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Market Access

Rules of Origin under EPAs: Key Issues and New Directions

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Introduction

Rules of origin (ROO) form a critical component of any trade agreement or preferential trade area. They describe the conditions used for the determination of a product's origin, thus setting the parameters for preferential access to a given trade partner's domestic market. Rules of origin can thus promote or curb trade, depending on their restrictiveness.

For the 78 ACP countries, all of which have a long association with the European Union, the latter forms an important market for their exports, especially in certain product categories. Preferential trade has been governed mainly by the provisions of successive Lomé Conventions, which offered ACP countries non-reciprocal market preference. In 2000, the 4th Lomé Convention was replaced by the Cotonou Agreement; its ROO, however, remaining largely unchanged from those contained in its predecessors. By being non-reciprocal in nature rather than the result of bilateral negotiations, they contained provisions which in the view of ACP stakeholders were often overly restrictive if not protectionist. The Cotonou Agreement sets the stage for a re-negotiation of the formal trading relationship between the EU and ACP countries, specifically its ROO, to form part of new Economic Partnership Agreements (EPAs) which are to be concluded by 2008. ROO negotiations are set to begin at the end of 2005 or by early 2006 at the latest.

Rules of origin: Their role in international trade

Rules of origin play an important role in the implementation of trade policy. They are used to determine the 'economic nationality' rather than merely the geographic nationality of goods, a distinction

that is important especially where a product is made up of materials sourced from more than one country.

Since trade policy often requires that market preferences be made available only to certain countries, for example the parties to a trade agreement, an absence of origin rules would lead to problems with transshipment and render preferential trade provisions meaningless. Known as trade deflection, products exported to a specific country could then be channelled through third countries that have more favourable market access to a given export market (that of the final destination), without any economic value-adding and associated benefits taking place in these preference-receiving third countries.

In the determination of origin, the distinction between economic and geographic source is important since the proliferation of global trade has meant that products are their produced in one location alone. Regional and country-specific competitive advantage, say in the manufacture of textiles, has meant that clothing production worldwide is increasingly using materials produced by a small number of highly competitive countries. ROO define the minimum processing that must be undertaken locally (in the preference-receiving country) in order for a product to be deemed to be of the economic nationality of that country. Geographic nationality, being the country from which the final product is shipped to its destination, does not qualify in this determination of origin.

While the prevention of trade deflection is the original and probably only legitimate purpose of origin rules, especially from a development perspective, many ROO regimes have evolved to become instruments and guardians of protectionism. Strict origin rules make compliance onerous, if not indeed impossible, especially for many developing countries with

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less-developed infrastructure or domestic production capabilities. Likewise, with international trade and associated supporting logistics having developed rapidly in recent years, it is no longer sufficient for a country to be able to merely *produce* a given input. These have to be produced within a given competitive framework, incorporating efficient and competitive lead times, pricing, quantitative, qualitative and other characteristics. Notwithstanding this, ROO are often still used to protect 'sensitive sectors', and political economy elements remain present in most ROO regimes.

Technical aspects of rules of origin regimes

There has been a proliferation of preferential trade arrangements in recent years, especially between developed and developing countries. While all preferential-trade rules are governed by a set of origin rules, the technical composition of these rules differs across trade regimes. Common among them is the fact that unless goods are wholly produced in the exporting country, they must be 'substantially transformed' in order to benefit from given trade preferences. It is however in the application of the 'substantial transformation' principle that ROO differ from each other.

Rules of origin methodology

As described earlier, ROO set the conditions for determining the economic nationality of a product. In order to be deemed the manufacture of an exporting country, a product must be either 'wholly produced' (the EU uses the term 'wholly obtained') or 'substantially transformed' in the exporting country. Substantial transformation is measured according to three key principles, each of which is described below. It should be noted that these criteria always apply only to the non-originating components of a product; materials wholly sourced from within a country or specific regional grouping (where applicable) are not required to undergo further processing.

Value added (or '*ad valorem*') (VA)

The 'value added' methodology is the most easily understood conceptually as it confers origin based on

a specific proportion of production value that must be added locally. However, some challenges are associated with the technical aspects of this methodology, especially with regard to the principal-cost basis to be used in the determination of sufficient local value added. An alternative way of using this methodology is by setting maximum foreign content thresholds instead.

Specific processing (SP)

Specific processing provides an alternative means of setting criteria for substantial (local) transformation. Specific processing rules require a non-originating material or product to have complied with a pre-defined set of local operations or processes, for example the fabric used in garments must be woven locally.

