

# Learning Lessons to Promote Certification and Combat Illegal Logging in Indonesia

September 2003 to June 2006

Emile Jurgens



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## List of Acronyms and Abbreviations

APKINDO	Asosiasi Panel Kayu Indonesia or <i>Indonesian Plywood Association</i>
BRIK	Badan Revitalisasi Industri Kehutanan or <i>Forest Industry Revitalization Body</i>
BSW	PT Bangun Sarana Wreksa
CAR	Corrective Action Request
CIFOR	Center for International Forestry Research
CITES	Convention on International Trade in Endangered Species
CoC	Chain of custody
DRT	PT Diamond Raya Timber
FLEG	Forest Law Enforcement and Governance
FM	Forest Management
FMU	Forest Management Unit
FPIC	Free prior and informed consent
FSC	Forest Stewardship Council
FTN	Forest and Trade Network
GFTN	Global Forest and Trade Network
GoI	Government of Indonesia
HCVF	High Conservation Value Forest
LEI	Lembaga Ekolabel Indonesia or <i>Indonesian Ecolabelling Institute</i>
LKS	Lesser-known species
MoF	Ministry of Forestry
MoU	Memorandum of Understanding
MTH	Mixed tropical hardwood
NGO	Non-Governmental Organization
RKT	Rencana Karya Tahunan or <i>Annual Work Plan</i>
RST	Rough sawn timber
RWE	Roundwood equivalent
SFM	Sustainable Forest Management

SPWP	Secondary Processed Wood Products
SLJ	PT Sumalindo Lestari Jaya
TFT	Tropical Forest Trust
TNC	The Nature Conservancy
TPTI	Tebang Pilih dan Tanam Indonesia or <i>Indonesian Selective Cutting and Planting system</i>
TTF	UK Timber Trade Federation
VPA	Voluntary Partnership Agreement
VVNH	The Dutch Timber Trading Association
WALHI	Wahana Alam dan Lingkungan Hidup or <i>The Indonesian Forum for the Environment</i>
WWF	World Wide Fund for Nature

# 1. Introduction

The Global Development Alliance to Promote Certification and Combat Illegal Logging in Indonesia (the Alliance) has made substantial progress since CIFOR released the first Learning Lessons report on the Alliance in 2003. Major milestones between September 2003 and March 2006 include:

- The design of a legality standard for Indonesian wood products;
- The successful testing of an independent legality verification and timber tracking mechanism;
- Creating awareness of the need for a regional approach to combat illegal logging amongst customs agencies;
- The establishment of Forest and Trade Networks in Indonesia and China and recruitment of forest and trade participants;
- The creation of a model of collaborative management between local communities and a timber concession in East Kalimantan;
- Integration of High Conservation Value Forest areas into the East Kalimantan land use plan;
- Agreement on criteria for sustainable palm oil production;
- FSC certification of a 270,000 hectare (ha) concession in East Kalimantan, representing the largest forest management unit certified under the FSC scheme in the whole of South East (SE) Asia;
- The first LEI certification of a community forest in Indonesia; and
- The acceptance of procurement policies by major paper users in Japan.

Progress has been achieved under difficult conditions and the Alliance's activities are bringing to light valuable lessons about the Indonesian forest sector and the opportunities and challenges for intervention. The sector is characterized by weak governance, political transformation, and financial insolvency. This messy state poses a substantial barrier to positive change but also presents fertile ground for learning lessons. The Alliance partners have continued to learn and in several cases have adapted their approach accordingly.

The Alliance's experience has shown that linking potential buyers of sustainable timber to Indonesian producers, by itself, is not enough to bring about the large and quick changes that were envisioned at the Alliance's inception. During the first three years of its activities, the Alliance has adapted its approach from focusing exclusively on market linkages to undertaking initiatives to improve enabling conditions and promote public policy incentives for sustainable forest management. Increased national stability following the 2004 change of government has led to improvement in the political and business climate, which presents increasing opportunities for the Alliance to combat illegal logging and improve forest management.

**Lessons learned** about the nature of demand for, and supply of, sustainable and legal verified timber from Indonesia include:

- Market demand for certified and legal forest products is driven by multiple factors including purchasing policies of corporations and regulatory policies of importing governments.
- Buyers looking for timber that can be proven to be legal or sustainable can either switch to timber suppliers that are perceived as being less risky, or place pressure on their current suppliers to pursue certification or legality verification.
- Companies in Indonesia are less likely to respond to demand from buyers that they are not trading with since there are significant costs and risks related to switching markets and the benefits are not always clear.
- Buyer preferences for legal and sustainable timber are often “lost in translation” from the consumer end of the supply chain through intermediaries to the source FME.
- Weak forest governance acts as a deterrent to investments in sustainable forest management in Indonesia.
- The role of Government in verifying “legal” timber is essential as the government is the ultimate legal authority. Yet, it is also problematic as those seeking verification have usually lost confidence in government systems.
- Legality should be addressed as one strand of the broader concept of responsible forestry and timber purchasing.
- Some government policies have acted as serious deterrents or disincentives for companies to engage in a program to achieve sustainable forest management.

- Demand for sustainable forest products does not necessarily translate to a willingness to pay for the additional costs of sustainable production.
- For certification to have a major impact on natural tropical forest management there needs to be greater acceptance of a stepwise approach.
- Environmentally sensitive buyers are mainly concerned about their corporate image, and need assurance that the products they purchase are approved by activist NGOs in their home markets.
- Multilateral cooperation, market approaches, and good governance all have an important role to play in combating the trade in illegal wood.
- Market based mechanisms require concerted action across all markets to succeed.
- In an ever improving political and business environment, market-based efforts are beginning to help improve forest management in Indonesia.

The Alliance has responded to the complexity and challenges that have emerged by focusing on improving the enabling conditions so that the full benefit of market linkages can be realized. While company-to-company linkages continue to be an important component of the program, the Alliance is working more closely at the policy level in Indonesia and import markets to create an improved regulatory and enabling framework for sustainable forest management. This framework is changing for the better and it is likely that this will create an environment where market links will play an increasingly important role.

While there are many examples of institutional learning that could be drawn from the Alliance activities during the period covered, this report focuses on two broad topics: i) facilitating market links to create incentives for Indonesian timber producers to invest in sustainable forest management; and ii) defining “legal timber” in the Indonesian context. This report is based on information provided by Alliance participants and stakeholders through interviews and written comments from September 2005 to April 2006, as well as a review of literature on market links, certification, legality verification, timber trade, and timber tracking.

Section 2 of the report provides a brief overview of the Alliance’s activities in the period between September 2003 and April 2006. This section is divided into four headings that correspond to four of the five activity areas in which the Alliance is active:

- i) Strengthening Market Signals to Produce Certified and Verified Legal Timber;
- ii) Increasing Supply of Certified Indonesian Wood Products;
- iii) Demonstrating Practical Solutions to Achieve Certification and Differentiate Legal and Illegal Wood Supplies; and
- iv) Reducing Financing and Investment in Companies Engaged in Destructive or Illegal Logging in Indonesia.<sup>1</sup>

Sections 3 and 4 of the report respectively deal with facilitating market links and defining legality. These topics are explored in some detail based on Alliance activities as well as background material. Section 3 has two parts. The first details the nature of demand for certified and legal verified timber products in the import markets where the Alliance has been active (Europe, USA, China and Japan). The second part looks at the impact of this demand on the Indonesian forest sector and details the barriers that prevent market signals from leading to greater supply of certified and legal verified timber products from Indonesia. Lessons that have emerged from Alliance activities related to facilitating market links and defining legality are detailed within the respective sections.

Section 5 provides the broader lessons that Alliance activities have helped bring to light. The report concludes with a series of recommendations that are aimed at informing the activities of the Alliance as well as those of other actors that wish to improve forest management practices in Indonesia.

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<sup>1</sup> The Alliance's fifth activity area is 'Sharing Lessons Learned'. This report is one of a number of contributions to that activity area.

## 2. An Overview of the Alliance's Progress from September 2003 to April 2006

### 2.1 Strengthening Market Signals to Produce Certified & Verified Legal Timber

#### 2.1.1 Continuing to Engage Timber Buyers

From September 2003 to April 2006, the Alliance expanded its engagement with companies that have the potential for increasing the level of demand for certified and verified legal timber from Indonesia. Both WWF and TNC continued to cultivate relationships with timber buyers in Asia, Europe, and North America. The Alliance partners engaged several strategic Japanese companies with strong links to the Indonesian timber sector, including Itochu and Sumitomo Forestry. These companies have expressed strong support for the concept of Alliance activities, and have indicated that they expected to be able to give a preference in their trading with Indonesia, for products from well-managed and legal forestry operations. WWF maintained its close engagement with the global buyers and creditors of the two biggest Indonesian pulp and paper companies, APP and APRIL, to assist them in evaluating their respective practices. The Alliance made the most significant progress in engaging the private sector through the expansion of WWF's Global Forest and Trade Network (GFTN), and through the successful promotion of sustainable paper purchasing policies in Japan.

#### *Expanding WWF's Global Forest and Trade Network*

WWF's GFTN has expanded and Forest and Trade Networks (FTNs) now exist in all countries that are major importers of Indonesian timber, including China, Japan, Germany, the UK and the USA.

- WWF established the **North America FTN** in 2005, and has enlisted four participants with commitments to responsible wood sourcing - BlueLinx (the largest distributor of building products in the U.S.), Johnson & Johnson, TBM Hardwoods (one of the largest U.S. importers of tropical hardwoods) and Wood Flooring International.

Over the last few years, WWF's GFTN has established a strong presence in Asia Pacific. As of June 2006, progress had been achieved as follows:

- The recently established **China FTN** had two forest participants (forest managers) and six trade participants (processors, manufacturers, traders or end-users). An additional six manufacturers had applied to join and are currently developing responsible procurement action plans to qualify for membership.
- The **Indonesia FTN** had four forest participants and eight trade participants. It also had a pipeline of applicants including seven forest managers, six community forests and eight processors and manufacturers. In February 2006, SLJ II became the first concession company to join Nusa Hijau. PT Perhutani, the state forestry company, signed a Participation Agreement with Nusa Hijau for five of its 52 Forest Management Units (FMUs). The five FMUs cover an area of over 167,000 hectares, all of which are located in East Java.
- In Japan, **WWF Sanshoukai**, had 27 members.
- The **Malaysia FTN** had three trade participants and nine applicants (seven traders and two forest managers).
- The **Vietnam FTN** was launched on 4 October 2005, and has since recruited four manufacturers as full participants and four others have applied to join.

