ECSA
European Community Shipowners' Associations

Study on the economic effects of the current VAT rules for passenger transport (second interim report)

ECSA Comments
September 2014

INTRODUCTION AND EXECUTIVE SUMMARY

ECSA - Presentation
The European Community Shipowners' Associations (ECSA) is the European association representing the interests of the national shipowners' associations of the European Union and Norway. European shipowners control 40 % of the global merchant fleet and are active in goods and passenger transport in all shipping trades, including between EU Member States. The ECSA member-associations have European ferry and cruise companies amongst their member-companies and any change to the current VAT rules and practices would have a profound effect on the entire sector.

Ferry industry – A definition
A ferry is generally defined as a vessel used to transport passengers and/or vehicles across a body of water on a regular, frequent basis. The ferry sector is not uniform and ferries can range from small ships carrying passengers across a harbour or river in an urban setting, to large sea-going ships carrying passengers, cars, trucks and other heavy cargo across short or longer distances where overnight sleeping accommodations are required. It should be noted that ferries are not necessarily all passenger vessels or all cargo vessels but often a combination of both. This fact is particularly relevant in the discussions on VAT.

ECSA's contribution to the VAT review
ECSA fully understands the European Commission's wish to analyse and understand the rather complex VAT mechanisms currently applied in the European transport sector and will contribute in a positive way to the review. The current rules have matured and developed over decades in order specifically to ensure fair competition and a maximal level of service for passengers or in order to fulfil other policy goals of Member States or the European Commission.

Assumptions used in the second interim report questionable
The assumptions used to define the characteristics of the passenger transport markets may well have a large influence on the perception of distortions and subsequently on the need to consider modifications to the VAT system. In this respect, ECSA would question the Commission's assumption that all modes of transport are in direct competition with each other in the European Union. Here it is useful to distinguish between freight and passenger transport. For passengers the choice of sailing by ferry is dictated by geographical or at times comfort needs. Only a few ferry routes are in direct competition with road/train services, even fewer with air transport, and even here passengers make a conscious choice for one mode over the other based on a number

of criteria, where cost is only one factor amongst many others as the elasticity between ferry prices and road/train prices is extremely small. This fact is also recognized by the consultants in their second interim report for DG Taxud[1]. This does however not mean that an increased price, due to the introduction of VAT for intra-EU passenger transport, will not have any effects. A price increase of up to 25% will, without doubt, lead to a reduction in the demand for passenger transport by sea. Whether a shift to other transport modes will occur will depend on other considerations as indicated.

For freight transport by sea the situation is more straightforward. Indeed, numerous studies have been made over the past years on the effects of the introduction of strict sulphur rules for ferries in 2015 and ECSA would strongly encourage the consultants and DG TAXUD to read through their conclusions. These undeniably conclude that the new sulphur rules will impose a substantial increase in ferry costs which will lead to modal backshift of goods being transported by road.

Furthermore, ECSA disagrees with the Commission's assumption that the current taxation regime for intra-EU passenger transport (currently zero-rated) creates problems in terms of tax neutrality and distortion of competition. On the contrary, ECSA is convinced that it will be the application of a positive rate of VAT to passenger transport that will result in a significant distortion of competition, not only between the modes of transport but also between Member States, because of the absence of harmonised VAT rates in the EU.

VAT review should also deal with rules and rate harmonisation
Moreover, ECSA wishes to stress that the current VAT treatment of intra EU passenger transport was introduced on the understanding that it would be reviewed when an agreement could be reached on the definitive arrangements for taxing trade between Member States (vide Articles 393 and 402 Directive EC/112/2006).

VAT rates can also serve other public policy goals
In addition, ECSA would like to draw attention to the fact that ferry services – being very often of highest importance for the existence of local communities on islands, etc – have a strong public interest and play an important role in ensuring the economic, social and territorial cohesion of the EU as well as assisting the free movement of citizens. This specific situation – in ECSA's opinion – fully justifies the current VAT arrangements.

Financial situation of the ferry sector very difficult
Finally, ferry operations in Europe have suffered severe losses over the last years due to the economic and financial crisis. Economic recovery in the EU is very weak and uncertain, leading to only slightly improving demand for ferry transport by shippers and passengers. In addition, as previously indicated, the new sulphur rules have already led to the closure of some routes which had become unprofitable. The impact of a fundamental change in the application of VAT would be yet another blow to the sector, which would have severe consequences both socially and economically.

[1] Study on the economic effects of the current VAT rules for passenger transport, Second Interim report – revised, TAXUD/2012/DE/334, page 71.

