

Rules of Origin – Trade in Welsh Industrial Goods Overview Report

1. RULES OF ORIGIN – TRADE IN WELSH INDUSTRIAL GOODS

Introduction

Rules of origin are one of the key non-tariff barriers to trade. They have a significant impact on how companies trade internationally. If they are not set at the right level, they risk limiting companies' ability to take advantage of free trade agreements (FTAs).

Origin can be understood as the economic nationality of the good. Rules of origin are negotiated as part of FTAs to determine whether a product qualifies for the preferential (lower) tariff – only goods considered sufficiently processed or obtained in one or more of the parties are eligible for reduced tariffs. Prior to January 2021, rules of origin were not needed between the UK and the EU as the UK was a member of the EU's Single Market and Customs Union. As a result of the UK and the EU signing the Trade and Cooperation Agreement ("TCA") in December 2020, a new set of rules of origin now applies to the trade between the UK and the EU.

Rules of origin that are too flexible can lead to third countries benefiting from the agreement without reciprocating. On the other hand, rules of origin that are too strict can limit companies' ability to comply and take advantage of the deal, as well as to source parts and components from outside the agreement. The balance between these two options can be difficult to achieve.

Businesses can choose whether or not to claim preferential tariffs for the goods they import. For some goods, tariff rates can be low or zero, even in the absence of a FTA. However, if the tariffs are substantial, the only option to avoid them is to import goods that meet the rules of origin.

This research was commissioned by Welsh Government to provide information and evidence on rules of origin requirements for key industrial goods, and to help understand how challenges related to origin provisions could potentially be addressed through Welsh trade policy. This is particularly relevant in the context of the UK's ongoing trade negotiations.

2. RESEARCH APPROACH AND METHODOLOGY

The research was conducted from January 2021 to April 2021 and involved three main phases:

- An analysis of primary and secondary trade data to help identify the key export industries and destination markets that are important for Wales;
- Direct engagement and interviews with Welsh exporters in the key export industries, as well as trade and export bodies; and

- A review and analysis of current rules of origin provisions, particularly from the latest UK FTAs, to determine their likely impact on Welsh exporters, including looking into certification and product-specific rules of origin requirements for the key export industries.

A total of 20 interviews were conducted with Welsh exporters/trade and export bodies from a total of 45 invitations issued. The interviewed companies were asked about their experiences of trading under preference. This included EU's trade agreements and their UK rolled-over versions as well as the new UK-EU trade deal.

Key Export Industries and Destination Markets

Welsh trade saw a decline in 2020 caused by the global pandemic. Goods exports from Wales approximated £13.4 billion in the year ending December 2020¹. This represents a £4.3 billion (24.4%) decline compared to the year ending December 2019.

In 2020, machinery and transport equipment, manufactured goods, and chemicals and related products accounted for 75% of total goods exports for Wales (with the machinery and transport category in itself representing 46%)². In fact, together with Minerals, Fuels and Lubricants, they have consistently represented the top export industries for the last 5 years (industries described at the SITC 1 industry level)³.

¹ Welsh Government analysis of HMRC trade in goods data, Welsh exports: 2020, available: <https://gov.wales/welsh-exports-2020>

² Regional trade data table, available here: <https://www.uktradeinfo.com/trade-data/rts-custom-table/>

³ Welsh Government statistics, Welsh exports: 2020, available: <https://gov.wales/welsh-exports-2020>

Figure 2: Key Welsh export industries 2016-2020⁴

	Sector (SITC 1)			
	Machinery and Transport Equipment	Chemicals and Related Products	Manufactured Goods	Minerals, Fuels, Lubricants etc.
2020	£6.20bn	£2.00bn	£1.90bn	£1.40bn
2019	£8.85bn	£2.05bn	£2.11bn	£2.46bn
2018	£8.52bn	£1.95bn	£2.16bn	£2.31bn
2017	£8.74bn	£1.94bn	£2.04bn	£1.94bn
2016	£7.92bn	£1.70bn	£1.77bn	£1.33bn

