PRODUCTIVITY COMMISSION ENQUIRY – CER RULES OF ORIGIN

SUBMISSION from Cambridge Clothing Co Ltd

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Introduction

Cambridge Clothing first traded within CER in 1991, and the volume of this business has increased more or less steadily since and now accounts for about 65% of total sales. One of our competitive strengths is our ability to deliver small numbers of a broad range of items to individual retail customers on demand. We now have over 150 customers in Australia and we export around 420 garments. At least half of these are ordered by customers from our stock programmes and delivered to their door within two days of receiving the order. Because of the necessity for scale, we develop and offer products that will sell in both New Zealand and Australia, and amalgamate the orders for manufacturing. In all cases Cambridge Clothing is the importer of the goods into Australia and the transactions are on an $A FIS basis.

In 1993, following a complaint laid by competitors, the Australian Customs Service enquired into the position of intermediate goods. In particular they were interested in worsted and woolen fabrics which entered New Zealand without duty, were used in making suits and other items which we then exported to Australia. We presented detailed submissions to this enquiry. The ACS then changed tack and examined our claim for preference under CER for these goods. Our claim was accepted.

Since the first enquiry we have been the subject of two others. On the most recent occasion, when the value of the Australasian currencies was at or near its lowest point against the $US in particular, the ACS found we had in some cases incorrectly claimed preference. We were required to pay duty on these and did so. We also redesigned our accounting system in consultation with the ACS so that it would produce live data that would allow us to measure accurately the proportion of CER cost content in each individual product as it was invoiced. This also makes it quicker and easier to provide evidence of compliance for any future enquiry.

As a result of these we know a lot about the rules of origin and their effects on our business. We’re not experts on the wider significance of CER to the broader relationship between Australia and New Zealand though.

Issues for consideration

A. Effects on our business of the rules of origin arrangements which underpin CER

1. Our products are much more commercially attractive if they qualify for preference. We find generally that those that don't qualify are either relatively unprofitable or don't sell in economic quantities. Since the vast majority of our products are made from woven fine wool fibre, and in our view there are no internationally competitive suppliers of this in Australia or New Zealand, this component is always a non-qualifying cost. We therefore include a maximum estimated NZ$ FIS purchase cost among the selection criteria for sourcing fabric for the two markets.
2. The effects of this restriction depend on prevailing exchange rates. But as a guide it is notable that the only fabric that is made exclusively from Australian (or NZ) merino wool (by Loro Piana in Italy) falls well outside the limit and so it's ironic that the only suits in the market made from this fabric are made elsewhere.
3. About a third of our sales are indented i.e. the customer orders them for future delivery. We then buy the fabric and make the garments. This cycle, an international norm in the trade, is about 9 months from customer order to garment delivery. The prices for the products are set and the contract of sale made before the fabric is landed and the actual cost known. Exchange rate movements affect this cost unless every individual transaction is covered.
4. Most of the rest of our sales to retailers are what we call stock service. We offer a selection of products at fixed prices for immediate delivery. We may buy fabrics as often as monthly to keep these programmes running. The cost of each new shipment will vary, again mainly with the exchange rates. And fabric is not the only cost subject to change of course. But this flow of product is more or less continuous.
5. Despite setting purchase price criteria to make sure each product qualifies for preference, the intervening uncertainties make it necessary to have a more or less live system to check whether it does. This check identifies any items that don't qualify. We have developed a process that allows us to add or substitute alternative components that bring the item above the qualification bar. This outcome is better than paying the duty because it reduces the loss of margin, and in some cases adds at least some customer value.
6. In principle the rules of origin appear to us consistent with the objectives of the CER. In practice we have experienced some inconsistencies and conflict, but these have generally been at the margins. We strongly support any initiatives to reduce the effects and frequency of these troubles, but we're not naïve enough to think they can be removed altogether.

B. Extent to which CER rules of origin increase trans-Tasman trade at the expense of trade with other countries

1. There is no evidence of this to our knowledge. To the contrary in fact – recently we showed a collection at Sydney Fashion Week, which was bought by a specialty store in California. This would not have happened without the CER and the encouragement it gives us to distribute throughout Australasia.
2. Without the CER Australia would still be by far New Zealand's largest offshore market. It's close, it's big, the language is common (almost!), and consumer tastes are similar. But the nature of the traded goods would have a different character, be at a far lower level, and as a company we would probably be less outward looking.

C. Effect on the location of investment

1. We have invested in showrooms twice in Melbourne (we grew out of our first premises 2 years ago) and once in Brisbane. We have opened one store in Melbourne and we're in the process of opening another, and we have funded the development of a designer boutique, also in Melbourne.
2. These are a by-product of the CER, and while most of this investment depends on having rules of origin something like they are now, they do not depend on them being exactly so.

D. Problems with the design and/or administration of the current rules of origin

1. **Dynamic nature of the costs**

- In particular the exchange rates of the currencies involved mean that an item that qualified in one year, made in the same materials with the same home prices may qualify at one time and not qualify at another.
- As mentioned above we redesigned our accounting systems to produce live data that would allow us to measure accurately the proportion of CER cost content in each individual product. Each day we run a report listing items about to be manufactured for export to Australia. The report itemises cost by qualifying and non-qualifying elements as defined by the ACS and identifies any items that do not qualify and the amount by which they fall short. It uses the actual landed cost of the relevant shipment of the raw materials and the current qualifying manufacturing costs. For each item on the report that fails to qualify we select from among the available options one or more elements of extra qualifying content to bring it up to the bar, before issuing the making order. If it fails to get over the bar we do nothing and assume that we will pay duty on that item.
- As a final check we run another daily report of all items being despatched for export that day to identify any that fail to qualify. These are declared on the export invoice as "NZ origin, non-qualifying", and we pay the duty.
- The one-off cost of designing and implementing the system was approximately $30,000. The annual cost of monitoring the reports and taking appropriate action varies between $5,000 and $12,000 depending on the number of items needing treatment.
- The direct cost of the extra content added to meet qualification in the June 2002 year was $289,000 (2.2% of sales), dropping to $132,000 (0.9%) in 2003.

