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on the Agreements with the tobacco industry and fight with the illicit tobacco trade

Committee on Budgetary Control

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Introduction

This working document is based on the briefing notes of Ian Walton-George (IWG) and Luk Joossens (LJ) et al. that were requested for the purpose of the workshop on cigarette smuggling, organised by the Policy Department D of Budgetary Affairs for the Committee on Budgetary Control on 22 January 2014 at the request of MEP's Bart Staes and Ingeborg Graessle. It also presents opinions expressed by the following experts in the course of the workshop: Anna Gilmore (AG), Leszek Bartłomiejczyk (LB), Howard Pugh (HP) and Luk Joossens (LJ).

This document consists of the following points:

1. Agreements with the tobacco industry
2. Assessment of the Agreements
3. Fight against illicit tobacco trade
4. Recommendations

1. Agreements with the tobacco industry

(For a brief description of the four Agreements see the table in Annex 1.)

- **History and purpose**

In 2000 the Commission launched civil proceedings against RJ Reynolds (RJR), Philip Morris International (PMI) and Japan Tobacco International (JTI) for involvement in cigarette smuggling and money laundering, and applied for an injunction to prevent smuggling in the future.

In late 2001, confidential discussions began between the Commission and PMI on a possible Agreement to cooperate in combating contraband and counterfeit cigarettes. Until 2010 PMI, JTI, BAT and ITL (the "big four") signed the Agreements¹.

The Agreements constitute a comprehensive document designed to **ensure that cigarettes are sold, distributed, stored and shipped in such a way as to minimise the risk of cigarettes finding their way into illicit channels**. The agreement also required implementing effective tracking and tracing measures by the industry.

The tobacco companies committed themselves to keeping their products out of the hands of criminals, middlemen and smugglers. The measures taken by the companies ("know your customer" provision, due diligence carried out on purchasers and contractors, implementation of tracking, tracing and scanning procedures, preventing money laundering, cooperating fully with law enforcement authorities etc.) are intended to ensure that their products will not find their way into illicit markets.

¹ The civil action against RJR is still continuing. There does not appear to be any indication of negotiations with RJR on a Cooperation Agreement.

- **Payment of annual instalments under the Cooperation Agreements**

The payments of annual instalments under the Cooperation Agreements with the big four tobacco companies – Philip Morris International (PMI), British American Tobacco (BAT), Japan Tobacco International (JTI) and Imperial Tobacco Limited (ITL) are being divided between the European Commission (9,7%) and the Member States (90,3%). These payments are intended to serve as a source of additional funding for anti-contraband and anti-counterfeit initiatives. It is entirely up to each of the Member States, and the EU, to decide how to use these monies. **Some of the Member States earmark the payments to fight cigarette smuggling, while others direct the money to the general budget.** The annual installments under the four Agreements amount to approximately 1.7 billion euro until 2029; while PMI contributes around 900 million euro, the majority of the funds (JTI and ITL around 300 million euro and BAT around 170 million euro). With around 200 million euro of the annual installments from the four companies, a law firm in the United States is paid for providing legal service to the European Commission.

The funds are managed by DG BUDG outside the European Union's annual budget. After payment of the US lawyer's annual fee, the remaining payments are transferred to the budget of the European Union. The Commission has so far not provided the Committee on Budgetary Control and the European Parliament with the movements on this account and the necessary explanations.

Concerning the funds transferred to the Member States, the Commission claims that it always strongly encourages the Member States to use the money for anti-fraud purposes, believing that the return on using it in such a way is very considerable indeed. However, no follow-up on the use of the funds has been requested from the Commission towards the Member States.

In addition to the annual installments, the four tobacco companies are obliged under the Agreements to remit additional payments to the Commission and the Member States, if contraband cigarettes are seized in a Member State. The recovered value of taxes and duties emerging from these seizure-based payments is minimal compared to what has been lost on the smuggled cigarettes from the larger seizures (as low as 0.4% in the UK). If the seizures in the Member States during a year exceed the baseline amounts defined in the Agreements, the tobacco companies have to pay the four-fold amount that would have been lost in duties and taxes. While these baseline amounts have never been reached in the history of the Agreements, the new Director General of OLAF took the initiative after taking office in 2011 to raise the baseline amount in the PMI Agreement from 90 million cigarettes to 450 million. The Commission tried to justify the increase for PMI with a baseline Aamount of 150 million cigarettes negotiated with BAT in 2010 and the proportions of the market shares of the companies in the EU.

