



How illicit trade benefits tobacco industry?

LUK JOOSSENS

Helsinki, 26 August 2014

“The tobacco industry is complicit in illegal trade. Smuggling is one of its business strategies.”

Dr. Margaret Chan, DG WHO, Abu Dhabi, 18 March 2015.

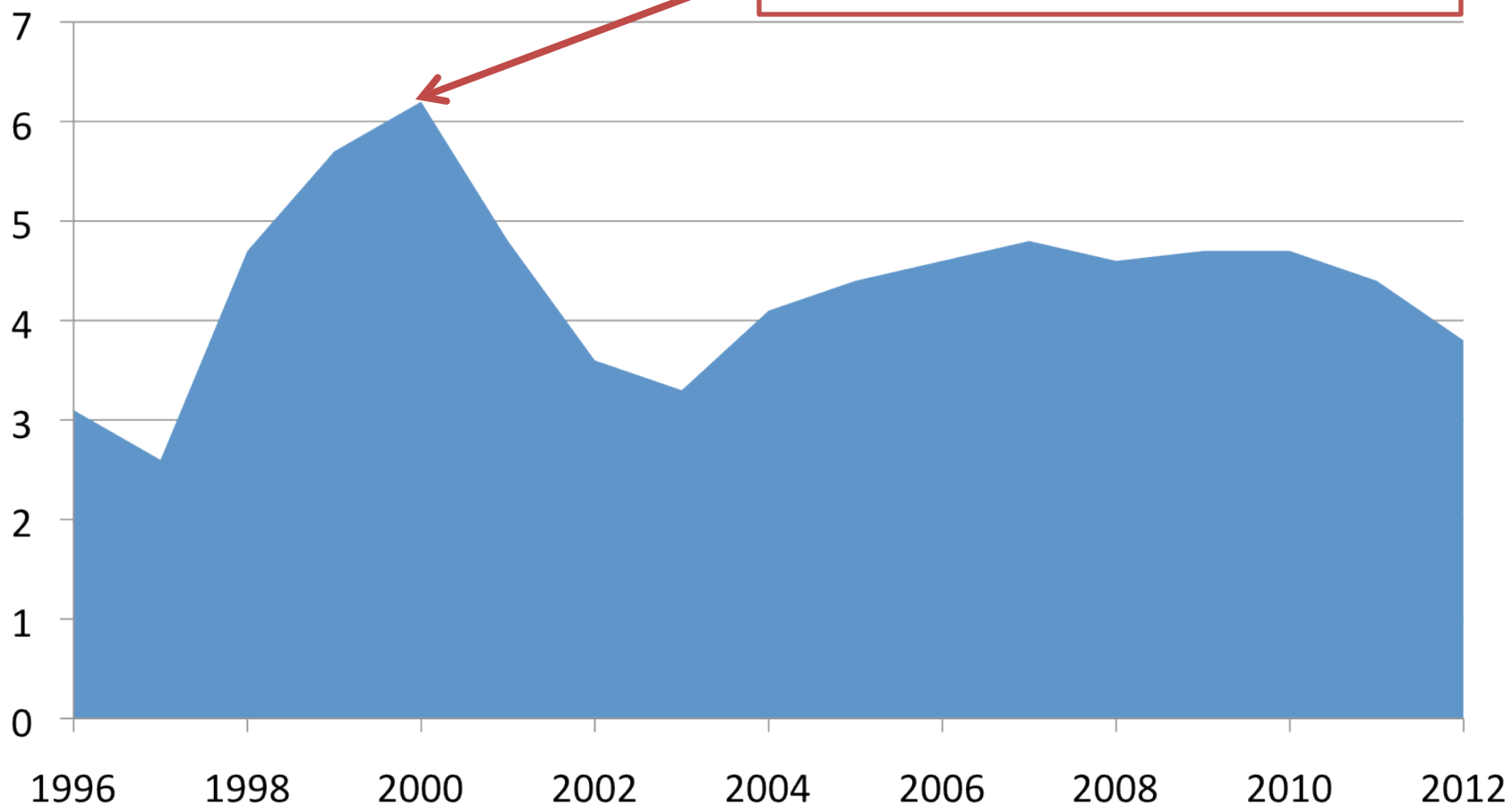


Lack of reliable data

- Growing evidence that industry sponsored estimates are too high.
- **KPMG Project Star data** cannot be used :
Report commissioned to meet specific terms of reference only known to Philip Morris International and KPMG
- **Seizure data** cannot be used to estimate illicit trade levels: however, they can indicate trends in illicit trade

Billions of cigarettes seized in the EU

EU sues tobacco companies



Three types of illicit cigarettes

- Illicit well known cigarette brands
- Illicit new cigarette brands mainly destined for the illegal market
- Illicit manufactured cigarette brands (including counterfeit cigarettes)

Illicit whites

Brands manufactured legitimately in one market, either taxed for local consumption or untaxed for export, and sold knowingly to traders who transport them to another country where the products are sold illegally without domestic duty paid.

