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Russia's Forests

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Overview

President Putin signed Russia's new Forest Code (FC) into law on 5 December, and it will enter into force on 1 January 2007. Emerging now from a four-year bureaucratic and legislative gestation and eagerly awaited all the while by the timber industry and environmentalists, this fundamental statute is designed to lay a modern foundation for the forest products industry - which in terms of output and efficiency falls well below potential.

Russia's forestland is a huge resource, the country's largest after hydrocarbons and minerals. As a cumbersome compromise document, the FC will not trigger instant transformations; but its key provisions will stimulate more responsible stewardship of leased forest land, and incentivise investment through longer minimum leasehold periods - even though Putin took a political decision against allowing outright private ownership of forest fund land. In a related move, Putin is pushing for a 30% tax on unprocessed (or 'round') timber exported from Russia. This export duty will be combined with lower import duties on timber processing equipment to enable 'value-addition' to take place on Russian soil. Substituting imported niche paper products in the strong domestic market looks to be the most promising focus for all types of investors in the sector.

Context

Key points of the new Forest Code and typical investment strategies

FC is bonanza for ill-intentioned, but disaster for forests

- > **Alexei Yaroshenko**, Greenpeace-Russia
- > **Tatiana Aleshkina**, Vedomosti

Public Judgements

FC provides legal framework and productive incentives

- > **Dmitri Chuiko**, Ilim-Pulp, government-liaison director

Wrap

The FC helps put forestland online as a revenue-generator, but geography is still a massive obstacle

Context

The industry and the 'China factor'

Until the 1990's, the international timber industry was dominated by Scandinavian and North American companies, with their mature harvesting facilities and downstream manufacturing capacity. New entrants to the timber market have since transformed the landscape. Now wood and wood products in quantities are available from Brazil, Southeast Asia, and the Pacific Islands, and various African countries.

In timber as in virtually all commodities markets, China's burgeoning growth has exerted a gravitational pull. China imports ever-increasing amounts of raw material (from lumber to waste paper) and exports corresponding volumes of manufactured wood products - from wood furniture to veneered boards and plywood, to chipboard and recycled paper packaging. Vietnam is already imitating the China strategy, importing raw materials and exporting finished products in increasing volumes, with India expected to follow suit.

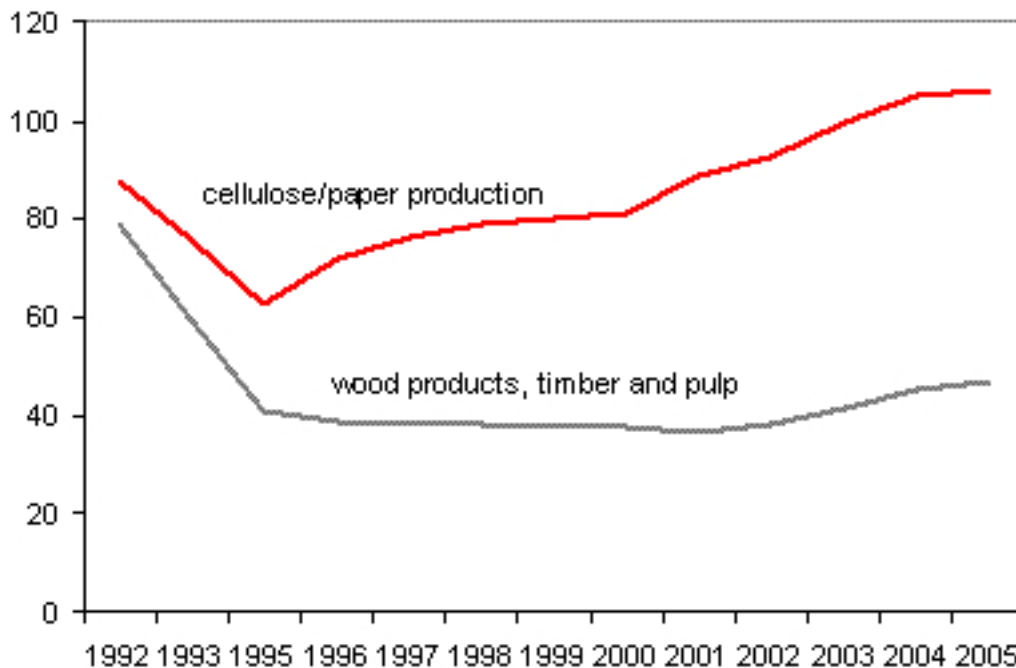
Into this picture comes Russia, whose forests make up about 27% of the world's forested land, the world's biggest forested areas after those in Brazil and Indonesia. Russian forests in the Far East are already the biggest source for China of raw wood materials, and 90 per cent of Russia's exported timber supplied 68 per cent of China's log imports in 2005. Stands in the Russian Northwest supply mills in the Baltics and Scandinavia.

