



FOREST INDUSTRIES INTELLIGENCE LIMITED

Market impact of a FLEGT VPA between Malaysia and the EU

**A study for the Netherlands Ministry of
Agriculture, Nature and Food Quality**

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"INFORMING THE SUSTAINABLE WOOD INDUSTRY"

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Executive summary

Aims and methodology

This study has been commissioned by the Netherlands Ministry of Agriculture, Nature and Food Quality (Ministerie van Landbouw, Natuur en Voedselkwaliteit) as input to the negotiation process for a Forest law Enforcement Governance and Trade Voluntary Partnership Agreement (FLEGT VPA) between the EU and Malaysia. Key questions addressed in the study are as follows:

- Assess how Malaysian timber products are traded with the European Union.
- Describe the policies and instruments with regard to legal/sustainable timber that have already been implemented and the options that are currently being discussed at European Union level and assess how these could affect production and trade of Malaysian timber, both in a short and longer term.
- Assess the extent to which purchasing patterns in the EU will be influenced or regulated by public procurement policies and by other emerging requirements for evidence of legality under a FLEGT VPA and NGO campaigns. Specifically assess whether European buyers will continue to purchase from Malaysia if she does not sign up to the VPA.
- In the six largest EU markets for Malaysian wood products in the EU, identify the companies and other organisations influencing market demand for these products. Assess what activities have already been carried out and/or plans made by these organisations to influence trade in legal and sustainable timber products.
- Assess the extent to which legal/sustainable timber trade is becoming a market and/or policy issue in the USA, Japan and China and the extent to which these trends will affect the import of Malaysian timber products, both in a short and longer term. Specifically assess the potential for these markets to serve as substitute markets in the event that trade with the EU becomes more difficult.
- Assess how future supplies of timber from competing countries might affect the Malaysian timber industry and trade and how this impacts on the desirability of Malaysia entering into the FLEGT Partnership Agreement.
- Assess what trade opportunities Malaysia's commitment to FLEGT will provide for third countries supplying products based on Malaysian timber indirectly into the EU.
- Assess the price levels that can be expected on EU markets if Malaysia provides evidence of legality of exported timber products, both in a short and longer term.
- Assess the extent to which major commercial banks are involved in policies to phase out illegal timber production and/or stimulate sustainable timber production and how this could affect production and trade of Malaysian timber, both in the short and longer term.

- Assess the market-related advantages and disadvantages for Malaysia entering into a FLEGT Partnership Agreement and recommend actions to maximise advantages and minimise disadvantages. Specifically advise on additional incentives that could be offered by EU governments to increase opportunities for VPA licensed timber.

The report has been compiled using a variety of information sources including: forest products trade data supplied by the Malaysian Timber Council, Malaysian Timber Industry Board, Eurostat, and the Global Trade Atlas; a series of meetings between the consultants and all the major Malaysian timber trade associations in January/February 2008; structured interviews with 151 organisations in the EU including 80 timber companies directly engaged in trading Malaysian wood, 21 trade associations, 29 government departments and 21 environmental non-governmental organisations (ENGOS); comments received from the Malaysian private sector during a series of three industry briefings on the FLEGT VPA process held in Kota Kinabalu, Kuching and Kuala Lumpur during April 2008; and a wide of range of secondary sources.

Malaysian wood products trade with the EU

Altogether around 14% of the total value of Malaysian wood product exports is destined for the EU. The European market is significant for taking a relatively wide variety of higher value wood products, including higher grade sawn lumber, plywood and furniture.

In line with overall growth in Malaysia's wood product exports, those to the EU have risen significantly from just under RM 2 billion in 2002 to around RM 3.3 billion in 2006. The recent growth in EU imports of Malaysian wood products has been concentrated in wood furniture, plywood and mouldings. The increase reflects a number of factors including: improving economic conditions in parts of Europe; inward investment in Malaysia's furniture, joinery and plywood manufacturing sectors; a general trend in Europe towards increased sourcing of furniture and joinery products from the Far East; a decline in the ability of certain competing countries to supply products into the EU market (for example Indonesian plywood, Brazilian sawn lumber); the comparative strength of European currencies against the dollar and Asian currencies; and an improved environmental profile for Malaysia resulting from the development of the MTCC scheme.

Peninsular Malaysia has moved much further than Sabah and Sarawak to develop secondary and tertiary wood processing industries. The move to value added processing has meant that, despite relatively low levels of log harvesting, the value of exports from Peninsular Malaysia is significantly higher than that of Sarawak and Sabah. Peninsular Malaysia is also the only region of Malaysia for which European markets account for a large share of wood product export sales. Around 21% of timber products exported from Peninsular Malaysia is destined for the EU. Equivalent figures for Sarawak and Sabah are 2% and 8% respectively.

Demand for Malaysian wood products in the EU is concentrated in a limited number of countries. The UK alone accounts for 32% of the value of Malaysian wood product imports into the EU, and well over half (56%) are destined for either the UK or the Netherlands. Together the top 6 markets (UK, Netherlands, Germany, Belgium, France and Italy) accounted for 84% of total EU-25 imports of Malaysian wood products in 2006.

The vast majority of Malaysian primary and secondary wood products are sourced from natural production forests. Malaysia has 15.3 million hectares of Permanent Reserved Forest (PRF) of which 3.11 million hectares are Protection Forest where no logging is allowed and 12.19 million hectares are set aside for sustainable timber production. Of the PRF, 7 million hectares are in Sarawak, 4.7 million hectares are in Peninsular Malaysia and 3.6 million hectares are in Sabah. In addition, Malaysia has 1.4 million hectares of forest land designated for conversion. Plantations represent only a very small proportion of national forest area, around 270,000 hectares.

Malaysian total log production stands at around 19-21 million m³ per year, with Sarawak accounting for around 12 million m³, Peninsular Malaysia around 4.5 million m³, and Sabah around 2.5 million m³. Under the Ninth Malaysia Plan (2006-2010), the Malaysian government expects log output to stand at around 19.6 million m³ in 2010.

Declining supplies from natural forests in Malaysia combined with strong emerging domestic wood demand fuelled by economic growth has also led to increasing levels of wood imports into Malaysia. In the past, Malaysian mills supplemented raw material by importing logs from neighbouring Indonesia. This trade is now prohibited following imposition of a permanent log export ban by Indonesia in 2002. Sawn lumber is now by far the most significant primary wood commodity imported into Malaysia, estimated in the region of 1 million m³ in 2007.

No full and comprehensive independent assessment of the level of illegal logging in Malaysia has yet been undertaken. However a variety of information sources support the broad conclusion that illegal logging is not a widespread problem in the country. Some ENGO reports suggest that illegal imports from Indonesia remain a problem but there is also clear evidence that Malaysian action to prevent illegal wood imports from Indonesia and elsewhere has intensified in recent years.

4.7 million hectares of Malaysia's permanent production forest is currently certified under the Malaysian Timber Certification Council (MTCC) scheme. The area includes the entire area of permanent production forest in Peninsular Malaysia. Only a small area (56000 hectares) is MTCC certified outside Peninsular Malaysia (in Sarawak). 76000 m³ of MTCC certified sawn lumber was exported from Malaysia in 2007. The vast majority was destined for the EU (mainly the Netherlands and the UK),

While Malaysia's primary and secondary wood products exports are mainly derived from natural forests, the wood furniture sector is heavily dependent on rubberwood. 83% of Malaysian furniture exports comprises wood. Rubberwood accounts for around 65% of wood furniture production, 15% is panel based and the remainder comprises hardwood (both tropical and imported temperate hardwood). A significant portion of the panels used for the manufacture of furniture are also ultimately derived from rubberwood. Malaysia has 1.24 million hectares of rubberwood plantations, 1.01 million of which are in Peninsular Malaysia.

Malaysian furniture production more than doubled in the decade prior to 2006, rising from US\$1.3 billion in 1997 to US\$2.8 billion last year. Factors that have contributed to this success include abundant raw material, particularly of rubberwood during the 1990s, and the Malaysian Government's commitment to support the sector. The Malaysian furniture industry is heavily oriented towards exports - which account for around 80% of production - with major markets in the United States, Japan, Australia, and the United

Kingdom. Malaysian furniture supply is very comprehensive and diversified in every segment, a factor that gives it a strong competitive edge on international markets.

EU Policy Instruments

The promotion of more widespread adoption of green public procurement has been a EU priority in recent years. EU member states have been encouraged to develop national action plans for GPP. 10 Member States have so far implemented national action plans for GPP, 7 have a draft plan, and the EC is working on development of such a plan with another 5 EU members.

As a priority action in 2007, the European Commission (EC) launched a new initiative on GPP designed to provide Member States with the necessary tools to raise the quantity and quality of GPP in the EU. An outcome of this initiative will be an EU Communication on Green Public Procurement. The Communication, anticipated in July 2008, is expected to identify timber products as one of 10 priority products for more detailed consideration in GPP. It is expected to include sample specification clauses establishing legality of timber as a condition of contract, but providing tenders with the option of offering sustainable timber as a variant. FLEGT VPA licenses are expected to be referenced as an example of an appropriate form of legality verification alongside other approaches. The Communication will set out recommendations that may be voluntarily adopted by member states.

An assessment of EU central government procurement indicates that these policies are a relatively weak lever with which to influence procurement behaviour in EU member states. They impact directly on only a small proportion of the overall timber trade and their effectiveness is undermined by inconsistent application between and within EU member states. These policies do not currently offer any significant incentive for countries to supply FLEGT VPA licensed timber. Only the UK policy at present includes an explicit reference to such timber meeting the requirements of the policy. Although other national governments have stated informally that FLEGT VPA licensed timber might be recognised in future, this is not yet reflected in formal policy guidance.

The short-comings of public sector procurement policy and voluntary industry mechanisms have led to recent interest in a legislative approach. The European Commission is due to release a Communication on the subject in July 2008 setting out recommendations for additional legislation to prevent imports of illegal wood products.

Civil society, government departments and industry in most major EU importing countries support such legislation. Nevertheless it has proved extremely difficult to reach a consensus view on the details of this legislation. There have been significant legal and technical objections to all the various legislative options considered during the EC's public consultation exercise. The EC is now considering proposing another option that would place a legal requirement on timber industry operators in the EU to show due diligence with respect the legality of wood supply. While the details of this approach have yet to be worked out, if such legislation were implemented and it was effective in extending and strengthening existing private sector initiatives, it would be a powerful mechanism to remove illegal wood from trade and boost market interest in FLEGT VPA licensed timber.

Through the Timber Trade Action Plan, the European Commission is now assisting timber importing associations to develop Codes of Conduct for their members which would focus on excluding illegal wood from supply chains. Policies have been introduced by the Netherlands, UK, and French associations which seem well designed to increase demand for FLEGT VPA licensed timber. These Codes have strong potential to extend responsible procurement practices into the private sector as timber trade association membership generally includes a high proportion of wood imports into EU countries. Efforts are being made to extend coverage and improve enforcement of these initiatives, but this is a slow process under current conditions of voluntary private sector action.

Interviews with EU companies trading in Malaysian wood products indicate that while larger distributors are adopting environmental procurement policies, this trend has not extended far amongst smaller importers and distributors. Most of those companies that have developed detailed policies have set a requirement that all wood should be from legal sources, or that procedures should be in place to minimise the risk of wood being derived from illegal sources. But while “legality” was established as a baseline requirement by some companies, most would obviously prefer “certified sustainable” wherever possible.

There is little evidence to suggest that the main buyers of Malaysian wood in the EU would cease purchasing from Malaysia if she does not sign up to the VPA. They would resort to private sector legality verification and certification systems where necessary. FLEGT VPA licenses are generally perceived to provide no more or less than private sector legality verification schemes. Legality verification is generally perceived as a short term measure on the way to sustainability. There is confusion amongst some interviewees as to how the VPA process relates to MTCC certification. Some interviewees wonder why an alternative mechanism is being developed which appears on the surface to offer less. Other interviewees recognise that licenses could be a useful mechanism for business-to-business assurances of legality and to assist conformance with emerging procurement requirements and see the FLEGT VPA process as a potentially useful stop-gap measure until such time as fully certified wood was available.

One of the most dramatic indicators of change in environmental timber procurement practice in Europe over recent years has been the rapid increase in chain of custody certification. The number of chain of custody certificates issued in Europe has increased by 40% in the last 2 years. A combined total of 7311 CoC of custody certificates have now been issued throughout the continent, including 3226 by PEFC and 4085 by FSC. This has led to a significant increase in the availability of certified wood products from domestic forest sources. This strongly implies that there will be significant pressure from the European domestic wood industry to push for tougher timber procurement requirements as a means of seeing some return on their investment in forest certification. However at present the distribution of chain of custody certificates throughout the EU suggests that European demand for certified forest products is still concentrated in a few markets including the UK, the Netherlands and Switzerland.

As uptake of chain of custody standards has increased in the EU, these standards have played an increasingly important role in guiding environmental procurement practices in Europe. Both FSC and PEFC now allow % based labeling of wood products so that a proportion of the wood they contain derives from non-certified sources. This has required the development of procedures to ensure that the non-certified portion of labeled products do not derive from illegal and other controversial sources. These standards

could therefore help drive interest in VPA licensed timber. This effect of chain of custody standards would be enhanced if FSC were to implement a new policy which is currently being considered to establish minimum procurement requirements covering all the operations of any company using the FSC trademark.

At present there is little evidence of willingness to pay a price premium for FLEGT VPA licensed timber. 33% of interviewed companies said they would pay no price premium for licensed timber on grounds that legally verified should be the standard price. 45% said they would pay a premium of 1 to 6%. 19% said they would pay a premium of 7 to 10%. Only 3% said they would pay greater than 10%.

Engagement in environmental timber procurement practices amongst European end-users of Malaysian wood products in the private sector is still restricted. In the construction sector there is some emerging interest amongst large corporations, particularly in the UK and Netherlands, that are introducing Corporate Social Responsibility policies, and specifically in relation to higher profile public sector projects. However very few companies have detailed procurement policies for timber and even less have developed procedures to ensure active implementation of these policies. Very few builders are taking action on timber procurement with respect to their private units. Levels of awareness and understanding of the FLEGT VPA process are very low in the construction sector. Where there is interest in environmental timber procurement, there is tendency for building professionals to rely on well established tools, such as FSC certification.

The relatively high degree of fragmentation in the EU furniture retail sector has resulted in relatively limited uptake of timber procurement policies. Some larger furniture retailers are beginning to scrutinise wood product origins and, due to the huge range of products involved, are adopting a risk based approach. The focus to date has been almost exclusively on outdoor furniture in tropical hardwoods. Since the large majority of Malaysian furniture is in rubberwood, it has not been a target for increased scrutiny. Where there is concern about product sourcing in the EU furniture sector, there is strong tendency to prefer FSC certification.

Policy developments in other major consuming countries

Japan

Japan is Malaysia's largest export market accounting for 24% of total export value in 2006. Japan is a particularly critical market for Sabah and Sarawak, representing respectively 30% and 46% of the total value of wood products exports in 2006. In 2006, 68% of export value comprised plywood, 10% wood furniture and 9% logs.

Japan was formerly the world's largest importer of tropical logs, but these imports have declined dramatically in recent years in response to tightening supply and a shift to domestic manufacturing with softwood logs. Meanwhile changing construction methods in response to concerns about earth-quake stability have meant that overall Japanese demand for plywood and other panel products has been rising at the expense of rough sawn lumber. As domestic production of Japan's tropical plywood has declined, imports have tended to increase. Malaysia has been taking an increasing share of this market over the last 5 years. Meanwhile tightening controls on illegal logging and restricted log supply have meant that Indonesian market share has fallen dramatically. Malaysia has

proved to be highly competitive in the market for high quality formaldehyde free products demanded in Japan.

Future prospects in this market are impaired by declining construction activity and government failures to undertake essential economic reforms. China has also emerged as a key competitor in markets for wood products. Nevertheless, even in the current downturn, housing starts in Japan exceed 1 million units per year. There are likely to be continuing opportunities for Malaysia to increase sales, particularly of plywood, wood furniture and laminates.

There is a strong emerging movement to buy only legal wood products in Japan encouraged by the central government timber procurement policy introduced in April 2006 requiring legal wood as a “criteria for decision” and specifying “sustainable” wood as a “factor for consideration”. In addition to forest certification, the policy recognises trade and industry association codes of conduct together with company-specific programs as mechanisms to demonstrate conformance. The government guidelines setting out appropriate forms of evidence are broad and flexible allowing a wide range of approaches.

Since public sector is believed to account for only 3% of total wood consumption in Japan, a major focus of this policy has been to engage the private sector. In this it has been successful – all 19 national timber industry associations in Japan now have some form of procurement policy, most using a template established by the Japanese Federation of Wood Industry Associations (JFWIA). At least 38 of the 49 member companies of Japan Lumber Importers Association have a procurement policy. Private sector procurement policies essentially follow government requirements that all timber should be legal and favouring sustainable wherever possible.

A multi-stakeholder Verification System Study Group has been established to consider appropriate forms of evidence to be accepted by the private sector. It has so far adopted a very flexible approach accepting existing documentation systems to demonstrate the legality of Malaysian timber (MTIB Statement on Legality of Timber Source, Malaysian Customs Form 2) and Indonesian timber (BRIK and SKSHH transport permit).

United States

The USA is important to Peninsular Malaysia as a market for wood furniture and BJC, and to Sarawak and Sabah as a market for plywood. The USA was an increasingly important market for these products between 2002 and 2006, particularly wood furniture. In 2006, US accounted for 35% of all Malaysian wood furniture exports. However future prospects in the US are now impaired by the economic downturn. The market is intensely competitive and likely to become more so. China is the key competitor to Malaysia in the US market. Nearly 50% of the total value of US furniture imports derived from China in 2006. In that year, Malaysia accounted for around 4% of the total value of US wood furniture imports.

Environmental issues look set to become much more important in the US market, with strong potential to benefit Malaysia. An amendment to the Lacey Act was passed by the US legislature in May 2008 which makes it an offence within the U.S. to trade in a wood product “*imported, transported, sold, received, acquired, or purchased*” in violation of any foreign law. The move has been supported by the American hardwood industry and the

US importing industry and environmental organisations. The law places the burden of proof with the prosecution who would have to demonstrate that wood derived from an illegal source. While the law is only likely to be applied to the worst offenders - importers with actual knowledge and intent to import illegal shipments – it is expected to actively encourage greater due diligence on the part of importers to reduce risk of prosecution. Suppliers in countries with complex supply chains (i.e. China) will be under great pressure to demonstrate the origin of wood products

A key feature of the Lacey Act is that it will not necessarily generate specific interest in FLEGT VPA licensing as it quite expressly does not set out to define a specific framework for legality verification. However it should increase the relevance of and commitment to existing industry codes and environmental policies, such as that developed by the International Wood Products Association (IWPA).

Public sector procurement policies are much less of an issue in the USA than in the EU. The presumption is that wood products are legally produced and traded unless deemed otherwise. Rather than require that wood be traceable to sustainable managed forests, government procurement is moving towards recognising green building standards that typically include preference for certified wood products. Construction under various green building initiatives currently accounts for around 1% of building starts in the US and is forecast to rise to around 5% in 2010. LEED is the leading green building initiative in the United States. At present it strongly favours FSC, is problematic for wood products generally, and does not boost demand for legally verified wood products. However a major review of the standard is currently underway that might lead to the standard being amended to increase effectiveness in promoting the responsible use of wood. One proposal is to phase in requirements for legality verification as a prerequisite for LEED certification.

China

China is an important emerging market for Malaysian wood products from all parts of Malaysia, but is particularly significant for Sarawak. Exports from Sarawak and Sabah to China mainly consist of logs, with smaller volumes of plywood and sawn lumber. Peninsular Malaysia mainly supplies composite panel products and sawn lumber. Malaysian exports of logs and sawn lumber to China have been very volatile in recent years and not shown any consistent trend. Exports of plywood to China have generally declined as China's domestic production capacity has increased.

Economic models predict that China's imports will have to rise from current levels of around 40 million m³ to 80 million m³ by 2020. They also predict that, all other things remaining equal, log imports together with composite panel imports would grow strongly. Imports of sawn lumber would remain static, while plywood imports would remain stagnant at low levels. Russia's plans to implement log export taxes and the decline in availability of illegal Indonesian logs may alter this pattern to some extent.

While China is becoming a major exporter of value added products, much of the wood that enters China is absorbed by the domestic market. A 2006 report on China's wood market by the private research organisation RISI indicates that of the 63 million m³ of sawn lumber, plywood, particleboard and MDF manufactured in China, only 8 million m³ is exported.

Until recently, it was safe to conclude that green timber procurement was not an issue in the Chinese market. However there are signs of a change in attitude. The Chinese government seems to have become more concerned about the impact of illegal wood imports on its international reputation, and there are also mounting worries about long term security of wood supply. China's Ministry of Commerce is now developing a "Sustainable Trade Strategy" which includes a proposal to develop a government procurement policy. Also in the private sector, the larger export oriented companies selling to retailers in Europe and the US, are becoming engaged in the issue. Passage of the Lacey Act amendment in the United States, China's largest wood export market, may increase these companies focus on responsible sourcing.

Nevertheless, there are enormous challenges. A recent report by the University of Beijing on the prospects for a government timber procurement policy concluded that there is a "lack of an appropriate macro-environment" for such a policy. The government would have to show real determination in order to overcome this. In the private sector, studies by TFT and others have highlighted that high levels of fragmentation, intense competition and price-focused business culture are a major problem in seeking to encourage responsible procurement practice.

In short, there might be opportunities to generate interest in legally licensed timber amongst Chinese export-oriented companies. But whether they would need the level of assurance provided by a VPA license is debateable. And the likelihood is that there will remain numerous opportunities to sell wood without any form of legality license into China's domestic market.

Malaysia's competitors

In the European tropical sawn wood market, Malaysia's leading competitors are Cameroon, Brazil and the Ivory Coast, with Indonesia and various other African suppliers including Gabon, Congo-Brazzaville, Congo Democratic Republic and Ghana somewhat behind. In the mouldings market, Indonesia is the dominant competitor, although China and Brazil are also significant. In European markets for hardwood plywood and for finished windows and doors, China, Brazil and Indonesia are key competitors. Indonesia was formerly regarded as the world's powerhouse in tropical plywood production but Malaysia has slowly eroded market share in recent years. China has been a growing force in this sector in recent years relying on imported logs for face veneers, notably from Papua New Guinea but also from Malaysia. The countries of the Congo basin continue to supply raw logs to EU-based manufacturers of tropical hardwood products which compete to some extent with Malaysian products.

Three of Malaysia's competitors are already engaged in formal FLEGT VPA negotiations: Indonesia, Cameroon and Ghana. Ghana is expected to be the first country to conclude VPA negotiations in July 2008, although it will be some time before the licensing system is fully up and running (perhaps 1-2 years). Cameroon only began formal negotiations towards a VPA fairly recently in November 2007. A draft legality standard has already been published and a study of the Cameroonian chain of custody has been undertaken. How to handle timber imports is currently a major issue in Cameroon given the large volumes of logs transhipped through Cameroon from other countries in the northern Congo region. Currently there is no indication of when the negotiations might be finalised. Formal VPA negotiations began in Indonesia in January 2007. A legality standard has been finalised and technical work has been progressing to

develop the legality verification system. However there are no clear indications at this stage of when Indonesia might finalise a FLEGT VPA with the EU. Latest reports from EC officials suggest that the private sector in Indonesia is concerned about lack of market incentives.

All the other leading African competitor countries with the exception of Ivory Coast have indicated a desire to enter into VPA negotiations. However China and Brazil have not indicated that they will enter into VPA negotiations.

Due to the presence of MTCC, Malaysia currently leads all other tropical supply countries in the area of certified forests. MTCC is currently being assessed for endorsement by PEFC which, if successful, will mean that MTCC certified timber is recognised as fully “legal and sustainable” in many European procurement policies. However Malaysia has a significantly lower area of FSC certified forest than two of its leading rivals, Brazil and Indonesia. Several competing countries also have relatively large areas enrolled in GFTN and TFT stepwise programs which are targeted towards eventual achievement of FSC certification, notably Cameroon, Congo-Brazzaville, Brazil and Indonesia.

Indonesia’s forest products sector is going through a major period of structural change. Legally sanctioned production in natural forests declined sharply between 1999 and 2005 from in excess of 25 million m³ to 5 million m³. This largely reflects excessive over-exploitation in the 1980s and 1990s. Natural production forest areas managed under concession agreements are now seriously depleted. A major demand-supply gap has opened up in the country which is being partly fed by a large increase in log supply from industrial plantations and other sources. However illegal wood continues to form a major component of the Indonesian supply equation, estimated to account for around 52 million m³ in 2006, 10 million m³ of which was exported. The Indonesian government is now engaged in a major effort to improve enforcement practices which is having a positive impact.

Despite major structural problems and the relatively small proportion Brazilian hardwood that is exported, Brazil remains a key competitor to Malaysia in the international market. The majority of timber currently harvested in the Brazilian Amazon currently derives from conversion forests. Only a small proportion of forest production is under proper management. Some 90% of all logging carried out in the region is done without proper permits. Recent reforms are improving the situation by providing a coherent set of instruments for the verification of legal forest production. Nevertheless, there remain significant obstacles to effective forest law enforcement, notably unresolved land tenure issues, poorly defined division responsibilities between federal and state authorities and lack of effective man-power.

Papua New Guinea is the key supplier of tropical logs to China. The PNG forest sector is dominated by Malaysian-owned interests which account for over 80% of log exports. On the surface, current levels of logging in the country appear to be within the boundaries of long-term sustained yield. However, in practice data on forest resources is inadequate to draw far-reaching conclusions about the ability of the forest to supply wood long term and areas are now being committed to logging that were previously deemed unsuitable. The legal status of PNG wood exports is a matter of considerable dispute. While the vast majority of log exports can be reliably traced to a legally sanctioned forest concession, influential external commentators point to widespread failures in enforcement of forestry

standards on these concessions leading to allegations that most wood exports should be regarded as illegal.

Of African supply countries, the traditional West African supply countries of Ghana and Ivory Coast are generally diminishing in importance due to past over-exploitation, while the countries of the Congo Basin are generally increasing in importance. Illegal logging remains a problem throughout the tropical hardwood supplying regions of Africa. However the governments of most countries are engaged in concerted efforts to improve regulatory procedures and systems of enforcement. A large proportion of wood exported to the EU from Central and West Africa derives from European-owned companies that are actively engaged in a process to develop and implement sustainable forest management plans in consultation with national administrations. Many have a long term commitment to achieving forest certification.

Potential for circumvention and trade diversion

A potential impact of FLEGT VPA licensing is that it encourages:

- Efforts to circumvent the licensing system by exporting Malaysian wood products to the EU via a major trading hub (without further conversion)
- Diversion of trade away from the EU involving the export of primary wood products to a manufacturing location outside Malaysia. Some of the finished products may then be exported to the EU.

Ultimately, whether or not trans-shipment or diversion occurs is a simple question of comparative costs. The available information suggests that levels of illegal logging in Malaysia itself are limited and the additional costs of conformance to the FLEGT VPA licensing system should not be great, so there should be little incentive to divert trade elsewhere.

As an extra measure to help deter circumvention, consideration could be given to requiring a Certificate of Origin for all wood products imported into the EU from the East Asian region.

The motive for circumventing the VPA process would be removed if the EU were to introduce legislation requiring timber industry operators to show due diligence with respect to the source of wood products.

On the surface there appears to be potential for trade diversion away from the EU, a process which would undermine the value and relevance of the FLEGT VPA process in Malaysia. Recent growth in Chinese and Vietnamese demand for wood raw material is occurring at a time when availability of tropical timber from the East Asian region is falling.

However, in considering the potential for trade diversion, it is important to note the specific role of the EU in the overall export market for Malaysian wood products. The product range exported to the EU is very different to that exported to other leading markets. To some extent, market niches occupied by Malaysian products in the EU will be absent in other countries or will be occupied by domestic or other competing suppliers. Furthermore, much time and effort has been invested in developing high value

European market over many years and it may not be an easy matter to switch to alternative markets.

There are a few factors which set the European market apart from other markets. Europe is particularly important to Malaysia in the market for high grade lumber, particularly for window frames. Regional markets in East Asia – notably Thailand – tend to take lower grade lumber, while China’s imports of tropical hardwood tend to focus on flooring grades. European markets have therefore played an important role in maximising sawmill yields and incomes. Europe has also played an important role in Malaysia’s efforts to move up the value chain, taking a significant proportion of Malaysia’s exports of mouldings, wood furniture and BJC products.

Chinese buyers tend to prefer logs and, if these are not available, then rough sawn lumber. Due mainly to cost advantages during processing, the same situation prevails in Vietnam. Neither country is likely to be receptive to significant increases in Malaysian exports of value added products. Any diversion of trade to China and Vietnam will only feed competition for Malaysian exporters in finished products markets. In short, trade diversion to China and Vietnam is possible, but it is not desirable from the perspective of improving returns to the Malaysian wood industry.

Moves to reduce exports of unprocessed raw material and boost value added production is a key component of Malaysian trade policy. This means that the existing government instruments are already playing a role to counter the diversion of trade in unprocessed products to China and other regional markets. It also emphasises that engagement in FLEGT VPA needs to be seen as an integral component of Malaysia’s larger efforts to move towards more value-added production.

The potential problem of trade diversion is probably best addressed by ensuring that the additional costs of FLEGT VPA licensing to the private sector are kept as a low as possible, by linkage to broader policy measures designed to reduce exports of unprocessed wood raw material, and through on-going monitoring of trade flows once the licensing system is in place.

In time, once the licensing system has been thoroughly tested, consideration might also be given to extending the system to cover all wood products exports, effectively removing the problems of diversion and circumvention

Banking sector

The study includes an assessment of the extent to which major commercial banks are involved in policies to phase out illegal timber production and/or stimulate sustainable timber production. The banks’ main points of leverage with respect to illegal logging and illegal timber trade are as follows:

- Through their policies with respect to foreign direct investment (FDI) and provision of finance to larger scale forestry projects;
- Through their policies with respect to provision of term loans, overdrafts and other facilities to their clients in the forest sector – policies which may be applied both in producer countries to influence harvesting practices and in consumer countries to influence procurement practices;

- Through their direct role in international timber trade transactions to ensure conformity of documentation requested by timber buyers.

Initiatives like the Equator Principles, the UNEP Finance Initiative and the London Accord are helping to change attitudes to social and environmental risk in project finance. There appears to be a significant degree of commitment to these processes among mainstream lending banks. However the impact of these initiatives is necessarily limited by the fact that they are voluntary. There is also no commonly agreed set of principles for monitoring or enforcing compliance by signatories and many locally-based financial institutions are not engaged.

Most of the bank facilities provided to forestry and timber companies are in the form of term loans and overdrafts which are not the major focus of international initiatives like the Equator Principles. At present, there appears to be little or no scrutiny of the timber sourcing practices of companies to which these facilities are offered. Although banks might expect borrowers to comply with environmental requirements and meet any applicable forest management criteria set down in law, there is tendency for compliance to be taken for granted on the assumption that there is effective monitoring and reporting of any non-compliance by the regulatory authorities.

At present, it seems likely that banks do not fully understand the risks associated with the forest products sector nor are they offering any strong incentives to their clients in the sector to adopt higher environmental standards.

The guidance that is currently being made available to banks on the issue through initiatives like the UNEP Finance Initiative, the Equator Principles and the Forest Accord, while a useful starting point, is incomplete. There was no reference to the role of the FLEGT VPA process in any of the guidance documents reviewed for this study. There was also a heavy focus on FSC certification.

Nevertheless, the concept of a phased approach to certification is inherent to much of the guidance now available, indicating that FLEGT VPA licensing would be seen in a positive light as an appropriate mechanism for reducing the risks associated with forest sector investments.

There are increasing signs that banks are interested in engaging more in the issue, driven both by the new opportunities arising in the forestry sector as a result of the emerging policy focus on environmental issues, particularly climate change, and the reputational risks associated with poor environmental practice.

Potential market related benefits of FLEGT VPA licensing

This study indicates that certain market related benefits might be derived from Malaysia finalising a VPA with the EU:

- The VPA process is an opportunity to resolve issues that are currently acting as a drag on marketing of Malaysian wood products. Interviews undertaken for this study with the EU private sector indicate that nearly half of importers harbour either negative or mixed views of Malaysian forestry practices. They have been particularly influenced by ENGO campaigns relating to native rights and alleged illegal wood imports from Indonesia.

- The VPA process is an opportunity to leverage EU support for improved regulatory programs and to build bridges between stakeholders
- Interviews with ENGOs indicate that they strongly support the VPA concept as a whole. Successful finalisation of a VPA that is endorsed by the leading international NGOs (WWF, Greenpeace) could provide a very useful platform on which to build confidence in Malaysian wood products.
- Finalisation of a VPA demonstrates leadership in the global policy debate surrounding illegal logging and sustainable forest management, supporting Malaysia's reputation as a reliable and responsible supplier of tropical hardwoods to international markets.
- Finalisation of a VPA would insure Malaysia against a long term risk of market exclusion in high value markets which are critical for ensuring maximum return on the forest resource.
- One practical effect of signing a VPA is that it will provide a means of legitimising wood derived from planned conversion forests on international markets. Certification schemes like FSC and MTCC cannot recognise such timber because of their focus on individual FMUs rather than national forest programs.
- There is potential for price gains to be achieved for VPA licensed timber in the EU market if supplies of wood of suspicious origin from other sources can be excluded from the market.
- If the VPA process helps resolve remaining differences between stakeholder groups, it could facilitate more widespread certification of sustainable forest management. It may well pave the way for MTCC certification to be recognised as an exemplary assurance of sustainable forest management. And through refinements to national regulatory processes, it is possible the VPA will make participation in MTCC a more realistic proposition for the wider industry.

The need for greater market incentives

A challenge for the FLEGT VPA process is that while these potentially significant market benefits exist, they appear too theoretical and nebulous to have direct appeal to the private sector. To some extent, these market benefits may also be contradictory. For example, there may be a conflict between the objective of legitimising timber from conversion forest and the desire to build bridges with ENGOs.

In practice, the direct and immediate market incentives for supporting the VPA – in terms of increased demand or better prices for VPA licensed products from Malaysia or wider recognition of good forestry practice in Malaysia - appear weak. The low level of illegal logging within Malaysia implies that the country has less to gain domestically than other VPA countries by way of increased capture of forest rents and a level playing field for legal operators. Compared to other VPA countries (notably in Africa), Malaysia has relatively low market dependence on the EU. This is particularly the case for Sabah and Sarawak. Public sector procurement policies within the EU are not an effective

mechanism to prevent continuing trade in illegal wood products and most do not provide explicit recognition for VPA licenses. Private sector procurement policies do not yet have comprehensive coverage so that the efforts of proactive importers are constantly undermined by less environmentally concerned operators.

In those sections of the market where there is demand for legally verified wood products, the MTCC certification system already provides a mechanism for the Malaysian private sector to provide these assurances. This system has extensive coverage in Peninsular Malaysia which is the primary source of Malaysian wood products exports into the EU. MTCC is engaged in efforts to achieve PEFC endorsement and to be recognised as providing an assurance of “legal and sustainable” timber which, if successful, would ensure that MTCC provided a higher level of assurance of good forest practice than the FLEGT VPA process.

While ENGOs have indicated their strong support for the concept of FLEGT VPA licensing, due to the concerns of some local groups in Malaysia, particularly with respect to NCR issues, some influential groups in the EU have been heavily critical of the FLEGT VPA process in Malaysia. There is a significant risk that this criticism could undermine market recognition of FLEGT VPA licenses issued in Malaysia.

In circumstances where only a few countries join a VPA, no other effective measures are introduced to prevent imports of illegal wood into the EU, and the process of legality licensing adds costs, there is a risk that Malaysian VPA licensed timber would lose market share in the [EU](#) to timber supplied from countries with high dependence on illegal wood that are not engaged in the VPA process, notably China and Brazil.

The key issue in creating future market incentives for FLEGT VPA licensing is to ensure that illegal wood is effectively blocked from the EU and other high value wood markets. If this can be achieved:

- Malaysian competitors in high risk tropical countries that are not signed up to a VPA are likely to struggle to deliver appropriate assurances of legally verified wood and lose market share. Problems are likely to be particularly pronounced for manufacturers in China due to industry fragmentation, the complexity of trading chains, and heavy dependence on imported wood of uncertain origin.
- FLEGT VPA licensed Malaysian suppliers would be well placed to take a larger share of the market, particularly as there should also be a reduction in available supply of wood from Malaysian competitors in other VPA countries that have higher levels of illegal logging (notably Indonesia and Africa).
- There would be potential for price gains for Malaysian VPA licensed timber as suspicious supplies are removed from the market and as EU importers struggle to obtain alternative verified legal supplies of tropical hardwood products.

Achieving a balance between costs and the need for regulatory reform

The Malaysian authorities have adopted a strategy of keeping the costs of the FLEGT VPA process to a minimum by basing FLEGT licensing on existing laws and regulatory mechanisms. This strategy aligns well with an existing policy environment in which

regulatory systems are largely effective in preventing illegal logging. The strategy avoids the creation of perverse incentives that would result if the costs to VPA licensed operators were increased at a time when there are inadequate controls to prevent trade in illegal timber products in other countries. It also reduces the risks of encouraging circumvention of the FLEGT VPA licensing and trade diversion to third countries.

However, it is also important to recognise that the value of VPA licenses as a mechanism to build European market confidence in Malaysian wood products is at least partly dependent on ensuring that critical campaigns by ENGOs are avoided. ENGOs need to be reassured that the VPA process will at least facilitate further moves to resolve remaining issues associated with Native Customary Rights and to increased uptake of sustainable forest management certification

Equally, ENGOs need to recognise that the market incentives to the Malaysian private sector entering into a VPA are weak and that the introduction of new measures that might be perceived as increasing the direct costs of VPA licensing to the private sector could lead to the failure of the negotiations. A spirit of compromise needs to prevail if all interests are to benefit from the process.

Transaction costs at point of import into the EU

Delays to shipment represent a significant business expense for shippers and their agents. For Malaysian exporters that have acquired an unrivalled reputation in the EU market for reliable shipment of tropical hardwoods, it is critical to ensure that any extra bureaucracy that might be associated with issue of FLEGT VPA licensing does not cause delays. It would be a particularly perverse outcome of the FLEGT VPA process if the extra bureaucracy that might be associated with importing VPA licensed timber in any way damaged Malaysia's reputation for reliable supply.

There is a very clear onus on the European Union to ensure that transaction costs associated with import of FLEGT VPA timber are no higher than those associated with timber from non-VPA countries. Turnaround times in the event of any uncertainty over the status of a license will have to be rapid, given that shipment time between Malaysia and the EU is typically only 19 days.

There needs to be very effective lines of communication between the customs authorities in both Malaysia and the EU Member States and their respective licensing and competent authorities. There also needs to be very clear lines of communication and efficient management systems operated by and between the competent authorities in the EU and the licensing authority in Malaysia.

Handling timber imports

According to current proposed procedures, imported timber may enter the VPA licensing system as long as it complies with all Malaysian laws and regulations governing timber imports. However, beyond border checks of existing legal documentation, the Malaysian authorities do not verify that imported wood products derive from legal sources. This raises the prospect of Malaysia being used as a laundering mechanism for illegal wood from neighbouring countries. There seem to be two possible solutions to this problem:

- Malaysia could itself consider introducing a Lacey-style Act as a measure to encourage due diligence on the part of importers.
- Malaysia could exclude all imported wood products specifically from the FLEGT VPA licensing system unless legitimate forms of independent legality assurance can be provided. It would be necessary for the Malaysian and EU authorities to work together to draw up a set of criteria for accepting forms of legality assurance.

Recommendations: creating additional market incentives

Various actions are already in train that would increase market incentives for FLEGT VPA licensed timber. This study highlights the importance of these actions being given the highest political priority in order to maintain the momentum and increase the value and effectiveness of the FLEGT VPA process as a whole. Recommended action to increase market incentives for FLEGT VPA licensing are provided below.

The European Commission should consider:

- Exploring the potential for EU-wide legislation that would require or encourage EU timber industry operators to show due diligence with respect to the legality of timber supplies. Wherever possible, the intent should be to build on, expand and strengthen existing private sector initiatives.
- Enhanced efforts to facilitate the harmonisation of private sector procurement policies at EU level which include formal recognition of FLEGT VPA licensing through, for example, the Timber Trade Action Plan.
- Much stronger direct marketing of the FLEGT VPA process, particularly targeting timber importing companies.
- Ensuring FLEGT VPA licensed timber is recognised in relevant EU Eco-labelling standards, for example the wood furniture standard.
- Working with the organisers of Green Building Initiatives (BREEAM, HQE) to encourage a requirement that timber of unknown or suspicious origin be explicitly excluded from any certified project.
- Encouraging private certification initiatives to establish a minimum requirement applicable to all the operations of a company using a particular forestry label that they must avoid using timber of unknown or suspicious origin.
- Building on existing links with China, on the country's increasing concern for resource security and plans to develop a "Sustainable Trade Strategy" to encourage a more proactive response on the issue of illegal wood imports.
- Working with other high value markets (notably Japan and US) to develop a consistent approach to legality definition and verification.

- Supporting the PcW initiative to develop a coordinated approach to provision of forest sector guidance to the financial services sector and ensure that this guidance contains explicit references to FLEGT VPA licensing process.
- Supporting the UK TTF in its work directly targeting investment research houses in order to raise awareness of forest sector issues, again ensuring that explicit reference is made to the FLEGT VPA process and its associated benefits.
- Supporting the UNEP Finance Initiative process, linking it more effectively with key forestry sectors and encouraging wider take-up of the initiative, particularly amongst European and Malaysian banks.

EU Member States should consider:

- Making unambiguous statements of intent to accept FLEGT VPA licenses as sufficient evidence of conformance to central government procurement policies.
- Enhanced efforts to ensure that public sector procurement policies are effectively implemented and monitored.
- Enhanced efforts to harmonise public sector procurement policies with other EU countries.
- Providing formal recognition in these policies that VPA licenses deliver more than private sector legality verification systems, for example by acknowledging that they combine traceability to verified legal forests with measures to improve forest governance.
- Broadening the scope of public sector procurement policies so that they focus not only on rewarding certified wood products but also on providing credit for measures to remove illegal wood from trade.
- Developing financial and other incentive mechanisms to encourage local authorities to follow national-level procurement policy.
- Encouraging importing trade associations to implement credible, time-bound, action-oriented and independently audited Codes focused on removal of illegal wood from supply chains.
- Giving explicit recognition in public sector procurement policies for industry codes that meet specified requirements with respect to member performance and enforcement as a means of extending participation in responsible purchasing practices throughout the private sector.
- Use of building standards to prevent the use of wood from unknown or suspicious sources in construction.
- Encouraging banks registered in their jurisdictions to sign up to the Equator Principles.

Recommendations: further research

This study highlights that there remain significant information gaps that undermine efforts to reliably assess the impact of a FLEGT VPA licensing on Malaysian trade. The following specific areas for additional research are identified:

- There is a need for a comprehensive data-based assessment of the risk of Malaysian timber products being derived from illegal sources.
- There is a need for a comprehensive assessment of the cost implications of introduction of the FLEGT VPA licensing system and of how these costs are distributed between the public and the private sector. This study can only be carried out once the details of the Timber Legality Assurance System, the Independent Monitoring System and the EU's systems of import control have been elaborated and should draw directly on pilot tests of the licensing system.
- The Malaysian wood sector as a whole would benefit from the development of an econometric model specifically designed to describe the Malaysian tropical hardwood industry. This could be used for forecasting the impact of a wide range of policy changes, not just those related to illegal logging.
- There is a need for further research into the feasibility of direct financial incentives (for example through levies and tax incentives) for FLEGT VPA licensed timber in the EU.

1 Introduction

1.1 Scope of project

This study has been commissioned by the Netherlands Ministry of Agriculture, Nature and Foos Quality (Ministerie van Landbouw, Natuur en Voedselkwaliteit) as input to the negotiation process for a Forest law Enforcement Governance and Trade Voluntary Partnership Agreement (FLEGT VPA) between the EU and Malaysia. Key questions addressed in the study, based on the Terms of Reference, are as follows:

- Assess how Malaysian timber products are traded with the European Union.
- Describe the policies and instruments with regard to legal/sustainable timber that have already been implemented and the options that are currently being discussed at European Union level and assess how these could affect production and trade of Malaysian timber, both in a short and longer term.
- Assess the extent to which purchasing patterns in the EU will be influenced or regulated by public procurement policies and by other emerging requirements for evidence of legality under a FLEGT VPA and NGO campaigns. Specifically assess whether European buyers will continue to purchase from Malaysia if she does not sign up to the VPA.
- In the six largest EU markets for Malaysian wood products in the EU, identify the companies and other organisations influencing market demand for these products. Assess what activities have already been carried out and/or plans made by these organisations to influence trade in legal and sustainable timber products.
- Assess the extent to which legal/sustainable timber trade is becoming a market and/or policy issue in the USA, Japan and China and the extent to which these trends will affect the import of Malaysian timber products, both in a short and longer term. Specifically assess the potential for these markets to serve as substitute markets in the event that trade with the EU becomes more difficult.
- Assess how future supplies of timber from competing countries might affect the Malaysian timber industry and trade and how this impacts on the desirability of Malaysia entering into the FLEGT Partnership Agreement.
- Assess what trade opportunities Malaysia's commitment to FLEGT will provide for third countries supplying products based on Malaysian timber indirectly into the EU.
- Assess the price levels that can be expected on EU markets if Malaysia provides evidence of legality of exported timber products, both in a short and longer term.
- Assess the extent to which major commercial banks are involved in policies to phase out illegal timber production and/or stimulate sustainable timber production

and how this could affect production and trade of Malaysian timber, both in the short and longer term.

- Assess the market-related advantages and disadvantages for Malaysia entering into a FLEGT Partnership Agreement and recommend actions to maximise advantages and minimise disadvantages. Specifically advise on additional incentives that could be offered by EU governments to increase opportunities for VPA licensed timber.

1.3 Methodology and data sources

This report has been compiled using a variety of information sources:

- Forest products trade data supplied by the Malaysian Timber Council, Malaysian Timber Industry Board, Eurostat, and the Global Trade Atlas
- A series of meetings between the consultants and all the major Malaysian timber trade associations in January/February 2008
- Structured interviews based on a set of standard questions (contained in ANNEX 3) with 151 organisations in the EU's 6 largest markets for Malaysian wood products, namely the UK, Netherlands, Belgium, Germany, France and Italy during November/December 2008. Interviewed organisations included:
 - 80 timber industry concentrating on companies directly engaged in importing, manufacturing and distributing products containing Malaysian wood. It is estimated that companies interviewed were responsible for a combined trade of at least 500,000 m³ of Malaysian wood imports, or around 60% of all imports from Malaysia into the EU.
 - 21 trade associations representing timber importing and wood manufacturing companies
 - 29 government departments, with a particularly focus on central government authorities with responsibility for developing procurement policy, but also including some authorities at regional and local level.
 - 21 environmental non-governmental organisations (ENGO)
- Comments received from the Malaysian private sector during a series of three industry briefings on the FLEGT VPA process held in Kota Kinabalu, Kuching and Kuala Lumpur during April 2008.
- A wide of range of secondary sources including existing studies and surveys of procurement policy and practice within the EU and other major consuming markets, various studies modelling the global impact of illegal logging on trade, ENGO reports and opinion pieces on illegal logging and policy responses, and documentation compiled by the European Commission, the governments of EU Member States and Malaysia.

1.4 Project Team

The bulk of the report has been prepared by Rupert Oliver, Director of Forest Industries Intelligence Limited. The following consultants contributed to various sections of the report:

- Pierre Declos undertook interviews and contributed to the preparation of country reports on France, Italy and Belgium.
- Barney Chan undertook interviews with trade associations in Malaysia and contributed to the preparation of the section on private sector views in Malaysia
- Gunther Hentschel undertook interviews and contributed to the preparation of the national report on Germany.
- Nico Leek and Annemieke Winterink of the Dutch consultancy firm Probos undertook interviews and contributed to the preparation of the national report on the Netherlands.

The study was overseen by a Steering Group comprising:

- Rob Busink, Netherlands Ministry of Agriculture, Nature and Food Quality
- Freezailah Che' Yeom, Malaysian Timber Certification Council
- Vincent. Van-Den-Berk, European Commission
- André de Boer, Netherlands Timber Trade Association VVNH
- Aimi Lee Abdullah, Malaysian Timber Council
- Chin Lee Yen, Gunung Seraya Sdn. Bhd

1.5 Structure of the report

The report is structured as follows:

- Section 2 includes an analysis of wood supply in Malaysia with the intention of setting the EU trade within the context of Malaysia's broader production and trade. It also includes a brief assessment of the supply of illegal wood to the Malaysian wood industry as this has an important bearing on the long term impact of a FLEGT VPA agreement on the availability of Malaysian wood products.
- Section 3 describes public and private sector and civil society initiatives in the EU with potential to influence demand for FLEGT VPA licensed timber, for example by encouraging European timber buyers to prefer legally verified timber over unverified timber. It summarises and provides an overview of public and private sector procurement policies which are described in more detail in the European national reports contained in Annex 1. It also reports the results of interviews with the private sector and ENGOs to assess attitudes to the current and potential marketing value of FLEGT VPA licenses from Malaysia.
- Section 4 assesses the extent to which illegal/sustainable timber trade is becoming a market and/or policy issue in the USA, Japan and China and the potential impact on Malaysian timber product imports both in the short and long term. It also assesses each market's long term trade potential. The aim is to provide an insight into the ability of these markets to substitute for EU markets if the latter become more difficult.

- Section 5 provides an overview of supply and policy developments in countries that are the main competitors to Malaysia in the EU wood market. The aim is to assess the extent to which a FLEGT VPA between Malaysia and the EU might impact on the relative competitiveness of Malaysian producers compared to producers in other countries.
- Section 6 discusses some of the trade impacts of Malaysia signing a FLEGT VPA, including the impact on price and potential for trade diversion and circumvention of the licensing process. Broad conclusions are drawn based on best available information derived from other sections of the report on likely future levels of wood demand and supply, the views of the private sector, together with consideration of various other secondary sources. Consideration is also given to means of dealing with some of the trade issues that arise from implementation of the licensing system.
- Section 7 assesses the extent to which the commercial banks are involved in policies to phase out illegal timber production and to stimulate sustainable timber production and analyses how this could affect production and trade of Malaysian timber.
- Section 8 summarises study conclusions and provides recommendations
- ANNEX 1 includes a series of country reports assessing current and potential future market attitudes to FLEGT VPA licensing in Malaysia main EU markets
- ANNEX 2 contains a report by the Malaysian consultant on Malaysian private sector views of the FLEGT VPA process.

2 Malaysia's wood supply and industry

2.1 Introduction

Based on desk research of trade statistics derived from MTC, MTIB, Eurostat and ITTO, together with a review of other secondary sources, Section 2 includes an analysis of wood supply in Malaysia with the intention of setting the EU trade within the context of Malaysia's broader production and trade. It also includes a brief assessment of the supply of illegal wood to the Malaysian wood industry as this has an important bearing on the long term impact of a FLEGT VPA agreement on the availability of Malaysian wood products.

2.2 Natural forest resource

About 56% (18.3 million hectares) of the Malaysian land area (32.8 million hectares) is classified as forest. The area of forest includes 17.9 million hectares of natural forest and 0.4 million hectares of plantation. 15.3 million hectares (84%) of Malaysia's forest land is designated as Permanent Reserved Forest (PRF) and must be managed and developed in a sustainable manner. Of the PRF, 3.11 million hectares are Protection Forest where no logging is allowed and 12.19 million hectares are set aside for timber production. Sarawak has 7 million hectares of PRF, Peninsular Malaysia has 4.7 million hectares, and Sabah has 3.6 million hectares.

1.4 million hectares of Malaysia's forested land is currently defined as "Stateland Forest" and is designated for conversion. Stateland forests mainly consist of degraded areas and will ultimately be cleared with the land put into alternative uses. In addition to forested land, Malaysian also has 5.6 million hectares of Agricultural Tree Crops.

Malaysia has lost an average of 140,200 hectares per year since 2000. Declining forest area in Malaysia is mainly a result of urbanization, agricultural fires, and forest conversion for oil-palm plantations and other forms of agriculture. In recent years the rate of land conversion for agricultural purposes has slowed as Malaysia has industrialised.

Saw and veneer log production in Malaysia was 19.1 million cubic meters in 1975, peaked at 40.1 million cubic meters in 1990, and declined to 20.6 million cubic meters by 2002. Log production is now hovering around 19-21 million m³ per year, with Sarawak accounting for around 12 million m³, Peninsular Malaysia around 4.5 million m³, and Sabah around 2.5 million m³. Under the Ninth Malaysia Plan (2006-2010), the Malaysian government expects log output to stand at around 19.6 million m³ in 2010.

4.7 million hectares of Malaysia's permanent production forest is currently certified under the Malaysian Timber Certification Council (MTCC) scheme. The area includes the entire area of permanent production forest in Peninsular Malaysia. Only a small area (56000 hectares) is MTCC certified outside Peninsular Malaysia (in Sarawak). 100 MTCC chain of custody certificates have been issued. 76000 m³ of MTCC certified sawn lumber was exported from Malaysia in 2007. The vast majority was destined for the EU (mainly the Netherlands and the UK), although small volumes are also now being sold into Australia, Japan and Korea.

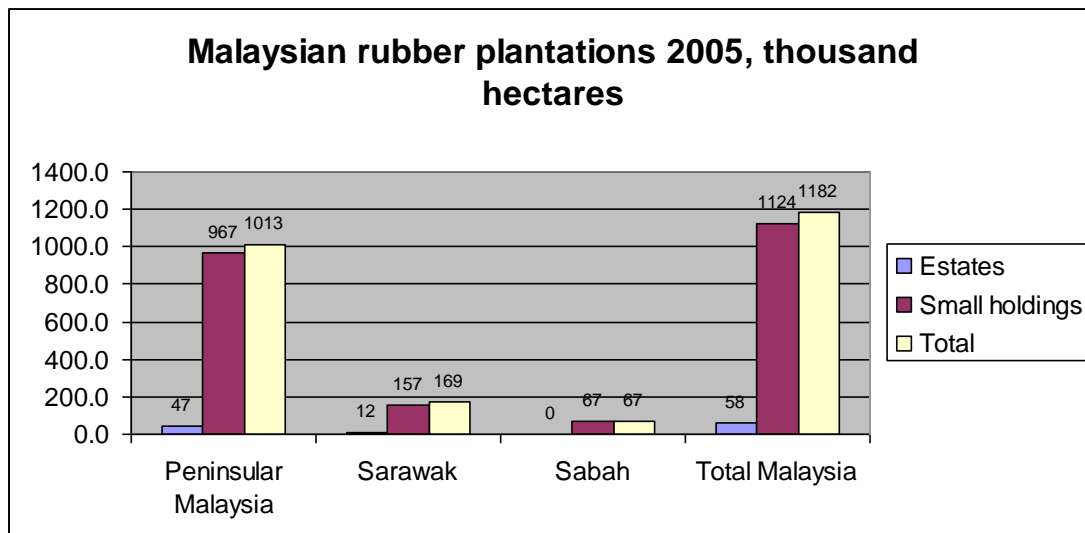
Malaysia's natural forests are highly diverse and play host to around 2000 different timber species. Around 200 species are used for timber production. For forest management and commercial purposes, many of these species are classified into groups which share similar characteristics. Major groups from the perspective of the commercial timber trade are *Shorea* spp (meranti), *Anisoptera* spp (mersawa), *Dipterocarpus* spp (keruing), *Dryobalanops* spp (kapur), *Hopea* spp (merawan), kedondong (*Canarium* spp, *Santiria* spp), *Pterocarpus* spp (angsana), and *Terminalia* spp (ketapang). Other key commercial species are *Gonystylus bancanus* (ramin) and *Intsia palembanica* (merbau).

