PLASTICS AND CHEMICALS INDUSTRIES ASSOCIATION INC

SUBMISSION TO THE PRODUCTIVITY COMMISSION RESEARCH STUDY INTO THE OPERATION OF RULES OF ORIGIN UNDER THE AUSTRALIA AND NEW ZEALAND CLOSER ECONOMIC RELATIONS AGREEMENT

17 OCTOBER 2003

EXECUTIVE SUMMARY

The Australian plastics and chemicals industries form a significant part of the Australian economy and the manufacturing sector and are at a significant stage of their development. Through its Action Agenda with the Federal Government the industry has identified a strategy of doubling its levels of exports while maintaining imports at their current levels, along with reforms to the regulatory environment faced by the industries.

The Australia-New Zealand Closer Economic Relations Trade Agreement has had a mixed impact on the Australian and New Zealand plastics and chemicals industry, providing it with a larger market place, while also making the New Zealand and Australian industries competitors with one another in domestic and international markets. As such the operation of the rules of origin along with many other aspects of the agreement are critical to the industry as are the issues being discussed under the numerous other bi-lateral agreements currently being negotiated by Australia and other countries.

While it has increased trade significantly it would seem that industry in both Australia and New Zealand believe that the rules are not being implemented in a fair fashion and changes must be made. While some changes have been made the rules governing origin in this agreement are now 20 years old and seemingly out of touch with the new global trade dynamic.

PACIA offers the following comments on the rules of origin under the CER, which are expanded on in the remainder of the submission:

- The emergence of Asia poses a significant threat to the Australian and New Zealand plastics and chemicals sectors and for the CER
- The current last process of manufacture 50% threshold is susceptible to manipulation and misrepresentation of costs therefore undermining the operation of the CER Trade Agreement
    - The rules fail to prevent trans-shipment via the CER trade area
    - Exchange rate fluctuations can have significant effects on the level of local content for many products
- The Commission must assess the ability for the CER to provide an advantage to New Zealand producers of final goods through the sourcing of cheaper intermediate goods
- Differences in the treatment of traded products between Australia and New Zealand need to be addressed to ensure they are implemented identically
- Given the problems with the ex-factory cost method PACIA recommends that the substantial transformation approach to rules of origin be pursued under the CER agreement. This would be consistent with the likely treatment of rules of origin under the current bi-lateral agreements being negotiated with Thailand and the United States and in line with the 1994 GATT agreement

1. INTRODUCTION

The Plastics and Chemicals Industries Association Inc (PACIA) is the national association for the Australian plastic and chemical sectors, which have a combined annual turnover of $23 billion and employ over 73,000 Australians. It is the fourth largest manufacturing sector in Australia, accounting for just under 10% of total manufacturing output and has one of the highest value adds of any manufacturing sector. The sectors face intense competition in both domestic and international markets with an annual export value of $3.4 billion compared with an annual import value of more than $9 billion. Through its Action Agenda, the industry has set itself growth targets to be achieved through import replacement and a doubling of exports by 2010.

PACIA represents 300 members across all sectors of the plastics and chemicals supply chain, including manufacturers, processors importers, distributors and transport and storage companies. These companies range in size from large multinationals such as BASF, Nufarm, Wesfarmers and Dow Chemical to small and medium sized companies, many of which are family-owned. Plastic and chemical companies are critical to the functioning of any economy as they provide the building blocks for nearly all other sectors of the economy, including agriculture, packaging, automotive, building and construction and information technology industries.

2. TRADE BETWEEN AUSTRALIA AND NEW ZEALAND IN PLASTICS AND CHEMICALS

New Zealand represents a significant trading partner for Australian plastics and chemicals products. In 2001 total trade between the countries was A$1,152 million. Of this Australia exported A$713 million of chemical and plastic products to New Zealand and imported A$440 million from New Zealand. New Zealand accounts for 17% of Australia's exports of plastic and chemical products and 6% of Australia's imports.

Over the last decade Asia has emerged as a significant import source for plastics and chemicals. In 2001 imports from the ASEAN group of nations to Australia accounted for 6% of imports while Chinese imports at A$880 million accounted for 5.5% of imports, with strong growth from these sources.

Apart from the trading relationship between New Zealand and Australia the CER agreement has seen the industries in each country become competitors in both domestic and international markets. This relationship enhances the importance of rules of origin in the CER agreement to ensure that competition remains fair for all companies in the free trade area.