The GTFN continued to track signals from its buyer members. As of June 2006, GFTN has generated over 270 market enquiries (potential orders for specified products using wood sourced from FTN forest members or certified forests) from FTN Trade members directed at 18 producer countries. Globally, these enquiries are worth over 277 million USD to producers. Approximately 25 percent of these enquiries were directed specifically at Indonesian producers or towards products which Indonesian producers can supply. Indonesia has received 49 enquiries from 8 countries (spanning Europe and North America plus Vietnam) with a total estimated value of more than 73 million USD. Of these enquiries, 20 have developed into market links (trading relationships) between buyers in France, Germany, Netherlands, Sweden, Switzerland, UK and USA with Indonesian producer FTN participants.

The WWF GFTN also published guidelines for the Responsible Purchasing of Forest Products. The guide outlines the various ways in which companies, including primary mills, secondary processors, importers, manufacturers, wholesalers and

retailers, can demonstrate compliance with best practices and ultimately with their own purchasing policies.<sup>2</sup> WWF has translated the guide into Indonesian, Chinese and Japanese. A seminar to present the guide in Japan attracted 100 company representatives.

### ***Promoting Responsible Paper Purchasing in Japan***

WWF has helped two major Japanese companies, Ricoh and ASKUL, to adopt responsible paper Ricoh (one of the biggest office products and producers) and ASKUL (a leading supplier of stationery and office supplies in Japan) to draft the policy. Ricoh stopped purchasing copy paper from Indonesia based on its responsible purchasing policy. Other major Japanese which such policies include - Canon Sales Co., Inc, Fuji Xerox Co, Ltd, Fuji Xerox office Supply, Oji Paper, Nippon Paper and Mitsubishi Paper Mills Ltd.

WWF Japan, Friends of the Earth Japan, Greenpeace Japan, Japan Tropical Forest Action Network (JATAN), and Global Environmental Forum launched a project aimed at “Promoting Responsible Paper Purchasing in Japan”. This project aims to create an informal corporate study group on responsible purchasing policy in Japan.

### **2.1.2 Engaging the Public Sector in Asian Markets**

As the Alliance became more engaged in creating market linkages there was a growing recognition that government policies play a critical role in supporting and creating the demand for sustainable timber products. For this reason the Alliance increasingly worked with the governments of buying markets to promote favorable policies. Significant work in this area occurred in China, Japan, and at the regional level.

WWF China helped facilitate a fact-finding delegation to Europe of senior officials in the China State Forest Administration and the Certification and Accreditation Administration. The officials visited the headquarters of two forest certification systems - the Forest Stewardship Council in Germany and the Programme for Endorsement of Forest Certification Schemes in Luxemburg, as well as retailers and government officials in the UK. As a result of the trip, the officials agreed on a process for promoting forest certification in China. WWF is now working with the relevant government agencies and key stakeholders to design a detailed work plan for implementing this process.

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<sup>2</sup> See [www.panda.org](http://www.panda.org) for a link to the guidelines.

TNC and WWF were lead organizers of the Business Dialogue on Combating Illegal Logging which was held under the auspices of The Forests Dialogue in Hong Kong in March 2005. The event brought together over 120 leaders from business, civil society and government and there was agreement that companies and governments must take responsibility to ensure that the wood and paper products they purchase are legal.<sup>3</sup> During the event there was a successful, informal side meeting between Indonesian and Chinese officials who, for the first time since the two governments signed an MoU two years earlier, progressed to the point of agreeing on next steps.

The newly appointed Director of TNC's Asia-Pacific Forest Program met with officials of the State Forest Authority (SFA) in Beijing in January 2006 and discussed a range of areas for possible TNC/SFA cooperation. Agreed points of cooperation include a SFA visit to Indonesia in the latter half of 2006 to develop a common understanding of the issues with Indonesian officials, in addition to jointly sponsoring a major international dialogue on illegal logging and trade in Beijing in the first half of 2007.

WWF Japan provided input to the Japanese Forestry Agency's Illegal Logging Working Group. WWF Japan helped promote the views of the NGO community on the role of the Working Group, and two members of the Working Group attended the recent Forest Dialogue meeting in Hong Kong. At the local authority level, WWF Japan and the Mie Prefecture in southwest Japan held a certification seminar and panel discussion together with an exhibition of FSC products.

TNC and WWF continued to assist with the development of the Asia Forest Partnership (AFP). TNC, under the auspices of the AFP, is conducting an analysis of legal opportunities and constraints to combat the illegal wood trade around Asia. WWF leads an AFP-affiliated initiative involving Tropenbos International-Indonesia, CIFOR, and the Ministry for Development Cooperation of the Dutch Government, which aims to promote sustainable forest management in Kalimantan. Due in significant part to the Alliance's efforts, promotion of cooperation between forest agencies and customs agencies was established as a core concern of both the AFP and the Asia-FLEG Process and will be a focal area for input to the forthcoming FLEG Ministerial meeting in 2007.

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<sup>3</sup> [www.theforestsdialogue.org](http://www.theforestsdialogue.org)

## 2.2 Increasing the Supply of Certified Indonesian Wood Products

### 2.2.1 Launching an Indonesian Forest and Trade Network

An important accomplishment of the WWF/TNC Alliance is the establishment of an Indonesian production-oriented FTN, Nusa Hijau, which was launched in October 2003. Nusa Hijau currently has four forest participants. Respectively, they manage a certified natural forest, an uncertified natural forest, an uncertified acacia plantation and five district-level teak plantation management units. A further seven industrial-scale forest managers and six community forest managers have applied to join and are in the process of preparing action plans. On the manufacturing side, the Indonesia FTN currently has eight trade participants and an additional eight applicants.

For several years, WWF delayed acceptance of any forest managers as participants into the Indonesia FTN due to uncertainty over what constituted legal compliance in Indonesia, and to allow time to develop eligibility criteria that would be consistent with the evolving MoU Legality Standard.

### 2.2.2 Supporting Certification in Indonesia

Alliance activities contributed to the certification of a major timber concession in Kalimantan, as well as to the first Indonesian community-based certification.

#### *PT. Sumalindo Lestari Jaya II*

PT. Sumalindo Lestari Jaya II, a 270,000 ha natural forest concession located in East Kalimantan, received FSC and LEI certificates in early 2006. SLJ II is now the largest tract of FSC certified forest in the whole of SE Asia, and represents Indonesia's third natural forest concession to achieve FSC certification.

TNC's role in the process included providing training and support to SLJ II to identify and develop management prescriptions for High Conservation Value Forest, develop a biodiversity monitoring plan, train staff in biodiversity monitoring techniques, highlight the company's strengths and weaknesses against the UK-RI MoU legality standard, and strengthen the company's chain of custody system. TNC remains engaged with SLJ to support additional biodiversity monitoring as this is an ongoing requirement for FSC certification.

On achieving certification, SLJ II became the first forest participant in the Indonesia FTN. WWF is now supporting the company to establish trading relationships with buyers wishing to source certified wood products.

### *Supporting Indonesia's First LEI Community Forest Certification*

On October 18th, 2004, the Indonesian Ecolabelling Institute (LEI) granted its first sustainable community-based forest management certificates to two community groups managing teak forests in Wonogiri, Java with the support of WWF and local NGOs. These first certifications have allowed LEI to field test and refine its new community forest management standard. The certification covers an area of approximately 800 hectares of valuable teak and mahogany forest. Since July 2004, WWF has been collaborating with local NGOs, including ARuPA and Persepsi, to promote sustainable forest management and improve market access in Wonogiri through LEI's community-based forest certification system. These pioneering certifications demonstrate that communities can achieve certification, and the challenge going forward is to demonstrate that certification can help the communities achieve economic gains.

WWF initiated a second pilot project for testing community forest management certification in Gunung Kidul. A working group was formed to pursue the process of certification. WWF's NGO partner, ARUPA, plans to continue supporting the Working Group with the aim of achieving forest certification for two sub-villages (Blimbing and Mendak) within one year.

### 2.2.3 Promoting the understanding of forest certification and illegal logging issues

Public awareness activities of the Alliance included TV spots, talk shows, advertisements, posters, workshops, exhibits, handbooks, newsletters, two documentary films, and the promotion of investigative reports in national magazines and newspapers. Articles on the Alliance and its activities appeared in Business Week, Far Eastern Economic Review, The Wall Street Journal, The Jakarta Post, Tempo and The Economist.

WWF continued to improve and update **[www.forestandtradeasia.org](http://www.forestandtradeasia.org)**, a multi-lingual (English, Chinese, Japanese, Vietnamese and Indonesian) website that acts as an information clearing house on certification and responsible forestry in the Asia Pacific region. In 2006, the site has averaged over 50,000 hits per month.

## **2.3 Demonstrate Practical Solutions to Achieve Certification and Differentiate Legal and Illegal Wood Supplies**

There are many barriers to certification in Indonesia including, weak NGO support, weak government support, difficulty in tracking timber from source to market, and a lack of consensus on what it means to be legal. The Alliance has begun to address these issues head-on and in years two and three of its program has made important contributions to defining legality and developing technology to reliably track timber. During this work, the Alliance has made several important shifts in its approach in large part due to increased awareness of the issues and the development of political will to address them. For the legality definition, it became clear that there was a need to constructively engage stakeholders in the process to enhance their sense of ownership. Thus, after developing a draft legality standard, TNC handed the process of refinement to a steering committee comprising representatives of key stakeholder groups including: The Department of Forestry, forest business, Industry associations, environmental and social NGOs. In the work on timber tracking, a gradual increase in political will has led TNC to promote the adoption of a nationalized log tracking system - the benefits of which would far outweigh the more market-based system previously promoted.

Other practical solutions to achieve certification that the Alliance developed in this period include tools to identify and delineate High Conservation Value Forests (HCVF) and the development of a collaborative management model to ensure mutually beneficial management of forest resources between local communities and timber concessions.

### **2.3.1 Defining “Legal”**

One of the first steps in the Alliance’s stepwise approach is for the forest manager to establish it has a “legal right to harvest”. In Indonesia, erratic law enforcement, opaque administrative procedures, and ambiguities in statutory provisions, make it difficult to verify whether a company is operating legally. Thus verifying legality may be almost as difficult for a concession company as it is to achieve forest management certification. A legality standard can help resolve these issues by proposing clear and auditable criteria that can be verified by independent auditors when auditing legality or the legal requirement component of voluntary certification standards (e.g. FSC Principle 1).

