WORLD TRADE ORGANIZATION

G/RO/W/202

30 October 2020

(20-7693)

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Committee on Rules of Origin

Original: English

SUBMISSION OF LDC TO THE COMMITTEE ON RULES OF ORIGIN *AD VALOREM* CRITERION

COMMUNICATION FROM THE LDC GROUP

The following submission, dated 30 October 2020, is being circulated at the request of the LDC Group.

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1 INTRODUCTION

1.1. As pointed out in a previous submission by the LDC Group[1], almost five years have now passed from the adoption of the Nairobi Decision on preferential rules of origin for LDCs. Some progress has been recorded in achieving better transparency trough the adoption of a notification template and the calculation of utilization rates of the Duty Free and Quote Free (DFQF) schemes. However there has not been parallel progress in implementing the substantive part of the Nairobi Decision, more precisely the paragraphs concerning the substantial transformation and certification requirements. As we are now almost past the 5th anniversary of the Nairobi Decision and we are heading for a new WTO ministerial possibly in 2021 it is of paramount importance to make concrete progress. It is now time to focus the debate in the Committee on Rules of Origin (CRO) on how to effectively implement the substantive aspects of the Nairobi Decision on preferential rules of origin for LDCs.

1.2. As previously stated, the LDC Group intends to progressively bring to the attention of the CRO the substantive aspects of rules of origin of preference granting countries that needs reform by contrasting them with the relevant paragraphs of the Nairobi Decision and identified best practices. The ultimate goal is to achieve better utilization of DFQF schemes and the attainment of the sustainable development goals (SDGs), namely SDG 17 target 17.12: *Ensuring that preferential rules of origin applicable to imports from least developed countries are transparent and simple and contribute to facilitating market access.*

1.3. In order to focus the debate, the LDC Group will submit a series of technical notes on each of the methodologies to define substantial transformation, namely (a) *ad valorem* percentage criterion; (b) change of tariff classification[2]; and (c) specific working or processing as well as cumulation and certification procedure.

1.4. This note, without being exhaustive, examines the use of the *ad valorem* percentage by preference-giving countries contrasting existing rules with the relevant paragraphs of the Nairobi Decision and listing some best practices and areas for improvement.

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[1] See G/RO/W/194 of 5 March 2020.

[2] A presentation on the change of tariff classification (CTC) has already been made by the LDC Group (RD/RO/72). The presentation has been substantiated by a submission by the LDCs (See G/RO/W/184) that identified a number of examples where the CTC has been used by some preference-giving Countries in a non-consistent manner with the Nairobi Decision. Bilateral meetings have been held with the EU and Japan to discuss how such inconsistencies could be resolved. The LDC Group will resume as soon as possible the meetings with these two Members and report the results to the CRO.

1.2 Substantial Transformation when Applying an *ad valorem* Percentage Criterion: Recalling Paragraph 1.1 of the Decision

1.5. On the *ad valorem* percentage criterion to determine substantial transformation, the Nairobi Decision provides that preference-granting Members shall:

> **"Adopt a method of calculation based on the value of non-originating materials**. However, Preference-granting Members applying another method may continue to use it. It is recognized that the LDCs seek consideration of use of value of non-originating materials by such preference-granting Members when reviewing their preference programmes.
>
> *Consider, as the preference-granting Members develop of build their individual rules of origin arrangements applicable to imports from LDCs,* ***allowing the use of non-originating materials up to 75% of the final value of the product****,* ***or an equivalent threshold*** *in case another calculation method is used, to the extent it is appropriate and the benefits of preferential treatment are limited to LDCs.*
>
> ***Consider the deduction of any costs associated with the transportation and insurance of inputs from other countries to LDCs*** (emphasis added)."

1.6. Accordingly, the issues to be considered are threefold:

(a) With the exception of Australia; New Zealand; Chinese Taipei; and the US, all preference-granting Members are using a method of calculation based on a value of non-originating materials. A positive development would be the adoption by the US and other Members mentioned above of a method of calculation based on value of non-originating materials. It has to be noted in fact that the US, as well as the other preference-giving countries, consistently use a methodology based on value of materials in all FTAs of recent generation;

(b) With the notable exception of Canada, no other preference granting Member currently allows a percentage of non-originating materials of up to 75% of the final value of the product;

(c) None of the preference-granting Members allow the deduction of costs associated with transportation and insurance and/or provisions are unclear on this vital issue.

