

Procurement Rules of Origin

Discussion Paper

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PROCUREMENT RULES OF ORIGIN

PURPOSE & SUMMARY

The purpose of this paper is to inform the Board of Directors that Management is considering proposing to the governing bodies of the Bank and the Fund the elimination of the rule of origin. Eliminating the rule of origin will significantly improve the competitiveness of the Fund in the global aid architecture.

PROCUREMENT - RULE OF ORIGIN

1. INTRODUCTION

- 1.1 Article 15(4) of the Agreement Establishing the African Development Fund (the “Fund Agreement”) restricts procurement in Fund operations to goods, works and services from member countries of the African Development Bank (the “Bank”), State participants of the African Development Fund (the “Fund”) or non-member States providing resources to the Fund. This requirement, colloquially referred to as the “rule of origin”, has resulted in substantial increases in the transaction and procurement costs in Fund operations, thus reducing the competitiveness of Fund products and their development effectiveness. It has also prevented the Fund from participating in new multi-donor products such as SWAPs and multi-donor trust funds.
- 1.2 In the general context of harmonization and alignment, underpinned by the *Paris Declaration on Aid Effectiveness*, the Bank regional member countries have been increasingly requesting the elimination of the rule of origin. Many of the Fund co-financiers have also been requesting more flexibility from the Fund in order to permit the provision of joint financing and the adoption of harmonized country approaches.
- 1.3 The purpose of this paper is to inform the Board of Directors that Management is considering proposing to the governing authorities of the Fund and the Bank the elimination of the rule of origin. Section 2 of this paper describes the rule of origin and its background. Section 3 lays out the problems that have resulted from the application of the rule of origin. Section 4 describes the various options for amending the rule of origin and management’s recommendation to eliminate the rule.

2. THE RULE OF ORIGIN AND ITS BACKGROUND

Description of the rule

- 2.1 The rule of origin, provided in Article 15(4)(a) of the Fund Agreement, states:

“The Fund shall impose no conditions that the proceeds of its financing shall be spent in the territories of any particular State participant or member, but such proceeds shall be used only for procurement in the territories of State participants or members, of goods produced in and services supplied from, the territories of State participants or members, provided that, in the case of funds received pursuant to Article 8 for a State which is not a participant or member, the territories of that State shall also be eligible sources of procurement from such funds, and may be eligible sources of procurement from such other funds received under that Article as the Board of Directors shall determine” (emphasis added).
- 2.2 The above-stated provision limits procurement with the use of Fund resources to State participants, member states of the Bank and States (that are neither State participants nor members), if such States contribute resources to the Fund under Article 8 of the Fund Agreement. A State that contributes resources under Article 8 enjoys procurement in respect of such resources, or generally from such other funds received under Article 8 as the Board of Directors of the Fund shall determine. The provisions of Article 15(4)(a), in effect, tie procurement to participation in the Fund or membership in the Bank. The rationale for this is that procurement is one of the expected benefits of participation in the Fund.

- 2.3 It is noteworthy that unlike the Bank Agreement, the Fund Agreement does not contain a provision allowing the Board of Directors to permit procurement outside of the Bank or Fund membership on a case by case basis. Accordingly and given the constitutional nature of the rule, no waiver of the rule of origin or exception thereto may be granted or authorised by the Board of Directors.
- 2.4 In a legal note issued in 2005, the General Counsel of the Bank opined that the restrictions/limitations contained in Article 15(4)(a) of the Fund Agreement do apply to Sector Wide Approaches (SWAPs), defined broadly as projects or programmes that cover entire sectors and sectoral projects involving co-mingling of funds among multiple donors. Thus the Fund must require that certain arrangements are put in place to ensure compliance with Article 15(4)(a), such as ring-fencing or segregating the Fund's resources or providing parallel financing to augment the resources of other donors, and insisting on the application of the procurement rules to such ring fenced or parallel financing. The General Counsel on the other hand opined that the rule of origin does not apply to budget support operations because such operations by their nature are participations by the Fund in financing the budget of an eligible RMC and thus such financing does not raise issues of direct procurement.¹

