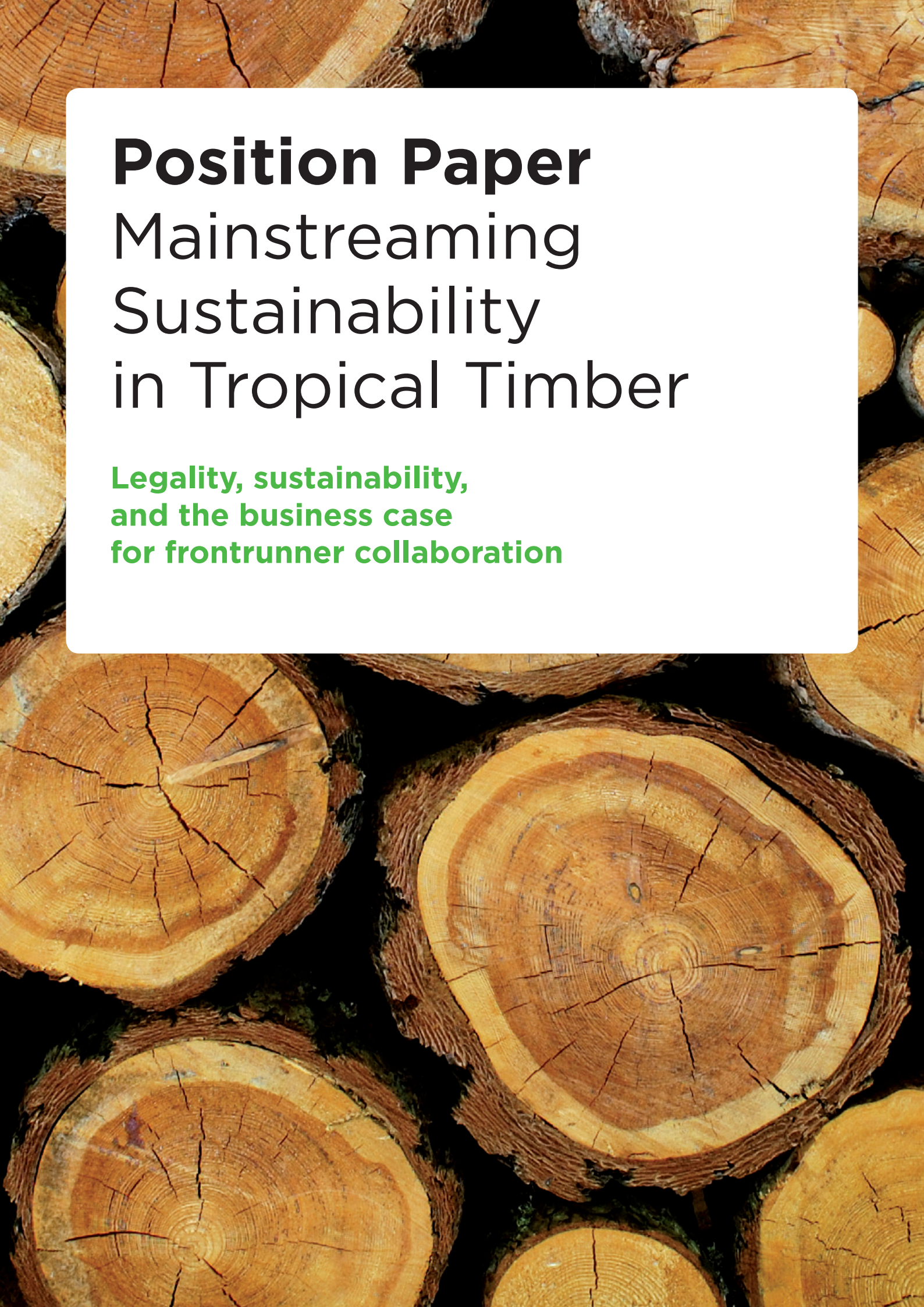


# **Position Paper**
# Mainstreaming Sustainability in Tropical Timber

## Legality, sustainability, and the business case for frontrunner collaboration

# Introduction

How do we manage our tropical forests in a responsible way? This is arguably one of the most critical challenges to global sustainability. We know from the successes of Forest Stewardship Council (FSC), Programme for the Endorsement of Forest Certification (PEFC) and other certification schemes that sustainable forest management (SFM) is viable in the right context. But for tropical forests, after 20 years, certification schemes have reached only 6% of the forests in key producing countries. In the past ten years, EU governments have invested in creating a viable context in the tropics through the Forest Law Enforcement, Government and Trade (FLEGT) Action Plan (see Box 4), without much success so far either. We need to drastically scale up efforts to make SFM mainstream. We now have a unique opportunity for doing so by leveraging new timber legality legislation such as those of the USA, Australia and the EU.

