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EIC
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EIC Position Paper

on the

Review of the OECD Local Costs rule in relation to Construction Services

About EIC

European International Contractors (EIC) has as its members construction industry trade associations from fifteen European countries and represents the interests of the European construction industry in all questions related to its international construction activities. In 2014, our member companies recorded an international construction turnover of around €165 billion of which more than €50 billion were generated outside the OECD region, i.e. the regions in which the Export Credit Agencies (ECAs) are particularly active in support of national exporters.

The OECD Local Costs rule and Construction Services

Since the inception of the OECD Arrangement on Officially Supported Export Credits in 1978, the purpose of the so-called “OECD Consensus” is to foster a level playing field regarding national rules and policies on government-backed financing for exports in order to encourage competition amongst exporters based on the quality and the price of their goods and services exported rather than who can provide the most favourable financial terms and conditions. The OECD Consensus sets out the most favourable financial terms and conditions that can be provided for official export credits, whether through direct financing, insurance, guarantees or interest rate support measures.

Over the past forty years, the limitation on support for local costs has only been changed once in 2008 when Participants agreed to increase the threshold to 30% of the export contract value. **EIC submits that the restrictive OECD approach towards local costs is no longer appropriate in the case of construction services** because, in the 21st century, it is imperative for building and infrastructure works to source locally to a maximum extent given that the final output must be constructed in the host country.

Recognising that building or infrastructure “products” such as roads, railways, ports, dams, hospitals, etc. are not exportable as such, the respective amount of local costs involved is evidently higher than in the case of export of goods or other services. Hence, the existing local costs restrictions in the OECD Consensus have a negative effect on the competitiveness of construction exporters from OECD countries. Furthermore, the OECD’s restrictive approach reduces potential welfare gains that trade in construction services offers to societies and thwarts the development policy of the OECD Development Assistance Committee’s (OECD-DAC) to strengthen the local construction sector in developing countries.

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The Rationale for Change in the case of Construction Services

The rationale for a change of the restrictive Local Costs rule in relation to the export of construction services is manifest in view of the following horizontal and sector-specific aspects:

- **Local nature of construction services:** The nature of the construction business requires – with very few exceptions e.g. off-shore oil platforms and some types of thermal plants – local production. It is the management capacity and the production process that is exported, the final output must be totally constructed in the host country. Therefore, an establishment and activities abroad in some form is generally necessary for construction exporters to perform the export contract. Nowadays, construction exporters from the OECD region need to be in a position to avail themselves of local construction companies, either as joint venture partners or as subcontractors, as well as the local labour force and local construction equipment in order to stay competitive.
- **Local procurement requirements:** It does not only make economic sense to have substantial local costs in construction projects, there is also a growing pressure to pose strict local content and local procurement requirements. Contracting Authorities in buyer countries are increasingly requiring significant elements of localised construction in their tenders, for instance in India and Kenya amounting to 40% of the total contract value, i.e. about 60% of the export contract value.
- **Characteristics of construction services:** For building and civil works, the optimal balance between national, foreign and local costs differs substantially from other export sectors, for instance capital goods and it makes economic sense to source locally to a maximum extent instead of artificially sourcing inputs (like stones, concrete, sand etc.) in third/neighbouring countries due to OECD restrictions on local costs.
- **Recipients' country perspective:** More flexibility on local costs in building and infrastructure projects would give more room for the realisation of construction services at optimal costs and would make ECA financing a more accessible and competitive funding instrument for recipient countries.
- **Lack of commercial long-term lending in local currency:** Local financing has become increasingly available in emerging markets. However, it is usually focused on the short-term while infrastructure projects need long-term financing for commercial viability. ECA support is necessary because of the size and long-term orientation of the projects as well as political risks.
- **Increased competition from outside the OECD:** Bearing in mind that construction is a relatively labour-intensive sector, competitors from non-OECD countries nowadays have significant cost advantages. These are further increased by official export credit support that is not bound by the OECD Consensus. The possibility of a higher share of OECD-ECA's support of local costs could establish a level playing field with construction exporters from non-OECD countries, thus fostering the competitiveness of the OECD construction industry and resulting in higher output and employment.
- **A bridge between export & development finance:** A more flexible approach of local costs would help building bridges between export & development finance. The OECD-DAC attaches great importance to realising and financing cost-effective infrastructure in developing countries, which is seen as essential for economic development, and a key requirement for poverty reduction. Moreover, the importance of infrastructure is recognised by the development world, which became most evident with the inclusion in the SDG´s of a specific goal, promoting to build resilient infrastructure.

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Discrepancy between Local Costs and Foreign Content rules

As a general rule of thumb it can be concluded that, depending on the technical complexity of the building or civil works project, the export value in construction, consisting of engineering and management services, key personnel and equipment plus overheads, varies between 25 - 50% of the total project costs, whereas corresponding local costs, such as local labour and purchase of local goods, for instance, stones, sand, concrete, etc., amount up to 75%. In case that the construction works form part of a more complex so-called EPC project (Engineering, Procurement, Construction) the share of the building and/or civil works amount to around 50%. This means that, under the OECD's current Local Costs regime, a portion of up to 67.5% of the total contract value of the construction works cannot be covered by official export credit support. This result constitutes **a grave discrepancy when compared with national rules and practices of OECD Participants concerning foreign content** where in some OECD countries a portion of up to 100% can benefit from official export credit support.

