NSW Container Deposit Scheme: Monitoring the impacts on container beverage prices and competition

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Introduction and overview

The NSW Business Chamber (the Chamber) welcomes the opportunity to respond to the Issues Paper relating to IPART's monitoring role on the impact of implementing the NSW Container Deposit Scheme (CDS). The Chamber is grateful for the additional time extended to the Chamber obtain direct feedback from our members on the CDS.

The Chamber is one of Australia's largest business support groups, with a direct membership of more than 20,000 businesses and providing services to over 30,000 businesses each year. The Chamber works with businesses spanning all industry sectors including small, medium and large enterprises. Operating throughout a network in metropolitan and regional NSW, the Chamber represents the needs of business at a local, State and Federal level.

The Chamber notes recent developments that have culminated in the launch of a $47 million rescue package following China's clampdown on imported recyclables. With hindsight, it is difficult to imagine the merits of the CDS stack up with such uncertainty downstream. While litter reduction has been touted as a key benefit of the CDS, the capacity to recycle returned containers is integral to almost any reasonable basis for assessing of the success of the CDS.

Noting limitations in the length of the reporting period and capacity to examine long-run impacts on beverage prices of the CDS, the Chamber proposes IPART conduct a bottom-up assessment of the costs incurred by businesses throughout the supply chain. While IPART has not been specifically asked to monitor operational elements, these should be considered as they relate to other aspects of the terms of reference.

The Chamber has a number of concerns relating to the implementation of the CDS. For example, feedback from the Chamber's members notes there have been significant negative impacts for operators located close to state boundaries. Some suppliers who have raised prices in these locations advise they have recorded significant negative impacts on retail sales of greater than 30 per cent.

As a means of addressing these and related issues the Chamber proposes a Border-Region Adjustment Mechanism to reduce the negative consequences of the scheme for retailers close to state boundaries. The Chamber estimates this mechanism can be implemented at a cost of under $1 million per annum.

Feedback from members indicates the CDS has resulted in changes to the competitive dynamic detrimental to NSW businesses in affected locations. Incompatibilities between retailers' business systems and those of the network operator have had a negative impact and are compounded by a lack of information for businesses in the supply chain.

The Chamber notes IPART is able to report on other matters considered relevant and encourages a proactive approach in identifying improvements or areas warranting further review.

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List of recommendations

Recommendation 1

IPART should conduct a bottom-up assessment of costs incurred by businesses throughout the supply chain to inform how prices are likely to adjust in the long-run.

Recommendation 2

Both direct and indirect costs incurred by businesses should be considered as part of a bottom-up assessment of the costs of the scheme.

Recommendation 3

IPART should investigate to gain a comprehensive and detailed understanding of how the CDS impacts businesses located close to the border, including through investigation of sales data.

Recommendation 4

The Government develop a border-region adjustment mechanism (the mechanism) to target support for businesses in border-regions facing disproportionate impacts from the CDS. IPART should investigate and identify key design principles building on the model proposed by the Chamber.

Recommendation 5

The border-region adjustment mechanism should be funded out of consolidated revenue.

Recommendation 6

IPART should take a broad view of its monitoring role, including by examining operational elements of the CDS. It should also identify improvements or potential concerns that may warrant further review.

Feedback on the proposed monitoring framework

The Chamber accepts data and methodological constraints may limit IPART in assessing the precise impact of the CDS. The approach outlined in the Issues Paper is a sensible approach to measuring the short-term impact on prices from consumers' perspective and is consistent with requirements of the terms of reference. This approach may, however, be insufficient in ascertaining the long-run impact of the CDS. The Chamber encourages IPART to supplement this approach by taking a broader view.

The Chamber is particularly concerned that the described approach does not measure costs absorbed throughout the supply chain and therefore not reflected in consumer pricing. Member feedback indicates a significant amount of cost absorption is occurring, meaning there is only partial cost pass-through to consumers. The Chamber therefore maintains there may not be sufficient evidence confirming beverage prices have increased beyond the costs associated with the scheme.

The absence of observable prices increases could be mistakenly seen as evidence of the successful implementation of the scheme from a consumer perspective, the Chamber contends many of the reasons for partial cost pass-through are unlikely to persist in the longer term as the market adjusts. These include (but are not limited to):

- **Price stickiness and menu costs** - it may take more time for businesses to adjust prices due to inertia in supply contracts, risk aversion, broader pricing strategies which may lag costs and the cost of changing prices.

