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SUSTAINABLE COFFEE

**INCREASING INCOME OF SMALL-SCALE COFFEE
FARMERS IN MEXICO THROUGH UPGRADING AND
IMPROVED TRANSPARENCY IN THE VALUE CHAIN**

microREPORT #45

March 2005

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CONTENTS

FOREWORD	I
EXECUTIVE SUMMARY	2
I. INTRODUCTION	4
A. THE GLOBAL COFFEE MARKET	4
B. THE CHIAPAS COFFEE PROJECT	4
C. SMALLHOLDER COFFEE PRODUCTION IN MEXICO	5
II. VALUE CHAIN INTERVENTIONS	8
A. MSE UPGRADING THROUGH BEST PRACTICES	8
B. DEVELOPING VERTICAL LINKAGES	9
C. STRENGTHENING HORIZONTAL COOPERATION AND COORDINATION	10
D. FACILITATING THE EMERGENCE OF SUPPORTING MARKETS	12
E. IMPROVING THE BUSINESS ENABLING ENVIRONMENT	14
F. SOCIO-ECONOMIC IMPACT OF THE PROJECT	14
III. CONCLUSIONS AND LESSONS LEARNED	15
A. THE ROLE OF THE LEAD FIRM	15
B. SUSTAINABLE SUPPORTING MARKETS	16
C. PRECONDITIONS TO VALUE CHAIN INVESTMENTS	16
D. CHANGES IN POWER AND BENEFITS	17
REFERENCE LIST	18
FIGURES	
FIGURE 1: Value Chain Map	6
TABLES	
TABLE 1: Chiapas Coffee Project Sales by Container	9
TABLE 2: Price Received by Farmers per Pound of Parchment Coffee After Fees for Services Deducted	10

FOREWORD

This paper is part of a series of ongoing research activities funded under the Accelerated Microenterprise Advancement Project Business Development Services (AMAP BDS) Indefinite Quantity Contract that explores industry-based strategies to achieving poverty reduction and broad-based economic growth. This case study illustrates how an NGO (Conservation International) in collaboration with a leading international coffee roaster (Starbucks), and with support from USAID, were able to realize increased incomes for rural farmers, significant investments in specialty coffee value chain upgrading, and important and potentially enduring environmental benefits.

This paper examines the extent to which micro and small enterprises (MSEs) benefit from participation in global and domestic value chains, the role of market leaders and the incentives required for participants to invest in upgrading.

A number of themes are explored including the relationships among participating firms and their role in project effectiveness and sustainability; preconditions to investment in value chain upgrading; the link between access to services and MSE ability to upgrade in response to new opportunities; and the appropriate level of service provision by a facilitating NGO.

JEANNE DOWNING

USAID/PR/MD

EXECUTIVE SUMMARY

This case study tells a story of how rural poor smallholder coffee farmers in the State of Chiapas in southern Mexico achieved significant increases in their earnings as a result of sales into a higher value market channel established in cooperation between Conservation International (CI) and the Starbucks Coffee Company (Starbucks) in a project funded by the United States Agency for International Development (USAID).

In 1997, when the CI-Starbucks partnership was being negotiated, world coffee prices were at an all-time low, and consequently, many farmers were abandoning the crop or cutting costs. This produced a threat to the sustainable supply of high quality coffee for Starbucks, to livelihoods for farmers, and to the natural resources that were being destroyed in pursuit of alternative livelihoods.

The Chiapas Coffee Project

The Chiapas coffee project began in 1997. Its purpose was to define and promote a set of land management practices to conserve biodiversity in the area adjacent to El Triunfo Biosphere Reserve and to demonstrate that farmers could obtain social and economic benefits through their adoption.

Traditional coffee farming threatened the Reserve because farmers cleared the forest to plant and polluted water sources with the waste created from processing. The project's recommended best practices include the use of shade trees to protect soil and water and provide habitat to wildlife and plants; and a ban on environmentally damaging prac-

tices such as hunting, dumping coffee waste in rivers and the inappropriate use of chemicals. Coffee produced according to these practices was trademarked by CI as Conservation Coffee™.

Adopting the best practices imposed costs on the farmers, including time to attend technical training and complete required documentation recording progress on annual targets, and increased labor investment in their farms. The main incentive to adopt the best practices was the availability of a market paying premium prices: Starbucks agreed to buy coffee meeting its quality requirements while fulfilling the best practices annual targets. It marketed the coffee under the brand name "Shade Grown Mexico."

Starbucks initially placed contracts directly with the cooperatives, which quickly demonstrated their inability to meet the challenges of exporting. CI therefore temporarily stepped in to cover the lack of marketing capacity of the cooperatives before establishing a relationship with a broker, which Starbucks later designated as its sole supplier in order to reduce transaction costs. Although this arrangement resulted in increased returns to farmers and a greater degree of transparency in pricing, four of the cooperatives rejected the requirement to work through a trader and withdrew from the project.

In addition to marketing services, farmers required access to agricultural training and extension, business planning training and financial services—all of which were also initially intended to be

provided through existing cooperative organizations. CI soon found the cooperatives to be inexperienced, administratively weak and unable to communicate to the farmers the concept of best practices or the risks and obligations associated with receiving credit and accessing international markets. As a result, CI began providing these services directly. As the cooperatives' skills and experience increased, CI transferred the implementation of these services to the cooperatives and to independent service providers, including community promoters.

The Role of the Lead Firm

The Chiapas coffee project illustrates the importance of market leaders in linking small and very small firms or farms into higher value markets. Lead firms with the capital, skills, incentives and commitment to invest in upgrading value chains that incorporate large numbers of smallholder producers can greatly accelerate growth and productivity. In this case, Starbucks provided an assured market, required strengthened and transparent linkages, provided product and market development services and shaped demand in the global coffee industry.

Sustainable Supporting Markets

The project demonstrates that farmers living below the official poverty line will pay fees for services to upgrade in response to economic incentives, and that private service providers can enter the market to make impacts more sustainable. While the project made a sustained commitment to providing vital services

that were unavailable, efforts were simultaneously made to build the service market.

Preconditions to Value Chain Investments

This case study identifies the following preconditions to private sector market leader investment in the value chain:

- The ability of the market leader to maintain some level of exclusivity in the market channel and a share

of the consequent premiums. In this case, this was achieved by establishing a unique brand.

- The presence of a facilitating entity—in this case CI—able to take responsibility for strengthening the organizational capacity of participating smallholders and reduce the risk of noncompliance with established agreements.