3. INTERNATIONAL IMPACTS

The plastics and chemicals sector is a truly global industry. World production of chemical and plastic products is estimated at US$1.7 trillion with over a third of this traded. Australia accounts for less than 2% of this production and as such is heavily impacted by changes in the international environment.

The last decade has seen a movement of plastic and chemical production facilities from developed countries to developing countries as capacity and technological development

continue to grow in these countries. The majority of plants established in these developing countries are aimed at producing bulk commodity products such as polyethylene, polypropylene and polyvinyl chloride. In addition, many of these countries have established a large industry around the manufacture of plastic goods using a variety of processing means including injection moulding, blow moulding and film production.

The plastics and chemicals industry in developing countries receives significant assistance from their Governments in the form of tariffs, infrastructure development, start-up assistance and taxation holidays. As such it tends to be these producers who establish the global price for these bulk commodity products.

In contrast, Australia has moved from a position of high tariffs to currently having some of the lowest tariffs on chemical and plastic products in the world. This has caused significant rationalisation in the Australian industry and moved the focus away from bulk commodity products to specialised products such as engineering polymers, masterbatches and compounds.

The emergence of Asia poses the greatest concern for the Australian industry. The rapid development of the industry in the ASEAN countries and China is showing through their increased share of global trade in chemicals and plastics products. To continue delivering benefits to both Australia and New Zealand in the face of this new source of growth, the CER requires a robust set of rules of origin to ensure it is not open to abuse from non-CER countries.

There are several key factors that will directly impact the Australian industry including the Free Trade Agreements being negotiated with Thailand and the United States, World Trade Orgnisation negotiations under the Doha Round, the development of other trading blocs and the harmonisation of rules of origin at the multi-lateral level.

In the course of discussions for the Thailand and United States Free Trade Agreements the industry has reviewed the various forms of rules of origin proposed by Australian, Thai and United States negotiators including:

- The final process of manufacture 50% rule under ANZCERTA (and slightly modified for the Australia-Singapore Free Trade Agreement)
- A Free On Board (FOB) approach akin to the ASEAN Free Trade Area (AFTA) 40% FOB rule
- An FOB approach with a threshold value of 55%
- The change in tariff classification (CTC) approach supplemented by a regional content value for selected products (as applied in Annex 3A of the United States-Singapore Free Trade Agreement)

As the submission will detail, PACIA and its members have assessed that a process of rules of origin based on substantial transformation provides the best mechanism for determining origin under a free trade agreement. Of equal importance however, for the industry is the monitoring, policing and enforcement of these rules of origin in the CER agreement.

PACIA and its members have noted on numerous occasions that a multi-lateral agreement represents the best opportunity for the industry to achieve significant gains

through trade. The collapse of the Doha round in Cancun was disappointing for the industry given the likely increased focus now by nations on bi-lateral trade agreements. This approach tends to result in trading blocs but more importantly can end up with companies in any one country having to understand rules and processes under a multitude of different free trade agreements.

Finally, a consideration for the Commission is the progress of talks on harmonising the treatment of rules of origin at the multi-lateral level as outlined in the 1994 GATT agreement. While any decision made is not binding (based on PACIA's understanding) on existing bi-lateral and regional agreements it would be sensible for the Commission to assess the potential path for these rules and ensure that countries entering into bi-lateral agreements ensure that they are prepared to adopt these changes.

4. CURRENT OPERATION OF RULES OF ORIGIN

Under the current CER agreement there are three categories for goods to qualify for preferential entry as follows:

1. Goods wholly the produce of the country (unmanufactured raw products);
2. Goods wholly manufactured in the country from one or more of the following:
    a. Unmanufactured raw products (of any country)
    b. Materials wholly manufactured in Australia or New Zealand or both;
    c. Materials determined to be raw materials of the country; and
3. Goods partly manufactured in the country.

Under category 3, two additional criteria need to be met:

i. The last process of manufacture must be performed by the manufacturer in either Australia or New Zealand; and
ii. Not less than 50% of the factory cost must represent qualifying expenditure ('50% rule').