- **Short-run competitive dynamics** - there is evidence some large volume retailers have sought to maintain price stability in the short run (with prices equal to jurisdictions without a comparable CDS) driving price competition for all suppliers.

- **Incomplete information** - suppliers do not yet have full visibility of the costs of the scheme (including smoothing of variable network operator costs) and unforeseen compliance costs.

- **Consumer sensitivity** - retailers are reluctant to dramatically increase prices as consumers may change shopping habits which cost not only sales of beverages covered by the scheme, but also other products purchased at the same time.

These factors may dissipate over time as they work through the market. Impacted businesses in the longer term may seek to improve margins by attempting to pass on a higher proportion of costs subject to what the market can bear. This means the observable impact on prices in the short-run may be different to the long-run.

For a true assessment of the impact of the CDS on beverage prices it is necessary to take a long-run view. Given IPART has been requested to provide a report to Government by December 2018 it is unlikely the long-run impact on prices will be observed in the identified timeframe. For this reason, the Chamber encourages IPART to take a broader view to incorporate factors likely to lead to price rises over time (if not directly observable within the monitoring period). This will require a bottom-up assessment of the costs incurred by suppliers throughout the supply chain.

Recommendation 1

IPART should conduct a bottom-up assessment of costs incurred by businesses throughout the supply chain to inform how prices are likely to adjust in the long-run.

A bottom-up assessment of the costs of the scheme

The Chamber encourages IPART to supplement its proposed approach with a bottom-up assessment of the costs of the scheme. A bottom-up approach would assess costs by estimating all of the costs incurred by suppliers throughout the supply chain. As noted above, a bottom-up approach is needed to allow IPART to assess the potential longer-term impact on prices.

A bottom-up assessment of costs should include all of the direct costs recovered through the scheme (for example those outlined in Table 2.3 of the Issues Paper), but also the indirect costs incurred by businesses. Indirect costs include the administration and compliance costs incurred by registered first suppliers and other businesses throughout the supply chain. Examples of these costs include (but are not limited to):

- Lodging information and remitting payments to the scheme coordinator.
- Time and effort required to find information about and understand obligations under the CDS, including the cost of any professional advice.
- One-off costs associated with adjusting systems and procedures to achieve compliance.
- Costs associated with changing prices or negotiating contract changes.
- Costs associated with consumer education performed by retailers.

The Chamber notes the Issues Paper does not draw attention to the potential impact of these costs. Instead, the Issues Paper notes suppliers can choose to pass on costs to their customers. If this occurs, indirect costs will translate into higher prices for consumers. Depending on the magnitude of indirect costs, this will result in higher prices than the direct cost of the CDS.

A bottom-up estimation of costs is critical to any assessment to determine whether beverage prices have increased beyond the costs of the scheme and the extent to which costs have been absorbed through the supply chain. While the Issues Paper makes it apparent IPART will consider direct costs as part of this exercise, it is less clear as how indirect costs may be treated.

A complicating factor in measuring the impact on beverage prices is that supplier fees vary depending on container return rates. As fees represent an advanced contribution and are based on an estimation of return rates, it is possible estimates of price changes over the monitoring period do not accurately reflect long-run levels where fees are reconciled with actual return rates. This will need to be factored into analysis of the impact of the scheme.

Recommendation 2

Both direct and indirect costs incurred by businesses should be considered as part of a bottom-up assessment of the costs of the scheme.

The need for a border-region adjustment mechanism

The Chamber's members indicate there have been significant negative impacts for operators located close to state boundaries. For example, some suppliers who have raised prices can demonstrate negative impacts on retail sales of greater than 30 per cent.

While businesses located close to the Queensland and ACT borders are impacted, these neighbouring jurisdictions are due to have schemes implemented in 2018 and so the Chamber's concerns principally relate to businesses located close to the Victorian border. South Australia already has a scheme in operation.

Summary of feedback from the Chamber's members

The Chamber has obtained feedback from a range of businesses located across NSW. Anecdotally it would appear businesses located close to the state border of Victoria have acted differently to businesses located further from state boundaries.