Illegal timber is estimated to represent between 25% and 70% of timber produced in some tropical countries[1]. As this illegal timber is produced and sold at a heavy discount, it is no surprise that the financial business case for SFM is challenging. But this is about to change. A new level playing field is likely to emerge as a result of the implementation of new timber legality legislation: the European Union Timber Regulation and the Lacey Act in the USA. Also in Australia legislation on banning illegal timber has been introduced. These programmes introduce a set of minimum legal requirements for the trading of timber, thereby improving the relative business case for SFM. For this report a cost analysis was conducted to determine the differential cost of certification under the new situation. The results show that given the required investments that will be needed to meet legal requirements,  the additional costs for companies of certification will be between 15% and 80% less than they were previously, depending on the context.

This substantial decrease in price differential provides a unique opportunity for tropical timber producers and users. They are in any case faced with the need to invest to comply with new legislation, and by taking a small additional step they can fully integrate sustainability in their operations. In addition, there will be a considerable jump in levels of certified production when there is a strong united message from key buyers in Europe that legality and SFM are vital and mutually supportive. For buyers themselves this offers a great opportunity to not only ensure that they are meeting the requirements of European legislation, but also benefiting from the associated commercial potential that certified timber offers.

To grasp this unique opportunity and to accelerate demand for licensed and certified timber from sustainably managed tropical forests, IDH The Sustainable Trade Initiative, the Dutch Ministry of Economic Affairs and other key partners in the sector convene the EU Sustainable Tropical Timber Coalition, in which we call for collaboration among frontrunners from the public and private sector in Europe through creating synergies between legality measures and sustainability efforts.

1 **Lawson, S.  and Macfaul, L., 2010, Illegal logging and the related trade, Indicators of progress: Country report cards. Chatham House**



# Sustainable forestry in the tropics: achievements and challenges

An important solution to irresponsible forest exploitation has been the development of sustainable forest management (SFM) techniques[2]. These techniques enable timber harvesting in a way that does not undermine the long term natural resource base that forests provide (see Box 1). The uptake of SFM practices in the timber sector has been strongly driven by voluntary certification schemes such as FSC, PEFC and others. Certification requires forestry enterprise to meet a set of principles and criteria, in return for which they are able to market their forest products as environmentally and socially responsible to markets that demand this and will sometimes reward this with premium prices. The uptake of SFM practices is furthermore stimulated through the Voluntary Partnership Agreements (VPA's) between the EU and producing countries, as part of the FLEGT Action Plan, in which producing countries are encouraged and supported to strengthen forestry legislation, including SFM, and enforcement thereof.

SFM provides a range of environmental and social benefits to communities and developing country governments (see Box 2). For timber companies, SFM offers the ability to continue generating revenues from forest exploitation. Well-established chain of custody certification[3] and licensing, and supply chain traceability technology give users and consumers the confidence that the timber has been produced sustainably.

2 **SFM tackles the issue of unsustainable forest exploitation. But deforestation is also driven by conversion of forests into arable land. A recent report by Kissinger, Herold, De Sy (2012) estimates that agriculture is the driver for 80% of global forest deforestation.**

3 **Approximately 13,000 chain of custody certificates are now held by EU and Chinese companies alone.**

Box 1
## Tropical forest: Some key facts

The General Assembly of the United Nations adopted in December 2007 the most widely, agreed definition of Sustainable Forest Management (SFM):

*Sustainable forest management as a dynamic and evolving concept aims to maintain and enhance the economic, social and environmental value of all types of forests, for the benefit of present and future generations. It is characterized by seven elements, including: (i) extent of forest resources; (ii) forest biological diversity; (iii) forest health and vitality; (iv) productive functions of forest resources; (v) protective functions of forest resources; (vi) socio-economic functions of forests; and (vii) legal, policy and institutional framework[4].*

**The case for SFM:**
- 1.6 billion people, more than 25% of the world's population, rely on forest resources for their livelihoods[5].
- 80% of terrestrial biodiversity is found within tropical forests[6].
- The global trade in timber and other forest products is estimated at almost US$330 billion/year[7].
- An estimated 13 million hectares of forest cover are being lost annually[8], the main part of which occurs in the tropics.
- This contributes 10% of global anthropogenic greenhouse gas emissions[9].