1.7. In addition, there are horizontal issues that need to be considered to carry out a balanced analysis of the use of *ad valorem* percentage criterion by preference giving namely but not limited to: (1) extent of the cumulation granted under each preferential arrangement; and (2) the existing practices of a preference-granting country under other preferential agreements.

1.8. In fact, the quantitative (with what other countries is possible to cumulate?) and qualitative (full or diagonal) extent of the cumulation that preference granting countries allow under each individual scheme play a role on the restrictiveness or leniency of an *ad valorem* percentage. This holds true also for other drafting techniques such as CTC and specific working or processing, but it becomes particularly evident when using an *ad valorem* percentage criterion applied across the board i.e. to all products. It has also been observed that modern rules of origin contained in FTAs show that the percentage criterion is mostly used in combination with a CTC and is seldom used as a standalone criterion. The maintenance of an unaltered stand-alone *ad valorem* percentage criterion from 1974 in the case of the US onwards can be hardly considered a best practice especially when there are strong indications and findings that such *ad valorem* percentage is not trade creating (as the LDC Group has been indicating since 2014[3]).

1.9. Another important aspect is that some preference-granting Members have adopted more lenient rules of origin for the same products under FTAs that they have negotiated with other partners and/or they adopted existing best practices under other FTAs on how substantial

[3] See "Accounting Underutilization of Trade Preference Programs: The U.S. Generalized System of Preferences" by Shushanik Hakobyan Middlebury College, August 2012, and the previous submission by the LDC Group, see "Challenges Faced by LDCs in Complying with Preferential Rules of Origin under Unilateral Preference Schemes" paper presented by Uganda on behalf of the LDC Group (document G/RO/W/148 dated 28 October 2014).

transformation could be achieved adopting less stringent requirements. This observation reveals that some preference-giving Members hesitate to engage in the necessary reforms to implement more flexible rules of origin for LDCs and adhere to the spirit of the Nairobi Decision.

1.10. This note addresses point (a) and point (c) above namely the methodology of the *ad valorem* percentage calculation and the issue of insurance and freight of non-originating materials. Point (b), the level of percentages, will be the subject of a separate note given the relevance of the topic.

1.11. Table 1 below summarizes the current practices of the different preference-granting Members.

Table 1: Summary of the Use of a*d valorem* Percentage by Preference Giving Countries

Country	Percentage Level	Numerator	Denominator	Use of VNOM	Deduction of insurance and freight	Gap from the Nairobi Decision
Australia	Value added by addition (50%)	Allowable factory cost	Ex-factory cost	No	N/A	25% + IFI
Canada	Max. VNOM 60% for LDCs (80% applying cumulation)	VNOM	Ex-factory price	Yes	No	IFI
Chile	Calculation by subtraction of non-originating materials (50%)	FOB price - VNOM	FOB price	Yes	N/A	25% + IFI
China	Min. value added by subtraction 40%	Price of goods minus the price of materials originating from the beneficiary country	FOB price	Yes	No	15% + IFI
European Union (EBA)	Max. VNOM 70%*	VNOM	Ex-works price	Yes	No/unclear	5% + IFI
Eurasian Economic Union	Max. VNOM 55%[4]	Customs value**	Ex-works price? **	Yes	No	20% + IFI
India	Min. 30% value added by subtraction	FOB price minus the VNOM	FOB price	Yes	No	5% + IFI
Japan	Max. VNOM 40%*	VNOM	FOB price	Yes	Unclear	35% + IFI
New Zealand	Value added by addition (50%)	Cost of materials + expenditures in other items of Factory or work cost in New Zealand or LDCs	Ex-factory cost	No	N/A	25% + IFI
Norway	Max. VNOM 70%	VNOM	Ex-works price	Yes	No	5% + IFI
South Korea	Max. VNOM 60%	VNOM	FOB price	Yes	No	15% + IFI
Switzerland	Max. VNOM 70%	VNOM	Ex-works price	Yes	No	5% + IFI
Chinese Taipei	Value added by addition (50%)	Production process	FOB price	No	N/A	25% + IFI
Thailand	Calculation by subtraction of non-originating materials (50%)	FOB price - VNOM	FOB Price	Yes	N/A	25% + IFI

[4] See Decision No. 60 of the Council of the Eurasian Economic Commission dated 14 June 2018.