Change in tariff heading (CTH)

This methodology is usually based on the internationally recognised and used Harmonised System nomenclature (HS), and requires that a product must be classified under a different heading than that of any non-originating input materials used in its manufacture. As the HS uses different levels of classification, CTH criteria are usually set at the 4-digit level of disaggregation.

While some ROO regimes make use of a single methodology for determining origin, others use a combination of criteria or even provide the option of complying with alternate methodologies. In general, the VA methodology is seldom used as the sole test for determining origin. An example is the African Growth and Opportunity Act (AGOA), the United States preference programme geared at qualifying countries from Sub-Saharan Africa, which uses a VA rule for determining local (or in this case regional) origin. Products must comply with a 35% threshold level of local value added, with specific rules applicable to the garment sector (essentially a range of SP rules). Another example is Canada's 2003 Market Access Initiative, which offers least-developed countries a 25% VA threshold in order to qualify for duty- and quota-free market access.

The VA rule, while being conceptually concise and thus easy to understand, suffers from the fact that its application is subject to a number of poten-

tially complicating variables. Foremost among these is the methodology used in determining a product's base cost, as this plays a critical role not only in this methodology's ease of use from an administrative perspective, but also in terms of compliance. Different cost calculations, which are beyond the scope of this report, include ex-works price, free on board price (FOB), cost plus insurance and freight (CIF) and so forth. Depending on which method is required, and what cost components are included and excluded, the outcomes can be vastly different.

A further criticism of the VA method is that depending on the cost components included or excluded in the value calculation, this can place a high administrative burden on the exporter and customs authorities. Many are not equipped to sufficiently deal with these matters without unnecessarily holding up the export process, especially in some developing countries. Likewise, the relatively significant movements in the exchange rate experienced by some countries *vis-à-vis* that of its trade partners may mean that a slight devaluation of the local exchange rate may suddenly disqualify a product from benefiting under a preference programme. As there is movement in a country's exchange rate, so does the ratio of local against foreign value added change.

More widely used are CTH and SP criteria. The EU's origin regime, which shows a high measure of consistency across preferential trade agreements that it is a party to, makes widespread use of CTH and SP criteria, and to a lesser extent VA principles (sometimes as an alternative or secondary rule).

While many origin regimes employing the CTH principle recognise a tariff shift at the 4-digit level as sufficient to confer origin, there is still much inconsistency in the use of this methodology. Efforts by the World Customs Organisation (WCO) to harmonise the application of ROO methodologies are still focusing on those found in non-preferential regimes, although there appears to be a favoured emphasis on the CTH methodology. The weakness of the CTH lies in its use of the HS classification system, which as mentioned earlier was not designed with this role in mind. As a result, CTH at the 4-digit level is sometimes an insufficient requirement for sufficient local transformation having taken place, while with other products the 4-digit level

would represent an overly onerous origin requirement. Despite this, the CTH methodology is relatively easy to understand and implement.

The SP methodology sets the processing operations that a product must undergo locally in order to qualify as originating in the home country. Associated with this methodology, although often broadly applied to all products covered by a trade agreement, are 'insufficient operations'. These define the processes that, on their own, are insufficient to confer origin. Like the VA and CTH methodology, this system has its own set of advantages and disadvantages. A clearly positive aspect is the fact that this methodology does not suffer from any ambiguity, since the necessary processing requirements are clearly defined and described. The disadvantage, of course, is the fact that they make ROO more cumbersome, as each product has its own set of requirements. This is burdensome for exporters (especially where these are not the same as producers), and customs authorities. Similarly, the SP methodology is subject to political economy elements, as home industry concerns may (and are known to) influence specific rules.

Cumulation of origin

Cumulation is important in expanding the scope of preferential trade. Cumulation provisions essentially describe the extent to which production may be shared between countries without forfeiting preferences under a given trade agreement. In other words, cumulation permits countries to use inputs produced in specific third countries without having to comply with the usual origin requirements, provided that such inputs are further processed in the exporting country claiming preferences.

