BREXIT PREPARATION AND IMPACT ANALYSIS

This report is a direct extract of part 3 of the NEXT plc Half Year Results Statement published on 25th September 2018.

INTRODUCTION

It appears to us that it would be in the interest of both the UK and remaining EU nations that the UK's departure from the EU is carefully managed, accompanied by a period of transition and some form of agreement for free trade. However, at this stage there can be no certainty that any such agreement will be reached so we are preparing NEXT for the possibility that the UK leaves the EU with neither a transition period nor a free trade agreement in place.

There are significant challenges involved in preparing for a no-deal outcome and we would not want to understate the work we are doing to prepare for this eventuality. However, we do not believe that the direct risks of a no-deal Brexit pose a material threat to the ongoing operations and profitability of NEXT's business here in the UK or to our £190m turnover business in the EU.

We are well advanced in our preparations and are setting up all the administrative, legal and physical infrastructure that will be needed to operate effectively if the UK and EU are unable to agree a free trade agreement. We are confident all the necessary arrangements we need to make will be in place by March of next year.

For the sake of clarity, we would like to stress that our analysis is specific to NEXT and should not be extrapolated to other businesses or industries.

KEY RISKS

We have undertaken a detailed analysis of the risks and operational challenges to our business and believe we now have a clear view of Brexit related risks and their potential impact on the business. Risks can be categorised into *direct risks* to our costs and operations and *indirect risks* that may affect our business through changes to the wider operating and economic environment.

Direct/ Indirect		Nature of risk	Risk level
Direct risks	(i)	Increases in tariffs and duty on goods imported **into the UK** from the EU and other countries	Medium
	(ii)	Administrative workload and costs in submitting necessary data on EU goods when they enter the UK **from the EU**	Low
	(iii)	Increases in tariffs and duty on goods exported **to the EU**	Low
	(iv)	Regulatory risks relating to the acceptability of product standards to UK and EU authorities	Very low
Indirect risks	(i)	Reduction in the value of Sterling along with associated increase in cost of goods from overseas	Medium
	(ii)	Queues and delays at UK and EU ports as a result of increased customs declarations for other companies	High

Each of the above risks will be covered in turn. Where possible we have tried to quantify the risks and detail the measures we are taking to mitigate the operational and financial challenges of a no-deal Brexit.

DIRECT RISKS

(I) IMPORT DUTIES ON GOODS ARRIVING IN THE UK

Potential Effect on Import Duties by Category

To understand the nature of the risks associated with higher import duties it is necessary to categorise goods into four groups:

Goods from:	*% of our stock*	Risk Level
a) Countries benefiting from Generalised System of Preferences (GSP)	53%	Low
b) Countries benefiting from EU Free Trade Agreements (FTA)	3%	Medium
c) Countries outside the EU without a trade deal or GSP	31%	No risk
d) EU and Turkey	10%	High

a) Goods from Countries Benefiting from Generalised System of Preferences (GSP)

The Generalised System of Preferences, or GSP, is a preferential tariff system which provides for formal exemptions from the more general rules of the World Trade Organisation (WTO). It is generally used to assist developing nations by allowing WTO member countries to lower tariffs for these nations without lowering them for imports from all other WTO countries (which is normally an obligation under WTO rules).

For the purposes of NEXT, GSP status means that we pay lower or no duty on importing goods from countries such as Cambodia, Bangladesh, India, Vietnam and Sri Lanka. Goods from countries benefiting from GSP account for 53% of our total stock.

In the explanatory notes to the Taxation (Cross-border Trade) Bill the Government has indicated that the UK will replicate the EU GSP rates, at their existing levels, to existing beneficiary nations once the UK has left the EU[1]. The power to grant GSP status is unilateral so, unless the Government changes its position, it is very unlikely that we will incur increased duty on goods from these countries[2] once the UK has left the EU.

b) Goods from Countries Benefiting from EU Free Trade Agreements (FTA)

We import 3% of our stock from countries with existing FTAs with the EU, c.75% of which comes from Tunisia, Morocco and Mauritius. These countries currently benefit from zero tariffs on clothing and footwear.

In the explanatory notes to the Trade Bill the Government has stated its intention to seek continuity in respect of the UK's current trade relationships through the EU, based 'as closely as possible' on existing trade arrangements.[3] This will be extremely helpful in ensuring a smooth transition and eliminates a significant business risk.