2.3 Plantations

Efforts are being made to encourage plantation development as a means of off-setting declining supply from natural forests. At national level, in order to encourage private sector involvement in forest plantations the government has introduced incentives under a scheme titled "Pre-Packaged Incentive for Forest Plantation (Including rubber)". The package provides tax relief including a full tax exemption for up to 15 years for the company undertaking the plantation project. Despite the incentives, many private operators still hesitate to finance forest plantations as the first financial returns do not materialise until at least 7 or 8 years after the initial investment. Competing land uses such as oil palm plantations tend to create quicker and higher financial returns. As a result, plantations still represent only a very small proportion of national forest area.

To date, Malaysia has established around 270,000 hectares of plantations, of which 140,000 hectares are in Sabah, 80,000 in Peninsular Malaysia and 50,000 in Sarawak. By species, FAO (2001) estimate the area of plantations to be: Acacia – 180,000 hectares, Eucalyptus – 19,000 hectares, teak – 12,000 hectares, other broadleaved species – 12,000 hectares, and conifers – 47,000 hectares.

Chart 2.1



The wood furniture and panels sector (excluding plywood) is heavily dependent on rubberwood. Malaysia has 1.24 million hectares of rubberwood plantations, 1.01 million of which are in Peninsular Malaysia (Chart 2.1). These plantations contain in the region

of 120 million m³ of rubberwood. The area and volume of rubberwood plantation has declined dramatically from 1.69 million hectares and 160 million m³ in 1995, with the decline concentrated in Peninsular Malaysia. Throughout the 1990s, a general slump in the world latex market, together with rising labour costs, pushed many plantation owners to shift from rubber to oil palm. The resulting glut of rubberwood logs from plantation conversion depressed prices below RM 75 per m³ for much of the decade. The area of rubber plantations established each year fell from over 30,000 hectares in the early 1990s to only 2000 hectares in 1999.

More recently, many processors in Malaysia have been reporting shortages of rubberwood supplies due to high latex prices which has meant that plantation owners are now reluctant to harvest rubber trees. There has also been some recovery in the rate of rubberwood plantation establishment which stood at over 20,000 hectares last year. This has yet to ease the shortage of rubberwood supplies resulting from strong consumption and reduced harvesting of existing plantations. To ensure an adequate supply of rubberwood and to increase the production of value added products, the export of rubberwood sawn lumber was banned in June 2005. This ban was tightened to include fingered-jointed lumber in August 2006.

2.4 Wood imports

Declining supplies from natural forests in Malaysia in recent years combined with strong emerging domestic wood demand fuelled by economic growth has also led to increasing levels of wood imports into Malaysia. Table 2.1 shows the dollar value of Malaysian wood product imports compiled from the Global Trade Atlas. Accurate volume data on Malaysian wood imports is not available from this source. To give some idea of the quantities involved, Table 2.2 is compiled from export data of some of the leading countries supplying to Malaysia.

In the past, Malaysian mills often supplemented raw material by importing logs from neighbouring Indonesia. However, this trade is now prohibited following imposition of a permanent log export ban by Indonesia in 2002. To support the Indonesian measure, Malaysia banned imports of Indonesian logs on 25 June 2002. And from 1 June 2003, Indonesian “squared logs” are not allowed to be imported into Malaysia. These “squared logs” are defined as large scantlings and squares with cross section of more than 60 sq in. Malaysia now imports only small volumes of logs – estimated in the region of 150,000 m³ in 2007 - mainly consisting of hardwoods from the United States, Australia and Myanmar together with some radiata pine from New Zealand.

Sawn lumber is now by far the most significant primary wood commodity imported into Malaysia, estimated in the region of 1 million m³ in 2007. A significant proportion of this volume derives from Thailand and Indonesia. In 2007, Thailand recorded sawn lumber exports to Malaysia of around 620,000 m³. This is mainly identified as “other non-coniferous wood” and comprised relatively low value material, perhaps rubberwood. Last year, Indonesia recorded sawn lumber exports to Malaysia of around 207,800 m³, a significant decline on levels of around 900,000 m³ recorded in both 2005 and 2006.

Malaysia’s imports of veneer sheets are estimated to have reached around 20,000 m³ in 2007, with around 50% derived from China. Malaysia also imports small volumes of plywood, in the region of 12,000 m³ in 2007, the majority sourced from China.

Table 2.1: Malaysia imports of primary wood products (US\$ 1000)

	2005	2006	2007
Logs			
World	27,276	37,387	23,394
United States	3,844	3,017	4,368
Australia	58	4,035	4,312
Myanmar	12,719	16,548	4,275
New Zealand	2,343	6,103	3,288
Sawn			
World	172,156	187,569	204,120
Thailand	27,677	60,275	54,183
Indonesia	80,558	48,796	28,837
United States	21,532	21,415	24,311
Australia	5,121	6,894	16,270
Myanmar	7,301	5,163	13,548
Brazil	1,479	1,676	10,315
Philippines	3,480	6,700	8,897
China	2,808	3,410	7,305
Veneer			
World	44,576	49,030	52,486
China	15,648	22,336	21,683
United States	7,360	6,410	6,839
Plywood			
World	10,867	26,277	27,693
China	6,329	20,024	19,316

Source Global Trade Atlas

Table 2.2: Quantity of exports of wood products to Malaysia by main supply country

	Units	2005	2006	2007
Logs				
Australia	m3	1179	14877	30212
New Zealand	m3	20887	50759	27809
USA	m3	9867	7269	13097
Sawn				
Thailand	m3	831390	425802	620526
Indonesia	m3	892129	907651	209995
USA	m3	36630	35344	36140
Philippines	Tonnes	169	1426	1631
Australia	m3	11391	15800	20097
Brazil	m3	2001	3184	9263
China	m3	2749	3518	5400
Plywood				
China	m3	4270	17348	9234
Veneers				
China	Tonnes	5297	7401	6258
USA	m2	3902	4043	3201

2.5 Illegal wood supply

As with most crimes, it is impossible to know with a high degree of certainty the extent of illegal logging. Furthermore, no full and comprehensive independent assessment of the level of illegal logging in Malaysia has yet been undertaken. However a variety of

information sources seem to support the broad conclusion that illegal logging is not a widespread problem in the country.

In recent years, a wide range of measures have been introduced to improve enforcement of forest regulations in Malaysia¹:

- Detailed procedures have been established to prevent licensed loggers from logging outside concession boundaries or in excess of the allowable cut. The trees to be cut above a minimum diameter are determined using a pre-felling inventory and marked by state foresters with personalised hammer-marks, as are boundaries of licensed areas. Post harvesting inspections are undertaken to ensure only trees within the allocated cut have been removed.
- Enforcement teams have been established within State Forestry Departments to patrol sensitive areas and support log checking procedures.
- A system of checking stations has been established throughout the country. All log carrying lorries are checked to ensure they are carrying appropriate “log removal passes”. Each individual log passing through a checking station must carry an original tag which will tally with state-approved harvesting plans.
- Enforcement teams now also set up roadblocks to undertake random spot checks of log-carrying logs.
- Public informants are encouraged through advertising campaigns and provision for rewards to report illegal activities to the relevant Forestry Department and procedures exist to ensure complaints are acted on within three days.
- In September 2007, the Malaysian government announced that the National Forestry Act, which is applicable in Peninsular Malaysia, would be amended to place the burden of proof that logs are legally sourced on those found in possession instead of requiring the authorities to prove that logs were obtained illegally.

So the Malaysian authorities seem very aware of the threat of illegal logging and are taking steps to eradicate the problem. Official enforcement figures provided by the Malaysian authorities also indicate that effective action is being taken to prevent illegal logging. Table 2.3 indicates that the authorities are actively detecting and monitoring illegal logging activities in the Permanent Forest Reserves. Table 2.4 indicates that action is being taken to prevent illegal logging - the number of arrests for forestry related crimes has risen in both Sabah and Sarawak in recent years. One (imperfect) measure of illegal harvesting in Malaysia is provided by the volume of seized logs in operations to curb such activities (Table 2.5). The volumes of seized logs in all three regions make up only a tiny fraction of the total log harvest.

Table 2.3: Cases of Illegal Logging in the Permanent Forest Reserves

	2004	2005	2006
Peninsular	18	12	2
Sabah	43	27	32
Sarawak	53	99	89
Total	114	138	123

Source: MTC

¹ Derived from a report for TTF FLEGT Roadshow in China, April 2008, “Changing International Markets for Timber – What Chinese and South East Asian Producers Can Do, Producer Country – Malaysia”, by Rupert Oliver, FII Ltd

Table 2.4: Number of Arrests

	Peninsular	Sabah	Sarawak
2001	12	17	7
2002	5	70	40
2003	5	123	51
2004	1	207	61
2005	1	302	54
2006	0	n.a.	71
Total	24	719	284

Source: FD Peninsular Malaysia, Sabah & Sarawak

Table2.5: Logs seized (m3)

	2004	2005	2006	2007
Peninsular	3,926	1,345	6,537	2,979
Sabah	15,983	20,163	16,684	18,953
Sarawak	10,504	24,510	14,769	23,240

Source: FD Peninsular Malaysia, Sabah & Sarawak

Other independent researchers have come to the conclusion that the level of illegal logging in Malaysia is relatively confined. In 2001, WWF Malaysia and the World Bank published two reports on forest law enforcement respectively in Peninsular Malaysia and East Malaysia². The report on Peninsular Malaysia concluded that:

“offenses such as illegal logging and forest encroachment are treated seriously by the law. The maximum punishments for such offenses are quite severe. In addition to heavy penalties, the authorities have instituted other measures to curb the problems and these include conducting spot checks, helicopter surveillance, regular training programs for their officers to equip them with the necessary knowledge and skills on forest law enforcement, and running public awareness campaigns. Realizing the significance of the problems and the need for combined efforts in eliminating them, the Forestry Departments often work together with other government agencies, including the police and the army, in their enforcement operations. Partly due to the strategies mentioned above, the incidence of forest crimes over the last several years shows a declining trend. The average number of illegal logging cases dropped from 223 for the period 1987 - 1993 to about 28 for the 1994 - 1999 period.”

The report on East Malaysia concluded that: *“the dimensions of forestry offences in Sabah and Sarawak are relatively small compared to the magnitude of the legal timber trade. In each of the two states about 300 cases of forest law infractions are detected annually - an average of one case per day. The annual volume of illegal timber seized in each of the East Malaysian States ranges from twenty to fifty thousand cubic meters - compared to the annual log harvest (1998) of five million m³ in Sabah and eleven million m³ in Sarawak.”* The report highlighted that cases of illegal logging are dealt with severely in the courts, and also noted that *“The Forest Departments of East Malaysia have sufficient personnel, financial resources and the legislative framework is adequate to reduce illegal forestry activity to an acceptable level.”*

² WWF Malaysia/World Bank, Overview of Forest Law Enforcement in Peninsular Malaysia, March 2001, 'Overview of Forest Law Enforcement in East Malaysia' Sept 2000

In 2004, the independent consultancy firm Seneca Creek was commissioned by the American Forest and Paper Association to assess the competitive impacts of illegal logging on the US forest products industry³. Seneca Creek drew the following conclusion with respect to illegal logging in Malaysia: *“While NGOs have complained about over-cutting and forest practices in parts of Malaysia that they view as unsustainable, ‘illegal’ forest activity with respect to domestic harvesting does not appear to be a severe problem in the country. Government officials acknowledge that some illegal logging occurs in remote areas of Sarawak and Sabah, but are confident that the volumes are very small (less than 5%)”*. Seneca Creek also point out that *“a calculation of derived roundwood demand based upon net trade of logs and the official harvest places domestic harvest at near the official level and thus supports this conclusion.”*⁴

In an effort to corroborate these conclusions, a review was undertaken of news articles mentioning Malaysia posted on the www.illegal-logging.info website during the year 2007. Only a few articles referred to illegal logging within Malaysia itself, for example the Malaysian Daily Express on 16 August 2007 carried a story suggesting that illegal logging was still a problem in parts of Sabah, while a story in the New Straits Times on 30 June 2007 suggested that illegal logging remained a problem in wildlife sanctuaries along the Sarawak-Kalimantan border. However, the thrust of both of these articles, and most of the other articles published on Malaysia’s domestic forestry, was to highlight the efforts that are being made to tackle the problem. The article on Sabah drew from a statement by a politician in Sabah calling on the Malaysian Anti-Corruption Agency to broaden its existing investigations into logging in Sabah to include a review of the source of income of Sabah’s forest rangers. The article on Sarawak was based on a statement by Chief Minister Tan Sri Abdul Taib Mahmud who also praised the actions of the enforcement unit of the Sarawak Forestry Corporation who were “going all out to catch those involved in illegal logging”.

There are reports which suggest that illegal wood continues to enter Malaysia from Indonesia. The Environmental Investigation Agency (EIA) and Telapak, an Indonesian ENGO, have made the illegal export of wood from Indonesia into Malaysia a major focus of their campaigns, publishing a series of reports. Drawing on their own on-ground investigations, EIA/Telapak claim significant volumes of wood continue to enter Malaysia illegally from Indonesia each year. Initially the focus was on Indonesian logs and ramin, but more recently concern has shifted to imports of rough sawn lumber in contravention of the Indonesian export ban on this commodity.

There is clear evidence that Malaysian action to prevent illegal wood imports from Indonesia and elsewhere has intensified in recent years. Actions have included: only allowing imports through a limited number of controlled check-points; establishing detailed and comprehensive documentary and inspection requirements for all wood imports; setting up co-ordinating bodies to guide enforcement activities of the forestry authorities, customs, police, and armed forces; introducing a ban on log imports from Indonesia to mirror the Indonesian export ban. Again official data indicates that

³ “Illegal Logging and Global Wood Markets: The Competitive Impacts on the U.S. Wood Products Industry”, prepared for American Forest & Paper Association by Seneca Creek Associates, LLC, 2004

⁴ A 2007 report for OECD on “The Economics Of Illegal Logging And Associated Trade” by Contreras-Hermosilla et al 2007 made reference to a 35% illegal logging rate in Malaysia, a figure which is occasionally quoted elsewhere in the literature. This figure is generally ascribed to a WWF book “Bad Harvest” by Dudley, Jeanrenaud, and Sullivan published in 1995. This book in turn draws on another secondary source, a paper entitled “Illegal Tropical Timber Trade – Asia Pacific” by DJ Callister published by Traffic in 1992. This figure, if it ever had any solid basis in fact, can now be safely dismissed as out of date.

enforcement actions are being taken to prevent illegal imports from Indonesia leading to confiscation of seized Indonesian timber (see Table 2.6)

Table 2.6: Confiscation of Indonesian Timber Imports - Number of cases

Region	2004	2005	2006
Peninsular	49	40	98
Sabah	71	42	159
Sarawak	12	6	6
Total	132	88	265

Source: MTC

EIA/Telapak has, on occasion, acknowledged positive action on the part of the Malaysian authorities to prevent illegal imports from Indonesia. For example one EIA/Telapak report notes that: *“by August 2003 shipments of round logs across the Straits of Melaka from Indonesian Sumatra to Peninsular Malaysia had dropped off dramatically. Field reports from Riau and Jambi provinces in Sumatra indicate that illegal cutting was reduced as a direct result, with some illegal loggers and illegal log shippers returning to agriculture”*.

With respect to Malaysia’s tough documentary and inspection requirements for imports of wood products from Indonesia, EIA/Telapak note that *“such measures hold great promise and deserve to be replicated elsewhere....If importing countries were to follow Sarawak’s example and incorporate the requirement for such paperwork and log markings into their import controls, this would offer a powerful means with which to fight illicit trade, providing a clear legal basis and practical enforcement tools for customs officers to halt shipments of illegally sourced wood”*

Nevertheless, in their most recent reports, EIA/Telepak allege that illegal imports from Indonesia remain a problem. In a March 2007 report⁵, it is suggested that *“investigations by EIA/Telapak in Sumatra and Peninsular Malaysia reveal that timber smuggling is still widespread, with the efforts of the enforcement agencies being undermined by a timber industry which refuses to stop dealing in stolen Indonesian timber”*. Malaysia is criticised specifically for not reacting to the Indonesian export ban on rough sawn lumber in the same way as it has to the export ban on logs by mirroring with an import ban. EIA/Telapak claim that *“large amounts of Indonesian sawn timber are flowing into Malaysia, unimpeded by enforcement agencies which do not have the powers to intercept it”*.

Table 2.7: Comparison of the volume data for sawn lumber imports into Malaysia vs exports from Indonesia (m3)

Year	2005	2006	2007
Indonesia exports	892000	908000	210000
Malaysia imports	1317000	781000	208000

Source Global Trade Atlas

There is one piece of evidence which suggests that efforts to monitor and control sawn lumber exports from Indonesia into Malaysia improved significantly during 2007. A comparison of Malaysian import data and Indonesian export data indicates that the vast discrepancies in recorded trade in 2005 and 2006 narrowed considerably in 2007 (Table 2.7). But this might be coincidental and needs further monitoring.

⁵ The Thousand-Headed Snake Forest Crimes, Corruption And Injustice In Indonesia, EIA/Telapak, March 2007

2.6 Primary wood processing capacity

Malaysia's wood processing sector has undergone major changes over the years, with downstream activities becoming increasingly important. Government strategy has been to restrict log exports and to encourage a range of value-added industries through various policy measures including provision of tax incentives, development of appropriate infrastructure, establishment of special Timber Processing Zones, research and market development. Although logs and primary wood products still make up a significant proportion of Malaysia's exports, the country has also emerged as a major exporter of panels (plywood, fibreboard, chipboard), flooring, and wood furniture.

Malaysian primary wood processing mills have a total installed capacity of 26.5 million m³, comprising 12.4 million m³ in Peninsular Malaysia, 6.5 million m³ in Sabah, and 7.6 million m³ in Sarawak. Primary wood processing capacity has fallen dramatically since the early 1990s when it stood at around 40 million m³. Given the current and future harvesting potential, the downward trend in primary processing capacity is likely to continue.

The wood-based industry is predominantly Malaysian-owned with 80% of companies being small and medium size enterprises. In the furniture sector, approximately 90% are small and medium sized enterprises.

Table 2.8: Malaysia tropical hardwood sawnwood¹ production, trade and consumption 2002-2007 (000 m³)

	2002	2003	2004	2005	2006	2007 ²
Production	4643	4769	4934	5173	5363	5565
Imports	645	757	1009	999	1100	1221
Exports	2506	2520	2762	3197	2800	3138
Apparent Consumption	2782	3006	3181	2975	3663	3647
Exports/production (%)	54	53	56	62	52	56
Imports/consumption (%)	23	25	32	34	30	33

Notes 1) These volumes are assumed to include rubberwood. 2) f = forecast
Source: ITTO

There are around 1,100 sawmills in operation in the country, including 650 in Peninsular Malaysia, 170 in Sabah and 280 in Sarawak. According to ITTO, tropical hardwood sawnwood production has been increasing in Malaysia, from around 4.6 million m³ in 2002 to 5.4 million m³ in 2006 (Table 2.8). This reflects the reduction in logs sent for export and strong demand for sawn lumber both in Malaysia and key export markets. Around 56% of Malaysian sawn lumber is exported. ITTO's figures also suggest that imports now account for around 18% of total sawnwood supply to the country.

There are 352 mouldings mills in operation in the country including 167 in Peninsular Malaysia, 28 in Sarawak and 157 in Sabah. The manufacture of mouldings represents the first stage in the downstream processing of sawnwood. The majority of moulding plants are small and they are usually in the existing sawmills, furniture or joinery mills. The main products from the moulding plants are general moulding, S4S, door stops, door jambs casings, skirting, architraves, door and window components such as stiles, rails, louvre blades and panelling, flooring pieces, finger joints and veneer-wrapped mouldings.

Plywood is the main wood panel product manufactured in the country. There are around 170 plywood mills in the country, 50 located in Peninsular Malaysia and 120 in Sarawak and Sabah. The bulk of the plywood produced in Malaysia is the standard 1220mm x 2440mm. A few mills manufacture speciality plywood overlaid with decorative veneers or melamin, PVC and polyester, as well as phenolic film-faced plywood and marine plywood. According to ITTO data, tropical hardwood-faced plywood production in Malaysia increased from 4.3 million m³ in 2002 to 5.1 million m³ in 2007 (Table 2.10). This again reflects the reduction in logs sent for export and increased domestic processing. As noted in section 2.4, Malaysia's imports of softwood and hardwood veneers from China and New Zealand have also been rising in recent years. A proportion of this imported volume is likely to be used to supplement domestic supplies of core veneer in the Malaysian plywood industry. Malaysia's plywood industry is heavily oriented towards exports which account for over 90% of production.

Table 2.9: Malaysia tropical hardwood veneer production, trade and consumption 2002-2007 (000 m³)

	2002	2003	2004	2005	2006	2007 ¹
Production	662	643	637	670	677	691
Imports	13	13	10	22	10	14
Exports	601	462	396	414	420	396
Apparent Consumption	74	194	251	278	267	309
Exports/production (%)	91	72	62	62	62	57
Imports/consumption (%)	17	7	4	8	4	5

Notes 1) f = forecast

Source: ITTO

Table 2.10: Malaysia tropical hardwood plywood production, trade and consumption 2002-2007 (000 m³)

	2002	2003	2004	2005	2006	2007 ¹
Production	4341	4771	4734	5006	5072	5190
Imports	17	7	8	27	27	13
Exports	3614	3875	4349	4537	4800	4800
Apparent Consumption	744	903	393	496	299	403
Exports/production (%)	83	81	92	91	95	92
Imports/consumption (%)	2	1	2	5	9	3

Notes 1) f = forecast

Source: ITTO

Malaysian plywood has a reputation for high quality, achieving international standards such as Japan Agricultural Standards (JAS), British Standards (BS) and International Wood Products Association Standards (IWPA) for the US market and Harmonised European Standards (EN) for Europe market. Malaysia is currently the largest exporter of tropical plywood in the world.

A range of other wood panel products are manufactured in the country. In the particleboard industry, the sector has diversified into the production of high value-added reconstituted panel products such as particleboard and medium density fibreboard. The particleboard industry currently comprises 16 companies. Today, Malaysia is a major exporter of particleboard with manufacturers able to comply with international standards such as BS, EN and Japan Industrial Standards (JIS).

Malaysia's MDF industry currently has 13 companies, with nine located in Peninsular Malaysia, three in Sarawak and one in Sabah. Besides MDF, the industry has continued to develop engineered products from veneer such as laminated veneer lumber (LVL),

laminated veneer cross-band (LVB) and laminated veneer sandwich (LVS) to meet the demand for structural and industrial applications.

2.7 Wood furniture industry

Malaysia ranks tenth as a world exporter of furniture and twentieth as a world producer. Malaysia's furniture sector has developed from a host of small manufacturers into a major industry. Overall production more than doubled in the decade prior to 2006, rising from US\$1.3 billion in 1997 to US\$2.8 billion last year (Table 2.11). Factors that have contributed to this success include abundant raw material, particularly of rubberwood during the 1990s, and the Malaysian Government's commitment to support the sector. Foreign investment has brought modern production techniques and equipment into the country while the government has invested in infrastructure. The industry is heavily oriented towards exports - which account for around 80% of production - with major markets in the United States, Japan, Australia, and the United Kingdom.

Table 2.11: Malaysia wood furniture production, trade and consumption 1997-2006 (million US\$)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Production	1344	1212	1489	1695	1574	1895	1907	2317	2527	2852
Imports	102	51	64	95	97	162	186	281	303	330
Exports	1180	1088	1361	1552	1344	1452	1577	1851	1973	2198
Apparent consumption	265	175	192	238	327	605	515	747	857	983
Exports/production %	88	90	91	92	85	77	83	80	78	77
Imports/consumption %	38	29	34	40	30	27	36	38	35	34

Source CSIL

According to the Malaysian Industrial Development Authority (MIDA), there were about 2,400 furniture firms in 2006, the majority employing fewer than 30 people. Mills involved for manufacturing furniture for export are concentrated on the West Coast of Peninsular Malaysia in the states of Johor, Selangor, Perak, Penang, Malacca and Federal Territory of Kuala Lumpur.

Investments both in new projects and in the expansion/diversification of existing operations have continued to rise in recent years (Table 2.12). Most of these projects have involved export-oriented companies. In 2006 foreign investment accounted for about 12% of the total. Furniture production rose by an average of 13% annually over the period 2001-2006.

Table 2.12: Approved investments in the furniture and fixtures industry in Malaysia 1998-2006

Year	Number of approvals	Potential employment	Capital investment proposed US\$ Million
1998	33	4,317	46
1999	46	3,998	61
2000	36	4,641	91
2001	36	2,386	49
2002	37	5,539	80
2003	49	6,684	82
2004	56	6,179	93
2005	55	6,587	138
2006	62	6,982	112

Source: CSIL

The vast majority (83%) of Malaysian furniture exports comprises wood (Chart 2.2). Rubberwood accounts for around 65% of wood furniture production, 15% is panel based and the remainder comprises hardwood (including both tropical and imported temperate

hardwood) (Chart 2.3). A significant portion of the panels used for the manufacture of furniture are also ultimately derived from rubberwood.

The fact that rubberwood obviously derives from rubber plantations and not from natural forest suggests that the issue of legality needs to be approached differently. During interviews, representatives of the Malaysian furniture sector claimed that due to the high price of rubber latex, owners (these being the planters) have a strong incentive to keep a close eye on their rubber trees, thus minimising the risk of stolen (ie. illegal) rubberwood.

Chart 2.2: Malaysian furniture exports Breakdown by material in 2006

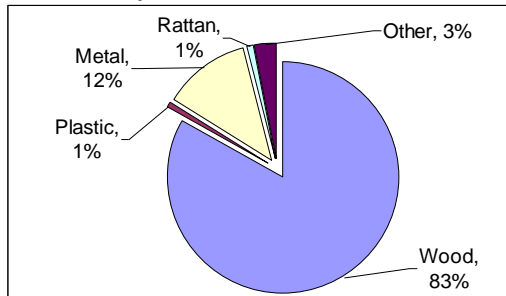
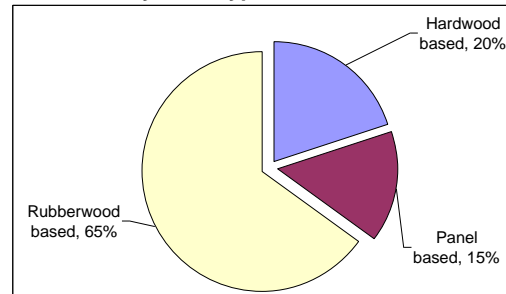


Chart 2.3: Malaysian wood furniture production Breakdown by wood type in 2005



Furniture produced in Malaysia ranges from the traditional to the contemporary. Products include bedroom furniture, dining sets, lounge sets, office furniture, garden furniture and antique furniture. Furniture exported from Malaysia is either assembled or in ready-to-assembly form.

Malaysia's competitive advantage in the furniture sector has traditionally been based on specialisation in rubberwood products and low cost production which in turn depended on abundant raw material and a reasonably cheap and competitive labour force. Malaysian firms have also tended to focus on so-called OEM (Original Equipment Manufacturing) strategies which are oriented towards mass production of furniture to standard designs provided by buying companies, most of which are located outside the country. Investment in research, development and design has traditionally been low.

However, Malaysia's ability to compete using OEM strategies has been progressively eroded with rising raw material costs and as labour costs are now less competitive compared to other Asian countries, particularly China and Vietnam. With government support, Malaysian firms are now progressively shifting to Original Design Manufacturing (ODM). Some companies are upgrading their production to higher value-added furniture incorporating indigenous design and better finishing. They are investing more in product development and design, seeking to make production more flexible and to create recognisable products. This may, in the future, allow firms to progress to OBM (Original Brand Manufacturing) and to concentrate on building recognisable brand names. An implication both of the new strategy and of declining rubberwood supplies has been to encourage efforts by Malaysian firms to diversify the timber species and range of materials used for manufacturing furniture.

2.8 Wood products trade

2.8.1 Overall trade

The last 15 years have been a period of significant volatility in Malaysian wood products exports. Exports were running at relatively high levels throughout the 1990s until 1998 when the Asian financial crises severely undermined regional markets. After a very brief recovery, another dip in Malaysian wood exports occurred in 2001 when Sabah’s log supply problems began to be felt in earnest and when the Asian log and plywood market came under intense pressure from cheap Indonesian product. This was at a time when illegal logging in Indonesia was at its height after the collapse of the Suharto regime.

Chart 2.4

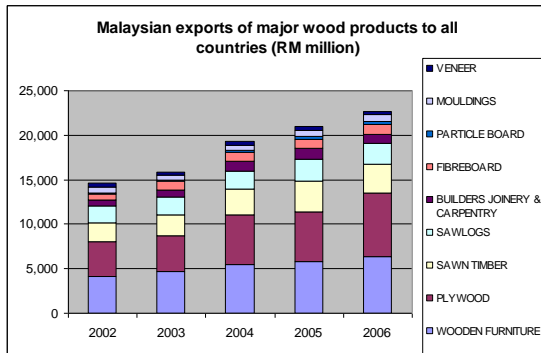
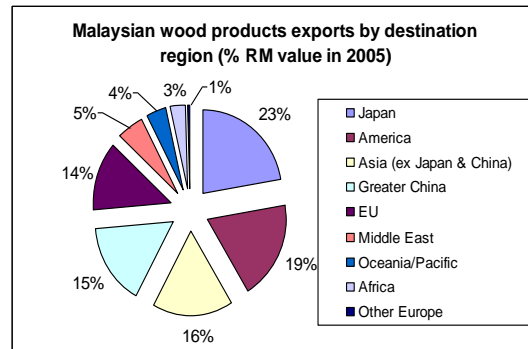


Chart 2.5



However since 2001, the value of Malaysian wood products exports has gradually improved, rising from RM 14.6 billion to around RM 23.3 billion in 2006. There has been particularly strong growth in the value of Malaysian furniture exports, partly boosted by government efforts to develop the industry, and in plywood exports. The latter trend reflects the decline in the Indonesian plywood industry as forest resources in that country have become depleted, and also moves by the Sarawak industry to reduce log exports and increase domestic production of plywood.

Chart 2.6

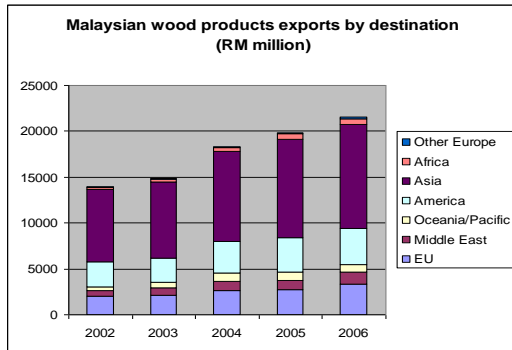


Chart 2.7

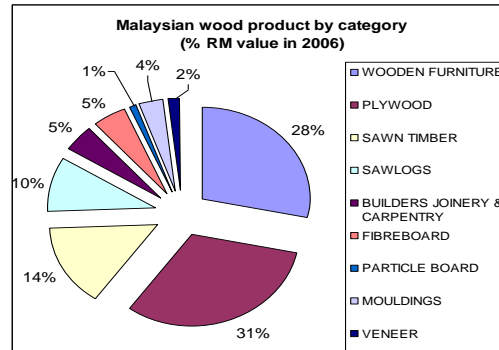


Chart 2.6 shows destination regions for Malaysian wood products. Japan and the Americas (primarily the United States) are the main markets, accounting respectively for 23% and 19% of the value of total Malaysian wood product exports. The USA is becoming increasingly important as a market for Malaysian furniture and plywood.

Altogether around 15% of the total value of Malaysian wood product exports is destined for the EU. The value of wood products exports to the EU has been rising in recent years. The European market is significant for taking a relatively wide variety of higher value wood products, including higher grade sawn lumber, plywood and furniture.

China is the key importer of Malaysian logs but also takes a range of processed products including sawnwood, plywood, fibreboard and small quantities of wood furniture.

There is also a significant export trade in wood products with other South East Asian nations, notably Thailand, Singapore, Vietnam, Indonesia and the Philippines. 16% of Malaysia’s wood exports are destined for Asian countries other than Greater China and Japan. The Middle East, notably UAE, and South Africa have been increasing in importance as markets for lower grade Malaysian sawn lumber in recent years.

Chart 2.8

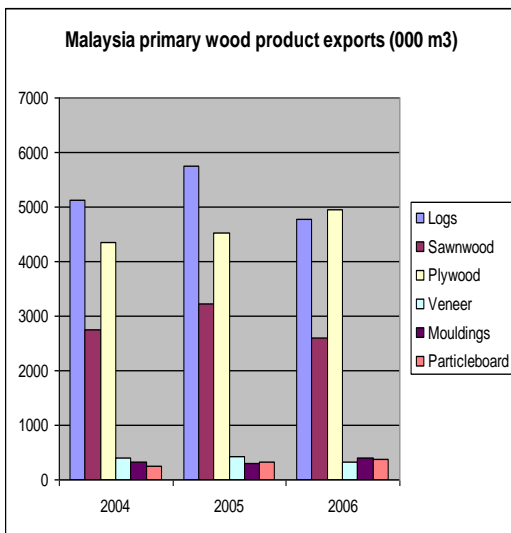


Chart 2.8 shows the value of Malaysian wood exports by product category in 2005. Plywood now makes up the largest single category (31% of total export value) followed by wood furniture (28%) and sawn lumber (14%). In 2005, logs accounted for only 10% of the total value of Malaysian wood products exports. However in volume terms, log exports are still significant, hovering around 5 million m3 during each of the last three years. Builders Joinery and Carpentry, composite panels, mouldings and veneer make up only a relatively small proportion of Malaysia’s total wood products exports.

2.8.2 Wood trade by Malaysian region

Chart 2.9

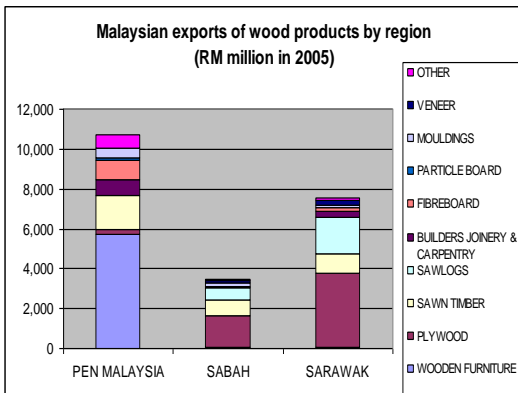
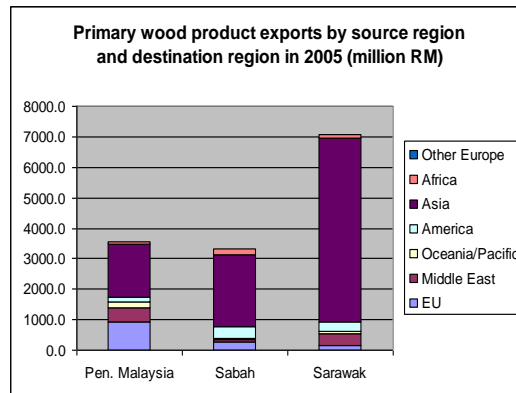


Chart 2.10



Peninsular Malaysia has moved much further than Sabah and Sarawak to develop secondary and tertiary wood processing industries. Peninsular Malaysia began restricting log exports in 1972 and imposed a complete ban in 1985. The move to value

added processing has meant that, despite relatively low levels of log harvesting, the value of exports from Peninsular Malaysia is significantly higher than that of Sarawak and Sabah. Total wood product exports from Peninsular Malaysia (including all secondary and tertiary solid wood products) stood at RM 10.7 billion in 2005 (Chart 10). This compares to RM 7.5 billion from Sarawak and 3.5 billion from Sabah.

In 2005, 53% of the total wood product export value from Peninsular Malaysia comprises wood furniture. Sawn lumber is the second largest export commodity from the region by value, making up 15%, followed by fibreboard (9%) and Builders Joinery and Carpentry (7.5%).

In volume terms, Peninsular Malaysia exported an average of 1.1 million m³ of sawn timber each year between 2002 and 2006. Fibreboard exports are also increasingly significant, hitting around 1.1 million m³ in 2006. Particleboard, moulding and plywood exports from Peninsular Malaysia are relatively less significant (each averaging around 200,000 m³ between 2002 and 2006), while veneer exports are negligible.

Peninsular Malaysia is the only region of Malaysia for which European markets account for a large share of wood product export sales. Around RM 2.2 billion (21%) of the RM 10.7 billion of timber products exported from Peninsular Malaysia was destined for the EU in 2005.

Wood product exports from Sarawak are dominated by plywood and logs, which accounted for 49% and 24% by value respectively in 2005. State policy is to progressively reduce log harvests to below 9 million m³ from current levels of around 12 million m³, to shift gradually from log exports, and to promote more downstream processing. At present, Sarawak state policy is to maintain a certain proportion of log exports to ensure that domestic market prices are not undermined, to maximise revenue and to promote efficiency in the domestic industry. Log exports are gradually declining while plywood exports are rising.

In volume terms, Sarawak exported an average of 4.3 million m³ of logs each year between 2002 and 2006. Equivalent figures for sawn timber are 1 million m³, plywood 2.8 million m³, and veneer 300,000 m³. Particleboard, fibreboard and moulding exports from the state are very limited.

The vast majority of wood product exports from Sarawak (around 86% by value in 2005) are destined for other Asian markets, notably China and Japan. Around 6% by value are destined for the Middle East, and 4% for the United States. Exports of wood products from Sarawak to the EU stood at only RM 143 million in 2005, around 2% of total exports from the state.

Availability of wood products from Sabah is generally declining. Heavy exploitation in the past has meant that Sabah now suffers from significant over-capacity in wood processing. State authorities are focused on greatly restricting log harvests, and diversifying the wood sector and other aspects of the state economy. Wood product exports are now dominated by plywood and sawn timber, which accounted for 46% and 23% respectively of the total value of exports from the state in 2005. However, Sabah has continued to export some logs which accounted for 17% of the total value of wood exports from the state in 2005. In addition, Sabah exports small volumes of mouldings and veneer.

In volume terms, Sabah exported an average of 930,000 m³ of logs each year between 2002 and 2006. Equivalent figures for sawn timber are 510,000 m³, plywood 1.2 million m³, and veneer 120,000 m³. Very small volumes of mouldings and particleboard are exported from the state, but no fibreboard.

The majority of Sabah's exports, around 71% by value, are destined for other Asian countries. Logs are destined mainly for China and Japan; plywood for Japan, South Korea and Taiwan; and sawn lumber for Thailand, Taiwan and Japan. However, around 8% of Sabah's total wood export value is destined for the EU. Most of the volume exported to Europe comprises sawnwood. In 2005, Sabah exported 123,000 m³ of sawn timber to the EU, mainly to Netherlands (49,000m³), Belgium (26,000m³) and the UK (22,000 m³). The United States is another important non-Asian market for Sabah wood products, importing 273,000 m³ of plywood from the state in 2005.

2.8.3 Wood exports by product and species

2.8.3.1 Logs

Malaysia's total log exports have hovered around 5 million m³ over the last 5 years (Chart 2.11). Exports from Sarawak amounted to 3.8 million m³ in 2006 and exports from Sabah were around 1 million m³ (Chart 2.12).

During each of the last 5 years, around 2 million of Malaysia's log exports have been destined for Greater China (comprising China, Hong Kong and Taiwan). Volumes exported via Hong Kong have generally been declining, while exports direct to the Chinese mainland have been rising. Logs sold into China are believed to be destined primarily for plywood manufacture, with smaller volumes destined for the furniture and joinery sectors. India is the second largest market for Malaysian logs, taking around 1.5 million m³ each year for the last five years, with a particular focus on keruing. Log exports to Japan have been declining in recent years, but still stood at over 1 million m³ in 2006. Log exports to Vietnam, the fourth largest market, have fluctuated between 300,000 m³ and 400,000 m³ a year since 2003.

Chart 2.11

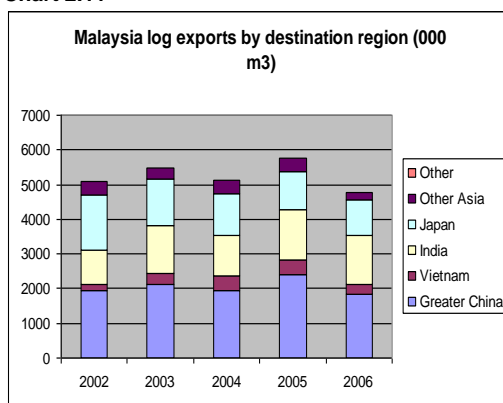
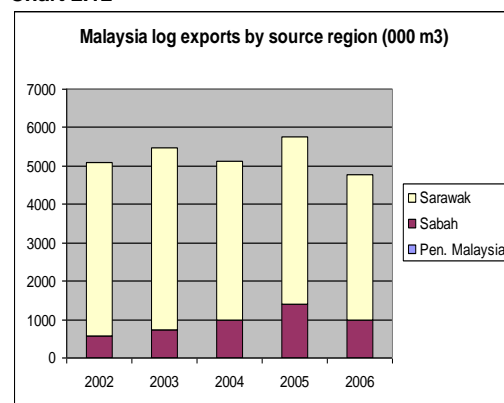


Chart 2.12



Data on species exported in log form is available only from Sarawak. Of the 3.8 million m³ of logs exported from the state in 2006: 858,000 m³ (22.8%) comprised meranti species; 927,000 m³ (24.4%) were classified as Mixed Light Hardwood (Swamp)

species; 460,000 m3 (12.1%) comprised Selangan Batu (Balau); 290,000 (7.7%) m3 comprised Kapur; 270,000 (7%) comprised Keruing; and 990,000 m3 (26%) comprised other species.

2.8.3.2 Sawn lumber

Malaysia’s sawnwood exports surged dramatically between 2003 and 2005, rising from 2.35 million m3 to 3.2 million m3 (Chart 2.13). The increase in the value of exports was even more dramatic (Chart 2.14), from RM 2.25 billion to close to RM 3.5 billion, a reflection of a significant increase in the unit prices of Malaysian sawn timber during this period.

Chart 2.13

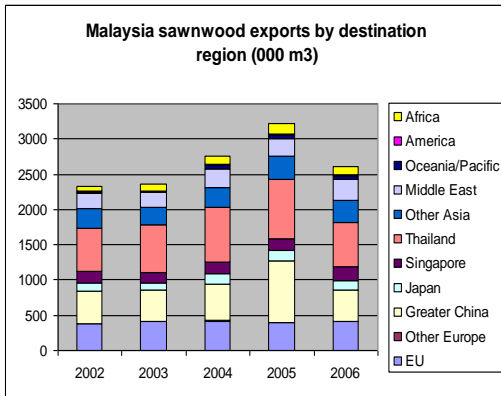
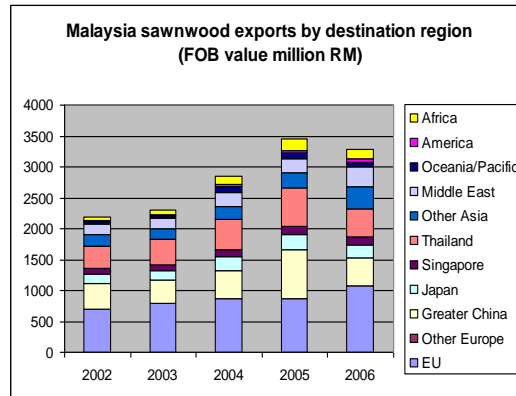
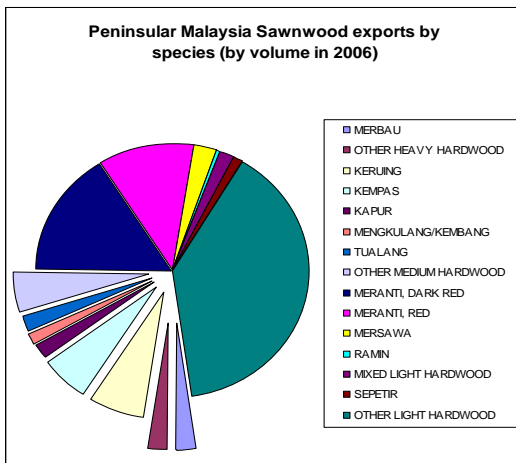


Chart 2.14



Both the increase in prices and Malaysian exports were due to strong international demand for tropical sawnwood in 2005, particularly concentrated in China, at a time of tightening supply. The volume of sawn lumber exports fell away significantly in 2006 to around 2.6 million m3, due mainly to dip in exports to China and Thailand. However, the value of exports held up reasonably well last year as demand in the European market, which tends to take higher grades and pay higher prices for Malaysian sawn lumber, showed signs of recovery after a long period of subdued demand. Last year, the EU accounted for around 16% of the export volume of Malaysian sawn lumber, but 32% of the value.

Chart 2.15



Data on sawn lumber exports by species is only available for Peninsular Malaysia (Chart 2.15). The data highlights the high number of species that are exported, with significant volumes identified under the “other” category. Generally there are an increasing number of species being utilised, partly due to declining availability of primary species and partly reflecting the greater willingness of manufacturers in emerging markets like China and Vietnam to utilise lesser known species.

Around 70% of the 1 million m³ of sawnwood exported from Peninsular Malaysia in 2006 comprised species categorised as “light hardwoods”, with dark red meranti and red meranti together accounting for around 25% (about 260,000 m³). The vast majority of Malaysian sawnwood exported to the EU consists of higher grades of dark red and red meranti which is widely used for a variety of joinery applications. Exports of ramin from Peninsular Malaysia, a swamp species which was a major export to the EU, have dwindled to negligible levels following listing of the species on CITES Appendix II and implementation of export quotas. Over 40% of Peninsular Malaysia sawnwood exports are classified as “other light hardwoods”, much of which is likely to be destined for other Asian markets. Around 20% of exports from Peninsular Malaysia are classified as “medium hardwoods”, the key species being keruing, kempas, and kapur. Only relatively small volumes of these species are now exported into the EU as sawn lumber as more logs are being diverted for plywood manufacture or to supply the Indian and Thai markets. Keruing demand in Thailand is easier to satisfy since buyers are willing to accept lower grade material.

Heavy hardwoods comprise less than 5% of Peninsular Malaysia’s sawnwood exports. Merbau is by far the most significant heavy hardwood exported, a species which is particularly popular in the flooring industry. Peninsular Malaysia exported around 20,000 m³ of merbau in 2006. Selangan Batau/Balau, another Malaysian heavy hardwood, is a very popular decking species in Europe, although volumes have been constrained by lack of availability in recent years. In 2006, Peninsular Malaysia exported only 7,500 m³ of the species as sawn lumber.

2.8.3.3 Mouldings

Chart 2.16

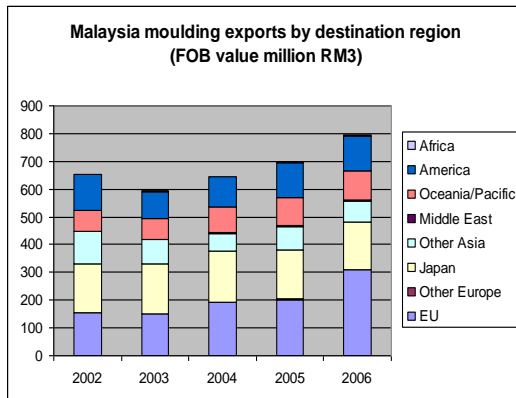
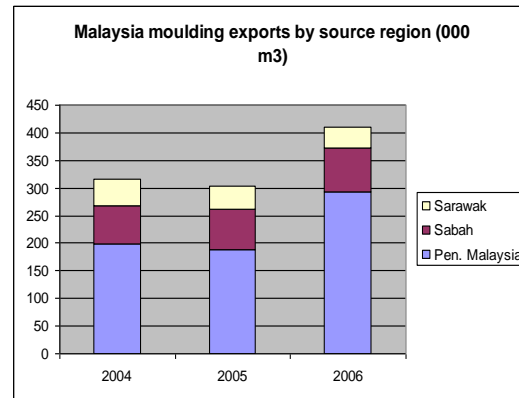


Chart 2.17



Mouldings are an increasingly important part of Malaysian wood export trade, with values rising sharply from around RM 600 million in 2003 to RM 800 million last year (Chart 2.16). Nearly all of the recent export growth was concentrated in the EU which now accounts for 38% of total export value. Other key markets are the United States, Japan and Australia. Moulding exports derive mainly from Peninsular Malaysia which accounted for 300,000 m³ of the total 400,000 m³ exported in 2006 (Chart 2.17).

2.8.3.4 Veneer

Chart 2.18

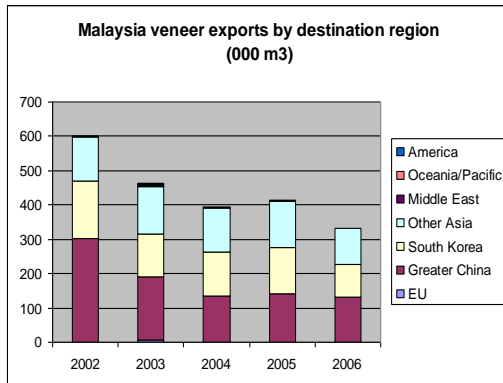
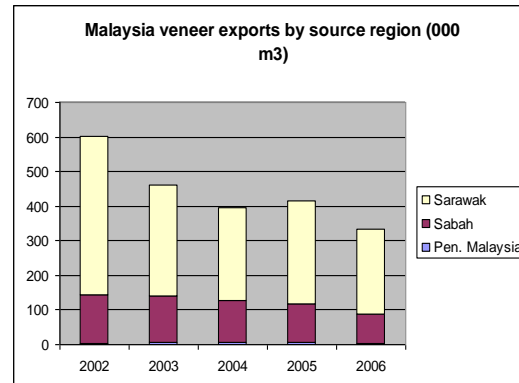


Chart 2.19



Malaysia’s exports of veneers have fallen dramatically over the last five years, from around 600,000 m3 in 2002 to around 325,000 m3 in 2006 (Chart 2.18). Exports are derived almost exclusively from Sabah and Sarawak and are negligible from Peninsular Malaysia (Chart 2.19). Greater China (China, Hong Kong and Taiwan) and South Korea are the leading export markets, together accounting for around two thirds of export volume. All the remaining exports are destined for other Asian markets.

As logs have become less readily available in Sarawak and Sabah, a larger proportion of rotary veneers are being diverted to domestic plywood production. There has also been an effort by Malaysian industry to reduce exports of rotary veneer to the Chinese plywood sector which is seen as an important competitor in the market for finished plywood products.

2.8.3.5 Plywood

Chart 2.20

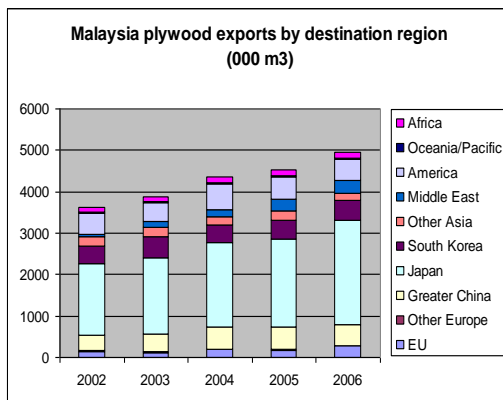
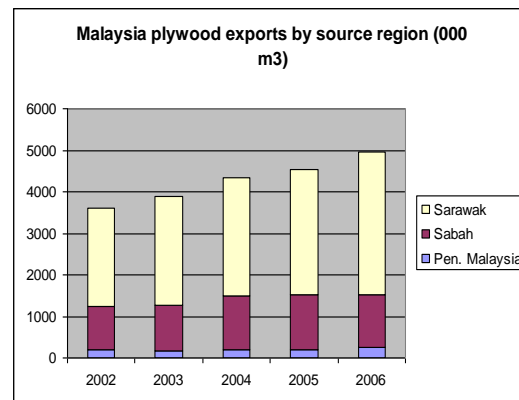


Chart 2.21



Malaysia’s plywood exports have been rising steeply over the last 5 years, from around 3.6 million m3 in 2002 to 5.0 million m3 in 2006 (Chart 2.20). Efforts to add value to wood raw material before export have meant that more logs and veneer are being diverted to plywood production. Malaysia’s market share in export market has also been rising steeply as supply problems have mounted in Indonesia and Brazil, two leading competitors in international tropical hardwood markets. Japan is by far the dominant

market, accounting for 2.5 million m³ of Malaysia's plywood exports in 2006, followed by Greater China (512,000 m³), South Korea (480,000 m³), and the United States (450,000 m³). The EU imported 271,000 m³ of Malaysian plywood in 2006, up from 152,000 m³ in 2002.

Plywood exports from Sarawak have risen particularly steeply over the last 5 years, from around 2.3 million m³ in 2002 to 3.4 million m³ in 2006 (Chart 2.21). Much of the remaining plywood export derives from Sabah, which accounted for around 1.3 million m³ in 2006. Exports from Peninsular Malaysia have averaged around 200,000 m³ over the last 5 years, with the vast majority of this (150,000 m³ in 2006) destined for the UK market.

2.8.3.6 Composite panel products

Chart 2.22

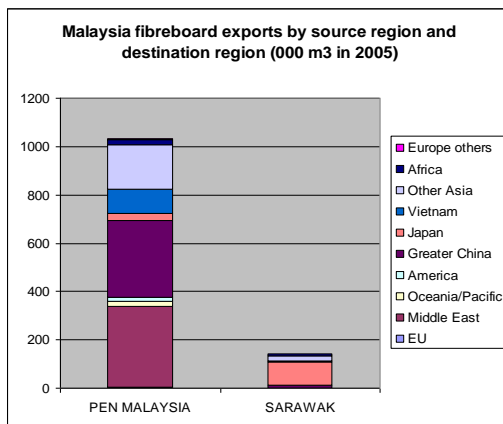
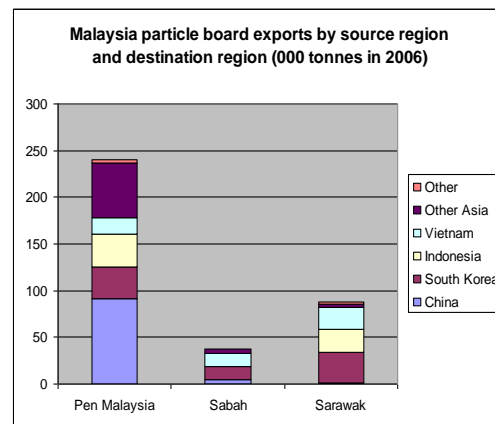


Chart 2.23



Malaysia's exports of composite panel products have been rising rapidly in recent years (Chart 2.22). Fibreboard exports increased from RM 619 million in 2002 to RM 1.15 billion in 2006. Particleboard exports rose from RM 115.8 million to RM 267.1 million during the same period. The vast majority of composite panel products exports derive from Peninsular Malaysia (Chart 2.23) and are destined for regional Asian markets where they are used for furniture manufacturing and interior joinery. Imports into the EU, which has a large domestic composite panel industry, are negligible.

2.8.3.7 BJC

Malaysia's exports of Builders Joinery and Carpentry (BJC) rose strongly between 2002 and 2005, from RM745 million to RM1162 million, before declining again to RM1026 million in 2006 (Chart 2.24). Major growth markets between 2002 and 2005 were the United States, Japan and the EU. Detailed data for destination regions in North America and Asia in 2006 was not available for this review. However the decline in BJC exports in that year is most likely related to the downturn in the US housing market. The available data indicates that exports to the EU held up between 2005 and 2006.