A draft definition of legality was developed in conjunction with the UK-Indonesia MoU process through a participative multistakeholder process involving District, Provincial and Jakarta level stakeholders. Once a draft standard had been developed, TNC decided that the legality standard process would be better managed by a local organization, and the Indonesian Ecolabelling Institute (LEI) was nominated as the body to take the standard forward in the future. TNC transferred management of the standard to LEI in late 2005. LEI has since formed a technical working group, on which TNC sits, that aims to finalize the standard. A steering committee, chaired by the Secretary General of the Ministry of Forestry, was also established to oversee the development of the standard in the first half of 2006.

WWF completed an advanced draft of “Keep it Legal” – a practical guide to the forest products trade on how to ensure legal compliance within the supply chain. The manual describes the nature and magnitude of the illegal logging problem and the threat it poses to forests and the people and businesses that depend on them. It details a systematic approach to identifying and eliminating the risk of illegal wood entering a given supply chain, and explains the challenges involved in developing a clear, fair and realistic policy on legal compliance. WWF is developing an Indonesia Country Guide to complement the generic “Keep it Legal” manual. The Country Guide will include an explanatory note on the legality standard and guidance on how it can be used to support responsible purchasing.

### 2.3.2 Developing an Independent Legality Verification and Timber Tracking System

TNC consultants SGS/URS completed a timber tracking system to complement the legality standard. The system was successfully pilot tested at SLJ II’s concession. The pilot began with an audit of the seven principles of legality set out by the MoU Legality Standard and this was followed by tracking timber from stump to mill gate.

Since the initial testing of the log tracking system, the Department of Forestry has completed development of its own tracking system. Discussions initiated by TNC have resulted in a Letter of Agreement between MoF, TNC and TFT to field test a hybrid “log administration system” comprising the MoF and TNC systems, in addition to the testing of a standalone commercial traceability system called TracElite. Once the systems have been piloted, the MoF plans to roll out log tracking systems to all forest concessions nation-wide. The Minister of Forestry wants the system to be fully operational across the country by the end of 2007.

### 2.3.3 Supporting the Protection of High Conservation Value Forests

In Riau Province, WWF worked with the Jikalahari network to assist local groups in providing information on social and environmental values to APRIL (one of the two large pulp companies in Riau) for its analysis of high conservation values in the Kampar Peninsular and Tesso Nilo Park. WWF is also in an ongoing dialogue with several oil palm concessions in Riau over the creation of wildlife corridors and the maintenance of HCVPs within and around their plantations. WWF, in collaboration with the Indonesian Palm Oil Commission (IPOC), has worked intensively with a palm oil company to prevent further conversion of HCVP in the corridor.

In Papua, WWF continued to identify high conservation values upstream in the Bian-Kumbe-Marø catchments. WWF also supported local stakeholders to establish a forum intended to encourage communication amongst stakeholders on issues related to land-use and spatial planning.

In East Kalimantan, TNC continued its effort to protect areas of High Conservation Value Forest in Berau and East Kutai Districts, and following negotiations with local government, 90 percent of the HCVP area within Berau District was incorporated into the district government's proposed land use plan. TNC's ecoregional plan for East Kalimantan which identifies macro level areas of HCVP has also since been integrated into the East Kalimantan provincial plan, and used by the Department of Forestry's spatial planning unit (Badan Planologi) for verification purposes. TNC is also working with communities with customary ties to the forest and the East Kutai government to develop a collaborative management approach to maintain HCVP in a former timber concession containing a large orangutan population. TNC successfully lobbied the Department of Forestry, and the local and regional governments to excise the ex forest concession from the production forest estate. The area of land is now a locally protected area under collaborative management to prevent illegal logging and hunting activities.

#### ***Gaining Acceptance of Criteria for Sustainable Oil Palm Production***

In 2003, WWF in cooperation with business partners initiated the Roundtable for Sustainable Palm Oil. The RSPO is an independent non-profit organization focused on promoting sustainable palm oil and achieving a common definition of responsible palm oil production. Members include producers, buyers, retailers, financial institutions and NGOs. WWF participated actively in developing a set of criteria known as the "RSPO Principles and Criteria for Sustainable Palm Oil Production". The criteria, which were overwhelmingly accepted by the RSPO

in 2005, give companies much-needed guidelines to produce palm oil in an environmentally friendly and socially responsible way. The criteria recognize the importance of HCVE. Specifically criterion 7.3 states that “Primary forest and any area containing one or more High Conservation Values must not be converted to plantation”.

### 2.3.4 Supporting Collaborative Management in SLJ IV

TNC worked with five villages surrounding the SLJ IV concession area in East Kalimantan to support collaborative management. In October 2003, TNC set up a management body, consisting of representatives from the five villages, Berau district government, SLJ IV, the Chief of the Berau Dayak Group, and TNC. The management body received training from TNC in village mapping techniques, communication, proposal writing, integrated farming, and community forest management. On June 1, 2004, an MoU was signed to develop a collaborative community forest management model between SLJ IV, TNC and the communities of the five villages. The agreement will increase community participation in planning, implementing, and monitoring forest management so that both the company and communities can derive benefits from the forest.

## 2.4 Reducing Financing and Investment in Companies Engaged in Destructive or Illegal Logging in Indonesia

### 2.4.1 Working with banks to improve environmental and social risk assessment

In April 2005, WWF convened a meeting in Jakarta with various banks and other stakeholders to explore their interest in developing a workable approach to bank risk assessment in the timber and plantation sectors in Indonesia. WWF and participating banks agreed to share information to identify target banks and strategies for getting them involved in such an initiative. WWF is currently working with several banks to develop a “handbook” to assist credit risk officers to screen for environmental and social risk in oil palm projects in Indonesia.

WWF also conducted meetings with Bank Indonesia, the Ministry of the Environment and relevant conservation and environmental NGOs with the aim of encouraging Bank Indonesia to strengthen the requirements for Indonesian banks to screen investments for environmental risk and impact. In a related initiative,

WWF supported the efforts of the Ministry of the Environment and KFW (a German aid agency) to build the capacity of small to medium sized enterprises to effectively address social and environmental issues in loan proposals, and to create soft loan incentives for them to do so. In January 2005, Bank Indonesia issued a new regulation on how Indonesian banks should rate the quality of their loans. The regulation lists “measures taken by the debtor to conserve the environment” as one of the factors that need to be taken into account by the bank. The regulation is a crucial first step in encouraging Indonesian financial institutions to act in a sustainable and socially responsible way.

#### 2.4.2 Influencing Asia Pulp and Paper’s creditors

In August 2003, WWF, APP (Asia Pulp and Paper Company Ltd) and the Sinar Mas Group (SMG) signed a Letter of Intent (LoI) under which APP and SMG agreed, among other things, that, before forests are converted to *Acacia* plantations, HCVF assessments should take place to:

- Identify and conserve HCVFs
- Fully comply with national laws, and
- Resolve land disputes with communities.

In February 2004, APP completed a Sustainability Action Plan (SAP), which, according to WWF, fell short of what was agreed in the LoI on several counts. As a result of these shortfalls in the plan and other concerns, WWF did not renew the LoI, which expired on February 19<sup>th</sup> 2004. However, WWF remains in contact with APP’s customers and creditors who continue to maintain pressure on APP to produce a stronger Sustainability Action Plan.

In June 2004, WWF Indonesia published two reports on APP’s involvement in illegal logging. These reports were designed to inform APP’s customers and investors about the nature of its operations and to put pressure on APP to make fundamental changes in its purchasing decisions. Major creditors of APP negotiated a confidential agreement on environmental covenants that will become an integral part of the Master Restructuring Agreements between APP and its creditors. The creditors also recognized the need for a further round of conservation assessment of the areas supplying fiber to APP. As a result, APP engaged SmartWood, an independent, nonprofit, forestry certifier, to identify high conservation value forests in areas supplying its pulpwood and to recommend appropriate conservation management systems.

### **3. Lessons on Linking Demand for Sustainable Timber Products to Supply from Indonesia**

#### **3.1 Demand for Sustainable Timber Products in Markets Where the Alliance is Active**

Trade initiatives relating to environmental concerns are receiving a new impetus with growing global interest in governance issues. Over the past decade, international development agencies have increasingly recognized the importance of good governance in target countries, and this interest is reflected in various initiatives that have a direct bearing on the tropical timber trade. The relevant forestry issues include illegal logging and the trade in illegally sourced wood products. These topics are generally discussed under the heading of Forest Law Enforcement and Governance (FLEG), and today inform the agendas of major environmental NGOs, of national and sub-national governments, and of forest industry participants. These actors are promoting mechanisms to curb the trade in illegally sourced timber products, and such mechanisms include legal procurement programs by public and private buyers, and trade regulations.

The following sections look at the demand for sustainable timber products from Indonesia in the markets where the Alliance has been mainly active. These markets are the European Union, the USA, Japan and China. The European and North American markets are generally viewed as being ‘environmentally sensitive’ but remain substantial importers of Indonesian timber products, and much of this trade is likely to come from unsustainable sources. Ongoing policy changes in these markets are likely to curtail this trade significantly in the future. The Japanese and Chinese markets are generally viewed as less concerned about sustainability of their timber imports, but promising developments, which are in part assisted by Alliance efforts, are beginning to take shape in these markets as well.

### 3.1.1 The European Union

The EU is generally considered to be a market where concerns relating to the environment run high. In major consuming countries within the EU, such as the UK, Germany, and the Netherlands, large environmental NGOs such as WWF and Greenpeace influence corporate behavior. In addition, environmental issues command substantial political space, at the national and sub-national government levels of individual member countries and at the EU regional level. These factors have manifested themselves in various trade related initiatives that seek to limit the use of illegally or unsustainably sourced wood products. Various governmental institutions and private sector buyers in the EU region are promoting procurement policies that seek to prevent the purchase of wood products from suspicious sources. These national and sub-national efforts are being complemented by various EU wide initiatives under the umbrella of the EC Action Plan on Forest Law Enforcement and Trade (FLEGT).

Many influential commercial buyers of Indonesian wood products in the EU have put in place processes that aim to reduce or eliminate the use of timber from illegal or unsustainable sources. Largely in response to pressure from environmental NGOs, buyers are reassessing their timber supply chains and implementing procurement policies to reduce the risk of damaging their corporate image.

For some companies this has led to a termination of trade in timber coming from high-risk countries such as Indonesia. For example, following a Greenpeace campaign in 2004, four large buyers of Indonesian timber products in the UK stopped sourcing timber from Indonesia.<sup>4</sup> B&Q, the large UK DIY retailer, now buys most of its plywood from FSC certified sources in Brazil,<sup>5</sup> and Travis Perkins, a major UK buyer of tropical timber, switched from Indonesian timber to verified legal timber from Ghana. Other companies based in the EU are working closely with NGOs such as WWF to find legal or sustainable sources of Indonesian timber.

