

Summary of Oral Evidence: 13th January 2013

Mr Austin Rowan, Adviser to the EU Office de Lute Anti-Fraude (OLAF), Task Group Cigarettes

Presentation

1. My name is Austin Rowan. I am an Adviser at the European Union Anti-Fraud Office [OLAF]. For the last four years, I've been head of the investigation unit in OLAF working on the illicit tobacco trade, and I led for the European Union during negotiations on the Illicit Trade Protocol. I came to join the European Commission in 1989 and prior to that I worked for the Republic of Ireland's Revenue, Customs and Excise service, where I ran a team fighting against excise fraud. Although I was based in Dublin, the majority of my work was on the border between Northern Ireland and the Republic where things were pretty active, to say the least.
2. OLAF is a Directorate General within the European Commission and our raison d'être is the protection of EU finances. When cigarettes or tobacco products are smuggled into the EU, there is obviously a loss of customs duties, which puts work in this area within our remit. The OLAF Director-General is totally independent in relation to our investigations and does not take instructions from the Commission, the European Parliament or anyone from the Member States.
3. I have seen smuggling, take place by just about every conceivable means, by large and small planes, by boat, by road. Just about the only thing we haven't seen is submarines. During the negotiations through the World Health Organisation on the Framework Convention on Tobacco Control, I was involved in negotiations for Article 15, which addresses illicit trade, and led to subsequent negotiations on the Illicit Trade Protocol.
4. In 1994 OLAF set up a task group cigarettes, to fight the illicit trade. At that time, we only had two member states with a really major problem: Spain and Italy, which were also, and this may be relevant to you, the two countries with the lowest tobacco taxes in the European Union. We now have 17 agents with 14 different nationalities. We coordinate criminal cases both in member states and third countries and we currently have 35 cases open. We also are responsible for the legally binding and enforceable agreements that EU and its Member States have with the big four tobacco manufacturers: PMI, JTI, BAT and ITL. We also provide funds to Member States through Hercule 2, an EU programme where we halve the cost of items like x-ray machines at ports and so on, and we are currently trying to increase this contribution to 80%.
5. We work closely with relevant agencies from the Member States, so for the United Kingdom we have our colleagues from HMRC, whereas for Portugal, for example, there are three agencies we deal with, Customs, Judicial Police and the Brigade Officiale, which is like a border agency. We do joint Customs operations with all the Member States. Examples of such Customs operations include Diablo, dealing with containers coming from China, and Sudan where, at the request of the United Kingdom HMRC, we addressed parcel post fraud, cigarettes being smuggled through the parcel post.

6. We have 40 mutual assistance agreements covering 54 countries outside the EU. For example, we have one with the USA, so we can send an investigation team to the US to work with the US colleagues and get evidence for court cases. This work has proved to be very effective, and has led to major successful prosecutions. We have one overseas liaison officer, placed in Kiev at the moment, and our plan is to have more, in China, probably the Middle East and Moscow. But, of course, we are, like everybody else, subject to budgetary constraints.
7. The figure for cigarettes that were seized in the European Union has been rather consistent over the years, but we are just beginning to see a decline. So in 2006 it was 4.58 billion cigarettes, and in 2011 4.39 billion. To give you some idea of the practical implications of this, each 40 foot container holds 10 million cigarettes. So if we divide 4.39 billion by 10 million, you actually get 439 x 40 foot containers. So, if you take it at that and say 440 x 40 foot containers, and assume that we may seize 5% or 10% of the illicit trade, a common Customs assumption for most forms of smuggling, you are looking at at least 4,000 x 40 foot containers being smuggled into the European Union. And this does not include what we call 'ant smuggling'; in other words, people going across the border, buying a few cartons and coming back without paying EU duty.
8. The financial gains, of course, for criminals are absolutely enormous and we estimate total tax revenue losses in the European Union at €10 billion per year. We estimate that the losses on a 40 foot container are approximately €2 million per container, and the figure for high tax jurisdictions such as the UK would be higher.
9. Counterfeit is a big problem, often sourced from China. It's now gone to about 50% but it's peaked at that. We also have the issue of cheap whites, where we have legal production in countries such as China but also inside the European Union or close to its borders. We think there are about 54 factories producing cheap whites inside in the European Union, the reason, of course, being that once you've produced the goods in the European Union, you don't have any Customs borders to pass. Cheap whites are generally known brands. If you want to order a container of brand ABC, you go to a manufacturer and you can have your own brand name on the product. The advantage for the criminals is that they're not dealing with counterfeit product so it cannot be seized in transit if a country has the powers to seize counterfeit goods. And if an item becomes too hot, they just change the brand name.
10. We know that – and we have received intelligence from our colleagues in HMRC –that there are about 17 cheap white factories in the United Arab Emirates at the moment. We also have a problem in Paraguay. Paraguay is a very small country and yet it has 36 factories producing seven days a week, 24/7. And the quantity they're producing is greater than that produced in Brazil which has 55 times the market many times that of Paraguay. So of course these factories are supplying the illicit trade in Brazil, Argentina, Uruguay and Chile, all the neighbouring countries. And when the authorities in Brazil or Argentina get a grip on this, then this trade is likely to be refocussed on the EU. We have already seen stuff coming from Paraguay on several occasions.
11. We also note that the principals in these activities, and I'm talking about the real money people, never commit a crime on their own territory. That makes it much more