Regime of other MDBs

- 2.5 The provisions of the Fund Agreement are the most restrictive amongst those of the charters of Multilateral Development Banks (MDBs):
- i. The International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA) eliminated membership-based procurement restriction to allow universal procurement in 2004;
 - ii. The European Bank for Reconstruction and Development (EBRD) Charter does not contain any membership-based procurement restriction and the EBRD has no such policy;²
 - iii. The Asian Development Bank (AsDB) Charter contains a provision similar to that of the Bank Agreement: the rule of origin is applicable to procurement in the operations of the AsDB (including the operations of the Asian Development Fund, as a Special Fund of the Asian Development Bank), but its Board of Directors has the power to open procurement to non-members on a case by case basis; in practice, exceptions are regularly authorized by the Board of Directors of the AsDB;
 - iv. The Inter-American Development Bank (IADB) Charter does not contain any membership-based procurement limitations. However, as a matter of policy, the IADB currently requires compliance with a rule of origin similar to that applied by the Fund³, with a few notable exceptions i.e. sector projects co-financed with other donors (such as SWAPs), import of medications in certain projects in the health sector or goods with the label "Made in the European Union".
- 2.6 There is a trend towards universal procurement becoming the best practice in the aid industry, as illustrated by the procurement rules adopted or modified most recently, such as those of the EBRD and IBRD/IDA, as well as by the development partners' commitments towards harmonization and development effectiveness.

¹ *Legal Note on the Applicability of Article 15(4) of the Agreement Establishing the African Development Fund*, dated 22 March 2005, by Adesegun A. Akin-Olugbade, General Counsel, African Development Bank,

² The Explanatory Note to Article 13 of the Agreement establishing the EBRD states that "Delegates agreed upon completely open procurement (and not procurement open only to members), based on international tendering, where appropriate, and believed that such tenders should be genuinely competitive, in line with the GATT Agreement on Government Procurement. [...]".

³ The procurement rules of the IADB were last updated by the Board of Directors in 2005.

3. ADVERSE EFFECTS OF THE RULE OF ORIGIN

- 3.1 Due in part to the considerable changes in the operating environment of the Fund, the rule of origin is having increasingly adverse consequences for the Fund and its recipients both in terms of competitiveness and development effectiveness.

Evolution of the business environment of the Fund towards multi-donor and harmonized approaches

- 3.2 The Bank Group and its development partners have been increasingly using multi-donor approaches (SWAPs, multi donor trust funds) aimed at reducing transaction costs, increasing coordination and enhancing development effectiveness. SWAPs represent approximately 20% of the 2008-2010 ADF pipeline and it is expected that the volume and nature of such multi-donor products and approaches will grow in the future.
- 3.3 The Bank Group has also recognized, along with other development partners that harmonization of procurement rules leads to simplification, which in turn frees up resources.⁴ As a signatory of the *Paris Declaration on Aid Effectiveness*, the Bank Group has committed to harmonize and streamline procedures to increase efficiency and reduce transaction costs for its Regional Member Countries – including harmonization of procurement rules (Indicator 9 of the Paris Declaration).
- 3.4 Furthermore, the *Globalization of the economy* with its consequences on capital movements and corporations' manufacturing and outsourcing policies make it increasingly difficult to attribute an origin to a good, work or service, thus challenging the very essence of the rule of origin.

Impact of the rule of origin on the recipients' costs of procurement and the competitiveness of the Fund products

- 3.5 By limiting the pool of possible suppliers, the rule of origin increases the procurement costs of its recipients, which directly reduces the impact of the Fund operations. The purpose of open competitive procurement system is to achieve economy and efficiency in public procurement. It is well established that systems which limit the origin of the goods, works and services result in increased costs, and thus in reduced aid impact.

