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19 December 2012

Stephen Williams MP
Chair
All Party Parliamentary Group on Smoking & Health
House of Commons
London
SW1A 0AA

Dear Stephen,

TMA response to the APPG on Smoking & Health: Inquiry into the illicit trade in tobacco products and the implications of the Illicit Trade Protocol

Further to my letter of 9 November 2012, I enclose the TMA's written submission to the APPG inquiry. The TMA represents the interests of its member companies (British American Tobacco, Gallaher Ltd which is a member of the JTI Group of companies and Imperial Tobacco Ltd) in the UK.

The TMA and its member companies are totally opposed to illicit trade and are committed to working with governments and authorities around the world to tackle tobacco smuggling and counterfeiting.

The illicit trade in tobacco products has been a serious problem for the UK for almost 20 years, one brought about by high levels of taxation in this country. Advice given to the then Chancellor in 1999 following an independent evaluation of the problem of tobacco smuggling by Martin Taylor, on which the Government's *Tackling Tobacco Smuggling*

strategy was largely based, makes this clear. The report¹ states; “The principal cause of the smuggling, of course, is the high level of duty in the UK”.

The tobacco industry is an important contributor to the UK economy, directly and indirectly supporting over 70,000 jobs, as well as delivering over £12 billion to HM Treasury in excise and VAT in 2011/12 alone. However, latest Government estimates show that up to £2.9 billion was lost in 2010/11² to the illicit market and this has wide implications for the manufacturers, wholesalers, retailers and many others in the supply chain, as well as the impact that illicit trade has on society as a whole.

We note from your letter that the inquiry intends to examine the impact of the illicit trade protocol and technological developments such as Codentify®. We have addressed these issues in our response and also sought to provide clarification on issues such as the perceived scale of the problem in the UK at this present time.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Jane Ashford', written in a cursive style.

¹ http://www.hm-treasury.gov.uk/foi_240712.htm

² <http://www.hmrc.gov.uk/stats/measuring-tax-gaps.htm>

1. The Scale of the UK Problem

1.1. HMRC estimates

The illicit trade in tobacco products deprives HM Treasury of £ billions in tax revenues per annum. Latest HMRC estimates put the figure at between £820 million - £2.9 billion in 2010/11. In terms of actual consumption, between 2-16% of cigarettes and 33-44% of hand rolling is estimated by HMRC to be illicit.

Level of illicit:

	Cigarettes			Hand rolling tobacco		
	Lower	Mid	Upper	Lower	Mid	Upper
2007/8	8%	14%	19%	45%	50%	55%
2008/9	7%	13%	19%	46%	50%	54%
2009/10	6%	11%	17%	37%	42%	47%
2010/11	2%	9%	16%	33%	38%	44%

Source: HMRC Measuring Tax Gaps Report 2012

Level of crossborder shopping:

	Cigarettes	Hand rolling tobacco		
		Lower	Mid	Upper
2007/8	6%	10%	9%	7%
2008/9	5%	10%	9%	7%
2009/10	3%	8%	7%	6%
2010/11	3%	8%	7%	6%

Source: HMRC Measuring Tax Gaps Report 2012

Note: When combining the smuggling and crossborder shopping estimates of Hand rolling Tobacco the methodology states that the lower value of smuggling is 'linked' to the higher value of crossborder shopping and vice versa.

Whilst the level of non-UK duty paid hand rolling tobacco is proportionately greater than the non-UK duty paid cigarette market, due to the comparative size and value of the cigarette market, the tax gap from illicit and crossborder shopped product is significantly higher.