Source: HMRC export statistics

The value of exports by larger companies employing 250 people or more, and exporting multiple products to several markets constituted 80% of total Welsh exports in 2019⁵. This indicates that Welsh exports are dominated by a small number of large companies who export a substantial amount of goods in terms of value, and a large number of small companies who export a few very varied products. In fact, 23.4% of Welsh exporters declared exporting only one product. These companies accounted for 8.1% of the total employment in Wales. At the same time, only 0.6% of Welsh businesses declared exporting more than 30 products. These companies accounted for 0.6% of the total employment in Wales. Furthermore, according to the same report, over 50% of Welsh companies export five or fewer products (representing just below 20% of employment).

Companies that export one or only a few products are much more susceptible to any changes and shifts in terms of competitive advantage. New FTAs affect this advantage depending on whether or not companies are able to meet rules of origin. At the same time, small and medium-sized companies/enterprises (SMEs) often do not have the ability to absorb extra costs. As a result, they are often more dependent on their products meeting rules of origin, as additional tariffs might eliminate profit margins. Furthermore, as SMEs have fewer resources, they might find it more challenging to

⁴ Ibidem, the 2020 figures are likely to reflect the impacts of Covid-19 on exports.

⁵ Patterns of Welsh trade by destination, product and business characteristics: 2019, 2020, available here: [Patterns of Welsh trade by destination, product and business characteristics - Office for National Statistics \(ons.gov.uk\)](https://ons.gov.uk/patterns-of-welsh-trade-by-destination-product-and-business-characteristics)

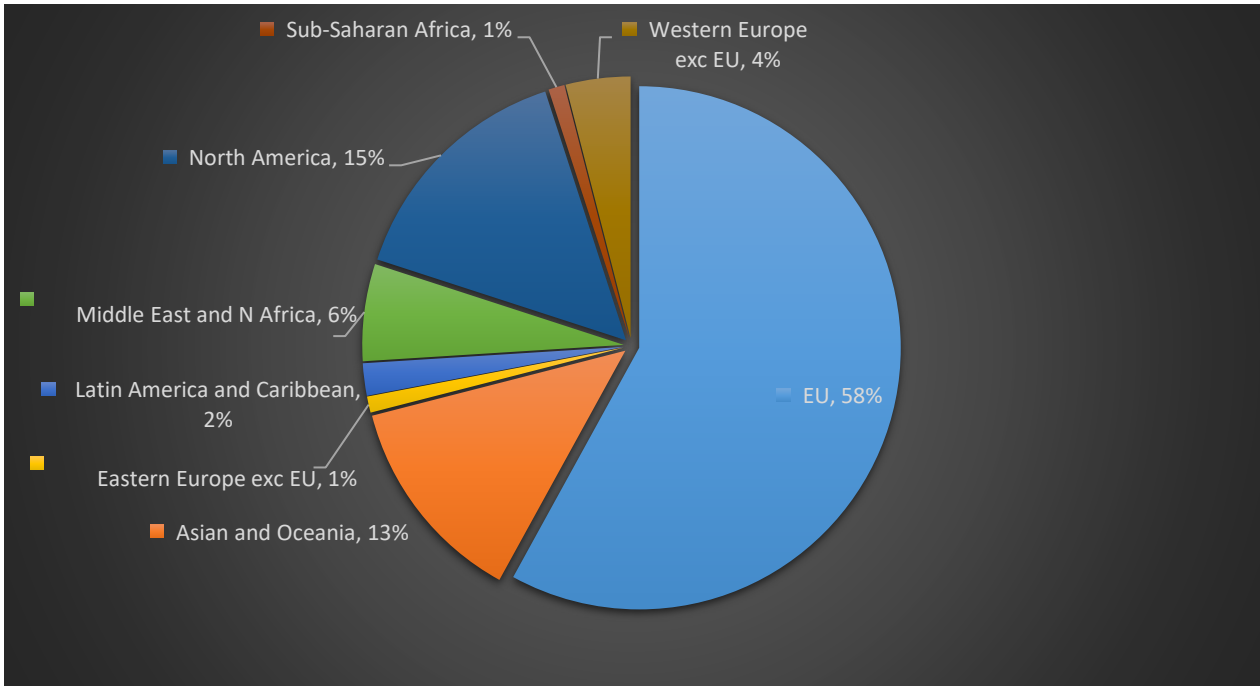
understand and comply with origin requirements. Lack of awareness of rules of origin requirements and lack of sufficient guidance and support disproportionately affects smaller companies.