The payments from the Agreements are often being presented by the tobacco industry to the public as philanthropy and corporate social responsibility rather than as settlement money. The seizure payments have, however, been relatively small. Despite the massive presence of contraband PMI products in the EU (estimated by PMI's Project Star at 21% of all contraband cigarettes consumed in 2011), the recent allegations of JTI smuggling operations and the significant presence of Classic cigarettes on the illicit market in the EU produced by Imperial Tobacco Limited (in the Ukraine), total seizure payments for all four companies in all EU countries, represented only 4 141 791 euro in 2012. This is the equivalent to payment for only 20 million seized cigarettes out of the 3,8 billion cigarettes seized in the EU in 2012.

Moreover, seizure data, being based only on seizures over 100,000 cigarettes over-represent counterfeits compared to genuine tobacco industry products. In 2011, the latest year that such data is available, PMI's Project Star report estimated that 13.5 billion genuine PMI cigarettes alone were sold on the EU illicit market, plus 2.5 billion of Imperial Tobacco's Classic. Two companies were responsible for at least 16 billion illicit cigarettes i.e. a quarter of all illicitly consumed cigarettes in Europe. The seizure payments that year came to 10,098,035.00 euro¹. This signals that law enforcement agencies only detect limited amounts of genuine contraband cigarettes. This also means that the seizure payments from the tobacco companies under the Agreements are only a tiny fraction of the taxes and duties lost due to contraband. In other words, the deterrent effect of the seizure payments does not appear to have reached its full impact.

At the same time, it is evident that the share of contraband cigarettes of the big four tobacco companies under the Agreement has been decreasing and other contraband cigarettes pushed into the market. Also the so called "*illicit whites*" made up around 16 billion cigarettes of all counterfeit and contraband cigarettes in 2012. Neither the Commission nor the Project Star report analysis, however, provides information on which company brands are implicated in contraband cigarettes.

- **Examination of seized cigarettes**

According to the Agreements, the relevant manufacturer is entitled to examine the seized cigarettes, and it subsequently sends a report to OLAF. If the manufacturer concludes that the cigarettes are counterfeit, the report must contain documentation and examination results demonstrating that conclusion. If OLAF, or any participating Member State, takes issue with the conclusion that the seized cigarettes are counterfeit, the matter will be referred to an independent laboratory designated by mutual agreement of the parties for final determination. So far, recourse to the independent laboratory has not occurred.

OLAF has signed contracts with the Scottish Ocean Institute, which developed a system to identify the origins of tobacco. Member States were told to provide, in case of doubt, seized packs to determine whether the product is genuine or counterfeit. However, no cases have ever been reported and been submitted for identification.

Very few seizures qualify for seizure payments. No seizure payments are made when the cigarettes are counterfeit, and customs officials rely on the industry to determine whether cigarettes are counterfeit (not eligible for seizure-based payments) or genuine (eligible for the payments). Since the Commission and Member States fail to conduct verifications of the classification determined by **the industry, the tobacco companies subject to the Cooperation Agreements have a theoretical incentive and an existing possibility to classify seized cigarettes as counterfeit. The Commission and the Member States obviously fail to properly implement the agreements.**

2. Assessment of the Agreements

- **Ian Walton-George**

¹ Source: Anna Gilmore

The Agreements have proved to be **imaginative and positive step forward** in the fight against cigarette smuggling. The companies have applied strong controls on their production, their customers and contractors, their storage and movement of cigarettes (particularly tracking and tracing) and the types of acceptable payment for the cigarettes.

The annual payments and the “*seizure payments*” have contributed to the budgets of the EU and the Member States. The EU budget has increased the funds available for the *Hercule II* Programme. The seizures of genuine products of the four manufacturers have fallen, but seizures of counterfeit products remains high, while the share of Member States’ markets taken by illegal “*cheap whites*” appears to be increasing.

The manufacturers have probably felt the benefit of more certainty about their position (including the release from the civil actions in New York), and perhaps a public perception that they are part of the “*good guys*” working to combat illegal activity. In addition, they have gained more contact with the enforcement authorities of the EU and the Member States, and have been able to pass on information about illegal shipments for possible enforcement action.

The companies’ profits are hit by counterfeit cigarettes and illegal cheap whites, so they need all the help they can get to combat these. **The companies** will no doubt be considering whether the benefits are sufficient for them to want to continue with the Agreements, but they **would probably also find it difficult to no longer be party to an Agreement** because of the possible resultant impact on the public and government perception of their motives.