(European commission, 2011)

The tobacco industry

- 50 years of experience in organising smuggling.
- More than 3 billion USD in payments and fines in EU and Canada to settle five smuggling lawsuits.
- Lawsuit against RJ Reynolds on smuggling charges involving Colombian and Russian crime syndicates.
- An investigation on the role of smuggling of JTI is ongoing since 2011.

BAT internal Documents in Asia

“BAT documents demonstrate the strategic importance of smuggling across global, regional, national, and local levels. Particularly important in Asia, contraband enabled access to closed markets, created pressure for market opening, and was highly profitable.”

Source: Collin J and al, Tobacco control, 2004.



BAT volumes down due to anti-smuggling measures

BY LAURENCE RIDGWAY

BRITISH AMERICAN TOBACCO surprised

shortfall by the end of 2003, when volumes should have

the German Federal Republic's **Reemtsma**, which, almost overnight, became an international company by acquiring, first, one of the German Democratic Republic's factories, and then, in rapid succession, two in Ukraine, one in Poland, and those of the state monopolies in Slovakia and Slovenia. Reemtsma became a significant force in Ukraine, producing at its Kiev and

leader, for many years holding 80% of the market. However, in recent years, with Gallaher leading, a mere two or three percentage points separated the two companies, which both ranked among the FTSE 100 top-quoted companies in the UK.

Ironically, it was the UK Chancellor of the Exchequer, Gordon Brown, and Customs and Excise who were partly responsible for Imperial's success

Illicit sales are thought to account for about 16%-24% of the 800 bn cigarettes BAT sells annually (in 2001)

...tobacco manufacturers have been accused in numerous media reports in recent years of not doing enough to stamp out smuggling, or even, on occasion, of having aided and abetted contraband trading.

BAT said that it would apply even more stringent criteria for the supply of trade customers, especially in the area of duty-free sales. It would carefully gauge the appropriate sales volume for each of its markets and refuse to oversupply, and, by these means, it was hoped that customers would not be able to do business with smugglers. "We are doing all we can to discourage a practice that is out of our hands," said a spokesman for the company.



Mr Broughton: Confident of the group's ability to progress.

September 30, 2001, BAT reported operating profits (before exceptional items) up 8% at £2,084m, pre-tax profits up 25% at £1,025m, and earnings per share increased by 8% to 45.76p. Looking to the future, chairman, Martin Broughton, commented that the board was confident of the group's ability to progress in bad times and in good.

TEN YEARS AGO, the biggest sale of tobacco factories in the history of the industry was in progress. Following the collapse of the Soviet Union and its neighbouring Comecon empire in Eastern and South-eastern Europe, state monopoly factories from the Baltic states and St Petersburg in the north, to Tashkent and Ljubljana in the south came up for sale. Western tobacco manufacturers, cheque books in hand, descended on them, and, within two or three

DM170m in the Cherkassy factory, but some of its equipment will now go to the Kiev plant.

Meanwhile, Reemtsma is still considering its future: whether to sell, seek a merger, or apply for a listing. A listing would probably produce less than the €5bn the company is thought likely to get from a takeover. As the world's fourth largest tobacco manufacturer, particularly strong in Central and Eastern Europe, Reemtsma could be attractive to several international rivals, among them Gallaher, **Japan Tobacco**, **Imperial Tobacco** and **Altadis**. Based on recent tobacco takeovers, Reemtsma would expect to fetch 11-12 times historical earnings, before interest, tax, depreciation and amortisation.

LAST YEAR, in its centenary year, **Imperial Tobacco** overtook **Gallaher** to become the number one tobacco manufacturer in the UK, the position Gallaher had snatched

goods overall.