Investment: history and prospects

Investment in the Russian timber industry during Putin's first term came from domestic sources, as 'oligarchs' moved into timber - consolidating assets, and building some vertical up-and-downstream linkages reflecting a longer-term investment horizon. Foreign direct investment into the sector was sparse, with insecure property rights a frequently cited concern; and hoped-for government investment did not materialise.

The Kremlin hopes the new Forest Code (FC) (see) will pave the way for private investment into the sector. Putin's 'Napoleonic' (Kommersant, 2004) plans for Russian forestry, 'increasing timber production volumes four-fold' by 2015, according to the Canadian Embassy's Irina Litvinovna, have been estimated to require increases in investment from the current year's \$1.5 billion to \$4 billion level. Industry representatives, eagerly awaiting the FC, also expect it to push production beyond the level where low investment now holds it (see chart).

Russian Timber Production (1990=100)



Source: GKS

However long its arrival, the FC is still only the tip of a legislative iceberg, since much of what it stipulates must now be fleshed out with regulation, which will, according to the FC's environmentalist detractors, take six to nine months to generate. The vast majority of its 109 articles contain sub-points stating the need for regulatory definition and clarification.

In a missed opportunity, the FC lacks any mention of a certification process, valued by sector consumers and wholesalers alike to ensure the legal origins of their purchases. Up to 40% of the Russian timber yield is harvested illegally (according to Forest Trends), and therefore under the tax radar. Illegal trade is boosted by Chinese demand for imports, boosted in turn by US demand for cheap finished wood products from China. Note: efforts are underway, and two separate Russian certification initiatives joined forces in mid-September 2006 to help bring Russia under the aegis of EU-based PEFC.

Business strategies

Pricing in the timber industry, while similar to other agricultural commodities in its stability-within-a-range, is different in that the timing of harvests is both somewhat discretionary - postponable until prices are favourable - and, from time to time, involuntarily hastened by insect infestation or natural disasters. Timber and wood-product prices are also highly sensitive to oil/transport costs both to markets and the nearest processing mills.

Money is made in the following ways:

1) Sector modernisation: In a 2004 interview, Frank Graves of Ilim-Pulp (the largest forest industry corporation in Russia, with 2005 sales of \$1.5 billion) emphasized that the way to make money with world wood/pulp prices low is to concentrate on lowering unit price. This requires mechanisation (while Japan's and Canada's mills might have 220 employees, Russia's equivalent mills have 5800) and mechanisation requires investment. Cash for investment, in turn, is easier to procure if you are big, your bigness both attracting strategic partners and appealing to lending

institutions.

2) Import substitution/niche paper products. International Paper announced (10/2006) with Ilim Pulp their intention to create a joint venture, expected to produce high-quality office paper and packaging (Ria Novosti). Many firms new to the Russian paper industry have gone in this direction, processing high-value niche paper products for the domestic market (medical dressings, corrugated packaging, etc.) instead of building big mills at remote locations. This strategy also requires mechanisation investment.