Impact on MSEs

By developing a product with attributes derived from the place and method of production, the dynamics of the power relationship between the smallholder farmers and the importer/roaster were changed in favor of the farmers. As a result, the benefit flow to the farmers also increased.

I. INTRODUCTION

A. THE GLOBAL COFFEE MARKET

An estimated 25 million farmers worldwide produce coffee, most of them smallholders with plots of 1-5 hectares. They operate in a global market in which supply outstrips demand, driving down prices. Over the last 15 years, farmers have also suffered a loss of access to services as governments have withdrawn subsidies that once supported training, extension, marketing and financial services. In response to lower prices and fewer services, coffee farmers have reduced investments essential for maintaining quality, such as renovating farms and maintaining processing infrastructure.

Over the same 15-year period, there has been a strong growth in demand for specialty coffees. This market segment embraces a number of different concepts and is characterized by a high degree of product differentiation, not unlike the wine industry. Its original and still predominant characteristic is quality. Specialty coffees are sometimes sold as single origin, as opposed to blends from different origins, to emphasize their distinctiveness.

Newer concepts to enter the specialty segment include environmental and social benefits at the point of production, categorized together broadly as “sustainable coffees.”¹ Organically certified coffee is an important part of this segment. Organic cultivation has little or no impact on the taste but provides benefits to the environment through guaranteeing the absence of

chemicals. Other concepts that are growing in the specialty segment are fair trade (coffee traded by producer associations at a guaranteed price that is determined by a set of fair trade standards) and eco-label (coffee grown under systems that conserve forest canopies).

The growth in the specialty coffee seg-

THE RISE OF SUSTAINABLE COFFEE

Sustainable coffees are now produced in 32 countries and consumed in 20. Global sales are about 125 million pounds, with a retail market value estimated at U.S. \$565 million. The organic market is the largest part of the sustainable segment, with U.S. retail sales of organically certified coffee estimated at U.S. \$223 million and growing at 20 percent annually. Fair trade coffees have been particularly successful in the U.S. market in the last few years. The fair trade labeling organization Transfair USA estimates that retail sales grew 90 percent in 2003 to U.S. \$208 million.

*Sources: Giovannucci, 2001,
Giovannucci, 2003
Transfair, 2004*

ment is part of a larger trend in food consumption in North America and Europe, where consumers are more informed about international trade, the

often low prices farmers earn, the poor working conditions of many employees, the environmental effects of agrochemical use and the impact on biodiversity of forest clearing. This increase in consumer awareness requires companies that process and manufacture coffee to know what is happening at all stages of the production process.

The strong growth in the specialty segment is taking place in a global coffee market that is growing only about 1 percent annually. In North America and Europe, total coffee demand is static or even falling slightly in the face of competition from other drink categories. However, the specialty segment is growing strongly in these markets.

B. THE CHIAPAS COFFEE PROJECT

The Chiapas coffee project, funded by USAID and implemented by CI in partnership with Starbucks was designed to increase the incomes of rural poor smallholder coffee farmers while conserving biodiversity through:

- Introducing an innovative product concept, Conservation Coffee™
- Developing vertical linkages to access new end markets
- MSE upgrading to meet the demands of this new market
- Strengthening horizontal cooperation and coordination to achieve scale
- Facilitating the emergence of supporting markets for financial services and technical assistance

- Improving the business enabling environment, both locally and internationally

1. THE PARTNERSHIP

The goal of the CI-Starbucks partnership was to create a market-based incentive system to improve the environmental and social impact of coffee farming, processing and trading, resulting in increased earnings for farmers, the stable long-term supply of high-quality coffee, and the conservation of biodiversity.

CI's role in the partnership was to bring together the firms in the value chain, government institutions and conservation organizations to define and promote "best practices," and to provide and facilitate business and financial services to enable farmers to adopt the practices and to increase their efficiency.

Starbucks² role in the partnership was to create a new coffee brand ("Shade Grown Mexico") that would grow the market, pay premium prices that would create an incentive for farmers to adopt the best practices, communicate to consumers about the social and environmental value of the partnership, and provide expert technical assistance in developing quality coffee.

Starbucks role reflected its values as a company: *"Purveying quality coffee means much more than selecting the finest beans in the world. It means protecting a way of life for farmers by supporting social, economic and environmental issues that are crucial to their livelihood. Starbucks is dedicated to creating a sustainable growing environment in coffee origin countries."*³

2. THE GEOGRAPHICAL LOCATION

The farmers participating in the Chiapas coffee project are located in the buffer zone of the El Triunfo Biosphere Reserve, a protected cloud forest of approximately 120,000 hectares (about 300,000 acres) that provides habitat for the threatened quetzal, ocelot and jaguar, rare plants and 240 bird species.

Coffee growing presents a challenge to conserving the biodiversity of the Reserve as farmers traditionally clear forest to plant, encroach on protected land and dump processing waste in waterways. Traditional growers are often unaware of the long-term value that the shade of forests has for production through retaining soil moisture, protecting the plants and providing habitat for birds and spiders that eat harmful insects.

Low coffee prices contribute to many of the problems threatening the biological integrity of the Reserve, including the introduction of livestock, fires to clear land, illegal extraction, and the establishment of settlements inside Reserve boundaries. At the start of the Chiapas coffee project, relationships between the low-income communities around the Reserve and the local authorities were strained: the administration considered agriculture a major threat to protecting wildlife.

Conversely, because the coffee sector has been very important to the economy of Chiapas, the government has traditionally subsidized it (especially in election years). At the time of this study, about 73,742 producers were farming

228,254 hectares in Chiapas, producing a third of Mexico's coffee.⁴ Subsidies covered occasional training, extension and financial services. Inefficiently executed government-funded rural credit programs had resulted in a culture of loan delinquency, preventing financial service institutions from entering the market and consequently leading to a lack of credit availability.