2. **Timing difference between setting prices and knowing raw materials landed costs**

- As mentioned above we set prices before we know precisely what all the costs are. During the three years to 2001 when the Australasian currencies were continuously weakening, there were many occasions when our estimate of raw materials landed costs turned out to be too low, and items we had assumed would qualify when pricing, turned out to be dutiable. This was very costly, and since our estimating was not sufficiently accurate, we re-designed our costing system to have it show for each individual item the precise proportions of qualifying and non-qualifying cost.
- While the A$ (and NZ$) remained weak we found we could not source all our fabrics below the cost limits. In the year to June 2002 we paid NZ$77,677 (0.6% of sales) duty on NZ origin non-qualifying products. This dropped to $3,998 in 2003 with the strengthening of the local currencies.

3. **Calculation of raw material cost**

- These are counted at their purchase price to the manufacturer/importer, and therefore include the supplier's margin. In cases such as ours where the vast majority of the raw materials must be imported because there are no local alternatives, the non-qualifying content contains a lot of margin. On the other side the major portion of local content is wages and overhead and therefore contains very little margin. We think this is inequitable.
- Attachment A is an example from our last ACS investigation that helps to illustrate this point. It summarises ACS cost analysis of a particular product. "Total costs of materials/components" (Items A and E) include manufacturer/supplier margins and in the example add up to $92.67 with 92% imported. Labour cost and factory overheads contain no margin. The "Specified percentage" in this example is 56.46% (proportion of local content). Attachment B is the same example with a nominal 30% deduction from the materials/components costs. This deduction is the imputed margin in these items and leaves an imputed factory cost. In the example this raises the proportion of local content to 64.49%.
- Imported raw materials bought from a local supplier (e.g. wholesaler) who doesn't transform the material in any way, include that supplier's margin. As a "Just In Time" manufacturer we outsourced the supply chain management and warehousing of standard materials (linings, pocketing, shoulder pads, threads for example). To reduce our non-qualifying cost we now buy direct from overseas source and manage the supply chain and warehouse the bulk goods ourselves. This is less efficient overall in our view, and has probably weakened the industry infrastructure as well.

4. **ACS interpretations**

- The measure of qualifying manufacturing cost allowed by the ACS excludes some elements we consider must be included to account properly for the costs of running the business. Examples of these include overseas travel by manufacturing people (necessary for the research and development to keep up with international best practice), telephones and stationery.
- Periodically we re-calculate the rates for both direct labour costs and overheads on the ACS approved basis and submit these to the ACS for their approval. This takes two and a half weeks at a cost of around $5,000 and needs to be done every year or so.

E. Changes that might be made to ensure the rules of origin better promote the goals of the CER

1. Substantial Transformation - Change of Tariff Heading or Classification

- Either of these arrangements has the advantage of certainty. In pure form there are no dynamic variables (such as exchange rates) that make nonsense of the *ad valorem* rules at the margin.
- In both cases all the troubles we have experienced would be eliminated
- The cost of monitoring compliance for all parties (including the ACS) would be much lower.
- The NAFTA agreement is based on these rules, and we understand the US is likely to use this template for future FTA's including the one with Australia.
- In practice we understand quite specific conditions and exceptions are usually negotiated into these rules, usually with the intention of protecting particular industries or sectors.
- This would be a fundamental change to the CER arrangements and might take a long time to put in place.

2. **Lower the qualification rule from 50% to 40% local content of total factory cost**
    - This is a practical and simple way to offset the inequity of the manufacturing exporter being able to include factory cost only, whereas the raw materials in the calculation all contain administration, selling and profit margins.
    - It requires little change from the current rules.
    - It does mean manufacturing exporters retaining systems to monitor compliance with the rules.
    - It may be appropriate to apply this rule to the TCF sector only. This would not contravene any of the objectives of the CER.

3. **Deduct an imputed margin for all raw materials in the content calculation**
    - As described above in D 3, bullet point 2.
    - This corrects the imbalance between costs that include margins (raw materials), and those that exclude margins (labour and factory overheads).
    - Margins vary a lot, depending on the item. Maybe more research could be done on this but we think 30% would be a modest estimate.
    - This change to the rule is not fundamental, is fair and could be applied universally.

F. Conclusion

1. In general the CER rules of origin have been effective – the arrangements have certainly benefited our company.
2. However the rules do have some unintended consequences, and these have caused us considerable cost. There are sufficient grounds for changing them so that more progress can be made towards achieving the CER objectives.
3. In a perfect world we think the most attractive change would be to Substantial Transformation because of the certainty it provides. However in practice this solution is likely to take too long to implement and runs the risk of being subverted by sectoral interests.
4. **We therefore submit the rules be modified by either lowering the local content requirement to 40%, or by deducting an imputed margin from the raw materials costs. While we like the logic and elegance of the latter option, we prefer the simplicity of the former.**