difficult for them to be prosecuted, so even big enforcement operations often net drivers or others only one or two steps up the chain. It is very difficult to follow the money, even though this is the key. Banks in the Middle East are often used to launder money – the Bank of Lebanon is a good example. And we see, of course, connections with drug trafficking and other illicit trades because it's so lucrative.

12. In the United Kingdom the penalties for big smugglers are very strong, probably the strongest in the European Union. But there are some countries where the penalties are no more than a slap on the wrist. If you are caught smuggling large quantities of cigarettes into the European Union, compared to for example bulk smuggling of cocaine where you will go to jail for a long time, penalties may be very small, no more than a €10,000 fine, if it even is that.
13. At every conference I go on this issue, I hear people saying, "Oh we need more international cooperation". This is true, but difficult, for example because we are bound by legal restrictions. A real advantage of the Illicit Trade Protocol is that when it comes into force and assuming that most countries ratify it, then we will have inbuilt international cooperation. We have, of course, existing mutual assistance arrangements, but the Protocol will help them develop.
14. In relation to the Protocol negotiations, I want to put on record that the support from the United Kingdom during the negotiations was outstanding, particularly from HMRC, because we needed a strong push from some of the bigger EU Member States. Some other Member States were not particularly interested. We went to the negotiations and we spoke as the European Union, with one voice, and we got the Protocol.
15. The Protocol offers us greater control of the supply chain. It will also create a level playing field for not only the law enforcement agencies but also for the tobacco manufacturers so they will all be treated equally. They will all be obliged to do certain things. For example, take the provisions on licensing. In the UK, and basically throughout the EU, there is nowhere you can set up a legal factory without a licence or equivalent authority. But there are countries in the world where you can just set up a factory and there's no license required.
16. Due diligence – know your customer – is vital. In our investigations in 1994, everything led to Switzerland. All the companies were based in Switzerland, and banking secrecy made access to key information exceptionally difficult. In early 2000, we did get hold of documents in relation to one particular case. And what we noticed was, one individual who was buying from an American manufacturer. He had one small office, computer and a telephone. And his turnover was more than €500 million a year. He was just the broker of course, the honest face to the manufacturers and all the cigarettes were then distributed. Due diligence means that you must know your customer. If you want to set up business with a trader, a manufacturer, it will not be good enough, as in the old days, to do it over the telephone. They will have to produce a copy of their passport and the banking records, and the invoice must be done in the currency from one of the countries in the transaction. You will not be able to go through offshore islands and havens. And the record keeping requirements mean that enforcement authorities will be able to trace the progress of transactions and the movement of goods.