Imperial's increased cigarette market share, currently 41.4%, came to light in the company's annual report for the year ending September 29, 2001, which highlighted the sustained record of growth that the company has maintained since its demerger from the **Hanson** conglomerate five years ago. Its core strategy of organic and acquisition-led expansion, underpinned by an efficient manufacturing base, has enabled it to deliver a compound growth in earnings per share of 15% over the five years. During 2001, turnover rose 13% to £5,918m against that of the previous year, generating profit increased by 8% to £604m and pre-tax profit by 10% to £484m. UK operating profit was down by 1% to £235m but international operating profits soared by 21% to £278m.

Imperial's shares, which have been buoyant on a falling London stock market, fell 5% to 553p after the report, largely as a

Price fixing

“Perhaps the most extraordinary documents shows the minutes of a meeting between managers from BAT and Philip Morris. (...) The minutes reveal that the executives discussed fixing prices in several Latin American countries, in both the legal and the “DNP” market. DNP stands for duty not paid-ie, smuggled.

Source: The Economist, 7 July 2001.

Disappearing containers

Containers often disappear in “free zones”. Goods introduced in a free zone are generally not subject to usual Customs controls. Due to the lack of control in some free zones, the goods may leave the zones unnoticed with a cover load.

Transit

The essence of transit is to allow temporary suspension of taxes on goods destined for a third country.

One BAT document on Transit Trade:

“Question: What is Transit Trade ?

Answer: Transit trade is the movement of goods from one country to another without payment of taxes and tariffs. It is more commonly known as smuggling.”

Transit

“With regard to the definition of transit it is essentially the illegal import of brands from Hong Kong, Singapore, Japan, etc. upon which no duty has been paid.”

BAT letter, 25 August 1989, 302000021

Incentives for RJR executives in Spain

In 1994 , the RJR defendants initiated a process by which their executives could receive massive bonuses if they met specified performance targets (in the illicit market in Spain). These bonuses could be as high as two or three million dollars to an executive who met certain targets.

Source : EU complaint, November 2000

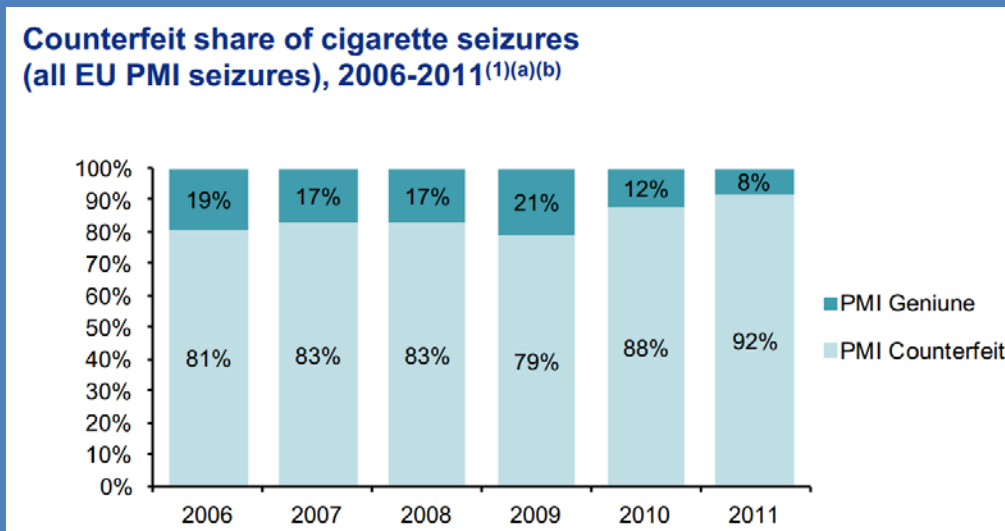
Agreements with the Four Major Tobacco Companies

- PMI, JTI suits dropped reached in return for an enforceable and legally binding agreement
- Cooperation agreements were concluded BAT and Imperial in 2010
- Key feature of these agreements are payments:
 - **Base payments** (fixed amounts paid over time)
 - **Seizure-based payments**



92% of PMI seizures in the EU are classified as counterfeit.

The industry has an incentive to classify seized cigarettes as counterfeit because no seizure payments are made when seized cigarettes are counterfeit.



Never in an independent lab

Since the first agreement came into effect in 2004 until 31 October 2013, the seized cigarettes have never been analysed by an independent laboratory and all determination has instead been based on Transnational Tobacco Companies' examinations.