The majority of chemicals and plastics products enter under the 2c or 3 categories. As noted above, many companies in the chemicals and plastics industries have expressed significant concerns at the operation of these rules including:

- Manipulation and misrepresentation of costs to achieve the threshold
- Lack of symmetry in the legislation's application between Australia and New Zealand
- The ability for Australian non-preferential tariffs to be avoided through the operation of the CER agreement
    - This includes issues surrounding the use of dumped product
- The application of Determined Manufactured Raw Materials (DMRM's)

The '50% rule'

The '50% rule' is the critical piece of the rules of origin framework and is built around the 'the factory' – defined as the place where the last process in the manufacture of the goods was performed – with a range of rules setting out eligible and ineligible costs that can be counted towards this 50%. Historical experience would suggest that monitoring of this value is largely autonomous and susceptible to manipulation and changes by overvaluing the domestic component of the goods or sourcing cheaper imports.

This issue is more prevalent for those companies engaged in the compounding, masterbatching and plastics processing sectors, but also impacts those companies producing chemicals and resins. The production of chemicals and polymers very often occurs in a integrated production structure where it becomes difficult to exactly determine where costs are attributed.

Trans-shipment of goods

One of the biggest issues for PACIA members and their downstream consumers is that of trans-shipment. This occurs when a producer imports a product largely assembled in a third country and makes minor adjustments to it ahead of claiming 50% factory cost. In most cases companies must manipulate the allowable aspects of expenditure to meet the domestic content rule. As a result the product avoids the Australian or New Zealand non-preferential tariff and enters duty free through New Zealand or Australia into the other market.

The ability for companies to manipulate the criteria of the '50% rule' stems from the numerous definitional problems and lack of strict adherence to the rules. In addition, the very nature and complexity of chemicals and plastics processes makes it easier to manipulate costs.

An indirect manipulation of the 50% rule arises from exchange rate movements, particularly for plastics products. In most cases imported raw materials are purchased in $US while goods are sold and costed in either $A or $NZ under the CER. Historically many companies have found that their product, which met origin requirements in the previous month, for instance, now doesn't because of a change in the exchange rate impacting the cost of imported raw materials. Equally, the reverse can occur where a product that was once not meeting origin requirements can become eligible due to a fluctuation in the exchange rate.

Intermediate goods and dumping of products

Aside from cost manipulation and trans-shipment issues a further problem arises through differences in the tariff levels and duty drawback procedures applied in Australia and New Zealand. This relates to intermediate goods and their use in the production process and impact on the final prices of goods.

Consider the following example of imports of Linear Alkyl Benzene (LAB) a pre-cursor for several chemical and plastic products. Under Australian legislation, imports of LAB incur a 3% tariff duty by virtue of the 3% cost impost on imported business inputs, while under New Zealand's legislation it enters duty free. This in addition to any duty drawbacks on exported final products.

Assuming that each country imports 1,200tpa of LAB to produce a final product sold into the domestic market. The Australian manufacturer faces an additional $55,000 - $65,000 in costs (depending on exchange rates) compared with the New Zealand manufacturer. Under the rules of origin calculation both companies could meet the threshold level through the inclusion of labour, other materials and overheads. As a result the New Zealand manufacturer is able to sell the product into the Australian market at a lower price as it does not have to recoup these additional costs.

This problem is further compounded by the use of dumped raw materials into the New Zealand market. Under the agreement, Australia and New Zealand removed their right to take dumping action against one another but did make provision for third country anti-dumping actions to be undertaken. While this is applicable for use when a dumped product is sold into the New Zealand market against the same Australian product it is a complex system in which to take dumping action.

New Zealand has fewer chemical producers than Australia and much of its imports are due to the absence of a domestic producer. As such it is not possible for New Zealand to take a dumping action against the foreign company because there is no damage to the domestic industry producing the product. Therefore New Zealand manufacturers of final products or near final inputs can source materials at lower prices than Australian manufacturers can, compounding the problem illustrated above.

PACIA's plastics members, particularly compounders and processors, have indicated that this is a significant issue for them. Along with some Australian resin producers they have expressed concern that their customers have to compete with cheap final products due to this intermediate goods issue. It should be noted that this impact only affects domestic producers in Australia as generally the duty drawback system can be used when exporting goods from Australia to New Zealand to claim back any duties paid on raw materials imported to Australia from a non-preferential country.

PACIA believes that the Commission must consider this aspect of the CER in its assessment of the principles behind the CER. According to the Treaty Agreement the purpose of the CER is to eliminate barriers to trade between Australia and New Zealand and to develop trade between New Zealand and Australia under conditions of fair competition. As such consideration must be made to having both Australian and New Zealand Tariff schedules equalised to ensure that this activity around intermediate goods is stopped.