Various forms of cumulation exist. These are bilateral, diagonal and full cumulation. Bilateral cumulation, being the simplest and most common form of cumulation, permits the unrestricted use of one another's inputs between parties to a preferential trade agreement. In other words, bilateral cumulation allows cumulation between the preference-giving and preference-receiving country. Where cumulation is permitted between certain preference-receiving countries, for example the SACU countries with respect to South Africa's trade agreement

with the EU, this is referred to as regional diagonal cumulation. Diagonal cumulation almost always has a regional component, and can substantially expand the scope of a trade agreement in that it implicitly recognises that different countries within a defined geographic area may have different industrial and productive capabilities and efficiencies. Diagonal cumulation can thus play an important supporting role in fostering regional economic integration.

Full cumulation can perhaps be described as an extended form of diagonal cumulation without the geographic or regional limitations. Full cumulation permits production to be shared among all members of a preferential trade regime, without the processing of an individual country having to be sufficient to confer origin on its own. In other words, the sum of all processing is seen in its totality. The main benefit of cumulation lies in the flexibility it gives to manufacturers and exporters, for example allowing certain processes or material requirements to be outsourced to more competitive beneficiary countries without jeopardising the final product's originating status.

Rules of origin in the EU-ACP Cotonou Agreement

Being a non-reciprocal agreement, Cotonou's ROO are not the result of a negotiated process, but rather a unilateral offer of preferential market access on the part of the EU. Cotonou's origin rules are based on those found in earlier Lomé Conventions, and are likewise largely consistent with other preferential trade agreements that the EU has entered into. They employ a mixture of wholly obtained, CTH, VA and SP methodologies for the determination of origin.

For example, the origin requirements for many agricultural categories are based on the wholly obtained criteria, that is, products must be wholly produced in the exporting country. In practice this means that livestock must be born and raised within the exporting country to be deemed to have originated there, fruit and vegetables must be grown there, fish caught within a country's inland or territorial waters, and so on.

Most resource-based and manufactured products are required to comply with a combination of CTH and SP criteria, and in some instances have an alter-

native option of a VA rule. For example, articles of apparel must be made up from yarn (which entails the local conversion of yarn to fabric to garment), or alternatively from fabric that is further subject to specific beneficiation requirements.

While an analysis of the Cotonou ROO shows that many of its origin provisions are not unreasonable or excessively onerous, it is both the overall package as well as the rules applying to certain key sectors that have made them the target of much criticism among ACP countries. Administrative requirements associated with exporting under Cotonou, such as the burden of demonstrating compliance with the rules, are relatively onerous, although this is an issue that often lies equally with the customs authorities in exporting countries.

Specific sectors where Cotonou's origin requirements are deemed to be particularly restrictive are those applying to the fisheries and textile and clothing sectors. The latter, as shown above, typically requires two distinct stages of transformation to be undertaken by the exporting country. This requirement implicitly fails to recognise that dynamics within the global textile and clothing production pipeline have shifted substantially since the 1970s when these rules were originally determined, making them excessively restrictive in today's environment. In practice they prevent ACP countries from availing themselves of the benefits of sourcing input materials (such as textiles) from low-cost countries in South-East Asia, for example as is permitted under the AGOA ROO which permit virtually unconstrained fabric inputs from third countries. Making matters worse is the fact that textile and more importantly garment production are relatively important manufacturing sectors in many ACP countries, and are often seen as an important step as developing countries diversify their economies away from a complete reliance on, say, a single agricultural product.

The fisheries sector is a further example of Cotonou's ROO shortcomings, showing unambiguous protectionist elements on the part of the EU (fish products constitute one of the largest export categories from the ACP). These restrictions extend beyond the product-specific ROO (so-called 'list rules') but also reach into the core definition of the 'wholly obtained' principle. Besides describing what

product categories are deemed to be wholly obtained in the exporting country (livestock born and raised there, fruit and vegetable products grown and harvested there, fish caught in the territorial waters, etc.), they impose further restrictions on the vessels used to harvest a country's fish stocks.

Specifically, any fish caught outside of a country's territorial waters,¹ but still within its 200-mile exclusive economic zone (EEZ), is subject to stringent fishing vessel, crew, registration (flag), and ownership nationality requirements. Essentially, all fish must be caught by a country's own vessels, or those owned by EU stakeholders. To be considered a domestic fishing vessel, the ship must be registered in and sail under the flag of an ACP state or the EU, be at least half-owned by nationals of the ACP (subject to further conditions pertaining to head office, the Board of Directors and capital), and must use the services of a crew that are at least half nationals of the ACP. While these conditions are consistent across most EU preference regimes, Cotonou provides some minor concessions: under certain conditions, leased or chartered vessels may be used, although even this concession is subject to prior approval by a so-called 'ACP-EC Customs Cooperation Committee'. But the concessions continue to prescribe that at least 50% of crew are ACP nationals, this being a slight concession from the usual 75% crew requirement.