However, this intention will require significant preparation on the part of the UK Government and we believe there is a medium level risk that the necessary arrangements will not be in place at the point the UK leaves the EU.

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[1] Page 15 of the Explanatory notes for Clause 10 of the **Taxation (Cross-border Trade) Bill**: "When the UK first leaves the EU, it is intended that the products and preferential tariffs applied in each tier would reflect the EU scheme to ensure that market access for all beneficiary countries is maintained."

[2] Schedule 3 of the **Taxation (Cross-border Trade) Bill** lists these countries by name according to category.

[3] Page 9 of the Explanatory Notes for Clauses 2 of the **Trade Bill**: "The Governments policy is to seek continuity in the UK's existing trade relationships as the UK leaves the EU. To achieve this, it will establish a UK trade agreement with each existing partner based, as closely as possible, on maintaining the effects of the current trade agreement that that country already has with the EU."

c) Goods from Countries Outside the EU, Without a FTA or GSP

Goods from these countries, such as China, account for 31% of our stock and currently attract the standard tariff rates applicable to clothing and footwear at an average of 11.8%. There is no risk of an increase in tariffs on these goods as a result of the UK leaving the EU. Though, of course, there would be an opportunity for the UK to lower the overall tariff rates (with countries without an FTA or GSP).

d) Goods from the EU and Turkey

10% of our stock comes from the EU and Turkey (which is in a Customs Union with the EU). This stock is currently duty free and would be liable to whatever standard level of import duty the UK chooses to set on clothing and footwear when it leaves the EU.

The UK government has not yet published the new tariff rates they would adopt in the event the UK leaves the EU without a FTA in place. For the purposes of our analysis of worst-case duty costs, we have assumed that the UK will adopt the same rates the UK (and EU) currently have for countries without an FTA or GSP, i.e. an average of 11.8% on clothing and footwear.

NEXT PLC COMMENT:
The opportunity to re-balance tariff rates and eliminate the net cost increase to the consumer

The WTO requires member states to impose the same tariff rates on all other member countries that do not benefit from specific trade agreements or GSP rates. So the UK will be required to impose tariffs on EU goods. However, whilst WTO rules set an upper level limit on rates, member countries can choose to set lower duty rates as they see fit. There is a strong argument that duty rates should be rebalanced in such a way that any increase in duty revenues coming from EU goods should be used to pay for lower overall tariff rates. This would eliminate any net increase in costs to the UK consumer, whilst maintaining revenue levels from customs duties. (It is perhaps worth noting that, at present, much of this revenue is sent directly to the EU and does not come to the UK Treasury.)

For example: in 2017 there was an estimated £1.1bn[4] receipt of customs duty from clothing and footwear (around 32% of all duty in the UK). If tariff rates were to remain at their current level of 11.8% and be applied to clothing and footwear imports from the EU and Turkey (as will be required under WTO rules), we estimate that UK Government revenues would rise by £1bn. To maintain income from customs duties at their current level and eliminate any increase in the overall cost of clothing to UK consumers, we estimate that the overall tariff rate could be lowered to 5.8%.

It will therefore be open to the UK to change its tariff rates to ensure that the UK consumers are not adversely affected overall by tariffs on EU goods. Put another way, if the Treasury were *not* to change tariff rates it would end up increasing taxes on UK consumers which, in the circumstances, we believe would be unhelpful.

We do not expect the Government to publish potential tariff rates at this stage, but it would be very useful if the Government could clarify its intentions in respect of overall tariff rates in the event of a no-deal Brexit. The clarity it has given in respect of GSP and existing trade deals serve as an excellent model. Even the most general indication that Government intends to manage tariffs so that Brexit does not increase overall duty costs for the consumer would be important. It would allow us to determine product prices in the coming year, confident that we will not need to increase prices to compensate for a potential increase in customs rates.

[4] This has been estimated using overseas trade statistics from the HM Revenue & Customs Trade Statistics Unit for the 2017 calendar year.

Estimates of Import Duty Risks by Category

The table below sets out the annual value of stock at cost from the various categories of import territories along with the potential duty that might be payable in the worst-case scenario of the UK not grandfathering existing FTAs and making no changes to the UK's tariff rates on departure. We have assumed there is no risk of additional tariffs on goods from developing countries benefiting from GSP.