Chart 2.24

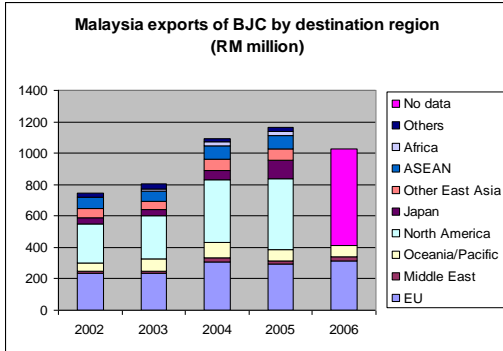
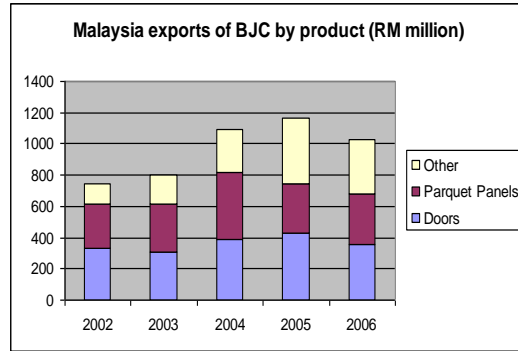


Chart 2.25



Malaysia’s BJC exports are dominated by doors (37% by value in 2005) and parquet panels (27% by value). The majority of the remaining 36% are classified in the customs statistics as “other BJC” (Chart 2.27).

Chart 2.26

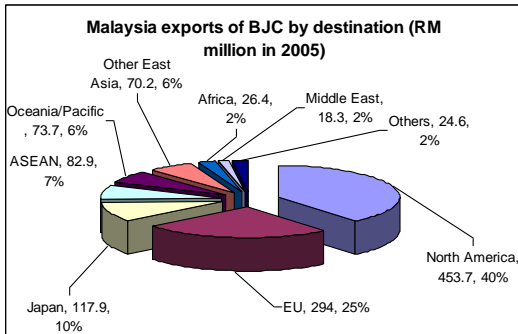
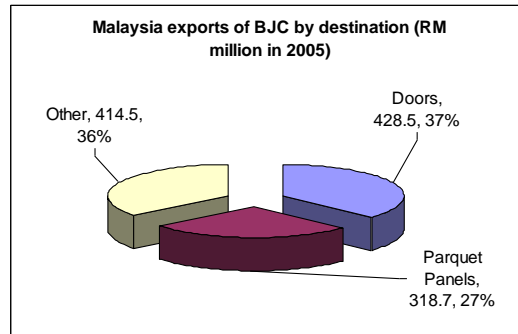


Chart 2.27



2.8.3.8 Wood furniture

Malaysia is the tenth largest furniture exporting country in the world, and the third largest exporting country in Asia after China and Vietnam. Due to their growing ability to supply large volumes of furniture at relatively low prices, these latter two countries are Malaysia’s major competitors in key export markets. Over the period 2001-2006, the value of Malaysia’s furniture exports rose by 10% annually (Chart 2.28). The vast majority of Malaysia’s furniture exports derive from Peninsular Malaysia.

The United States is Malaysia’s largest export market for wood furniture, accounting for RM 2.2 billion of the total RM 6.4 billion exported in 2006 (Chart 2.29). The EU collectively was the second largest market, accounting for RM 1.1 billion of exports in 2006, nearly half of which were destined for the UK. Other key markets are Japan (RM 574 million in 2006) and Australia (521 million).

Chart 2.28

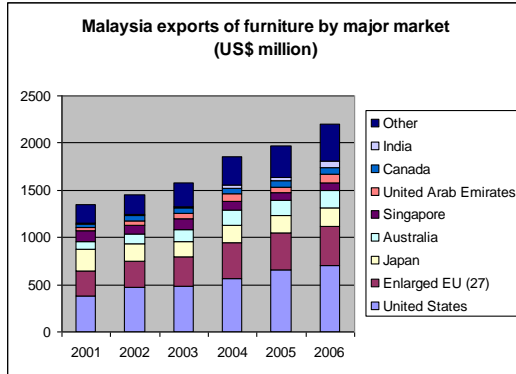


Chart 2.29

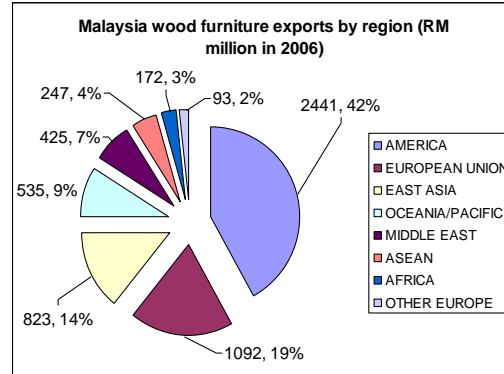
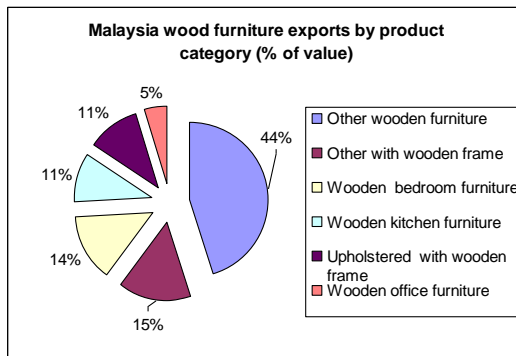


Chart 2.30



Malaysia exports a wide variety of furniture products (Chart 2.30). According to a recent report by CSIL, the Italy-based furniture industry research organisation, “*Malaysian furniture supply is very comprehensive and diversified in every segment, a factor that gives it a strong competitive edge on international markets*”. 44% of the value of Malaysian wood furniture exports is in the “other” category.

The next largest segment, contributing 15% of exports in 2006, is “other furniture with a wooden frame” which includes un-upholstered seating, both for internal and external use. Wooden bedroom furniture and kitchen furniture each contribute around 11% to the export value. Office furniture is relatively insignificant, accounting for only 5% of wood furniture export value.

2.9 Malaysia’s market position in the EU

Europe takes a diverse range of mostly high value products that generate high returns for the Malaysian economy. The EU has been an expanding market for Malaysian wood products in recent years. With sluggish economic growth in Japan and USA heightening the need to diversify markets, the EU is likely to remain an important market for Malaysian exporters in the long term. However, while the EU is a significant export market for Peninsular Malaysia, to date the EU has not been an important export market for Sabah and Sarawak.

In line with overall growth in Malaysia’s wood product exports, those to the EU have risen significantly from just under RM 2 billion in 2002 to around RM 3.3 billion in 2006 (Chart 2.31). The increase reflects a number of factors including: improving economic conditions in parts of Europe; inward investment in Malaysia’s furniture, joinery and plywood manufacturing sectors; a general trend in Europe towards increased sourcing of furniture and joinery products from the Far East; a decline in the ability of certain

competing countries to supply products into the EU market (for example Indonesian plywood, Brazilian sawn lumber); the comparative strength of European currencies against the dollar and Asian currencies; and an improved environmental profile for Malaysia resulting from the development of the MTCC scheme.

Chart 2.31

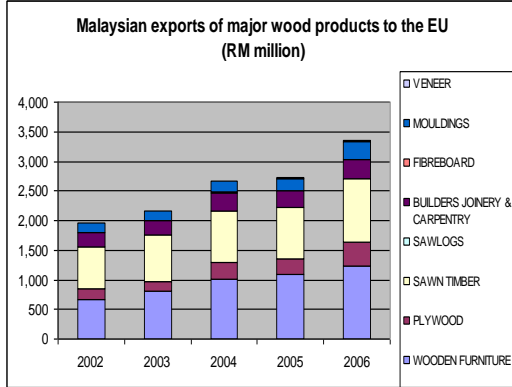
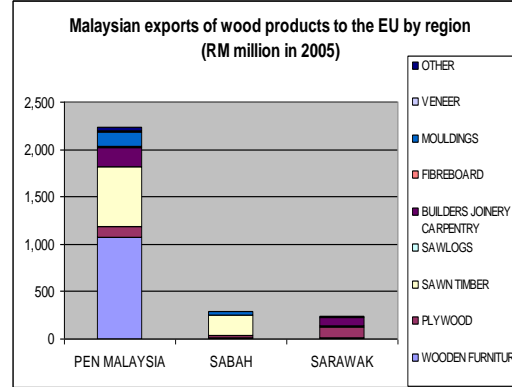
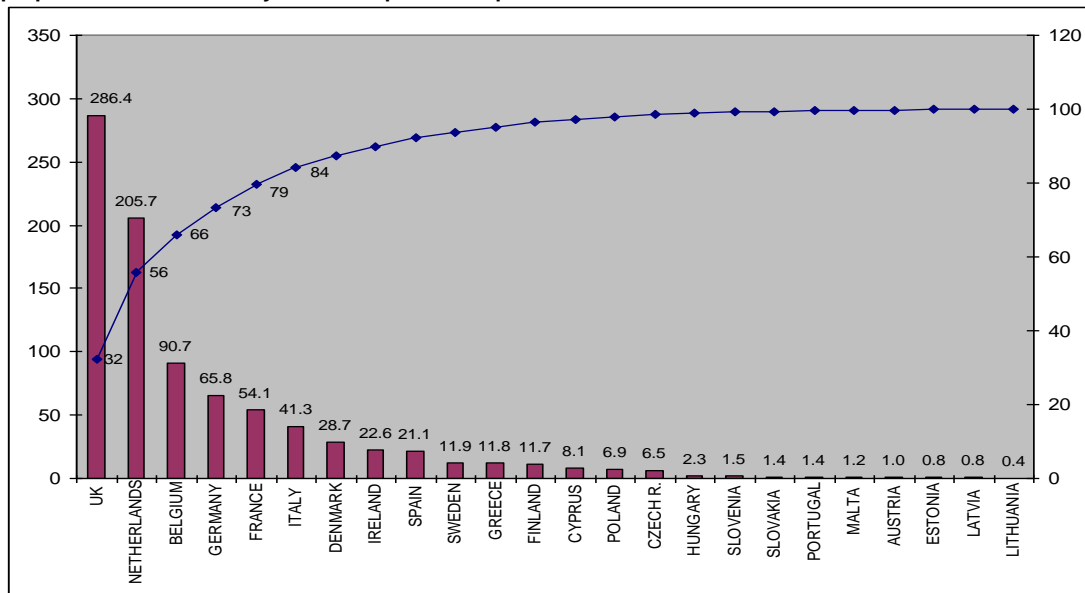


Chart 2.32



During 2006, EU imports of Malaysian wood products comprised: RM 1.2 billion of wood furniture (36%); RM 1.1 billion of sawnwood (33%); RM 414 million of plywood (13%); RM 312 million of Builders Joinery and Carpentry (9%); RM 309 million of mouldings (9%); RM 7 million of fibreboard (negligible %); and RM 5 million of veneer (negligible %). Over the last five years, there has been particularly strong growth in European imports of Malaysian wood furniture, plywood and mouldings. European imports of sawn timber have grown more slowly over the last 5 years, partly owing to tight supplies, although improvements in the Dutch and German economies added extra impetus to the trade between 2005 and 2006.

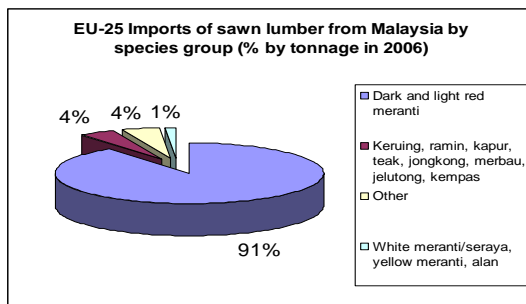
Chart 2.33: Value of Malaysian wood products imports by EU-25 country in 2006 (000 euros) and cumulative % proportion of overall Malaysian wood product imports



Of the total RM 2.77 billion of wood products that Malaysia exported to the EU in 2005, 2.24 billion (81%) derived from Peninsular Malaysia, 0.29 (10%) derived from Sabah and 0.24 (9%) derived from Sarawak (Chart 33). Peninsular Malaysia was the source of 98% of the wood furniture value supplied to the EU, 73% of the sawnwood value, 77% of the moulding value, 69% of the BJC, and 45% of the plywood value. Sabah accounted for 24% of the sawn timber value, 16% of the moulding value, and a negligible proportion of all products. Sarawak accounted for 46% of the plywood value, 28 % of the BJC value, and a negligible proportion of all other products.

Chart 2.33 illustrates the value of Malaysian wood products imports by EU-25 country in 2006 together with the cumulative % proportion of overall Malaysian wood product imports. The main markets in the region are the UK (€286 million), Netherlands (€206 million), Belgium (€91 million), Germany (€66 million), France (€54 million) and Italy (€41 million). Demand is heavily concentrated, with the UK alone accounting for 32% of Malaysian wood product imports into the region, and well over half (56%) destined for either the UK or the Netherlands. Together the top 6 markets account for 84% of total EU-25 imports of Malaysian wood products in 2006. These markets are explored in more detail in the country reports contained in Annex 1.

Chart 2.34



Species data is only available for sawnwood imports into the EU-25. This shows that the European trade in Malaysian sawnwood is dominated by dark and light red meranti which together account for 91% of import tonnage (Chart 2.34). White and yellow meranti account for 1%. Trade data for other individual Malaysian species is not provided by Eurostat. However market

reports indicate that other major species traded in Europe include red balau/selangan batu (notably for decking), merbau (for flooring), keruing and kapur (for heavy duty applications such as truck floors), ramin (for mouldings), and nyatoh (for joinery and furniture).

3 EU Policy Developments

3.1 Overview

This section describes public and private sector and civil society initiatives in the EU with potential to influence demand for FLEGT VPA licensed timber, for example by encouraging European timber buyers to prefer legally verified timber over unverified timber. It summarises and provides an overview of public and private sector procurement policies which are described in more detail in the European national reports contained in Annex 1. It also reports the results of interviews with the private sector and ENGOs to assess attitudes to the current and potential marketing value of FLEGT VPA licenses from Malaysia.

3.2 Public sector initiatives

3.2.1 EU Communication on Green Public Procurement

The promotion of more widespread adoption of green public procurement has been a EU priority in recent years. General provision for inclusion of both environmental and social criteria was made in the EU directives on public procurement when they were last revised in 2004⁶, although no formal arrangements for their treatment were made at that time. Also in 2004, Green Public Procurement (GPP) was established as a priority action in the Environmental Technologies Action Plan for the EU.

In June 2006, the EU Council formally recognised the potential of GPP for achieving its sustainability goals. A renewed Sustainable Development Strategy was published which set a target for EU-wide implementation of green procurement. This target states that by the year 2010, the average level of GPP in the EU should be at the level of the best-performing Member States at the June 2006 reference date. Therefore, with regard to timber, the policy implies that by 2010 all Member States should have implemented GPP comparable to the current procurement policies of “first-movers” on this issue, which include the UK, Belgium, and France.

In line with the strategy EU member states have been encouraged to develop national action plans for GPP. 10 Member States have so far implemented national action plans for GPP, 7 have a draft plan, and the EC is working on development of such a plan with another 5 EU members.

As a priority action in 2007, the European Commission (EC) launched a new initiative on GPP designed to provide Member States with the necessary tools to raise the quantity and quality of GPP in the EU. An outcome of this initiative will be an EU Communication on Green Public Procurement.

Contacts with EC DG Environment indicate that the Communication is expected to be published in July 2008. The Communication will aim to promote legal compliance as an underlying baseline for GPP, respect of internal market principles and continuous improvement of the environmental performance of products and services.

⁶ Directive 2004/18/EC of 31/03/2004, official Journal of the EC, series L, N° 134, of 30/04/2004

To ensure EU members effectively implement GPP, the Communication is expected to describe mechanisms by which the EC will monitor both the quantity and the quality of green procurement. Monitoring quantity of GPP is likely to be achieved by counting the value and/or number of 'green' contracts compared to the overall value/number of public procurement. To measure the quality of green procurement, the Communication is expected to refine GPP definitions and to identify clear criteria defining environmentally friendly product groups, and to provide legal guidance for the tendering process and specification clauses.

The Communication is expected to identify timber products as one of 10 priority products and services for more detailed consideration in GPP. In the short-term, the Communication is not expected to lead to a single system or set of GPP criteria for forest products applicable to all Member States. A common approach is complicated by the diversity of forest resources and trade patterns of the various EU member states.

Instead the Communication is expected to contain guidance on appropriate public sector specification clauses for timber products and to clarify the extent to which requirements for "legal" and "sustainable" timber may be included in government procurement. The communication is planned to include sample specification clauses establishing legality of timber as a condition of contract, but providing tenders with the option of offering sustainable timber as a variant. FLEGT VPA licenses are expected to be referenced in the draft communication as an example of an appropriate form of legality verification alongside other approaches.

The Communication will set out recommendations that may be voluntarily adopted by member states. Meanwhile, the European Commission is also now in the early stages of a cost/benefit analysis to assess the potential for mandatory measures on GPP. However this is expected to be a long and complicated process.

3.2.2 Overview of national level public sector procurement policies

Through interviews with public procurement officials and analysis of secondary sources, this study has assessed the current scope of public sector timber procurement policies in the 6 leading markets for Malaysian timber in the EU (UK, Netherlands, Belgium, Germany, France and Italy). A summary of this review is contained in Table 3.1 and full details of each country's procurement policy are contained in Annex 1. With respect to level of acceptance of FLEGT VPA licenses and MTCC certification, the following broad conclusions may be drawn from this analysis:

- Central government procurement policies have been prepared in five of the six European countries, the only exception being Italy.
- The timber procurement policy is mandatory for central government agencies in all 5 countries that have adopted such a policy.
- Local government agencies are encouraged to voluntarily adopt the policy in all five countries. In each country national government is actively engaged in providing guidance to local authorities. However only the Netherlands has a system for monitoring of actual implementation of these policies at local authority level.

Table 3.1: Summary of central government procurement policies in major EU markets

	Belgium	France	Germany	Netherlands	UK
Federal/central government	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory
Local authorities	Guidance	Guidance and active promotion	Guidance and promotion (2 states adopted)	Guidance and promotion - national monitoring	Guidance and active promotion
Coverage of public sector	Fed. Gov limited, states more significant. Overall 5-10%	All public sector, up to 25%	Fed. Gov. around 5%, states more significant	NA	All public sector, in the region 8%-15%
Current requirement	Sustainable	Legal and sustainable	Sustainable	Legal minimum, sustainable preferred	Legal minimum, sustainable preferred
Evidence accepted	FSC, some PEFC	Flexible and inclusive, no hierarchy of evidence	FSC, PEFC, other systems assessed as equivalent	Legal: as UK Sustainable: being defined	Legal: various, must conform to criteria Sustainable: FSC, CSA, PEFC, SFI, other systems assessed as equivalent
Anticipated changes	-----	2008 policy change to increase certification focus	Review 2010/2011	Sustainable to become minimum requirement in 2010	Minimum requirement: 2009-2015: sustainable or FLEGT VPA After 2015: sustainable only
FLEGT VPA recognition	None at present	French gov. currently accepts & indicates it will accept after policy change, but no formal guidance yet	None at present	Currently accepts as legal. Future guidance under development	Currently accepts as legal. Accepted 2009-2015 when no certified wood. Not accepted after 2015.
MTCC recognition	None at present	Currently accepted as legal and sustainable	None at present	Legal only. Should be subject to review	Legal only. Review scheduled May 2008
Monitoring	None	Review planned 2008	None but impact to be assessed 2010/2011	National monitoring program	Surveys of implementation - reveal major inconsistencies between departments & agencies

- Although accurate data is not available on the share of overall timber procurement destined for the public sector, the indications are that this sector only accounts for a small minority of the overall market even when local

authorities are included. This places a significant limit on the overall market impact of these policies.

- Policies established by the Belgian and German governments set a minimum requirement for timber to be sustainable. FLEGT VPA licenses in isolation do not therefore provide a sufficient level of assurance for compliance with either policy. Neither does either country accept MTCC certification as sustainable.
- The UK and Dutch policies establish verified legal as a minimum and accept FLEGT VPA licenses as evidence. MTCC certified timber is also accepted as evidence of legal timber by each country.
- The French policy is currently ambiguous with respect to likely level of acceptance of FLEGT VPA licenses. The minimum requirement is that timber must be from a “legal and sustainable source”, but there is no clear hierarchy of evidence separating “legal” from “sustainable” timber. A “legality license” is referenced as one possible form of alternative evidence to independent certification that wood is “legal and sustainable”. MTCC would be acceptable as “legal and sustainable” timber under current guidance.
- Although all policies – with the exception of the Belgian policies – allow for alternative forms of evidence, the surest mechanism for demonstrating that wood is verified sustainable is independent certification. FSC is explicitly recognised as evidence of sustainability in Belgium, Germany and the UK. PEFC is regarded as delivering an equivalent level of assurance in Germany and the UK. Belgium does not give a blanket endorsement to PEFC, but instead assesses national PEFC systems individually. The Netherlands has yet to finalise a set of criteria for assessing sustainability, but current indications are that this will lean heavily towards independent certification.
- Major changes in these various central government procurement policies are anticipated in the near future that will have a significant bearing on the level of acceptance of both FLEGT VPA licenses and MTCC certification.
 - Following a major public consultation exercise during 2007, the French government has stated that it intends to tighten requirements for public sector procurement to place a stronger focus on forest certification. However, they have also indicated informally that they will continue to accept FLEGT VPA as sufficient evidence of conformance after the policy change. At this stage it is not clear when the changes will be implemented or how FLEGT VPA licenses will be treated in relation to forest certification (whether they will be viewed as equivalent to forest certification or only preferred in the absence of suitably certified wood products).
 - The German policy will be subject to review in 2010 or 2011.
 - The Netherlands government has already made a commitment to requiring that all timber is “sustainable” from 2010. The guidance on acceptable evidence for sustainability is currently being developed and no final decision has yet been taken on the acceptability of FLEGT VPA licenses or MTCC certification after that date.

- The UK government has stated that from April 2009 until April 2015, all wood must be from a verified sustainable source or, if this is not available, a FLEGT VPA licensed source. After April 2015, all wood must be from a verified sustainable source. Detailed guidance on appropriate forms of evidence for sustainability is currently being developed. UK government is also currently reviewing its assessment of MTCC certification which might allow for its acceptance as evidence of sustainable timber.
- The level of monitoring by central governments to ensure effective implementation of timber procurement policies varies considerably. To date, the Belgian, French and German governments have not implemented any comprehensive systems of monitoring, although both the French and German governments indicate that reviews of policy implementation are planned in the future. The Netherlands already has in place a system for monitoring of sustainable procurement practices which will accommodate timber procurement. To date, the UK government has probably gone further than the others to survey levels of implementation by central government departments. These surveys have revealed that application of the policy is inconsistent between departments and agencies, few of which have developed effective systems to enforce or monitor policy implementation. Furthermore, contrary to current guidance, a significant proportion of central government agencies are already insisting that all wood products supplied must be certified sustainable. Awareness of central government policy also remains very low at local authority level.

Overall this assessment indicates that to date public sector procurement policies are a relatively weak lever with which to influence procurement behaviour in EU member states. These policies impact directly on only a small proportion of the overall timber trade and their effectiveness is undermined by inconsistent application between and within EU member states.

Furthermore, these policies do not currently offer any significant incentive for countries to supply FLEGT VPA licensed timber. Only the UK policy at present includes an explicit reference to such timber meeting the requirements of the policy. Although other national governments have stated informally that FLEGT VPA licensed timber might be recognised in future, this is not yet reflected in formal policy guidance.

These conclusions are broadly in line with those of the WWF Barometer survey which is undertaken annually to assess how actions in support of the EU FLEGT Action Plan are being progressed by EU Member States. The most recently available survey published in May 2007 concludes, with respect to a question on the effectiveness of government timber procurement policy, that *“Austria is the only country to receive full points for this question, for the comprehensive and far-reaching nature of its public timber procurement policy. A number of other countries have a policy in place, but in each case the policy fails to achieve the maximum effect due to one or more weaknesses in its implementation. In particular, countries are urged to ensure that their public procurement policies apply bindingly to all levels of government, and include all the necessary aspects of legality and sustainability....A depressingly large number of countries has yet to institute any such policy; however a number of countries have indicated that work is underway towards development of such a policy.”*

With respect to demonstrating implementation of a public sector procurement policy, WWF conclude: *“Of the 10 countries with a public procurement policy in place, only Denmark is able to demonstrate that a number of projects have adhered to the national procurement policy. None of the other countries have been able to prove that the policy is making any difference to purchasing patterns, although work is currently underway in a Belgium, France and the UK to institute a means of assessing this.”*

It has to be acknowledged that for many governments the process of developing and implementing pragmatic timber procurement policies is still in its infancy. The process is complicated by the need to accommodate the often polarised views of national stakeholders, and the technical challenges of developing purchasing criteria capable of accommodating the huge diversity of forestry situations in supply countries while also meeting EU and WTO procurement rules.

There are also efforts being made to overcome some of the failings of these policies. For example, the governments of the Netherlands, UK and Denmark are working together in an effort to overcome the problem of lack of consistency between national procurement policies. Following a meeting in The Hague, Netherlands, between Government representatives from UK, the Netherlands and Denmark in the last quarter of 2007, it was agreed to develop a common framework for policies. The UK government’s Central Point of Expertise on Timber (CPET) was commissioned to conduct an initial comparison of the three country’s criteria with the goal of harmonising the language on those criteria deemed to be the same. The intent is that this common framework will then be presented to other European member states as a basis for their own policies.

It should also be noted that the influence of government procurement policies can extend well beyond the direct impact on immediate suppliers. As noted by FII Ltd in 2007, based on an analysis of the UK government policy, *“the policy has greatly increased the sensitivity of larger importers, merchants and manufacturers to negative publicity....by doing so it has provided an important additional incentive for these companies to implement far-reaching corporate commitments to sourcing verified wood products....Furthermore the private sector now looks to government to set the standard for credible legality verification and certification in the UK.”*

Nevertheless, given the technical and political challenges involved, the shortcomings in implementation, and the relatively limited extent of public sector involvement in timber procurement, it is unlikely that these policies working in isolation can act as an effective deterrent to trade in illegal wood products or provide a significant market advantage to FLEGT VPA licensed timber.

3.2.3 Additional legislative options

The short-comings of public sector procurement policy and voluntary industry mechanisms have led to recent interest in a legislative approach. The European Commission is due to release a Communication on the subject in July 2008 setting out recommendations for additional legislation to prevent imports of illegal wood products.

The Communication will be the culmination of 18 months of intensive discussions and consultations on various additional legislative options beginning with an on-line public consultation between December 2006 and March 2007. This first consultation sought views on five options:

- Expanded coverage of the bilateral approach through FLEGT Voluntary Partnership Agreements (VPAs) between the EU and timber exporting countries
- Private sector measures including industry codes of conduct and tracking systems
- An import ban on illegally harvested timber. Evidence of legality would have to be provided at point of import.
- Legislation which prohibits the trading and possession of timber and timber products harvested in breach of the laws of the country of origin (an approach similar to the Lacey Act in the United States). The burden of proof lies with the interest claiming that imported products are illegal. Goods are considered legal unless proven otherwise. Disputed cases would be tried in European courts of law. There would be no obligation on the importer to develop tracking and verification systems but in a high risk situation, the importer may wish to protect itself against unwarranted claims by developing tracking and other verification systems. In regions where the risk of illegal logging is low, such systems may not be necessary.
- Legislation which requires that only legally harvested timber and timber products be placed on the market. This option would require importers to provide evidence of the legality of forest harvesting at point of origin. The burden of proof would be placed on the importer who has to prove that goods are legal. Goods are considered illegal unless shown to be otherwise. Being unable to do so would constitute an offence punishable under European laws.

The results of this consultation were published on the “Your Voice in Europe” website in summer 2007⁷. The results were also fed into an EC-commissioned study by the consultancy firm Savcor Indufor Oy to assess the impact within and outside the EU of the various legislative options put forward in the Public Consultation. As part of the impact assessment study, further stakeholder consultations were held at a series of national workshops inside and outside the EU. The data derived from a questionnaire issued to stakeholders at these workshops has been made available at the Indufor website⁸. This study formed the basis for the Commission’s Impact Assessment Report which will be taken into consideration by EU decision makers in political discussions on how to take the process forward.

An indication of the level of apparent support within the EU for the various options can be derived from a combination of: analysis of EC’s report on public consultation; data from the Indufor workshops; and the results of interviews conducted for the current study with trade association representatives, ENGOs and government officials. The situation can be summarised as follows:

- There seems to be strong support from all interests – government, private sector and civil society – for not only continuing implementation of the VPA process, but also for it’s expansion to include a wider range of products and for the development of tighter procedures to prevent circumvention.

⁷ <http://ec.europa.eu/environment/forests/pdf/addloptionssynthfinal.pdf>

⁸ http://www.indufor.fi/flegt/Stakeholder_report.pdf

- There seems to be general agreement amongst all interests that private sector initiatives are a useful but insufficient measure to prevent illegal wood imports. Private sector initiatives should be developed in combination with other initiatives.
- There seems to be strong support from ENGOs and some minor support from private sector interests and government for an import ban on illegally harvested timber. However this option also drew significant concerns, particularly from government officials, over the technical challenges of implementation and potential WTO implications.
- There seems to be some moderate support from private sector interests for legislation that would prevent the marketing of illegal timber in the EU and place the burden of proof on the interest claiming that wood is illegal. However there seems to be little or no support for this option amongst ENGOs who argue that establishing a chain of evidence and bringing prosecutions under such an act would be difficult. Some government officials also express concern over the practicalities of introducing such a law in the EU. It would require EU courts to make “extra-territorial” judgements on the laws of other countries, something which they are only rarely willing to do. Another legal objection is that bringing prosecutions under a Lacey-style act would require a much higher degree of co-operation on legal matters than currently exists with many exporting countries. EU formal cooperation on legal matters with other countries is often limited, particularly with governments that still use capital punishment.
- There seems to be strong support from ENGOs for legislation requiring that only legally harvested timber be put on the market placing the burden of proof on the supplier. However this approach has been challenged by the private sector and some government officials on grounds that: it would represent a reversal of the burden of proof - all wood would be assumed to be illegal unless proven otherwise; and such a measure would be disproportionate to the scale of the problem - all suppliers, even in low risk countries, would have to prove legality in order to capture the relatively low volume of wood that might be illegal.

In short, while there is a groundswell of support for additional legislation, it has proved extremely difficult to reach a consensus view within the EU on the details of this legislation. There seem also to be significant legal obstacles associated with introduction of all legislative options originally proposed by the European Commission.

There is still no clear information on what the EC Communication will actually recommend. Informal discussions with EC officials suggest that there is now little prospect of introducing any of the legislative options originally proposed. Instead, the EC is considering recommending that a legal requirement for “due diligence” is imposed on importers and distributors. The legal and technical issues associated with development and implementation of such a law are likely to be challenging. For example how is “due diligence” to be defined, which EU companies should be subject to the due diligence requirement, and how will compliance be monitored and enforced?

On the other hand, timber trade associations in the EU are already engaged in a process to develop risk assessment procedures, environmental timber procurement policies and

codes of conduct which might provide a foundation for evolution of a regulatory framework. Such a law would avoid the problems associated with establishing a chain of evidence linking a particular piece of timber with an illegal forestry operation overseas. By requiring companies to implement procurement systems and procedures, the full power of the private sector could be brought to bear in developing demand for verified legal timber and preventing market access for illegal wood products. If structured appropriately and backed by effective procedures for enforcement, such a regulation could provide a significant boost for FLEGT VPA licensed products.

3.2.4 EU legislation requiring criminal sanctions for environmental damage

In May 2008, the European Parliament reached an agreement with EU member states on legislation that will force national governments to apply criminal sanctions to those causing deliberate or negligent damage to the environment. The agreed directive makes clear that criminal sanctions can only be requested in case of "*substantial damage*", death or serious injury and limited to areas where the EU has competence, leaving national legislation intact in other areas.

According to the agreed text, the list of punishable crimes will include: "*the killing, destruction, possession and trading of specimens of protected fauna or flora species, except when it concerns negligible quantities with little or no impact on the specimen's conservation status*". Any inciting or aiding and abetting of such conduct will equally be considered a criminal offence. Member states will have two years to transpose the Directive on criminalising environmental damage.

This legislation would probably lead to tougher sanctions in certain EU countries for illegal harvesting and illicit trade in endangered species listed in CITES or identified in EU legislation. If additional legislation were introduced in the EU to control imports of illegal wood – whether modelled on Lacey or establishing direct obligation on EU operators for "due diligence" as currently proposed - this legislation would probably have the effect of ensuring tough sanctions for infractions.

3.2.5 EU Ecolabel

Although EU Eco-labelling criteria have been developed for a range of paper products, no equivalent criteria have yet been finalised for any solid timber product. However, after years of debate a set of criteria for EU Eco-labelling of wood furniture now seem to be close to completion. The criteria were due to be finalised by the end of 2007 for consideration by the Ecolabelling Board in early 2008.

The new label is designed for wooden domestic, contract or outdoor furniture containing at least 90% wood or wood-based materials calculated by weight, with no non-wood material to exceed 3% of the product's total weight. This last restriction effectively excludes upholstered furniture, metal and plastic office furniture, and kitchen cabinets.

Drawing on previous experience, a representative of the UK's Furniture Industry Research Association suggests that uptake of the Eco-label, which is voluntary, may be limited. He notes that only 2 or 3 manufacturers throughout the whole of Europe have decided to promote an eco-label for mattresses. According to FIRA, the current level of market interest may well be insufficient to justify the extra costs for most manufacturers.

On the other hand, the Eco-label may well be seen as a useful tool for implementation of emerging green public procurement policies in the EU. If so, interest may rise in that part of the furniture industry selling product into the public sector – mainly mass produced office furniture and some kitchen furniture for the social housing sector.

With respect to timber origin, the draft criteria require that all virgin solid wood from forests must originate from forests managed in accordance with inter-governmental sustainable forestry principles (including Pan European, Montreal, ITTO). In addition, at least 70% of solid wood, and 40% of wood-based materials, must come from independently certified forests.

The draft criteria for allowable evidence are phrased such that they should allow for recognition of a variety of certification programs. The criteria state that “*certification standards must be compatible with SFM as defined through inter-governmental processes and certification systems must fulfil the criteria listed in paragraph 15 of the Council Resolution of 15 December 1998 on a Forestry Strategy for the EU*”. This latter document requires that forest certification schemes be “comparable” and that performance indicators be compatible with “*internationally agreed principles of sustainable forest management*”. It also requires that certification schemes involve independent auditing of forestry practices and are voluntary, credible, transparent, cost efficient, openly accessible and non-discriminatory.

However, the criteria for the uncertified portion of the eco-labelled product lean more towards FSC, mirroring the requirements of the Controlled Wood standard. They require that any uncertified timber used should not derive from illegal harvesting, GM trees, or high conservation value forests. This would be verified through provision of “*appropriate declarations, charter, code of conduct or statement*”.

There is no direct reference to FLEGT VPA licensing in the draft criteria, which seems surprising given that the European Commission is itself responsible for co-ordinating the scheme. Under the draft criteria, a FLEGT VPA license would facilitate compliance with requirements for the uncertified portion of eco-labelled products, but would be insufficient on its own to satisfy these requirements (since it would provide no assurance with respect to GM trees of high conservation value forests). On the other hand, MTCC certified timber should satisfy the requirements established for certified sustainable timber under the scheme.

3.2.6 Procura+

Procura+ is an initiative designed to support public authorities across Europe in implementing sustainable procurement and to help promote their achievements. The Campaign was established in 2004 by ICLEI, an international association of local governments and national and regional local government organizations that have made a commitment to sustainable development.

Procura+ participants are encouraged to implement a management system to ensure continuous improvement in sustainable procurement practices. They are encouraged to adopt procurement principles, developed by Procura+, for six specific product groups selected as having a particularly high potential for sustainable procurement activities.

Procura+ does not attempt to set universal procurement standards for the 6 product groups due to “the very different national regulatory frameworks and other conditions across the EU”. Instead it has developed a set of guidelines setting out alternative approaches which may be used.

Of the 6 product groups, the “building construction and renovation” group is relevant to timber products. The guidance for this group suggests that “*for all construction work it is possible to exclude the use of certain substances, however this should be accompanied by a requirement or preference to use more sustainably produced materials*”.

The guidance identifies “non-sustainably or illegally harvested timber” amongst the “substances” that should be excluded from construction work. The guidance uses the criteria developed for the EU Ecolabel for copying and graphic paper to define “non-sustainably or illegally harvested timber”. It requires that timber derives from forests managed according to standards aligned with international and regional forestry principles (the ITTO Guidelines are referenced as relevant standards for tropical forests). Evidence of compliance to these standards should be verified by “appropriate” certification (FSC is referenced as an example) or, where this is absent, “appropriate declarations, charter, code of conduct or statement”.

In addition, the guidance requires that the tenderer “*must declare that a minimum of X% of materials to be used in construction (by value) must be produced in compliance with the standards underlying a Type 1 ecolabel according to ISO standard 14024*”. Type 1 ecolabels are third party verified labels based on life cycle impacts, such as the EU Ecolabel, the Blue Angel and Nordic Swan.

The Procura+ initiative has some limited potential to create demand for FLEGT VPA licensed timber from Malaysia. However, in order for such timber to conform fully to the guidelines, it would be necessary to provide clear documentary evidence that the legality standard on which the VPA licensing is based fully conforms to the ITTO principles. It should also be noted that to date, the impact of the Procura+ initiative on European procurement practices has been fairly limited. So far only 18 local authorities in the following 6 countries are participating: France (4), Denmark (1), Italy (8), Portugal (1), Spain (3) and Switzerland (1).

3.3 Private sector initiatives

3.3.1 European Timber Trade Action Plan

3.3.1.1 Background

TTAP is a partnership between the Tropical Forest Trust, European timber trade federations⁹ and producer country associations¹⁰. The primary objective of TTAP is to establish and ensure verified legality within the supply chains of members of participating timber trade associations. TTAP works directly with timber suppliers in a number of tropical producing countries to meet EU buyer requirements for third party verified legal

⁹ FBCIB (Belgian Timber Importers' Federation), VVNH (Netherlands Timber Trade Association), UK-Timber Trade Federation, LCB (French Timber Trade Federation), European Hardwood Federation (UCBD), European Timber Trade Association (FEBO)

¹⁰ Malaysian Timber Council (MTC), IFIA (Association Inter Africaine des Industries Forestières)

wood products. TTAP is a 7 year project (March 2005 to December 2011), funded by the European Commission (7 million) and the participating timber trade federations and their members (2 million).

A key policy aim is to harmonize European trade federations' purchasing policies, seeking a level of consistency between countries and also with public sector procurement policies. This should simplify and facilitate conformance to EU requirements by overseas suppliers.

TTAP has also developed a tool to assess the risk of illegal wood entering a supply chain and established TTAP requirements for chain of custody systems. By 2011, TTAP seeks to ensure legal verification of at least 70 supply chains of timber trade federation members which are anchored in TTAP producer countries.

3.3.1.2 Harmonisation of trade association procurement policy

TTAP is working jointly with the European Hardwood Federation (UCBD) to facilitate a process to harmonise the purchasing policies of European timber importing associations. The process builds on a formal commitment made by UCBD members in 2006 to work towards harmonisation. To date three UCBD/TTAP workshops have been held to discuss the issue, in Stockholm during June 2007 and Brussels during November 2007 and March 2008.

Reports from the workshops to date indicate that it is taking time to build consensus around a common approach and progress towards harmonisation has been slow so far.

European Commission staff members have been intimately involved in the UCBD/TTAP discussions, ensuring that there is a high level of awareness amongst UCBD member associations of the VPA process and of progress to develop legality assurance systems in supplier countries.

An important output from the TTAP/UCBD harmonisation process has been a study to compare the various existing trade association codes of conduct and environmental procurement policies now being implemented across Europe. The first study was issued in January 2007 while a second updated study is currently in draft form. Details of current trade association procurement policies in the key EU markets for Malaysian wood products - extracted from the most recent draft study – are shown in Tables 3.2 and 3.3. Drawing on information derived from interviews carried out for the current study, Table 3.2 also estimates the proportion of imports of Malaysian primary wood products covered by members of the respective trade association.

The first point to note from this analysis is the relatively high proportion of national trade in primary wood products covered by members of the trade associations, emphasising the significant potential of these organisations to help drive interest in and demand for verified legal products. Members of the Belgian and French trade associations are believed to account for at least 90% of national imports of Malaysian primary wood products, while the equivalent proportion is believed to be at least 70% for the Netherlands and Italian trade associations.

Table 3.2: National associations covered in TTAP review of environmental procurement policies
 From "Review of EU and North American Timber Trade Federations' Codes of Conduct and Purchasing Policies – Update 2007". Draft Version 30 November 2007. Gunther Hentschel, TTAP

Country	Timber Trade Federation (TTF)	Number of members	Dominant business types	Estimated coverage of primary wood products imports by volume (logs, sawn, plywood, veneer)	
				All imports	From Malaysia ¹
Belgium	FBCIB	50	Importer	80%	>90%
	FNN	180	Wholesale, importer	<20%	na
France	LCB	160	Merchants, importer, agents	60-70%	>90%
Germany	GD Holz	1000	Wholesale, importer, agents, planing mills, retail	80%	Na
Italy	Fedecomlegno	200	Merchants importer, agents	70%	70-80%
Netherlands	NTTA	150	Wholesale, importers	60%	70-80%
UK	UK TTF	180	Merchants, importer, agents	60%	30-50%

1. Estimated coverage of imports of Malaysian primary wood products is based on interviews carried out for this study. All other information derives from TTAP study.

The overall proportion of Malaysian imports covered by members of the UK Timber Trade Federation (UK TTF) is believed to be lower than this, in the region of 30-50%. While, UK TTF members are believed to account for perhaps 75% of UK imports of sawn lumber and mouldings from Malaysia (around 22,000 tonnes of the total 28,300 tonnes imported in 2006), they probably only account for around 30-40% of UK imports of Malaysian plywood (perhaps 40,000 tonnes of the total 115,000 tonnes imported in 2006). This reflects the fact that some of the UK's largest plywood importers and merchants are not members of the TTF, including Travis Perkins, Jewson, and Montague L. Meyer. These companies are either implementing their own environmental procurement policy or are members of the WWF's Global Forest and Trade Network.

Table 3.3 provides an indication of how far each national trade association has progressed to develop and implement either a green purchasing policy, or a code of conduct including green procurement principles, for their members. Importing Federations in all countries with the exception of Italy have developed some form of green procurement policy for their members. The importing Federations of Belgium, France, Netherlands and the UK have established as an underlying principle that all members must trade in legal timber as a minimum. In Germany, members must seek evidence of legality, although at this stage it is not yet compulsory that they trade only in verified legal timber. These principles are binding on all members in Germany, Netherlands and the UK, and are planned to be binding in Belgium and France.

While the minimum requirement established for legality in most cases suggests rising demand for FLEGT VPA licensed timber, all the policies also indicate that preference will be given to verifiable sustainable timber wherever possible. The policies of the French, Netherlands, and UK Federations go further than this, requiring a step-wise approach towards buying only verifiable sustainable timber. The French and Netherlands policies go so far as to establish time-bound targets for achievement of this goal. In these instances, FLEGT VPA licenses have a certain shelf-life after which they will no longer be acceptable on their own.

Table 3.3: Status of timber trade association environmental procurement policies.

From "Review of EU and North American Timber Trade Federations' Codes of Conduct and Purchasing Policies – Update 2007". Draft Version 30 November 2007. Gunther Hentschel, TTAP

Principles	Criteria	Belgium FBCIB	Belgium FNN	France LCB	Germany GD Holz	Italy Federlegno	Netherlands NTTA	UK TTF	EU FEBO	EU UCBD
Code of Conduct principles	Binding to all members	✓	-	✓	✓	-	✓	✓	-	-
	Members to trade in legal timber as a minimum	✓	✓	✓	-	-	✓	✓	✓	-
	Members to seek evidence for legality	✓	✓	✓	✓	-	✓	✓	✓	-
	Members to give preference to verifiable sustainable timber	✓	✓	✓	✓	-	✓	✓	✓	-
Purchasing Policy principles	Step-wise approach towards buying only verifiable sustainable	✓	-	✓	-	-	✓	✓	-	-
	Time-bound targets	-	-	✓	-	-	✓	-	-	-
	Set procedures for members implementing the policy	✓	-	✓	-	-	✓	✓	-	-
	Systematic monitoring of members' compliance	-	-	✓	-	-	✓	✓	-	-
	3 rd party auditing	-	-	✓	-	-	✓	✓	-	-
	Consultation with Government for policy development	-	-	✓	-	-	✓	✓	-	-
	Consultation with ENGOs for policy development	-	-	✓	-	-	✓	✓	-	-
Tools for members' implementation provided by TTF	Programs to support legality verification, timber tracking, etc.	✓	✓	✓	-	-	✓	✓	-	✓
	Initiatives to support members' with chain-of-custody cert.	-	-	✓	-	-	✓	✓	-	-
	Other tools and initiatives	-	-	✓	✓	✓	-	✓	-	-
Evidence for compliance and monitoring	Membership of WWF GFTN or comparable schemes	-	..	✓	..	..	-	✓	..	..
	Audit reports	-	..	✓	..	..	✓	✓	..	..
	Volumes of CSA, FSC, MTCC, PEFC, SFI certified products	✓	..	✓	..	..	✓	✓	..	..
	Volumes of products certified to other scheme based on int. criteria (e.g. LEI, Certflor)	✓	..	✓	..	..	✓	✓	..	..
	3rd party verified legal timber	✓	..	✓	..	..	✓	✓	..	..
Status of implementation and support	Members are demonstrably implementing purchasing policy	✓	-	✓	-	-	✓	✓	-	-
	TTF employs Purchasing Policy/ Environmental Manager	-	-	✓	-	-	✓	✓	-	-
	TTF provides documents for implementation of green policies	-	-	✓	-	-	✓	✓	-	-
Status of implementation and support	TTF provides training/ workshops	-	-	✓	-	-	-	✓	-	✓
	TTF provides member site-visits	-	-	-	-	-	-	✓	-	-
Alignment with the respective public procurement policy	General objectives	✓	-	✓	-	..	✓	✓	..	..
	Purchasing objectives	✓	-	✓	-	..	✓	✓	..	..
	Evidence for legal timber	✓	-	✓	-	..	✓	✓	..	..
	Evidence for sustainable timber	✓	-	✓	-	..	✓	✓	..	..
Management, members' contributions and funding	Formal committee or board for environmental affairs	✓	-	✓	-	-	✓	✓	-	-
	Stakeholder engagement in policy implementation	-	-	✓	-	✓	✓	✓	-	-
	Members pay extra for implementing the purchasing policy	-	-	✓	-	-	✓	✓	-	-
	Access to external funding (e.g. Government)	-	-	-	-	-	✓	✓	-	-

✓ implemented; ✓ partially implemented; light green boxes are policy upgrades since 2006

The underlying message of the existing trade association policies is that evidence of legality, including FLEGT VPA licenses, is viewed as a stage towards sustainable

forestry, which should be seen as the real goal. In all cases the underlying assumption is that “sustainable” equates to “independently certified”, with all associations accepting a range of certification schemes (including both FSC and PEFC) as evidence of sustainability. Discussions with individual trade associations suggest that attitudes specifically with respect to MTCC vary. For example, the UK TTF and French LCB accept MTCC as sustainable while the Netherlands TTA judges MTCC to provide an assurance of legality only.

It is important to emphasise that while these principles have been set, trade associations vary in the extent to which they can enforce green procurement policies and demonstrate progress. At this stage only the French, Netherlands and UK trade associations can provide evidence to demonstrate that members are implementing the purchasing policy. The Belgian Federation is moving in this direction. The French, Netherlands and UK trade associations require systematic monitoring of members’ compliance to their procurement policies, and have introduced procedures for third party auditing of conformance together with annual reporting of progress. Progress is monitored through assessment of the volume of timber supplied that is third party verified as legal or sustainable or derived from companies that are members of the WWF GFTN or similar stepwise schemes.

3.3.1.3 Gap assessments and chain of custody

In addition to work on timber procurement policy in the EU, another major role of TTAP is to complement the FLEGT VPA process through the implementation of private-sector legality verification systems, thereby preparing companies for VPA licensing.

TTAP legality verification systems involve assessment of chain of custody linked to verification of legality at forest management unit level. TTAP will work with existing systems where possible. The first stage of implementation in any producer country is to work through the various draft and finalised legality standards relevant to that producer country. From these TTAP draws up a checklist, always with an eye to ensure best practice. In Malaysia, MTCC has provided an effective starting point for participation.

According to TTAP, their work provides an effective framework for facilitating and pilot testing VPA licensing. TTAP’s initial assessment of relevant legality standards can provide a starting point for agreement of a national legality standard. Having acquired practical experience, TTAP is also well placed to comment on the commercial implications, including cost impacts and other practical challenges.

Participation in the TTAP process involves three stages:

- **Stage 1: Gap Assessment.** The TTAP team will visit individual points in the supply chain (factories and forests) to identify weaknesses that may allow the entry of illegal timber. The gap assessment includes an action plan to remove any weaknesses with estimates of costs for implementation, outlining the requirements for a company to achieve legal verification. Gap assessments are joint-funded by TTAP and participating companies.
- **Stage 2: Chain of Custody (CoC) training and support.** Based on the gap assessment, viable supply chains are invited to implement chain of custody (CoC) systems for the verification of the origin of timber (legality of origin), as a

basis for the establishment of legality. The TTAP team provides training and support and assists with financial and technical resources.

- **Stage 3: Third party verification of the supply chain.** TTAP provides some financial assistance for each supply chain to be audited by a third party verifier to ensure the chain of custody system implemented can provide assurance of legality of wood origin in the product.

Fourteen Malaysian companies encompassing 9 supply chains are already engaged in this process in Malaysia. The companies cover both trade and primary manufacturers and mainly supply plywood and sawn lumber to the UK and Dutch markets. Smaller volumes are destined for the Belgian market. According to TTAP in December 2007, one company had achieved full CoC certification and another was very close to achieving CoC. Three companies have undertaken gap assessments and are in the implementation stage. Six companies have completed gap assessments, but have not yet started implementation. Three companies have gap assessments scheduled for early 2008.

The number of Malaysian companies engaged in TTAP projects is comparable to other regions. Eleven supply chains are currently being investigated in Africa and around nine in Indonesia.

TTAP has established an overall objective to cover 20% of tropical hardwood products imported by members of timber trade associations engaged with TTAP. TTAP aims to complete approximately 350 gap assessments (200 in Asia and 150 in Africa) and to provide follow up training on CoC systems to meet a required CoC standard in approximately 35 supply chains¹¹.

3.3.2 WWF Global Forest and Trade Network

The WWF's Global Forest and Trade Network (GFTN) has been an important initiative encouraging uptake of responsible procurement policies and practices in the EU for several years. This network of companies that are committed to sourcing and promoting "credibly certified" wood products continues to be dominated by a limited number of large retailers and their suppliers (see Table 3.4).

The total number of companies that are members of the network in Europe has declined quite significantly in the last two years. This reflects the introduction of tougher membership requirements and new systems of monitoring to ensure a higher level of commitment by network members. So the decline in numbers probably does not reflect any underlying decrease in demand for certified products, but rather an effort by WWF to focus their efforts on a hard core of committed companies.

The direct influence of the WWF GFTN on purchases of Malaysian timber products is limited in all EU markets with the exception of the UK. Several of the UK's largest importers and distributors of Malaysian hardwood products are members of the network including Travis Perkins (plywood), Saint Gobain (plywood, sawnwood), and Timbmet

¹¹ In addition to these TTAP projects, Tropical Forest Trust in association with the UK Timber Trade Federation is undertaking similar work on plywood supply chains in China with funding from UK Department for International Development.

(sawnwood, mouldings). However in other European countries, very few of the large importers of Malaysian hardwood products are members of the network. Throughout Europe, the large construction and furniture sectors are very poorly represented within the GFTN.

Table 3.4: Membership of the WWF Global and Forest Trade Network in Europe in September 2007

	Total	DIY retailer	Other retailer	Paper/packaging	Printer/publishing	Joinery/flooring manufacturer	Importer/distributor	Other manufacturer	Construction/Housing assoc.	Other
UK	46	3	8	6	5	3	6	3	3	9
Belgium	20	1	5	3		2	6	3		
Switzerland	18		4		1	5	2	4		2
Germany	16	3	1		2		5	2		3
Netherlands	16	2	1	1		3	3	1	2	3
Sweden	14		4	1		1	3	1	1	3
France	11	2	2			3		2		2
Spain	11	1				2	5			3
Austria	9	4	1	1	1	1				1
Romania	1									1
Total	162	16	26	12	9	20	30	16	6	27

The GFTN is most influential within the retailing sector. Membership is dominated by a range of high profile retailers and their immediate suppliers, again with a particularly strong presence in the UK. Major retailers that are members of the network include B&Q, Sainsbury, OBI, Bauhaus, Brico, Carrefour, Castorama, Leroy Merlin, and IKEA. There are also a limited number of joinery and flooring manufacturers (including Forbo Parquet in Sweden, Magnet in the UK, and Luvipol in Spain).

While the number of GFTN members is limited, the level of commitment to certified products shown by these companies is very high. For example, builders merchants like Jewson and Travis Perkins have stated publicly that the vast majority of wood products they purchase must be supplied as certified within a couple of years. They are doing this despite low levels of visible demand from end users. Instead the objective is to protect corporate brands, to minimise the risk of damaging environmental publicity, and to ensure long-term access to lucrative public sector contracts.

Wood trading companies that are participants in the GFTN are committed to a stepwise approach to responsible procurement. Participants set company-specific targets for progressive improvement and their progress against these targets is verified annually by the GFTN coordinator or a GFTN nominated assessor. Participants must eliminate, within five years, all timber from sources identified – using supplier questionnaires and other tools - as “unknown/unwanted” in their supply chains. Members must progressively increase the proportion of timber originating from sources designated as “known”, “known licensed source”, “in progress toward certification”, or “credibly certified”. They must also achieve credible chain of custody certification for at least one processing facility owned or managed by the participant within one year and for all facilities owned or managed by the participant within five years.

Detailed criteria have been established for categorisation of timber supplies. Unwanted sources are those where:

- the forest is known or suspected of containing high conservation values, but which is not certified or progressing to certification, or where the forest manager cannot otherwise demonstrate that the forest and surrounding landscape is managed to ensure that those values are maintained.
- the forest is being converted from natural forest to a plantation or other land use, unless the conversion is justified on grounds of net social and environmental gain.
- the timber was illegally harvested or traded.
- the timber was traded in a way that drives violent armed conflict or threatens national or regional stability (i.e. what is commonly called conflict timber).
- the harvesting or processing entity, or a related political or military regime, is violating human rights.
- the timber is from genetically modified trees.
- the source forest is unknown.

The degree of traceability and verification required of individual suppliers to demonstrate that wood is not “unwanted” depends on the level of risk associated with a particular supply country. For low-risk countries, a simple self-declaration from the supplier may suffice. In high-risk situations the degree of scrutiny and verification required will be much greater, and third-party verification may be required (that is, a chain-of-custody certification for the supply chain).

The next step is to show that wood is from a “Known Licensed Source”. This involves a basic level of legality checking to verify that the timber originated from a forest management unit in which the harvesting entity had a legal right to harvest. For high-risk situations, a higher level of due diligence may be required, involving a higher level of scrutiny and assigned the label “Verified Legal Timber.” That designation requires the purchaser to obtain proof not only that the harvesting entity had a legal right to harvest, but also that the entity complied with the law when harvesting the timber in question. It also requires a higher degree of scrutiny over the chain of custody.

