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A basic guide to Rules of Origin with focus on the EU system

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1.1 Rules of Origin and their role in international trade

The purpose of Rules of Origin

Rules of Origin (RoO) play an important role in the regulation of international trade, and are a core component of preferential trade arrangements. RoO set out the conditions under which traded goods are considered to be originating in a specific exporting country; in a sense, they describe the conditions under which a specific nationality—in particular that of the preference receiving country—is conferred on a product shipped from one country to another. Essentially, RoO confer a form of economic origin on products, being the country where a specific minimum degree of transformation and value addition has taken place. In that sense, the determination on origin goes beyond purely the last location where further processing has taken place, and is likewise not based simply on the last geographic location from where a product is shipped. Consequently, as long as tariff and quota regulations discriminate between different trade partners, RoO will remain relevant.

RoO are important as without them, no trade would be able to take place under a preferential trading arrangement as any preferences would be exploited by exporters from non-eligible countries. This—often referred to as trade deflection —entails goods passing through the territory of a country with more favourable market access conditions to a preference-giving third country.

As long as tariff-based barriers remain, RoO will continue to act as a tool for distinguishing between preferential trade and trade that is subject to normal trade rules, most commonly normal import tariffs or quota limits. Compliance with the relevant origin requirements will continue to reward traders with a margin of preference that, in most cases, will enhance the competitiveness of goods traded under a preference regime.

Preventing trade deflection, and with it the dissipation of trade benefits away from the intended beneficiaries under a preferential trade arrangement, is the original and only legitimate role of RoO. In reality, RoO have gone beyond acting only as instruments to prevent trade deflection. RoO, in many instances, have become discretionary trade policy instruments that have bowed to commercial and country-specific vested interests, setting conditions that do little to foster growing trade but more to protect specific industrial interests. In fact, where RoO are overly restrictive, they raise the cost of production as firms are forced to source from second-best locations. The likelihood of this is greater in non-reciprocal preferential trade agreements, where the RoO are not the result of bilateral engagement and negotiation but rather the prerogative of the preference-giving country. In the absence of persuasive guidelines, for example under the banner of the WTO, RoO will continue to be subject to the pressures of domestic protectionism.

RoO can, from an economic perspective, lead to sub-optimal supply and production configurations within countries or regions forming part of a preferential trade area (PTA). As RoO set the conditions under which a given product may benefit from preferential market access, usually by prescribing minimum local processing, firms may be tempted to utilise inputs sourced from within a PTA in order to benefit from enhanced market access, rather than from more competitive sources elsewhere. The decision to source locally depends on the benefit (or margin of preference) available to the exporter, who must contrast possibly higher cost inputs against enhanced competitiveness as a result of a remission or reduction of duties in the destination (import) country. In other words, RoO create a set of incentives for traders within a given PTA, whose size and relevance ultimately depend on the margin of preference and cost differentials between sourcing inputs locally or from abroad.

RoO can also play a meaningful role in supporting local development, specifically by providing incentives to source materials locally, and by developing local or regional product value chains. This occurs when demand for upstream input materials is stimulated by appropriate RoO, in the context of significant preference margins. For example, a fabric mill may be induced to step up production if local garment producers are required to use local fabric in order to benefit from preferential access

to the market of a trade partner. The reality, however, is that RoO in isolation, in most cases, do not lead to greater development. Domestic economic policies, the general trading environment and other commercial realities play a key role in determining sourcing decisions, and RoO that seek to create trade without recognising these realities will simply undermine and suppress trade between preferential trade partners.

Preferential and non-preferential Rules of Origin

While the emphasis here is on preferential RoO, the distinction between the two types of RoO is important to note. Non-preferential RoO are rules and regulations that are imposed by a country in relation to a specific domestic policy or legal requirement, and generally apply to all goods entering its jurisdiction. Non-preferential RoO are used in a number of fora, including labelling requirements (relating to country of origin), the management and imposition of anti-dumping duties and other safeguard measures, government procurement and so forth.[1] In essence, non-preferential RoO seek to distinguish between domestic and foreign products.

Non-preferential RoO are also the subject of joint harmonisation efforts by the WTO Technical Committee on Rules of Origin and World Customs Organisation, although much work remains to be done in defining a set of conditions that would become binding on all WTO member states. While the WTO Agreement on Rules of Origin thus far provides certain guiding principles and a broad work programme for harmonising non-preferential RoO, this appears to have had only limited impact in preventing even non-preferential RoO from being used as discriminatory trade policy instruments. Only once completed would a new RoO framework become binding on member states.

Preferential RoO, as outlined earlier, essentially provide the basis for determining the eligibility of a traded good for preferential treatment, for example a waiver from import duties or quota restrictions. Preferential RoO are contained both in reciprocal (whereby mutual preferences are granted) and non-reciprocal trading arrangements

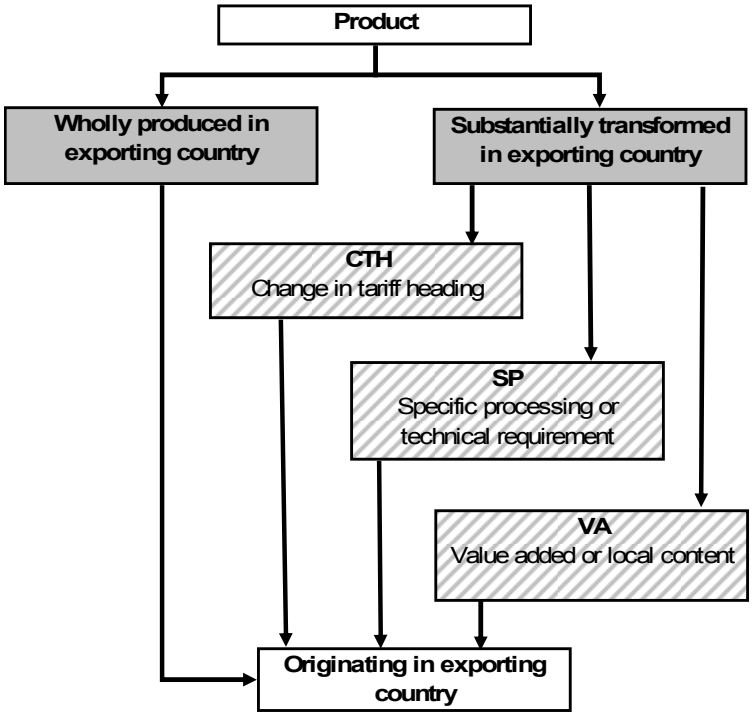
[1] World Customs Organisation: See http://www.wcoomd.org/ie/en/AboutUs/fiche6_ang.pdf.

(for example unilateral market preferences provided by a developed country to a group of lesser developed countries). Considering the recent proliferation of preferential trade agreements at the bilateral level, preferential RoO have gained in importance and play a critical role in determining market access conditions between trade partners.

1.2 Methodologies used in determining origin

Wholly obtained or substantially transformed: The value added, change in tariff heading and specific processing tests to determine local origin

RoO regimes found in PTAs employ a range of methodologies to define origin. In the absence of a binding international agreement on preferential RoO, let alone non-preferential trade rules, trading partners continue to make use of a range of different methodological benchmarks to determine origin. The primary distinction is between goods that are wholly produced in the preferential trade partner and exporting country, and those that are made up of inputs sourced from different parts of the world. While the origin of a wholly produced product is largely beyond dispute in terms of applying the RoO, goods made up from both local and foreign content are subject to closer scrutiny.



Four key methodologies are used to determine whether a product should be considered as originating in the exporting country. Most RoO regimes deem a product that is made up solely of materials sourced from within a country, or which is a growth of the exporting country, to be originating. This requirement is known as the 'wholly obtained' test in EU agreements, and is a common feature across a wide range of origin regimes. Products typically qualifying as originating under the wholly obtained principle include mineral products extracted from soil or seabed, vegetable products and live animals born and raised in the exporting country as well as fish caught in a country's inland and territorial waters by their vessels (as is shown in Annex I, the EU rules provide an elaborate and somewhat controversial definition on what is considered as "their" factory ships, where fish is caught outside the territorial waters of an exporting country). Products that are made exclusively from the above would, by extension, also be considered to be wholly obtained and therefore deemed originating. Annex I provides the "wholly obtained" conditions used in the Cotonou Agreement (and with minor adaptations in other EU agreements).

The alternative to wholly obtained is for a product to undergo substantial transformation in the exporting country. Substantial transformation in accordance with specific requirements in effect confers originating status on a product and qualifies it for preferential market access, thus differentiating it from products that may simply be transhipped through the exporting country's customs territory. Substantial transformation requirements therefore ensure that the working and processing undertaken in the exporting country go beyond a minimum set level and that market preferences indeed accrue to the trading partner or beneficiary within a PTA rather than to third countries.

Three tests can be applied to prescribe and measure substantial transformation. None of these methodologies has been developed specifically with RoO in mind, and each has certain shortcomings which will be discussed later. Largely as a result of these shortcomings, but also with a view to increasing the flexibility to producers and exporters, some RoO regimes employ more than one test to measure substantial transformation. Others provide exporters with a choice between more than one test, based on different methodologies, while others utilise a single methodology yet

change the criteria with which such methodology is used, for example between countries having different levels of economic development, or between different product groups and industry sectors. Each of these methodologies —change in tariff heading, specific processing and value added—is described below.

◘ Change in tariff heading (CTH)

Substantial transformation is considered to have occurred when the materials have been transformed to such an extent that the finished good (to be exported) can be classified under a different tariff heading to its input components, based on the harmonised commodity trading system nomenclature (HS). The HS is used universally[2], mainly to classify trade flows and for purpose of managing tariff treatment of imports, and is consistent between countries up to the 6-digit level. All goods are categorised according to sections, chapters (2-digit), headings (4-digit) and sub-headings (6-digit), representing increasing levels of disaggregation and commodity description. Although the CTH methodology using a narrow definition refers to a change in tariff *heading*, representing a product transformation at the 4-digit level, it is here referred to more broadly as representing a change at any predetermined HS classification (it could, then, also be referred to the 'change in tariff classification' rule). In other words, this methodology could be applied at various levels of disaggregation and is not limited to a change at the 4-digit level.

Example CTH Source: Cotonou Agreement

HS 2007Jams, marmalades, fruit jellies, etc.

RoO: **"*Manufacture in which all the materials used are classified within a heading other than that of the product*" and**
"*The value of any materials of Chapter 17 used does not exceed 30% of the ex-works price of the product*"

Fruit (e.g. oranges HS0805) is generally classified within chapter 08 and sugar (e.g. cane sugar HS1701) within chapter 17. Marmalade is therefore originating if the *making up* takes place within the exporting country; the second requirement (a VA restriction) stipulates that non-originating sugar may be used up to 30% by value of the ex-works price of the product

[2] As of November 2006, 126 countries were contracting parties to the Harmonised System Convention (Source: World Customs Organisation).

◘ Specific processing (SP)

This alternative methodology is also known as the 'technical test', as it provides specific working and processing requirements that must be undertaken within the exporting country in order to be deemed as originating there. This methodology requires individual application of the 'processing required' and does not lend itself to being uniformly applied across product sectors.

Example SP Source: *Cotonou Agreement*

HS 4102Raw skins of sheep or lambs, without wool on

RoO: **"*Removal of wool from sheep or lamb skins, with wool on*"**

The process of removing the animal's wool is considered sufficient to be regarded as substantial transformation of the underlying product.

◘ Value added (VA)

The value added methodology involves setting a specific threshold, expressed as a percentage, in relation to the proportion of local and/or foreign content of a product. In its most basic form, VA sets a *minimum local* content requirement that applies to a product seeking preferential market access under a PTA. Alternatively, a *maximum foreign* content can be specified, which limits the use of non-originating materials beyond a certain threshold. The VA methodology further requires rules relating to the basis on which value added is calculated, for example factory sales price or net production cost. The latter in particular requires that restrictions are set on what may or may not be included in the calculation relating to content and value added.

Example VA Source: *AGOA Legislation*

HS 7223.00.10 Stainless steel, round wire

RoO: ***Direct cost of value of materials plus direct cost of processing in the beneficiary country must equal at least 35% of the product's appraised value at the US port of entry. In addition, up to 15% of the 35% may consist of US-made parts and materials.***

The combined value of materials and processing in the home ("beneficiary") country must exceed 35%, while almost half of this may be made up of materials sourced from the United States. The "value" of the transaction includes packaging costs, selling commission, royalty and licensing fees incurred by a buyer, and the value of free assistance that may have been provided to the buyer conditional upon the sale. Included under the "direct costs of processing" are the cost of labour, engineering or supervisory quality control, machinery costs (and depreciation of machinery and equipment), as well as Research and Development costs (R&D). These further guidelines are specific to AGOA and may vary between different PTAs.

Current EU RoO, where use is made of a VA basis for determining origin, generally set a value of non-originating content threshold that may not be exceeded. In many RoO regimes this methodology is used as an alternative requirement, or as a sub-rule. For example, the rule may require a CTH and as an alternative requirement limit the value of non-originating materials to a given threshold, based on the ex-works price of the product or the total value of materials. The rule may also limit the use of non-originating materials, in instances where the application of a given primary rule *may* lead to outcomes that would see very little local value added. The VA test therefore also has merit in reducing the likelihood of the primary rule being met without any significant value being added.

The underlying cost basis applied to the calculation of product and material prices, and hence local against non-originating content, has a significant effect on the restrictiveness of a given VA threshold. This is an important factor that must be considered by trade negotiators when agreeing to changes in RoO that stipulate certain measures of local or foreign content. Where the ex-works basis is used, the final "factory-door" selling price, less any transportation charges in shipping the product from the producer / exporter to the importer, is considered to be the denominator on which to base local or foreign content. By extension this means that local factor mark-up is considered to be part of local content, rasing the overall value of local processing and reducing, in relative terms, the value of non-originating materials used.

Where the basis for calculation is the net production cost, which considers only the direct costs associated with the production of a given vehicle (and which requires any "non-related" administrative costs, as well as certain intangible inputs to be discarded in the calculation), the denominator is effectively reduced. All other things being equal, this means that local content is also reduced even if only by not being able to include local mark-up in the calculation for the final price of the product. A lower denominator means that imported materials, all other things being equal, account for a relatively higher non-originating content threshold. While it is possible to set equivalent thresholds using either the ex-works or production cost basis, the latter will require a higher non-originating (or lower local) content threshold in order to be considered equally restrictive to a RoO using the ex-works basis. Administratively, the ex-works basis is significantly simpler to use.