	Stock delivered[5] at cost £m	***Participation***	**Current duty £m**	**Maximum potential additional duty £m (e)**
General System of Preferences	925	*53%*	25	-
No trade agreement	535	*31%*	40	-
Free Trade Agreement	60	*3%*	-	5
EU & Turkey	170	*10%*	-	15
UK	50	*3%*	-	-
Total	**1,740**	***100%***	**65**	**20**

As can be seen from the table above, NEXT has relatively little exposure to stock purchased from the EU and Turkey (c.10%). Around half of this stock is from Turkey, where recent devaluations in the Turkish Lira will mitigate much of any possible increase in duty.

In the unlikely event that (a) the UK did not replicate FTAs with countries like Mauritius and Morocco and (b) no change was made to the overall level of tariffs applied, the maximum additional increase in the cost of goods would be around £20m which would add less than +0.5% to our prices at most. In reality some of these additional costs would be shared with suppliers or eliminated through alternative sourcing routes.

5 Stock delivered at cost includes commission, which is not subject to duty. Duty on homeware goods is significantly lower than clothing and footwear from most origins.

(II) ADDITIONAL ADMINISTRATIVE COSTS OF BRINGING EU STOCK INTO THE UK

Data and Declaration Administration

Although there is no customs border between the EU and UK, any company importing more than £1.5m or exporting more than £250k per annum is required to submit Intrastat[6] declarations for **all** goods flowing into the UK from the EU and vice versa.

Intrastat declarations contain almost entirely the same data that is required to make a customs declaration. Therefore, we do not anticipate any additional data will be needed in order to import goods from the EU post-Brexit and so there is little additional work in respect of data collection.

Time at Ports, Bonded Warehouses and Authorised Economic Operator (AEO) Status

Potential Delays (assuming fully functional ports)

The combination of NEXT's bonded warehousing, which means that duty is not incurred at the point of entry, along with its status as an Authorised Economic Operator means that, at present, all stock travelling into the UK destined for our warehouses from ***outside*** the EU incur only minimal delay on entry in the UK.

For example, a consignment of leather goods, with correct export documents, arriving from Tunisia by truck via Calais would typically pass all necessary clearances and be free to depart within an hour of arriving in Dover. Occasionally a consignment will be randomly selected for physical inspection and this can take a few hours.

Goods arriving from Portugal currently incur no delay other than a passport check, though it could still be selected for random inspection. So, there is no intrinsic reason why our EU goods should spend very much longer in customs than they presently do as a result of a no-deal Brexit. **Please note, this assumes that there are no other delays at our ports which is a major risk, see (ii) Delays at UK and EU Ports on page 10.**

Cost of Customs Admin

We will be required to make additional payments for customs clearance charges in respect of goods. We estimate that the increase in the volume of declarations will carry an administrative cost of around £100k.

We are in the process of ensuring that our computer systems and imports teams have the capacity to deal with any increase in workload.

[6] Intrastat is the system for collecting information and producing statistics on the trade in goods between countries of the EU.

(III) IMPORT DUTIES FOR STOCK GOING TO THE EU FROM THE UK

We currently have annual sales[7] revenues in the EU (excluding UK) of £190m. Of this, £85m is through sales in our stores and the balance is sold online. Of our Online sales in the EU, £47m are dispatched to the consumer through our German warehouse.

Currently almost all our goods are delivered into our UK warehouse and subsequently shipped to EU customers in one of three ways:

			Sales £m
Online	(i)	Dispatched direct from our UK warehouses to EU customers	58
	(ii)	Shipped and held in our German warehouse for direct dispatch to EU customers	47
Retail	(iii)	Via our 27 stores in Eire, 7 stores in Czech Republic, 2 stores in Slovakia and 1 store in Sweden	85
Total			**190**

The tariff issues for these sales are as follows:

a) The risk of incurring double duty

b) The risk of paying duty on the selling price of the goods, rather than the cost price

c) The risk of stock losing GSP relief on entry to the EU

The nature of these risks and the steps we are taking to mitigate them are set out below.

a) Risk of Double Duty

There is a theoretical risk that stock originally imported into the UK could end up incurring double duty if it is subsequently exported to any country outside the UK. This potential cost does not exist for NEXT as our UK warehouses are Customs (or Bonded) Warehouses. This means that stock travelling to these warehouses does not incur duty on entry in the UK, but only when items are dispatched from our warehouses to UK stores or UK customers.