Procurement of IT products and the rule of origin

Lead international IT suppliers usually contract with their clients through local or regional resellers. One exception to this practice is for large "volume agreements", i.e. agreements above certain amounts which are repeated each year. In those cases, the pricing offered can be 25-35% less than that for series of individual agreements. Such contracts also allow greater end-user satisfaction, shorter lead times to acquire IT products and global coverage for all the warranties with the supplier.

However, some IT suppliers refuse to enter into volume agreements if compliance with the rule of origin is required as their sophisticated logistics system would not permit the countries of supply to be limited to the member countries of the Bank. As a result, instead of a volume approach, competitive bidding with resellers has to be organized for each procurement activity, which can mean delays of at least 6-9 months and higher prices.

- 3.6 The rule of origin also alters the competitiveness of the Fund by preventing the Fund from participating in SWAPs and other multi-donor instrument unless the funds are ring-fenced and special rules are adopted by the recipient to ensure compliance with the

⁴ DAC Guidelines and Reference Series, Harmonizing Donor Practices for Effective Aid Delivery, Volume 3: strengthening procurement capacities in developing countries, OECD 2005, p.25

rule of origin. Discussions with Fund recipients have shown that there is generally uncertainty and lack of understanding amongst recipients as to the application of the rule of origin to such multi-donor programmes and SWAPs. As a result, the rule of origin isolates the Fund in multi-donor operations (which, as indicated above, currently represent approximately 20% of the 2008-2010 ADF pipeline) and weakens the Bank's voice amongst its development partners.

The Example of the Malawi Support to Health Sector Programme (SWAP)

Discussions about this SWAP began in 2003. The Fund appraised the programme in 2004, along with other donors, and originally decided to contribute UA 20 million out of a total estimated cost of USD 735 million. Other donors include the IDA, DFID, NORAD, OPEC Fund, UNFPA, the Global Fund and Kfw. The original project design contained a request for a waiver of the application of the rule of origin. However, following the General Counsel's legal opinion on the matter, it was considered by the Board of Directors in March 2005 that it was not within its purview to waive the rule of origin.

Accordingly, management decided to re-design the operation, to make it a discrete sub-project in which Fund resources would be ring-fenced so that the Fund rules of procurement, including the rule of origin could be applied. After re-appraisal in 2005, the project was approved by the Board of Directors on 24th November 2005, i.e. more than 8 months after its original submission to the Board of Directors and with a total amount reduced to UA 15 million.

Due to its status as a discrete donor in a multi donor basket operation, the Fund has been isolated from the core group of pooled donors. The Government of Malawi has been focusing more on the pooled resources, as a result of which the disbursement of the Bank resources had not started by April 2007, while resources of some other donors were almost fully disbursed. The discrete status of the Bank has also resulted in extra reporting requirements for the Government of Malawi.

- 3.7 The rule of origin also increases the transaction costs of the Fund recipients by preventing full harmonization with the procedures of other donors or with country systems, if eligible, and by making it necessary to train procurement officers to issues of origin which are specific to the Fund procurement rules.
- 3.8 Finally, for areas requiring a particularly high degree of flexibility, coordination or responsiveness, such as assistance to fragile states which is particularly relevant to the African continent, the rule of origin is a major handicap to the Fund in establishing a policy that meets its objectives of coordinated, fast and flexible engagement.

4. AMENDING THE RULE OF ORIGIN

Possible Scenarios for amending the rule of origin

- 4.1 In light of the above issues, and considering the absence of any flexibility in the Fund Agreement to waive the rule of origin or permit exceptions thereto, four possible scenarios for amending the rule of origin in the Fund Agreement were proposed by the General Counsel of the Bank at the request of the Bank's senior management:
- i. introducing an exception to the rule of origin for joint financing arrangements;
 - ii. permitting universal procurement, unless required otherwise by specific arrangements with donors;
 - iii. permitting universal procurement;
 - iv. Allowing the Board of Directors to permit procurement from non Bank members or non Fund participants on a case by case basis (similar to the provision existing in the Bank Agreement and in the Agreement Establishing the Asian Development Bank).