**The role of the market:**
- Illegal logging deprives developing countries of an estimated USD 10 – 15bn in lost royalties each year[10].
- Illegal logging is also thought to depress world timber prices by as much as 16%, distorting global markets and undermining legal operations[11].

Box 2
## Environmental and social benefits of forest management certification

Despite the uneven application of SFM globally and in different regions, there is strong evidence to suggest that SFM has numerous positive environmental and social impacts. Economic impacts of SFM will be explained later in the paper.

**Environmental benefits**
At the heart of SFM is the management of forests to ensure environmental sustainability. The application of SFM has numerous positive impacts including improvements in the cultivation of forest trees and biodiversity conservation. A recent report by Putz et al (2012) demonstrated that in forests where a regime of selective logging, an important element of SFM, 76% of the carbon stocks are maintained and 85% – 100% of species of mammals, birds, and invertebrates, remain after logging[12].

**Social benefits**
SFM ensures that rights of local communities and indigenous people to own and manage their lands are respected, cultural and economic benefits that forest communities obtain from the forest are maintained, and the well being of forest workers is maintained or enhanced. A number of studies have demonstrated that there have been improvements in social conditions as a result of SFM certification which include *"improved pay and conditions for workers, the development of community infrastructure and the provision of training"*[13].



Box 3
## Certification's current footprint in the Tropical Permanent Forest Estate

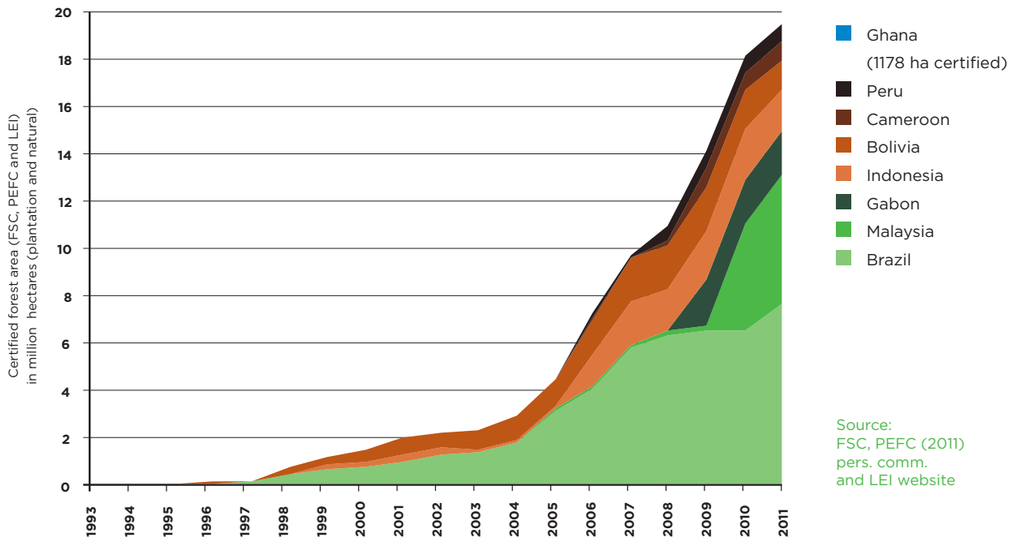
- Of the forest area demarcated within each country only a proportion of that is legally classified as forest, known as the permanent forest estate (PFE). The PFE is split into two areas, productive PFE and protective PFE[14].
- The estimated size of the tropical PFE is 783 million hectares, comprising 425 million hectares of production forest and 358 million hectares of protection forest[15]. The production PFE is that area of the forest that has been legally designated for the production of timber and includes natural and plantation forest.
- In tropical countries there are an estimated 22.4 million hectares of plantation forests, which represents approximately 5% of the total production PFE[16]. The remainder of the production PFE is natural forest.
- Only 6% (19m ha) of the production PFE in the key tropical producer countries assessed is now certified[17].

Certification has taken place mainly in *temperate* forests, where almost 400 million hectares have been certified to the two largest global schemes in the last ten years. This equates to the land area of Germany being certified each year. In *tropical* forests, the growth in certification has been much slower, with some signs of increasing growth over the last five years[18]. A total of approximately 19 million ha of tropical production forest has been certified[19] (see Box 3). Amongst countries analysed, Malaysia has progressed furthest with over 50% of its permanent production forests now certified.