Other provisions in Cotonou describe conditions for cumulation, so-called value tolerance, drawback and other requirements. Provisions for cumulation are broad, including bilateral, diagonal and full cumulation. It should be noted that full cumulation among all ACP countries is possible for the simple reason that ACP countries are subject to, and may benefit from, the same set of origin rules under Cotonou. Differentiated origin rules and full cumulation are mutually exclusive, since it would merely open up the possibility of transshipment and thus severely undermine a trade regime having more restrictive origin rules.

Cotonou does however contain a number of limiting provisions with respect to the principle of cumulation. These relate mainly to cumulation with South Africa, and to neighbouring developing countries (a concept whereby cumulation is extended to

a small number of pre-defined non-ACP countries). Specifically, materials originating in South Africa – itself an ACP country but not benefiting from Cotonou's trade provisions – may be used without further processing, but the value added in the ACP country must exceed the value added in South Africa. This cumulation only applies after three to six years following the conclusion of the TDCA and does not apply to all products (as listed in Annex XIII). Also, this cumulation is only possible after the lifting of tariffs on these products agreed between the EU and South Africa, and following publication in the *Official Journal of the European Communities* of the date on which these conditions have been met. South African materials must also have obtained originating status by application of ROO identical to those set out in the Cotonou Agreement.

Cumulation with materials originating in 'neighbouring developing countries, other than an ACP state, belonging to a coherent geographical entity' is possible, but requires the prior conclusion of administrative agreements between the ACP countries, the EU and the affected neighbouring countries. For products listed in HS50-63 (textiles and clothing), CTH processing must also subsequently take place in the ACP country, while a further Annex prescribes the working or processing required on *certain* of the textile and clothing products listed in HS50-63. It would appear that these provisions restrict rather than enhance cumulation options for ACP countries.

Drawback provisions describe a scenario whereby non-originating (i.e. imported) materials used in the manufacture of final goods having originating status (and subsequently exported) receive an exemption from or remission of import duties. In many origin regimes, including the majority that the EU is party to, drawback is expressly prohibited as it is seen as a form of subsidy, and incentive to use foreign-produced inputs. In the Cotonou Agreement, however, drawback is not prohibited; in fact, no mention is made of drawback in its ROO.

Finally, value tolerance provisions are a feature in Cotonou's origin rules, and are set at a 15% threshold. Value tolerance is in effect a derogation from normal origin rules, and provides producers and

exporters with an additional measure of processing flexibility. Value tolerance essentially describes the proportion of materials, expressed as a percentage value, which are exempt from complying with usual origin requirements. For example, a garment could use certain foreign materials, such as interlinings, buttons and zips, so long as the combined value of these materials does not exceed either the 15% value tolerance threshold or any other threshold specifically indicated in the product-specific rules. Besides a similar value tolerance threshold contained in the EU–South Africa Agreement, no other EU Agreement contains a value tolerance provision higher than 10%.

A fresh approach to rules of origin: Recent proposals by the EU

Over the past two years there have been a number of proposals on the part of the EU with a view to revising its general ROO framework. While its policy is for overall consistency across its preferential trade regimes, and specifically ROO contained therein, the current rules are largely based on a system that has already been in operation for some decades. Considering that industrial configurations globally have changed considerably in recent years, while industrial tariffs between WTO member states are being gradually reduced or dismantled, the current ROO regime had become somewhat outdated. Likewise, experience had shown that onerous ROO and their associated administrative requirements were a key burden to the natural development of export trade in many ACP countries, as the current non-reciprocal framework still contained too many protectionist elements.

Green Paper on the future of rules of origin

In December 2003 the European Commission (EC) published a *Green Paper* on the future of ROO in preferential trade arrangements. In response to the changing nature of international trade, and objectives of preferential trade arrangements, the *Green Paper* was to aid the EC in a process that was to culminate in the formulation of revised origin guidelines and compliance procedures. Up to that point, evidence from trade flows and the uptake of prefer-

ences (specifically the GSP and Cotonou Agreements) had shown that a significant proportion of imports eligible for preferences failed to use them (see also UNCTADT, 2003).