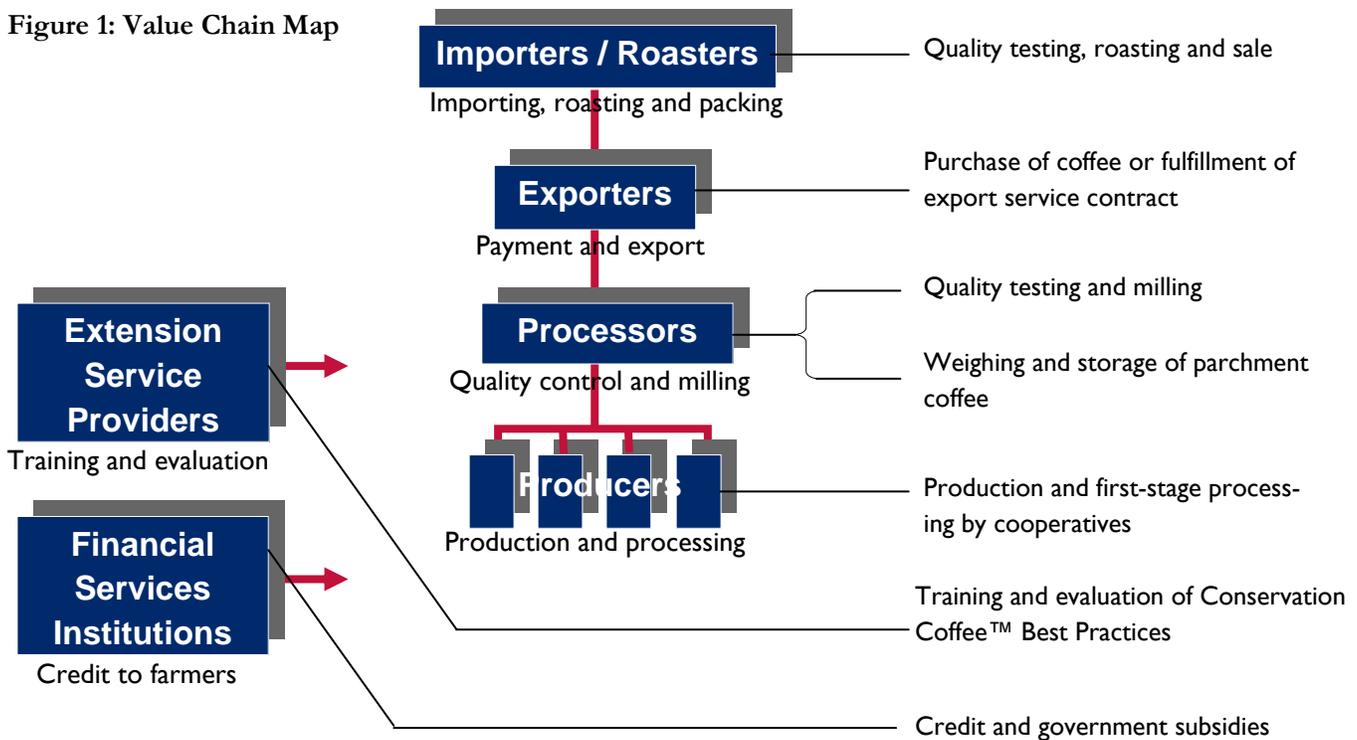
As is the tradition in Chiapas, many coffee producers are members of cooperatives. In general, the coffee cooperatives lack basic capacity in business administration. Cooperatives had been formed not as business entities but as tax-exempt legal entities to promote social solidarity and wellbeing among members and their communities. Their officers had minimal education and no management experience. This situation caused their substantial dependence on technical staff that the state government subsidized and encouraged them to appoint.

C. SMALLHOLDER COFFEE PRODUCTION IN MEXICO

1. THE VALUE CHAIN

The farmers who produce coffee in Mexico are removed from the major final product markets, both in terms of geography and number of links in the value chain. The situation in Chiapas, where most farmers are smallholders (2-4 hectares) who depend primarily on coffee sales for their livelihoods, is fairly typical.⁵ Farmers harvest their coffee in the form of cherries from the tree and undertake the first stage of processing to remove the coffee beans from the cherries and dry them. Farmers sell the

Figure 1: Value Chain Map



dried beans to independent local traders or buying agents of processing/trading companies, or to a cooperative if they are members of one.

Processing/trading companies undertake milling, a second processing stage that consists of removing the coffee bean skin (parchment) and then sorting and grading for quality in terms of bean condition as defined by trade standards.

The processor/trader bags the green, unroasted beans for export or local sale. Export-quality green coffee is imported either by a trading company that sells it on to a roaster or by a roaster directly. There has been considerable integration in the coffee industry, particularly by large trading companies. Only a few companies—Neumann, Volcafé and the ECOM Group are the three largest—undertake most of the world’s coffee trading.

The roaster roasts and blends the coffee to achieve the consistency and flavor profile determined for the brand. Most brands belong to roasters, who then sell the branded consumer products to retailers.

A value chain map is presented as Figure 1 above.

2. RETURNS TO MSE PRODUCERS

The power and benefit flows between traders and roasters in the commodity (as opposed to specialty) coffee value chain are highly asymmetrical, with a small number of lead firms determining the amount and type of coffee that is bought and the international commodity market largely determining the price that roasters pay. The product attributes are largely enshrined in the brand value, far in the value chain from the producers, who hence have no leverage to ne-

gotiate more favorable prices. Less than 10 percent of the retail price of coffee products accrues to the farmers.⁶

The weak bargaining position of coffee farmers in the value chain is due to a number of constraints, which result in lower earnings and poverty.

End Market Constraints

The very low international price for coffee affects the ability of smallholders to invest in quality. Coffee farmers lack an economic incentive to improve their product and service quality because it does not gain them a higher price from local distribution channels. At the start of the project, the Conservation Coffee™ concept was as yet unknown in the market.

Enabling Environment Constraints

There is limited investment in agriculture, especially in a marginalized state such as Chiapas. Periodic, subsidized

public sector schemes—particularly in advance of elections—make agriculture unattractive to the private sector.

Horizontal Linkage Constraints

As with many rural enterprises, local traders undertake additional functions—such as credit provision—to compensate for the lack of independent local service providers. Most small-holder coffee producers live below the poverty line and are usually in debt. The cooperatives lack business skills and transparency. Consequently, farmers tend to assume that everyone is trying to exploit them—a mindset that makes it difficult to build trust in new ideas and collaborations.

Vertical Linkage Constraints

The coffee cooperatives often employ technical advisors with government support but are usually not able to manage these people effectively, leading to inefficiencies. Farmers' lack of knowledge of markets, geographic isolation, small scale of production and low education levels make identifying and directly accessing more rewarding relationships in the value chain very difficult.

Supporting Market Constraints

Few financial institutions are willing to provide credit: the decline of coffee prices increases the risk of financing the small-scale coffee sector, which has a

history of low profitability and loan default. Politically motivated soft government loans have led to a culture of non-repayment. Producer organizations, government agencies and other service providers lack the resources and tools to provide relevant training and extension.