JTI has recently been accused of Orchestrating Cigarette Smuggling

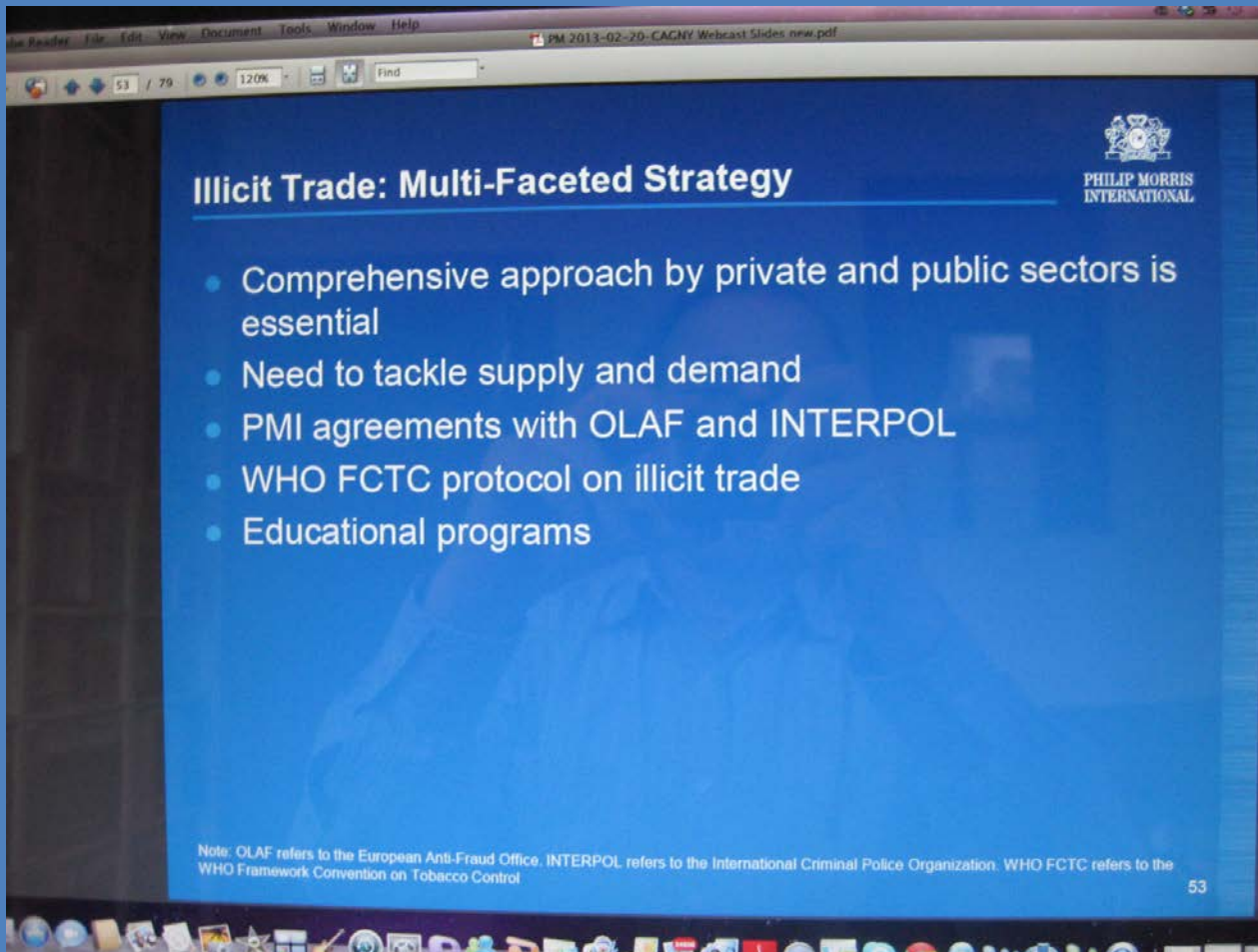
“A subsidiary of Japanese Tobacco Inc. has been accused of smuggling cigarettes from Cyprus into Syria in 2011. 450 000 cartons of cigarettes were allegedly sold to the brother of Syrian President Bashar al-Assad. OLAF is currently investigating these allegations.”