The importance of rules of origin to Welsh exporters is further demonstrated by the high proportion of total products exported from Wales to just three countries, and the dependency on the EU market.

Welsh exports to Germany, France and the USA combined represented 47% of the total value of exports in goods in 2019⁶ and 43% in 2020⁷. This represents a highly concentrated export market. Furthermore, over 50% of Welsh exporters send goods to 5 or fewer markets (representing just below 29% of employment) and 25.8% of Welsh businesses declared exports to only one country⁸.

58% of Welsh goods exports in 2020 were destined for the EU market⁹. Within the UK, Wales’ trade with the EU is second only to Northern Ireland which has a separate trading arrangement with the EU under the Northern Ireland Protocol.

Figure - Exports destinations as % of total exports, Wales, 2020 ¹⁰



⁶ Patterns of Welsh trade by destination, product and business characteristics: 2019, 2020, available here: <https://www.ons.gov.uk/businessindustryandtrade/internationaltrade/articles/patternsofwelshtradebydestinationproductandbusinesscharacteristics/2019>

⁷ Regional trade data table, available here: <https://www.uktradeinfo.com/trade-data/rts-custom-table/>

⁸ Ibidem

⁹ Ibidem

¹⁰ Ibidem

The lack of availability of trade data covering Welsh imports and exports on a commodity code level limited the scope for quantitative analysis. This meant that the project relied heavily on the highly aggregated trade data available for Wales, alongside qualitative insights from industry representatives. Access to more detailed trade data for Wales would have facilitated a more in-depth and meaningful analysis of trade flows.

3. KEY FINDINGS

LACK OF AWARENESS OF ROO, CUSTOMS ISSUES AND TRADE OPPORTUNITIES

- **A low level of awareness in customs formalities.** Like companies in other parts of the UK, Welsh exporters tend to rely on customs brokers to carry out their customs formalities. As companies are legally responsible and liable for the accuracy of the information submitted on their behalf by customs brokers, they need to be aware of their obligations.
- **Origin requirements are difficult to understand and companies can have a low level of awareness of origin requirements.** Companies that have either not traded under preference before (as they have only ever traded as part of the EU Single Market), or who have traded under preference but relied on brokers to complete the origin process without their engagement were found to be those most likely to fall into this category. These companies may require additional advice and support on how to meet origin requirements going forward to ensure that they are compliant with new trading obligations (and how to evidence and complete statement of origin certificates). This is particularly important as companies issuing incorrect certificates can be subjected to penalties and fines by the authorities concerned.
- **Companies are unsure whether they qualify for preferential origin/tariffs.** Due to a lack of understanding and awareness, some companies were unclear whether they now qualify for preferential origin in their trade with the EU, or whether preferential origin was being claimed by their customers in non-EU countries with which these companies have been trading for many years prior to Brexit. This can imply a low level of awareness with opportunities provided by FTAs.
- **SMEs are less likely to be familiar with origin requirements or be adequately resourced to deal with the added complexities.** All of the above issues disproportionately affect SMEs. SMEs tend to particularly rely on third parties such as customs brokers when dealing with origin requirements as they do not have the expertise or resource themselves. Larger companies with in-house specialists or those that are part of a wider corporate, often international,

structure tend to have better understanding of rules of origin. However, even such companies found the amount of time their employees had to familiarise themselves with the origin requirements as being insufficient.

Origin is a complex area and the available guidance is not always comprehensive or clear for companies that do not have a prior understanding of customs. In addition, some of the simplifications introduced under the TCA have led to companies believing inaccurately that they do not need to provide proof of origin.

