House of Commons
Treasury Committee

Excise Duty Fraud

Fourth Report of Session 2004–05

Report, together with formal minutes, oral and written evidence

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The Treasury Committee

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Contacts

All correspondence for the Treasury Committee should be addressed to the Clerk of the Treasury Committee, 7 Millbank, House of Commons, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769. The Committee’s email address is: treascom@parliament.uk.
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1 Introduction

1. The Treasury Committee established a Sub-committee in July 2001 to scrutinise the work of the various bodies for which Treasury Ministers are accountable. The Sub-committee announced, in October 2004, an inquiry into excise duty fraud. The terms of reference of the inquiry were to review Customs and Excise’s strategies for tackling tobacco smuggling, alcohol fraud, and fraud in the oils sector, and to examine for each of these areas:

- the level of fraud and how this has been estimated;
- the steps taken and proposed to reduce the level of fraud; and
- the impact these have had on the level of fraud and on compliance costs.

2. We heard oral evidence from Customs and Excise on 17 November 2004, from the British Beer and Pub Association, and the Scotch Whisky Association on 8 December 2004, from British American Tobacco, Gallaher Group, Imperial Tobacco Group, and Philip Morris International on 12 January 2005, and from John Healey MP, the Economic Secretary, on 2 February 2005.

3. We visited Budapest and Prague in January 2005 to be briefed by the Hungarian and Czech finance, tax and customs authorities on their experience of excise duty fraud and efforts to combat it, and to learn in particular about the use of tax stamps on alcohol. We visited a distillery and a bottling plant in Scotland to discuss tax stamps with the industry. We were briefed on the potential impact of tax stamps placed across the top of the bottle and of alternatives such as incorporating them into the design of existing front or back labels. We also took the opportunity provided by a visit of the main Committee to China to discuss with China Customs and the Chinese State Tobacco Monopoly Administration their efforts to combat the counterfeiting of tobacco products in China, with particular emphasis on those aimed at the UK market. We also received a number of written submissions, most of which we have published with this volume. We are grateful for all the evidence we received, written and oral, and for the help given by those who briefed us.
2 The level of excise duty fraud and Customs’ strategy for tackling it

4. The Government is committed to tackling tax fraud in order “to protect the revenue required for investment in public services, to protect legitimate businesses, and to protect society from organised crime.”¹ The revenue generated from excise duties on tobacco, alcohol and oils is significant. Excise duty receipts for 2003–04 totalled some £38,444 million. The amount of excise duty evaded by smuggling and fraud is also significant. Customs and Excise have estimated (for those areas where this was possible) that revenue losses for 1999–2000 were some £3,980 million. By 2003–04 this figure had fallen slightly to £3,750 million. Table 1 below provides details of excise duty receipts, and estimates for revenue evaded through smuggling and fraud.

Table 1: Excise duty receipts and estimated revenue evaded by smuggling and fraud

<table>
<thead>
<tr>
<th>Excise duty receipts 2003–04 a</th>
<th>Latest estimates of revenue evaded b</th>
<th>Estimated revenue evaded 1999–2000 c</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tobacco</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cigarettes</td>
<td>£7,634m</td>
<td>£1,900m²</td>
</tr>
<tr>
<td>Hand rolling tobacco</td>
<td>£297m</td>
<td>£750m³ n/k</td>
</tr>
<tr>
<td>Other tobacco</td>
<td>£162m</td>
<td>n/k</td>
</tr>
<tr>
<td></td>
<td></td>
<td>£2,000m</td>
</tr>
<tr>
<td></td>
<td></td>
<td>£630m n/k</td>
</tr>
<tr>
<td></td>
<td></td>
<td>n/k</td>
</tr>
<tr>
<td>Alcohol</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beer</td>
<td>£3,044m</td>
<td>n/k</td>
</tr>
<tr>
<td>Spirits</td>
<td>£2,362m</td>
<td>£250me n/k</td>
</tr>
<tr>
<td>Other alcohol f</td>
<td>£2,159m¹</td>
<td>n/k</td>
</tr>
<tr>
<td></td>
<td></td>
<td>£350m n/k</td>
</tr>
<tr>
<td>Oils</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Diesel</td>
<td>£9,848m</td>
<td>£850m⁹ n/k</td>
</tr>
<tr>
<td>Petrol</td>
<td>£12,713m</td>
<td>n/k</td>
</tr>
<tr>
<td>Other oils</td>
<td>£225m</td>
<td>n/k</td>
</tr>
<tr>
<td></td>
<td></td>
<td>£1,000m⁹ n/k</td>
</tr>
<tr>
<td></td>
<td></td>
<td>n/k</td>
</tr>
<tr>
<td>Total:</td>
<td>£38,444m</td>
<td>£3,750+m</td>
</tr>
<tr>
<td></td>
<td></td>
<td>£3,980+m</td>
</tr>
</tbody>
</table>

a Source: HM Customs & Excise Annual Report and Accounts 2003–04 p 136
b Source: HM Customs & Excise Measuring and Tackling Indirect Tax Losses Dec 2004, Tables 3.1, 3.8, 3.11, 3.13
c Source: HM Customs & Excise Measuring Direct Tax Losses Nov 2002 (Tables 3.1, 3.4) and Measuring and tackling indirect tax losses Dec 2003 (Tables 4.6 and 4.10); range figures for 1999–2000 for some of the categories marked ‘n/k’ were initially given in the 2002 publication, but have not been repeated in later updates
d 2003–04
f mostly wine, but also cider & perry: for 2003–04, receipts were wine (in. c made wine) £2006m and cider & perry £153m
g calendar years, GB only

5. Customs and Excise first published estimates of the scale of excise duty fraud for spirits, cigarettes and hydrocarbon oils in 2001 (for 1999–2000) showing that the illicit market share in the UK: for spirits was 15%; for smuggled cigarettes was 21%; and for diesel (in Great Britain) was 4%.² We asked Customs and Excise how excise duty fraud had risen to such levels. A senior Customs official told us that:

¹ Ev 79, para 1
² Measuring Indirect Tax Fraud, HM Customs and Excise, November 2001, tables 2.2, 2.4, and 2.8. These illicit market share estimates were subsequently revised for: spirits to 11%; cigarettes to 17%; and diesel to 8%.
“Fraud grew through the 1990s for a variety of reasons. One of the reasons was the significant facilitation to trade and to passenger movements which took place with the single market. That coincided with very large growths in international trade and passenger movements. Passenger movements are up something like 70%, air travel is an awful lot cheaper than it was at one stage and volumes of trade into and out of the UK have doubled in the last decade. That, combined with the facilitation around the single market, has been exploited by organised crime and once that effect takes hold it has a multiplying effect. We saw that grow very rapidly in the latter part of the 1990s. Obviously also the UK is an attractive place for fraudsters because of our relatively high rates. Inevitably that makes us a target to exploit. I would also acknowledge that in some respects during the 1990s we in Customs did not respond as quickly as we might have done to some of those problems. At that stage we did not seek to estimate the overall size of problems. We did not seek to set outcome targets in terms of reducing fraud, but we measured ourselves rather in terms of outputs. At times that could be a rather perverse measurement because measuring yourself in terms of the volume of products seized or the number of people prosecuted could in many ways be a measure simply of the problem growing rather than the effect in tackling it. We tried to change that situation over the last four to five years and now try to measure ourselves in terms of the outcome we are achieving and in that sense the direction of travel is now in the right direction, albeit not nearly far enough.”

6. In recent years, the Government has established a new strategic approach to tackling indirect tax fraud, based on accurately assessing the size and nature of the problem, setting clear objectives and targets for tackling it, identifying the operational responses required to achieve those targets, and monitoring the delivery of results. Measuring the scale of, and trends in, excise fraud is inherently problematic because of the difficulties in estimating total consumption from survey data. This information is used in estimating fraud levels which are based on a comparison of estimated total consumption with duty paid consumption and an allowance for cross-border shopping. Customs’ estimates of excise duty losses from smuggling and fraud are updated annually in papers published with each Pre-Budget Report.

7. Several industry witnesses considered, unsurprisingly, that a significant factor in the level of excise duty fraud and smuggling was the relatively high level of excise duties in the UK. The Tobacco Manufacturers’ Association told us that “we believe that despite the enforcement policies of [Customs and Excise] and the measure of success that [Customs’ strategy for tackling tobacco smuggling] has delivered, the UK’s high level of [non-UK duty paid] tobacco consumption will continue unless the fundamental reason for this unacceptable situation—the high level of UK tobacco tax—is addressed.” The Road Haulage Association noted that it “remains of the view that the only way that [the]
problem [of fuel smuggling] can be eradicated altogether is to remove the differential that exists between fuel duties within the EU.”

The British Beer and Pub Association told us that “a major incentive for fraudulent activity in the UK is the high rate of duty per se and the differential in duty between the UK and France. Regulatory options proposed by [Customs] do not include removal of the incentive but rather focus on reducing levels of fraudulent activity. The regulatory options under consideration are directed towards treating the symptoms rather than tackling the root cause of the problem.”

8. Customs and Excise accepted that there was a relationship between rates of duty and the level of fraud, but noted that:

“… it is important to bear in mind that in most cases the illicit product is a product which has borne either no duty or very little duty indeed; in the case of spirits we are talking about diverted duty suspended product, in the case of oils we are talking about the misuse of red diesel and in the case of tobacco we are predominantly talking about product which has come from the far side of the world, having borne negligible or no duty. When we compare duty rates, it is really comparing duty rates in the UK against zero or near to zero. That is the context and indeed several other countries in Western Europe, with much lower rates of excise duty than the UK, also suffer significant smuggling problems and fraud problems in these areas. Italy and Spain, for example, have had substantial tobacco smuggling problems despite having much lower rates of tax. Belgium has a very substantial diesel fraud problem despite being in the bottom third of oils tax rates in the Member States. It is very much more complicated than a straightforward lower tax equals lower fraud equation.”

9. We asked the Economic Secretary about the extent to which estimated levels of fraud and cross-border shopping were taken into account when setting duty rates. The Economic Secretary noted that “[…] every government takes a judgment about the balance of taxation across the range to produce the revenues required for public expenditure and investment, but […] the most significant factor in cross-border shopping, […] is that since 1993, with the introduction of the single market, the right to cross-border shop— in other words, bring back excise goods […] in as great a quantity as one wants for personal use— is part of the fundamental rights for citizens within the European Union single market.”

The Economic Secretary also confirmed that in making annual judgments about duty rates in the Budget the potential impact on smuggling was taken into account.

10. In response to questions about the level of excise duty fraud and smuggling the Economic Secretary noted that:

“It is not satisfactory. It is still significant, as I explained, but on the other hand if we had not put the action and investment in place which we have done over the last few years the situation would be significantly worse. We have still got a lot more to do, which is why we have set, from government, Customs and Excise and the successor
body some quite tough public service agreement targets to reduce these levels of fraud still further, but if we had not taken this action on tobacco and on oils two or three years ago we would have been faced with not just a shortfall or a gap which we reported at PBR in December of around £3.5 billion but a gap of almost £7 billion.”

11. Excise duty fraud grew significantly during the 1990s partly as a result of the opportunities provided to criminals by the introduction of the single market and of the large increases in international trade and passenger movements. We note Customs’ acknowledgement that they did not initially react with sufficient speed to these developments. We are concerned that Customs failed to recognise and react to the effect that these events, which were predictable, would have on the level of smuggling and fraud. But we welcome the more strategic response which has subsequently been put in place.

12. While the differential in excise duty rates between the UK and other countries may be a significant factor in the level of legitimate cross-border shopping, most smuggling and fraud involves products on which little or no duty has been paid. Customs accepted that there was a relationship between rates of duty and the level of fraud. We would welcome a published study of this relationship.

13. We support the approach now adopted by Customs that efforts to tackle fraud must be based on an accurate assessment of the size and nature of the problem. We acknowledge that estimating the level of excise duty fraud is difficult. Although useful progress has been made, we are concerned that losses from smuggling and fraud are currently estimated to be some £3,750 million a year, and therefore remain at an unacceptable level.
3 Tackling tobacco smuggling

14. The majority of tobacco fraud detected by Customs involves large-scale organised smuggling of large quantities of cigarettes (typically between one and eight million sticks at a time) in freight. These cigarettes, although often manufactured in the UK, are generally sourced from outside the EU and carry little or no tax. Genuine products sourced in global wholesale markets may be obtained for as little as 70p per pack (significantly less still for counterfeit). The typical UK illicit street price is around £2.50 per pack. At the lower end of the smuggled market more product is sourced EU duty paid and brought into the UK by large gangs of air passengers working as ‘runners’ for organised groups.14

15. Customs’ new strategy for tackling tobacco smuggling was launched in 2000 against a background of increasing growth in tobacco smuggling which, Customs estimate, would have seen the illicit market grow to some 34% by 2002–03 if no action had been taken. The strategy is based on attacking the economic profitability and risk/reward ratio of smuggling through an end-to-end strategy of disruption. It involves the suppression of supply of UK manufactured product, legislative change, the use of new technology, and increased resources both at the ports, overseas and inland. The strategy was funded by an extra £209m over three years, which was invested in increased resources and in new technology. Under the strategy Customs have:

- increased front-line and investigative staff by almost 1,000 to allow better detection through improved intelligence;
- further developed their network of officers based overseas who work closely with local enforcement agencies to detect tobacco (counterfeit or otherwise) targeted on the UK by international criminal gangs and provide tactical and profile intelligence enabling better targeting by detection and investigation staff;
- installed a national network of x-ray scanners to detect high volume cigarette smuggling in freight;
- following new legislative measures introduced ‘UK Duty Paid’ fiscal marks on tobacco products to help prevent, detect and deter the handling, distribution, sale and purchase of smuggled tobacco. The introduction of the mark was accompanied by a range of new offences and penalties designed to crack down on the sale of illicit tobacco; and
- to distinguish more clearly between smugglers and genuine shoppers, increased (in October 2002) the guide levels for cigarettes and hand rolling tobacco from 800 to 3200, and from 1Kg to 3Kg respectively (representing a six months supply for the average smoker).15

14 Ev 79, paras 10–11
15 Ev 79, paras 14–19
Estimating the level of tobacco smuggling

16. Customs’ estimates of the revenue lost through fraud and smuggling for cigarettes and hand rolling tobacco, the corresponding illicit market shares, and how these have changed are noted in tables 2 and 3 below.

Table 2: Cigarette revenue evaded through fraud and smuggling and illicit market share (%)

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<tbody>
<tr>
<td>PBR2001</td>
<td>£2,700m</td>
<td>£2,800m</td>
<td>£2,800m</td>
<td>£2,700m</td>
<td>£2,700m</td>
</tr>
<tr>
<td></td>
<td>20.5%</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
</tr>
<tr>
<td>PBR2002</td>
<td>£2,000m</td>
<td>£2,800m</td>
<td>£2,700m</td>
<td>£2,700m</td>
<td>£2,700m</td>
</tr>
<tr>
<td></td>
<td>17%</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
<td>21%</td>
</tr>
<tr>
<td>PBR2003</td>
<td>£2,700m</td>
<td>£2,600m</td>
<td>£2,400m</td>
<td>£2,000m</td>
<td>£1,900m</td>
</tr>
<tr>
<td></td>
<td>21%</td>
<td>20%</td>
<td>18%</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>PBR2004</td>
<td>£2,700m</td>
<td>£2,500m</td>
<td>£2,000m</td>
<td>£1,900m</td>
<td>£1,900m</td>
</tr>
<tr>
<td></td>
<td>21%</td>
<td>20%</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
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</table>


Table 3: Hand rolling tobacco revenue evaded through fraud and smuggling and illicit market share (%)

<table>
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<th></th>
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</thead>
<tbody>
<tr>
<td>PBR2002</td>
<td>£630m</td>
<td>£670m</td>
<td>£580m</td>
<td>£580m</td>
<td>£750m</td>
</tr>
<tr>
<td></td>
<td>68%</td>
<td>61%</td>
<td>52%</td>
<td>51%</td>
<td>57%</td>
</tr>
<tr>
<td>PBR2003</td>
<td>£680m</td>
<td>£580m</td>
<td>£580m</td>
<td>£630m</td>
<td>£750m</td>
</tr>
<tr>
<td></td>
<td>63%</td>
<td>52%</td>
<td>51%</td>
<td>53%</td>
<td>57%</td>
</tr>
<tr>
<td>PBR2004</td>
<td>£680m</td>
<td>£580m</td>
<td>£630m</td>
<td>£750m</td>
<td>£750m</td>
</tr>
<tr>
<td></td>
<td>63%</td>
<td>52%</td>
<td>53%</td>
<td>57%</td>
<td>57%</td>
</tr>
</tbody>
</table>


Cigarettes

17. Customs’ estimates indicate that the amount of smuggled cigarettes in the UK peaked in 2000–01 at 21% of the market and that this has subsequently fallen to 15% by 2003–04. The Tobacco Manufacturers’ Association told us that their estimate for the total volume of the market that evades UK duty through all forms of smuggling and cross-border shopping did not differ markedly from Customs’. For 2003 the Association estimated a level of non-UK duty paid for cigarettes and hand rolling tobacco of 28% and 72% respectively, which was comparable to Customs’ estimate for 2002–03 of 27% and 69%. The Association noted that “unlike [Customs] we are not to able determine how much of this [non-UK duty paid] volume is smuggled. Our analysis, which is based on the analysis of cigarette packs found in regular large-scale pack collections and face-to-face consumer interviews, does not provide us with any insight as to whether they are legal or illegal imports. However, we are able to determine the product’s intended country of sale and whether it is genuine or counterfeit. Counterfeit cigarettes are a recent development in the UK and although small in volume—we estimate around 2 billion cigarettes out of the total UK consumption of 74 billion in 2003 were counterfeit—it is a growing problem.”16

16 Ev 77, paras 9, 10
18. Imperial Tobacco noted that they were concerned that cigarette smuggling may have increased slightly in 2003 to 18% of the total market compared with Customs’ figure of 15% for the year ended March 2004. But Imperial told us that “the important thing is that, while there may be slight differences over the estimates and the components of the non-UK-duty-paid segment, directionally we broadly agree the way things are going. […] we would agree with Customs that things are moving very much in the right direction.”

19. Customs and the tobacco industry broadly agree on the scale of cigarette smuggling, that it peaked in 2001 at around 21% of the market, and that it is now declining. Customs’ strategy for tackling tobacco smuggling appears to be having an effect on illicit cigarettes, but with revenue losses running at £1,900 million a year, there is still a long way to go.

**Hand rolling tobacco**

20. Unlike cigarettes, where the trend in smuggling is downwards, the illicit market share for hand rolling tobacco has risen, following a decline to 52% of the market in 2001–02, to 57% in 2003–04. Given that a further 14% of the market is accounted for by legitimate cross-border shopping, Customs’ figures show that as little as 29% of the hand rolling tobacco market in the UK in 2003–04 was duty paid. Revenue losses from smuggling on hand rolling tobacco have increased from an estimated £580 million in 2001–02 to £750 million in 2003–04. The Economic Secretary accepted that there was “a very significant level of illicit activity with hand rolling tobacco” and told us that:

“[…] we are dealing here with what is a very well-entrenched and long-established illicit market in hand rolling tobacco. The Pre-Budget Report explained that we are doing further work on this as we try and untangle the differences with hand rolling tobacco smuggling and bootlegging from cigarettes. We are considering, at the moment, within the Treasury and within Customs, a range of different things that we might put in place. I hope we will be able to confirm a fresh focus on hand rolling tobacco within the overall tobacco strategy fairly soon.”

21. The fact that only 3 out of every 10 packets of hand rolling tobacco consumed in the UK are duty paid is a matter of very serious concern. The illicit market share for hand rolling tobacco has been above 50% of the market for each year since estimates have been available, and is now rising. In our view this indicates that the level of smuggling in this area is extraordinarily high. We note that the Treasury and Customs are considering what action to take to provide a fresh focus on hand rolling tobacco in their strategy for tackling tobacco smuggling. Effective action is urgently required.

**Co-operation with tobacco manufacturers**

22. In the first two years following the launch in 2000 of Customs’ new strategy for tackling tobacco smuggling, Customs seized over 5 billion cigarettes, either in, or en route to, the UK. The majority of these cigarettes were originally manufactured in, and exported from,
the UK. While the vast majority of UK exports did not feed the UK smuggled market, most smuggled cigarettes were UK manufactured UK brands. As UK smokers are predisposed to purchase cigarette brands they are familiar with, it was not surprising that these brands were the most popular with smugglers.20

**Memoranda of Understanding**

23. A key element of Customs’ strategy is to reduce the supply of cigarettes available to smugglers. In respect of genuine product Customs aim to work closely with the major tobacco manufacturers to tackle smuggling and the manufacturers have all publicly stated a wish to see an orderly market in the UK for their products and to co-operate with Customs. To formalise this co-operation, Customs entered into Memoranda of Understanding with all three major UK tobacco manufacturers. These agreements were designed to reinforce co-operation in tackling tobacco smuggling into the UK, particularly the large-scale organised freight smuggling that dominates the illicit supply. Customs signed a Memorandum of Understanding with Gallaher in April 2002, with British American Tobacco in October 2002 and with Imperial in June 2003.21

24. Under these agreements Customs look to the manufacturers to ensure that they supply product only where there is a legitimate demand for it in the intended final market, sharing their understanding of that demand with Customs as necessary. Customs also look to the manufacturers to help identify the supply routes of any suspect export trade and to refuse sales where the end-sale (consumption) destination is in doubt. Where it is discovered that any particular distributor has been shown to be behaving improperly, Customs expect that manufacturer to re-visit the trading relationship in question with a view to discontinuing it.22

25. We asked the three major UK tobacco manufacturers for their views on how the memoranda of understanding were working in practice:

- Imperial Tobacco told us that it was “working so well that we have also signed Memoranda of Understanding with another 6 European nations’ customs authorities, and we are in discussion with a further 12 customs authorities in Europe and beyond.”23

- Gallaher believed that the system was “working exceptionally well. We have seen a reduction in the non-UK-duty-paid volume from around 25 billion to 20 billion cigarettes in the last 5 years. […] We would still like greater resource put into Customs, but the Memorandum of Understanding, as a principle, has been very useful. We were the first to sign it, and we are equally looking to use this technique in other parts of Europe and also farther afield.”24

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20 Ev 105, para 3
21 Ev 105, paras 4, 5
22 Ev 105, paras 5, 6
23 Q 261
24 ibid.
• British American Tobacco told us that “we have always co-operated with Customs anyway, so the Memorandum of Understanding just takes us to a new level of that co-operation. We are very happy with the way things are going. I think that Customs are very happy too.”

26. Asked what changes signing a memorandum of understanding had made to the way in which they co-operated with Customs, Gallaher considered that it had made no significant difference as it simply enshrined what they were doing at the time. Imperial Tobacco told us that the memorandum had not made a difference to trading policy but was “at the cutting edge of best practice on illicit trade prevention and detection.” British American Tobacco said “I think we were always doing stuff before, we are just doing more of it.”

27. Customs told us that they thought “what has undoubtedly happened is that tobacco manufacturers as a result of that memorandum of understanding have taken a lot more care who they supply a product to, in what markets they supply them to and I think you can see that in the amount of genuine UK manufactured cigarettes that are in the illicit market. It has reduced significantly and that is why counterfeit [product] has come up. So in my view things have changed significantly.”

28. Customs also introduced a voluntary system, which was not part of the memoranda of understanding, to raise concerns about particular customers of tobacco manufacturers. This involved Customs notifying the manufacturers of cases where repeated seizures were made of stock originally supplied to specific distributors and which appeared disproportionate. This process and the resultant requests that manufacturers take action to address those particular supplies by either restricting or ceasing future supply was known as the yellow and red card system. Cards have been issued where Customs believe that there is a serious risk of a high proportion of further supplies to a specific customer illegally re-entering the UK market. Customs expect manufacturers to take action against such customers and would fully expect customers who are given a yellow card to be the subject of enquiries by the manufacturer.

29. The fact that Customs have not issued any red or yellow cards in the last two years was viewed by Customs as evidence that the steps they require under the memoranda of understanding to be taken by tobacco manufacturers were being taken. The manufacturers were stopping supply before cards were issued or they were not supplying customers to begin with because they knew that the circumstances were not legitimate.

30. Customs have signed memoranda of understanding with the major UK tobacco manufacturers designed to reinforce co-operation in tackling tobacco smuggling into the UK. We expect tobacco manufacturers to co-operate fully with Customs to ensure
that their products do not get into the hands of smugglers. We note the views of both Customs and the UK manufacturers that the current arrangements are working well and that this is evidenced by a reduction in the amount of genuine UK-manufactured cigarettes in the illicit market.

The agreement between Philip Morris and the European Commission

31. Philip Morris is the only overseas manufacturer with a significant presence in the UK market. Customs officials told us that they worked “[...] with Philip Morris in much the same way as we work with each of the UK manufacturers. We seek to track and trace—the phrase we use—their product in the same way as we seek to with UK manufacturers and we meet with Philip Morris on a regular basis.”32 Philip Morris products sold in the UK are imported from their factories in Germany and Portugal. Philip Morris told us that while they had not signed a memorandum of understanding with UK Customs, and one had not been proposed, they did work closely with Customs.33 Philip Morris noted that:

“[...] we have signed an agreement with the European Commission and 10 of the Member States that is very extensive and constitutes a commitment on our part, and a commitment on the part of the European Commission and the 10 signatory Member States, to co-operate together to fight illegal trade of all forms; and, for us, particularly to focus on the alarmingly increasing trade in counterfeit goods. That agreement has very extensive compliance protocols, customer oversight provisions, product tracking and tracing provisions, as well as a commitment by us to contribute a substantial amount of money—over a billion dollars—to the European Commission over the next 12 years, in order to enhance their efforts to do everything they can to prevent the growing trade in illegal and, particularly, counterfeit products.”34

32. Philip Morris observed that the UK was not a signatory to that agreement, but it could, if it wished, sign the agreement and become a party to it.35 Philip Morris told us that “we are more than happy to have the UK sign the European agreement. It is far more extensive in its provisions, its scope and extent than any Memorandum of Understanding that exists with our company and other governments, or other companies and the UK government or other governments.”36

33. Action on Smoking and Health (ASH) considered that the legal agreement between Philip Morris and the EU was “the gold standard by which all cigarette manufacturers’ attempts to control excise tax fraud should be judged from now on [as under the agreement] specific, measurable, achievable, relevant and timed targets have been set and penalty payments are exacted from [Philip Morris] if these are not met. In contrast the ‘Memoranda of Understanding’ that [Customs] has with each of the UK manufacturers are inadequate. They rely entirely on the goodwill of the companies and have no measurable

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32 Q 56
33 Q 262
34 Q 262
35 Q 263
36 Q 264
outcomes.” ASH believed that “the key feature of this agreement is that from now on Philip Morris […] will be heavily penalised if it does not control smuggling of its cigarettes. This is far more significant than the $1.25 billion dollars that the company have agreed to pay the EC over the next twelve years which is of symbolic value only as it is believed to represent only a tiny portion of the amount the EC has lost through smuggling, due to unpaid duties, fees and other taxes.”

34. The European Anti-Fraud Office (OLAF) told us that the agreement, signed by Philip Morris, the European Community and 10 Member States in July 2004, was “a landmark which is unique in scope and innovative in method” as it includes:

- a comprehensive set of rules that Philip Morris must follow as to how it sells and receives payment for cigarettes in order to significantly reduce the capability of third parties to smuggle cigarettes into the EC.

- agreed tracking and tracing procedures, to assist law-enforcement efforts to combat future smuggling and counterfeit.

- payments by Philip Morris in the event of any significant seizure of authentic cigarettes to the EC and the Member State which seized the cigarettes equal to the total amount of lost duties and taxes which would have been due on those cigarettes if they had been legally distributed for retail sale in the Member State of seizure.

- additional payments by Philip Morris in the event that there are seizures of Philip Morris cigarettes in any given year in excess of a baseline amount (based on the average number of Philip Morris cigarettes seized throughout the EC in the years 2001 and 2002) equal to five times the customs duties and taxes owed on those cigarettes.

35. The European Anti-Fraud Office considered that these commitments greatly exceeded those of any individual Memorandum of Understanding between a cigarette manufacturer and a Member State and noted that the agreement had two further unique features which distinguished it from other individual agreements. It is legally binding and subject to a specific enforcement mechanism; and it provides for substantial payments by Philip Morris, up to a total of some $1.25 billion over the next 12 years, which could be used to combat smuggling and counterfeit.

36. The Agreement also resolves all past disputes between the parties relating to contraband cigarettes. In particular, the Agreement brings to an end all litigation between the European Community and the ten Member States and Philip Morris relating to contraband cigarettes. The Agreement also provides that any Member State has the unconditional right to become a party.
37. We asked the UK tobacco manufacturers whether the EU agreement with Philip Morris was stronger than their memoranda of understanding with UK Customs and whether they would be willing to enter into a similar agreement. Imperial Tobacco told us that:

“the difference I would see is that there was also litigation, or contemplated litigation, involving the EU and the ten Member States and Philip Morris. We are not involved in any form of litigation related to smuggling and we see the Memorandum of Understanding as more appropriate. It is extremely comprehensive. It not only covers illicit trade into the UK, ex-UK manufactured product, but it covers all our factories in other parts of the world and it comprehensively covers counterfeit, which has been the growing problem over the last couple of years. I would therefore argue that ours is a very comprehensive document with Customs and is working very well.”

British American Tobacco said;

“I think there are bits of the agreement that we would support and there are bits that we would not support. The bits that we would not support would be voluntarily paying the excise on product that other people had smuggled, frankly I think that would be ridiculous. I think some of the tracking and tracing bits in the Philip Morris agreement are, to quote [Customs], ‘missing the point’ in terms of controlling smuggling because Philip Morris has talked about being able to identify the first customer and where there is a problem with the second customer, but by the time the product gets smuggled it has probably gone through ten or 12 customers, so I do not think that is going to create a great benefit either. I can understand why Philip Morris would like this to become an industry standard because they have spent a lot of money putting it together but I do not think it is going to solve the problems. I think bits of it we would support, but not all of it.”

38. The Economic Secretary told us that the reason why there was no memorandum of understanding with Philip Morris was because “we have given priority to our three UK manufacturers [as] their products were a significantly greater share of the illicit market in the UK and the seizures we were making. In the last year, Philip Morris’s brands constituted only 3.5% of the seizures we made and the vast majority of those were counterfeit, not actually produced by Philip Morris. I would not rule out looking for a memorandum with Philip Morris and we are considering that but the imperative was to get a proper arrangement in place with our own manufacturers based in the UK.”

39. Asked about the EU agreement with Philip Morris, the Economic Secretary noted that the basis for this agreement was very different. It was a legal document, largely designed as part of a deal to drop litigation in the EU against the company, circumstances which did not apply in the UK. The Economic Secretary accepted that there were some very substantial elements in the EU agreement, but considered that it was weaker in law enforcement terms than the UK memoranda of understanding which contained some

43 Q 269
44 Q 358
45 Q 422
features that were more useful to Customs. Under the UK memoranda companies had agreed to stop supplying customers when Customs issue a warning that they have serious concerns, rather than on the basis of a conviction which was a requirement of the EU agreement with Philip Morris. Similarly, under the memoranda Customs had the ability to track and trace a customer on a packet of 20 cigarettes found as part of a contraband consignment, but under the EU agreement a case of 10,000 cigarettes was required before the track and trace procedure would be instituted.\footnote{46}

40. The Economic Secretary noted that “we have three agreements in place with the principal sources of the cigarettes that we have a problem with that are working well. We certainly are ready to consider reinforcing those agreements and […] we are ready to consider whether or not we should be reaching some sort of memorandum of understanding with other tobacco companies as well […]”\footnote{47} The Economic Secretary thought that “if we become a party to the [EU agreement with Philip Morris] then we may be able to take advantage of some of the operational features of the [agreement], but I believe we would not stand to gain from any of the payments that Philip Morris may make under it.”\footnote{48} In a subsequent note the Economic Secretary confirmed that, while not entitled to a share of the $1.25 billion being paid over 12 years for anti-contraband and anti-counterfeit initiatives, it was open to the UK to co-sign the agreement and invoke protocols for the receipt of supplementary payments by Philip Morris in the event of certain future genuine product seizures above a defined limit. Based on 2003–04 seizure volumes, Customs believed that the supplementary payments to the UK for smuggled Philip Morris cigarettes would have been “well under £1 million.”\footnote{49}

41. Customs have not sought a memorandum of understanding with Philip Morris, as they gave priority to the three UK manufacturers whose products dominate the illicit market in the UK. Philip Morris have a legal agreement with the EU and 10 Member States as part of a deal under which litigation in the EU against the company was dropped. According to Philip Morris and some other witnesses this agreement is more extensive in its provisions and scope than the UK memoranda of understanding. This view was not shared by the three UK tobacco manufacturers or by Customs, who consider the EU agreement to be weaker in law enforcement terms in some areas.

42. The memoranda of understanding between Customs and the UK manufacturers predate the EU agreement with Philip Morris. However, answers we received to questions asking what difference the memoranda had made to what was being done before did not leave us with an impression of a radical change in the practices of the major UK tobacco companies. We recommend that Customs review the provisions of each memorandum in the light of the commitments contained in the EU agreement with Philip Morris with a view to reinforcing the existing arrangements where necessary.

43. We are concerned to note, particularly in view of the claimed success of the memorandum of understanding with UK manufacturers, that Customs have not sought a
similar agreement with Philip Morris. The UK could have signed, and still can sign, the EU agreement with Philip Morris with the prospect of receiving payments from the company when their tobacco products are seized as contraband. Had this been done, payments would have been due to the UK for smuggled Philip Morris cigarettes in 2003–04. Whether it would be better for the UK to sign the EU agreement or to seek a separate memorandum of understanding with Philip Morris depends upon the arrangements that can be negotiated with the company. But doing nothing is unacceptable. We expect Customs to take this matter forward as a matter of urgency.

Counterfeit cigarettes

44. As a result of Customs’ work with the tobacco manufacturers to reduce the availability of genuine products, large scale organised smuggling gangs who supply most of the illicit market have increasingly switched their attention to counterfeit product. Accordingly there has been a significant increase in the volume of counterfeit cigarettes seized. In 2003–04, 54% of cigarettes seized were counterfeit, a more than three-fold increase over 2001–02.50

45. Counterfeit cigarettes are completely untaxed and unregulated. Research on these cigarettes indicates that counterfeit cigarettes contain on average markedly higher concentrations of arsenic (3 times the level of their genuine counterparts), cadmium (5 times) and lead (5.8 times)—all of which are listed by the International Association for Research in Cancer (IARC) as carcinogens—as well as increased levels of tar and nicotine. This research has identified that habitual smoking of counterfeit cigarettes has significant potential harm to human health from these heavy metals and adds substantially to the considerable risks already associated with smoking cigarettes.51

46. The Economic Secretary acknowledged that Customs were not doing enough to tackle counterfeit cigarettes, but noted:

“[…] we certainly are doing more than we were a couple of years ago as it becomes much clearer that counterfeiting is a bigger problem. […] the threat of counterfeit cigarettes is not just a threat to the revenues to the public purse, the latest evidence suggests that counterfeit cigarettes are significantly worse than ordinary cigarettes for the health of the people that smoke them, and in many cases have very significant levels of heavy metals like arsenic. The sorts of measures we are trying to take to deal with counterfeit include—and this is relatively recent I have to say—increasingly constructive co-operation with China and some of the governments in the Far East, because it is there that we have the biggest problem as the largest source of counterfeit cigarettes finding their way into the UK and other parts of Europe.”52

47. Philip Morris told us that a memorandum of understanding between Customs and the UK manufacturers estimated that 190 billion cigarettes had been counterfeited in China in 2002, making it one of the main sources of such material. However, there was also counterfeiting in Europe, in other parts of Asia and in Latin America. Philip Morris noted that “China is working very, very hard to address the problem, and last year the Chinese
Government prosecuted more than 150,000 cases against counterfeiting operations.”53
British American Tobacco noted that:

“Most counterfeit cigarettes, including many of those coming into the UK, originate from China. To address this particular problem in China, a coalition was established by a number of international cigarette manufacturers and Chinese authorities to identify and de-commission the factories making counterfeit cigarettes. […] British American Tobacco, Imperial and Philip Morris are members of this coalition together with [Japan Tobacco]. The coalition has been operating for several years and has achieved considerable success. In 2004 alone nearly 400 factories in China were raided and 350 cigarette making machines were seized.”54

48. Some of the additional resources provided to Customs for tackling tobacco smuggling were used to further develop their network of officers based overseas. During our visits to Hungary, the Czech Republic and China we met and were briefed by the Customs’ Fiscal Liaison Officers based overseas covering those countries. The value of close co-operation with local enforcement agencies and intelligence gathering was clear.

49. We were also briefed by the Chinese State Tobacco Monopoly Administration on the scale of counterfeiting cigarettes in China, their efforts to tackle the problem, and the efforts of the coalition with manufacturers which makes a valuable contribution to this work. It is all the more surprising therefore that although a memorandum of understanding on co-operation on Customs matters was signed with China in October 2002, a single UK Customs officer remains based in Hong Kong but is expected to cover the whole country.

50. Counterfeit cigarettes are a significant and growing problem in the UK that threaten both revenues and public health. We note Customs’ efforts and those of the industry to tackle this issue which, to be successful, depend on co-operation with enforcement agencies overseas to identify contraband destined for the UK and to cut off the supply of counterfeit cigarettes at source, the illegal factories where they are made.

51. We were surprised to learn during our visit to China, the largest source of counterfeit cigarettes destined for the UK, that there was only one UK Customs officer, based in Hong Kong, to cover the whole country. We were also surprised to discover that until our visit there had been no meetings between UK Customs and the State Tobacco Monopoly Administration, the agency charged with tackling cigarette counterfeiting in China. We recommend that Customs review the resources they are devoting to intelligence gathering and co-operation with enforcement agencies overseas and the location of the officers concerned and consider placing officers within China.

53 Q 342
54 Ev 104, para 9
4 Tackling alcohol fraud

52. The movement of alcohol under duty suspension facilitates the legitimate trade by avoiding the need for fiscal controls at frontiers, and the vast majority of these movements arrive safely. However, most spirits fraud is perpetrated through the diversion onto the UK market of product which is being moved under duty suspension ostensibly between excise approved warehouses, often involving traders in different Member States of the EU. This can happen on import or export. Consignments of spirits, on which no tax has been paid, are obtained and diverted by fraudsters who cover their tracks with forged or duplicated paperwork. This illicit spirit is then sold mainly through licensed outlets at full (or close to) normal retail price. Neither the consumer, nor the honest trader, can distinguish illicit from licit goods.\(^{55}\)

53. Inward diversion occurs when duty suspended product is imported, ostensibly for a UK warehouse, but is diverted en route and placed on the UK market without duty payment; outward diversion occurs when product described as destined for exportation never in fact leaves the country and is diverted onto the UK market. There are other types of fraud, but according to Customs these account for a small proportion of the total tax losses.\(^{56}\)

54. Customs’ strategy for tackling alcohol fraud has centred on operational activity to identify and tackle the fraudsters responsible for alcohol fraud. Customs consider that introducing measures through legislation that narrow the scope for fraudsters to exploit weaknesses in the system is key to maximising operational effectiveness. The Chancellor’s announcement in December 2003 that he would introduce tax stamps on spirits from 2006 is a key part of Customs’ strategy, the fundamental principles of which are to:

- make it as difficult as possible for a fraudster to deal with—and hide amongst—the legitimate trade, at all points along the supply chain;
- make it easier for Customs, the trade and the public, to identify and trace illicit product; and
- substantially drive up the costs—and thereby significantly reduce the profits—of being involved with spirits fraud.\(^{57}\)

Estimating the level of alcohol fraud

55. Customs’ estimates of the revenue lost through fraud and smuggling for spirits, the corresponding illicit market shares, and how these have changed are noted in table 4 below. Customs have not published regular estimates of the level of fraud for other alcohols such as beer and wine.\(^{58}\)

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\(^{55}\) Ev 88, paras 70, 71
\(^{56}\) Ev 89, para 72
\(^{57}\) Ev 90, paras 81, 82
\(^{58}\) Range figures for beer and wine were published with PBR 2002 (see Measuring indirect tax losses, Nov 2002), but have not been repeated in later years.
Table 4: Spirits revenue evaded through fraud and smuggling and illicit market share (%)

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56. In contrast to the position on tobacco, Customs’ published estimates of the level of spirits revenue evaded have showed a scale and trend of fraud that are disputed by the industry. The published figures have also been subject to significant revisions in subsequent years.