So currently, goods passing through the UK warehouses to countries outside the EU do not pay UK duty. This means that duty is only paid in the country where the stock is received by (i) an Online customer, (ii) an overseas NEXT shop or (iii) a franchise partner.

b) Risk of Paying Duty on Selling Price Rather than Cost Price

There is an additional risk when goods are sold online and dispatched from the UK to the EU. Customers will become liable for duty on the *selling price* of the goods rather than their cost price. This is because the customer would, in effect, be importing the goods at selling price into the EU from outside.

There are two ways in which stock is delivered to our EU customers:

- Stock is held in bulk in our German warehouse and dispatched to customers from this warehouse, which is within the EU
- Directly to customers from our UK warehouses

[7] Sales in the last 12 months.

Two different approaches to resolving the problem of paying duty on selling price will be adopted depending on the method of delivery.

Goods sent to EU customers from our German warehouse

We have set up a German company. It is likely goods would be sold to our German company from our UK company. Goods would then be deemed to have been imported into the EU by our German company at cost plus a reasonable transfer premium, in the same way as if they had been imported direct from the overseas territory in which they were manufactured.

It is our intention to bond our German warehouse facility so that goods will only incur duty when they leave it and go into free circulation in the EU. This will enable unsold goods that return from Germany to the UK to avoid double duty (see above).

Goods sent direct to EU customers from the UK

Goods sold directly to EU customers from the UK incur duty on the selling price of the goods. This would represent a very serious increase in costs to consumers as any increase in selling price required to recover the cost of duty would itself incur duty for the consumer.

In the short term this problem is mitigated by the fact that all consumer purchases going into the EU of *less than* €150 do not incur duty. The vast majority of our orders to EU customers are under this threshold. So, the increase in duty payable on the orders of more than €150 would be more than offset by a saving on duty on orders for less than that amount.

In the longer term this mode of trade is vulnerable to any change in the import threshold and it is our intention to steadily increase the volume of our EU business served through our German warehouse.

We have established an Eire company which will own goods sent from the UK to our Eire **Retail stores**. This means that goods can be imported into Eire at a cost (plus a reasonable transfer premium) and will therefore incur very little additional duty.

c) Potential Loss of GSP Relief on EU Imports

Without mitigation, this issue could give rise to a material increase in costs for our EU business and at worst could increase our selling price of goods in the EU by 2%.

Despite the fact that our UK warehouses are bonded, once the UK leaves the EU, goods that are imported to the UK and subsequently exported to another country generally lose their GSP relief and incur full duty charges.

For example, if stock is delivered **directly** to our German warehouse from Bangladesh (a GSP country) then those goods receive GSP relief and incur no duty. When the UK leaves the EU, if goods with GSP relief are imported into the UK and subsequently exported to the EU they would lose GSP relief and incur full duty.

If we took no action this would be a problem for stock sold in our Eire stores and through our German warehouse. The solution to this problem is to pre-allocate stock to our German warehouse and Eire stores at the point we contract for the goods. These goods would then pass through the UK *in transit* and in doing so, maintain their GSP status. We aim to have the systems in place to operate this solution by March 2019.

Although this solution addresses most of the potential cost, it requires an accurate prediction (on a line by line basis) of how much stock will be required in both Germany and Eire. Any over or under estimates in stock quantities would require a transfer of stock to or from our UK warehouse, and this stock would then lose GSP relief.

Currently Norway, Switzerland, Iceland, Lichtenstein and Turkey have agreements with the EU that allows stock transferred between these countries and the EU to maintain its GSP relief. There is a chance that the Government will agree a similar arrangement with the EU but we are not relying on any such agreement being reached.

(IV) STANDARDS AND GOODS REGULATION

There is a risk that goods sent from the UK may not be accepted as complying with EU standards after the UK leaves the EU.

We do not believe that this represents a risk to NEXT. The vast majority of our goods are independently tested and conform to EU (and hence to UK) standards. The test results we receive confirm that goods comply with EU standards and, given that they are generally provided by companies operating outside the UK, we can see no reason why our test results would not be acceptable to the EU.

There is no indication that the EU or UK intend to change relevant product regulation in the short term, so we see little medium term risk of non-compliance with either UK or EU standards. In the longer term there is a risk of divergence, though we are already used to complying with standards in many different territories and do not envisage that any divergence would create a significant additional workload.

The tests we undertake are done by independent companies accredited by the EU, many of whom are located outside of both the EU and UK. We can see no reason why the UK's departure from the EU would affect the validity of these companies' test results.