Firm Level Upgrading Constraints

Neither farmers nor cooperative officers have the necessary knowledge of international markets, coffee quality or business management to build competitive enterprises. In addition, they lack the facilities required for processing coffee, limiting their options for adding value to the product.

3. VALUE CHAIN OPPORTUNITIES

At the outset of the project there were, however, a number of significant opportunities to be exploited. The most important of these was Starbucks' interest in playing the role of a lead firm driving industry change, and its commitment to increasing the learning and benefit flows to smallholder farmers.

The authorities responsible for managing El Triunfo Reserve were very supportive of the idea of producing according to the best practices and helped to promote this concept among farmers in

addition to participating in defining the practices.

Other opportunities included the growth of the specialty coffee market and the availability of USAID funds (PVC Matching Grants program and the Global Development Alliance) awarded to CI.

¹ Giovannucci, 2003

² Starbucks does not use an apostrophe when the name is written as a possessive adjective.

³ Starbucks website, as viewed November 2004

⁴ Consejo Mexicano de Café, 2002

⁵ CI's socio-economic study of Chiapas coffee farmers revealed an average income of about U.S. \$30 per week at household level, with no other sources of cash income. On average, 33 percent of each community's land is dedicated to coffee growing and 29 percent is covered by forest. The remainder is used for the production of maize and beans, housing, and grazing lands.

⁶ Oxfam International, 2002

II. VALUE CHAIN INTERVENTIONS

A. MSE UPGRADING THROUGH BEST PRACTICES

The project aimed to establish market incentives for farmers to become stewards of the Reserve through the adoption of best practices. Capitalizing on recent trends seen in consumer preference, the adoption of best practices would enable the coffee farmers to improve their competitive position.

The cooperatives that participated in the project already had organic certification, which is available in Chiapas at a manageable cost. However, the best practices developed early in the project went beyond organic standards, which CI considers insufficient to create biological connectivity and conserve the ecosystem functions in the wider landscape.

1. DEFINING CONSERVATION BEST PRACTICES

Defining best practices had four steps. First, a global framework was designed. In 2001 CI developed the “Conservation Principles for Coffee Production” jointly with the Consumer’s Choice Council, Rainforest Alliance, the Smithsonian Migratory Bird Center and the Summit Foundation, and in consultation with industry leaders, including Starbucks, farmer organizations and nongovernmental organizations.

Second, a draft of best practices was developed based on available research and knowledge of local practices.

Third, farmer focus groups were convened to refine the draft best practices for the specific origin.

Finally, the draft best practices were reviewed and finalized with local and international experts. The best practices are periodically updated to reflect the knowledge gained through their application. A highly participatory approach ensured support for the practices among farmers, processors and other service providers.

2. STARBUCKS PREFERRED SUPPLIER PROGRAM

The Conservation Coffee Best Practices formed the basis for Starbucks own system of purchasing guidelines, defining economic, social, environmental and quality standards for growing and processing coffee. The Chiapas project became the pilot site for testing the guidelines and the training, technical assistance, financial services and monitoring programs necessary to promote their adoption.

Based on the guidelines, and with CI’s technical support, Starbucks introduced in November 2001 its Preferred Supplier Program (PSP), which evaluated suppliers using a scoring system that awarded points for the achievement of defined social, environmental and quality criteria. It operated on the basis of self-reporting, using existing documentation, and including a verification process to check data validity, rather than undertaking external inspection.

The result was a low-cost, uncomplicated reporting system based on com-

pliance with the guidelines, which documented the value passing through the chain, and which was compatible with other certification systems.

Applicants to the PSP who achieved a minimum of 60 percent total performance rating and 60 percent in each subject area achieved a Preferred Supplier status to Starbucks. This status earned them preferential contract terms and priority for buying. Applicants achieving an overall 80 percent rating with a minimum of 60 percent in every subject area were awarded Strategic Supplier status. This carried the additional benefit of a one-year premium of U.S. \$0.05 per pound on all green coffee meeting the program guidelines and shipped during the first crop year in which that score was achieved.

In addition, Starbucks encouraged continuous improvement with a one-year U.S. \$0.05 premium for all green coffee shipped by supplier applicants who achieved at least a 10 point increase in their score above 80 percent over the previous year.

3. STARBUCKS C.A.F.E. PRACTICES

In March 2004, Starbucks re-named and re-launched the PSP as Coffee and Farmer Equity (C.A.F.E.) Practices, to address additional social conditions, labor issues, environmental practices in coffee processing and economic transparency criteria.

Starbucks is presently training local verifiers in C.A.F.E. Practices in order to reduce the verification cost. This is an

important consideration in a market characterized by a proliferation of certification schemes, all bearing a cost for the farmers.

Starbucks has committed to purchasing 60 percent of C.A.F.E. Practices verified coffee by 2007.

4. LEAD FIRM-DRIVEN UPGRADING

The upgrading of smallholder coffee is being driven by Starbucks, the largest roaster and a major retailer of specialty coffee products and beverages. By offering a secure market and price premiums, it is using its strength as a lead firm to pull best environmental and social practices through the specialty coffee value chain for the benefit of small-scale producers.

This leadership also sends a challenge to other coffee companies to move in a similar direction to avoid weakening their capacity to compete for raw material supplies.

B. DEVELOPING VERTICAL LINKAGES

In August 1999, coffee cooperatives working with the project made their first sale to Starbucks, which launched a new brand, “Shade Grown Mexico,” in all its own stores in North America. The product carried CI’s logo and a conservation message. It recorded the highest sales on Starbucks website and could not be maintained in stock all year because of limited supplies.

The concept of shade-grown coffee was not unknown in the international market. By 1999 other specialty coffee companies had introduced products

that referred on their packaging to the required CI to reluctantly step in to cover

Table 1: Chiapas Coffee Project Sales by Container

(1 container = 38,000 lbs of green coffee)

Client	1999/2000	2000/01	2001/02	2002/03	2003/04
Starbucks	8	19	42	45	42
Other	6	2	2	2	0
Total	14	21	44	47	42

value of conserving forest shade as habitat for birds. Starbucks product was innovative in its attribute of a whole system of best practices and subsequently in the commitment of the company to developing a complete purchasing system based on the concept of environmental and social responsibility.

1. STARBUCKS TO COOPERATIVES

Starbucks initially placed contracts directly with the cooperatives. This proved to be a difficulty from the outset in building a sustainable trading model. Functional upgrading requires quick and thorough development of the skills required to perform the new function.