Feedback from independent supermarkets located some distance from state boundaries suggests they have been able to recover increases in the cost of goods sold via price increases without a large impact on sales. On the other hand, feedback from independent supermarkets located close to state borders particularly Victoria, indicates they have had to either significantly reduce margins to match prices across the border or maintain margins at the expense of major reductions in sales volumes. This impact is intuitive as it is relatively easy for consumers to purchase equivalent products across the border without costs associated with the CDS.

The impact on retailers located close to the border would appear to vary depending on the type of retailer, type of product and the context in which the products are sold. For example, price increases in dollar-terms are more visible for bulk-buy packs and consumers may be more price sensitive. For these products, the dollar savings may be sufficiently large for many customers to switch where they do their grocery shopping. This not only results in the loss of beverage sales, but also other products purchased as part of a larger grocery shop. Anecdotal feedback provided by the Chamber's members suggests they are likely to match prices across the border in order to avoid loss of sales, and as a result are absorbing a significant drop in profitability.

For some product categories price matching is not an option as margins are low. For example, margins on some categories of alcohol are already low and there is very little scope to absorb cost increases. Where this is the case, retailers close to state borders have reported a fall in sales volumes.

In other circumstances, there is little discernible differences in the impact on retailers in border-regions compared with those located in the rest of NSW. For example, consumers are less price sensitive where a beverage is purchased in circumstances where convenience is highly valued.

The Chamber encourages IPART to investigate the impact of the CDS on retailers located close to the NSW/Victorian border. It is the Chamber's view that the Government, whether through IPART or otherwise, should have a comprehensive and detailed understanding of impacts on retailers in impacted locations. This includes an investigation of sales data. Examples of locations to consider include Albury, Corowa, Mulwala, Barooga and Wentworth along the NSW/Victorian border.

Exploring impacts on retailers in Queanbeyan on the ACT border and Tweed Heads on the Queensland border would also be insightful, though may be subject to different effects due the prospective introduction of comparable schemes in the adjacent jurisdiction.

Recommendation 3

IPART should investigate to gain a comprehensive and detailed understanding of how the CDS impacts businesses located close to the border, including through investigation of sales data.

How the "deposit" affects purchasing behaviour

It may be suggested NSW consumers are no better or worse off if they purchase from across the border or in NSW as they are theoretically able to recover any price increases via the 10 cent refund available upon returning the container to a collection point. However, as noted in the Issues Paper, there are fixed costs associated with the CDS and it is reasonable to expect there will be pressures to pass these onto consumers over the longer term. This means consumers may pay more through higher retail prices than they can collect via deposit refunds.

Furthermore, the deposit is unlikely to influence purchasing decisions for consumers who do not anticipate that they will return the container. It is unclear at this stage how many containers will be returned to collection points, however, the scheme coordinator estimates 50 per cent of containers will be recovered via Material Recycling Facilities (MRFs) with between 40 and 50 per cent recovered from collection points over the first three months. A lower share of containers returned to collection points may imply a higher share returned by MRFs and so CDS costs will not necessarily reduce to facilitate a corresponding reduction in prices for consumers.

Even if a relatively high share of containers come from collection points, many will be returned by individuals other than the original purchaser. For example, some people may collect containers from other consumers and claim the deposit on their behalf. For this reason, the ability to claim back the deposit may fail to mitigate the impact of higher prices on consumer behaviour. The Chamber is also aware of reports suggesting beverages supplied in Victoria are being returned to obtain a refund from the NSW CDS.

Each of these considerations is relevant in the context of assessing impacts on businesses located close to state boundaries as it suggests consumers will behave as if the deposit were like a tax rather than a refundable amount from the headline price. This is consistent with the behaviour observed by the Chamber's members located close to state boundaries.

Potential solutions

The Chamber maintains a policy response is needed to address the disproportionate impact of the CDS on businesses located close to state boundaries, particularly businesses located on NSW/Victorian boarder.

The Chamber accepts it would be impractical for Government to wind back implementation of the scheme in border regions for a range of reasons. Further, an approach which is not carefully designed may risk shifting border issues from one region to the next.

The Chamber proposes the Government develop a border-region adjustment mechanism (the mechanism) to target support for businesses in border-regions facing disproportionate impacts from the CDS. The mechanism would operate until a comparable scheme exists in the adjacent jurisdiction. Specifically, the mechanism would aim to financially compensate businesses that have experienced losses as a result of the CDS.