57. The Scotch Whisky Association, in evidence submitted on behalf of the Gin and Vodka, and Wine and Spirit Association, told us that it did not accept that Customs’ estimates of fraud were accurate. It believed that:

“the combined efforts of the spirits trade and [Customs] have resulted in a major reduction of fraud in recent years, a downward trend that continues to this day. Whatever the level, the industry has always been committed to working with the government in tackling fraud, as it hurts brands just as much as it impacts on government revenue. Following the accepted significant levels of fraud around 1997–98, measures taken to reduce illegal activity have delivered results. However, the Customs methodology for estimating revenue losses from fraud continued to suggest a rising trend into 2001–02. This ignores major cooperation between industry and Customs, steps taken by the industry and importantly, the success resulting from the considerable additional resources given to Customs to tackle the problem. Surprisingly, it implies that this combined and cooperative approach has had no impact. It is also inconsistent with the market reality. The official fraud estimates suggest that legitimate sales and revenue should have been falling. This is contrary to the measurable market reality. Traders have seen a drop in market disruption caused by illegal sales. The government has benefited from rising revenue receipts. This points to success in fighting illegal activity.”

58. In December 2003 Customs published their first estimates of spirits fraud for 2001–02, which showed revenue losses had increased to £600 million. The Scotch Whisky Association noted that:

“the whole trade immediately questioned the new figures. Both the scale (equivalent to 200,000 bottles every day), and especially the new suggestion of an upward trend in 2000–01, so contradicted market experience that, on behalf of the whole joint alcohol trade, the Scotch Whisky Association examined the basis for the methodology and figures in much greater detail. This work quickly threw up a number of anomalies which were reported to Treasury and Customs. Other survey
data on spirits consumption from the Office of National Statistics emerged and contradicted the survey data relied on by Customs in both scale and trends. An alternative gap analysis, using this government data, suggested that the revenue gap was at its greatest in 1997–98 and then reduced significantly, that losses for 2001–02 could be less than a quarter of the official estimates and, importantly, on a downward trend.

59. A National Audit Office memorandum, published in March 2004, examined the significant disparities between Customs’ estimate of spirits fraud of some £600 million for 2001–02 and that produced by the Scotch Whisky Association of some £100 million to £150 million for the same year. The National Audit Office calculated that Customs’ estimate of £600 million should more properly have been presented as a range between £330 million and £1,080 million. Likewise the National Audit Office calculated that the Scotch Whisky Association estimate of £100 million to £150 million lay between £10 million and £260 million. The National Audit Office concluded that the different methods used by Customs and the Scotch Whisky Association were “reasonable to professional statisticians. But it is difficult to accept that both methods are reliable when they result in such widely different estimates of consumption. It is therefore clear that further work needs to be done by the Office for National Statistics, with Customs and the Scotch Whisky Association, to explain why there are such different estimates for consumption and therefore alcohol fraud.” The Office for National Statistics are currently conducting work to explain and reconcile the differences between the different estimates of alcohol consumption. The outcome of this review has not yet been published.

60. In December 2004, Customs published their latest estimates of spirits fraud which revised the figure for revenue losses for 2001–02 downwards from £600 million to £450 million and showed estimated losses for 2002–03 of £250 million. In accordance with one of the recommendations made by the National Audit Office, Customs noted that the figure for 2002–03 of £250 million fell statistically within a range of minus £150 million to plus £650 million, illustrating the level of uncertainty attached to this estimate.

61. The British Beer and Pub Association observed that Customs were “unable to accurately measure the amount of large-scale smuggling/diversion fraud for beer. This is a concern for the industry and must be a concern for the Government.” Customs told us that they “continue to explore alternative methods to estimate the overall scale of beer and wine fraud. Although a robust quantification of the problem is not yet possible, the available operational evidence gives no clear indication that revenue losses resulting from beer or wine fraud are as substantial as those from spirits.” Asked about the lack of any estimate for beer and wine fraud, Customs noted:

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60 Ev 92, paras 10, 11
61 Estimating the level of Spirits Fraud, Memorandum by the Comptroller and Auditor General, 10 March 2004, para 6
62 Ibid, para 10
63 Ev 88, para 66
64 Measuring and Tackling Indirect Tax Losses – 2004, Dec 2004, Tables 3.1 and 3.2
65 Ev 61, para 1.1
66 Ev 88, para 69
“we have not been able to manage to do the sort of gap analysis of the illegal market in beer and wine because the numbers are small. [...] Basically, the market is so much larger and the problem so much smaller that it is very difficult to get a precise figure, but we think that the illicit market in beer, for example, is less than 4% of the market and the basic gap analysis would suggest they are collecting more tax than beer is actually consumed, which probably is a bit unlikely. We are fairly confident that this is a very small market.”

62. We recognise that estimating the level of spirits revenue evaded through fraud and smuggling is difficult. But confidence in Customs’ estimates of spirits fraud is undermined by a number of factors. The figures are disputed by the industry, whose alternative estimate, showing fraud to be much lower, is equally valid statistically. The level of uncertainty attached to Customs’ estimates is such that their latest figure for fraud, of £250 million a year, falls statistically within a range of minus £150 million to plus £650 million. And if the methodology used for estimating spirits fraud is applied to beer, it produces a result that suggests more tax is collected than beer is consumed.

63. Given these factors, we conclude that specific estimates for spirits fraud can only be viewed with caution. We look to the review being undertaken by the Office for National Statistics to result in more accurate estimates being produced. We expect this to be completed and published promptly.

64. Excise duty receipts on beer, wine and other alcohol products were some £5 billion in 2003–04, substantially more than the £2.4 billion collected on spirits. We note Customs’ evidence that the level of fraud is much lower in this area, but it is of concern that there are no reliable estimates to support this view. We look to Customs to provide robust estimates of the level of fraud in all areas where significant revenue streams are at risk.

**Tax stamps on spirits**

65. In 2002 Customs undertook a consultation on a proposal to implement a tax stamp system for spirits. Customs told us that the consultation established that tax stamps would have the advantage of allowing enforcement staff, the trade, and the public, to distinguish between legitimate and illicit spirits at the point of retail sale. The presence of a tax stamp would prevent the distribution of unstamped spirits at full market value and would increase the risks taken by anyone dealing in illicit spirits. The impact on fraud would be significant. But others argued that tax stamps were not the best way to combat fraud, expressing concern that employing a strip stamp across the top of the bottle was an old fashioned and ineffective solution that would require bottlers to buy new machinery, that tax stamps would be easy to counterfeit, and that they could make counterfeit spirits appear genuine. These matters were considered by the Scottish Affairs Committee in its report on the proposals in April 2004 and the arguments for and against tax stamps as a means of tackling fraud are set out in the Committee’s report and the Government’s
response to it. We have not duplicated this work, concentrating instead on the strategic case for a tax stamp regime.\textsuperscript{69}

66. The Government decided not to proceed with tax stamps in 2002, but asked Customs to work with the industry to tackle fraud and to explore alternative means of making progress in reducing the illicit market share.\textsuperscript{70} In 2003 the Government consulted on a range of alternative options for reducing the opportunities available to commit fraud through the framework for holding and moving alcohol in duty suspension. According to Customs, responses “indicated that, while some of the measures would be acceptable to the industry and would have a small further impact in reducing fraud, the most significant proposals—radically to restrict the circumstances in which alcohol could be moved and sold in duty suspension—would not deliver an anti-fraud benefit that was proportionate to its compliance cost to the industry. The Government therefore concluded that tax stamps were the only way to combat spirits fraud effectively—both today and in the future.”\textsuperscript{71}

67. In the 2003 Pre-Budget Report the Government announced the intention to implement tax stamps, but “gave industry a final opportunity to put forward an alternative measure that would be as effective in tackling spirits fraud. The trade’s alternative proposals took the form of a package of proposed new controls on the alcohol supply chain, but [the Government] concluded that the proposals would be significantly less effective in tackling fraud than tax stamps. The Chancellor therefore confirmed in the 2004 Budget that tax stamps would be implemented early in 2006–07.”\textsuperscript{72}

68. The Scotch Whisky Association told us that the announcement in the 2003 Pre-Budget Report that the Government was proposing to introduce tax stamps on spirits “was both a surprise and a blow to the entire spirits industry. Tax stamps are a barrier to free intra-EU and international trade and unhelpful to UK efforts to oppose trade barriers in some 200 markets worldwide […] International experience has shown tax stamps are of limited experience in combating fraud. Therefore the industry […] submitted […] a package of 17 alternative measures […] but regrettably this was rejected.”\textsuperscript{73}

69. When the Chancellor confirmed in Budget 2004 that tax stamps would be implemented, Customs’ latest estimate of the losses from spirits fraud was £600 million for 2001–02. That figure was subsequently revised down to £450 million in the Pre-Budget Report 2004, which also provided the first estimate for 2002–03—a further fall in the level of losses from spirits fraud to £250 million. We asked the Economic Secretary whether, given that losses had declined significantly without the introduction of tax stamps, it was still necessary to go ahead with the scheme. The Economic Secretary told us that a level of fraud which resulted in an illicit market share of 7% still needed to be tackled and that:

“[…] it would be irresponsible of us, as a Government, not to take action to deal with that and I think it would be unfair on those legitimate businesses that do pay their

\footnotesize{\textsuperscript{69} Scottish Affairs Committee: Third Report, Session 2003–04, The Proposed Whisky Strip Stamp (HC 419), and Second Special Report, Session 2003–04, Response by the Government to the Third Report (HC 822)}

\footnotesize{\textsuperscript{70} Ev 90, para 84}

\footnotesize{\textsuperscript{71} Ev 91, para 85}

\footnotesize{\textsuperscript{72} Ev 91, para 86}

\footnotesize{\textsuperscript{73} Ev 94, para 26}
tax to have their own products and their markets undermined in that way, which is, in the end, why the industry is so strongly with us on the commitment to tackle fraud. They do not like tax stamps but they accept it and they now believe […] that these can be introduced as a result of the detailed discussions we have had with them in a way that will work, and they can be introduced in a way which makes the costs that are imposed on industry proportionate to the problem that we face.”

The Economic Secretary confirmed that he was resolute in his determination to introduce tax stamps. Discussions with the industry “simply did not throw up any other credible alternatives that would allow us to deal with this spirits fraud. In those circumstances, we took the decision—and this is the position we are in—that tax stamps can be introduced, they need to be introduced and we will introduce them in a way that balances our ability to tackle fraud with not imposing unnecessary costs on the industry in doing so.” Legislation for the introduction of tax stamps was included in the Finance Act 2004.

70. The Government announced a number of measures to offset and mitigate the impact of compliance costs of tax stamps on the industry. The 2004 Pre-Budget Report noted: “in addition to freezing spirits duty for the remainder of the Parliament and meeting the additional printing and distribution costs entailed by duty stamps, the Government:

- has decided, based on industry proposals, to make targeted exemptions from the duty stamps regime;
- has decided to adopt the industry’s proposal to allow duty stamps to be incorporated into bottle labels, and, subject to further work with the industry on detailed stamp design, is inclined to allow additional flexibility in the format of stamps; and
- believes there is a case for not attaching a financial liability to duty stamps, and will work further with the industry to examine the implications of this for the impact of duty stamps on both fraud and compliance costs before making a final decision.

As a result of incorporating these features into the planned duty stamps system, overall compliance costs—at the time of the Budget estimated by the industry at £23 million start-up and £54 million a year ongoing—could be reduced to £7 million start-up and £5 million a year ongoing based on the industry’s estimates. This means duty stamps remain a proportionate measure […]”

71. The Government is convinced that tax stamps on spirits bottles are required to tackle alcohol fraud. Following lengthy and detailed consultations with industry, which have resulted in a number of changes to the proposals to minimise compliance costs, a tax stamp scheme is to be implemented early in 2006–07. The decision to proceed with the scheme was made when losses were estimated to be some £600 million a year. But

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74 Q 393
75 Q 411
76 Ev 91, para 88
77 Pre-Budget Report 2004, Cm 6408, paras 5.96, 5.97
estimated losses have fallen, without a tax stamp regime being in place, to £250 million a year, a figure which on past experience could well be revised downwards.

72. The decision to implement tax stamps should be based on accurate and up-to-date assessments of the level of fraud, and of compliance costs, in order to determine whether the expected benefits outweigh the costs. Customs’ estimates of fraud contain a significant level of uncertainty, and the most recent figure is for the year 2002–03. We expect this estimate to be revised as new information is available, either from later figures, or as a result of the review being undertaken by the Office for National Statistics. But as the latest estimate of fraud (£250 million a year) is of a different order of magnitude from the estimated compliance costs (£7 million start-up costs and £5 million a year thereafter), we conclude that the latest proposals for tax stamps cannot be considered a disproportionate response to the problem.
5 Tackling oils fraud

73. This report has concentrated on tobacco smuggling and alcohol duty fraud. We received little evidence on oils fraud and accordingly make only limited observations on this issue.

74. In Great Britain, losses from oils fraud are principally the result of rebated fuels fraud—the laundering, mixing and misuse of red diesel and kerosene, and some oils used for industrial processes. The key fuels are:

- Red diesel, which carries a lower rate of duty (4.22 pence per litre, compared to 47.1 pence per litre for ultra low sulphur diesel) and is for use in heating and off road vehicles, such as farm machinery. It is chemically marked and dyed red.

- Kerosene, also known as paraffin, which carries no tax when it is used for running domestic heating systems. It is chemically marked and dyed yellow.

- ‘Tied oils’ also known as technical oils or base oils, which carry no tax when used for specific industrial purposes such as anti-rusting agents or lubrication oils.78

75. There are three main types of fraud. Laundering is the treatment of rebated and duty-free fuels with chemicals to remove their markers and dyes to make identification of its use as a road fuel harder. Mixing involves combining rebated and duty-free oils to make an illegal road fuel or to dilute road diesel. Misuse is illegally using unadulterated rebated and duty-free fuels in road vehicles. In addition to these fraud types, Northern Ireland has the problem of cross-border smuggling, where duty-paid fuel purchased in the Republic of Ireland is brought into Northern Ireland for re-sale, exploiting cross-border price differentials.79

Estimating and tackling oils fraud

76. Customs produce estimates of the revenue lost through fraud for diesel, and the corresponding illicit market share, in Great Britain. These are shown in Table 5 below. Customs also publish estimates for non-UK duty paid consumption in Great Britain, but as this is very small (under 2%) and there is no operational evidence of a petrol fraud problem, Customs do not attempt to disaggregate this figure between fraud and legitimate cross-border purchases. Because of the difficulties in conducting a survey around the Irish land border, which is some 350 miles long and has over 500 crossing points, it is not possible to estimate the quantity of oils legitimately supplied into vehicles in the republic and driven into Northern Ireland for consumption in those vehicles (cross-border shopping). Therefore, rather than reporting the illicit share, Customs report the proportion of the market that is non-UK duty paid, without distinguishing between illicit and legitimate cross-border shopping. For Northern Ireland, Customs’ latest published

78 Ev 85, para 42
79 Ev 85, paras 43, 44
estimates suggests £350 million is lost annually due to diesel and petrol consumption which is non-UK duty paid.80

Table 5: GB Diesel revenue evaded through fraud and smuggling and illicit market share (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
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<tbody>
<tr>
<td>PBR2001</td>
<td>£200m  2%</td>
<td>£450m  4%</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>PBR 2002</td>
<td>£700m  6%</td>
<td>£950m  7%</td>
<td>£600m  5%</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>PBR2003</td>
<td>£1,000m  8%</td>
<td>£850m  7%</td>
<td>£650m  5%</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>PBR 2004</td>
<td>£1,000m  8%</td>
<td>£950m  7%</td>
<td>£750m  6%</td>
<td>£850m  6%</td>
<td></td>
</tr>
</tbody>
</table>


77. Customs’ strategy for tackling oils fraud is focused on stopping large-scale criminal and commercial fraud by combining law enforcement action, centred on the large-scale supply and use of illicit fuel, with a better control of the sale and distribution of red diesel, kerosene and ‘tied oils’. Customs have introduced a control regime for suppliers of rebated fuels which required all businesses selling them to be authorised by Customs, to exercise a duty of care when selling those fuels, and to record information on their sales and provide that data to Customs monthly. Additional resources have been provided for extra staff and investment in new testing technology to prevent and identify fraud more easily, coupled with a national publicity campaign, and tougher sanctions. The strategy also introduced a new ‘Euromarker’ to be applied to all rebated gas oils and kerosene in the EU to help identify fraud.81

78. We received little evidence on oils fraud during our inquiry. Customs’ estimates of the level of fraud do not appear to be a matter of dispute with the industry, but we are concerned that proper figures for Northern Ireland are not available.

79. We note Customs’ evidence that oil frauds in Great Britain are principally the result of rebated fuels fraud—the laundering, mixing and misuse of red diesel, kerosene, and oils used for industrial processes. We are concerned at the scale of fraud in this area, currently estimated to be some £850 million a year, and we are struck by the fact that there has been a consistent pattern of estimates for a given year being subsequently revised upward. We cannot consider Customs’ strategy for tackling oils fraud to be working satisfactorily when losses continue at this level. We therefore recommend that this strategy and the resources devoted to tackling oils fraud be reviewed if there is not a significant improvement when the next figures are produced with the Pre-Budget Report 2005.

80 Ev 85, paras 39, 41, and Measuring and Tackling Indirect Tax Losses – 2004, Dec 2004, Tables 3.16 and 3.18
81 Ev 86, paras 48–51
Conclusions and recommendations

Excise duty fraud

1. Excise duty fraud grew significantly during the 1990s partly as a result of the opportunities provided to criminals by the introduction of the single market and of the large increases in international trade and passenger movements. We note Customs’ acknowledgement that they did not initially react with sufficient speed to these developments. We are concerned that Customs failed to recognise and react to the effect that these events, which were predictable, would have on the level of smuggling and fraud. But we welcome the more strategic response which has subsequently been put in place. (Paragraph 11)

2. While the differential in excise duty rates between the UK and other countries may be a significant factor in the level of legitimate cross-border shopping, most smuggling and fraud involves products on which little or no duty has been paid. Customs accepted that there was a relationship between rates of duty and the level of fraud. We would welcome a published study of this relationship. (Paragraph 12)

3. We support the approach now adopted by Customs that efforts to tackle fraud must be based on an accurate assessment of the size and nature of the problem. We acknowledge that estimating the level of excise duty fraud is difficult. Although useful progress has been made, we are concerned that losses from smuggling and fraud are currently estimated to be some £3,750 million a year, and therefore remain at an unacceptable level. (Paragraph 13)

Tobacco smuggling

4. Customs and the tobacco industry broadly agree on the scale of cigarette smuggling, that it peaked in 2001 at around 21% of the market, and that it is now declining. Customs’ strategy for tackling tobacco smuggling appears to be having an effect on illicit cigarettes, but with revenue losses running at £1,900 million a year, there is still a long way to go. (Paragraph 19)

5. The fact that only 3 out of every 10 packets of hand rolling tobacco consumed in the UK are duty paid is a matter of very serious concern. The illicit market share for hand rolling tobacco has been above 50% of the market for each year since estimates have been available, and is now rising. In our view this indicates that the level of smuggling in this area is extraordinarily high. We note that the Treasury and Customs are considering what action to take to provide a fresh focus on hand rolling tobacco in their strategy for tackling tobacco smuggling. Effective action is urgently required. (Paragraph 21)

6. Customs have signed memoranda of understanding with the major UK tobacco manufacturers designed to reinforce co-operation in tackling tobacco smuggling into the UK. We expect tobacco manufacturers to co-operate fully with Customs to ensure that their products do not get into the hands of smugglers. We note the views of both Customs and the UK manufacturers that the current arrangements are
working well and that this is evidenced by a reduction in the amount of genuine UK-manufactured cigarettes in the illicit market. (Paragraph 30)

7. The memoranda of understanding between Customs and the UK manufacturers predate the EU agreement with Philip Morris. However, answers we received to questions asking what difference the memoranda had made to what was being done before did not leave us with an impression of a radical change in the practices of the major UK tobacco companies. We recommend that Customs review the provisions of each memorandum in the light of the commitments contained in the EU agreement with Philip Morris with a view to reinforcing the existing arrangements where necessary. (Paragraph 42)

8. We are concerned to note, particularly in view of the claimed success of the memoranda of understanding with UK manufacturers, that Customs have not sought a similar agreement with Philip Morris. The UK could have signed, and still can sign, the EU agreement with Philip Morris with the prospect of receiving payments from the company when their tobacco products are seized as contraband. Had this been done, payments would have been due to the UK for smuggled Philip Morris cigarettes in 2003–04. Whether it would be better for the UK to sign the EU agreement or to seek a separate memorandum of understanding with Philip Morris depends upon the arrangements that can be negotiated with the company. But doing nothing is unacceptable. We expect Customs to take this matter forward as a matter of urgency. (Paragraph 43)

9. Counterfeit cigarettes are a significant and growing problem in the UK that threaten both revenues and public health. We note Customs’ efforts and those of the industry to tackle this issue which, to be successful, depend on co-operation with enforcement agencies overseas to identify contraband destined for the UK and to cut off the supply of counterfeit cigarettes at source, the illegal factories where they are made. (Paragraph 50)

**Alcohol fraud**

10. We were surprised to learn during our visit to China, the largest source of counterfeit cigarettes destined for the UK, that there was only one UK Customs officer, based in Hong Kong, to cover the whole country. We were also surprised to discover that until our visit there had been no meetings between UK Customs and the State Tobacco Monopoly Administration, the agency charged with tackling cigarette counterfeiting in China. We recommend that Customs review the resources they are devoting to intelligence gathering and co-operation with enforcement agencies overseas and the location of the officers concerned and consider placing officers within China. (Paragraph 51)

11. We recognise that estimating the level of spirits revenue evaded through fraud and smuggling is difficult. But confidence in Customs’ estimates of spirits fraud is undermined by a number of factors. The figures are disputed by the industry, whose alternative estimate, showing fraud to be much lower, is equally valid statistically. The level of uncertainty attached to Customs’ estimates is such that their latest figure for fraud, of £250 million a year, falls statistically within a range of minus £150
30  Excise Duty Fraud

million to plus £650 million. And if the methodology used for estimating spirits fraud is applied to beer, it produces a result that suggests more tax is collected than beer is consumed. (Paragraph 62)

12. Given these factors, we conclude that specific estimates for spirits fraud can only be viewed with caution. We look to the review being undertaken by the Office for National Statistics to result in more accurate estimates being produced. We expect this to be completed and published promptly. (Paragraph 63)

13. Excise duty receipts on beer, wine and other alcohol products were some £5 billion in 2003–04, substantially more than the £2.4 billion collected on spirits. We note Customs’ evidence that the level of fraud is much lower in this area, but it is of concern that there are no reliable estimates to support this view. We look to Customs to provide robust estimates of the level of fraud in all areas where significant revenue streams are at risk. (Paragraph 64)

14. The Government is convinced that tax stamps on spirits bottles are required to tackle alcohol fraud. Following lengthy and detailed consultations with industry, which have resulted in a number of changes to the proposals to minimise compliance costs, a tax stamp scheme is to be implemented early in 2006–07. The decision to proceed with the scheme was made when losses were estimated to be some £600 million a year. But estimated losses have fallen, without a tax stamp regime being in place, to £250 million a year, a figure which on past experience could well be revised downwards. (Paragraph 71)

15. The decision to implement tax stamps should be based on accurate and up-to-date assessments of the level of fraud, and of compliance costs, in order to determine whether the expected benefits outweigh the costs. Customs’ estimates of fraud contain a significant level of uncertainty, and the most recent figure is for the year 2002–03. We expect this estimate to be revised as new information is available, either from later figures, or as a result of the review being undertaken by the Office for National Statistics. But as the latest estimate of fraud (£250 million a year) is of a different order of magnitude from the estimated compliance costs (£7 million start-up costs and £5 million a year thereafter), we conclude that the latest proposals for tax stamps cannot be considered a disproportionate response to the problem. (Paragraph 72)

**Oils fraud**

16. We received little evidence on oils fraud during our inquiry. Customs’ estimates of the level of fraud do not appear to be a matter of dispute with the industry, but we are concerned that proper figures for Northern Ireland are not available. (Paragraph 78)

17. We note Customs’ evidence that oil frauds in Great Britain are principally the result of rebated fuels fraud—the laundering, mixing and misuse of red diesel, kerosene, and oils used for industrial processes. We are concerned at the scale of fraud in this area, currently estimated to be some £850 million a year, and we are struck by the fact that there has been a consistent pattern of estimates for a given year being
subsequently revised upward. We cannot consider Customs’ strategy for tackling oils fraud to be working satisfactorily when losses continue at this level. We therefore recommend that this strategy and the resources devoted to tackling oils fraud be reviewed if there is not a significant improvement when the next figures are produced with the Pre-Budget Report 2005. (Paragraph 79)
Formal minutes of the Committee and the Sub-committee relating to the Report

Sub-committee

Wednesday 9 March 2005

Members present:

Mr Michael Fallon, in the Chair

Mr Nigel Beard
Mr Jim Cousins
Angela Eagle
Mr David Heathcoat-Amory
Norman Lamb

Mr John McFall
John Mann
Mr James Plaskitt
Mr Robert Walter

The Sub-committee deliberated.

Draft Report (Excise Duty Fraud), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 79 read and agreed to.

Resolved, That the Report be the First Report of the Sub-committee to the Committee.

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

Several papers were ordered to be appended to the Minutes of Evidence

Ordered, That the Appendices to the Minutes of Evidence taken before the Sub-committee be reported to the Committee.—(The Chairman.)

[Adjourned to a day and time to be fixed by the Chairman.]
Main Committee

Wednesday 9 March 2005

Members present:

Mr John McFall, in the Chair

Mr Nigel Beard  Mr Jim Cousins  Angela Eagle  Mr Michael Fallon  Mr David Heathcoat-Amory
Norman Lamb  Mr James Plaskitt  Mr Robert Walter

Draft Report from the Sub-committee (Excise Duty Fraud), brought up and read.

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

Paragraphs 1 to 79 read and agreed to.

Resolved, That the Report be the Fourth 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.

Ordered, That the Appendices to the Minutes of Evidence taken before the Sub-committee be reported to the House.—(The Chairman.)

[Adjourned till Tuesday 15 March at 9.15 am]
Witnesses

Wednesday 17 November 2004

Mr Mike Wells, Acting Director, Strategy Unit, Mr Paul Gerrard, Acting Head of Tax Strategies, Strategy Unit, and Mr David Hubbard, Head of Excise Group, HM Customs and Excise

Wednesday 8 December 2004

Dr David Long, and Mr Peter Scully, The British Beer and Pub Association (BBPA) and Mr Ian Good, Chairman, Mr Gavin Hewitt, Chief Executive and Mr Ian Shearer, Director of Operations and Technical Affairs, The Scotch Whisky Association (SWA)

Wednesday 12 January 2005

Mr Ben Stevens, Regional Director, Europe, British American Tobacco, Mr Nigel Northridge, Chief Executive, Gallaher Group Plc, Mr Gareth Davis, Chief Executive, Imperial Tobacco Group PLC, and Mr David Davies, Senior Vice-President, Corporate Affairs, Philip Morris International

Wednesday 2 February 2005

John Healey, a Member of the House, Economic Secretary, HM Treasury and Mr Paul Gerrard, Acting Head of Indirect Tax Fraud Strategy, HM Customs and Excise
List of written evidence

Mr Lawrence A Rourke  Ev 58
Retailers Against Smuggling  Ev 58
British Beer and Pub Association  Ev 61; 102
Road Haulage Association Ltd  Ev 68
Tobacco Workers’ Alliance  Ev 69
Philip Morris International  Ev 71
Tobacco Manufacturers’ Association  Ev 75
HM Customs and Excise  Ev 79; 104
The Scotch Whisky Association  Ev 91; Ev 139
British American Tobacco  Ev 103
Imperial Tobacco Group PLC  Ev 107; 134; 140
Gallaher Group Plc  Ev 115
Action on Smoking and Health  Ev 129
European Anti-Fraud Office  Ev 136
HM Treasury  Ev 137
Oral evidence

Taken before the Treasury Committee (Treasury Sub-Committee)

on Wednesday 17 November 2004

Members present:
Mr Michael Fallon, in the Chair
Mr Nigel Beard
Angela Eagle
Norman Lamb
Mr John McFall

Witnesses: Mr Mike Wells, Acting Director, Strategy Unit, Mr Paul Gerrard, Acting Head of Tax Strategies, Strategy Unit and Mr David Hubbard, Head of Excise Group, HM Customs and Excise, examined.

Q1 Chairman: Mr Wells, welcome back to the Committee. Could you introduce yourself and your colleagues?
Mr Wells: Yes, of course. Good afternoon. My name is Mike Wells, I am the acting director of strategy for Customs and Excise. On my left is David Hubbard, who is the head of our excise group. On my right is Paul Gerrard who is the head of my tax strategy group.

Q2 Chairman: Could we start with a general point? You say in your memorandum “… the government is committed to tackling tax fraud”. So far as excise duty is concerned is the government succeeding?
Mr Wells: We are making some good progress. After some very sharp rises in excise fraud in the 1990s in particular the trend has started to reverse and we are seeing reductions across most of the excises. However, that is not enough and we are not complacent about the changes we have managed to make so far. The trend is in the right direction and we shall be publishing the latest set of figures at the time of the next pre-budget report (PBR), which I think will show that trend is continuing. If it would help the Committee, I should certainly be pleased to submit an additional memorandum once we have those latest results.

Q3 Chairman: I understand why those cannot be available now. The latest figures you do have show in percentage terms smuggling and fraud accounting for 51% of the hand rolling tobacco market, 18% of the cigarette market and 16% of the spirits market, losing us a total of £3.5bn a year. Is that really satisfactory?
Mr Wells: No, it is not satisfactory.

Q4 Chairman: But you said you were succeeding.
Mr Wells: My point was that the direction of travel is in the right direction now rather than in the wrong direction as it was several years ago. It is not enough. Our objective is to reduce those levels of fraud further. They were rising very sharply and had we not taken the action which we took with the various strategies we might talk about later today, I think those losses would have continued to escalate. They are not growing any longer, they are reducing. In the case of hand rolling tobacco, which you mentioned, I would agree that figure is still too high, but it is about 1,000 tonnes a year less smuggled tobacco than it was several years previously. Similarly on cigarette smuggling we have seen the volumes of cigarettes which are smuggled reduced by about 15%. We have also seen reductions in other areas such as cross-Channel passenger smuggling in the alcohol sector. There are grounds for some belief that we are moving in the right direction, but it is not far enough yet and I would not presume to say that it is a satisfactory state of affairs.

Q5 Chairman: When you say that it is moving in the right direction, you estimate the total loss at £3.5bn. That lost revenue seems to have jumped enormously in recent years. Why was that? Why did it increase so rapidly?
Mr Wells: Fraud grew through the 1990s for a variety of reasons. One of the reasons was the significant facilitation to trade and to passenger movements which took place with the single market. That coincided with very growths in international trade and passenger movements. Passenger movements are up something like 70%, air travel is an awful lot cheaper than it was at one stage and volumes of trade into and out of the UK have doubled in the last decade. That, combined with the facilitation around the single market, has been exploited by organised crime and once that effect takes hold it has a multiplying effect. We saw that grow very rapidly in the latter part of the 1990s. Obviously also the UK is an attractive place for fraudsters because of our relatively high rates. Inevitably that makes us a target to exploit. I would also acknowledge that in some respects during the 1990s we in Customs did not respond as quickly as we might have done to some of those problems. At that stage we did not seek to estimate the overall size of problems. We did not seek to set outcome targets in terms of reducing fraud, but we measured ourselves rather in terms of outputs. At times that could be a rather perverse measurement because measuring yourself in terms of the volume of products seized or the number of people prosecuted could in many ways be a measure simply of the problem growing rather than the effect in tackling it. We tried to change that situation over the last four to five years and now try to measure ourselves in
terms of the outcome we are achieving and in that sense the direction of travel is now in the right direction, albeit not nearly far enough.

**Q6 Chairman:** Some of these factors you mention were known factors, were predictable factors, you knew we had entered the single European market, you could see air passenger traffic growing.

**Mr Wells:** Hindsight is a wonderful thing is it not? Perhaps in hindsight the combination of those different things would have made it more predictable that fraud would grow. As I acknowledged, the approach in the 1990s, which was about pursuing outputs rather than outcomes probably was not the right one to do that. With hindsight that may be correct. I would add that in trying to measure the overall size of problems and pursuing an approach based on reducing the overall size of the problem, we are quite unusual amongst tax authorities and the older, more traditional style of measuring outputs alone is much more common elsewhere. We were maybe not alone in not anticipating those things as well as we might have done.

**Q7 Mr McFall:** I should like to look at the issue of tax stamps and the Scotch Whisky Association memorandum which we received. In their memorandum the Scotch Whisky Association say that there is an urgent need for a reality check to be introduced to Customs' methodology and estimates of fraud. You are well aware that the National Audit Office concluded that your estimate for spirits fraud of £600m should be presented as a range between £330m and £1,080m. They also concluded that the Scotch Whisky Association estimate should be presented as a range between £10m and £260m statistically. Does this not mean in practice that no one knows what the level of spirit fraud is? The Scotch Whisky Association mentioned that the NAO themselves did not get to the bottom of the matter. Give us your comments on that and whether you agree with the Scotch Whisky Association?

**Mr Wells:** It is certainly the case that measuring an illicit market is an extremely difficult thing to do. Firstly, by definition it is illicit, therefore it makes it very difficult to have certainty and I would not suggest that there is certainty in the estimates. Secondly, in the case of the so-called sin taxes there is a difficulty also in measuring total consumption. A lot of us sometimes tend to underestimate our consumption of these things, so there is a difficulty there too. Having said that, the National Audit Office did find Customs’ estimates of the spirits market to be reasonable.

**Q8 Mr McFall:** They also found the Scotch Whisky Association estimates reasonable.

**Mr Wells:** They did.

**Q9 Mr McFall:** So we do not know where we are.

**Mr Wells:** When we come to update our estimates we shall also be publishing a so-called confidence range, as the National Audit Office recommended. We recognise that is a sensible thing to do and we will do that. Nonetheless we believe that the illicit spirits market is a substantial market and evidence from frauds we have detected and indeed frauds which have been the subject of hearings before this and other committees illustrates that there has been a substantial spirits fraud problem. Although the absolute level of spirits fraud is something on which undoubtedly there is a degree of uncertainty and hence that is why we will publish a range, I would still maintain that there is a significant spirits problem.

**Q10 Mr McFall:** The evidence you presented to other committees was regarding alcohol being sold in and around pubs, street markets and car boot sales. Is that correct?

**Mr Wells:** No, I am referring to major diversion fraud in spirits, which has been going on for a number of years. There were very substantial frauds during the 1990s, during the period I was referring to earlier and indeed in more recent times and in the memorandum we have submitted to this Committee we have identified some of the frauds we found in the year 2001–02, which is the last year for which we have published spirits fraud estimates. We know that substantial numbers of frauds were taking place. We know that there were organised criminal groups.

**Q11 Mr McFall:** Do you have hard evidence to present to us today?

**Mr Wells:** What I have said to you is that I believe that the estimates we have published are reasonable and that within the context of a range and acknowledging the degree of uncertainty, I believe that spirits fraud is a significant problem and that the operational evidence also suggests that it is a significant problem.

**Q12 Mr McFall:** It would be helpful if harder information were out in the public domain, because this is largely a theoretical debate here.

**Mr Wells:** We should like as much as anybody to be able to provide the most precise estimates that we can do. As you said with your initial question, there is a wide range and the difficulty is trying to make that more precise. We do publish our figures each year. We do open them up to examination and we are open to making changes where the evidence supports the basis for making those changes.

**Q13 Mr McFall:** The issue here is that there is such a wide range of estimates that there is little credibility about them. They really need more credibility.

**Mr Wells:** I can only really say again that I should like that to be the case.

**Q14 Mr McFall:** With a range from £150m to £1bn there is something wrong somewhere, that is the issue. Is that correct?

**Mr Hubbard:** It is correct that we would find it difficult to regard either of these estimates as unequivocally reliable. I know you have been a very active participant in all the discussions which have gone on about this issue. Both the Chancellor of the Exchequer, when he gave evidence to the Treasury
Committee after the Budget, and the Economic Secretary to the Treasury in the debate in the committee of the whole house in dealing with the legislation acknowledged that there was uncertainty about these estimates. There is no disagreement that there is uncertainty: the disagreement comes as to what action it is appropriate to take in the light of this uncertainty. There clearly is spirits fraud there; there is some uncertainty about the extent of that fraud, so there is a judgment to be made about what action it is still important to take in the face of that fraud.

Q15 Mr McFall: The Scotch Whisky Association memorandum states that Customs’ estimates imply unfortunately that none of the measures which the Scotch Whisky Association has undertaken on a voluntary basis, like 1998 excise warehousing regulations, 1999 owner of warehousing regulations, etcetera, has made any impact on the level of fraud. They are saying that does a disservice to people.

Mr Wells: The question was around the voluntary measures with the industry and the impact they had had. The first thing to say is that the last year’s figures we published are for 2001–02 and they predate those particular voluntary steps which we welcome. We will be publishing updated figures at around the time of the Pre-Budget Report. I do expect them to show some reduction in spirits fraud, but nonetheless it will still be a substantial problem. The variety of measures which have been taken are clearly helpful, but the problem remains substantial.

Q16 Mr McFall: Do you think, as Customs and Excise, that tax stamps are essential to combat fraud? Can you give me an assessment of how the talks are going between you and industry regarding its implementation?

Mr Hubbard: In the debate in the Committee of the whole House in April you called for intense dialogue and for constant dialogue among all parties in the interests of getting a good deal for everyone involved. We have continued to have very extensive discussions with the industry, both Customs and Treasury officials and the Economic Secretary to the Treasury, John Healey. What we have been doing is exploring a number of different aspects of the detailed design of a tax stamp system, in the hope of finding ways to minimise compliance costs on the industry, while also maintaining the anti-fraud benefit of the tax stamp scheme. Without going into too much detail, the three key areas which could make a significant reduction to compliance costs are the exact scope of the tax stamp scheme, that is exactly what products would be required to bear a tax stamp, the design of the tax stamp, that is whether it is a strip stamp over the top of the bottle or a label-incorporated mark with a self-adhesive option, or a mixture of those and options for financial security or for alternatives to financial security in the way the tax stamp scheme operates. On those and other aspects we have had a very constructive dialogue with industry and there are now several options which ministers are considering in the run-up to the Pre-Budget Report on the way forward.

