

## Role Models in China's Forest Products Industry

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### Role Models in China's Forest Products Industry:

Companies Developing Chain-of-Custody Systems to Protect Against Illegal or Unsustainable Wood Sourcing

*The Chinese wood products industry has come under increasing international attention for its potential role in importing (and re-exporting) wood materials which cannot be verified as having come from sustainably managed or even legally harvested forests around the world. This situation does not mean that all production originating from Chinese mills is illegal, but it does highlight the problem is that proving legality is very difficult.*

*In the past 2 years, several Chinese firms, supported by certified forest schemes in China and supplying countries, have taken a lead in changing the way they conduct business. They are beginning to implement chain-of-custody systems which can demonstrate legal and sustainable products from forest to end consumer. These firms are discovering that such systems can not only help to protect their market share in environmentally-sensitive markets such as Europe, Japan and North America, but even to gain market share.*

*By helping to protect the international reputation of China's wood products industry, these firms can serve as role models within China, especially for China's export-oriented wood products industry. Learning from their experiences will be critical in expanding these good practices to other enterprises across China.*

**Background:** In order to meet the burgeoning domestic and export demand for manufactured wood products, China is now importing forest products from many more countries than in the past. Between 1997 and 2005, China's total forest product imports more than tripled in volume (roundwood equivalent) from 40 million to 134 million m<sup>3</sup>, and more than doubled in value.

Unfortunately, many of countries which supply the raw materials needed to feed the Chinese wood products manufacturing industry suffer from governance problems in their forests: unsustainable and illegal logging are significant problems in these countries (boldface text in Table 1).

**Table 1: Top Suppliers of China's Imports, by Volume (2006)**

Timber Products Overall	Logs	Lumber
<b>1. Russia (50.7%)</b>	<b>1. Russia (67.9%)</b>	<b>1. Russia (19.3%)</b>
<b>2. Malaysia (4.9%)</b>	<b>2. PNG (6.4%)</b>	2. USA (16.8%)
<b>3. PNG (4.5%)</b>	<b>3. Malaysia (4.4%)</b>	<b>3. Thailand (11.6%)</b>
<b>4. Indonesia (3.9%)</b>	<b>4. Myanmar (3.2%)</b>	<b>4. Indonesia (7.4%)</b>
<b>5. Thailand (3.8%)</b>	<b>5. Gabon (3.0%)</b>	5. Canada (6.6%)
Plywood	Wood Pulp	Paper
<b>1. Indonesia (54.4%)</b>	1. Canada (17.5%)	1. Taiwan (17.9%)
<b>2. Malaysia (28.0%)</b>	<b>2. Indonesia (16.5%)</b>	<b>2. Russia (11.6%)</b>
3. Japan (3.8%)	5. Brazil (13.0%)	3. S. Korea (10.6%)
<b>4. Russia (3.1%)</b>	<b>4. Russia (12.6%)</b>	4. Japan (9.1%)
5. Finland (2.6%)	5. US (10.1%)	<b>5. Indonesia (6.8%)</b>

Source: Chinese Customs; see Forest Trends 2006. Note: Percentages indicate countries' share of China's total imports in each category.

In order to prove legality of their products, the single biggest issue facing Chinese wood products manufacturers is the complex nature of their supply chains, with the many traders and middlemen in the process and indirect access to raw material resources. With few exceptions, most factories have never had incentives to develop Wood Control Systems (WCS) which usually include components such as a wood procurement 'program', Chain of Custody (COC) systems, wood origin control process, internal audit procedures, and reporting feedback mechanisms.

This situation does not mean that all production originating from Chinese mills is illegal: the problem is that proving legality is very difficult. Supply chains for domestic wood can in some instances involve 8-10 different transactions from the time the wood leaves a farmer's plot or the forest until it arrives at the mill. For wood coming from state-run forests, the supply chain is shorter, but there are still a number of links in the chain. The nature of this supply chain, with the numerous farmers, traders, shippers, and processors, means that it is virtually impossible for any Chinese manufacturer to provide complete documentation for legality, to attest that the raw material inputs are sustainably managed, or to account for each step in the supply chain. This is a key aspect in proving legality, and also a key criticism China's industry faces.