Country	Percentage Level	Numerator	Denominator	Use of VNOM	Deduction of insurance and freight	Gap from the Nairobi Decision
United States (GSP & AGOA)	Min. 35%	Cost of materials produced in preference-receiving country plus the direct cost of processing carried out there	Appraised value of the article at the time of entry into the United States	No	No	10% + IFI and methodology of calculation

Note: Most used percentages, **English translation of the legal text not available, VNOM: Value of Non-Originating Materials, IFI: Issue of Freight and Insurance; N/A: Not Applicable.

1.3 Discussion on non-conforming *ad valorem* percentages Rules of Origin and practices by preference granting countries

1.12. The LDCs wish to bring to the attention of preference-granting Member a series of issues that are not in conformity with the spirit and the letter of the Nairobi decision as follows:

1.3.2 Use of a methodology for the calculation of the *ad valorem* percentage criterion different from a value of materials methodology;

1.13. As illustrated previously by the LDC Group and in recent literature[5] there are different methodologies for the calculation of the *ad valorem* percentage. The methodology used by Australia; New Zealand; Chinese Taipei; and the US uses what is commonly defined a value-added calculation by addition as shown below:

a) Value added calculation by addition

$$\frac{Direct\ cost\ of\ processing + value\ of\ originating\ material}{Appraised\ value\ (ex - factory\ price)} = \ ...\%$$

1.14. Paragraph 1.1 of the Nairobi decision calls for the adoption of a methodology for the calculation of the *ad valorem* percentage based on the value of non-originating materials that could be expressed as follows:

b) Value of material calculation

i. Value added by subtraction of non-originating materials:

$$\frac{Ex\ Works\ value - VNOM}{Ex\ Works\ value} = \ ...\%$$

ii. Maximum value of non-originating materials:

$$\frac{VNOM}{Ex\ Works\ Value} = \ ...\ \%$$

Where

VNOM: Value of non-originating materials;
(Ex-Works is sometimes replaced by the FOB value)

[5] See "Convergence on the Calculation Methodology for Drafting Rules of Origin in FTAs Using the *ad valorem* Criterion by Stefano Inama and Pramila Crivelli, Global Trade and Customs Journal, Volume 14, Issue 4 © 2019. See also "The methodologies of drafting the ad valorem percentage criterion" Existing practices in African RECs and way forward in AfCFTA Note drafted by the Division for Africa, Least Developed Countries and Special Programmes of the United Nations Conference on Trade and Development (UNCTAD) in preparation of the AfCFTA 7th Technical Working Group Meeting on Rules of Origin available at https://unctad.org/system/files/officialdocument/aldc2018_AfCFTA_TWGRoO7_tn_advalorem_en.pdf

1.15. It has been recognized in various instances[6] that the methodology of calculation based on "value added calculation by addition" is not a best practice. The large majority of FTAs at present uses a value of material methodology.

1.16. In fact, the definition of direct processing costs is complicated as there is a distinction in the direct processing costs of manufacturing of a finished product that could be considered as value added as follows:

(a) Items included in the direct costs of processing operations: like labour, dyes, mould, research, inspection; and
(b) Items not included in the direct costs of processing operations: like profit, general overhead expenses.

1.17. A simple search in the US customs ruling website (https://rulings.cbp.gov/home) reveals that there are around 375 to 800 records of rulings about the definition of direct costs of processing. This is rather compelling evidence of the complexities involved in the definition and interpretation of processing costs. The disadvantages of a value-added calculation by addition could be summarized as follows:

- Itemization of costs to the single unit of production: this requires accounting, and some discretion remains in assessing the unit costs;
- Currency fluctuations may affect the results of the calculation;
- Low labour costs in LDCs may result in low values added locally (turning this into a disadvantage instead of being a factor of competitiveness for LDC producers).
- The value added-content requirement may necessitate the submission of additional evidence of manufacturing costs (this may include product specifications, bills of materials, product cost sheets, payment records, overhead allocation schedules, raw material purchases, proof of factory labour, and support for manufacturing overhead);
- Production records must establish the value of the materials used in the originating article on a lot-by-lot, batch-by-batch, shipment-by-shipment basis;
- Documentation and records supporting originating status must be verifiable by linkage to inventory and accounting records including summary records such as monthly production reports and accounts payable records.