-Incident occurred after signing the agreements

The new strategy of the Industry towards illicit tobacco trade

- ◆ Provide alarming estimates on the size of the illicit trade
- ◆ Use the illicit trade argument to attack high taxes and tobacco regulation
- ◆ Promote agreements with governments
- ◆ Promote their track and trace standard “codentify”

The new strategy of the Industry towards illicit trade



The image shows a screenshot of a presentation slide displayed in a PDF viewer. The slide has a blue background with white text. At the top right, there is the Philip Morris International logo. The main title is 'Illicit Trade: Multi-Faceted Strategy'. Below the title is a bulleted list of five points. At the bottom left, there is a note explaining acronyms. At the bottom right, the number '53' is visible. The PDF viewer's interface is visible at the top and bottom of the slide.

PM 2013-02-20-CAGNY Webcast Slides new.pdf

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Illicit Trade: Multi-Faceted Strategy

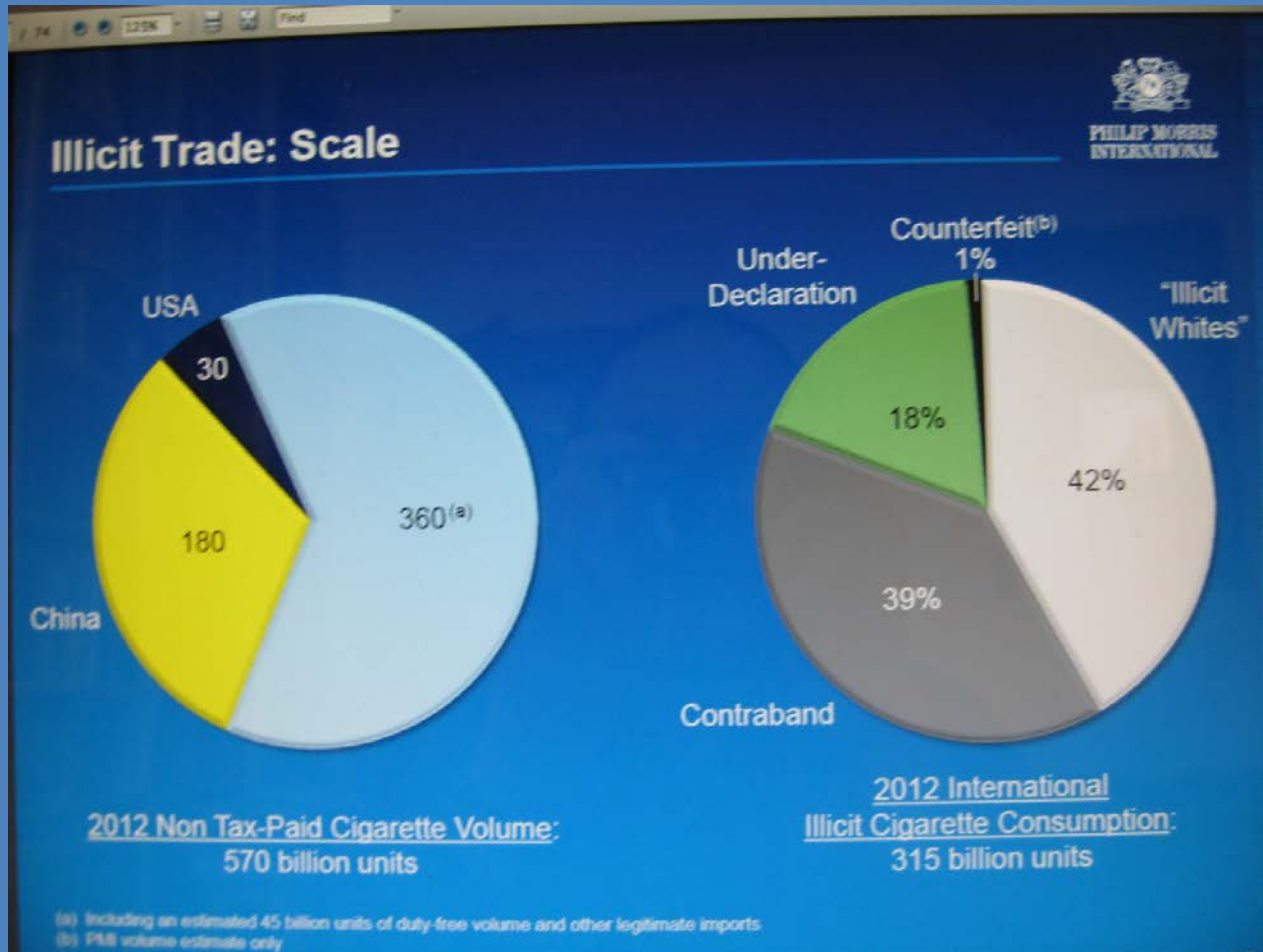
PHILIP MORRIS INTERNATIONAL

- Comprehensive approach by private and public sectors is essential
- Need to tackle supply and demand
- PMI agreements with OLAF and INTERPOL
- WHO FCTC protocol on illicit trade
- Educational programs