The *Green Paper* recognised the need for ‘new equilibria’ in (a) the criteria for determining ROO as well as the framework for their implementation, (b) in 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 involved in the procedures for declaring, certifying, and checking preferential origin. However, it eventually failed to place much emphasis on the substantive issues that were preventing beneficiary countries from using EU preferences, despite point (a) above. In particular, the document failed to address key concerns by stakeholders that the current rules were too restrictive.

A subsequent summary report on the *Green Paper* consultative process was published in 2004, and concluded that:

- the present origin rules do not fit current economic reality;
- current ROO are seen as being too complex, restrictive and lacking transparency; and
- the current origin rules should be rationalised and simplified.

EC communication on rules of origin

In March of 2005 the EC published a formal communication titled *The rules of origin in preferential trade arrangements: Orientations for the future*. It represented the next stage in the process of revising the EU’s ROO requirements, and outlined a number of concrete proposals. The Communication also indicated that this document would inform the position to be adopted by the EC in the negotiation of EPAs. While EPAs are likely to feature a form of reciprocity and will be *negotiated* agreements, the reality on the ground is that the EC’s position is frequently seen as the *de facto* outcome of any negotiations. Negotiators for ACP countries will have to be alert to this.

Two broad issues are dealt with by the EC’s communication:

- the conditions for a product to be considered as originating (i.e. the ROO); and
- issues around the implementation and control of trade preferences, and the development of instruments to ensure compliance with the obligations governing preferential trade.

The first issue represents a substantial departure on the part of the EU from current ROO methodology in that it proposes the use of a single methodology for products or materials that are not already wholly obtained in the beneficiary country. In other words, the proposal does away with the CTH and SP tests, and proposes an across-the-range VA methodology. Differentiation is envisaged between different product sectors, rather than a single percentage threshold for all sectors.

The communication outlines the envisaged basis on which the determination of costs, being production cost and local content, should be based. It departs from the *ex-works*² methodology contained in the Cotonou Agreement and introduces 'local value content' (LVC) against 'net production cost' (NPC). NPC would include any direct materials used, originating and non-originating, as well as direct labour costs and expenses that can be directly attributed to the production of a good. Indirect materials such as fuels, energy, plant and equipment also count towards NPC (and of course where applicable to the LVC component). But the EC's definition of cost departs from other methodologies in that it envisages specifically excluding a number of other cost elements, including marketing and administrative costs, profit mark-up, packaging, and other overheads not directly attributable to or contained in the product (or used in the production of the product). As emphasised earlier, the basis used in the determination of costs has an important bearing on the restrictiveness of the VA threshold defined in the ROO. The result of these specific exclusions would in direct comparison correspond to a relatively lower VA threshold, if all other variables were set equal.

The EC communication also specifically touches on three sectors, at least two of which are frequently seen as key sticking points with regard to Cotonou's current ROO. These are the fisheries and textile sectors, while mention is also made of the agricultural

sector in general. The essence of the Communication is that these three sectoral areas require specific analysis with respect to the applicability of a VA criterion in future ROO

The fisheries sector, as outlined earlier, is subject to very onerous origin requirements for fish caught outside a country's territorial waters yet still within its EEZ. Rules regarding ownership and flag of vessel, and the nationality of crew and captain, are just some of the many conditions affixed to this sector. The current origin regime for fish is thus often perceived to be excessively restrictive by ACP countries, with the result that ACP countries have been unable to use this export sector to the extent that they would have were ROO more liberal.

Despite these criticisms, the communication fails to address the key issues relating to fisheries ROO. The solitary suggestion pertains to the current requirement regarding the nationality of the crew engaged in fishing within the EEZ, and proposes to remove this condition.

With respect to the textile sector, the communication makes no real proposals except for a general acknowledgement that future ROO in this sector will require special analysis. Explicit reference is made to the EC's 2003 communication 'on the future of the textile and clothing sector in the enlarged European Union'.

Issues around the implementation and control of trade preferences, and the development of instruments to ensure compliance with the obligations governing preferential trade, are dealt with more extensively. The EC proposes changes to the administrative systems currently in use to govern origin provisions, including an elaborate pre-registration system whereby any exporter must be registered with the home country's customs authorities before being permitted to receive preferential market access to the EU. While the proposals speak about self-certification by exporters, the ultimate responsibility (financial and otherwise) of such claims would lie with customs authorities of the home country. Failure to comply with these regulations, for example declarations by exporters which subsequently prove to be false, could result in the suspension of preferences for the beneficiary country. Further, the systems required for registration, including the process

by which customs authorities should conduct assessments into the affairs of its exporters, would be prescribed by the EU, thereby effectively removing a degree of autonomy that currently prevails under Cotonou.