DETAILED ANALYSIS OF / COMMENTARY ON THE STUDY PREPARED BY THE CONSULTANTS FOR DG TAXUD

This part of the ECSA paper contains a detailed analysis of, and a commentary on, the findings / conclusions put forward by the consultants in their second interim report. Detailed comments on the various scenarios are included in the table overview that is attached to this paper.

1. **Lack of data**

For the ferry sector, ECSA deplores the general lack of data in the consultants' report. It is stressed repeatedly throughout the report that the consultants have found it easier to compare bus/rail and air transport. This is reflected in all the analyses and tables included therein. Unfortunately, this also means that very little of the report is applicable to the ferry sector. Indeed, as highlighted on page 12 "*no consistent readily available datasets*" were found for water based transport and ferries are not included in a single table of chapter 2 Passenger transport demand and supply.

ECSA has consistently attempted to meet with the consultants, has provided quantitative analysis prepared by external auditors and generally aimed to be as transparent as possible. Although the consultants had not themselves taken the initiative to make contact with ECSA (ECSA had responded to the Commission's Green Paper "on the future of VAT – Towards a simpler, more robust and efficient VAT system" (SEC(2010) 1455 final)), ECSA contacted them as soon as the organisation was made aware of this exercise.

It is not surprising therefore that the lack of industry consultation is clearly reflected in the second interim report and ECSA therefore largely questions the validity of its conclusions for the ferry sector and passenger transportation by sea. Moreover, ECSA would like to make it clear that for that reason alone this report can by no means be considered as a proper basis for further regulatory action.

2. **Alleged distortions**

In principle, ECSA supports the need to address distortions of competition but underlines that the report actually addresses different markets. In this respect, it should be noted that different situations in terms of VAT, both between modes of transport and between domestic, intra-EU and international passenger transport do not necessarily constitute distortions of competition. As highlighted on page 40 of the consultants' report (using the bus/rail/air example but ignoring ferries), one of the main competition factors are the travel times and modes are only effectively competing when their travel times are comparable, which rules out competition on a high proportion of routes. **It is therefore surprising to read that distortion of competition between modes is an issue at EU level.**

Moreover, the report acknowledges that distortions of competition can also be the result of policy objectives to encourage transport in one market rather than another. Finally, the report acknowledges that most of the distortions are

either theoretical or low and in ECSA's view this does not justify any action which would cause serious unintended detrimental consequences.

ECSA strongly disagrees with the assumption that the current VAT regime creates a distortion of competition between the various transport modes or between intra-EU and international transport (i.e. transport between the EU and non-EU countries). All Member States currently apply a zero-rate VAT to intra-EU and international passenger transportation by sea and air, as indicated in the report (vide Table 3.5). Moreover the vast majority of Member States also apply a zero rate to intra-EU and international passenger transport by rail or road.

The following example of a voyage between France and the UK – where the 4 modes are in use – illustrates the current situation:

- *Sea transport* – A ferry trip from/to the UK to/from the continent is zero rated.
- *Air transport* – Air fares from/to the UK to/from the continent are zero rated.
- *Rail transport* – Eurostar and Eurotunnel tickets from/to the UK to/from the continent are zero rated.
- *Road transport* – A coach trip to/from the UK to/from the continent is zero rated and will benefit from the ferry zero rating the fares.

It therefore follows that economic distortions between different modes of transport in the passenger transport sector do not exist as a result of the current VAT regime.

ECSA underlines that the overall assessment of whether there is any distortion of competition between the various modes of transport must be holistic: it is necessary to take into account other important factors as well, such as the uneven distribution of State subsidies and grants that provide benefits to the rail sector in particular, or the differences in VAT rates applied - for example in the hotel sector - between one country and another which are not seen as creating a distortion of competition. Furthermore, the list of other taxes and users charges applicable in the various modes of transport provided in Chapter 3 is incomplete[2]. It therefore fails to address the advantages / benefits and does not provide the wider picture.

ECSA firmly believes that the current VAT system has no advantages or disadvantages for sea transport when compared to other modes of transport and hence disagrees with the view that there is distortion of competition amongst modes of transport.

On the contrary, ECSA believes that it is the application of VAT to passenger transport that would result in distortions of competition, not only between the modes of transport but also between routes and Member States, because of the absence of harmonised VAT rates in the EU. This argument will apply to most of the scenarios put forward in the study.

[2] See our comments in section 4 of this paper.

At the same time it should be noted that the second interim report does not take into account any new distortions (non existing today) that would be introduced by the application of the new rules proposed in scenarios presented by the consultants. This point will also be further elaborated in Chapter 5 and in the attached table overview.

3. ECSA comments on Chapter 3 – Passenger transport demand and supply in the EU

As mentioned earlier, as data on ferry operations are not included in this chapter of the report ECSA will make some general remarks on some of the assumptions made by the consultants.