3) China strategy: labour-intensive manufacture, often of wooden products. IKEA is busy here in Russia, but the scale is small. Russian industrial impetus looks to be actually trending in the opposite direction, towards increased labour-productivity through mechanisation, rather than following India and Vietnam, heirs to the China strategy, with their armies of low-cost artisans.

Public Judgements

The FC provides a legal framework and productive incentives

Dmitri Chuiko is director of Ilim-Pulp's government liaison and is a leader in the sector's industrial associations. Interviewed by 'Expert North-West' (11/2006), Chuiko praises the stipulations of the new Code that create systemic incentives for better forest management, linking lease renewals to satisfactory resource management and improving investment incentives by the increased minimum length of leaseholds. A 10-49 year lease band will motivate investors to make improvements without fear of losing possession of their investment, and, for those nervous about losing forest access to private owners, the 49-year maximum is not as close to private ownership as a 99-year lease. Chuiko notes that among a significant portion of Russians there is still the mentality that private ownership is bad and private ownership of natural resources is very bad indeed.

On the whole, Chuiko believes the Forest Code, though flawed, is a workable document - a legal framework which business needs to proceed. Chuiko also praises the FC as an achievement in itself, considering the variety of opposing viewpoints that had to be hammered in to a single document.

He does note the failure to mention certification as a lost opportunity that would have pleased the FC's environmentalist detractors and been something with which business would have happily complied.

The FC is a bonanza for the ill-intentioned, but a disaster for forests

To the general complaints that the FC is too full of generalisations and too open to interpretation, **Alexei Yaroshenko**, of Greenpeace and forest.ru, adds that forests won't be looked after, and a free-for-all will occur in the months-long period required to flesh out regulations necessary to make the FC workable. Yaroshenko dislikes that the FC gives a green light to construction in the forest - the building of infrastructure is, indeed, part of the point of the FC - and calls construction by temporary custodians a first step towards alienating citizens from their forest heritage.

Tatiana Aleshkina, reporting for **Vedomosti** with confirmation by legal experts, noticed that the gap to private forest ownership that Putin sought to close in the face of massive public opposition accidentally remains open. (During the period of regulation-writing, forestland is by default governed by existing land regulation, which allows private ownership.) Aleshkina notes that legislators will probably quickly plug the gap and reduce its consequences.

Wrap

The glittering prospect for Putin of another colossal natural resource providing tax revenues (once it is made profitable by investment) is probably too good to be true. Geography still means Russian forestlands have tremendous logistical hurdles to overcome, with precious little extant roadage and transport infrastructure to help; and geography also makes illegal logging hard to monitor. Stable and low-ish world prices are keeping margins low, at least for pulp and low-value-added products. Also, unless the federal authorities take on a kind of super-ombudsmanship, it is not clear how the new FC alleviates collusion between local authorities and illegal loggers since it gives those very local authorities more responsibility for forest oversight. Also dampening enthusiasm should be optimistic Chuiko's conclusion that the FC is probably a transitional document, implying its compromises and minced words are still not what business ideally wants.

On the other hand, if the FC works as intended, it could set in motion numerous virtuous cycles: commercial leaseholders will be motivated to invest in technology for mills, since they have clear terms of (longer) temporary ownership. They should also be keener to take better care of the assets, since renewal of leases will be contingent on this. The new economics of the FC favours larger companies that can both afford the greater forest maintenance costs and the higher prices at auction, and this will probably force smaller mills to consolidate or enter arrangements with bigger companies. Since smaller mills are most vulnerable to the temptation of illegal logging, consolidation promises to be good for the sector.

The initial publicity around the FC may help curb some of the illegal activity, as the sector realises it is in the public view.

Next tests

1. Regulations giving effect to the provisions of the new FC: quality and speed of preparation.
2. Effectiveness of new FC regime in reducing the amount of illegal logging, especially in the strong China-demand driven timber export trade in Siberia and the Far East.