EC defence of the choice of value added as the preferred ROO methodology

Shortly after (and based on) the publication of the March 2005 communication, the EC published a working paper titled 'Justification of the choice of value added method for the determination of the origin of processed products'. It seeks to entrench and justify the EC's earlier proposals regarding a new and uniform ROO methodology. It also provides a rebuttal to some of the criticism that had earlier been levelled against this shift to a new (or rather single) methodology.

The working paper makes strong statements to highlight the fact that current origin rules contained in EU trade regimes are in need of an overhaul. Specifically, the paper argues, current rules 'are too numerous and different', are 'complex', and furthermore are 'opaque, unequal and rigid'. It goes on to substantiate these statements, while illustrating the variation in current origin requirements by means of a table. This is replicated in Table 1.

A number of arguments are presented in favour of value-added. Some of these, presented below, have been drawn from the EC's communication:

- (the) value-added method would provide both a single criterion to be applied (...) and flexibility in defining the thresholds to reach (...);
- such a method would (...) allow determining with a common tool for all kinds of products the real 'local content' that a product has obtained during its manufacturing process (or a 'regional content' in the event of cumulation);
- (the value-added methodology) is particularly relevant for an assessment of the impact of a processing on development;
- (the) value-added method would be an incentive to source originating materials (even if more expensive than (sourcing from) non-originating countries) from the exporting country or from a country belonging to the same cumulation zone (...) (or to utilise) other local regional production factors; and
- (the) value-added method is the only (methodology) which would allow real simplification by (...) (removing variables such as) minimal operations, value tolerances, alternative rules and most of the introductory notes to list rules, (as well as) covering (...) the identification of sufficient processing on non-originating materials.

Judging by developments over the past two years it is increasingly evident that the EU acknowledges that its current ROO regime is in need of an overhaul. The choice of VA as a departure point for new origin rules, with special rules for the agricultural, fisheries and textile sectors, represents a significant departure from the *status quo* but with as yet unknown consequences. No single methodology is flawless, and considering the many administrative issues associated with this methodology (and systems of control

Table 1. Breakdown of 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: WO = wholly obtained; CTH = Change in tariff heading; SP = Specific processing; NR = No rule (manufacture from any heading)

Source: EC (2005b)

proposed by the EU) it is not clear whether a VA methodology will actually enhance access to the European market.

Key ROO-related challenges in EPA negotiations

With ROO negotiations between ACP countries and the EU due to start by the end of 2005, there is little time left to prepare. However, the outcome of these negotiations will be of key significance for ACP countries, as the ROO contained in future Economic Partnership Agreements (EPAs) will define many of the conditions of EU market access (and in terms of proposed reciprocity, also vice versa). Further, as long as import tariffs and especially tariff spikes remain globally, ROO will be relevant and important. But ROO are not the only determinants of market access, with trade barriers (such as technical standards, sanitary and phytosanitary measures, labelling requirements), issues around trade facilitation (many of which are affected by recent EU proposals) and a host of other issues also play an important role.

A number of issues are of particular relevance in the context of EPA ROO negotiations. Key among these was whether ROO negotiations should be conducted at the all-ACP level or individually by the six EPA configurations, being SADC (Southern Africa), ESA (East Africa), ECOWAS (West Africa), CEMAC (Central Africa), CARIFORM/CARICOM (Caribbean) and the Pacific Forum (Pacific countries). At an ACP Council of Ministers session held in Botswana in May 2004, the decision³ was taken to include ROO in the list of issues that was to be negotiated at the all-ACP-EC level (others included for joint negotiations were trade-related issues and dispute settlement). Despite this, officials at both the ACP Secretariat and the EC indicated mid-2005 that there was still scope to conduct ROO negotiations at the regional level.

There are both advantages and disadvantages to negotiating ROO at the regional level, and they can be summarised as follows. Disadvantages include a loss in regional flexibility, considering different levels of development and commercial interests *vis-à-vis* EU market access. Advantages include the fact that

all-ACP negotiations will benefit from a stronger bargaining position, greater availability of negotiation expertise, and importantly, the possibility of ensuring full-cumulation between all ACP countries by way of a single and consistent ROO framework. As emphasised earlier, the mutual exclusivity between dissimilar origin rules and full cumulation means that negotiating parties face a choice between conducting ROO negotiations independently, or prioritising the need for full cumulation but within the context of less regional flexibility and differentiation.