17. Internet sales will not be banned but they will be subject to all the conditions of the protocol. Now, I do not know how an internet trader, if he is going to sell to somebody in a country that is very far away, is going to carry out due diligence and tracking and tracing of the product, but that's their problem. And the same requirements will apply to free zones.
18. Free zones around the world are a major issue for us because many of them don't even have Customs control. Host country governments may like the zones because they produce employment but often all they want to see is that when goods come in, their final destination is outside their own territory. They do not really care what happens to them after that. I call free zones aircraft carriers for fraud. To give you an example: huge amounts of cigarettes come into the Emirates free zone. They are in a warehouse along with 100 boxes of T-shirts coming from China. So they put 900 boxes of cigarettes into a container and then just before they close the container, they put in 100 boxes of T-shirts. But when the Bill of Lading is prepared and sent off to, say, the European Union when it's coming in to Hamburg, the container is described as holding 1,000 boxes of T-shirts. And you might get maybe 500 containers of T-shirts coming in a day. I said to my colleagues in Antwerp once, when we had detected fraud coming in toys from China – they come in for Christmas in August - "look, could you not really concentrate on this?" They replied that in Antwerp alone, they got 350 containers of toys coming from China a day and the most they could scan is about 5.
19. Free zones will in future be subject to all the provisions of the Protocol including tracking and tracing, due diligence, and anti-money laundering provisions. The EU succeeded in getting agreement that it would be prohibited to export cigarettes and other tobacco products intermingled with other non-tobacco products. Brazil and Canada and other countries strongly supported the EU position and they even thought this was such a good idea, they said that intermingling of this kind should become a criminal offence. And it now is.
20. For us, tracking and tracing is perhaps the single most important provision of the Protocol.
21. The next picture shows a factory near Warsaw. We got a request from the German Customs Investigation Service to coordinate this investigation. We don't have powers of arrest, but when you have five or six different Member States involved, you need somebody to coordinate it, and this is the added value that we can provide. In this case the investigators noticed that the factory was bringing non-tobacco products, paraphernalia for the manufacture of cigarettes and also a lot of what was described as waste tobacco. We contacted all the various countries: Estonia, Latvia, Belgium, Lithuania; all the countries that were involved. We identified the particular criminal group, the main organisers and an illegal factory. The principal was based in Russia, and two of the technicians involved also, and the Russian authorities contacted us over a weekend and said, "These guys are moving." We were able to alert the Lithuanian authorities and the Polish authorities and the German authorities. Two of them flew to Latvia and then into Poland and the principal went as far as Germany and Hamburg. And by surveillance and so on, the factory was identified. The Polish Police went in in March 2011 and they found a lot of raw cut tobacco – which was high quality and not tobacco waste at all - and they also found 5 million Regal

cigarettes. Now, as you probably know, Regal cigarettes is a brand that would be used in the United Kingdom. So, almost certainly, this factory was supplying the United Kingdom. On the same day, the Lithuanian Customs seized three Ukrainian lorries carrying 34 tons of tobacco. Investigations revealed that so-called waste tobacco was being exported from Brazil, the destination was declared to be Armenia, but it was coming into Lithuania and from Lithuania, it was picked up by Ukrainian trucks and they were diverting it into illicit manufacture in Poland. The product was fine cut tobacco, in other words the content of cigarettes. So this fine cut tobacco was imported, diverted into the Polish factory covered by a quantity of tobacco waste. At the border, the external border from the EU on the east, before it goes to Armenia, they look inside the truck and they see only waste tobacco. So the transit is discharged. So, no fraud identified at the time.

22. But we could not track the money from the fraud - we had no mutual assistance agreement with Brazil. We looked at the Mutual Legal Assistance Treaties between the Member States to use one of them. Only one country in the EU has an MLAT with Brazil; the Netherlands. And we cannot ask a Dutch prosecutor to help us in relation to a case involving Lithuania, Germany, and other countries – but not the Netherlands. So, we have lost all this invaluable evidence. My colleagues in Brazil were big supporters of the Protocol, so we expect that when it comes into force, we will eliminate that particular problem. The picture of the factory shows sophisticated production equipment, kitchen facilities, televisions and the factory is self-contained - they even have their own generators. And there was a brand new packing machine, worth well over €1 million. It's a German machine. It was so new that the grease on it, on the parts, was yellow. It was still yellow; it hadn't turned black. But when we investigated to try and trace it, we found it was a counterfeit machine produced in China. The losses to the EU and the Member States per week would have been €6 million. And the whole operation probably cost them about €1.5 million to set up. So one week of business and you are in profit.
23. Another concealment method we found was large paper rolls. The value of these paper rolls is high. So if you start, as a Customs Officer, cutting these up, you'd better be right or you will have no career afterwards. But you cut it down and in the middle, of course, they have all the cigarettes concealed. Again, we're talking here about millions in lost revenue.
24. In the beginning of discussions over tracking and tracing, the big tobacco manufacturers only wanted tracking and tracing required on master cases. But we said, you can take goods out of a master case easily as well as cutting out the mark. We want marks down to the pack level. And that is what the Protocol requires.

