

House of Commons
Committee of Public Accounts

TOBACCO SMUGGLING

Third Report of Session 2002–03

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*Report, together with
Proceedings of the Committee, Minutes of
Evidence and Appendices*

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Committee of Public Accounts

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Footnotes

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THIRD REPORT

The Committee of Public Accounts has agreed to the following Report:

TOBACCO SMUGGLING

INTRODUCTION AND LIST OF CONCLUSIONS AND RECOMMENDATIONS

1. In 2000–01 HM Customs and Excise (Customs) collected duty and VAT of £9.5 billion on the sale of cigarettes and tobacco. For that year they estimated, however, that £3.5 billion had been lost through evasion of duty and VAT on all tobacco products, equivalent to 1p on the basic rate of income tax. Some 17 billion cigarettes were smuggled into the UK in the year, with an estimated revenue loss of £2.8 billion. Most of these illicit imports were produced in the UK by three tobacco companies, exported and then smuggled back. About half were produced by the Imperial Tobacco Company. We therefore took evidence from Imperial Tobacco, and from the Chairman of Customs and Excise.

2. Tobacco and cigarette smuggling into the UK grew markedly in the mid-1990s following the removal of routine frontier controls between EU states. Customs acknowledged that they had been slow to respond to that growth, and it was only in 2000 that targets to restrict and reduce the level of smuggling were set.

3. Customs estimated in March 2000 that, without additional enforcement action, smuggled cigarettes would account for 25% of those smoked in the UK. The Government committed £209 million to slow the rate of growth, stabilise and then reduce illicit market penetration over three years. Customs were set targets to restrict cigarette smuggling in 2000–01 to 21%, and reduce it to 18% by 2004–05. Their strategy is to make smuggling less profitable, and less attractive, by increasing the chances of smugglers getting caught and securing heavier penalties.¹

4. On the basis of a Report by the Comptroller and Auditor General on Customs' Appropriation Accounts for 2000–2001, we examined:

- the success of the Customs' strategy for combating tobacco smuggling;
- the co-operation they receive from cigarette manufacturers in tackling smuggling;
- the sanctions being used to deter smuggling; and
- the use of x-ray scanners to detect smuggled tobacco.

5. In the light of our examination, the Committee draws the following overall conclusions:

- Smuggling of cigarettes is costing £2.8 billion a year in lost revenue (£3.5 billion if hand-rolled tobacco is included). Even if Customs meet their target for 2004-05 of limiting cigarette smuggling to 18%, there will still be a loss of VAT and duty of almost £2 billion annually. To get it down further at tolerable cost will continue to require the full cooperation of the UK cigarette manufacturers in the supply of information and in applying export policies which discourage smuggling.
- Since 1997 there has been a marked increase in the number of cigarettes manufactured by Imperial Tobacco being smuggled back into the UK, which has coincided with a substantial increase in the company's international profits. The

¹ C&AG's Report, *Audit of HM Customs and Excise under Section 2 of the Exchequer and Audit Act 1921, Appropriation Accounts 2000–01, Volume 16: Class XVI (HC 335-XVI)*, paras 5.4–5.10

company acknowledged that Customs had seized large quantities of their cigarettes in 2000–01 though they disputed the precise figures. On the basis of Customs' estimates, the tax and duty lost through smuggling from the two main Imperial brands affected was some £1.4 billion in 2001–02.

- Against this background, Customs and Excise were understandably concerned about a perceived lack of co-operation from the company in assisting with their investigations into this state of affairs. The company need to take a positive approach to preventing smuggling, notably by providing more timely responses to Customs' requests for information and by exercising greater discretion in their choice of export markets. It cannot help Imperial Tobacco's good name if there is a question mark over their attitude in this matter.
- Customs aim to agree Memoranda of Understanding with the manufacturers. They had done so with Gallaher, and have since done so with British American Tobacco. Imperial Tobacco need to offer a similar level of assurance on their business practices, so Customs can have sufficient confidence to complete a Memorandum with that company too. Pending the completion of a memorandum, Customs should have unfettered access to relevant information held by Imperial, which should in turn be accessible to the Comptroller and Auditor General so that he can report as necessary to Parliament.
- Customs have a difficult balance to strike in facilitating legitimate trade while at the same time deterring smuggling through seizure of assets or prosecution. Since 1999–2000 Customs have initiated fewer prosecutions, concentrating on those who smuggle significant quantities of cigarettes, while relying on seizure of vehicles and goods for lesser cases. The growing level of evasion suggests that Customs need to prosecute some of those engaged in lower level smuggling in order to emphasise the criminal nature of this offence, and act as a greater deterrence to others.

