

Brexit preparations – Supply chain mapping

May 2017



Brexit will result in substantial trade-related impacts on both the UK and the EU. UK Prime Minister Theresa May has confirmed that the UK will leave the single market and the EU customs union. In place of this arrangement, the UK will either have to agree a new deal with the EU or fall back on World Trade Organization (WTO) rules.

The extent to which a free trade agreement between the UK and the EU can be negotiated either in tandem with, or subsequent to, the negotiation of the UK's withdrawal from the EU remains the subject of much debate. Even if the EU agreed to parallel negotiations, it is not clear that a satisfactory agreement can be reached in such a short timeframe. If no agreement is reached between the EU and the UK, and no adequate transitional arrangements are put in place, on the UK's exit from the EU the UK-EU trade relationship will be governed solely by WTO rules.

In any event, on its exit from the EU, the UK will have to establish its own WTO schedules of concessions and commitments for imports of goods and services. On 6 December 2016, Liam Fox, the Secretary of State for International Trade, announced to Parliament that the UK will seek to replicate the UK's current obligations, as set out in the shared EU schedule, as far as possible. The "as far as possible" qualification refers to the fact that a small proportion of concessions, namely tariff rate quota and agricultural subsidy commitments, are expressed in terms of the EU as a whole, and so it will be necessary for the UK to determine its shares of those commitments. It is possible that other WTO members would object to the UK's determination of these shares. In the worst case scenario, where the UK miscalculates shares, the UK would have to recalculate those shares or else compensate affected WTO members by offering market access in other areas of export interest.

Under WTO rules, there would be four key impacts of Brexit on trade for the UK.

Four key impacts of Brexit on trade

Goods

1. In the absence of an arrangement between the UK and the rest of the EU, when the UK exits the EU, neither party can discriminate against (or in favour) of the products of the other party compared to “like” products from other developed country WTO members. This means:
 - > **The UK could (and most likely would) charge tariffs on EU imports at the rates set out in its WTO schedules.** The UK could theoretically waive tariffs on imports from the EU but, if it did, under the WTO’s most favoured nation (MFN) principle it would also be obliged to waive the same tariffs for those products for all other WTO members. If the UK unilaterally waived the tariffs on imports to the UK from these other countries, it would lose important bargaining power to negotiate trade agreements with them.
 - > **EU member states would charge tariffs on UK goods at the rates the EU sets for WTO members that it does not have a preferential scheme or trade agreement in place with** (based on the EU Common Customs Tariff). If the EU were to waive those rates for the UK, it would also have to waive them, for the same products, for other countries under the MFN principle.
2. On exit day, the UK will lose the benefit of the EU’s existing free trade agreements, such as those with South Korea and Canada, unless it is able to strike new or replica deals. The UK will continue to be a party to these treaties, but will cease to benefit from them, as the relevant rights and obligations in these agreements only attach to the UK as long as it is an EU member state. **WTO rules will mean that the UK could not seek to build trading relationships with new partners by offering lower rates than it offers to other countries, or agreeing to lower tariffs in only some sectors (eg cars or pharmaceuticals). The only way the UK could offer more favourable rates would be to enter into its own free trade agreements with third countries.** An agreement only qualifies as a free trade agreement if it covers “substantially all” trade between the parties to the agreement, which has been taken to mean at least 90% of existing trade and 95% of all products, including those that are not traded between those parties. Free trade agreements take time to negotiate and cannot be concluded prior to the UK’s withdrawal from the EU. In the interim, both the UK and third countries would charge

tariffs on the other’s goods based on their MFN concessions. However, Brexit also provides the opportunity for the UK Government to negotiate new trade agreements with countries such as the U.S., Australia, New Zealand and Japan (although it should be noted that the EU itself is currently negotiating agreements with Australia, New Zealand and Japan). Such agreements would open up new opportunities for UK businesses but also have the potential to increase competitive pressures on businesses as, for example, the UK import market would become more accessible for exporters from other countries.