There are a very small number of products where UK standards are higher than EU standards (e.g. fire retardancy standards on children's nightwear). In these rare cases there is the possibility that the EU would no longer accept a test result which only stated that the items satisfied the (higher) UK standard. In such cases we will ensure that test reports state that items are compliant with both standards.

INDIRECT RISKS

(I) DEVALUATION OF STERLING

There is a risk of volatility in the value of the Pound and NEXT has covered all its Dollar currency requirements for the whole of 2019/20 at rates that are comparable to the exchange rate in the current year. In effect, we have insured the Company against cost price volatility as a result of the potential devaluation of the Pound. The corollary of this is that if the Pound significantly strengthens next year we will not reap any of the reward until the following year.

The following table sets out our Dollar costing rates for the current year along with the rates we have secured from next year:

$ Conversion rate	2018/19	2019/20	Var
H1	1.26	1.35	+7%
H2	1.32	1.32	0%
Full year	**1.29**	**1.33**	**+3%**

(II) DELAYS AT UK AND EU PORTS

There has been much talk of what may or may not happen at our ports if the UK were to leave the EU without a customs arrangement in place. It is not yet clear how well prepared HMRC systems, customs and other relevant personnel will be for the upcoming potential increase in workload and data capture.

We believe that this indirect risk of interruption to the smooth operation of our ports represents the biggest risk to our business from Brexit. The more information that can be provided by the Government on how they plan to manage *and* mitigate the increased workload would be helpful.

In our own sector there is no reason why goods should not flow with relatively little friction through customs from the EU, in the same way they currently come into the country from non-EU countries. The issue will be the preparedness of the UK authorities and UK businesses.

NEXT PLC COMMENT

Opportunity to Streamline Import Processes

It appears that most of the measures under discussion to ensure smooth operation of our ports post-Brexit are designed to perform the same procedures as currently undertaken for non-EU imports but in much greater volume.

It would be helpful to know if the Government are also considering changing some current customs practices, procedures and rules in such a way as to speed up the processing of in-bound traffic. The Government may consider the following measures that we believe would reduce the volume of work required at our ports and airports:

- Temporarily raising **import thresholds** for goods bought into the UK by small importers so that they avoid customs procedures
- Implement the kind of **self-assessment tax procedures** for customs tariffs and duties that mirror other UK taxes such as VAT. The Government trusts businesses to collect £125bn[8] of VAT through self-assessment, so it would seem reasonable to trust them also to collect £3.5bn[9] of Duty in the same way. We believe that this would push much of the administrative burden back from the points of entry to UK and do much to alleviate pressure on UK ports
- Extend temporary **Trusted Trader** (or Authorised Economic Operator) status to many more importers through a simplified and less burdensome application and certification process. This status allows certain checks on vehicles, drivers and customs classifications to take place inland or at a later date rather than at ports

The earlier that these or other measures are communicated to the business community the more likely they are to be successfully implemented.

[8] HM Revenue & Customs (Trade Statistics Unit), Value Added Tax Bulletin August 2018.
[9] HMRC Tax & NIC Receipts: information and analysis (August 2018).

SUMMARY

Departure from the EU without a free trade arrangement and managed transition period is **not** our preferred outcome. However, NEXT is well prepared for this eventuality and we have all the administrative, legal and IT framework in place to ensure that we are able to carry on running the business as we do now.

In terms of costs there would be some additional administrative costs but, in the scheme of the Group, these will be de minimis. We welcome the Government's decision to replicate GSP arrangements and, where possible, grandfather the EU's existing free trade agreements. These arrangements dramatically reduce the risk of higher duty costs for the business. There would, of course, be duties to pay on imports from the EU, however the net cost to the UK economy of these tariffs will entirely depend on what tariff rates the Government would adopt post a no-deal Brexit. Clarity on the Government's intentions on this issue would be very welcome.

We believe that the biggest risk to our business is the external risk of UK ports not coping with the additional volume of customs work they would be required to undertake if no changes are made to the UK's current procedures. As outlined above, we believe that it remains open to the Government to initiate changes in the way customs procedures operate and that such measures could eliminate much of the risk to our ports.

In conclusion, as long as:

- ports and customs procedures are well prepared for the change, and
- tariff rates are adjusted to ensure no net increase in duty costs to consumers

we believe we can manage the business to ensure no material cost increases or serious operational impediments.