Q17 Mr McFall: Evidence we have received indicates that the root cause of much of excise duty fraud is, in the opinion of those submitting the evidence, the high rate of duty per se and in comparison with other countries. To what extent is the estimated level of fraud from cross-border shopping taken into account when setting duty rates?

Mr Wells: On the question of rates of duty and their relationship to fraud, undoubtedly there is a relationship; it would be foolish of me to pretend there was none. However, it is important to bear in mind that in most cases the illicit product is a product which has borne either no duty or very little duty indeed; in the case of spirits we are talking about diverted duty suspended product, in the case of oils we are talking about the misuse of red diesel and in the case of tobacco we are predominantly talking about product which has come from the far side of the world, having borne negligible or no duty.

When we compare duty rates, it is really comparing duty rates in the UK against zero or near to zero. That is the context and indeed several other countries in Western Europe, with much lower rates of excise duty than the UK, also suffer significant smuggling problems and fraud problems in these areas. Italy and Spain, for example, have had substantial tobacco smuggling problems despite having much lower rates of tax. Belgium has a very substantial diesel fraud problem despite being in the bottom third of oil tax rates in the Member States. It is very much more complicated than a straightforward lower tax equals lower fraud equation. Of course there are also a variety of other reasons for which these taxes are applied. I referred earlier to them colloquially as sin taxes and indeed there are other environmental, social and health reasons for which these taxes are applied. That has to be considered, as do the other ways in which fraud can be tackled and as does the relative balance of the different types of taxation for raising the revenue which is needed for public services. Clearly it plays a part, but it is one part of a complex mix.

Chairman: Let us turn and look at tobacco in some more detail.

Q18 Angela Eagle: Your PSA target for tobacco smuggling is to reduce the illicit market to 17% by 2005–06. Is that a demanding enough target given that the illicit market share for 2002–03 was only 1% higher than that at 18%. A 1% improvement does not seem an awfully demanding target to achieve.

Mr Wells: The first thing to say is that the target was set prior to us achieving that figure, which is better than the target we were set for the year in which it was 18%. We began with this strategy in 2000. Cigarette smuggling was growing very rapidly from negligible levels in the mid-1990s; about one in five cigarettes smoked in the UK was smuggled by around the turn of the century, so that was a growth
of 20% in four years. There was every reason to believe that was going to continue at a rapid rate had we not taken action. Experience elsewhere in the world has shown that illicit markets could get to very large levels. We have seen that in the United Kingdom with hand rolling tobacco, indeed the industry were forecasting, as were Customs and Treasury models, that without action smuggling would continue to grow very rapidly. To the financial year we have just finished we forecast that it would have been at 34% without action. It is against that expected growth that the target to achieve 17% was set; effectively half that it would otherwise have been.

Q19 Angela Eagle: So your argument really is that you have prevented growth and held the line and taken it down.

Mr Wells: In effect we are trying to run up a down escalator, or vice-versa, and therefore one has to bear that in mind. Nonetheless, what we have achieved is something which is better than our original forecast and I would hope that we will better that 17% target and indeed we have now been set a new PSA target which runs through to 2007–08, by which time we have been tasked to get the illicit cigarette market down to 13%. We are not trying to limit our achievement to the level of 17%. If we can better that and if we can better it faster, then that is certainly our objective.

Q20 Angela Eagle: When you announced the latest results in December of last year you noted that you had made a number of methodological changes to the way you arrived at your estimates which reduced the illicit cigarette market by one percentage point over a full year. People are always suspicious of changes to such methodologies. Is this just to give you more room to reach your targets? What were the objective reasons for the changes you made? We heard earlier that this is a difficult area in which to make estimates.

Mr Wells: The specific change, the half a per cent in a half year and 1% in a full year relates to the changes in the so-called minimum indicative levels. For statistical purposes—and, I stress, for statistical purposes only—we took a slice above which we said anybody with more than a certain number of cigarettes, about 1,200, around that sort of number, would be deemed to be doing so not for their own use; anybody below that would be deemed to be doing so for their own use. In practice that was not how we operated at the ports, I hasten to add, but for statistical purposes in calculating, that was the split we used. When the indicative levels were changed so that the indicative level—

Q21 Angela Eagle: The guide levels.

Mr Wells: Yes, effectively the guide level was raised to 3,200 cigarettes. We felt it was inappropriate to continue with an assumption that those bringing less than the guide level we then applied were doing so not for their own use and we changed that. Indeed there was a real change in the market at the same time with a greater degree of cross-border shopping as a result. The consequence of that was effectively to switch about half a per cent of non tax paid in that year between the smuggled and shopped. The other thing to say is that although those methodological changes have taken place, there is nothing between us and the tobacco industry in terms of estimates. By contrast with the spirits sector, where there certainly are differences of view, in the case of tobacco both the industry and we have a very similar view as to the non-UK tax-paid share of the market. If anything, the industry tends to believe that a rather larger share of the non-tax-paid is actually shopped and a rather smaller share smuggled than we do. Both we and they would agree that we have seen a reduction in smuggling over the last two years.

Q22 Angela Eagle: In terms of tobacco smuggling, to let us get a handle on it, what are the main forms of smuggling and how is this smuggled product then distributed? I know that there has been a switch from properly, legally made product to a counterfeit product, which it might be even more dangerous to smoke than the legal product. What has been going on in this market that you could tell us about to give us a handle on how your intervention has changed behaviour?

Mr Wells: The mode by which product is smuggled has changed quite markedly over the course of the strategy, in particular cross-Channel passenger smuggling has reduced very substantially and air passenger smuggling has risen, partly as a result of the reduction in the cross-Channel, but also because of cheap air fares. The vast bulk of smuggling continues to be large-scale freight smuggling and the nature of that product has changed. When we began this strategy something around 70 to 80% of the entire product we seized was UK manufactured product which had been exported to locations outside the European Union, often to far flung countries, had gone on a circuitous route and ultimately was smuggled back in freight consignments into the UK.

Q23 Angela Eagle: Was that with the connivance of the manufacturers?

Mr Wells: No, I would not use that phrase. However, at one stage we had concerns as to the extent of the controls the manufacturers themselves were applying.

Angela Eagle: Delicately put, Mr Wells.

Q24 Norman Lamb: They must have known what was going on? They saw the volumes.

Mr Wells: I previously attended and gave evidence to one of your fellow committees, the Committee of Public Accounts, in this area and I would not put it like that. I would say that the controls which some manufacturers were exercising at one point were not as strong as we should have liked and partly as a result of those hearings and partly as a result of the dialogue we had with the manufacturers that situation has changed quite markedly. Now the proportion of product that we seize that is UK manufactured in the first place has reduced very substantially. It is less than half the 70 to 80% I
referred to and when we publish the latest figures in the PBR that will show it reducing further. What we have seen, as UK manufactured product has reduced, is that counterfeit product has replaced it. Ultimately UK smokers primarily want to smoke UK brands, brands they are familiar with. As we have restricted with the manufacturers the availability of UK manufactured product for organised smugglers to get hold of, so we have seen the rise in counterfeit. That counterfeit product, often manufactured in the Far East, but also in Eastern Europe as well, is even worse for you than the genuine stuff.

Q25 Angela Eagle: It is full of grit and dust and all sorts of things, is it not? 
Mr Wells: It can be. It also has very high levels of products such as cadmium and other things which do all sorts of very bad things to you.

Q26 Angela Eagle: Heavy metals. 
Mr Wells: Exactly. That is not to say, I hasten to add, that I am suggesting the genuine product is good for you, but in a sense it is even worse.

Q27 Angela Eagle: The Gershon reforms and the efficiency savings which you are going to be making with your merger with the taxation authorities and the new switch to serious crime arrangements are meaning a lot of change. Could you say how you are going to keep your eye on the ball with all that going on? Secondly, are you worried about a loss of staff, which is implied in the Gershon reforms and the savings which would make it harder for you to do the job you are doing now? 
Mr Wells: On the first point, keeping an eye on the ball, that is an absolutely key point for everybody in the organisation and one which I know the Chairman, David Varney, has been stressing extremely strongly. The new outcome target we have been set on tobacco is an illustration of the fact that we are continuing to keep the eye on this ball. I would say that the area of anti-smuggling is perhaps one of those areas which is less immediately impacted by the merger with the Inland Revenue than perhaps some of the VAT business taxation areas. I would expect the direct impact of that to be relatively modest in that respect. I also, for the same reason, would not imagine that the anti-smuggling areas of themselves are likely to be one of the most obvious areas for efficiency savings to be achieved as a result of merger. That is not to say there might not be benefits to be had from merger, for example particularly in the area of investigation where the Inland Revenue have particular skills in financial accounting, forensic accounting, et cetera. We think that we on the Customs side will gain benefits from that, in particular in seeking to attack the financial assets of organised criminals in the tobacco smuggling area. You also refer to SOCA, the Serious Organised Crime Agency, and that is in many ways as significant if not more significant in this particular area. There are great numbers of similarities between the way in which tobacco and other excise products are smuggled and class A drugs are smuggled.

Q28 Angela Eagle: And people. 
Mr Wells: Yes, people are smuggled. The Serious Organised Crime Agency is not going to come into force until, Parliament willing, 2006, but if it does come into force then, it will be important that the relationship we establish with it is one where we can work co-operatively in these areas and indeed we expect something in the order of 1,400 people from Customs and Excise to move into the Serious Organised Crime Agency. We hope that we can both benefit from that co-operation, in terms of utilising some of the skills which the police agencies that will contribute to SOCA bring to the party where they are better than we are, and vice-versa, where Customs may have the leading expertise. That is a very big issue on our radar at the moment and it is undoubtedly one which we have to be very conscious of.

Q29 Mr Beard: You have changed the strategy and apart from additional resources you have changed the practices within the strategy which has given you these results. What are the changes you have made to your strategy in tackling tobacco smuggling? 
Mr Wells: The first thing to say is that we have moved from an outputs to an outcomes focus. I the new switch to serious crime arrangements ... was a tendency to chase results rather than focus on outcomes. That is the first thing. That is the context. In terms of what we have actually done in the organisation and one which I know the practice, we brought together a variety of different tactics which tried to say: what is the nature of this problem, how can we best use all our resources to concentrate on the points of vulnerability for the fraudster and alter the balance of risk and reward. That has meant doing things like employing new technology. We have a fleet of freight X-ray scanning equipment around the country now which is as a result of the government investment in our strategy; £209m over three years. We do have more staff as a result of that in these areas. We have made legislative changes such as the introduction of fiscal marks on tobacco products so that it is clear that we can distinguish the licit from the illicit.

Q30 Mr Beard: Could you explain that? 
Mr Wells: Yes. All tobacco products which are duty paid carry a fiscal mark indicating that they are UK duty paid, so that we or a retailer or any member of the public cannot be duped into believing that smuggled product is in fact genuine UK tax-paid product.

Q31 Norman Lamb: At what point is that duty payable?
**Mr Wells:** It is paid when the product is released from duty suspension, which in the case of tobacco is ordinarily when the manufacturers release that product from stock.

**Q32 Norman Lamb:** So the manufacturer puts the stamp on?

**Mr Wells:** Yes, ordinarily as part of the manufacturing process in fact.

**Q33 Mr Beard:** Presumably the same stores could be releasing cigarettes for export, in which case they would not have a duty stamp on them.

**Mr Wells:** That is right. Where product is not UK duty paid—

**Q34 Mr Beard:** So it is coming from the same origins?

**Mr Wells:** UK manufacturers manufacture product both tax paid for the UK market and duty free for export all around the world.

**Q35 Mr Beard:** I am sorry. What I am saying is that if you release them from bonded warehouse where they have not paid the duty so far and go out into the United Kingdom market and have a fiscal stamp on them, there will be others going out to the ports which do not have a fiscal stamp on them.

**Mr Wells:** Yes, that is right, they are heading out. We do not believe that tobacco product is diverted en route out of the UK in the way that spirits can be. The nature of the tobacco industry is rather different from the spirits industry. Whereas there is a myriad of producers and exporters of spirits, in fact the UK tobacco industry is dominated by three companies, BAT, Gallaher and Imperial, which have 90-plus per cent of the market.

**Q36 Mr Beard:** Please carry on. I interrupted you. **Mr Wells:** Applying these fiscal marks, applying a range of sanctions which we did not have previously around those fiscal marks, the capacity to prohibit sales of tobacco where we find illicit sales taking place, use of publicity to try to raise awareness. We shall be doing further publicity later this year on counterfeit; one of the issues we talked about earlier. We have also done quite a lot in the area of internet sales. We have actually won some awards for our advertising in this area whereby if you type into search engines phrases like cheap cigarettes or whatever a pop-up will appear explaining the correct procedures and the fact that you cannot buy tobacco over the internet and have it posted into the UK. We put fiscal liaison officers into 16 different countries around the world to tackle product coming from there. We have worked with the tobacco manufacturers trying to squeeze UK product, as we touched on earlier, and ultimately we have tried to bring all that together under what we rather grandly term a directing mind in Customs and Excise, which is my strategy area and that is what we try to do to pull all the disparate elements together to that purpose.

**Q37 Mr Beard:** Could you say what the different means are by which cigarette smuggling is going on? You mentioned earlier in response to Angela Eagle that the biggest emphasis now is on bulk freight. Is it just in lorries going out across the Channel, or are there other sources of tobacco smuggling?

**Mr Wells:** It is predominantly freight smuggling, we believe. That is both in containerised shipping which arrives from around the world, typically from the Far East. We make a great many seizures at Felixstowe and Southampton which are both container freight ports. There is also a large amount of smuggling in heavy goods vehicles. That smuggling is often extremely sophisticated now; it is often very similar in nature to the sorts of concealments we see for Class A drugs.

**Q38 Mr Beard:** Is this smuggling in freight, whole lorries which are going with this on, or is this part of a cargo of tomatoes or whatever?

**Mr Wells:** Typically now, these are sophisticated concealments. If I may give you one example, I was talking about counterfeit earlier, we made one very large seizure not so long ago where two packets of cigarettes at a time were concealed in a tin of peas and that was a full load of tins of peas. The entire process, the manufacturing of the peas themselves, was fraudulent. In other words, somebody had gone to the lengths somewhere in the world of setting up a manufacturing capacity to manufacture tins, to manufacture the labels to appear to be real.

**Q39 Mr Beard:** These were counterfeit cigarettes?

**Mr Wells:** Yes, these were counterfeit cigarettes. Each was sealed, two packets at a time, inside those tins. That is the level of sophistication.

**Q40 Angela Eagle:** Did you spot that with the port X-ray machines? You might not be able to say, but how on earth did you discover that one?

**Mr Wells:** I am not certain in that particular case. I cannot tell you immediately off the top of my head how we found that particular one, but clearly we look for a whole variety of things, things which are telltale signs that something is not quite right about a particular load. I am not sure what it was in that particular case.

**Q41 Mr Beard:** You say in your memorandum that the strategy is based on attacking the economic profitability and risk-reward ratio of smuggling through an end-to-end strategy of disruption which involves “the suppression of supply of UK manufactured product”. What do you mean by the suppression of UK manufactured product?

**Mr Wells:** This is coming back to the point about UK manufacturers which we talked about a little earlier. UK smokers naturally enough want UK brands. The UK market is dominated by UK brands: 90-plus per cent of it is UK manufactured brands; 9 out of the 10 leading brands are UK manufactured. That is what they want and naturally enough that is what the large-scale organised criminal gangs want to get hold of as well. They want to obtain that product.
Q42 Mr Beard: Let us concentrate on that, the UK manufactured.

Mr Wells: What we have been doing, working with the manufacturers is to try to ensure that they put in place a series of controls to make sure that when they are exporting product around the world, that product is actually going to be consumed in that market to which they will export it.

Q43 Mr Beard: The point you are making in your memorandum is that your new strategy is to attack the economic profitability and the risk/reward ratio in an end-to-end strategy. I am asking what you are doing in that respect.

Mr Wells: One end of the process is the point of sale, wherever that might be in the world and that is the starting point. We seek to make it more difficult upstream at that point for organised criminals to get hold of the product which is most valuable in the first place. Then we seek to tackle it en route from wherever that may be back to the UK through a network of liaison officers and a large chunk of the cigarettes we take out are taken out en route to the UK, working with authorities in those countries. Then we seek to tackle the situation at the border through the use of X-ray scanning technology and the like, to weed out more product. Once any product has got through there, then we seek to tackle it at the retail level in the UK.

Q44 Mr Beard: You would have done all this before, would you not?

Mr Wells: Not to the same level, not with the same cohesiveness in the elements of our strategy. We did not previously have fiscal marks to restrict that, we did not have the same network of liaison officers posted around the world, we did not have X-ray scanning technology, we did not have the number of people deployed to this that are now being funded to carry out this activity.

Q45 Mr Beard: You also note in your memorandum to us that the 3 major UK manufacturers have now signed memoranda of understanding with you to help you tackle smuggling.

Mr Wells: Yes.

Q46 Mr Beard: Is it not strange that three major companies have to sign a memorandum of cooperation to enforce the law?

Mr Wells: We have covered some of this area already. I think it is a welcome development that they have wanted to do this.

Q47 Mr Beard: Never mind welcome development. Why is it that we have three major British companies which plainly up to now have not been co-operating or you would not have needed the memoranda? You now have memoranda with them which are basically saying that they will co-operate with you in enforcing the law of this country. Is it not strange?

Mr Wells: I think that it would have been preferable in some cases for some controls to have been exercised voluntarily earlier; on that I would not seek to argue with you. Nonetheless we are where we are and I would say that the changes we have seen in export controls since those MoUs have reduced the ease with which organised gangs can obtain UK product. I would acknowledge that tackling the smugglers is a difficult issue for the manufacturers as well in some cases, their product is greatly in demand amongst smugglers, they do have a legitimate business in trying to export product, tobacco is a major export earner for this country and the vast majority of tobacco which is exported from this country does not come back again. There has to be a balance in these things.

Q48 Mr Beard: Answer me this: what are they doing now under this memorandum which they have signed that they were not doing before they signed it?

Mr Wells: They are exercising a much greater degree of self-control in terms of examining export markets and examining who their customers are in certain places before they make sales. When they make sales, they are approaching that process in a more cautious way than they were at one stage, so that they are making supplies perhaps initially not of UK brands or perhaps only to more tried and trusted customers than perhaps at one stage they were.

Q49 Mr Beard: You mentioned earlier that the amount of UK manufactured has come down to 50% of tobacco smuggling compared with 80%. Am I quoting you correctly?

Mr Wells: Yes. In the year 2002–03, the last year for which we have published figures, it was around about 35 to 40%.

Q50 Mr Beard: It is still quite a lot, is it not?

Mr Wells: It is. Figures we will publish for the next year will show it falling again.

Q51 Mr Beard: It is still substantial.

Mr Wells: Yes.

Q52 Mr Beard: I am not belittling what you have achieved in any way, but there is still a substantial amount there. How has that been, despite the tightening up of the memorandum and the tobacco companies deciding to be good citizens? Why is that still going through?

Mr Wells: Part of it is to do with the age of the product. It does take some time for this to unwind. Cigarettes we seize sometimes date back in age of manufacture four years or so; there is an unwinding process in part there. Also, inevitably, some product does get through in the sense that there is some product which is hoovered up by smugglers, despite our efforts or the manufacturers’ and from time to time there may be issues in respect of particular supplies. The relationship we have with the manufacturers is one where we are constantly in dialogue with them to work with them and to press them if needs be, to exercise tighter controls where that may be apparent still.

Q53 Mr Beard: What share of the UK market do these 3 UK manufacturers have?
Mr Wells: Do you mean the legitimate market?

Q54 Mr Beard: Yes.
Mr Wells: Gallagher and Imperial have over 80% of the market and with BAT as well over 90%.

Q55 Mr Beard: So they are substantial players in this market.
Mr Wells: Yes, the UK market is dominated by those 3 companies.

Q56 Mr Beard: What co-operation are you getting from overseas manufacturers?
Mr Wells: There is really only one overseas manufacturer who is significant in the UK market and that is Philip Morris and we work with Philip Morris in much the same way as we work with each of the UK manufacturers. We seek to track and trace—the phrase we use—their product in the same way as we seek to with UK manufacturers and we meet with Philip Morris on a regular basis. Indeed I believe that although Philip Morris are not a UK manufacturer, they attend Tobacco Manufacturers' Association meetings and we meet with TMA as well. We try to deal with Philip Morris in much the same way as with UK manufacturers.

Q57 Mr Beard: Do they all use a similar logistic system from the manufacturing base, the factory through the gates to bonded warehouses and then on to the delivery system?
Mr Wells: In terms of the three UK manufacturers, yes. Obviously in terms of overseas manufacturers the process is rather different. From wherever the product is first manufactured it will go into the UK duty control system when it is declared on commercial import into the UK. The situation with illicit tobacco is not one of diversion, but of smuggling. The product has left the control system, if you like.

Q58 Mr Beard: I ask you because Philip Morris have said to us that they think the solution to this is a more secure distribution system. The implication is that it has not been all that secure up to now.
Mr Wells: I have heard this idea of licensing before and it really rather misses the point of the tobacco smuggling situation, which is rather different to the spirits and alcohol problem, which is a diversion problem, of product moving within the system. With tobacco, take the example I gave you with the canned peas, these are not people who are trying to move product—

Q59 Mr Beard: The canned peas were people who were making cigarettes elsewhere. I am talking about the UK situation.
Mr Wells: Yes, but the situation throughout is one where product is moving legitimately within the regime. It is once it has passed that point; it is once it has been put onto the market somewhere else in the world where duty rates are negligible, is then bought up by organised criminals and smuggled back in concealment to the UK. I do not really think that is the way forward in this area.

Q60 Mr Beard: Could I quote the Tobacco Manufacturers' Association? They have pointed out that two of the key markers for measuring the success of your strategy in reducing these smuggled cigarettes are an increase in the price of cigarettes on the black market and the volume of products seized and that these two markers show that you are not achieving the success you hoped for. They point out that the price on the black market has remained unchanged for the last five years at £2.50 for 20 and you seized 1.9bn cigarettes in 2002-03 against a target of 5bn. How do you respond to that criticism?

The Committee suspended from 3.30pm to 3.40pm for a division in the House.

The Tobacco Manufacturers' Association have said that they would have expected the price to rise if you were really reducing the number of smuggled cigarettes and it has not done.

Mr Wells: There are two things bearing on the illicit retail price which force the price to stay low: one is the price in the licit market and what we have seen there is a steady downtrading to what are termed ultra-low-price cigarettes.

Q61 Mr Beard: Can we just compare like with like, because that is the observation which has been made? If you are comparing the best product from Britain with something which is made of brick dust you are not really comparing like with like.
Mr Wells: That was going to be my second point. You can obtain legitimate product tax paid in the UK for something around £3.66, which is about the cheapest on display. By comparison smugglers have to offer a discount to smokers if they are going to buy from illicit sources, so that is one reason why the price is repressed. The second is the changing nature of the product. As you say, this kind of counterfeit that we are now seeing is extremely poor quality and necessarily, just as you would not expect to pay full price for a counterfeit Rolex, so you would not expect to pay full price for this. That bears on price. If I may give you an example of that, last week we were successful in obtaining a court order for a £45,000 confiscation against two Scottish criminals involved in a smuggling attempt involving 700,000 counterfeit cigarettes. In that case, one of the defendants’ own lawyers said that the product was so poor that it would have taken a box of matches to light a single cigarette.

Q62 Mr Beard: I am sorry, but we are deviating from the main point they are making. They are saying, accepting that there is an abatement of the smuggled value of the cigarettes, that this smuggled value is the same now as it has been for the last five years, so it is not evidence that there are any fewer cigarettes on the market.
Mr Wells: There is evidence that there are fewer cigarettes on the market, 2.5bn fewer smuggled cigarettes on the market.
Q63 Mr Beard: So why is the price not falling then?
Mr Wells: For the two reasons I have given: one because the smugglers have to maintain a discount over legitimate prices and legitimate prices in the ultra low sector, which has become increasingly popular, have been held down. The tobacco manufacturers themselves talk about £1 per pack differential.

Q64 Mr Beard: But they are saying that despite the differential, the differential is the same, down at £2.50 for 20 and it has been there for the last five years.
Mr Wells: Yes and the reason for that is because cheaper cigarettes in the legitimate market have become progressively more popular and that has meant that there has been a necessity for smugglers to keep their prices low. Secondly, the increasing amount of counterfeit which is on the illicit market means that that is cheap product also and that means that irrespective of the volume, the quality of the smuggled product is reducing and hence that is why—

Q65 Mr Beard: What you are saying is that if all things had been equal the price would have risen, but it has not done. That is what you are saying.
Mr Wells: What I am saying is: had legitimate prices been rising and had the quality of the product stayed the same, in that situation it is likely that the price would have risen. However, things have not stayed equal.

Q66 Mr Beard: It is a bit like “If we had some bacon, we would have eggs and bacon, if we had some eggs”, is it not? It is that sort of argument.
Mr Wells: Yes.

Q67 Mr Beard: X-ray scanners have detected 700m smuggled cigarettes since they were introduced in 2001. Seven hundred million out of the billions which are being smuggled is actually quite a small proportion. Are you putting enough resources into this?
Mr Wells: It is 700m over two years out of the quantities seized at the border in the UK. Where it is necessary for us to seize product overseas, or where we seize it from other modes of transport, it is not fair to correlate that with X-ray scanners. In the maritime freight environment about 37% of what we seized in those two years was seized with X-ray scanners. We have not just found cigarettes with scanners either: we have found over a tonne of Class A drugs, we have found over 45 tonnes of hand rolling tobacco and we have found over 1,600 illegal immigrants with X-ray scanners. They also mean that we can examine more freight and we can do so more quickly. I know that some of the issues which have been raised with this Committee by the Road Haulage Association are issues around delays at ports and necessarily scanning, which is a far quicker process than manual examination of lorries, provides a benefit in that respect as well.

Q68 Mr Beard: So you say you are not under-resourcing the search.
Mr Wells: No, I do not think I would feel that we were under-resourced in the network of X-ray scanners.

Q69 Mr Beard: Several witnesses have suggested that the rewards from tobacco smuggling are high, the risks of detection are low and the punishments, if caught, are relatively mild. That seems to be supported by the evidence of prosecutions, where the number of people sentenced has fallen from 884 in 2000–01 to 106 in 2002–03, admitting that in the latter case the average length of sentence was 27 months compared with 13 months in 2000–01. How do you answer that criticism?
Mr Wells: On the question of the number of prosecutions, what we saw in the early part of the tobacco strategy was a significant number of prosecutions of relatively small-scale passenger smuggling situations. As that cross-Channel passenger smuggling reduced, so the concentration in terms of prosecutions was on the larger, more complex organised gangs. So the absolute number of prosecutions can be misleading. In any case we will see the number of prosecutions—

Q70 Mr Beard: Even when it is a drop from 884 to 106?
Mr Wells: Yes. I think we will see the number rising again in this year back up to something more in the middle of those two figures as we see an increasing emphasis again on prosecuting those in the air passenger smuggling area, which was one of the growth areas which I mentioned earlier. There are changes in the dynamics, in the nature of smuggling, which affect the number of prosecutions. It is not just the number of prosecutions, it is the size of any given prosecution and the complexity of the organisation. A large-scale major organised player counts as one prosecution, just as a small-scale individual smuggler counts as one prosecution. The number can be rather misleading.

Q71 Mr Beard: Are you sure that it is not the problem you have had in Customs & Excise in the past of mounting successful prosecutions and that can be manifested in these figures?
Mr Wells: No.

Q72 Mr Beard: You are still not able to mount successful prosecutions.
Mr Wells: I do not think that is the reason. When we publish the following year’s figures, 2003–04, I think you will see that the number of prosecutions is up on 2002–03. The reason for that pattern is explained by the changing pattern of smuggling rather than the reason you suggest.

Q73 Norman Lamb: May I ask quickly about vehicle seizures? The EU Commission believes that the powers Customs and Excise deploy are unlawful under European law and have challenged the government in that respect. Can you bring us up to
Mr Wells: Essentially the basic point is that as an important facilitation for the great majority of legitimate trade, it is possible for alcohol products to be traded across the European Union, moving in what we term duty suspension. That is essentially a system whereby goods can move from controlled premises in one country to another, travelling from one to the other without the duty being paid, subject to certain paperwork and subject to certain guarantees. What happens in fraud, both ways, product originating in warehouses elsewhere in the EU or product originating in warehouses in the UK, is that somewhere along the route it gets diverted, it does not go to its destination. The fraud then takes place and the paperwork is typically falsified from the destination to say that the product has arrived when it has not. The goods get diverted illicitly onto the market and by the time the authorities catch up with that fraud, if indeed they do, the fraudsters have gone, as has the product.

Q76 Norman Lamb: As I understand it, there is inward fraud diversion, goods coming into the country and outward and, within the country, moving from one bonded warehouse to another.

Mr Wells: Yes.

Q77 Norman Lamb: What is the rough breakdown? Which of those is most prevalent?

Mr Hubbard: We think that by far the majority is inward and outward diversion in roughly equal proportion. Let us say between 40 to 45% each, but then a small element of 5% or so is made up of other forms of fraud such as smuggling or intra-UK diversion, as you have just said, or some other minor forms, for example, registered excise dealers and shippers and other frauds.

Q78 Norman Lamb: I have to say that I was surprised that in the whole of your memorandum there was no reference at all to Lord Butterfield’s inquiry, a very substantial, weighty report on the basis of a judicial inquiry into what had gone wrong with prosecutions in this area. Is it not a bit of an omission to make no reference at all to Butterfield?

Mr Wells: That is a subject in its own right; as you say, it is a very heavy topic.

Q79 Norman Lamb: It is, but it is pretty central and there are lots of recommendations within it.

Mr Wells: The issues which that refers to are in respect of frauds which took place in the 1990s, not fraud which is taking place now.

Q80 Norman Lamb: But there are lots of recommendations within this about changes to current practice.

Mr Wells: Yes and those recommendations have been accepted and are being acted upon; indeed I believe there have been separate hearings in front of this Committee and in front of others in respect of the matters which the Butterfield report refers to.
Q81 Norman Lamb: I am acutely aware that there are issues which will be sub judice because of the suspensions and so forth and I fully understand that you cannot stray into that area. However, it is the case that some crucial evidence, which was the existence of the informant record for the owner of the bonded warehouse, was not passed by Customs to Lord Butterfield until after he had reported, which meant that the minister gave an incomplete statement to Parliament. Are you going to ask Lord Butterfield to look again to see whether the existence of that evidence changes his conclusions in any way?

Mr Wells: As you infer, there is an ongoing police investigation in this area. I know that the Economic Secretary to the Treasury, John Healey, has written to the Chairman of this Committee on that matter. I know that David Varney, my Chairman, has given evidence on this matter to the TSC. I am afraid there really is nothing further that I can add to the information.

Q82 Norman Lamb: So there is no plan to ask Lord Butterfield to look at it further?

Mr Wells: I am not in a position to add to the information on that area which you have already been given.

Q83 Norman Lamb: As I understand it, Customs officers visit new bonded warehouses within two months of them being established to monitor activity. Why is it that sometimes it can be up to two months after it starts? Presumably quite often it is in new bonded warehouses that there may be criminal activity under way. Should it not be immediately?

Mr Hubbard: Perhaps there may be a misunderstanding there. Clearly a bonded warehouse has to be approved by us to start business, so there is a process of engagement with us even before a bonded warehouse can start to work. As far as I am aware there is no bar on us following up that initial approval work with checks as and when we wish.

Q84 Norman Lamb: In essence you are monitoring it from the start.

Mr Hubbard: Yes.

Q85 Norman Lamb: You refer in paragraph 77 of your memorandum to “Fulcrum”. Can you explain what “Fulcrum” is?

Mr Gerrard: Fulcrum is an initiative which we ran in August 2002. The initial operation was run in early 2002 and then a subsequent set of operations was run later that year, in August 2002. I have to be careful what I say because some of that is sub judice and some of it is an ongoing investigation, but I shall be as frank as I possibly can be. As a result of the second phase of the Fulcrum initiative, we knocked six operations in August 2002. As a result of that we have seized a great deal of product, illicit spirits and a large number of vehicles. We have revoked the approvals of a number of warehouse keepers’ premises and owners of goods, by that I mean the approvals which allow them to operate in the duty suspension regime. We have carried out a very significant exercise to recover the revenue which has been evaded. We estimate for Fulcrum as a fraud around £100m.

Q86 Norman Lamb: Do you sometimes do it by way of disruption rather than prosecution?

Mr Gerrard: Yes.

Q87 Norman Lamb: How many civil assessments have been made against individuals and companies as part of this operation?

Mr Gerrard: I do not have the number, but I can say that we have secured about £40m of revenue.

Q88 Norman Lamb: Could you come back to us with some details?

Mr Gerrard: If I can supply further details, I certainly shall.1 Criminal action is ongoing, but if it is okay, I would rather not say anything more about that because it is sub judice.

Q89 Norman Lamb: One particular concern has been expressed that by using disruption and imposing assessments on people, you may be catching entirely innocent people. No assessment of the case is made through a criminal court and yet there are individuals who have been bankrupted as a result of this operation without any opportunity to have their day in court. Do you have any concerns? This is quite draconian. Do you have any concerns about those people’s civil liberties basically?

Mr Wells: On that particular point, it is not correct to say there is no redress. The means of redress are different in terms of civil procedures but nonetheless there are means of redress, just as there would be in any other form of tax assessment through the tribunals’ process and the civil courts. There are situations where it is necessary to act very rapidly in terms of tackling fraud and with the best will in the world, in criminal cases, it takes some considerable time for cases to come to court. Indeed in relation to the earlier issues we were referring to and the large sums of money which went missing in those cases when a number of prosecutions were being pursued and, to use the jargon of the time, loads were being allowed to run, one of the concerns expressed was that action was not taken swiftly enough to protect the revenue. There clearly is a balance to be struck between the measures which are taken swiftly to ensure that revenue losses are kept to a minimum and the appropriate use of criminal powers and sanctions.

The Committee suspended from 4pm to 4.10pm for a division in the House

Q90 Norman Lamb: In paragraph 77 of your memorandum you deal with prosecutions and it shows that in cases of mixed excise, which I

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1 In total 29 excise and 34 VAT assessments have been issued totalling £6.8m and £33.4m respectively. Assessments have been issued to 25 companies so far and excise goods with a duty value of £0.46m have been seized.

However some of the assessments are subject to appeal and ongoing enquiries may also result in further assessments being raised, so the final figure may differ from that above.
understand is a mixture of alcohol and other excise goods, there was effectively a collapse in the success rate of prosecutions in 2002–03 compared with 2001–02 with 28 unsuccessful. What was the reason for that?

Mr Gerrard: I cannot say with certainty, but I think it is to do with the appeals process for a number of the bond cases.

Q91 Norman Lamb: These are cases which have been successful, but have been appealed and lost on appeal, are they?

Mr Gerrard: I think so.

Q92 Norman Lamb: Do you have any breakdown within that figure of the numbers which were discontinued as opposed to a finding of not guilty because, for instance, of procedural irregularities?

Mr Wells: I am not sure of the answer.

Q93 Norman Lamb: Could you provide a note?

Mr Wells: We can let you have a note on that one.2

Q94 Norman Lamb: With regard to beer and wine, you do not have any estimate for beer and wine fraud but you say that you think it is definitely lower than spirit fraud. The British Beer and Pub Association have said to us that it “is a concern for the industry and must be a cause for concern for the Government”. What are you doing to resolve the problem? What is your estimate? You have not given official figures, but what is your estimate of the extent of the fraud?

Mr Wells: Unofficially we think that the illicit beer market is relatively small.

Q95 Norman Lamb: So there is a bit of a disagreement there with the trade, is there?

Mr Wells: No. I understand that the trade also recognise that there has been a very substantial reduction in what they term the van trade. They carry out a survey of what they call the white van trade, which shows that has dropped by seven-eighths from its peak. What is less clear is to what extent other forms of fraud might have emerged or grown in place of the cross-Channel passenger smuggling where I think both the industry and ourselves agree that has reduced substantially. What we are trying to do in that area is to look to see whether we can establish some statistically viable sampling exercises which might give us a feel for the scale of the illicit market in this area. We are hoping to run those sample surveys in the New Year and if the results are robust—and I know that this and other committees will give us a good hard time if they are not, but if they are, then we will seek to publish something in next year’s Pre-Budget Report.

Q96 Norman Lamb: You indicated that there is not much between you and the trade, but the British discrepancies in the trade figures and they give as an example the fact that UK trade figures indicate that over 1.1m hectolitres of beer were exported to France which have not been accounted for in French import statistics. They say that is evidence of fraudulent activity. How do you respond to the disparity in figures there?

Mr Wells: Just to come back to the former point about the disparity between ourselves and the trade, what I was trying to say was that there was agreement between us on the area where there has been a reduction in fraud and that is the white van area. What I was further saying was that we are unsure as to the volume of fraud in the diversion area. We would agree that there has been some movement into that. But it is not our belief that the volume of fraud taking place in that area is of the same order of magnitude as that in the spirits area.

Q97 Norman Lamb: So you have no estimate?

Mr Wells: We do not at the present time and that is what we want to do the sampling work on.

Q98 Chairman: Finally on oils. Your PSA target for oils fraud has been changed, has it not?

Mr Wells: Yes

Q99 Chairman: It was originally to reduce the illicit diesel market, but it is now to ensure the illicit market for all road fuels is no more than 2%. Why has that changed?

Mr Wells: It rolls forward the position on diesel. What it does also is make sure that we are not inadvertently, as it were, overlooking the petrol market, where at the present time the non-tax-paid share is very low; we think at least 98%/99% of the market is tax paid, but the important thing is to make sure that it stays that way.

Q100 Chairman: One per cent of the petrol market might be quite chunky in terms of lost revenue.

Mr Wells: In terms of the degree of cross-border shopping in the petrol area, particularly in Northern Ireland, but also to some extent on the south coast as well, naturally enough people perfectly legally fill up their tanks when they come back from abroad.

Q101 Chairman: What is 1% roughly in lost duty?

Mr Wells: I think I can answer you that one in revenue terms, if you will bear with me a second. I thought I could and now I am not sure I can. Perhaps I can let you have a note on that.3

Chairman: You owe us a note on 2 or 3 bits there. Thank you very much indeed. That concludes our session today.

2 Beer and Pub Association say that duty fraud is damaging the beer market and point to Of the 28 unsuccessful cases in 2002/03, 21 were as a direct result of the Liverpool abuse of process hearing in November 2002 and the related appeal hearings concerning the original London City Bond cases. The remaining seven unsuccessful cases are unrelated. Three were unsuccessful because of the case being stayed/no evidence offered, one was withdrawn in the Magistrates Court and three cases were acquitted.

3 For Great Britain 1% of illicit activity in the petrol market represents a revenue loss of £160m; this is compared to a revenue loss of £135m for 1% of illicit activity in the GB diesel market.
Wednesday 8 December 2004

Members present:

Mr Nigel Beard

Norman Lamb
Mr John McFall
Mr George Mudie
Mr Robert Walter

In the absence of the Chairman, Mr McFall was called to the Chair

Witnesses: Dr David Long Director, Brewing and Mr Peter Scully Interbrew, The British Beer and Pub Association (BBPA) and Mr Ian Good, Chairman, Mr Gavin Hewitt, Chief Executive and Mr Ian Shearer, Director of Operations and Technical Affairs, The Scotch Whisky Association (SWA), examined.

Q102 Mr McFall: May I open the meeting by welcoming you to the Sub-committee and, for the sake of Gurney’s shorthand writer, starting with Mr Scully would you identify yourselves please? Mr Scully: My name is Peter Scully and I am here representing the British Beer and Pub Association, although I work for Interbrew UK. Dr Long: I am Dr David Long; I am Director, Brewing, of the British Beer and Pub Association. Mr Good: I am Ian Good, Chairman of the Scotch Whisky Association and also Chairman of the Edrington Group.