6. Our further conclusions and recommendations are:

- (i) Customs need reliable information on the extent of smuggling to assess the success of their strategy to combat it. They are refining their methodology for calculating the level of smuggling. They should submit the revised methodology to independent expert appraisal.
- (ii) Imperial Tobacco had been exporting cigarettes to some unusual markets, and had found it necessary to terminate these trading agreements because the cigarettes were re-entering the UK. In our view they might have foreseen that exports to such markets were likely to be diverted in this way.
- (iii) The company drew attention to the impact of their actions in reducing the incidence of smuggling, but on the basis of limited information covering a few months only. Evidence of improvement over a longer period will be necessary.
- (iv) In September 2000 Customs launched a campaign to change perceptions of cigarette smuggling. This campaign was targeted at drivers of Heavy Goods Vehicles and retailers but not specifically at smokers. Customs should also promote wider public awareness that purchasing smuggled tobacco diverts revenue from public services into the hands of the criminal community.
- (v) By July 2002 Customs had introduced 12 x-ray scanning machines and ultimately plan to have 20 to cover the 43 ports and points of entry. More machines would give better coverage and reduce the need to move scanners between ports. Any such moves should be discreet and at random so that smugglers are not

forewarned. The Department also need to resolve the operating difficulties associated with the scanners at some ports, and improve the scanners' throughput to the levels envisaged by the manufacturers.

EXTENT OF CIGARETTE SMUGGLING

7. Customs estimate that 70–80% of smuggled cigarettes are being transported into the country by organised criminals in freight, principally in deep-sea containers or 'roll on roll off' ferries. During 2000–2001 Customs made over 360 seizures from containers or lorries, each in excess of one million cigarettes.² Their aim is to tackle smuggling by increasing the level of checks, and to make smuggling less profitable or attractive by increasing the chances of getting caught and increasing the penalties imposed. They also aim to disrupt the activities of smugglers by confiscating assets and vehicles.

8. Customs acknowledged that measuring the extent of smuggling, and their success in combating it, was imprecise. They seized 38% more cigarettes than targeted in 2000–2001 and believe that they met their target for the year by restricting the market share of smuggled cigarettes to 21%, plus or minus 2%. They do not yet have reliable data, but believe they achieved at least the same result in 2001–2002.³

Figure 1: Analysis of UK Cigarette Consumption and Smuggling in 2000–01		
Estimated consumption of duty paid cigarettes	56 billion	Generating £9 billion in Duty and VAT
Legitimate cross border shopping	5 billion	Representing Duty and VAT foregone of £0.8 billion
Estimated number of smuggled counterfeit cigarettes	1.9 to 2.9 billion	Representing a loss of Duty and VAT of between £0.3 and £0.5 billion
Estimated number of smuggled (non-counterfeit) cigarettes	14.1 to 15.1 billion	Representing a loss of Duty and VAT of between £2.3 and £2.4 billion
Total estimated number of smuggled cigarettes	17 billion	Representing a loss of Duty and VAT of £2.8 billion
Estimated UK consumption of cigarettes	78 billion	
<i>Note: Total cigarettes seized in the year: 2.8 billion</i>		

Source: C&AG's Report (paragraphs 5.30 and 5.31) and Customs' estimates

² Q 128

³ C&AG's Report, paras 5.30, 5.33

9. **Figure 1** sets out the significant scale and financial impact of cigarette smuggling. It represented a loss to the Exchequer in 2000–2001 of £2.8 billion in VAT and Duty (£3.5 billion when hand-rolled tobacco is included), with further losses of Corporation and Income Tax because of the licit sales foregone by shops and other outlets. Customs' target has been to restrict cigarette smuggling to 18 % by 2004–05, but even if they achieve their target, the loss will still represent almost £2 billion a year in tobacco duty and VAT. Customs' acknowledged to us that the target of 18% was not particularly ambitious.⁴ Their Public Service Agreement targets are reviewed annually, and since our hearing Customs have been set a new target⁵ to restrict smuggling to 17% by March 2006.

