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Dear Sir

RULES OF ORIGIN SUBMISSION

1 INTRODUCTION

- 1.1 Fisher & Paykel Appliances (F&PA) manufactures a range of home appliances, including washing machines, refrigerators, chest freezers, ranges, clothes dryers and dishwashers in plants located in Auckland, Mosgiel (Dunedin) and Cleveland (Brisbane). It is one of New Zealand's leading international manufacturers. The New Zealand market accounts for 29% of the Company's sales revenue of \$780 million, 47% comes from Australia and the remaining 24% from other export markets.
- 1.2 F&PA's principal target markets are New Zealand, Australia, the US, and the EU.
- 1.3 The Customs tariff on whiteware imported into Australia from developed countries is 5% (4% from China). In New Zealand the developed country rate is 7% and for developing countries it is 5.5%.
- 1.4 F&PA has found that qualifying content over the past fifteen years has been affected by the following issues:
 - Closure of local manufacturers supplying components and substitution with imported materials / in-house manufacture.
 - Substantial cost efficiencies as the Company adjusted to compete with the prices of imported product.

- Qualifying overheads, which have not only been reduced, but allocated over increased production volumes.
- Use of materials that are not available in Australia or New Zealand e.g. electronics.

Nevertheless, the company is still able to achieve Rules of Origin (ROO) qualification. However, it foresees a future point when ROO will become an issue. F&PA's preferred strategy is to increase production in New Zealand and Australia instead of building further plants offshore. If the issues set out in this submission are not addressed, this strategy will need to be reviewed.

- 1.5 This submission addresses F&PA's views on the current ROO, examines the various options available, and recommends a preferred course of action. In addition, comment is provided on the "incremental improvements" being examined by Australian and New Zealand officials within the context of the overall review.

2 JOINT MINISTERIAL STATEMENT

- 2.1 We refer to the Joint Ministerial Statement on Rules of Origin, produced by the Australian Minister for Trade and the New Zealand Minister for Trade Negotiations on 28 August 2003. It is noted that officials will be guided by five principles, all of which are endorsed by F&PA.
- 2.2 The Statement also refers to a number of incremental improvements, which will be addressed in the short to medium term. F&PA is interested in the outcome of the outsourced manufacture issue, and is supportive of the decision to consider the issue of "imported intermediate goods". More detailed comment is made later in this submission.

3 BACKGROUND

- 3.1 Appendix 1 sets out the history of F&PA from its commencement in 1934 through to its current status as an internationally competitive manufacturer of home appliances.

4 F&PA'S PHILOSOPHY

- 4.1 F&PA's philosophy is borne out of a necessity to be innovative in order to export and to compete domestically. The Company's innovation and its strength in research and development provide the basis of its manufacturing approach.
- 4.2 F&PA finds New Zealand and Australia good places to manufacture for the following reasons:
- There is access to a relatively reasonably priced and skilled labour force.
 - There is access to raw materials at competitive prices.

- 4.3 This is offset to some degree by the following factors:
- Lack of a suppliers' infrastructure (such as injection moulding, electronic assemblies), which means that F&PA has much higher capital investment than competitor appliance manufacturers in other parts of the world. The increased reliance on in-house manufacture has added to the number of production processes that must be developed and managed and the skilled resource required.
 - F&PA's geographic isolation means more extensive working capital is required to fund the cost of holding stock and the cost of carrying debtors while payment is awaited. Stock holding costs comprise additional buffer stocks of raw materials to cover stock-out contingencies and stock in transit for both imported raw materials and exported finished goods for the Company's various export markets.
- 4.4 F&PA continues to do its research and development in New Zealand. This is because the New Zealand labour force provides good skills, which are attracted to the whiteware industry. In other developed countries these skills tend to migrate to industries which are more "fashionable".
- 4.5 The Company's strategy has been to locate its research and development (R&D) facilities next to its manufacturing plants. This is because product engineering and production engineering have been integrated and a substantial amount of R&D has been expended developing manufacturing processes to build F&PA's innovative products on a relatively small scale (albeit that the Company manufactures approximately 1 million units per annum, this is small on a global scale).
- 4.6 For instance, F&PA pioneered, in conjunction with Japanese steel mills, the use of prepainted steel in the manufacture of appliances in the 1960's and developed flexible manufacturing systems. Furthermore, it has had to develop production machinery to manufacture specific innovations such as the Smart Drive washer motor.
- 4.7 F&PA found that its flexible manufacturing and smaller scale requirements exceeded the capability of traditional machinery manufacturers and had to set up its own business in New Zealand, Production Machinery Limited, to build substantial amounts of its production plant. An unintended consequence is that this company is now a supplier to other global appliance companies.
- 4.8 F&PA has built separate washing machine and refrigerator plants in Brisbane, Australia. However, the Company has been careful to ensure that these are clones of the New Zealand plants so that new technologies can be developed in New Zealand and easily transferred to the offshore factories.
- 4.9 In summary, F&PA does not see that R&D for product and production can be divorced, even though other countries offer substantial tax breaks and incentives for R&D independent of its application.