The lack of formal disputes about the operation of the Agreements is an indicator that both sides have felt that the Agreements have worked as intended, and that reasonable approaches have been taken to any smaller and incidental disagreements. Overall, the Agreements should be regarded as a success, and **consideration now needs to turn to what remains to be done to build on this success and to plug any gaps, and what the next phase should be at an EU and global level.**

- **Luk Joossens**

The high share of PMI contraband products in the EU, the large prevalence of an Imperial Tobacco cigarette brand from the Ukraine on the contraband market and recent investigations over Japan Tobacco’s involvement in large-scale cigarette smuggling **call into question the effectiveness of the Agreements.**

The increase of seizures of other brands (58% in 2008, according to the European Commission (EC)) **do not prove that the Agreements are effective** and have contributed to the reduction of smuggling activities. The EC does not reveal details of the seized brands of cigarettes, but it claims that illicit whites are gaining importance.

The cigarette seizure payments might be incentive for the tobacco companies not to be involved in the smuggling operations, but their possible effect should not be overestimated as very few seizures qualify for seizure payments. **The industry has an incentive to classify seized cigarettes as counterfeit.** One industry-commissioned study states that on the one hand 16% of illicit Philip Morris cigarettes consumed in the EU were counterfeit, but, on the other hand, 92% of illicit Philip Morris cigarettes seized in the EU were counterfeit in 2011.

(AG) Agreements **do not appear to have deterred the industry's involvement in illicit**

trade. There remains a deficit of accurate data on the scale and nature of the illicit trade. According to the Project Star report smuggling is increasing; according to seizure data, decreasing; thus we cannot be certain which direction the trend is going. According to the Project Star report a significant problem remains with tobacco company brands being smuggled: a break down is provided only for PMI brands and for ‘Classic’ which is an ITL brand. However, this shows that around 25% of the EU illicit cigarette market still comprises of genuine PMI and ITL brands. The level of genuine PMI brands outstrips the level of counterfeit PMI brands by a ratio of 5:1 and is also larger than the level of leading illicit white brands. In short, the problem of genuine industry brands outstrips the problem of counterfeit and illicit white and remains a major problem despite the agreements.

3. Fight against illicit tobacco trade

In order to step up the fight against fraud affecting the EU budget, in 1988, the European Commission established a Unit (“*Unité pour la coordination de la lutte contre la fraude*” – **UCLAF**) within its Secretariat General. UCLAF recruited specialist investigators from the Member States’ enforcement authorities and built a small task group/force within the unit to combat cigarette fraud. UCLAF became the European Anti-Fraud Office (OLAF) (in 1999) and with the new Director General in 2011, as well as with the adoption of the new legal basis (in 2013), the Office has undergone some major changes.

In particular, the new Director General implemented some grave changes after taking up his office. He dismantled the existing unit for cigarette smuggling by allocating its staff to different duties. An umbrella case – in which several investigations into cigarette smuggling had been opened and been conducted – was closed with a final report of a few pages.

After hefty criticism by the European Parliament’s Committee on Budgetary Control, the Director General has now declared cigarette smuggling as one of the investigational policy priorities for the year 2014.

Since the establishment of UCLAF’s Task Group, according to the Commission, close working links were established with the Member States in order to tackle international cigarette fraud, and there were **considerable successes in terms of seizures of very large quantities of cigarettes** and the means of transport used to move them (ships and lorries), and the prosecution of smugglers by the Member States.

However, cooperation between OLAF and the European Police Office (EUROPOL) in the field of cigarette smuggling could be better improved. The exchange of information on cigarette smuggling between the two entities has been refused by OLAF.

- **The current state of play of cigarette smuggling**

(LB) Illicit trade includes: smuggling of genuine products, false declaration, counterfeit products, illegal production and distribution within the EU, overproduction exceeding local demand.

The main sources of illicit cigarettes are Belarus (dominating), Ukraine, Russia, China and Middle East (UAE) and South countries (new smuggling channels).

Trends in illicit trade at the eastern border of the EU:

1. Decline in seizures (according to the Commission and Member States is due to stricter border controls);
2. Increase of domestic illegal production using cut tobacco (usually untaxed);
3. New routes though the Balkan states (less controlled);
4. Growing use of available legal channels (e.g. postal services); and
5. Illicit trade inside a country (e.g. Poland).