Questions and Answers

25. **Q:** First of all, I would like to understand what agreements you have with the manufacturers and whether they actually pay towards helping catch the illegals? Secondly, on money I wonder about the relationship between the EU and some of the countries involved in illegal manufacture and shipping, many are countries which receive aid. Is the EU looking at that? Third, is the EU looking at how we can have something like the UK standard penalties throughout the Union? And finally, about

resources for you and your colleagues, and HMRC too, should we be making recommendations that you have more resources in order to catch more of this?

26. **A:** The EU agreements started out of litigation. The European Union and Member States - not including the United Kingdom - sued R J Reynolds and JTI and Philip Morris International in Eastern District New York. The agreements arose from that. We are still suing R J Reynolds and we're waiting for a decision from the Circuit Court as to how we proceed. We're alleging money laundering, and a lot of other very serious offences in relation to their activities. These are legally binding and enforceable agreements and the manufacturers cannot walk away from their obligations. They are obliged to do tracking and tracing. They are obliged to do due diligence, anti-money laundering provisions, everything that we wanted. They also have to make seizure payments so if, for example, a container of JTI product is seized they will pay the appropriate duties, the Customs duties, which come to the EU and the Member States. The agreements are working, and the level of diverted legitimate product from the major manufacturers has fallen sharply.
27. On money, we never see the money, because it's all done offshore and they don't keep records in it so even if you do a search of premises, you are not going to find the bank records. It is hard enough to get assistance in relation to banking in the European Union and you can imagine how difficult it is when you go outside the Union. Of course, the EU gives a lot of money to many of these countries but there is understandable reluctance to use this as a lever.
28. On penalties, it is a sovereign right of each Member State to impose whatever penalties they wish. But we do see the UK as a good example, where if you do wrong you pay the penalty and the appropriate sentences are given. And it is a real deterrent. The Commission is working on a Communication for an EU action plan on trade offences generally, and one of the things that we think should be put in is that there should be consistent penalties, equivalent penalties, right throughout the EU.
29. On resources, the Commission is getting staff cuts of 5% across the board. So we will actually have a 5% cut in staff which is difficult of course. We would have no problem with resources being given, subject to results being achieved. I know the UK have done this on several occasions and it's worked. They've got the extra resources but they've also delivered. And no-one can argue with that. So it would certainly be a very good recommendation.
30. **Q:** What is your view on the difference between counterfeit and other forms of illicit product? Presumably, some of the stuff that's coming from China is being made in the factories of worldwide tobacco companies and is to the detriment in the sense that it is the real product. Some of it also is counterfeit. Have you any feel for what the split between the two is?
31. **A:** Counterfeit products are products that are made without the authorisation of the manufacturer. A lot comes from China, produced in underground factories, awful conditions and so on. China is the biggest cigarette manufacturer in the world, by the way, and their legal industry is state controlled. So, it's very much in their interest that they fight counterfeit themselves. Counterfeit production also happens in Russia and the Ukraine. They bring in the acetate tow for the filters. They bring in the paper. They

bring in fine cut tobacco so the whole operation can be done very quickly. But that also is illicit trade. Then you have the smuggling of the genuine product and of the cheap whites which is genuine product, but with no legitimate market in the country where it is eventually sold. We estimate that for the EU, the proportion of illicit trade that is counterfeit is approximately 50%, and the rest then would be made up of genuine product, including, of course, the cheap whites.

32. **Q:** It would be true to say that if you could go after the manufacturers whose products are found to be part of the illicit trade that would be a way of addressing the issue?
33. **A:** Absolutely. If you've got a problem with flooding, you turn off the tap, instead of starting to plug the holes all along the pipe. That's why we sued certain manufacturers in the United States, to stop that.
34. But you're absolutely right. I mean, even in the European Union, in countries down near the Mediterranean, we have manufacturers. We have one manufacturer producing goods for export from his own particular member state with absolutely no genuine market whatsoever for that product in the world. It was going into places like Port Said, Mersin in Turkey and then was just flooding back into the EU. The Protocol helps with this because now manufacturers would be obliged to track and trace. They can't just say there's somebody who rings them up from Egypt. They'll have to do due diligence and so on.
35. **Q:** In terms of cooperation with other parts of the world, from what you say about Paraguay might not be that surprising. It's a fairly dysfunctional place. But some of the other countries that you've listed, in particular Singapore and the UAE wouldn't fall into that category; especially Singapore which you'd imagine to have one of the most controlling governments on the planet in terms of law enforcement and so on. Yet it's a problem there. Is that because the Singapore government is not signatories to the Protocol or doesn't take tobacco control seriously?
36. **A:** No-one has ratified the Protocol yet, and we hope that Singapore will. The problem with Singapore is all out of the free zone. The free zone gives a license to somebody to come in and carry out their business. Of course, it has to be a legal activity. You can't manufacture illegal drugs. Essentially, in very simple terms, if you bring 100% materials, at the end of the day, that 100% of materials is supposed to be exported from your free zone. Or if they go into home consumption, then you pay your duties. There's no Customs control, and cracking down on diversion of products into illicit channels might be against their business interests, employment creation policies and so on.
37. **Q:** Who has the power of initiation of the authorisations that you're involved in? Does OLAF undertake operations of its own initiative? Or is it always in cooperation or consultation with, or does the initiative, in fact, lie with the Member States' Customs authorities?
38. **A:** It can happen both ways. An initiative from us could be, for example, if we're getting information from the UK, we're getting information from Germany, maybe Greece or other countries and we have identified a pattern. We will call an ad hoc meeting of officials from those member states. We will discuss it and see if it is a case