Mr Hewitt: Gavin Hewitt, Chief Executive of the Scotch Whisky Association. Mr Shearer: And I am Ian Shearer, Director of Operational and Technical Affairs at the Scotch Whisky Association.

Q103 Mr McFall: Thank you and welcome. May I start off with Mr Good. According to Customs, most spirit fraud involves the sale of the genuine product on which duty has been fraudulently evaded through licenced outlets at full or above the normal retail price. Now you say in your submission that the industry has always been committed to working with the government in tackling alcohol fraud, and I quote, “... as it hurts brands just as much as it impacts on government revenue”. How does alcohol fraud hurt brands? Mr Good: Probably the best way to answer that is to talk about the personal experience that we have. Our company owns brands such as The Famous Grouse, The Macallan, Highland-Park, premium brands. If we do not have control over their promotion, their positioning, then we lose control over one of the main assets of our business, that is the brands. Therefore anything that is done in the marketplace which is detrimental to the positioning of our brands is detrimental to our company and to industry.

Q104 Mr McFall: Does any fraud take place with your brands, and if it does, where do you as a company think it takes place and what are you trying as a company to do about it? Mr Good: The first thing is that there is a lot less fraud now than there was. Our experience is that with our brands there is still fraud, but it is on a much lesser scale than it was. I believe there are many reasons why that situation exists: one is that there has been a tremendous amount of work done between our industry and Customs and Excise to try to stamp out fraud. Fraud is detrimental to the government, is detrimental to our industry, is detrimental to our brands and we are determined to stamp it out as much as we can. As far as our brands are concerned, what we do is try to ensure that it is sold only to legitimate traders; traders who are bona fide, traders who have taken out Customs and Excise guarantees. In other words, it is sold between companies who are legitimate.

Q105 Mr McFall: Have you as a company undertaken any investigations? What has it uncovered, as regards fraud? What have any investigations that you as a company have undertaken, you have a famous brand, Famous Grouse, produced as regards fraud? Where is it taking place? Mr Good: Again using the example, what we found was that we sold our goods to company X. Company X then in turn sold it onto company Y. We found, for example, that our sales to company X increased significantly and in relation to the size of company X, it seemed unreasonable that they were taking so much of our product. We then traced that, because we can trace every bottle; we have lot codes on every bottle, and we can trace that to when it was shipped, who it was shipped to, et cetera. We found that what company X was doing was selling it onto company Y. Company Y was not as scrupulous as company X and that was where we found the fraud.

Q106 Mr McFall: Did you report company Y to Customs? Mr Good: Not only did we do it, but we found in talking to other companies that they were finding the same problem. We took a dossier to Customs and Excise on that specific occasion.

Q107 Mr McFall: What percentage of the brands of your company alone do you think are subject to fraud? Mr Good: Our belief is that the figure is extremely small now; probably less than 2%.

Q108 Mr McFall: So in terms of working with Customs and the government, is it worth the candle, doing all this stuff with tax stamps?
**Mr Good:** Absolutely. We would argue—

Q109 Mr McFall: There is a brouhaha about tax stamps, but it seems to me that everybody is working well together now. When I ask government they say everything is fine. When I ask industry they say it is very important that everybody works together. I just wonder how we got this split in the first place, but over to you.

**Mr Good:** I think you have to go back over history. We would argue that if you look at the, the change from, let us say 1993 to 1998 and then subsequently, the amount of work that was being done between the industry and Customs and Excise has increased dramatically in that period. We have a memorandum of understanding, we have a joint task force. These things were not in existence before. You talk about the brouhaha over tax stamps. One of the reasons we were opposed to tax stamps was that we believed that the steps which were being taken by the industry and Customs and Excise to reduce fraud were in fact working. Now there was some debate on the figures which suggested it was not working. We argued that it was and there is some evidence now that maybe the figures that were being quoted before were exaggerated.

Q110 Mr McFall: Now you have a memorandum of understanding with the government and the government informs us they are setting out plans to provide duty stamps for spirits and confirming the implementation of further regulatory changes, there are announcing the creation of a new Customs intelligence unit, they are setting out proposals for Customs to build on existing work with the spirits industry, these are all things that you welcome.

**Mr Good:** Yes; absolutely.

Q111 Mr McFall: What I am trying to say is that I just cannot understand where the split came from. You say this is vital now, but at the time you were saying a lot of this was unnecessary. It does seem to be necessary now and you have come together with the government to work constructively, is that correct?

**Mr Good:** We did say working constructively was necessary and we felt that the steps we were taking with the MoU and the joint task force was actually providing results.

Q112 Mr McFall: Yes, but you did not say tax stamps were necessary. Do you still think they are necessary now, given that the government have modified the proposals, putting it on bottles? Are you happy with that?

**Mr Good:** Tax stamps provide a check.

Q113 Mr McFall: Which must be good.

**Mr Good:** Which is good. But the various steps that we have talked about, the MoU and the joint industry task force, get to the root of the problem and prevent the problem happening rather than tax stamps which, if you like, check what has happened after the event.

Q114 Mr McFall: Are you happy that the government is opposed to tax stamps at the moment?

**Mr Good:** We think it is an improvement, a considerable improvement. What we have to make sure is that it is proportionate to the size of the problem. If there is any suggestion that the cost to the industry is going to be disproportionate to the size of the problem, then it is going to make our industry uncompetitive and that would be bad news for UK PLC, given the size of export earnings from the industry. Anything that makes our industry less competitive is bad for the industry.

Q115 Mr McFall: But the big ones in the industry that I spoke to, felt there was not going to be a problem with tax stamps. The issue was for small companies and therefore it was important to impress upon the government that you had to work with small companies. I note from the Memorandum of Understanding that the government will make targeted exemptions from the duty stamps regime; specifically goods sold by registered mobile operators and export shops will be exempt from the requirement to bear duty stamps. That must be a good thing and that must show that constructive dialogue and engagement are taking place between the industry and the government on a subject which both of you think should be tackled because there is still fraud at the moment. Is that correct?

**Mr Good:** Absolutely. I would argue that the situation has changed significantly from the original announcement on tax stamps. That is an example again of the two parties working together to get the correct solution.

Q116 Mr McFall: Exactly. But what we were all saying at the time was that negotiation is very important. You should not stand off. As you know, a number of us were involved with you and the Treasury in trying to get to that stage. So everything is hunky-dory now and you are working along.

**Mr Good:** Things are a lot better. To say it is hunky-dory...

Q117 Mr McFall: We can never get heaven on earth, but we are getting there.

**Mr Good:** You never get heaven on earth.

Q118 Mr McFall: Okay; we are getting there. Now on the issue of the Customs’ estimates for spirits fraud, their latest figures were in the Pre-Budget Report (PBR). Their estimates of fraud for 2001–02 will be reduced from £600 million to £450 million and their figures for 2002–03 show a fall to £250 million. They describe these as the most robust and up-to-date estimates presently available. Do you agree with that statement?
**Mr Good:** Yes. We have some very detailed sort of information on that. Gavin, do you want to start and then Ian?

**Mr Hewitt:** First, I think it is highly significant that the figure we now have for fraud in 2002–03 is 7%, £250 million as you say. That is a very big reduction from the revised figure of 13% for the previous year, which was previously 16% and €600 million; and they have revised the figures back down the line. What we have always said, and Ian Shearer can elaborate on this if you are interested, is that effectively the data set, the figures which Customs and Excise have been using to produce their fraud figures, are wrongly based. We started off from that and we say that there are some market realities to show that they are actually wrongly based. They have used one set of ONS statistics. We showed, and it is attached behind the PBR statement, that there is another set of statistics which show a very different story about the level of fraud. When we take our statistics and our data set, which are government statistics, and put them together with the market reality, we believe very strongly that it is our statistics which are right and Customs which are wrong.

**Q119 Mr McFall:** So you think the 7% figure is not correct.

**Mr Hewitt:** I believe that the 7% will be further revised.

**Q120 Mr McFall:** To what?

**Mr Hewitt:** ONS is doing work at the moment.

**Q121 Mr McFall:** What is your figure?

**Mr Hewitt:** We gave a figure, for example, for 2001–02 where we said the figure for fraud, using the NAO work which looked at it, was between £10 million and £260 million. That was the spread when the NAO looked at our figures, which were worked on the General Household Survey. That compared with the figure, when the NAO corrected it, which was £330 million and £1,080 million for the Customs figures. So our figure is substantially lower. We believe, if the ONS look and come out with the right data set, which is what they are working on at the moment, we may well see some figures changing yet again.

**Q122 Norman Lamb:** With those ranges is it not the truth that nobody knows how much fraud there is?

**Mr Hewitt:** We do believe we know the truth, but the government has actually chosen statistics which do not reflect market realities. We believe the figures are very close, much closer to ours, because we have the reality of the market to prove them.

**Q123 Mr McFall:** How come you have the Holy Grail and the government does not have it?

**Mr Hewitt:** I am afraid we have a very expert statistician who has worked very hard on it.

**Q124 Mr McFall:** Mr Shearer, welcome. You tell us, educate us all here.

**Mr Shearer:** What has happened is that Customs and Excise have used one survey set for the consumption of spirits, but there are other ONS survey sets out there and we believe that there is a need for a check to be introduced on which set of figures accords most closely with reality. Interestingly, the government actually also published our alternative figures last week in an annex to the Pre-Budget Report. They did publish the alternative survey estimates and by those figures, which are based on the work that we did, the illicit market share in 2000–01 was 6%, in 2001–02 it was 3%, it compared with the government’s estimate, which I think was 13%, and in 2002–03 the level of illicit market was minimal, possibly less than 2%, compared with the government’s estimate of 7%. Now why do I talk about reality checks? One needs to look not just at the theoretical debate which tends to create this kind of fog of uncertainty, but you also need to look at some reality checks on the figures. The first one is market disruption and Ian spoke in his introduction about the kind of market disruption he experienced on his brands in the 1990s. There was evidence that some of his brands were getting into cash-and-carries and that they were definitely being illicitly traded. At the present time, he is not experiencing that, so the industry is not experiencing the market disruption that it used to. The second reality check is actually the revenue that the government is getting. If you look at the revenue figures for spirits, they have gone up continuously since 1998; they have actually gone up by 35% since 1998 which is an increase of about £600 million. You will remember that the £600 million was the original speculation as to the size of the fraud problem, but the revenue has actually gone up by £600 million since 1998. If revenue is going up, that suggests that fraud has been going down.

**Q125 Norman Lamb:** Or consumption is going up.

**Mr Shearer:** Well that is the third reality check. The third reality check is consumption and the Customs estimate is based on an estimate of consumption. However, their estimate of consumption is so huge, that it does not tally with the experience of sales and marketing people as to what the level of consumption really is. Also, as I said, there are other ONS surveys on spirits consumption which show a totally different trend from the consumption trend which is shown in the original Customs’ survey that they have relied on. So there are two different pictures of consumption there. A couple of other very brief reality checks. One is: what are Customs actually seizing and detecting in terms of fraud? If you look at their seizures, the stuff which comes in through the ports, these have considerably fallen. They have gone down by 57% between 2000–01 and 2002–03. If you looked at the outward frauds that they are detecting and asked them now what hard evidence there is that there are now currently major outward frauds going on, they are quite reticent on the subject because there is not much hard evidence at the moment of outward
fraud. The third sort of thing is that if 7% of the market were illicit, that would be about 80,000 bottles a day. Now if that kind of fraud were being found in the marketplace by Customs’ investigators, Ian’s company and other companies would be expecting phone calls from Trading Standards’ and Customs’ officers around the country on a regular basis saying “Can you tell us about this bottle and this lot code? What is the history of this lot code? Should it be in the UK market at all?” and we are just not getting that volume of calls. I think in Ian’s company he has had about one call in the last year.

Mr Good: One in the last year.

Mr Shearer: The final reality check is, if you do an analysis of the market by sales channels; how much the average consumer spends in the supermarket on spirits, how much they spend in off-licences and how much they spend in independent corner shops on spirits. This 7% figure which the government quotes is equivalent to total sales of just about half of all corner shops in the UK. When they said it was £600 million, that would be every bottle in every corner shop in the UK. We assume there is no fraud in supermarkets and major off-licence chains, by the way, because those have very secure supply chains, but the current figure is equivalent to probably about half of all corner shops in the UK and every bottle in that share of the market. I put it to the Committee that that is slightly implausible.

Q126 Mr McFall: So we are talking about the level of fraud here, and you are arguing about the range. Is that right? Fraud still exists but we are arguing about the range.

Mr Hewitt: Yes.

Mr Shearer: But we think it is not just a picture of uncertainty. You can do these reality checks which either back up, or do not, one set of figures.

Q127 Mr McFall: Why can you not sit there with Customs? I would expect that if Customs and yourselves sat down and presented us with a common theme here, we would chip away. It is like a marshmallow here. Why is this?

Mr Hewitt: You know how far we have actually argued. When the Chancellor last year, on 10 December, came out and proposed tax stamps as a solution to fraud, we actually seriously criticised and continue to criticise the figures. We have shown time after time after time that the figures which Customs and Excise are using are wrongly based. We have been consistent in this. Our persistence led to the NAO looking at the figures, looking at our figures and looking at the government’s figures. They made comments when the NAO report was produced to the Committee of Public Accounts. The Committee of Public Accounts looked at them and asked the ONS to go away and look at the data sets. Why did the government’s own data sets, the different ones, produce such different figures? That is the work the ONS is now dealing with and we are looking forward to the results of their inquiries.

Q128 Mr McFall: And that famous NAO survey showed the range was between £10 million and £1.080 million.

Mr Hewitt: Precisely so.

Q129 Mr McFall: Not very precise is it?

Mr Hewitt: They did a very good job in the time available, but when they did that report, and they admitted this themselves, they were not able to apply the market reality checks which Ian has just set out.

Q130 Mr McFall: Right; so we have got it then that you are working well with the government and this is a common theme and we are going to have tax stamps and we are going to crack down on fraud. The government thinks there is big fraud and you think it is medium or wee fraud. Is that right?

Mr Hewitt: Yes.

Mr Good: It is certainly not significant.

Q131 Mr McFall: Dr Long, welcome. Dr Long, you said in your memorandum that duty fraud, and I quote “is damaging the UK beer market”. Illicit beer sales will damage pubs and other retail outlets, but what effect does beer fraud have on brewers if it is UK brands or overseas brands brewed in the UK under licence that are involved? What is the scene?

Dr Long: I think the picture is very much as described by The Scotch Whisky Association, that the differential in excise duty as between the UK and France and other countries within continental Europe is driving fraud. This is damaging to the beer market and it is damaging to brands, both those produced in the UK as UK brands and those produced under licence from brewers overseas. I think this is a straight matter of economics in the market: if the price of the product is undermined this will damage the product in the market.

Q132 Mr McFall: Customs have not been able to estimate the excise duty losses on beer or wine from smuggling. How significant is duty fraud in these areas and do you have any estimates of the sums involved?

Dr Long: When we talk about fraud, we have to be clear that we are talking about a number of aspects here. We are talking about smuggled beer; we are talking about outward diversion fraud, inward diversion fraud and drawback fraud. Fraud is notoriously difficult to measure but for the last 10 years The British Beer and Pub Association has been carrying out surveys and one of the surveys is in relation to the so-called white van trade. This is a highly visible form of smuggling of beer into the UK and over the last 10 years we have been measuring this and we have very robust figures which now show that that van trade is at an extremely low level. We have down-played the amount of work that we are now carrying out in Calais on that work. There is no doubt that some of that smuggled beer will be diverted into,
displaced into other areas, maybe into larger-scale smuggling, but that is extremely difficult to measure in terms of trailers.

**Q133 Norman Lamb:** Do you mean high value consignments which are diverted?

**Dr Long:** I am talking about trailer-loads of beer which could be coming in, but we have no means of measuring that.

**Q134 Norman Lamb:** What happens? Does it pull up in a lay-by on a motorway or whatever and get off-loaded before it ever gets to its destination?

**Dr Long:** That is precisely what happens. This is either beer which has paid French duty, and remember that the French duty comparison for a 5% ABV product would be 5 pence, UK duty would be 35 pence, so we are talking about that sort of differential or—

**Q135 Norman Lamb:** Or movement between two warehouses.

**Dr Long:**—moving between two warehouses it never reaches the destination, but fraudulent paperwork suggests that it has. This is then diverted onto the UK market, having either paid no duty at all or having paid French duty.

**Q136 Norman Lamb:** Do you have no estimate at all about how much of that is going on?

**Dr Long:** We have no estimate, but, again, we rely on information which we have from the market, which suggests that the level of fraud is in fact at a low stable level and it is that residual level of fraud that we are trying to tackle. We have some evidence that we presented in our written paper to the Committee which looks at the difference, the discrepancy, between import and export data between the UK and France. There will be statistical differences of course between different fiscal authorities in different Member States, but we believe that this discrepancy is too large to explain by a statistical difference. It would indicate a level of fraud which, again, is relatively low and relatively stable.

**Q137 Mr Walter:** May I go back to Mr Good? It seems quite clear from what you have already said that nobody really knows what the extent of this situation is, in terms of excise duty fraud or duty foregone by purchases either legally or illegally outside the UK net. You have said that the Customs’ figures for the levels of fraud are inconsistent with your own knowledge. I wonder whether you could just give us some idea of exactly how much of your information is available to Customs. Do you share every piece of information that you have with Customs authorities?

**Mr Good:** Absolutely. Part of the joint industry task force and the memorandum of understanding that you have with Customs, together at the back with our own statistical discrepancies, there is a complete discrepancy between import and export data. The Committee which looks at the discrepancy, both in the Pre-Budget Report papers, page 12, there are the figures of statistics and spirits estimates, together at the back with our own calculations. You have cross-border shopping, which is what you are talking about, buying legitimately in France or Germany and bringing it in, at £150 million, but that is not fraud, that is legitimate purchasing in another tax regime and bringing it in. They calculate then, the illicit fraud, that is the fraud in smuggling, at £250 million. So legitimate trading, people bringing goods in but having paid the tax in another regime or in the duty-free shop if you are outside the EU, is £150 million, fraud is £250 million. Those are their figures. Our figures are £150 million legitimate trading in another tax regime and effectively zero, because they say the figures, and they accept this, do not produce a meaningful result, that is basically it is very, very small.

**Q140 Mr Walter:** I am just trying to get a handle on the figures. To what extent is this excise duty fraud totally domestic? Is any of it totally domestic?

**Mr Good:** What we are talking about principally is domestic duty; it is where duty is not being paid in the UK market. What probably would be happening would be that someone would sell, let us just take our company, we would sell to another
company in warehouse X. That would be sold without paying duty. The expectation would be that when that company were putting it onto the shelves, they would pay duty and that would be gathered in the normal way. The problem would tend to be where that company, not necessarily that company, but a company in that warehouse, was selling onto another party who was not paying duty and was perhaps saying “I'm now selling it to France” and it was coming back in without duty being paid.

Q141 Mr Walter: So basically you as an industry are losing control of the goods.
Mr Good: Correct. That is one of the reasons why we are as keen as the Customs and Excise and the government to stamp out fraud.
Mr Shearer: The big frauds of the 1990s were the so-called outward frauds where it started in a warehouse, a third party warehouse, and then it went off to the continent allegedly, but disappeared into the UK market.

Q142 Mr Walter: It never actually went to the continent.
Mr Shearer: It never actually got there. Then huge controls were put in place around about 1998 to stop that type of fraud and we believe that those controls were largely effective, though there have been one or two instances—

Q143 Mr McFall: Give us a flavour of those controls.
Mr Shearer: The warehouse controls were significantly improved. In the mid-1990s Customs had possibly been approving one or two people as warehouse keepers whom they perhaps should not have been approving and they clamped down on looking at what these warehouse keepers were doing in their warehouses. It is really just all about effective oversight of the warehouse.

Q144 Norman Lamb: Are you talking about the London and City Bond?
Mr Shearer: There have been one or two well-known cases.

Q145 Norman Lamb: That is still in place and still doing business.
Mr Shearer: It is a very large and successful third party warehouse and it is still widely used. I do not think there is any suggestion that it is fraudulent at the moment. But anyway, when that fraud was stopped, there was a risk of this other type of fraud called inward fraud where the stuff goes out to the continent, then comes back in again and then disappears. Customs picked up on that in around about 2000-01 and the secret to that is just putting more intelligence-based controls at the ports. John Rocques, who investigated all this in about 2001, said the only way to do this was to put controls at the ports. Customs have done that; in around about 2001, they put a whole lot more people in the ports. We help those people because they phone us up and say “What do you know about this brand or that brand”. That has led to this decline in seizures at the ports that I reported, so we think the lid is on that type of fraud as well.

Q146 Mr McFall: It was John Rocques who suggested duty stamps, was it not?
Mr Shearer: It was among his recommendations.

Q147 Mr Walter: May I just get a quantification? May I just look at the, if you like, cross-border fraud and try to get a quantification on that and the white van trade and so on? How much of that is through the corner shop as you have described it and how much is off the back of a van or through unofficial networks and so on? I have heard evidence, not in your industry but in the tobacco industry and we are going to hear evidence from the tobacco manufacturers later in this inquiry, that in terms of hand-rolling tobacco most of this is out of the back of a van on a Friday night. How much of that is there in the spirits industry?

Mr Hewitt: You need to look at where the spirits are sold in the UK. About 70% is in the supermarket, the big supermarkets where the supply chains are very tightly controlled between the producers and appearing on the shelf. Fifteen per cent is in the controlled off-licences, the off-licences which are controlled by the big companies and where the supply chain is very, very tightly controlled. We do not believe that there is very much fraud at all within those tight supply chains. That leaves, at maximum, 15% for the corner shop. As Ian said before, on the figures which they produced last year in the PBR at 16% of £600 million, every single bottle sold, and that was the equivalent of 200,000 bottles a day, was going to have to be illegitimate in the corner shop, that is had escaped duty.

Q148 Norman Lamb: What about sales to pubs and clubs? Does that not happen?
Mr Hewitt: This is another form; there are other problems associated there.

Mr Good: That is the difference between the on and the off trade. Gavin is talking about the off trade. There is the on trade, which is selling to the pubs and that would tend to be done through wholesalers, cash-and-carry.

Q149 Mr Beard: What steps do you take in the industry to vet the people who are driving the lorries or running the warehouses, to make sure they are bona fide people? In the London bonded warehouse which has just been referred to, some of the people involved there had criminal records.

Mr Hewitt: Companies who have controlled supply chains know exactly who it is they are using, whether it is Edrington, Diageo or Allied.

Q150 Mr Beard: In the past they have not done, have they?
Mr Hewitt: They do.
Q151 Mr McFall: Could you tell me, when you lose control, at which stage you lose control? I think that is what Nigel is getting at.

Mr Good: When you say lose control, we always know the bottle, because it has a lot code number on it. On the back of the label there will be a lot code number which will say when that was bottled, the time it was bottled, that would lead to a case and the case is then controlled. So we can control the bottle. What we cannot do is control it once it goes from our warehouse or our distribution company’s warehouse to the third party. At that point, the third party can either quite legitimately put it onto its shelf, quite legitimately sell it onto another party. There is nothing to stop him doing that, but what we have to hope is that when he sells it on to another party, if he is selling it duty paid there is not a problem, if he is selling it under bond, we need to be sure that the warehouse that he is selling it to has the same controls as the original warehouse.

Q152 Mr Beard: If we are just talking about when it is under bond, it would not take a lot to vet the people properly who are handling it.

Mr Good: Let us talk about guarantees.

Mr Hewitt: What we as the industry had proposed to Customs was that most of the fraud was coming and produced out of third party warehouses, not out of the primary producer and the distributor. Those third party warehouses, in our view, were not being adequately controlled by Customs.

Q153 Norman Lamb: Were not or are not?

Mr Hewitt: They were not being adequately controlled and we still believe there are aspects which are still not being adequately controlled. I use one example and this is within the last year, a Liverpool bond third party warehouse where I have been told that one of the directors of that company has a criminal record for fraud and that bond is still operating.

Q154 Norman Lamb: Outrageous, is it not?

Mr Hewitt: That is a fact and that is a question of control by Customs.

Q155 Mr McFall: Yes, but is it not a question for the industry as well, for the industry to alert Customs to check what is happening?

Mr Hewitt: Yes; absolutely.

Mr Good: I think the other thing is that legitimate companies, the Allieds, the Diageos, the Pernods, the Edringtons, the Grants, these kinds of people know that because we have intelligence on which warehouses we would not send our goods to and we would not think of sending our goods to that warehouse.

Q156 Norman Lamb: There was a period in the 1990s, which went on for quite a long time, when we knew that massive frauds were going on and yet the products were still going through those warehouses.

Mr Good: Yes, but they were not going direct to those. That was the point. We were selling it to them.

Q157 Norman Lamb: I appreciate that, but you could see what was happening, because you were tracing your goods.

Mr Good: Yes.

Q158 Mr Walter: I just want to try and get a quantity. We have talked about the measurable fraud, but what is the black market? How do you know how big that is of the people who are either selling direct to the consumer into the back door of a pub or a club or the restaurant or whatever? How big is that market?

Mr Hewitt: It goes back again to the estimates of fraud and the basis on which you calculate that fraud and there are different data sets which have produced different figures.

Q159 Mr Walter: What do you think it is?

Mr Hewitt: We think the figures, obviously working on the GHS, the General Household Survey, together with the consumption, together with the clearances, taking all that together, indicate that fraud at the moment is in the region probably of 2 to 3% maximum. Maybe even less, but I am willing to accept that there is fraud and let us put it at that. We believe that it is not even at 7%. That is because we are looking at an official government set of statistics, using that in exactly the same way as Customs and Excise are using a different set of statistics, hence the ONS study of which is the right data set to use. We are in a difference now between a very low percentage figure, let us accept 2 to 3% or less, and the 7% which Customs are now using.

Q160 Mr McFall: We are focusing on the supply chain. Let us keep going on that.

Mr Hewitt: May I answer one question? You say we were aware of fraud going through. May I just remind you of what was going on in the London bond, which was that Customs admit they were allowing fraud to run? Now those figures are therefore being used against us.

Q161 Mr Beard: The first part of it in the London bond warehouse was that there was a lot of smuggling. There was another case where they allowed the fraud to run and lost £670m in the process, but the fraud was there to start with.

Mr Hewitt: The fraud is there, but it is the third party warehouse. Now let me just support controls. We brought that to the attention of Customs. We have suggested, very strongly to Customs, that they should tighten up the process of guarantees of third party warehouses, that is a warehouse guarantee should not be used where they do not know the owner of the goods.

Q162 Norman Lamb: Explain how a guarantee works.
**Mr Hewitt**: A guarantee is required for all movement and holding of excisable goods under bond. Edrington has a guarantee, Diageo has a guarantee, all the way through the supply chain people have guarantees.

**Mr Good**: That would be financed by a bank and there would be a significant cost in doing that. It is a legitimate business transaction which people would need to enter into and therefore the bank would investigate the *bona fides* of the person who was looking for guarantees.

**Mr Hewitt**: These third party warehouse guarantees were being used to allow movements out of the bond, out of the third party warehouse, and then they disappeared. The point was that the owner of the goods, the person who was transporting, taking those goods out, was not at risk himself. He had no guarantee against these goods and so effectively he was able to escape, sell the goods into the market and escape without penalty. We, as the industry, suggested that did not make sense. The guarantee should be provided by the owner and therefore, in a sense, as owner, Mr X, who is rather suspect, rather fraudulent should be required to come back into the banking system and actually raise a guarantee of his own. If he is fraudulent and the banks check him out, he probably will not get a guarantee, which means that those goods will not move from the third party warehouse because there is no guarantee.

**Q163 Mr McFall**: Looking at your responsibility in this, how far can you take it along the supply chain and guarantee that the people who are in the bonded warehouses are *bona fide*? That is what we are actually interested in today, where you lose control, where fraud takes place.

**Mr Good**: To answer that, the easiest thing to say really is where fraud is most likely to take place. It is after it has left what you call the legitimate trade. If, for example, we were selling under bond to a large supermarket chain, we would not think twice about that because that would be totally controlled. If we were selling to a chain of cash-and-carries, we would need to be sure that they were going there and they were definitely going into those cash-and-carries. Because of the buying patterns of the cash-and-carries, they could be buying for a whole range of smaller cash-and-carries and that is when it can start. If they are selling it from that warehouse to another bonded warehouse, who in turn are then selling it on to another bonded warehouse, which is quite legitimate, it is each time it goes through a bonded warehouse that there is a likelihood of fraud.

**Q164 Norman Lamb**: How long have you been able to trace your bottle all the way through?

**Mr Good**: Since the 1990s.

**Q165 Norman Lamb**: The scandal is that in that period of the 1990s, well over a billion pounds of duty was lost to the Exchequer. You were able to trace the bottles and yet it was happening. What I want to know is how on earth it was allowed to happen. Customs and Excise are in the dock clearly, because they were allowing these frauds to continue, but what about your responsibility? You knew it was happening, what were you doing about it?

**Mr Good**: Well, again I can give you an example. There was one particular case where we were selling to warehouse X. He was in turn selling on to another company. That company was then distributing it without paying duty. It was being sold in a number of cash-and-carries. Legitimate cash-and-carries came back to us and said ‘Why is cash-and-carry A able to sell Famous Grouse at that price?’.

**Q166 Norman Lamb**: What date are we talking about?

**Mr Good**: That would be 1996. We checked with the then United Distillers, with IDV, with Allied and we found that they were having the same problems with this particular customer. The four companies gathered the evidence and took it to the Customs in 1996 and said ‘We believe that this particular company is perpetrating very significant fraud’.

**Q167 Norman Lamb**: Was action taken?

**Mr Good**: Yes.

**Q168 Norman Lamb**: Then that company clearly was replaced by lots of other companies because the frauds persisted.

**Mr Good**: The fact is that was 1996 and that was when we as an industry were getting extremely concerned that the control over our brands was being seriously hampered by this fraudulent business.

**Q169 Norman Lamb**: Was there a prosecution in that case?

**Mr Good**: Yes.

**Q170 Norman Lamb**: Is it one of the ones which is going to fall?

**Mr Good**: I do not know what has happened in that particular case. They certainly were prosecuted.

**Q171 Norman Lamb**: But once that fraud was sorted out, it was replaced by loads of others, because fraud was continuing throughout the late 1990s and well beyond 2000.

**Mr Good**: I think what you would see, subsequent to that type of liaison with Customs, was that there was a much more formal link between the industry and Customs to try to eradicate this fraud.

**Q172 Mr Beard**: Why could you not ensure that the duty is paid at a level which you control? If it is going to go out to all these different people it is provided duty paid.

**Mr Good**: I would suggest you ask the Chancellor why 74% of every bottle of whisky is duty and VAT.

**Q173 Mr Beard**: That is not the question I am asking.

**Mr Good**: I know that, but the point is that it has such a significant cash flow impact on our industry.
Q174 Mr McFall: Let us make it easy for you then, dead easy. Let us pay the duty when the product leaves production, then everything is fine after that, because you have paid at that level. What is your problem with that?

Mr Hewitt: The Government would be in contravention of EU law.

Q175 Mr Beard: Why?

Mr Hewitt: Because under EU law duty suspension is allowed for legitimate traders, any trader, right through to the point of consumption and you only pay tax at that point.

Q176 Mr McFall: Is there no chance of getting around that?

Mr Hewitt: It is not we who control that.

Q177 Mr McFall: I am sad for you: you are frustrated, you want to pay it at the factory level—

Mr Hewitt: Have I misunderstood?

Mr Good: Let us come back. Let us have a reality check. The impact that would have on the industry would be catastrophic.

Q178 Mr McFall: It could be phased in.

Mr Good: How would we be able to develop our business overseas if we were being hammered by the UK government in terms of the cash flow of our industry?

Q179 Mr McFall: If I were the Chancellor, what I would say to you guys would be “Wait a minute. Okay, if you say it is EU law, let us debate that and I’ll get my lawyers to go and see whether it is EU law”. You have to keep a tab on it the whole way along the line and not lose control of it. I think this is the issue here which we are highlighting. At the moment, at some stage, you lose control of it and we want you to retain that control and then it would make it simple for everyone in the production. I just think this is an elaborate—

Mr Good: The point we are making is that when there is so much money involved, you will inevitably get people who try to defeat the system. What we are saying is that the system has been tightened very significantly; the controls are much better than they ever were and therefore the quantum of fraud is very low now. You will never eradicate fraud.

Mr Hewitt: May I make the point that the government is interested in the competitiveness of British industry.

Q180 Mr McFall: I understand that.

Mr Hewitt: If you apply duty at the point of production and the companies who produce have to pay that duty, they are seriously disadvantaged vis-à-vis foreign spirits’ producers who are allowed to operate under EU law. There is allegedly a single market within Europe and we must have a single rule.

Q181 Mr McFall: Why do we not all unite in a campaign to see whether we can get the law changed and have it paid on production?

Mr Hewitt: It is open to the Chancellor to campaign for that.

Q182 Mr Walter: We could almost suggest a single rate of duty, but we will not go down that route. I want to move on to beer and wine, but wine obviously is a different kettle-of-fish. Customs told us that they are continuing to “explore alternative methods to estimate the overall scale of beer and wine fraud, although a robust quantification of the problem is not yet possible”. Dr Long, in your evidence to us you said “Over the last five years, UK trade figures indicate that over 1.1 million hectolitres of beer was exported to France that has not been accounted for in French import statistics. In the same time period French trade statistics also show nearly 1.7m hectolitres of beer exported to the UK that does not appear in UK import statistics”. Are you involved in trying to find ways of actually estimating the exact level of cross-border fraud in this area?

Dr Long: We were interested to read in the document which accompanied the pre-budget report (PBR), Measuring and Tackling Indirect Tax Losses 2002, that mention was made of supplementing information with periodic testing. We are not sure what that means. This is a Customs and Excise initiative. We stand ready to talk with Customs and Excise in whatever way we can assist them in developing such methodologies. We have been engaged for 10 years in measuring the fraud which we know is visible and easily measurable. It is that hidden fraud which is very difficult to measure. The figures we refer to are indicative of irregularities. I would not claim that these are a robust measure of fraud, but we feel that they are worthy of further investigation. Customs and Excise have been advised of these data. They carried out their own assessments and they believe that they are not in fact robust measures. They have set those aside and they have not put any estimate of fraud into the document which accompanied the PBR and have made mention of this additional statistical analysis that they wish to carry out.

Q183 Mr Walter: Could you just give the Committee a ballpark idea of what you think the quantum is of diversion fraud and what the quantum is of large-scale smuggling?

Dr Long: In terms of smuggling, the data we have presented in the written evidence would suggest that the value of smuggling into the UK in van trade would be in the order of £2 million.¹

Q184 Mr Walter: What is that as a percentage of consumption?

Dr Long: Duty is in the order of £3bn, so it is an extremely small figure. We have been talking about spirit fraud, but we should emphasise that we are talking about orders of magnitude less. We are talking about very small levels of residual fraud in

¹ Duty lost from “residual” van trade could be up to £5 million. A ballpark estimate of total smuggling and diversion fraud would be in the region of £50 million in duty (representing about 1.5% of beer consumption).
the beer trade, about which we are not complacent. We wish to drive that down and work with Customs and Excise, but it is a matter of scale. This is very small-scale fraud that we are talking about.

Q185 Mr Walter: And diversion?
Dr Long: Outward diversion is very well controlled. We have no accurate measure for inward diversion fraud.

Q186 Mr Walter: What about wine? What sort of quantum are we looking at there?
Dr Long: I am afraid I am not able to comment on that.

Q187 Mr Walter: The only information which was available related essentially to cross-Channel smuggling. You have stopped your surveys which you used to conduct on that, basically those on heavily laden vans, because the smuggling has dropped significantly. Customs have also stopped their cross-Channel smuggling survey. In the absence of this information, how are we going to know whether this is going up or down?
Dr Long: That is not quite correct in fact. We have reduced the level of surveillance in Calais now to a very low level, because that van trade has all but collapsed. We have in fact carried out two exercises in the current year, very low level surveillance, to see what sort of activity there is around the cash-and-carry areas in Calais. We would stand ready to reactivate those surveys to the level at which they were formerly conducted, if there were any indication that had risen, perhaps as a result of a relaxation of Customs activity. It seems to us to be very clear that the enhancement of Customs activity in 2000 had a direct impact on that level of smuggling. Perhaps if Customs are challenged in the European Court on the level of activity in channel ports, there could be a resurgence of activity and that is why we have maintained that low level of surveillance.

Q188 Mr Walter: Do you think the decrease in this has been because of the level of Customs' surveillance rather than because the Chancellor has the relative levels of duty about right?
Dr Long: I would say very much the former.

Q189 Mr Walter: I thought you might.
Dr Long: Yes, there was a direct impact on this highly visible trade across the Channel and this was entirely due to the level of activity in the Channel ports.

Q190 Mr Walter: Is there any discernible problem in terms of cross-border trade between Northern Ireland and the Republic of Ireland?
Dr Long: This is not marked, but we would see this whole area as actually a European issue. The Chancellor repeats the mantra of fiscal sovereignty and we understand that. However, the UK is not alone in having a problem; in fact the degree of cross-border smuggling is relatively low in the UK. When we looked, for example, in Sweden, the amount of beer which is consumed in that country which has not paid Swedish duty is about 33% and all this is because of cross-border differentials. It is a domino effect. If the duty rate in the UK were reduced, then there would be an immediate problem in southern Ireland. We would talk about approximation of duties, rather than harmonisation of duties and we believe that would be achieved, not by increasing the low duty rates in those countries with low levels of excise duty, but by starting a process of reducing the high level of taxation, particularly in northern European countries. When the single market opened in 1993, a target level of excise duty was set. The levels of excise duty have moved generally downward towards that target level or below. The UK stands alone in moving away from that target level of duty and in fact exacerbating the problem that we have.

Q191 Mr McFall: I want to look at the memorandum of understanding. In that memorandum of understanding the government clearly believes that duty stamps can work provided the trade can demonstrate a clear commitment to supporting them in other ways. The trade and Customs working together is extremely important. It is important that progress is made in signing this memorandum of understanding, but given that some trade bodies have been in discussions with Customs for over 3 years it does not look very encouraging. How can you zoom into that?
Mr Good: Ian Shearer has some grey hairs but that is one of the things which has been giving him—

Q192 Mr McFall: How can you get that speeded up and get something done?
Mr Shearer: In the Budget 2002 the Chancellor set up this body called the Joint Spirits Fraud Task Force. One of the objectives was to improve all the channels of communication between us and Customs on all sorts of things. After a while we decided to try to formalise that in a memorandum of understanding. That was negotiated during 2002–03 where we tried to capture all the things the task force was doing. If there were any delays in that process incidentally, it was not entirely our fault that there were some delays during the negotiations. We were just about to sign this and we were about to launch it at a seminar in Glasgow last December and the Pre-Budget Report announcing tax stamps was the previous day.

Q193 Mr McFall: Come on, we are beyond that now. Let us get going.
Mr Shearer: We are beyond that. The memorandum of understanding is still on the table and we will have to—

Q194 Mr McFall: Give us some hope on that.
Mr Hewitt: This is certainly something which would be a visible indication of our serious desire to cooperate intimately with Customs. I want to see the whole of the debate on tax stamps behind us. We will not necessarily wait for the debate to be behind us
but I would hope that we should be able to say—remember it is not just the SWA, it is the gin, vodka, the wine and spirits—

Q195 Mr McFall: The trade bodies are negotiating.  
Mr Hewitt: All the industry, all the trade bodies. There is a very important thing too. There is another memorandum, to which you may not have seen reference, which is one with the warehouses. That is one which is probably the most important of them all. It is not the producers who have been creating the fraud, it is further down the line. I believe that we should be able to come and agree. A lot of what we are talking about on tax stamps is already reflected in the memorandum of understanding.