The Chiapas cooperatives had demonstrated in 1997 and 1998 their inability to meet on their own the challenges of direct exporting, failing in critical aspects of service such as sending pre-shipment samples, shipping within the contract period, notifying the client of shipment, sending full documentation, maintaining consistent quality and shipping the amount of coffee contracted. The gap between the experience of the cooperatives and the requirements of exporting to a large specialty coffee company was too great to bridge.

For Starbucks to receive product on time and to quality specifications re-

quired CI to reluctantly step in to cover the lack of marketing capacity within the cooperatives, which contracted local processors for milling their parchment coffee.

The urgency of a more sustainable approach became clear as Starbucks increased its demand in response to the success of “Shade Grown Mexico.” Sales to Starbucks from the Chiapas coffee project are illustrated in Table 1 above.

2. COOPERATIVES TO BROKER

The cooperatives resisted CI’s first attempt in 2000/01 to introduce a local trading company into the project. Nevertheless, it became essential for CI to pull back from its unanticipated role in supporting marketing for the cooperatives. To this end, CI established a relationship with *Agroindustrias Unidas de México* (AMSA), a member of the ECOM group, to provide export services to the cooperatives for the 2001/02 harvest.

AMSA received parchment beans from the cooperatives, processed, selected and graded them and prepared the export documentation. This arrangement continued for the 2002/03 harvest and the cooperatives began to trust AMSA, which returned to them a higher yield of export quality green coffee from the parchment beans they supplied than

they had previously obtained from other local processors.

AMSA also returned to the cooperatives the damaged beans that were not saleable, known locally as *desmanche*. This waste product has a small value, which increased farmers' earnings. These efficiencies offset the additional fee AMSA charged the cooperatives for export documentation.

3. STARBUCKS TO BROKER

After receiving its 2003 shipments, Starbucks wanted to change the export procedure for future years. It requested AMSA to buy from the cooperatives and sell directly to Starbucks and asked CI to facilitate the new arrangement. The reason for the change was to reduce Starbucks' transaction costs by dealing with only one supplier. Starbucks would then have direct communication with the supplier. The cooperatives could not communicate with international clients because they do not all have telephones, do not speak English and lack written communications skills.

In response to this new situation, CI facilitated a purchasing system that required Starbucks contracts to state both the price that Starbucks would pay AMSA and the price that AMSA was to pay the cooperatives. CI facilitated the negotiation between AMSA and the cooperatives by providing a detailed costing of each of the processing and exporting services that AMSA provided.

Initially, when exporting directly, the cooperatives were managing many functions. This, combined with their administrative weakness, made it much more difficult to undertake rigorous cost

analysis. When AMSA entered into the chain, the cooperatives were left with fewer functions, making it easier to calculate their exact costs. This transparency also helped overcome the cooperatives' distrust of AMSA. Moreover, Starbucks experience in the Chiapas project alerted it to the great importance of transparency in the value chain,

STARBUCKS PRICING

Starbucks has two pricing levels, one for organically certified coffee and one for in-transition, i.e. coffee that is in a three-year period of conversion to organic and is not yet certified. "Shade Grown Mexico" is a certified organic product, which is now available year-round in Starbucks retail outlets in USA, Mexico, Europe and Asia.

which it then introduced into the C.A.F.E. Practices.

4. BENEFITS OF NEW VERTICAL LINKAGES FOR PRODUCERS

Despite the system's transparency, four of the cooperatives participating in the project rejected the requirement to work through a trader that they perceived as having not treated them fairly in the past. They believed they would obtain higher prices selling elsewhere. Lengthy meetings failed to resolve the conflicts and the four cooperatives pulled out of the project. A few mem-

bers called press interviews to denounce CI for "weakening and dividing the cooperatives."⁷

The other cooperatives participating at that time remained in the project, and AMSA also offered its services to individual farmers who were implementing the best practices and wanted to continue selling to Starbucks. A number of these farmers accepted, and as a result the amount of coffee supplied to Starbucks from the 2003/04 harvest was almost at the level of the previous year.

The result of the new export procedure was positive for farmers. Although Starbucks buying price did not change, farmers earned more for their coffee than in 2003 when they exported through their cooperatives because of increased efficiency of transactions. Moreover, the cooperatives improved their cash flow, as AMSA paid them on receipt of the coffee; and their risk decreased because AMSA undertook quality control to Starbucks standards, removing the possibility of rejected shipments. Table 2 below shows payments to producers.

C. STRENGTHENING HORIZONTAL COOPERATION AND COORDINATION

Many producers throughout the world consider direct exporting to be the optimal strategy. However, while the price paid clearly increases as a product goes through the value chain, attempting to bypass intermediaries exposes the pro-

Table 2: Price in Mexican pesos received by farmers per pound of parchment coffee after fees for services deducted

	1999/2000	2000/01	2001/02	2002/03	2003/04
Organic	10.05	9.43	9.47	9.73	10.16
In-Transition	8.20	6.32	6.22	7.78	8.92
% above local price		61%	87%	75%	47%

ducer to significant trading and currency risks and may therefore not be the best approach to improving farmer earnings.

Inexperienced enterprises lack an adequate knowledge of processing and trading procedures to create a uniform coffee and provide a high-quality service to an international buyer and generally lack the economies of scale required to fulfill contracts competitively. Such enterprises may serve farmers poorly by causing importers to withdraw from the market.

1. COOPERATIVES AS EXPORTERS

The Chiapas project suffered initially from this problem. When CI started the project in 1997, it facilitated direct exporting by three cooperatives established close to the El Triunfo Biosphere Reserve—a decision based on the farmers' stated interest in building their own organizations to compete with the private traders operating in the region.

CI started by training the farmers through the cooperatives, but found that the transmission of information was poor and the adoption levels for new skills were extremely low. The technical staff lacked capacity to make accurate production estimates, contract with buyers an amount of coffee they could fulfill, calculate their credit needs and meet minimum standards for either organic certification or the more demanding best practices. Farmers were exposed to risks and took on obligations without being fully informed of the consequences.

2. COOPERATIVES BYPASSED

CI's key strategic interest was to implement the best practices. Once the cooperatives' lack of capacity was understood—a weakness that was exacerbated by the regular turnover of officers mandated in the cooperatives' constitutions—CI changed its approach, perceiving its best option to be providing the training and extension services directly to farmers. However, the cost of taking on the role of a service provider was high.

Furthermore, although to avoid long-term dependence CI included fully the cooperatives' technical staff, resentment grew at what the technical staff considered to be an undermining of their role. The situation also caused confusion among farmers about the roles of CI and the cooperatives. An analysis of local capacity and sufficient participatory process at the outset could have reduced these negative factors.