Some advantages and disadvantages of each RoO methodology

None of the methodologies discussed above are optimally suited to the application of setting RoO. Each test has both advantages and disadvantages, some of which will be discussed here. In the absence of internationally binding guidelines, the use of different methodologies for determining origin alongside different origin 'thresholds' means that ultimately it is exporters and international trade that may be compromised by the various RoO methodologies. This is particularly so, given not only the exponential growth in international trade in recent years, but also a mushrooming of PTAs often with overlapping memberships. Furthermore, trade and production have evolved to such an extent that there is an increasing 'polarisation' of production across the world, with comparative advantage and resource endowments meaning that few finished goods today are wholly produced in one country only but are utilising competitive inputs sourced from a range of locations. This has implications for preferential RoO, as these sometimes tend to be inconsistent with commercial realities and global value chain dynamics.

While there is no clear 'best' methodology, it must be emphasised that the purpose of preferential origin rules is the prevention of trade deflection. Bearing this important objective in mind, RoO should be simple to administer—both for traders and customs

authorities—and should not be trade distorting. At the same time, it is the prerogative of preferential trade partners to devise rules that ensure that significant processing takes place in the preference-receiving country, while not at the same time serving as a guise for protectionist trade policy.

The change in tariff heading (**CTH**) methodology, which is based on the HS nomenclature, lends itself to the application of preferential RoO in a large majority of instances, but is undermined by the fact that the HS system was not developed with RoO in mind. Rather, its purpose was the administration of tariffs and related trade policy, recording of trade flows, and so forth. This classification system categorises products generically according to their material properties and therefore mostly combines unprocessed raw materials in the same HS Section or HS Chapter as further processed and beneficiated final goods. For example, unprocessed sugar cane through to sugar confectionery are located in Chapter 17, cotton and cotton fabric in Chapter 52, and natural rubber and, for example, conveyer belts of rubber, in Chapter 40.

Overall, the CTH is relatively simple to administer, both by producers and exporters as well as by customs authorities. This simplicity is one of the factors that make CTH attractive, while the level of local transformation embodied by this methodology generally does not represent a significant trade barrier to producers, especially in lesser developed economies.

Problems arise when further processed goods are classified in the same heading as their material inputs, this being the case in certain instances at the 4-digit heading level (being the most common disaggregation used in the CTH methodology). This means that were a CTH methodology to be applied as a test for conferring local origin, some products would not qualify. Examples include fresh and dried vegetables (HS 7102), raw and further processed diamonds (HS7102), or parts of agricultural machinery used for soil preparation or cultivation, as well as the machinery itself, which both fall into 8432.

Further drawbacks of the HS system include the fact that it is still subject to revision, and ad hoc changes take place especially as 'new' products require classification. Also, a tariff jump (at whatever level of disaggregation) does not represent a consistent level of transformation, processing or value addition. For example, fresh or chilled fish livers and roes (HS 0302) are categorised in a different heading once frozen (HS 0303). Here, simple freezing would deem the frozen product originating under a 4-digit CTH test. Similarly, the transformation of cotton yarn (HS 5205) into woven cotton fabric (5208) represents a CTH, although the latter arguably involves a far greater degree of (local) transformation than the former.

The specific processing (**SP**) test is often seen in the least favourable light as a general RoO methodology, although it can be extremely useful in supplementing the other methodologies given some of their shortcomings. In an ideal world, SP could be used to determine appropriate levels of local transformation that strike a balance between preventing trade deflection and not acting as inappropriate barriers to trade; SP can be nuanced to cater for the various product and industry specific scenarios that are not adequately dealt with by the CTH or—as discussed later—the VA methodology.

But a major drawback of SP is the fact that it is not universally replicable across a RoO regime and requires line by line negotiation between trade partners. This allows protectionist and other political economy considerations to influence the outcome of SP negotiations and rules, as is evident today in a number of preferential trade arrangements. Likewise, in order to achieve a satisfactory outcome, the SP methodology requires intense consultations with industry in order to develop appropriate SP criteria—something that is unrealistic given the large number of products and processes that would need to be covered. Despite its merits in certain instances, SP also fails to deal with the important objectives of simplification and transparency, both for traders and for customs authorities who are tasked with ensuring compliance both on the export and import side. Administratively, this would likely result in slowing down the trade process and work against the objective of greater trade integration between the parties to a PTA.

The value-added (**VA**) methodology entails setting a local or foreign content threshold in the determination of origin. Conceptually, this methodology is simple, and it can be applied almost universally across the product spectrum. VA lends itself to the setting of different thresholds depending on the particular product or industry sector, and is also suitable in differentiating between lesser and more developed countries through the application of lower or higher local content requirements respectively. In other words, VA lends itself to at least a basic form or asymmetry between countries that may be very different in terms of their economic and industrial profile. VA is used in a number of PTAs, either as the primary RoO methodology or as an alternative option.

A number of challenges complicate the use of VA. Probably the most important is the administrative burden that VA imposes on producers, exporters and customs authorities. Exporters must be able to demonstrate compliance with any given VA threshold, which requires detailed accounting records to be maintained and in many instances the use of cost accountants to prove compliance. Customs authorities must also have in place systems that can verify the accuracy of any claims made in relation to local content, both on the exporting and the importing side, which is standard practice but substantially more technical and onerous with VA. Exporting countries' customs authorities are usually required to have in place adequate systems to register exporters and ensure compliance with the relevant RoO calculations, as noncompliance and incorrect claims would seriously undermine the trade process and jeopardise the functioning of a PTA. Likewise, customs authorities on the importing side must be able to verify any claims, which require cooperation with the exporting country and potentially holds up the process more than the use of other methodologies does.

The burden of cost accounting required also depends on the cost basis used for determining local against foreign content. For example, the ex-works basis would deem the price at which a given product leaves a factory in which the last processing took place to be the cost denominator on which to base local content. The net production cost basis would typically only look at certain direct material and labour costs and at other direct expenses such as royalties in the permutation of content

value. Many cost elements would then be specifically excluded—for example product packaging, certain marketing costs, etc. This complicates the burden of proof.

While the ex-works basis is generally simpler to administer, it also has certain drawbacks compared to a production cost basis. For example, in certain sectors exporters are not able to simply set the price, but must in effect “fit in” with a given world price for a product or are subject to the buying power and value chain dominance of the buyer in specific output markets. This means that exporters might have to reduce the selling price in order to accommodate different shipping charges and still remain competitive in a price-sensitive market. Likewise, large buyers may require volume or seasonal discounts, all of which reduce the local value-added by effectively reducing the mark up charged. These influences may affect the originating status of a product, a situation that would not arise under an equivalent (lower) threshold using only production cost as the denominator.

Various other issues are relevant to the VA methodology. Amongst these is the fact that value calculations are influenced by movements of currency exchange rates, or even the (in)efficiency of a country’s banking system. A depreciation of the local currency would raise the value of foreign content, and may even cases change a product’s status from originating to non-originating, while high financial charges (incl. currency exchange rates, etc.) would likewise artificially inflate foreign content of a product. It is also often argued that VA may act as a disincentive for local productivity improvements, as any efficiency gains that translate into lower local costs also affect the cost ratio of local against foreign content. The counter-argument to this might be that, in reality, producers in developing countries are more likely to benefit from greater efficiency improvements contained in imported content (and expressed through lower import costs) than brought about internally. Likewise, according to global practice, most VA thresholds require less than 50% local content, meaning that the benefits of importing low-inflationary, if not deflationary, pressures are probably widespread.

Not unlike the CTH and SP methodologies, a single across-the-board threshold will not necessarily imply similar local processing requirements, and will also not impose

the same burden on producers. The impact on producers depends on the availability and competitiveness of local against foreign materials, labour cost and other commercial realities, for example where an appliance manufacturer must source from abroad key components that make up a large portion of the final cost due to limited sources of supply globally. Setting a local content threshold inappropriately high would take away the ability of many marginal producers and certain industry configurations that rely on tapping into global sourcing opportunities.

The lack of a universal RoO methodology that is easily applied and simple to administer, yet which is able to balance the need to prevent trade deflection with the objective of enhancing trade under a given preferential trade regime, means that RoO will continue to be an important yet challenging component of trade agreements. In considering which may be the preferred methodology in a given scenario, for example the negotiation of regional trade agreements, Economic Partnership Agreements (EPAs) between the European Union (EU) and African, Caribbean and Pacific (ACP) countries or any other bilateral PTA outside the multilateral WTO framework, it is necessary to recognise that certain situations and industries require a more flexible approach than a simple across-the-board application of a single methodology. At the very least, the objectives of transparency, simplicity and equity should remain key to the outcome of RoO negotiations, so that compliance with RoO themselves do not become a technical barrier to trade.

1.3 Other components of RoO

RoO entail more than the basic tests that deem a product originating or nonoriginating under a PTA. Various other dimensions to RoO regimes expand or restrict the requirements under which a product may qualify for preferential treatment, including provisions relating to the use of materials from specific partner countries to be deemed as automatically originating, certain waivers from a strict interpretation of the rules and ‘insufficient operations’ that on their own are specifically excluded from contributing to a product’s originating status.

Cumulation

Cumulation refers to provisions that permit materials and operations from more than the exporting country to contribute to 'substantial transformation'. Cumulation essentially increases the geographic scale of the exporting country, as it permits the use of inputs from certain partner countries without such inputs having to undergo further substantial transformation in the final exporting country. Such inputs are considered as originating the product where further processing takes place, even though it may not have been substantially transformed and might have entered that country under the cumulation provisions. With respect to the ACP group of states, for example, cumulation provisions consider all ACP countries to be a single territory for RoO purposes, subject to certain conditions, which allows the substantial transformation of a product or material to be undertaken jointly in more than one territory.

Cumulation provisions have certain technical limitations, and these must be considered in the context of the overall objective of RoO. As outlined at the start of this chapter, the original and arguably only legitimate objective of RoO is to prevent trade deflection, which would entail goods from a country enjoying less preferential market access to a third country transhipping its goods through the customs territory of a country having more favourable access to that third country. While this theoretical scenario is probably tempered by reality, as this entails additional shipping costs and possible import tariffs levied by the 'go-between' (unless such re-exports qualify for a waiver or remission of import duties), it nevertheless forms the key theoretical basis of cumulation. That is, cumulation is made possible by the fact that both cumulation partners face equal market access conditions—essentially the same RoO—in the market of the third country. In such a scenario there is little if any benefit to be obtained from trade deflection and thus no danger of a PTA being undermined by trade deflection from associated countries. Cumulation therefore has the potential of playing an important role in facilitating trade between countries belonging to the same PTA.

Different forms of cumulation provisions can form part of preferential RoO. These are bilateral, full, diagonal and regional cumulation.

- **Bilateral cumulation**

Bilateral cumulation is the most elementary form of cumulation and involves cumulation between the principal partners in a given PTA. It entails being able to freely utilise goods and materials originating in each other's customs territory for further processing (such materials are considered local content when used in that country's exports to its principal trade partner), without having to undertake specific transformation in accordance with the applicable RoO. Material content must however first be *originating* in the partner country before it may be used for cumulation purposes, as it would otherwise be considered as trade deflection and thus undermine the PTA. Bilateral cumulation is common to all preferential RoO regimes.

- **Full cumulation**

Full cumulation permits working and processing to be undertaken by all parties to a PTA without reference to minimum transformation requirements set out in the RoO. All processing and materials are jointly rather than individually considered in determining if and where a product is originating, although the final country in which working and processing took places is ultimately deemed to be the origin of the final export product. Full cumulation essentially expands the territory of the exporting country to apply to all parties to a PTA. An example of full cumulation is the treatment of ACP countries as a single territory for RoO purposes under the EU-ACP Cotonou Agreement.

- **Diagonal and regional cumulation**

Diagonal cumulation is a form of cumulation that goes beyond the usual boundaries of bilateral and full cumulation in that it permits, under certain circumstances, the use of materials from third countries not party to an agreement to be classified as originating in the exporting country. Such materials are not required to undergo substantial transformation in line with RoO requirements when further processed by the final exporting country, but must nevertheless be originating in the third country

by way of an application of RoO that is identical to the RoO between the exporting country and the country of final destination. This means that an existing preferential trade relationship, framed by similar RoO, must exist between the third country and the home country's principal partner in a given PTA. This form of cumulation is a feature in the EURO-MED Agreements, where a number of countries each have a separate yet similar agreement with the EU; diagonal cumulation permits cumulation of originating goods and materials between the EU trade partners without having to again undergo substantial transformation in the final exporting country when shipped to the EU.

Regional cumulation is a derivative of diagonal cumulation but applies only within a specific regional context—often neighbouring developing countries or those belonging to an existing regional integration initiative. An example where regional integration is a feature in RoO is the EU's Generalised System of Preferences (GSP), which permits cumulation between three predefined groups of GSP beneficiaries.

Value tolerance

Value tolerance rules—sometimes also called *de minimis* (meaning 'not worthy of concern')—are RoO provisions that somewhat alleviate the strict application of RoO list rules or core methodologies underlying a particular RoO regime. Usually, the *de minimis* provision is in the form of a VA-based component and which in effect represents a waiver from normal rules. A 15% value tolerance threshold means that up to 15% by value of the product does not need to meet origin requirements. This is a useful enhancement to RoO as it provides manufacturers with greater input flexibility, especially where certain inputs are not available locally or can not be sourced at a competitive price within the country. EU RoO base the value tolerance on the ex-works price of the product (if the rule requires the use of certain originating inputs, value tolerance allows up to 15% of non-originating materials to be used), although other agreements also have different forms of value tolerance. The African Growth and Opportunity Act (AGOA) for example has a 25% "findings and trimmings" rule applicable to garment exports.

Where specific value-added thresholds form part of the RoO of certain product categories, value tolerance thresholds are limited in their application as they do not supersede specific value-added or value-related requirements, for example where non-originating content is subject to a specific maximum threshold as is sometimes the case in the Cotonou Agreement. Likewise, certain sectors can be excluded from the application of value tolerance provisions. In the EU-South Africa Agreement (Trade and Development Co-operation Agreement or TDCA) the value tolerance provisions do not apply to certain sectors (textiles and clothing in HS Chapters 50-63) and are limited to a lower threshold in others (for example fish and tobacco products).

Value tolerance provisions are only relevant where value-added does not form the core RoO methodology used in a RoO regime, but are a supplementary mechanism to alleviate the restrictiveness of RoO where tariff heading and technical processing tests are used in the consideration of origin of a product.

Insufficient operations

Insufficient operations define certain processes that *on their own* are inadequate to confer origin on a product, irrespective of whether the product otherwise complies with the applicable origin requirements. A range of processes and undertakings could, if necessary, be included in such a list of 'insufficient operations', which is a prominent feature of preferential trade regimes to which the EU is a party. Typically, processes such as simple preservation of a product—through cold storage—as well as the process of packaging, affixing of labels or simple assembly of packages is included in such a list, as it is argued that such processes do not change the economic nature of the product and by themselves do not add sufficient value to be worthy of changing the origin of a product shipped under preferential trade relations.

A full list of 'insufficient working or processing' operations, using that which is contained in the current Cotonou Agreement, is provided in Annex 2

Developmental dimensions?