THE UTILISATION AND AWARENESS OF TRADE PREFERENCES/AGREEMENTS

- **Relevance of origin requirements.** Many Welsh products in the top export industries are subject to very low or zero tariffs as a result of multilateral tariff liberalisation or under WTO sectoral agreements (e.g. on pharmaceuticals, ICT equipment or aviation). If tariffs are zero then companies could decide not to use a FTA even if one is in place. When tariffs are low, companies may also decide to pay full tariffs, since determining and proving preferential origin can be resource intensive, and possibly be more expensive than paying the tariffs.
- **The UK-EU Trade and Cooperation Agreement.** The EU market will likely remain a significant trade destination for Wales. Many of the interviewed companies stated they export to the EU, which will remain an important destination for them. Therefore, the TCA will most likely be the trade deal used by the majority of Welsh exporters going forward, especially for those industries with high tariffs.
- **Continuity Agreements.** Interviewed companies indicated the importance of the UK's continuity agreements for their trade, especially those with Canada, Mexico, Switzerland and Japan.
- **Future Agreements.** The UK is currently negotiating a number of FTAs: this includes a potential agreement with Australia¹¹, New Zealand, the US and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership ("CPTPP"). Agreements with other trading partners are also being explored (e.g. India). Only a few companies indicated an interest in any of these agreements. The US and Australia were cited as potentially being the most beneficial from those currently being negotiated. However, companies mentioned a range of non-tariff barriers that they thought were preventing them from increasing their low levels of sales to these markets. Interest in joining the CPTPP depended on companies' supply chains, as many

¹¹ Agreement in Principle was not concluded with Australia at time of writing.

companies are already benefiting from bilateral agreements with CPTPP members. The benefits of entering a regional grouping would be of interest for companies with supply chains that lend themselves to the use of regional cumulation.

IMPORTANCE OF CUMULATION

- **Lack of third-party cumulation.** The lack of third-party cumulation is seen to have an adverse effect on Welsh exporters, particularly for those that relied on the EU's trade agreements prior to the end of the Transition Period. The lack of a third-party cumulation arrangement in the TCA means that goods from the countries that both the UK and the EU have a trade agreement with, processed in Wales, cannot be counted towards originating content when exported to the EU. The lack of third-party cumulation in EU trade deals means that Welsh inputs or processing cannot count towards originating content when goods are exported from the EU to third countries, even when both the UK and the EU have a FTA with that country.

This is also the case for goods coming from developing and the least developed countries. The EU has a special system of unilateral preferences for developing and least developed countries called the Generalised Scheme of Preference ("GSP") that provides tariff-free access to the EU market to these countries. The GSP comes with dedicated rules of origin and origin provisions that are more flexible than the ones under most trade agreements. Although the UK replicated the EU's GSP and introduced extended cumulation to allow GSP countries to use EU inputs for the purpose of exports to the UK, the EU has not introduced a similar measure meaning that the reverse is not possible, and GSP countries cannot use UK inputs in their exports to the EU.

- **No access to the PEM convention for Welsh companies.** The UK is no longer part of the system of regional cumulation called the Pan-Euro-Med (PEM) convention. The PEM convention currently comprises the EU, the EFTA States (Switzerland, Norway, Iceland and Liechtenstein), Albania, Algeria, Bosnia and Herzegovina, Egypt, the Faroe Islands, Israel, Jordan, Kosovo, Lebanon, Republic of North Macedonia, Montenegro, Morocco, State of Palestine, Serbia, Syria, Tunisia and Turkey (and partially Andorra and San Marino). The PEM Convention allows for cumulation of originating materials to count as originating between members. This regional system of cumulation was particularly important for a number of Welsh (and the UK) industries such as textiles and automotive, although it was also used by companies in other industries. The PEM convention is based on trade agreements where identical rules of origin exist between the members. The loss of regional cumulation impacts any company that benefited from the PEM system.