WWF-sponsored “buyer groups”, or Forest and Trade Networks (FTNs), exist throughout the EU and include DIY stores, supermarkets, home furnishing outlets, wood product manufacturers, timber importers and traders, house

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<sup>4</sup> RIIA 2004.

<sup>5</sup> Steve Crewe, personal communication.

builders, and construction and civil engineering concerns that are committed to purchasing and selling timber products made from sustainably produced timber. In June 2006 WWF's European FTNs comprised approximately 180 members. Some members have stopped importing Indonesian wood products,<sup>6</sup> while others are actively seeking legal supplies of Indonesian timber with the support of the Indonesian FTN.

TNC, as part of its Alliance activities, visited several European private sector organizations involved in the tropical timber trade. These included importers of Indonesian timber in the UK and the Netherlands and the timber trade federations of the UK, France and Belgium. These federations, along with the Dutch, are involved in a five-year project to identify legal timber from Indonesia, Malaysia, Cameroon and Gabon and track it to market in their countries. Companies which were visited included Finnforest UK (which has suspended all purchases from Indonesia, pending a credible system to verify legality) and FETIM, Dekker Hout and Jongeneel in the Netherlands. In the UK the Alliance also maintains contact with Kingfisher, the supplier to the B&Q DIY chain.

Several national, municipal, and provincial governments in the EU are in various stages of developing procurement policies that could have an impact on the import of Indonesian timber products. The public sector is a major timber market segment in the EU, and approximately 20 percent of the total timber demand in Europe goes through governmental institutions. National level procurement policies that aim to ensure that only legal and sustainable timber is used, are being developed in the UK, the Netherlands, France, Germany, and Denmark.<sup>7</sup> For example, in August 2005, Germany presented a draft law that would oblige German timber companies to certify that the timber they import was legally sourced. The law would outlaw import or marketing of wood sourced illegally in non-EU countries.

In October 2002, the UK government launched a FLEG program – known also as the Illegal Logging Program. This is aimed at facilitating reforms by national, regional and international institutions to address the problem of illegal logging and international trade in illegally harvested timber. The program aims to contribute to a better understanding of the causes of illegal logging and to secure cooperation between a wide range of actors in developing and implementing solutions. As part

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<sup>6</sup> Steve Crewe, personal communication.

<sup>7</sup> RIIA 2004.

of the UK FLEG program, the UK and the GoI signed an MoU on illegal logging which committed the Governments of the UK and Indonesia to:

*Work together to reduce, and eventually eliminate, illegal logging and the international trade in illegally logged timber and wood products between [Indonesia and the UK], by rapid development and implementation of the necessary regulatory and policy reforms.*

The UK FLEG program has worked closely with The Nature Conservancy and the GoI to develop a definition of legal wood for Indonesia (see Section 4).

***EU Action Plan on Forest Law Enforcement, Governance and Trade***

In May 2003, the European Commission launched the EU Action Plan on Forest Law Enforcement, Governance and Trade (FLEGT). This marked the beginning of a long process by which the EU aims to develop and implement measures to address illegal logging and related trade. The measures set out by the FLEGT Action plan include:

- support for improved governance and capacity building in timber-producing countries;
- development of Voluntary Partnership Agreements with timber-producing countries to prevent illegally produced timber from entering the EU;
- efforts to reduce the EU's consumption of illegally harvested timber and discourage investments by EU institutions that may encourage illegal logging.<sup>8</sup>

The most prominent of these measures is a proposed licensing system for legal timber that is based on Voluntary Partnership Agreements (VPAs) with producer countries. Under these agreements, timber exported to the EU from participating producer countries would be identified as legal by means of licenses issued by the exporting countries. The scheme would initially cover sawnwood, roundwood, plywood and veneer, with more value-added wood products to be included at a later stage. The scheme would be implemented on a voluntary (but binding) basis, with timber exporting countries that have entered into a VPA with the EU.

In addition to the proposed licensing scheme, a review of existing national legislation and additional legislative options for the national and EU levels are being considered under the FLEGT initiative. These options include anti-money

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<sup>8</sup> FLEGT Briefing Notes, <http://europa.eu.int>

laundering legislation, criminal legislation such as laws addressing the transport and sale of stolen goods, and the possibility of a prohibition on the import of illegally produced timber into the EU.<sup>9</sup>

### 3.1.2 The USA

The USA has various private and public sector initiatives relating to concerns about deforestation that could have an impact on imports of Indonesian wood products. On the private sector side, several large importers of Indonesian wood products are responding to pressure from environmental NGOs and are reevaluating their timber supply chains. For example, International Paper, the global forest products leader, endorses a moratorium on purchasing Indonesian timber “until the Indonesian government...and those companies who harvest wood there take the steps required to protect the forests and return to sustainable forest practices.” Home Depot, the world’s largest home improvement retailer recently reduced purchases of Indonesian plywood by 70 percent from 1999 levels. Centex Homes, a major US homebuilder has stopped using Indonesian hardwoods.<sup>10</sup>

Several state and municipal procurement initiatives place restrictions on the use of tropical wood products in public projects. Several US municipalities have enacted bills or ordinances that ban or restrict the municipal purchase of tropical timber.<sup>11</sup>

A US President’s Initiative against Illegal Logging aims to assist developing countries combat illegal logging and its associated trade and to reduce corruption in the forest sector. The President’s Initiative facilitates partnerships under USAID’s Sustainable Forest Products Global Alliance to develop legally sourced forest products. One of these partnerships is the WWF/TNC Alliance to Promote Certification and Combat Illegal Logging in Indonesia. Further actions relevant to Indonesia will include:

- Community-based forest management and protection;
- Promoting governance, transparency and accountability in the forest sector;
- Addressing illegal logging threatening orangutan habitat;

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<sup>9</sup> FLEGT Briefing Notes, <http://europa.eu.int>

<sup>10</sup> [http://www.ran.org/ran\\_campaigns/old\\_growth/indonesia/](http://www.ran.org/ran_campaigns/old_growth/indonesia/)

<sup>11</sup> ITTO 1999.

- Follow-up to the East Asia Ministerial Conference on Forest Law Enforcement and Governance.<sup>12</sup>

### 3.1.3 Japan

Environmental awareness in Japan is reportedly lower than in Western Europe and the USA, but several processes indicate that the Japanese market is becoming more sensitized to issues of sustainability. According to the ITTO there is a nascent “Green Movement” of local level NGOs, which has been spawned by media coverage of the depletion of tropical forest resources.<sup>13</sup> Importantly, after the first Japanese company received an FSC Forest Management (FM) certificate in 2000, certification has made rapid progress in Japan. At the beginning of 2006, there were 24 companies with FSC FM Certificates and the number of FSC Chain of Custody Certificates in Japan had reached 288, the fifth highest in the world.<sup>14</sup> Several major companies in Japan including Canon Group, Nippon Paper Group, Fuji Xerox, Ricoh, ASKUL, Oji Paper, and Mitsubishi Paper Mill have established responsible purchasing policies for paper. WWF assisted Ricoh, ASKUL (a leading supplier of stationery and office supplies in Japan) in drafting their responsible paper purchasing policies. Ricoh stopped buying from their Indonesian supplier because it did not meet Ricoh’s standards. ASKUL is a major buyer from APP and has shifted to plantation grown fiber. Mitsubishi Paper Mill and Fuji Xerox are members of WWF’s Japan FTN.

In 2003, the governments of Japan and Indonesia made a Joint Announcement on the Cooperation in Combating Illegal Logging and the Trade in Illegally Logged Timber and Wood Products. The accompanying Action Plan details ways to develop, test, and implement systems for verification of legal compliance, and the effective collaboration of enforcement agencies and networks which will affect the legality of products produced and traded. However, implementation of actions related to the agreement has reportedly been slow.<sup>15</sup>

Japan is preparing a wood products procurement policy for domestic and imported materials based on an amendment of the Basic Plan of the Law Concerning the Promotion of Procurement of Eco-Friendly Goods and Services by the State and Other Entities (Law on Promoting Green Purchasing). As part of this process,

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<sup>12</sup> <http://www.whitehouse.gov/infocus/illegal-logging/piaail.html>

<sup>13</sup> ITTO 1999.

<sup>14</sup> <http://www.certified-forests.org/data/coc3.htm>

<sup>15</sup> RIIA 2004.

Japan's Forest Agency has published a "Guideline for Verification on Legality and Sustainability of Wood and Wood Products."<sup>16</sup> The Basic Plan proposes that wood sourced from natural forests should be "legally harvested or produced in forests under sustainable forest management," and applies to the use of wood in paper, office and home furniture, and construction materials. The Guideline proposes that proof of legality and sustainability can be provided by one of three types of institutions:

- A forest management certification body,
- An institution accredited by a forestry or timber industry association, or
- Companies themselves (self declaration).<sup>17</sup>

### 3.1.4 China

Imports of wood to China have been rising sharply and are likely to continue to grow as domestic timber production is outpaced by demand for domestic use and for export. Over-exploitation of natural forests in many regions has depleted standing timber volumes, and logging bans and restrictions limit production in regions that are still rich in timber resources. By contrast, domestic consumption is increasing in line with China's economic growth and rising living standards.<sup>18</sup> Also, exports of value-added timber products have been growing significantly.

The Chinese market plays a major role in the potential of market-based initiatives to improve forest management in Indonesia. However, Chinese buyers have been slow to implement responsible purchasing programs, and China is probably a major destination for illegally traded wood from Indonesia. As European and North American markets become more selective, there is a danger that Indonesian producers that now supply these markets will shift their sales to China, thereby avoiding having to comply with more stringent environmental requirements. However, several factors provide hope that the Chinese market may become more environmentally sensitive in the future.

Market links to Europe and the USA are gradually driving forward forest certification in China. Government agencies, academics and forestry experts in China are working to develop national certification standards and systems that will satisfy the demand of the international market. This process is actively supported by several international organizations such as the World Bank/WWF

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<sup>16</sup> <http://www.rinya.maff.go.jp/policy2/ihou/eiyaku.pdf>

<sup>17</sup> <http://www.forestandtradeasia.org/posting/japan/english/498/>

<sup>18</sup> Chunquan et al. 2004.

Alliance which has worked to strengthen Chinese forest certification capability through trainings and seminars.

As of June 2006, four forest management units held FSC forest management certificates and 150 companies held FSC CoC certificates. WWF's China FTN which was launched in March 2005 already has five companies from mainland China and three companies from Hong Kong that have qualified as its first official members. The companies include two of China's largest state-owned forest bureaus, three major private manufacturing companies based in mainland China, and three trading companies located in Hong Kong.