Services

3. At present, the movement of services within the EU occurs as a function of the freedom of movement and EU-wide regulation of services. For example, companies authorised by one member state can provide financial services throughout the EU. When the UK leaves the EU it will also leave this system of regulation. **In the absence of a deal between the UK and the EU, the imposition of additional regulatory requirements and standards for services will increase compliance costs and may prohibit the provision of certain services between the EU and the UK.** Should no agreement be reached, the relationship between the EU and UK will be based on WTO rules under which member states specify their commitments and limitations on a specific sectoral basis.

Government procurement

4. From exit day, the UK would no longer need to comply with the EU’s public procurement rules. However, its public procurement rules are likely to remain largely similar to the EU’s, particularly if the UK becomes a party to the Government Procurement Agreement (GPA). The GPA is a plurilateral agreement within the WTO framework which aims to open government procurement markets among parties. Because the EU is a party to the GPA, UK companies would have access to EU procurement markets and vice versa. However, it will be more difficult for companies to complain about violations of EU or UK public procurement obligations, because the GPA is only enforced by parties to the agreement (ie states) whereas under EU law action can be taken by companies directly. In addition, GPA rights are not as extensive as those under EU law.

What does this mean for business?

If no agreement is reached between the EU and the UK and WTO rules govern post-Brexit relations, businesses are likely to experience increases in costs as a result of tariffs, customs checks and regulatory compliance requirements. Even if an agreement is reached, there may still be cost increases due to customs checks and regulatory compliance requirements.

Whilst the outcome of negotiations between the EU and UK is still to be seen, businesses should be proactive in reviewing their supply chains to identify where goods and services are imported and exported. This will enable an awareness of where key vulnerabilities to cost, delays and increased regulation lie, what actions, such as changing suppliers, renegotiating contracts or shifting operations, could be undertaken to prepare for Brexit and what opportunities there may be for new relationships or ways of operating to make the most of changes occurring on Brexit.

Our guide to supply chain mapping, below, is intended to guide businesses through the activity of mapping their supply chains, posing key questions for businesses to consider to properly assess their activities and identify their Brexit-related exposure in the area of trade.

Guide to Supply chain mapping

Map your supply chain

- > Ensure you are clear on the origin of all products in your supply chain (direct or indirect) (for further information see “Rules of Origin” overleaf).
- > Identify the countries you trade with (EU and non-EU) and the value they represent.
- > Identify the EU and international standards your business is currently required to comply with (for further information see “Product standards” overleaf).
- > Identify cross-border services provided.

Assess potential post-Brexit costs and risks

- > What tariffs would apply to your goods:
 - > imported from the EU and third countries into the UK? *Basis for determining tariffs: EU tariffs for third countries (on the assumption that the UK adopts the EU’s WTO schedules and the UK and EU do not conclude an FTA changing this position).*