None of the cooperatives that joined the project in 1997 or those that entered in subsequent years had any knowledge of export markets. As CI had not yet entered into the partnership with Starbucks, it needed to identify clients that would buy the coffee. It did this successfully by facilitating sales to three specialty coffee companies: Rapunzel Pure Organics, Green Mountain Coffee Roasters and Frontier Coffee. Securing licensing agreements and investment commitments contributed to covering some of CI's costs of project implementation.

Because of the inexperience of the cooperatives, CI negotiated the contracts with these buyers on their behalf, facili-

tated the sending and approval of samples and physically accompanied the cooperatives to the agencies and shippers to fulfill exporting requirements. The Mexican harvest takes place from November and contracts are shipped in the first half of the following calendar year. CI avoided the loss of the market to the cooperatives as a result of poor quality product or service, but only by detailed involvement in the transactions and by acting as the communications channel for seller and buyer.

3. ONGOING CHALLENGE

The concerns of the farmers about the local intermediaries despite the weakness of the cooperatives to compete with them, the newness of the concept of best practices, the lack of service providers in the region, and the remoteness of Chiapas from the coffee export distribution points were the factors that influenced CI to take a direct service provider approach.

CI discontinued membership of a cooperative as a condition for participating in the project. The criteria for participation now are a commitment to implementing the best practices and the location of the farm in a strategic area for conservation. CI gives preference to farms at high altitude because of quality considerations and also to those that have initiated organic certification procedures. There is a formal application procedure and an induction course for new participants.

While the introduction of AMSA into the value chain has allowed individual nonmembers of cooperatives to sell to Starbucks, the failure of the cooperatives to provide effective horizontal

linkages between producers continues to present two ongoing challenges: institutional sustainability and scale of impact.

CI is evaluating the option of establishing a local organization to assume most of its own remaining role, including validating the best practices, facilitating cooperatives' negotiations with service providers and clients, and monitoring export performance. With regard to scale, CI is particularly interested in attracting large farm owners to the project in order to extend the best practices to the widest possible area and to achieve connectivity between forest fragments in the landscape.

D. FACILITATING THE EMERGENCE OF SUPPORTING MARKETS

1. FINANCIAL SERVICES

Existing Services Market

The market opportunity with Starbucks required accompanying financial services to enable the farmers to invest in best practices and the cooperatives to finance the purchase and sale of coffee. The only available source of financing was through local traders who often lent money to farmers and deducted repayment plus interest when buying the product, usually setting the buying price low and the interest rate high.

Farmers referred to these traders as “Coyotes”, because they exploited the farmers' lack of knowledge of the market. Sometimes farmers sold elsewhere because they could get a better price, despite holding an advance from a trader, thereby contributing to the in-

debtedness and mistrust that characterized many transactions in these poor communities.

Early in the project, CI looked for a local financial services institution but found none. In 2000, the Mexican government, with financing from the Inter-American Development Bank, began a program called *Fondo Acción* implemented through *Banco de México*, the National Bank. The purpose of *Fondo Acción* was to provide low interest loans to the rural farming sector, and additionally, to provide some funding for technical assistance and training. It opened a small office in Chiapas. However, CI's initial efforts to facilitate *Fondo Acción* funding to the cooperatives were unsuccessful, as it was distrustful of the capacity of the cooperatives to reimburse loans.

Direct Service Provision to Stimulate the Market

Given the farmers' need for financial services, CI again assumed the role of direct service provider. In March 2001, CI partnered with Ecologic Enterprise Ventures, Inc., a non-profit environmental fund, to launch *Fondo Eterno-Verde*, to provide loans to the cooperatives. CI capitalized the fund with a loan from the International Finance Corporation (IFC).

A training course in business planning that started in 2000 taught the cooperatives how to prepare cash flows to support their applications to the Fund. Farmers began to understand for the first time that a business plan with a cash flow projection enabled them to calculate how much money they needed to borrow and thereby take more con-

trol over the management of their enterprises.

The integration of *Fondo Eterno-Verde* as a supporting market actor driven by premium prices for the coffee enabled its successful operation. Despite the tradition of loan default in the community, the Fund lent over four consecutive harvest cycles, from 2000/01 to 2003/04, a total of U.S. \$1,400,000 in pre- and post-harvest finance to the cooperatives and received 100 percent repayment. Starbucks provided a partial loan guarantee and CI initially recovered the principal by prior claim on the payments Starbucks made for the coffee. This arrangement has been discontinued because the incentive system drives timely repayments.

Emergence of Service Providers

Fondo Eterno-Verde incorporated a savings requirement, which enabled the cooperatives to acquire capital and reduce their future borrowing requirements. Building a savings account and fulfilling their repayment obligations has also enabled the cooperatives to acquire a credit history and become viable clients for a private financial service provider.

Indeed, *Fondo Acción* was persuaded by CI's successful experience to begin lending in the 2002/03 harvest and to continue in 2003/04, providing about 30 percent of the cooperatives' requirements. Additionally, *Fondo Acción* participated in refining the business planning and credit application training program so that it could harmonize its application procedures with those of *Fondo Eterno-Verde*.

2. PRODUCTION TECHNICAL ASSISTANCE

CI required farmers participating in the project to take part in training courses in quality and farm management techniques, and then to implement the recommendations in order to achieve their upgrading targets. In 2000 training was expanded to include business planning.

Coffee quality was improved by controlling coffee diseases, maintaining farm cleanliness and taking care of the plants. The yields of coffee from the cherry increased from improved wet processing techniques so that a higher quantity could be processed by the cooperative. Starbucks tested sample quality and provided feedback to the cooperatives.

Farm Management Plan and Evaluation

CI designed the project's extension approach around the concept of setting targets for adopting best practices over a period of time that is realistic and agreed to by each farmer. To remain in the project, the farmer had to meet an annual target. Information about each farm and its annual targets was recorded in a Farm Management Plan and Evaluation, to which all parties had access. The process has six main steps:

1. Collect Global Positioning System data to accurately map coffee farms.
2. Undertake a diagnosis of each farm to assess its coffee growing practices, e.g. shade diversity and use of organic techniques.
3. Develop an annual plan with each farmer to define short- and long-term targets to conserve biodiversity and improve production.
4. Evaluate each farmer's progress towards targets through an annual on-farm review to identify challenges, determine training needs and agree on new goals.
5. Assess the coffee processing and quality on each farm every harvest season to educate farmers on quality control, processing, managing seasonal labor and post-harvest handling.
6. Inform farmers about credit opportunities, contract obligations and risks, training activities and conservation.