5 AUSTRALIAN AND NEW ZEALAND MANUFACTURING ENVIRONMENT

- 5.1 F&PA's local supplier base for components has been substantially displaced by previous tariff reductions, forcing the company to source many of its components off shore.
- 5.2 The increased unavailability of locally (New Zealand and Australian) sourced raw materials, together with F&PA's export growth (because of increasing volumes to third countries) could result in preference eventually being lost. The growth in exports has resulted in fixed New Zealand and Australian based costs being spread over increasing volumes. (e.g. if New Zealand based fixed costs are \$20 million and production volume is 600,000 units, the allocation per unit is \$33.33. However, if production is lifted to 1,000,000 units and fixed costs remain the same, the allocation is \$20).

6 CURRENT ROO RULES

- 6.1 The Company's ability to meet the requirements of ROO rules has provided many export opportunities into Australia and from Australia into New Zealand. On the other hand, qualification for preference can impact on investment decisions. For example, investing in production capacity will be assessed by the effect of that additional capacity on ROO qualifying costs. This can contribute to investment decisions being influenced by a level of uncertainty beyond that normally expected.
- 6.2 In F&PA's experience, the ability to achieve preference is not usually threatened by any single factor, but rather a combination of factors. The loss of F&PA's supplier base, coupled with increased production volumes, have been the principle factors. The Company now finds that innovative materials are not available in New Zealand and Australia and componentry such as electronics and specialist plastics and steel must be obtained from non-qualifying sources.

Advantages of the ad valorem system:

- 6.3 The *ad valorem* approach is familiar to F&PA and it has constructed its costing systems and accounts in a way that enables it to efficiently generate the necessary supporting information for preference purposes.
- 6.4 The respective Australian and New Zealand Customs administrations have built up a wealth of expertise over the years in implementing the *ad valorem* approach, and in this context, understanding the whiteware industry. This institutional knowledge should not be discarded lightly.
- 6.5 There is no need to establish a significant number of specific rules dealing with individual manufacturing or specific processes.
- 6.6 Compliance is simpler because the principles used are those common to businesses and deal with financial information, rather than the more obtuse and somewhat technically difficult application of tariff classifications.

Disadvantages of the ad valorem system:

- 6.7 The current threshold of 50% qualifying content is too high, given the developments in manufacturing technology and the virtual removal of the manufacturing infrastructure in New Zealand (and, but perhaps to a lesser extent, Australia) which previously supplied components to the whiteware industry.
- 6.8 F&PA's main strength is its intellectual property (innovation) which is only recognised under the *ad valorem* approach to the extent that it has been capitalised. In other words, the bulk of the intellectual property cost cannot be included as qualifying content.
- 6.9 The current ROO format is a deterrent to using one manufacturing base and achieving economies of scale. Qualifying content reduces because as production increases the overhead (fixed costs) is spread over a wider base, and the percentage diminishes.
- 6.10 F&PA's qualifying overheads tend to be fixed. Raw materials are variable while labour is more or less fixed due to highly automated factories. This means that the greater the volume of manufacture the lower the percentage for fixed overhead.
- 6.11 F&PA is driven to reduce cost in order to compete. One of the consequences of this is that the Company obtains raw materials from low cost countries (which it often competes against in the market). Any cost benefits may, however, be influenced unfavourably by exchange rate movements

Other Issues:

- 6.12 The *ad valorem* system has produced a number of anomalies, which has disadvantaged F&PA. These can be summarised as follows:
- In-house manufacture due to the demise of local support infrastructure (injection moulding, electronics), has led to a reduction in qualifying origin due to the removal of the former supplier's margin.
 - There is an allowance for interest in qualifying origin, but not dividends. Dividends represent a cost of capital and should be recognised in qualifying content.
 - Telephones and international travel costs are not recognised.
 - A definition of "factory" is needed so that a campus-type arrangement like F&PA's site can be taken into account.
 - The 2 percent margin of tolerance for unforeseen circumstances should be increased to reflect the volatility of factors affecting preference.
- 6.13 F&PA would expect these issues to be addressed and corrected in the current review, which would make the *ad valorem* approach much more attractive to the company.

7 OTHER ROO OPTIONS

7.1 In addition to the *ad valorem* system, the ROO approaches generally used in Trade Agreements consist of the following:

- (i) **Change of Tariff Heading (CTH):** The simple requirement here is that the final good comes under a different tariff heading than all its input goods. The common classification system used is the Harmonised Commodity Description and Coding System (the HCDC system).
- (ii) **Change of Tariff Classification (CTC):** The same as for CTH, but extended beyond the 4-digit level using the HCDC system.
- (iii) **Specific Processes:** This requires an identification of all the processes that are carried out in the territory that will confer origin on that product.

7.2 It is interesting to note that none of New Zealand's current Free Trade Agreements or Closer Economic Partnerships contain ROO based on the CTH approach. Having said that, we recognise that internationally, this approach is becoming more widely used. In particular it is employed extensively by the United States in its bilateral agreements, often in conjunction with an *ad valorem* component and other specific rules, which are complex and onerous.