Revenue loss from illicit (£ million)

2010/11	Lower	Mid	Upper
Cigarettes	300	1,200	2,100
Hand rolling	520	660	810
Total	820	1,860	2,910

Source: HMRC Measuring Tax Gaps Report 2012

1.2. Tobacco manufacturers estimates

Non-UK duty paid cigarette consumption:

Since 2011, the TMA's member companies and Philip Morris have jointly commissioned research, the Empty Pack Survey (EPS), into measuring the non-UK duty paid (NUKDP) cigarette market - which is a measure of both illicit product and legally crossborder shopped product. In summary:

- discarded cigarette pack collection in 105 large towns or cities across the UK
- packs are collected in such a way as to be representative of national cigarette consumption
- around 25,000 packs collected each year over two waves
- results are shared with HM Revenue & Customs and HM Treasury

The EPS survey results are as follows:

	2008 Q2	2009 Q4	2010 Q4	2011 Q2	2011 Q4	2012 Q2
NUKDP	23.6%	21.2%	17.4%	13.9%	19.3%	16.5%

Pre-2011 results are based on Philip Morris' empty pack survey which was based on a similar methodology

Based on work undertaken through previous surveys and understandings of NUKDP consumption, there is a seasonality, where higher levels of NUKDP are usually apparent in the latter half of the year, reflecting issues such as summer travel. The overall trend in NUKDP is therefore most evident when comparing the quarterly results with those of the previous year.

Whilst the overall trend is for a reduction in NUKDP this decline was reversed between 2010 Q4 and 2011 Q4. The TMA believes that further excise increases that have taken place since make it likely that the figure for 2012 Q4 will see a further increase in the level of NUKDP.

2010 Q4	2011 Q4	change in Q4 results
17.4%	19.3%	+ 1.9%

2011 Q2	2012 Q2	change in Q2 results
13.9%	16.5%	+ 2.6%

Non-UK duty paid hand rolling consumption:

The tobacco manufacturers also look at measuring the level of hand rolling tobacco that has avoided UK duty, and a survey conducted on behalf of JTI is conducted monthly.

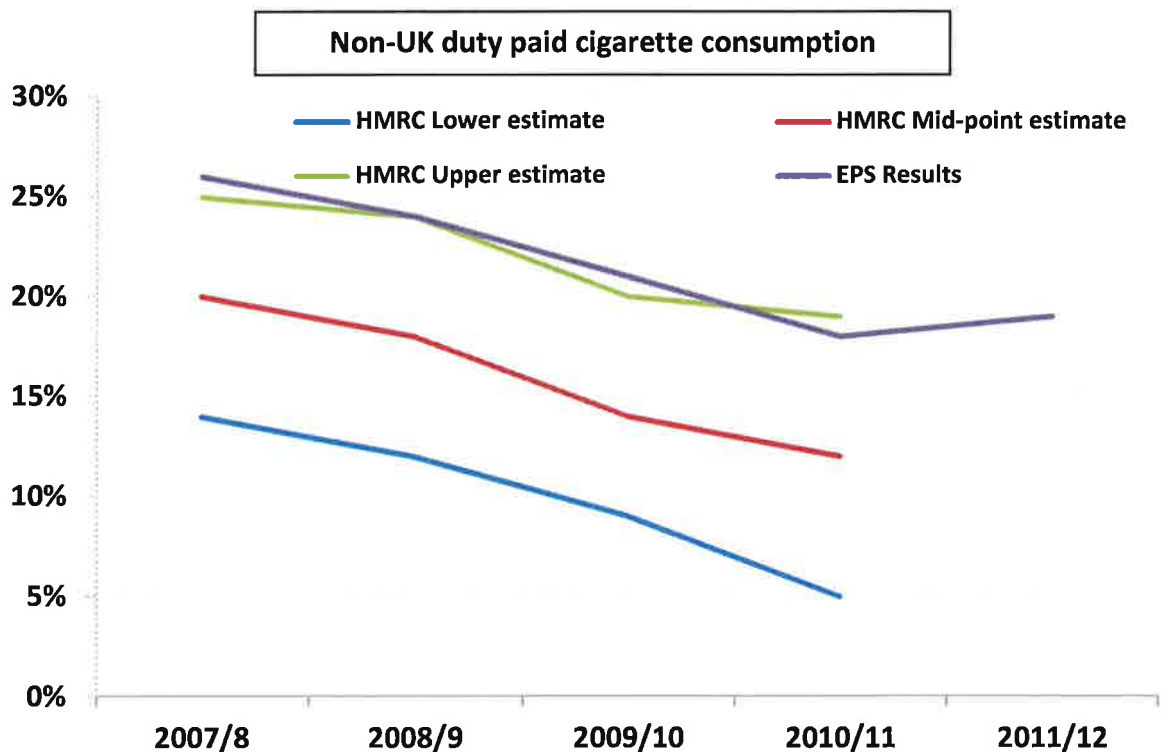
	2008/2009*	2009/2010	2010/2011
Non-duty paid	61%	55%	54%