4 Secretariat of the Convention on the Biological Diversity. 2009. Sustainable Forest Management, Biodiversity and Livelihoods: A Good practice Guide. Montreal, 47 +iii pages.
5 WWF, Forest, jungles, woods and their trees [WWW] WWF, available from wwf.panda.org/about_our_earth/about_forests accessed 7 September 2012.
6 Ibid
7 UNEP, Reporting Forests: A journalist's guide to the role of forests in sustainable development and human well being. UNEP (2011)
8 UN FAO, Global Forest Resources Assessment 2010, UNFAO, FAO Forestry Paper 163 (2010)
9 Baseline Map of Carbon Emissions from Deforestation in Tropical Regions, Winrock International, published in Science, 22 June 2012
10 European Forest Institute, Illegal Logging [WWW], European Forest Institute, www.euflegt.efi.int/portal/home/flegt_intro/illegal_logging accessed 7 September 2012
11 Lawson, S. and Macfaul, L., 2010, Illegal logging and the related trade, Indicators of progress: Country report cards. Chatham House
12 Putz, F. E., Zuidema, P. A., Synnott, T., Peña-Claros, M., Pinard, M. A., Sheil, D., Vanclay, J. K., Sist, P., Gourlet-Fleury, S., Griscom, B., Palmer, J. and Zagt, R. (2012), Sustaining conservation values in selectively logged tropical forests: the attained and the attainable. Conservation Letters, 5: 296–303.
13 Cashore, B., Gale,F., Meidinger,E. And Newsom,D. Forest certification in developing and transitioning countries, Yale School of Forestry and Environmental Studies. Available from www.environment.yale.edu/files/biblio/YaleFES-00000147.pdf accessed 7 September 2012
14 Not all forest area within a country is available for certification, as it will not be legally designated for timber production or may be set aside for other land uses.
15 International Timber Trade Organisation, 2011, Status of tropical forest management 2011, ITTO
16 Ibid
17 In nine study countries analysed which includes Bolivia, Brazil, Cameroon, DRC, Gabon, Ghana, Indonesia, Malaysia, Peru
18 This recent growth has been as a result of significant efforts of frontrunner companies, community groups and certification initiatives such as The Borneo Initiative, The Congo Basin Programme, The Amazon Alternative, WWF Global Forest Trade Network, The Forest Trust and so on.
19 In nine study countries analysed: Bolivia, Brazil, Cameroon, DRC, Gabon, Ghana, Indonesia, Malaysia, Peru.

Diagram 1

## Progress to date of certification in tropical forests



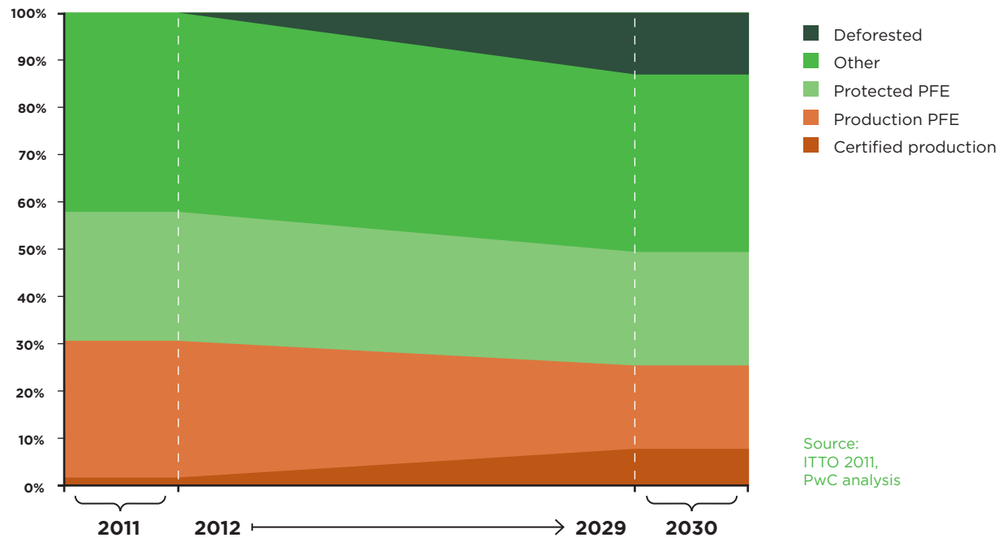

Source:
FSC, PEFC (2011)
pers. comm.
and LEI website

While there are some positive examples in terms of certification, looking at these figures we must conclude that for tropical forests certification has not had the impact many had hoped. After 18 years, certification only covers 6% of PFE forest in the tropics, of which approximately 20% is plantation forest. Our analysis forecasts that by 2030 two-thirds of forest will remain uncertified and that deforestation will outpace certification. Looking ahead then, we believe that certification will remain an important tool, but we consider it highly unlikely that – in a business-as-usual scenario – certification will become mainstream practice in the tropics.