Management Recommendations

- 4.2 The Bank senior management recommends the option of permitting universal procurement without restriction because it is the most consistent, clear and efficient of the four options, both for the Fund and the recipients of its financing.
- 4.3 By allowing situations where the rule of origin continues to apply, the other options do not eliminate the increased procurement costs to recipients in such situations and maintain a structural impediment to the harmonization of procurement rules amongst donors and the use of country systems in recipient countries.
- 4.4 Furthermore, the co-existence within the Fund of different applicable regimes depending on the nature of the operation or the origin of the funds may result in implementation and interpretation difficulties. It may also provide wrong incentives to recipients to design their projects or programmes in sub-optimal ways to avoid the application of the rule of origin. The co-existence of applicable regimes would also increase transaction costs for the Fund and for recipients due to the necessity to have different sets of procurement documents, and different procurement review procedures.
- 4.5 In the case of Option 1 described above, there is also a risk that new products are developed in the future that do not fall within the scope of the exception (joint financing) but for which the application of the rule of origin would be considered as undesirable, thus necessitating further amendments of the Fund Agreement.
- 4.6 Finally, Option 3 presents the greatest clarity and certainty for Fund recipients and Bank staff, whereas the other options all contain a degree of uncertainty, either because a decision of the Board of Directors is required on a case by case basis, as is the case for Option 4, or because the applicable rule or exception to the rule would require interpretation in certain circumstances, as may be the case for Options 1 and 2.
- 4.7 Given the fact that the rationale for recommending the adoption of universal procurement for Fund operations applies mutatis mutandis to procurement in Bank operations, Bank management considers it is consistent to recommend amending also the Agreement establishing the Bank to allow for universal procurement in Bank operations.
- 4.8 There is a risk that allowing universal procurement reduces the incentive for new participants to join the Fund or for current State Participants to channel resources through the Fund. However management is of the view that the benefits to the Fund's recipients and to the Fund's competitiveness of allowing universal procurement greatly outweigh this risk. Furthermore, considering the commitments of the donor community towards harmonization and alignment, management believes this risk to be rather confined.

Procedure for amending the Fund Agreement

- 4.9 For each of the options described in section 4.1 above, the applicable procedure for amending the Fund Agreement is the one provided in Article 51 of the Fund Agreement. Amendment of the Fund Agreement at the initiative of management requires the approval of such amendment by the Board of Directors of the Fund, which shall then submit the amendment to the Board of Governors of the Fund for approval, at the majority of three-fourth of the total voting power of the participants. If the proposed amendment is approved by the Board of Governors, the Fund shall, by circular letter or telegram, ask the participants whether they accept the proposed amendments. Amendments enter into force for all participants three (3) months after the date of the communication from the Fund informing the participants that three-fourths of the participants having eighty-five per cent of the voting power have approved the proposed amendment, unless the Board of Governors specifies a different period or date.

- 4.10 Given the necessity for at least three-fourths of the participants having eighty-five per cent of the total voting power of the Bank to approve and, for State Participants, ratify the proposed amendment, it is expected that the minimum time period necessary for the amendment of the Fund Agreement to become effective would be twenty-four months. Depending on the pace of ratifications by State Participants, this time period could last several more years.

5. CONCLUSION

- 5.1 This paper has demonstrated the adverse effects of the rule of origin for the Fund and the recipients of its financing.
- 5.2 As a result of such adverse effects, and given the changing environment in which the Fund is operating, Senior Management is considering proposing to the Board of Directors, Board of Governors and State Participants the amendment of the Fund Agreement to permit universal procurement in Fund operations.
- 5.3 Eliminating the rule of origin will significantly improve the competitiveness of the Fund in the global aid architecture. It will allow the Fund to fully participate to the growing number of SWAP operations from which it is practically excluded today. It will reduce the procurement and transaction costs of recipients and thus increase the value of the Fund financial assistance. It will also reduce the transaction costs of the Fund, and greatly facilitate the implementation by the Fund of the harmonization and alignment agenda.