(LJ) During the period 1996-2012, cigarette seizures in the EU were highest in 1999-2000, when the international tobacco companies were accused of being involved in smuggling operations, and among the lowest in 2003, when the EU had not yet signed any agreement with the tobacco companies. In the EU-27, cigarette seizures have decreased from 4.8 billion in 2007 to 3.8 billion cigarettes in 2012. Based on the cigarettes seizures trends alone, one might conclude that the problem of illicit cigarettes is decreasing in the EU.

(AG) There is evidence of on-going tobacco industry involvement in illicit trade and oversupply of their products, which leak into the illicit market. **Overproduction and oversupply of cigarettes to some countries exceeds the legitimate demand and fuels the black market.**

There has been a shift from the smuggling of container loads of genuine tobacco towards the smuggling of counterfeit products and “*illicit whites*” (i.e. legally produced cigarettes sold on the illicit market) since the Agreements were signed with the “big four”. There is growing evidence that the tobacco industry remains involved in illicit trade and fails to control its supply chain.

Surveys conducted for the tobacco industry tend to overestimate the phenomenon of illicit tobacco. Data provided by the industry is unrepresentative and unreliable. The methodology used is not transparent. There is growing evidence that empty pack surveys conducted by the tobacco industry are designed to overestimate non-domestic products and provide results convenient to the industry¹. (There are also conflicts of interest where the tobacco companies are involved in assessing whether foreign cigarettes picked up during empty pack surveys are non-domestic duty paid, genuine or counterfeit.

- ***Hercule* programme**

The *Hercule* programme is a Community programme to fight against fraud affecting the financial interests of the EU. Since 2007 it also contains funds which are to be used for anti-fraud purposes, including the fight against cigarette smuggling and counterfeiting. This programme received 98.5 million euro over seven years. It has funded, wholly or in part, the purchase of scanners by Member States for use at their borders when examining freight, training and seminars for officials relating to combating cigarette fraud, and even funding for part of the negotiations on the Protocol to the World Health Organization’s Framework Convention on Tobacco Control (WHO FCTC) to eliminate the illicit trade in tobacco products.

- **Incentives and consequences of cigarette smuggling**

¹ According to a briefing of Professor Anna Gilmore.

Factors contributing to the illicit tobacco trade:

- high incentives (differences in prices of cigarettes) and loopholes;
- insufficient measures controlling the tobacco supply chain; and
- lack of adequate equipment (e.g. X-ray)
- Tobacco companies make profits by selling to a distributor¹.

Consequences:

- very large **losses of revenue** for the budgets of both the EU (evaded customs duties) and the individual Member States (evaded excise duties and Value Added Tax) estimated at 10 billion euro based on seizures reported by the Member States or 12.5 billion euro according to KPMG (2012);
- economic, health and social implications;
- **it undermines the impact of effective tobacco control measures** such as tobacco taxation, youth access laws, and health warnings, thus reducing their potential to prevent many tobacco-related premature deaths;
- contrary to tobacco industry predictions, increasingly **strict tobacco control regulations did not affect the scope of illicit cigarette trade**;
- illegal profits fund other areas of **serious organised crime**, as illicit trade is almost exclusively the domain of organised crime groups;
- **harms legitimate business** interests.
- **Tracking and tracing system**

Tracking and tracing comprises of national and/or regional tracking and tracing systems and a global information sharing focal point.

Benefits of tracking and tracing: Brazil, Turkey and California after having installed the system noted an increase in income from taxes on tobacco (in spite of lower production) and a decrease in smuggling and illicit trade. These systems are all run independent of the tobacco industry.

The WHO Protocol to Eliminate Illicit Trade in Tobacco Products includes provisions for a

¹ It makes no difference if this distributor feeds the legal or illegal channels. This is true as long as the cigarettes are not seized by law enforcement agencies in the Member States, for which the four companies subject to the Cooperation Agreements would have to pay additional seizure payments. In fact, as cigarettes sold in illegal channels have a cheaper final resale price, higher sales can be expected. Since only 4.5 billion of a total of 65.5 billion counterfeit and contraband cigarettes are seized every year, tobacco companies would theoretically only need to account for a conservative 7% risk-premium when selling to distributors that feed illegal channels. Assuming that more cigarettes from tobacco companies would be seized than the baseline amount of 780 million, then, using the simple average of excise yields as of July 2013, an adequate risk-premium for each cigarette expected to exceed the baseline amount would be on average around 1.4 cent per cigarette. If the respective cigarette is not expected to exceed the baseline amount such a risk-premium could be estimated at around 0.35 cent per cigarette.

global tracking and tracing regime which, when implemented, will contribute towards preventing genuine cigarettes from finding their way into illicit channels throughout the world.