*12 months to April 2009

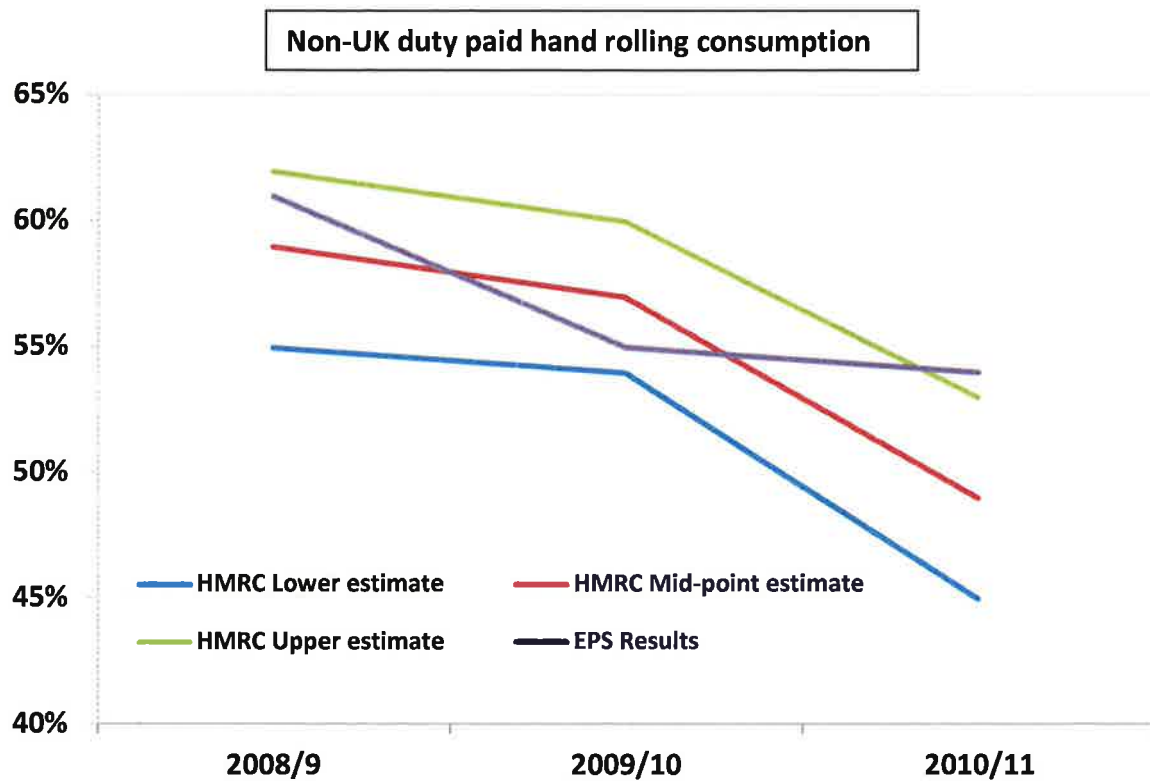
The results derived from the JTI pouch swap survey are broadly in line with HMRC estimates for the non-UK duty paid market.

1.3. HMRC & tobacco manufacturers data trends

Whilst it is difficult to measure the illicit market, both HMRC and industry research show similar downward trends from 2007/8 through to 2010/11. However, recent EPS figures show that this downward trend may be reversing. Should this reversal continue, the HMRC Tax Gap Reports covering **2011/12 and 2012/13** may reveal an increase in non-duty paid levels, which would equate to a **potential increase in lost tax revenues to the Government**.



The trend in non-UK duty paid hand rolling tobacco is broadly the same across HMRC and industry surveys, as non-UK duty paid levels continue to fall.