Note: OLAF refers to the European Anti-Fraud Office. INTERPOL refers to the International Criminal Police Organization. WHO FCTC refers to the WHO Framework Convention on Tobacco Control

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CEO PMI Calantzopoulos 20/11/2013 New York



Data on seizures in Europe from the World Customs Organisation in 2011

- Seizure of counterfeit cigarettes: 155 million.
- Seizure of regular brands: 1297 million.
- Seizure of illicit whites: 400 million.

According to the WCO, 9% of the seized regular brands were counterfeit and 91% genuine.

The Australian experience on counterfeits

Sir Cyril Chantler noted that in Australia “hardly any counterfeit standardized packages have been found to date.” Furthermore, a representative of one of the Australian tobacco manufacturers informed Sir Cyril’s team that his company had seen a reduction in counterfeit products following the introduction of standardized packaging in that country.

?

*Are high taxes the main
cause for smuggling?*

Cigarette smuggling in the UK 2000-2012

Year	Smuggled cigarettes %	Tobacco tax revenue	Price pack cigarettes £
2000	21%	£7.6 bn	3,88
2002	16%	£8.0 bn	4,39
2004	15%	£8.1 bn	4,65
2006	15%	£8.1 bn	5,05
2008	13%	£8.2 bn	5,44
2010	9%	£9.1 bn	6,13
2012	9%	£9.7 bn	7,09

**Source: HM Customs and
revenue.**

UK Government Tobacco Smuggling Strategy

- 2000:1) £209 million over three years,
2) 1000 more Customs officers / investigators,
3) Additional x-ray scanners,
4) tougher sanctions;
- 2006 supply chain legislation fines up to £5 million, focus on hand-rolled tobacco;
- 2008 Combined Revenue, Customs and Border Agency strategy with increased punishment and intelligence analysis.
- 2008/9 spend on strategy £100 million yearly

Legal price and illicit trade (2007)

World Bank income group	Average legal price per pack (US\$)	Illicit market share
Low income	1.13	16.8%
Middle income	1.89	11.8%
High income	4.91	9.8%

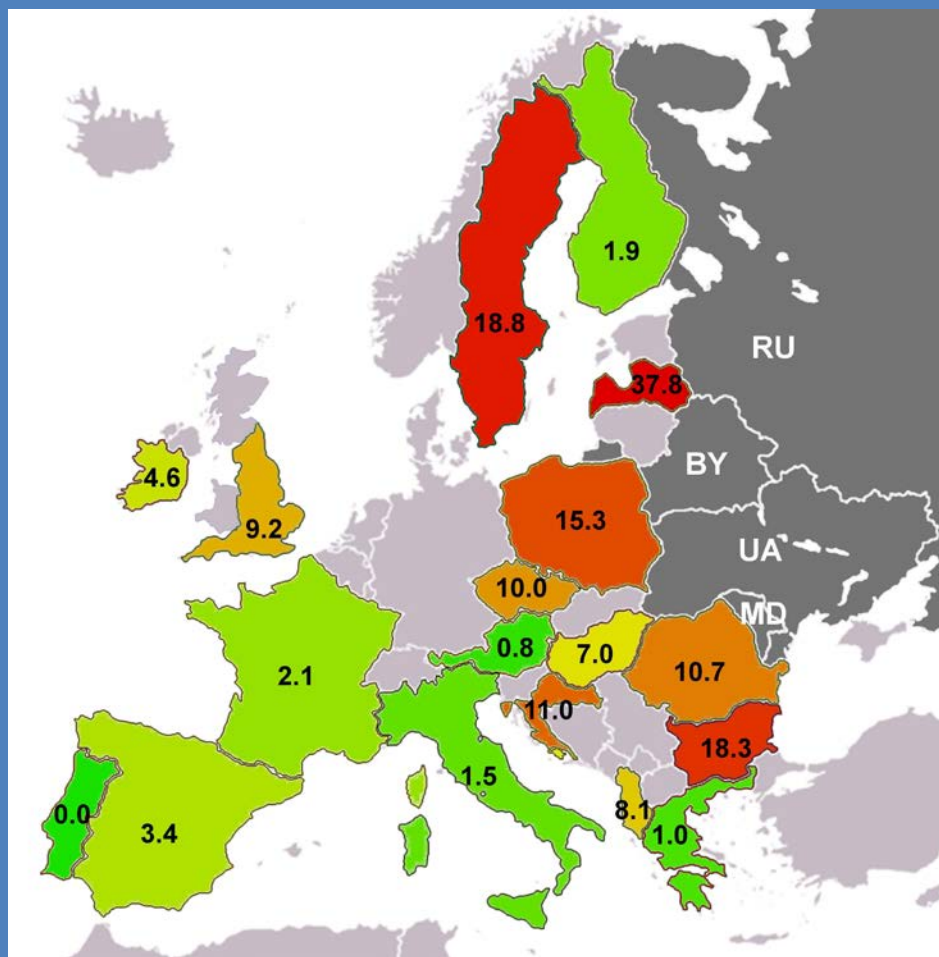
5 268 smokers in 18 countries were asked to show their tobacco pack in 2010