- **European Commission Strategy and action plan to tackle the illicit trade in tobacco products**

The Commission refers to two sets of data to measure the financial losses and the level of the illicit cigarette trade in Europe:

- **the KPMG Project Star report and empty pack surveys** which showed an increase of 30 % in the consumption of illicit cigarettes over the last 6 years, and estimates the EU illicit cigarette trade at 11.1 % of the total cigarette market in 2012 (the report was financed by PMI and commissioned to meet specific terms of reference established by PMI);
- **the seizure data** showed a decrease of 21% over the same 6 years (this data is unreliable for measuring the level of illicit trade in the EU; it can indicate trends in the illicit market, but it does not take into account the efficiency, number, law enforcement activities and "*ant smuggling*").

The main purpose of the Project Star report was to determine if Member States who joined the EU on, or after, 1 May 2004 would be entitled to seizure payments as foreseen in the Agreement. It was never intended that the Project Star report would be made public or used as a reference by the EU, or the Member States, when highlighting the volume of the illicit trade in the EU, or used for any other purpose. Yet it is widely and selectively used by PMI in its lobbying efforts.

The EC Strategy does not propose any measures to control and prevent illegal diversion of raw tobacco, filters or papers.

- **Revised Tobacco Products Directive (TPD)**

The tobacco industry tends to overstate the illicit cigarette trade problem. **Graphic health warnings, restrictions on packaging and regulation of ingredients** are claimed by the tobacco industry to be drivers of the illicit cigarette trade. However, there is no convincing evidence of the impact of the first two measures. Moreover, the 2001 Directive did not increase illegal trade or cause massive job losses, contrary to the tobacco industry's forecast.

The **ban on menthol flavour** cigarettes will have a marginal impact as they constitute only a fraction of the EU cigarette market. Those who currently smoke flavoured cigarettes are much less likely than other smokers to use illicit cigarettes. Moreover, it is well established that menthol flavoring in cigarettes is associated with smoking initiation, especially among the young. It increases nicotine dependence in young smokers and decreases smoking cessation in adult smokers. **Prohibiting menthol as a cigarette flavoring would result in reduced smoking initiation, increased smoking cessation and a significant reduction in the number of premature deaths.** The benefits of the ban on menthol cigarettes far outweigh any risks associated with the possible increase in illicit cigarette trade.

The socio-economic benefits of the revised TPD resulting from the reduction in health care costs, productivity losses and premature mortality alone are estimated at over 9.4 billion euro

annually.

Most of the reports concerning the alleged impact of the revised Directive on illicit trade levels are commissioned by cigarette manufacturers. Unlike academic research studies, these studies provide only limited information about their methodology and data collection, thus are not replicable. Moreover, the tobacco industry has previously alleged that other tobacco control legislation would increase the illicit tobacco trade, but such increases did not occur.

The costs of obtaining illegal cigarettes should also be taken into account. These include, for example, costs of obtaining information on where the illicit cigarettes are being sold, costs of the trips to the places where they are sold (since the illicit cigarettes are not as readily available as legal cigarettes), and the moral costs of the '*breaking rule*' (most people have reservations against breaking rules). The brand choice available in the illicit market is not the same as in regular stores.

- **OLAF's liaison officers**

The major source of counterfeit cigarettes remains China, although there are also factories in countries on the eastern border of the EU and even within the Member States.

As part of the cooperation under the Agreements, OLAF intended to place liaison officers in four key countries: China, Ukraine, Russia and Egypt. An officer was placed in Beijing for four years and **this liaison created excellent links with the Chinese authorities** leading to positive results in protecting the financial interests of the EU. **Unfortunately, OLAF did not replace the liaison officer in China** when the 4-year term of duty came to an end due to the need for budgetary savings. This was a short-sighted decision, given the returns which are produced by having an official on the spot to liaise with the Chinese authorities.

OLAF has placed an official in the Ukraine and, once again, the benefits have been significant. It is to be hoped that the official will be replaced when his contract comes to an end. OLAF's intentions to place officers in Russia and Egypt were unfortunately abandoned, also for budgetary reasons. Also Belarus has become a problem concerning smuggling, but no OLAF officer is allocated for this region either.

4. Recommendations

Some of the experts have presented the following recommendations in relation to:

1. New Agreements

There are differences in opinion between experts whether new agreements should be made or existing agreements renewed.