Even when imported wood has necessary export documentation, the weakness of governing institutions in exporting countries can mean that 'legal' product may in fact be 'illegal.' For example, in Papua New Guinea, official inspections at export only verify the quantity and description of the timber to ensure export taxes are paid; there is no connection between unlawful nature of operations in the forest and the legal documentation that PNG wood products carry. Official export documentation is therefore likely to be laundering of the 'unlawful' timber into legitimately-produced exports. These governance issues in supplying countries thereby indirectly undermine efforts by Chinese firms to ensure the legality of their supply chains, and cast doubt on the entire industry.

**Leaders in Chinese Wood Products Industry:** However, within this environment, several Chinese firms are beginning to recognize the issues involved and the potential impact they can have on particularly their export-oriented markets. They are taking steps to change the way they conduct business. Over 100 Chinese companies have obtained FSC COC certification in recent years, and there are now a number of FSC certified forests in China. China has established 13 test projects for its own forest certification scheme. Overseas customers, such as B&Q and Home Depot with its recent Chinese acquisition, are looking to establish legality and sustainability in their wood supply chains.

Kingfisher Asia, Ltd, a sister company of B&Q UK, has recently begun to work with the UK Timber Trade Federation (UKTTF) on a program to support their Chinese manufacturers that will help them meet the UK demand for legally verified wood products. Yingbin Nature, a flooring manufacturer in China, is changing its sources for its flooring products destined for European and US markets. In 2006, Yingbin started a joint venture with the Youhao State Forest Bureau in Heilongjiang Province, manufacturing birch plywood that is FSC certified (WWF GFTN, 2006). Yingbin also hopes to source more wood products from Russian companies which will be able to provide certified logs in the near future.

Domestic manufacturers are working to establish positive actions focused on domestic supply. These include a group in Shandong/Henan Province and another company in Guangzhou that are attempting to more directly control their plywood supply chains, poplar and eucalyptus respectively, by working directly with individual farmers or the State Forest Administration. In the latter case this involves exploring options for FSC certification of state-owned plantations.

Further actions being taken by progressive manufacturers include efforts to shorten supply chains by linking directly to overseas suppliers who can provide full documentation of origin and legality. Some companies who are exploring the use of less controversial species for face/back veneer including the possibility of using locally grown plantation species. Such actions require the encouragement of buyers to ensure markets and to provide support that will drive the necessary changes.

**Challenges:** Chinese operators still face challenges in implementing these kinds of reforms, such as:

- *Complexity of the Supply Chain:* For most enterprises, retracing the path of from its entry in China to its arrival at the mill is a formidable feat. Even before processing, a log can change hands many times, with little reliable documentation. This lack of transparency puts up several hurdles for origin verification.
- *Cost to Implement Wood Control Systems:* Though it represents an investment in the firms’ future, establishing control over the supply chain has significant costs for a business.
- *Lack of Incentive from Consumers:* While legal and sustainable sourcing has begun to be an issue for the global wood products market, consumer preferences have yet to signal a deep change to producers. Though the climate is changing, companies will be hard-pressed to alter their systems until they see solid demand-side incentives.

**Incentives:** While significant challenges remain both for these firms, as well as others that wish to follow suit, market-based incentives are growing and increasingly being recognized. These include:

- *Cost Savings from Shorter Supply Chains:* While legal logs often do cost more once all taxes and royalties have been paid, there are many “hidden” costs. By shortening supply chains and working directly with suppliers, it means there are fewer transactions and fewer hands that which each piece of wood goes through – usually resulting in lower costs. In addition, with illegal wood, bribes are often associated at each point along the supply chain. Bribes and other fees often add 10-15% more onto the cost of illegal wood.
- *Cost Savings from More Efficient Wood Handling Systems:* Proper wood handling procedures can make processing facilities more efficient.
- *Quality Control:* Illegal wood products often sit in the forest for many months, so by the time they reach the processing facilities in China, quality may have deteriorated. While legal logs may cost more, better quality can lead to higher recovery so sawn timber costs can be up to 16% lower (Table 2).

**Table 2: Cost Recovery of Legal vs. Illegal Logs**

ILLEGAL LOGS			LEGAL LOGS		
Log price	Recovery	Sawn timber cost	Log price	Recovery	Sawn timber equivalent cost
\$185/m3	40%	\$462.50/m3	\$200/m3	50%	\$400/m3

Source: Tropical Forest Trust, 2003.