The next step is to purchase timber from a “Source in Progress to Certification”. Such timber must derive from a known licensed source and from a participant in one of a range of private sector initiatives establishing a time-bound process of progressing toward credible third party certification. Currently participants in the WWF GFTN, Tropical Forest Trust, Rainforest Alliance's Smartstep and Woodmark Forest and CoC Program are recognised.

The final step is to source from a Credibly Certified Source defined as those certification systems assessed as credible under the WWF/World Bank Forest Certification Assessment Guide. At present FSC is the only certification system assessed as meeting this requirement.

The Guidance issued to GFTN members stresses that laws in supplier countries may be inequitable, reinforce unfair relationships or disregard customary forest rights. To safeguard against associating with unjust but legal outcomes in a supplying country, participants are advised to focus on the goal of sourcing from sustainable rather than legal sources. Legal compliance is seen by the GFTN as a factor that contributes to sustainable forest management rather than as the end game.

A key question for the purposes of this study is where a Malaysian FLEGT VPA license is likely to lie in the GFTN hierarchy of assurances. A discussion with George White, Responsible Purchasing Co-ordinator of the GFTN, indicates that GFTN is generally supportive of the concept of FLEGT VPA licensing. However, White emphasised that the FLEGT VPA should not be seen as the end of the process. Rather it creates an “enabling environment” for further progress towards certification.

White noted it is difficult to be absolutely certain of where a FLEGT VPA license would stand in their hierarchy before the system is fully operational. However, based on his existing knowledge of the process, White thought that a VPA legality license would likely be treated as a “known licensed source”. As such it would ensure that Malaysian wood was not excluded from GFTN member supply chains and there would be no obligation on suppliers to provide additional evidence of legality.

As a “known licensed source”, the VPA legality license would have a status equivalent to that of MTCC certification and of private sector legality verification systems such as Smartwood VLO and SGS TLTV. When questioned on whether there was any possibility of VPA legality licenses being given a higher status in the hierarchy than these private sector initiatives (given that legality assurance systems require a much broader national stakeholder process) White thought that this would not be an option. He noted that the next category of “Progressing to Sustainable” is very narrowly defined, requiring that individual supplier companies must be working within one of the recognised stepwise frameworks to achieve credible certification.

The GFTN guidance also includes an assessment of the level of assurance that can be provided by the MTCC system. This guidance indicates that 100% MTCC certified has high value as a form of legality verification and that no further legality related checks over and above this are required. However products carrying MTCC per-centage labels require extra verification of the non-certified portion of the product.

Given that MTCC is already recognised as a “known licensed source”, White suggested that the VPA legality licensing framework would not, on its own, add any marketing value to the MTCC certificate. However, the presence of a reliable legality licensing system may well facilitate individual company participation in a GFTN recognised stepwise framework. In turn, this would allow recognition of a wider range of Malaysian timber products as “progressing to sustainable” and eventually “credibly certified”.

White also noted that an alternative, or parallel, option for Malaysian exporters would be to further elaborate MTCC so that it meets the requirements of “credible certification” as set out in the World Bank/WWF Alliance Forest Certification Assessment Guide (FCAG). MTCC was subject to an assessment against the FCAG in mid 2007 the results of which have not yet been published.

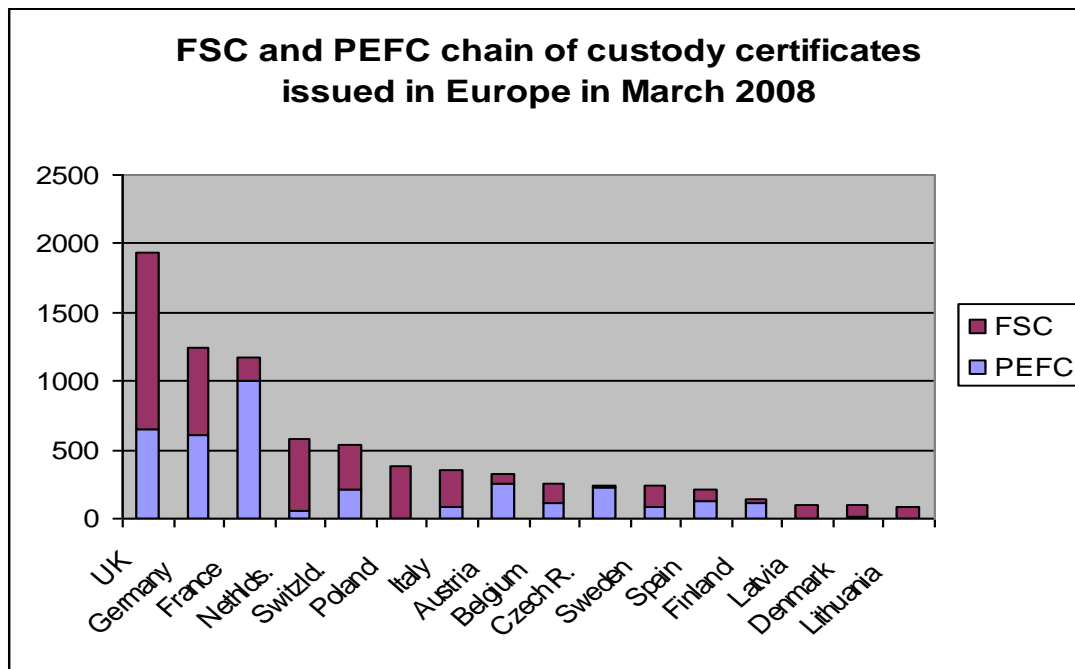
3.3.3 Chain of Custody certification

One of the most dramatic indicators of change in environmental timber procurement practice in Europe over recent years has been the rapid increase in chain of custody certification. The number of chain of custody certificates issued in Europe has increased by 40% in the last 2 years. A combined total of 7311 CoC of custody certificates have now been issued throughout the continent, including 3226 by PEFC and 4085 by FSC.

The most obvious impact of this increase in chain of custody certification has been to increase the availability of certified products in the European market. Around 87 million hectares of Europe's commercial forest area, that's about 50%, is already certified to either FSC or PEFC. However until recently, a large proportion of certified logs from these forests never made to market as labelled product due to lack of uptake of chain of custody certification. This is now changing. European traders are increasingly able to supply both FSC and PEFC certified European hardwoods as standard without any need to pay a premium. This strongly implies that there will be significant pressure from the European domestic wood industry to push for tougher timber procurement requirements as a means of seeing some return on their investment in forest certification.

The signs are that the proportion of European hardwood that can be supplied as certified material will tend to increase. Romania, a country which joined the EU at the start of this year and a key source of Eastern European hardwoods, is committed to certifying 4 million hectares of the nation's 6 million hectares of forest and recently announced significant tax incentives to achieve this goal.

Chart 3.1



The extent of chain of custody certification varies throughout Europe (Chart 3.1). This provides a crude measure of demand for and availability of certified forest products throughout the continent. The indications are that European demand for certified forest products is concentrated in a few markets including UK, the Netherlands and Switzerland. The high number of chain of custody certificates in France, Germany and Poland partly reflects relatively large domestic processing industries and may be less indicative of strong end-user demand. Uptake of chain of custody in Spain and Italy remains very limited. Chain of custody tends to be most prevalent in the supply chains of a few large consolidated business sectors such as home improvement retailing and parts of the paper and panels industry. It is less prevalent in more fragmented sectors which nevertheless account for a large proportion of timber demand, including construction and furniture.

Many of the importers, manufacturers and merchants dealing in Malaysian wood products in the EU have adopted chain of custody certification. Of 75 European companies interviewed for this study that positively stated they are dealing in Malaysian timber, 44 are FSC chain of custody certified and 24 are PEFC chain of custody certified.

As uptake of chain of custody standards has increased, these standards have played an increasingly important role in guiding environmental procurement practices in Europe. Both FSC and PEFC now allow % based labeling of wood products so that a proportion of the wood they contain derives from non-certified sources. This in turn has required the development of procedures to ensure that the non-certified portion of labeled products do not derive from controversial sources.

Over the last three years, FSC CoC certified organisations have been tightening requirements for all non-certified wood used in FSC labeled products to be derived from “FSC controlled sources”. Companies wishing to supply FSC controlled wood must implement a verifiable management system and acquire evidence to demonstrate that the wood does not derive from controversial sources, defined as:

- a forest area where traditional or civil rights are violated;
- forests with high conservation values which are threatened;
- wood harvested from GM trees;
- illegally harvested wood;
- natural forest that has been converted to plantations or non-forest use.

For all incoming controlled wood, the company must require supplying companies to provide a declaration confirming the origin of wood or wood fibre to district level and confirming that wood is controlled in accordance with the FSC standards.

The content of the FSC controlled wood standard implies that a FLEGT VPA license would greatly facilitate efforts to demonstrate that wood derived from an FSC “controlled” source – satisfying the requirements for traceability and for legally harvested wood. However, a FLEGT VPA license could not be used in isolation to demonstrate that wood is “controlled”. To achieve this, additional measures would be needed to ensure that the legality standard on which the FLEGT VPA license is based provided confidence that the other FSC controlled wood criteria are being met.

PEFC also has a standard designed to prevent wood from “controversial sources” finding its way into PEFC labelled products, but the requirements are less onerous than those of FSC. PEFC simply defines “controversial” as any wood derived from illegal sources. The standard requires that PEFC CoC custody certified companies introduce safety checks such as risk analyses, external assessments and on-site inspections to ensure the legality of any uncertified wood used. The scope and the intensity of the checks depend on the risk of procuring timber from illegal harvesting. Under the PEFC system, the existence of a FLEGT VPA license should be a sufficient assurance that the wood does not derive from a controversial source.

While the number of companies that have signed up to FSC and PEFC chain of certification in Europe is impressive, it is important not to over-emphasize the impact on broader procurement practices in the industry. The fact that a company implements chain of custody on a part of its operations is no guarantee that it actually supplies any

certified timber or is seeking a significant volume of controlled wood. Anecdotal reports derived from regular discussions with traders throughout the EU, including during interviews for the current study, indicate that many companies are essentially reactive in nature. They may buy small volumes of certified wood to satisfy occasional orders, but they are not working proactively to expand or develop markets for certified products. With limited end-user demand, the vast majority of wood they trade remains uncertified.

However, this situation may be about to change. FSC has opened a public consultation on a new policy for companies using the FSC trademark. The draft new policy is FSC's response to concerns about "greenwashing": companies achieving FSC certification for a small part of their operation in order to associate themselves with the FSC trademark and then going on to supply only tiny volumes of certified product. The draft new policy seeks to establish minimum procurement requirements covering all the operations of any company using the FSC trademark.

The draft policy states that any organisation seeking to associate itself with the FSC or the FSC trademarks must formally declare that it is not in any way associated with:

- Illegal logging or the trade in illegal wood and forest products
- Violation of traditional and civil rights in forestry operations
- Destruction of high conservation values in forestry operations
- Conversion of forests to plantations or non-forest use
- Planting of genetically modified trees in forestry operations
- Other activities that may bring FSC's reputation into disrepute, negatively impact FSC's credibility or contradict FSC's values

Given the large numbers of companies that are FSC chain of custody certified across Europe, FSC's adoption of this policy could have a significant effect on the broader procurement practices of the European wood trade and industry. Thousands of companies would be under a formal obligation to ensure that all their wood purchases, irrespective of their certification status, effectively derived from FSC controlled sources. Failure to demonstrate this would result in a company's expulsion from the FSC system, denying them the opportunity of marketing FSC products. However serious questions need to be raised over FSC's ability to enforce these requirements.

3.4 Views on market acceptance of FLEGT VPA licenses

3.4.1 Private sector

This study involved interviews with companies buying Malaysian timber products in the six leading European markets for these products. Interviews were conducted in November/December 2007 with 75 European companies identified as directly engaged in the trade in Malaysian wood products. Based on information provided on annual trade volumes by interviewees, it is estimated that interviewed companies represented 60%-70% of total EU imports of Malaysian timber. Interviewees were dominated by importers, distributors and agents, but also included several leading manufacturers and retailers. Full details of the outcome of the interviews are provided in the country reports contained in Annex 1. An overview of responses from all 6 countries is summarised here.

A point worth highlighting is that with a limited amount of research involving consultants with background knowledge of the timber industries of each country, it was possible to

identify the vast majority of European companies directly engaged in the import of Malaysian wood products, with the exception of furniture. The import trade in Malaysian wood products is evidently highly concentrated, suggesting that marketing campaigns designed to raise awareness of the role of FLEGT VPA licensed timber from Malaysia need not be overly expensive. Much may be achieved through carefully targeted marketing campaigns focusing on these companies.

Main results from the interviews are as follows:

- The interviews revealed that at present the level of awareness of FLEGT VPA process amongst companies trading in Malaysian timber is split about a third each between those that were “totally unaware” (33%), “partially aware” (39%) and “very aware” (28%).
- A slim majority (56%) of interviewed companies held positive views about Malaysian forestry practices. 8% had a negative perception and the rest held mixed views. This is a positive result from the perspective of the Malaysian trade. However, given that interviews focused on companies engaged and with a direct interest in this trade, the sample may well be biased.
- Interviewees were asked to comment on the factors that influenced their perception. Positive perceptions were overwhelmingly explained on the basis of interviewees “trade experience” - that is through direct contact with suppliers or visits to Malaysia. Other factors mentioned less often were availability of MTCC certified wood products and marketing campaigns of MTC.
- Negative perceptions were linked to concerns over the credibility of MTCC certification, bad press relating to native rights in Sarawak and Sabah, and procurement of illegal wood from Indonesia.
- Only a minority of interviewed companies (38%) were able to provide details of a formalised environmental procurement policy for wood products. However, these policies were more common amongst larger distributors. As a result, the proportion of wood trade covered by companies with policies was higher. Companies identified as already possessing policies represented around 50-60% of Malaysian volume traded by all interviewees. Policies were particularly well developed amongst the large plywood distributors in the UK, driven on by a desire to gain access to lucrative Olympic development contracts.
- Most of those companies that had developed detailed policies had set a requirement that all wood should be from legal sources, or that procedures should be in place to minimise the risk of wood being derived from illegal sources.
- But while “legality” was established as a baseline requirement by some companies, most would obviously prefer “certified sustainable” wherever possible. FLEGT VPA licenses were generally perceived to provide no more nor less than private sector legality verification schemes. Legality verification was generally perceived as a short term measure on the way to sustainability.

- There was confusion amongst interviewees as to how the VPA process relates to MTCC certification. Many respondents wondered why an alternative mechanism is being developed which appears on the surface to offer less.
- When asked directly “would you favour VPA licensed timber over unlicensed timber”, 91% of interviewees said they would discriminate in this way.
- However there was little evidence of willingness to pay a price premium for FLEGT VPA licensed timber. 33% said they would pay no price premium for licensed timber on grounds that legally verified should be the standard price. 45% said they would pay a premium of 1 to 6%. 19% said they would pay a premium of 7 to 10%. Only 3% said they would pay greater than 10%.
- Most respondents indicated that the willingness of their own customers to pay a premium would be even less, placing strict limits on their ability to pay more.
- There was little evidence to suggest that companies would cease trading with Malaysia should the country not sign up to a VPA. UK companies very aware of the FLEGT VPA initiative were asked this question directly. Of 14 respondents, 13 said they would continue to trade with Malaysia using private sector initiatives where necessary.

3.4.2 Environmental Non-Governmental Organisations

This study involved interviews with EU-level representatives of major environmental groups undertaken in November/December 2007 to ascertain their views on the market acceptability of FLEGT VPA licenses. Each interviewee was asked to express their views on: forestry practices in Malaysia; on their position with respect to the FLEGT VPA process generally and in Malaysia specifically; on their position with respect to the marketing of FLEGT VPA licenses; and on the need for and scope of additional legislative options. During these discussions, reference was made to a report “Forest Governance in Malaysia: An NGO perspective” which was produced for FERN by JOANGOHutan, a coalition of Malaysian NGOs in September 2006. Main messages of this report and of the interviews are that:

- NGOs are generally supportive of the FLEGT VPA process and enthusiastic about the potential of FLEGT partnership agreements to bring all interests together to try to resolve problems. One interviewee noted that the FLEGT VPA process could “facilitate the transition to Sustainable forest management”.
- On the other hand, NGOs have a very negative view of Malaysian forestry practices. Specific issues cited were: the conflict over native customary rights in Sarawak; the alleged illegal smuggling of logs (particularly merbau) into Sarawak from Indonesia and laundering for shipment to China; the forestry practices of Malaysian operations in African countries and Papua New Guinea; and the continuing conversion of natural forests into plantations.
- Therefore NGOs support of the FLEGT VPA process is conditional on a lengthy list of requirements being met with regard to the structure of the negotiation process and the content of the legality standard.

- According to the FERN/JOANGOHutan report, NGOs will support the FLEGT VPA process “if properly done”, by which is implied the need for a thorough examination of forestry practices. In the case of Malaysia it is reckoned there is a particular need to address land conflicts with indigenous peoples. The report recommends that the VPA process in Malaysia “should include a proper analysis of all existing legislation, including the Federal Constitution as well as the state forest and land laws, the Orang Asal’s adat law, legal and human rights instruments and institutions, both within and outside Malaysia as well as court decisions including those of the Native Courts.”
- One interviewee spelt out a set of criteria for credible legality licensing, suggesting the need for: a) a high quality legality standard that “does not lead to legalisation of destructive forestry practices or of forest operations in intact forests”; b) the development of this standard through a truly multi-stakeholder process based on agreed procedures, including resources to be made available for disadvantaged stakeholders, balanced representation of economic, social and environmental interests, and independent facilitation; c) a “reliable and robust tracking system”; and d) a “strong and transparent institutional framework”. This interviewee also expressed concern that the existing MTCC framework, of which NGOs have been highly critical, may be used as the basis of the legality licensing system.
- There is at present a high level of NGO dissatisfaction with the Malaysian FLEGT VPA process. Reference was made to the JOANGOHutan memorandum of 28 September 2007 criticising the on-going consultative process¹². One interviewee compared the Malaysian FLEGT VPA negotiation process unfavourably against equivalent processes in other countries, suggesting that it was “by far the worst” and “threatened to discredit the whole process”. It was suggested that there seemed to be little willingness on the part of the Malaysian government to address the concerns of the NGOs. This was contrasted with the situation in Ghana and Cameroon where, it was suggested, there has been broader and more balanced stakeholder participation¹³.
- One interviewee said there was a need for greater clarity of the objectives of the Malaysian FLEGT VPA negotiations. It was suggested that since the Malaysian negotiation is being led by the Ministry of Plantation Industries and Commodities, this led to a heavy focus on the objective of maintaining market access for Malaysian timber products in EU markets. Therefore, this interviewee suggested, there was insufficient focus on broader environmental and development objectives.

¹² The submission from Network of Indigenous Peoples and Non-Governmental Organisations on Forest Issues (JOANGOHutan) and The Indigenous Peoples’ Network of Malaysia (JOAS) of 28 September reports a wide range of grievances. The submission claims that: meeting structure, direction and procedures are unclear; the agenda and meeting scheduling were irrational; civil society groups have not received reports or records of meetings; the process to define a legality standard has been inadequate; and core issues of concern to NGOs are not being addressed, including “violations of Native Customary Rights (NCR) of indigenous communities by timber concessions” and “the non-transparent manner in which licences for timber concessions are granted”.

¹³ The JOANGOHutan/JOAS Memorandum of September 2007 also contrasts the alleged failings of the Malaysia VPA process with positive progress made in the VPA processes of other countries “more economically challenged than Malaysia”. It suggests that “Indonesia in fact has gone one step further in developing a strong definition of legality within a widely supported consultative process”.

- Concern was also expressed over the scope of the Malaysia VPA. One interviewee commented that since it is only likely to apply to logs, lumber, veneer and plywood, there was significant potential to circumvent the VPA through further manufacturing in Malaysia.
- NGOs made clear that moves to address these issues is seen as a precondition for lending their weight to help improve EU market access for FLEGT VPA licensed timber from Malaysia.

4 Policy developments in other key markets

4.1 Introduction

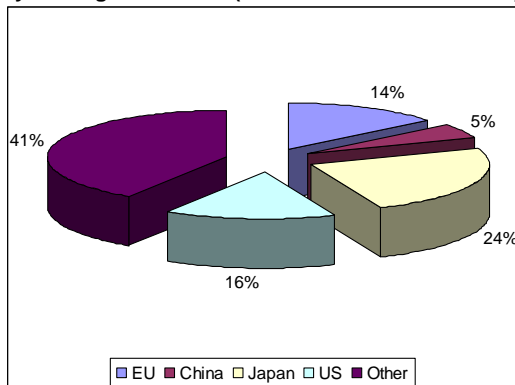
The impact of the FLEGT VPA licensing system on Malaysian trade will be at least partly dependent on events in export markets other than the EU. The USA, Japan and China are major markets for Malaysian wood products. Of the estimated RM 23.4 billion exported by Malaysia in 2006, RM 5.68 billion (24%) was destined for Japan, RM 3.64 billion (16%) was destined for the United States, and RM 1.16 billion (5%) was destined for China. This compares to RM 3.35 billion (14%) destined for the EU (Chart 4.1).

Each nation plays a very different role in Malaysia's export market profile (Chart 4.2). Japan is critical as an export market for plywood, and is also an important market for logs and wood furniture. The US is mainly important as an export market for wood furniture, and to a lesser extent plywood. China is important mainly as an export market for logs.

This section has two objectives:

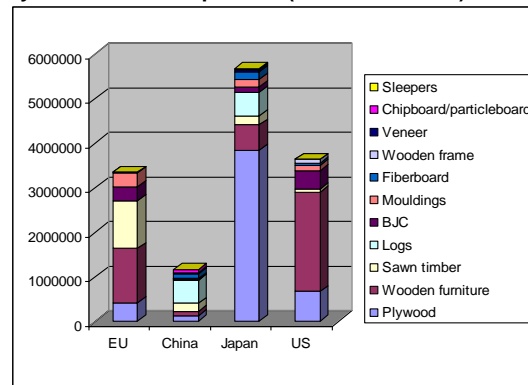
- To assess the extent to which illegal/sustainable timber trade is becoming a market and/or policy issue in the USA, Japan and China and the potential impact on Malaysian timber product imports both in the short and long term.
- To assess each market's long term trade potential. This will provide an insight into the ability of these markets to substitute for EU markets if the latter become more difficult.

Chart 4.1: Value of Malaysian wood product exports by leading destination (% of total RM value in 2006)



Source: MTC compiled by FII Ltd

Chart 4.2: Value of Malaysian wood product exports by destination and product (RM 1000 in 2006)



Source: MTC compiled by FII Ltd

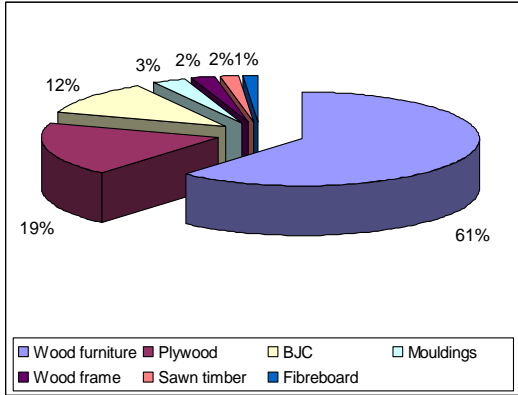
4.2 The United States

4.2.1 Recent Malaysian trade with the United States

The US is the world's largest producer and consumer of wood products, but represents just 1% of global consumption of tropical wood products. Almost all of what the US imports in tropical wood products is in the form of processed products. This is reflected

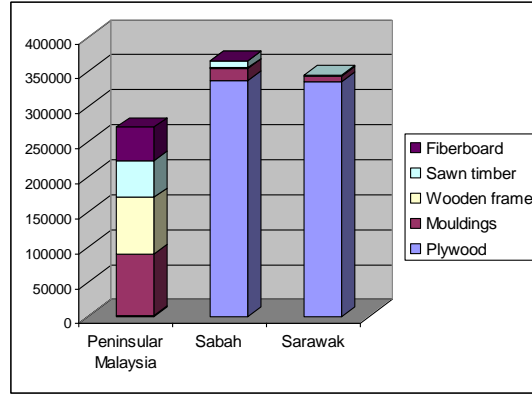
in Malaysia’s export data. In terms of value, Malaysia’s exports to the United States are dominated by wood furniture, plywood and BJC, with small volumes of mouldings, wood frame, sawn timber and fibreboard (Chart 4.3). Malaysia’s exports the United States of wood furniture, BJC, mouldings, wooden frames, and lumber derive mainly from Peninsular Malaysia. For Sabah and Sarawak, the United States is a significant plywood market (Chart 4.4).

Chart 4.3: Value of Malaysian wood product exports to the US (% RM value by product in 2006)



Source: MTC compiled by FII Ltd

Chart 4.4: Value of Malaysian primary and secondary wood products exports to the US by source region and product (RM 1000 in 2006)



Source: MTC compiled by FII Ltd

Malaysia’s exports of wood furniture to the United States, which consist primarily of rubberwood products, were rising strongly during the period 2002 to 2006 (Chart 4.5). This was a time when the United States housing market was still buoyant and when there was a major process of restructuring underway in the US domestic furniture sector.

The rise in Malaysia’s exports of wood furniture to the US forms part of a wider trend. Since 1999, US imports of wood furniture and parts more than doubled from around US\$7 billion to US\$15.6 billion in 2006. Overall imports currently represent upwards of 45% of the total value of wood household and office furniture consumed in the United States. China has taken a very large slice of the US market. Nearly 50% of the total value of US furniture imports derived from China in 2006. In that year, Malaysia accounted for around 4% of the total value of US wood furniture imports¹⁴.

Meanwhile US domestic furniture production has dropped dramatically. For example, in North Carolina, where the furniture industry has long been an economic mainstay, a report issued by the state Department of Commerce concludes that the industry "is contracting fast with no bottom in sight" and short of decisive action "will soon be history"¹⁵.

The United States has become Malaysia’s leading destination for wood furniture exports, accounting for 35% of total export value in 2006. However competition in this market is stiff for low cost producing countries, particularly China and Vietnam. By establishing a strong reputation for product quality, service and innovation, Malaysia has been able to grow its position in the US market in recent years. At the same time however, major

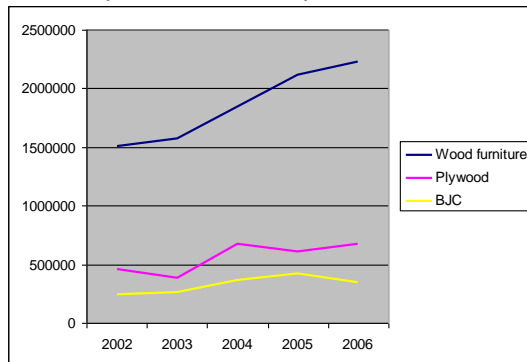
¹⁴ American Forest & Paper Association (AF&PA) statistics

¹⁵ Taken from Journal of Business and Entrepreneurship, March 2007, Surviving Industry Decline

manufacturers have been keen to avoid over-dependence on the US market and to expand sales into other high value markets, notably Europe.

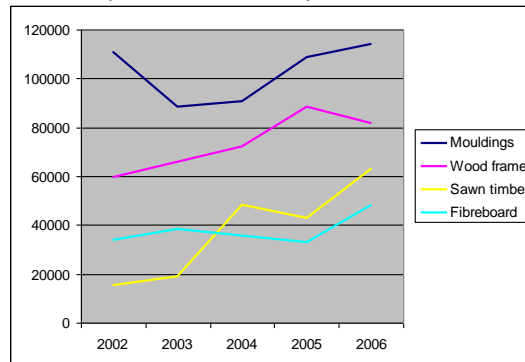
The importance of Malaysian manufacturers implementing a market diversification strategy in the wood furniture sector has become more pronounced since early 2006 as the US market has suffered a significant downturn due to the weakening housing market and sagging value of the dollar. This has led to ever more frantic competition for US sales amongst manufacturers in a wide range of Asian countries.

Chart 4.5: Value of Malaysian wood product exports to the US (RM 1000 2002-2006)



Source: MTC compiled by FII Ltd

Chart 4.6: Value of Malaysian wood product exports to the US (RM 1000 2002-2006)



Source: MTC compiled by FII Ltd

A report from PIERS Global Intelligence Solutions published in early 2008 indicates that US furniture imports peaked and levelled off at about an annual rate of 2.1 million TEUs — the equivalent of a 20-foot container — between 2005 and 2006. They started to drop off in early 2006, falling to about 1.8 million TEUs by early 2007, but were projected to reach 2 million by early 2008. It is notable that PIERS listed Malaysia amongst the top 10 U.S. source countries alongside China, Vietnam, Taiwan, Italy, Thailand, Indonesia, Germany, Brazil and Hong Kong¹⁶.

US imports of BJC products have followed a similar trajectory to that for wood furniture (Chart 4.6). Overall US imports of BJC products were valued at US\$1481.5 million in 2006, a significant increase over levels of only US\$760 million reported in 2000. According to US trade statistics, in 2006 imports of BJC from Malaysia were valued at US\$28.5 million, around 2% of total US imports of these products. The largest external suppliers to the United States were Canada (56% of total US imports), China (12%), and Brazil (10%). US imports of BJC from Indonesia, probably Malaysia's most direct competitor, were \$38 million, around 2.5% of total US imports of these products. Malaysian exports of BJC to the US rose strongly between 2002 and 2005, but declined again in 2006, probably a reflection of mounting competition from other Asian countries as the US building sector began to cool.

Malaysia's exports of plywood to the United States saw significant growth between 2002 and 2006. According to Malaysian trade statistics, exports of plywood to the United States reached 451,000 m³ and were valued at RM 674 million in 2006. In that year, Malaysia was the largest supplier of tropical plywood to the US, accounting for around

¹⁶ PIERS stands for Port Import Export Reporting Service. Its figures are for shipments through U.S. ports, and don't take into account cross-border trade between the US and its neighbors, Canada and Mexico.

32% of all imports of this commodity (1.4 million m³). Indonesia, the next largest supplier accounted for around 30%. Malaysia has taken market share from Indonesia in this market in recent years. However China is also an increasingly important player in the US market for hardwood plywood, gaining market share against all other suppliers. Tropical hardwood plywood is sold in the US both as a commodity for general use as well as for high-value finished applications. It is particularly important in the market for structural and external applications where high strength and durability is required.

Malaysian trade data indicates that exports of mouldings to the United States have been variable in recent years, with annual value hovering around RM 100 million (Chart 4.6). US trade data indicates that in 2006, the US imported hardwood mouldings with a total value of \$191 million, of which \$17.5 million (9%) derived from Malaysia. US imports of hardwood mouldings increased rapidly between 2000 and 2006, a trend driven by Chinese manufacturers. In 2006, US imports of this commodity from China accounted for 40% of total imports by value¹⁷.

Malaysia has become well established in a significant niche market in the United States for wood frames (for pictures and mirrors etc). The value of Malaysian exports of these products to the US increased strongly from around RM 60 million in 2002 to nearly RM 90 million in 2005, before falling again to around RM 80 million in 2006. As for mouldings, competition from China and other Asian manufacturers is likely to be very strong in this market.

Malaysia has significantly increased exports of sawn lumber to the US in recent years (Chart 4.6). In the sawn lumber market, Malaysia has been gaining market share from both Brazil and Indonesia, both of which have suffered from supply problems. The dramatic decline in Brazil's mahogany trade during the late 1990s has been particularly important in providing opportunities for other, previously less utilized, tropical species that are comparable in characteristics and more competitively available including Malaysian meranti. However Malaysia's share of the total market remains relatively restricted. According to the US import statistics, Malaysia supplied nearly 50,000 m³ of tropical hardwood sawn lumber to the United States in 2006, around 14% of total US imports of this commodity (364,000 m³). Brazil continues to occupy a dominant position in the US market for tropical sawn lumber, accounting for around 50% of all imports of this commodity in 2006¹⁸.

Within the US wood market, tropical sawnwood tends to occupy very particular but important niches. It is primarily used in high-end furniture, cabinets, flooring, architectural woodwork, decking, and mouldings, and in specialized industrial applications, such as in marine uses and truck beds. In some applications, tropical wood species compete directly with temperate domestic species, most commonly in architectural, decking and flooring applications. Where tropical wood species compete with domestic varieties, species preference is often a function of taste and fashion. For some uses, such as in boat-building and decking, tropical wood has distinct performance advantages. The use of tropical species in US flooring, millwork (i.e. moulding) and builders joinery has been expanding in recent years. However, in the context of a huge US wood market, tropical

¹⁷ AF&PA statistics

¹⁸ AF&PA statistics

wood products (excluding wood furniture) comprise only about 1 - 2% of US consumption¹⁹.

4.2.2 US trade potential

Economic conditions in the US are worsening. Forecasts by the Economist journal in February 2008 indicate that real GDP in the US will grow by only 0.8% in 2008 and by 1.4% in 2009. The US is expected to experience a recession during part of 2008. A more rapid recovery will be delayed by what is expected to be a prolonged period of balance-sheet adjustment by US financial institutions and the deep housing market downturn. This is expected to have a significant impact on demand for all wood products, although commodity grades of imported plywood may be particularly affected as these are closely tied to the level of construction activity. The weak dollar is generally undermining the competitive ability of countries exporting to the US in relation to domestic industry.

Meanwhile intense competition for sales within the US domestic wood processing industry will inevitably place limits on the ability of Malaysian suppliers to expand share in the US hardwood market. The United States has a huge domestic hardwood resource. Between 1953 and 2007, the volume of U.S. hardwood growing stock more than doubled from 5,210 million m3 to 11,326 million m3. U.S. federal government forecasts indicate that further increases of 15 to 20 percent are expected in the hardwood growing stock inventory through 2030. At the same time, domestic hardwood consumption in the US is tending to fall due to the collapse of the domestic furniture industry and more recently due to the housing downturn.

Tropical hardwood competes reasonably well in the US for specific applications in the high-end furniture, architectural woodwork and flooring sectors. However except for some industrial applications where the rot resistance and hardness characteristics of imported varieties of tropical woods are superior, lower-grade tropical species cannot compete well with domestically available hardwoods in large-scale commodity markets for hardwood timbers²⁰.

Opportunities for all sawn lumber suppliers to the US furniture industry have declined in recent years. Driven by a shift to overseas manufacturing, hardwood use by the US furniture industry is less than half of what it was in 1999, a drop of over 3 million m3. ²¹

China and Vietnam are becoming increasingly important suppliers of tropical hardwood to the US market. They are competing with Malaysia in finished imported products such as furniture, stock mouldings, flooring and other BJC products. However China and Vietnam will be vigorous competitors for Malaysia in these markets.

There may also be opportunities in the decking market. Tropical sawnwood used for decking has gained in popularity in up-scale housing and commercial buildings in recent years. Malaysia faces particularly stiff competition from Brazil in this market segment.

¹⁹ Report on the Review of the US market for Tropical Timber Products, International Tropical Timber Organization, Alberto Goetzl & Håkan C. Ekström, July 2007

²⁰ Report on the Review of the US market for Tropical Timber Products, International Tropical Timber Organization, Alberto Goetzl & Håkan C. Ekström, July 2007

²¹ ITTO, July 2007 - see previous footnote

An emerging issue for all suppliers of tropical plywood into the US are increasing controls being imposed in the US on formaldehyde emissions. Malaysian mills that have already made a commitment to supply the Japanese market with formaldehyde free product will tend to benefit and may boost market share, particularly at the expense of smaller Chinese manufacturers that are less able to make the adjustment.

Chinese furniture, plywood and flooring manufacturers have come under fire in the US market from the domestic industry over alleged government subsidies which have been the target of WTO investigations. These subsidies are now being phased out, again opening up potential new opportunities for Malaysian exporters to reclaim and expand market share in the US.

Forest certification and legal wood sourcing are also emerging now as key issues in the United States market likely to impact on long term competitive performance in the US market. It seems likely that these factors should enhance the competitiveness of Malaysian producers in relation to other Asian suppliers, particularly China, in the US market. The rest of this section considers in more depth the extent to which wood sourcing issues are likely to impact on US market demand for Malaysian and other imported wood products.

Overall the outlook for expanding markets for Malaysian wood products in the US seems mixed. There are likely to be opportunities to expand sales of Malaysian tropical hardwood plywood in the US in the long term, but in the short to medium term demand will be negatively affected by the downturn in construction activity. Due to the scale of domestic hardwood supply, potential to expand the market for tropical sawn timber is restricted to a few niche markets (high value flooring and windows and reproduction furniture) which are themselves coming under pressure from overseas competitors. The best long term opportunities for Malaysian exporters lie in the market for value-added products, notably finished furniture, moulding, and frames.

4.2.3 US government procurement policy

4.2.3.1 Overview

Until recently it was possible to draw a fairly clear distinction between the European FLEGT's relatively strong focus on demand-side measures to tackle illegal logging and the US approach which focused almost exclusively on capacity-building through foreign assistance. There were relatively few efforts by US government agencies to develop timber procurement policies. However during 2007, the focus of the US approach was transformed by the efforts of a coalition of major environmental groups and domestic wood industry to push through an amendment to the Lacey Act which would effectively place new and potentially far-reaching obligations on importing companies to ensure that all wood products do not derive from illegal sources. At the same time, emerging concern for global warming, given a significant boost by the campaigning efforts of nobel prize-winning Al Gore, is just beginning to encourage wider interest in and uptake of green building initiatives, particularly LEED, which also include measures to improve timber sourcing practices.

4.2.3.2 Federal government procurement policy

Federal government procurement policies, as well as policies by jurisdictions at the state and local levels, include various requirements to purchase environmentally preferable products (EPP) and services. The US government centralizes its purchasing policies under the Federal Acquisition Regulations (FAR) which govern agency acquisition of supplies and services. The FAR is codified in Title 48 of the United States Code of Federal Regulations and is periodically updated. An Office of Federal Procurement Policy Act (OFPP) oversees the implementation of federal procurement policies. The most common government procurement policies are those that mandate recycled content in paper purchasing.

It is probably safe to say that few tropical wood products are purchased directly by government agencies, but purchasing rules generally extend to government contractors. To date, unlike in Europe, government procurement policies are not dictating that wood products be purchased from verifiably legal and sustainable sources. The presumption is that wood products are legally produced and traded unless deemed otherwise. And rather than require that purchased wood products be traceable to sustainably managed forests, government procurement is moving towards recognizing “green building” standards that typically include preferences for certified wood products²².

4.2.3.3 State and municipality procurement policy

As has been the case in parts of Europe, some localities in the United States have imposed restrictions or outright bans on the use of tropical wood products in public procurement. In at least two states and several municipalities, procurement policies restrict the use of tropical wood in public construction. These include the states of Arizona and New York and local jurisdictions in San Francisco, Santa Monica and Santa Cruz in California; Baltimore in Maryland; and Bellingham in Washington. Most of these prohibitions were put in place during the 1990s following successful lobbying campaigns by environmental groups. More recently, NGOs have shifted to advocating instead policies requiring that wood purchases be from certified (usually FSC) sources.

4.2.3.4 Lacey Act Amendment

The Lacey Act currently regulates trade in fish and wildlife, making it unlawful to “import, export, transport, sell, receive, acquire, or purchase” any fish or wildlife products that are “taken, possessed, transported, or sold in violation of any foreign law.” Legislation was introduced in the House of Representatives and the Senate in 2007 to amend the Lacey Act to include plants, and therefore, timber²³. In fact two proposals to amend the Lacey Act have been introduced. The Legal Timber Protection Act (officially referred to as H.R.

²² Report on the Review of the US market for Tropical Timber Products, International Tropical Timber Organization, Alberto Goetzl & Håkan C. Ekström, July 2007

²³ In more detail, the Legal Timber Protection Act amends the Lacey Act Amendments of 1981 to make it unlawful for any person to import, export, transport, sell, receive, acquire, purchase in interstate or foreign commerce, or possess any plant taken (i.e., captured, killed, harvested, or collected) in a foreign country that is: (1) taken, transported, or sold in violation of any law that applies in the place (including a park, forest reserve, or other officially protected area) where the harvest, taking, transport, or sale occurs; (2) taken without paying required royalties, taxes, or stumpage fees; (3) exported or transhipped in violation of any legal limitation; (4) taken, exported, or transhipped in violation of any international law, treaty, or international agreement, or (5) without any official documentation of compliance with applicable legal requirements. The Act would redefine “plant” to mean any wild member of the plant kingdom, including roots, seed, parts, and products thereof (but excluding common food crops and cultivars).

1497) has been proposed as a stand-alone bill by Senator Earl Blumenauer (D-Oregon). Another bill S.1930, has been introduced by Senator Ron Wyden (D-Oregon) which would implement the legislation through an amendment to the much broader Farm Bill²⁴.

Passage of S.1930 is now at a very advanced stage despite delays as Farm Bill negotiations have become very difficult and protracted. Nevertheless current indications are that it will be enacted in late May or early June 2008.

Passage of the new legislation has been actively promoted both by US domestic industry and environmental groups. Domestic industry efforts have been coordinated by the Hardwood Federation which represents over 14,000 businesses and one million hardwood families in the United States. The Environmental Investigation Agency (EIA) has encouraged and coordinated the ENGO campaign to promote the new law.

The Lacey Act amendment was originally opposed by the International Wood Products Association (IWPA), which represents US importing companies, together with a coalition of associations representing end users and small businesses²⁵. These organisations objected to the original bill because it did not include an “innocent owner” defence for civil forfeitures, had a broad definition of “any foreign law,” and included a new documentation requirement for the country of origin for the harvested tree. Following these organisations’ intervention, the proposed bill was altered to include “innocent owner” protections, a narrow definition of “foreign law” to mean natural resources-related laws only, and a reduction in the monetary penalty for mistakes in documentation from \$10,000 to \$250. As a result the importing industry is also now supporting the legislation.

In accordance with Lacey, the new law will place the burden of proof on the prosecution rather than with the defence. In other words, if charged under the new law, traders of wood products in the U.S. will not be required to prove that the wood in question derives from a legal source. Instead, it will be up to the prosecution to demonstrate that the wood in question was taken in violation of a foreign law.

The Lacey Act amendment is not expected to lead to a large number of prosecutions. The U.S. Department of Justice has indicated that, given limited personnel resources and the high costs of gaining a conviction, the amended law would only be applied with respect to the worst actors – importers with actual knowledge and intent to import illegal shipments. US industry analysts expect that a limited number of cases may be brought early on – perhaps targeting furniture imports from China as these have had a particularly significant impact on US domestic manufacturing industry²⁶. The aim would be to raise awareness of the illegal logging issue and to increase pressure on timber importing companies to undertake due diligence with respect to their timber sources. In order to reduce the risk of prosecution, importing companies would have a strong incentive to increase scrutiny of their supply chains with the aim of avoiding illegal wood.

Implementation of the Lacey Act should therefore favour those suppliers that are better placed to provide assurances that wood derives from legal sources. Chinese manufacturers are widely expected to be the major losers (a key reason for the US

²⁴ IWPA press release November 2007

²⁵ Including the National Association of Home Builders, National Federation of Independent Business, National Lumber and Building Material Dealers Association, American Home Furnishings Alliance, and the National Marine Manufacturers Association

²⁶ Personal communication, Al Goetzl, Seneca Creek Associates

domestic industry backing the initiative in the first place) due to their dependence on relatively long and complicated wood supply chains.

4.2.4 US private sector initiatives

4.2.4.1 IWPA Procurement Policy

The 210 members of IWPA include importers, manufacturers, overseas producers, and transport companies engaged in the US wood importing industry. These companies are believed to account for just about all the tropical hardwood imported into the country.

Ever since 1992, IWPA's Board of Directors has been promoting two environmental procurement policies for Members' voluntary use: an "Environmental Policy for Wood" and a "Purchasing Policy for Wood and Wood Products". According to these policies, IWPA members can voluntarily commit to:

- Seeking and providing the clearest practical information regarding product sources
- Initiating and promoting efforts to achieve the fastest practicable progress toward environmentally sound permanent forest management worldwide...
- Seeking and providing evidence of good forest management practices and giving preference to sources of wood products that are operating within all laws of the country concerned
- Giving purchasing preference to sources within countries demonstrating a commitment to a national forest management program..."

In 2002, IWPA strengthened their members' commitment to sourcing only legal products in a "Statement on Illegal Logging" which stated that: "IWPA promotes compliance, by all parties, with national, state and local laws and regulations pertaining to logging and forest management. IWPA members condemn the violation of such laws and commit to purchase only from suppliers and/or individuals who are in support of this policy... IWPA believes forest law enforcement is a sovereign right and responsibility of governments... IWPA pledge to conduct trade in wood products in compliance with all applicable laws and regulations, not only of the timber-producing countries but also those of the country of destination."

This statement is far-reaching, although neither it nor the IWPA environmental policies are currently backed by any systems for monitoring members' compliance, for the establishment of binding targets, or guidance on appropriate forms of evidence. The policy aims are broad and not time-bound, calling only for "the fastest practicable progress" towards sustainable forest management²⁷.

Guidance with respect to acceptable forms of evidence is very broad and covers only sustainable forest certification. The purchasing policy states: "Labels or certificates warranting sustainability will not be acceptable unless they have the approval of the Forestry Department/Ministry of source countries which have established comprehensive national forestry action plans, or until such time as an internationally acceptable criteria for sustainability is established by a recognised authority." In their policy statements,

²⁷ Review of EU and North American Timber Trade Federations' Codes of Conduct and Purchasing Policies – Update 2007, EU Timber Trade Action Plan (TTAP), November 2007

IWPA strongly emphasises that an absence of certification does not necessarily mean lack of quality forest management. It highlights the need to recognise countries or companies improving management practices.

As things stand, IWPA's procurement policies and illegal logging statement do not seem to have been a major driver of demand for verified legal and sustainable wood products. On the other hand, there is a feeling in the US importing industry of the need for some tropical producers to provide more credible assurances of good practice as a foundation for wider acceptance in the US market. According to ITTO in July 2007, *"Demand for certified wood products [in the US] remains very low, but certified wood products are attracting increasing attention. Premiums for certified wood products are the exception rather than the rule. The lack of sufficient supply of certified wood products is frequently cited by importers and distributors as a given in the marketplace. Not surprisingly, there is an assortment of opinions about the role of certification in the US wood market. Amongst importers, the prevailing view is that certification is not likely to result in price premiums, but it may help to secure and legitimize trade in certain tropical species"*²⁸.

In early 2008, IWPA made the following comment with respect to market prospects: *"The trend towards 'green building' and certification will become dominant obstacles to the industry in 2008. If the hardwood industry does not face up to these two challenges, we can expect growing institutional roadblocks to the use of our already underutilized hardwood resource. We can argue amongst ourselves whether third-party certification stamps are meaningful or whether people will pay for the reassurance they purport to provide, but the environmental movement has captured the stage. For too long the industry has turned a blind eye, hoping that ignoring anti-industry forces would somehow make them go away. How well the industry succeeds in communicating the message of sustainability could well determine the look of the industry for the balance of the decade and beyond"*²⁹.

Passage of the Lacey Act amendment has significant potential to raise the profile of the IWPA procurement policies as companies would have a very real incentive to demonstrate that they take their legal sourcing responsibilities seriously. With respect to market value of FLEGT VPA licences, the flexible approach adopted by IWPA to date in relation to acceptable forms of certification, and the strong focus on conformance to national forestry programs, strongly implies that FLEGT VPA licensing would have value for provision of credible evidence of legality to IWPA members and may even be accepted as evidence of sustainability. On the other hand, it also seems likely that private sector legality verification and certification initiatives would be regarded as equally credible.

4.2.4.2 Green building initiatives

In the United States, systems for rating the environmental performance of buildings are increasingly being utilized and codified for government procurement. The Leadership in Energy and Environmental Design® (LEED) developed by the US Green Building Council is currently the most recognized of the programs, although Green Globes® and some state-specific guidelines have also been adopted.

²⁸ Report on the Review of the US market for Tropical Timber Products, International Tropical Timber Organization, Alberto Goetzl & Håkan C. Ekström, July 2007

²⁹ www.iwpawood.org

The value of green building construction starts was around \$12 billion in 2007, and is projected to increase to \$60 billion by 2010 according to the U.S. Green Building Council, citing McGraw-Hill Construction Analytics. Since launching LEED in 2000, USGBC has registered almost 8,000 projects and certified nearly 1,000 buildings, encompassing more than 1 million square feet.

The recent growth in green building seems impressive, but these figures are relatively small compared with the overall size of the US construction sector. Overall construction starts in 2006 stood at around \$1180 billion in 2006. Currently green construction accounts for only around 1% of total construction starts and (assuming zero change in construction activity over the next four years) the level of green construction in 2010 would only amount to 5% of the total market.

At present, most LEED users are federal, state and local government entities, and nonprofits. All General Services Administration³⁰ projects must meet LEED standards; so must the military, the U.S. State and Energy Departments and the Environmental Protection Agency. Nine states have adopted LEED for government building projects, including California, New York and New Jersey, while three states require LEED for all public and private projects over a certain size. Numerous municipalities and universities use the standards, as do Ford, Honda, Toyota, Boeing and IBM. National commercial real estate companies such as Liberty Property Trust, Hines, and Transwestern are now developing and managing sustainable properties. LEED-registered projects by building type show that 22% are multi-use, 17% commercial office buildings and 9% higher education, with other occupancies in the low-to mid-single digits. Local governments own 25% of the registered projects, nonprofits own 19% and state governments own 12%.

The recent growth in LEED registered projects reflects increasing concern for carbon emissions and energy efficiency and also the declining costs of green construction. In the past it was estimated that LEED conformance would add about 10% to the cost of a project, but recent estimates suggest it adds only about 2% to 3% to total costs. Rising energy costs also mean that the extra costs of LEED construction are more rapidly offset by the savings of having an energy-efficient building³¹.

The relative significance of LEED construction projects is also likely to increase in the building sector in coming years. While residential construction has slowed dramatically, a mini construction boom is currently underway across government agencies. The reasons vary: military base closings and realignments, war needs, post-Katrina rebuilding, the need for more border checkpoints and embassies, among others. The Pentagon alone has \$21 billion of planned building projects, mostly relating to the 2005 base realignment and closure process, new barracks and brigade centers related to the war on terrorism, and new and renovated facilities to support wounded soldiers returning from war.

At present the LEED standard is problematic for wood products generally and would not do anything to boost demand for legally verified wood products. The standard tends to favour building materials containing recycled content over materials produced from renewable resources. The exception within the LEED framework is that "points" can be awarded for short-rotation bio-based products and for FSC-certified wood products.

³⁰ General Services Administration (GSA) is an independent agency of the United States government established in 1949 to help manage and support the basic functioning of federal agencies. GSA oversees \$66 billion of procurement annually and contributes to the management of about \$500 billion in U.S. Federal property.

³¹ Articles drawn from www.usgbc.org

Thus, imported bamboo products and imported wood products that are FSC-certified are favorably treated in the LEED system. FSC certification is the only certification system currently recognized in the LEED standard, a fact that has been contested by the US wood products industry³².

Now there is a major review of the LEED standard underway that might have an important bearing on demand for legally verified and MTCC certified wood products. In 2007, the US Green Building Council commissioned Yale University to assess policy options for forest certification and the use of wood in the LEED program³³. Yale University has recommended that LEED broaden its approach and consider other forest policy mechanisms in addition to FSC forest certification. It is proposed that *“USGBC can increase its effectiveness in promoting responsible wood use by focusing not just on rewarding the top performers through forest certification, but also ‘weeding out the bottom’, i.e. those forestry operations that are so destructive that the wood they produce should never be used in a USGBC project. [Yale University] suggests phasing in requirements for legality verification as a prerequisite for LEED certification. Such a system would be based on a “risk assessment” identifying areas where there is a high risk of illegal activity and requiring legality verification for wood originating from those areas”*.

With regard to forest certification, Yale University proposes various options for consideration by USGBC that would allow recognition of a range of systems. For example, USGBC may set out a set of performance requirements to which certification systems must conform if they are to be recognised for LEED credits. This may provide a window of opportunity for recognition of MTCC certification under LEED.

Yale University also proposes replacing the current system of credits for rapidly renewable materials with a system that awards credits based on a complete life cycle assessment. This would be much more favourable to wood generally than the current system.

Green Globes, a program of the US Green Building Initiative based on the UK BREEAM system, is a significant competitor to LEED. Green Globes as developed a particularly strong presence in the residential construction sector through affiliation to the National Association of Home Builders and direct promotion to local home builder associations across the US. It provides credits for materials produced under a range of recognized forest certification systems. Credits are currently available only for the SFI, CSA, FSC and American Tree Farm System (AFS). There is currently no minimum requirement that timber be legally sourced.

Overall green building initiatives influence only a relatively small portion of the US construction market. Nevertheless they are beginning to play a more important role in encouraging interest in sustainable timber sourcing in the US construction sector, particularly in publicly funded projects. If LEED is amended as proposed by Yale University, it would generate more interest in legality verification and create a valuable marketing opportunity both for VPA licensed and MTCC certified wood products.

³² Report on the Review of the US market for Tropical Timber Products, International Tropical Timber Organization, Alberto Goetzl & Håkan C. Ekström, July 2007

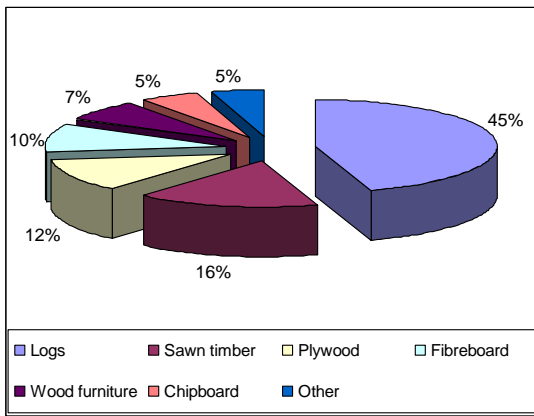
³³ Full details of the Yale University review are available at <http://www.yale.edu/forestcertification/USGBCFinal.htm>

4.3 China

4.3.1 Recent Malaysian trade with China

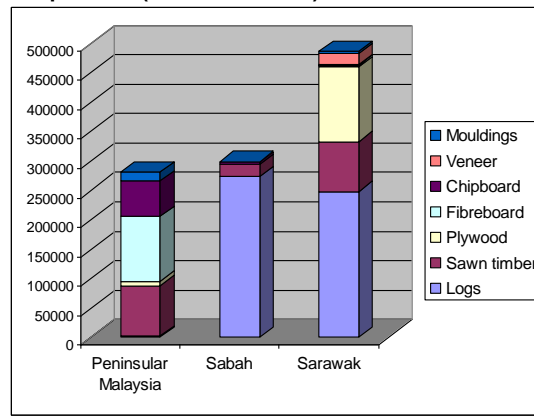
Malaysia’s exports to China are dominated by logs which accounted for 45% of total export value to the country in 2006, with lesser volumes of sawn timber and plywood (Chart 4.7). Logs sold into China are believed to be destined primarily for plywood manufacture, with smaller volumes destined for the furniture and joinery sectors. A significant proportion of sawn lumber is destined for China’s flooring sector. Malaysian plywood is destined mainly for structural construction applications.