7.3 A common argument for the use of CTH is that it removes the necessity for adequate costing records and allows an exporter to ascertain more readily whether a product qualifies for preferential entry. As referred to above, this is not an issue for F&PA, which maintains a costing and financial system tailored to providing the requisite information for preference. It is the company's view that, having to make assessments of changes in tariff heading would require a technical expertise and understanding of Customs precedents that is not readily available in the corporate sector. CTH on its own will not provide a total solution and the second tier test could introduce complexities that would negate any perceived advantages over the *ad valorem* approach.

7.4 The HCDC system is large and complex and requires considerable technical expertise to interpret and apply. There is a considerable body of precedents to assist in this respect, both within the World Customs Organisation, and from other Customs administrations, but the inherent uncertainty in the interpretation of the Rules of Tariff Classification will disadvantage exporters.

7.5 Use of the CTH approach, either separately or in conjunction with specific processes, will require in certain categories the development of a list of exceptions and variations. These lists are usually open to manipulation by interested parties and lack consistency and transparency in their application.

7.6 F&PA agrees in principle with the CTH approach, but recognises that the detail likely to be involved undermines its suitability. For instance, the likelihood of a complex second tier test, lists of specific exceptions and variations, and the difficulty of accommodating the "parts of" definition, make this approach less attractive.

8 PREFERRED OPTION

- 8.1 F&PA's preferred option for ROO under CER, given the concerns with resolving difficulties under CTH, is a continuation of the *ad valorem* approach subject to the following changes:
- A lowering of the qualifying content percentage to 40% in conjunction with a resolution of the issues raised in paragraph 6.12 of this submission.
 - A resolution of the intermediate inputs issue to facilitate preference qualification.
- 8.2 The establishment of a Joint Customs Committee to ensure a harmonised approach to the manner in which rules are administered is supported, provided the Committee operates in a manner that provides timely and cost effective decisions.

9 INCREMENTAL AMENDMENTS

Outsourced Manufacture:

- 9.1 This is not an issue for F&PA because of the vertically integrated nature of the company's manufacturing processes. However, the company remains interested in the outcome of the negotiations as it may provide an opportunity to reduce costs for products that may be developed in the future.

Intermediate Inputs:

- 9.2 F&PA supports this approach as a means of not penalising manufacturers who are forced to import componentry which is not available in either Australia or New Zealand.
- 9.3 F&PA understands that the proposal is to remove this cost completely from the "factory or works cost". We submit that consideration needs to be given to creating a transparent, expeditious scheme which would enable the true factory cost of a product to be calculated, by giving qualifying status to the determined items.
- 9.4 F&PA is unsure of the administrative regime that is proposed to determine whether goods are manufactured in Australia and or New Zealand, and how the current 3% tariff on all goods imported into Australia under concession will be addressed in this respect.
- 9.5 F&PA wishes to reserve the right to make further submissions once more detail is available.

10 CONCLUSION

- 10.1 F&PA endorses the review of CER ROO.
- 10.2 F&PA believes New Zealand and Australia are an ideal manufacturing base for its business, but in order for F&PA's innovative and research lead approach to continue and allow the Company to develop and succeed, changes to the ROO are essential.
- 10.3 F&PA submits that the current *ad valorem* system is the most practical approach for ROO subject to certain amendments being made.
- 10.4 F&PA submits that the changes outlined in this submission require implementation to ensure that the *ad valorem* approach takes into account changes in technology and business practices that have taken place since the commencement of ANZCERTA and its predecessor.
- 10.5 F&PA requests a meeting with officials to discuss aspects of this submission further, and is happy to provide any further information or explanation that may be required.

Yours faithfully

John Bongard
Managing Director

HISTORY OF FISHER & PAYKEL APPLIANCES

- 1 F&PA commenced business in 1934 as an importer of refrigerators and washing machines. In 1938 it started manufacturing appliances under licence to several major international appliance companies.
- 2 F&PA realised in the mid-1960's that it would never be competitive while it continued to manufacture products under licence to other larger manufacturers. The Company could never make a cheaper copy of another manufacturer's product due to its smaller production volumes.
- 3 So, F&PA began a 30-year journey to develop a full range of home appliances. To compete, these had to be innovative, not only in the design of the products, but also in the method of manufacture. This drove the development of flexible manufacturing systems, which countered the disadvantages of small scale.
- 4 Typically, each product took 10 years to develop. The table below shows the major developments:

Year	Developments
1965	Pressurised Dryer
1979	Compact Refrigerator (525mm)
1985	Award Series Refrigerators (635mm)
1986	Chest Freezers
1987	Gentle Annie Electronic Washer (5kg)
1989	Award Series Refrigerators (790mm)
1990	Smart Drive Washer (5kg, 6kg and 7kg)
1992	Award Series Refrigerator (680mm)
1998	Active Smart Refrigerators (635mm, 680mm and 790mm)
1998	Dish Drawer
2002	Titan Cooker
2003	Smart Load Dryer

- 5 The substantial number of patents that F&PA holds reinforces the innovations that have been incorporated into these products.
- 6 F&PA exported its newly developed dryers, chest freezers and refrigerators into Australia under NAFTA before the implementation of CER. Furthermore, two factories have been built in Australia in the past 13 years. CER has been positive for the Company overall.