So far the drive for certification in China has come from demand for sustainable timber in China's export markets. In 2002 all the companies in China with FSC CoC certification were furniture exporters.<sup>19</sup> Also, all the China FTN members with links to Indonesia have exposure to European and North American markets. Kingfisher for example is a trader that purchases timber products for B&Q UK. Yingbin, which is working with WWF to identify legal timber sources in Indonesia, also has market links to North America and Europe.

In December 2002, China and Indonesia signed an MoU on illegal logging. The MoU recognizes the significant roles and responsibilities of both countries in combating illegal logging and the trade of illegally harvested forest products. So far progress related to the MoU has been slow predominantly because the MoU was made with the Chinese State Forest Administration responsible for domestic forestry issues, rather than with the China Customs Agency, responsible for the screening of imported goods. Nevertheless during the recent Business Leadership Meeting on Illegal Logging in Hong Kong, Indonesian and Chinese officials held an informal side meeting where they, for the first time, progressed to the point of agreeing on next joint steps. TNC has subsequently taken the initiative to facilitate an informal visit by the SFA to Indonesia in late 2006, which will be followed up with a joint conference on illegal logging due to be hosted in Beijing in 2007.

China's impact on Indonesia's forest may depend to a large extent on the size of the portion of China's imports of Indonesian timber that is re-exported to markets with more stringent environmental requirements. The USA, Japan and Hong Kong are the dominant importers of Chinese timber based products with the

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<sup>19</sup> Wenming et al 2002.

EU playing an increasingly important role. Exports to the USA and EU member countries have increased substantially since 1997.<sup>20</sup> Since the most profitable use of Indonesian meranti logs in China is probably for products that are slated for international markets, it is likely that a substantial portion of Indonesian timber that reaches China, both legally and illegally, is re-exported.

### 3.2 Lessons on the Nature of Demand for Sustainable Timber Products from Indonesia

**Market demand for certified and legal forest products is driven by multiple factors including purchasing policies of corporations and regulatory policies of importing governments.** Over the course of the Alliance's activities governmental processes have taken an increasingly important role in shaping the demand for sustainable forest products from Indonesia and the Alliance has responded by working closely with governments in various importing countries. These processes have the potential to impact demand both directly and indirectly:

- Direct impacts are through public procurement policies which affect timber used in public construction projects. For many countries this represents a large portion of imports of Indonesian timber products. Public procurement policies requiring the use of legal or sustainable wood in public construction contracts are causing contracting companies to source legal and sustainable wood materials. The governments of the UK, Netherlands and Belgium have strict legality and sustainability requirements for timber products used in all their contracts. Such public procurement initiatives already affect a large portion of the market for Indonesian timber and are likely to expand.
- Indirect impacts are through regulations that restrict trade in illegally sourced timber products. Such regulations affect private and public buyers equally.

**Buyers looking for timber that can be proven to be legal or sustainable can either switch to timber suppliers that are perceived as being less risky, or place pressure on their current suppliers to pursue certification or legality verification.** Several European and North American companies have chosen to switch away from Indonesian wood altogether as a result of domestic NGO pressure. Since most Indonesian wood products can easily be replaced by timber from other countries, many companies are able to maintain their environmental

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<sup>20</sup> White et al 2006.

reputations by simply switching to suppliers in less controversial countries. For example, following Perhutani's FSC suspension, several German retailers switched to furniture made from FSC certified Eucalyptus from Latin America. Also, after a Greenpeace campaign in 2004, four large buyers of Indonesian timber products in the UK stopped sourcing timber from Indonesia.<sup>21</sup> B&Q now buys most of its plywood from FSC certified sources in Brazil, and Travis Perkins, a major UK buyer of tropical timber, switched from Indonesian timber to verified legal timber from Ghana.<sup>22</sup>

Some companies however choose to engage Indonesian suppliers. WWF and The Tropical Forest Trust (TFT) have been helping companies with market links to Indonesian manufacturers to encourage their raw material sources to achieve FSC certification. For example, WWF has worked closely with BlueLinx and Lowe's Companies in the USA to identify concessionaires in Indonesia that are well positioned to progress towards FSC certification, while TFT actively links its Indonesian supplying members with its producing members.

### 3.3 Linking Demand to Supply

#### 3.3.1 Transmission of Market Signals to Forest Management Enterprises

One of the greatest impediments to the transmission of market signals to the forest manager can be attributed to the nature of the wood trade itself which is typically opaque and involves a large number of middlemen and intermediaries. The layered structure of the timber trade makes it difficult for companies to know whether their supplies are coming from legal sources, and this has obvious implications for retailers that are concerned about the legality and sustainability of their sources.

Businesses, whether log traders, sawmills, secondary industries, agents or finished product traders, all aggressively guard their upstream supply chain information out of fear of being cut out of the market. This makes it difficult for buyers to transmit their market requirements directly to source Forest Management Enterprises (FMEs) and as a direct result the great majority of market signals are placed on the manufacturer. Manufacturers are therefore the critical link in the

<sup>21</sup> RIIA 2004.

<sup>22</sup> Steve Crewe, personal communication.

supply chain as they are able to control the use of wood in their products and deliver market signals from buyers to their raw material suppliers.

Given that many Indonesian FMEs operate independently from downstream manufacturers there is often insufficient incentive for FMEs to comply with market demand. Even where manufacturers are vertically integrated, the FME will often seek out the highest bidder rather than sell exclusively to its associated industry. FMEs are unlikely to invest in certification unless manufacturers give them direct incentives for doing so.

Furthermore there are often numerous links in the wood supply chain separating the manufacturer from the final retailer. For example, the most common trade channels for the international plywood trade are:

- direct contract sales to overseas customers, often through sales offices or agents: this is the common form of trade for sales to continental Europe;
- sales to traders, predominantly based in Singapore and Hong Kong; and
- sales to representatives of overseas companies who are buying directly at origin.<sup>23</sup>

In the UK, unlike the rest of Europe, timber agents play a central role in the timber import trade. The agents take orders from manufacturers and retailers and seek out timber suppliers that can provide timber at the right specifications. Until the 1980s, agents imported most of the UK's tropical timber, but then a number of large manufacturers began to import directly from their own overseas sources.<sup>24</sup>

In Japan, trading houses or Sogo Soshas play a central role in the distribution of tropical timber. The Sogo Soshas buy approximately 70 percent of domestic and imported panels. They tend to have a global reach and dominate the entire export and import industry. Several Sogo Soshas are vertically integrated into all aspects of the tropical timber trade.<sup>25</sup> Subsidiaries of Marbeni, Itochu, Sumitomo Corporation, Sumitomo Forestry, and Sojitzu are involved in the import of Indonesian plywood.<sup>26</sup> They buy plywood for on-sale to wholesalers who resell

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<sup>23</sup> ITTO 2003.

<sup>24</sup> Gale 1998.

<sup>25</sup> Cashore et al 2004.

<sup>26</sup> Mutai Hashimoto, personal communication.

approximately 95 percent of this to other wholesalers for secondary processing and redistribution.<sup>27</sup>

Following the dissolution of the Indonesian Plywood Association's (APKINDO) marketing network in 1998, plywood mills have had to find their own market outlets and the importance of direct marketing and of traders has grown substantially. Sales to traders probably account for at least a quarter of Indonesia's plywood exports. Sales to the Middle East mostly go through traders in Singapore, sales to China sometimes go through traders based in Hong Kong, and sales to the USA sometimes go through Japanese trading houses. Some end-users, such as large construction firms and large furniture manufacturers in Japan and Europe, are increasingly making an effort to create more direct market linkages to producers and to bypass the traditional importing firms.<sup>28</sup>

As a result of non-transparent supply chain many importers are reassessing their sources of timber and are attempting to bridge the information gap between themselves and the forest. In Indonesia, this has meant that companies have worked with organizations including WWF's Forest and Trade Network (FTN), the Tropical Forest Foundation (TFF), and the Tropical Forest Trust (TFT) to identify sources of legal and sustainable timber.

### 3.3.2 Incentives for Indonesian Manufacturers

Due to the presence of cheap substitutes for the bulk of Indonesian wood products, it is likely that most of the additional costs of legal and sustainable timber management will have to be borne by FMEs often supported by manufacturers and other downstream businesses in the supply chain. According to the ITTO, "the market where tropical hardwood is irreplaceable and unique is exceedingly small, and therefore product prices have to be set at levels appropriate to the competition from other products, not just other tropical producers."<sup>29</sup> With substitutes, such as engineered wood products and non wood products such as plastics and metals, becoming increasingly prevalent, the market is unlikely to absorb any significant price increase.

An incentive for Indonesian manufacturers to invest in sustainable forest management is that this may allow them to secure or maintain access to high-

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<sup>27</sup> ITTO 2005.

<sup>28</sup> ITTO 2003.

<sup>29</sup> ITTO 1999.

margin stable markets that offer good terms of trade. There is evidence that European and Japanese markets are important to some Indonesian timber products exporters. In April 2004, the European Union put into effect a requirement for all structural plywood to adhere to EU strength and safety rules (“CE marking”), and according to APKINDO, a significant number of the Indonesian plywood mills were willing to become compliant with the new requirements in order to maintain market access to the EU.<sup>30</sup> Also the fact that some of the major concessions have been making efforts to become certified indicates that there are perceived benefits to continued market access. There is also some anecdotal evidence that China is not seen as an attractive market, due to lower prices and less congenial business practices than Europe or Japan.

Continued access to European and North American markets is important for Indonesian producers because finding new markets can involve significant costs. Indonesian producers tend to value long term business relationships for two reasons. Firstly, Indonesian business transactions tend to rely heavily on personal relationships which take time to develop. Secondly, the value of such relationships is likely to increase over time as manufacturers adapt their processing technologies to meet the specific needs of buyers, allowing them to produce higher value-added products.

Another potential financial benefit for producers of complying with environmental market requirements is that this may shorten the supply chain that leads to end markets. Work by WWF’s GFTN has demonstrated that European and North American buyers of Indonesian wood products often face extremely complex supply chains and are often unaware of the source of the wood that they purchase. Environmentally sensitive buyers are increasingly recognizing the need to take charge over their supply chains in order to avoid the risk of illegal wood or wood of dubious origin from entering their supply chain. In many instances, buyers are trying to establish direct contact with FMEs in Indonesia that have the potential to produce legal verified or FSC certified wood. For manufacturers this means potentially greater profits, as they are able to capture revenue that is currently absorbed by transaction costs and by intermediaries in the supply chain. This is of particular relevance to small scale FMEs that otherwise do not have direct access to foreign markets.

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<sup>30</sup> APKINDO, personal communication.