Chart 4.7: Value of Malaysian wood product exports to China (% RM value by product in 2006)



Source: MTC compiled by FII Ltd

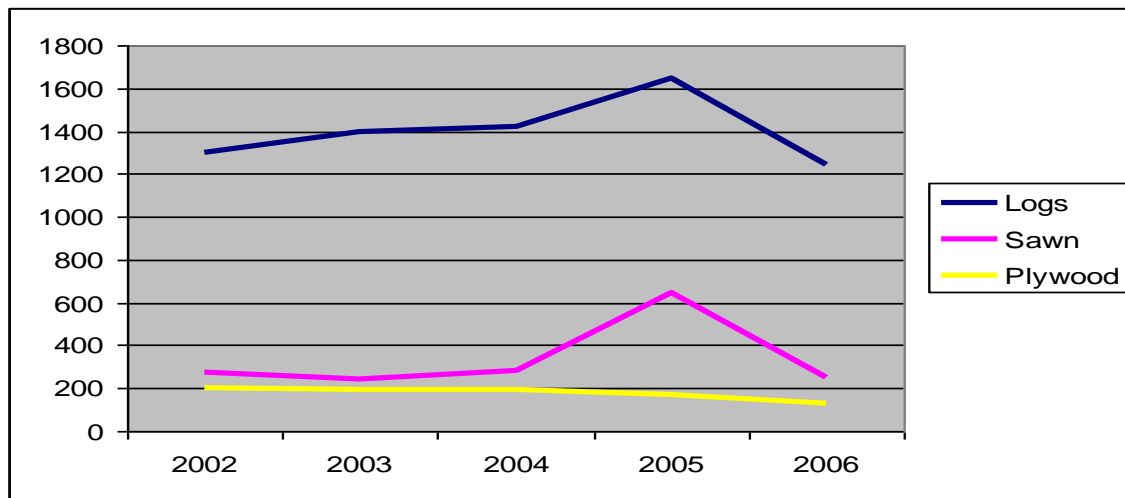
Chart 4.8: Value of Malaysian primary and secondary wood products exports to China by source region and product (RM 1000 in 2006)



Source: MTC compiled by FII Ltd

A significant feature of Malaysia’s wood products trade with China in the past was the volume of indirect trade via Hong Kong. However with economic liberalisation in China, this indirect route is now declining in importance and more wood is exported directly into the Chinese mainland.

Chart 4.9: Volume of Malaysian exports of logs, sawn lumber and plywood into China/Hong Kong (000 m3 2002-2006)



Source: MTC compiled by FII Ltd

Chart 4.9 shows recent trends in Malaysian exports of logs, sawn lumber and plywood into China/Hong Kong. Malaysia's log exports to the region rose from 1.3 million m³ to a peak of over 1.6 million m³ in 2005 before declining again to 1.2 million m³ in 2006. Malaysia's sawn lumber exports to the region followed a similar pattern, rising strongly between 2001 and 2005 from 275,000 m³ to over 600,000 m³ before declining again in 2006 to 252,000 m³. Exports of Malaysian plywood to China/Hong Kong declined progressively from 204,000 m³ in 2002 to only 132,000 m³ in 2006. China's imports of plywood are generally declining in response to development of China's domestic wood processing industry.

4.3.2 China trade potential

The growth potential of the Chinese wood market is very considerable. China's economic liberalisation measures and integration into the world economy have led to rapid growth in recent years. GDP growth exceeded 11% in both 2006 and 2007 to lead all major economies. Growth is projected to continue to lead the world at nearly 10% in 2008. At the same time, high levels of investment in China's wood processing capacity combined with relatively low labour costs have meant that the country has become increasingly important as a global wood processing hub. With domestic harvesting restricted, China's wood imports have risen sharply since the mid-1990s. A significant proportion of imports arrive in the form of logs with Russia becoming an increasingly dominant supplier.

While other parts of South East Asia have seen imports of wood products increase in response to rising export demand for finished products, rising Chinese demand is more due to changes within the domestic market. A 2006 report on China's wood market by the private research organisation RISI indicates that of the 63 million m³ of sawn lumber, plywood, particleboard and MDF manufactured in China, only 8 million m³ is exported. Of the 63 million m³ of the wood products manufactured in China, around 33 million m³ is estimated to be consumed in the construction sector, while 30 million m³ is destined for the furniture sector. Only a minority of furniture manufactured in China is exported. China's furniture production was valued at \$57 billion in 2006 while exports amounted to around \$17.5 billion (31%). Similarly, domestic consumption accounts for two thirds of Chinese flooring production and 82% of Chinese door production.

In the past decade or so, primary wood products have experienced a consistent increase in their share of China's forest product imports, with round logs and sawnwood seeing the largest share of growth. In 2006, RWE import volumes into China of softwood logs were 19.72 million m³ and of hardwood logs were 12.44 million m³. Equivalent figures for hardwood and softwood sawnwood were 7.13 million m³ and 3.8 million respectively. Together these four commodity groups made up around 90% of total wood import volume. In contrast, high valued added products such as veneer, fiberboard and plywood have been steadily declining as a share of imports.

While the majority of wood products manufactured in China are for the domestic market, its wood product exports have risen rapidly and supply a large and increasing share of markets in Europe, North America and both West and East Asia. Between 2003 and 2006, the value of wood furniture exports from China increased from USD 4.46 billion to USD 11.1 billion. The value of other solid wood product exports increased from USD3.46 billion to USD8.58 billion during the same period. On a RWE volume basis, exports of

wood products (excluding furniture) increased from 14.86 million m³ to 36.31 million m³ between 2003 and 2006. Of non-furniture wood products, plywood is by far the largest single commodity export accounting for around 33% by value and 54% by RWE volume in 2006.

Due to inadequacies in trade statistics, it is not possible to accurately assess the extent to which China's wood product exports derive from imported timber. Nevertheless, it is likely that imports of timber account for a significant proportion (perhaps 30-50%) of the total exported – particularly as face veneers, which determine how a product is marketed. With respect to the furniture sector, one estimate is that exports of furniture processed with imported materials accounted for around 41 percent of the sector's total export value in 2006³⁴.

Meanwhile China's timber consumption has grown rapidly. Chinese consumption of industrial wood currently ranks third in the world at 140 million m³. Domestic production supplies around 85 million m³, leaving a gap of around 55 million m³. With rapid economic growth and industrialization, the domestic wood shortage is expected to get more severe in future even when re-exporting of wood products is not considered.

China's furniture industry increased the value of its production by around 400% in just 8 years, from 87 billion Yuan in 1998 to 400 billion Yuan in 2006. Similarly growth in China's flooring production has averaged 20-30% annually in recent years. The most recent production numbers for the industry place annual output at approximately 330 million m² in 2006, up from 290 million m² in 2005.

Based on modelling of projected future supply and demand patterns in China under three different investment policy scenarios, Northway and Bull (2007) conclude that *“Under each scenario, China's forests supply an ever-shrinking amount of industrial roundwood to meet domestic consumption, and the country does not reach self-sufficiency. The forecasted increase in domestic forest product consumption outpaces the increase in domestic supply, leading to increased trade over the next 25 years, especially in sawlogs”*³⁵.

Northway and Bull predict that imports will have to rise from current levels of around 40 million m³ to 80 million m³ by 2020. They also predict that, all other things remaining equal, log imports together with composite panel imports would grow strongly. Imports of sawn lumber would remain static, while plywood imports would remain stagnant at low levels. Russia's plans to implement log export taxes and the decline in availability of illegal Indonesian logs may alter this pattern to some extent.

Despite this picture of unrelenting growth, over the last 2 years China's wood processing industry has come under increasing strain. It has faced mounting problems to source competitively-priced wood raw material. The rising costs of labour, energy, and transportation have been undermining competitiveness in international markets. The USA, Canada and Europe have become more vigorous in pursuit of anti-dumping measures and more determined to ensure that China conforms to WTO rules. In

³⁴ Professor Song Wenming, vice-President of Beijing Forestry University, speaking at the EU-China FLEGT Conference in Beijing, September 2007

³⁵ Steven Northway and Gary Bull July 2007, Forest Products Trade Between Russia and China: Potential Production, Processing, Consumption, and Trade Scenarios, University of British Columbia, Forest Trends

response, the Chinese authorities have been phasing out various tax breaks and other supportive measures for export industries.

Chinese companies have also been adapting. Through investment in new machinery, producers are increasingly substituting lower quality, lower cost domestic plantation wood for imported solid wood. Domestic production of composite panels is rising strongly, and these are increasingly used to produce export quality finished wood products at lower costs. The share of solid wood furniture in total Chinese furniture manufacturing declined from 75% in 1998 to 34% in 2004. Similarly production of solid wood flooring has declined dramatically in recent years in favour of engineered wood flooring and laminates.

Therefore to some extent relatively low quality domestic wood products from fast-growing plantations are substituting for higher cost solid timber products in the Chinese market. Nevertheless, such is the pace of growth in the China's wood processing sector that demand for higher value tropical hardwood products is likely to remain strong in the medium to long term, particularly from the domestic construction market.

China's housing policy is now encouraging private ownership over state-sponsored accommodation. This combined with rising affluence has meant that China's home mortgage market is growing rapidly and sales of residential homes have increased by 40-50% per year since 1999. The construction area completed in China each year is around 1.2 billion square meters, about 6 times that of Europe. Of this area, around 500 million square meters comprises urban housing. It is estimated that each year about 5 million Chinese families are buying a new home creating huge demand for furniture and other wood products for interior decoration.³⁶

Against this background, China seems to have strong potential to absorb rising volumes of Malaysian wood products in future years. This conclusion is tempered by the observation that China is unlikely to be receptive to significant increases in Malaysian exports of value added products such as mouldings, BJC and furniture. This is due to the country's relatively low domestic labour rates, rapidly expanding domestic wood processing facilities, and obvious ability to compete in global markets for semi-finished and finished wood products. Chinese buyers have a strong preference for logs whenever possible. But the evidence of the American hardwood lumber sector – which has seen exports to China surge from less than \$7 million in 1995 to around \$468 million in 2006 – indicates that there are also strong emerging opportunities in the sawn lumber sector.

4.3.3 Chinese government procurement policy

Some preliminary efforts have been made to introduce green procurement requirements into China's public sector, mainly with a view to reducing energy demand and promoting energy efficiency. In December 2006, the Chinese government introduced a policy requiring central and provincial governments to prioritize their purchasing of environmentally friendly products and services. The policy is intended to be fully implemented at all levels of jurisdiction starting in 2008. A "green purchasing list" specifying a range of recommended products carrying the China Environmental Label, China's only national eco-label for environmentally friendly goods and services, has been established. The Label is based on standards and certification procedures

³⁶ Research and Markets, China Furniture Market Report 2006-2007 <http://www.researchandmarkets.com/reports/c49413>

developed by the China State Environmental Protection Administration (SEPA). Government purchasers will be required to buy products from the list when these alternatives are available; otherwise financial authorities may refuse to pay for the items.

The current green purchasing list includes 859 products in 14 categories, ranging from vehicles, photocopiers, printers, and televisions to flooring, paint, and other construction materials. The list encompasses several wood products, including plywood, fibreboard, veneer, floorboards, and furniture. However the environmental standards for panel products only establish requirements for formaldehyde emissions and do not cover raw material sourcing issues. Only the furniture standard makes any reference to timber sourcing. It notes that if the timber content is in excess of 10% of the weight of the furniture, the timber shall not come from preserved natural forest or rare species. FSC-certified timber is automatically recognised as meeting this requirement. Accessories such as draw handles are not included in this restriction.

So as things stand, China's government procurement policy can do little to drive demand for verified legal wood products in the Chinese market. Much hinges on the willingness of the government to move forward with a policy with the specific aim of raising standards of environmental timber procurement.

Until relatively recently, the indications were that the Chinese authorities were unwilling to recognise any responsibility for illegal timber imports and were opposed to demand side measures to tackle the problem. For example, on May 8, 2006 the International Herald Leader – which is operated by China's state Xinhua News Agency - included a special report on the connection between illegal logging, China and the rest of the world. The whole tone of the report aimed to steer responsibility away from China towards the US, European, and Japanese consumers. The overview article countered ENGO and western media claims that China is primarily responsible for driving illegal logging, alleging that the main responsibility lies at the end of the commodity chain – that is demand from customers of finished products in EU, US and Japan. China “*only plays the part as the world's workshop*”. Officials from China's State Forest Administration were quoted at length suggesting that China is already doing enough by participating in international FLEG processes and with its focus on self-sufficiency in timber supply through a massive plantation program.

More recently, there are indications of a thaw in the government's resistance to demand-side measures within China itself. In part this reflects efforts by the EU to promote greater use of trade measures in China to tackle illegal logging. At an EU-China summit in 2005, leaders from both sides "pledged to work together to tackle the problem of illegal logging in the Asian region". To take the co-operation process forward, a conference was held in Beijing during September 2007 jointly arranged by the Chinese government and European Commission. The objective of the conference was to discuss joint efforts to combat illegal logging and promote sustainable forestry. European officials used the Conference as a platform to promote the value of demand side measures. In a written message to the conference, China's Vice-Premier Hui Liangyu said that protecting forest resources and alleviating the global environmental crisis is the responsibility of all nations. As a responsible developing country, China would crack down on illegal logging and illegal trade, and strengthen bilateral and multilateral cooperation in promoting forest sustainable management. Also at the conference, one SFA official acknowledged that “*Green procurement is certainly a valuable incentive that*

consuming countries should consider” and that “if each country and company can design a good green procurement policy, regional FLEG will benefit”.

More concretely, China’s Ministry of Commerce is now engaged in a process to develop a “sustainable trade strategy”. As part of this process, the International Institute for Environment and Development (IIED) has been commissioned to prepare a study considering how to integrate sustainable development into China’s policies on forestry and international forest products trade. The study involves an assessment of China’s social and environmental impacts on the forest products commodity chain and includes recommendations on how to improve sustainable practices. A multi-stakeholder Steering Committee chaired by the China Ministry of Commerce has been established to oversee the study.

At a meeting in London in July 2007, IIED suggested that attitudes within the Steering Group have changed during the course of the project. At the first meeting of the Group in 2006, Chinese officials were very defensive, claiming that problems with respect to illegal wood are shaped by timber supplying countries and rich consumers of finished products. China was seen as an intermediary with little leverage or responsibility to intervene. However, with the provision of more detailed information on the scale of the illegal logging problem and the role played by China’s importing industry, IIED suggested that Chinese officials have become more open to the idea of demand-side measures. IIED has been sufficiently encouraged to include as a recommendation in their final report to the Ministry of Commerce that consideration should be given to the development of a Chinese government procurement program to encourage legal and sustainable wood products. Another recommendation is that the Ministry seeks to improve China’s “brand” through better corporate responsibility aimed at sustainable wood products.

While these potential trade measures are now being openly discussed in China, it should be emphasised that, as elsewhere, even if positive decisions were taken to move forward the challenges of implementation are likely to be considerable. A 2007 study by the University of Beijing on the potential for a government timber procurement policy in China highlights some of these challenges. The study notes that an appropriate “macro environment” for implementation of such a policy is absent at present. There is a lack of appropriately qualified purchasing professionals. Furthermore China does not have a comprehensive and unified government procurement system capable of disseminating appropriate information, imposing standards and monitoring implementation at all levels of government. Therefore any policy change would have to be accompanied by a political commitment to devote significant resources for capacity development.

4.3.4 Chinese trade procurement policy

None of China’s domestic trade associations is yet promoting an environmental timber procurement policy for their members. There are significant challenges involved in promoting, developing and implementing such policies amongst Chinese wood trading and manufacturing companies. Lack of end-user demand for verified legal and sustainable wood products, particularly in the domestic market, is one problem. Another problem is extreme fragmentation of the wood processing sector in China. Today, there are 10,350 sawmills in China, only 350 of which are considered large with an annual capacity of 30,000 cubic meters or more. Similarly, there are over 3,000 wood based panel mills across China, of which over 2,000 are plywood mills with low technology.

There are over 500 particleboard mills, only two or three of which have an annual capacity of over 100,000 m³. There are an estimated 50,000 furniture enterprises in China, each employing an average of 100 people.

The potential to develop wood procurement systems and practices in the Chinese plywood and flooring sector has been explored in a March 2007 report by the Tropical Forest Trust (TFT) for the UK government³⁷. This report notes that most manufacturers in these sectors do not possess the internal capability, whether in the form of Wood Control Systems, procurement policies, or internal control procedures, to even begin to monitor their raw material supply chain. Furthermore, with numerous traders, shippers, processors, even farmers, involved in the supply chain, it is generally extremely difficult for Chinese wood products manufacturers to provide complete documentation on legality or to account for each step in the supply chain.

The TFT report also highlights that domestic market conditions are not conducive to the development of environmental timber procurement policies. It notes that overproduction and excess capacity in all wood processing sectors in China is rife, giving producers little pricing power particularly in the price-sensitive domestic market. Entry, and exit, is easy, and there is very little differentiation or branding for the products manufactured by most companies. Substitution of similar products from other suppliers, whether Chinese or from other international producers, is often easily accomplished. Manufacturers face intense competition both in the international and domestic market. These pressures, combined with a business culture where imitation, copying, and 'creative' accounting are widely practiced, leads many manufacturers to cut corners when and where they can. If able to secure cheaper or more desirable raw materials from 'questionable' sources, then they will.

This TFT report goes on to suggest that *"In the near term, China itself is unlikely to be able to implement control systems to ensure legality of product entering its wood processing industry, for reasons including bureaucratic indifference; local protectionism of manufacturing and jobs; tax and revenue demands; cost competition within not only the domestic industry but also from other wood production centers; and difficulties in implementing and enforcing a nation-wide system"*.

Despite these concerns, the TFT report concludes with some positive commentary on the opportunities for developing interest in verified legal wood products in the Chinese market. It suggests that *"markets are changing"*, particularly noting the efforts of overseas retailers such as B&Q and Home Depot to establish legality and sustainability in their wood supply chains. It notes the rising number of FSC chain of custody certified companies in China which, by the end of 2007 had reached 367. Most of these are companies engaged in the supply of products to retailers in Europe and North America.

There is also a WWF Forest and Trade Network in China (CFTN) which currently has eighteen members. WWF claims that the total roundwood equivalent volume of timber traded collectively by members of this network now exceeds 2.5 million m³.

TFT also notes that *"one of the key characteristics of Chinese manufacturers is that they are extremely adaptable as well as shameless imitators. Faced with economic incentives*

³⁷ China Wood Products Supply Chain Analysis, Helping Chinese Wood Producers Achieve Market Demands for Legal and Sustainable Timber. Funded by DEFRA, March 2007

(or disincentives) to change, they will. It only takes a few examples of 'first movers' who are seen to be gaining an advantage by changing the way they operate for more companies to move in that direction". TFT reckon that flooring companies, due to their relatively larger size, are more likely to be inclined to develop environmental procurement policies than plywood manufacturing companies which tend to be relatively small. If so, this might imply some emerging pressure on Malaysian suppliers of flooring grade timber to China to demonstrate that wood is at minimum from legal sources.

The proposed amendments to the U.S. Lacey Act should also help to drive interest in legally verified wood products in those sectors of the Chinese manufacturing sector exporting significant volumes to the United States, notably flooring and furniture. Importers in the US would have a major incentive to buy these products only from those manufacturers that can demonstrate they have taken sufficient measures to ensure the legality of wood supplies.

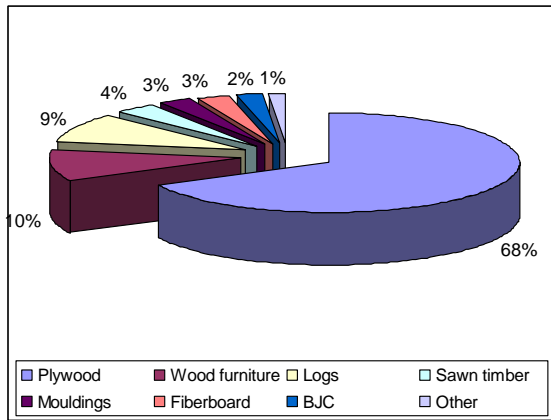
So those seeking to develop markets for verified legal wood products in the private sector in China can point to some positive developments. On the other hand, these developments need to be balanced against the vast scale of the Chinese market. As noted above, the majority of wood products manufactured in or imported into China are destined for the domestic market. The number of chain of custody certified companies (367) is tiny compared to the actual number of companies known to be engaged in the Chinese wood trade and industry (which runs into the tens of thousands). The roundwood equivalent volume of wood traded by members of the WWF CFTN involves a large amount of double counting (since volumes traded both by buyers and their suppliers are included) and even then accounts for less than 2% of total Chinese wood consumption. It seems certain that numerous opportunities to sell wood for Chinese domestic consumption without any form of legality verification will continue to exist for the foreseeable future.

4.4 Japan

4.4.1 Recent Malaysian trade with Japan

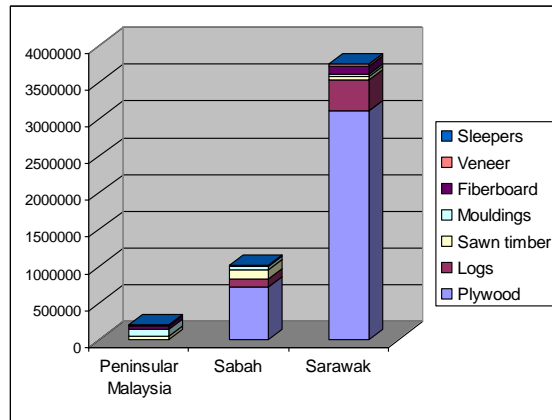
Malaysian exports to Japan are dominated by plywood which accounted for 68% of total export value to the country in 2006 (Chart 4.10). Of the remainder, 10% of export value comprised wood furniture and 9% logs.

Chart 4.10: Value of Malaysian wood product exports to Japan (% RM value by product in 2006)



Source: MTC compiled by FII Ltd

Chart 4.11: Value of Malaysian primary and secondary wood products exports to Japan by source region and product (RM 1000 in 2006)

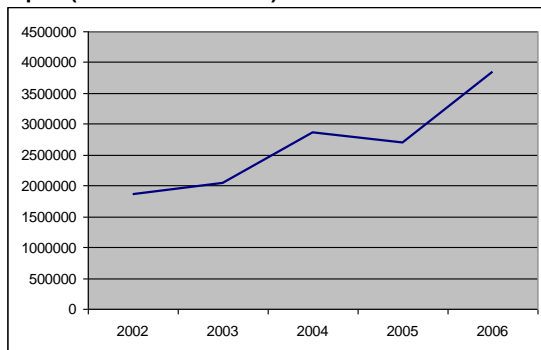


Source: MTC compiled by FII Ltd

By Malaysian region (Chart 4.11), Japan is a critical export market for Sarawak and Sabah taking a large proportion of each state’s plywood exports. It also remains a reasonably significant market for logs, particularly from Sarawak. For Peninsular Malaysia, Japan is primarily important as a market for wood furniture. Relatively small volumes of other products from the region are exported into Japan each year, including mouldings, sawn timber, fibreboard and BJC.

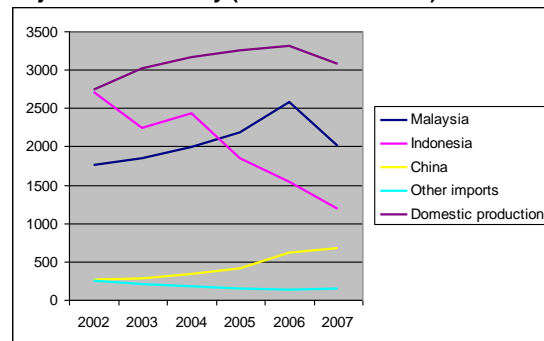
The value of Malaysia’s plywood exports to Japan increased dramatically from less than RM 2 billion in 2002 to close to RM 4 billion in 2006 (Chart 4.12). The increase in volume terms was less rapid, from 1.64 million m3 to 2.5 million. There was therefore a significant increase in the unit value of plywood exports over the period from RM 1133/m3 to RM 1519/m3 reflecting the general rise in global plywood prices over this period due to strong international demand for wood raw material and tightening tropical wood supply.

Chart 4.12: Value of Malaysian plywood exports to Japan (RM 1000 2002-2006)



Source: MTC compiled by FII Ltd

Chart 4.13: Volume of Japanese plywood supply by major source country (1000 m3 2002-2007)



Source: Japan Plywood Manufacturers Association (JPMA)

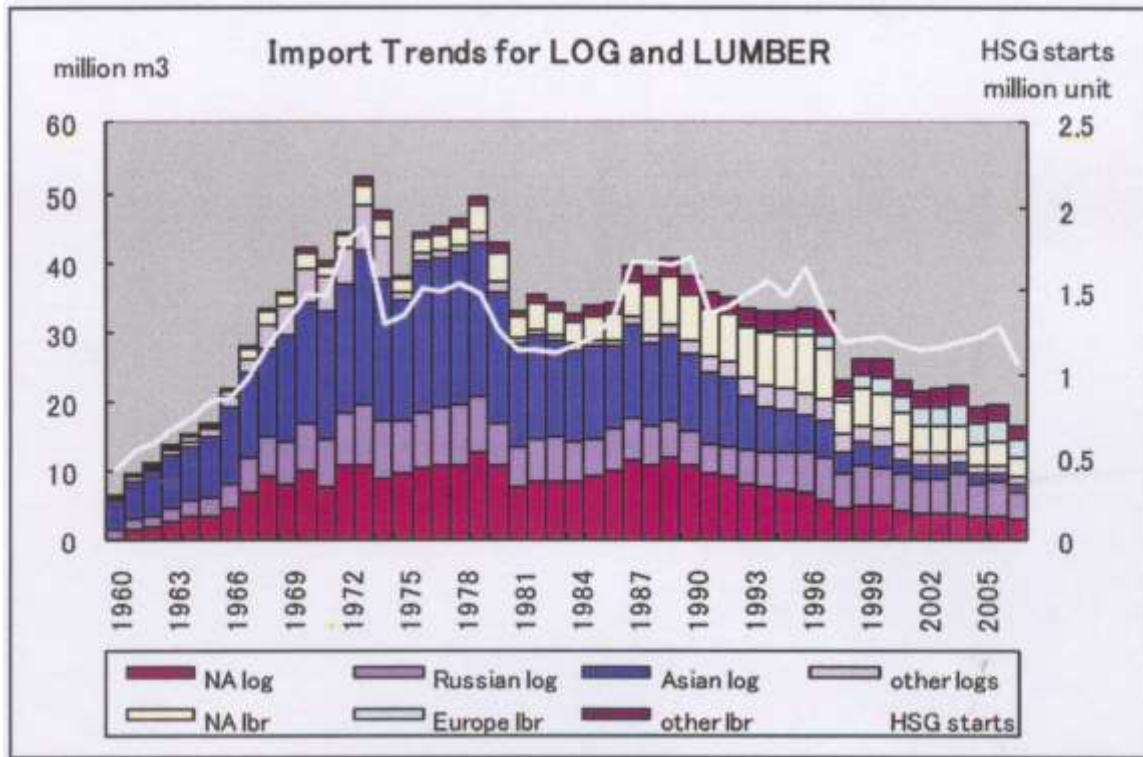
There are several reasons for strong growth in Malaysia’s plywood exports to Japan during the 2002 to 2006 period. A key factor was declining availability of Indonesian plywood in response to forest depletion and efforts by the Indonesian government to

curtail illegal log supply. Chart 4.13 showing Japanese plywood supply by country of origin indicates that between 2002 and 2006 Malaysia was taking market share from Indonesia. Japan’s imports of Indonesian plywood fell from around 2.75 million m3 to around 1.5 million m3 during the period.

Another factor was a dramatic structural change in the Japanese domestic wood processing industry starting from around 1999. This is well illustrated by Chart 4.14 which shows long term trends in Japanese logs and lumber imports against housing starts from 1960 to the present day. In the years between 1960 and 1985, there was a very close relationship between log imports and housing starts, reflecting the fact that Japan imported nearly all wood in its raw state for further processing in the country. Between 1985 and 1999, log imports began to decline as more sawn lumber was being imported, particularly from North America. Nevertheless there remained a close correlation between combined log and lumber imports and housing starts.

However from 1999 onwards, both log and lumber imports continued to decline even as housing starts remained constant. This is because there has been a strong shift towards increased use of pre-fabricated products in the Japanese construction sector, an increasing proportion of which are imported. Following the Kobe earthquake in 1995, there was also a big shift in construction methods away from traditional post and beam construction towards greater use of load bearing panels which combine a lumber frame with wooden boards such as OSB and plywood. As a result demand for structural plywood and other composite panels in Japan has remained strong, but demand for lumber has tended to wane. There has also been a shift away from traditional rough sawn solid lumber in favour of laminated products which are seen as more stable and stronger.

Chart 4.14: Japan log and lumber import trends 1960-2007



Source: Japan Lumber Journal

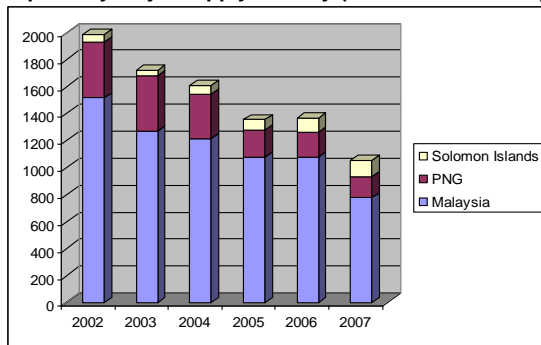
There have also been big structural changes within Japan’s plywood sector itself. Declining availability and rising prices of tropical hardwood logs since the late 1990s encouraged Japan’s domestic plywood mills to increasingly shift away from processing tropical hardwood logs in favour of softwood logs, notably from Russia. Japan’s imports of tropical logs have been in continuous decline since the early 1990s. The latest data suggests that this trend has only intensified in recent years. Between 2002 and 2007, Japan’s imports of these logs declined from nearly 2 million m3 to only 1 million m3 (Chart 4.15). Malaysia remains by far the largest supplier of tropical logs to Japan, accounting for around three quarters of total import volume.

While Japan’s imports of tropical logs have declined and Japan’s plywood mills have been switching over to production of softwood plywood, Malaysia’s manufacturers were able to boost sales of structural plywood in the Japanese market between 2002 and 2006. However, latest Japanese import data suggests there may have been a partial reversal of this trend last year. Between 2006 and 2007, Japanese imports of plywood from Malaysia declined from around 2.5 million m3 to 2 million m3. A sharp deterioration in Japan’s housing starts during 2007 was a major factor. Another factor was increased competition from Chinese plywood. Japan’s imports of Chinese plywood rose sharply between 2005 and 2007 despite the weakness of Japan’s construction sector.

While Malaysian plywood competes directly with Indonesian and some Chinese plywood in the Japanese market, it does not compete so directly with domestic plywood. There is now a clear division between Japan’s domestic plywood supply and imported product. The vast majority of plywood manufactured in Japan consists of thicker product (12mm and above) whereas imported plywood is mainly thinner product (6-12 mm).

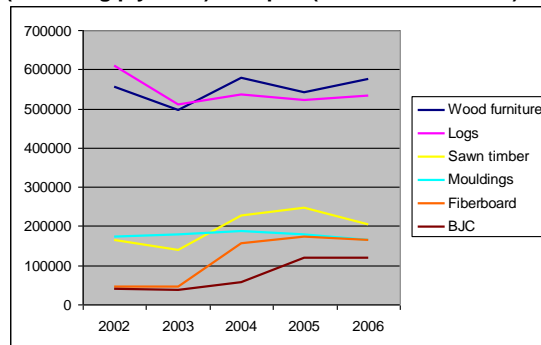
A major issue in the Japanese plywood market in recent years has been strong demand for low formaldehyde products. This demand has been driven by tough requirements for structural panels to be certified as low emission products introduced as an amendment to Japan’s Building Standard Law in July 2003. Now nearly all wood products require “four-star” JAS certification indicating very low formaldehyde emissions. Initially this law provided a boost for domestic plywood manufacturers that were better placed to satisfy JAS requirements. However after making significant investments and adjustment to manufacturing processes, many Malaysian manufacturers are now able to supply appropriate JAS conformant products.

Chart 4.15: Volume of Japanese “southsea” log imports by major supply country (1000 m3 2002-2007)



Source: Japan Lumber Journal

Chart 4.16: Value of Malaysian wood product exports (excluding plywood) to Japan (RM 1000 2002-2006)



Source: MTC compiled by FII Ltd

Trends in exports of other Malaysian wood products to Japan have been less dramatic (Chart 4.16). The value of Malaysia's exports of wood furniture to Japan remained broadly flat over the period 2002 to 2006, varying between RM 500 million and RM 575 million. This suggests a loss of market share since overall Japanese furniture imports were rising rapidly during this period, from around 378 billion yen to around 450 billion yen. However Malaysia is not alone in suffering a loss of market share in the Japanese wood furniture market. Japan's imports from China have been rising very rapidly at the expense both of Japan's domestic industry and all other furniture supplying countries. During the period 2000 to 2005, Japan's imports of furniture from China increased from 90 billion yen to 190 billion yen. In 2005 China accounted for 43% of all Japan's furniture imports. In that year, Malaysia was Japan's seventh largest external furniture supplier, accounting for 4.3% of all Japan's imports. The value of Japan's domestic furniture production decreased rapidly from 2500 billion yen in 1997 to 1500 billion yen in 2002, stabilising at that level between 2003 and 2006.

In value terms, there have been some minor increases in Malaysia's exports of Malaysian sawn lumber, fibreboard and BJC to Japan, but overall levels of export of these commodities are relatively confined. The value of Malaysian exports of mouldings remained static between 2002 and 2006.

4.4.2 Japan trade potential

Short term prospects in the Japanese wood market are very uncertain. Recent figures suggest GDP growth in the country remains sluggish. For example, the Economist Intelligence Unit indicates that real GDP grew by 2.1% in 2007 and forecasts only 1.5% in 2008 and 1.4% in 2009. Factors dragging down growth include the strong yen, which is denting exports, a pronounced slump in housing starts, the high price of crude oil, and the effects of the sub-prime loans crises on the Japanese financial system.

Longer term economic prospects are also fairly gloomy. Japan's politicians have thus far failed to introduce economic reforms that would sustain the country's fragile recovery from the 1990s period of stagnation and deflation. In the long run Japan needs to cut public spending and cope with a declining population. Japan's exporters are also heavily exposed to the United States slowdown.

Nevertheless, Japan is a prosperous country with the world's second largest economy. The top Japanese firms are among the most efficient and best-run firms in the world. Unemployment, while high by historic Japanese standards, is around 4.1%, lower than in most developed countries. The average Japanese household has over \$100,000 in savings, and disposable income of about \$4,000 per month. The Japanese housing market remains the second largest market among developed countries after the United States. Even in the current slump, total annual housing starts are in excess of 1 million units. There is also a large remodelling market in Japan which is expected to become more significant as the new housing market declines over the long term.

As now, the plywood market is likely to present the best opportunities long term for the Malaysian industry. Although China is becoming a more vigorous competitor, Chinese manufacturers also face mounting challenges in sourcing adequate raw material, ensuring appropriate product quality, rising labour and fuel costs, and the progressive removal of government subsidies. Meanwhile, lack of raw material supply has meant that

Indonesia's ability to supply large commercial volumes to the Japanese market has continued to decline. Rising interest in the legality of timber sources in Japan also has significant potential to boost the competitiveness of Malaysian shippers against key rivals.

The market for structural laminated lumber is expected to continue to grow in Japan. To date much of this product has been derived from domestic producers or Europe and comprises softwood species. However there may also be opportunities for Malaysian producers.

There may also be opportunities to expand sales of wood furniture in Japan as the domestic industry has shrunk. However, to date the signs are that Malaysian manufacturers, like just about all other manufacturers, have struggled to compete against China in this market segment. The average level of household spending on furniture is also tending to fall in Japan, declining from 14000 yen/household in 2000 to 10000 yen/household in 2005.

An increased reliance on pre-fabricated products in the construction sector may offer new opportunities for Malaysian BJC products (including windows, doors and flooring) in Japan.

4.4.3 Japanese government procurement policy³⁸

The Japanese government has been a leading advocate of increased global efforts to tackle illegal logging. According to the Ministry of Agriculture the government's "fundamental policy" is that illegally harvested wood should not be used in the country. The government sees efforts to combat illegal logging, and therefore to help reduce carbon emissions resulting from deforestation, as a key element of international efforts to tackle climate change.

Japan's policy responses initially focused on capacity building and other supply side measures in timber supplying countries. The government emphasises its contribution to international efforts to combat illegal logging. Japan initiated the "Asia Forest Partnership" (AFP) in cooperation with the Government of Indonesia during the Johannesburg Summit (WSSD) in 2002. Japan is cooperating with Indonesia to combat illegal logging under the frameworks of a "Joint Announcement" and "Action Plan" signed by both governments in June 2003. Under the Action Plan, Japan is developing a system to identify harvesting sites and verify the legality of logging activities in Indonesia through satellite images as well as a log tracking system. Japan also makes a large voluntary contribution to projects addressing illegal logging issues implemented by the International Tropical Timber Organization (ITTO).

More recently the Japanese government has increased its emphasis on demand side measures within Japan. In April 2006, Japan introduced a government procurement policy favoring wood and wood products harvested in a legal and sustainable manner. The policy was introduced by revising the Basic Policy on Promoting Green Purchasing which is designed to facilitate implementation of the Green Purchasing Law. Under the terms of the Green Purchasing Law, all national public entities (the parliament,

³⁸ A major reference for this section of the report is "Japan's public procurement policy of legal and sustainable timber, progress, challenges and ways forward, Institute for Global Environmental Strategies", 2007

government ministries and agencies, and other institutions) are required to formulate purchasing policies that take account of environmental impacts, to promote the procurement of products based on these policies, to keep records of their purchases and to make these available to the general public. This legal obligation does not extend to local governments but they are expected to make efforts to adhere to its prescriptions.

The Basic Policy on Promoting Green Purchasing facilitates implementation of the Green Purchasing Law by setting out principles for the procurement of goods considered to be “eco-friendly”. It spells out the basic direction for green purchasing and the designated procurement items. For each item it sets out evaluation criteria and other matters related to their purchase. The evaluation criteria for each item are divided into “criteria for decision” and “factors for consideration”. The “criteria for decision” must be taken into account when establishing procurement targets, whereas the “factors for consideration” are factors that are important for reducing environmental impact, but cannot be applied as uniform criteria at present. Technically, the Basic Policy is not legally binding, as it is not part of the Green Purchasing Law. However, as an official government policy with detailed provisions to guide implementation of the law, it carries considerable weight.

The Basic Policy now includes legality in the “criteria for decision” and sustainability in the “factors for consideration” for selected wood and wood products. The five categories of wood and wood products are 1) paper, 2) stationary, 3) office furniture, 4) interior fixtures and beddings, and 5) wood and wood products used in public works projects such as lumber, glued laminated timber, plywood and laminated veneer lumber. In effect, the timber procurement policy gives greater weight to legality than sustainability; the legality of the specified wood items must be considered in public procurement, whereas sustainability need only be considered as desirable.

The Basic Policy on Green Purchasing refers to a document formulated by the Forestry Agency which provides more detailed guidance on the verification of legality and the sustainability of wood and wood products. The Guideline for Verification on Legality and Sustainability of Wood and Wood Products is not legally binding, but as a reference document for the Basic Policy it is considered to be mandatory for central state authorities. In contrast to some European government procurement policies, the Japanese Guideline is relatively short and lacking in detail. “Legality” in the context of wood products is defined briefly as “harvested in a legal manner consistent with procedures in the forest laws”. The Guideline does not seek to establish an operational definition of sustainable forest management. The Guideline allows three different mechanisms by which suppliers may verify legality and sustainability: forest certification and chain of custody systems; codes of conduct of wood industry associations; and self-established procedures of individual companies. However no criteria are established to assess the credibility of different forms of legality verification and forest certification.

In practice therefore, the Japanese government has been highly flexible with regard to the forms of evidence to be accepted. By recognising codes of conduct and other private sector initiatives, a great deal of responsibility has been passed on to the private sector. Government contractors bear the main responsibility for the legitimacy of goods and the sustainability of forest management at point of origin.

The Japanese government’s decision to provide only broad guidance and to rely on the private sector has been the subject of criticism. A recent detailed report on the Japanese procurement policy by Global Environmental Strategies (IGES) suggests that the policy

lacks rigour particularly with respect to wood from “high risk” countries. Drawing on wood supplies from Papua New Guinea as a case study, IGES argues that the Japanese government’s definition of legality is too narrow: “By only focusing on harvesting, Japan’s national public entities could find themselves inadvertently procuring timber that is linked with the unjust acquisition of timber harvesting rights and violations of laws not specific to forestry”. IGES argue that the wide range of approaches to legality verification combined with the lack of a firm commitment to sustainable wood has meant that there is little scope to generate price premiums, even for certified products.

IGES propose that the Japanese government should mirror European policies by developing an operational definition of sustainable forest management linked to a set of minimum criteria and procedures for assessing existing verification systems in a consistent, comprehensive and transparent manner. IGES also recommends direct collaboration with the EU to officially recognise the VPA licensing schemes “as one step towards developing a global wood licensing system”.

Nevertheless, there is a rationale for Japan’s current more flexible approach which has had some positive benefits. The public sector does not itself cover a significant proportion of overall procurement activity in Japan, only around 3% according to IGES. Public procurement is reasonably significant for some products – for example concrete forming plywood for public works projects – but barely impacts on the vast majority of wood consumption. Therefore a major intent of Japan’s procurement policy has been to elicit a response from the private sector. In this it seems to have been successful. In particular, the strong emphasis on codes of conduct has encouraged a remarkable and rapid increase in levels of industry participation in these initiatives (see section 4.4). Already, IGES estimates that 60% of current central state purchases of lumber and plywood are now accompanied by evidence of legality (although the rigour of the evidence may be questionable). And widespread engagement of private companies in codes of conduct should have the effect of gradually increasing levels of knowledge and awareness of responsible trading practices throughout the entire trade and industry, not just those involved in public sector contracts.

4.4.4 Japanese trade procurement policy

In the private sector, the Japan Federation of Wood Industry Associations (JFWIA) is playing a leading role to develop interest in and demand for legally verified products. This is partly due to JFWIA’s very close relationship with the national government. JFWIA is an umbrella organisation, comprising virtually all associations related to wood industry in Japan as its members. Its member associations, in turn, have a high rate of membership amongst the private industry sector. One of the functions of the JFWIA is to represent the private interests of its member associations’ member companies. In this sense, it is comparable to the wood industry/ timber trade federations existing in other industrialised countries. However, JFWIA is distinct from these in having strong formal and informal linkages with the government, specifically the Forestry Agency which operates under the Ministry of Agriculture, Forests and Fisheries. This close relationship is evidenced by a high interchange of leading officials between MAFF and JFWIA. Moreover, government funding constitutes a significant share of the annual income of JFWIA, roughly 17% in FY2004.

As early as 2001, JFWIA established an Investigation Committee with the objectives of identifying issues and collecting and disseminating information on overseas illegal

logging. In October 2002, the Committee issued a declaration on the use of legal and sustainable timber, and subsequently advised the wood industry under its umbrella not to accept timber which had clearly been illegally logged and traded.

Following formulation of their procurement policy, the Japanese government delegated responsibility for managing a “Project to Promote a Comprehensive Response to Illegal Logging” to the JFWIA. This three-year project (2006-2009) is backed by a grant of US\$ 1 million from the Japanese Ministry of Agriculture, Fisheries and Forestry (MAFF). It has involved the formation of a “Council for Tackling Illegal Logging Issue” comprising representatives from environmental NGOs and timber associations and academic experts. A Verification System Study Group has been placed under the authority of the Council with a mandate to assess appropriate systems to verify legality and sustainability. Another working group has been established to undertake educational and marketing activities. It has developed a website (<http://www.goho-wood.jp/>) and pamphlets providing information on action in Japan to combat illegal trade. Other working groups have been established to manage and commission a range of research programs in support of the Project including case studies of overseas companies with progressive timber procurement policies and a survey of systems to verify legality/sustainability in three exporting countries (China, Russia and Indonesia).

The activities of JFWIA and the Japanese government have been instrumental in ensuring relatively high levels of private sector awareness of illegal logging as an issue. This was confirmed by two surveys of wood trade and industry attitudes to illegal logging undertaken by the JFWIA and the Ministry of the Environment in 2005. Nearly all respondents to the surveys indicated that they were aware of the influence and significance of the illegal logging issue and nearly two thirds acknowledged that illegally logged timbers were being imported to Japan. Around half of respondents indicated that they were taking measures to ensure that their wood derived from legal sources, with 20% indicating they were showing preference to “Forest Stewardship Council (FSC), Programme for the Endorsement of Forest Certification Schemes (PEFC), etc.”

One interesting result of the surveys was that it suggested that customers of the Japanese wood industry were more interested in the origin of wood products than in the legality of these products. Only 38% of respondents indicated that their customers were interested in the legality of timber whereas 61% said their customers were interested in the origin of timber. Relatively high levels of interest in the origin of timber is likely to reflect the campaigns run by the Japanese Forestry Agency and some local authorities to promote domestic timber over imported timber.

At that time, the surveys indicated that only around 10% of wood industry companies had developed an environmental wood procurement policy. However introduction of the government procurement policy in April 2006 transformed the situation. The Japanese government entrusted the wood industry associations, particularly JFWIA, with responsibility for design and implementation of the codes of conduct that could be used to demonstrate conformance to the public sector procurement policy. JFWIA finalised a code of conduct in March 2006 just before the government policy came into effect. Article 1 of the “Code of Conduct Concerning Measures Against Illegal Logging” states that JFWIA “strongly opposes all illegal activities that may impair the health of forests”. The Code announces that JFWIA supports the procurement policy of the Japanese government (Article 3) and that in the international arena it is committed to “showing

respect” to the efforts of international forest conservation/forestry organisations and the producer countries.

JFWIA’s Code is supported by an “Operating Procedure” which regulates the accreditation of businesses with respect to verification of legality and sustainability of wood products. The Operating Procedure also prescribes on-site inspections when they are deemed necessary. Businesses belonging to the JFWIA member associations are required to provide information during such inspections, which are announced in advance. In case of infractions, such as falsification of evidence, accreditation may be withdrawn and the infraction may be publicised on the corresponding association’s website.

The JFWIA Code of Conduct has served as a prototype for the majority of its member associations. By 16 March 2007 all 19 national timber industry associations and 104 prefectural timber industry associations had established codes of conduct for the purpose of supplying public contracts. Conformance to the Codes is voluntary for members of each association, although those companies that formally sign up are subject to mandatory checks. In January 2008, IGES reported that 6000 (24%) of all the associations’ member companies (25,286) were signatories to the policies. The pace of company uptake of the Codes remains high, rising by over 20% during the course of 2007.

Engagement in illegal logging issues seems to be particularly high amongst importers that are members of the Japan Lumber Importers Association (JLIA). JLIA member companies are believed to represent around 40% of all timber importers in Japan. In March 2007, IGES reported that 38 (79%) of JLIA members are signatories to the association’s Code of Conduct on illegal logging. Action on illegal logging was identified as one of seven priorities in JLIA’s Business Plan for 2007. Specifically the Plan authorized the development of a system to investigate and monitor import volumes of legally verified lumber.

As part of the “Project to Promote a Comprehensive Response to Illegal Logging”, Japanese wood importers, their associations and the JFWIA have explored options to accept existing verification schemes in producer countries. According to current documentation on the Goho wood website³⁹, verification of legality may be provided through:

- forest Certification (with SGEN, FSC, SFI, CSA, PEFC mentioned as examples);
- or “documents issued by authorities concerned on legality and sustainability of wood and wood products (Permission on harvesting, exporting, etc.)”;
- or other documents with the same level of reliability as the above.

There is also a broad and not clearly defined requirement for an adequate chain of custody to ensure the legality of timber and for evidence that wood is harvested in a legal and sustainable manner. It is noted that forms of evidence will vary due to differing legal systems and commercial customs in each country. It is also noted that “additional papers and documents might be requested if there is considerable evidence of the existence of illegal logging”.

³⁹ www.goho-wood.jp, “Documents Required for Verification on Legality and Sustainability of Wood and Wood Products - Illustration for Overseas Company”

Acceptable forms of evidence were the major theme of the first “International Seminar for Tackling Illegal Logging”, organised by the JFWIA in February 2007 in Tokyo and sponsored by the Forestry Agency. Representatives from key supply countries, including Malaysia and Indonesia, introduced their existing systems of legality verification at the seminar. Following on from the seminar, according to IGES, JFWIA now accepts as evidence of legality from Malaysia the MTIB Statement on Legality of Timber Source⁴⁰ combined with the Malaysian Customs Form 2 (Export Declaration)⁴¹. Evidence currently accepted from Indonesia is the BRIK export permit combined with the SKSHH transport permit.

In the absence of appropriate timber tracking and monitoring management systems for Russia and China, options for provision of legal assurances from these countries are still being explored by the Verification System Study Group under the Council for Tackling the Illegal Logging Issue.

JFWIA has now developed a specific “Goho”⁴² wood logo to market products meeting industry requirements for legal wood. In December 2007, JFWIA hosted a second “International Seminar for Tackling Illegal Logging” in Yokohama with the specific aim of discussing the role of “Goho” wood as a mechanism to promote sustainable forest management. Following discussions, the seminar’s executive committee concluded that there should be concerted efforts to expand the trade in Goho-wood in Japan. It was also concluded that the current verification procedures developed by the Japanese wood industries are “efficient and realistic”.

It seems clear that these various measures are creating interest in and rising demand for “legal” wood in Japan. However, as things stand the requirements for legally verified wood are so broad and flexible that they are unlikely to create specific demand for a system as evolved and sophisticated as the proposed FLEGT VPA licensing process. For imports from Malaysia, Japanese importers are accepting existing documentation procedures as evidence of legality. It is possible that this situation may change as the level of awareness and understanding of illegal logging issues rises and with mounting pressure from environmental groups. It is also possible that countries and suppliers implementing sophisticated verification systems may push for more vigorous standards for legality verification in order to exclude competitors perceived to have less rigorous systems. But recent reports suggest that Japanese trade associations are content to pursue the existing flexible approach.

⁴⁰ The “Statement on Legality of Timber Source” is issued by MTIB at the request of Malaysian timber suppliers. To obtain the Statement, which is issued on a consignment basis, suppliers must sign a “Declaration of Legality” form stating that wood for export fulfils all legal requirements including that the source of logs is a forest area that has been approved by the relevant State Forestry Department or the authority responsible for the forest management of the respective state. Imported logs and timber may be sourced only from countries permitted by the Malaysian Government. MTIB guidance emphasises that the import of logs and large scantlings & squares from Indonesia is prohibited. Details of logging licenses, felling areas and removal passes must be stated in the “Declaration of Legality” form allowing MTIB to make background checks as necessary.

⁴¹ Malaysian Customs Form No. 2 is the declaration of goods to be exported, which is issued only with the following supporting documents: delivery order; packing list; original invoice; bill of lading; and certificate of origin.

⁴² Goho means “legal” in Japanese

5 Competing countries

5.1 Introduction

This section provides an overview of supply and policy developments in countries that are the main competitors to Malaysia in the EU wood market. The aim is to assess the extent to which a FLEGT VPA between Malaysia and the EU might impact on the relative competitiveness of Malaysian producers compared to producers in other countries.

During the private sector survey in the EU, industry representatives were asked to identify the major competing countries supplying wood to the EU market. The response can be summarised as follows:

- Indonesia, China and Brazil were identified as the major competitors in the plywood market. China was generally seen as an increasing competitor, while Indonesia was seen as a declining force.
- Central and West African nations were identified as the major competitors in the sawn lumber market, with sapele and sipo being the principal direct competitors to red meranti which dominates EU sawn lumber imports from Malaysia.
- In some EU countries, notably France and the Netherlands, Brazil was also perceived to be a significant competitor in the supply of tropical sawn lumber.
- Indonesia was seen as the most significant competitor in the supply of hardwood mouldings.
- Temperate hardwoods and softwood products were very rarely identified as competitors, generally seen as occupying a different niche. The only exceptions were occasional references to treated softwoods for external applications and to American hardwoods for flooring and other interior applications.

Charts 5.1 and 5.2 show Malaysia's market position in relation to other developing world suppliers of hardwood products. The charts have to be treated with a certain amount of caution. Since they include both tropical and temperate hardwoods they overstate the importance of Brazil and China as competitors, both of which supply significant volumes of temperate hardwood products which do not in practice compete directly with Malaysian products. For example much of the plywood supplied by China comprises domestic poplar and Russian birch.

Although imperfect, the Charts go some way towards providing a quantitative description of where Malaysia stands in relation to key competitors in the EU market. They tend to confirm the anecdotal evidence derived from the private sector survey suggesting that: in the tropical sawnwood market, the leading competitors are Cameroon, Brazil and the Ivory Coast, with Indonesia and various other African suppliers including Gabon, Congo-Brazzaville, Congo Democratic Republic and Ghana somewhat behind; in the mouldings market, Indonesia is the dominant competitor, although China and Brazil are also significant; and in the markets for hardwood plywood and for finished windows and doors, China, Brazil and Indonesia are key competitors. The Charts also highlight that

the countries of the Congo basin continue to supply raw logs to EU-based manufacturers of tropical hardwood products which compete to some extent with Malaysian products.

Chart 5.1

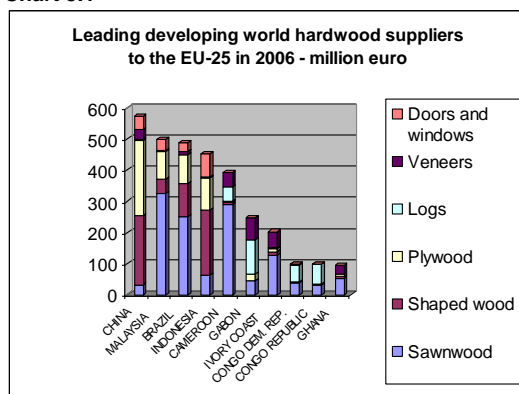
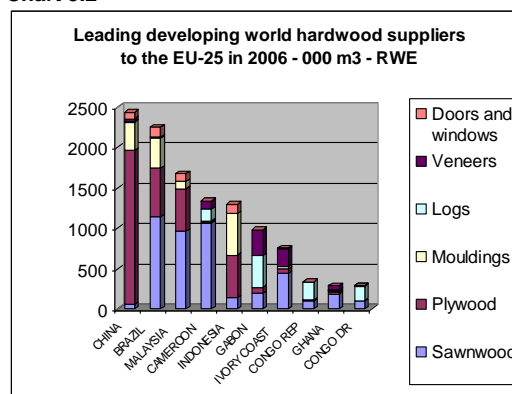


Chart 5.2



The remainder of this section provides an overview of the supply and policy situation – particularly in relation to the FLEGT VPA process – in the various countries supplying competing products to the EU. The analysis includes all the countries referred to above with the exception of China which is dealt with in detail in section 4.3 of this report. The analysis also includes Papua New Guinea (PNG) and Liberia. While PNG is not an important direct supplier of wood product to the EU, it is now believed to be the leading source of tropical hardwood logs used in the manufacture of Chinese plywood, significant volumes of which are imported by the EU. Liberia has not been a supplier of tropical hardwood to the EU in recent years due to the collapse of forest sector infrastructure and UN sanctions on the Liberian timber trade in the wake of the recent civil war. However, following improvements in the political environment and moves to reform forestry practices, the UN sanctions on Liberia were lifted in 2006 and production is now gearing up so that Liberia is likely to become a significant supplier to the EU in the future.