Illicit tobacco were defined as

- 1) it was bought from illicit sources, as reported by smokers,
- 2) it had an inappropriate tax stamp,
- 3) it had an inappropriate health warning,
- 4) its price was substantially below the known price in their market.

Source: Joossens L, Lugo A, La Vecchia C, Gilmore A, Clancy L, Gallus S, Tobacco control, 2013.

Illicit tobacco products in 18 European countries in 2010



Joossens L, Lugo A, La Vecchia C, Gilmore A, Clancy L, Gallus S, Tobacco control 2013

Illicit tobacco products in 18 European countries in 2010

The data show that illicit trade is not directly related to tobacco prices, but is more frequent in countries with a land or sea border with Ukraine, Russia, Moldova or Belarus.



Tax margin and illicit trade

A high tax margin may provide the initial incentive to tax evasion, but is only one of the many factors influencing illicit trade.

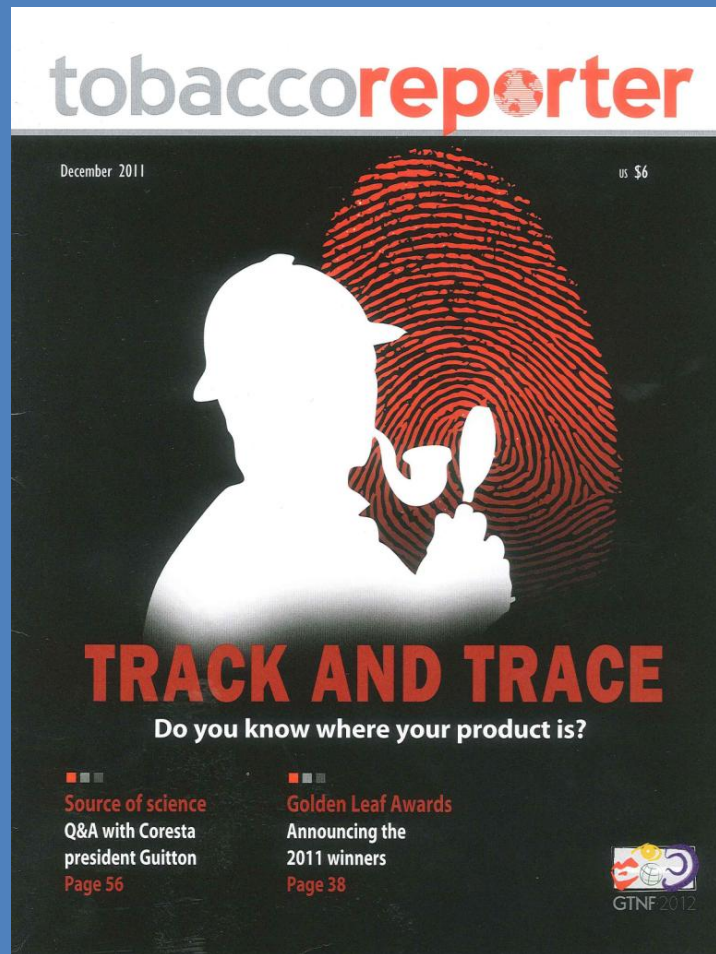
Levels of smuggling depend on...