39. **Q:** When you talked about the revenue loss on a 40 foot container, the figure you gave was the average loss of €2 million, but do you have a figure for the loss in the United Kingdom?
40. **A:** I'm sure my colleague from HMRC would be in a better position on that but I would say it would be up close to €3 million. In Ireland, which has the highest taxes in the EU, it's up to about €4 million.
41. **Q:** When I met with ITL they showed me a German box of cigarettes that was effectively doing tracking and tracing in terms of the markings on the outer packaging and on the individual packs themselves. Do you have a comment on that?
42. **A:** As the requirements of the agreements, the four agreements with the manufacturers, we're happy that all those requirements are met and we do actually visit them. We do look at tracking and tracing. But the Protocol is a new animal, as is the draft EU Tobacco Product Directive which also has tracking and tracing provisions. That has to be discussed with the Council and the European Parliament. At this point in time, the tracking and tracing systems that we have meet our requirements as per the agreements but we have to keep an open mind what's going to happen in relation to the Protocol and the Directive.
43. **Q:** Can you comment on your dealings with the tobacco manufacturers in the context of Article 5.3 of the Framework Convention.
44. **A:** Our agreements with the manufacturers were borne out of litigation in the United States. We agreed to move forward but on a legally binding and enforceable basis, the agreement. The industry has great resources in relation to the illicit trade and people all over the world. So, from that point of view, it would be irresponsible of us not to take intelligence when it is available. On the other hand, in relation to the agreements, if you read the agreements, they are strictly cooperation agreements in the fight against contraband and counterfeit products. They were negotiated by OLAF and by the legal service of the Commission. They had to get the approval of the College of the Commission. And that approval was given on the explicit understanding that these agreements are not to be used as a tool by the tobacco industry to come forward and, for example, influence the Commission in relation to price or any other policy. They must be strictly limited to illicit trade. And that is what we have done. I was involved in the negotiations of Article 5.3 of the FCTC which relates to contacts with the industry by government employees and so on. And we were able to get agreement that these agreements had merit in the fight against fraud and, therefore the guidelines to Article 5.3 allow for such legally binding and enforceable agreements in the illicit trade context only.
45. **Q:** A question about plain packaging and the impact that might have on illicit trade. We had an Assistant Chief Constable from Greater Manchester and a senior trading standards person saying that, in their opinion it would have no effect. I wondered if you could give any new perspective on that?

46. **A:** You have to remember the resources of these criminals. They're absolutely amazing. And not just in relation to the money, it also goes to the technology and so on. We know for a fact, and I have seen it for myself, that manufacturers sometimes are not easily able to tell themselves whether a product is counterfeit or not. They have to examine the silver paper and so forth. So the counterfeiters have reached a stage where they can copy any packaging. We have a situation in Ireland where there's a cigarette called John Player Blue, actually it is peculiar to Dublin. And they were bringing in a new pack of this John Player Blue. The Irish authorities were also bringing in a new revenue stamp, tax stamp, with the harp on it and so on. And the Irish authorities had a seizure of fake John Player Blue; a container coming into Ireland from China, of outstanding quality. So you had this fake John Player Blue, the new packaging and the new Irish tax stamp, just one week after it was introduced. And it had come from China which takes three weeks. So, they were produced even before the legitimate product hit the Irish market. So, for me, plain packaging ...well, what difference will it make? My understanding of plain packaging is, this is just a personal view, is that it's not actually blank packaging - there will be a huge amount of let's say, health warnings and also covert/overt security measures on it.