CO-OPERATION FROM CIGARETTE MANUFACTURERS IN TACKLING SMUGGLING

10. The majority of cigarettes smuggled into the country have been manufactured here. Customs look to UK tobacco manufacturers to pursue export policies which do not encourage the re-import of smuggled cigarettes. Customs are reliant on the co-operation of the cigarette manufacturers for the supply of relevant information on the volumes they have produced and exported and on export destinations.⁶ The Department have therefore sought to agree Memoranda of Understanding with the cigarette manufacturers as a framework for co-operation in combating smuggling.

11. Customs told us they had recently entered into a Memorandum of Understanding with Gallaher, and have since also reached agreement with British American Tobacco. But they had concerns about the timeliness, promptness and completeness of information provided by Imperial Tobacco. The Company had moreover been exporting very significant volumes of cigarettes to countries where they had no domestic market share.⁷ As a consequence the Department had found it necessary to issue warnings on these export practices.

12. Imperial Tobacco manufacture a number of leading brands including Regal and Superkings. Customs believe that as many as 65% of the Regal and Superkings cigarettes exported by the Company were smuggled back into this country, compared with a rate for all cigarettes of only 16%. The Chief Executive of the company acknowledged that there had been a marked increase from 1997 in the number of their cigarettes being smuggled back into the UK, and that very large quantities of his company's cigarettes had been seized by Customs in 2000–2001.⁸

13. On the basis of data provided by Customs the two Imperial brands, Regal and Superkings, make up about one half of the entire smuggled market.⁹ The data indicated that the illicit market for these cigarettes in this country appeared to be significantly greater than the licit market (**Figure 2**) yet there was little smuggling of Imperial's leading UK cigarette, Lambert and Butler. One of the main reasons appears to be that the company are restricted to exporting Lambert and Butler cigarettes to a more limited number of countries than Regal and Superkings because of trade mark ownership issues.

14. The company acknowledged holding information from which they could tell if one of their wholesale customers was selling cigarettes in a territory allocated to another of Imperial's customers, and in these circumstances they took action to terminate supply. Customs estimate that nearly 8 billion of Imperial's cigarettes are nevertheless smuggled into the UK each year.¹⁰

⁴ Q 4

⁵ 2002 Spending Review

⁶ Q 117

⁷ Q 170

⁸ Qq 291, 329–332

⁹ Q 166

¹⁰ Q 338

Brand	Licit Market		Illicit Market³	
	% of Licit Market	No of Cigarettes	% of Illicit Market	No of Cigarettes
Superkings	5.3	3.0 billion ¹	30.1	4.4 billion ²
Regal	3.9	2.2 billion ¹	20.1	2.9 billion ²

¹

Approximate figures on the assumption that UK consumption of licit cigarettes is 56 billion.

²

Approximate figures on the assumption that the illicit market is comprised of the 14.6 billion non-counterfeit cigarettes estimated to be smuggled into the UK annually.

³

In addition to those cigarettes successfully smuggled into the UK, Customs seized a further 1.2 billion Regal and Superkings cigarettes in 2000–01.