Diagram 2

## Forecast growth rates for certification and deforestation within eight study countries




Source:
ITTO 2011,
PwC analysis

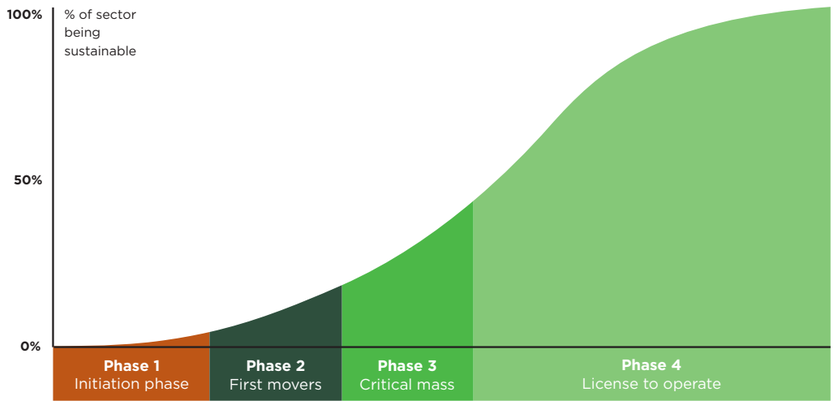
The uptake of SFM in the tropics has been limited by the absence of a solid business case. Producers incur higher costs when implementing SFM practices and complying with certification standards, for example, new housing and facilities for staff, the implementation of community development programmes and High Conservation Value Forest analyses. Although improvements in productivity in the long term may compensate for some of these costs, these in turn are offset by the loss of production volume as a result of significant reductions in the Annual Allowable Cut (AAC) to meet sustainable levels. In addition, the opportunity cost of SFM is high, given the high revenues achievable through forest conversion for other commodities (cattle, soy, palm oil, etc). Relatively these costs are highest when competing with illegal production.

Anecdotally, producers claim that they lack strong market signals demanding certified products. Even progressive large European retail buyers are procuring on a tactical basis from a fragmented base of smaller suppliers. Non-discerning buyers - particularly in India and China - are now consuming more tropical timber and are not asking for certified products, nor paying a premium.

# Legality as a game changer for market transformation

The process of market transformation is illustrated in Diagram 3 below. We consider the tropical forestry sector to be somewhere in early phase 3 – given that certification has certainly moved beyond a small number of first movers. However, we would now like to see the sector move through phase 3 into phase 4, where SFM is essential to retaining license to operate, as is already common practice in many temperate forest regions.

Diagram 3
**The four phases of sustainable market transformation**




Source: New Foresight

With a range of powerful importing countries introducing new legislation to regulate imports of timber into their markets, there is a unique opportunity to bring tropical forestry to its next phase of market transformation. In 2008 the Lacey Act was amended in the USA, making it unlawful to import illegally logged timber. Similar legislation is being considered in Australia and New Zealand. The EU Timber Regulation (EUTR) comes into force in March 2013. All importers of timber will have to demonstrate they have completed due diligence to prove its legal origin.



Box 4
**Background to the EU Forest Law Enforcement Governance and Trade (FLEGT) and the EU Timber Regulation (EUTR)[20]**

**The European Union's Forest Law Enforcement, Governance and Trade (FLEGT) Action Plan** identifies a range of measures to address the problem of illegal logging and related trade. An important element of this is the implementation of actions aimed at reducing the trade and use of illegally-harvested timber and promoting the use of legally-harvested timber in the EU. The mechanism through which the EU proposes to do this is the VPA between the EU and timber-producing countries where illegal logging is a problem.[21] This agreement commits the producer country to implement governance and legislative reform in the timber sector in order to produce timber which is deemed to have been produced legally. In many countries, forestry legislation is already based on the premise of sustainable forest management.

Central to the VPA is the establishment of a licensing scheme to ensure that only timber products that have been produced in accordance with the national legislation of the exporting country are imported into the EU. Under the licensing scheme, import into the EU of timber exported from a Partner Country will be prohibited unless the timber is covered by a valid license.