SELF-CERTIFICATION

- **Unfamiliarity with self-certification origin requirement.** Self-certification is the most common form of origin certification in recent FTAs. While there are certain benefits to certification by a third party, businesses in many regions have been vocal about their preference for self-certification since third-party certification requires additional time and cost to be factored in before goods can be exported. The research found that companies were experiencing difficulties around certifying origin both under the TCA, as well as some of the continuity agreements. In most cases, these issues related to the change or differences in the format of an origin statement. Previously statements from the UK included an approved exporter or a Registered Exporter (“REX”) number¹², but now only statements need to refer to the company’s Economic Operators Registration and Identification (“EORI”) number¹³. This issue was however quickly resolved by companies once the companies or local customs officers became aware of the change.

SUPPLIERS’ DECLARATIONS, INDIRECT EXPORTS AND THE AWARENESS OF ORIGIN REQUIREMENTS FURTHER DOWN THE SUPPLY CHAIN

- **Confusion over the need to obtain supplier declarations.** One of the simplifications introduced under the TCA was deferring the obligation to hold a suppliers’ declaration¹⁴ at the time of import or export. This simplification has only been introduced until the end of 2021¹⁵. However, this does not change the requirement for the exporter and importer to be confident that the goods meet the rules of origin. This simplification appears to cause a degree of confusion as companies believe it means they are not required to verify the origin of the purchased goods, and in some cases even that they are not required to provide a certificate of origin. If the importers and exporters are unaware of origin requirements, then it is likely that companies supplying them, who are not necessarily importing or exporting themselves,

¹² A Registered Exporter (REX) programme is a version of approved exporter registration that has been introduced by the EU under certain agreements. Initially introduced for developing and least developed countries it became a requirement under other trade agreements as well. For example, to export under the EU- Canada trade agreement, EU exporters had to register for the REX scheme. That also included UK exporters who were already registered with the UK version of the approved exporter.

¹³ The EORI is the main identification number in all communication with customs authorities in the EU. The number is required to submit declarations, apply for authorisations, etc.

¹⁴ A suppliers’ declaration is a document that a domestic manufacturer provides to the exporter to confirm that their products meet the applicable rule of origin. As such it is not a customs form, but a document supporting the origin claim.

¹⁵ Claiming preferential rates of duty between the UK and EU, 2021, HMRC guidance, available here: <https://www.gov.uk/guidance/claiming-preferential-rates-of-duty-between-the-uk-and-eu>

might not understand what “originating” means. The research found that awareness of origin and customs requirements, in general, is often much lower further down the supply chain, and suppliers require support to answer origin-related questions regarding their products.

- **The need for indirect exporters to be aware of origin issues.** In addition to companies having to rely on their suppliers to provide origin information as previously outlined, many Welsh companies will be affected by the new origin requirement as a result of them being indirect exporters. Indirect exports occur when companies supply parts or even finished goods to another UK based company, which then exports the final product. This is particularly important when the origin is determined based on the value of originating components (value-added criterion). As many Welsh products are sold as parts and components of products that end up being exported from the UK, the rules of origin under the TCA will affect them as well. The full impact of this might only become known once suppliers’ declarations simplification period ends.

MINIMAL PROCESSING REQUIREMENTS INCLUDING FOR EU-ORIGINATING GOODS

- **Impact of minimal processing requirements on companies.** Minimal operations are a list of processes deemed not sufficient enough to confer preferential origin. As a result, any goods that have been imported into a country and subjected only to these minimal operations will not be considered originating when they are exported to the other party. Minimal operations can have a profound impact on supply chains and affect companies across all sectors. Many businesses were set up to import products into the UK and distribute them across both the UK and the EU markets. These distribution businesses now face double tariff and double customs procedures as a result of Brexit. This also impacts Welsh companies re-distributing some of the products previously imported from the EU. The most frequent scenario is goods imported from the EU (mainland) and re-exported to the Republic of Ireland or Northern Ireland (if these goods are considered at risk). Such goods are now subject to tariffs on entry into Ireland, even if they were imported into the UK under preferential tariffs. While different workarounds have been suggested by the UK and EU Member States, for example, the Returned Goods Relief¹⁶, they do not offer a full solution.