5.2 Illegal logging and SFM indicators

A broad overview of how Malaysia compares to key competing countries (excluding China) against a range of illegal logging and sustainable forest management indicators is provided in Table 5.1. The table highlights:

- Three of Malaysia's competitors are already engaged in formal FLEGT VPA negotiations: Indonesia, Cameroon and Ghana. All the other leading African competitor countries have indicated a desire to enter into negotiations. China, Brazil and the Ivory Coast have not indicated that they will enter into VPA negotiations.
- Malaysia is generally regarded as being dependent on a significantly lower level of illegal supply than all leading competitor countries (see also section 2.5).
- Due to the presence of MTCC, Malaysia currently leads all other tropical supply countries in the area of certified forests. MTCC is currently being assessed for endorsement by PEFC which, if successful, will mean that MTCC certified timber

is recognised as fully “legal and sustainable” in many European procurement policies.

- However Malaysia has a significantly lower area of FSC certified forest than two of its leading rivals, Brazil and Indonesia. Several competing countries also have relatively large areas enrolled in GFTN and TFT stepwise programs which are targeted towards eventual achievement of FSC certification, notably Cameroon, Congo-Brazzaville, Brazil and Indonesia.

Table 5.1: Malaysia’s competing wood supply countries: illegal logging and SFM indicators

	Formal FLEGT VPA Neg. ¹	Anticipated availability FLEGT VPA Licensed timber ²	Certified areas ³	Range of estimates of illegal wood supply ⁴	Scion estimate of “most likely” illegal supply ⁵	Private sector legality verification systems ⁶	Private sector stepwise programs ⁷
	F/I/N ¹	Year	(000 has)	% harvest	% harvest	(000 has)	(000 has)
Asia							
Malaysia	F	2009-2010	MTCC: 4800 FSC: 98	3-35%	5%		
Indonesia	F	2009-2010	FSC: 702 LEI: 275	50-80%	60%	VLO	GFTN: 641 TFT: 871
PNG	N	na		70%	Na		
West Africa							
Ghana	F	2009-2010		20-66%	30%		GFTN: 330 Smartstep: 151
Ivory Coast	N	na		20-40%	30%		
Liberia	I	2010-2011		20-40%	30%		
Central Africa							
Cameroon	F	2010-2011	FSC: 315	20-50%	30%	TLTV: 1344 OLB	GFTN: 1172 TFT: 364
CAR	I	2011-2012		20-40%	30%		
Congo-Brazzaville	I	2010-2011	FSC: 296	20-40%	30%	TLTV: 3098 OLB	GFTN: 1160 TFT: 1291
Congo-Kinshasa	I	2013-2015		20-40%	30%		
Gabon	I	2010-2011	Keurhout: 1185	20-40%	30%	OLB	TFT: 634
South America							
Brazil	N	Na	FSC: 3300 ⁸	13%-90%	19%		GFTN: 1223

1. “F” – Formal negotiations towards a VPA are underway; “I” the country has expressed interest in formal negotiations towards a VPA but these have not yet begun; “N” the country has not yet expressed any interest in formal negotiations towards a VPA

2. The “anticipated date” for availability of Licensed Timber is very speculative and is based on the authors reading of current progress under the FLEGT VPA process and, in countries that have not yet begun formal negotiations, the authors understanding of existing regulatory systems in the country. The aim is to provide a “realistic” view of when countries might be in a position to start supplying VPA licensed timber.

3. FSC refers to Forest Stewardship Council. MTCC refers to Malaysian Timber Certification Council. Keurhout is a Dutch based industry-run labelling scheme. LEI is a national certification system for Indonesian forestry.

4. The range of estimates of % illegal harvest is compiled from various studies including Seneca Creek for AF&PA (2004), Scion (2007), OECD (January 2007) and various environmental group reports. These figures should be treated with considerable caution as the definition of illegal wood supply varies widely between studies and many are based on reports designed to present a strong environmentalist message. Also the Seneca Creek and Scion reports do not seek to differentiate between levels of illegal logging in the various African countries and instead provide one figure for the full region, hence the consistency of figures for African countries. These figures do not generally represent an accurate quantitative assessment of illegal wood supply and are best regarded as an indication of the level of concern about illegal wood supply in the various countries.

5. VLO refers to Smartwood Verified Legal Origin. OLB refers to Eurocertifor-BVQi Origin and Legality of Wood (OLB). TLTV refers to SGS Timber Legality & Traceability Verification. Accurate data on the scope of VLO and OLB with respect to countries and area covered was not available at time of this review

6. VLO refers to Smartwood Verified Legal Origin. OLB refers to Eurocertifor-BVQi Origin and Legality of Wood (OLB). TLTV refers to SGS Timber Legality & Traceability Verification. Accurate data on the scope of VLO and OLB with respect to countries and area covered was not available at time of this review

7. TFT refers to Tropical Forest Trust. Smartstep is a scheme run by Smartwood/Rainforest Alliance. GFTN refers to WWF Global Forest and Trade Network.

8. FSC certified area in Brazilian Amazon is estimated from nationwide data that does not differentiate between tropical and temperate forests. The area includes 1.5 million hectares of Kayapo indigenous lands which supply Brazil nuts rather than timber.

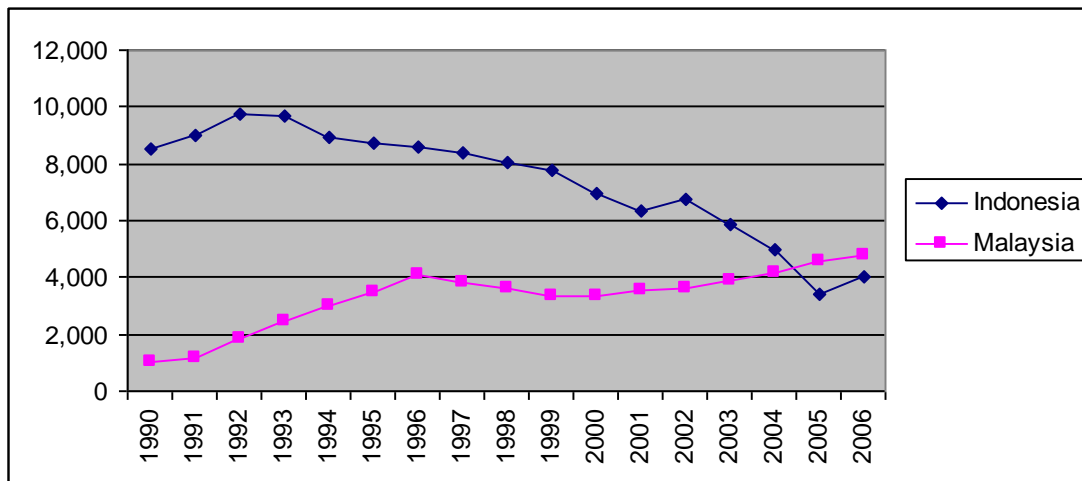
- Two African countries – Congo-Brazzaville and Cameroon - also have large areas enrolled in private sector legality verification systems.
- Overall, the indications are that while Malaysia may have established a lead in supply of certified product to the EU market, this lead could be eroded in the future.

5.3 Indonesia

5.3.1 Wood supply

Indonesia has for many years been the leading competitor to Malaysia in global markets for tropical timber products. Competition has been particularly intense in the plywood industry. Indonesia was formerly regarded as the world's powerhouse of tropical plywood production but Malaysia has slowly eroded Indonesia's market share and now leads Indonesia in volume terms (see Chart 5.3). Indonesia's exports of rough sawn lumber are officially banned, leading to Indonesia becoming a significant exporter of higher value mouldings and decking product.

Chart 5.3: Indonesia and Malaysia Plywood Exports 1000 m3

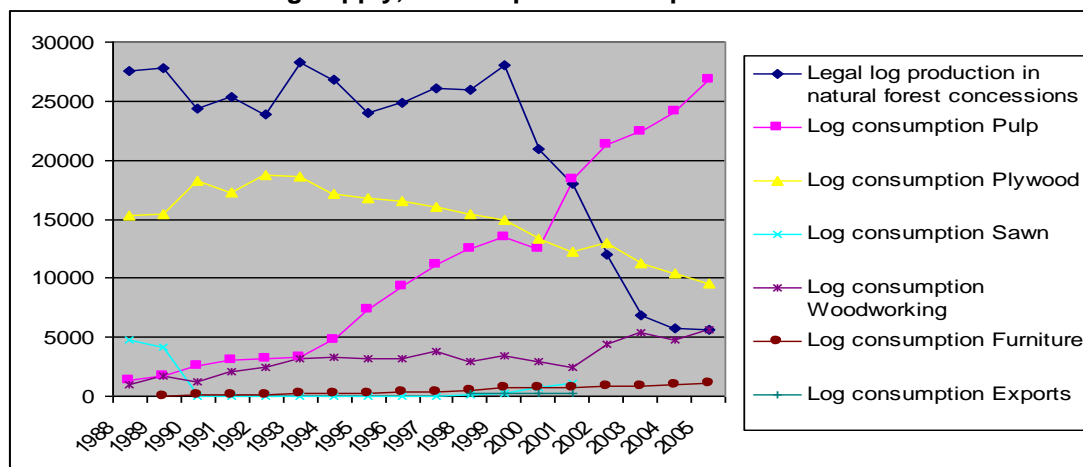


Source: ITTO 2006, APKINDO, MPMA

Indonesia's forest products sector is currently passing through a period of major structural change. Legally sanctioned wood production from natural tropical forests declined sharply between 1999 and 2005 from in excess of 25 million m³ to around 5 million (Chart 5.4). This largely reflects excessive over-exploitation during the 1980s and 1990s due to the uncontrolled expansion of timber processing industries in Indonesia in the 1980s and the subsidized promotion of pulp and paper mills in the 1990s - all without ensuring a sustainable supply of timber.

The natural production forest areas managed under concession agreements (so-called HPH) are now seriously depleted, the most accessible tropical lowland forests in Sumatra and Kalimantan having come under particularly intense pressure. In the early 1990s, there were nearly 600 forest logging concessions in Indonesia. Today, there are less than 300. In the province of East Kalimantan, the leading log and plywood producing province in Indonesia, the number of HPH forest concessions dropped from an all time high of 200 in 1993 to 56 in 2006. The resultant supply - demand imbalance that has built up in Indonesia is continuously dogging the forestry sector and remains a major underlying structural problem that drives illegal logging and the movement of illegal timber within and out of Indonesia.⁴³

⁴³ Opinion piece by Krystof Obidzinski, CIFOR Forests & Governance Programme

Chart 5.4: Indonesia log supply, consumption and exports

Source: BRIK

While harvests in natural tropical forest concessions have declined, consumption of logs in Indonesia has held up strongly (Chart 5.4). Consumption of logs for pulp and paper production has risen rapidly and there has also been a less dramatic increase in log consumption for woodworking (mouldings, decking, joinery products) and furniture.

To some extent the demand-supply gap that has opened up in recent years is being fed by a large increase in log supply from industrial plantations and a variety of other sources. According to a projection by the Ministry of Forestry prepared in August 2007⁴⁴, total log production in Indonesia was expected to reach 69 million m³ in 2007, with a significant proportion coming from pulpwood plantations, community forests, rubber and oil palm estates, and conversion forests. Ministry of Forestry data suggests that the proportion of total Indonesia wood supply derived from natural forest has fallen from about 95% in the early nineties to around 30% in 2007 (including 9% from HPH concessions and 21% under government permits to clearfell for conversion to other uses).

However, illegal wood continues to form a major component of the Indonesian supply equation. The Ministry of Forestry estimates that in 2006, illegal logging stood at 52 million m³. In the same year, about 10 million m³ of timber was exported from Indonesia without documentation in contravention of the export bans on logs and rough sawn timber. Numerous factors continue to drive illegal logging in Indonesia, most notably: the difficulties of enforcement throughout a sprawling country with a vast coastline; continuing disputes over the control and use of forest resources between central and regional government; corruption; and the economics of the supply chain which mean that there are still only weak incentives to encourage legal operation.

The Ministry of Forests has also projected log supplies for the next 10 years. This suggests that legally sanctioned volumes available from natural forests will increase from 5.8 million m³ in 2007 to 15.1 million m³ in 2017, a significant rise but still well below levels prevailing in the 1990s. The area of active HPH is currently only around 17.5 million hectare and is not expected to increase. Although intensified management including planting and tending might allow an increase in the AAC from HPH

⁴⁴ Referenced by Indufor, 2008, in a Market Impact Assessment of the EU FLEGT VPA with Indonesia

concessions in the future, expectations are that harvest levels will remain relatively low. However volumes available from pulpwood plantations and so called HTR – proposed short-rotation community forests – are expected to increase dramatically.

Table 5.2: Estimated/projected timber volumes per source and type of utilisation, million m3

Timber Supply Source	Timber Supply Projections by Year		
	2007	2012	2017
Total	69.0	82.1	192.3
Natural forest	5.8	9.4	15.1
Pulp wood plantations/HTI	18.0	34.6	63.2
Saw log plantations/HTI	0	6.3	10.8
HTR ⁴⁵	0	0	72.0
Perum Perhutani	0.9	0.9	0.9
Community Forests	6.0	6.0	6.0
Rubber Estates	6.0	6.0	6.0
Oil Palm Estates	10.0	10.0	10.0
Coconut Plantations	8.0	8.0	8.0
ISK and IPK ⁴⁶	14.0	0.6	0
Import	0.2	0.2	0.2
Industry Timber Supply Allocation	69.0	82.1	192.3
Sawnwood	27.2	30.9	78.9
Plywood	10.3	13.1	31.4
Particle board	2.2	3.5	11.6
Pulp ⁴⁷	29.2	34.6	70.4

Source: A Road Map for the Revitalization of Indonesia's Forest Industry. August 15, 2007.

These conclusions are supported by another study conducted by ITTO and the Ministry of Forestry⁴⁸. Chart 5.5 indicates that primary natural forest will be logged out by 2025, while availability of wood supply from secondary forest will also diminish rapidly over the coming decades. The study has in fact underestimated the productivity of the plantations for the period 2001-2007 which are, in reality, already contributing more than legal production in the natural forest.

The declining dependence of the wood processing industry on the large HPH concessions and the rising dependence on conversion forests has greatly increased the complexity of wood supply chains in the country, making monitoring and enforcement all the more difficult. Many Indonesian plywood and other manufacturers now rely heavily on third parties for the supply of logs and often have little information on either the source or the conditions under which they are harvested.

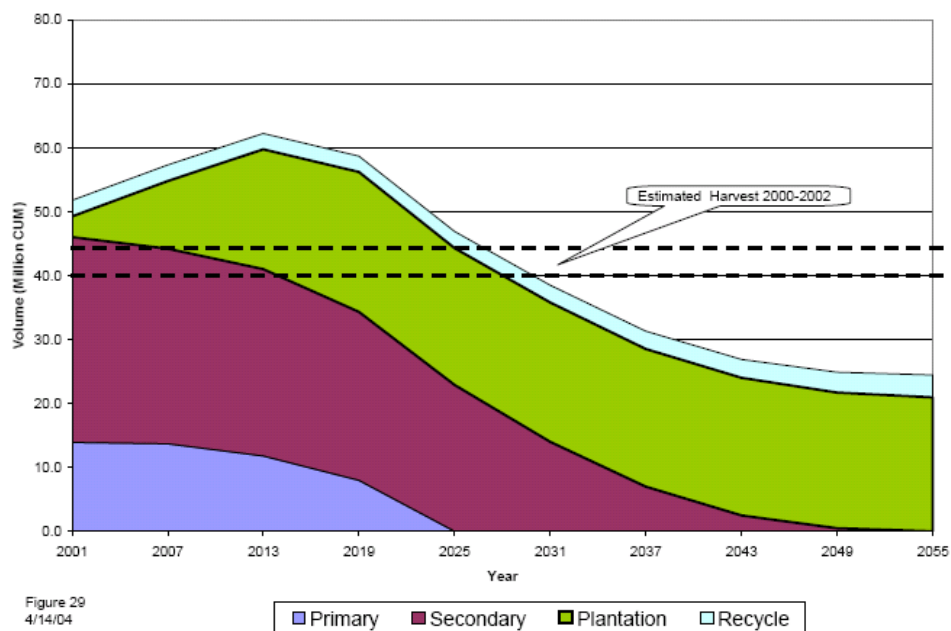
To adjust to the changing market conditions, plywood mills are producing more secondary products such as particle board, block board and MDF, using by-products from plywood milling. However, financial constraints prevent the industry from upgrading facilities and equipment. To maintain and/or increase revenue, the mills are also producing more value-added products such as fancy plywood, using imported veneer and the majority of these products are for export.

⁴⁵ Proposed community timber plantations, which will be developed, and be ready for harvesting reaching 8 years of age, hence the jump in wood supply for year 2017

⁴⁶ Central Government permits to clear-fell for conversion to other land uses

⁴⁷ The estimates for pulpwood allocation seem low. BRIK has mentioned that consumption in 2006 was about 36 million m3.

⁴⁸ Referenced by Indufor, 2008, in a Market Impact Assessment of the EU FLEGT VPA agreement with Indonesia

Chart 5.5: Projection of Indonesian wood fibre supply 2001-2055

Source: ITTO/Indonesian Ministry of Forestry,

5.3.2 Forest law enforcement

While illegal logging remains widespread, the Indonesian government is now engaged in a major effort to improve enforcement practices. A key event came in March 2005 with the passage of Presidential Instruction No. 4 Concerning Eradication of Illegal Logging. This law establishes that efforts to tackle illegal logging are a national priority. The Minister for Political, Law and Security Affairs was given responsibility for coordinating all related agencies in the national effort and for reporting directly to the President on progress every 3 months. The Instruction requires a wide range of Ministries and enforcement agencies to accelerate efforts to eradicate the problem and requires the Finance Ministry to set aside the necessary funds. Provincial governors are required to revoke any logging licenses issued and to revise any regional regulations and Governor's decrees in contravention of federal forestry legislation.

In September 2007 the government established a new "Coordinating, Monitoring and Evaluation Team (Kormonev) for Eradication of Illegal Logging". The Team comprises 24 people including representatives of: the Ministry for Political, Legal and Security Affairs; the Office of the Attorney General; the National Intelligence Agency; the National Army; the National Police; the Ministry of Forestry and NGOs. The Kormonev Team is assisted by 8 staff members.

At the same time, the Indonesian government has been actively engaged with other countries calling on them to assist in their efforts to curtail illegal wood product exports. It

has agreed Memorandum of Understanding (MoU) to cooperate in tackling illegal logging and trade with the UK (August 2002), China (December 2002) and Japan (June 2003).

Various other initiatives to tackle illegal logging are underway. The Ministry of Forestry is now drafting a new law on illegal logging to improve law enforcement operations and expedite efforts to curb the practice. The Ministry for Political, Legal and Security Affairs is establishing a Case Tracking Database to provide a single point of reference on illegal logging cases. There is a collaborative program ongoing between the Ministry of Forestry and South Dakota State University to develop a new more sophisticated forest monitoring system. The Ministry is also working in partnership with Forest Watch Indonesia (FWI) to establish a comprehensive GIS database on forest utilization licenses - especially those dealing with selectively felling in natural forests and creating timber plantations.

These various measures are already believed to be having a positive impact on forest law enforcement in the country. For example, according to CIFOR research cross-border timber trade in Kalimantan decreased by as much as 70% in 2006.

5.3.3 FLEGT VPA negotiations

In January 2007, Indonesia and the EU agreed to enter formal negotiations towards a FLEGT VPA. The FLEGT VPA process in Indonesia has built directly on earlier work undertaken as part of the UK-Indonesia MoU to develop a “legality standard” through a multi-stakeholder process. The legality standard was finalised in January 2007. The UK-Indonesia MoU also involved preliminary work on the development, testing and implementation of systems of verification of legal compliance based on independently verified chain-of-custody and identification systems.

In early 2008, it was announced that the Ministry of Forestry had started field tests on an online system for timber administration (known as the Timber Traceability System) which includes online report on payment of forest levies and reforestation funds. The system is being tested in 26 forest concessions in State Forests and 19 primary forest product industries. The online system will be a part of proposed integrated system that will be developed jointly by the EC – Indonesia FLEGT Support Project and Ministry of Forestry. The proposed integrated system will combine four different existing information databases on administration of forest products, forest concessions, forest industries, and forest levies/reforestation funds. The system uses 2 dimensional barcodes which are attached to all trees before harvesting. Information about the log such as species, volume, height, diameter, concession, position of harvesting compartment, etc. is stored in the label. This information will be sent and stored at a central database in the Ministry of Forestry two years before the tree is felled. When the tree is harvested, the government officers will verify the data on the logs with the data of the trees in the central database which was stored two years ago. With this online system, it is expected that the process of timber administration and the payment of forest levies/reforestation fund will become more effective and efficient and also help with verification of timber legality (Chain of Custody or Log Tracking) from the forest concession to the industry.

Although a legality standard has been finalised and technical work has been progressing on development of the legality verification system, there are no clear indications at this stage of when Indonesia might finalise a FLEGT VPA with the EU. Latest reports from

EC officials indicate that the private sector is particularly concerned about the apparent lack of market incentives to sign a VPA⁴⁹.

5.3.4 Forest certification

At present private sector certification of sustainable forest management is not widespread in Indonesia. SFM certification currently applies to only 17 forest management units with a total area of about 1,850,000 hectares.

5.4 Brazil

5.4.1 Forest resources

Around 347 million hectares of the Brazilian Amazon, 86% of the original forested area, is still under forest. Large areas of the Amazon rainforest are reserved or so remote as to be inaccessible for timber production. The federal government estimates that 31% of the land in the Amazon is publicly owned and protected. Of the remaining land area, 24% is privately owned (although it is uncertain whether these titles are legitimate) and 45% are so-called *terras devolutas*, or public, but without public use.⁵⁰ Private land owners are officially obliged to keep 80% of the area of their land holdings under forests.

The Brazilian government is only now developing policies and procedures to enable sustainable exploitation of timber on publicly owned lands under the terms of concession agreements. Government policy is to allocate 50 million hectares of public lands under such agreements by 2010. The first agreements were announced in early 2008. ITTO estimates that the area of “permanent forest estate” on private lands which is available for timber production amounts to 43.9 million hectares of which an estimated 21.9 million hectares of currently accessible forest could produce a sustainable yield of 15.2–21.9 million m³ per year.

While these areas have significant potential to provide a sustainable source of timber long-term, the majority of timber currently harvested in the Amazon derives from conversion forests. Deforestation rates in Brazil are high, averaging 2.31 million hectares per year (0.4%) between 1990 and 2000, rising to 2.7 million hectares between August 2003 and July 2004. Deforestation rates declined for several years after that and stood at only 1.12 million hectares between August 2006 and July 2007. However between August 2007 and December 2007, deforestation rates rebounded sharply to reach 3 million hectares in the 5 month period. Deforestation is driven to a large extent by large-scale conversion to commercial agricultural crops and trends in deforestation rates tend to correlate with changes in prices for these products.

⁴⁹ Presentation by Julia Falconer, EC DG Development, to Chatham House illegal logging update meeting in June 2008.

⁵⁰ The land tenure situation in the Brazilian Amazon is rooted in the time of colonisation when the Portuguese Monarchy donated lands to settlers who were allowed to subdivide it among interested farmers. If these lands were not used they were returned to the Crown, and became known as *terras devolutas*. In other words, ‘ownership’ was defined not only on the basis of a judicial recognition of a title, but also on the basis of the ability or interest to use the land in a productive way.

5.4.2 Wood industry competitiveness

An ITTO Expert Mission Report published in November 2001 provides one of the most comprehensive sources of information on the broad status of the wood processing industry in Amazonia. It highlights numerous problems in the sector which limit international competitiveness. There is a very high degree of industry fragmentation. The tropical hardwood sector is dependent on a very fragile wood supply chain. This is due to several factors including climate conditions, bureaucracy, and risk of land occupation. In the Amazon region, there is a serious shortage of modern management skills and knowledge of efficient technologies. Small and medium-sized mills do not have direct links with markets which is reflected in low revenues.

Another problem is heavy over-reliance on short-term supplies from land cleared for agriculture. Logging operations are concentrated on "pólos madeiros", the zones of new agricultural settlement on the forest fringes. After the initial boom in an area, these "frontier" areas have always gradually faced severe wood shortages, followed by inevitable outmigration of the industry to new areas. Such instability has meant that the wood-based industry in the Amazon has only a few larger, efficient and well-managed companies.

Against this background, accurate information on the level of commercial harvesting in the Brazilian Amazon has not been available. The ITTO Expert Mission Report notes that the Amazon region of Brazil produces about 60 million m³ of roundwood per year. This contrasts with data from ITTO's Annual Review which indicates average tropical hardwood log production levels of 2002-2007 of only around 25 million m³. In practice it is extremely difficult to estimate how much wood is derived from forest conversion in the Brazilian Amazon each year. The much higher estimate from the mission report is probably more representative of the actual level of harvest.

The vast majority of wood that is harvested in Brazil remains in the country. No hardwood logs are exported. ITTO data indicates that Brazil's tropical hardwood sawn lumber production averaged 15.3 million m³ per year between 2002 and 2007 and was rising strongly. However, only an average of 1.2 million m³ per year (8%) was exported, the volume declining over the 5 year period. A higher proportion of the tropical plywood produced in Brazil is exported, around 40% of the average 1.2 million hectares produced per year between 2002 and 2007.

Despite the problems of the Brazilian timber sector, and the relatively small proportion of wood that is exported, Brazil remains a key competitor to Malaysia in the international market. Tropical sawn lumber and plywood exports each averaging around 1.2 million m³ per year are very significant. Much of the volume is destined for the United States, but the EU is a significant market for several products. Malaysian sawn lumber competes directly with Brazilian sawn lumber of sapupira (a heavy duty flooring species), tauari (a light general joinery species), tatajuba (a heavy duty joinery species, jatoba (dark species favoured in flooring), ipe, garapa and massaranduba (the last 3 all decking timbers). Brazilian tropical hardwood plywood is also a major competitor to Malaysian plywood in the EU market.

The marketing constraints resulting from fragmentation of the Brazilian wood sector is compounded by the lack of any central marketing organisation for Brazilian tropical wood suppliers to rival MTC.

5.4.3 Law enforcement

By law the use of natural forest resources on private land requires the presentation of a sustainable forest management plan (plano de manejo florestal sustentável – PMFS) to IBAMA. Legislation requires that private land owners preserve 80% of forest land as natural vegetation and allows 20% to be converted. The land maintained as forest requires a PMFS for harvesting. The requirements for authorization of deforestation are much easier to fulfil than the highly bureaucratic requirements for the approval of forest management plans and annual operation plans. This compounds the weak competitiveness of sustainable forest management as a land-use. There is a strong incentive to illegally log the 80% of forest that is meant to be retained. It has been reported that only about 7% of forest production is under proper forest management (FAO 2004).

Illegal logging is a widespread problem in the Amazon. According to Verifor, legal timber is produced from either authorised land clearance or from managed forests. However, there is considerable disparity between these authorised volumes and the amount consumed by the forest industry. Some 90 percent of all logging in Brazil is done without the proper permits, according to the Environment Ministry (IBAMA).

A large proportion of the illegal logging is not linked to the timber industry. IBAMA places more of the blame on farmers who clear forest plots to create soybean fields and cattle ranches. Officials say that ranching and farming are responsible for up to 80 percent of total deforestation nationwide. Much of the illegal logging also comprises young trees used to feed charcoal ovens. Charcoal is sold on in large quantities to steel manufacturers.

Verifor recently reviewed the measures to prevent illegal logging and promote sustainable forestry in the Brazilian Amazon. Verifor note that recent reforms are leading to a coherent set of instruments for the verification of legal forest production. Over the last 10 years Brazil has undergone a steady process of adaptive improvement in the normative framework regulating forest management and land-use change, driven in large part by a concern over deforestation in the Amazon.

According to Verifor, the most significant of recent legislative change is the 2006 Law on Public Forest Management, which allows (for the first time) legal timber production on public forest land under a concession system. With perhaps as much as 45% of the Amazon under this type of tenure there is now the opportunity to regularise considerable quantities of timber production that were previously illegal. The creation of a federal Forest Service and a Fund for forestry development under this Law should also make the control system less dependent on the political priority attached to environmental management that has been a major reason for uneven progress in the past. Another structural design element introduced under this Law is the requirement for 3-yearly independent audits of concessions given out on public forests.

Verifor note that inter-ministerial cooperation and coordination - involving parts of government not usually involved in policy discussions on forest development, such as the Ministries of Justice, Defence and Science & Technology - has strengthened national efforts to address the problem of illegality.

The sharp increase in the rate of deforestation during the second half of 2007 encouraged President Lula to announce a new range of measures to combat the rise. Lula decreed a total ban on deforestation in the 36 worst-hit municipalities. The president also told landowners they must prove they are complying with the law requiring that 80% of their land be preserved as natural vegetation. Those not in compliance will be ineligible for government credit and prohibited from selling their property. Measures will also be introduced to stop noncompliant businesses from marketing their produce. Hundreds of federal agents are being deployed to help enforce the measures. Fines for illegal cutting have been stiffened. Officials also have tried to expand the scope of potential violations. For example, slaughterhouses that process meat from illegally cleared ranches can be cited.

While the intent is there, there remain significant obstacles to effective forest law enforcement in the Brazilian Amazon. The current reform process must be seen against a backdrop of uncertain land tenure. Lack of capacity within the State administrations for the issuance of land title continues to undermine efforts to secure legal compliance. Unresolved land tenure remains a significant constraint to verifying forest legality in Brazil. Furthermore, recent devolution of regulatory functions has created additional challenges in a Federal system, where the division of responsibility between the different levels of government is not well defined. Some forest-rich States, particularly in the Amazon, are amongst those whose environmental agencies responsible for forest monitoring and enforcement are seriously under-resourced.

The low professionalism among forest managers poses another weak link in the control system, which is not helped by the lack of clarity over their responsibilities regarding forest management controls. Authorities have passed laws to make it easier to confiscate timber, machinery, and vehicles but officials don't have the resources to seize more than a fraction of the potential haul.

Application of existing legislation is also held back by lack of capacity within the judicial sector. IBAMA applied almost \$1 billion in fines last year but only received about 10 percent of the value levied, according to its own estimates.

There is a critical need for capacity development across the whole control system. There is also a need for a more co-ordinated response, linking greater enforcement activities with measures to provide alternative sustainable livelihoods for the rural poor. Illegal logging has come to be valued as a consistent economic opportunity for the millions living below the poverty line in the Amazon region.

To date the Brazilian government has shown no inclination to sign a FLEGT VPA with the EU, preferring to focus on domestic measures to improve enforcement of forest laws.

5.4.4 Forest certification

The private sector in the Brazilian Amazon has been actively engaged in efforts to implement forest certification mainly through the FSC scheme. However certified areas still constitute only a small proportion of forest area in the Amazon region. There are some 20 certified logging operations, including seven community forestry initiatives and two certified

planted forests. Together, these certified forests occupy 1.7 million hectares in the Amazon⁵¹. Anecdotal reports indicate that while availability of certified wood from Brazil is increasing, supply tends to be very inconsistent and prices volatile.

5.5 Papua New Guinea

5.5.1 Wood industry trends

PNG has around 29.4 million hectares of forest land, of which 6.2 million hectares is considered operable production forest. Of this, 2.4 million hectares has been logged and left for regeneration. Most logging to date has been carried out in more accessible lowlands which have high volume of commercial timber species, especially in the northern parts of the country. Timber yields are assessed to be around 30-50 cubic meters per hectare managed on a 40 year rotation, less than 50% of yields typical of dipterocarp forests in other parts of South-East Asia .

Papua New Guinea's forest industry is predominately focused on the harvesting of natural forest areas for round log exports. There is little plantation production and only a limited number of processing facilities. According to ITTO, PNG's log production remained stable at 2.25 million m³ per annum between 2004 and 2006. Log exports were slightly in excess of 2 million m³ per annum during the same period. China is by far the dominant market, taking around 1.7 m³ per annum. Added-value products are relatively insignificant in volume terms but becoming more important in value terms, now constituting almost 25% of total timber export value. Most of this is still relatively low-value sawn timber.

The sector is dominated by Malaysian-owned interests. Based on data derived from SGS log monitoring export reports, seven Malaysian companies were responsible for 87% of log exports in 2003.

On the surface, current levels of harvesting in PNG appear within the boundaries of long term sustained yield. Rough estimates of the stock of merchantable timber in commercial forests have led the PNG Forest Authority (PNGFA) to set the sustainable yield for PNG at 4.9 million m³ per year.

However Verifor suggest that PNGFA tend to over-estimate the available resource and that the current level of harvest is much higher than suggested by log export statistics. Verifor note that information on the status of PNG forest resources at individual concession level is currently inadequate to draw far-reaching conclusions about the ability of the forest to deliver wood volumes in the long term. Furthermore, it is suggested that PNGFA is currently *"in the process of committing forest areas to logging which were previously deemed unsuitable"*. Verifor concludes, *"In the medium term PNG is at risk of running out of accessible timber resources and losing forestry as an economic sector if it continues to pursue the current levels of log exports.....The demise of timber exports as a viable economic sector in PNG may still be some time away. However, as the remaining resources are granted, there will be increasing pressure to log in less favourable areas at increasingly high costs"*

⁵¹ The Amazon is also host to the largest single FSC certification in tropical forests comprising the 1.5 million hectares of Kayapo Indigenous lands. However this land is certified for supply non-wood forest products rather than timber.

5.5.2 Forest regulation and law enforcement

The legal status of PNG wood exports is a matter of considerable dispute. While the PNGFA argue that since the vast majority of log exports can be traced via an SGS log export monitoring system to a legally sanctioned concession area, nearly all exports can be shown to conform to a narrow definition of “legal timber”. On the other hand, influential external commentators including Forest Trends and Verifor have pointed to evidence of wide-spread failures in enforcement of forestry standards and tax evasion leading to allegations that most wood exports should be regarded as “illegal”.

A Forest Trends report “*Logging, Legality, and Livelihoods in Papua New Guinea*” summarizes the findings from five independent reviews of the timber harvesting industry conducted between 2000 and 2005. The reviews were initiated by the PNG government in response to the widely held view that forest management in the country was not providing long-term benefits to the country or its citizens. The reviews were conducted following terms of reference approved by the Government and the World Bank by teams of independent experts, including lawyers, foresters, economists, and environmental and social scientists. The review teams received access to official records, logging sites, and company documents and were able to conduct wide-ranging interviews with industry officials, landowners, and government officials.

The Reviews included a study of fourteen logging projects covering a gross area of 3.17 million hectares and with a local population of over 83,000 people. In 2004 these operations produced 1.3 million cubic meters of logs with a declared export value of US\$70 million. According to the Forest Trends report, “*none of these 14 projects can be defined as legal and only one project manages to meet more than half of the key criteria set for a lawful logging operation.... The reviews show that the primary governance role of the PNG Forest Authority is seriously deficient, and that there is a political vacuum with no demonstrated government interest in controlling the problems in the sector*”.

According to Forest Trends, the PNG Government and its regulatory institutions “*have all the necessary policies, laws, and regulations to ensure that sustainable timber production can be achieved*”. Furthermore “*virtually all timber harvested from natural forest areas in PNG has official sanction in the form of a permit or license issued by the relevant authority*”. However, Forest Trends also suggest that: “*although all timber harvesting operations may be officially licensed, there are serious issues of legal non-compliance at almost every stage in the development and management of these projects. For these reasons the majority of forestry operations cannot credibly be characterized as complying with national laws and regulations and are therefore ‘unlawful.’*”

Forest Trends base this conclusion on a definition of legality which encompasses:

- Broad compliance with prevailing legal principles in their instruments which underpin the operating rights;
- A general observance of statutory and regulatory controls in the harvesting operation itself;
- A more general conformity to the legal standards governing all business operations in PNG.

Forest Trends suggest that the most widespread and demanding problems are the failure to secure the informed consent of resource owners to timber harvesting and the inability of the State to ensure sustained yield management in natural forest areas. The Reviews provide massive evidence that resource owners are not making informed decisions about the use of their resources, and the consent that has been given for current and future forestry operations is clearly legally flawed. In many projects these failures are exacerbated by unlawful permit extensions, clear failures to apply or enforce applicable harvesting standards and failures to meet infrastructure and processing obligations. There is also clear evidence of a deeply concerning trend of labor abuse in many projects.

The conclusions of Forest Trends are supported by Verifor who suggest that “*despite the reforms of the early to mid-1990s....there would appear to be continuing significant instances of unlawful behaviour*”.

The Papua New Guinea Forest Industries Association (PNGFIA) has published on their website (www.fiapng.com/asamadu.html) a commentary on allegations of widespread illegality in PNG by Dr Kwame Asumadu, an independent consultant based in Australia. The commentary focuses mainly on countering allegation about log smuggling, an issue which is not covered in the Forest Trends report.

The article makes a convincing case that SGS control procedures are effective in ensuring that only logs from legally sanctioned concession areas are exported. The article notes that SGS log tracking procedures include: provision of log tags to be affixed to the end of each log by producers at the time of scaling at the log landing as prescribed by the PNG Forest Authority; pre-shipment log inspections to check species identification and log scaling; and monitoring of ship loading to verify the species and volumes actually loaded. According to Asumadu, under the SGS monitoring system, no logs can be legally exported from PNG until all the prescribed procedures (involving 22 steps) have been followed. Checks and balances built into the system ensure that the next step cannot be completed until the preceding procedure has been fully certified by both the PNGFA and the SGS that all requirements have been duly complied with. Asumadu quotes the SGS' PNG General Manager, Mr Bruce Telfer, who indicates that in the last 12 years, SGS has not uncovered large-scale log smuggling in the log export trade in PNG.

However, the article is less convincing in its response to Forest Trends conclusions of widespread malpractice during forestry operations. The article admits that SGS' monitoring activities in PNG do not cover these operations. The main counter-argument is to suggest that the definition of illegality used by Forest Trends in their analysis is too broad. Asumadu implies that on the basis of the narrow FAO/ITTO definition – i.e. illegality refers only to “*harvesting, transporting, processing, and trading of forest products in violation of national laws*” - PNG can legitimately claim that most wood is legally sourced. However this is not the case if illegality is taken to mean that forest operations “*have met all laws and regulations and international treaties including labour rights, indigenous people's rights and the payment of all taxes and fees*”. According to the author, “*this is a much broader definition and encompasses areas of responsibility which are beyond the mandate of the PNGFA*”.

Asumadu concludes that “one area definitely requiring immediate action is the definition of illegal harvesting activities in the context of PNG's forestry law and policy. At present, there is no agreed national definition of illegal harvesting activities in PNG”.

The conclusions of the Forest Trends report encouraged the UK Timber Trade Federation to advise members in June 2006 that PNG is “high risk” from the perspective of illegal logging and to avoid bintangor faced plywood. However, anecdotal reports suggest this voluntary boycott has been only partially effective. A FII Ltd report commissioned by the TTF in 2007 quotes a timber agent speaking after a recent visit to Tilbury Docks “there are acres and acres of Chinese plywood, some with Bintangor clearly marked on the packaging”. While the large UK distributors are believed to have effectively boycotted bintangor faced plywood, the boycott has not extended far amongst smaller distributors.

5.6 Africa

5.6.1 Cameroon

The vast majority of EU imports from Cameroon comprise sawn wood, with smaller volumes of logs, veneers and mouldings. Plywood production and exports are insignificant. Logs now represent only a small proportion of total exports from Cameroon as government policy has been to increase value added processing. Much of the log volume shipped out of Douala port in Cameroon is in transit from the Central African Republic and northern parts of Congo (Brazzaville). An increasing share of log exports is now destined for China.

With an average 693,000 m³ of sawn lumber exported between 2002 and 2007, Cameroon has the greatest industrial capacity in forested Africa. Ayous, sapele and tali represent the largest proportion of Cameroon timber exports. Sapele sawn lumber is the major competitor to Malaysian meranti sawn lumber used for a wide range of joinery applications.

Levels of officially sanctioned harvest declined dramatically from around 3.5 million m³ in the late 1990s to around 2 million m³ per annum during this decade. This is believed to be close to the long term sustainable level. However Cameroon has suffered from excess installed capacity. Industrial processing capacity increased rapidly from 1.2 million m³ in 1994 to 2.7 million m³ in 2003. Industry therefore suffers from a continual shortfall in log supply, a factor which has contributed to illegal logging in the past. This is exacerbated when small scale artisan producers are included, who consume around 1 million m³ of logs per year.

Some of the key building blocks for legal enforcement, legality verification and sustainable forestry are already in place in Cameroon. A new forest policy has been adopted; an SGS' export control project is operational; a Forest Crime Monitoring Unit has been established, the NGO Global Witness operates formally as an Independent Observer; a National Working Group on certification is operational; some of the largest concessionaires have made far-reaching voluntary commitments to sustainable forest management; and framework certification standards have been developed.

These developments have all contributed to an improvement in detection of fraud and improved law enforcement. In 2004, the MINEF Minister stated that recent efforts to combat illegal logging and tighten controls on concessions has ensured a continuous increase in government tax receipts from forest operations, which have been at around CFA 144.5 billion per year since 2002. He suggested that companies winning contracts to exploit the forest are now "80% in accordance with the law". An April 2005 report by Global Witness concluded that "*A trend can be detected towards increasing regularity of control and decreasing infractions in the forest sector.*"

However, Global Witness have also noted that there seems to be a tendency for illegal activities to be shifting towards the logging of trees below permitted diameter, the logging of volumes in excess of those authorised, and the logging of species for which no felling permission has been granted. At the same time illegal industrial logging is increasing in Community Forests, which, as a management system, is still fragile in Cameroon, and currently with little Government support to put sustainable administrative and economic systems in place.

Cameroon was amongst the first group of countries to engage in a FLEGT VPA process with the EU with formal negotiations beginning on 28-29 November 2007. A draft legality standard was published on 19 November 2007. A study of the Cameroonian chain of custody has been undertaken.

Private sector initiatives in Cameroon to provide assurances of legal and sustainable practices have expanded considerably in recent years. There are now over 300,000 hectares of FSC certified forest. Several more concessionaires are now working actively towards FSC certification. 1.172 million hectares of forests in the country are enrolled in the WWF GFTN, while 1.291 million hectares are enrolled in TFT. Over 1.3 million hectares are covered by SGS TLTV legality verification system.

5.6.2 Congo-Brazzaville

Forests resources in Congo-Brazzaville are substantial standing at around 22 million hectares. Commercial log production in Congo Brazzaville averaged 1.44 million m³ between 2002 and 2007. Although commercial log production has been rising in recent years, harvesting is believed to be below the long term sustainable yield. This combined with a relatively low level of population in Congo-Brazzaville, suggests that the country has potential to become a more significant supplier of wood products to international markets in the future. The government has predicted that log production in the country will increase to over 2 million m³ in future years. However major infra-structure constraints have limited more rapid development of the timber industry.

The EU imports mainly logs from Congo Brazzaville with smaller volumes of sawn lumber. Congo-Brazzaville is now the only major supplier of African redwood logs into the EU, notably sapele and sipo. Both species are used for the manufacture of high value joinery products in the EU and are direct competitors to Malaysian timber species.

A national policy objective of reducing log exports to a maximum of 40% of production is now close to being achieved. During the period 2002-2007 log exports comprised 45% of production. China is the leading export market for Congo-Brazzaville logs, but there are also significant exports to several EU countries.

The Congo-Brazzaville government has been actively engaged in efforts to promote sustainable forest management and prevent illegal logging and trade:

- A new forest law was published in 2000 in line with ITTO Objective 2000, founded on the sustainable management of forests for a sustained production of timber and non-timber products and a greater contribution of the forest sector to socio-economic development.
- A National Forest Product Export Control Service has been established with the support of SGS. This physically verifies all exports of forest products and calculates the taxes due. It also provides an analysis of activity in the sector, especially of percentage of local processing of logs into primary wood products, which are subject to quota regulations.
- In June 2003, the NGO Global Forest Watch signed an agreement with the government to collaborate on a project to help control illegal logging and improve forest law enforcement. This project uses satellite images to map all Congo's logging roads, forest titles (forest concessions, community forests, etc.) and protected areas, and compares this data with existing forest legislation.
- Collaboration between the government authorities and concession holders in the north of the country have facilitated forest inventories on at least 6.4 million hectares, providing a major foundation for long term sustainable management in the region.
- In January 2007, Resource Extraction Monitoring (REM) and Forests Monitor started the implementation of a 3-year project of Capacity Building in the Congo Basin and Independent Monitoring of Forest Law Enforcement and Governance in the Republic of Congo.

No specific indications on the level of illegal logging in the country could be identified for this study. However work undertaken by the Independent Monitor in 2007 indicates that while certain aspects of the regulatory system for forests are working well, other areas need attention. For example the resources made available to the government forest authorities are insufficient to allow for proper surveillance and enforcement.

The majority of wood exported to the EU from Congo-Brazzaville derives from European-owned companies operating concessions in the northern part of the country. These companies are actively engaged in a process to implement sustainable forest management plans in consultation with national and local administrations. They are developing plans in accordance the requirements of a "Practical Forest Development Plan for Natural African Tropical Production Forests" drawn up by the ATIBT .

To date, 296,000 hectares of forest in the country have been FSC certified, comprising one of five concessions managed by Congolaise Industrielle des Bois (CIB), part of the European DLH/ tt-Timber Group. A further 1.1 million and 1.3 million hectares respectively are enrolled in the GFTN and TFT programs which facilitate stepwise progress to FSC certification. Legally verified wood is also increasingly available. 3.1 million hectares of forest are covered by the SGS TLTV legality verification system, with other areas covered by the OLB system operated by Bureau Veritas.

In 2005, ITTO reported that while there has been significant progress towards sustainable forest management in the north of the country, problems are reported in the south. According to ITTO, in this region more than 1 million hectares of forest have been

allocated for harvesting in lots of about 50,000 hectares to operators largely unskilled in forest management.

The government of the Congo Republic has contacted the European Commission to start VPA negotiations which are due to be launched on 3 - 4 June 2008. A workshop to establish a national plan for negotiations, with representatives of the Congolese government and the EU took place on 3-4 December 2007 in Brazzaville. On 11 April 2008, a Working Group on Legality met to discuss the FLEGT process in the country. A national seminar on legality is likely to start on 20 May 2008. The government has commissioned an assessment of the regulatory control system and chain of custody systems to prepare for VPA negotiations.

5.6.3 Congo Democratic Republic

DRC's undoubted potential as a major player in international timber markets has been severely constrained by the unstable political environment. The devastating civil war between 1997 and 1999 led to the complete destruction of industrial capacity throughout much of the country. Sporadic fighting has continued in the eastern parts of the country ever since, disrupting the reconstruction process. Foreign businesses have curtailed operations due to uncertainty about the outcome of the conflict, lack of infrastructure, and the difficult operating environment.

The country has a vast untapped forest resource. The total area of tropical forest amounts to around 125 million hectares. Around 80 million hectares of rainforest is classified by the environmental group Global Forest Watch as "large areas in low access tracts" defined as forest areas at least 2 kilometers (km) from public roads and in contiguous blocks of at least 1,000 km². Around 22 million hectares of these low access forests are formally allocated for concessions.

Current commercial harvesting levels are negligible compared to the long-term potential. ITTO data indicates average commercial log harvests of only 122,000 m³ between 2002 and 2007. The vast majority of wood products exports are in the form of logs. An ITTO survey of concessionaires in 2003 indicates levels of harvesting as follows: afrormosia (35%), sapele (26%), iroko (15%), sipo (10%), wenge (6%), tiama (4%), limba (2%).

At the end of the civil war, almost 45 million hectares of concessions were formally held under long-term logging contracts in the country. These concessions had been allocated through discretionary procedures, and without land use planning nor consultation with local communities. The DRC government, along with the World Bank and UN FAO, has been working towards improving the regulation of industrial logging to promote economic development. As part of this process, since 2002, the Government canceled 163 timber concessions totaling 25 million hectares and declared a moratorium on the allocation of logging contracts pending the adoption of transparent procedures. Areas returned to the public domain are now meant to go through the participatory land use planning and sustainable management processes set forth in a new Forest Code.

With support of the World Bank, the Government plans to reallocate the forest resources under a transparent system and to improve monitoring and enforcement of forest laws. 40% of the cancelled concession area will be redistributed according to the new code to decentralized local collectivities for local social infrastructure works. The World Bank and FAO are involved in preparing a national forest zoning plan, which will serve to define

areas for logging, conservation and community use. The new Forest Code provides that protected areas are to cover 15% of the national territory.

Recent reports suggest that implementation of this reform process has been very slow. In early 2008, Global Witness, the UK based NGO, reported their findings from a scoping mission on independent forest monitoring in DRC. The findings suggest that the forest sector in the country is still in total disarray and that little progress has been made to improve the situation since the end of the civil war. Global Witness suggest that: the reform proposed for land use planning in 2002; 70% of the current 156 forest titles were issued or modified after the moratorium on new concessions in 2002; the legal framework in DRC is incomplete and inconsistent - of the 42 application decrees in the Forest Code, only four have been signed; there is no budget for control operations; the salaries of forest administration officials are low; there is no technical equipment; the professional capacity among control officials is low; and artisanal loggers are not registered, but are receiving logging permits.

In early 2008, the World Bank announced that it is increasing its involvement in the DRC forestry sector with US\$64 million in new funds. The Bank intends to work with regional and local authorities in overseeing forest management planning and curbing illegal logging.

Some of the conclusions of the Global Witness report have been challenged by the Fédération des Industriels du Bois en RDC. While the Federation accepts that illegal logging is rife in DRC, it notes that the commercial wood sector is not a major actor in the process. Drawing on an FAO study, the Federation suggests that industry exploits only about 400,000 m³ per year in DRC, whereas the small-scale artisanal sector and illegal loggers exploit 5 million m³ per year. The local population collects and burns (slash/burn) an additional 50 million m³ per year. The Federation claims that recent financial audits have demonstrated that industrial companies operating in the DRC do pay their taxes despite struggling to survive in a country with negligible infrastructure and a highly uncertain and volatile business environment.

The Federation comments that *“Industrial logging companies hope that the conversion of their old titles will take place during 2008, which will result in a new type of contract and the ability to implement SFM plans. Some companies are already working on SFM and, in the near future, DRC will be able to demonstrate that 6–8 million ha of forest concessions are exploited in a sustainable manner. The next step will be to achieve certification”*.

The government of the DRC has made a request to start formal discussions towards a FLEGT VPA with the EU. Although informal talks are ongoing, there is at present no indication on when formal negotiations might start.

5.6.4 Central African Republic

The Central African Republic (CAR) is a relatively small supplier of tropical hardwoods to international markets. Log production levels averaged 579,000 m³ per annum between 2002 and 2007, experiencing a slow rising trend. Log exports have been declining in recent years in response to government policy to restrict exports to 40% of production levels and encourage domestic processing. Nevertheless, exports of sawn lumber and other processed wood products remain very confined.

CAR has two distinct and separate forest areas - the Southeastern forest area (around 1.5 million hectares), whose timber potentials are largely unknown and which is not commercially logged; and the Southwestern forest (3.5 million hectares), whose commercial timber is presently being harvested. Forest species most abundant in this region are limba, sapele, and ayous, together comprising almost three quarters of this total volume. The vast majority of southwestern forest resource has already been allocated to concessions. Nearly all are in the hands of ten foreign-owned timber companies.

There are significant constraints to further development of CAR's forest industry including the country's landlocked position, a poor transportation system, a largely unskilled work force, a legacy of misdirected macroeconomic policies, continuing political uncertainty, and high levels of bureaucracy.

According to ITTO, some of the preconditions for sustainable forest management are present in CAR. In 1990, the country introduced a forest code that sets out social, environmental and silvicultural norms. Two forest inventories have been carried out, the results of which can support forest management planning and economic analysis. Concessionaires are required by law to prepare a forest management plan within three years of issue of a concession permit. In the interim period, the concessionaire must harvest according to specific prescriptions of the Ministry.

However, ITTO also point out that there is a gap between the law and its implementation in the field. ITTO suggest there is little awareness in the private sector of the need for SFM. Moreover, the forestry administration lacks the capacity to oversee management of the PFE and to enforce the law, including by imposing sanctions when rules and regulations are infringed.

The government of the Central African Republic (CAR) requested in mid-2007 to start formal discussions with the European Union for developing a VPA. After a visit by EC official in late November 2007, there are indications that formal negotiations could start in September 2008.

The consultancy firm REM, as part of a 3-year project of capacity building in the Congo Basin funded by through the EC Tropical Forests budget line and DfID, has initiated contact with stakeholders in-country in preparation for a feasibility study on the possibilities for independent monitoring of the forest sector in CAR.

5.6.5 Gabon

Gabon is host to a significant area of primary tropical forest. Total forest area in the country is 21.2 million hectares, of which less than 2 million hectares is classed as secondary forest or fallows. Around 16 million hectares of rainforest is classified by the environmental group Global Forest Watch as "large areas in low access tracts" defined as forest areas at least 2 kilometres from public roads and in contiguous blocks of at least 1,000 km². 19 million hectares of Gabon's forests are classified as production forests, of which around 12 million hectares gazetted for timber exploitation.

Log production levels in the country averaged 3.4 million m³ per annum between 2002 and 2007. These are generally considered to be slightly below the forests long term

sustainable potential. However harvesting is concentrated on a limited range of commercially valuable species – particularly okoume used for the production of plywood. Therefore, maintenance of current production levels into the future is likely to depend on utilisation of a wider range of species.

Around 50% of logs harvested in Gabon between 2002 and 2007 were exported. The EU, particularly France, was formerly the largest market for Gabon logs, but an ever larger proportion is now destined for the Chinese market, which took 1.15 million m³ in 2007. However overall log export volumes have been falling in recent years due partly to the development of the domestic wood-processing industry and EU anti-dumping duties on Chinese plywood manufactured with okoume. Gabon's exports of sawn timber and rotary veneers have tended to rise in recent years, although not to such an extent that they compensate in volume terms for the decline in log exports.

There have been significant efforts in recent years to improve forest enforcement and move to sustainable forestry in Gabon. A new forest code was introduced in 2001 setting out more transparent procedures for allocation of forest concessions and requiring that management plans must be submitted and approved within three years for all logging operations. By February 2006, 6.4 million hectares of forest concessions in the country were already engaged in the forest management planning process, of which 2.8 million hectares had had management plans approved by the Gabon authorities.

In addition the new Forest Code: established a National Forest Fund to maintain sustainable management practices; classified most of the forest area into distinct production forests and protected areas; and demarcated certain forest areas as rural forests, reserved for rural communities who can obtain revenues either by logging themselves or by renting out to logging companies. An IMF report published in December 2004 noted that "The reforms in the forestry sector are progressing well".

Gabon has probably progressed further than any other African country to develop forest certification procedures. A national certification system has been developed known as PAFC Gabon which is currently seeking PEFC endorsement. In 2006, close to 900,000 hectares of forest were already pursuing certification under PAFC Gabon. Around 1.1 million hectares are currently independently assessed as in conformance to the Dutch Keurhout standard.

The government of Gabon has indicated that it wants to enter into formal negotiations with the EU towards developing a VPA. Talks between the two governments are ongoing, and a national VPA workshop to define the road map for negotiations (and discuss a first draft of the FLEGT legality definition) was held in March 2008. The Gabonese government has set up a working group on FLEGT. Formal VPA negotiations are likely to start in the second half of 2008. The consultancy firm REM has initiated contact with stakeholders in Gabon in preparation for a feasibility study on the possibilities for independent monitoring of the forest sector.

5.6.6 Liberia

Commercial harvesting and agricultural cash cropping in the country was effectively suspended between the late 1980s to late 1990s due to civil war. As a result, by the end of the 1990s, Liberia was the only west African country still with a significant area of undegraded tropical hardwood forests. During Charles Taylor's domination of the country

between 1997 and 2003, harvesting levels increased dramatically to over 1 million m³, perhaps double the sustainable level. UN sanctions on the timber trade implemented in 2003 meant harvests fell away again in 2004. According to ITTO data, between 2002 and 2007, harvests averaged only 330,000 m³ per year, with the majority exported as logs.