Application of the rules of origin

Another concern for PACIA members is the recent application of rules of origin definitions by the Australian and New Zealand Customs Services relating to the treatment of imported materials provided to manufacturers at no cost by importers of the final preferential goods. This may occur in cases where the raw materials and design and testing arrangements are undertaken by the importer and provided to a toll manufacturer or through a multinational company.

In applying the rules of origin to New Zealand exports, Australia counts only the expenditure of the last process of manufacture. That is, it excludes the costs of any imported materials from the total expenditure figure. As a result the producer only counts his value added which generally passes the '50% rule' as it equates for a majority of the factory cost.

However, in its application of the rules to Australian exports New Zealand determines a value for these imported materials to be included in the total factory cost figure. However, these imported materials cannot be included in the qualifying expenditure figure. As a result a higher level of value is required to be added by the manufacturer in the last process than their equivalent manufacturer in New Zealand to meet the 50%

threshold, placing Australian exporters at a disadvantage relative to New Zealand exporters.

PACIA would ask that the Commission recommend that both Australia and New Zealand work to amend their legislation to ensure that their application remains identical as originally envisaged in the principles of the CER. This consistency in approach should be a cornerstone principle of the agreement regardless of the type of rule of origin method used.

In each of the cases noted in this section PACIA and its members believe that an approach based on substantial transformation measured by a change in tariff classification would resolve the issues identified above. The reasons for this are outlined in the next section.

5. PROPOSED CHANGES TO RULES OF ORIGIN OPERATION

Substantial Transformation

Given the discussion above, PACIA believes that several changes can and should be made to the operation of the rules of origin in the CER. These changes should take account of the current problems and issues surrounding the CER along with consideration of the outcomes of the Australia-Thailand and Australia-United States Free Trade Agreements.

The issue of transhipment and manipulation of the rules of origin is the most immediate problem facing the Australian plastics and chemicals industries. In the course of considering rules of origin PACIA has favoured a system that uses a measure of substantial transformation to determine origin. In particular its preference is for a change in tariff classification (CTC) method supplemented with a local content test for selected products.

The majority of plastics and chemical processes are extremely complex and often occur in integrated plants where it becomes difficult to attribute costs. Under substantial transformation the measure becomes a change in tariff classification, which can be demonstrated relatively easily with products being transferred at market prices. This removes the need to calculate costs to meet a particular threshold value and therefore removes the potential for both deliberate and accidental errors in calculation of local content. It also removes the problem of exchange rate fluctuations on the local content portion of the factory cost.

Recognising that there are some products where only a small proportion of materials may be needed to produce a change PACIA supports the additional requirement of ensuring a portion of these products meets a local content threshold. The preferred approach for the industry is outlined in Annex 3A of the United States-Singapore Free Trade Agreement.

In addition to being a CTC approach, the ROOs in the United States-Singapore Free Trade Agreement includes an additional overriding rule which states - for Chapters 28 to 40 of the harmonised tariff code (chapters covering plastics and chemicals products) any good that is the result of a chemical reaction is declared to be a good of origin. This is also supported by PACIA and should be considered by the Commission.

PACIA recommends that the Commission investigate the potential for a movement to a substantial transformation method under the CER agreement. In doing so it should be mindful that this is likely to be the approach taken in the Australia-Thailand and Australia-United States Free Trade Agreements being negotiated and may also be reflected in the outcomes of WTO and WCO negotiations.

Interim measures

Recognising that changing the rules of origin under the existing CER agreement cannot be done overnight, PACIA would make the following comments on possible interim measures:

- PACIA and its members would not support the reduction of the current 50% rule ahead of any change in the rules of origin
- In dealing with the issue of exchange rate fluctuations and their impact, the Commission should consider the appropriateness of section 153K of the Customs Act 1901 to accommodate such changes. Section 153K allows the 50% threshold to drop to 48% where Customs is satisfied that there exists a temporary distortion that lowers the local content value.
- Changes need to be made to ensure that the rules under the CER are applied in the same fashion by Australian and New Zealand custom services for the interim period
- Authorities in both New Zealand and Australia need to ensure that adequate resources are in place to monitor, police and enforce the rules of origin under the CER
- Both countries must work closely with all industry sectors to develop an appropriate set of substantial transformation rules of origin for the Australia-New Zealand CER
    - This includes establishing a clear timetable for change including key targets to be achieved.

These measures and points need to be considered by the Commission in developing their research on this issue.

Plastics and Chemicals Industries Association
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