Q196 Mr McFall: So we could be talking about 6 months at the most before a memorandum is signed. Is that correct?  
Mr Hewitt: As the representative of The Scotch Whisky Association it has to be signed and agreed by all my member companies and on that basis I certainly will want to go—

Q197 Mr McFall: Will you take that to your next meeting then?  
Mr Hewitt: It is not on my agenda for tomorrow, but this is certainly something I want because we want to discuss it with Customs and Excise at our next meeting with Customs and Excise in January.

Q198 Mr McFall: Could you envisage it being on your agenda the day after tomorrow?  
Mr Hewitt: Do you want me to call them all together specially? I do not think that this is an issue. The industry is ready to co-operate totally and fully with Customs and Excise.

Q199 Mr McFall: But government and Customs see it as an issue, so it is important, if this co-operative spirit is to be maintained, to get that memorandum signed as quickly as possible. Do you agree?  
Mr Good: The principle is absolutely right. We want the MoU. That is the piece of paper which says “We want to work together and make sure we stamp out fraud”. In the PBR the Chancellor recognised that the industry and Customs had been working together. What we are saying is that he has recognised it, we want to do it, there are still one or two issues outstanding, let us get them out.

Q200 Norman Lamb: Is the memorandum containing the package of measures which you put forward as the alternative entirely different?  
Mr Hewitt: No, the memorandum predates the package of measures we put forward before the budget. Can I also emphasise that we have been producing more measures. We have given all sorts of ideas to Customs and Excise which they can put in place. The memorandum of understanding is not signed because effectively they took the carpet from under us last December when we were ready.

Q201 Mr McFall: They are bad people, these Customs and Excise, are they not?  
Mr Hewitt: I had a signature from nearly all the companies of our membership to go and sign it. That was one of my very first duties.

Q202 Mr McFall: We have moved on from that. Mr Good, you are the Chairman of The Scotch Whisky Association, so you can have chairman’s prerogative and put it on the agenda, can you not?  
Mr Good: Absolutely. For the avoidance of doubt, there is no suggestion of people dragging their heels. Quite frankly we are trying to get the whole question of how we best stamp out fraud and that has to be a combined effort. We want to do it.  
Mr McFall: And do it quickly.

Q203 Norman Lamb: Are you saying the warehouse ownership is—  
Mr Hewitt: No, we do not. This is the warehouse association. It is separate.

Q204 Norman Lamb: Sure, but you said a few minutes ago that you think they should be signing up their own shortly.  
Mr Hewitt: They have negotiated. It is absolutely crucial that they should sign too.

Q205 Norman Lamb: They have negotiated, have they?  
Mr Hewitt: They have negotiated a text. They are in the same state as we are, as I understand it.

Q206 Mr McFall: Can you give us a date?  
Mr Shearer: No. Can we reassure you about the controls in these third party warehouses, back to an earlier comment of yours about the loss of control in these third party warehouses, as well as the memorandum which they are negotiating? I would give Customs a lot of credit. Since 1997 and all these huge problems which occurred, a series of new controls has been introduced at these third party warehouses. It is really the job of Customs.

Q207 Norman Lamb: You have just given evidence about a man with a conviction for fraud in charge of a warehouse in Liverpool now.  
Mr Shearer: I cannot comment on that.

Q208 Norman Lamb: You just have done; or your colleague has.  
Mr Hewitt: Presumably they are satisfied that the two other directors are legitimate.

Q209 Norman Lamb: You clearly criticised that.  
Mr Hewitt: I did; correct.

Q210 Norman Lamb: Is that part of your package of measures which ought to be taken?  
Mr Hewitt: We would argue with Customs that if they find there is an irregularity the licence to trade under duty suspension should be withdrawn. End of story.
Q211 Norman Lamb: A warehouse which has a director with a conviction for fraud ought not to be capable of this.
Mr Hewitt: Basically has not passed the test of being a fit and due person to carry out the job.

Q212 Norman Lamb: Is that the test?
Mr Hewitt: That must be the test.

Q213 Mr McFall: That could be in the memorandum of understanding of the warehouse people. We did mention that a major part of this fraud problem is the ability of fraudsters to acquire goods from unknowing legitimate traders, producers or warehouse keepers. What can be done by Customs to stop that happening? You have said there is work to be done with Customs to stop that happening and you have indicated in the past few years there has been progress there but maybe more could be done. Duty stamps are obviously a major part of that. What more could be done across the industry to reduce the scope for such acquisitions to happen? For example, would the trade consider more radical voluntary action selling duty paid to customers about which it has doubt and could that feature in that memorandum of understanding?
Mr Good: That happens. It does not happen so much now but as has happened in the past, where there has been any question that someone would sell on or some question about whether they were bona fide, then one route is to sell duty-paid.

Q214 Mr McFall: If that were included in the memorandum of understanding—
Mr Hewitt: It is.

Q215 Mr McFall: If it is signed, then that is going to happen. Surely that step in itself, which is quite radical, must help reduce fraud?
Mr Good: The only issue I am querying is the question of “radical”. We have been doing it and we would do it, because we want to stamp out fraud.

Q216 Mr McFall: But Norman talked about guys from Liverpool and elsewhere screwing the system.
Mr Hewitt: We do not trade with them.
Mr Good: Our company would not trade with that warehouse.
Mr McFall: Somebody must be trading with them.

Q217 Norman Lamb: Who is trading with them then?
Mr Good: These are third party warehouse people trading between themselves.

Q218 Norman Lamb: Which is where the fraud is perpetrated.
Mr Hewitt: Most of the fraud.

Q219 Mr McFall: You guys could stop it by getting the duty paid, asking them to pay it because there has been a question mark over them.
Mr Hewitt: May I just explain? May I take Edrington’s as an example? They pass it on to the distributor. That is under duty suspension. The distributor passes it on to another legitimate trade who is at that point a third party warehouse; again, known to their distributor. That third party warehouse then can trade to another person. That is well understood. That is not in Edrington’s control at any moment.

Q220 Mr McFall: I understand that. What I am saying to you is that what is in Edrington’s control is that you are supplying to people. If you have doubts about them, then you ask them to pay duty. That is the point.
Mr Good: Exactly and that is what we do; that is what we have done.

Q221 Mr McFall: What is the problem then? This should be a land free of fraud then, if that happens.
Mr Good: The point I was making earlier was that we have had one call in the last year from Customs and Excise with even a question mark over fraud of our products.

Q222 Mr McFall: I would put it back to you that maybe a quality control exercise should be instigated by yourselves with your own companies looking at things like that to verify the veracity of the people down the line.
Mr Good: We have a team of people; Diageo have a team of people; Allied have a team of people. Their job is security. That is to make sure that we are not trading with illicit traders.

Q223 Mr McFall: There is a dislocation here. You are here because there is fraud. You have said that we cannot stop fraud, but we are trying to eliminate it and we want more radical steps to eliminate that. You have already admitted that in Liverpool and elsewhere you have it. If you have doubts about this step, asking for duty to be paid, surely to goodness that must eliminate fraud quite a bit. Would you not agree?
Mr Shearer: The big companies do look at this.

Q224 Mr McFall: But others do not, is that correct?
Mr Hewitt: Yes.
Mr Good: Yes.

Q225 Mr McFall: How can we get to the others who do not?
Mr Good: Some of the companies you say do not, are small companies and they do not have the resource effectively to have a protection department; they do not have anything like that. They may legitimately sell—

Q226 Mr McFall: So we have identified a black hole here; we have identified a black hole.
Mr Good: There are areas—

Q227 Mr McFall: No, no; we have identified a black hole.
Mr Good: That is why there is fraud.
Q228 Mr McFall: How do we...?  
Mr Hewitt: May I say how we do it? We have suggested to Customs that those companies allowed to trade under duty suspension should be registered and there should be a known register of companies which are totally approved by Customs to operate under duty suspension, to trade under duty suspension.

Q229 Norman Lamb: A fit and proper person test of some sort.  
Mr Hewitt: It is the job of Customs to make sure that each company is legitimate, has a good track record on paying tax.

Q230 Mr McFall: So you are discussing this with Customs; there is a memorandum of understanding coming. What is your suggestion? Would you agree that memorandum of understanding can take us a long way? Is that right?  
Mr Hewitt: We should like Customs to do that, but Customs say they have a problem because they cannot stop people trading. I am sorry: that is not an acceptable response.  
Mr McFall: There is an industry responsibility here. You should have accepted that industry responsibility and seen it and that black hole which was described.

Q231 Mr Walter: Are you saying that there are warehouses, there are traders who are what one might call bonded traders, who are trading, yet Customs and Excise do not approve or register or have any control or any means of checking what is in those warehouses, what is bonded, what is duty paid?  
Mr Hewitt: No. Technically every person who is trading in bonded goods is checked by Customs and they do have, and they say and they claim they have, an assurance and they check to make sure they are legitimate traders. If they have done enough checks, we will not have leakage from these people. If they are leaking, they are not legitimate traders and they should not be on the register. Hence the point I made about one bond which we know has a director who has a criminal record for fraud.  
Mr Shearer: One example of a very new control which has just come in is that all these warehouses now have to do electronic mandatory warehouse returns. Monthly they have to submit detailed information about what is in their warehouses and the idea is that Customs can then do trend checks on this. This is one example of the kind of controls where I think they have been very successful. I really believe that the level of fraud has come down significantly and it is a story of success.

Q232 Norman Lamb: It did come down.  
Mr Shearer: Since 1997 all sorts of new controls have been put in place and one has to give Customs credit, they are policing this system more effectively.

Q233 Mr Walter: You are saying that it has come down, but that does not alter the fact that the system still operates whereby somebody can operate duty free in the UK and Customs are happy for them to operate duty free, yet Customs themselves admit that this is open to abuse. Let me give you a parallel. I used to have a farm and a Customs and Excise man would come to check my VAT returns and he would be more interested in the level of my phone calls. Yet here we are talking about millions and millions of pounds, to which they seem almost to have turned a blind eye in the past.  
Mr Hewitt: That is exactly the point we are making. It seems to me that like a football referee, if someone gets it wrong there is a yellow card, if someone gets it wrong twice there is a red card on the basis that the first time it might have been a mistake, but with two mistakes where you are cheating the system you should not be let off.  
Q234 Mr McFall: I would be the last to divide you, but I think Ian Shearer has a different view on that in terms of Customs.  
Mr Shearer: It is very interesting to see that you are in the Thatcher Room. If we go back to Mrs Thatcher, in those days there used to be a Revenue officer in every bonded warehouse. They were taken away during the 1980s and this was great for blue chip companies, because there was no Revenue officer watching everything they were doing. Blue chip companies were trusted to police themselves effectively. It did open up opportunities for the unscrupulous in these third party warehouses. I believe that by policing these properly—

Q235 Norman Lamb: Hang on. We have already have any control or any means of checking what is established that Customs and Excise were allowing the frauds to continue; they were aware of it happening. Whether you have a bloke there or not—  
Mr Shearer: I do not know whether that was before these new warehouse returns or not.

Q236 Norman Lamb: It was in the 1990s.  
Mr Shearer: With these new warehouse returns and other effective controls, if you watch, where is the brand going that these warehouses are sending? Is it going abroad? Why would a warehouse in Liverpool be exporting one of Mr Good’s brands? Surely an intelligent use of warehouse returns would mean that Customs would be phoning up and asking whether this brand should be going abroad. You can police this system effectively if you study the warehouse returns properly. This system has just come in and I believe that it will be very helpful in trying to police the system more effectively.  
Mr Hewitt: There are still gaps, but they are doing better.

Q237 Mr McFall: There is still a black hole and there is responsibility on both sides.  
Mr Hewitt: Yes.  
Mr Good: Absolutely.

Q238 Mr McFall: Is there any scope for a more consistent standard of vigilance across the industry to reduce fraud? Are some traders more careful than
others to whom they sell? If so, is there anything the trade as a whole can do to ensure more rigorous checks?

Mr Good: A lot of it comes back to scale. Small companies will not have the resource to put in the policing which the larger companies do have. Some of the smaller companies will not be trading with what you might call international brands and therefore perhaps would be less concerned, not about fraud, but less concerned about where their goods end up. For example, if we sold our goods to a warehouse in the UK and they legitimately sold it on to a warehouse in France, we would be concerned because in fact our distributor in France was getting goods coming into France from the UK that could disrupt the market. The question of control over brands is perhaps much more legitimate in terms of the bigger companies than a smaller company which is not developing brands, but is perhaps developing a secondary brand. They would not have the resource and they may be vulnerable to the person who just wants to trade a bottle of whisky rather than a brand.

Mr Hewitt: Additionally, in the 17 proposals we put forward before the Budget, there was a very important proposal and I touched on it already. It was that warehouses, particularly now we are talking about third party warehouses, should not have their guarantee used for the movement of goods under bond. It is the person who owns those goods who should actually be liable for that guarantee. If that owner is a fraudulent person, he will find it very difficult to get that guarantee. It is a fundamental change of where you get the guarantee for moving and holding.

Q239 Norman Lamb: Is it perfectly possible to implement that? No problem with European law or anything like that?

Mr Hewitt: Nothing. There is no difficulty whatsoever.

Q240 Norman Lamb: What is stopping you doing it?

Mr Hewitt: I think Customs are looking at it and I think they may well change the process.

Q241 Norman Lamb: How long have they been looking at it?

Mr Hewitt: We put it on the table at the start of this year.

Q242 Mr Walter: So you are saying that a legitimate trader, a bonded warehouse, can sell the goods which somebody else is going to ship, even if that person may not be a fit and proper person to take those goods without them having paid duty.

Mr Hewitt: Yes, unfortunately at the moment they can use the warehouse guarantee. I own a lorry-load of whisky. I have it parked in warehouse X. I then move that to another third party warehouse, as the owner. At the moment the warehouse guarantee is being used, very often, to ship from that warehouse to the other warehouse, for the movement. I as the owner am not liable for duty; it is the warehouseman. Off that owner goes, he may slip away, not pay the duty, divert it onto the market. He has escaped because he has not put down any guarantee; he is not liable for anything, the warehouseman is and they are not his goods. Effectively, if you put the responsibility to put the money up front on—

Q243 Norman Lamb: Does the warehouseman avoid having to pay up on his guarantee?

Mr Hewitt: At this point Customs have a difficulty. Effectively, technically, the warehouseman is liable, but of course it is not the warehouseman who is responsible for the diversion.

Mr Shearer: Warehouse keepers are already very careful about whom they allow to use their guarantee, for obvious reasons. What they are talking about is a further code of practice or something where they would be even more careful about who uses their duty guarantee.

Mr Hewitt: If you create the system that the guarantee against fraud by movement is the owner, then you will indeed tighten this system very much.

Q244 Norman Lamb: Dr Long, you note that there are several regulatory measures to reduce beer fraud which have not been progressed because Customs' attention has been focused on the tax stamp issue. Could you just set out what measures you have in mind?

Dr Long: These were regulatory options which were actually discussed during the course of the past year, but were not progressed because of the attention which was understandably focused on the higher risk issue.

Q245 Norman Lamb: What are they?

Dr Long: We discussed issues such as the curtailment of movements in duty suspension. The Committee has talked about this. We were very opposed to this as an idea; the simple idea that if you do not have a duty suspense system, then you do not have a problem because you do not have diversion. In fact we made very strong representations about this, as did The Scotch Whisky Association and that idea was dropped. Several measures have now been carried forward into the business briefing which was issued with the PBR last week, things like notification of cash transactions and advance payments, real-time notification of excise movements, civil penalties for wholesalers and retailers. These are the sorts of issues which were being discussed. There was also a suggestion for beer and wine that there would be discussions on documentation and guarantees. In fact we have not had such discussions because resource has been drawn into the area of tax stamps.

Q246 Norman Lamb: You suggest that Customs adopt a risk-based approach to fraud which concentrates on movements to third party warehouses, what we have been talking about today. Why is this the area of greatest risk? I think we know why it is the area of greatest risk, but do you think enough is being done to tackle fraud at that point? When you put forward the recommendation that
they should adopt this risk-based approach, the suggestion is that they are not really doing this at the moment.

Dr Long: That is absolutely right. We have said as an industry for a long time now, that there really is not a robust risk-based assessment. The legislation is applied as a blanket and this will affect the legitimate trader and very often actually not target the fraudulent trader. For example, in the case of the brewing industry, we would estimate that there were something like 150,000 duty suspended movements between the operating sites within the same company ownership. There is a huge movement of beer for onward packaging and packaging back to another brewery.

Q247 Norman Lamb: Do you suggest that number of movements implies that quite a proportion of those is fraudulent?

Dr Long: What I was coming on to say is that we take those 150,000 out of the picture. We would imagine the creation of a virtual brewery with movements, regardless of distance, which are controlled within the same computer system, which are extremely low risk to the Revenue; in fact I would say zero risk. I know of no fraudulent activity within that company curtilage. Then there are 25,000 movements which are outside that ring, which are moving down that chain of third party warehousing which has been described. It is those multiple movements, where the original despatcher of the goods is not aware of where those goods have actually ended up, and it is from there that there is a danger of a diversion fraud. What we are saying to Customs and Excise is that there should be a robust modelling of risk in order that we can help in saying let us take these low risk movements out of the picture and let us focus down on where there is fraud. Let us put that precious Customs and Excise resource into tackling where we all know the fraud is likely to be.

Q248 Norman Lamb: Is the guarantee point which we have been discussing part of that?

Dr Long: Absolutely right. We think that there should be a hierarchy of guarantees, that in fact in those low/no-risk movement areas a guarantee is irrelevant. In those higher risk movements which are outside the virtual brewery, then there ought to be a higher requirement for a guarantee. We also believe that there should be a guarantee applying to the haulier, because in the majority of instances the diversion fraud which would occur would be with a complicit haulier. Finally, just going back to this point, given that we have suffered a loss probably of billions of pounds in duty, where does the fault lie for that staggering and outrageous loss? I appreciate that we are talking about organised crime, so that is where the fault ultimately lies, but why was it allowed to continue for so long? Did Customs fail to keep their eye on the ball?

Mr Hewitt: You have to understand that in the development of the single market and the development therefore of an EU duty suspension regime—

Q249 Norman Lamb: It created the opportunity.

Mr Hewitt: —it created the opportunity for people to move in.

Q250 Norman Lamb: Why take so long to get it sorted?

Mr Hewitt: If I may say so, I do think at that point—and I do support what Ian said, that things are getting better and that we have successes on both sides, but at that point—the eye was taken off the ball, what was happening was not seen and then we found ourselves caught up in very substantial fraud, culminating in 1997–98, which was the high year.

Mr Shearer: The eye was very much back on the ball from then.

Q251 Norman Lamb: You have made your point.

Mr Hewitt: There was a time when they just did not see what was happening.

Q252 Mr McFall: You are the defender of Customs and Excise. Two or three points for the record. You have been opposed to the government’s proposal to introduce tax stamps, but last week the government announced a number of changes to the proposals, including targeted exemption. I note they are talking about goods sold by registered mobile operators such as ferries and airlines and export shops which will be exempt from the requirement to bear duty stamps and the exemption of liqueurs as a class can be achieved in a way which avoids complexity. Uncertain of the degree of new risk, the government is attracted to the case for doing so. What is your view on that and on these changes in particular? Have they alleviated your main concerns, given the seeming progress which has been made here?

Mr Good: We have made a lot of progress since a year ago. There is an understanding now that both sides really do want to stamp out fraud. There was a feeling before that the industry could have done a lot more. Now there is a recognition that the industry has done an awful lot and that Customs are now seeing that the more we can work together, the better it is going to be. I think we have moved a long way.

Q253 Mr McFall: On the issue of compliance costs and I know that is a big issue for the smaller companies, as mentioned earlier, do you agree that the proposals coming forward from the government will significantly reduce the compliance costs of the schemes which were originally envisaged.

Mr Good: Oh, yes; the compliance costs will be reduced. One thing we do have to bear in mind is that while the compliance costs have been reduced, they are ongoing. They are something which are going to be a cost, particularly to smaller companies; it is going to be a cost to them for ever and a day. It is not just going to be a one-off and then they get back to normal.

Q254 Mr McFall: You say that the benefits of the package of measures suggested to the industry in response to the Chancellor’s challenge to find a better way of tackling fraud than tax stamps, in
Mr McFall: Maybe creeping into that memorandum of understanding will be the issue of duty paid to customers, about which you have doubts. Or am I going too far there?
Mr Good: That is in it.
Mr Shearer: It is in it. A lot of the things in the MoU, including that one, are already happening. The MoU is an expression of all the things which are already happening.

Mr McFall: Yes, but there is still a way to go on taking account of the black hole.
Dr Long: May I just mention two points quickly, which perhaps we have been concerned about in our dealings with Customs and Excise? One we have mentioned, which is the beer fraud task force, in which we stand ready to play our full part. The other one is something which we have raised on several occasions and which we think could have a very dramatic effect on reduction of fraud. This is what we call simplification and modification or modernisation of the system. When we look at the complexity of the legislation we have and the way that companies operate, not only producing beer, but producing ready-to-drink ciders, etcetera, we believe there is great scope for simplification of the system by having a single registration, for example, of multi-site operations for provision of financial security for duty suspended movements, etcetera. The idea that we have presented is of utilising modern IT in order to track goods and ascribe the appropriate level of liability at the start of the movement, verifying the warehouse automatically. When the movement has been completed and the duty has crystallised then that is signalled, again electronically. We have mentioned this on many occasions to Customs and Excise and we have made presentations to the joint alcohol and tobacco consultation group. As yet it is disappointing that they have not taken those matters forward, particularly since we have offered one man day per month of logistics, of financial expertise, to act as a sounding board for Customs and Excise.
Mr McFall: What we will do is bring the minutes to the attention of Customs and Excise in the next few days and if you have any short-term problems with Customs and Excise, see Mr Shearer. Thank you for your attention.

Q255 Norman Lamb: Are these measures largely which have to be introduced by Customs and Excise?
Mr Hewitt: These are measures which largely have to be introduced, but it is the whole question of change in the process of guarantees, change in controlling warehouses a bit more efficiently.

Q256 Norman Lamb: They are not initiatives within your area of responsibility, but things for Customs and Excise.
Mr Hewitt: We have to co-operate with whatever it is they are going to do, but we are very happy to do it and we believe that it would actually massively improve the control of fraudulent activity.

Q257 Mr McFall: If I might sum up, we agree that we will never eliminate fraud, wines, spirits, beer, whatever else it is, but alcohol fraud has come down significantly, particularly since the 1990s; that is what we have been told. However, there is still a black hole somewhere, Mr Good and I agreed on that. The main issues or the main risks are through third party traders and maybe corner shops, off-licences. Am I correct in saying that?
Mr Good: Yes.

Q258 Mr McFall: You also accept the need for greater controls and working along with Customs and Excise you will be pushing for this memorandum of understanding to be implemented pretty soon.
Mr Good: As quickly as possible.
Wednesday 12 January 2005

Members present:

Mr Michael Fallon, in the Chair
Mr Nigel Beard  Mr John McFall
Mr Jim Cousins  Mr Robert Walter
Norman Lamb

Witnesses: Mr Ben Stevens, Regional Director, Europe, British American Tobacco, Mr Nigel Northridge, Chief Executive, Gallaher Group Plc, Mr Gareth Davis, Chief Executive, Imperial Tobacco Group PLC, and Mr David Davies, Senior Vice-President, Corporate Affairs, Philip Morris International, examined.

Q261 Chairman: May I welcome you to the Subcommittee this afternoon, to help us in our inquiry? A key element of the strategy to reduce tobacco smuggling is reducing the supply of cigarettes that are available to smugglers. As I understand it, Customs have signed a Memorandum of Understanding with the three major UK tobacco manufacturers. How is that working in practice?

Mr Davis: From our point of view, it is working very well. It is something that obviously will continually be revisited in the regular meetings, so that it can be maintained as the cutting edge of best practice. I would elaborate a little more and say that it is working so well that we have also signed Memoranda of Understanding with another six European nations' customs authorities, and we are in discussion with a further 12 customs authorities in Europe and beyond.

Mr Northridge: From our perspective, I would reiterate what Mr Davis has said. I feel that it is working exceptionally well. We have seen a reduction in the non-UK-duty-paid volume from around 25 billion to 20 billion cigarettes in the last five years. There are three sources of illicit volumes that are still coming into the UK: one relating to outside Europe; second, counterfeiting; third, people going to Europe itself, which I am sure we will talk about later on. We would still like greater resource put into Customs, but the Memorandum of Understanding, as a principle, has been very useful. We were the first to sign it, and we are equally looking to use this technique in other parts of Europe and also farther afield.

Mr Stevens: We are very happy. We have always co-operated with Customs anyway, so the Memorandum of Understanding just takes us to a new level of that co-operation. We are very happy with the way things are going. I think that Customs are very happy too.

Q262 Chairman: How does Philip Morris work this? You are not a UK company. Have you signed a similar agreement, or has anything been proposed with Philip Morris?

Mr Davies: No, we have not. We do work closely with the UK Customs and Excise. Our products are sold here. They are imported from our factories in Germany and Portugal. As you know, we have signed an agreement with the European Commission and 10 of the Member States that is very extensive and constitutes a commitment on our part, and a commitment on the part of the European Commission and the 10 signatory Member States, to co-operate together to fight illegal trade of all forms; and, for us, particularly to focus on the alarmingly increasing trade in counterfeit goods. That agreement has very extensive compliance protocols, customer oversight provisions, product tracking and tracing provisions, as well as a commitment by us to contribute a substantial amount of money—over a billion dollars—to the European Commission over the next 12 years, in order to enhance their efforts to do everything they can to prevent the growing trade in illegal and, particularly, counterfeit products.

Q263 Chairman: Is the UK one of those 10 states?

Mr Northridge: From our perspective, I would reiterate what Mr Davis has said. I feel that it is working exceptionally well. We have seen a reduction in the non-UK-duty-paid volume from around 25 billion to 20 billion cigarettes in the last five years. There are three sources of illicit volumes that are still coming into the UK: one relating to outside Europe; second, counterfeiting; third, people going to Europe itself, which I am sure we will talk about later on. We would still like greater resource put into Customs, but the Memorandum of Understanding, as a principle, has been very useful. We were the first to sign it, and we are equally looking to use this technique in other parts of Europe and also farther afield.

Q264 Chairman: What is preventing you signing an agreement with the British Customs?

Mr Davies: We are more than happy to have the UK sign the European agreement. It is far more extensive in its provisions, its scope and extent than any Memorandum of Understanding that exists with our company and other governments, or other companies and the UK government or other governments.

Q265 Chairman: Has the UK Government or Customs proposed a Memorandum to you?

Mr Davies: No, they have not.

Norman Lamb: Why do not the UK Government sign up to this, in your view?

Mr Davies: I think that is a question you have to ask your Government.

Q267 Norman Lamb: But your view of this? You must have talked to them.

Mr Davies: No, I have not talked to the UK Government about that. I think that it is a question you have to put to the Government, as to why they do not wish to sign on to this agreement.
Q268 Chairman: The other three of you, do you regard the European Union agreement as stronger than your Memorandum of Understanding with the British Customs?

Mr Davis: I do not particularly, Mr Chairman, no. I think that our Memorandum of Understanding is—

Q269 Chairman: Because you have signed one with other EU Member States.

Mr Davis: We have signed separate Memoranda with other European states, yes. The difference I would see is that there was also litigation, or contemplated litigation, involving the EU and the ten Member States and Philip Morris. We are not involved in any form of litigation related to smuggling and we see the Memorandum of Understanding as more appropriate. It is extremely comprehensive. It not only covers illicit trade into the UK, ex-UK manufactured product, but it covers all our factories in other parts of the world and it comprehensively covers counterfeit, which has been the growing problem over the last couple of years. I would therefore argue that ours is a very comprehensive document with Customs and is working very well.

Q270 Chairman: Since you last appeared before the Public Accounts Committee, I think it is true to say that seizures of your brands have actually declined. Is that right?

Mr Davis: Since 2001—which predated the PAC, which I think was in June or July 2002—at the time we came to the PAC, seizures of our products were already down 40% in the prior six months; but since 2001 seizures of genuine Imperial product are down by 92%. It is fair to say that, in the four months ending September 2004, in total 3 million cigarettes of Imperial’s were seized.

Q271 Chairman: To what do you attribute that step change? It is not just the Memorandum, is it?

Mr Davis: No, I think that a lot of the activity was taking place before the Public Accounts Committee meeting, but since that time, working strongly in association with Customs, we have obviously made very significant inroads into the problems of smuggling of genuine product into the UK—for our product. The sad thing to reflect is that, I would not say there has been an exact mirroring, but there has been a very significant uplift in the amount of counterfeit product coming into this country, and I think that is the major challenge we now face.

Q272 Chairman: With Gallaher the story is not quite as good, is it? Customs told us that, for 2003–04, 74% of all the cigarettes they seized in that year were two of your brands.

Mr Northridge: Yes. Unfortunately, it all relates to one particular distributor, who has responsibility for about 12 territories. Having signed the Memoranda of Understanding, and being the first company to so do, we felt it was correct to introduce that customer to Customs before we gave him the contract in 2002. Initially, things seemed to go very well. There was no sign of product coming back. Then, at the end of 2003, beginning of 2004, product started returning. We subsequently withdrew the brand of Sovereign, despite the fact that the packaging of that brand had been designed to be completely different from that in the UK in the first place. We withdrew that brand in June of last year and we have not sold cigarettes of our brands to that individual since. We have effectively suspended the contract.

Q273 Chairman: For all brands?

Mr Northridge: For all brands, to all those territories, to that distributor—because it is clear to us that he is unable to exercise the control we need within our international trading policy to ensure that that product remains in the markets it was destined for.

Q274 Chairman: How does that happen? Do you not vet a distributor?

Mr Northridge: Absolutely. We go to huge lengths to understand not only his intent but the guiding minds of the owners of the company, his experience, his knowledge of the tobacco industry, his sub-distributors. Unfortunately, further down the chain, it would appear that there are people who have been able to get their hands on this stock and return it to the UK. We therefore have no other methodology, other than to withdraw the brand and to discontinue the trade.

Q275 Chairman: So it was the control procedures that were at fault? It was his control procedures that were at fault?

Mr Northridge: It is his control procedures that are at fault. However, we appointed him and so we are not blameless in that sense. It is wholly unacceptable, and that is the reason we have withdrawn business, or suspended trade.

Q276 Mr Walter: I wonder if I could follow up on that one point. In the case of that particular distributor, are you physically delivering the stock to him in that territory, or is he taking possession of the stock in this country and exporting it himself?

Mr Northridge: We mark the product with the destination market, the distributor, and the time and place of manufacture. In some cases, we ship directly to market. In some cases, we ship to his warehouses and then we follow up by visiting the markets that he subsequently ships to.

Q277 Mr Walter: Is there any possibility that those cigarettes never actually left this country?

Mr Northridge: I do not believe so, no.

Q278 Mr Walter: I wonder if I could go on more generally to the evidence that you have submitted. I think that all of you basically suggested that the whole area of tobacco smuggling grew exponentially in the 1990s. One of the figures that stands out to me when I look again at the Gallaher
evidence is that you say, “By the end of the 1990s, the Tobacco Manufacturers Association estimated that some 78% of UK consumption of hand-rolling tobacco was sourced abroad. In other words, four out of five hand-rolled cigarettes smoked domestically have no UK duty paid on them”. This enormous increase—does this imply that Customs and Excise had taken their eye off the ball in that period?

Mr Northridge: I think that it is very easy with hindsight. At the time, I think that we were also taken a bit by surprise. Despite the fact that in the late 1990s we were developing relationships with Customs, we were shocked by the increase. We started restricting our supply to Belgium on that basis. However, it became very clear, with a tax-driven differential of over £5 for one 50 gramme pouch, and very easy to pack and to take this product across—and I think that it coincided with the price war battle with the ferries, so that for a couple of years you could get across to Belgium very small problem. The whole market grew.

Q280 Mr Walter: The whole market grew.

Mr Davis: It only represents about 12% of total UK consumption. Paradoxically, however, it is a more difficult one, because the vast majority of roll-your-own tobacco that comes into this country is EU duty paid; i.e. it has borne duty in another EU Member State. Basically, the inflow is largely dominated by cross-border shopping and/or what we would call bootlegging, which is product which has attracted duty in the intended country, the destination market, but has been brought back in quantities for the purpose of illegally reselling. It has borne duty in some country of the EU. With cigarette it is somewhat different, in that there is a much wider field, as it were.

Q281 Mr Walter: This trade was, if you like, the white van trade. What were Customs doing? In your opinion, what were Customs doing in this period? Obviously not stopping it.

Mr Davis: The thing that kicked it into life was very much the entry into the Single Market in 1993. That is when it took off. As my colleague said, it perhaps caught everyone a little by surprise and it took some time to catch up with that. I think that the difficulty Customs have had—and it has been a real difficulty—is the growth in indicative allowance limits for British citizens exercising their free will as EU citizens to travel to another Member State to purchase goods, et cetera, and the difficulty in being able to differentiate between the legitimate cross-border purchaser and the bootlegger. As we know, the UK Government has taken a fair amount of stick in recent years from the EU Commission, in terms of the enforcement and the seizure regime that we have had at the ports. I think that Customs have had to bear a lot of unfair criticism in trying to control what is a particularly difficult area.

Q282 Mr Walter: Mr Stevens, do you have a view on that?

Mr Stevens: Yes, I concur with what Mr Davis and Mr Northridge have said. Smuggling of BAT brands into the UK has never really been a problem, I have to say. The amount of BAT product that has been seized, as a percentage of the total seizures, is less than a third of 1%. So it is a very small problem.

Q283 Norman Lamb: Why is it different between different companies?

Mr Stevens: I have no idea why it is different between different companies. I can guess. BAT was not really in the UK market before 1999. It was only when we merged with Rothmans that we entered the UK market. We have a very low market share in the UK anyway. Our market share is below 6%. When people do cross borders to smuggle brands, they tend to smuggle market-leading brands. So the smaller manufacturers tend to fall off the end of the equation—would be my guess.

Q284 Mr Walter: The estimate of non-UK-duty-paid share of total UK cigarette consumption peaked in the year 2000 at 31%—which, if I were in the Treasury, I would be somewhat concerned about. It seems to have slipped back now to about 27%. Mr Gareth Davis, perhaps I could put this to you, because this was in your submission. In terms of the smuggled element of that, based on your pack collections you showed that cigarette smuggling had slightly increased in 2003 to 18%, whereas Customs estimated it had fallen to 15%. Have you looked at those figures with Customs, to see why not only are your figures different but your trends are different?

Mr Davis: The answer is yes. We discuss the figures at our regular meetings with Customs. The important thing is that, while there may be slight differences over the estimates and the components of the non-UK-duty-paid segment, directionally we broadly agree the way things are going. Estimates of this nature in this type of trade are incredibly difficult to attain, and it is very difficult to verify their accuracy in total; nevertheless, they are estimates. Basically, we establish our figures by market research; and via pack collection exercises, where we collect discarded packs. We collect around 10,000 packs a quarter from pubs, clubs, football grounds, racetracks, et cetera, and analyse those. There is a slight difference in the estimated
size of total consumption between the TMA, ourselves and Customs and Excise. I think that they are largely about collection period, timing differences. The other difference is that in our figures we take the Customs number for what we would call official/legal cross-border purchases. If we apply that figure of Customs to our total estimate, we are left with a derived figure, which would suggest 18% on our data, rather than the 15% of Customs. However, overall, directionally, in macro terms, we would agree with Customs that things are moving very much in the right direction.

Q285 Mr Walter: Why do you think that is?

Mr Davis: If we look at the point you made, Mr Walter, over the period that we are talking about the trend has come down from 31% and we are in the mid-twenties somewhere. Whether it is 24 or 26 or whatever, it is definitely moving down. Certainly in the latest 2004 data from Customs, it has moved down again to the figure they quote as around 15%. We would not really take issue with it. We think that estimates are notoriously difficult. The timescales and the periods of measurement are somewhat different between some of the manufacturers and Customs, and I think that accounts for most of the differences. Directionally though, we do not disagree.

Q286 Mr Walter: Can I go back to the Gallaher statement to us and quote? You say, “Taken alone, the bootlegged issue, which is probably of greater concern because those products have been seized by the Customs and Excise analysis of seizures suggests that contraband cigarettes appear to be almost entirely sourced from outside the EU. By contrast, the pack surveys and our analysis of pack discards indicate that around 60% of non-UK-duty-paid cigarettes come from markets inside the EU”. What leads you to this view, which seems to be in total contradiction with the Customs’ view?

Mr Northridge: To be honest with you, Mr Walter, it may be confusing in the way we have articulated it, because I would not disagree with what Mr Davis was saying or, indeed, indicatively with what Her Majesty’s Customs have been saying. We believe that the UK non-duty-paid element in the UK market is somewhere around 25 or 26%, which is very similar. We think that there are three sources to that. The thing that has changed in the last five years is the source of that change. Originally, some 80 to 90% of seizures were tobacco or cigarettes coming in from outside Europe. That is now between 20 and 30%. In terms of the huge growth in the UK non-duty-paid portion which is coming from Europe, it is impossible for us to ascertain, or indeed Customs, to what extent that is based on people legitimately going and buying cigarettes for their own consumption as opposed to bootlegging. We believe that an increasing portion of that element is being bootlegged, as opposed to people buying for their own consumption. We have a concern that, going forward, that may increase, unless we can work together with Customs to try to reduce that potential. Anecdotally, I read in a newspaper over the Christmas holiday that a plane from Tenerife landed at Newcastle Airport on Christmas Day; they did not expect there to be Customs officials around on Christmas Day, and there were. They walked through the airport, leaving their bags, and there were 2 million cigarettes left on the carousel. Those are examples of what can happen — with the realisation and the knowledge that if you only buy the 3,200 indicative allowance and you sell those cigarettes on, you can, at full retail differentials, make £500. That will pay for your weekend trip to Spain. I think that there is a real need, if we can, to get the whole of Europe to apply a fixed limit which you are allowed as an individual to have in your possession. I understand that the French authorities are debating at the moment whether that should be, for example, 1,000 cigarettes. If we had tax harmonisation, this issue would not arise. Without that, with differentials — for example in Spain, Portugal and Greece, where people are increasingly travelling to on budget airlines — they can acquire cigarettes at full retail price at less than half the price of the UK. Without any indication as to what limit they are allowed to bring back, I think that increasingly people will be tempted to bring back more than they are going to consume themselves, and find a business. The problem with that is that it opens up illegal channels; it does not have the same control, in terms of access to children; and the third is counterfeit, which we have all mentioned, which is a very big and growing problem for all of us. However, to me, it is still nowhere near the size of the bootlegged issue, which is probably of greater concern because those products have been manufactured by people who we have known—

Q287 Mr Walter: So you stick by your view that 60% of the non-UK-duty-paid cigarettes come from within the EU?

Mr Northridge: Absolutely, but I do not know what portion of that 60% are legally being purchased by people, as opposed to being bootlegged.

Q288 Mr Walter: I appreciate that.

Mr Northridge: That is the differential. I do not believe that Customs or my competitors here would greatly disagree with that number. It used to be about two-thirds coming from outside Europe; now it is 60% coming from within Europe, but maybe only half of that is bootlegged — maybe not even half of it. We simply do not know. I do not believe that Customs could possibly know, because it is very difficult. There are 45 million trips by British people across to Europe every year. That is a huge opportunity for people, with one little carrier bag, to bring back more cigarettes than are for their own consumption.