**The VPA process is currently underway in a number of countries[22]:**

- **VPA agreed and developing timber tracking systems:**
  Cameroon, Central African Republic, Congo, Ghana, Indonesia and Liberia
- **In formal VPA negotiations:**
  DRC, Gabon, Malaysia and Vietnam

If we assume that all these countries successfully implement the VPAs by 2022 across their entire production PFE, this could result in 80m hectares of natural forests being managed under closely monitored harvesting regimes. Contrast this with our best case scenario estimate of 65m hectares which could be certified in the absence of FLEGT by that same year[23].

**The EU Timber Regulation** enters into force in 2013 in all EU member states. It will prohibit the placing of any illegally harvested timber on the EU market. The regulation will require all entities that first place timber onto the EU market to carry out due diligence on the timber and the timber supply chain including keeping track of whom timber or timber products were bought from, and where applicable, to whom they were sold.

This will mean that any traders of tropical timber will have to provide evidence that the timber they have imported is from a legal source.

20 Adapted from the FLEGT briefing notes. European Forest Institute, 2007, FLEGT Briefing Notes, Briefing note number 01, European Forest Institute, Available from www.euflegt.efi.int/portal/home/flegt_intro/flegt_action_plan accessed 7 September 2012

21 www.euflegt.efi.int/files/attachments/euflegt/efi_briefing_note_03_eng_221010.pdf

22 Chatham House update - www.illegal-logging.info/uploads/1_Torta050712.pdf

23 In the best case scenario we have assumed that the area certified in each of these countries grows at the same rate that it has done for the last 10 years, including all the areas that are now in being prepared for certification by one of the certification initiatives, such as GFTN.

Box 5
## Definitions of 'legal' timber

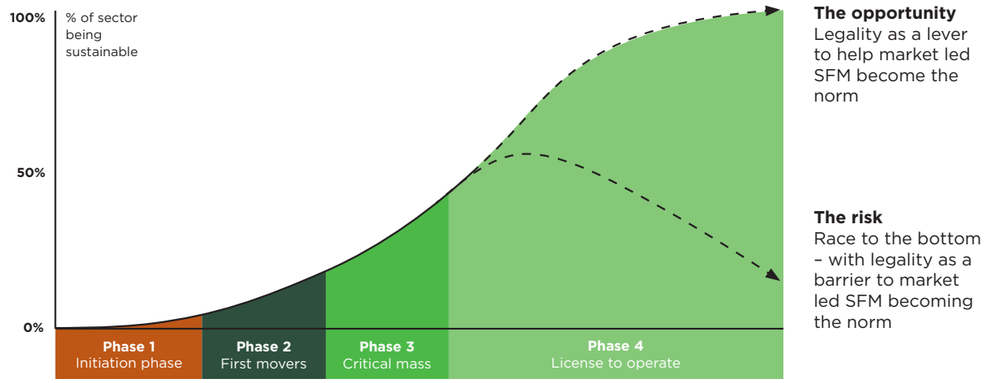
**Legality in timber may be defined in a number of ways:**

- A 'truly' legal operation should be in compliance with *all* relevant laws and regulations within a country.
- A narrower definition of 'certified legal' could mean *demonstrable* legality, whereby a company is independently audited against a legality standard, which in turn requires adherence only to a narrower set of relevant environmental and social laws, as defined in the standard.
  As an example, in Indonesia, the local legality standard SVLK VLK only requires companies to demonstrate compliance with a defined set of laws (e.g. payment of timber royalties), which do not in themselves mean company compliance with all relevant laws and regulations has been achieved.
- For the purposes of the FLEGT Action Plan, and within the VPAs, the standards that are used to demonstrate 'compliance with the law' may differ between countries. At the back of a typical VPA is a legality matrix or 'grid' which defines the regulatory references, indicators and verifiers to clarify the laws for which enforcement will be monitored within the context of a VPA.
- Finally, some commentators use the term 'false legal' to describe situations where companies have obtained certificates of legality through illegal or improper means. In this situation, claims of legality cannot be substantiated following proper due diligence.

This legislation is highly relevant to SFM. The *opportunity* is that legality will help to boost SFM. Better governance and legality enforcement will raise the standards of forestry operations, thereby lowering the compliance costs of SFM. The *risk* is that, without care, legislation may lead to a narrow, 'legal only' focus becoming the norm. This 'race to the bottom' could jeopardize the biodiversity, community and climate benefits which have been achieved so far (see also Box 5).