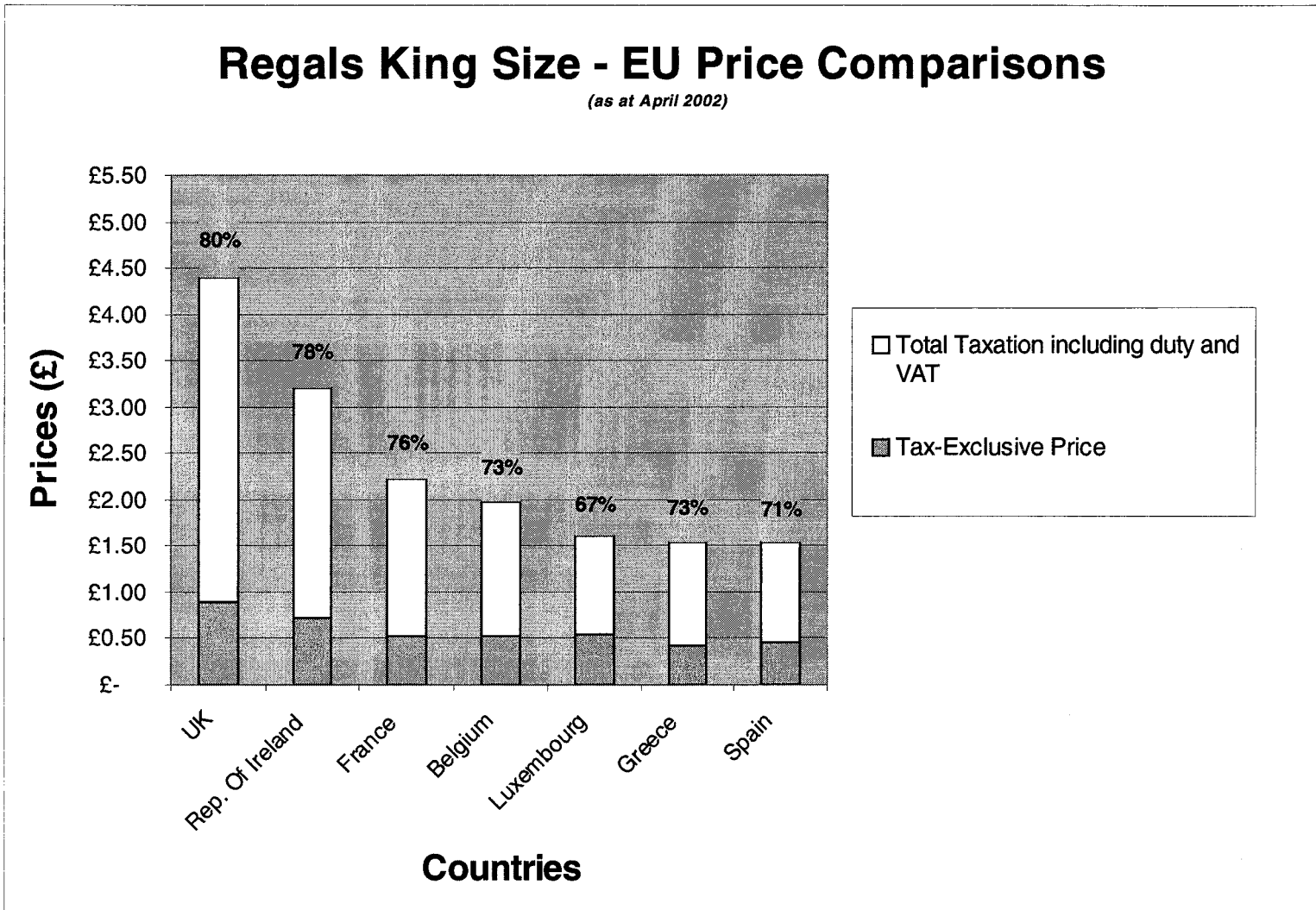
Source: Customs' estimates

15. Imperial told us that the company had no incentive to encourage smuggling as it hit their duty paid sales, on which they made the largest profit margins. The diversion of cigarettes from overseas markets into the smuggled trade also affected the investment they had made in developing those markets. Moreover, the smuggling of counterfeit cigarettes depressed sales of their genuine products.¹¹

16. The company said that the incidence of smuggling into this country was due to the high duty rates applied. We observed that Imperial contributed to the high cost of cigarettes, as the basic price charged by the company in the UK for its cigarettes was higher than in other EU countries. **(Figure 3)**