Proposed new OECD Local Costs rule for Construction Services

The OECD Consensus stipulates currently in Article 10 lit. d No. 1) that the Participants may provide official support for local costs, provided that *"Official support provided for local costs shall not exceed 30% of the export contract value"*. Local costs are defined in Annex XV under lit. j) as *"expenditures for goods and services in the buyer's country that are necessary either for executing the exporter's contract or for completing the project of which the exporter's contract forms a part…"*. The export contract value is defined under lit. e) as *"the total amount to be paid by or on behalf of the purchaser for goods and/or services exported, i.e. excluding local costs as defined hereafter…"*.

EIC holdes that the **systematics of the OECD Local Costs rule adheres primarily to the sphere of capital goods** for which the "export contract value" can be easily defined and where the local cost component is an ancillary element of the export contract, representing a minor factor of the total contract price. **In case of construction export services, however, the distribution between export contract value und local costs is reverse to the extent that the local cost component is the most significant part of the total contract value.**

Against that background, it could well be argued that:

- Construction Services should be exempt from the OECD Consensus altogether; or
- The Local Costs definition should apply strictly to ancillary goods or services; or
- The different treatment of foreign content and Local Costs is outdated and should be replaced by a consistent regime on third-country content to be regulated and adminstrated by each individual OECD member.

Since such a fundamental modification of the OECD Consensus will most likely not be feasible or would require many years of negotiations, **EIC proposes the following two amendments**:

a) To change the percentage in 10 lit. d no.1) to "… Official support provided for local costs shall not exceed ~~30%~~ of the export contract value" – from 30% to **50%**; and

b) To establish a **Sector Understanding on "Construction Services"** (as defined under the UN Statistics Central Product Calssification (2015) Section 5) with an **overall contract value of more than SDR 10 million**.

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Concluding Remarks

At the origin of the „Arrangement on Officially Supported Export Credits“ was the desire on the part of some OECD governments in the early 1970s to have a “gentlemen’s agreement” to bring order to official export financing. In April 1978, the so-called “Consensus” was agreed under the auspices of the OECD. There are at present nine Participants (Australia, Canada, the European Union, Japan, Korea, New Zealand, Norway, Switzerland and the United States) and two regular observers (Turkey and Israel). In addition, Brazil is a Participant to the Aircraft Sector Understanding (ASU) since 2007.

The rules of the OECD Consensus are constantly evolving, adapting to changing needs of the users and the market. Over the last decade alone, the **Participants have negotiated regular updates and upgrades to the Arrangement**, including two successive aircraft sector understandings (2007 and 2011), a revised sector understanding (SU) for nuclear power plants (2009), a new SU for renewable energies and water projects (2009), which was then extended to include both climate change mitigation (2012) and climate change adaptation projects (2014), a new SU on rail infrastructure projects (2014) and a new SU on Coal-Fired Electricity Generation Projects (2015). In addition, the Participants have integrated rules for project finance transactions into the Arrangement, modified the provisions for supporting local costs and introduced a common framework for risk-based pricing of buyer and country credit risk.

In its latest Report to the U.S. Congress on global export credit competition for the period 1st January through 31st December 2014, the Export-Import Bank of the United States has made the following observation (page 7 and 8): *“Under the Arrangement, ECAs are held to uniform lending and transparency rules designed to prevent a global financing race to the bottom. These rules have long helped to ensure that global competition is influenced primarily by free market factors such as quality and price of goods and services. The Arrangement covers “traditional export credit support,” meaning export credit activity that is directly tied to exports. This activity includes direct loans, guarantees, and insurance products. Beginning at the turn of the century, China and other countries’ ECAs began to institute trade-related overseas financing programs operating outside of the OECD Arrangement… With the introduction of these programs, the share of trade-related official support governed by the Arrangement began to fall rapidly.* ***Where 100% of trade-related official support fell under the aegis of the Arrangement in 1999, today that share has been reduced to only 34%****”* [EIC emphasis].

This analysis shows that, in order to stay relevant, the OECD Consensus must be reviewed and updated to maintain a level playing field between the leading export nations. The **“Business and Industry Advisory Committee to the OECD” (BIAC)** has called during the November 2015 Consultation Meeting with Civil Society Organisations and the OECD Export Credits Committees for a noticeable increase of the Local Costs rule. BIAC believes as well that restricting official support for Local Costs to 30% of the export contract value is no longer appropriate and does not reflect the needs of OECD industries, especially since for certain renewable energy projects, official support provided for local costs allows 45% of the export contract value and for ships and civil aircraft the Arrangement does not include any restrictions on support for Local Costs.

Berlin, 24 May 2016