1.3.3 Adjustments to Value of non-originating materials-issue of deduction of cost of insurance and freight

1.18. In a calculation methodology based on the value of the non-originating materials as numerator as shown in (b) above, the computation of the value of such non-originating materials has a bearing on the outcome of the percentage calculation. This holds especially true when one considers that the cost of insurance and freight of inputs for landlocked or island LDCs may be almost equivalent to a third of the value of the shipment, if not more. Cost of insurance and freight of non-originating materials are exogenous factors depending on geographical locations and have little to do with substantial transformation.

1.19. The deduction method suggested by LDCs is based on adjustments made to the value of non-originating materials allowing for the deduction of insurance and freight costs from the customs value of non-originating materials. The deduction of the cost of insurance and freights from the value of non-originating materials ensures a fairer calculation and may greatly facilitate compliance with the rules of origin for landlocked (16) and island LDCs (11).

1.20. Consider the following example[7]: A manufacturer based in Lilongwe (Malawi) is manufacturing steel frames using imported steel tubes. The applicable RoO is a 70% allowance of non-originating materials. The manufacturer purchase steel tubes from China to manufacture the steel frames for USD 10,000. After manufacturing the steel tubes into steel frames by cuttings, soldering,

[6] Ibidem, footnote 5.
[7] Example from "The methodologies of drafting the *ad valorem* percentage criterion" Existing practices in African RECs and way forward in AfCFTA Note drafted by the Division for Africa, Least Developed Countries and Special Programmes of the United Nations Conference on Trade and Development (UNCTAD) in preparation of the AfCFTA 7th Technical Working Group Meeting on Rules of Origin available at https://unctad.org/system/files/officialdocument/aldc2018_AfCFTA_TWGRoO7_tn_advalorem_en.pdf.

galvanizing, coating the manufacturer sells the frames sold to a South African importer at an ex-works price of USD 16,000. It follows the value-added calculation below:

$$\frac{10,000}{16,000} = 0.625 = 62.5\% < 70\%$$

The frames are therefore originating.

1.21. However, if the value of non-originating material is based on a CIF basis, the cost of insurance and freight from China to Lilongwe, an average of USD 1,250 for ocean freight and USD 3,600 for inland[8] transport has to added to the cost of purchasing the container of steel tubes. Thus, the calculation will be as follows:

$$10,000 + 3,600 + 1,250 = 14,850\ USD$$

$$\frac{14,850}{16,000} = 0.928 = 92.8\% > 70\%$$

1.22. The frames are in this case largely exceeding the threshold of 70%.

Table 1: Example of the relevance of Freight and Insurance

	Without Freight and Insurance	**With** Freight and Insurance
(a) Foreign Materials	10,000	10,000
(b) Ocean Freight	1,250	1,250
(c) Inland Freight	3,600	3,600
(d) Ex-Works Price	16,000	16,000
(e) Value Added Calculation	$\frac{a}{d} = \frac{10000}{16000} \times 100\%$ $= \mathbf{62.5}\% < 70\%$	$\frac{a+b+c}{d} = \frac{10000+3600+1250}{16000} \times 100\%$ $= \mathbf{92.8}\% > 70\%$
Rule Satisfied?	**YES**	**NO**

1.23. As can be seen from this illustration, the exorbitant costs of transport and insurance are crippling any effort to comply with the *ad valorem* percentage requirement.

1.4 Initial expectations of the LDCs on the implementation of the Nairobi decision on *ad valorem* percentage

1.24. As a result, LDCs expect the following best practices to be implemented by preference - granting Members:

- Whenever it is used, the method of calculation should be based on value of materials methodology and based on the value of non-originating materials out of the ex-works price or (FOB).[9]
- Australia; New Zealand; Chinese Taipei; and the US are called to introduce the necessary reforms in their Rules of origin to adhere to such best practice.
- All preference giving countries using this method of calculation should allow for the deduction of the costs of insurance and freight from the value of non-originating materials.

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[8] UNCTAD estimates based on field visits.

[9] It is noted that in some sectors other methodologies such as CTC and Specific working or processing may be used as recent practices in FTAs have shown to better reflect the processing stages of the global value chains.