¹¹ Q 307

Figure 3: Variations in the basic (tax free) price of Regals across the EU



Source: *Imperial Tobacco*

17. The company explained that for several years their business strategy had been to increase their international business, and from 1997 the company's international profits had risen markedly. Figures for turnover and profitability are shown in **Figures 4 and 5** respectively, distinguishing between United Kingdom and international business. Customs' figures indicated that the company had been sending two thirds of its exports of Regal and Superkings, totalling some three billion cigarettes, to just five locations, namely Latvia, Kaliningrad, Afghanistan, Moldova and Andorra. These locations did not seem to be among the most promising of UK export markets, and indeed the company had subsequently terminated their supply to these locations at short notice.

Figure 4: Imperial Tobacco Group's turnover

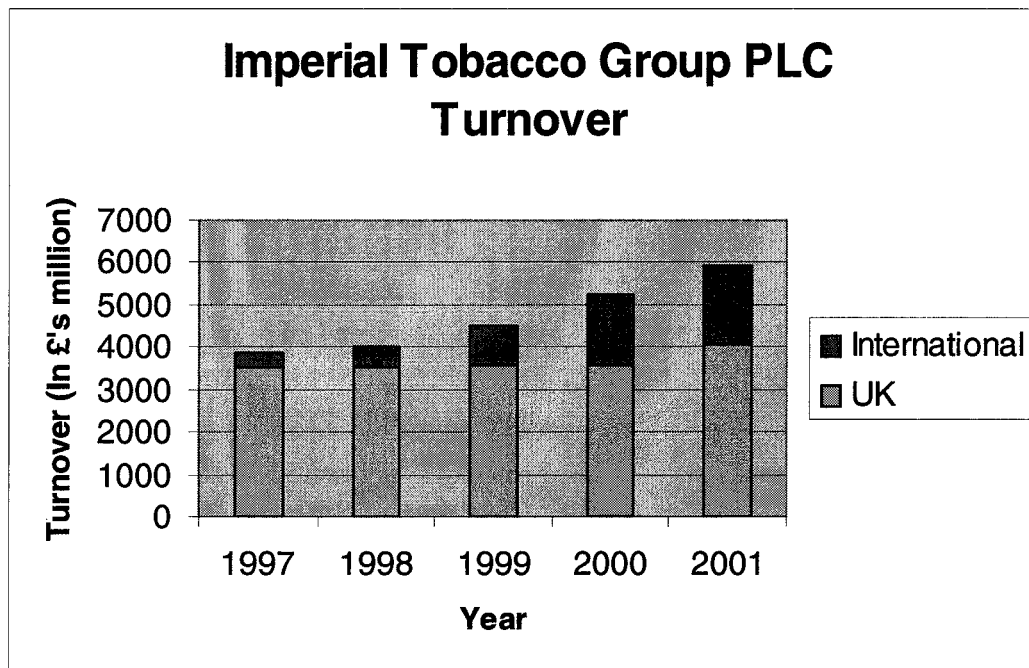
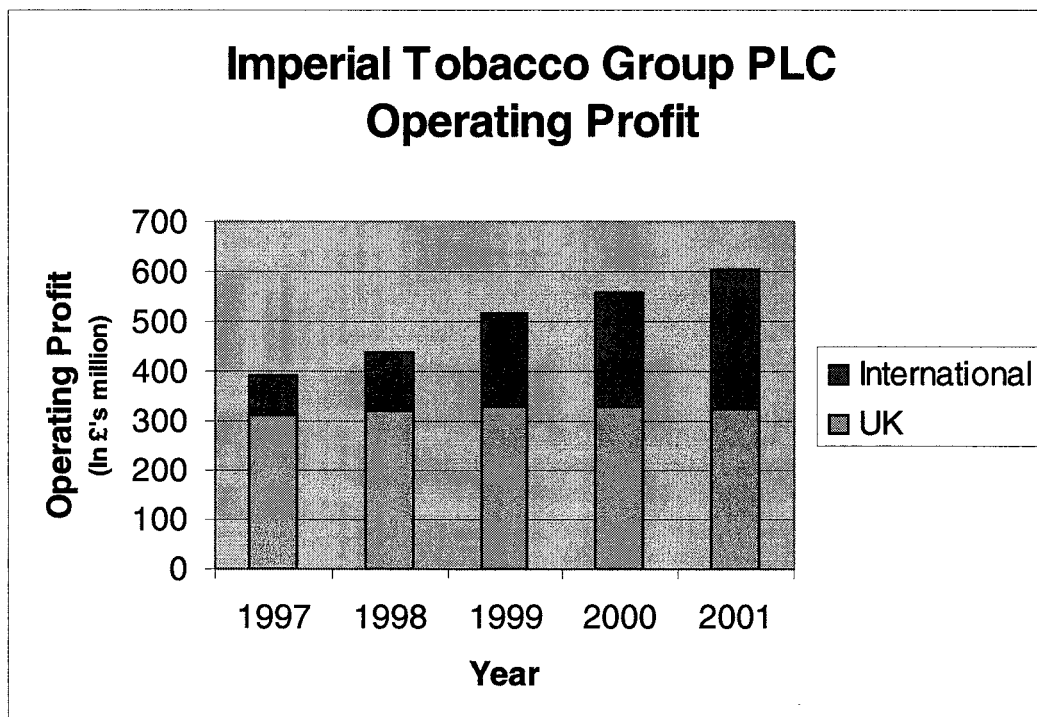