Following the fall of the Taylor regime and the UN sanctions, donors helped to form the Liberia Forest Initiative (LFI), a partnership of government, international organizations and NGOs. With assistance from the LFI, the Government of Liberia has undertaken significant reforms related to concession allocations, forest laws, draft regulations, and financial controls. In July 2006, the UN sanctions were lifted. Furthermore, under the supervision of a Liberian Land Use Planning Commission, the LFI completed a forest use suitability map in June 2006. The map defines how forests should be divided amongst the three major use opportunities: conservation, commercial forestry, and community management of forests.

Commercial harvesting was due to begin again in Liberia's forests in March 2008 for the first time since the UN sanctions were imposed. At this stage, likely future levels of harvesting and trade are uncertain, but with a forest area much greater than either Ghana or the Ivory Coast, the country clearly has potential to be a significant supplier to international markets. Prior to UN sanctions logging for the European market focused heavily on niangon (a valuable redwood species that competes directly with meranti species), with lesser volumes of khaya, iroko, african walnut, and kusia (opepe). A range of mainly peeler species were exported to China.

On December 8 2006, the Government of Liberia formally informed the European Commission that Liberia is actively considering a VPA. The announcement followed a series of preliminary discussions on the EU FLEGT Action Plan and VPAs in Liberia. Already forest management and timber tracking systems are being developed which could provide a suitable basis for FLEGT VPA licensing in the country. The Liberian Forest Development Authority has hired SGS and Helveta (a software firm) to set up an electronic system to track all of Liberia's timber. The system is planned to cover all commercial forestry so any log without a barcode will be inherently suspect.

5.6.7 Ghana

Ghana's capacity to supply tropical wood products to the EU market has been diminishing in recent years. Levels of harvesting have for long exceeded long term sustainable levels, particularly outside the forest reserves, and availability of good quality hardwood logs is now declining. A key underlying factor has been very high population pressure. Ghana has a per-capita forest area of only 0.07 hectares, the lowest of any major tropical timber supplying country to the EU. This has encouraged widespread forest conversion, illegal logging mainly to supply the local needs of rural communities, and also made political decisions to close down excess capacity in rural areas with few alternative employment opportunities that much more difficult.

Between 2002 and 2007, log production in Ghana averaged 1.3 million m³ per annum, in excess of sustainable harvesting levels which stand at well below 1 million m³. There a government restrictions on exports and undried sawn lumber from the country. Past over-exploitation of commercially valuable species means current harvests are heavily focused on wawa/obeche and lesser known species. Only very limited volumes of high

value redwoods are available, including khaya, sapele, iroko, and utile. Much is now supplied kiln dried at relatively high prices. Sawm lumber exports averaged 118,000 m³ per year during the period 2002 to 2007.

Due to Ghana's relatively accessible location and stable economic and political environment it has progressed farther than any other African country to develop wood processing facilities. It is the leading exporter of tropical hardwood plywood in tropical Africa, although export volumes are relatively confined – averaging 118,000 m³ per year between 2002 and 2007 – with much of the volume destined for other regional markets rather than the EU.

Ghana has taken a very positive stance on the FLEGT VPA process and now looks set to be the first country to finalise an agreement. The development process has been co-ordinated by a multi-stakeholder VPA Steering Committee (SC) with membership drawn from the public sector, industry, civil society, academia and research institutions, together with four Working Groups which are technical sub-committees of the SC. Working Groups have covered respectively: the Legality Standard; the Verification and Licensing Scheme; the Regulation of the Domestic Market; and Timber Industry Restructuring.

The VPA process in Ghana is seen as delivering two major benefits. First is a technical system for independent legality verification which comprises a recognised legality standard and systems for independent verification of compliance to the standard and of chain of custody. Second is the creation of a new consensus-based decision-making framework in the Ghanaian forest sector. According to Ghanaian government officials, active participation of non-governmental actors is adding depth to the forest policy formulation process.

The Working Groups delivered their final reports in early March 2008 and these have now been rationalised into policy and legislative reform recommendations for the Government of Ghana. The Steering Committee has prepared a Ministerial Policy Brief for the Minister leading to a formal mandate for final negotiations now underway in May 2008 and expected to be finalised in June 2008.

It will however take more time for Ghana to build up sufficient capacity to supply FLEGT licensed timber. The Legal Standard Working Group found that Ghana's current forestry legislative does not adequately support the provisions of the Ghana's constitution of forest policy. It has therefore recommended a 2-year process of participatory policy and statutory reform after the VPA agreement is reached to enable Ghana to supply FLEGT licensed timber. Introduction of a new comprehensive legality verification system will also be phased in, starting with control of the export market, including exports to all destinations, not just the EU. The control system will later be extended to the domestic market. A "Mass Balance" approach will be used to volume and claims control focusing on material input, conversion factors and outputs with complete segregation at all critical control points along the supply chain.

A Timber Validation Entity will be established which will issue certificates of legal origin and certificates of legal compliance to exporters. The creation of the TVE will involve some changes to the functions of the FC (TIDD) and CEPS to eliminate duplication, loopholes, delays and unnecessary costs. The Policy Committee has recommended that the TVE be entirely independent of both the FC and MLFM.

Most large private companies operating in Ghana are committed to achieving FSC certification and some forest areas are now enrolled in stepwise programs towards achievement of this long term goal. However, until such time as this ambition is realised, the FLEGT VPA system will be vital for promoting Ghana's commitment to good forest governance and ensuring future market acceptance of Ghanaian wood products in the EU.

5.6.8 Ivory Coast

A short and brutal civil war in 2002 split the country in two, divided between government-held territory in the south and rebel-held territory in the north. A fragile peace now reigns, backed by the UN Mission in Cote d'Ivoire (ONUCI) comprising 6000 peace keepers. These severe political problems have seriously undermined what was one of Africa's more successful economies and severely damaged the nation's forests and associated industries.

Statistical data indicates that closed tropical hardwood forests cover around 3.2 million hectares of the country. However the nation's forests have been heavily logged in the past and significant areas of forest reserve have been converted to plantation and invaded for agricultural land. Even before the civil war, wood supplies were becoming an increasingly pressing problem for the Ivory Coast industry. Deforestation over the last 30 years has been dramatic. Long term harvesting has been well in excess of sustainable levels and resources have become depleted. Commercial forest harvesting fell around 25%-30% following the civil war.

According to ITTO data, between 2002 and 2007, 1.4 million m³ of logs were harvested each year, perhaps double the long term sustained yield. Harvesting volumes were declining rapidly during this period. Prior to the civil war, Ivory Coast was a significant manufacturer of mouldings and other value added products, but now much of the volume is exported as sawn lumber. Prior to the civil war, much of the industry was the hands of European-based operators. Anecdotal reports suggest much of the capacity was sold on to Liberian interests after the civil war and that, due to political uncertainty, the industry is now managed with a short-term view to maximise profits. In recent years Ivory Coast has continued to be a significant supplier of ayous, sapele and iroko sawn lumber with dubious environmental credentials.

On paper, Ivory Coast has a framework designed to prevent forest conversion and promote sustainable forestry practices, including a detailed forestry and environmental code. In practice, implementation proved largely ineffective even before the civil war due to intense pressure of population, which was fuelled by immigration and led to widespread conversion to agricultural cash crops, particularly cocoa.

The forest management situation in Ivory Coast is well summarised by ITTO in their 2005 report on the Status of Tropical Forest Management: *"Côte d'Ivoire's 230 state-owned classified forests (forêts classées) have been over-harvested and have become depleted of timber; natural forests in the rural zone (domain rural) and planted forests are providing an increasing part of the timber supply. Institutional responsibility for forestry administration as changed several times in recent years, with the likely result of reducing administrative effectiveness. The level of enforcement of existing laws and decrees appears to be low in much of the PFE. Forest management plans are under*

preparation or have been prepared for the forest reserves, but few have been prepared for the domain rural. Illegal logging and deforestation are thought to be widespread, exacerbated by civil unrest”.

Although EU commentators have occasionally referred to Ivory Coast as a potential candidate for a FLEGT VPA, there are no reports of any progress being made to open negotiations. There are no certified forests in Ivory Coast.

Table 5.3: Malaysia's competing wood supply countries: economic indicators and forest area

	Pop. 2007	Pop. Growth	GDP 2007/capita	GDP growth 2007	Total Forest Area (Range)	Area of closed natural forest	Per capita forest area	Annual deforestation 2000-2005
	millions	%	US\$	%	million has	million has	has	%
Asia								
Malaysia	25.3	1.74	14400	5.7	19.3-19.5	19.1	0.75	-0.7
Indonesia	237.5	1.18	3400	6.1	105-120	100.4	0.42	-2.0
PNG	5.9	2.11	2900	4.0	30.6	30.2	5.12	-0.5
West Africa								
Ghana	23.4	1.93	1400	6.2	2.7-6.3	1.6	0.07	-2.0
Ivory Coast	18.4	1.96	1800	1.7	7.1-11.7	3.2	0.17	0.1
Liberia	3.3	3.66	500	8.5	3.5-5.7	4.1	1.24	-1.8
Central Africa								
Cameroon	18.5	2.22	2300	3.2	13.3-23.8	20.0	1.01	-1.0
CAR	4.4	1.49	700	4.0	22.9-29.3	4.8	1.09	-0.1
Congo-Brazzaville	3.9	2.70	3700	2.8	20.3-22.1	22.0	5.64	-0.1
Congo-Kinshasa	66.5	3.24	300	7.0	128-135	126.2	1.89	-0.2
Gabon	1.5	1.95	13800	4.5	25.8	21.8	14.53	0
South America								
Brazil	191.9	0.98	9700	4.5	444-544	489.5	2.55	-0.6

Sources: CIA, FAO

Table 5.4: Malaysia's competing wood supply countries: timber trade indicators

	Tropical logs		Tropical sawn		Tropical plywood	
	Production Average 2002-2007	Exports Average 2002-2007	Production Average 2002-2007	Exports Average 2002-2007	Production Average 2002-2007	Exports Average 2002-2007
	000 m3	000 m3	000 m3	000 m3	000 m3	000 m3
Asia						
Malaysia	25303 ▲	5178 ↓	5161 ▲	2883 ↓	4955 ▲	4472 ▲
Indonesia	23800 ↓	248 ▼	6304 ↓	1950 ▽	5476 ↓	3189 ▽
PNG	2220 ⇌	2012 ⇌	51 ⇌	36 ⇌	5 ⇌	4 ⇌
West Africa						
Ghana	1295 ▽	0 ⇌	468 ▽	243 ▲	118 ↓	63 ↓
Ivory Coast	1452 ▼	114 ↓	464 ▽	347 ↓	64 ↓	45 ⇌
Liberia	330 ↓	290 ↓	6 ⇌	4 ⇌	0 ⇌	0 ⇌
Central Africa						
Cameroon	2004 ▲	192 ↓	693 ⇌	628 ⇌	26 ▽	17 ⇌
CAR	579 ▲	169 ▼	113 ▲	50 ⇌	1 ⇌	1 ⇌
Congo-Brazzaville	1435 ▲	647 ▼	205 ▲	161 ▲	2 ⇌	1 ⇌
Congo-Kinshasa	122 ▲	109 ▲	34 ▲	34 ▲	1 ⇌	0 ⇌
Gabon	3416 ↓	1701 ▼	221 ▲	174 ▲	92 ▽	92 ▽
South America						
Brazil	25217 ▼	4 ⇌	15281 ▲	1209 ▼	1194 ▽	471 ▼

Trend 2002-2007: Sharp rise - ▲; Rise - ▲; Stable - ⇌; Decline - ▽; Sharp decline ▼; Fluctuating ↓

Sources: ITTO

Table 5.5: Development of forest management planning in African supply countries

	Cameroon	Gabon	Congo	DRC	CAR	Total
Dense forest area	21436000	21190000	25914000	124566000	8227000	201333000
Production forests	10500000	19000000	12000000	87000000	3300000	131800000
Area gazetted for exploitation as of 02/2006	7000000	12000000	10000000	22000000	3000000	54000000
Area under forest management process	4347791	6368424	7114835	9679639	2993954	30504643
Preparatory phase	79442	1906888	1724422	2977527	276840	6965119
Development of the management plan	727699	1538688	3088253	6702112	1461948	13518700
Management plan submitted	338771	117606	2302160	0	707947	3466484
Management plan agreed	3201879	2805242	0	0	547219	6554340
Certification in process						
ISO14001	0	2031788	3298617	0	0	5330405
Pan African Forest Certification	0	874656	0	0	0	874656
Forest Stewardship Council	494085	333954	370160	1440869	0	2639068
Others (Keurhout...)	0	1727788	0	0	0	1727788

Source: *Forest management in Central Africa: where are we?* R. NASI, B. CASSAGNE and A. BILLAND, *International Forestry Review* Vol.8(1), 2006

6 Price and trade issues

6.1 Introduction

This section of the report discusses some of the trade impacts of Malaysia signing a FLEGT VPA agreement, including the impact on price and potential for trade diversion and circumvention of the licensing process.

The section is necessarily more speculative than other sections of the report. Forecasting future price levels and trade flows in the wood products industry is fraught with difficulty. Forest resources are hugely diverse, extensive and influenced by a wide range of factors including legitimate and illegal harvesting, conversion to other uses, fire and pests, and a changing policy environment. Statistical information on forest resources, production levels and trade is incomplete and often of very poor quality, particularly with respect to tropical forest resources. Markets and trading chains are highly complex and lacking in transparency. The data problems are inevitably even more pronounced when seeking to assess the impact of policies to address illegal logging which is, by its very nature, difficult to monitor.

Broad conclusions are drawn based on best available information derived from other sections of this report on likely future levels of wood demand and supply, the views of the private sector, together with consideration of various other secondary sources. Consideration is also given to means of dealing with some of the trade issues that arise from implementation of the licensing system.

6.2 Trade modelling

6.2.1 Overview

Developing forecasts of prices is generally carried out using econometric models. Ideally, the impact of the FLEGT VPA process on the Malaysian wood industry would be assessed using a model specifically designed to describe the Malaysian tropical hardwood industry. However the process of developing such models is technically challenging and time consuming and lies outside the scope of the current report.

An alternative approach may be to utilise existing models of the forestry sector that have been developed at the global level. There are at least two of these in existence: the Global Forest Products Model (GFPM) which originated as one output of the FAO Outlook studies; and the EFI-GTM Global Forest Sector Trade Model (GFSTM). Unfortunately these models do not have sufficient resolution to provide detailed insights into the impact of policy changes implemented by a limited range of countries on the trade flows of specific commodities. For example, the GFPM does not differentiate between softwood and hardwood products, or between finished plywood and veneer sheets.

Nevertheless these models can provide an insight into the potential impact of major changes in the direction of global forest policy. Various studies have already been undertaken using the GFPM model based on simplistic assumptions about the level of

illegal logging in supply countries⁵² to assess the overall effects on forest products markets of international efforts to eradicate illegal wood from trade (Seneca Creek/AF&PA 2004⁵³, Turner et al 2007⁵⁴, Li et Al 2007⁵⁵). Another study has been undertaken using the GFSTM specifically to assess the potential impact of the FLEGT VPA process on trade flows⁵⁶. Relevant results of these various analyses are summarised in the following sections.

6.2.2 Seneca Creek/AF&PA 2004

The study assesses the impacts of illegal logging globally on the competitiveness of the US forest products sector. It uses a systematic assessment of illegal logging rates and trade to estimate overall levels of illegal wood trade. It concludes that between 12% and 17% of the volume of hardwood roundwood and as much as 23% to 30% of the volume of hardwood lumber and plywood traded globally could be of suspicious origin.

An economic simulation using the GFPM is undertaken for the period 2002 to 2012 comparing scenarios for the period 2002 to 2012. One scenario assumes that illegal logging is progressively phased out during the period 2002 to 2007 worldwide. The baseline scenario assumes business as usual. The analysis suggests that illegal material depresses world prices by 7% - 16% on average depending on the product.

The predictions of the GFPM for the year 2012 with respect to level of production and trade as a result of eliminating suspicious roundwood production in key supply and consuming countries are shown in Table 6.1.

The simulation assumes that around 12% of hardwood roundwood supply to the Malaysian industry is of suspicious origin. Nevertheless, the simulation indicates that Malaysia would be a beneficiary of moves to eradicate suspicious wood from trade. Malaysian roundwood production and exports would increase, although Malaysian production and exports of sawnwood would decline slightly. Malaysian panel products exports would rise by 5%. By contrast, Indonesian plywood exports would drop dramatically, putting upward pressure on world panel prices. West and Central African regions would also see a dramatic drop in exports of roundwood and sawn lumber. In the EU, declining availability of suspicious wood is compensated by an increase in domestic roundwood production. The EU also benefits from increasing exports. The total volume of EU imports of sawnwood and panels would be essentially unchanged under this alternative scenario, although the sources would change benefiting countries with lower levels of illegal logging.

⁵² All these studies are based on a rough estimate of the percentage of "illegal logging" in each supply country drawing on a range of secondary sources. Assumptions are then made with respect to how levels of "illegal logging" are translated into trade volumes. Although efforts may be made to ensure broad comparability between countries, in practice it is extremely difficult to resolve differences in the definitions of "illegal logging" that may have been applied by different authors - definitions which might or might not include illegal logging for small scale domestic utilisation, larger scale illegal operations to convert forests for other uses, theft of commercially valuable timber, or major or minor infractions of existing concession agreements.

⁵³ "Illegal Logging and Global Wood Markets: The Competitive Impacts on the U.S. Wood Products Industry", prepared for American Forest & Paper Association By Seneca Creek Associates, LLC, 2004

⁵⁴ "Implications for New Zealand Wood Products Sector of Trade Distortions due to Illegal Logging", Turner et al, July 2007, Scion.

⁵⁵ Li et al, "Long term effects of eliminating illegal logging on the world forest industries, trade and inventory"

⁵⁶ Impact Assessment Report on the EU FLEGT VPA with Indonesia, Indufor, 2008

Table 6.1: Changes to the level of production and trade as a result of eliminating suspicious roundwood production, predictions of the GFPM for the year 2012.

	% change			Volume change 1000 m3		
	Round-wood	Sawn-wood	Panels	Round-wood	Sawn-wood	Panels
Production:						
EU-15	5%	5%	0%	16,673	4,679	162
Japan	13%	7%	2%	4,042	988	103
U.S.	1%	1%	2%	5,386	911	874
Malaysia	8%	-2%	1%	2,060	-110	48
Brazil	-2%	-2%	-2%	-2,069	-482	-143
China	-23%	-10%	-9%	-18,455	-818	-3185
W/C Africa	-23%	-28%	2%	-6,362	-1,353	23
Indonesia	-33%	-31%	-32%	-24,356	-2,490	-5,162
Russia	-16%	-32%	5%	-25,102	-7,685	294
Exports:						
U.S.	0%	49%	35%	0	1,332	777
EU-15	4%	12%	5%	919	5,164	1,456
Brazil	0%	-1%	4%	0	-27	98
Malaysia	48%	-1%	5%	1,809	-27	390
W/C Africa	-39%	-51%	10%	-2,492	-1,063	64
Indonesia	-44%	-55%	-51%	-318	-1,451	-4,199
Russia	-19%	-57%	30%	-11,867	-7,097	488
Imports:						
EU-15	-9%	0%	0%	-5,704	30	-61

One key conclusion of the study is to highlight the importance of ensuring costs of demonstrating legality are kept to a minimum in order to reduce incentives for illegal activity: *“the sometimes wide gap in cost between legitimate, legally procured timber and illegal timber provides an incentive for smuggling. To be effective, solutions to the illegal logging issue must reduce the spread between the costs of operating illegally and the costs of operating legitimately. Policy makers should consider that raising costs for legal trade could have a perverse and unintended impact”*.

6.2.3 Turner et Al 2007

The report assesses the implications for the New Zealand wood products sector of trade distortions due to illegal logging. It was prepared for the New Zealand Government by the research association Scion. The study relies on the GFPM model and another model developed specifically for the New Zealand radiata pine industry. The value of the detailed results of this study to the current impact assessment is reduced by apparent errors in the published data on production and trade relating specifically to Malaysia⁵⁷. Like the Seneca Creek study, it concludes that countries with lower levels of suspicious wood supply experience higher production, exports and prices for their wood products.

⁵⁷ This issue was raised with Joseph Buongiorno, one of the study authors, who agreed there might be errors in the data relating to Malaysia produced as part of the New Zealand study.

The authors draw broad conclusions from the results with respect to the value of the FLEGT initiative and other forms of certification, suggesting that as things stand there may be a significant economic disincentive for manufacturers in countries that are dependent on suspicious wood to move forward with these initiatives: *“While exporters of wood products from legally sourced material would increase revenue with the removal of illegal logging, manufacturing sectors in countries that utilise illegally sourced wood would experience a decline. The economic incentive for addressing illegal logging, therefore, does not lie with the manufacturing sectors (consumers) in countries where illegal logging occurs, but in countries without illegal logging.”*

This study also highlights the need for solutions to illegal logging which seek to raise the cost for illegal producers without also raising the cost for legitimate producers *“otherwise, the cost gap will continue to exist and could even widen, providing greater incentive to illegal operators”*.

6.2.4 Li et Al 2007

Using the GFPM, the study assesses the economic impact on the world forest sector of a progressive elimination of illegal logging, comparing predictions from 2007 to 2020, with and without a gradual reduction of illegally logged industrial roundwood between 2007 and 2011.

The study differs slightly from others based on the GFPM since it includes as an underlying assumption that *“a large part of the curtailment of timber supply due to the stoppage of illegal logging would be compensated by increased legal production incited by higher prices”*.

As a result it concludes that, without illegal logging, overall world annual production of industrial roundwood would decrease by no more than 1%. The overall impact on world forest products prices of eradicating illegal logging worldwide would also be relatively minor. World prices would rise by 1.5 to 3.5 percent for industrial roundwood and by 0.5 to 2% for processed products.

Nevertheless, even with this assumption, the model indicates that there would be a significant decrease in industrial roundwood production in tropical countries (up to 8%) concentrated in countries that have high rates of illegal logging. And there would be more substantial impacts on prices for particular products derived from these countries. For example, the model predicts an increase in the price of Indonesian plywood of around 10% assuming a “low” level of illegal logging (50% of sawlog supply), or an increase of around 20% assuming a “high” level of illegal logging (80% of sawlog supply) (Chart 6.1).

Chart 6.1: Predicted price of plywood and veneer in Indonesia, in the base scenario, and with a progressive elimination of illegal logging from 2007 to 2011, with high or low assumed rates of illegal logging



Source: Li et al 2008

6.2.5 Indufor 2008

An insight into the potential impact of the EU's FLEGT licensing system on trade with the EU is provided in a recent study to assess the trade impact of a potential FLEGT VPA with Indonesia⁵⁸. This study uses the EFI-GTM Global Forest Sector Trade Model and is based on the following premises:

- only "basic" VPA products are considered - logs, sawnwood, plywood and veneers;
- the baseline scenario is "business as usual" with no measures taken to prevent imports of illegal wood into the EU ;
- two alternative scenarios are postulated for comparison:
 - "VPA 6" in which it is assumed that the EU finalises VPAs with six countries that are either engaged on have shown an interest in engaging in the process namely Malaysia, Indonesia, Ghana, Cameroon, Gabon, Congo Brazzaville.
 - "VPA 12" in which EU finalises agreements with 12 countries considered "high risk" from an illegal logging perspective, namely the six VPA countries plus Brazil, China, Russia, Ukraine, Belarus and Vietnam. The latter scenario has no realistic prospect of coming to fruition since none of the additional 6 countries are likely to enter into a VPA in the foreseeable future. However the scenario gives some indication of what the effects might be of alternative policy measures – such as EU legislation - that are

⁵⁸ "Analysis of the Trade Impact Of The VPA For Indonesia", Main Report, Jakarta, 28 February 2008

effective in preventing illegal wood from a wide range of countries entering the EU.

The simulation is based on a rather simplistic opening assumption that “*the introduction of the licensing scheme will cause a sharp decline in the production of various products as illegal goods are no more accepted by the EU market*”. It is proposed that introduction of VPA agreements will mean that the proportion of illegal wood supply in the various VPA countries currently destined for the EU market will simply be removed from overall supply for a brief period. As a result during implementation, roundwood harvesting would fall across the VPA-6 countries. However production would soon rebound “*as the sector adjusts its activities to increase the supply of legal goods to the EU market*”.

Another simplification of the modelling exercise is that it does not accommodate potential beneficial demand-side effects of VPA licensing, for example the possibility that legality licensing could increase confidence in products from VPA countries and actually boost market demand in Europe. Nor is it able to differentiate between changes in prices for VPA licensed products destined for the EU and prices for unlicensed products destined for other markets.

Nevertheless, the modelling exercise does provide some useful insights. Specifically it suggests that:

- there is a risk of negative trade impacts associated with entering into a VPA licensing agreement if only a restricted number of other countries participate. The simulation indicates that under such circumstances VPA licensed products may continue to be undercut by lower-priced products from non-VPA countries.
- if a significant number of other countries join a VPA (i.e. simulating the introduction of more effective mechanisms such as EU legislation to prevent imports of illegal wood into the EU) there is potential for significant price gains for VPA licensed wood products due to the reduction in overall level of supply.

6.2.6 Implications of trade modelling exercises

From the perspective of the Malaysian timber industry, it is possible to draw a range of broad conclusions from these modelling exercises:

- A concerted global campaign to eradicate illegal wood supply is likely to have a significant impact to increase prices of wood products from countries where illegal logging is believed to be relatively high.
- Equally the impact on wood products prices for those countries believed to have a relatively low level of illegal logging should be confined.
- Since best available information suggests that Malaysia has relatively low levels of illegal logging (see Section 2.5) whereas suppliers in major competing countries – notably China, Indonesia and Brazil – are likely to have relatively high dependence on illegal logging (see Sections 4 and 5), Malaysia should be a major beneficiary of international moves to eradicate illegal logging.

- In circumstances where only a few countries join a VPA, no other effective measures are introduced to prevent imports of illegal wood into the EU, and the process of legality licensing adds costs, there is a risk that Malaysian VPA licensed timber would lose market share in the EU to timber supplied from countries with high dependence on illegal wood that are not engaged in the VPA process (notably China and Brazil).
- In circumstances where effective measures are introduced to prevent imports of illegal wood into the EU, it is possible that Malaysian VPA licensed timber would benefit from significant price gains in the EU market and would take market share from timber supplied from countries with high dependence on illegal wood.
- Therefore in a situation where the EU has effectively shut the door to illegal wood from other sources, higher costs associated with VPA licensing may be justified in order to assure continued market access and to benefit from higher prices.
- However, the authors of these studies frequently refer to the need to keep costs of implementation to a minimum – often referencing the OECD study (Contreras-Hermosilla et al, 2007) which suggests that to be successful, policies designed to tackle illegal logging should avoid raising the cost of legitimate logging. Otherwise the cost differential would increase the incentives for illegal operators.
- The fact that Malaysia would benefit from international moves to eradicate illegal logging might provide a motivation for Malaysia to move rapidly towards finalisation of a FLEGT VPA, and to engage in active market promotion of the process, in order to encourage key competitor countries to join the process.
- On the other hand, there is a risk that such action by Malaysia could turn out to be an empty and potentially costly gesture since, as Turner et al note, there is little economic incentive for addressing illegal logging within the manufacturing sectors of countries that are dependent on illegal log supplies.

6.3 Impact of FLEGT VPA licensing on transaction costs

The extra costs that might be associated with FLEGT VPA licensing in Malaysia, and how these are allocated between the public and private sector, will have a very direct bearing on prices, level of uptake by the trade, and the relative competitiveness of Malaysian wood in the EU market. However, there is not yet any clear information on costs as the details of the verification system are still being worked out. The question of direct costs of conformance to the licensing system will be dealt with in detail in a later study based on full pilot testing of the system.

The available indications are that the extra costs associated with compliance to the system should not be significant. In 2006, Verifor documented and analysed Malaysia's existing legal and institutional arrangements for verification of legal compliance in the forest sector.⁵⁹ The study identified areas where it may be necessary to introduce "incremental improvements" to ensure full conformance with the requirements of a FLEGT VPA. These included:

⁵⁹ Country Case Study 8: Systems for Verification of Legality in the Forest Sector, Malaysia: Domestic Timber Production and Timber Imports, Adrian Wells, Verifor (a.wells@odi.org.uk)

- mandatory Chain-of-Custody based on computerised tree tagging and log tracking;
- mechanisms to verify mill throughput and recovery rates to enable routine reconciliation of import data with domestic production and processing statistics;
- measures to tighten administration of timber imports, including links to legal validation by source countries and issuances of Transit Removal Passes for small-dimension timber;
- consistency in sampling and standards between complementary public-sector and external audits, to provide more effective oversight;

Nevertheless, Verifor concluded that *“the fact that verification systems are largely in place also means that the cost of incremental improvements may be relatively small”*

Details of the verification system that have so far been released also suggest that costs of compliance should not be significant since the system will be largely based on existing procedures. According to the Ministry of Plantation Industries and Commodities⁶⁰:

- The definition of “legal timber” that will be used is clearly focused on laws pertaining to forestry, timber industry and trade. The full definition is as follows: *“Timber harvested by licensed person from approved areas and timber and timber products exported in accordance with the laws, regulations and procedures pertaining to forestry, timber industry and trade of Malaysia”*.
- The legality standard is based entirely on existing laws, regulations and procedures. The standard sets out principles and criteria of legal timber separately for the 3 regions of Malaysia due to their different legislative frameworks.
- The Timber Legality Assurance System under the VPA will be the existing system of issuance of export licenses for timber and timber products from the 3 regions of Malaysia as implemented by the Malaysian Timber Industry Board (MTIB) in Sabah and Peninsular Malaysia, and the Sarawak Timber Industry Development Corporation (STIDC) in Sarawak.

There may be extra costs associated with introduction of the Independent Monitoring System. At time of preparing this report, only a broad outline of this system has been made available. The Ministry of Plantation Industries and Commodities has indicated that the system will:

- Be carried out in accordance to documented methodology;
- Be at regular intervals, including unannounced checks of any part of the system;
- Cover all aspects of the Timber Legality Assurance System;
- Consider inputs from external stakeholders;
- Collect objective evidence.⁶¹

⁶⁰ Drawn from presentations by representatives of the Ministry of Plantation Industries and Commodities delivered at industry briefings on the Malaysia-EU FLEGT VPA held in Kuching, Kota Kinabalu, and Kuala Lumpur between 4 and 8 April 2008.

⁶¹ Drawn from presentations by representatives of the Ministry of Plantation Industries and Commodities delivered at industry briefings on the Malaysia-EU FLEGT VPA held in Kuching, Kota Kinabalu, and Kuala Lumpur between 4 and 8 April 2008.

However the Ministry has also stated that: *“in implementing the VPA, the Ministry will not burden the industry or individual operator by imposing additional cost, either directly or indirectly. Whatever funding is needed for IMS will have to be borne by the Government(s)”*⁶².

Another set of additional transaction costs may be incurred at point of import into the EU due to the extra bureaucratic requirements of VPA licensing. Delays to shipment represent a significant business expense for shippers and their agents. If products are not off-loaded within a set time period after arrival at port, usually a maximum of three days, the shipping companies will charge demurrage at punitive rates. For Malaysian exporters that have acquired an unrivalled reputation in the EU market for reliable shipment of tropical hardwoods, it is critical to ensure that any extra bureaucracy that might be associated with issue of FLEGT VPA licensing does not cause delays. It would be a particularly perverse outcome of the FLEGT VPA process if the extra bureaucracy that might be associated with importing VPA licensed timber in any way damaged Malaysia’s reputation for reliable supply.

**Table 6.2 Information required on the VPA licence
(according to draft EU regulation dated 31 January 2008)**

Name & address of the licensing authority.
FLEGT licence number
Period of validity of the licence.
Name and ISO Code of partner country from where the timber products exported to the EU.
Means of transport at the point of export.
Name and address of the Licensee (exporter)
Commercial description of the product(s).
Common or scientific name(s) of the species of timber used in the product. This may be omitted for a composite product or component that contains multiple species whose identity has been lost (e.g. particle board).
Four-digit or six-digit commodity code using Harmonised Commodity Description and Coding System.
The country where the species of timber was harvested. Where a composite product include for all sources of wood used. May be omitted for a composite product or component that contains multiple species whose identity has been lost (e.g. particle board).
Overall volume in m3.
Overall weight in kg defined as the net mass of the timber products without immediate containers or any packaging, other than bearers, spacers, stickers etc
Number of units, where a manufactured product is best quantified in this way.
Any distinguishing marks where appropriate e.g. lot number, bill of lading number.
Signed by the authorised official and stamped with the official stamp of the licensing authority. The place & date shall also be indicated.

There is a very clear onus on the European Union to ensure that transaction costs associated with import of FLEGT VPA timber are no higher than those associated with timber from non-VPA countries. This is at least recognised by the European Commission in the draft Implementing Regulation (version dated dated January 2008) which states that *“considering the competitiveness of the international timber trade, the implementation of the FLEGT licensing scheme requires that the procedures concerning the release for free circulation of FLEGT licensed timber products do not lead to undue delays in importation procedures. It is therefore necessary to provide for procedures for*

⁶² Personal communication with Mr Wan Mazlan Wan Mahmood, Under Secretary International Affairs, MPIC

the verification and acceptance of the FLEGT licence that are as simple and practical as possible, without however compromising the credibility of the system”.

In order to facilitate rapid turnaround on arrival, the draft regulation allows for licences to be lodged and verified before the arrival of the shipment as long as certain conditions are met. The license must be in a particular format and contain all the information shown in Table 6.2. Licenses must be lodged with the competent authorities of the Member State who are then responsible for informing the customs authorities as soon as a licence has been accepted. FLEGT VPA licence numbers must be declared on the official customs declaration form (the Single Administrative Document) covering the shipment.

The draft regulation also states that in case of doubt as to whether a licence can be accepted, the competent authorities may request additional information to the licensing authority of the partner country. The draft regulation indicates that in the event of uncertainty over the validity of any particular license, additional physical checks may be carried out to assure the competent authorities that the shipment in question conforms to the information provided in the licence and where necessary to the records of the respective licence held by the licensing authority.

Obviously there needs to be very effective lines of communication between the customs authorities in both Malaysia and the EU Member States and their respective licensing and competent authorities. There also needs to be very clear lines of communication and efficient management systems operated by and between the competent authorities in the EU and the licensing authority in Malaysia. Turnaround times in the event of any uncertainty over the status of a license will have to be rapid, given that shipment time between Malaysia and the EU is typically only 19 days.

As the licensing system is still untried and untested, it is not possible at this stage to give any clear indication of the ability of the system to work appropriately or effectively. The nearest parallel is perhaps presented by the existing CITES controls on ramin from Malaysia. Agents contacted for this study suggest that the CITES controls are very bureaucratic and that it can be a struggle to obtain all the paperwork on time. In order to avoid any negative impact on the Malaysian trade, the FLEGT VPA licensing system will have to be significantly less bureaucratic than that currently operated for CITES.

6.4 Market implications of NCR and other forest reform issues

Other additional costs might be associated with the FLEGT licensing system if the expectations of some ENGOs with respect to the content of the regulatory standards were to be met. ENGOs have raised the need for the existing legal framework to better accommodate the rights and interests of forest-dependent, native communities as a condition of their support for the process (see section 3.4.2). In addition, some groups have pushed for more comprehensive coverage in laws and procedures that relate to labour and environment.

While circumstances vary widely depending on existing levels of performance, studies relating to forest certification suggest that costs associated with compliance with higher social and environmental standards tend to overshadow the direct costs of auditing. For

example, a study by FRIM and financed by ITTO⁶³ was carried out between 1996 and 2002 in a 136,000 hectare concession area managed by KPKKT, a subsidiary of Golden Pharos Sdn Bhd, in the state of Terengganu. It compared compliance with the original MC&I as formulated by the National Committee on Sustainable Forest Management in 1997 and based on the ITTO SFM principles, with conventional logging practices. It indicated that direct external costs of auditing amounted to US\$53,600, compared to US\$131,000 additional compliance costs over the 5 year period. Total cost of production according to the MC&I amounted to US\$1691/hectare or US\$53/m³, compared to US\$1039/hectare or US\$30.8/m³ under conventional logging.

Similarly, a recent study by WWF GFTN⁶⁴, provides estimated costs for a shift from conventional logging to reduced impact logging to achieve FSC or MTCC forest certification in Malaysia of approximately MYR340 thousand (US\$100,000) for 4,000 hectares to MYR4.3 million (US\$1.26 million) for 40,000 hectares, giving an average additional cost of MYR96 (USD28) per hectare. The study notes that a particularly significant cost may be associated with the reduction in annual allowable cut, averaging 33% on pre-certified AAC levels.

Of course these figures have no direct bearing on the costs of FLEGT VPA licensing, but they do suggest that forest reform measures designed to accommodate wider social and environmental standards have potential to add significant extra costs.

The current situation with regard to NCR and broader environmental and social issues within the VPA process has been summarised by Dato' Dr. Freezailah⁶⁵: *"During all the debates and discussions, the responsible authorities gave their views stressing that such concerns have been adequately addressed to the extent possible under the legal framework and be based on the interpretation of the relevant laws by the responsible authorities. And disputes will have to be settled through the judicial process. Nevertheless, there may be grey areas in certain aspects of the laws that govern NCR issues. They need to be reviewed and addressed, but such an exercise is not within the scope of the VPA which does not seek to enact new laws or amend existing legislation"*.

On broader environmental and social issues, Dato' Dr. Freezailah comments: *"These are included in the TLAS and specifically addressed at the 'criteria' level as 'Environmental Management' and 'Worker Safety and Health'. Once again I must stress that we are targeting legal timber in the VPA and therefore cannot really be expected to include a more comprehensive set of legislation on these issues which are appropriate in forest certification for sustainability."*

Therefore the current approach is very much to focus FLEGT VPA on existing laws, regulations, and procedures with the implication that additional costs of compliance should be limited. This approach aligns well with current uncertain market demand for FLEGT VPA licensed timber reflected by the evidence of a general lack of awareness of FLEGT VPA licensing in the EU market, current lack of explicit recognition of such licensing in European government procurement policies, and uncertainty over price

⁶³ FRIM/ITTO - "A Model Project for Cost Analysis to Achieve Sustainable Forest Management" (PD31/95 Rev3(F)), cited in "Report On Financial Cost-Benefit Analysis Of Forest Certification And Implementation Of Phased Approaches", Simula et al, ITTC(XXXVII)/13, 5 November 2004

⁶⁴ WWF GFTN, Natural Capital: Financing Forest Certification in Malaysia, July 2007

⁶⁵ Dato' Dr Freezailah Che'Yeom, Chairman Malaysian Timber Certification Council, Advisor, Malaysia-EC FLEGT VPA speaking at industry briefings on the EU-Malaysia FLEGT VPA in April 2008.

premiums and the development of effective legislation to remove illegal wood from trade. It takes account of the risk of VPA licensed timber being undercut by illegal wood from non-VPA countries and minimises any risk that perverse incentives might be created to circumvent the system.

However ENGO campaigns calling for the VPA process to be expanded to accommodate concerns over NCR and broader environmental issues clearly create a major dilemma for the Malaysian authorities. If ENGOs decide that their concerns are not being adequately addressed, their campaigns could significantly undermine the market value of the resulting FLEGT VPA licenses as a mechanism to build greater confidence in Malaysian wood products. On the other hand, the current environment of uncertain market interest in FLEGT VPA licensed timber might not justify the extra cost.

ENGO groups face an equally challenging dilemma. Interviews for this study suggest that current market incentives for FLEGT VPA licensing are not so great that the private sector feels there are significant benefits to be gained from adopting a VPA. This is particularly true of Sarawak and Sabah which export only a small proportion of their product to the EU. The existence of MTCC is also widely seen by the Malaysian private sector as already providing an effective assurance in the EU market. If ENGOs push too hard, the result could be collapse of the process. The negotiating position of ENGOs would be strengthened if there were greater market incentives for FLEGT VPA licensing.

This is one of those situations where all interests may benefit from the FLEGT VPA process only if a spirit of compromise prevails. Civil society needs to be reassured that the VPA process will facilitate action to resolve remaining NCR issues and to move forward on broader sustainable forestry issues. The private sector needs to be reassured that any additional costs that may arise from the VPA process will be off-set through increased prices and/or improved market share, for example through the EU adopting legislation that impedes market access of illegal wood or through greater recognition of FLEGT VPA licensed timber in public sector procurement policies.

6.4 Potential for higher prices for FLEGT VPA licensed timber

The willingness of the European private sector to pay a price premium for FLEGT VPA licensed timber has been assessed in section 3.4.1 of this report. Interviews with EU importers indicate that there would be only limited willingness to pay premium prices for FLEGT VPA licensed timber over unlicensed timber products. Interviews with the private sector in Malaysia also revealed a high degree of scepticism over the possibility of achieving premium prices, partly informed by the disappointing premiums so far achieved for MTCC certified wood products (see Annex 2).

However these opinions were expressed based on current perceptions of market conditions and, in some cases, a relatively low level of awareness of the FLEGT VPA licensing concept. Economic laws dictate that higher prices would be generated if market demand for FLEGT VPA licensed timber exceeded available supply. This issue is therefore in need of further investigation.

A number of factors support the notion that if existing operational EU policy measures with respect to the illegal wood trade are projected into the future, significant price increases for FLEGT VPA licensed timber are unlikely.

- Section 5 of this report indicates that FLEGT VPA agreements are likely to become operational in several of the major competing countries to Malaysia over the next 1 to 5 years, including Indonesia and all the major African supply countries with the exception of Ivory Coast. The eradication of timber products of suspicious origin into the EU from these countries would likely have a positive impact on market prices if it were not for the continuing availability of competing wood products of suspicious origin from countries not engaged in the VPA process – notably China and Brazil.
- Central government procurement policies are not at this stage proving to be an effective driver of demand for legally verified wood products (see section 3.2.2). Although now being implemented in all the main EU countries importing Malaysian timber (with the exception of Italy) enforcement and co-ordination is proving difficult and monitoring is inadequate. Even if effectively implemented across the EU private sector, they are still only likely to capture a maximum of 25% of the market.
- There is a strong focus amongst those organisations that are implementing timber procurement policies, both in the public and private sector, to focus on rewarding the “top 10%” that are certified rather than blocking the “bottom 10%” of wood that is illegal. Increasing availability of certified softwood and composite panel products from domestic and other temperate sources is tending to reinforce this trend.
- With the exception of the UK, there is no explicit recognition for FLEGT VPA licensing in any EU government procurement policy. While there are signs that some governments might be willing to recognise VPA licensed timber, this is almost always secondary to the objective of sourcing certified sustainable timber.
- Efforts by trade associations to tighten up procurement practices through development of Codes of Conduct and Environmental procurement policies are having an impact in some EU countries, notably the UK, Netherlands, and France, but commitment to these voluntary initiatives is variable and monitoring of conformance is still very patchy (see section 3.3.1.2).
- Detailed analysis of European demand for “legally verified” wood indicates that while larger distributors and manufacturers in some parts of the EU are beginning to demand these forms of verification, smaller distributors and manufacturers – which often account for a large share of the overall market - are not (see section 3.4.1 and country reports in Annex 2).
- The efforts of those organisations willing to take a proactive stance on this issue and to commit to sourcing only verified legal wood products are undermined by those distributors that are not engaged. As a result prices tend inevitably to converge around the lowest common denominator.
- Awareness of FLEGT licensing is quite low, even amongst traders directly engaged in Malaysian wood products (see section 3.4.1).

- Evidence from the certification movement indicates that development of demand on a voluntary basis takes years of concerted marketing effort.
- MTCC certified wood products have not achieved a significant premium in the EU (usually in the region 2-4%)⁶⁶.

Overall, if the existing policy measures are projected into the future, there are likely to be slow incremental improvements in awareness and demand for FLEGT VPA licensed timber, particularly if the process were backed by a well organised, co-ordinated and carefully targeted marketing campaign. This is likely eventually to boost overall levels of market confidence in products from VPA countries. However price levels are unlikely to receive a significant boost as levels of demand for licensed products would probably never exceed the ability of VPA countries to deliver, while the continuing availability of cheaper potentially illegal wood products from non VPA countries would be a constant drag.

However, it is also clear that a very different market environment could emerge if the EU were to introduce more effective measures to block trade in illegal wood. The European Commission is currently considering proposing legislation that would oblige EU timber industry operators to show “due diligence” with respect to the legality of wood products (see section 3.2.3). If such a measure were introduced, and it was effective in ensuring that EU timber operators adhered to comprehensive timber procurement policies like those currently being implemented by the most pro-active companies, the impact on market demand for FLEGT VPA licensed timber could be significant. Impacts could include:

- Malaysian competitors in high risk tropical countries that are not signed up to a VPA are likely to struggle to deliver appropriate assurances of legally verified wood and lose market share. Problems are likely to be particularly pronounced for manufacturers in China due to industry fragmentation, the complexity of trading chains, and heavy dependence on imported wood of uncertain origin.
- FLEGT VPA licensed Malaysian suppliers would be well placed to take a larger share of the market, particularly as there should also be a reduction in available supply of wood from Malaysian competitors in other VPA countries that have higher levels of illegal logging (notably Indonesia and Africa).
- There would probably be significant price gains for Malaysian VPA licensed timber as suspicious supplies are removed from the market and as EU importers struggle to obtain alternative verified legal supplies of tropical hardwood products. This is dependent on the fact that tropical hardwood products are generally not easy to substitute. This is illustrated by the willingness of the European market to follow tropical hardwood prices upwards in times of limited supply. For example, the UK delivered price of kiln dried sapele sawn lumber increased by 38% from around £420-430/m³ in July 2005 to around £580-590/m³ in February 2007 with no noticeable let up in consumption.

⁶⁶ Monitoring UK market conditions for “legal” and “legal and sustainable” wood products, Rupert Oliver, Report for Timber Trade Federation and Department for International Development, FII Ltd, March 2007

6.5 Potential for circumvention and diversion

6.5.1 Defining the issue

Another potential impact of FLEGT VPA licensing is that by imposing extra costs on the direct trade in wood products to the EU, it encourages:

- 1) Efforts to circumvent the licensing system. This would involve exporting Malaysian wood products to the EU via a major trading hub (without further conversion, or with only minor modification such as kilning or additional sorting by grade or length);
- 2) Diversion of trade away from the EU. This would involve the export of primary wood products such as logs and rough sawn lumber to a manufacturing location outside Malaysia. Some of the finished products may then be exported to the EU.

Ultimately, whether or not trans-shipment or diversion occurs is a simple question of comparative costs. The available information suggests that levels of illegal logging in Malaysia itself are limited and the additional costs of conformance to the system should not be great, so there should be little incentive to divert trade elsewhere. Furthermore the motive for circumventing the VPA process would be removed if the EU were to introduce legislation requiring timber industry operators to show due diligence with respect to the source of wood products.

Nevertheless, there is uncertainty surrounding both the potential for extra costs to the private sector resulting from VPA licensing and the ability of the EU to act to effectively block imports of illegal wood. Therefore the issue is worthy of further investigation.

It is important to note in the context of trade diversion that, while Peninsular Malaysia is heavily reliant on the EU market, neither Sarawak nor Sabah export a significant proportion of their wood product to the EU – only around 2% and 8% respectively by value. So in the latter two regions, there is only limited potential for the licensing system to lead to the diversion of existing trade. However there might be potential to create another disincentive for these two regions to engage in the EU market.

6.5.2 Insights from trade statistics and private sector interviews

A comparison of Malaysian export data to other countries in the East Asian region (Table 6.3) with EU import data from these countries (Table 6.4) provides some indication of the potential for Malaysian wood either to circumvent the licensing system or to be diverted elsewhere. Drawing on this data together with discussions with the private sector in the EU and Malaysia, a number of broad conclusions may be drawn:

- As one of the world's largest ports which also plays host to a large timber trading sector, Singapore is already acting as a conduit for Malaysian wood products, including sawn lumber, mouldings and plywood, entering the EU. Interviews with the private sector in Malaysia also indicated that in Sabah and Sarawak, trans-shipment of finished products is quite common as there are real problems with frequency of ships going through their ports. Mother ships regularly pick up containers in both Singapore and Port Klang from East Malaysian feeder ships.

However the volumes of wood products imported by the EU from Singapore are currently small (and will include wood from Indonesia as well as Malaysia).

Table 6.3: Malaysia wood product exports to potential circumvention countries (2006 unless otherwise stated)

	Logs 000 m3	Sawnwood 000 m3	Moulding 000 m3	Veneer 000 m3	Plywood 000 m3	BJC RM million	Wood furniture RM million
China	1188.5	211.0	10.7*	25.8	100.4	9.4	82.6
Hong Kong	41.1	40.3	4.1	4.2	60.2*	1.5	33.3
Indonesia	16.4	14.6*	0.4*	33.4	4.2*	4.6	12.6
Philippines	23.2	143.1*	0.1*	29.9	65.3*	4.2	50.9
Singapore	0.6	195.8	8.0	45.8	60.2	45.7	170.3
Thailand	61.4	63.6	4.3*	5.0	55.5	19.1	13.8
Vietnam	305.0	40.8*	0.7*	0.2	1.1*	3.2	3.3

Table 6.4: EU-25 wood product imports from Malaysia and potential circumvention countries (2006)

	Tropical hardwood logs 000 Tonnes	Tropical hardwood sawn 000 Tonnes	Hardwood mouldings 000 Tonnes	Tropical hardwood veneer 000 Tonnes	Hardwood plywood 000 Tonnes	BJC Euro million	Wood furniture Euro million
Malaysia	1.7	281.0	33.8	0.5	130.2	32.7	304.4
China	0.2	3.5	140.5	2.0	407.5	42.5	2158.6
Hong Kong	0.0	0.0	0.3	0.0	0.1	1.6	42.0
Indonesia	0.6	49.3	188.1	0.6	129.6	76.4	552.2
Philippines	0.0	0.6	1.1	0.0	0.1	4.9	17.1
Singapore	0.1	9.9	8.1	0.0	7.7	1.1	33.1
Thailand	0.2	1.2	4.9	0.7	0.0	2.5	137.8
Vietnam	0.0	0.0	0.9	0.0	0.0	0.2	473.2

- EU imports from other countries that could potentially be acting as a conduit for Malaysian wood (without further processing) - including Thailand, Hong Kong, and the Philippines which are all large importers of Malaysia logs and sawn lumber – are clearly not engaged in this activity at present. EU imports of logs and sawnwood from these countries are negligible. There are likely to be strong economic disincentives to using these countries as intermediaries (notably additional transport costs). Nevertheless, interviews for this study with the private sector in Malaysia suggest that it might happen. There are cases of trans-shipment from Malaysia through ports as distant as Kaohsiung in Taiwan.
- Although the EU imports significant volumes of wood product from Indonesia, Malaysia only exports relatively small volumes to this country. Furthermore, the risks of Indonesia acting as conduit for Malaysian wood would be effectively erased if Indonesia also signs a FLEGT VPA.
- Malaysia is exporting very large volumes of logs and sawn lumber into China and Vietnam both of which are also key competitors to Malaysia in EU finished wood products markets. The same is true, although to a lesser extent, with respect to Thailand and the Philippines. The likelihood is that significant volumes of Malaysian wood are already entering the EU in the form of plywood and mouldings from China, and wood furniture from China, Vietnam and Thailand.

Interviews with the private sector in Malaysia confirmed that this is an issue for the FLEGT VPA process.

6.5.2 Certificates of Origin as a mechanism to help prevent circumvention

The issue of circumvention may be partly addressed through the simple expedient of requiring shippers of timber from the East Asian region into the EU to provide a Certificate of Origin.

At present, importers of any product into the EU must declare these products on the Single Administrative Document (SAD). With the signing of the declaration, the importer becomes responsible for the accuracy of the information given in the declaration and the authenticity of any supporting documents attached. As part of this declaration the importer must state the country of origin and value of the imported good, supporting this information with a copy of an invoice from the shipper. Technically, any failure to record this information accurately may be subject to penalties for mis-declaration.

However, while customs authorities will carefully scrutinise information on the value of imported goods in order to ensure that the correct duties are applied, they have little interest in the stated country of origin unless there is a specific need for more accurate information on the source of products. This applies, for example, when the importer is claiming a preferential tariff under the EC GSP system or when a product is subject to anti-dumping legislation. In these circumstances, EU customs authorities have power to request a Certificate of Origin if there is any doubt as to the correct origin of a given product.

A Certificate of Origin (so-called "Form A") is a document which is signed by the exporter and authorised by a designated certifying authority - usually the government foreign trade office or the Chamber of Commerce of the exporting country benefiting from a preferential GSP tariff or wishing to avoid anti-dumping duties imposed on another country. Certificates of Origin are based on a set of Rules of Origin whereby products are determined to originate in a particular beneficiary country if they are: "wholly obtained in that country"; or "sufficiently worked or processed there". If there is no transformation or only minor transformation in a country through which a product is trans-shipped, then the country of origin does not change.

So for example, if Malaysian sawn timber is exported for grading or kilning in Singapore this would not constitute sufficient working to alter the country of origin (which would still be regarded as Malaysia). On the other hand, if the wood were planned, sanded, end-jointed or converted into any other wood product in Singapore, this would constitute sufficient working for the country of origin to be treated as Singapore. These rules could be applied equally well to FLEGT licensing so that a license would be required in the former instance but not in the latter.

Requesting Certificates of Origin for all timber shipments from East Asia would not be a fool proof system to prevent circumvention. Certificates of Origin are not always issued with adequate control or investigation and the credibility of documents issued by some countries is open to question. But at least such a mechanism would provide an additional tool for monitoring trade flows from the region and help to identify malpractice should it arise.

6.5.3 Dealing with trade diversion

The issue of trade diversion is probably more significant than that of circumvention. The potential for increased Malaysian trade with China is highlighted in Section 4.3.2 which notes that China's wood consumption exceeds domestic production by around 55 million m³ and that the gap between supply and demand is forecast to grow. Consumption is also rising strongly in Vietnam. According to the US Embassy in Vietnam, the value of the nation's imports of wood materials (mainly logs, sawn wood and veneers) increased from \$104 million in 2000 to \$580 million in 2006.

These increases in wood consumption are occurring at a time when availability of tropical hardwoods from the East Asian region is falling. Indonesian production from natural forests now seems to be in long term decline (see Section 5.2.1). Production in Papua New Guinea, now the leading supplier of tropical hardwood logs to China by a significant margin contributing 2 million m³ in 2006, may already be in excess of sustainable levels (see Section 5.4.1).

On the surface therefore, it seems that new emerging demand in East Asia has potential to soak up large quantities of Malaysian wood and could render the FLEGT VPA process largely irrelevant. However, in considering the potential for trade diversion, it is important to note the specific role of the EU in the overall export market for Malaysian wood products. The product range exported to the EU is very different to that exported to other leading markets. To some extent, market niches occupied by Malaysian products in the EU will be absent in other countries or will be occupied by domestic or other competing suppliers. Furthermore, much time and effort has been invested in developing high value European market over many years and it may not be an easy matter to switch to alternative markets.

There are a few factors which, to some extent, set the European market apart from other markets. Europe is particularly important to Malaysia in the market for high grade lumber, particularly for window frames. Regional markets in East Asia – notably Thailand – tend to take lower grade lumber, while China's imports of tropical hardwood tend to focus on flooring grades. European markets have therefore played an important role in maximising sawmill yields and incomes. Europe has also played an important role in Malaysia's efforts to move up the value chain, taking a significant proportion of Malaysia's exports of mouldings, wood furniture and BJC products.