¹⁶ The Returned Goods Relief allows a trader to send unaltered goods back to the EU without the payment of duties. Import VAT is also waved provided that the goods are reimported by the same company that exported them in the first place. In order to use the RGR, the importer would normally require the original export declaration and need to fill in an additional form.

COMBINING OF PROCESSING AND PREFERENCE

- **No restrictions on duty drawback will be beneficial for FTAs.** Duty drawback allows businesses to claim back duties already paid on non-originating materials used to produce a good which is then re-exported. One of the most common duty drawback methods relates to inward processing relief. Inward processing is a customs relief which allows goods to be imported from a third country with a suspension of customs duties and import VAT. If after processing, goods are re-exported to the same or another third country, customs duties and import VAT never become due. If the goods remain in the country and are sold on the local market, the goods need to be declared to customs and duties and import VAT become due. Prohibition or restriction of drawback under any FTA would in this instance mean that goods imported for inward processing cannot benefit from preferential status at the time of export to the trade agreement partner. Many FTAs include duty drawback prohibition and as a result, inward processing cannot be combined with preferential origin. Under the TCA however, these two can be used together to allow a product to be imported under inward processing with customs duties and import VAT being suspended. When the product is then processed to the point where it meets the rules of origin under the TCA and exported to the EU, the duties and import VAT does not become due. Allowing Welsh and UK exporters to use both processing and preference provides additional flexibility and should be sought under other FTAs.

4. CONCLUSIONS

There can be various reasons why companies choose not to use preferential tariffs. For example, it may be that due to their supply chains and business models their products do not meet rules of origin. However, it is also common to see companies trading under full tariffs due to a lack of awareness and low level of understanding of rules of origin. On the other hand, preferential origin claims can be rejected at the time of import. Lack of compliance with origin requirements can be also be uncovered during post-importation checks and audits. For example, when companies provide proof of preferential origin without being able to substantiate it.

This is particularly relevant for companies that have limited experience with international trade and have only started exporting in January 2021, due to the new custom and regulatory border with the EU. These companies will be required to understand origin and customs related procedures very quickly in order to maintain their clients. While these problems affect all regions of the UK, they might be of particular relevance for Wales given the importance of exports and the EU market for the Welsh economy.

Similar issues can be seen further down the supply chain. A significant proportion of Welsh businesses are indirect exporters - they sell products to clients located in other parts of the UK to be used as parts or components in products that are then exported to the EU. It is important for such companies to also understand origin rules as they can be asked to provide suppliers' declaration.

Additional guidance and support for Welsh companies, in particular for SMEs, would be helpful. Customs and rules of origin, in particular, can be a daunting area for businesses that do not have prior experience of trading internationally. In order to increase the utilisation of trade agreements, additional support is required for SMEs. SMEs often do not have a detailed understanding of customs arrangements, which includes rules of origin, and therefore cannot take advantage of the opportunities available to them. Equally, companies also need to understand their responsibilities and liabilities when it comes to origin and customs to avoid audits and penalties. This means understanding not only how to provide an origin statement, but also how to check whether the product meets the rules, and collecting and keeping all of the supporting documentation as defined by the terms of the FTAs.

Supporting companies by providing training and guidance can play an important role. The key element would be to ensure that such training and guidance is provided by people or organisations with sufficient and practical experience of exporting, and dealing with customs and rules of origin.

The research identified certain provisions that provide additional flexibility for Welsh exporters. Provisions such as third-party cumulation or allowing to use duty drawback together with preferential origin should be included in prospective FTAs where possible. The research also discussed the benefits and risks around self-certification. Increasing awareness and knowledge of origin procedures would also help to eliminate risk in this area.

Many companies have been affected by the EU originating products being subject to full tariffs when they are returned to the EU. Simplifications for returned goods, re-exports and return of goods for repair in prospective FTAs would be helpful.

Particular issues and dependencies in respect of product-specific rules of origin in certain sectors were identified. Access to more detailed trade data, alongside further research and stakeholder engagement would enable the Welsh Government to identify further issues around product-specific rules of origin and provide valuable input into UK's trade talks.