Figure 5: Imperial Tobacco Group's operating profit



18. Customs had been seeking explanations for these anomalies for some time, and for information on the Company's export strategies for these brands, but without success.¹² Imperial were concerned that Customs considered the company to have been less co-operative than other tobacco manufacturers.

19. In early 2001 Customs had introduced a system of red and yellow cards to identify customers of tobacco manufacturers about whom they had serious concerns. These were based on the proportion of a particular customer's total purchases that appeared to find their way back into the UK. Cases of most serious concern were red card customers. Customs would expect a fully co-operative tobacco manufacturer to take action against such customers, and would expect yellow carded customers to be the subject of enquiries by the manufacturer. Customs had not found it necessary to issue any cards to British American Tobacco, only two to Gallaher, but 17 to Imperial.

20. Imperial considered that, in reaching a decision on terminating trading with a customer, fine judgements were required. It was not straightforward to cease trading with a customer simply because it appeared that smugglers had chosen to obtain supplies of their products from that customer. If a customer's supplies were cut off, his reputation might be damaged and infrastructure costs incurred wasted, so it was not a decision that Imperial took lightly. Nevertheless, the Company had terminated supplies to almost 30 customers since December 1999 because of such concerns. Many of these supply arrangements had been terminated before Customs had raised any concerns on them.

21. In May 2002 Imperial purchased the German tobacco company, Reemtsma, who manufacture the West brand of cigarettes. The World Customs Organisation reported that in 2000 West was the most frequently smuggled cigarette brand in Europe. Imperial's Chief Executive was however unaware of this situation, or of the criminal prosecution being brought against Reemtsma's by the German Customs authorities.¹³

THE SANCTIONS BEING USED BY CUSTOMS TO DETER SMUGGLING

22. Customs have a range of sanctions, including the power to prosecute individuals, the non-restoration of any vehicles used to transport smuggled goods and, following court action, the seizure of individuals' assets. Customs normally apply sanctions if they consider the amount of cigarettes imported by individuals to be beyond that expected for personal consumption. Although not applying a rigid limit, Customs have worked on a figure of 800 cigarettes per person in line with a minimum indicative limit set by the EU. If they found quantities in excess of that amount they often prosecuted, or seized assets, such as the vehicle involved.¹⁴

23. New Regulations laid before Parliament in October 2002¹⁵ and to come into force from 1 December 2002 have increased the indicative amount of cigarettes that can be imported for personal consumption from 800 to 3,200, and increased from 1kg to 3kg the amount of hand-rolled tobacco. Customs will continue to seize any vehicle used in smuggling, but will now offer small-scale first-time offenders the opportunity to have their vehicles back for a fee equivalent to the amount of the duty that they had attempted to evade. Large-scale and repeat offenders will not have their vehicle restored.¹⁶