### ***The Incentive of Direct Market Links: Community Teak Plantations***

For small scale teak producers, the possibility of direct market access is probably the largest incentive for certification. Small scale producers tend to manage teak plots that are usually between one and ten hectares giving them little market power on an individual basis and placing them at the mercy of middlemen who tend to absorb most of the profit. WWF and its partners are developing market links between the communities at Wonogiri, that produce certified teak, and a Dutch buyer, which has expressed strong interest in a long term partnership with the two communities. Reportedly Wonogiri should be able to attain a price that is more than double the price they received before they were awarded forest management certificates.

Under a similar scheme supported by TFT in South Sulawesi, teak wood from FSC certified forests managed by a community cooperative will be sold directly to TFT manufacturing members in Indonesia who helped finance the project.<sup>31</sup>

### ***Incentives for PT Sumalindo Lestari Jaya to Pursue Certification***

PT Sumalindo Lestari Jaya (SLJ) is an integrated plywood and mixed density fiberboard (MDF) producer based in East Kalimantan. SLJ's Unit II concession (SLJ II) became FSC-LEI certified in January 2006. The concession is located in the West Kutai and Malinau districts of East Kalimantan and encompasses 269,660 ha. In February 2006, SLJII became the first concession company to join WWF's Indonesia FTN, Nusa Hijau.

According to Sumalindo, the company had several reasons for pursuing certification. As a public company Sumalindo is required to operate at a high level of transparency and access to global financial markets increasingly requires transparent and legal business practices. Also, SLJ's stock value and borrowing capacity depends on its future ability to turn a profit, which largely depends on having a sustainable supply of timber which SFM can provide. Sumalindo competes with four other public companies involved in the forestry sector in Indonesia and its strategy is to become a global company with brand recognition. This partly explains why Sumalindo is trying to take the lead in sustainability initiatives. An unexpected potential benefit of certification for Sumalindo could be the possibility of selling certified timber to furniture companies. Sumalindo

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<sup>31</sup> FSC Press Release, Geneva, May 24th 2005. <http://www.tropicalforesttrust.com>

has been approached by furniture companies that are exploring the possibility of using lesser known species as alternatives to certified teak.

Sumalindo's certification has raised significant interest from several major UK plywood importers that see this as validation for staying engaged in the Indonesian timber sector. These companies have expressed a desire to keep purchasing from Sumalindo in the future.<sup>32</sup>

### 3.4 Lessons on the Supply of Sustainable Timber Products from Indonesia

**Companies in Indonesia are less likely to respond to demand from buyers that they are not trading with since there are significant costs and risks related to switching markets and the benefits are not always clear.** Even if buyers were offering significantly higher prices, manufacturers would not be able to respond easily. WWF and TNC have learnt that most plywood producers, including Sumalindo, have existing long-term relationships with buyers which they do not want to jeopardize. Thus, the cost of creating new market links gives buyers with existing business relationships leverage over their suppliers. This suggests that market based approaches to conservation are more likely to be successful if buyers continue to engage rather than boycott Indonesian wood products.

Several members of WWF's GFTN have suspended their purchases of Indonesian timber and it is likely that this impedes Nusa Hijau's ability to promote certification. The Alliance has responded by encouraging companies with existing business relationships in Indonesia to stay engaged. For example, WWF, through the GFTN, has supported companies like BlueLinx and Lowe's Companies in working with existing suppliers. In addition, TNC has worked closely with timber trade federations in Europe to encourage them to stay engaged in Indonesia. The Alliance's stepwise approach to certification, which includes legality verification, is a key component of a strategy that seeks to overcome the current challenges of certification in Indonesia, while allowing environmentally sensitive buyers to support progress.

Another attribute, apart from price and time-frame that manufacturers are likely to look for in a market link is the product range that the relationship covers. Since mills often operate below capacity due to raw material shortages, they need

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<sup>32</sup> George White, personal communication.

to maximize the profit on each cubic meter of log. This means that mills need a market for second and third quality products, and will prefer buyers that are less specific in their demands. Thus a factor that has probably limited the response to market enquiries provided by WWF's GFTN is that these tend to be for a narrow range of specifications. While such enquiries are appropriate for the wholesalers and timber brokers that European and North American buyers traditionally deal with, they may not be appropriate for a plywood mill that is seeking to unload all of its production.

**Buyer preferences for legal and sustainable timber are often “lost in translation” from the consumer end of the supply chain through intermediaries to the source FME.** As discussed above in Section 3.2, and 3.1.1 the layered structure of the timber trade makes it difficult for companies to know whether their raw materials are coming from legal and sustainable sources.

WWF recommends that buyers ask their suppliers to provide verifiable information on the source of the timber in their products. If the suppliers want to avoid misinforming their buyers they then need to enquire further into their own supply chains. In theory, this should result in traceability of products back to their forest sources as each successive link in the supply chain asks similar questions about the source of the wood, and whether it comes from a well-managed or legal forest source. However, in practice, intermediary traders often inhibit the flow of information for fear of disclosing sources to their competitors, or of giving too much information to their customers at the risk of being cut out of the supply chain. The result is that specification related to responsible sourcing at the end of a supply chain, are often not accurately communicated to those at the start of the chain.

Companies wanting genuine transparency in their supply chains thus tend to seek greater vertical integration to reduce the number of links through which their wood source queries must pass. If this trend continues, timber agents face the risk of being squeezed out, or perhaps reinventing themselves as “responsible wood sourcing” agents.

**Weak forest governance acts as a deterrent to investments in sustainable forest management in Indonesia.** In most concessions there is a large gap between current forestry practices and those that would be acceptable under the LEI or FSC certification scheme. Unlike forestry in Europe and North America where

SFM certification is closer to the industry norm, common Indonesian forestry practices are rarely sustainable and often illegal. Therefore, significant change in operational practice is required to achieve certification in Indonesia which in turn requires significant time and capital investments.

Widespread illegal logging also has other important implications for the success of certification. The availability of timber which was logged without payment of the appropriate royalties and taxes drives down the market prices of timber and this discourages long term investments in forests and forest management. Also uncontrollable illegal logging on a timber concession can preclude that concession from becoming certified. This can be a problem when outside loggers, or communities are involved in illegal logging.

Another governance issue that impedes the progress of certification is an uncertain business climate in the forestry sector. After Soeharto's fall from power, forest sector governance was marked by dramatic shifts from centralized to decentralized and back to centralized control. The sector is still adjusting, and timber companies complain about a lack of transparency and predictability of current forestry policies. For example, in the 'soft landing policy' the MoF decreed an annual allowable cut for Indonesia which was so low that it exacerbated the existing shortage of legal raw material. Companies that TNC worked with faced problems having their cutting permits renewed for reasons that were reportedly not clear. For example PT Daisy Timber had to withdraw from the timber tracking system pilot test because of the delay in approval of its annual management plan by the Provincial Forest Service.

Thus major incentives for pursuing certification in Indonesia may be the easement of logging quotas and other assistance provided by the MoF for companies pursuing certification. The Alliance recognizes the importance of government support for certification and WWF's Nusa Hijau hopes to facilitate lobbying for government incentives for its members. In this regard TNC, WWF and the International Finance Corporation recently supported a study on the role that government incentives can play in promoting certification. The study identified a range of possible incentives which the Alliance is promoting to the MoF.

## 4. Lessons on Promoting Verifiably Legal Timber

### 4.1 Defining “Legal Wood”

Some importers of Indonesian timber are insisting on legality because they see this as a step towards sustainably sourced timber, rather than as an end to itself. For several large private sector market participants, the motivation for seeking legal supplies of timber stems largely from the prospect of targeted NGO campaigns against them and/or their clients. These companies are therefore principally concerned about broad NGO consensus on the legality standards that they adopt. A major effort to design a standard that has the consensus of Indonesian stakeholders was undertaken by TNC in coordination with the UK-RI MoU process to combating illegal logging.

According to community activist stakeholders, legal wood from Indonesia hardly exists. This is because the laws that were designed to protect the rights of forest dwelling communities were disregarded when concessions were granted to timber companies. Most of Indonesia’s forestland is populated, and most timber concessions enclose communities which have traditional, or *adat*, claims to the forest. ICRAF and WALHI have shown that few, if any, concessions were established according to the requirements set out by existing laws. Specifically, provisions that relate to the delineation of the forest estate and concessions, and which involve community consultation were rarely followed to the letter. In fact, it is estimated that only 10 percent of the state forest zone has been properly delineated by the MoF, making logging on the other 90 percent technically illegal. The percentage of properly gazetted concessions within the State Forest Zone is even lower.

According to others, a focus on the legality of timber from Indonesia is counterproductive. They are concerned that verified legal timber would be broadly accepted as the equivalent of sustainable timber. They cite research that shows the Indonesian selective cutting system (TPTI) is inadequate for protecting the environmental services of the forest. They also argue that from a social

standpoint, accepting the legality of timber that is logged according to current rules and regulations, means endorsing a legal framework that has marginalized forest-dwelling communities, and that may have contributed to abuses of human rights. Furthermore the laws are undergoing a reform process that began after the fall of Soeharto. Fortunately the provisions made within the governance structure of the legality standard support a dynamic process and actively encourage the standard to be maintained in line with legal reforms.

#### 4.1.1 The UK-RI MoU Legality Standard

Forest certification, as promoted by FSC and others, seeks to provide consumers with information principally about sustainability, but also regarding the legal compliance of the forest management enterprise. Over the past years there has been a considerable effort by TNC, in collaboration with DfID, to design a consensual legality standard for Indonesia, as well as a workable timber tracking and verification system.

The UK-RI MoU to combat illegal logging, signed in April 2002, was complemented by an Action Plan which placed the task of defining illegal logging at the top of the MoU's agenda. The first and third items (A1 and A3) on the MoU Action Plan relate directly to the definition of illegal logging:

- *Adopt working definition of legal logging.*
- *Review of forest and forest-related legislation, including decentralization regulations; customary laws; constitution; forest law, rules, regulations, decrees; trade and transport regulations.*

As a result, UK DfID hired a team of consultants to carry out a review of applicable laws in Indonesia, and later worked closely with TNC to develop a legality standard and log tracking system for Indonesia. TNC with a team of URS/SGS consultants carried out multi-stakeholder consultations involving interviews, questionnaires and a series of workshops at district, provincial, and national levels. Participants at these consultations included representatives of district, provincial and national level governments, forest concessionaires, and local communities living within or close to forest areas, as well as NGO representatives, community organizations, academics and forest observers, and international agencies. Following these consultations, the URS/SGS team delivered a draft report on the legality definition to TNC in November 2003. The legality definition was later reworded into 7 principles each comprising criteria and indicators as detailed in Box 1.