- > exported to the EU from the UK?
Basis for determining tariffs: EU tariffs for third countries (on the assumption that the UK and EU do not conclude an FTA changing this position).
- > if the UK does not remain a party to agreements between the EU and third countries (eg the EU-South Korea FTA)?
Basis for determining tariffs: Tariffs imposed by the relevant country on third country goods.
- > if the UK negotiates its own separate trade agreements with third countries (eg Australia, the U.S.)?
Basis for determining tariffs: As an example only, existing tariffs set in trade agreements the relevant third country already has in place.
- > What tariffs would apply to goods in your supply chain (upstream or downstream) that depend on imported goods which are subject to UK/EU barriers?
Calculate the applicable tariffs using the assumptions above when conducting this exercise.
- > If tariffs are imposed/increased, do you have agreements to import or export goods which: (a) will result in you being liable for these extra costs; or (b) could be jeopardised by increased costs borne by your counterparty? If so, what are the nature and duration of these contracts? Is renegotiation an option?
- > Can your supply chain be easily adapted to avoid unnecessary back and forth between the EU and UK?
Back and forth may lead to payment of tariffs multiple times post-Brexit. Businesses may, however, rely on EU inward processing relief (relief from customs duties and import VAT on goods imported into the EU for processing before being exported back outside the EU) and outward processing relief (relief from import duty on goods re-imported to the EU after being sent to a third country for processing or repair). The UK may also implement similar processing relief post-Brexit.
- > To what extent does your business rely on processing relief (inward or outward) on imports to/exports from the UK?
Post-Brexit the availability of these forms of relief within the UK is yet to be determined. Businesses who, prior to Brexit, claimed EU processing relief on supply chains involving the UK may no longer be able to do so.
- > To what extent does your business model rely on the provision of products or services from the UK to EU member state governments or from the EU to the UK government?
It is not yet clear how open government procurement markets between the EU and UK will be post-Brexit.
- > What logistical issues and financial costs would delays in your supply chain create?
Delays may be unavoidable as and when new customs processing requirements are implemented between the EU and the UK.
- > Can any aspects of your supply chain into the UK be onshored or conducted in a country the UK is likely to have its own trade agreement with? Would this cost more than the tariffs that will be imposed on imports from the existing supply country?
Calculate the applicable tariffs using the assumptions above when conducting this exercise.
- > To what extent does your business rely on provision of cross-border services involving the UK/ EU?
It is likely that there will be restrictions imposed on market access and changes to regulation, such as licensing, post-Brexit.
- > To what extent does your business need to meet product standards and gain licences? How adaptable would your business be to the need to meet multiple standards?
Even if, on exit day, the UK applies identical standards and licensing processes to those of the EU, there is a risk that the UK standards and processes may diverge from their EU origins in the future for policy reasons. See “Product standards” for further details.
- > Which of your products/suppliers are subject to long-term supply contracts? When will these be reviewed? Can you use break clauses if you wish to purchase elsewhere?

Factor costs and changes into your budget and Brexit plan

- > Assess additional costs identified as a result of mapping your supply chain and answering the questions above.
- > Factor additional costs into your overall Brexit plan. Consider streamlining processes to mitigate these. Could these costs be passed on to consumers or suppliers? What issues would passing on these costs lead to?
- > Plan ahead where entering into longer-term supply contracts.
- > Where costs, issues or required changes are identified that could have a material impact on the business of your company, report back to the board and determine appropriate strategies to manage these.
- > Consider engaging with governments on your trade priorities and/or using media to influence public opinion. Ensure that your industry is coordinated in approach through membership of trade organisations and specific working groups.

Rules of origin

Complex products are made up of many component pieces which may be manufactured and adapted in different countries as the end product is gradually assembled. To take a simple example, the seat of a bicycle begins as raw materials which are then manufactured into a seat, which then forms part of a bicycle along with the frame, wheels and gears which may all be imported from different countries. The bicycle is then packaged and sold. What is the bicycle's country of origin?

“Rules of origin” are the criteria used to define where a product, such as the bicycle in this example, was made. They are an essential part of trade rules as they allow countries to effectively implement discriminatory trade policies, such as quotas and preferential tariffs, against exporting countries. There are also rules of origin for services under free trade agreements for services (also known as economic integration agreements), although they are usually more relaxed and rarely prove as much of an issue for trade as rules of origin for goods.

Rules of origin differ from agreement to agreement. The EU is a party to the Regional Convention on Pan-Euro-Mediterranean preferential rules of origin (PEM Convention) which contains identical rules of origin for contracting parties. It is likely that the EU will want to apply the rules in this convention to the UK on Brexit. Different rules of origin for trade agreements with countries which are not party to the PEM Convention could be agreed.

Generally, rules of origin state that if a product is wholly obtained or produced completely within one country, that is its place of origin. For a product which has been produced in more than one country the product is determined to have its origin in the country where materials or components are sufficiently transformed into a different product.