RoO can have an important impact on development, in that by setting the criteria by which the origin of a product is determined for purposes of preferential market access, RoO can both act as an incentive and discouragement to trade and development. The link between RoO and trade is indisputable, although it is also beyond question that favourable RoO will not – on their own – lead to trade and development.

RoO can have a positive impact on development if the criteria that determine origin are defined in such a way as to provide an incentive to economic agents to increase production, to invest, and ultimately to export. Since preferential RoO permit duty-free or duty-reduced exports—in addition to other preferences—between the contracting parties to a preferential trade arrangement, the incentive of complying with relevant RoO must be weighed against any additional processing and administrative costs that might be associated with the RoO. Where the net result is a positive outcome—meaning that the incentive of complying with RoO is sufficiently large to warrant the 'cost' of compliance, then RoO can play an important role in development in the exporting country. Favourable market access represents a source of competitive advantage, which may drive development through greater investment and production.

While RoO can act as a driver to development, commercial realities play at least as important a role in whether RoO lead to greater trade and induce development. It is sometimes argued that restrictive origin requirements—for example those that force producers to source materials locally instead of from abroad—will create a demand for upstream products and ensure more vertically integrated development. Such a scenario can indeed have a positive outcome, especially when the margin of preference (calculated as the difference between preferential entry and duties liable under normal tariff relations) of exporting duty-free is sufficiently large, and of equal importance, where profit margins are not overly tight, thus allowing producers to absorb the cost of sourcing from perhaps less favourable locations. Goods in industries that are typically part of producer-driven value chains may more readily fall

into such a scenario, including, for instance, the motor vehicle manufacturing industry.

The impact of restrictive origin rules as a guise for promoting development will be entirely different in products and industries that face far tighter margins and higher competitive pressures, especially those where the dynamics are such that they could be described as forming a part of buyer-driven value chains, as is generally the case in the clothing manufacturing sector. Here margins are tight and prices largely determined by buyers rather than by producers; RoO that restrict the choice of producers to source their inputs from the most competitive sources will invariably remove producers' competitiveness and stifle trade and development.[3]

It is open to debate whether RoO should be seen as a vehicle for development, although few would argue that RoO especially between unequal trade partners (for example the EU and a developing country) should be development-friendly. In this context, upstream development and local processing are seen as the key objectives of RoO, besides preventing trade deflection from countries with less favourable market access to a given trade partner. Proponents argue that RoO should at all times have a developmental dimension, and that well-crafted RoO are of critical importance in ensuring long-term and sustainable benefits to the signatories of a preferential trade arrangement.

Sceptics of RoO as a tool for development argue that it is not the responsibility of RoO to provide the incentive for development, and that good intentions in this regard are likely to fail (as highlighted by the example of the clothing sector earlier). Any incentive to further upstream development will only be successful if this fits in with important commercial realities of the sector in question, and further, is heavily influenced by both the exporting and importing country's economic policies, industrial environment and general business and trade dynamics. Further, the latter would

[3] An example that may be relevant here is the RoO facing the clothing sector under the EU Cotonou Agreement or GSP, which essentially require two stages of domestic processing including the use of local or regional fabric. These provisions have done little to incentivise upstream fabric production among African countries and have over the past few decades resulted in only very marginal exports of clothing to the EU.

argue that RoO should only be focused on providing ready access to foreign markets in the most liberal way possible, while still ensuring that origin rules require sufficient local processing in order for the exporting country not to become a transhipment route, thereby undermining the underlying preferential trade arrangement that connects it to its trade partner.

Derogations

Derogations refer to mechanisms whereby changes can be made—usually retrospectively and on a temporary basis—to the RoO governing a preferential trading relationship between two or more countries. Normally, prior to a derogation being agreed to, appropriate derogation mechanisms must be in place, for example a joint committee comprising officials from all countries concerned. Furthermore, special circumstances should warrant a derogation. Derogations are usually country-specific and time-bound, and take into consideration particular circumstances that prevent a party to an agreement from complying with existing origin provisions. Derogations may also be quota-based, whereby a waiver from normal origin requirements is permitted within a specific annual quota limit.[4]

Derogations are potentially important features of bilateral trade agreements in that they can augment rules that are drawn up for a group of countries (without being able to deal with specific circumstances), as well as by accounting for certain supply weaknesses that may occur from time to time (for example the seasonal non-availability of a certain input). At the same time, derogation mechanisms serve no more than a complementary role to the underlying RoO, and should not become vehicles for circumventing agreed upon origin requirements without proper justification.

[4] For example, the ACP States have been provided with a derogation for certain tuna products, whereby subject to a quantitative and time-bound limit the ACP may use a quantity of non-originating tuna for further processing (canning) operations. This is an example of a derogation that might be grounded in the fact that the tuna industry is of critical importance to many ACP States; and for certain parts of the year, tuna stocks migrate in and out of the waters of ACP States as they are a largely pelagic species. See also: 2005/181/EC: Decision No 2/2005 of the ACP-EC Customs Cooperation Committee of 1 March 2005 derogating from the concept of 'originating products' to take account of the special situation of the ACP States regarding the production of preserved tuna and of tuna loins (HS heading ex 16.04).

Derogation mechanisms are useful only when the administrative procedures around derogations are clearly defined, transparent, not overly cumbersome and with clear time lines attached. In the absence of a clear framework for derogation procedures, the process becomes overly cumbersome and negates any potential benefit that applicants (countries) may derive from it.

The absorption principle or "roll-up"

The absorption principle consider goods and materials that have gained local origin by undergoing substantial transformation to be treated as forming part of local content when used in any further processing. In other words, no account should be taken of the non-originating materials of a product that has already earned "originating status".

Using the textile and clothing value chain as an example, where the relevant RoO might require that a good is made up of at least 50% local content, fabrics can be used which in turn may have acquired local origin status by having been transformed locally from imported fibres. No account will then be taken of the value of the imported fibre (contained in the fabric, which is now on its own already considered "originating") when the determination is made how much local content is contained in a product. In practice, when applied to the VA principle, a 50% local content rule can therefore in reality translate into an even larger non-originating content under the absorption principle (when considering all input costs through the various production phases of a product). The absorption principle features in some way or another in many preferential RoO regimes, including the EU GSP.

2. Sectoral issues facing African countries in EU preferential trade

2.1 Restrictive Rules of Origin in EU trading arrangements

The nature of EU Rules of Origin

Rules of Origin (RoO) form a core component of preferential trade arrangements, by defining the terms under which a product is considered as originating in the preference receiving country and therefore eligible for duty-free or reduced-duty exports to a preferential trade partner.

While the prevention of trade deflection remains the original objective of RoO, it is clear that many origin regimes - particularly the EU RoO arrangements - often go beyond this objective. It could even be argued that in practice, the purpose of RoO is not to enhance trade but to restrict and control it, and only provide preferences in sectors that are considered less sensitive to policymakers.

When RoO are developed on a non-reciprocal basis, as has been the case in the EU GSP or the preferences granted to ACP countries under the Lome/Cotonou Agreement, the outcome is often one that favours the preference giving countries at least for key sectors of potential export interest in the beneficiary country. This opens the RoO to the influence of special stakeholder and lobby groups (mainly of the preference-giving country), a situation that is potentially exacerbated where RoO are drawn up or negotiated at the sectoral or even product or tariff line level as is the case with the EU RoO regime. It is understandable that domestic industries, especially where these have political clout (for example as a result of their contribution to the economy), would seek to protect their interests against competition from low-cost or resource-rich countries that the EU offers duty preferences to.

RoO that are today viewed as excessively restrictive might also be interpreted as such as a result of changing economic and political realities. For example, as will be discussed in greater detail later, the economic dynamics of the textile and clothing industries—including factors of competitiveness, industrial location, industrial

organisation, value chain realities, etc.—are today substantially different to what they were three decades ago when Lomé I was drawn up. What might have been considered reasonable at the time, given the dynamics of the sector and a generally high-duty environment, today represents conditions that are outdated and overly restrictive. The fact remains, however, that the requirements for "substantial transformation" faced by African countries in order to gain duty-free or preferential access to the EU market have remained largely unchanged since the earliest Lomé treaties.

RoO obviously have the potential of playing a positive role in development, for example where they support an environment that provides incentives for investment, upstream development and local sourcing. But RoO in isolation will seldom be development friendly where their fundamental point of departure is to restrict the use of foreign materials, and to expect producers to source materials from (domestic) suppliers that might be far less competitive than other (foreign) sources. Exporters will always prefer sourcing locally if competitively-priced materials are available, or unless instructed to do otherwise by international buyers, due to the clear advantages with respect to costs and (not least) language. The EU RoO instead give the distinct impression of being tools to regulate or restrict rather than induce trade. While this might not be applicable to all goods, it certainly holds true for some sectors. Although African producers have the option of exporting to the EU under various programmes, including Cotonou, GSP and in many instances the GSP offshoot 'Everything-But-Arms', the RoO are virtually the same in each programme. More recently, a special Council Regulation has facilitated preferential trade for those ACP countries that have initialled an Interim Economic Partnership Agreement (EPA) with the EU, and while these RoO contain some important changes they leave the treatment of most sectors unchanged from the EU's other RoO regimes.

With the European Commission intends to revise its preferential RoO regime, not much of this change has taken place due to continuing uncertainty about how best to restructure its trade regime and which RoO methodology to use in conferring origin on qualifying products. Although the Commission had originally intended to implement its revised RoO regime through its GSP and possibly the EPAs, this has

not happened. EU RoO have remained largely unchanged over the past few decades, particularly the rules contained in the GSP and Cotonou Agreement. While the EU has concluded a number of trade agreements with a host of countries since the mid-1990s (including South Africa, Mexico, Chile and various Mediterranean countries), these contain essentially the same origin requirements as do the GSP and Cotonou Agreement. While this is reflective of the EU's desire to maintain a degree of harmonisation between its preferential RoO—bearing in mind the administrative burden placed on EU customs authorities tasked with enforcing compliance with the rules—it is perhaps also indicative of the EU's relative inflexibility until now with respect to revising rules that have long been considered as 'problematic' by foreign traders.

EU RoO are mainly sector- and product-specific and confer originating status on goods (exported from the beneficiary country) that are either wholly obtained there, or which have undergone a process of substantial transformation in accordance with various set conditions. The EU applies more than one methodological basis: either the specific processing rule (whereby a predefined production process must be followed), the use of a value-basis (usually in the form of limiting inputs from certain input categories, or limiting the value of materials) or a change in tariff heading (where the materials used must be classified in a tariff heading other than that of the product). In many instances, elements of more than one methodology are applied, while in others the exporter has a choice of two or more tests to determine origin.

There is no set pattern that determines the EU's preferential origin rules. Their 'inconsistency' is based partly on the fact that no single methodology is ideal in all circumstances (or rather, applying a single rule would probably create very unequal origin requirements), and the fact—as alluded to earlier—that the EU's preferential origin regime has largely been moulded by its own protective, industrial and agricultural interests. In the March 2005 Communication on a future Rules of Origin regime, the European Commission shows the large number of methodological permutations that feature in the EU's preferential RoO—with the SP rule applied most (27.5% of total) followed by CTH (18%) and a combined CTH / VA approach (17.2%

of total). These figures are overall numbers applicable for the entire range of EU preferential RoO.

2.2 Specific sectoral challenges under current EU trade agreements

The EU's current RoO have frequently been listed as one of the major impediments to greater market access for its trade partners, who raise the fact that the erosion of preferences over the past decade or so (mainly as a result of the increasing number of countries with preferential market access to the EU, and lower EU import tariffs under normal tariff relations) make compliance with some RoO disproportionately onerous given the relatively small benefit that accrues from compliance. The argument is that the cost of complying with RoO (for example greater administrative burden, restrictions on sourcing etc.) must be less than the applicable tariff by not complying with the RoO. The lower the preference margin, the less inclined a producer will be to export under a given preferential trade arrangement.

Two sectors stand out for having been subject to highly restrictive RoO within the EU RoO regime, namely textiles/clothing and the fisheries sector. While other issues also play a role in undermining exporters' access to the European market, notably supply-side constraints in many developing countries, the cost of logistics in getting products to market, bureaucratic hurdles, standards (for example sanitary and phytosanitary), RoO remain a key determinant in whether producers are able to export their products to the EU under trade preferences.

Textiles and Clothing

Global trade in textiles and clothing was valued in 2005 at almost US$ 500 billion - split roughly 60:40 in favour of clothing - based on WTO estimates[5]. Double digit growth was recorded in the mid- to late 1980s, and again in the early parts of this century, probably as a result of further integration of the sector with normal trade disciplines under the WTO Agreement on Textiles and Clothing (ATC). Although the WTO data currently does not reflect post-2005 trade, the year when the ATC fell

[5] http://www.wto.org/english/res_e/statis_e/its2006_e/its06_bysector_e.htm.

away, indications are that the growth in trade has accelerated notwithstanding the subsequent protective measures imposed by the world's largest importers of textiles and clothing, namely the United States and Europe.

Textiles and clothing exports are of great importance to developing countries, where much of the production (especially in the clothing sector) takes place. Clothing manufacture is labour intensive and provides relatively low barriers to entry, and has long been promoted by developing countries as an entry point for greater economic diversification and upgrading. Clothing manufacture and exports have evolved into highly competitive activities, where only the least-cost producers are able to survive without special market preferences. No ACP country features amongst the leading 15 clothing or textile exporters in the World.

The EU maintains relatively high import tariffs for textiles and particularly clothing, with imports of the latter attracting two-digit duties. Considering the highly competitive nature of clothing production, a reduction or waiver of import duties on these items is therefore likely to have a significant impact on the ability of exporters to compete, especially in the case of ACP developing countries relative to the low-cost producers in South East Asia. Considering that the EU is the single largest importer of textiles and clothing, its RoO become particularly relevant to 'marginal' exporters—exporters (from countries) not normally considered to be amongst the lowest cost producers of textiles and clothing globally.

RoO for textiles and clothing generally require a 'double transformation' in order to be considered by the EU as an originating product of the exporting (beneficiary) country. In other words, materials must normally go through two distinct production processes, which in the case of clothing might entail the conversion (weaving) of yarn into fabric, and the conversion (cut, make and trim, or making up) of fabric into garments. Alternative transformation requirements apply to garments that are embroidered, or which fall into a category which is further differentiated (for example *embroidered* clothing, which as an *alternative* can be made up from unembroidered fabric provided the value of the unembroidered fabric used is less than a certain percentage of the ex-works price of the product).

For textiles, the concept of 'double transformation' is applied in a similar manner as to clothing. For cotton yarn, the RoO requirement entails the manufacture from coir yarn, natural fibres, man-made staple fibres not carded or combed or otherwise prepared for spinning, or chemical materials, textile pulp or paper. The conversion of, say, natural fibres to yarn entails a distinct stage of transformation, while the weaving of yarn into fabric entails another.