As noted in section 4.3, Chinese buyers tend to prefer logs and, if these are not available, then rough sawn lumber. Due mainly to cost advantages during processing, the same situation prevails in Vietnam. Neither country is likely to be receptive to significant increases in Malaysian exports of value added products. Any diversion of trade to China and Vietnam will only feed competition for Malaysian exporters in finished products markets. In short, trade diversion to China and Vietnam is possible, but it is not desirable from the perspective of improving returns to the Malaysian wood industry.

Moves to reduce exports of unprocessed raw material and boost value added production is a key component of Malaysian trade policy. This means that the existing government instruments are already playing a role to counter the diversion of trade in unprocessed products to China and other regional markets. It also emphasises that engagement in FLEGT VPA needs to be seen as an integral component of Malaysia's larger efforts to move towards more value-added production.

The potential problem of trade diversion may be best addressed by ensuring that the additional costs of FLEGT VPA licensing to the private sector are kept as low as possible, by linkage to broader policy measures designed to reduce exports of unprocessed wood raw material, and through on-going monitoring of trade flows once the licensing system is in place. In time, once the system has been thoroughly tested, consideration might also be given to extending the system to cover all wood products exports, effectively removing the problems of diversion and circumvention.

6.6 Issues related to Malaysian wood imports

According to currently proposed procedures for the Timber Legality Assurance System in Malaysia, imported timber may enter the VPA licensing system as long as it complies with all Malaysian laws and regulations governing timber imports. However, beyond border checks of existing legal documentation, the Malaysian authorities do not verify that imported wood products derive from legal sources. Section 2.4 of this report indicates that in 2007 Malaysia imported a total of around 900,000 m³ of sawnwood, the vast majority derived from Thailand and Indonesia, both countries widely considered high risk from the perspective of illegal wood supply. There are also small but rising volumes of imports of plywood and veneer from China.

In the absence of thorough procedures in Malaysia for vetting the legality of all wood imports, the current system raises the prospect of Malaysia being used as a laundering mechanism for illegal wood from neighbouring countries. This is a general issue for the VPA process as a whole that has been highlighted by ENGOs. For example, a joint briefing on the FLEGT VPA process by Greenpeace, Global Witness and FERN notes that: *“If the partner country has no national legislation prohibiting the importation of illegally logged timber and timber products, timber logged illegally in a non-partner country could enter Europe legally via the partner country, accompanied by a valid legality licence. Importation into Europe would be legal, despite the timber’s illegal origins. Effectively, the timber would have been laundered. In order to close this loophole, either the partner countries should amend domestic legislation to prohibit the importation of illegally logged timber and timber products or the regulation itself should be amended so that the FLEGT licensing scheme is limited to timber harvested in the partner country concerned.”*

There are objections to both solutions proposed by the ENGOs in the Malaysian context. Even the EU after devoting significant resources to the issue, is struggling to identify a reliable legislative mechanism allowing it “to prohibit the importation of illegally logged timber”. The second solution of limiting FLEGT VPA licensing only to domestic timber could not work for any product that might combine wood from imported and domestic sources. For example, Malaysia is now exporting FSC certified plywood to the EU which combines a radiata pine core imported from New Zealand with domestically produced tropical hardwood face-veneer.

There seem to be two possible solutions to this problem:

- Malaysia could itself consider introducing a Lacey-style Act as a measure to encourage due diligence on the part of importers. However there are significant

challenges associated with introducing such legislation, as the situation in the EU illustrates.

- Malaysia could exclude all imported wood products specifically from the FLEGT VPA licensing system unless legitimate forms of independent legality assurance can be provided. These might include other FLEGT VPA licenses, certification systems such as FSC, PEFC or LEI, or private sector legality verification systems such as Smartwood VLO, or SGS TLTV. However it would be necessary for the Malaysian and EU authorities to work together to draw up a set of criteria to determine the forms of legality assurance that may be accepted for imported inputs into the Malaysian licensing system.

7 Role of the finance sector

7.1 Introduction

This section assesses the extent to which the commercial banks are involved in policies to phase out illegal timber production and to stimulate sustainable timber production and analyses how this could affect production and trade of Malaysian timber.

The commercial banks have potential to radically alter the way forests and forest products are perceived and managed. Banks can influence the forest products industry at all stages from forest ownership and management, through all aspects of manufacturing and transport, to final point of sale. They are engaged in transactions with business counterparts of all sizes, their role encompassing corporate banking, project and structured finance, transactions with small and medium enterprises (SMEs), and the provision of financial services to governments. They may also be engaged in corporate advisory services, mergers and acquisitions, asset management, equity/debt capital markets, and leveraged finance (i.e. lending money for transactions).

The potential of banks to play a role in helping to tackle illegal logging is clearly recognised in the EU FLEGT Action Plan which identifies improved financial due diligence as a key tool for reducing the demand for illegally logged timber. It suggests the need for clearly defined, legal and sustainable supplies of timber for all large-scale capital investments in the forestry sector and proposes that banking due diligence be improved to take this, as well as the key social and environmental risks associated with investment in the forestry sector, into account.

The FLEGT Action Plan places particular emphasis on investments made with public funds, such as export credits. However, given its sheer size and scope, the greatest potential for meaningful action is likely to lie with the private finance sector. Action on illegal logging in this sector is heavily dependent on voluntary measures.

According to a Chatham House report by Jade Saunders⁶⁷, there is only limited scope for governments in the EU or elsewhere to impose requirements on the private finance sector in line with the aspirations of the FLEGT VPA Action Plan. Saunders notes that lending and credit provided by all European private banks is governed by a state authority that licenses their activities and can revoke a licence where necessary. The main concerns of regulators are the risk-management systems and levels of capitalisation. Enforcement action can be taken on these grounds alone, and risk is usually very narrowly defined, almost always, in practice, excluding environmental or social factors to any significant degree. The core criteria for issuing such licences do not include responsibility for any illegal acts by a bank's clients and there are no examples of licences being revoked on such grounds, even where criminal convictions have been established. Saunders suggests there is little political will in the EU Member States to regulate the financial sector on environmental or social grounds.

Various voluntary programs are now underway designed to harness the power of the private finance sector in pursuit of broad environmental and social goals, notably the UNEP Finance Initiative, the Equator Principles, the London Accord and an initiative

⁶⁷ "Improving Due Diligence In Forestry Investments, Restricting Legitimate Finance for Illegal Activities", Jade Saunders, Associate Fellow, Chatham House, June 2005

recently launched by Pricewaterhouse Coopers (PcW). This report reviews the scope and content of these existing voluntary initiatives in order to assess the extent to which they might generate interest in sustainable forestry issues generally and demand for FLEGT VPA licensed and sustainably certified timber in particular. It considers the policies relating to the forestry sector developed by some of the world's leading international banks that are part of these voluntary initiatives. Drawing from a recent study by Chris Knight and Darius Sarshar for WWF's GFTN⁶⁸, it considers the current relationship between the financial sector and the forest industry in Malaysia. It also summarises views on the significance of "shareholders and investors" derived from interviews with the European timber trade and industry conducted as part of this study. Finally it considers the potential direct role of banks to help scrutinise the legality of trade flows. From this broad conclusions are drawn with respect to the potential impact of banks' policies on demand for FLEGT VPA licensed and sustainably certified wood from Malaysia.

7.2 Equator Principles

The Equator Principles which were agreed in June 2003 are a set of voluntary guidelines for the categorization, assessment and management of social and environmental risks in the project finance sector. To date, 61 financial institutions including many of the world's largest have signed on to the Equator Principles. According to the World Bank, signatories represent at least 85% of global cross-border project finance. In recent years, export-credit agencies and multilateral development banks have also signed on to the Equator Principles. The World Bank claims that with such broad coverage, the Principles have become the *de facto* standard for all banks and investors on how to deal with potential social and environmental effects of projects to be financed⁶⁹.

The Equator Principles are based on the International Finance Corporation's (IFC) Policy and Performance Standards on Social and Environmental Sustainability (revised April 2006). By signing the Equator Principles, financial institutions are committed to not providing loans to borrowers that are not willing or able to comply with IFC Performance Standards. While broadly applicable to a wide range of industrial sectors, including extractive industries, infrastructure and manufacturing, the IFC Standards include specific prohibitions with respect to forest operations.

The IFC standards specifically require that forest resources be managed in a sustainable manner. Lending to forest operations that lead to the conversion or degradation of natural forests is expressly prohibited. There is also a clear requirement for a comprehensive social assessment for all proposed loans and also for indigenous peoples' informed participation in such an assessment. The client must also demonstrate sustainable management through an appropriate system of independent certification. An appropriate certification system is defined as "*one which is independent, cost-effective, based on objective and measurable performance standards and developed through consultation with relevant stakeholders, such as local people and communities, indigenous peoples, civil society organizations representing consumer, producer, and conservation interests. Such a system has fair, transparent, independent decision-making procedures that avoid conflicts of interest.*" Furthermore forestry standards must

⁶⁸ "Financing Forest Certification in Malaysia" by Chris Knight and Darius Sarshar was published by WWF's Global Forest & Trade Network (GFTN) in July 2007 with the support of USAID and the EU

⁶⁹ World Bank FLEG Newsletter No. 5, March 2007

meet “*performance standards compatible with internationally accepted principles and criteria for sustainable forest management.*”

Therefore, the IFC standards are already calling for forms of assurance of responsible forest management that go beyond FLEGT VPA licensing. However, they do provide scope for a phased approach to forest certification, stating that: “*where a pre-assessment determines that the operation does not yet meet the requirements of such an independent forest certification system, the client will develop and adhere to a time-bound, phased action plan for achieving such certification*”.

While a wide range of large international financial institutions have signed the Equator Principles, and they are a relatively new development, there is still frustration among some NGOs at the pace of implementation and at the lack of transparency about new investment decisions which makes assessments of the impact of the Equator Principles very difficult⁷⁰. According to Saunders (2005), key challenges facing wider acceptance and an independent assessment of impacts of the Equator Principles include:

- The limited scope of application of the Principles to direct project lending above US\$50 million, which may exclude many investments in the forest-products industry;
- The lack of accountability mechanisms within the framework of the Principles;
- The lack of consistency of implementation and policy development among the institutions that have signed up, a particular concern in a sector where much investment is syndicated among more than one institution;
- The lack of commonly agreed principles for monitoring or enforcing compliance by signatories;
- Projected costs associated with Equator-compliant project management;
- Client confidentiality procedures governing disclosure of individual lending decisions by banks;

Furthermore, while the large banks that are members of the Equator Principles represent the majority of cross-border lending and other financial services, it would be wrong to overstate their influence over social and environmental policy. Such banks can be, and frequently are, undercut by other locally-based financial institutions that may not have adopted similar environmental or social safeguards.

7.3 UNEP Finance Initiative

UNEP FI is a global partnership between UNEP and the financial sector. Over 160 institutions, including banks, insurers and fund managers, work with UNEP to understand the impacts of environmental and social considerations on financial performance. Many of the financial sectors biggest names are participating in the Initiative including 8 of the world’s 10 largest banks measured by shareholder equity (Citigroup, JP Morgan Chase, Bank of America, HSBC, Mitsubishi Financial Group, Royal Bank of Scotland Group, BNP Paribas and Mizuho).

Every financial institution wishing to join UNEP FI must sign a statement of environmental commitment. This includes a commitment to integrate environmental

⁷⁰ “Improving Due Diligence In Forestry Investments, Restricting Legitimate Finance for Illegal Activities”, Jade Saunders, Associate Fellow, Chatham House, June 2005

considerations into operations, asset management, and other business decisions, in all markets, and to identify and quantify environmental risks as part of the normal process of risk assessment and management. Of specific relevance to the FLEGT VPA process, is that the statement notes with regard to the institution's customers: *"we regard compliance with applicable environmental regulations and the use of sound environmental practices as important factors in demonstrating effective corporate management"*.

The role of the Initiative is to provide practical research, develop guidance, assist in capacity building and to host international conferences and events bringing together finance professionals from around the globe. It operates through a series of workstreams including amongst others one on Climate Change and another on Biodiversity and Ecosystem Services.

The Initiative also commissioned URS Consultants to prepare a series of guidance notes *"to assist its members to understand, identify and analyse the potential effects of their own, and their clients', activities across a range of issues such as climate change, biodiversity, water, human rights and responsible investment"*. One such guidance note, published in March 2007, covers "Forestry and Logging". This identifies the "legality of supply chain" as one of 11 "Key sector Risks and headline Issues. Other issues include: degradation of forest values and sustainability; human rights of workers and communities; deforestation - cash cropping of soya, palm and rubber; climate change; sustainable community development; and land rights of resource dependent communities.

Reflecting the broad range of identified concerns, the guidance leans heavily towards independent certification of sustainability. While both FSC and PEFC are referenced, the guidance favours FSC on grounds that "PEFC performance standard and chain of custody control mechanism is weak."

With regard to forest governance and legality, the guidance notes that *"permits, consents and licences are likely to be required for forestry and logging operations the specifics of which will depend on the relevant regulatory framework in the location of the operation/facility. In developing regions, weaker governance structures may mean that there is less stringent implementation of local controls and regulations or indeed there may be no controls at all. In such cases the project proponent should ideally adopt international environmental and social standards and industry best practice"*.

So while the guidance encourages lenders to promote third party certification against international environmental and social standards, particularly FSC, and does not specifically mention FLEGT VPA licensing, it also suggests a role for the latter form of assurance. FLEGT VPA licensing would allow developing countries to argue that they do indeed possess good governance with respect to the timber industry and should therefore not necessarily have to conform to full forest certification in the first instance.

7.4 The London Accord

The London Accord is a collaboration between investment banks, research houses, academics and NGOs to produce an 'open source' research resource for investors in climate change solutions. The major output of the Accord comprised a CD and website

(www.london-accord.co.uk) published in December 2007 to set out the context for investments in climate change solutions, analyse individual opportunities and discuss the implications for the construction of investment portfolios. As a key element of emerging international action to alleviate climate change, forest management was one of several focus areas for research under the Accord.

The London Accord is expected to be particularly influential in the international finance sector because it is built on the direct participation of mainstream investment research houses, frequently associated with global investment banks, to assess current investment opportunities in carbon reduction. Deutsche Bank, Morgan Stanley, Credit Agricole, HSBC, Sarasin, Société Générale, CSFB, ABN and Canaccord Adams, amongst others, all contributed research. The results were published widely via Reuters' syndication and the City of London Corporation Research Series.

Two reports made up the main output of the Accord in relation to forestry. The first report, entitled "Forest Assets for the Future - Climate Change & Forests: The Paper Play", was prepared by the French research organisation Cheuvreux in association with Credit Agricole. The paper provides a brief overview of the links between forests and climate change with a major focus on European forestry, particularly pulp and paper. The tropical forest issue is characterised in rather simplistic terms and dealt with mainly under the heading of "deforestation". The paper summarises the current status of and potential for "avoided deforestation" mechanisms concluding that *"although carbon storage [in forests] is a particularly tricky path to implement, the carbon sink properties of forests are acknowledged and should gradually be financially rewarded in some form"*.

Drawing from this conclusion, the report suggests that companies with large sustainably managed forest holdings are likely to become increasingly attractive from both a financial and an environmental standpoint for investors looking for sustainable exposure to climate change.

Certification is identified, also rather simplistically, as the major existing response to forest overexploitation, with the clear implication that the presence or absence of certification should form a major component of any financial risk assessment in the forest sector. The report describes the various competing systems, mentioning MTCC alongside FSC and PEFC and notes the problems resulting from lack of mutual recognition between these systems which has led to some EU companies adhering to various systems.

The second report of relevance to forestry was entitled "Combat Climate Change - Exploring the Sustainable Solutions". This report, provided by Forum for the Future aimed to address the problem that investment options to combat climate change all have wider sustainability implications, which will ultimately contribute to the commercial viability of these investments. On forestry, the report highlights that markets do not currently value forests properly because they do not take account of the vital ecosystems services they provide. As a result, the report suggests, there is an economic incentive to convert forests to a more productive use such crops for food or biofuel. This, the report suggests, is a major contributory factor to illegal logging in many countries. The report notes that while buying up forests in order to prevent them being depleted may seem superficially attractive, this fails to recognise *"the importance of land rights, the vested interests of many powerful people in those environments and the livelihoods of those who depend on the forests"*. The report also notes the technical challenges of

developing appropriate systems and reward mechanisms for “*avoided deforestation*”. It suggests that “*any initiative to improve the rate of avoided deforestation has to be designed in full consultation with individuals and communities in developing countries to prevent charges of ‘carbon colonialism’, and to achieve buy-in for the critical action required.*”

The report concludes that while there is still much too little investment to meet the challenge of climate change, investor interest in options to combat the problem is growing and the London Accord is expected to play an important part in developing this interest. It also suggests that the impacts of different options on wider sustainability need more sophisticated analysis. The report recommends that investors should require rigorous research of sustainability impacts for all investment options to combat climate change, and develop criteria for investment that include both social and environmental safeguards. It also recommends that Governments should consider tax incentives for funds designed to invest in options to combat climate change, provided they incorporate sustainability criteria; and should further explore how to make more constructive links between the interconnected agendas on carbon and international development, particularly on forestry.

Overall, the output of the London Accord suggests that the mainstream investment research houses are still feeling their way on the forestry issue. There is growing recognition of the potential from increased investment in forest management, although the major long-term opportunity is identified as being in carbon storage rather than in timber production. There is however awareness of the need to accommodate broader sustainability concerns within the climate change agenda where the FLEGT VPA process has an important role to play – although this is not made explicit in the Accord guidance.

7.5 PwC Finance Sector Project

Pricewaterhouse Coopers (PwC), the financial services company, has launched an initiative to prepare forest sector guidance for the finance industry. The underlying rationale is that while banks are already involved in a number of relevant initiatives the approach with respect to forests is uncoordinated.

In association with the UK Timber Trade Federation, PwC convened a meeting with a number of banks in November 2007. The meeting discussed three case studies of bank policies relating to forest products and the timber trade. The conclusion of the workshop was that bank policies have had some impact on forestry and trade practices, but that specific forestry-related advice is still limited. Other conclusions were:

- Reputational risk is a growing and major concern at senior level;
- There is a lack of consistency which is confusing to customers, and which makes banks wary of implementing policies that could disadvantage them in the market;
- Any new initiative must recognise and respect existing work;
- There has to be global follow through, making a difference on the ground, to ensure there is consistent discrimination in favour of progressive companies.

Banks at the workshop endorsed the view that sustainability is a key aspect of their long-term strategies and agreed that more work needs to be done to increase knowledge and understanding.

In April 2008, PwC are understood to be seeking further funding from the World Business Council for Sustainable Development (WBCSD) to further develop the work. The aim would be to develop a comprehensive resource and guidelines for all banks to facilitate the development of their bespoke policies on financing the forest sector.

7.6 Policies of some leading banks

Several of the world's leading banks that are participants in the Equator Principles and/or UNEP Finance Initiative have been encouraged to develop far-reaching internal policies setting out criteria for loans to the forestry sector and to address issues of implementation across their investment portfolios. This process has been facilitated by the International Finance Corporation (IFC) and UNEP which offer training and continued support. In the case of IFC, three course modules have been developed to meet the needs of different banks and the range of professionals within the institutions that will be involved with the Equator Principles.

All four of the world's largest banks (by shareholder equity) have developed specific policies for loans into the forestry sector:

- **Citigroup**, the world's largest bank, has developed a policy designed specifically to ensure that no loans are made to clients engaged in illegal logging. The bank has developed procedures whereby countries are assessed to be high or low risk with respect to illegal logging. In high risk countries the policy requires that clients in the forestry sector must achieve independent certification within a time frame agreed between Citigroup and the client. Furthermore, FSC certification is mandatory *"where there is a significant threshold of concern about the legitimacy of forest operations"*.
- **JP Morgan Chase**, the world's second largest bank, has developed a policy which *"prefers FSC"* when the bank finances forestry operations that may impact high conservation value forests *"unless a comparable assessment process underpins a conservation plan"*. However the Bank also states that *"we will review and understand the merits of the different internationally accepted forestry certification standards to better understand best practices."*
- **Bank of America**, the world's third largest bank, has a policy which prohibits any loans for forest operations in primary tropical forests or *"intact forests"* as defined by the World Resources Institute. Loans may only be made for forest operations in primary temperate and boreal forest if these are independently certified. The Bank's policy states that it will be evaluating the value of certification programs in association with *"existing environmental alliances"*.
- **HSBC**, the world's fourth largest bank, states a *"preference to deal with customers operating to FSC or an equivalent FSC-recognised standard."* While

the bank will accept clients that are not FSC certified, it requires that all clients are “*following a credible path to achieve [FSC] compliance*”.

7.7 Activism targeting banks

International civil society has become increasingly active in encouraging banks to take a firmer stand on environmental and social issues. In 2003, a wide range of civil society organisations, including many of the leading international environmental groups issued the “Collecchio Declaration on Financial Institutions and Sustainable Development” calling on financial institutions to embrace six main principles which reflect civil society's expectations of the role and responsibilities of the financial services sector in fostering sustainability. The principles included commitments to sustainability, 'To do no harm', responsibility, accountability, transparency, and sustainable markets and governance⁷¹. Meanwhile direct ENGO pressure on the largest banks to conform to the commitments made under Equator Principles and UNEP Finance Initiative is rising. An ENGO group “Banktrack” has been established with the specific aim of monitoring and reporting on conformance.⁷²

7.8 Study of links between Malaysian forestry sector and commercial banks

In July 2007, the WWF GFTN published “Natural Capital: Financing Forest Certification in Malaysia” which studies in some detail the links between the Malaysian forestry sector and financial institutions⁷³. The authors of the report conducted 44 interviews with timber companies, investment consultants, lenders and government departments in Malaysia between November 2006 and January 2007. From this they were able to draw broad conclusions with respect to the current and future role of the finance sector in promoting legal and sustainable forest management in Malaysia.

Key conclusions from the report include:

- Some large international banks that have signed the Equator Principles, including HSBC, Standard Chartered and Citigroup, are operating in Malaysia. However the relevance of these principles is lessened by the fact that they are designed for project finance whereas most of the bank facilities provided to timber companies are in the form of term loans, overdrafts and export credit facilities. Therefore the Principles may not formally apply to forestry client relationships.
- At least 15 banks currently provide facilities to public and private Malaysian timber companies, mainly in the form of standard commercial loans. In addition these banks provide overdraft, foreign exchange and trade credit facilities. They also act as guarantors for Forest Management Units (FMUs), providing bank guarantee funds to government agencies which can be drawn on in cases of non-compliance with license terms and conditions.
- Companies interviewed for the report expressed an interest in borrowing more from banks, in particular for the establishment of plantations, but also for

⁷¹ See <http://www.foe.org/camps/intl/declaration.html#6>

⁷² See www.banktrack.org

⁷³ http://assets.panda.org/downloads/natural_capital.pdf

expansion and to ease financial burdens on other parts of the business. There was also interest in raising capital on international equities markets.

- Although several banks have developed CSR programmes, commercial loans are generally granted without explicit and formal processes for assessing the environmental sustainability of borrowers' operations. Banks expect borrowers to comply with environmental requirements and meet any applicable forest management criteria set down in law. However, they take compliance for granted on the assumption that there is effective monitoring and reporting of any non-compliance by the regulatory authorities⁷⁴.
- Banks neither adequately understand the risks associated with forestry, nor do they offer any incentive to their clients to achieve forest certification.
- From the mid-1990s to 2004, 46 timber-related companies obtained public listings on the main or second boards of the Bursa Malaysia (the Malaysian Stock Exchange). These companies range considerably in size and many are holding companies for up to 20 subsidiary companies. Several companies report large international institutional shareholders such as UBS and JPMorgan, but in general investors with publicly available environmental or social investment criteria are not significant shareholders⁷⁵.
- There has been no recent or current funding of forestry activities in Malaysia by either the World Bank or the Asian Development Bank (ADB)
- At the time of writing two international investment management companies, the Global Emerging Markets Forestry Fund (GEMFF) and New Forests, were actively seeking investment opportunities in Malaysia. Both were looking specifically for operations capable of being or already certified to FSC. GEMFF was looking to invest in plantations or natural forest management operations, the assets considered including both concessions and manufacturing facilities. New Forests represented institutional investors seeking to take a majority or significant stake in a sustainable managed forestry or plantation asset. Manufacturing facilities were not required and ideal investments would include or be contiguous to areas that can be managed for conservation value.
- There are already a few examples of funding for Malaysian forestry operations through the market for carbon credits.⁷⁶ Banks are moving into the carbon market and are likely to have a future interest in forest carbon sequestration initiatives.

⁷⁴ As noted by Saunders (2005), the incentive for banks to undertake rigorous checks of the environmental and social standards of companies to which they make commercial loans is relatively limited. Unlike shareholders, lenders are not 'co-owners' of the companies in question, and as a result these types of investment entail less risk for the lender in the event that the company is badly managed

⁷⁵ Saunders (2005) also notes that the Malaysian timber-processing sector has also been successful in raising capital on international equities markets with investment and unit trusts in Europe and North America and a few Asian countries holding just over 3% of the total equity of Malaysian timber companies listed on the Kuala Lumpur Stock Exchange.⁷⁵ This figure does not include all pension and insurance funds and so may be a considerable underestimate.

⁷⁶ An example is the INFAPRO project which comprises an area of 30,000 hectares of degraded forest initiated in 1992 by the Innoprise Corporation and Forests Absorbing Carbon Emissions (FACE) Foundation of the Netherlands. INFAPRO is largely funded through the sale of carbon credits (through the FACE Foundation) to European companies and organisations that wish to offset their carbon emissions.

- Four prominent banks, either in discussion or in their public policies, showed willingness to consider providing finance using more sophisticated or ‘holistic’ assessments of borrowers’ credit ratings, which take into account the environmental sustainability of forestry practices.

7.9 Commercial banks as a driver of responsible procurement in the EU

An insight into the level of interest by the commercial banks in responsible procurement by the European timber trade is provided by the structured interviews undertaken with timber trading companies and their associations for this study. During these interviews, private sector organisations in 5 EU countries (UK, Netherlands, Belgium, France, and Italy)⁷⁷ were asked to score various factors in driving demand for verified legal and sustainable timber. “Shareholders and investors” were included in the list of possible driving factors. “Shareholders and investors” is of course a rather broad term encompassing much more than just the commercial banks. The results therefore cannot be interpreted as a direct measure of the impact of the banks, but rather of the level of interest of the broader financial community in responsible timber procurement practices.

Table 7.1: EU Private sector responses to the question “how significant are shareholders and investors in driving demand for verified legal and sustainable timber”

	Total respondents	Insignificant	Moderately significant	Very significant
UK	16	0	6	10
Netherlands	16	6	4	6
France	13	6	4	3
Belgium	14	9	4	1
Italy	13	9	4	0
All 5 countries	72	30	22	20

Table 7.1 indicates that of around 160 private sector organisations interviewed, 72 responded directly to this question. Each factor was scored on the following scale: 0 for “insignificant”; 1 for moderately significant; and 2 for “very significant”. The extent to which “shareholders and investors” are seen as major drivers of demand verified legal and sustainable timber varies between EU countries. In the UK, all 16 organisations responding to this question said that this factor is significant, with a large majority (including the main timber trade association) indicating it is “very significant”. This factor was also seen as significant by a large majority of respondents in the Netherlands, and by a slim majority in France. However in Belgium and Italy most respondents perceived this factor to be relatively insignificant. The Consultant undertaking interviews in these countries reported that many respondents did not understand how “shareholders and investors” might play an active role in encouraging responsible timber procurement practices.

The fact that “shareholders and investors” are more engaged in encouraging responsible procurement practices in the UK and the Netherlands than elsewhere may be a reflection of the longer history and greater intensity of NGO campaigning on forestry and broader environmental issues in the two countries. The UK’s large financial services sector has been a relatively early mover on environmental issues. The FTSE4Good

⁷⁷ The German consultant used a slightly different set of structured questions which did not capture this data.

Index Series was launched in 2001 with the aim of measuring the performance of companies that meet globally recognised corporate responsibility standards, and to facilitate investment in those companies. Several of the larger timber trading companies interviewed for this study made a point of noting that their decision to move forward with far-reaching environmental procurement policies was heavily influenced by a desire to maintain their placement in the FTSE4Good Index. The London Accord is another demonstration that the UK finance sector has taken a collective decision to behave proactively with respect to the opportunities and threats presented by emerging environmental issues.

Evidence from UK also suggests that the timber trade associations themselves might play a role to encourage greater interest within the finance sector. In recent months, the UK Timber Trade Federation (TTF) has taken steps to engage directly with the financial services sector with the aim of ensuring that appropriate recognition is given to the environmental benefits of the timber trade in general and responsible trading companies in particular. The TTF have been working with PwC to develop appropriate guidance for the finance sector (see Section 7.5). The TTF is also now seeking funding for a pro-active program of work with the aim of developing and providing direct input to the main investment research houses.

7.10 Role of banks in trade transactions

Commercial banks have potential to exert their influence on the forest products sector in ways other than through the development of criteria for investment and commercial loans. In a report for ITTO⁷⁸, Landrot explores the role of banks in the area of transport, suggesting that they could play a more direct role to help control trade in illegally logged timber.

Landrot notes that it is typical for international timber trade transactions to be handled by means of a Letter of Credit (LC). The LC is a document issued by a bank according to the instructions of the buyer. The LC authorizes the seller to draw a specified sum of money under specified terms, usually the receipt by the bank of certain documents within a given time frame.

Landrot notes that the bank is responsible not only for making the payment but also for ensuring conformity of the documentation requested by the buyer. The bank therefore has direct access to all the documentation relevant to a particular transaction. Since the bank has a direct interest in the financial security of its client, and also in protecting its own reputation, this raises the possibility of the bank being more pro-active in monitoring timber transactions for signs of irregularities.

The presence of a simple credible mechanism such as a FLEGT VPA license to determine the legitimacy of a particular cargo might help facilitate the banks' performance of this broader role.

⁷⁸ Study on the international transportation of tropical timber products, prepared for the International Tropical Timber Organization, by J.J. Landrot and Anthony Lo with technical assistance from ATIBT, 12 October 2007

7.11 Conclusions relating to finance sector

The commercial banks' main points of leverage with respect to illegal logging and illegal timber trade are as follows:

- Through their policies with respect to foreign direct investment (FDI) and provision of finance to larger scale forestry projects;
- Through their policies with respect to provision of term loans, overdrafts and other facilities to their clients in the forest sector – policies which may be applied both in producer countries to influence harvesting practices and in consumer countries to influence procurement practices;
- Through their direct role in international timber trade transactions to ensure conformity of documentation requested by timber buyers.

Initiatives like the Equator Principles, the UNEP Finance Initiative and the London Accord are helping to change attitudes to social and environmental risk in project finance. There appears to be a significant degree of commitment to these processes among mainstream lending banks. However the impact of these initiatives is necessarily limited by the fact that they are voluntary. There is also no commonly agreed set of principles for monitoring or enforcing compliance by signatories and many locally-based financial institutions are not engaged.

Most of the bank facilities provided to forestry and timber companies are in the form of term loans and overdrafts which are not the major focus of international initiatives like the Equator Principles. At present, there appears to be little or no scrutiny of the timber sourcing practices of companies to which these facilities are offered. Although banks might expect borrowers to comply with environmental requirements and meet any applicable forest management criteria set down in law, there is tendency for compliance to be taken for granted on the assumption that there is effective monitoring and reporting of any non-compliance by the regulatory authorities.

At present, it seems likely that banks do not fully understand the risks associated with the forest products sector nor are they offering any strong incentives to their clients in the sector to adopt higher environmental standards.

The guidance that is currently being made available to banks on the issue through initiatives like the UNEP Finance Initiative, the Equator Principles and the Forest Accord, while a useful starting point, is incomplete. There was no reference to the role of the FLEGT VPA process in any of the guidance documents reviewed for this study. There was also a heavy focus on FSC certification.

Nevertheless, the concept of a phased approach to certification seemed inherent to much of the guidance now available, indicating that FLEGT VPA licensing would be seen in a positive light as an appropriate mechanism for reducing the risks associated with forest sector investments.

There are increasing signs that banks are interested in engaging more in the issue, driven both by the new opportunities arising in the forestry sector as a result of the emerging policy focus on environmental issues, particularly climate change, and the reputational risks associated with poor environmental practice.

8 Conclusions

8.1 Potential market related benefits of FLEGT VPA licensing

This study indicates that certain market related benefits might be derived from Malaysia finalising a VPA with the EU:

- The VPA process is an opportunity to resolve issues that are currently acting as a drag on marketing of Malaysian wood products. Interviews undertaken for this study with the EU private sector indicate that nearly half of importers harbour either negative or mixed views of Malaysian forestry practices. They have been particularly influenced by ENGO campaigns relating to native rights and alleged illegal wood imports from Indonesia.
- The VPA process is an opportunity to leverage EU support for improved regulatory programs and to build bridges between stakeholders
- Interviews with ENGOs indicate that they strongly support the VPA concept as a whole. Successful finalisation of a VPA that is endorsed by the leading international NGOs (WWF, Greenpeace) could provide a very useful platform on which to build confidence in Malaysian wood products.
- Finalisation of a VPA demonstrates leadership in the global policy debate surrounding illegal logging and sustainable forest management, supporting Malaysia's reputation as a reliable and responsible supplier of tropical hardwoods to international markets.
- Finalisation of a VPA would insure Malaysia against a long term risk of market exclusion in high value markets which are critical for ensuring maximum return on the forest resource.
- One practical effect of signing a VPA is that it will provide a means of legitimising wood derived from planned conversion forests on international markets. Certification schemes like FSC and MTCC cannot recognise such timber because of their focus on individual FMUs rather than national forest programs.
- There is potential for price gains to be achieved for VPA licensed timber in the EU market if supplies of wood of suspicious origin from other sources can be excluded from the market.
- If the VPA process helps resolve remaining differences between stakeholder groups, it could facilitate more widespread certification of sustainable forest management. It may well pave the way for MTCC certification to be recognised as an exemplary assurance of sustainable forest management. And through refinements to national regulatory processes, it is possible the VPA will make participation in MTCC a more realistic proposition for the wider industry.

8.2 Existing market incentives for FLEGT VPA licensing

However, a challenge for the FLEGT VPA process is that while these potentially significant market benefits exist, they appear too theoretical and nebulous to have direct appeal to the private sector. To some extent, these market benefits may also be contradictory. For example, there may be a conflict between the objective of legitimising timber from conversion forest and the desire to build bridges with ENGOs.

In practice, the direct and immediate market incentives for supporting the VPA – in terms of increased demand or better prices for VPA licensed products from Malaysia or wider recognition of good forestry practice in Malaysia - appear weak. This conclusion is based on the following observations:

- Available information suggests that illegal logging within Malaysia itself is not a significant source of wood supply. This implies that Malaysia has less to gain domestically than other VPA countries by way of increased capture of forest rents and a level playing field for legal operators.
- Compared to other VPA countries (notably in Africa), Malaysia has relatively low market dependence on the EU. This is particularly the case for Sabah and Sarawak.
- Within the EU itself, the research shows that larger distributors are increasing scrutiny of their supply chains. However this trend has not extended far amongst smaller importers and distributors.
- Even amongst larger companies, the role of FLEGT licenses is little understood. There is confusion over how such licenses will relate to existing private sector initiatives. Those companies that are committed to a procurement policy are generally more interested in securing certified wood where possible than in blocking out illegal wood.
- This is reflected in surveys of EU private sector opinion indicating relatively limited willingness to pay market premiums for FLEGT licensed timber.
- Central government procurement policies are being implemented in all the large EU importing countries of Malaysian timber with the exception of Italy. However these directly impact on only a small volume of overall trade (up to 25%). They can be difficult to enforce and monitoring of implementation is often lax.
- While central government procurement policies in the UK and Netherlands have established legal as a minimum requirement, the German and Belgian policies are already demanding certified sustainable. Only the UK policy currently includes explicit guidance on FLEGT VPA licenses.
- In those sections of the market where there is demand for legally verified wood products, the MTCC certification system already provides a mechanism for the Malaysian private sector to provide these assurances. This system has extensive coverage in Peninsular Malaysia which is the primary source of Malaysian wood products exports into the EU. MTCC is engaged in efforts to achieve PEFC

endorsement and to be recognised as providing an assurance of “legal and sustainable” timber which, if successful, would ensure that MTCC provided a higher level of assurance of good forest practice than the FLEGT VPA process.

- Interviews with European companies indicated that they will not cease trading with Malaysia if she does not sign up to a VPA. They would be content, many would even prefer, to resort to private sector initiatives when necessary.
- While ENGOs have indicated their strong support for the concept of FLEGT VPA licensing, due to the concerns of some local groups in Malaysia, particularly with respect to NCR issues, some influential groups in the EU have been heavily critical of the FLEGT VPA process in Malaysia. There is a significant risk that this criticism could undermine market recognition of FLEGT VPA licenses issued in Malaysia.
- In circumstances where only a few countries join a VPA, no other effective measures are introduced to prevent imports of illegal wood into the EU, and the process of legality licensing adds costs, there is a risk that Malaysian VPA licensed timber would lose market share in the [EU](#) to timber supplied from countries with high dependence on illegal wood that are not engaged in the VPA process, notably China and Brazil.
- Market incentives for FLEGT VPA licensing are particularly weak in the furniture sector:
 - Malaysia exports very little office furniture into the EU, so public sector procurement policy is not a significant factor.
 - The relatively high degree of fragmentation in the EU furniture retail sector has resulted in relatively limited uptake of timber procurement policies.
 - Some larger retailers are beginning to scrutinise wood product origins and, due to the huge range of products involved, are adopting a risk based approach.
 - The focus to date has been almost exclusively on outdoor furniture in tropical hardwoods. Since the large majority Malaysian furniture is in rubberwood, it has not been a target for increased scrutiny.
 - Where there is concern about product sourcing in the EU furniture sector, there is strong tendency to prefer FSC certification.

8.3 Future market incentives for FLEGT VPA licensing

While existing market incentives for FLEGT VPA licensing appear weak, various policy initiatives are now in train that have potential to strengthen market incentives for FLEGT VPA licensing. The following observations can be made in relation to future market prospects for FLEGT VPA licenses:

- The key issue in creating future market incentives for FLEGT VPA licensing is to ensure that illegal wood is effectively blocked from the EU and other high value wood markets. If this can be achieved:

- Malaysian competitors in high risk tropical countries that are not signed up to a VPA are likely to struggle to deliver appropriate assurances of legally verified wood and lose market share. Problems are likely to be particularly pronounced for manufacturers in China due to industry fragmentation, the complexity of trading chains, and heavy dependence on imported wood of uncertain origin.
- FLEGT VPA licensed Malaysian suppliers would be well placed to take a larger share of the market, particularly as there should also be a reduction in available supply of wood from Malaysian competitors in other VPA countries that have higher levels of illegal logging (notably Indonesia and Africa).
- There would be potential for price gains for Malaysian VPA licensed timber as suspicious supplies are removed from the market and as EU importers struggle to obtain alternative verified legal supplies of tropical hardwood products.
- The strength of support for some form of legislation designed to prevent imports of illegal wood into the EU is considerable. Civil society, government departments and industry in most major EU importing countries support such legislation.
- It is proving a challenge to evolve a legislative framework to prevent imports of illegal wood into the EU. There have been significant legal and technical objections to all the various legislative options considered during the EC's public consultation exercise. The EC is now considering proposing another option that would place a legal requirement on timber industry operators in the EU to show due diligence with respect the legality of wood supply. While the details of this approach have yet to be worked out, if such legislation were implemented and it was effective in extending and strengthening existing private sector initiatives, it would be a powerful mechanism to remove illegal wood from trade and boost market interest in FLEGT VPA licensed timber.
- Through the Timber Trade Action Plan, the European Commission is now assisting timber importing associations to develop Codes of Conduct for their members which would focus on excluding illegal wood from supply chains. Policies have been introduced by the Netherlands, UK, and French associations which seem well designed to increase demand for FLEGT VPA licensed timber. These Codes have strong potential to extend responsible procurement practices into the private sector as timber trade association membership generally includes a high proportion of wood imports into EU countries. Efforts are being made to extend coverage and improve enforcement of these initiatives, but this is a slow process under current conditions of voluntary private sector action.
- The US legislature is poised to introduce an amendment to the U.S. Lacey Act which would make it offence within the U.S. to trade in a wood product "*taken, possessed, transported, or sold*" in violation of any foreign law. There is strong support for this measure from domestic industry and ENGOS. The US timber importers' association – IWPA – has also indicated its support for the measure subject to changes designed to make compliance easier for small companies.

However the US Lacey Act amendment will not necessarily generate specific interest in FLEGT VPA licensing as it quite expressly does not set out to define a specific framework for legality verification.

- The Japanese market, which is particularly critical for exporters in East Malaysia, is also moving towards requiring evidence of legality from exporters. Since introduction of the government timber procurement policy in April 2006, there has been a major move by the private sector to develop and implement timber procurement policies designed to remove illegal wood from supply chains. All 19 national timber industry associations in Japan now have some form of procurement policy. However, as in the US, the new measures in Japan will not necessarily generate market interest in or a requirement for FLEGT VPA licenses. Since introduction of their procurement policy, Japan's government and trade associations have been very flexible on the forms of evidence to be accepted, seemingly content to recognise existing legality verification procedures and documentation from Malaysia.

To summarise the market situation, it seems clear that while existing market incentives for FLEGT VPA licensing seem weak, longer term prospects are much stronger. The political will to eradicate illegal wood from trade clearly exists in the major high value export markets of Japan, the EU and the United States. All the key actors in each country – including government, ENGOs and trade interests – are aligned in their broad support of this common objective. The challenge in these countries is now to evolve and implement trade policy measures that are effective in removing illegal wood products from trade while avoiding the imposition of excessive additional requirements on legitimate operators and ensuring continued conformance with international trade rules.

In the EU, the evolution of additional legislation is likely to be the key factor in providing a strong market incentive for FLEGT VPA licensing. There is a need to broaden the scope of public sector procurement policies so that they focus not only on rewarding certified wood products but also on providing credit for measures to remove illegal wood from trade. There is a need to ensure formal recognition of VPA licenses in procurement policies and to increase awareness of the role of these licenses amongst buyers. Increasing interest in and demand for VPA licenses in more fragmented end-using sectors where there are large numbers of small operators - such as construction and furniture – is a particular challenge. In these sectors, there is potential to build on emerging private sector procurement codes, some of which already seem well adapted to increase specific demand for FLEGT VPA licenses.

8.4 Other market-related issues

8.4.1 Achieving a balance between costs and the need for regulatory reform

The existing strategy of keeping the costs of FLEGT VPA process to a minimum by basing FLEGT licensing on existing laws and regulatory mechanisms aligns well with the current situation. The available information suggests that current systems of control are largely effective in controlling illegal logging within Malaysia. The current strategy avoids the creation of perverse incentives that would result if the costs to VPA licensed operators were increased at a time when there are inadequate controls to prevent trade

in illegal timber products in other countries. It also reduces the risks of encouraging circumvention of the FLEGT VPA licensing and trade diversion to third countries.

However, it is also important to recognise that the value of VPA licenses as a mechanism to build European market confidence in Malaysian wood products is partly dependent on ensuring that critical campaigns by ENGOs are avoided. ENGOs need to be reassured that the VPA process will at least facilitate further moves to resolve remaining issues associated with Native Customary Rights and to increased uptake of sustainable forest management certification

Equally, ENGOs need to recognise that the market incentives for the Malaysian private sector to enter into a VPA are weak and that the introduction of new measures perceived to increase the direct costs of VPA licensing to the private sector could lead to failure of the negotiations. A spirit of compromise amongst all interests needs to prevail if benefits are to be derived from the process.

8.4.2 Transaction costs at point of import into the EU

Delays to shipment represent a significant business expense for shippers and their agents. For Malaysian exporters that have acquired an unrivalled reputation in the EU market for reliable shipment of tropical hardwoods, it is critical to ensure that any extra bureaucracy that might be associated with issue of FLEGT VPA licensing does not cause delays. It would be a particularly perverse outcome of the FLEGT VPA process if the extra bureaucracy that might be associated with importing VPA licensed timber in any way damaged Malaysia's reputation for reliable supply.

There is a very clear onus on the European Union to ensure that transaction costs associated with import of FLEGT VPA timber are no higher than those associated with timber from non-VPA countries. Turnaround times in the event of any uncertainty over the status of a license will have to be rapid, given that shipment time between Malaysia and the EU is typically only 19 days.

There needs to be very effective lines of communication between the customs authorities in both Malaysia and the EU Member States and their respective licensing and competent authorities. There also needs to be very clear lines of communication and efficient management systems operated by and between the competent authorities in the EU and the licensing authority in Malaysia.

8.4.3 Circumvention and diversion

A potential impact of FLEGT VPA licensing is that it encourages:

- Efforts to circumvent the licensing system involving exporting Malaysian wood products to the EU via a major trading hub (without further conversion)
- Diversion of trade away from the EU involving the export of primary wood products to a manufacturing location outside Malaysia. Some of the finished products may then be exported to the EU.

Ultimately, whether or not trans-shipment or diversion occurs is a simple question of comparative costs. The available information suggests that levels of illegal logging in

Malaysia itself are limited and the additional costs of conformance to the system should not be great, so there should be little incentive to divert trade elsewhere.

As an extra measure to help deter circumvention, consideration could be given to requiring a Certificate of Origin for all wood products imported into the EU from the East Asian region.

The motive for circumventing the VPA process would be removed if the EU were to introduce legislation requiring timber industry operators to show due diligence with respect to the source of wood products.

The potential problem of trade diversion is probably best addressed by ensuring that the additional costs of FLEGT VPA licensing to the private sector are kept as low as possible, by linkage to broader policy measures designed to reduce exports of unprocessed wood raw material, and through on-going monitoring of trade flows once the licensing system is in place.

In time, once the licensing system has been thoroughly tested, consideration might also be given to extending the system to cover all wood products exports, effectively removing the problems of diversion and circumvention.

8.4.4 Handling timber imports

According to current proposed procedures, imported timber may enter the VPA licensing system as long as it complies with all Malaysian laws and regulations governing timber imports. However, beyond border checks of existing legal documentation, the Malaysian authorities do not verify that imported wood products derive from legal sources. This raises the prospect of Malaysia being used as a laundering mechanism for illegal wood from neighbouring countries. There seem to be two possible solutions to this problem:

- Malaysia could itself consider introducing a Lacey-style Act as a measure to encourage due diligence on the part of importers.
- Malaysia could exclude all imported wood products specifically from the FLEGT VPA licensing system unless legitimate forms of independent legality assurance can be provided. It would be necessary for the Malaysian and EU authorities to work together to draw up a set of criteria for accepting forms of legality assurance.

9 Recommendations

9.1 Creating additional market incentives

Various actions are already in train that would increase market incentives for FLEGT VPA licensed timber. This study highlights the importance of these actions being given the highest political priority in order to maintain the momentum and increase the value and effectiveness of the FLEGT VPA process as a whole. Recommended action to increase market incentives for FLEGT VPA licensing are provided below.

The European Commission should consider:

- Exploring the potential for EU-wide legislation that would require or encourage EU timber industry operators to show due diligence with respect to the legality of timber supplies. Wherever possible, the intent should be to build on, expand and strengthen existing private sector initiatives.
- Enhanced efforts to facilitate the harmonisation of private sector procurement policies at EU level which include formal recognition of FLEGT VPA licensing through, for example, the Timber Trade Action Plan.
- Much stronger direct marketing of the FLEGT VPA process, particularly targeting timber importing companies.
- Ensuring FLEGT VPA licensed timber is recognised in relevant EU Eco-labelling standards, for example the wood furniture standard.
- Working with the organisers of Green Building Initiatives (BREEAM, HQE) to encourage a requirement that timber of unknown or suspicious origin be explicitly excluded from any certified project.
- Encouraging private certification initiatives to establish a minimum requirement applicable to all the operations of a company using a particular forestry label that they must avoid using timber of unknown or suspicious origin.
- Building on existing links with China, on the country's increasing concern for resource security and plans to develop a "Sustainable Trade Strategy" to encourage a more proactive response on the issue of illegal wood imports.
- Working with other high value markets (notably Japan and US) to develop a consistent approach to legality definition and verification.
- Supporting the PcW initiative to develop a coordinated approach to provision of forest sector guidance to the financial services sector and ensure that this guidance contains explicit references to FLEGT VPA licensing process.
- Supporting the UK TTF in its work directly targeting investment research houses in order to raise awareness of forest sector issues, again ensuring that explicit reference is made to the FLEGT VPA process and its associated benefits.

- Supporting the UNEP Finance Initiative process, linking it more effectively with key forestry sectors and encouraging wider take-up of the initiative, particularly amongst European and Malaysian banks.

EU Member States should consider:

- Making unambiguous statements of intent to accept FLEGT VPA licenses as sufficient evidence of conformance to central government procurement policies.
- Enhanced efforts to ensure that public sector procurement policies are effectively implemented and monitored.
- Enhanced efforts to harmonise public sector procurement policies with other EU countries.
- Providing formal recognition in these policies that VPA licenses deliver more than private sector legality verification systems, for example by acknowledging that they combine traceability to verified legal forests with measures to improve forest governance.
- Broadening the scope of public sector procurement policies so that they focus not only on rewarding certified wood products but also on providing credit for measures to remove illegal wood from trade.
- Developing financial and other incentive mechanisms to encourage local authorities to follow national-level procurement policy.
- Encouraging importing trade associations to implement credible, time-bound, action-oriented and independently audited Codes focused on removal of illegal wood from supply chains.
- Giving explicit recognition in public sector procurement policies for industry codes that meet specified requirements with respect to member performance and enforcement as a means of extending participation in responsible purchasing practices throughout the private sector.
- Use of building standards to prevent the use of wood from unknown or suspicious sources in construction.
- Encouraging banks registered in their jurisdictions to sign up to the Equator Principles.

9.2 Further research

This study highlights that there remain significant information gaps that undermine efforts to reliably assess the impact of a FLEGT VPA licensing on Malaysian trade. The following specific areas for additional research are identified:

- There is a need for a comprehensive data-based assessment of the risk of Malaysian timber products being derived from illegal sources;
- There is a need for a comprehensive assessment of the cost implications of introduction of the FLEGT VPA licensing system and of how these costs are distributed between the public and the private sector. This study can only be carried out once the details of the Timber Legality Assurance System, the Independent Monitoring System and the EU's systems of import control have been elaborated and should draw directly on pilot tests of the licensing system;
- The Malaysian wood sector as a whole would benefit from the development of an econometric model specifically designed to describe the Malaysian tropical hardwood industry. This could be used for forecasting the impact of a wide range of policy changes including VPA licensing.
- There is a need for further research into the feasibility of direct financial incentives (for example through levies and tax incentives) for FLEGT VPA licensed timber in the EU.

ANNEX 1: EU Country Reports

A1.1 United Kingdom

A1.2 Netherlands

A1.3 Belgium

A1.4 Germany

A1.5 France

A1.6 Italy

All country reports are contained in separate files.

ANNEX 2: Views of Malaysian Private Sector

A2.1 Introduction

This report was prepared by the Barney Chan based on a series of personal visits and meetings with all the major timber associations in Malaysia and their members. The intent of the meetings was to better understand Malaysian private sector perspectives on the EU Malaysia VPA. During the week of 21 January 2008, meetings were held in Kuala Lumpur with the following: (i) TEAM, (The Timber Exporters' Association of Malaysia), representing 380 companies, focus on traders (ii) MWIA, (Malaysian Wood Industries Association), representing about 500 companies, focus on sawmillers, (iii) MWMJC, (Malaysian Wood Moulding & Joinery Council), representing 110 companies, focus on moulding, (iv) MFIC, (Malaysian Furniture Industry Council), representing about 500 companies, focus on furniture, and (v) MPMA, (Malaysian Panel-Products Manufacturers' Association), representing 89 companies, focus on plywood mills.

Meetings were held in the week of 18 February 2008, in Kota Kinabalu with STIA (Sabah Timber Industries Association), representing 213 companies and focus on downstream mills, and in Kuching with STA (Sarawak Timber Association) representing 550 companies and focus on both upstream and downstream activities.

The meetings in all regions made very similar points, though it is necessary to understand the regional backgrounds in order to appreciate the points made. The individual representatives met were all very candid and forthcoming with their views. Their views and concerns are grouped and re-arranged as points below.

A2.2 Perspectives on this market study.

Almost all interviewed questioned the timing of this Market Study: all strongly felt that the Study should have been done prior to any initial negotiations with EU and before any VPA related activities take place in Malaysia.

A study like this would have given better understanding of the perspectives of the Malaysian private sector, which in turn would have guided both the Malaysian and the EU sides in their approach to the VPA.

Indeed, there is a mood of coolness amongst the private sector towards the VPA.

A2.3 Perspectives on the need of a VPA.

The private sector is aware of the EU FLEGT initiative but is somewhat vague on the VPA. The associations said this is probably due to the fact that the VPA itself is still a concept that is taking shape with no specific details available yet. For example, the question of definition of legality was raised: some say they would not be able to discuss the VPA meaningfully unless and until they know what is considered legal and illegal. Some worry that the definition is being stretched to cover issues beyond forestry.

A few questioned the need of a VPA as they felt that the current MTCC certification scheme can adequately address the legality issues. There is fear that a VPA will lead to

an unnecessary and costly additional layer of bureaucratic procedures, at a time when adhering to current procedures are already challenging enough.

A2.4 Perspectives on the advantages of a VPA

The private sector is unanimous in saying they cannot yet see any advantage to be gained from a VPA with EU.

Market Access has always been touted by promoters of VPA, especially from the EU side, as an advantage for signatories of VPAs. However, the private sector says that market access is directly linked to prices, and prices are a function of market mechanisms. There is always market for products at a price which the buyers can afford unless there is an outright ban on those products. Also, the EU needs to recognise that Malaysian timber products are currently exported to many parts of the world.

The private sector is pessimistic that there will be a price premium for timber products certified as legal under the VPA. They point to the current markets of timber with certificates of sustainability where the premium, if it exists at all, is very minimal (They gave an example of certified plywood which had a premium of only US\$ 10 a cubic metre over un-certified plywood). In any case, it is felt that in an open economy, the market mechanisms will eradicate any premium when the supply of such products is sufficient to meet demand.

A2.5 Concerns over the disadvantages of a VPA.

The immediate fear is the additional cost of compliance. It is generally accepted that additional manpower and resources are needed though there is uncertainty as to what really needs to be done under a VPA. Even one or two more percent increase in production costs can push producers away from profitability towards break even (For example, furniture manufacturers gave an average gross profit of around 8% only).

In addition, there is also fear that competitors in countries like Indonesia, Thailand, Vietnam and China will not be burdened by any additional constraints as they are not party to any VPA with EU. The Malaysian producers will face steeper challenges to sell their products in EU if it is business as usual in these main competing countries.

A2.6 Call for incentives

The question is asked: what incentives would attract the private sector to adopt a VPA with EU.

There are vague requests for financial assistance to help offset costs of compliance. There is a wish for the EU buyers or end users to share part of these additional costs. However, nothing solid can be proposed at this stage as the real costs of compliance are as yet unknown.

Some asked for waiver of import duties and associated fees/levies since these are within the ambits of the EU member countries' governments. On the other hand, some private sector representatives doubt any such assistance will be passed on to the producers as they see the importers internalising this for their own benefits.

One interesting comment was made on incentives: the EU should appreciate the benefits of giving incentives to the Malaysian exporters under this VPA. These benefits will attract those in countries who have not signed a VPA with EU to come forward and request a similar arrangement as with Malaysia. In other words, the private sector of other countries will want to take advantage of the VPA benefits too.

It seems clear to all that, as it stands, there are no incentives for the private sector to support a VPA with EU.