While specific features of the mechanism require further consideration, one approach involves categorising retailers and beverage types based on consumers' sensitivities to price changes. A rebate could then be calculated based on the number of units sold, the retailer type and the type of beverage sold. For example, a can of soft drink sold as part of a multi-buy pack in a supermarket would receive a larger rebate than a chilled can of soft drink sold individually at a convenience store (because consumers are less price sensitive in the latter scenario and losses are less likely to occur). Figure 1 below illustrates the concept.

Figure 1 – Matrix of consumer sensitivities

<table>
<tr><td colspan="2"></td><th colspan="2">Beverage type</th></tr>
<tr><td colspan="2"></td><td>Low price sensitivity (e.g. any container sold individually)</td><td>High price sensitivity (e.g. containers sold as part of a multipack)</td></tr>
<tr><th rowspan="2">Retailer type</th><td>Low price sensitivity (convenience store, restaurant or cafe)</td><td>0.5 x rebate</td><td>0.75 x rebate</td></tr>
<tr><td>High price sensitivity (retailer selling a wide range of products)</td><td>0.75 x rebate</td><td>1 x rebate</td></tr>
</table>

The mechanism would compensate any business within a designated boundary away from the border of a jurisdiction without a comparable CDS. The drawing of boundaries would need to ensure the same cross-border challenges are not shifted to another location. In practice, this would mean ensuring there is sufficient geographic distance between eligible and ineligible commercial centres at all points across the border. If this is not possible then a two-tiered rebate could apply based on distance from the border.

The precise calibration of the mechanism would depend on further analysis of consumer price elasticities and the extent to which costs have affected retailers. The rebate per container may also need to adjust to reflect changes in the variable costs of the scheme.

The Chamber estimates a robust scheme that could reasonably compensate businesses along the NSW/Victorian border could be applied at a cost of less than $1 million per annum. This is a relatively small cost in the context of the $47 million rescue package to deal with China’s ban on imported recyclables. The Chamber proposes simplicity should be a guiding principle of any compensatory mechanism and the cost of implementation should be funded out of consolidated revenue.

Recommendation 4

The Government develop a border-region adjustment mechanism (the mechanism) to target support for businesses in border-regions facing disproportionate impacts from the CDS. IPART should investigate and identify key design principles building on the model proposed by the Chamber.

Recommendation 5

The border-region adjustment mechanism should be funded out of consolidated revenue.

Impacts on competition and other issues

Changes in the competitive dynamic following the implementation of the CDS appear to reflect underlying market conditions that existed prior to its introduction. For example, some of the Chamber's members have reported larger liquor retailers are retaining their pre-CDS prices. This may reflect larger retailer's ability to negotiate keener discounts from suppliers (to maintain margins) or their ability to sustain lower or negative margins for a longer period. In some cases, it may be easier for larger retailers to cross-subsidise affected product lines through price increases in unaffected lines.

The Chamber maintains IPART should monitor whether these practices are sustained in the longer-term and assess impacts on small and medium enterprises operating throughout the supply chain.

A further competitive impact is the barriers to entry generated for prospective first suppliers of beverages in NSW. Administrative burden associated with the CDS, which is mostly a fixed cost, represents a higher per-unit cost for smaller businesses. For example, a retailer considering the economics of self-importing beverages to sell directly to consumers may be discouraged. There is merit in exploring whether fee discounts for smaller first suppliers can be adopted to mitigate this effect.

The Chamber has also received feedback suggesting there are ongoing implementation challenges associated with applying to become and then fulfilling responsibilities as a collection point operator. Examples of concerns include the lack of useful information available online and incompatibilities with the systems used by the network operator (which appear to be configured to satisfy the systems of larger retailers).

For many retailers participation as a collection point is necessary to avoid losing business. Member feedback suggests that acting as a collection point operator can present significant cash flow impacts with a period between when operators are reimbursed following issuing a refund to consumers. Further, there do not appear to be well-developed feedback channels for businesses to report operational concerns relating to the CDS.

While these issues relate to operational elements that IPART is not explicitly required to examine, the Chamber encourages IPART to take a broad view of its monitoring role as these issues impact the overall cost and efficiency of the CDS.

Recommendation 6

IPART should take a broad view of its monitoring role, including by examining operational elements of the CDS. It should also identify improvements or potential concerns that may warrant further review.