Diagram 4
## Market transformation scenarios for tropical timber




Source: New Foresight

It is clear that a strong focus on driving forward legality legislation (such as EU TR and Lacey), without due consideration of the commercial and sustainability impacts of this, carries a number of significant risks.  For such regulation to be successful, it should be complemented with aligned efforts to promote sustainable forest management such as FLEGT and certification..

# Will legality make SFM more affordable?

In a tropical country with poor governance and law enforcement, the costs to a timber producer of attaining SFM certification is greater than for a timber producer in a country where legal standards are well enforced. Especially if these legal standards are not far from sustainability standards. In this way, the implementation of FLEGT VPAs in tropical countries will help to improve the business case for SFM for producers. This, in turn, would help buyers of tropical timber to secure increased volumes of sustainable products, and in doing so to make their supply chains more sustainable and with less risk.

To explore this opportunity for shared value creation, we developed a cost framework to test whether VPA implementation would reduce the additional costs of moving from legal to sustainable production. The cost framework compares the costs a company will incur as it moves between three scenarios: from (1) a 'typical' tropical forestry company scenario operating without close regulatory oversight to (2) a legally verified company[6] in a VPA country and finally to (3) achieving FSC certification. We applied this framework to Cameroon and Indonesia, consulting companies and experts for their data and views. Cameroon and Indonesia are interesting case studies because of their relatively good progress in implementing Voluntary Partnership Agreements.

Our analysis indicates that in Cameroon, forestry law and FSC standards are already closely aligned. Producers who invested in complying with all relevant laws will have already incurred around 60% of the costs required to comply with the FSC standards. This means that legislation could play a significant role in lowering the additional costs of FSC certification for timber companies in Cameroon.

Our analysis for Indonesia suggests that the cost impact of legislation differs significantly depending on how legality is defined:

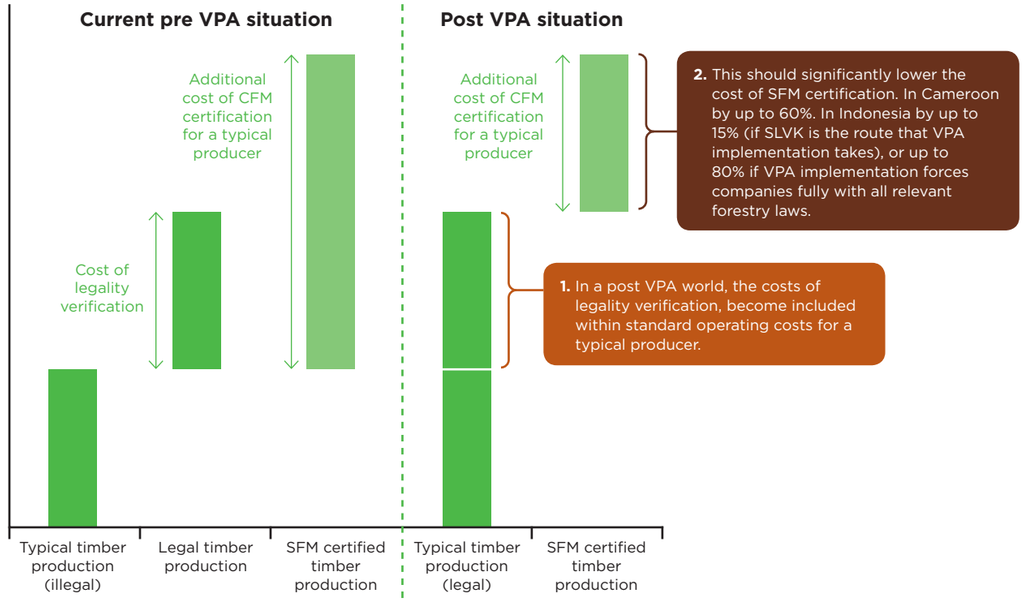
- If we consider legal to mean having obtained SVLK VLK, then this only makes up 15% of the costs of that same company getting FSC certified. For many companies operating in Indonesia, attaining certification under the SVLK VLK standard is a simple exercise that involves limited changes to their current practices.
- However, for those companies who comply fully with all forestry legislation and regulation, our analysis suggests they will have already incurred on average 68% of the costs of FSC certification, but in some cases up to 80%.

