDISA – Development and Research Center for the High Jungle (Centro de Desarrollo e Investigación de la Selva Alta)

CGAP – The Consulting Group to Assist the Poor

CRSM – Caja Rural San Martín

FLO – Fair Trade Labeling Organisations International

FONCODES – Compensation and Social Development Fund (Fondo de compensación y desarrollo social)

gtz – German Technical Cooperation (Gesellschaft fur Technische Zusammenarbiel)

HIVOS – Humanist Institute for Cooperation with Developing Countries

IDACA – Engineers for Agro-ecologic and Alternative Crop Development (Ingenieros para Desarrollo Agro ecológico y Cultivos Alternativos)

INDS – Engineering for Development (Ingeniera para Desarrollo)

JAS – Japanese Agricultural Standards

NOP – National Organic Program

Novib – Oxfam Netherlands

OCIA – International Organic Crop Improvement Association

PEAM – Upper Mayo Special Project (Proyecto Especial Alto Mayo)

PRONATUR – Promoter of Natural Agriculture (Promotura de Agricultura Natural).

qq – Quintal, one quintal of exportable coffee is 46 kg while one quintal of parchment coffee (unshelled, un processed) equals 56 kg.

UNOPS – United Nations Office of Project Services

UNDCP – United Nations Drug Control Program

Incagro – Innovation and Capacity Building for Peruvian Agriculture (Innovaciones y Capacitación para el Agro Peruano)

2. Documents Required by the FLO

- Copy of the most recent version of the statutes
- Copy of the legal constitution of the organization
- Diagram of the organization's structure
- List of delegates or community representatives, if applicable
- List of the names all of association members with area, total production volume, and information concerning which producers have hired labor on their farms
- Internal Rules and Procedures, if they exist and are not part of the statute
- The Minutes of the last two general assemblies
- Copy of the written reports given to members during the last two general assemblies
- Minutes of the governing board meetings
- Financial statements from the last two fiscal periods
- Financial audit documents if they exist
- Lists of crop collected by the organization (verification of the quantities and prices of the collected crop)
- Work plans, sales plans, training plans
- List of all of the organization's hired workers (in administration or processing)
- Documents which prove the social guaranties of said workers (social security, pensions, etc.)
- Copy of the occupational health plan if one exists
- Registry of the monitoring of environmental aspects (soil analysis, samples of disease detection, if one exists)
- List of chemical products used in cultivation
- Validation of an organic certification if one exists (certificate, inspection reports)
- Copy of export license, if one exists
- Contracts with Fair Trade buyers and/or exporters

- Statistics of sales in national and international markets, including average yearly prices and buyers.¹⁵

¹⁵ Alan, Vivian, y Antje Kachel. "FLO-Cert Certification of Socio-Economic-Development GMBH: Requisitos para preparación de inspección FLO-Cert grupos de pequeños productores". This document was provided to the author by Miguel Alegria.

3. Exports of Peruvian Coffee by Producers Organizations¹⁶

Organization	Vol.(qq)	% Total Exports	% Exp. by organizations
COCLA LTDA	214,018.54	6.90%	43.90%
CECOVASA	52,044.18	1.70%	10.70%
CAC La Florida	42,521.00	1.40%	8.70%
CEPICAFE	35,939.62	1.20%	7.40%
Corp. Produc. Café Perú S.A.C.	29,100.00	0.90%	6.00%
Asoc. Pro. Rodriguez de Mendoza	16,515.00	0.50%	3.40%
C.A.C Bagua Grande	13,478.61	0.40%	2.80%
Central de Cafetaleros Nor Oriente	12,561.00	0.40%	2.60%
C.A.C. La Prosperidad	7,995.00	0.30%	1.60%
C.A.C. Pagoa LTDA	7,782.00	0.30%	1.60%
C.A.C. Oro Verde	7,050.00	0.20%	1.40%
C.A.C. San Juan de Oro	6,225.00	0.20%	1.30%
C.A.C. Frontera de San Ignacio	5,527.50	0.20%	1.10%
C.A.C. Satipo Ltda	5,250.00	0.20%	1.10%
C.A.C. Valle Rio Apurímac	4,973.48	0.20%	1.00%
Asoc. Cafetaleros Solidarios de San Ignacio	4,350.00	0.10%	0.90%
C.A.C. Industrial Narajillo	4,125.00	0.10%	0.80%
C.A.C. Casil LTD	3,300.00	0.10%	0.70%
Union de Cafetaleros Ecologicos	3,300.00	0.10%	0.70%
Asoc. de Productores Cafetaleros el Juan Marco	1,650.00	0.10%	0.30%

¹⁶This summary of exports by producer's organizations was elaborated by the author using coffee export statistics from the Camara Peruana de Café.

Central de Productores Agroecologicos	1,605.00	0.10%	0.30%
C.A.C. La Divisoria LTDA	1,579.50	0.10%	0.30%
C.A.C. Sotenible Valle Ubirik	1,367.00	0.00%	0.30%
Asociación Distrital Agropecuaria	1,237.50	0.00%	0.30%
Asoc. de Productores Valle Alto Mayo	825	0.00%	0.20%
Asoc. de Productores Cafés Especiales	825	0.00%	0.20%
C.A.C. de Servicios Café Hemalu de los Bosques	750	0.00%	0.20%
C.A.C. de Frutos Ecologicos	738.56	0.00%	0.20%
Asoc. de Productores Café Perú S.A.C.	425.5	0.00%	0.10%
Total	487,058.99	16%	100%

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