Q289 Mr Walter: But Customs’ estimate is that only 15% is smuggled.

Mr Northridge: Yes, but that is 60% of the 22% or the 25%. In and of itself, it is about 15 and then you have to add the small portion of cigarettes that are still coming in from outside Europe, but that is declining very quickly. So, in all, the numbers are
not dramatically different. We just wanted to bring attention to the fact that we, at Gallaher, would very much like there to be some fixed limit, so that consumers themselves knew what they were entitled legitimately to bring back into the UK, as opposed to indicative figures—which were 800 and then went to 3,200, and which I think has led to a growth in this bootlegged business. Unfortunately, I cannot prove it to you, other than anecdotally, reading newspaper articles, and our sales force—300 people—going to a shop where suddenly the business is decimated, and we think that it is maybe because of a car boot sale, or a pub next door, or a house on a housing estate where somebody is travelling weekly. I think that increasingly they will go to the accession countries, where you can buy cigarettes fully duty paid for less than £1. You are only supposed to bring 200, but if you think that there is a pretty good chance that you will be able to get an easyJet or a Ryanair flight and walk through without being stopped, I think that increasingly they will do so. If you see Customs, I think that is a pretty big deterrent.

Q290 Norman Lamb: Do you all agree that there should be a fixed limit rather than indicative levels? Mr Davis: I would like to put one further dimension on that. I think that the idea of a fixed limit is laudable, but—

Q291 Norman Lamb: Is it lawful? Mr Davis: That is the problem as I see it. We then have to look at the pragmatic aspects of it. In fact, the current debate in the EU Commission is to abolish indicative limits, and it just becomes a free-for-all. So that would be very much contra to the way the EU is thinking. I do not think that the problem is with indicative limits; it is lack of adherence to the indicative limits which is the problem. I think that is what we have to do.

Q292 Norman Lamb: Other than equalising tax rates, which is unlikely to happen given the political debate, what else could be done to tighten it up? Are you talking about much better Customs controls? Mr Davis: I think that there are a number of things in terms of recommendations. We very much believe in closer frontline co-operation with Customs. We do not think that the problem is just about container scanning or that type of trade—the container trade coming in. We also think that there is still a cross-Channel activity that needs to be controlled, with closer frontline co-operation and resources.

Q293 Norman Lamb: Are there things that Customs are not doing that you think they ought to be doing? Mr Davis: There are a couple of things that would very much help us and Customs in the activities. We are promoting two of those things with Customs. One is the ability for them to seize genuine product, where it has been diverted by a third party—which they can do perfectly legally from the country of destination, with correct paperwork, and the Customs cannot seize the product. We have just undertaken two cases in Holland and Belgium where, paradoxically, we have used intellectual property law in order to seize that product in those countries.

Q294 Norman Lamb: This requires a change in the law. Mr Davis: Whether it be law or the rules of engagement, I am not quite sure where it falls. Certainly, if our Customs and indeed other countries’ customs authorities could have that power of seizure, and then when they have seized it destroy it, where it has plainly been mis-declared or is an illegal movement of product, that would help.

Q295 Norman Lamb: You said there was another one. Mr Davis: Extending the concept of the European transit guarantee bond to a worldwide basis would help, whereby monetary guarantees were put in place with the various fiscal authorities throughout the world. That would flag up suspicious movements much more clearly to the various Customs authorities.

Q296 Norman Lamb: Have you proposed this to Customs? Mr Davis: Yes. We are in discussion with Customs on that. Obviously, it is not entirely within their bailiwick. A lot of this would involve international customs authorities. However, we would certainly be promoting it through those where we have an MoU.

Q297 Norman Lamb: So that I understand the scale of it in pounds, the 18% of the total UK market which is smuggled—what is that in pounds, in lost duty? Mr Davis: In lost duty, I think the latest figure is around £3 billion.

Q298 Norman Lamb: Per year? Mr Davis: Yes.

Q299 Mr Cousins: I wonder if I might ask Mr Davies for some comments on the questions which have just been raised by my colleague. Mr Davies: May I first say that indicative limits are a matter of great concern, but it cannot be looked at in isolation. Several governments in Europe have expressed the view to us that if one had clear rules about what one could purchase and what one could bring home, that, in and of itself, would reduce the amount of illegal cross-border selling. There is a great deal of confusion about what one is allowed to do and what one is not allowed to do. Looking at fixed limits alone, however, leads one to miss opportunities. The first place one has to start is the establishment of a secure distribution network for cigarettes throughout the supply chain—from manufacturers to logistics providers to wholesalers and to retailers.
Q300 Norman Lamb: With traceability.
Mr Davies: With traceability and with enforcement, because once you have established that distribution chain and one attaches to that requirements through licensing, for example, then you have to protect the legitimate supply chain. That requires enforcement, obviously. However, there are measures that can aid enforcement. One could, for example, make it unlawful for a licensed retailer of tobacco products to sell more than a certain quantity of cigarettes on any given day to an unlicensed purchaser. That system actually does exist in Spain, for example. If one is selling more than, shall we say, 1,000 cigarettes on a daily basis to a purchaser, there is ample reason to suspect that is not for personal consumption. If one were to make the possession of a licence dependent on commitments and responsibilities to sell responsibly and not to sell irresponsibly, I think that would do much to address the problem of the losses to revenue that this government and other governments suffer as a result of the confusion around cross-border sales. Yes, one has to harmonise government policy in relation to protection of the internal market. However, today in Latvia the tax is 16 euros per 1,000 cigarettes and here in the United Kingdom it is 268. If one were to have a pure internal market for cigarettes, no one would buy cigarettes in the United Kingdom; they would buy them all in Latvia. That does not promote policy within the UK for revenue protection, the prevention of fraud, or the promotion of public health policy, in terms of using taxation as a measure to reduce consumption of cigarettes. So I think that you have to look at the issue holistically; not seize on one issue. You have to look at how one can accomplish a secure distribution network, with obligations attached to every player within the supply chain, which will ensure that there is no infiltration of that network; that there is no diversion from it and no circumvention of it.

Q301 Mr McFall: In your submission, Mr Davies, you said that we need “the creation of a secure distribution network”. That is why Philip Morris support “the licensing of tobacco product, manufacturers, importers, exporters, warehouse proprietors, transporters, distributors and retailers. Any person trading . . . without a licence would be subject to severe penalties. Any licensed person trading in genuine non-domestic or counterfeit cigarettes upon which UK taxes have not been paid should be subject to the same penalties, as well as forfeiture of their licence”. On a superficial basis, that looks very much like a watertight situation. First of all I would ask why we have not moved to that and, second, would everyone at the table agree that we should have such a licensing system? Mr Davies, could you answer first?
Mr Davies: It is a solution but it also requires enforcement, obviously. That is why we advocate, as part of the structure of a secure distribution network, the issuance of licences, with severe penalties attached for violating conditions. Conditions can include an obligation to maintain appropriate records; an obligation to permit government to audit movement of goods and to audit shipments to customers; an obligation on retailers not to sell product that is not lawfully tax-paid product; an obligation on retailers not to sell to young people. There is a whole range of measures, but it clearly requires enforcement. Smuggling depends on a willing marketplace and a distribution network. To the extent you have an unregulated distribution network, you are encouraging and facilitating smuggling.

Q302 Mr McFall: But if I could take Mr Northridge's point, from what you said earlier on it was the breakdown of the distribution network that caused the problem. So if we had a licensing system which included proprietors, transporters, distributors and retailers, that would be an almost foolproof system, and the problem that arose with Gallaher would not arise in the future.
Mr Northridge: I would not disagree at all, Mr McFall. I just do not believe that, while that is a fantastic vision, in a practical or administrative sense you would be able to get to it. As Mr Davies said, it requires huge amounts of buy-in from everybody, right across the whole of Europe. We cannot get tax harmonisation at the moment. To ask for this kind of vision would be even more difficult that getting tax harmonisation.

Q303 Mr McFall: So it is a pipe dream then?
Mr Northridge: No. It is a new concept to us. I have only heard of it in the last few weeks. I just believe that it would be very difficult. I believe that the BAT-driven initiative of the export bond guarantee is a step in the same direction, without the same degree of difficulty. It will not be easy because, again, it will require a lot of government and Treasury buy-in but, ultimately, I think that it is a more practical solution. Mr Stevens: There are a number of different issues that we are talking about here. I think that licensing the supply chain can help in some circumstances. For example, if you are trying to stop traders selling products to children, then licensing them and withdrawing the licence can be very helpful. The situation in the UK is slightly different. The majority of the smuggled product being sold in the UK, as far as I am aware, is sold in pub car parks and car boot sales. It is bought, duty paid, in other European markets. A licensing system will not really help you there. That is the problem we have with it. On the other hand, it could cause the most enormous administrative burden. To license the entire supply chain across the whole of Europe, which is what you would be talking about, would be extremely difficult. Therefore, I think that there are advantages in having licensing, but I am not sure that we will solve the problem we are debating today with it. That is my concern.

Q304 Mr Walter: Perhaps I could come in on Mr Davies’s point. We do not need a licensing system, because any legitimate retailer is already subject to all that kind of audit from Customs and
Excise in his VAT return. We all know what his turnover is—unless he is committing fraud. So we do not need to go down the licensing route. Mr Stevens has a very valid point there: that it is the people who are selling outside the legitimate chain who we have a problem with.

**Mr Davies:** I think that we have to create consequences. A licensing mechanism provides a unique opportunity to create very serious consequences. I should also say this. Let me come back to the issue of whether it is a pipe dream and whether administratively the burdens can be overcome. I do not think that it is a pipe dream—if there is a real commitment on the part of government and on the part of those involved in the trade to solve the problem, which is hurting all of us. The Government is losing hundreds of millions of pounds. We are losing hundreds of millions of euros in lost sales. If there is a real commitment, it can be made to happen, and it can be self-financing.

**Q305 Norman Lamb:** Just explain how you are losing your sales.

**Mr Davies:** Because every time someone buys illegal product—ours, for the most part, it is counterfeit product—we are losing sales. Not only that, we are putting our brand equity at enormous risk, because the quality of those products does not match ours. Let me just say this by way of analogy. The port of Rotterdam invested 14 million euros in a scanner. Within the first six months they had recovered 20 million euros in lost duties. A licensing scheme, taking the same sort of approach, can be self-financing in terms of the recovered losses to both the government, manufacturers, and others involved in the distribution chain.

**Q306 Norman Lamb:** Is there any precedent for this in other products or other jurisdictions?

**Mr Davies:** Spain has a licensing scheme, which includes limitations on the quantities of products that retailers can sell. They enhanced those provisions in the late 1990s. As this Committee is probably aware, through a combination of significantly increased enforcement efforts and these changes to the licensing system in Spain, we have seen a very dramatic reduction in the levels of illegal sales of cigarettes within the kingdom of Spain. I think that is a very good example.

**Q307 Norman Lamb:** Mr Northridge, you refer in your submission to further research by Customs and Excise in conjunction with other EU customs authorities, “to help to establish more accurately the scale of smuggling from other EU countries, thereby enabling supply routes to be focused upon and controls to be put in place”. Have you suggested this to Customs? Is this something that is likely to be taken up?

**Mr Northridge:** Yes. With the opportunity of meeting Customs at every level and with policy every six months or so, they are aware of and they share our concern.

**Q308 Norman Lamb:** Because there is clearly a lack of intelligence, is there not, about what is actually happening?

**Mr Northridge:** Yes, and I think that the intelligence that existed for the tobacco products being brought in from outside Europe allows us to turn our attention to within Europe.

**Q309 Norman Lamb:** According to Customs, large-scale, organised smuggling gangs, who supply most of the illicit market, have increasingly switched their attention to counterfeit product. As a result, there has been a significant increase in the volume of counterfeit cigarettes seized, which we have heard about. Do you measure the volume of counterfeit cigarettes in the market, using your pack surveys, and what is your estimate of the level of counterfeiting?

**Mr Northridge:** We started our pack survey in 1998, where we interview—perhaps “interview” is too strong a word—we get 500 or 600 people every month to contribute towards that survey. It suggests that somewhere around 2½% of the market—say, 2 to 3 billion cigarettes currently being consumed in the UK—are counterfeit, and it is growing.

**Q310 Norman Lamb:** Is that an estimate that you share?

**Mr Stevens:** Of the BAT product that is seized and given to us by Customs to look at, 80% is counterfeit. So it is very significant.

**Mr Davis:** For us it is 93% that are now counterfeit, and we go to some pretty grotty places to do pack collections. We would estimate a little higher than Mr Northridge; probably somewhere nearer to the Customs’ estimate. I think that their mid-range estimate is about 4 billion cigarettes.

**Q311 Norman Lamb:** According to your submissions, the root cause of tobacco smuggling is the fact that the UK has the highest taxes on cigarettes in the EU, but the UK retail price net of taxes is also the highest in the EU. In the UK it is £1.05, compared to 68p in France and 54p in Spain. Do you accept that your own pricing policies are also contributing to the problem?

**Mr Davis:** No, I do not. If you look at the tax-exclusive prices in the UK as a percentage of the retail price, you find the UK is one of the lowest in Europe at about 22%.

**Q312 Norman Lamb:** Because the tax is so high.

**Mr Davis:** If we look at Sweden, it is 30%; Germany and Italy, 26%; the Netherlands, 29%. It is only France, at 20%, that is lower.

**Q313 Norman Lamb:** Just going back to the figures I quoted you—

**Mr Davis:** The absolute cash amount.

**Q314 Norman Lamb:** Why £1.05 in the UK, 54p in Spain? You are making a lot more profit here than in Spain.
Mr Davis: There are also some significant differences in the market. In the UK, we have 191,000 points of sale to service. In Spain—one of my colleagues may correct me if I am wrong—I think that it is around 15,000. This is obviously higher absolute prices, so we have higher retail margins—because of the higher insurance costs, because of the higher tax-driven prices, higher property costs. Also in this country, ourselves and the retailers have the cost of discounting—which does not take place in other countries. If we put all those—

Q315 Norman Lamb: So you are saying the figures that I quoted do not include what is happening in terms of discounting?
Mr Davis: No, that takes place after, as it were.
Mr Northridge: An interesting point, I believe, is if you look over the last decade and strip out inflation and the excise increases, in total the price of Gallaher cigarettes over that 10 years, on a volume-weighted basis, has only increased by 5.7%. Not per annum: in total, over 10 years.

Q316 Norman Lamb: But you are still making more here.
Mr Northridge: Our margins have increased because we have been able to take out costs, and we have economies of scale; but, from a consumer perspective, it has not had a huge effect.

Q317 Norman Lamb: You are still making more on your packet of cigarettes here than you are in Spain.
Mr Northridge: We are. Absolutely, yes.

Q318 Norman Lamb: Substantially more—double.
Mr Northridge: At the premium end, yes. On our biggest selling brand in the UK, Mayfair, we do not. It is about the same as we make in continental Europe, but on the premium brands we do make more. But we have invested far more, over many years, and they have a higher cachet in that sense. We tend at Gallaher to be in the value end in Europe and in the premium end in the UK, so we would expect the margins to be higher. The important thing from the tax-driven, smuggling perspective is that the retail price differential—striping out inflation and tax—has increased by only 6%. Even if you took just the taxed price in the UK of, say, Benson and Hedges at £3.77, it is still more than double the full margin price in Spain. Even if we made them, sold them and distributed them for free, it would still be more than double.

Norman Lamb: I am sure that you will not do that.

Q319 Mr Beard: You have supplied us with written evidence, setting out what you are doing to combat this illicit trade in both genuine and counterfeit products. Can you give us an idea of what resources you are devoting to combating cigarette smuggling, say in terms of the number of people you have involved in this sort of exercise? Mr Northridge?
Mr Northridge: We have a specific brand detection team of around seven or eight people. The point I have tried to make, more importantly than that but in that context, is that we have a sales force of 300 in the UK and a global sales force of 2,500 people, and our international trading policy, in our submission, is really a way of life. It is implicit in the way in which our commercial people do business. Everybody is charged with ensuring that that policy is enshrined in the way they act, feeding that information back up through the brand enforcement team, through internal audit—which is good risk assurance—to the board, where we identify it on a quarterly basis and debate it, and then give all that information back to Customs. That, I believe, is more relevant than the specific eight or nine people who are in that brand detection squad. If you take that, plus the market research, plus the external agencies that we also use, plus witness statements, attending court sessions, etc., we estimate that we spend in excess of £1 million in that area. However, I want to reiterate the point I have made. It really is a way of life. Everybody who is employed at Gallaher at the commercial end understands that it is their responsibility to do everything in their power to bring these people to justice or to eradicate that business. In that sense, therefore, they are all whistle-blowing.

Mr Davis: I concur with what Mr Northridge has said. It is very much embedded throughout all of our sales organisations worldwide.

Q320 Mr Beard: How many people do you have?
Mr Davis: On top of that, on the specific brand integrity side, as we call it, we have got a fixed staff of 25 people worldwide who are liaising with the various Customs Authorities, getting involved in cooperation with other manufacturers with raids on counterfeit factories, and what have you. I would estimate our ongoing overhead, as it were, on top of what is embedded throughout the sales organisations to be between £5 million and £6 million, something like that, with some of the fees we pay as well.

Mr Stevens: We have probably nearer 100 people involved in brand enforcement, either directly or indirectly, looking at counterfeit or smuggling, costing tens of millions of pounds. That involves going into China and trying to stop the manufacture of counterfeit products in China. It is a very significant operation for us.

Mr Davies: We have a brand integrity group staffed by approximately 55 people. In addition, there is a group within our packaging department that is dedicated to exploring ways in which we can effectively counter the efforts of those criminals engaged in counterfeiting our products. The brand integrity group conducts investigations, gathers information and works with law enforcement authorities in over 60 countries. For example, in 2003 we were responsible for providing information that led to 350 successful raids on counterfeiting operations and the seizure of over a billion cigarettes. In addition, we work with Customs Authorities to provide them with information and training. In 2003 we conducted more than 70 training sessions with Customs Authorities in more than 25 countries. On these efforts we spend somewhere between $30 million and $40 million...
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Q327 Mr Beard: What would be the number of people you are dealing with comparable with these you have suspended?
Mr Stevens: Something over 1,000 for BAT.

Q328 Mr Beard: Over 1,000. What about you, Mr Davis?
Mr Davis: Probably somewhat less than that. In our case, I would think probably 100 or 200, something like that.

Q329 Mr Beard: Mr Northridge?
Mr Northridge: I would guess around 100 but I would need to check that, Mr Beard, I do not have that figure.\(^1\)

Q330 Mr Beard: All three of you in those companies have laid quite an emphasis on this Memorandum of Understanding, a new dawn has come and you have got the Memorandum of Understanding. What are you doing differently now, having signed the Memorandum of Understanding, compared with what you were doing before you signed it? Mr Northridge?
Mr Northridge: I cannot think of anything. We had ground so over the last three years? Written the international trading policy about a year before we signed the Memorandum of Understanding and we saw the Memorandum of Understanding as simply enshrining what we were doing at that time. I cannot think of any significant difference in our trading policy as from beforehand.
Mr Davis: Not in our trading policy but it cements the commitment where we go way, way beyond the law. Basically we are looking at the cutting edge of best practice on illicit trade prevention and detection. We are very much looking at it on a much more international scale with UK Customs and what can be done as regards the sources and routes, \textit{et cetera}, but also very much emphasised over the last year or two a huge amount of liaison on counterfeit and basically liaising on unsolicited approaches that we get from distributors and things like that, the enormous amount of witness support that we give. As Mr Northridge says, we have been doing a lot of these things for decades and they are enshrined. The Memorandum goes beyond those things and it is really a state of mind. Wherever we can mutually help each other we do, and that is the absolute norm. The one last point is that the interaction is almost on a daily basis. Yes, there are significant meetings at various levels of management on a regular basis but the interaction is very much daily.
Mr Stevens: We have always co-operated with Customs. The Memorandum of Understanding takes us well beyond what we are required to do by law.

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1 The figure is dependent on the method of distribution adopted in each of our markets. In the UK and Ireland, for instance, where we deliver direct to wholesalers and some of the retail trade we have nearly 4000 customers. We do not believe, however, that the purpose of the question was to identify such customers. Removing this type of customer, and duty free retailers such as airport shops etc, results in a figure of around 100 distributors globally.
Q331 Mr Beard: What does it include that you were not doing before?
Mr Stevens: I think we were always doing stuff before, we are just doing more of it. We are doing much more communication with Customs, we are doing some training with Customs, and we provide witness statements with Customs. It is more development of the relationship rather than a list of the activities that are done now that were not done before.

Q332 Mr Beard: This is very puzzling because we heard that the figures were not good and now we have got the Memorandum of Understanding, and you have mentioned it now and have mentioned it in your submissions, and Customs and Excise have mentioned it, it is a new dawn, yet when I ask you what has changed, nothing has changed.
Mr Stevens: The figures were always good for BAT, so there has never been a smuggling problem for BAT. There has always been good co-operation between Customs and BAT.

Q333 Mr Beard: What sounds very strange to people looking in from outside is that you are all subject to the law of the country and then you sign a Memorandum of Understanding that transforms things and you say you are going to co-operate. That is how the message is coming over to us and that sounds very strange because you are subject to the law anyway.
Mr Stevens: I can only answer that question from BAT’s perspective. We have always co-operated with Customs in BAT and the Memorandum of Understanding demonstrates and lays out how we co-operate with Customs. Customs have never had a problem with smuggling of BAT product into the UK and it has never been a significant issue.

Q334 Mr Beard: Where is the Memorandum likely to have its biggest impact, on product that is yours that has been returned to the United Kingdom or on counterfeit product?
Mr Davis: I think increasingly it will be on counterfeit. Under the latest Customs’ figures we are seeing about 54% of the illicit market is counterfeit, so it is bound to be more down the counterfeit route I suggest, Mr Beard.

Q335 Mr Beard: One of the things puzzles us, again, is we have heard this story about Andorra, for instance, importing so many cigarettes that the population could not possibly have smoked them all if every man, woman and child had smoked from breakfast time to bedtime until they died. Your brands were amongst those going to Andorra in this ridiculous farce. Why did you not stop this and why did you not do something about it when it was spotted?
Mr Northridge: If I can speak for Gallaher, Mr Beard. Clearly we were aware of the huge sales growth, obviously, and we alerted Customs to it and they were aware of it too, but those cigarettes were duty paid and they were being purchased by people who, in the main, we felt were buying for their own consumption at the time.

Q336 Mr Beard: On that scale?
Mr Northridge: We then voluntarily significantly reduced supply to Andorra and subsequently we have reduced supply—I can think of two examples—to Luxembourg and indeed to Belgium in conjunction with Customs because we do not believe that market requires that amount of stock.
Mr Davis: Looking at the Andorra situation, it is a market, as I understand it, of about 2 to 3 billion cigarettes a year and we sell about 40 million cigarettes a year in Andorra, which is about 2%. I think it peaked at 300 and something million. I think Spanish and French Customs also took action in that situation. Andorra is a very significant shopping place for people, not just for cigarettes but for white goods, everything, it is that sort of place.

Q337 Mr Beard: I am not focusing on Andorra but on a situation where they were plainly importing cigarettes out of any scale to what the population could consume. Plainly there was some funny business going on and you did not seem to do anything about it.
Mr Davis: I think there was something done about it, Mr Beard. There are time lags and one of the things we have learned about is time lags. If I look at the seizures of genuine Imperial products in the year ending September 2004, I think it was a total of 66 million with 3 million in the last four months. By far and away virtually all of that relates to product which was actually sold in 1999, so there is a big stockpiling and time lag effect on these things.

Q338 Mr Beard: Have you anything to add to that, Mr Stevens?
Mr Stevens: I think Customs would confirm that this was never an issue for BAT.

Q339 Mr Beard: You refer again in your submission to the codes you place on cigarette packets and cartons. Do those not enable you to determine to whom each packet was supplied? Is that information that you supply to Customs so that they can trace smuggled cigarettes to the purchaser?
Mr Stevens: Yes, we share all of that information with Customs.

Q340 Mr Beard: Is that tracing done?
Mr Stevens: Yes.

Q341 Mr Beard: Is it being acted on?
Mr Stevens: Yes.

Q342 Mr Beard: According to British American Tobacco, China is the main source of counterfeit British American Tobacco products and most counterfeit cigarettes, including many of those coming into the UK, do originate from China. Do
the other companies represented here share the view that China is the biggest source of counterfeit cigarettes?

Mr Davies: Certainly it is one of the largest. The world Customs organisations estimated that in 2002 there were 190 billion cigarettes counterfeit in China alone but, having said that, it is true that there is counterfeiting that occurs in Europe, in other parts of Asia and in Latin America. The trade in counterfeit cigarettes is huge. The counterfeit cigarette business is our fourth largest competitor now. China is working very, very hard to address the problem, and last year the Chinese Government prosecuted more than 150,000 cases against counterfeiting operations. By its very nature it is extraordinarily difficult, it needs the concerted efforts of governments across the world, of those involved in the trade, our suppliers, our business partners, and that is why we believe that the agreement that we have entered into with the European Commission will be a very, very effective tool because they are committing in that to join with us, not only within Europe but to reach out to governments across the world, to fight this problem.

Mr Davis: To echo what Mr Davies has said, China, Russia and the Balkans seem to have been the main areas, but China has dominated, I think. Certainly in conjunction with BAT, with Philip Morris and Japan Tobacco we have participated in many activities that in the last year have closed down 31 illicit factories, 11 illicit warehouses, 20 illicit printing factories, and we have seized around 675 million cigarettes in these types of activities as well. Much of that, particularly in China, has been with the full co-operation of the Chinese tobacco monopoly and Chinese Customs. I think it is a problem that the Chinese are very aware of and we are all working very hard on it, but the scale of the problem, as Ben outlined, is so enormous that it is a bit like painting the Forth Bridge.

Q343 Mr Beard: To tackle this problem a coalition was established by a number of international cigarette manufacturers and the Chinese authorities to identify and de-commission the factories, as you were mentioning. The other companies represented here, Mr Northridge, are all part of that coalition, but why are you not?

Mr Northridge: We have not suffered to the same extent as my competitors over the last two or three years, but during the last 12 months we have and we have been contributing informally where there has been product that was clearly destined for the UK counterfeit from China or elsewhere. I do not think it will be very long before we formally join and, in fact, we are in negotiation at the moment.

Q344 Mr McFall: Mr Davis, you mentioned your anti-counterfeiting operations against criminals with the UK as the target market and mentioned closing 31 counterfeit factories. Where were these located?

Mr Davis: The majority were in China.

Q345 Mr McFall: Were any UK based operations?

Mr Davis: We have had a couple of occasions when these have not been what I would call illicit factories but of the back street type in a garage type of counterfeit operations. We have found some in the UK and obviously we were straight on to Customs as soon as we were informed.

Q346 Mr McFall: Where in the UK, can you tell us?

Mr Davis: If my memory serves me correctly, I think one was in the North East but I do not know the exact location.

Q347 Mr McFall: If you can send us a paper on that.2 Mr Davis: Certainly our people will do so. Just to add to this, one of the issues is one of the resources that we do have is that the component supply industry to the tobacco industry is actually quite concentrated, there are not that many printers and suppliers of filter tow, that manufacture filter tips. More and more manufacturers are engaging with the supply chain to actually get more control from their point of view over where their products go because these counterfeiters do need to source these components from somewhere. I think if we move down the chain, and we are doing this very much in association with Customs, this is one significant area where we can make a lot of progress.

Q348 Mr McFall: Yet Gallaher’s and Imperial Tobacco have mentioned about the need to tackle counterfeit cigarettes and prevent the materials necessary for cigarette manufacturing being obtained. Can I ask how practical a proposition that is? What type of material do you have in mind? How many suppliers of these are there worldwide? In other words, is it a sophisticated technology or if you do not destroy your surplus machinery, as Imperial Tobacco said, can others make it at the drop of a hat?

Mr Northridge: From Gallaher’s perspective I think you have raised two points, Mr McFall. In terms of trying to bring suppliers of raw materials into the whole network of trying to prevent counterfeiting I would reiterate what Mr Davis said, that the tow manufacturers are the most obvious people because really the components of cigarette packaging are paper or cardboard, foil, and then when it comes to the cigarette itself the tobacco, and there are only 6 or 8 worldwide suppliers of tow, so I think that would be a good source. In terms of machinery, the Gallaher policy is that if we are not going to use it ourselves and if we cannot sell it back to the manufacturer then we will destroy it.

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2 See Ev 134
Q349 Mr Walter: What about the tobacco?

Mr Davis: Paradoxically that is probably the easiest thing for a counterfeiter to obtain. It is of questionable quality, one would have to say, but that is probably the easiest of all the components to obtain because a lot of it is domestically grown.

Q350 Mr McFall: In a sense, the proposition is not as practical as it would appear.

Mr Davis: No, I think there is a lot of mileage and a lot of merit in it because a cigarette without a filter is not going to be terribly attractive for anyone to buy given the tobacco types that they are using. I think the issue with counterfeit is that a lot of the punters who buy counterfeit tobacco are not sure when they buy the carton. The printing looks very good, it looks to be a bona fide carton, but it is when you open it and smoke it that you realise you have been had, or doubly had.

Q351 Mr McFall: A last one from me. ASH has sent us a briefing on this, no doubt friends of yours. How many of you smoke, by the way? Three out of four. It is three gold ambassadors for your companies. You are the odd man out, Mr Stevens. ASH has referred to the legal agreement between Philip Morris and the EU on smuggling as the gold standard by which all cigarette manufacturers attempting to control excise tax frauds should be judged from now on. What they are asking us to do is to urge Customs and Excise to renegotiate the Memorandum of Understanding that it has with tobacco companies up to the Philip Morris standard and to sign up to the PMI agreement. Would you be happy to enter into negotiations with Customs and Excise to do that?

Mr Northridge: Do you mean to the extent of paying a fine? In what sense? We are not a signatory to the Philip Morris agreement.

Q352 Mr McFall: Mr Davies is the expert on this. What should your competitors sign up to here?

Mr Davies: I think that is a question that really is better addressed to them.

Q353 Mr McFall: What you are doing that they are not doing?

Mr Davies: We believe that the measures that are embedded in that agreement are going to be extraordinarily effective in addressing the illegal trade, particularly this growing counterfeit trade. To the extent that anyone who is involved in the cigarette business chooses to take the same approach, I think we would all benefit. Whether they should sign up to it is a question that has to be addressed to them and not to me.

Q354 Mr McFall: I understand. Would you be willing to enter into negotiations? Customs and Excise are sometimes behind the curve, we find, and we have got to prepare the ground carefully for them. If you say that you would be willing to enter into negotiations today, maybe in our submission we will ask Customs and Excise to have a little chat with you on it.

Mr Northridge: I am very happy to talk to Customs and Excise on any subject as we see them so regularly.

Q355 Mr McFall: You must know what this agreement is about yourselves.

Mr Northridge: The background to the agreement is to clear up an historic litigation issue, to which we were not a party.

Q356 Norman Lamb: Can you summarise what the litigation issue was so we understand what we are talking about?

Mr Davies: Several years ago, the European Commission filed a lawsuit in the United States of America in a federal courthouse in Brooklyn. Principally it was brought against three entities: Philip Morris, Japan Tobacco and RJ Reynolds. The essence of the claim that was being made was that the defendants had facilitated the smuggling of cigarettes leading to lost revenues within the European Union. The lawsuit was dismissed by that court. An appeal was taken by the European Commission, which was unsuccessful. It was following the conclusion of that appeal, flowing out of the discussions we had been having with them, that we began the negotiations towards this agreement. This agreement as we characterise it and, indeed, as the European Union characterise it, is a commitment to co-operate. It makes sense because what we came to realise, both we—Philip Morris International—and the European Commission and the 10 member countries involved, was that we had a shared problem. We had a shared problem of illegal trade that was causing damage to government revenues, causing damage to our revenues, harming our consumers, harming society in Europe as a whole, and we realised that the best way to address this shared problem was to have a shared solution and by working together we could accomplish more than we could working separately. That is why it is called a co-operation agreement and that is why it is focused on measures on their side and measures on our side that we believe will be effective in fighting illegal trade.

Q357 Mr McFall: Given that is the gold standard then, and the legal case is in the past, in a sense would you all be willing to enter into negotiations with Customs and Excise to get to this gold standard? Mr Stevens first. Just quick answers.

Mr Stevens: As far as I understood it the billion was the cost for settling the cost of the court case with the EU and we do not have a court case with the EU.

Q358 Mr McFall: As Mr Davies said, this illegal trade is harming consumers and it is harming society. On the basis of that criteria, are you willing to enter into negotiations?

Mr Stevens: I think there are bits of the agreement that we would support and there are bits that we would not support. The bits that we would not support would be voluntarily paying the excise on
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product that other people had smuggled, frankly I think that would be ridiculous. I think some of the tracking and tracing bits in the Philip Morris agreement are, to quote HMC, “missing the point” in terms of controlling smuggling because Philip Morris has talked about being able to identify the first customer and where there is a problem with the second customer, but by the time the product gets smuggled it has probably gone through 10 or 12 customers, so I do not think that is going to create a great benefit either. I can understand why Philip Morris would like this to become an industry standard because they have spent a lot of money putting it together but I do not think it is going to solve the problems. I think bits of it we would support, but not all of it.

Mr McFall: But you would be willing to negotiate that.

Norman Lamb: Mr Northridge’s body language is that it is not that simple.

Q359 Mr McFall: We will come to him. Mr Davis?

Mr Davis: I would take issue that it is actually the gold standard because I do not think it is at all. I can understand ASH saying it is the gold standard because anything that increases the cost of our licence to operate they would support, but they would, would they not? I do not think it is the gold standard, I think the gold standard is the sort of things that we are currently doing.

Q360 Mr McFall: Would you be willing to look at measures like that?

Mr Davis: I am always willing to discuss anything with Customs, but it has to be on an equitable basis.

Q361 Mr McFall: Mr Northridge?

Mr Northridge: Mr Lamb is right. I agree with 99% of what Mr Stevens said. I think the gold standard is the Memorandum of Understanding.

Q362 Mr McFall: You are a bit naïve and a bit of a soft touch, Mr Davies?

Mr Davies: I do not think I would characterise it that way. I do not think the European Commission or OLAF or any of the 10 Member States would characterise it that way.

Q363 Mr Beard: Mr Northridge, how can you say that when a few minutes ago you were saying that you had not really changed very much from what you were doing as a result of the Memorandum of Understanding, so why is it the gold standard?

Mr Northridge: Because it has worked, but we were doing that before.

Q364 Mr Beard: What does “worked” mean if you are doing the same afterwards as you were doing before?

Mr Northridge: It is about better collaboration, it is about more focus, more regular meetings. In our case, all the MoU did was to formalise what was in existence beforehand, but it has led to much closer co-operation.

Q365 Mr Beard: From what we have heard this afternoon it sounds as though before you were not really co-operating and now you are. I attribute the unworthy motive that now you see looming on the horizon a threat from counterfeit cigarettes that do touch your turnover, whereas the previous round-trip cigarettes did not and, therefore, you were not all that bothered about co-operating.

Mr Northridge: I disagree with you, Mr Beard, and I would like to think that Customs would agree with me that our relationship with them before the MoU was as it is after the MoU.

Q366 Mr Cousins: I think we should remind ourselves that we are talking about an illegal trade which supports petty criminal networks which reach every neighbourhood in this country. Mr Northridge, you have made reference to the incident that occurred at Newcastle Airport over the holiday season and, for whatever reason, Customs, who are not normally present at Newcastle Airport, were present. A large number of bags were left on the conveyor belts and they contained between two million and three million cigarettes. There is no reason to suppose that the people concerned were coming to Newcastle. The fact is we have a large number of airports in this country now which support charter and cheap flights to an increasing range of destinations at which Customs are not routinely present. The Newcastle incident that was picked up might be repeated every day of the week in any of the airports in Britain outside of the big ones with a permanent Customs presence. Do you feel that the optimistic picture given by Customs in their evidence to the Committee on counterfeit cigarettes is borne out by your own reference to the Newcastle incident, which demonstrates that the lack of presence by Customs officers at this increasing range of airports may be one of the sources of our difficulties?

Mr Northridge: I believe that there will have been an excellent return on the investment in 2000 in an extra 1,000 Customs officers, as evidenced by the reduction in non-UK duty paid from around 25 million to 20 million. I believe that same investment would get a good return again in the next five years if that was able to be achieved. I think greater presence at airports, at ports, and helping and encouraging them to work together on counterfeit would get fantastic returns.

Q367 Mr Cousins: I wonder if I could ask Mr Stevens, you were an advocate of the Export Bond system in your evidence to the Committee. What reaction have you had from Customs to the idea of an Export Bond system which is internationally validated and which, of course, the Government would have to take up with other jurisdictions?

Mr Stevens: The Export Bond is pretty much rolling out what currently happens in the EU around the rest of the world.
Q368 Mr Cousins: Beyond the EU?
Mr Stevens: Beyond the EU. The Export Bond itself would not solve some of the problems of smuggling into the UK because where smugglers go and hoover up duty paid stock around Europe—

Q369 Mr Cousins: Do forgive me, Mr Stevens, the Committee is short of time. I am not asking for a rehearsal of what the Export Bond is, that is in your evidence and we are grateful to you for it. What I am asking you is what is your perception of the energy and enthusiasm and commitment that our Customs Authorities are putting into getting that kind of international agreement beyond the EU that the Export Bond system needs to be put into effect. That is my question.
Mr Stevens: I think we have had good discussions with Customs and Excise and we are not at the stage yet of rolling it out worldwide, but it is something that we think would make a difference.

Q370 Mr Cousins: You have had discussions with them and you both agree it is a nice idea. What evidence do you have of the energy with which Customs has taken this up with other jurisdictions?
Mr Stevens: I cannot answer that off the top of my head.

Q371 Mr Cousins: Thank you. Mr Davies, I think in response to a question from me, you set out very, very clearly your suggestion of a licensing system and, as our Chairman has referred to, we have had other evidence about your agreement with the EU. What reaction have you had from our governmental authorities, from Customs and Excise, when you have discussed these issues with them? Have they been enthusiastic? Have they said, “Well done, what an interesting idea, there are bits here we want to look at”? How have they reacted?
Mr Davies: We have had no discussions with the Customs and Excise Authorities here directly concerning the agreement. We have had numerous discussions with them in relation to the issues addressed by the agreement. I thought initially that they viewed the concept of securing a distribution network through means such as licensing had some appeal. I was rather surprised to read in the transcript of their testimony before this Committee the comment that it rather misses the point, because I do not think it does. I think it misses the point not to realise that the heart of controlling the issue is to secure and protect a legitimate supply chain.

Q372 Chairman: Thank you all very much indeed. Mr Davis, I think you promised a note on something that Mr McFall asked you.
Mr Davis: Yes.

Q373 Chairman: If the Committee could have that reasonably quickly.
Mr Davis: Indeed.
Chairman: Thank you all very much.
Wednesday 2 February 2005

Members present:

Mr Michael Fallon, in the Chair
Mr Nigel Beard
Mr Jim Cousins
Angela Eagle
Mr David Heathcoat-Amory

Norman Lamb
Mr John McFall
Mr James Plaskitt
Mr Robert Walter

Witnesses: John Healey, a Member of the House, Economic Secretary, HM Treasury, and Mr Paul Gerrard, Acting Head of Indirect Tax Fraud Strategy, HM Customs and Excise, examined.