- Urgent action is now needed in relation to **other manufacturers**. There are still manufacturers which do not have an agreement with the EU (e.g. in Cyprus, Bulgaria, Luxembourg, Greece, Croatia). This means that illegal cigarettes can more easily find their way into the hands of fraudsters. In addition, if these cigarettes are seized, **there is no guarantee that information can be obtained by the authorities about the components of the supply chain.**

It might be argued by some of these manufacturers and Member States that it would be premature to take such a step since there will be a world-wide system coming into force in the coming years when the WHO Protocol comes into force. However, the Protocol will not be in force for several years, and **the EU must take early action** to protect itself against unrestricted sources of genuine cigarettes produced by manufacturers established within its borders. Furthermore, implementation of additional cooperation agreements with additional manufacturers within the EU will not result in contradictory or inconsistent requirements on the manufacturers even when the Protocol becomes enforceable. This is due to the fact that special care was taken to ensure that the existing agreements would be fully compatible with the requirements of the Protocol. As such, **agreements with additional manufacturers would only result in additional benefits to the EU and the Member States.**

- The slight **differences between the four Agreements need to be considered.** Action on a world-wide level will also have a bigger impact on success in preventing the smuggling of genuine cigarettes. There must be equally strong policing and administration of the Agreements so that the full benefits can be obtained from their provisions.
- "*Illicit whites*" are cigarettes produced legally in the country of manufacture and subsequently smuggled into the EU. Countries such as Russia (Kaliningrad), Belarus and the Ukraine, where prices of cigarettes are much lower than those in the Member States, are major sources of supply of such cigarettes.

The countries where these manufacturers are based argue that no laws are broken in their territory, and that it is up to the EU and the Member States to protect their own borders. However, since the EU gives large amounts of aid to these countries **it should be possible to exert some more pressure to obtain at least a better flow of information** from them about the quantities of cigarettes being produced and their first destinations.

Furthermore, there is new evidence to suggest that, for example, an Imperial Tobacco brand - Classic - produced legally in the Ukraine has featured heavily in the EU illicit market and is classed as an illicit white brand in PMI's Project Star report. Although Imperial has now ceased production of Classic in the Ukraine, it has significantly increased production of Imperial Classic in Belarus despite no change (even perhaps a slight decline) in smoking prevalence in that country. This suggests that close attention needs to be paid to the practices of the major tobacco companies.

Any new trade agreements should contain the necessary provisions to allow the EU to combat the unrestricted production of illicit whites. Once again, these source countries might argue that the problems will be resolved in a few years by the implementation of the WHO Protocol without the need for action now. This argument should not be accepted as an excuse for delay as there would be no inconsistencies or

incompatibilities between any cooperative agreements and the Protocol (although of course the EU should encourage these countries to ratify the Protocol and could offer to assist these countries with the implementation of the Protocol as part of an overall deal). In any case, the Protocol should be seen as the minimum required standard, and the EU should continue to expect more from the four manufacturers with which it has Agreements.

- **Reliable information about the illicit production and movement of cigarettes.** There are many cooperation arrangements in place with specific enforcement authorities in third countries, and these must continue to be used to the fullest extent. Information and intelligence from the four manufacturers also plays a significant part in targeting enforcement action.

Independent research and verifications should also be carried out concerning the ratio of illicit cigarettes consumed in the EU and the origins of seized tobacco. There is a need for an independent study based on a transparent and unbiased methodology. The agreements should require funding for a report similar to Project Star but conducted independently of the tobacco companies.

- **Harmonisation of the Agreements** - The four Agreements contain the same strong core elements, but are slightly different in form, and their content differs very slightly. This is inevitable given the times at which they were negotiated and the differences between the companies themselves. Consideration could therefore be given to possible harmonisation of some elements of the Agreements.

It will therefore be important to **ensure that the current Agreements are not watered down in any way**, and a political question even arises as to whether the Agreements have really provided strong tools to curb smuggling. As stated, some experts agree this was not the case and therefore argue that agreements are not the best instrument, and that tracking and tracing systems are a better tool.

If agreements would be prolonged, they should be improved and made to meet the highest standards taken from each of the Agreements. This could be an objective of the negotiations with PMI later this year. At the very least, there could be a decision to prolong the current PMI Agreement for two years (until 2018) as it stands, and to re-examine the position again in 2016. OLAF should **carry out a comparative study of the four Agreements** to see which provisions should ideally be changed to bring them up to the highest standard contained in any of the Agreements.

- **Tracking and tracing system** - the Member States should be encouraged to start building such systems to monitor production and trade from the production line to the final point of sale.