Under current rules an alternative requirement for qualifying printed textiles fabrics entails the printing process as well as *at least* two further preparatory or finishing operations (such as bleaching, mercerising, impregnating, scouring, etc.), and that the value of the unprinted fabric may in turn not exceed a certain percentage (usually 47.5%) of the ex-works price of the product. In reality, this implies that low-end fabric will not readily qualify for the status of 'originating' (since the cost of the source material constitutes a high proportion of the total cost), but instead may be limited to high-end fabrics where significant value-adding activities have taken place to the source material.

EU RoO for textiles - example Source: *Cotonou Agreement*

HS 5204 - 5207 Yarn and thread of cotton

- Manufacture from:

- raw silk or silk waste carded or combed or otherwise prepared for spinning; natural fibres not carded or combed or otherwise prepared for spinning; chemical materials or textile pulp; or paper-making materials

HS 5208 - 5212 Woven fabrics of cotton

- Incorporating rubber thread: Manufacture from single yarn

- Other: Manufacture from

- coir yarn; natural fibres; man made staple fibres not carded or combed or otherwise prepared for spinning; chemical materials or textile pulp; or paper

or…

- printing accompanied by at least two preparatory or finishing operations (such as scouring, bleaching, mercerizing, heat setting, raising, calendering, shrink resistance processing, permanent finishing, decatizing, impregnating, mending and burling) where the value of the unprinted fabric used does not exceed 47.5% of the ex-works price of the product

EU RoO for clothing - example Source: *Cotonou Agreement*

Chapter 61 Articles of apparel and clothing accessories ,knitted or crocheted:

- Obtained by sewing together or otherwise assembling, two or more pieces of knitted or crocheted fabric which have been either cut to form or obtained directly to form:

- manufacture from single yarn

- Other:

- Manufacture from natural fibres; man-made staple fibres not carded or combed or otherwise

Issues and challenges

At issue here is whether the current rules impose an *unreasonable* obligation on producers in beneficiary countries, a question that needs to consider some of the dynamics prevalent in the global textile and clothing industries. In particular, it is necessary to understand the important role of value chains.

Value chains describe the chain of productive (i.e. value-adding) stages of a product's manufacture, beginning with raw material extraction to final end-use. In other words, value chains incorporate aspects of production, distribution (i.e. logistics and marketing) and consumption. An analysis of a sector's value chain allows the identification of where value is created during a product's life cycle from manufacture, distribution and end-use. While a traditionally held view is that value is created predominantly in the manufacturing process, this is often no longer the case today. Design, marketing and logistics play an increasingly significant role in the final make-up of a product's value. Likewise, these activities are increasingly undertaken in different locations, and are often not confined to a single country. This is particularly true for the textile-clothing pipeline.

One of the most important dimensions of value chains involves the control over the economic activities in a product life cycle. Control may be balanced where no firm or single stakeholder (for example producer, retailer) wields an undue influence. In 'producer-driven' value chains, which are typically found in the capital or technology-

intensive industries (for example the automotive and computer industries), producers are normally able to exert the most influence. In producer-driven value chains, factors such as proprietary technology and know-how often represent defining barriers to entry, with such industries often consisting of large multinationals.

The textile and clothing sectors typically fall into the definition of 'buyer-driven' value chains. These value chains are usually defined by a large number of operators/producers, high labour intensity, and typically feature industries where design and marketing, rather than actual production, play leading roles. In fact, investment in design, branding and advertising are important barriers to entry.

In the global textile and clothing industry, a number of large multinational brand-owners and retail chains exert a large degree of control over production generally, either directly or indirectly. International brand-name owners play a major role in determining the design of their range of garments, and invest large sums in branding and supply chain management. Production becomes almost secondary in nature; as is typical in buyer-driven value chains decisions around production and sourcing are determined or influenced to a large extent by these multinationals rather than by producers. Production is often not very specialised, as a result of which buyers are able to choose where to source their products from, and to a large extent (effectively) also the price that they are willing to pay.

In general clothing production, producers are therefore unable to exert much influence on the price of a garment, but are often also limited as to where they may source their input materials from. Costs and price structures are generally well known in the market place, and it is typically up to the producers to indicate whether they are able to supply on time, at the predetermined price, and in the required quantities. As is typical in production of commodity-type goods (including basic garments), producers exert little influence on the selling price as this is virtually a given; rather, profitability and sustainability lie in the improvement of production efficiencies and internal cost structures.

While numerous other factors have contributed to the wide proliferation of textile and particularly clothing production globally, the result of these value chain dynamics is that any restrictions (imposed on producers) which do not complement these realities are likely to severely undermine the ability of textile and clothing producers to compete globally. This is particularly so in cases where a country is not globally competitive along the entire production chain. Most, if not all, ACP countries fall into this category.

Detractors of a more flexible approach to origin rules for textiles and clothing would argue that a more source-neutral dispensation (i.e. rules where producer have greater flexibility over their sourcing options from a greater number of countries) will lead to a rapid decline in all but the most basic clothing assembly activities. The argument goes further that by allowing producers to use inputs irrespective of their economic origin will in effect transfer the economic benefits of textile and clothing production away to unintended beneficiary countries (namely the suppliers of materials), will significantly reduce local value-added and will remove any incentive for investment in upstream activities (relative to that of the final product).

The reality, however, remains that more than three decades of Cotonou-type RoO for textiles and clothing have failed to provide sufficient incentive for any significant and lasting textile manufacturing industry, notwithstanding local incentives and government support policies. This is despite the fact that the EU's high tariff-based trade barriers and quantitative restrictions imposed on many of the lowest-cost producers globally, have also for many years provided exporters in beneficiary countries with a significant competitive advantage over exporters from other countries.

Changes to EU-ACP RoO contemplated in the EPAs

During the EPA negotiations between the ACP countries and the EU during 2007, agreement was reached on major changes to the RoO concerning textiles and clothing. These essentially involve changing the requirements for qualifying textiles and apparel from a two-stage local transformation to a single-stage rule, which would

allow clothing and textile producers to utilise non-originating fabric and yarn respectively in the manufacture of qualifying goods under the EPA.

These changes have only been implemented as follows: until such time that ACP countries have implemented the Interim EPA, a special Council Regulation by the European Commission - published in December 2007 and shortly before the expiry of the Cotonou Agreement - has been put in place to facilitate preferential access to qualifying ACP countries. This regulation applies only to those countries that have initialled an Interim EPA; non-signatories fall under the GSP or any other bilateral agreement, whose RoO relating to textiles and clothing remain unchanged. The modified RoO are contained in the Council Regulation, while preferential market access will revert to the EPA once these are fully in force.

For clothing the most significant impact has been a change to the rules which now requires that qualifying garments must simply be made from fabric, irrespective of the origin of such fabric. The implication of this global sourcing rules is that producers may source their fabric requirements without restrictions, and based purely on commercial prerogatives rather than restrictions imposed by the RoO.

For textiles, a similar simplification to the rules has been implemented and is similarly contained in the Council Regulation as well as the RoO of the various EPAs. Although RoO remain subject to review until such time that they have been finalised and implemented, the changes already appear in the completed Cariforum-EU EPA which is a strong indicator that they will not be further amended at this stage (unless within the context of a wholesale change to the ACP-EU RoO regime). Textile rules are now also based on the principle of single-stage transformation: for fabrics, this entails manufacture from yarn (which may be of any source), which implies that only the weaving of the fabric must take place locally. Alternatively, printing plus two prepatory or finishing operations undertaken on non-originating raw fabric can, subject to conditions, confer origin. For yarn itself, the qualifying conditions have remained unchanged.

	"Old" RoO (Former Cotonou Agreement, GSP / EBA)	"New" RoO (EPA / Market Access Regulations)
Yarn **(e.g. HS 5204: cotton yarn)**	*Manufacture from natural fibres not carded or combed or otherwise prepared for spinning* **or** *chemical materials or textile pulp* [of any source]	**Same as previously**
Fabric **(e.g. HS 5208: woven fabric of cotton)**	**If incorporating rubber thread:** *Manufacture from single yarn* [of any source] , **otherwise** *manufacture from natural fibres, coir yarn, man-made staple fibres not prepared for spinning* [of any source] ***or*** *Printing plus 2 prepatory or finishing operations provided that the non-originating unprinted fabric is valued at less than 47.5% of the ex-works price of product*	Manufacture from yarn [of any source] *Printing plus 2 prepatory or finishing operations provided that the non-originating unprinted fabric is valued at less than 47.5% of the ex-works price of product*
Knitted fabrics **(Chapter 60)**	*Manufacture from natural fibres or man-made staple fibres not prepared for spinning or chemical materials or textile pulp* [of any source]	Manufacture from yarn [of any source]
Clothing **(not knitted) (e.g. HS 6205 Shirts)**	*Manufacture from yarn* [of any source]	*Manufacture from fabric* [of any source]

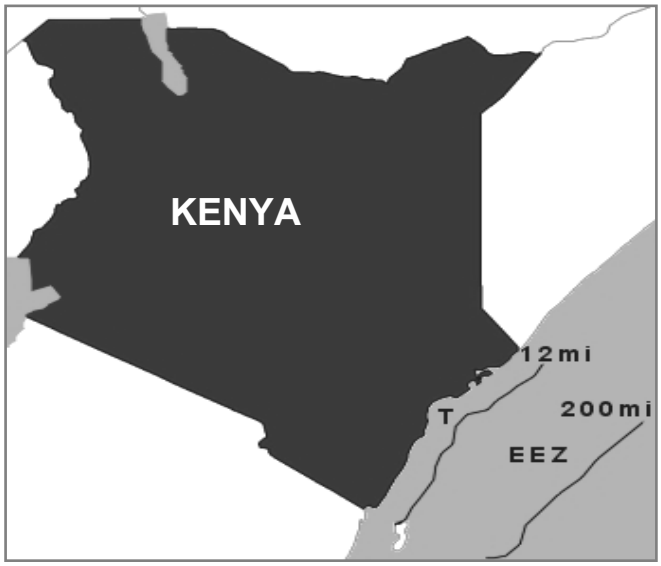
Fisheries

Fish represents another 'special interest' area, both from the perspective of market access and RoO, but also in terms of the sector's importance to the countries that export it (to the EU), as well as to the EU itself. Trade in fish products is also subject to wide-ranging economic and political sensitivities, while the EU's RoO regime relating to fish has long been the subject of severe criticism in some quarters.

On RoO the EU essentially differentiates between fish (and other seafood products) caught inland (including up to the 12-mile territorial zone), and fishery products from

beyond the 12-mile zone. Fish caught within the zone is considered as originating in the exporting country and has no further origin conditions and obligations imposed on it.

Fish caught beyond the 12-mile territorial zone is subject to restrictions emanating both from within the definition of 'wholly obtained' as well as from the product-specific RoO for fish and processed fish products. Since much of the commercial fishing effort is assumed to take place beyond the territorial zone, the RoO applicable to fish are indeed highly relevant, especially with respect to countries that do not have a significant domestically-owned fishing fleet.



One of the underlying principles applied to the origin of fish is the nationality of the fishing vessel rather than the location of the fishing activity. The latter point will be described more fully below, but essentially revolves around the fact that the economic jurisdiction (and management of the economic benefits derived therefrom) over a country's adjoining sea extends far beyond the territorial definition used by the EU RoO regime.

The wholly-obtained principle, one of the guiding and generally straightforward tests used to allocate origin, provides further detail on the RoO applicable to fish. The following is taken from the Cotonou Agreement, although the provisions in so far as they relate to fish products bear a large degree of similarity with those found in other EU preferential trade regimes. Article 3(1)(e)-(g) of Protocol I, Annex V to the Cotonou Agreement, states inter alia that wholly obtained products include:

EU RoO: Wholly obtained principles relating to fish Source: *Cotonou Agreement*

(e) "products obtained by hunting and fishing conducted there"

(f) "products of sea fishing and other products taken from the sea *outside the territorial waters by their vessels*" (emphasis added) and

(g) "products made aboard their factory ships exclusively from products referred to in subparagraph.

"Vessels" and "their factory ships" are further defined, and variation to this definition occur in different agreements.

In the Cotonou Agreement:

- qualifying vessels must be registered in an ACP or EC State;
- must sail under the flag of an ACP or EC State;
- ownership: at least 50% by nationals of an ACP or EC State;
- at least 50% of the crew, master and officers included, must be nationals of the ACP or the EU.

While provision is made for the African, Caribbean and Pacific countries (ACP) to use chartered vessels (to conduct fishing activities up to the 200 mile Exclusive Economic Zone (EEZ))[6], a set of other conditions make this option unfeasible in many instances. Under Cotonou, the exporting state would have to submit an application to the ACP-EC Customs Cooperation Committee, which considers whether the proposed lease provides adequate opportunities for developing (unspecified) capacity in the ACP fishing industry. The requesting state must further have offered the EU the opportunity to negotiate a bilateral fisheries agreement, which entails preferred access for EU fishing vessels in the EEZ of the requesting state (fish caught by EC vessels under such arrangements no longer qualifies as ACP fish but is considered EU fish). The offer to negotiate a bilateral agreement must have been declined in order for the leasing of vessels to be considered for catching fish that is considered as originating in the ACP State. Notwithstanding these requirements, the crew conditions (50% or more local or EU nationals) remain in place.

[6] The delineation of territoriality and the EEZ is found in international maritime law, with the UN Convention on the Law of the Sea (UNCLOS) defining the territorial sea as extending up to 12 miles from a country's coast. The EEZ refers to the sea beyond the territorial sea and up to 200 miles offshore. Countries have exclusive economic rights over the EEZ, although this does not extend to certain *traversing* rights.

Despite the large degree of similarity between the RoO for fishery products across the EU's preferential trade arrangements, the Cotonou Agreement provides slightly greater flexibility with respect to the ratio of ACP/EU nationals to foreigners. The EU GSP and its derivatives (including Everything But Arms (EBA)) require that 75% of the crew are nationals of the beneficiary State (or the EU), and that the captain and officers are all nationals of the beneficiary State (or the EU).

The wholly obtained principle and its associated conditions contain the core origin requirements relating to fishery products. The specific RoO for fish (contained in HS Chapter 03: fish and crustaceans, molluscs and other aquatic invertebrates) require 'manufacture in which all the materials of Chapter 3 used must be wholly obtained'. This means that the 'wholly obtained' provisions apply.

Some processed fish products are categorised within Chapter 16, specifically 1603 ('extracts and juices of meat, fish or crustaceans, molluscs or other aquatic invertebrates') and 1604 ('prepared or preserved fish; caviar and caviar substitutes prepared from fish eggs'). The RoO require, for any processed fish products, that 'all the materials of Chapter 3 used must be wholly obtained'. This means that the same conditions apply as for Chapter 3 fish products, and that the further processing (for example HS1604.1311 'sardines in olive oil', or HS 1604.1411 'tuna in vegetable oil') is on its own insufficient to confer origin. Besides the market incentives provided by further beneficiated fish products (for example higher prices), the RoO prohibit the use of non-originating fish content irrespective of the true value that is added by the further processing activities.