To determine sufficient transformation, any of three general rules are typically used:

Rule	According to this rule a product has been sufficiently transformed, and so originates:
Change of tariff classification	In the country where the code of the product differs from the code of its components under the Harmonized System (an internationally standardised system of names and numbers to classify traded products).
Percentage value added	Where it increases in value so that it meets a certain level, this being either a maximum allowance of non-originating materials or a minimum requirement for domestic content.
Special processing	When a specific manufacturing or processing operation is carried out (as described in the product-specific list rules).

The EU has a table which sets out which of these rules should be applied to determine the last substantial transformation of a product. Products are classified based on the same code as is used to determine tariff rates. If more than one rule is listed in the table for a particular product, the entity making a customs declaration may choose which rule to apply. The most common rule is the change of tariff classification.

There are also typically minimum processing requirements and rules permitting “tolerance” of minor deviations from rules of origin. In addition, rules on “cumulation” permit input products from certain origins (usually where there is an equivalent free trade agreement with the importing country) to be counted as “originating” in the exporting country.

Product and production process standards

Businesses need to comply with WTO-compliant product and production process standards of any country into which they sell a product or service. If UK standards start to diverge from EU ones as a result of future changes either in EU law which are not followed by the UK or vice versa, any business supplying to both the UK and the EU will have an additional set of standards to follow. The UK also currently benefits from mutual recognition with other EU countries, which would be unlikely to continue post-Brexit absent a free trade agreement with the EU. At a minimum, if mutual recognition is to be continued under a future EU-UK agreement, this would rely on the UK undertaking an obligation to continue accepting EU standards.

A separate issue is conformity assessment procedures, a technical term referring to the means by which products and production processes are tested. Mutual recognition is also a possibility for these. In practice, this would mean that the UK and EU would each recognise the other’s testing procedures and agencies. Testing procedures can apply both to national standards and other standards, which means mutual recognition of conformity assessment procedures is possible without mutual recognition of the underlying product and production process standards being tested. This is, in fact, the most common form of mutual recognition.

An alternative to mutual recognition is harmonisation of standards. There is an international and a European element to this. Under WTO law, the UK and the EU must base their technical regulations on international standards unless they are deemed to be an ineffective or inappropriate way of meeting

a legitimate domestic objective. The UK is currently a member of international standards organisations including the International Organization for Standardization (ISO) and the International Electrotechnical Commission (IEC). The UK government has confirmed that the UK British Standards Institution (BSI) will retain its membership of these bodies, which means that many standards will continue to be identical across the UK and the EU.

The EU follows standards set by the three European Standards Organisations (the European Committee for Standardisation (CEN), the European Committee for Electrotechnical Standardisation (CENELEC) and the European Telecommunications Standards Institute (ETSI)). Although they are not EU bodies, they have special status in the EU. All CEN and CENELEC members must implement their standards as national standards without any modification and withdraw any conflicting national standards. CEN and CENELEC interact with their international counterparts through specific cooperation agreements. Under these agreements, new projects are jointly planned between the European and international bodies and cooperation with international standards is achieved where possible. For example, approximately 80% of CENELEC standards are identical or similar to IEC standards.

The BSI has indicated that its “ambition” is for continued CEN and CENELEC membership, where it would be able to influence the development of new European standards. Without UK membership of the EFTA, however, this would require amendments to the constitutions of the two bodies.

The UK can remain a member of ETSI as its rules of membership are different.

This checklist is part of a suite of documents that also includes “[Brexit: a checklist for General Counsel](#)” and “[A checklist for Brexit-proofing contracts](#)”. A full collection of Brexit materials is available on our dedicated [Brexit microsite](#) on the Client Knowledge Portal.

For more information please get in touch with your usual Linklaters contact or any of the contacts listed [here](#).

May 2017

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