¹² Qq 220, 241

¹³ Qq 449-461

¹⁴ Qq 71-73

¹⁵ The Excise Goods Beer and Tobacco Products (Amendment) Regulations 2002

¹⁶ HC Deb, 29 October 2002, cols 686-8W

24. Prior to 2000–2001 Customs pursued a large number of small prosecutions. They changed their approach at that time to improve the quality of their prosecutions, with the result that the average sentence awarded by the courts went up along with the number of defendants per case. Customs also focussed their prosecutions on those smuggling organisations at the upper end of the scale, relying primarily on the seizure of vehicles and goods, and the imposition of fines, for those engaged in lower level smuggling. As a consequence, the overall number of prosecutions dropped in 2000–01 by around 19%, when compared with the previous year. Since they gave evidence to the Committee, Customs have announced a further development, whereby they will conduct an increased number of prosecutions against large-scale smugglers as well as those serial cross-Channel passengers engaged in smuggling.¹⁷

25. Customs confiscated over 10,000 private light vehicles in 2000–01, almost double the number in previous years. They have adopted since July 2001 a similar confiscation policy on Heavy Goods Vehicles, seizing vehicles on first offence where the amount of duty evaded exceeds £50,000 and seizure on second offence where the duty evaded is less than £50,000.¹⁸ Although this sanction is used, Customs recognise that the seizure of a valuable HGV represents a major sanction to a company. Their decisions on restitution of the vehicle have regard to the level of culpability of the haulier.

26. Cigarette smuggling may wrongly be seen as a victimless crime, without recognising that much of it is undertaken by organised crime. Customs accept that there is a need to change perceptions and launched in September 2000 a public awareness campaign aimed at informing people about the law, and persuading them to comply with it. The Department told us, however, that this campaign had been targeted at HGV drivers and retailers. They had not commissioned market research to ascertain the general public's view of tobacco smuggling.¹⁹

27. Customs consider x-ray scanners to be a key weapon in their armoury against tobacco smuggling. They told us that they had 12 scanners in operation at the major ports, which between them handle 90% of the container traffic and three quarters of the 'roll on roll off' traffic. Because of the introduction of scanners, smugglers are thought to be switching their operations to other ports, or importing their tobacco in other ways to avoid detection. Customs therefore plan to have a total of 20, which they will move periodically between the 43 major ports and points of entry. Customs acknowledged that there were teething problems with their scanners and that the introduction of the machines could have been better planned to avoid many of the logistic problems they had encountered. After they had introduced the machines Customs discovered the need for more training than expected, particularly in image interpretation.²⁰ They also underestimated how many staff would be needed to operate the machines.

28. Customs have had differing levels of performance from the scanners in each port. The manufacturer's estimates were that between 30,000 and 50,000 vehicles and containers could be scanned annually. Customs, however, have been achieving only some 10,000 to 20,000. Effective operation of the scanning machines is being limited in some instances because of the lack of space at ports. Limitation in the space available at Dover, for example, has served to reduce the number of lorries that can be scanned in a day, and Customs are unable to achieve the throughputs built into their assumptions. They intend in the future to set separate targets for each port.

¹⁷ HC Deb, 29 October 2002, cols 686–8W

¹⁸ Qq 47–54, 162–164

¹⁹ *Ibid*

²⁰ Qq 10–11

29. Customs have experienced problems at some ports with locating and retrieving containers.²¹ The port authorities are often required to undertake building works when scanners are introduced at their ports, employ more staff and purchase additional plant. Customs recognise the need to maintain the full co-operation of the port authorities if they are to maximise the effectiveness of the machines.