In summary, HMRC and tobacco industry data are based on different methodologies, but they show the same trends. The difference between the data sets is largely due to the 18 month time lag involved in HMRC figures, therefore HMRC are reporting on 2010/11 data, whereas the tobacco industry figures are more up to date. **We anticipate that the 2011/12 HMRC data will replicate the trend identified in the EPS data and show an upturn in non-UK duty paid cigarette consumption, highlighting further lost tax revenues to the Government.**

1.4. Revisiting old HMRC estimates

A paper published by the Taxpayers Alliance in April 2012³ revealed that HMRC Measuring Tax Gaps Reports tended to underestimate the scale of illicit trade, as figures were revised upwards in later years. This was apparent from 2004/5 through to 2008/9, when the revenue loss from illicit cigarettes was revised up by £1 billion. A similar pattern occurred with estimates of illicit hand rolling tobacco. The most recent Measuring Tax Gaps Report published in September 2012 highlights this issue:

Estimate of illicit trade in cigarettes

	2011 Report		2012 Report		Difference in Revenue
	%	Revenue Loss (£ millions)	%	Revenue Loss (£ millions)	(£ millions)
2009-10	16	£2,200	17	£2,300	+ £100
2010-11	-		16	£2,100	

Source: HMRC Measuring Tax Gap Report 2011 & 2012

Therefore, the most recent HMRC report suggests that the upper estimate of revenue loss from illicit cigarette sales in 2009/10 was actually £100 million greater than first estimated.

³ <http://www.taxpayersalliance.com/home/2012/04/research-285-billion-lost-black-market-alcohol-tobacco-diesel-years.html>

2. Tackling illicit trade

2.1 The FCTC Illicit Trade Protocol

In November 2012, at the fifth meeting of the Conference of the Parties of the FCTC, the Parties adopted the proposed text of the Illicit Trade Protocol (ITP). The TMA's member companies have consistently supported the development of the ITP and now encourage the government to undertake consultations with all relevant stakeholders on its implementation.

The scope of the ITP is very broad; it contains measures in the areas of: licensing, due diligence, tracking and tracing, financial controls, record keeping, duty free sales, internet sales, free zones, offences and sanctions, and international cooperation.

Many of the controls proposed in the ITP may already exist in the UK. But due to the transnational nature of the illicit trade in tobacco products, the UK still experiences a high level of illicit trade. The significant impact of the ITP on illicit trade can be expected from the consistent application of these measures in all countries that sign and ratify the ITP. Today, international criminals take advantage of different rules in other countries to facilitate their illegal dealings. Once the ITP is implemented in all signatory countries, the criminals will lose the benefit of safe havens from which they organize their illegal businesses.

As mentioned above, the scope of the ITP is very broad. It therefore has the potential to result in many unintended negative consequences if implemented without input from the relevant stakeholders. These unintended consequences could further erode the competitive advantages of legal products compared to illicit tobacco products, resulting in greater incidence of illicit trade. To minimize this risk, responsibility for implementation of the ITP should be given to experts in HM Revenue & Customs.

2.2 OLAF Agreements

The EU is fully aware of the risks posed by the different tax levels applied across the Member States. The Directive setting out the tax rules for tobacco products states “A certain degree of convergence between the tax levels applied in the Member States would help to reduce fraud and smuggling within the Union”.⁴

The TMA’s member companies have all signed individual agreements with the European Union to jointly combat the illicit trade in tobacco. The agreements cover general co-operation between the member companies and the Anti-Fraud Office of the European Community (OLAF).

Under the agreements, the TMA’s member companies work together with the European Commission and the law enforcement authorities of the Member States to tackle the smuggling and counterfeiting of tobacco products. The agreements strengthen cooperation in a number of areas and include funding by the member companies over a number of years to support anti-illicit trade initiatives.

The Government has described these agreements as being: *“an important step forward in the fight against tobacco smuggling. Signing them sends a clear and consistent signal that we are working in step with the EU, other member states and tobacco manufacturers to tackle the illicit trade in tobacco products.”*⁵

2.3 Memoranda of Understanding (MoUs) and Supply Chain Legislation

One of the cornerstones of the UK Government’s Tackling Tobacco Smuggling strategy and the fight against tobacco smuggling is the Memoranda of Understanding (MoU) between the TMA’s member companies and HM Revenue & Customs (HMRC). The first MoU was signed in April 2002 with a revised, common MoU signed in March 2006.