Footnote 9 (page 30) shows a fundamental misunderstanding of the ferry sector – which cannot be likened to bus travel. Not only are passengers in cars a significant component of the ferry market but so are foot passengers and even cyclists and these should by no means be excluded from the analysis. In fact, the ability for travellers to board a ferry with their car or other means of transport and then to pursue their journey that way at the destination, is an important reason why some chose maritime transport over land or air transport.

In Chapter 2 B (The European passenger transport market from the operators' perspective), it is stated that intra-EU transport markets tend to be oligopolistic and that EU transport policies have made slow progress to address this tendency in the ferry sector. ECSA disagrees with this statement, which appears to be a gross over-simplification of the facts. In Europe, the ferry sector is very diverse. For example, the extreme competition existing between ferry services in the English Channel has led to (public) companies going bankrupt. It is true that in other parts of Europe some ferry routes are operated solely by one company but this is due to the simple rule of supply and demand. Establishing a ferry operation is not easy and is financially burdensome. It demands massive investments in infrastructure at sea and on shore and unlike rail, this infrastructure has not historically been provided by the state.

It is also worth underlining that on page 42, the report highlights that: "*The passenger ferry markets for domestic, intra-EU and extra-EU routes are very competitive. A recent assessment of ferry routes in the three main ferry regions – the Mediterranean, the English Channel/North Sea and the Baltic identified more than 20 ferry operators, and there are possibly at least as many covering services to the Greek and Balearic Islands.*" ECSA fully agrees with this statement, but it does appear to contradict the previous statement regarding oligopolistic structures.

On page 28, the report highlights that the costs of fixed infrastructure is higher for network-based modes such as rail and metro, but this ignores the fact that often this infrastructure is state built, the costs of which are not charged or only partially to the user.

ECSA is also concerned with the fact that on page 29 of the report, it is concluded that: "*the passenger transport market in the EU Member States is not sufficiently* *homogenous to permit a single profile to describe the demand or supply of transport services or to address sensitivity to price changes (Task 1), the impacts of VAT exemption or reduced rates, market distortions arising from policy differences between modes, the presences of powerful incumbents or alliances or of some operators being established or supplying services in different member states (Task 3).*" ECSA believes that significantly more analysis is needed before any conclusions can be taken seriously.

Again, on the measurement of transport capacity, the consultants choose to work with a model which does not encompass ferries. ECSA fails to understand the relevance of using one single measurement method for all modes of transport.

4. ECSA comments on Chapter 4 – VAT regime for maritime transport

ECSA has some difficulty in understanding the purpose of chapter 4.B or the point it is trying to make but has the impression that it relates to scenario 9. However, if that is the case, ECSA draws attention to the fact that the report has significant shortcomings. Firstly, the general list of taxes imposed (table 3.7) should be clarified and completed, as it fails to acknowledge the existence of many charges relevant for shipping:

- Insurance taxes (premiums?) and registration fees, listed for road transport, also apply in shipping.
- Port charges are applicable in non TEN-T core networks ports ; we do not understand why the table limits its "analysis" to core network ports.
- The same comments also goes for locks and bridges.
- In addition to port charges, ship operators are subject to taxes based on the ship's size, volume of cargo and number of passengers carried.
- All port services give rise to fees, regardless of whether or not the ship has actually used the service: pilotage, towage, mooring, reception facilities, cargo handling...).
- Ship operators also pay for the use of shore side electricity, if available.
- In France, there are also (small) taxes which fund port associations, the national society for maritime safety and the seamen's club.

Secondly, table 3.8 should be amended as regards *France*, as two taxes applicable to the overseas territories are missing, notably the tax on passengers[3], and the tax on maritime journeys to protected natural sites[4].

5. ECSA comments on the proposed VAT reform scenarios

Under this heading, ECSA will look at the individual scenarios brought forward by the consultants on the basis of a number of criteria. From this it will become clear that significant problems would arise from most – if not all – of them, in particular in terms of compliance costs and administrative burdens. Indeed, disproportionate administrative complications will arise under all scenarios without VAT rate harmonization. Furthermore, establishing the different output tax liabilities for a journey

[3] loi n° 2006-1771 du 30 décembre 2006, art. 117 ;
[4] Loi n° 2002-276 du 27/02/2002 relative à la démocratie de proximité, art166

crossing different territories and/or international waters will be extremely difficult and high investment costs to update IT systems will be required at a time when investments are required for adapting the fleet to environmental challenges. Also, establishing compliant VAT invoices/receipts with several VAT rates from different Member States will be extremely difficult, particularly for SMEs. More generally compliance issues (invoices/receipts, EC sales list requirements…) will become even more complex.

Moreover, companies will need multiple VAT registrations (particularly complicated for the coach industry in relation to the number of countries they cross and the small size of the operators).