Direct Service Provision to Facilitate Upgrading

The Farm Management Plan required carrying out and processing surveys on all farms in sufficient detail to verify many procedures and propose improvements. Two visits were made each year, one for agronomic practices and the other during the harvest to check processing practices. The data gathered have been processed and stored, as a valuable resource for this and other coffee projects.

The opportunity of growing the project that the Starbucks partnership presented, the fact that CI had specific technical expertise in conservation practices and the weakness of the local service providers justified CI's approach to provide extension and training services directly, while extending the timeframe in which the project could become sustainable and move to scale, and also adding to the project cost.

Development of Private Sector Service Providers

So that CI could withdraw from direct service provision as soon as possible and disseminate best practices more widely, it began to identify and train best practices promoters in the communities where the project worked. These promoters were selected for their expertise and standing in the community, and included some technical staff of the cooperatives.

To make the training of promoters more sustainable, CI introduced and oriented *El Colegio de la Frontera Sur* (ECOSUR). This new local partner adopted a farmer field school methodology that built on farmers' knowledge and taught them to understand problems and the range of solutions available. The training program, called *Escuelas de Campo y Experimentación para Agricultores* (ECEA), combined classroom field trials of best practices on model farms in each of the communities participating in the project with classroom courses in Shade Canopy Diversification and Management; Soil Fertility Management and Conservation; Integrated Pest and Disease Management; and Harvesting, Processing and Post-Harvest Handling. After completing the course and an apprenticeship program with an extension service provider, the new trainers provide these services to farmers independently in their communities.

In the 2001/02 harvest, CI negotiated with the cooperatives the payment of fees for the extension services through the mechanism of a levy on each bag of coffee sold. This levy yielded U.S. \$52,000 in 2003.

This mechanism was an important step in transparency. Hitherto, cooperatives

had deducted from the price paid to farmers the cost of services provided by technical staff; but no information was provided to farmers about those costs. The new system made the pricing of services explicit and encouraged farmers to evaluate the usefulness of services they were receiving from both CI and the cooperative technical staff.

E. IMPROVING THE BUSINESS ENABLING ENVIRONMENT

1. LOCAL ENVIRONMENT

CI, Starbucks and the El Triunfo Biosphere Reserve management shared an interest in reducing threats to the biodiversity of the Reserve by facilitating higher farmer earnings through the promotion of shade coffee practices that protect habitat for native species, prevent soil erosion and enable agricultural production to grow without destroying the environment.

The policy environment played an important facilitating role in this project. The Reserve's administrators strengthened farmers' understanding and acceptance of the value of the natural environment, reinforcing their economic motivation to adopt the best practices that conserve it.

The Mexican government also has introduced a program enabling the community promoters to become accredited extension service providers and charge for their services

CI aimed to demonstrate that managing land for biodiversity is compatible with improving livelihoods for coffee farmers. CI and the Reserve collaborated on

studies of vegetation patterns and deforestation in El Triunfo. CI also included the Reserve's authorities in the project planning process to build understanding of various stakeholders' interests and to debate issues of difference.

The process of agreeing on best practices contributed substantially to improving relations between farmers and the Reserve. The practices prohibited any community with a cooperative participating in the project from having a logging contract. The Reserve's 2003-2008 management plan incorporates the best practices as one of eight development principles, an indicator of leveraging the project's success from one site to a larger landscape in the buffer zone of the Reserve that includes other coffee communities where the project is not working directly.

2. INTERNATIONAL ENVIRONMENT

The most important aspect of the business enabling environment for the Chiapas coffee project, however, was not local but international. The success of the project relied on: (1) the existence of a large, influential and well-resourced private sector firm to establish and ascribe value to an exclusive brand; and (2) a credible nongovernmental organization with expertise in conservation to develop and verify compliance with a set of conservation best practices.

F. SOCIO-ECONOMIC IMPACT OF THE PROJECT

CI commissioned socio-economic studies in 2001, 2002 and 2003. The consultant interviewed farmers individually and carried out a series of participatory

workshops. The key findings, taken from the 2003 report, are as follows:

Adoption of Best Practices

Nine recommended practices are being implemented by the majority of beneficiaries (more than 60 percent), as well as between 20 and 40 percent of non-beneficiaries. Practically all coffee producers, both beneficiaries and non-beneficiaries, have implemented three of the conservation practices: separation of pulp without throwing it in the rivers, shade management and tree planting.

Profitability

As a result of increased harvests and price developments, the profitability of a hectare of coffee in 2003 was 6,754 pesos (U.S. \$570) for beneficiaries and 5,368 pesos (U.S. \$453) for non-beneficiaries.

Well-being

The study considered diet and housing. Meat consumption shows a slight increase over the three years for both beneficiaries and non-beneficiaries. 88 percent of beneficiaries and 71 percent of non-beneficiaries have a cement floor—a measure of improved housing conditions.

Total Income

Beneficiaries in 2003 had an average yearly net income of \$36,392 pesos (U.S. \$3,071). Non-beneficiaries obtained \$20,392 pesos (U.S. \$1,721).

⁷ The Herald, August 23, 2004

III. CONCLUSIONS AND LESSONS LEARNED

A. THE ROLE OF THE LEAD FIRM

The Chiapas coffee project demonstrated the importance of creating a partnership with the lead firm very early in order to create the market incentives for changing behavior in the value chain. Farmers must perceive realistic market opportunities if they are to commit to spending time in project planning and adopting practices that cost them money and effort. Starbucks played four critical roles in the Chiapas coffee project.

1. PROVIDED MARKET DEMAND

Starbucks provided market demand for the finished product, paying a premium for the attributes of generating conservation benefits in the production community. A general increase in world coffee prices would most likely reduce the differentiation between prices available to farmers from regular and specialty coffee and make the adoption of best practices less attractive to them. The project is strongly placed to respond to that eventuality through the information it has generated about costs, through Starbucks commitment to maintaining the transparent value chain model, and its willingness to increase the amount of coffee that it will buy through the PSP system.

2. REQUIRED STRENGTHENED AND TRANSPARENT LINKAGES

Starbucks created the requirement to address traditional inefficiency and lack

of transparency in the value chain between cooperatives and their members and between farmers or their cooperatives and processors/traders.

3. PROVIDED SERVICES

It provided services to the cooperatives to transfer knowledge in several areas.