- Ease and cost of smuggling tobacco in a country
- Presence and level of development of organized crime networks
- Likelihood of getting caught and prosecuted
- Punishment for convicted smugglers
- Presence of informal distribution networks
- Industry participation
- Level of corruption

Tracking and tracing

- Tracking and Tracing covers a wide variety of systems to determine the current and past locations of goods.
- In the coming years, both the EU and FCTC will take important decisions in relation to tracking and tracing systems.
- The tobacco industry is heavily promoting their system “codentify”.

An obligation of unique, secure and non-removable identification markings on all packages (packs, cartons, master cases)



The marking should provide info on

- (a) date and location of manufacture;
- (b) manufacturing facility;
- (c) machine used to manufacture
- (d) production shift or time of manufacture;
- (e) the name, invoice, order number and payment records of the first customer:

The marking should provide info on

- (f) the intended market ;
- (g) product description;
- (h) any warehousing and shipping;
- (i) any known subsequent purchaser
- (j) the intended shipment route

Data matrix codes on exported cigarettes In Brazil since 2011



Information Stored in the code:

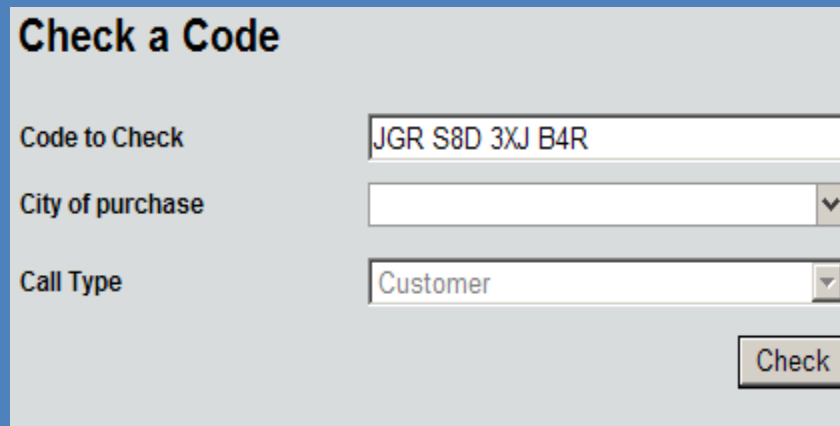
- Manufacturer
- Date/time of Production
- Production Line
- Brand
- Country of Destination

2D barcodes are a cost effective solution

- 2D bar codes have already been used on many consumer products, such as food, alcohol, pharmaceuticals and tobacco products.
- 2D bar codes are machine readable and can be implemented at high speed production lines
- 2D bar codes can be read by inexpensive readers (including smart phones)
- 2D bar codes can be supplied by multiple suppliers

The industry response

In 2011 BAT, JTI, PMI and ITL created the Digital Coding & Tracking Association. They claim to promote “cost effective industry standards for track & trace, called codentify”.



Check a Code

Code to Check

City of purchase

Call Type

DCTA-Lithuania Codentify agreement june 2014

In June 2014, DCTA signed an agreement with the Ministry of Finance of Lithuania to verify tobacco taxes. Article 6 stipulates that

“DCTA remains holder of any and all intellectual property rights in the Digital System and/or other technologies proprietary to DCTA. The Ministry of Finance of the Republic of Lithuania acknowledges that it will not acquire any such intellectual property rights.”

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Article 8

“8.2. Each Party shall establish, in accordance with this Article, a tracking and tracing system, **controlled by the Party** for all tobacco products”

8.12. Obligations assigned to a Party **shall not be performed by or delegated to the tobacco industry.**

8.13. Each Party shall ensure that its competent authorities, in participating in the tracking and tracing regime, **interact with the tobacco industry and those representing the interests of the tobacco industry only to the extent strictly necessary** in the implementation of this Article.”

Codentify

"The tobacco industry actively promotes its own technology solution, Codentify, which it claims complies with the Protocol. However, based on desktop research, it appears that this system does not meet the requirement of Article 8.2 that the tracking and tracing system has to be “controlled by the Party”.

FCTC secretariat, 17 October 2014.

Conclusion

The tobacco industry strategy on illicit trade has changed over the years, but illicit trade still serves their interests.