The tobacco industry should not be involved in control activities. Tracking and tracing systems, as a state controlled system, should be independent and free from tobacco company influence.

Effective tracking and tracing systems also entail: production and distribution control, product inspections, auditing and reporting. Secure product marking, both visible and invisible, should be introduced for customers/wholesalers and customs to control the supply chains and get adequate information. Such secured marking has to be done directly at the factory; otherwise products can enter the market without identification.

- **A comprehensive and global approach at the border**, and within EU, with effective control measures are required. There should be smaller seizures but more frequent, since they can add up to big numbers that are often not reported due to their small size.

During the workshop some of the other experts argued, however, that in fact, in the current state of affairs, there is no justification for the prolongation of the Agreements or a need for new Agreements. When the first Agreement was concluded with PMI in 2004, the Agreement had two major advantages concerning enforcement:

1. The setting up of a track and trace system, including both products from in and outside the European Union; and
2. Seizure payments, when genuine PMI products were seized in the 10 EU countries which were part of the Agreement.

However some of the experts now argue that in 2014, the evaluation of those two advantages has changed:

1. The EU adopted, in March 2014, the Tobacco Products Directive which foresees a traceability system in a regulatory context which applies to all tobacco companies in the 28 EU Member States from the manufacturing to the first retail outlet. A legislative and regulatory system is better than the PMI controlled traceability system.
2. There is no need to conclude new agreements with other tobacco companies in the EU, because the new Tobacco Products Directive and its traceability obligations will apply to all tobacco companies. However, products coming from third countries outside the European Union do not fall under the scope of the track and trace requirements of the newly adopted Tobacco Product Directive.
3. Ensuring that the traceability system adopted consequent to the TPD is independent of industry and other vested interests, and consistent with the obligations of the FCTC, obviates the need for additional traceability obligations.
4. The system of seizure payments was an attractive measure, but it has failed since law enforcement agencies only find, in the best case, a mere 10% of illicit cigarettes and they show little interest in verifying the categorisations of seized cigarettes determined by the industry. This lack of adequate control opens the opportunity and theoretical incentive for the industry to undeclare seized goods.

Neither the Commission, nor the Member States, have so far made recourse to the possibility to have the seized product analyzed by an independent laboratory, as foreseen in the Agreements with the four international tobacco manufacturers.

5. In addition, seizure payments do not apply to small seizures. The *modus operandi* of the smuggling operations for regular tobacco company brands has changed: consignments of smuggled cigarettes have become smaller and ‘*ant smuggling*’ more frequent. ‘*Ant smuggling*’ refers to the organised and frequent crossing of borders by a large number of individuals with relatively small amounts of low taxed or untaxed tobacco products. The main countries of origin for illicit cigarettes from the eastern border in the European Union are Russia, Ukraine and, increasingly, Belarus. In the case of Russia, most of the products seized are genuine. In most cases, PMI does not pay seizure payments for cigarettes produced in Russia, as the crossing of the border is done with small amounts of smuggled cigarettes for which no seizure payments apply.
6. Collectively, points 4 and 5 above indicate that the seizure payments are currently totally inadequate to deter industry involvement in the illicit trade.
7. An additional problem is the total lack of transparency. The Agreements are based on non-transparent, secret and intense relationships between the tobacco companies, the Member States and the EU which might be in conflict with the WHO FCTC, the public health aims of the EU and its transparency agenda.

Given the above, without significant change to, the strengthening and an increase in transparency of the Agreements, according to some of the experts, there are almost no advantages to having new agreements or renewing existing agreements. Far more could be achieved by having an effective track and trace system in place, run independently of the industry and other vested interests in line with the FCTC. While the Project Star report has provided useful data, there are concerns about its lack of transparency and the quality of the data inputs, and it would be far better if commissioned and conducted independently of the industry and other vested interests but with industry funding.

2. OLAF's liaison officers

- OLAF has to play its part in cutting the cost of the Commission’s administration, but **the costs of having suitable officers in a small number of key third countries would be far outweighed by the savings made to the budgets** of the Member States and the EU as a result of the prevention of smuggling from those countries.

The UK has 28 overseas intelligence officers who helped the country to prevent a revenue loss of 815 million euro between 2011 and 2012. The illicit UK cigarette market was reduced from 21% in 2000 to 7% in 2011.

At a minimum, **the EU should have liaison officers in China, UAE, Ukraine, Belarus and Russia**, which could prevent substantial financial losses in the entire EU.