Coffee Quality

Starbucks expertise in coffee tasting (cupping) provided information on cup quality and coffee flavor profiles. Farmers can achieve quality improvements through receiving feedback on samples and market information. Upgrading through improved quality control systems and processing technology enables farmers to produce a high quality, consistent product that overcomes irregularities inherent in a system depending on many small production units with differing infrastructure and production practices. Conversely, inconsistency in coffee cup characteristics discourages coffee roasters from building on the trend of developing single origin coffee that command a higher price.

Export/Import

Starbucks Coffee Trading Company's expertise in contract negotiation, transportation and customs procedures facilitated market access and enabled it to develop a transparent supply system in the PSP and C.A.F.E. Practices.

Product and Market Development

Starbucks developed a product specifically for the project and, through its own stores and retail business partner-

ships overseas, promoted it in North America, Asia and Europe.

4. PROMOTED SUSTAINABLE COFFEE

Starbucks promoted to the industry greater environmental and social sustainability in coffee producing countries by setting the example. Its communications through public relations, media campaigns, web page design and retail promotions to promote "Shade Grown Mexico" built awareness among consumers about the issues of environmental, economic and social sustainability in coffee producing regions.

The model for inter-firm transactions that the project developed responds to increasing demand for companies to manage their supply chains. Many companies have begun working on codes of practice but these are often criticized for not being subject to independent audit and failing to address key issues of poverty, environmental degradation and social inequity. The fair trade movement, writing on the Common Code for the Coffee Community states, "*Few farmer associations have been involved in the process...the code can be misused too easily for advertising purposes of the companies involved without addressing the root causes of the coffee crisis.*"⁸

The transparency in the value chain that the Chiapas coffee project created involved farmers in all stages of planning and implementation and demonstrated its ability to deliver economic benefits to farmers, as well as conservation benefits for the landscape.

USAID required CI to undertake an independent evaluation of the project in 2003 as a condition of its grant. CI also contracted a consultant to make a socio-economic assessment of the project's impact with an award from IFC. Both studies interviewed a number of farmers and concluded that the main motivation for the farmers was the price premium that they obtained from Starbucks, "*According to the socio-economic studies and what was seen in the field, the advantages of Conservation Coffee for the environment have not yet been internalized fully – price is still the main, if not sole, motive.*"⁹

B. SUSTAINABLE SUPPORTING MARKETS

The Chiapas coffee project has demonstrated that farmers living below the official poverty line will pay fees for services to upgrade in response to price incentives and that private service providers can enter the market to make impacts more sustainable.

1. DIRECT SERVICE DELIVERY

Where services were essential to the project's success, but no provider could be identified—such as was the case with financial services—CI had to take direct responsibility for providing them in order to "prime the pump." The project made a sustained commitment to providing vital services that were unavailable while simultaneously building the market. CI set standards for service provision and ensured that independent providers had the capacity and knowledge to provide them.

Farmers will pay fees for service only after, and not before, the project demonstrates the value of the services to be

provided. Fees must be based on realistic cost analysis and phased in as the clients perceive their value. It is helpful to have such fees embedded in the agreement with the buyer, rather than have the service providers collecting fees directly from the small farmers.

Smallholders need a range of services in order to upgrade, which may be unavailable or of poor quality. Without direct delivery of services by an implementing partner, smallholder upgrading to meet the new conservation standards would not have been possible. However, direct service provision raises significant exit challenges.

2. IMPORTANCE OF HORIZONTAL LINKAGES

In remote rural locations, the lack of communications facilities and infrastructure makes transaction costs higher and service provision slower. Both factors discourage service providers from entering the market and will require the project to provide services for a longer time than would be required in other environments with better enabling conditions for enterprise development. In such a context, strong horizontal coordination is a priority in order to develop a demand of sufficient scale to attract service providers.

Investments in increasing the efficiency of inter-firm relationships, both among producers and between producers, buyers and service providers, generate efficiencies essential to increasing the productivity and competitiveness of the industry.

3. IMPORTANCE OF VERTICAL LINKAGES

The existing relations with the target group in the area of implementation are a strong determinant of service providers' ability to enter the market. Relations are unfortunately often dominated by mistrust and the perception that poor communities cannot meet sophisticated market standards. These factors slow down the process of achieving sustainable service delivery. Strengthening transparent vertical linkages is key.

C. PRECONDITIONS TO VALUE CHAIN INVESTMENTS

The success of the Chiapas coffee project is largely the result of an MSE upgrading process driven by a private-sector lead firm. Market leaders with the capital, skills, incentives and commitment to invest in upgrading value chains that incorporate large numbers of smallholder producers can greatly accelerate growth and productivity.

Private sector market leaders are more likely to invest in upgrading a value chain incorporating large numbers of small firms when they are able to maintain some level of exclusivity in the market channel and a share of the consequent premiums. In this case, this was achieved by establishing a unique brand.

CI has played a crucial role in facilitating the relationship between Starbucks and AMSA, and between AMSA and the coffee cooperatives. It established the best practices and provided services necessary for upgrading where markets were weak or missing. CI continues to

validate the best practices, facilitate co-operatives' negotiations with service providers and clients, and monitor export performance. In the absence of an implementer on the ground, it is highly unlikely that such relationships could have been established or maintained.

Private sector market leader willingness to invest in upgrading particular value chains is more likely to occur in the presence of a facilitating entity able to take responsibility for strengthening the

organizational capacity of participating smallholders and reducing the risk of noncompliance with established agreements.

D. CHANGES IN POWER AND BENEFITS

By developing a product with attributes derived from the place and method of production, the dynamics of the power relationship between the smallholder farmers and the importer/roaster were

changed in favor of the farmers. As a result, the benefit flow to the farmers also increased.

⁸ Fair Trade Advocacy Newsletter, September 2004, distributed by IFAT

⁹ Zettelmeyer, 2004

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Web Sites

BDS Information Exchange	www.bdsknowledge.org
Conservation International	www.conservation.org
Consejo Mexicano de Cafés	www.cafesdemexico.com/consejomexicanodecafe
Financial Times	www.ft.com
IFAT	www.ifat.org
Rainforest Alliance	www.rainforest-alliance.org
SCAA	www.scaa.org
Scientific Certification Services	www.scscertified.com
Starbucks	www.starbucks.com
Transfair	www.transfairusa.org

Accelerated Microenterprise Advancement Project (AMAP) is a four-year contracting facility that USAID/Washington and Missions can use to acquire technical services to design, implement, or evaluate microenterprise development, which is an important tool for economic growth and poverty alleviation.

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