A slight mitigating factor to the above is the fact that the Cotonou RoO provide for an automatic derogation of the above rules in the form of an annual quota (to be divided amongst ACP States as appropriate) of tuna fish that is not required to conform to the above rules. This derogation is presumably founded in the fact that tuna are highly migratory deep sea fish and that during certain periods of the year would not be readily available to commercial fishermen and processing plants.

Issues and challenges

The RoO for fish are controversial as their impact can have substantially different impacts on different countries. They are founded in the EU's underlying desire to provide market access to ACP States but within the confines of strong politico-economic pressures from within the Union. Various countries have a strong interest in the fisheries sector, either as a result of large domestic fishing fleets or substantial investment in processing facilities. Dwindling fish stocks in EU coastal waters and increasing environmental pressures regarding sustainable resource utilisation has forced EU fishing interests to look beyond its own areas of jurisdiction. RoO, and particularly bilateral fisheries agreements, can play a meaningful role (from the perspective of EU interests) in ensuring considerable access to fishing stocks in ACP countries.

For ACP countries with a strong commercial fishing industry the current RoO—insofar as the wholly obtained principle is applied—do not pose an excessive burden even if the reasonableness of the obligations may be questionable. Ownership, registration and crew components are readily complied with for fish caught beyond the territorial waters. Countries such as Namibia (incidentally the largest exporter of fish amongst the ACP group) and the Seychelles have on the whole been able to comply with current regulations (although it is not known to what extent they may have benefited from a more flexible dispensation). A potential handicap relates to the flag/registration of the vessels, since the dynamics of the maritime industry are known to be unique, for example as regards registration of vessels in certain territories for insurance and taxation-related reasons, or because the obligations on the vessel's owners with respect to safety certification, tonnage and so forth may be somewhat more lenient. Also, the challenges around potential leasing of vessels, and the pressure on concluding bilateral fishing treaties with the EU, may have both positive and negative implications for exporting countries.

For smaller countries with less established commercial fishing industries, the current rules represent a potential hindrance and the RoO are sometimes perceived as being obstructionist rather than instrumental in preventing trade deflection. This hindrance

relates mainly to the restrictions placed on vessels and crew fishing beyond the territorial waters, and effectively prevents countries from utilising foreign (non-EU registered) vessels. Leasing of fleets is not a practical option due to the onerous conditions attached to this, and is likely to receive a go-ahead from the ACP-EC Customs Cooperation Committee only if the utilisation of fish stocks is of little interests to EU operators (who would then instead push for the conclusion of a bilateral fisheries agreement). The benefits of such bilateral agreements, especially to the country in whose economic zone the subsequent fishing effort takes place, are not entirely clear, as licensing and quota fees are considered in many cases to be low, and little control over actual catches is possible. In fact, other than the 'user fees', exporting countries stand to benefit little from such arrangements, and circumvention of the various control mechanisms implemented to monitor such activities are often said to be lacking. Nevertheless, it is not the intention here to dispute that recipient countries do indeed derive an economic benefit from these arrangements.

Where countries lack the ability to utilise their fishing resources themselves, and being tied into arrangements of supplementing own crew and vessels with EU manpower and vessels, an additional administrative burden enters the equation. Also, EU crew and vessels are known to be less competitive than, say, operators from Southern Asia, which may have a negative impact on downstream competitiveness of this sector's products. For example, further processed fish products, which are already burdened by the need to contain only wholly obtained fish, and may be less competitive in the European market as a result of these RoO-related restrictions. Current EU RoO do not 'reward' the further processing of fish products (contained in HS 1603 and HS 1604), irrespective of the industrial effort required and value added. This slightly peculiar situation calls into question the intention of EU RoO for fishery products—whether to prevent trade deflection or to act as a protectionist barrier to trade.

One way to reduce the restrictiveness of current RoO is to revise the conditions underlying the 'wholly obtained' principle in so far as it relates to fish. For fish caught within the territorial waters there is no special administrative or compliance issue

involving the originating status of fish. But considering that much of the commercial fishing effort takes place beyond this zone, the current rules could be substantially simplified by extending the 'cut-off' as to where the additional conditions start applying. It has been suggested that extending the treatment currently afforded to inland and territorial fish to the 200-mile EEZ would substantially lighten the burden of compliance and automatically deem fish caught within miles as being of local origin. This would also affect much of the commercial fishing activity.

There have been arguments against this, mainly from the EC but also from some ACP countries currently able to comply with the RoO and fearing an influx of lower-cost participants from abroad. But here the role of domestic fishing policy and regulatory environment needs to be emphasised. The EEZ remains the exclusive economic domain of the adjoining state, meaning that simply because the RoO may consider fish caught within this much larger area as being of local origin (without having to comply with ownership and crew requirements), this does not transfer any rights to foreign operators. There can be no automatic entry of foreign-registered boats to conduct fishing within the EEZ, as foreign vessels' rights within this zone are limited to passage only. So while broader flexibility in the RoO essentially further 'opens the door' to the EU market, it does not transfer rights to third parties. It does, however, allow exporting countries to determine the extent to which it permits third countries to utilise its fishing resources (with a view to exporting to the EU market).

The drawback to this, of course, lies in the ability (or inability) of countries to effectively and sustainably manage their fishing stocks and permit access to a greater variety of third country vessels *should there be a need for this in the absence of locally owned commercial fishing fleets.* It must be acknowledged that such an arrangement potentially introduces environmentally unsustainable incentives, just as the current arrangement has introduced incentives that have not always been in the best interests of the exporting country concerned.

Changes to EU-ACP RoO contemplated in the EPAs

EPA negotiations led to some changes to the RoO concerning fish and fisheries products. These are largely contained in the "wholly obtained" provisions which set out the conditions pertaining to the location of fish caught, conditions around the vessel and leasing and chartering arrangements.

One of the changes concerns the requirement that at least 50% of the crew, master and captain of the vessel included, had to be nationals of the ACP country or the EU. This condition has now been removed under EPAs (and under the interim Council Regulation on ACP-EU RoO), which now allows crew of any nationality to be hired by vessels engaged in catching "originating" fish.

Similarly, the conditions attached to the ownership of a qualifying vessel have been simplified. Previously (under the Cotonou Agreement), the Chairman of the Board of Directors or Supervisory Board, and the majority of members of such boards, were required to be nationals of States party to the Agreement. Under Cotonou, this implied any ACP State(s). This specific requirement has been removed, although other ownership requirements remain largely the same.

One of the key issues that remains unresolved is the treatment of fish caught within a country's Exclusive Economic Zone (EEZ), which EU RoO do not recognise explicitly except in so far that they limit leased or chartered vessels from operating on the high seas (the area outside of the EEZ). Some countries, notably Namibia, continue to protest this issue by insisting that fish caught within its EEZ should be considered to be fish of local origin when landed locally, given the fact that Nambia's fishing legislation recognises fish as such and considering that Namibia has strong rules in place to monitor any fishing activity within its EEZ. Similarly, the Cariforum EPA group also continues to engage the EU on this matter. Only the Pacific region has received a special derogation with respect to fish, which allows global sourcing of fish material when used to make up goods of Chapter 16 (processed fish, for example canned tuna). The EU consented to this derogation largely due to the fact that it has few direct fishing interests in this region; for the EU's distant water fleet the Pacific, at

this stage, is of relatively little interest. For the Pacific, this was the single most important change to the RoO as its actual and potential exports to the EU are almost exclusively based on fisheries products.

The chartering and leasing provisions were also changed in the EPA provisions (they remain the same as under Cotonou in the interim Council Regulation though), and instead of requiring an offer (by the ACP country to the EU) of negotiating a fisheries partnership agreement now only requires the offer to the right of first refusal for a leasing and chartering agreement.

A specific 15% value tolerance was also introduced for some parts of Chapter 3 (applicable to those fisheries products that were further processed, such as filleted fish, molluscs in brine etc.). The tolerance permits up to 15% non-originating fish materials for these product categories. However, considering that previously the Cotonou Agreement (and again the EPAs) already contain a general 15% tolerance for all products, including fish, this specific tolerance will be of little value to producers and exporters.

Other sectors

Supply side constraints and other trade barriers often play a critical role in restricting the ability of ACP exporters to compete successfully in the EU, particularly in processed goods. Nevertheless, various RoO related restrictions continue to reduce the ability of ACP producers to export originating products to the EU.

One such provision relates to the use of sugar content, which affects various products (for example processed fruit products such as jams and marmalades in HS, preserved fruit in HS 2006, fruit juices in HS 2009, white chocolate in 1704 and cocoa based chocolate of Chapter 18, confectionery in 1704, etc.). These products are not allowed to contain sugar content valued at more than 30% of the ex-works price of the product, failing which they do not comply with the RoO.

This restriction affects ACP countries that are competitive in processed goods containing sugar, especially when these countries also have ready access to raw sugar. An example is Swaziland, which has a strong processed food industry (jams, canned fruit, etc.), and is also a producer of sugar. Making matters worse, Cotonou contains a large list of products (including fruit and vegetable products) excluded from cumulation with neighbouring South Africa, likewise a member of the Southern African Customs Union (SACU), which further curtails Swaziland's ability to maximise economic benefits in the production of affected goods.

Products of the milling industry (Chapter 11) are also impacted on by the current RoO. The current rules require 'manufacture in which cereals, edible vegetables, roots and tubers of heading No (HS)0714 or fruit used be wholly obtained'. This means that the further processing of these inputs, or the location where such processing takes place, is insufficient to confer origin as all inputs must also be produced locally. Any shortages of raw materials, even some, would disqualify products of the milling industry from benefiting under the relevant preferential trade agreement (the above example is based on Cotonou rules). The cumulation provisions further reduce the ability of producers to comply with the RoO—unless all materials are available locally—in that a large number of typical inputs are in fact specifically excluded from cumulation.

A number of products are produced through the assembly of components. EU RoO consider 'simple assembly of parts to constitute a complete product' as being insufficient to confer origin, even if a product-specific origin rule has been met. Insufficient operations are listed in Article 5 of Annex V of the Cotonou Agreement. This provision is potentially problematic, given the dynamics of certain sectors. For example, in some sectors the manufacture of components is highly concentrated in that only few factories worldwide make such components. Contributory reasons to this situation usually relate to the technical nature of the components, the investment required to set up operations, and the competitiveness of the product which might keep out new competitors. LCD screen panels, computer processors and memory chips may be suitable examples. The final product, for example a notebook or personal computer, essentially consists of an array of components that are

assembled to form a transformed and substantially different product. Restrictions on the 'assembly of parts', especially given that producers of the final good do not have the choice of producing certain components themselves (given commercial realities referred to above), means that certain products will not readily comply with the applicable RoO.

2.3 Arguments in favour of less restrictive Rules of Origin

Although the prevention of trade deflection is the original and only truly legitimate objective of preferential RoO, clearly much more is involved as the make-up of RoO has important and wide-ranging economic consequences. RoO have become an important trade policy instrument, and potentially have the ability to help guide or restrict investment flows, protect or expose industries from competition and act as an enhancement or barrier to regional economic integration.

But preferential RoO need to consider more than protectionist interests, especially within a bilateral preferential trade framework between economically unequal partners. RoO should be guided by principles that would help ensure an equitable outcome to the parties to an agreement. These principles should include, *inter alia*:

- RoO requirements should not be unduly restrictive from the perspective of the producer
- RoO should be guided by the principle of preventing trade deflection
- RoO requirements should be transparent and economically defensible
- RoO requirements must consider their impact on trade facilitation and administration
- RoO requirements should be consistent with, or guided by, related laws and conventions

- RoO should be enforceable, and should not impose an undue economic or administrative burden both on the authorities tasked with ensuring compliance as well as on the producers and other affected stakeholders themselves

- RoO should recognise, as far as is possible, their relationship with trade tariffs and preference margins, and that the overall cost to producers and exporters of compliance with preferential RoO needs to be substantially less than the cost of paying import tariffs

- RoO and market access/tariff negotiations should ideally be linked

- RoO must embrace commercial realities, since restrictive RoO (given tariff liberalisation) will especially in highly competitive industries be insufficient to induce producers to switch their sources of supply to more expensive local or regional ones (in order to comply with RoO)

- RoO should encourage as far is possible or applicable regional trade within a preferential trade area through liberal cumulation facilities

The challenge of configuring RoO that subscribe to all of the principles listed above is extremely challenging, and in reality probably impossible. There may even be some contradictions contained in these principles, for example the desire for simple administrative requirements in the context of preventing RoO being circumvented through trade deflection. Nevertheless, it remains an important task to be guided by the objective of transparent RoO that ensure that the economic benefits under a PTA accrue largely to the parties to the Agreement.

A question is whether RoO are indeed still relevant. Indeed, in the absence of tariff-related trade measures, not only between the parties to a trade agreement but indeed anywhere in the world (since margins of preferences are present as long as tariffs, including tariffs on the exports of competitor countries, exist), preferential RoO would no longer be relevant. Indeed, for any country that removes all tariff-based restrictions on any imports into its country irrespective of source, and is not part of

another preferential trade area, there is no reason to continue imposing RoO. But the reality is that such a situation is still a long way off and indeed is unlikely to ever materialise. This means that RoO will continue to matter and be relevant.

One of the strongest argument in favour of less restrictive RoO—besides the potential welfare effects that flow from increased international trade and manufacture to comparative advantage—is that preference margins have decreased significantly in recent years. These reductions have taken place unilaterally, in the context of WTO commitments as well as with respect to the increased opening of domestic markets by developed countries to goods produced in a broader range of developing countries. Lower preference margins have translated into unbalanced RoO, where the cost of complying with specific RoO (from an administrative and processing perspective) bears less and less relation to the cost of entering a given market under normal tariff relations (i.e. under normal tariffs in line with WTO commitments).

Another argument entails the changing nature of production compared with two or three decades ago. Globally there has been a vast increase in trade, a lowering of logistics and telecommunications costs, and an increasing specialisation and concentration of industries and production. Far from being produced within a single country, most processed goods today contain at least some nonoriginating content. This is because certain countries (or in highly concentrated industries, certain producers) are simply far more competitive at producing certain goods and materials than others; in order to remain competitive throughout the value chain producers must source inputs from the most competitive sources available. The cost of not being able to source according to unrestrained commercial business principles may render processed goods uncompetitive and can have negative implications for consumer welfare. Of relevance here is a product's competitiveness in the export market, since RoO are relevant in international trade.

Furthering this argument is the unique nature of value chains, as was discussed earlier. Unless producers have the necessary flexibility in order to source materials from competitive sources, and are able to fit into the commercial realities and dynamics of their specific sector (for example, garment production houses that are *de*

facto obliged to utilise fabrics from licensed suppliers in line with their clients' requirements and cost considerations), RoO may seriously undermine the ability of producers to export "RoO-compliant" products. In many instances, then, paying normal import duties or sourcing from more expensive local suppliers may be the only (theoretical) options available but would simply render them unable to compete in their chosen export market, especially in highly competitive industries.