30. Customs consider intelligence to be essential to the success of the scanners. They try never to stop vehicles at random because they believe such searches are almost wholly ineffective. Specific intelligence on particular lorries or shipments, developed through targeted operations and covert means, had enabled Customs at Dover to increase the detection rate from scanners and other means from between 2 and 3% to 56%.²²

²¹ Q 194

²² Qq 31–32, 36

MINUTES OF PROCEEDINGS OF
THE COMMITTEE OF PUBLIC ACCOUNTS

SESSION 2001-02

MONDAY 29 APRIL 2002

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Mr David Rendel
Mr Ian Davidson	Mr Gerry Steinberg
Mr Barry Gardiner	Jon Trickett
Mr Nick Gibb	Mr Alan Williams
Mr George Osborne	

Sir John Bourn KCB, Comptroller and Auditor General, was further examined.

The Committee deliberated.

Mr Brian Glicksman, Treasury Officer of Accounts, was further examined.

Customs and Excise Standard Report 2000-2001: Tobacco Smuggling (Appropriation Accounts 2000-2001 Volume 16: Class XVI, Departments of the Chancellor of the Exchequer, HC 335-XVI) was considered.

Mr Richard Broadbent, Chairman, and Mr Mike Wells, Director, Law Enforcement Policy, HM Customs and Excise, were further examined (HC 806-i).

The witnesses withdrew.

The Committee further deliberated.

* * * * *

[Adjourned until Wednesday 1 May at Four o'clock.

* * * * *

WEDNESDAY 19 JUNE 2002

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Mr George Howarth
Mr Ian Davidson	Mr Nigel Jones
Geraint Davies	Mr George Osborne
Mr Frank Field	Mr David Rendel
Mr Barry Gardner	Mr Gerry Steinberg
Mr Nick Gibb	Mr Alan Williams

Sir John Bourn KCB, Comptroller and Auditor General, was further examined.

The Committee deliberated.

Mr Brian Glicksman, Treasury Officer of Accounts, was further examined.

The Customs and Excise Standard Report 2000–2001: Tobacco Smuggling (Appropriation Accounts 2000–2001 Volume 16: Class XVI, Departments of the Chancellor of the Exchequer, HC 335-XVI) was further considered.

Mr Gareth Davis, Chief Executive, Mr Bruce Davidson, Managing Director, and Mr John Dibble, General Manager, Economic Affairs, Imperial Tobacco Plc, were examined; and Mr Mike Wells, Director, Law Enforcement Policy, HM Customs and Excise, was further examined (HC 806-ii).

The Chairman declared a non-pecuniary interest in having received hospitality in the last Parliament from tobacco companies, which may have included Imperial Tobacco Plc.

The witnesses were further examined.

The witnesses withdrew.

The Committee further deliberated.

* * * * *

[Adjourned until Monday 24 June at Four o'clock.

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SESSION 2002–03

MONDAY 2 DECEMBER 2002

Members present:

Mr Edward Leigh, in the Chair

Mr Geraint Davies
Angela Eagle
Mr George Howarth

Mr Brian Jenkins
Mr David Rendel
Mr Alan Williams

Sir John Bourn KCB, Comptroller and Auditor General, was further examined.

The Committee deliberated.

Mr Brian Glicksman, Treasury Officer of Accounts, was further examined.

* * * * *

Draft Report (Tobacco smuggling), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraph 1 brought up, read, and disagreed to (paragraph omitted).

Two new paragraphs—(*Mr Davies*)—brought up, read the first and second time, and inserted (now paragraphs 1 and 2).

Paragraphs 2 and 3 (now paragraphs 3 and 4) read and agreed to.

Paragraph 4 (now paragraph 5) read and disagreed to (paragraph omitted).

Paragraph 5 read, amended and agreed to.

Paragraph 6 read and postponed.

Paragraphs 7 to 16 read and agreed to.

Paragraph 17 read and disagreed to (paragraph omitted).

New paragraph 17—(*Mr Davies*)—brought up, read the first and second time, and inserted.

Paragraphs 18 to 30 read and agreed to.

Postponed paragraph 6 read a second time, amended and agreed to.

Resolved, That the Report, as amended, be the Third Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select Committees (Reports)) be applied to the Report.

* * * * *

[Adjourned until Wednesday 4 December at Four o'clock.]