Finally, ECSA believes that some of the policy scenarios put forward could conflict with the taxing jurisdictions of Contracting States to UNCLOS, particularly in relation to high seas transit.

A detailed analysis and commentary on the 11 individual scenarios is included in the table overview attached to this paper.

6. <u>Analytical tools for evaluating the VAT reform scenarios</u>

The consultants' report relies on three models, notably TREMOVE, EDIT and CPM and all three models rely on the same set of assumptions. However, there are some serious shortcomings in the underlying assumptions that need to be addressed, in particular as regards GDP projection and oil price projection.

a. GDP projection

The GDP projections follow the baseline scenario of the 2009 Ageing Report. Based on that the report estimates that the GDP growth in the EU28 will be around 2.2% for in the decade 2010-2020. That level of growth is comparable to the growth experienced in the 1990's. This approach fails to take into account the economic growth experienced in the 2000's, where the European countries grew at historically very high rates. However, after taking into account the bounce back in growth rates in 2010 and 2011 the EU28 countries have once again descended into a deep, structural, economic crisis. Therefore, if the EU28 countries are to experience an average growth rate of 2.2% pa. for 2010-2020, the annual growth rate will have to exceed 2.2% by quite a large margin to offset the slow start to the decade. Although more preferable, that is a very unlikely scenario, which in turn will overestimate the positive effects of GDP growth on trade by sea in the three models.

b. Oil price projection

The report follows the IEA oil price projections, which state that the oil price is expected to rise from $59 in 2005 to $106 in 2030. However, at the present time, (July 2014) Brent oil is trading at around $110. Earlier this summer the price touched $115 due to the war in Iraq. Needless to say, oil price is very volatile and by its very nature, finite.

As the world economy grows so will the need for oil, pushing the price higher. As such, a 2030 oil price projection of $106 is remarkably low and more realistic parameters should be employed in the models before using the results to determine VAT rule changes. Moreover, with new sulphur rules applicable regionally from 2015 and globally from 2020/2025, the demand for refined oil products is likely to grow exponentially, leading to higher prices not only for maritime transport but for all transport modes. Already nowadays the price for low sulphur fuel is some 40% higher than that of the most frequently used bunker fuel. The price differential is expected to increase even further due to the increased demand as of 1 January 2015 and as of 1 January 2020.

The two assumptions mentioned here are critical to the three models. ECSA believes that the consultants base their findings on very optimistic values for these parameters and that this will lead to a result that overestimates the ability of the ferry sector to absorb the results of most of the tabled scenarios and the negative effects of the proposed VAT changes.

c. Passenger activity growth

It should also be noted that the consultants' report does not include any estimates on maritime passengers' expected growth, which ECSA considers unfortunate.

CONCLUSIONS

ECSA considers that the second interim report contains important flaws on various aspects and in particular as regards the 11 scenarios.

First of all, these scenarios aim at addressing the assumption that there is currently a relevant distortion of competition as a result of the current taxation regime for passenger transport. As explained above (as well as in previous ECSA submissions), there are currently no distortions of competition amongst modes of transport. On the contrary, ECSA firmly believes that an application of VAT to passenger transport will create distortions of competition, not only between the modes of transport but also between domestic, intra-EU and international passenger transport.

Secondly, all 11 scenarios fail to take into account all relevant criteria to assess the current situation and to make projections for the future and hence do not provide a full and accurate picture. Criteria that the second interim report does not cover include, *inter alia*, environment, safety, social and legal issues and particularly compliance costs and additional administrative burdens linked to the nature of international shipping and/or fairness.

When analysing the individual scenarios, ECSA had serious difficulties in understanding several of them, both in terms of content and objectives. Hence, ECSA had to seek clarifications from the consultants. However, even after having received these clarifications and/or additional information, ECSA still failed to understand some of them.

ECSA notes that the consultants' report itself has acknowledged that most of the distortions are either theoretical and/or low and believes this finding indicates that taking any regulatory action on that basis is flawed. In addition, the lack of relevant data on maritime transport included in the report has not allowed the consultants to have a comprehensive understanding of the intricacies of the European ferry sector. It is clear that any change to the current situation will have significant unintended detrimental consequences.

Finally, ECSA refers to scenario 11, i.e. an extension of zero-rate for intra-EU and international passenger transport to all modes of transport, including rail and road transport and is of the view that if this scenario would be pursued, it would be the ECSA's preferred option based on the information it has up to now. Indeed, this scenario would consolidate some of regulations without disturbing the fragile economic balance of the ferry industry

ECSA looks forward to further constructive discussions with the consultants and DG TAXUD so that the current methodological flaws can be properly addressed, and the report can promote valid scenarios for the future.

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