Less restrictive RoO are also likely to be development-friendly. While the old notion of pro-development RoO entailed raising restrictions to force producers to utilise mainly local or regional inputs, even if such inputs were only available at a higher price, a new approach is needed that marries pro-development RoO with commercial realities. If this entails RoO that are source-neutral, which entails rules that impose few obligations on the sourcing of inputs, then the outcome is likely to be a far greater uptake of preferential trade and increased investment in downstream processing. The growth of the garment industry in Lesotho is a case in point: although investment has taken place mainly in garment assembly operations—a traditionally low-skill and low-wage industry—this has also entailed the creation of a vast number of new employment opportunities. Rising exports from downstream producers may in turn incentivise upstream producers to increase their productivity and ability to compete with foreign suppliers, as it can be safely assumed that downstream producers will switch to local sources of supply as soon as the cost-differential is reduced (to the extent that benefits flowing from local sourcing outweigh the potential costs and often considerable business risks associated with foreign sourcing).

3. Recent proposals on a revision of the EU Rules of Origin regime: A time-line of developments and outline of core features

3.1 Overview of the principles and practices of EU preferential access origin requirements

The European Community implemented the first Generalised System of Preferences (GSP) in 1971—the first of a number of developed countries to do so—which effectively reduced or scrapped the import duties of exports from a large number of developing countries. But a critical component of the GSP was its Rules of Origin regime, which provided the guidelines under which a qualifying product from an eligible country could benefit from this preferential trade arrangement (PTA). Without RoO the GSP would have been immediately undermined by exports originating in third countries but transhipped through beneficiary countries.

The EU RoO were challenged by the fact that at that time—as is still the situation today—there was no universally accepted and standard method for determining origin. While different methodologies were available, none was perfectly geared as an appropriate RoO instrument and each had its own advantages and drawbacks. This is rooted in the fact that the methodologies available were generally not devised with RoO in mind—for example the Harmonised System Nomenclature (HS) used for purposes of recording trade flows and managing tariff treatment of certain products, among other uses. Furthermore, the GSP entailed an entirely nonreciprocal market opening on the part of the European Community, and it was naturally its prerogative to tailor the preferential RoO as it saw fit. The result was a blend of methodologies that sought to set appropriate and acceptable conditions for preferential market access from developing country beneficiaries.

The RoO in the EU preference programmes and FTAs contain a selection of value-added (VA), specific processing (SP) and change in tariff heading (CTH) methodologies, as well as a number of hybrid outcomes that combine more than one methodology. Further, European origin requirements in select cases offer a choice of

methodologies, for example compliance with an SP requirement *or* a CTH on non-originating materials.

Beyond these underlying methodologies, RoO regimes ultimately adopted by the European Community feature the concept of cumulation, whereby materials sourced from more than one of its trade partners may be used as if they were originating. Limited forms of cumulation are permissible under the EU GSP, while broader cumulation features in the EU's bilateral and regional trade agreements. For example under the Cotonou Agreement, ACP countries are permitted to cumulate production with each other. The pan-European and Mediterranean system of cumulation extends this feature to the bilateral trade agreements that the EU has concluded with various Middle Eastern and North African countries, for example Tunisia, Algeria, Morocco and Jordan amongst others.

The key facilitating factor for cumulation provisions is the fact that the underlying trade regimes between the EU and most of its preferential trade partners bear a large degree of harmony in its origin requirements. As was discussed, cumulation requires RoO consistency as without it there exists a likelihood that preferential market access contained in a particular agreement would be undermined by goods transhipped from another area, even if that particular area also benefits from preferential market access with the EU. Since cumulation provisions have at their core the outcome that a product exported to the EU is deemed as originating in the final exporting country even when some of the materials it contains originate in the customs area of a cumulation partner (provided that the further processing jointly meets the origin requirements), cumulation requires that such materials have obtained originating status through the application of similar origin requirements as of the final exporting country. Otherwise, where the margin of preference (the difference between preferential duties against normal tariffs) is sufficiently large, and the origin requirements sufficiently dissimilar to provide a *de facto* incentive, trade deflection would take place. The prevention of trade deflection is clearly a core objective of RoO.

3.2 New beginnings: A revised RoO framework for the EU

A proliferation of PTAs concluded outside of multilateral WTO forum saw the emergence of a new set of challenges: that of general trade and market access policies fine-tuned to specific trade partners, and the potentially complicated array of origin requirements for European importers sourcing from the EU's preferential trade partners. Likewise, the plethora of trade agreements created an increasingly challenging environment for customs officials in the EU, who were being tasked in interpreting and verifying the originating status of goods entering the European customs area under specific preferences.

In recognition of these challenges, the EU sought to streamline its market access requirements, and particularly its RoO. By creating some form of harmony between the RoO contained in the various PTAs, the EU would provide its stakeholders with a more predictable and consistent environment in which to complete international trade transactions, with obvious efficiency benefits. A look at EU PTAs concluded over at least the past decade already reveals RoO conditions that bear a large degree of similarity to each other. A more consistent approach also increased Europe's negotiating position vis-à-vis its trade partners, as there was less risk of precedents being set, or concessions awarded, that the EU would be under pressure to replicate on a larger scale.

But despite the large degree of RoO consistency, or perhaps because of it, the EU RoO had become somewhat outdated and unwieldy. Commercial realities, such as global sourcing and regional centres of competitiveness, value chain developments and natural resource endowments, have had the effect of making some of the EU's origin requirements increasingly protectionist in nature. Whereas the old argument has long been that RoO should help facilitate trade while at the same time protecting domestic industrial interests, these global changes have meant that both exporters and importers are often disadvantaged by restrictive origin requirements, especially when their sourcing and production decisions are not allowed to follow their most efficient course. An example often cited concerns that of the textile and clothing industries: whereas three decades ago textile production was highly dispersed, today

only a relatively small number of countries hold a true competitive advantage in this sector through resource endowments, relevant industrial configurations and economies of scale. Where downstream garment manufacturers are unable to tap into these supply networks through restrictive origin requirements, their chance of remaining competitive even under preferential market access conditions for the final product is rapidly diminishing.

Facing increasing criticism from traders in foreign countries as well as internally, the EU has been under pressure to harmonise and simplify its preferential RoO. This has eventually led to a process beginning with a Green Paper on the future of (EU) Rules of Origin, as well as public and internal discussion papers on how to improve the European preferential RoO regime.

Green Paper on the future of the EU RoO regime

The European Commission (EC) published a Green Paper on the future of RoO in preferential trade arrangements at the end of 2003. It recognised the need for 'new equilibria' in (a) the criteria for determining RoO and the framework within which they are implemented as well as (b) the mechanisms for safeguarding the economic interests of the contracting parties (countries) bearing in mind the objective of promoting legitimate preferential trade, and (c) in the responsibilities of those—essentially customs personnel—involved in the procedures for declaring, certifying, and checking preferential origin.

The Green Paper ultimately did not offer improvement options with respect to many of the substantive issues preventing Europe's trade partners from accessing its market under preferential access conditions. This was despite the fact—as highlighted in point (a) above—that one of the key objectives of this process was to look into the criteria for determining RoO. Specifically, little mention was made of the challenges surrounding RoO methodologies that the EU had been applying in determining origin, its impacts on foreign exporters and producers and domestic importers, and how it intended revising and emending these.

Furthermore, the paper did not in any material way deal with specific sectoral issues, something which was interpreted in many quarters as one of the main shortcomings of this initial consultation process. The treatment of offshore fisheries products, certain agricultural products and the textile-clothing sector have long been regarded as sectors where the EU's trade partners—especially developing countries—were able to maintain a degree of international competitiveness and comparative advantage.

What the Green Paper focused on most were the administrative aspects of managing the requirements for preferential market access. The EU was finding itself in the situation where it was party to an increasing number of preferential trade agreements involving a large number of countries, but also with a growing challenge of ensuring compliance with the appropriate RoO. Compliance and control issues, and the overall management of preferential market access for other countries, ultimately became the main focus of the Green Paper. In this regard, various proposals relating to customs controls—albeit at the broader policy level—were put forward.

The Green Paper received feedback from a broad range of stakeholders, whose inputs reinforced the notion that the current RoO regime is excessively restrictive, at least in some instances. A report by the European Commission on the feedback received was published in 2004 and concludes—based on the feedback received—that stakeholders identified the following issues as being key EU RoO-related challenges (commentary in brackets added):

- 'the present origin rules do not fit current economic reality';

[*for example, RoO for the garment sector imply a very outdated notion of the textile-clothing pipeline, namely that it can be classified into distinct stages, each with similar levels of transformation. The rules generally require two distinct local stages of production, for example yarn to fabric and fabric to garment conversion, rather than giving credit for elaborate value-added processes within each 'stage'*]

- ‘that current ROO are seen as being too complex, restrictive and lacking transparency’;

[*the current rules often impose sourcing requirements that restrict producers from using materials from foreign sources; even where there is a lack of local availability, economic reality dictates that unless a certain source is used the final product will not be internationally competitive. This argument can be taken further, where restrictive RoO may prevent producers to remain competitive within a given value chain, which may dictate that certain inputs are sourced from a handful of global low-cost producers or where buyers and retailers go as far as specifying what supply networks to utilise in order to comply with their particular requirements—a scenario common in the large-scale garment manufacturing industry*]

- ‘that the current origin rules should be rationalised and simplified’.

[*the current EU RoO utilise various different underlying methodologies, and in many cases apply these in a non-uniform manner—for example where a change in tariff classification is required at the chapter or 4-digit heading level, where different technical requirements are enforced, or where value thresholds are inconsistent*].

EC Communication on RoO: Proposals for change

Following the Green Paper consultation process, the EC published a formal communication in March 2005. This document, which took into consideration the feedback received, was entitled ‘The rules of origin in preferential trade arrangements: Orientations for the future’. It also represented the most concrete indication on the shift in thinking on the part of the EC with respect to RoO issues, and revised systems for ensuring compliance with the appropriate trade legislation. Furthermore, the document indicated that it would help inform the EC negotiation position on EPAs. This makes it of particular relevance and interest to ACP countries as they embark on the post-Cotonou negotiation process.

The March 2005 Communication goes significantly further than the Green Paper as it deals to some degree with substantive RoO issues rather than mere compliance and control relating to preferential trade. Nevertheless, the latter continues to form a

critical component of the Communication. Essentially, the two main areas dealt with are the conditions for a product to be considered as originating (this being the RoO) and issues involving the implementation and control of trade preferences together with appropriate instruments to ensure compliance with the relevant terms and conditions.

►RoO issues

The March 2005 Communication falls short on specifics, especially with respect to some of the sector-specific issues that are frequently raised as impediments to EU market access. While the textile, fisheries and agricultural sectors are mentioned, the Communication largely defers discussion on them beyond an acknowledgement that some of the issues need to be revisited within an appropriate forum. With respect to the textile sector, the Communication provides little indication that the EC is prepared to move away from the current RoO methodology, beyond stating that the sector will require further analysis as well as referring to an earlier (2003) textile-related 'Communication on the future of the textile and clothing sector in the enlarged European Union'. In fact, the gist of the EC's dealing with these sectors evolves mainly around the challenge of applying an appropriate (local) value-added threshold, considering that the EC appears to be increasingly in favour of such a RoO methodology. This is discussed further below.

With respect to fisheries, the Communication suggests changing the nationality requirement, which currently requires between half and 75% of crew, captain, ownership and board of directors to be nationals of the exporting country or the EU. At present, EU RoO for fish shipped under preferential trade conditions impose strict conditions on fish caught beyond the 12-mile territorial zone (note that fish caught in inland waters and within the territorial zone are exempt from these conditions and deemed as originating). The conditions for deep sea fisheries relate to ownership and flag of vessel, as well as master and crew. In this context, and considering that the sector is of significant economic importance in many of the EU's preferential trade partners, it would be fair to say that the Communication provides little indication of any significant progress made in liberalising EU market access within this sector.

A major change of direction revolves around the issue of RoO methodologies used in EU preference regimes. As outlined in the previous Section the EU currently employs a range of methodologies in the determination of economic origin—value-added, change in tariff classification and specific processing—usually as a single rule and at times as combination and/or alternative requirements. In this Communication, the EC proposes a shift to a single methodology—based on value-added (VA) local content requirements—to replace the combination of methodologies used at present (it does concede that in certain instances this methodology may need to be augmented by additional or alternate rules). This represents a major departure from current norms and involves a number of complicating issues foremost around the calculation of cost components (see Box 1 below)—which would need to be resolved. It must be noted, though, that this single methodology would always be in addition to the 'wholly obtained' principle and applies only to products consisting of inputs made in more than one country (unless exempted under relevant cumulation provisions).

The EC concedes that a single VA threshold may not be appropriate to achieve the desired outcome, especially with respect to the applicability of the methodology to all sectors, the level of economic development in beneficiary countries, and the appropriateness of a given threshold in relation to the actual transformation that would take place locally. This is a known drawback of the proposed methodology, especially when applied universally, as different sectors involve different dynamics and economic realities, particularly when certain inputs are only available (in commercial quantities and priced competitively) from few sources internationally. This problem may prevail in certain sectors more than in others, for example the textile sector or in high-technology industries where a small number of global producers are able to supply key components competitively (LCD screens, computer memory and processor chips, fridge compressors, etc.).

Besides the possible use of differentiated local content thresholds between sectors, as well as in their application to certain countries (for example, least-developed countries within the EU GSP group of beneficiaries), the EC also acknowledges in its Communication that VA may not be best suited in its application to agricultural, fishery or textile products. Some of the EC's concerns probably relate to the

indivisibility of certain products (for example, applying value-added to fresh/whole fish), issues around measurability of VA (agricultural products), or the unique dynamics of the textile-clothing pipeline value chain where similar processes may entail entirely dissimilar VA outcomes.

Box 1. VA cost calculations

The key to the VA methodology's specific thresholds lies in the cost components used in determining the final value of the product, and the method for calculating its constituents.

The EC *Communication* proposes a departure from the *ex-works* basis for determining production cost, a basis widely used in current preferential trade arrangements that the EU is a party to. *Ex-works*, as it is defined in the Cotonou Agreement (Protocol I, Article 1), refers to 'the price paid for the product ex works to the manufacturer in whose undertaking the last working or processing is carried out, provided the price includes the value of all the materials used, minus any internal taxes which are, or may be, repaid when the product obtained is exported'. While the EC's most recent (March 2007) draft proposals to the ACP EPA regions reverts to an ex-works basis, this entails a non-binding proposal by the EC and may yet be discarded. Therefore, the production-cost basis proposed earlier, in various forums, is further discussed below.

This cost calculation proposed by the EC introduces the concepts of 'net production cost' (NPC) and 'local value content' (LVC) as the two key determinants in calculating the applicable local content thresholds. Whereas *ex-works* includes essentially all cost components used in the determination of the final factory gate-price, including mark-up, the method proposed by the EC would apply a far narrower definition to the production price of a product. While the exact methodology has yet to be determined, indications are that NPC would include direct materials (both originating and non-originating), direct labour costs as well as other expenses directly attributable to the production of the final product.