“MoUs between HMRC and the UK tobacco manufacturers have been an important element of the strategy, and have played a crucial role in restricting the availability of genuine cigarettes to smugglers.” Tackling the Tobacco Smuggling Strategy 2006

The MoU creates a comprehensive framework for co-operation aimed at combating the smuggling of both genuine and counterfeit tobacco products into the UK as well as seeking

⁴ DIRECTIVE 2011/64/EU (available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:176:0024:0036:EN:PDF>)

⁵ Justine Greening, then Economic Secretary to the Treasury; Hansard HC Deb 23 November 2010: Column 272W

to deter all aspects of the illicit trade in tobacco products. To supplement the MoU key elements of the agreement have been enshrined in legislation⁶ so that any tobacco company, operating anywhere in the world, is under the same obligations as the TMA's member companies to ensure that it does not allow its products to be smuggled. A guide to this legislation⁷ is available from the HMRC website.

However, the MoU goes further than the legislation. For example, there is an undertaking that both industry and HMRC will work together to identify and assess technologies that could be of benefit in tackling the trade in illicit tobacco products. The development of the covert anti-counterfeit technology introduced on cigarette packs in the UK in 2007 is a prime example of the benefit of the MoU approach in identifying particular concerns and quickly arriving at effective solutions. The TMA's member companies are currently working with HMRC in developing a revised MoU.

2.4 **Working in partnership**

In April 2011, the Government published its refreshed Tackling Tobacco Smuggling Strategy. Within the strategy there is a clear additional commitment from HMRC and UKBA to establish a new anti-illicit joint working group with the UK tobacco manufacturers and the Tobacco Manufacturers' Association with the aim of proactively developing an improved and shared understanding of the illicit market in the UK.

The overarching Anti-Illicit Trade Joint Working Group, which formalises long-standing interactions between HMRC and the Industry, provides an open forum for the Tobacco Industry and HMRC experts to meet bi-annually to share insight and experience, examine issues, and explore opportunities for the industry and/or HMRC to tackle the illicit market and emerging threats.

The Anti-Illicit Trade Joint Working Group supports and complements the Memoranda of Understanding between HMRC and the tobacco manufacturers and/or the EU Co-operation agreements.

Other work streams identified include intelligence sharing and communications, with a communications framework already in place that sets out that the TMA, Philip Morris UK & HMRC will jointly work together to develop more effective marketing and communications around illicit tobacco.

⁶ The Tobacco Products Duty Act 1979 (as amended by the Finance Act 2006)

⁷ Notice 477. Tobacco products duty: control of supply chains

2.5 Codentify®

The Digital Coding and Tracking Association (DCTA) was founded by the four major international tobacco companies⁸ in 2011 with the aim to promote cost effective industry standards and supporting technology solutions to tackle illicit trade. The Codentify® technological solution can deliver product authentication, tracking and tracing and digital tax verification.

Codentify® product authentication enables law enforcement and other officials to distinguish between genuine and counterfeit products.

The system uses unique alphanumeric codes so there will be no need for dedicated scanning devices or specialist training.

Codentify® track and trace will enable stakeholders to monitor and secure the distribution of products worldwide. A unique code is securely applied directly onto every packaging unit.

As products move along the supply chain between different trading partners, the unique codes are scanned, creating a complete record of its journey history.

These unique codes, together with Codentify® track and trace data exchange and reporting formats, are based on international standards. This enables all stakeholders throughout the supply chain to use standard equipment and processes to track and trace product movements within and across national borders.

Codentify® track and trace enables law enforcement authorities to retrieve information about the product, its manufacture, distribution and legal status, including products in transit.

Codentify® track and trace provides law enforcement authorities with the visibility needed to accurately identify national and international illicit trade patterns and assist criminal investigations.

Codentify® digital tax verification enables governments to protect tax revenues by strengthening recovery capabilities and reducing opportunities for evasion.