24 **We used SVLK in Indonesia and VLC in Cameroon as proxies for what VPA implementation might require of companies. Given full VPA implementation has not been achieved in any country yet, we have estimated the costs and activities involved in moving to 'demonstrable legality' by using VLO, VLC and PHPL/SVLK related costs as indicators.**



Diagram 5

**Reduction of the additional costs of SFM under legality in Cameroon and Indonesia**




It is clear from the case studies that there is substantial diversity within and between countries. In Indonesia, the low level of cost for companies to attain the legality standard suggests that the legal baseline situation is higher, but may also indicate that the SVLK standard is based on a narrow definition of legality. This provides a good opportunity to increase the levels of legal compliance within the country. Cameroon presents a significantly different picture but equal opportunity, demonstrating that significant efforts aimed at getting companies legally certified, could indeed reduce the financial barriers to SFM certification.

In different ways, both country case studies demonstrate that strong legality standards that are aligned and complementary to the SFM certification process will help to address a number of the underlying requirements of the SFM standards and could improve the business case for producers.

# Legality and certification: capturing the momentum

Our cost analysis confirms that legislation does have significant potential to make SFM more affordable. However, even when improving the business case for SFM, the development of legislation alone is unlikely to push timber producers to become SFM licensed or certified. Two key things need to happen: buyers need to send the right signals, and the voluntary standards need to be well aligned with legality efforts.

The jump in levels of SFM will come when key buyers demand legal and sustainable timber products. This necessitates a strong united message from key buyers in Europe that sustainability and legality are vital and mutually supportive. Although legal timber will be a minimum requirement, it does not have the same marketability (or the potential for price premium) as licensed or certified timber from sustainably managed forests. Under the new legislation FLEGT timber has a green lane and certified timber is likely to be considered low risk by the EU. For buyers this offers a great opportunity to not only ensure that they are meeting the requirements of legal procurement policies, but also benefiting from the associated commercial potential that certified timber offers.

In order to fully realise the synergies, it is important that the certification standards align with the requirements of the VPAs. The standards already address the majority of the requirements of the VPA and both will allow producers to continue to access European markets. Promotion of the SFM through VPAs and certification will provide companies with access to additional commercial opportunities. To give this an additional push, buyers need to align their procurement to all stimulate SFM, be it through demand for FLEGT timber from VPA countries, certified timber or – ideally – both.



# Call for action

We have seen why now is the perfect moment to accelerating sustainable forest management, both from a conservation point of view and from a business perspective. Therefore the Dutch Ministry of Economic Affairs and IDH The Sustainable Trade Initiative have taken the initiative to convene a EU Sustainable Tropical Timber Coalition (EU STTC) of private sector companies, local authorities and national governments that share the ambition to accelerate demand for certified or licensed timber from sustainably managed tropical forests to the tipping point of 30% by 2015 in the EU by creating synergies between legality measures and sustainability efforts. The Coalition will bundle demand for legal and sustainable tropical timber and it will bundle efforts to accelerate sustainable forest management in the tropics. This combination of demand side and supply side pressure will pave the way for a smoother transition to more sustainable timber markets.

Each participant in the Coalition (total about 20 companies, 5 national governments and 20 local authorities) sets its own ambitious targets and commits to undertake concrete activities within its sphere of influence to achieve these targets. Companies and local authorities will commit to working towards 100% sustainable tropical timber, national governments will in addition commit to aligning with each other and with private initiatives. Each participants will be supported by one of the lead organizations in the EU STTC. They will be offered co-funded communication and PR services, networking opportunities and technical consultative support throughout the supply chain. The consultative support will come from a pool of experts specialized in market links and buying of sustainable tropical timber.

Together with the lead organizations, IDH The Sustainable Trade Initiative and the Dutch Ministry of Economic Affairs will facilitate the building the Coalition. The participants, lead organizations, IDH and The Dutch Ministry of Economic Affairs (for an up to date overview of the participant list please see www.idhsustainabletrade.com/linkingeurope) will work towards a joint public presentation in September 2013 on their combined ambition and the activities that they will each undertake. Those participants that have started already will present their results so far, during the September 2013 event.

**You are invited to join the EU Sustainable Tropical Timber Coalition, strengthen your commitment and get support to achieve your ambitious targets and to make sustainable forest management mainstream in the tropics.**

## Colofon

This position paper is developed by IDH The Sustainable Trade Initiative and is based on research undertaken by PricewaterhouseCoopers UK. Input and insights were provided by key stakeholders in the tropical timber sector.

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