Indirect materials, including fuels, electricity, plant and equipment also count towards the calculation of NPC**.** Other costs, such as packaging and general overheads not directly attributable to the final product, marketing expenses, administrative overheads and mark-up, are excluded. A number of cost elements are yet to be defined to the extent that they should be included or excluded in any cost calculation.

LVC is the component of NPC that is deemed as originating in the exporting country, and against which any VA threshold or Sufficient Processing Threshold (SPT) is applied. It is expressed as a percentage of NPC, contains the same cost components as NPC, on the condition that these are of local origin.

$$LVC = \frac{NPC - VNOM\,*}{NPC} x100$$

where VNOM is the **v**alue of **n**on-**o**riginating **m**aterials

In other words, local content (expressed as a percentage) is the difference between net production cost (as per the permissible cost components) and the value of non-originating cost components. Where local value content percentage (LVC) exceeds a specific threshold—yet to be determined—a product would be deemed as originating in the home country. This methodology can also be used to express a maximum foreign content; in such a case, the difference between NPC and LVC may not exceed a certain threshold.

Note that thresholds determined under this proposed methodology are not directly comparable with thresholds determined under the 'ex-works' basis, which essentially includes mark-up as local content. An equivalent threshold using pure production cost would typically be a lower value.

►Implementation and compliance issues

With respect to the implementation and control of trade preferences, the Communication provides an indication that the EC views this as a critical component of any future RoO regime. Likewise, appropriate instruments to ensure compliance with the relevant terms and conditions are seen as vitally important to ensure the success and integrity of a future preferential trade regime.

Under existing trade arrangements, a significant degree of self-regulation takes place, with customs authorities in exporting countries tasked with developing systems to ensure compliance with the appropriate trade rules. Whereas a standardised export certificate is used (EUR.1, or in the case of EU, GSP Form A), customs authorities in the various exporting countries are largely at liberty to implement tailored systems to regulate the use of preferences, and to verify statements on origin.

While the current system has mostly worked well, occasional abuses and fraudulent actions on the part of exporters and customs authorities in some exporting countries are presumably at least partly behind the new EC proposals on regulating this process. The Communication proposes a form of 'self-certification', but within a much more controlled environment where specific obligations are imposed both on traders involved in each transaction as well as the customs authorities in the exporting and importing country.

To start with, prospective exporters would have to be registered as *bona fide* and EU-eligible exporters within a system that—according to indications—would be largely prescribed by the EC. Although this is presumably as a result of perceived weaknesses in the current system, there are fears that a more complex system determined by the EC not only undermines the autonomy of customs authorities in exporting countries but also substantially increases the administrative burden both on customs and exporters. The EC has suggested that such a system should include detailed descriptions of industrial processes and commercial activities, as well as a demonstrated compliance with any prescribed local value content (LVC) and net production cost (NPC) thresholds.

Various stakeholders have expressed their concern about the lack of local capacity to implement and enforce such a system, and fear that it will further contribute to a process that is often unwieldy and cumbersome. Also, in order to demonstrate compliance with applicable content value thresholds, especially where there might be a substantial number of cost inclusions and exclusions, this means providing certifying authorities with sensitive and often proprietary information (for example unit costs data).

The EC proposals further call for the exporter registration process to require a detailed description of the exporter's system to trace origin. This is clearly to aid the verification process and will to guide customs authorities in their assessment of export shipments, both prior to registration as 'approved exporters' and on an ad hoc basis where deemed necessary.

While there is clearly merit in developing systems that are uniform and ensure a certain minimum standard, questions may be raised about the perceived loss of autonomy by customs authorities from exporting countries to implement appropriate systems and registration procedures, as well as the increased burden on customs authorities and exporters that this may require. The proposed systems, albeit yet to be more clearly articulated, place a substantial burden on customs authorities especially where a lack of resources, including that of competent staff to manage such elaborate processes, exists. Together with the potential coliability that might result from false declarations, already stretched customs authorities in some exporting countries might become weary of registering exporters or be unable to commit the necessary resources to ensure compliance with this process. This—a view expressed by various stakeholders following the EC's publication of the Communication—may result in a greater burden on the trade process than is currently the case, and could be seen as somewhat of a technical trade barrier in itself.

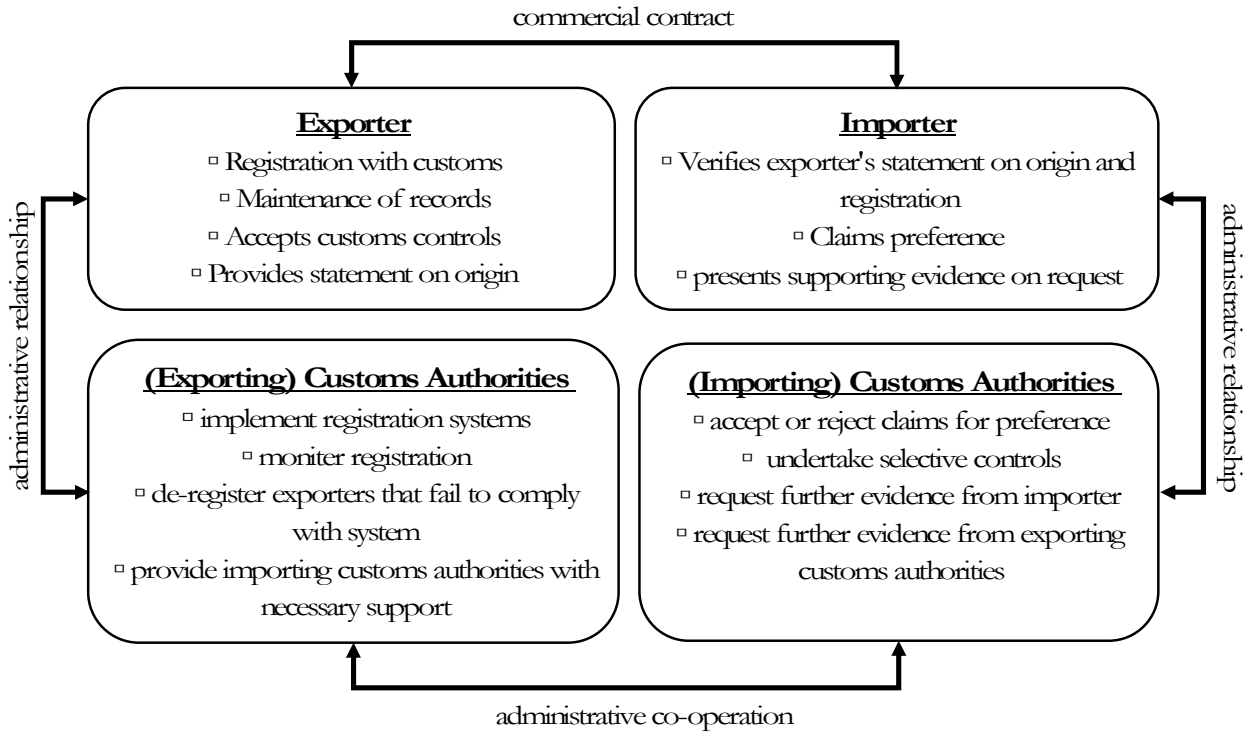
On the question of liability, the EC proposes that customs authorities in exporting countries are ultimately liable for the declarations made by exporters—following the prescribed registration process—and may incur sanction where false declarations on

the origin status of a good result in the avoidance of customs duties. The failure to comply with these customs systems, for example declarations by exporters which subsequently prove to be false, could result in the suspension of preferences to the beneficiary country.

Despite the verification, registration and monitoring systems by customs authorities proposed by the EC, the other actors in the trade process—importers and exporters and their agents—will continue to play an important role in the trade process. Exporters would be required to provide any necessary information to customs authorities in order to be registered, as discussed above, accept ongoing monitoring by customs authorities and sign declarations of origin. Importers would provide statements on the origin of their shipment—based on the information provided by the exporter—and would need to verify that the exporter is registered and has provided correct information on the origin of the good. Importers would also be required to provide customs authorities in the importing country with additional evidence to verify the origin of a good, if requested, and should cover themselves against the risk and consequences of false declarations with the aid of appropriate commercial and legal instruments.

Customs authorities in the importing country have an ongoing relationship both with the (local) importer as well as the customs authorities in the exporting country. In line with the EC proposals, the customs authorities would accept any claims for a duty-preference based on the declaration on origin by the importer, subject to requesting additional evidence on an ad hoc basis or where it is unable to verify origin based on the evidence provided to it. In such cases the customs authorities in the importing country may request assistance from the customs authorities in the exporting country in verifying the origin of the product in question.

Figure 1. Overview of responsibilities of traders and customs agencies contained in EC proposals



Choice by the EC of the value-added methodology: EC perspectives

In April 2005 the European Commission followed up on its March 2005 Communication with a Working Paper entitled 'Justification of the choice of a value added method for the determination of the origin of processed products'. With this publication it sought to provide a deeper understanding of its proposal—as communicated earlier—to replace the current system of determining 'substantial transformation' with one that is largely based on a single methodology. This, the EC argues, would simplify the determination of origin of processed goods imported from its preferential trade partners and ostensibly answer critics' calls for a more uniform and simple approach to the allocation of origin. The paper also refutes some of the main arguments against the shift to a VA-based approach.

The Working Paper provides a summary of the RoO system currently used in EU PTAs. This involves a product imported into the EU originating in the country of a

specific preferential trade partner if such products are either wholly produced there or have been substantially transformed from non-originating materials. Substantial transformation is brought about through an application of various tests: based on a change in tariff classification (usually at the 4-digit 'heading' level using the HS nomenclature); based on a technical requirement (specific processing) or a derivative of value-added and value-tolerance where for example the material content may not exceed a certain percentage of the product's final value.

Besides the various core RoO methodologies, the EC's current preferential RoO regime has regulations containing so-called exclusions (this can be described as a so-called 'negative test'), processes that on their own are *insufficient* to confer originating status, even if they comply with a specific RoO that might be applicable to a certain product. In mitigation of the above, *value tolerance* provisions provide some relief in that they permit a certain percentage (value or weight) of the final product to be non-originating without that product losing its (local) originating status. The current system of cumulation permits countries to comply with the RoO as a group provided this is supported by a system of administrative cooperation.

These rules have remained largely unchanged over the past three decades (for example, the RoO contained in the Lomé I Convention closely resemble those still applying to the ACP countries under the current Cotonou regime). While not universally difficult to comply with, in various sector-specific instances they do nevertheless represent a very high burden to exporters in partner countries as well as to customs authorities (mainly in the EU) who are tasked with interpreting the various rules and ensuring compliance.

The EC in its Working Paper underscores its argument in favour of a more uniform approach to the determination of origin—using the VA methodology—by providing an overview of the use of the various methodologies in all the PTAs that it is a party to. This table, reproduced below, aims to support the assertion that a single methodology, barring perhaps a certain number of sector-specific exceptions, would provide economic agents (I.e. exporters, importers and customs authorities) with a clearer framework within which to operate. On its own, this argument is not without

merit even if it might favour mainly EU-based importers, since a more harmonised approach could simplify sourcing decisions especially to the extent that these relate to processed or semi-processed goods.

The table below provides an overview of the use of various RoO methodologies, and their use in various combinations, as they are contained in various EU preferential trade arrangements.

Table 1. The use of RoO criteria in EU preferential trade agreements

Method:	**WO**	**CTH**	**SP**	**VA**	**WO+CTH**	**WO+VA**
Number of rules	29	98	150	128	4	4
% of total	5,3%	18%	27,5%	23,5%	0,7%	0,7%
Method:	**CTH+VA**	**SP+VA**	**WO+CTH +VA**	**Sets + VA**	**NR**	**TOTAL**
Number of rules	94	28	2	2	6	545
% of total	17,2%	5,1%	0,4%	0,4%	1,1%	100%
Key to acronyms: WO=wholly obtained CTH=change in tariff heading SP=specific processing NR=no rule (manufacture from any heading)						

Source: EC (2005b)

The EC's main arguments in favour of a single methodology are that

- the current rules are too numerous and different;
- current rules are complex;
- current rules are opaque, unequal and rigid.

With regard to future RoO contained in preferential trade regimes the EC argues that the current rules are no longer feasible and thus don't represent a viable option going forward. This is based on the objective that the rules should not only be easy to be understood and applied by traders and producers, but also by the relevant customs authorities both in the exporting and importing country. They should also contribute to the objective of sustainable development in the beneficiary country concerned.

This last argument provides an indication that the EU is not in favour of rules that create an environment where 'too little' local transformation takes place to a product, in other words, where rules are so liberal that they provide little incentive for stakeholders to embark on a production (and related investment drive) to expand local production and sourcing and ultimately drive local development rather than relying on imported materials. Without doubt this is a strong argument if not altogether convincing; however, on a more cautionary note it is submitted here that commercial realities should all the while be strongly considered so as to ensure that the RoO do not overly limit producer's options of producing goods for export in the most efficient manner possible. It has to be remembered that RoO are relevant in the presence of a preference margin, and that part of the 'cost' of receiving this margin lies in complying with relevant RoO. Where preference margins become small (over time, in the light of tariff liberalisation and an increasing numbers of countries with preferential market access to the EU), producers may forego the preference in favour of benefiting from fewer limitations with regard to their sourcing options.

The EC reflects briefly on what it deems to be the main arguments in favour and against the use of SP and CTH methodologies, and concludes with an overview of arguments supporting its choice of VA as the preferred methodology.

It rejects a technical or specific processing (SP) requirement as it fails to meet the objective of 'simplification' of the EU's RoO. The SP methodology would require line by line negotiations which are time consuming and complex, and potentially allow specific sectoral interests to influence proceedings more than might be the case in other methodologies. On the CTH, the EC submits that the HS nomenclature, on which CTH is based, is ill-suited as first choice and simplified future RoO regime. It argues that under the current rules there are too many cases where the use of CTH has to be supplemented by a VA requirement, further differentiation at the 6-digit HS sub-heading or through additional rules or exclusions, for example where both unprocessed and further processed goods appear in the same category. Besides, CTH does not reflect a consistent transformation requirement across product sectors.

On the use of a single VA methodology, the EC's core arguments can be summarised as follows:

- VA provides easy options of defining and differentiating a specific local (or regional in the case of cumulation) content threshold to be achieved
- VA is development friendly due to the link between local content requirements and development, while the impact on development is measurable
- VA provides an incentive to source locally even if more expensive than the non-originating (materials) (EC 2005b: 7, brackets added).
- VA provides a simpler approach to the RoO methodology as it does away with many of the exclusions and supplementary rules (e.g. value tolerances, etc.).