Q374 Chairman: Welcome back to the Subcommittee, Minister. In your memorandum to us you say you are committed to tackling tax fraud in order to protect the revenue you need for public services, to protect legitimate businesses and to protect us from organised crime. Are you succeeding?

John Healey: Yes, we are making progress. The gap, if you look across the excise regimes, is still quite significant, which is why we attach such importance to the investments we are making and the strategies we are putting in place. However, if you look across the regimes you will see that instead of a rising trend we now have a falling trend, whether that is in alcohol, oils or tobacco, and if we consider what would be the situation if we had not put the strategies in place we would be seeing cigarette fraud, last year, at a level of 36% of the total market instead of 15%, and we would have seen fraudulent oils at 9% instead of 6%, which means that over the last few years we have safeguarded at least £3 billion of the public purse.

Q375 Chairman: Your figures show that the revenues actually evaded through both tobacco smuggling and spirits fraud are running at almost £3 billion a year. Is that satisfactory?

John Healey: It is not satisfactory. It is still significant, as I explained, but on the other hand if we had not put the action and investment in place which we have done over the last few years the situation would be significantly worse. We have still got a lot more to do, which is why we have set, from government, Customs & Excise and the successor body some quite tough public service agreement targets to reduce these levels of fraud still further, but if we had not taken this action on tobacco and on oils two or three years ago we would have been faced with not just a shortfall or a gap which we reported at PBR in December of around £3.5 billion but a gap of almost £7 billion.

Q376 Chairman: Why do you claim the situation is getting better and that you are reducing fraud when, if you look at hand rolling tobacco, losses have increased by £170 million to some £750 million and in diesel oil fraud there has been an increase in fraud of £200 million to £850 million? That means it is getting worse, not better.

John Healey: If you separate the two there: on diesel, if you look at the situation in 2000 when we started our work on this, the size of the illicit market was 8%; since then we have cut it by a quarter to 6%. So, on diesel, it is not getting worse and we do expect it to start getting better quite significantly because most of the major parts of the anti-oils fraud strategy we put in place we put in place during the course of 2002 and, of course, the figures we have been able to publish in the PBR in December were the levels of fraud for 2002-03. On hand rolling tobacco, I think the situation is more worrying. There is certainly a concern there. If you look at the total consumption and pattern of the market, we have an increased consumption—we have a bigger market, if you like, particularly as there has been a general shift in smoking habits downgrading from premium brands—what you see in the latest figures we have been able to publish, with hand rolling tobacco, is that the illicit size of the market is very significant, but it is a smaller share of that bigger market. That means that the revenue loss is actually up, so the revenue loss, you will see in the latest figures, is up £70 million but the share of the illicit hand rolling tobacco market is down 6%. Now, we are dealing here with what is a very well-entrenched and long-established illicit market in hand rolling tobacco. The Pre-Budget Report explained that we are doing further work on this as we try and untangle the differences with hand rolling tobacco smuggling and bootlegging from cigarettes. We are considering, at the moment, within the Treasury and within Customs, a range of different things that we might put in place. I hope we will be able to confirm a fresh focus on hand rolling tobacco within the overall tobacco strategy fairly soon.

Q377 Chairman: You say it has dropped 6% but that is since the year 2000, and your own figures show increases in each of the last three years: 52%, 53% and now 57%. That means nearly six cigarettes in every 10 are illicit. Is that acceptable?

John Healey: It is not acceptable. It is a very significant level of illicit activity with hand rolling tobacco. It is down since we introduced the tobacco strategy in the year 2000, which is why I make the point that there is a 6% drop. Nevertheless, because more people are smoking more hand rolling tobacco the scale of revenue lost to the public purse has gone up, and it has gone up by £70 million.
Q378 Chairman: Finally, from me, on spirits fraud, when you started on the spirits fraud route with the tax stamp, you said the fraud was £600 million, then you thought it was £450 million and your latest estimate is that fraud is actually £250 million. How credible is this, when you keep revising the figure down so dramatically? Are you just guessing?

John Healey: No. The calculations and estimates we published in December are based on the methodology that we have put in place over the last three years and published the details of. I think, to understand the set of figures we were able to publish in December alongside the Pre-Budget Report, it is important to understand that two things were happening: first of all, there was a revision of some of the back series—in other words the previous year’s numbers—and that was based on changes that the ONS and Defra made to the data that came out of the expenditure and food survey. That is the first thing. The second thing is the figures also carried the latest year that we were able to make our assessments for, 2002–03, for which we had not made an estimate before. The drop from 14% to 7% starts to show the impact of a number of the actions that we were taking in the year 2002–03 starting to have an effect. I think there is a combination of two things: in those latest figures: there are, partly, revisions of data on the surveys that we use, and, secondly, there are, I think, the first signs of an impact of some of the measures we took a couple of years ago to try and deal with spirits fraud.

Q379 Chairman: As I understand it, you have asked the ONS to sort of referee where we have got to and what the actual figure is. When are we expecting their final pronouncement?

John Healey: The ONS are studying the methodology that we use in Customs and that the trade use. They have done so as a response to the National Audit Office’s report.

Q380 Chairman: When are we expecting an answer?

John Healey: I cannot tell you, I am afraid, because the ONS operates in a relatively independent way.

Q381 Chairman: Do you expect it to be before the Budget?

John Healey: I am not in a position to tell, I am afraid. It is their judgment, when they feel the work is completed and when and how they want to publish it.

Q382 Mr Heathcoat-Amory: As well as the £3 billion that the Treasury is losing from fraud and smuggling, there is also the legitimate activity of cross-border shopping, whereby people simply buy in the lower-taxed jurisdiction in France, and so on. Do you have any estimate of what that is costing the Exchequer, in addition to what is lost through illegal activity?

John Healey: Yes, we do. We have estimates of the legitimate cross-border shopping for tobacco and for alcohol. We have an estimate for oils in Great Britain but not in Northern Ireland.

Q383 Mr Heathcoat-Amory: Can you tell us what they are?

John Healey: Which ones are you interested in?

Q384 Mr Heathcoat-Amory: Let us start with tobacco and alcohol.

John Healey: For tobacco, the current level in our judgment of cross-border shopping is £1.2 billion, set alongside the illicit share of the market—in other words the smuggled cigarette market—which we put at £1.9 billion. In other words, there is a total, if you like, of non-UK duty paid for tobacco of just over £3 billion.

Q385 Mr Heathcoat-Amory: And on alcohol?

John Healey: Paul, have you got the figures for alcohol?

Mr Gerrard: I am afraid I have not got the figures with me but I can write a note.

John Healey: We can provide those figures for you. 1

Q386 Mr Heathcoat-Amory: We are therefore talking about another huge revenue loss, which is really created by the duty gap. Can I put it to you that as well as being tough on the crime of smuggling we ought to, at least, look at the cause of the crime, which is the relentless increase in British duties against those on the continent? We are paying a heavy penalty for actually widening the gap and adding to the problem. Does the Treasury have a tax policy here to at least hold the problem even if it cannot dramatically reduce it?

John Healey: Let me take the example of tobacco, and the Government does have a clear tax policy in relation to tobacco; it is actually the same one that was pursued by the previous government, which is that we see a role for the high pricing of tobacco as a way of helping to reduce consumption and to discourage people from starting to smoke. That has been a significant factor in the overall reduction in the numbers of people that smoke in this country over the last 20 years or so. Every government takes a judgment about the balance of taxation across the range to produce the revenues required for public expenditure and investment, but I may say to you, I think the most significant factor in cross-border shopping, which was the point you started on, Mr Heathcoat-Amory, is that since 1993, with the introduction of the single market, the right to cross-border shop—in other words, bring back excise goods, tobacco, fags, booze, in as great a quantity as one wants for personal use—is part of the fundamental rights for citizens within the European Union single market. The high level of cross-border shopping that makes up a significant component of the non-UK duty paid figures that I have cited to the Committee is a direct result of the single market and is something that we, as a Government, as I think the government that you were a part of, strongly support.

1 See Ev 137
Q387 Mr Heathcoat-Amory: You have not quite answered my question. You have an incentive to put duty up for revenue purposes and there is a health dimension, certainly, for smoking. But that policy adds to the smuggling problem, and I put it to you that we are therefore fighting a problem with one hand tied behind our back; unless you do have a conscious policy of acknowledging that the problem is getting worse, and that perhaps should at least counter the traditional Treasury itch to put all taxes up wherever possible.

John Healey: If I may say so, I think the situation is a good deal more complex than that. If you look at oils, for instance, Belgium has a significantly lower fuel duty rate than the UK but it has a serious problem with oils fraud. If you look at tobacco, the real problem with the scale of tobacco smuggling is not tobacco that comes in from other European Union states, the majority of the tobacco that we seize comes in without any duty paid in any jurisdiction from outside the European Union; it comes up in bulk. Therefore, relative duty rates between the UK and France or Belgium or Spain are actually beside the point in terms of the incentives and the operation of these smuggling gangs.

Q388 Mr Heathcoat-Amory: Yes, but the huge profits to be made are a function of the very high duty rate in this country. Therefore, you are setting up an economic incentive for a crime and you do not seem to acknowledge this in your tax policy—or perhaps you do?

John Healey: We do; we take into account, as we make the annual judgments about duty rates, the factor of smuggling, the potential impact on smuggling. We did so, indeed, in the Budget last year and the Pre-Budget Report last year when we said we would raise the duty rate on red diesel, for instance, by 1p a litre in order to start to reduce the gap between the main fuel duty rates for road fuels and red diesel—to some extent part of the bigger strategy, but, nevertheless, a step towards reducing the potential profits of the smugglers. So we do take these factors into account and we take them into account each year when we decide on the duty levels in the Budget.

Q389 Mr Heathcoat-Amory: Can I ask you for more about your estimates, particularly on spirits? The National Audit Office have examined the estimates made by Customs & Excise and also made by The Scotch Whisky Association, and in both cases the NAO calculate that the true range of possibilities is enormous. For instance, the true range of Customs estimates should be, for the year 2001–02, between £330 million at the low end and over £1 billion at the high end. So we really have not quantified the problem with any precision. What further work is going on about this and when can we have it?

John Healey: The most important work that is going on the Chairman referred to earlier on, which is the work that the Office of National Statistics are doing. You are right, the National Audit Office, when it had a look at this area, stressed, I think, three things. First of all, that this is inherently difficult territory to get an accurate and reliable figure on. It is the scale of the illicit market, and by its nature that is difficult to do. So it concluded, therefore, that any estimates had a significant degree of uncertainty. The second thing it said was that both the methodology that Customs had established and the one used by the trade are reasonable. The third thing it said, as you have indicated, was that because of the degree of uncertainty the respective methodologies should both express the assessment of the level of fraud and illicit market as a range. Further work is rightly (and this is welcome from my point of view) being done by the Office of National Statistics. It is doing it independently and we are co-operating as fully as we can to give them whatever data and assistance is going to be useful, but that is the ONS’s work; the nature of its relationship with government is significantly of independence. How it does its work and when it reports is, as I said to your Chairman earlier on, Mr Heathcoat-Amory, a matter for them, and I simply do not know.

Q390 Mr Heathcoat-Amory: Do we not need this in time for the Budget? Again, some very important decisions are going to be made by the Chancellor about these revenue limits. Again, we are sort of struggling in the dark, are we not? We do not even know the extent of the problem, let alone how to deal with it.

John Healey: Well, I would welcome it as soon as the ONS is able to feel it has concluded its work satisfactorily. Even though there is a difference in the methodology that the industry and we would use, there is no dispute about the fact there is a significant problem with spirits fraud. There is no difference between us in the commitment on the need to tackle it, and indeed as a Committee you heard the industry (in particular, the Scotch Whisky Association) making that point to you.

Q391 Mr Walter: In 2002, if we look at the spirits fraud for a second, Customs undertook a consultation on the whole question of tax stamps. However, the Government decided not to proceed with that but asked Customs to work with the industry. In the 2003 Pre-Budget Report you announced you were going to introduce tax stamps. Can you just explain to the Committee why you changed your mind?

John Healey: In short, we had another look at the position. The figures based on our methodology suggested that this was perhaps a more significant problem than we had anticipated before. We had had a number of operational exercises—Customs operations—which had underlined the fact that there were some very serious and significant criminal gangs at work on this, and we finally took the view that the progress that had been made in discussions with the trade following the previous decision simply were not getting us to the point where we could confidently say we could put a package of measures in place to deal with this fraud without using a form of tax stamps at the centre of it. So it was a combination of, frankly, a lack of progress in discussions with the industry from the previous time
we had considered it, a greater concern about the scale and significance of the fraud and a judgment that we could do this in a way which meant we could introduce tax stamps system which could bear down on fraud in the way that we needed to do but, also, we could introduce it in a way that minimised the burden of compliance on the industry, which is indeed exactly what we are trying to do at the moment.

Q392 Mr Walter: So it was the scale that persuaded you that you should go ahead with this?

John Healey: I think I have been very clear: it was also the fact that nearly 18 months of discussions with the industry, frankly, failed to produce anything significant by way of other measures that would give us a convincing set of measures which would tackle the fraud.

Q393 Mr Walter: The scale of the problem is not as great as it was, because when the Chancellor confirmed in the 2004 Budget that he thought that the losses from spirits fraud were £600 million a year (and the Chairman mentioned these figures earlier on) that figure was then revised down to £450 million and your latest estimate is that it has fallen to £250 million. So, the scale of the problem is not as great as you thought it was. Therefore, is it still necessary to go down this route of imposing tax stamps?

John Healey: Yes. In my judgment, a scale of fraud which is costing the Exchequer £450 million on the revised figures in 2001–02 and, on the revised figures, was 14% of the market is significant and needs to be tackled. In my view, a level of fraud which is still at 7% needs to be tackled, and I think that would be, as I tried to explain earlier, the view of the industry, and I think you heard that from the industry themselves when they gave evidence. What I indicated earlier on is that what we see in the drop between 2001–02 and 2002–03 is the impact of a number of actions that Customs took during that year. It simply does not remove the fact that we have a significant spirits fraud problem. To give you an example, Mr Walter, within the last few days we have had within Customs intelligence which shows that in the last few weeks there have been 84 consignments of spirits worth £10 million of tax evaded to the UK Exchequer currently bound from one European Union state to the other, diverted into the UK without tax paid and with false documentation. Now, you have got organised gangs, but that is one organisation, one operation in the last few weeks—intelligence that has come to us only in the last few days. When you have a scale of systematic fraud in the spirits field of that nature, I say to you it would be irresponsible of us, as a Government, not to take action to deal with that and I think it would be unfair on those legitimate businesses that do pay their tax to have their own products and their markets undermined in that way, which is, in the end, why the industry is so strongly with us on the commitment to tackle fraud. They do not like tax stamps but they accept it and they now believe, as you have heard as a Committee, that these can be introduced as a result of the detailed discussions we have had with them in a way that will work, and they can be introduced in a way which makes the costs that are imposed on industry proportionate to the problem that we face.

Q394 Mr Walter: I will come back to the mechanics of the implementation, in a moment, but I just wanted to look at the scale of this and just question your priorities here. We are now talking about spirits fraud of £250 million (a figure that has been revised down quite considerably) but we have got hand rolling tobacco smuggling with revenue losses of £750 million, which is three times as much. Have you got the priority right here in spending all this time looking at spirits?

John Healey: I would say to you yes, on two accounts. First of all, we moved first and strongest on tobacco because the scale was much greater. Secondly, I would suggest, Mr Walter, if you look at the tobacco strategy that was put in place three years ago, that brought an investment of £209 million into the tobacco strategy, an extra 1,000 Customs officers to deal with the tobacco problem, 14 X-ray scanners introduced as part of the new technology at the frontiers to help us deal with this and, if you like, a schedule and scale of response and investment in tobacco which, I think, is in proportion to the fact that the fraud and the gap we faced on tobacco was, as you say, significantly greater than alcohol. We are now turning our attention seriously to alcohol. We need to do that, but it was certainly right that we tried to tackle tobacco as our first priority and we have actually put a good deal more resources, more investment and more effort into tobacco than to date we have on alcohol. That does not, in my view, remove the conclusion that we have to do more on alcohol, and that is precisely what we are developing with the industry at the moment.

Q395 Mr Walter: You are not going to have tax stamps on tobacco?

John Healey: We are not going to have tax stamps on tobacco, but one of the measures that we did introduce several years ago was a fiscal mark, and that has been helpful as part of a quite wide range of measures as part of the tobacco strategy. That played its part. With alcohol, the nature of what we face is different, the industry is different, and with tax stamps at the centre of a strategy and a number of other things alongside it I am confident that we are going to be able to continue to reduce the scale of the illicit market in spirits, and continue to reduce therefore the scale of the tax gap and revenue losses to the public purse.

Q396 Angela Eagle: When we visited the Customs officials in Hungary and the Czech Republic to look at their tax stamp system, they believed that the strip stamps across the top of the bottle were good and that they provided an assurance that the bottle had not been tampered with and the contents were actually genuine as well as representing proof of duty paid. Yet you have announced that you are going to settle for tax stamps in the back label of the bottle after the industry lobbied Treasury. Can you
explain why this change is acceptable and why you think the Hungarians and Czechs are quite happy with strip stamps and yet you have abandoned that idea?

**John Healey:** I might ask Paul Gerrard, as Head of our Customs Tax Strategy, to come in on this in a moment with some of the more operational assessments. I think it matters less where the tax stamp is placed on the bottle and more on two things: one, the nature of the design and the security features that are incorporated in them and, secondly, the difficulty with which it can be forged or applied to illicit products. I understand the views that the Hungarians and the Czechs might take, but I find it quite curious, to be honest, because I think it is more difficult to forge a stamp that is part and parcel of a label, because what you need to do is not just forge the tax stamp, you have got to be able to forge the label and you have got to find the right product in order to apply it. My assessment of that would be that to place the tax stamp on the back label is probably less susceptible to counterfeiting and those sorts of problem than a strip stamp per se. I do not know whether Paul Gerrard wants to add to that.

**Mr Gerrard:** I think that is right, because what tax stamps mean is that the fraudster has to have a supply of marked products otherwise it stands out as being non-tax paid. If the mark is integrated into the back label then in order to make it appear to be marked the whole bottling process has to change, whereas if you have a stamp that goes over the top that can be applied at any point in the supply chain, including when the retailer puts it on the shelf and can literally put the strip over the top. From my perspective, as a law enforcement officer, I would say that the integration of the label in the bottling process is a better anti-fraud measure than a strip over the top. I have not discussed it with the Hungarians or the Czechs so I do not know what the reasoning is for that, so I could not answer.

**Q397 Angela Eagle:** Is it not easier to steam labels off and counterfeit the stamp? How happy are you with the level of security?

**Mr Gerrard:** You can perfectly well do that but it is much longer, and if you have 10,000 bottles to steam off the labels the bottles and put on a pre-printed, fraudulent version it is that much more difficult than applying the strips over the top with some glue.

**Q398 Chairman:** If it is optional to either put it on the back of the bottle or a strip stamp it is going to be very confusing for consumers to know whether their bottle has been tampered with or not.

**Mr Gerrard:** I do not think the final decision has been made on the final make-up of the scheme, but it is one of the issues about loose stamps that will be applied over the top. There will need to be some control over those and to be clear to the consumer what they are looking at. I think the key is the nature of the design of the stamps so that they can recognise that as being tax paid.

**Q399 Mr Walter:** I wanted to come back on this whole question of the design. The Committee went up to Scotland earlier this week for a meeting with the Scotch Whisky Association and others there. There were a number of problems that they raised with us. You have suggested that the stamp may incorporate a hologram and that there should be just one printer who would be responsible for producing that stamp/hologram. Is that correct?

**John Healey:** Back in Budget 2004 we suggested, as our starting point, that is what could be possible. We were concerned to make sure that the design of the tax stamp incorporated sufficiently strong security features and that it was difficult to reproduce and to forge. Part of the discussions we are having with the industry at the moment is looking at the practicalities of what sensible security and design features may be incorporated into the stamp and, also, given that, what are the sensible arrangements for having those printed. The industry, as they may have told the Committee, have recently suggested to us that their own system of security printers could handle the sort of arrangements that we are looking to put in place, so we are looking very hard at that moment. As Paul Gerrard said earlier on, we have not made a final decision on that, but it is something we are discussing very closely with the industry.

**Q400 Mr Walter:** The point that the industry made to us was that the demand for labels is variable throughout the year and if there is only one printer at the time of their peak demand and the printer is backing up they cannot label their bottles. Can I go back to the design? I am unclear as to whether you are in favour of just a label that goes on the back of the bottle or whether you might consider a strip that goes over the top or some other form of labelling on the bottle. What is the thinking?

**John Healey:** Perhaps I can clarify that because we did set this out in the Pre-Budget Report in December. First of all, we have accepted the case that has been put to us by the industry, and actually we see some significant advantages, as I indicated earlier on to Miss Eagle, in that tax stamp being incorporated in the back label of particular products, if that seems sensible to the industry. The second thing is that because the tax stamp will need to be capable of being affixed at different stages in the production and distribution process, particularly, for instance, for people importing into this country for sale in the UK, it will be necessary to have a stamp which can be fixed separately. The third thing is that we have said, and said in the Pre-Budget Report, that we would look closely at and confirm subsequently whether or not as a third option (in which there is an interest within the industry) we have the tax stamp affixed also as a strip stamp. So there could be three options. That brings us back to the point Mr Gerrard made, which is that the important factor is that the design is significantly distinctive for consumers and Customs officers to be able to spot whether it is in a back label or affixed elsewhere and is designed in a sufficiently sophisticated way that it has security features that
make it more difficult to counterfeit. That is where we are at the moment; we are discussing these very closely with the industry, and they have made the same point to me. Mr Walter, that if the whole of the industry was dependent on a single printer some of these bottling operations—as Mr McFall knows very well from his own constituency—operate very high volumes, very short delivery—just-in-time delivery—timescales and they have a concern that if they have to source all their tax stamps or back labels incorporating tax stamps from a single printer it makes them critically dependent on the capacity of that single printer to deliver what they need to keep their lines running.

Q401 Mr Walter: So we could have a situation of, if you like, three different systems with some consistency between those systems. Imported products would have either a strip over the top or a label put on somewhere else on the bottle; the domestic products—Scotch, gin, vodka—at the point of manufacture would, in all likelihood, have a back label incorporating the tax stamp. Can I just pose to you a question here, which certainly has occurred to me, which is the implication for the Single Market? We have a European Single Market. If a product manufactured in this country on a production line has the label put on the back, which is duty paid in the UK, is the manufacturer then able to export it or is he stuck with that as a UK product?

John Healey: He would be printing and fixing a tax stamp because it was a product that was specifically produced for market and sale in the UK.

Q402 Mr Walter: Is that not against the spirit of the Single Market?

John Healey: No. It would be the decision of the manufacturer about which market he was producing for.

Q403 Mr Walter: Surely the whole essence of the Single Market was that products can be freely traded and we have bonded warehouses and duty suspension, and so on. In that system surely the product should be able to be sold in any EU country.

John Healey: We do indeed have a duty suspension system and actually that is part of the reason we have the dilemma—

Q404 Mr Walter: That is another matter. You have not suggested getting rid of that system and you are bound, I think, by European law to collect it. Let us assume that the situation is as it is. Are we acting in contravention of the Single Market by having a product that is designed specifically for one market and cannot be traded?

John Healey: Our legal advice has not suggested that is a problem.

Mr Gerrard: I have spent many enjoyable hours with lawyers and the Counsel, and my understanding is it does not contravene the Treaty.

Q405 Mr Walter: What about the practical problems for UK manufacturers? I have not taken any information from this particular manufacturer but it is one that springs to mind, which is Bushmills in Northern Ireland, where most of their product goes across the border. They are not going to be in a position, necessarily, at the point of manufacture to know exactly which market that is destined for—whether it is the UK duty-paid market or the Republic of Ireland duty-paid market.

Mr Gerrard: My understanding is they will have a decent idea of where that product is bound, and as the Minister has said we have not finalised what the system will be but my understanding is that what we are proposing is legal and, in practical terms, achievable by the industry.

Q406 Mr McFall: Just a couple of quick questions, Minister. You mentioned 84 consignments worth £10 million. Is there any indication that these spirits originated in the UK and have been diverted back?

John Healey: The particular example I gave you was where consignments of spirits that were produced in another European Union country apparently bound for another European Union Member State—not the UK—were diverted into the UK illegally and illicitly with false documentation so that, apparently, according to the documentation, these 84 lorry-loads were dispatched from one EU country and delivered to another but, in fact, ended up in the UK market without UK duty paid, and diverted into our supply chain with no way, once they are in the supply chain, of being able to nail them.

Q407 Mr McFall: The Scotch Whisky Association tells us that the estimates are much less than you say. Are there any examples of spirits that originate in the UK being diverted back? Are there any examples brought to you by Customs recently?

Mr Gerrard: I have got a couple of examples of UK manufactured products being exported and allegedly then being diverted, then coming back into the UK bonded and being diverted. For example, I have 12,500 litres of vodka manufactured in the UK brought back in and found at unauthorised sites, and I have got 15,000 litres of whisky at Ramsgate, which again is UK—

Q408 Mr McFall: So we are talking about a considerable amount of money.

Mr Gerrard: That is right. It is about £100,000, for that kind of volume, in duty.

Q409 Mr McFall: Some people suggest within the industry that the estimates are much less. If the Treasury agree that the estimates are much less than, say, £100 million, is it worth the bother of going ahead with tax stamps, or is the Government resolute in pushing the tax stamps in terms of fraud?

John Healey: As you know, Mr McFall, we do not accept the basis of the method that the trade use for calculating their fraud estimates. Our operational experience suggests, as Mr Gerrard and I have tried to stress to the Committee, that there are some serious gangs out there that are perpetrating some widespread and large-scale frauds. Essentially, we have an understanding with the industry. They are
strongly committed to helping us tackle fraud and they recognise—although their estimates may differ from ours about the level—it is a significant problem. They recognise that we do need to put in place new measures to deal with that. Our proposed measures have the tax stamp at the centre of those, and we are looking also, as we have confirmed in the Pre-Budget Report, at some of the ideas that have come from the industry. As the chairman of the Scotch Whisky Association confirmed to the Committee, the notion of the introduction of a tax stamp is a useful check on the fraud. It is not all we have got to do and it is not all that we will do, but it has an important, central part to play. I think, as I said earlier to the Committee, the industry understandably does not want it, does not really like it, but I think accepts that it has got an important part to play and, increasingly because of the detailed discussions that we are having with them, accepts that it can be done and be brought in in a way that is going to be proportionate to the problem and not put on to the industry unnecessary costs.

Q410 Mr McFall: I think clarity would be helpful here. So you could not envisage a scenario, as a Treasury, whereby tax stamps are not worth pursuing? In other words, tax stamps, from your perspective, are here to be implemented?  
John Healey: We touched on this earlier on.

Q411 Mr McFall: I would just like clarity.  
John Healey: When we first considered tax stamps and decided not to press ahead with them, we then had a period of discussions with the industry where, frankly, (and they included a formal consultation as well from the Government during the course of 2003) that simply did not throw up any other credible alternatives that would allow us to deal with this spirits fraud. In those circumstances, we took the decision—and this is the position we are in—that tax stamps can be introduced, they need to be introduced and we will introduce them in a way that balances our ability to tackle fraud with not imposing unnecessary costs on the industry in doing so.

Q412 Mr McFall: So you are resolute in your determination to introduce tax stamps?  
John Healey: Yes.

Q413 Angela Eagle: I get the impression that these industries, both the spirit producers and the tobacco manufacturers, were not that interested in engaging with you on the smuggling and fraud problems until, certainly in the case of tobacco, counterfeiting became a problem. Since then you have negotiated a series of memoranda of understanding which assist in, hopefully, both the industry and Customs working together to challenge this very large revenue loss that we now face. Would that be an accurate assessment?  
John Healey: I do not think it is entirely fair. It is true to say that we share at present both the judgement that the scale of counterfeiting is very much higher than it was two or three years ago, we share a strong interest in dealing with it, but in my judgement the interest and the co-operation we have had from the UK tobacco manufacturers to some extent, I have to say, followed out of interest in this House, particularly in the Public Accounts Committee and, also, in this Committee—an interest in which Members of his House came to the conclusion they felt the tobacco manufacturers were not showing enough serious intent in dealing with tobacco problems. When one looked at the level of UK-manufactured cigarette exports to some countries they were so extraordinarily large-scale for the size of the population for likely consumption in those countries that there was obviously a problem with that being a likely route to see tobacco manufactured in this country diverted back in without any UK duty paid.

Q414 Angela Eagle: You are thinking of Andorra where the daily cigarette consumption would have had to be 200 per person, every member of the population, to justify the figures that were being exported there?  
John Healey: Andorra was, indeed, an example, though not the only example. I have to say, over the last couple of years particularly, now we have memoranda of understanding signed and in place with each of the UK manufacturers, the level of co-operation we have is very good. The impact on, if you like, the proportion of genuine UK manufactured cigarettes which we are now seizing, as opposed to counterfeit, I think, tells its own story.

Q415 Angela Eagle: The thing that stuck me particularly when we visited Hungary and the Czech Republic was the grave threats and highly organised threats posed by sophisticated counterfeiting operations, not only from China but also from illicit manufacturing centres set up, run by Vietnamese and other gangs, in the Czech Republic producing highly dangerous counterfeit cigarettes. Do you think Customs are doing enough and working closely enough with their colleagues across the European Union, particularly at the outer borders of the new EU Member States, to tackle this serious, emerging danger to public health?  
John Healey: We are not doing enough but we certainly are doing more than we were a couple of years ago as it becomes much clearer that counterfeiting is a bigger problem. You are absolutely right, Miss Eagle, the threat of counterfeit cigarettes is not just a threat to the revenues to the public purse, the latest evidence suggests that counterfeit cigarettes are significantly worse than ordinary cigarettes for the health of the people that smoke them, and in many cases have very significant levels of heavy metals like arsenic. The sorts of measures we are trying to take to deal with counterfeit include—and this is relatively recent, I have to say—increasingly constructive co-operation with China and some of the governments in the Far East, because it is there that we have the biggest problem as the largest source of counterfeit cigarettes finding their way into the UK and other parts of Europe.
Q416 Angela Eagle: Do you, finally, have a strategy for the other end, the retail end? Counterfeit cigarettes cannot get out and pose an even greater threat for the population of smokers than smoking their normal brands unless there is quite a sophisticated retail operation to spread the smuggled and counterfeit cigarettes into the UK. Can you give us a flavour of what you are doing to try to prevent that end of the distribution chain being as effective as it currently is?

John Healey: You are absolutely right. Part of the investment that I talked about earlier on in the tobacco strategy with the extra personnel that Customs deployed on this has been deployed inland rather than at the frontiers. People often have the perception of Customs as simply a frontier operation and organisation but we do a significant amount of work seizing and disrupting and detecting inland. I will ask Paul Gerrard to give you some instances of the inland work. He and I went together on a Customs operation just over a year ago to the Holloway Road which is the good example of the sort of outlet for bootleg cigarettes and smuggled tobacco.

Mr Gerrard: One of the most important things about illicit cigarettes and particularly about counterfeit is that at present more than half of those cigarettes are sold through informal distribution networks rather than the traditional corner shop or supermarket. They are sold on street corners like the Holloway Road. Therefore, when people are buying them they are buying them at a cheaper price. We did a lot of work in December, which the Minister played a large part in, in explaining the nature of that in that if you are buying cheap cigarettes you really do not know what you are buying and you will not know what you are buying until you light it up, and at that point it will taste awful or it may fall all to pieces. There is a lot of work we can do on educating people about the fact that when they buy cheap cigarettes they have got no idea what they are buying until they actually light it up because there is no difference now. The days of finding illicit cigarettes and counterfeit where they spelt the name wrong are long gone. These are very sophisticated counterfeiters now. In addition to that, we do an awful lot of work inland using blitz techniques with brigaded forces to hit hot-spot areas where we have intelligence and where we have other information that tells us there is a problem there. It is about trying to affect demand by an educational process but also by having very well-targeted enforcement and we seize millions and millions of cigarettes inland.

Q417 Angela Eagle: And prosecution. If people are found selling these things what kind of punishment can they expect to receive?

John Healey: We have a range of sanctions available to us starting from the most basic of seizure of cigarettes which of course will be a loss of their investment, shall we say, but also in terms of prosecutions. With the fiscal mark legislation that the Minister referred to earlier, it is a straight liability offence. If they are selling unmarked product we can seize that and we can prosecute for that. There still is the prosecution option and we are increasingly prosecuting what we would term “inveterate” offenders. Where normal seizure action has not worked then we will prosecute.

Q418 Mr Beard: A key element of your strategy for tackling tobacco smuggling is to reduce the supply of cigarettes available to smugglers and Customs and Excise have entered into memoranda of understanding with the three major UK manufacturers in order to reinforce co-operation in tackling tobacco smuggling in the United Kingdom. That has already been mentioned. When we were talking to the chief executives of the three UK tobacco companies we were left rather perplexed because when we asked what the difference is now you have signed this memorandum and what you were doing before, they told us there was no difference. So how can the memoranda be having the impact on the situation that is being said?

John Healey: There is certainly a difference from Customs’ point of view. Paul, do you want to explain the difference it has made to us in terms of our working relations with the tobacco companies and the intelligence and action we can take as a result of it?

Mr Gerrard: Under the memorandum of understanding, which we have worked at now for over a period since the strategy started in the year 2000, we are able to challenge deliveries to certain customers if we have suspicions about them, not necessarily evidence of criminal activity but where we have suspicions about the supply chain, and we issue what we term yellow and red cards, ie a yellow card where we have serious concerns and a red card where we say “we do not want you to supply”. I think what has undoubtedly happened is that tobacco manufacturers as a result of that memorandum of understanding have taken a lot more care who they supply a product to, in what markets they supply them to and I think you can see that in the amount of genuine UK manufactured cigarettes that are in the illicit market. It has reduced significantly and that is why counterfeit has come up. So in my view things have changed significantly. Tobacco manufacturers may not agree with me but my own view (and I have worked in this for five years now) is that it has changed very significantly.

Q419 Mr Beard: The other perplexing thing is here are three major United Kingdom corporations subject to United Kingdom law; why do they have to sign a memorandum of understanding before they start abiding by the law?

Mr Gerrard: I think it is a question for the tobacco manufacturers rather than me.

Q420 Mr Beard: I did ask them that and we got no satisfactory answer. We got the answer I have just mentioned to you.

Mr Gerrard: I am not sure I can add much to that, with apologies.
Q421 Mr Beard: The other question is that we, as already has been mentioned, have both the smuggling of their own brands and counterfeit cigarettes and from their point of view they are quite different because if their own brands are smuggled and come back into the United Kingdom they still make a profit out of it. However, if their own brands are taken over by counterfeit cigarettes, they do not.

It was plain from the questions we asked them that they are very worried about the growth of counterfeit cigarettes. Is it not likely they are going to co-operate like Billy-o on a memorandum to stop counterfeiting but they will much more relaxed in stopping smuggling of their own brands?

Mr Gerrard: The memorandum of understanding has made a great impact on the smuggling of genuine UK manufactured cigarettes. I am absolutely certain that tobacco manufacturers are very concerned about counterfeit and they are certainly keen to work with us on that as well. Our focus always is on illicit cigarettes. Whether it is counterfeit or whether it is genuine it is illicit cigarettes and getting that market down still further, and that is what our focus is.

Q422 Mr Beard: ASH told us that the legal agreement that exists between Philip Morris, an external manufacturer, and the European Union on smuggling was “the gold standard” by which all cigarette manufacturers’ attempts to control excise fraud should be judged from now on. Philip Morris told us that they were more than happy to have the United Kingdom sign up to this agreement and it was far more extensive in its provisions, its scope and extent than the memoranda of understanding that we are now talking about. How do you react to that?

John Healey: Customs regularly meets with Philip Morris. The reason that we have given priority to our three UK manufacturers is that their products were a significantly greater share of the illicit market in the UK and the seizures we were making. In the last year, Philip Morris’s brands constituted only 3.5% of the seizures we made and the vast majority of those were counterfeit, not actually produced by Philip Morris. I would not rule out looking for a memorandum of understanding with Philip Morris and we are considering that but the imperative was to get a proper arrangement in place with our own manufacturers based in the UK.

Q423 Mr Beard: That was not my point. My point was this memorandum of understanding between the European Union and Philip Morris, of which we have got a summary here, is far tougher than memorandum of understanding that have been entered into by Customs and Excise and the UK manufacturers. For instance, the first part agrees a comprehensive set of rules. The second part agrees tracking and tracing procedures. The third part says that despite these things, when Philip Morris cigarettes are confiscated Philip Morris will pay five times the normal Customs duty on them, and it is legally binding. You can understand what ASH and indeed the European Anti-Fraud Office are saying.

They are saying that is a great deal tougher than the memorandum that are applying to the UK manufacturers that we are discussing.

John Healey: Can I say to you three things, Mr Beard. First of all, there are similarities. The memorandum of understanding between the EU 10 Member States and Philip Morris does have similarities with our own three. In each case the manufacturer agrees to help the customs authority identify who they are selling genuine tobacco to. They undertake to stop supplies where these are clearly being fraudulently then sold on. They also agree to provide information that will help customers. The second thing is that the basis of the Philip Morris memorandum is very different from our own. The Philip Morris memorandum is a legal document. In large part it was designed as part of a deal to drop litigation in the European Union against the company. We are not in those circumstances here. Thirdly, whilst there are some features that we do not have in our own memorandum of understanding, there are two significant ways in which I would say to you that the memorandum of understanding with Philip Morris is weaker in law enforcement terms than our own. The first is, and Paul Gerrard mentioned this earlier on, in our one we have an agreement that the companies will stop supplying to customers where we issue a warning, where we have not got a conviction in place, which is a requirement under the Philip Morris memorandum but we have good grounds and we say to the company we have serious concerns about supplying to this consumer. The second is and you mentioned the track and trace—

Q424 Chairman: Is that the red and yellow card system?

John Healey: That is our red and yellow card system.

Q425 Chairman: You have also said in your memorandum to us that Customs has not issued any red and yellow card in the last two years.

Mr Gerrard: We have the ability to do that.

Q426 Chairman: But you have not issued any.

Mr Gerrard: I will need to check the detail of this but certainly we have been in discussion with one tobacco manufacturer about a supplier.

Q427 Chairman: This is 17 December, your supplementary memorandum says that you have not issued any cards in the last two years.

Mr Gerrard: That would suggest therefore that the steps that we require under the MOU to be taken by tobacco manufacturers are being taken.

John Healey: My point, Chairman, is the grounds and the evidence on which Customs can go under our three agreements to companies and say stop supplying this customer are different and easier and better for Customs in this country than they are under the Philip Morris agreement, which is based on secured convictions. The fact of issuing red or yellow cards means that we have found that the companies by and large and to that extent have responded when we have asked them to do that.
Q428 Norman Lamb: You are saying they are stopping supply before having to serve a card on them?

John Healey: Yes.

Mr Gerrard: Or they are not making the supply to begin with because they know those circumstances are not legitimate.

Q429 Mr Beard: But under the conditions we have got it includes strict criteria concerning the “know your customer” rules and regulating the ways in which a company can receive payment for cigarettes to eliminate money laundering. It goes on. These are not “bolting the door with a boiled carrot”; these are substantial principles which are involved.

John Healey: Forgive me; I am not suggesting that there are not some very substantial elements of the Philip Morris memorandum. I am simply making at this point the argument there are some features of our own memoranda that are more useful to Customs than the details of the Philip Morris one. You mentioned track and trace and we have under our memoranda and our working relationship with the three companies in this country an ability to track and trace a customer on a packet of 20 if we find that is part of a contraband consignment. If you check the Philip Morris memorandum, you will find they have to have a case of 10,000 cigarettes before they will institute the track and trace procedure with customs. In those circumstances I am just saying to you that is one feature in which our own memorandum of understanding compares with very well with the one for Philip Morris and the European Union.