In general, chain-of-custody systems make processing facilities more efficient, with greater focus on recoveries and efficiencies rising. As can be seen above, while overall costs for legal wood can indeed be lower, the working capital requirements required to go direct are generally beyond the reach of many manufacturers, particularly in the plywood sector. This is why many companies prefer to source small quantities from the supply ‘cartels’ that dominate China’s wood distribution system, creating further obstacles towards legality.

**Market pressure:** A major driver behind these changes is the changing international market environment. Pressure from overseas markets, where scrutiny of product legality for the more ‘questionable’ wood species has been increasing, is perhaps the leading factor in convincing companies to look more closely at their supply chains. For Chinese firms to maintain their market share, they will need to respond to these questions.

In Europe, Japan and North America, there have been rising calls not only from NGOs but also governments to sanction China’s wood processing companies because of the perception that they are gaining market advantage by using illegally sourced wood.

In Europe, governments are installing public procurement policies requiring that all contracting bids for the construction of civic works needs to prove at least legality of all wood products. The UK, Denmark, the Netherlands, Germany and Spain are all looking at ways to harmonize these procurement policies, possibly under an EU-wide program. Private construction procurement policies are likely to follow suit. The EU is looking at legislative options to ban any imports which cannot be verified as legal, and in a related matter, have called for an anti-dumping investigation against Chinese plywood.

Japan has also recently instilled a public procurement policy, and there is early evidence that it is beginning to impact on both producers in Siberia and the Russian Far East and their customers in China.

In the US, this has contributed to calls for imposing countervailing duties on Chinese high-gloss paper products. Draft legislation in the US Congress in March 2007 would prohibit the import of any wood products that are known to originate from illegally sourced timber.

Both the London and Vancouver Olympics have confirmed that they will be requiring all construction of the Olympic venues to be independently verified as being not only legal, but sustainable.

**Assistance for Chinese Mills:** There are many examples of companies who are working to improve their supply chains and raise levels of internal governance. International groups are helping in this process: both the Tropical Forest Trust (TFT) and WWF are pursuing projects that aim to raise the threshold for legality, linking Chinese companies to sustainably managed forests, and then to the market.

WWF in 2005 launched its China Forest & Trade Network (FTN), as part of WWF’s Global Forest & Trade Network (GFTN), a global effort to improve forest management and encouraging buyers to act more responsibly in their purchasing of forest products. The China FTN has grown to 12 Trade Participants and 2 Forest Participants (encompassing a number of forest product sectors and sourcing from all over the world), all committed to time-bound action plans to eliminate illegal wood and other unwanted sources and to increase the amount of certified fiber in their products. These companies are linked to markets in the United States, western Europe and China. China FTN has translated and distributed widely the GFTN guide – Responsible Purchasing of Forest Products.

TFT has been collaborating with more than a dozen Chinese sawmills to improve their supply chain since early 2006. TFT officers operate from their China office, working to link these mills to their verified legal timber sources and, ultimately, consumer markets in Western Europe. TFT sustainable forestry projects cover 2.7 million hectares in Indonesia, Malaysia, Vietnam, Laos, Bolivia and Africa, including the first FSC-certified forests ever in Indochina and the Republic of Congo. TFT has translated its ‘Good Wood, Good Business’ publication into Mandarin, providing an industry-orientated guide for Chinese businesses interesting in excluding illegal wood from their supply. These types of market-based motivations offer concrete incentives for Chinese manufacturers to pursue.

Both WWF GFTN and Tropical Forest Trust are growing in China and are open to working with more companies wishing to respond to market forces whilst cleaning up their supply chains.

**Summary:** While the situation facing China’s wood processors is challenging, there is cause for optimism. It only takes a few examples of ‘first movers’ seen to be gaining an advantage by changing the way they operate for a whole sector to move in that direction. Factory owners are savvy and can show concern about global environmental issues. Those with vision understand the value of legal, sustainable raw material supply, and are taking steps to achieve this objective.

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For more information on TFT and GFTN, also visit these websites:

- <http://www.tropicalforesttrust.com/>
- <http://www.panda.org/gftn/>
- <http://www.forestandtradeasia.org/>

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