Licensed manufacturers apply to government for permission to produce online via a secure internet connection. On approval, production can begin under real-time government control. A unique, secure code is applied onto every packaging unit. Once printed, these codes are counted and encrypted production information is immediately and securely

⁸ BAT, ITG, JTI & PMI

communicated to government. Using this information enables governments to accurately calculate and reconcile due taxes.

Codentify® track and trace will enable stakeholders to monitor and secure the distribution of products worldwide and is fully compliant with the provisions contained in the FCTC Anti-illicit Trade Protocol.

2.6 Covert Markings

It was announced at the 2007 Budget that the Government had accepted an offer from the TMA's member companies to voluntarily incorporate technology on cigarette packs to allow the easy identification of genuine/counterfeit product in the retail network. Since 1st October 2007 all cigarettes manufactured for the UK market by our member companies and Philip Morris International carry the technology. This was extended to hand rolling tobacco from 1st October 2008. The anti-counterfeiting (reader) device used to detect illicit counterfeit product is being used across the UK by HM Revenue & Customs and Trading Standards Officers.

Covert markings are invisible to consumers and retailers in the absence of the hand held reader technology, therefore the sophisticated design features in tobacco packaging such as embossing and bevel edging, provide consumers and retailers with reassurance that they are handling a genuine product, much in the same way consumers and retailers can tell the difference between real bank notes and monopoly money.

The Government is currently looking at the issue of standardised packaging for tobacco products, and whilst covert markings may still be in place voluntarily under standardised packaging, by removing branding, logos and colours from packaging, it will make it easier and cheaper for counterfeiters to copy. This will in turn make it harder for retailers and smokers to know if they are being offered a genuine product.

It should be noted that Mike Norgrove, Director, Excise, Customs, Stamps and Money, HMRC, recently told the Northern Ireland Committee, that with regards to plain packaging: *"the obvious danger from our point of view is that the ability to detect counterfeit or illicit material would be made more difficult by a system where there was no difference between one packet and another"*.⁹ Given his experience it is obvious that his concerns should be considered very carefully.

⁹ Available at: <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmniaf/uc556-i/uc55601.htm>

For more information on the TMA member companies' views on standardised (or plain) packaging, including in relation to the potential for such measures to exacerbate the issue of illicit trade, please see their respective submissions to the recent consultation.¹⁰

2.7 Communication

Persuading smokers not to buy illicit tobacco is a tall order and requires coordinated efforts by all stakeholders. The TMA funds consumer awareness campaigns such as Don't be Tempted, which provides points of contact to report illicit tobacco sales (HMRC Hotline). The TMA also supports the Tobacco Retailers Alliance which helps raise awareness of illicit trade through a network of 26,000 retailers and its Retailers Against Smuggling campaign.

The TMA also works in partnership with Trading Standards as supporters of the Real Deal campaign for fake-free markets and on many local initiatives. We are disappointed that the work to prevent and tackle illicit trade in tobacco is sometimes compromised by individual Trading Standards forces who decline to work in partnership with the TMA citing public health concerns, rather than prioritising actual enforcement activities.

3. Conclusion

The TMA's member companies work extensively with a number of enforcement agencies in the UK and across the world to tackle the illicit trade in tobacco products. The manufacturers have been at the forefront in developing technological solutions which provide greater supply chain security as well as delivering the means for enforcement agencies to detect illicit products.

We support effective and proportionate measures, but with increasingly higher levels of tobacco taxation and prevailing economic conditions, the ability to tackle illicit trade effectively is made much more difficult, as consumers are increasingly incentivised by above inflation excise increases to seek non-UK duty paid products. By adopting a more measured approach to tobacco taxation, the Government would address head on the key driver of the illicit trade in tobacco products.

¹⁰ These are available at:

http://www.bat.com/group/sites/UK__3MNFEN.nsf/vwPagesWebLive/DO7J7DCZ?opendocument&SKN=1

<http://www.jti.com/how-we-do-business/key-regulatory-submissions/>

<http://www.imperial-tobacco.co.uk/index.asp?page=453>