Experience in the past has also shown that not all ROO provisions contained in the Cotonou Agreement pose difficulties for ACP exporters. In fact, the majority are seen as being reasonable by stakeholders, who instead cite other trade barriers as posing even greater challenges. However, ROO in a number of key sectors are nevertheless seen as being overly restrictive, especially in fisheries and textiles, as well as the burden of proving compliance.

A strong thread in recent EC communications is a proposed tightening of the administrative controls associated with preferential trade. This system foresees the introduction of elaborate systems, many of them electronic or based on detailed company assessments by local customs authorities. While in theory these proposals appear entirely sound, the reality on the ground is that a surge in procedural formalities will do little to enhance market access for ACP countries. Instead, stakeholders in some ACP countries have expressed the view that an escalation of these procedures, many of which are to be dictated by the EU, will merely serve to hold up the trade process or indeed promote a climate of corruption. In any case, what is required are home-grown systems and if anything a reduction in unnecessary bureaucracy, an issue that calls for high levels of vigilance from ACP negotiators.

Sectoral issues, particularly around the textiles and fisheries sectors, would involve a substantial lessening of current restrictions. The two-stage transformation requirement that prevails in the textile sector, and which requires two distinct stages of production to be undertaken locally, is completely out of tune with current dynamics in this important sector. In fact, the implicit classification into 'stages of

transformation' is outdated and a remnant from early EU origin regimes of the 1970s, particularly the GSP and early Lomé Conventions. It fails to recognise, both explicitly and implicitly, that first of all beneficiation activities are today far more diverse in this sector than they were three decades ago (for example, a simple fabric can undergo various stages of beneficiation that make it a product with unique technical, design and aesthetic characteristics without changing its classification or general product description), and that global dynamics have changed with regard to geographical centres having distinct price competitiveness. AGOA, which has proved a resounding success mainly in its more liberal approach to ROO in the clothing sector, permits fabric to be sourced from any third country, thus allowing beneficiary ACP countries to utilise competitive inputs and remain competitive in their exports. As a result, there has been a resurgence of the sector (and exports) in a number of African countries.

As indicated earlier, the fisheries sector is subject to stringent rules with regard to vessels, crew and ownership when exporting fish caught in the EEZ. A relatively simple solution, and one that has been endorsed informally by every EPA region, would be to extend the definition of 'wholly obtained fish' beyond the 12-mile territorial waters up to the 200-mile EEZ. Stringent conditions similar to the present ones could instead apply to fish caught outside the EEZ, to prevent the abuse of trade preferences by third countries undertaking fishing activities 'on the high seas'.

The issue of cumulation remains important, despite the fact that there is relatively little evidence suggesting that intra-ACP cumulation has indeed been of substantial benefit. It is likely though, that as regional economic integration advances over the years, that cross-border trade will also grow, thus making the issue of full cumulation potentially critical. But the same applies to cumulation with neighbouring countries that are not ACP countries but nevertheless part of an existing regional integration initiative; on this matter the EC has expressed a willingness (in its March 2005 communication on the future of ROO) to consider additional cumulation where there is a demonstrable need for it, and

where the necessary administrative procedures are in place. A lack of such a provision could potentially undermine existing or future regional integration initiatives.

On the EC's preference for a VA methodology, this matter requires further analysis. In the absence of clear analysis, it is impossible to predict whether specific thresholds will benefit or disadvantage ACP exporters, particularly where their products already qualify under current rules. Likewise, the choice of net production cost (NPC), with its numerous cost exclusions, would significantly increase the burden of proving compliance in most categories, and possibly also 'raise the bar' where the threshold is set at too high a level. It must be borne in mind that a, say, 35% ex-works VA threshold would equate to a far higher NPC equivalent threshold. Perhaps maintaining current rules but adding an additional uniform VA rule may be a solution, as it is then a given that at least no sector would be worse off.

Related to VA are the issues of currency movements, and maximum foreign content (FC) versus minimum local content (LC) equivalent, and the inherent disincentive of the VA methodology's approach to increase local production and sourcing efficiencies. Movements in the value of a local currency can from one day to the next push a local product made up partly with imported materials below the local content requirement, despite all manufacturing processes remaining equal.