**Box 1. Principles of Legality for Forestry Operations and Timber Processing in Indonesia**

“Timber is legal when the validity of its origin, logging permit, logging system and procedures, administration and transport documentation, processing, and trade or transfer are verified as meeting all applicable legal requirements.”

**Principle 1. Land Tenure and Use Rights**

The legal status of, and tenure rights to the Forest Management Unit are clearly defined and its boundaries have been properly gazetted. The Company has documented, legally established rights to harvest timber within those boundaries, and harvests timber only within those boundaries.

**Principle 2. Physical and Social Environmental Impact**

The Company has an Environmental Impact Assessment (AMDAL) covering the Forest Management Unit that was prepared in the prescribed manner, and can demonstrate that it complies with all legal, physical, social and environmental requirements stated in the AMDAL, as well as all legal requirements for monitoring and reporting on implementation of the AMDAL.

**Principle 3. Community Relations and Workers Rights**

The Company complies with all its legal responsibilities in ensuring the well-being of communities affected by its activities in the Forest Management Unit, its provision of services to local communities, and the well-being and safety of its workers and contractors employed in the Forest Management Unit.

**Principle 4. Timber Harvesting Laws and Regulations**

The Company conducts all forest planning, harvesting and other activities within the Forest Management Unit in compliance with relevant government regulations.

**Principle 5. Forest Taxes**

The Company pays all relevant legally prescribed fees, royalties, taxes and other legal charges related to its use of the Forest Management Unit and the timber extracted from it.

**Principle 6. Log Identification, Transfer and Delivery**

The Company ensures that all logs transported from the Forest Management Unit are properly identified, have correct associated documentation and are transported in accordance with government regulations.

**Principle 7. Timber Processing and Shipping**

Timber processing facilities and shipping companies have valid licenses and operate in accordance with applicable government regulations.

Following the publication of the draft of the legality standard, it became apparent that the standard required greater Indonesian ownership and so TNC decided to adopt a less prominent role in the process. The standard was handed over to LEI which facilitated the formation of a steering committee and a technical working group to oversee the future development of the standard.

#### 4.1.2 WWF's "Keep it Legal" Manual

In developing the "Keep it Legal" manual, WWF recognized that companies would need to balance the range of legal compliance issues of concern to stakeholders with the need to contain auditing costs. A comprehensive approach to determining the legality of forest products could cover many issues beyond forestry (for example, adherence to laws relating to taxes, labor, health, corporations, transport, customs, pollution or money laundering); many ingredients besides wood (finishes, other materials, packaging), and many phases of production (harvesting, hauling, milling, shipping, manufacturing, trading, and end use). In addition, a deeper approach could address the procedures leading up to the grant of a forest concession license, including adherence to planning laws, impact assessment requirements, tendering procedures, contractual "fairness" provisions, and absence of any suspicion of corruption or collusion.

For a company to direct its purchasing away from the products of illegal logging and in favor of legal operators, it needs to know what is meant by "legal" or acceptable sources. WWF GFTN developed a two-tiered approach to defining and verifying legal compliance (see Table 1). This approach is designed to ensure that a company's investment in legality checking is proportionate to the risk of a given product containing illegally-sourced timber. WWF recommends that suppliers that fall into a low-risk category (based on a risk-rating assessment) are verified using the basic legal compliance check. High-risk sources require a much greater level of scrutiny, as defined under the full legal compliance check. The approach assumes that legality checking is primarily a response to the problem of illegal logging, and thus focuses on supply chain activities that relate to illegal logging.

In defining the legality of a timber source, the basic category is "known licensed source". Verifying that the timber in a product is from a *known licensed source* involves checking that the timber originated from a forest management unit in which the harvesting entity had a legal right to harvest. It requires the purchaser to (a) know the geographic source of the timber, and (b) confirm that the harvesting

**Table 1 – Known Licensed Source and Verified Legal Timber**

<b>Basic legal compliance check</b>	<b>Known licensed source</b> <ul style="list-style-type: none"> <li>• The purchaser knows where the timber was grown and can identify the harvesting entity.</li> <li>• The harvesting entity has a legal right to harvest (has a harvesting permit and authorization from the forest owner).</li> <li>• The chain of custody is unbroken.</li> </ul>
<b>Full legal compliance check</b>	<b>Verified legal timber</b> <ul style="list-style-type: none"> <li>• Timber was legally harvested.</li> <li>• Charges were paid.</li> <li>• Timber was legally traded (including compliance with CITES laws).</li> <li>• Third-party audit of legal compliance was conducted and chain of custody verified.</li> <li>• Equates to compliance with FSC Principles 1.1 and 1.2 plus checking the legality of importing and exporting.</li> </ul>

entity had a legal right to harvest. It does not involve verifying that the timber in a product was actually harvested and traded legally. For example, the timber may have been cut in breach of the permit conditions, royalties may not have been paid, or the timber may have been exported illegally. It also does not involve third-party verification of the chain of custody.

The second category, requiring a higher level of scrutiny, is described as “verified legal” timber. The category requires the purchaser to obtain proof that, in addition to having a legal right to harvest, the harvesting entity complied with the law when harvesting the timber and that the timber was legally exported or imported. The category also requires a higher degree of scrutiny over the chain of custody. WWF recommends that purchasers undertake this higher level of compliance checking where there is a high risk of illegal timber entering their supply chain. Forest management certification systems that require independent chain-of-custody audits can also provide this level of assurance on legal compliance.

## 4.2 Lessons on Defining “Legal” Timber

**The role of Government in verifying “legal” timber is essential as the government is the ultimate legal authority. Yet, it is also problematic as those seeking verification have usually lost confidence in government systems.** The GoI creates the laws and regulations that govern the use of Indonesian forests, and these laws are applied and interpreted by government courts and enforcement agencies. Furthermore, forestry laws can only be reformed by the legislature with inputs from the MoF and other governmental institutions with jurisdiction over forest areas.

Regulatory, or non-voluntary, approaches by public institutions such as the EU FLEGT Action Plan, while also motivated primarily by concerns over sustainable forest management, are likely to be constrained by WTO regulations relating to non-tariff barriers. Due to these constraints, the EU and individual WTO member states may be forced to accept a legality standard promoted by the GoI. For example, the legality licensing scheme proposed under the EU FLEGT Action Plan is designed to work with legality licenses provided by governments of exporting countries.

While there is a role to play for third-party auditors and voluntary legality verification, compliance with governmental agreements will require a system that is administered by the government. For this reason it is essential that the Legality Standard, or a similar framework for defining legality, is adopted by the government.

Agreement on legality criteria raises difficult questions over the relationship between government administration and audits against the standard. Is the standard to be used purely to assess the legal compliance of forest industry actors, or is it also to be used to assess whether the law was correctly applied by the relevant government administrators? In either case, what is the consequence of finding that a forest management operation is flawed by an administrative defect in the application of the law? If such a defect is due to actions beyond the control of the forest manager, does it mean the manager has to cease operation and/or will be unable to supply legal timber, until the administration remedies the defect? What status should government grant to findings by independent auditors that administrators have failed to correctly apply the law in granting relevant permits or cutting approvals? These are difficult questions that will need to be answered as the legality standard process is concluded.

**Legality should be addressed as one strand of the broader concept of responsible forestry and timber purchasing.** Not all forest laws are good; some are bad, unfair, or corruptly administered. Thus, purchasers cannot simply focus on legality to be seen externally as credible. Probably none of the existing Indonesian concessions are fully compliant with the seven principles of the draft legality standard, and the standard's insistence on proper gazettal would exclude most concessions from becoming compliant in the medium-term even if they were making efforts to improve their forest management practices. Discussions are currently underway on how best to apply the standard, with some stakeholders proposing a stepwise approach to achieving legality.

## 5. Broad Lessons Learned

### **Some government policies have acted as serious deterrents or disincentives for companies to engage in a program to achieve sustainable forest management.**

It is widely recognized that voluntary mechanisms, such as certification and third party legality verification, can only play a part of the solution to deforestation and that government intervention plays an important complementary role. However, experiences of the Alliance suggest that in Indonesia the government and more broadly, governance- is also a critical factor that can determine the success or failure of the voluntary mechanisms themselves.

Regulations for harvesting and transporting trees in Indonesia are currently very cumbersome, favor large scale producers, and create opportunities for corruption. The process of arranging all the necessary permits for forest operations can be lengthy and too costly for well intentioned producers. The complicated bureaucracy creates opportunities for collecting informal payments, which raises the cost of production significantly, and leads to a lack of transparency and weak governance. The decentralization process has probably increased the regulatory burden as the process of reform has temporarily led to conflicting laws and lack of clear responsibilities over forest sector activities.

A promising development with regards to market linkages is the existence of bilateral MoUs related to FLEG that Indonesia has with the governments of the UK, China and Japan, as well as the legality licensing scheme proposed under the EU FLEGT initiative. The impact of these agreements will depend on the willingness and capacity of the GoI to implement them. A key component of the GoI's efforts will be the log administration system that it uses to identify legal logging. The current system has thus far not achieved credibility in the market but the MoF is developing an improved system which it plans to be operational in 2007.

Governments in countries that import Indonesian timber products also play a critical supporting role for forest certification and legality verification initiatives in Indonesia. The public sector is a major timber-market segment, and approximately 20 percent of the total timber demand in Europe goes through governmental institutions. Public institutions generally require wood products that are used for public construction projects, and it is likely that a substantial proportion of the Indonesian plywood and inexpensive furniture reaching the EU market would be affected by public procurement policies. Governments of importing countries also implement bilateral FLEG agreements and other bilateral and multilateral agreements that impact the timber trade.

**Demand for sustainable forest products does not necessarily translate to a willingness to pay for the additional costs of sustainable production.** The Alliance's experiences suggest that some buyers are willing to pay "premium prices", but that these alone are not high enough to convince suppliers to pursue certification. Nusa Hijau's experience with PT Irma Sulindo, a concessionaire in Papua Province is an illustrative case. The company holds the right to a new concession that produces merbau which supplies the company's outdoor furniture manufacturing facilities in Sulawesi. PT Irma Sulindo indicated a willingness to pursue certification conditional on WWF finding buyers willing to pay around USD 1,250/m<sup>3</sup> for its certified products. Since this was more than twice the market price, such buyers could not be found. It is not clear how representative PT Irma Sulindo's challenge is of the price premium required to compensate Indonesian producers for investing in certification, but it is likely that the required premium is substantial. Anecdotal evidence does however suggest that a premium of up to 15% has been paid by buyers behind closed doors for FSC certified natural forest wood.