The EC also counters arguments against the VA approach:

- VA is a well-known and widely accepted approach, and producers already have to calculate local against foreign content if utilising current value tolerance rules
- The EC's preference of VA would be accompanied by a comprehensive new approach to the control of preferences (reference to proposed measures relating to the customs process, and responsibility and liability of economic agents)
- The impact of variations and seasonality of prices, especially of raw materials and those relating to exchange rate movements, could be mitigated by introducing reference prices or using average prices over longer time periods
- The beneficial impact on local content of higher labour costs (against other producers from countries with lower costs) should not automatically be attributed to inefficient management practices and labour unproductivity but "could result from better employment conditions in terms of wages and social protection".

Subsequent developments: early EC proposals to the EPA regions

Two years following the publication of the EC's Communication and follow-up Working Paper—the EC presented a more formal position on the future of its RoO (more on this below). While the new methodological approach was to apply primarily

to its GSP as a non-reciprocal and unilateral system of preferences, it was also to guide its negotiation position for Economic Partnership Agreements (EPAs) with the ACP States.

To assist the EC in the formulation of a position, it has commissioned various studies within the framework of its 'Better Regulation Rules', which are to feed into an overall impact assessment of the proposed changes to the RoO regime and the EC's eventual position and policy. These include a general study that, through econometric analysis, seeks to identify VA thresholds that are equivalent to the current GSP RoO. In effect these would likely provide some form of point of departure for the EC and it is assumed will help inform the EC's negotiating position vis-à-vis the ACP group (again bearing in mind that revised RoO would apply first to the EC's non-reciprocal arrangements, such as the GSP).

The EC has also commissioned studies on sector-specific RoO issues, and economic developments in these sectors. The sectors covered include the textiles/clothing sector, as well as fisheries, and it is envisaged that the outcomes and findings of these studies will also help inform the EC's overall impact assessment of the proposed RoO changes.

In March 2007 the EC presented a draft 'Convention on Rules of Origin for the purposes of Economic Partnership Agreements' together with an outline of the principles guiding the EC's proposals. The EC emphasised that these documents were not official proposals but—without prejudice to the negotiating position that the Commission might take—should be seen as being part of the consultation process with a view to the opening of negotiations. In subsequent bilateral meetings with officials from EPA countries the Commission reiterated the view that the proposals it has presented are negotiable, including its position on the underlying RoO methodology.

According to the documentation attached to the latest round of EC proposals, three key principles guide its draft convention. These are *simplification*, *development* and

predictability. With reference to these principles, contained in the EC documentation, the draft convention can be summarised as follows:

Simplification:

- The draft convention acknowledges that current RoO are too complex
- Re-emphasises earlier proposals around a single across-the-board methodology, and simpler procedures for compliance with the rules
- Proposes a single methodology based on value-added using the 'ex-works' price (recent proposals focused on net production cost)
- Proposes simplification of procedures by establishing a system of exporter registration
- Introduces self-certification by registered exporters (exporters no longer need to apply for origin certificates to be issued by customs authorities for each consignment)
- Proposes a computerised exporter database that can be accessed by stakeholders in exporting as well as importing country.

Development:

- Emphasises RoO as an important tool for the implementation of trade policy
- Current rules often prevent developing countries from exporting to the EU under preferential RoO (provides as an example the case of textiles and clothing)
- Acknowledges the need for an appropriate local processing threshold (in the context of the proposed value-added methodology)
- Expresses willingness to consider all-ACP cumulation (as is currently the case) as basis for negotiation, but emphasises technical limitation relating to cumulation between (EPA) regions having different RoO for the EU market
- Emphasises the need for a legal framework with regard to administrative co-operation between the regions in order for cumulation to be technically feasible.

Predictability:

- Emphasises that administrative cooperation within a secure and predictable framework is critical to foster growing trade

- Proposes the use of risk analysis techniques as tools to support administrative authorities to fulfil their responsibilities, for example with respect to exporter registration and ongoing compliance with RoO requirements
- Emphasises that the need for authorities in beneficiary countries to have sufficient legal, procedural and operational capacity to ensure efficient functioning of the proposed preferential trading area
- Emphasises the need for targeted monitoring to support the control of preferences, based on risk analysis.

Critique of the EC proposals and recent developments

The current system for allocating origin has seen little revision over the past three decades, which is probably related predominantly to the fact that most of the EU's preferential trade partners receive non-reciprocal preferences, the EU's desire to keep it's preferential RoO as consistent between trading partners as possible, and the fact that its preferential origin regime has received easy "passage" through WTO waivers. These allowed the EC to continue with its programme of nonreciprocal preferences to the ACP group. The pending expiry of this waiver forced the EC (and the ACP) to revisit the current RoO arrangements and to explore more seriously ways in which it can be improved. While GSP preferences may continue to operate under normal WTO disciplines, the expiry of the Cotonou arrangement at the end of 2007 means that the EC should be in a position to enter into a revised and broadly reciprocal arrangement by that time. It should be noted that while GSP preferences (including those under the EBA) are a potential fall-back position for the ACP, the RoO there under are no less restrictive and even contain certain restrictions that Cotonou RoO have done away with.

The Green Paper provided an indication of the EC's priorities, even though it was short of substance on RoO-related market access issues. Its focus on administrative arrangements and control mechanisms underlined the EC's desire to improve the overall control over the preferential trade arrangements that it is a party to. The fact that it failed to deal with those issues important to many developing country trade partners, such as the RoO in the textile and fisheries sectors, was heavily criticised.

The March 2005 Communication offered greater clarity on the proposed shift in policy within the EC, although again the focus was predominantly on systems of control and administrative issues. However, the proposal to change the RoO methodology to one based almost exclusively on value added signified a major departure away from the status quo. The EC is proposing net production cost (NPC) against which local content thresholds are to be determined, with little clarity yet about what cost components would form a 'direct' part of the product and which were to be excluded (Note: as discussed later the EC's offer to the ACP of provisional RoO reverts to the ex-works basis, as discussed later).

One of the drawbacks associated with this methodology is the fact that it requires detailed accounting records and administrative resources neither of which are readily available in enterprises located in poor countries. These cost components and records are likewise subject to dispute and misinterpretation. Considering that the administrative effort of producers and exporters (and possible changes to the production and sourcing setup) has to bear relation to the cost saving and gains in competitive (or preference margin) of not having to pay import duties in the export market, it is questionable whether an elaborate methodology will contribute to the objectives of simplifying and enhancing preferential trade. This margin of preference, considered the difference between preferential market access and entry under normal tariff relations, must be significant enough to persuade traders to comply with the relevant RoO. Considering that the majority of EU import tariffs are already low or being further reduced under WTO commitments and the Non-Agricultural Market Access (NAMA) negotiations, it is unlikely that the proposals as they stand would lead to a greater uptake of preferences than is the case at present.

It is also questionable whether the proposed use of a solitary VA methodology represents a simplification of the current RoO regime. While VA is relatively easy to understand at the conceptual level, the presence of numerous cost components—with inclusions and exclusions—significantly complicates its application. The EC's most recent proposals around value added and the use of ex-works in favour of net production cost seem to be a positive move, although it must be emphasised that the EC is at this stage not firmly committed to either methodology. Irrespective of which

value-based methodology it proposes, there remain a number of significant drawbacks. For example, the influence of exchange rate and raw material price volatility can rapidly alter the originating status of a good, and it would be difficult to deal with this through a system of managed prices (for example time-bound or moving price averages, etc.) as proposed by the EC. In an environment where a developing country's exchange rate against the EU is more likely to depreciate over time than appreciate (there are of course notable exceptions, and recent history—for example Madagascar in 2007—has shown that small open economies can experience exchange rate appreciation following substantial currency inflows resulting from large multi-year Foreign Direct Investment (FDI) projects).

The EC also argues that a local content threshold should induce producers to source material contents locally or elsewhere under any cumulation arrangements. By implication, the EC favours a local content threshold that is higher than what may be necessary to prevent trade deflection (this being the original role of RoO)[7]. The EC goes so far as to state that VA provides an incentive to source locally 'even if (such materials are) more expensive than the non-originating (materials)' (words in brackets added). While it is indeed desirable to provide incentives for local sourcing—and this could indeed be an important developmental outcome—it is submitted that high local VA thresholds will not induce local sourcing that results in greater cost to producers *unless* the margin of preference in a particular product category is extremely high. RoO that are not at least partly source-neutral to allow producers to benefit from global economies of scale or other countries' competitiveness in certain material categories are unlikely to result in final products that are competitive on the European market. Likewise, considerations such as the ability to fit into global value chains, for example in the textile-clothing pipeline where it is often a requirement for clothing producers to source from specific licensed suppliers located elsewhere, are a critical requirement if producers located in the EU's trade partners are to benefit from the preferential market access offered under a trade agreement.

[7] Some studies have determined that the threshold to prevent trade deflection is generally low, and as low as 10% (see for example the findings of the Blair Commission; www.commissionforafrica.org).

Provisional outcomes of the RoO negotiations between ACP countries and the EU

EU-ACP RoO did not undergo a major revision during the EPA negotiations, although some of the changes that were made, notably the revised textiles and clothing RoO, are significant and potentially far reaching. Instead of negotiating at the all-ACP level, EPA regions eventually engaged on this matter at the regional level, although this predictably resulted in very few differences to the substance of the various agreements.

Since it was not possible for all the parties involved in the negotiations to immediately and fully implement the provisional EPAs, and to ensure continued preferences for those ACP countries that had initialled an agreement and at a level that was similar to the outcome of the RoO negotiations at that point in time, the European Commission issued a Council Regulation8 . This would facilitate preferential access to the EU market on a basis similar to - and in some instances better - than the previous Cotonou Agreement. It applies only to those ACP countries that had initialled an Interim EPA.

The main changes can be summarised as follows: cumulation under the Council Regulation - the interim arrangement - is permitted only amongst signatories, which effectively is an outcome that is significantly less favourable than the Cotonou Agreement (which permitted full cumulation among all ACO countries). Presumably, the restriction is based on the fact that the RoO applicable to preferential market access are now different between the GSP/EBA and the new arrangement. Cumulation provided for under the EPAs, once implemented, is similar to that which was permitted under Cotonou (involving all ACP countries).

From a sector-specific perspective, the major changes involve the RoO in the textile and clothing sector (discussed earlier), which are now substantially more advantageous to producers and exporters than previously. Instead of requiring two local stages of transformation the new rules require only one to confer origin. In the

[8] Council Regulation (EC) No 1528/2007 (of 20 December 2007)

fish sector, the changes appear to be less profound, with only some additional flexibility regarding the conditions attached to vessels, and specific value tolerances for non-originating fish material. The issue involving the treatment of fish caught within a country's 200-mile EEZ remains largely unchanged, and continues to associate the nationality, flag and ownership of the vessel with the origin of the fish, rather than where such fish has been caught and the jurisdiction over such area. The RoO also continue to require wholly obtained fish under Chapter 16 (canned fish etc.), despite the fact that the further processing in itself adds significant value to the final product. For The Pacific countries, the concept of global sourcing of fish was introduced as a special dispensation, and involves permission to use any fish provided it is landed locally and further processed within Chapter 16. Also, a range of conditions attach to this provision, inter alia an environmental management plans to be submitted to the European Commission

A few changes were also made to the treatment of processed agricultural products. These changes to the RoO are contained in a special Annex and are considered as derogations from the "normal" rules; in most instances, the derogation is applicable only to a subset of a product, for example goods containing less than a certain percentage of sugar, and therefore may be useful only in some situations. Derogations remain subject to monitoring and possible countervailing measures in the EU should exports under the provisions threaten any domestic interests.

The Interim EPAs make provision for a revision of the RoO within a certain number of years (generally three years from the conclusion of the EPA). However, even until such time that a full EPA is signed the opportunity remains in place to revisit the RoO and to renegotiate some of its provisions, bearing in mind that the EU wishes to preserve a large degree of consistency within its preferential RoO regime and may thus not show sufficient flexibility with respect to requests for change.

Annex 1

Sample list of "wholly obtained" requirements

1. The following shall be considered as wholly obtained, in the ACP States or in the Community, or in the overseas countries and territories defined in Annex III, hereafter referred to as the OCT:

(a) mineral products extracted from their soil or from their seabed;
(b) vegetable products harvested there;
(c) live animals born and raised there;
(d) products from live animals raised there;
(e) products obtained by hunting or fishing conducted there;
(f) products of sea fishing and other products taken from the sea outside the territorial waters by their vessels;
(g) products made aboard their factory ships exclusively from products referred to in subparagraph (f);
(h) used articles collected there fit only for the recovery of raw materials, including used tyres fit only for retreading or for use as waste;
(i) waste and scrap resulting from manufacturing operations conducted there;
(j) products extracted from marine soil or subsoil outside their territorial waters provided that they have sole rights to work that soil or subsoil;
(k) goods produced there exclusively from the products specified in subparagraphs (a) to (j).

2. The terms "their vessels" and "their factory ships" in paragraph 1(f) and (g) shall apply only to vessels and factory ships:

(a) which are registered or recorded in an EC Member State, in an ACP State or in an OCT
(b) which sail under the flag of an EC Member State, of an ACP State or of an OCT;

(c) which are owned to an extent of at least 50 per cent by nationals of States party to the Agreement, or of an OCT, or by a company with its head office in one of these States or OCT, of which the Chairman of the Board of Directors or the Supervisory Board, and the majority of the members of such boards are nationals of States party to the Agreement, or of an OCT, and of which, in addition, in the case of partnerships or limited companies, at least half the capital belongs to those States party to the Agreement or to public bodies or nationals of the said States, or of an OCT;
(d) of which at least 50 % of the crew, master and officers included, are nationals of States party to the Agreement, or of an OCT.

Annex 2

Sample list of "insufficient working or processing operation"

(a) operations to ensure the preservation of products in good condition during transport and storage (ventilation, spreading out, drying, chilling, placing in salt, sulphur dioxide or other aqueous solutions, removal of damaged parts, and like operations);

(b) simple operations consisting of removal of dust, sifting or screening, sorting, classifying, matching (including the making-up of sets of articles), washing, painting, cutting up;

(c)

(i) changes of packaging and breaking up and assembly of packages;

(ii) simple placing in bottles, flasks, bags, cases, boxes, fixing on cards or boards, etc., and all other simple packaging operations;

(d) affixing marks, labels and other like distinguishing signs on products or their packaging;

(e) simple mixing of products, whether or not of different kinds, where one or more components of the mixtures do not meet the conditions laid down in this Protocol to enable them to be considered as originating in an ACP State, in the Community or in the OCT;

(f) simple assembly of parts to constitute a complete product;

(g) a combination of two or more operations specified in subparagraphs (a) to (f);

(h) slaughter of animals.

2. All the operations carried out in either the ACP States, the Community or the OCT on a given product shall be considered together when determining whether the working or processing undergone by that product is to be regarded as insufficient within the meaning of paragraph 1.

Source: Cotonou Agreement Rules of Origin / Annex V / Article 5