3. WHO Protocol to Eliminate Illicit Trade in Tobacco Products (signed by the EU on

20/12 /2013)

- **The EU and the Member States need to continue to play a key role in pushing forward the ratification and implementation of the Protocol.** It will be necessary to use the EU's experience with the provisions of the Agreements to encourage and provide support to some of the less developed countries which wish to introduce tracking and tracing, and other measures.

There may be tensions between implementing an effective Protocol and keeping the burdens on business to a minimum, and it will certainly be a challenge to develop and implement a global regime. There will be some cost for this work, but again the ultimate benefits should far outweigh them since the global regime will fill many of the gaps which currently exist in combating illegal cigarettes coming into the EU. **It would be very helpful if EU funding could therefore be made available for some of the work.**

4. Production of raw tobacco

- Since the end of EU tobacco subsidies, **there is no more duties and control over the production of raw tobacco;** it is a product without registration, monitoring or control.

For this reason, some Member States have reintroduced measures to monitor the production of raw tobacco. This unregulated trade of raw tobacco leaf created the potential emergence of in-country factories specialising in the production of counterfeit cigarettes.

While the Commission acknowledges that illegal tobacco manufacturing in the EU is a growing problem, **the Strategy and the Action plan do not propose any measures to control and prevent the illegal diversion of raw tobacco, acetate tow or cigarette papers.**

Europol also expects that illicit manufacturing within the EU will increase, since it is more difficult to detect imports of raw tobacco and materials than imports of manufactured cigarettes.

6. Revised Tobacco Directive

- It is extremely important that the ban on menthol cigarettes take effect in all EU Member States and that **no Member State will be granted a transition period** before this ban to stop the free flow in the Schengen Area.
- The revised Directive **gives the tobacco industry a central role** in tracking and tracing system (contrary to the FCTC Protocol) and **it excludes the word "secure" from "secure unique identifier"**. This is in clear contradiction with the letter and spirit of both the FCTC and the FCTC Protocol which the EU has signed.

The EU needs to ensure that the Directive is correctly aligned to the provisions of the FCTC and its Protocol to avoid future legal challenge or ambiguity.

7. National initiatives and cross border cooperation to combat smuggling

In order to fight illicit trade organised on a global scale, national and transnational measures should be taken:

- tracking and tracing system;
- strengthen national regulation (e.g. on untaxed cut tobacco) and legal tax free import for further sale;
- enabling access of customs services to transparent and public data on illegal trade and legal production in the EU countries;
- increase international cooperation;
- creating a special EU fund to support customs needs (new X-ray scanners for wagons and trucks etc.);
- automatic car plate and container codes recognition system allowing for the observation of car and container movements;
- discouraging actions (monitoring of bazaars, internet, postal parcel etc.);
- automatic car plate and containers codes recognition system ;
- campaign to gain public support to decrease consumption of illegal goods.

Annex 1 - The EU's Agreements with four cigarette manufacturers - main facts

Annex 1

The EU's Agreements with four cigarette manufacturers - main facts
(based on the briefing note by I. Walton-George)

Company	Philip Morris International (PMI)	Japan Tobacco International (JTI)	British American Tobacco (BAT)	Imperial Tobacco Limited (ITL)
Signed	2004	2007	2010	2010
Duration	12 years (2016)	15 years (2022)	20 years (2030)	20 years (2030)
Payments to be made	USD 1 billion over 12 years	USD 400 million over 15 years	USD 200 million over 20 years	USD 300 million over 20 years
Payments so far	Almost 100%	USD 280 million	USD 27 million	USD 50 million
Supplemental/additional payments	<p>1. In case of seizure of 50,000 or more genuine cigarettes, payment of 100% of the duties and taxes due</p> <p>2. If the number of seized cigarettes exceeds the baseline amount, supplemental payment rises to 500% of the evaded duties and taxes</p>			
Baseline amount	90 million (now 450 million)	90 million	150 million	90 million
Main elements	<p>(a) conduct rigorous checks on its customers and contractors (“EC Compliance Protocols”);</p> <p>(b) accept only limited forms of payment for cigarettes in order to combat money laundering;</p> <p>(c) implement far-reaching product-tracking and product-tracing procedures so that information can be obtained about the chain of supply if cigarettes are subsequently found in illicit channels;</p> <p>(d) cooperate fully with law enforcement authorities; and</p> <p>(e) make substantial payments to the EU and the participating Member States.</p>			
Provision for the negotiation of a possible new Agreement	Yes	No	Yes	Yes
Agreement settled all legal disputes between the company and the EC in relation to smuggling	Yes	Yes	No	No