To alleviate the administrative burden associated with the local content calculation, a switch to requiring FC (in place of LC) as a component of the final cost calculation for ROO purposes may be an option. For example, *minimum* 35% LC would equate to *maximum* 65% FC. Exporters could use the invoiced cost of imported materials as a proportion of final cost to verify compliance with ROO, rather than the administratively more burdensome calculation using local costs. The sometimes-used argument about the danger of under-invoicing holds little weight in the context that ROO should not be burdened with this administrative function, which is after all the responsibility of customs authorities and the like. But even with this method complications arise if the outcome to trade negotiations is a ROO regime that has a high number of cost variable

exclusions in the determination of a baseline product cost.

Another issue inherent in the VA approach is its implicit bias against increasing local production efficiencies. This is due to the fact that over time greater local efficiencies will in turn lower the value of local content, which in certain cases may push a product's local value added below the minimum threshold required by the applicable ACP–EC ROO. This methodology may likewise provide an incentive to source material that are of a higher cost (made in a less efficient way?) than foreign equivalents, which despite its potential developmental dimension (of sourcing locally or within the region) may in effect price the final good 'out of the market'. On the issue of using inputs from higher cost sources the EC's recent working paper on its defence of the choice of a VA methodology even states:

'(the) value-added method would be an incentive to source originating materials (even if more expensive than the non-originating ones) from the exporting country or from a country belonging to the same cumulation zone and to use other local/regional production factors'.

It remains questionable whether 'institutionalised' incentives to source at higher cost will indeed enhance ACP country's market access to the EU. In fact, anecdotal evidence suggests that poor countries without sufficient upstream capabilities have, as a rule, never succeeded in remedying these shortcomings based solely on the requirement of restrictive origin rules (a recent example is AGOA, where despite the looming end of the 'third country provisions' for garment exports, little or no investment was undertaken in upstream textile production). Whatever the case, unless positive progress is made on the key issues it is unlikely that a new ACP–EC ROO regime will provide exporters (especially in ACP countries) with more favourable market access to the EU than is the case at present.

Conclusion

Despite the pending start of ACP–EC ROO negotiations, it is clear that there is little assurance that

future ROO will in fact enhance the ACP's trade relationship with the EU. Many factors and uncertainties contribute to this uncertainty, not least of all the apparent lack of a coherent strategy containing the ACP's offensive interests. In its defence, a number of recent initiatives have sought to formulate negotiating positions, even if time constraints do not permit a rigorous analysis of the potential impact that any one ROO methodology may have – especially the EC's preference in this respect.

As with all trade negotiations, real challenges are often hidden away in the detail. Issues such as the EC's proposed net production cost (NPC) basis for valuing goods seeking preferential market access are a case in point, as not only does it form a significant departure from previous practice, but also it may be that the exclusion of specific cost components have the potential to substantially alter the qualifying status of current exports.

Full cumulation has long been an issue perceived as 'non-negotiable' within a future EPA framework, both in the context of seeking improved ROO based on the current 'acquis', but also from a political level. As a consequence, the decision was taken to negotiate future ROO as a bloc, thus preventing a potential conflict between different ROO regimes and maintaining provisions for cumulation. But the real benefit of this approach, it is submitted, lies in the fact that as a coherent negotiating bloc the ACP group will inevitably have greater negotiating expertise and leverage.

Since ROO potentially play such a vital role of enhancing (or denying) market access among preferential trade partners, an apparent lack of awareness of important ROO issues among stakeholders – including some policymakers and economic agents such as producers and exporters – emphasises the need for ongoing capacity building in this area. Even among the various EPA configurations and regional secretariats, and by extension their constituencies, significant differences in the overall level of awareness regarding ROO continue to prevail. As long as import tariffs and related measures continue to form part of trade policy, preferential ROO will be an important variable for countries wishing to benefit from preferential market access. In that context, the

benefits from a revision of ACP–EU ROO under proposed EPAs will continue to be measured against the margin of preference that compliance with relevant origin rules would entail.

Endnotes

- 1 International law (the UN Convention on the Law of the Sea) defines the territorial sea as extending up to 12 miles from the coast, while the exclusive economic zone (EEZ) refers to the area between 12 miles and 200 miles from a country's coastline (or less where applicable, for example where island states are closer than 400 miles apart).
2. 'Ex-works' 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' (Protocol I, Article 1 of the Cotonou Agreement).
3. Decision No. 5/LXXIX/04.

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