The presence of large amounts of cheap illegal timber in the market currently makes it very difficult for legally sourced and FSC certified timber to compete. However, it is likely that as restrictions on the trade of illegally sourced timber are put in place, the playing field will become more level. According to a study commissioned by the American Forest and Paper Association (AF&PA) in 2004 illegal logging constitutes around 7 percent, or USD 5 billion of the global primary wood products trade. The study calculated that the removal of illegally sourced roundwood from global trade would lead to a price increase of between two to four percent of US domestic wood prices.

**For certification to have a major impact on natural tropical forest management there needs to be greater acceptance of a stepwise approach.** Companies that demand certified products are risk averse and able to source them from regions that are perceived as less risky for their corporate image. Several European and North American companies have chosen to switch away from Indonesian timber altogether following pressure from NGOs in their home markets. Since most wood products manufactured in Indonesia are also manufactured in other countries, many risk averse companies maintain their environmental reputations by simply switching their procurement to less controversial countries.

The switch away from uncertified Indonesian sources is not necessarily a good thing. The move does send a signal to manufacturers, but as long as there is sufficient demand for uncertified timber from less discerning markets this signal does not translate to pressure for companies to pursue certification. In addition, WWF's experience has shown that companies in Indonesia often lack the technical and financial capacity to pursue certification on their own, even if they wish to do so. Thus, at least in the short-term, the impact of boycotting the vast majority of Indonesian timber, on the grounds that it is not certified may not have much positive impact on the way Indonesia's forests are managed. Ultimately, it could undermine natural forest management as a viable land-use, creating pressure for natural forests to be converted to other uses such as agriculture or monoculture timber plantations, thus driving further forest loss in Indonesia.

When buyers switch away from uncertified Indonesian timber, the positive impacts of certification are not necessarily transferred to other regions. In some cases the switch is likely to be to non-timber substitutes. This is especially the case for plywood which has been losing global market share to plastics, and metals. In many cases since little certified tropical hardwood from natural forests is available globally, buyers switch either to certified plantation grown timber from other regions or to temperate hardwoods. In both cases the direct benefits of certification are considerably less than in natural tropical forests. The shift to regions and forest types for which certification is easier and less costly reduces the impact of certification as there is little difference in these cases between "business as usual" forest management and that prescribed by forest certification. In the end little is saved except for the reputation of the company making the switch.

Thus, companies wishing to make a positive impact on the environment through their purchasing behavior should engage Indonesian producers and pressure them

to improve their forest management practices. WWF and TNC have tried with some success to help existing buyers of Indonesian timber products to work with Indonesian suppliers to help them produce more sustainably. However, for many buyers, engaging their Indonesian suppliers may require more investment than they are able or willing to make, given that market or product substitution is often more financially viable. In many cases the largest disincentive for companies to engage with companies that are not certified is that such efforts may not lead to better relations with NGOs in their home markets since these NGOs often have a 'certification or nothing' policy. WWF plans to increase its efforts to explain to these NGOs the potential benefits of a stepwise approach to certification.

**Environmentally sensitive companies are mainly concerned about their corporate image, and need assurance that the products they purchase are approved by activist NGOs in their home markets.** The Alliance's experience is revealing the importance of broad based NGO support for market based initiatives. Demand for sustainable wood products from Indonesia is largely generated by pressure that NGOs exert on companies in Europe and North America. Similarly, short term supply in Indonesia is affected by the degree to which certification and legality verification are embraced by the national NGO community. A lack of universal NGO support for these mechanisms in Indonesia is one factor that has discouraged companies from responding to market demand. In response, building such support has been a critical Alliance activity.

Environmental activist NGOs play a key role in creating the demand for sustainable and legal timber in European and North American markets. NGOs in these markets have substantial influence over timber buyers and government policy makers. Visible firms, such as those in the Do-It-Yourself (DIY) construction industry, want to create and maintain reputations for environmentally responsible business practices. Activist NGOs apply pressure to these firms through their ability to stage media campaigns that link a particular company to unsustainable or illegal logging.

The NGOs that put pressure on companies to buy only sustainably sourced timber, also effectively decide which timber qualifies and which doesn't. In Indonesia this makes creating market linkages difficult, because influential national NGOs that have linkages to NGOs in timber markets, advocate a boycott of Indonesian timber until far reaching reforms of the forestry sector have taken place. Several Indonesian NGOs believe that under the current concession system, sustainable

forest management is not possible and that market based efforts to introduce forest certification or legality verification could impede wider scale forest governance reforms. NGOs such as WALHI and AMAN are particularly concerned with redressing the traditional land use rights of forest based communities.

An illustrative example of the influence of NGOs on market links is presented by TNC's experience with Sumalindo. Even though the company was well along the path to certification, it became the target of a Greenpeace campaign in June 2003. Based on information provided by a coalition of Indonesian NGOs, the East Kalimantan Working Group (EKWG), Greenpeace had identified Sumalindo as one of several plywood suppliers to a UK government construction site, and raised concerns about the company's practices. The EKWG also stated that Sumalindo was owned indirectly by the Indonesian military.<sup>33</sup> These claims were disputed, but this did not prevent them from damaging Sumalindo's reputation in the European market.

An implication of the Alliance's strategy of engaging Indonesian timber companies is that the Alliance has in some cases positioned itself as a cushion between companies pursuing certification and NGOs that are opposed to such efforts. According to Perhutani, the main benefit of working with WWF's Nusa Hijau is that WWF can shield the company from NGO attacks. Perhutani management is under the impression that the reasons for Smartwood to suspend Perhutani's FSC certificates in 2002 were related to pressure from national NGOs. By working with WWF, Perhutani hopes to avoid such a situation in the future.<sup>34</sup>

WWF and TNC do not claim it is their role to protect companies from NGO campaigns and in many cases perceive pressure from activist NGOs as a positive force for change in the forest sector. Nor do they question the right of any organization to criticize another, or to vigorously defend against such criticisms. However, tools developed by the Alliance can provide users with credible lines of defense against NGO critiques. For example, membership of GFTN requires a company to make clear commitments to responsible forestry, including time-bound targets for achieving steps toward certification, or eliminating unknown and unwanted wood sources. Similarly, use of timber tracking systems, such as those piloted by TNC, can provide companies with a robust defense against claims that they are accepting illegal timber.

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<sup>33</sup> EKWG 2003.

<sup>34</sup> Perhutani staff, personal communication.

**Market based mechanisms require concerted action across all major markets to succeed.** The market for Indonesian timber products is global, and the purchasing preferences of European and North American markets will have a limited impact on Indonesian producers, as long as these have access to markets with less stringent environmental requirements. Thus, there is a need to continue engaging the Asian markets for Indonesian timber products, in particular China, Japan, Malaysia, and the Republic of Korea. Also, efforts to promote market based mechanisms need to take into account the complex, and often international, nature of timber supply chains. For example, much of the Indonesian timber that enters China is likely to be re-exported as higher value processed wood products to Europe and North America.

**In an ever improving political and business environment, market-based efforts are beginning to help improve forest management in Indonesia.** When the Alliance first set out to promote certification in Indonesia, the approach assumed that putting potential buyers of certified timber in touch with concessionaires would provide sufficient incentives for those concessionaires to pursue certification. The reality turned out to be more complex as there are significant barriers for producers to pursue certification in Indonesia. Many of these barriers are related to a lack of enabling conditions which take time to change, and are out of the direct control of timber buyers and producers. However, change is occurring and there is potential that market mechanisms such as certification will play a much more significant role for Indonesia's forests in years to come.

A key barrier to the adoption of certification is Indonesia's uncertain business climate which discourages long term investment. The Alliance began its activities at a time when Indonesia had only just begun pulling out of a financial and political crisis with major implications for the forestry sector. This macro-economic crisis was coupled with the recognition that unsustainable logging practices had severely depleted the raw material of much of the forestry industry. Indonesia is still in a process of recovery and efforts are being made to restructure the forestry industry. As these processes continue, it is likely that remaining concession companies and timber processors will have greater capacity to invest in sustainability.

The uneven playing field which raises the opportunity cost for concessionaires to get certified may be flattening. The MoF has made clear commitments to reduce illegal logging and has stated that it will eliminate the use of timber from natural forest (MTH) for pulp production by 2009. With inputs from TNC, the MoF is

developing a log tracking system which could be up and running within the next few years. These governance reforms are in large part being driven by pressure from buyers and are likely to strongly reduce the amount of ‘cut and run’ timber on the market. In the medium term such reforms will decrease the gap between standard forest management practices and those required under FSC certification.

Some companies that are barred from FSC certification because of past events (e.g. the 1994 cut-off date on conversion of natural forest to plantation) are investing in a “next best” approach of verifying legality combined with HCVF delineation and protection. APP and APRIL, the dominant paper companies in Indonesia are under increasing pressure from buyers in Europe, Australia, the USA, and Japan to invest in sustainability. While these companies are barred from FSC certification because they continue to convert natural forest areas, they have made some effort to work with NGOs, including WWF, to reduce the amount of illegal timber they use and to identify HCVF forests for preservation.

## 6. Recommendations

1. Keeping environmentally sensitive buyers engaged with Indonesian timber producers is an important activity that TNC and WWF might consider expanding. This may entail identifying more existing buyers of Indonesian timber products and working closely with them to put pressure on their suppliers to invest in SFM, or to pursue forest certification.
2. For buyer enquiries to create new market links that promote investments in SFM, they should meet the following criteria:
  - Prices and quantities that are high enough to compensate for the investment costs
  - Purchasing agreements that are long-term
  - Agreements that are backed up by personal relationships or other guarantees acceptable to Indonesian producers.
  - Agreements that provide an outlet for the whole product line
3. A strategy that the Alliance could consider for creating more meaningful market enquiries, would be to work more closely with manufacturers to find out what types of agreements would motivate them to invest in SFM. Also, in order to create more comprehensive market enquiries, the Alliance could consider working with a large timber broker or wholesaler that can pool orders.
4. Attempts at defining a practical legality standard need to take into account the complexities of the Indonesian forestry legal framework to allow conscientious companies to participate in a stepwise approach to legality and certification. Improper licensing procedures by government authorities in the past leave many forest concessions in a legal limbo which they are powerless to change.

5. The Alliance should continue to work on the policy level to encourage laws and regulations that support FLEG initiatives. In particular, efforts should be stepped up in Japan and the USA.
  
6. For market demand to influence forest management in Indonesia there must be a critical mass. For this reason there is a need to continue focusing on the major Asian markets for Indonesian timber products including China, Malaysia, the Republic of Korea, and Japan. As part of this, more analysis of the re-export of Indonesian wood from China to European and North American markets is needed.

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