Q430 Mr Beard: But the management of British American Tobacco have come up with and written to us with their proposal for an export bond which makes reasonable sense, but it would have to be done by a number of countries together and the ten who have signed up to the European arrangement would be ten such countries that could apply this. Why are we inventing our own solutions through these memoranda that stand on their own which, as the industry told us, do not seem to have made that much difference anyway? That is their viewpoint. Why are we not signing up to the European agreement?

John Healey: We have three agreements in place with the principal sources of the cigarettes that we have a problem with that are working well. We certainly are ready to consider reinforcing those agreements and, as I have said to you, we are ready to consider whether or not we should be reaching some sort of memorandum of understanding with other tobacco companies as well, but with Philip Morris in particular their branded cigarettes are really a relatively small part—

Q431 Mr Beard:—no. Philip Morris is not the issue here. The issue is that we have got the European agreement that Philip Morris happen to have signed up to but anybody else can sign up to too, but we have not signed up to it and I have asked why have we not and why should we not?

John Healey: Because the relative advantage to us in dealing with the smuggled cigarettes that we face in the UK is much greater by taking action with the three UK manufacturers than it is with some of these companies like Philip Morris, which in this case is a party to the European agreement but will not to any significant amount make a direct difference to the smuggled product that we have in this country.

Q432 Mr Cousins: Under the Philip Morris agreement with the European Union, Philip Morris undertakes to make a series of payments totalling $1.25 billion over a period of years to the European Union for counter-smuggling and counter-counterfeiting work. How much of that money are you aiming to get to come to Britain to assist our work and your work?

John Healey: I think you will find, Mr Cousins, that none of that money is available to us in the UK. We are not a party to the—

Q433 Mr Cousins: But you could be a party to the agreement.

John Healey: We are not a party to the agreement.

Q434 Mr Cousins: You could be.

John Healey: I think you will find that if we become a party to the agreement then we may be able to take advantage of some of the operational features of the memorandum, but I believe we would not stand to gain from any of the payments that Philip Morris may make under it.

Q435 Norman Lamb: Could you clarify that for us?

John Healey: Yes.2

Q436 Mr Cousins: So of this $1.25 billion that is going to the European Union none of it is going to come to Britain?

John Healey: As things stand at the moment, none of it will.

Q437 Mr Cousins: None of it will come to Britain.

John Healey: As I did explain earlier on, this memorandum was a way of settling—

Q438 Mr Cousins:—The origins of it are understood—

John Healey:—some litigation that we are not a part of with Philip Morris.

Mr Beard: That is how it began but it stands on its own now, surely?

Q439 Mr Cousins: Do any of your memoranda of understanding with British manufacturers give any contribution to counter-counterfeiting work or anti-smuggling work?

John Healey: They do not contain a financial contribution at present.

Q440 Norman Lamb: Would you like to see that happen? You have compared and contrasted the legal agreement and the memorandum of

2 See Ev 138
understanding. Would you like to see the best of both combined together to achieve a better end result and with everyone part of the same regime? Is that your end objective?

John Healey: I think the unity of the regime is not the main priority. The main priority is to have in place memoranda of understanding and a level of co-operation with the companies that matter that helps us deal with the counterfeit and the smuggling problem that we have got.

Q441 Norman Lamb: Given that there is another approach which is securing some funding; is that something that you would like to pursue so far as strengthening the memorandum of understanding with British companies?

John Healey: Just as I said we would be prepared to consider the case for joining the memoranda of understanding that is in place with Philip Morris, we would be prepared to consider refining and reinforcing the memoranda of understanding we have with our own three domestic manufacturers.

Q442 Mr Beard: How do you react, Minister, to this proposal from British American Tobacco for an export bond because, as I understand it, you cannot implement that standing alone but you can if you are in co-operation with allies.

John Healey: You are absolutely right that in order for it to have any chance of flying at all a number of countries would have to implement it altogether. To be perfectly frank, I am not sure that it would make a great deal of difference. The real problem with cigarette smuggling is not in the first stage of supply between manufacturer and first consumer, which of course is what the bond covers, it is that you then get smuggling operations that confect a series of sales on and consumers in a supply chain which the bond would not be covering and from which the cigarettes then get diverted into illicit sales. So I am not convinced that the BAT bond idea would make a great deal of difference to us.

Q443 Norman Lamb: You talked a little earlier about your strategy to deal with the massive growth in counterfeit cigarettes and you have said that the vast bulk of it is coming from China and you have said that you have started to talk to China. Is there any sign yet of anything emerging from that or is it just an aspiration of yours? Are they co-operating to try and stop this enormous flow coming into Europe?

John Healey: I should be clear that China is significantly at the centre of this but it is broader than that in the Far East and a little bit in Eastern Europe. The short answer is yes but there are small signs and it is early days. I have will give you a couple of examples, Mr Lamb, and I am happy to let the Committee have a fuller note on this.¹ We have had Customs officers out in Hong Kong helping to train some of the Chinese customs officers in techniques for profiling export consignments. That was only in the latter months of last year and we have had, as part of that development of working co-operation, intelligence from the profiling that they have done of their exports from Shanghai, and that information has allowed us to intercept at least two significant shipments of cigarettes at Felixstowe that were manufactured in China and destined obviously for the UK market which would have become part of the illicit market here.

Q444 Norman Lamb: Do they do any scanning yet or is that something for the future? Are they scanning the stuff going out of their ports?

John Healey: That may be something for the future. Generally to take the UK experience we tend to scan and we tend to use scanning equipment for the import stage rather than the export stage.

Q445 Norman Lamb: But that is a clear opportunity to stop it with co-operation from them?

John Healey: It may well be.

Q446 Norman Lamb: According to Customs, cigarette seizures from air passengers are growing substantially and now account for 20% of all seizures. That is presumably linked to the growth of cheap flights going in and out of small airports around the UK. Have you reviewed the Customs presence at these airports to ensure that officers are present when such flights arrive because the impression we get is that your major Customs effort is concentrated on the big airports and big sea ports. Does that not just give a green light to the smugglers to use the smaller ones?

John Healey: Two things and then I will ask Mr Gerrard to come in. Part of the shift that we have seen in greater cigarette smuggling through air passengers has been, as one might anticipate, a response from the tobacco smuggling gangs to the pressure that we are putting on other parts of their supply chain, so it is a response you would expect to see with well-organised criminal organisations.

Q447 Norman Lamb: So you then have to respond to that?

John Healey: So therefore we have to respond and of course we will make sure that the sort of presence and operation that we have at airports is tailored to try and meet the emerging threat.

Q448 Norman Lamb: Does that mean you are actually shifting your attention to the smaller airports where it is coming in?

Mr Gerrard: We do not have infinite resources so we need to target those resources well and we do target them well and we target them as effectively as we can. To give you a couple of examples, on Christmas Day this year at 1.00 am Customs officers were deployed to a provincial airport and we seized over two million cigarettes from 21 passengers coming back on a low cost flight. That is about 100,000 cigarettes for each passenger. It was Christmas Day, it was 1.00 am in the morning and it was a provincial, not a big airport—

Mr Cousins: It is a very substantial, well-run airport.

¹ See Ev 138
Q449 Norman Lamb: You have offended him now.
Mr Gerrard: I say that as someone who comes from very close to a provincial airport as well.

Q450 Norman Lamb: That example highlights what is happening, does it?
Mr Gerrard: Absolutely, we are deploying increasingly our own resource and other resources to that threat. At another airport we seized over a million cigarettes and secured five convictions from inveterate smugglers. The key will be as they move their focus we need to be fleet of foot enough to move as well.

Q451 Norman Lamb: The Tobacco Manufacturers' Association have pointed out that there are two markers to measuring the success of your strategy, first of all whether there is an increase in the price of cigarettes on the black market, which would indicate a reduction in supply, and the volume of products seized, but they say it shows that you are not necessarily achieving the success you had hoped for. The price of the black market has remained at about £2.50 for five years and the amount seized in 2002–03 was 1.9 billion cigarettes against a target of five billion. That does not sound like great success against the target you set yourself.
Mr Gerrard: I think the target we set ourselves and what we measure ourselves by is the size of the illicit market. We have in the past measured ourselves by outputs. To give you an example that sticks in my mind, in 1998–99 we seized 600 million cigarettes. The following year we trebled that and seized 1.8 billion cigarettes. Unfortunately, the illicit market went from 12 to 18%. Because we seize more may not necessarily be an indicator of success. I would say firstly that the measure of success must surely be the size of the illicit market and that has gone down from 21% to 15%. The second point on street price is absolutely right but the street price is not so much cause and effect as that and, in particular, if you are bringing in counterfeit (and 54% of our seizures last year were counterfeit) you are able because of the price of those counterfeits to deliver them at a much cheaper price. I would disagree with the TMA. I think the measure of success is the size of the market and I think the other things are more complex.

Q452 Norman Lamb: Several witnesses have suggested that the rewards for tobacco smuggling are high, the risks of detection are low, and the punishments, if caught, are relatively mild. It seems to be supported by the evidence of prosecutions where the number of people sentenced has fallen from 884 in 2000–01 to 429 in 2003–04, so less than half, when the average sentence was 14 months. So what is your response to the significant reduction in the number of people being prosecuted?
Mr Gerrard: Just to say I think the figures for the year 2000–03 and the reduced average sentence does reflect our increased efforts on what you would term the lower level distributions, the inveterate tobacco smugglers, et cetera. In terms of the risk to reward ratio (the risk is so low and the reward so high) when we tackle tobacco smuggling we look to inflict maximum economic damage on the tobacco smuggler—vehicle seizure, seizure of product and in tackling the organisations we look to not just take out their capital, their cigarettes, by seizing them, we also look to prosecute them and we look to go after their money.

Q453 Norman Lamb: Why the reduction? Why only half the number of prosecutions compared to 2000–01?
John Healey: In many ways it is important not just to focus on prosecutions, as Paul Gerrard has been saying. In many ways, in the prosecutions you see some of the shifting patterns we discussed a moment ago in response to your last question. In 2000 where we had the 884 prosecutions during that year that included quite a large overhang of small-scale seizures and prosecutions from the late 1990s and quite a large number of cross-Channel smuggling cases. As we move beyond that the prosecutions that we were mounting were fewer in number but more complex and designed to hit some of the organisers behind these fraud gangs. What you now see in the latest figures is again a reduction in the average length of sentence as what we are picking up now are an increasing number of air passengers where the amounts that are being smuggled are lower and therefore generally the average length of sentence, although it is not under Customs' control, is beginning to drop as well, so I think you are seeing signs in the prosecution numbers and length of sentences that reflects the quite fluid nature of the fraud we are trying to tackle.

Q454 Norman Lamb: One would expect if there was this shift toward gangs using carriers to bring it in through airports that there would be an increase in prosecutions, a return almost to the old days where there were lots of smaller prosecutions?
John Healey: You are seeing precisely that. That is my point. If you look at the figures for 2003–04, they show precisely that pattern compared to the previous year.

Q455 Norman Lamb: And a growth in the number of prosecutions?
John Healey: The number is up from the previous year and the length of sentence on average is lower.

Q456 Norman Lamb: Just a question on prosecutions—this is on alco fraud—in 2001–02 there were 91 successful and eight unsuccessful prosecutions in Excise fraud. In 2002–03 there were just 34 successful, down from 91, and the unsuccessful were up from eight to 28. Are those the bonded warehouse cases which have collapsed? Is that what that refers to?
John Healey: No, the London City Bond cases were prosecutions and convictions that were secured in the late 1990s.

Q457 Norman Lamb: So why this big increase in unsuccessful prosecutions?
Mr Gerrard: I think we provided you with a note for this last time. I am trying to find the figures and unfortunately I cannot. A good number of those are the appeals from the LCB where the original conviction was being appealed and overturned.

Q458 Norman Lamb: So it looks as if it is related to the London City Bond.
Mr Gerrard: We have sent you a note. I just cannot find it in my papers.

Q459 Norman Lamb: You have obviously had lots of problems with that and I will not stray into areas that are subject to police investigation, but when we had the Scotch Whisky Association giving evidence to us they expressed concerns over some of the practices that were still disturbing them within some of the bonded warehouses. Mr Hewitt, who I think is the Chief Executive of the Association, says, “I use one example, and this is within the last year, of a Liverpool bond third party warehouse where I have been told that one of the directors of that company has a criminal record for fraud and that bond is still operating.” Is that a problem that is still continuing and are you aware of that case?
Mr Gerrard: I am not aware of that specific case.

Q460 Norman Lamb: Could you investigate and do a note for us?
Mr Gerrard: I can ask Mr Hewitt for some further information on that and I am happy to see what we can provide on that.

Q461 Mr Cousins: Just to follow that, how many scanners have you actually got?
John Healey: For tobacco?

Q462 Mr Cousins: Yes?
John Healey: We have got scanners deployed generally. We have a certain amount of mobile equipment but generally we have scanners deployed in 14 of the most significant ports where we see the most regular route for tobacco smuggling.

Q463 Mr Cousins: So you have got 14, as it were, permanent ones and how many mobile ones?
Mr Gerrard: I do not know the precise number off the top of my head.

Q464 Mr Cousins: Could you let us know?
Mr Gerrard: Yes.4

Q465 Mr Cousins: Do you still operate a car pool on which people draw to drive around the country to make brief appearances at airports and ports?
Mr Gerrard: We have official vehicles that are obviously used—

Q466 Mr Cousins: How many cars do you have in the car pool?

4 See Ev 138

Mr Gerrard: I do not know.

Q467 Mr Cousins: Perhaps you would let us know.
Mr Gerrard: I can do, yes.

Q468 Mr Cousins: One of the suggestions has been that there should be a licensing system which would secure the whole tobacco network. Is that something that you are considering?
Mr Gerrard: It is something that we have discussed with the tobacco manufacturer that has raised it. I think the point is that the nature of the illicit market and the criminal organisations that Customs and Excise deal with means that they operate outside that licensing regime. Those who want to be in the licensing regime would be in it. These individuals operate outside it. The whole illicit tobacco market is just that; it is illicit from start to finish.

Q469 Mr Cousins: But the licensing regime would presumably be accompanied by very severe penalties for people operating outside the licensing regime?
Mr Gerrard: I am not clear how the licensing regime would impact when counterfeit cigarettes are brought into the country if they are brought into the country illicitly and therefore they are outside legitimate controls.

Q470 Mr Cousins: But the point is that the licensing regime provides a secure route which is the basis of detecting the people who are not operating through those secure routes?
Mr Gerrard: As I said, the nature of the illicit tobacco market is such that they would operate outside those secure routes. I am not clear, having looked at it, how that would help when dealing with organised criminality who are not part of that licensing regime but would quite easily get product from this.

Q471 Mr Cousins: Are you operating primarily a regulatory system or a forensic system and one that depends on investigation? Which is your primary approach?
Mr Gerrard: When tackling the illicit market in cigarettes, which is illicit from start to finish, we engage in a law enforcement effort which involves both detection and intelligence and very sophisticated criminal investigations.

Q472 Mr Cousins: How many bodies do you have committed to this?
Mr Gerrard: Over 2,200.

Q473 Mr Cousins: And how does that compare with 2000–01 when the number of prosecutions was twice as great as it was last year?
Mr Gerrard: We have 2,200 at the moment with an illicit market at 15% and in 2000 we had 1,200 with an illicit market of 21%.

John Healey: But as I think we have tried to stress, simply looking at prosecutions is only part of the picture. During the first three years of the tobacco strategy we also disrupted 190 tobacco smuggling gangs, not necessarily showing up in the...
prosecutions figures but playing a part in reducing the market share of the operations which are feeding the illicit tax-free market in this country.

**Q474 Mr Cousins:** Yes but we have been given these figures about disrupting gangs. It is not entirely clear what each of these units of disruption of gangs actually means.

**Mr Gerrard:** When we disrupt a gang we put that criminal organisation out of business for a period of time. The length of that period depends on what other action we take in terms of criminal prosecution or, more importantly, when tackling organised criminality getting after the money and seizing the criminal benefits. If you take away the money and get after the money that is what really hurts serious organised criminality.

**Q475 Mr Cousins:** You mean outside the measure of prosecutions there is another process going on which is monetary in its approach and completely separate?

**Mr Gerrard:** No, it is linked to criminal prosecutions but one criminal prosecution could result in assets being confiscated from a criminal of £2 million. The Proceeds of Crime Act is a vital tool in this because what it does is it allows law enforcement agencies to get after the criminals’ benefits.

**Q476 Mr Cousins:** Perhaps you would be able to give the Committee some information which would shed some light on this?

**Mr Gerrard:** I can give an answer now.

**Q477 Norman Lamb:** You do disrupt sometimes without prosecuting and there are concerns, are there not, amongst some people subjected to this who claim they are innocent that this circumvents the proper process of enabling them to defend themselves in court?

**John Healey:** It is certainly true that some of our action will be civil action rather than criminal action but it is also the case that where any sort of action like that is taken, Customs have to be able to stand up the evidence in the case that the activity was breaking the tax law. People in those cases have the right to an independent review of the seizures within Customs and they also ultimately have the right to challenge those seizures through the magistrates’ courts or through the adjudicator.

**Q478 Norman Lamb:** But it is after the event?

**John Healey:** Yes it is after the event but there are rights, safeguards and appeal processes in place.

**Q479 Angela Eagle:** How much money have you seized under the Proceeds of Crime Act?

**Mr Gerrard:** I do not have the figure to hand but I could certainly provide it to you with a note. 5

**Angela Eagle:** I think that would be helpful.

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5 See Ev 138
**Mr Gerrard:** I can tell you now if you want or I can write to you. It is not a problem. The Europe indicative limit for cigarettes is 800, ours is 3,200; for hand-rolling tobacco it is one kilogram and ours is three kilograms; and on alcohol we operate precisely the same minimum indicative levels as other European countries.6

**Mr Cousins:** Thank you.

**Chairman:** To wrap up we have got two more areas of questioning, Angela Eagle’s question on oils and then Norman Lamb on VAT.

Q486 **Angela Eagle:** How much of the oils fraud that you have identified actually involves misuse of red diesel?

**Mr Gerrard:** Our assessment is that the vast majority of the illegal fuel market in Great Britain is as a result of frauds involving red diesel and kerosene. Because it is an illicit market I cannot give you precise proportions, but the vast majority of that is as a result of red diesel or kerosene fraud.

Q487 **Angela Eagle:** I know you have narrowed it but have you looked, Minister, at just getting rid of the difference in duty and if needs be compensating farmers in a different way?

**John Healey:** We keep all that area of—

Q488 **Angela Eagle:**—it seems the most obvious.

**John Healey:**—of rebate rate and impact on smuggling under review. Just to be clear, the situation in Northern Ireland is different. In Northern Ireland there is both a significant cross-border shopped element of the non-UK duty paid and there is also because of the long land border a significant smuggled element which is not, frankly, part of the problem we face in the rest of the United Kingdom.

**Mr Gerrard:** One other thought on that which is that the Australians got rid of their marked fuel about three or four years ago and brought in a reclaim system. What they found is that that does not get rid of the fraud, it just changes the fraud type. You get multi-million dollar reclaim frauds rather than what we have now marked fuel misuse. It does not necessarily get rid of the fraud; it just changes the mode.

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6 European legislation specifies that the 90 litre level for wine should include no more than 60 litres of sparkling wine. UK regulations do not distinguish between still and sparkling wine but simply state that the indicative level for wine is 90 litres.

Q489 **Norman Lamb:** Mr Healey, could I just ask you while you are here about the important issue that has been raised by the Forum of Private Business about this practice of stores such as Tesco’s and possibly Specsavers as well setting up operations in Jersey and selling to the domestic market in the UK DVDs, CDs and so on and managing to avoid payment of VAT and thereby managing to sell a CD for £8.90 or something, completely undercutting traders within this country. Do you first of all agree that that is unfair competition essentially and that it is something that has got to be addressed and attempts should be made to close down what likes like a loophole?

**John Healey:** Certainly it is the case that some countries are using what is in this country an £18 threshold for imports of goods from outside the European Union which if they are below that value do not attract VAT or customs duty. Now it is the case that some businesses are arguing that this is an avoidance, it is not illegal but it is an avoidance and it undercutters their ability to compete effectively in the UK market. It is also the case that this is at present leading to a not insignificant revenue loss of about £80 million a year.

Q490 **Norman Lamb:** I was going to ask. It is an £80 million loss of revenue to the Exchequer?

**John Healey:** £80 million at present.

**Norman Lamb:** But growing? Is the trend going up?

Q491 **Chairman:** Could we let the Minister answer because he is in the middle of an answer.

**John Healey:** As things stand at the moment, that is set to grow over the next few years to a couple of hundred million but on the other side we also see arguments from consumer groups that would like us not to reduce the threshold, as some businesses argue, but to increase it because of the benefits that would bring to the consumer. These are matters that, as you would expect, like other tax issues, we keep very carefully under review.

Q492 **Chairman:** We have to leave that there now. You have promised us a number of notes. Obviously we are coming to the end of this inquiry on excise duty and it would be extremely helpful if we could have those even more promptly than usual. We want to report in time for the Budget, unless of course you can tell us when the Budget is?

**John Healey:** I will undertake to let you have the further information very rapidly.

**Chairman:** Thank you very much.
Written evidence

Letter from Mr Lawrence A Rourke to the Clerk of the Committee

Having been a self-employed shopkeeper for the past 25 years, I feel better placed than most to speak on the damages caused by tobacco smuggling.

When I entered this profession, cigarettes did not pay the rent, with an average mark up of 8%. But they did bring a volume of customers through the door with the potential of extra sales. If at this time I knocked 10p off 20 cigarettes, customers were satisfied.

Customers were loyal. They would go on their annual holiday, buy their allowance, and return to me when they smoked them.

The effects of Excise Duty Fraud have been soul destroying, with its damage to my business, lifestyle and future. At its peak my sales dropped between £800 to £1,000 per week. Rolling tobacco sales were nil. From a situation of paying cash to all my creditors, my business is held together with loans, credit cards and general luck. I cannot afford any social life for my 100 hour labour, pension funds are unaffordable. I feel very bitter towards past and present Governments for the way this has been handled. After working every day of my life since the age of 15, I am now 57, but have nothing to show for all that hard work.

In these days of compensation, I would like to see someone fight the corner of the small size employed businessman who has been sold up the river.

I understand there is an undercurrent against the hard work being done by the Customs. Regarding personal allowances, I am begging your Committee to recommend no let up, and action to protect what is left of my livelihood.

15 October 2004

Memorandum submitted by Retailers Against Smuggling

(i) Retailers Against Smuggling and the Tobacco Alliance

“Retailers Against Smuggling” is the campaign of the Tobacco Alliance, which was formed 20 years ago to voice the views of independent retailers of tobacco on all matters related to tobacco tax.

Today the Tobacco Alliance represents over 18,500 independent retailers across the UK. It is funded by the Tobacco Manufacturers’ Association.

(ii) Submission Objectives

This submission presents the facts on the causes of tobacco smuggling and the effect it has on independent retailers—and as a result, local communities across the UK—and suggests what the Government can do to address this problem.

In making recommendations, “Retailers Against Smuggling” seeks to encourage the Government to bring UK tobacco tax levels more into line with the rest of the EU thereby:
— reducing the incentive to smuggle;
— restoring law and order in communities;
— safeguarding the livelihoods of legitimate retailers.

(iii) The Cause of the Tobacco Smuggling Problem

UK cigarette smokers pay more tobacco tax than any other EU Member State. Taxes on handrolling tobacco are by far the highest in the EU.
The burden of tax borne by smokers is a greater percentage than that on any other excise goods. High taxes lead to wide price differentials within the EU. In July 2004, the price of a packet of 20 cigarettes was £4.82, compared to just £0.37 in Latvia.

A 50g pack of handrolling tobacco costs £9.50 in the UK whilst the cost in Poland is £0.77. Increasing tobacco tax encourages smuggling, thereby leading to a greater availability of cheap cigarettes on the UK market.

With such wide price differences for tobacco between the UK and the Continent, criminals are increasingly turning their attention to smuggling cigarettes. Huge profits can be made by individuals purchasing duty-paid tobacco products on the Continent and selling them in the UK. Needless to say, tobacco products sourced from elsewhere in the world, especially counterfeit, can realise even greater profits for the smugglers.

Tobacco is light and relatively easy to transport (when compared to alcohol, for example). The penalties for those caught smuggling tobacco are minor compared to, for example, drug smuggling. The chances of being caught and imprisoned are insufficiently high to deter smugglers.

There are not sufficient HM Customs & Excise officers or scanners to provide enough of a disincentive to smuggle. Latest Customs’ estimates are that 27% of cigarettes and 69% of handrolling tobacco consumed in the UK are non-UK duty paid.

(iv) The Effect:

(a) On Independent Retailers

The following information comes from “The Impact of Smuggling and Cross-Border Shopping on Independent Tobacco Retailers” carried out by Albermarle Marketing Research in 2004 on behalf of “Retailers Against Smuggling”. A fuller version of the statistics is included in the PowerPoint presentation “Economic Research 2004” accompanying this submission.¹

¹ Not printed.
One in four retailers is considering closing as a result of the effects of tobacco smuggling on their sales. Last year, tobacco smuggling reduced the average retailer’s sales by £49,736.

The effect of the fall in sales has been significant enough for 28% of retailers to consider reducing the number of staff they employ and 25% of retailers have actually cut jobs.

95% of retailers are aware of tobacco smuggling.
74% report being aware of tobacco products being sold illegally in their area.
88% of retailers report that smuggling has decreased their tobacco sales, with 36% claiming that there has been a dramatic decrease.
74% of retailers expect the situation to get worse.
93% don’t think the Government is doing enough to help retailers affected by smuggling.

Tobacco smuggling is often seen as a “victimless crime”. However, it is clear that there are victims of the black market in tobacco, specifically the retailers of tobacco products.

Retailers are not the only losers: Treasury tobacco revenue losses since records began in 1995 have already exceeded £20 billion.

(b) On Communities

Independent retailers continue to fulfil an essential role in the community.

It is these retailers who provide a vital service to those with particular local needs: the elderly, people without access to transport and disabled people.

More lost jobs and more shops closing leaves communities without the local supplier that they have always been able to depend upon.

(c) On Law and Order

Smuggling has become “big business,” and is being organised by criminal gangs who are often violent.

Smuggling tobacco is a significant threat to law and order in the UK. Criminality is on the increase. The penalties for tobacco smuggling are not as severe as those for drug smuggling. However, tobacco smuggling is proving to be equally profitable for the criminal gangs involved. Similar rewards, lower risks.

Rising levels of organised crime across the UK will clearly have a negative impact on regions already characterised by high levels of deprivation, social exclusion and poverty.

The longer the delay in tackling the root cause of the problem—ie. the UK’s high tobacco tax regime—the greater will become the grip of criminality. A black market, once established, is very difficult to eradicate.

(d) On Young People

Almost a third (29%) of retailers know of smugglers supplying underage smokers.2

Smugglers do not care who they sell their goods to—children have easier access to tobacco on the black market than from legitimate retailers who demand proof of age.

94% of retailers are in favour of a national proof of age card.3 CitizenCard is by far the best known.

Initiatives such as the CitizenCard "No ID No Sale” campaign will be undermined if black market accessibility continues unchecked.

3 Ibid.
(v) Conclusion and Recommendations

UK tobacco taxes are well above those in the rest of the EU. This must be addressed.

20 CIGARETTES ACROSS THE EU—JULY 2004


HM Customs and Excise do not have sufficient resources to eradicate smuggling. Its seizures represent just a small proportion of the total quantity of bootlegged and smuggled tobacco.

The great majority (73%) of retailers believe that to combat the tobacco smuggling problem taxes should be frozen or reduced.4

The Government must give serious consideration to bringing the UK’s tobacco tax levels more into line with those of our European partners, as has been done recently, for example in Denmark and France. Until this happens smuggling-related crime will rise, more retailers—the backbone of communities across the land—will be forced to close, and more jobs will be lost across the UK.

1 November 2004

Memorandum submitted by the British Beer and Pub Association

1. Introduction

1.1 The British Beer and Pub Association (BBPA)5 welcomes this inquiry; since duty fraud is damaging the UK beer market as well as the Treasury’s revenue stream. HM Customs & Excise (HMCE) are unable to accurately measure the amount of large-scale smuggling/diversion fraud for beer. This is a concern for the industry and must be a cause for concern for the Government.

1.2 A major incentive for fraudulent activity in the UK is the high rate of duty per se and the differential in duty between the UK and France. Regulatory options proposed by HMCE do not include removal of the incentive but rather focus on reducing levels of fraudulent activity. The regulatory options under consideration are directed towards treating the symptoms rather than tackling the root cause of the problem. Members of the BBPA are keen to work with HMCE towards the joint objective of reducing duty fraud.

1.3 On several occasions over the past two years, the BBPA has suggested that HMCE and the trade engage in a joint work programme on modernisation and simplification to reduce compliance costs, improve revenue assurance and release HMCE resource to focus on the higher risk areas in order to combat fraud.


5 The BBPA is a Trade Association representing 98% of the UK brewing industry and interests of owners and operators of over 35,000 public houses throughout the UK.
Modernisation would complement the fraud reduction strategy in achieving more effective control. A longer-term plan would capitalise on existing technology and dovetail with future requirements under the EU’s Electronic Movement Control System (EMCS).

1.4 In order to tackle fraud we continue to advocate a risk-based approach. The BBPA considers that the majority of movements between sites within the same ownership and between brewing companies are low risk
and are essential in order to facilitate consumer response times. The BBPA is not aware of any fraudulent activity connected with such movements. Any human errors are reported and, since the duty is accounted for, there is no risk to the revenue.

1.5 A joint approach is essential. HMCE should utilise their authority effectively in the context of risk analysis. Operational staff should be fully trained and qualified to meet this objective.

1.6 A high degree of quality assurance audits, control, and investigation work by HMCE managers, should ensure that the legitimate trade is not antagonised and disadvantaged by needless restrictions, and that the force of the law is focussed and directed reasonably where it is needed most.

2. Level of Fraud and How this has been Estimated

2.1 The level of fraud is difficult for both industry and government to quantify. The Association believe that the only way HMCE can accurately determine the level of fraud is through collaboration with industry.

2.2 Cross-border shopping, smuggling and fraud

2.2.1 BBPA volume estimates for duty paid imports for the last 13 years are shown in Table 1a and Table 1b, Annex I. These are based on two regular surveys commissioned by the BBPA starting in 1992 and 1993.

2.2.2 The total volume of duty paid personal imports has fallen since a peak in 1997 although there was an upturn in 2003.

2.3 Cross-border shopping survey

2.3.1 Each month over 200 people on Calais dockside on the Shuttle are interviewed by market research company HI Europe regarding their alcohol purchases to bring back to the UK. This survey is statistically reliable with a robust methodology. This is the basis of our volume estimate for ‘normal’ passengers/legitimate cross-border shopping.

2.3.2 Increased price competition from UK supermarkets and the abolition of the duty free regime in 1999 resulted in beer volumes falling from their 1997 peak. The number of day-trippers to France fell and those who did go were increasingly buying wine at the expense of beer. In the second half of 2001 and 2002, the HMCE “zero tolerance” policy towards bootleggers in vans (Table 2) extended to other vehicles and cross-channel shoppers buying over indicative limits, and with the ensuing publicity surrounding this, volumes purchased fell further.

2.3.3 However 2003 saw an upturn in beer volumes (+17%) as day-tripper numbers increased along with the average volume bought per person. There was an increase in the proportion of beer buyers buying over the minimum indicative limits and this has coincided with the modification of HMCE policy regarding seizure procedures and the stopping and searching of vehicles following defeat in the High Court at the end of October 2002.

2.4 The “van trade”

2.4.1 This survey commenced in 1993, and is undertaken by commercial investigators (ex-police) who are stationed at Calais dockside and the Shuttle entrance logging vans and note whether they are heavily laden or not.

2.4.2 Additional resources and a “zero tolerance” approach adopted by HMCE, combined with the higher fare prices, saw a sharp decline in this trade during 2000. HMCE seized 10,200 vehicles in the financial year 2000–01 or 200 per week. Not surprisingly, beer smuggled in heavily laden vans fell by a further 89% in 2001. The high likelihood of vans being stopped, seized, and destroyed combined with rising costs has made bootlegging in vans uneconomical.

6 The BBPA rationale for ascribing a low level risk is that there is one computer system in operation, the goods are owned by the producer and there is visibility of movements.

7 It should also be noted that there is a grey area regarding when cross-border shopping becomes smuggling. A significant proportion of respondents in the HI Europe survey purchase more than the indicative limit of 110 litres of beer and this increased in 2000 and 2001 when the van trade declined. Hence the amount of beer that could be classed as smuggled is considerably higher than just the van survey volume.

8 Ev 67
2.4.3 Consequently only very limited surveillance was undertaken in 2002. mass work indicated that the professional “bootlegger” was still very much in business with vans and car Trailers seen at outlets being loaded by pallets in quantity. However the overall level of this type of trade was only a small proportion of what is was at its peak and this was also reflected in the fall in the number of outlets dedicated to supplying the bootlegging trade. No further surveillance was undertaken in 2003.

2.4.4 What is unclear is whether beer smugglers have switched to other activities or whether smuggling has transferred to other routes or, as is more likely, an increase in paper fraud or in beer being smuggled in large-scale consignments in lorries and/or sea containers to meet the demand of established networks in the UK. Unfortunately any such volume will not be captured in BBPA surveys.

2.4.5 Each year until 2003, HMCE undertook their own cross-channel smuggling survey over a two-week period in June. This showed a dramatic fall in cross-channel beer smuggling in 2001, with total revenue evaded down from £260 million in 2000 to £20 million. The figure fell to £15 million in 2002. No survey was undertaken in 2003.

2.4.6 In terms of large-scale smuggling/fraud, and hence total illicit beer consumption, the latest HMCE report (November 2003) states that they are still not able to provide a robust quantification for this. The report states though:

“...there is no clear indication that the illicit beer market supplied in this new way (diversion fraud/large-scale smuggling) represents a greater proportion of the market than the previous estimate [2000–01] of 4%”

2.4.7 Since the cross-channel smuggling survey has ceased and HMCE are still not able to accurately measure the amount of large-scale smuggling/diversion fraud for beer, this must be a cause for concern for the Government as well as the Industry.

2.5 Duty fraud

2.5.1 The high rate of duty per se encourages fraud. One indication of where diversion fraud/large-scale smuggling may exist can be seen by the difference between reported beer import and exports statistics in the UK and in France for trade between the two countries. This is shown in Table 2, Annex I.10

2.5.2 Over the last 5 years, UK trade figures indicate that over 1.1 million hectolitres of beer was exported to France that has not been accounted for in French import statistics. In the same time period French trade statistics also show nearly 1.7 million hectolitres of beer exported to the UK that does not appear in UK import statistics.

2.5.3 Clearly possible evidence of diversion fraud or other fraudulent activity is not necessarily confined to trade between the UK and France. According to the trade database of Global Trade Information Services Inc, there are significant differences with two other of the UK’s major trading partners, the USA and Germany (Table 3 Annex I).11

2.6 European dimension (Table 4 and 5)12

2.6.1 With the introduction of the Single Market in January 1993, a target rate of 18.7 Euros was set with the aim being to harmonise beer duty rates in the EU. Since then all the EU countries which were significantly above this rate, except the UK, have reduced their duty rates significantly. Following the latest increase last year, the UK rate has now increased by 28% since the start of the Single Market moving it still further away from the target rate.

2.6.2 The duty differential between the UK and its nearest neighbours has also increased in recent years as other EU countries have not tended to index-link duty rates. For example, the last French increase was in 1997. Even if inflationary increases were undertaken in all countries, the absolute differences would still increase between the high and low tax countries

2.6.3 We are also aware that DG Taxud has issued two reports; one on tax rates and the other on distance purchasing. The latter proposing a liberalisation of the regime, removing the requirement for the purchaser to accompany the goods with a concomitant removal of current minimum indicative levels.

2.6.4 These developments could weaken the ability of UK Customs to prevent avoidance and fraud and hence increase the flow of legal and illegal beer from lower taxing countries. This would do further damage to the UK brewing industry; and increase losses to the Exchequer. With the removal of Nordic Derogations, the Finish Government reduced beer duty rate by 32% in order to prevent the predictable increase in the flow of beer from lower-taxing Estonia.

2.6.5 Despite already having a relatively low rate, Austria has also announced a cut in beer duty of 4% to combat the potential cross-border trade with neighbouring countries following EU enlargement.

10 Ev 67
11 Ev 67
12 Ev 67-68
2.6.6 The European Commission is proposing to take the UK to the European Court of Justice regarding the "disproportionate" treatment of cross-border shoppers who buy over the indicative limits and are buying for family and friends on a “not for profit” basis. Hoverspeed have also launched a £50 million damages claim against HMCE regarding their “heavy handed” searches of their passengers. Clearly in a Single Market, the UK cannot continue to maintain what are essentially illegal fiscal border controls.

3. Steps Taken and Proposed to Reduce the Level of Fraud

3.1 Recent beer duty increases have widened the gap between the rates applied in the UK and mainland Europe. This continues to provide an incentive for duty fraud. The solution remains in the hands of the Government.

3.2 The Chancellor introduced a major initiative to reduce spirits tax fraud in the 2004 Budget. Tax stamping is to be introduced in 2006. Although this does not directly affect the brewing industry, we would like to ensure that tax stamps are not extended to all alcoholic drinks. It would be impracticable for tax stamps to be introduced for beer and would be wholly disproportionate. HMCE considered a number of regulatory options in 2003. This focussed attention to restricting duty suspended movements. Restricting movements in the brewing sector would have headline costs of £5–10 million for the industry to introduce essential systems changes and cover cash-flow losses.

3.3 The BBPA contended that the majority of duty-suspended movements of beer in the UK are of low risk to the revenue and are essential to satisfy trading patterns and market demands. We were pleased that the proposals to stop duty-suspended movements, was dropped. There are a number of other regulatory measures, which have not been progressed because the attention of HMCE has been focussed on the tax stamp issue. We are keen to discuss these matters further in the context of an overall simplification and modernisation plan.

4. The Impact These Have Had on the Level of Fraud and on Compliance Costs

4.1 Beer premises registered under the Alcoholic Liquor Duties Act (ALDA)

4.1.1 The brewing industry has invested heavily in fabric and systems to create national distribution networks to meet the requirements of the End Product Duty system which was introduced in 1993. Payback calculations were based on an assumption that the current system would have longevity. The industry is concerned that regulatory changes, could require extensive systems development and, possibly, a re-organisation of the warehousing system. This would have a significant impact on compliance cost.

4.1.2 Beer is a relatively low value high volume good which is perishable. This needs to be moved close to market to satisfy demands from retailers for just-in-time deliveries.

4.1.3 Beer registered premises are regulated under the ALDA. Where such premises are managed properly under existing UK and EU procedures we would maintain that the beer regime operates satisfactorily and that it is a low risk business in terms of potential revenue loss. We would oppose an all-embracing regulation of breweries under Customs and Excise Management Act (CEMA) perhaps driven by a mistaken belief that this will have a significant effect on levels of fraud. Whereas, we consider, that there is a strong case to align alcohol trade systems in order to simplify them, there is no benefit that could be gained from removing ALDA registrations and replacing these with CEMA approvals. This would result in high compliance costs to the brewing industry for little or no return in the battle against fraud.

4.2 Alcohol fraud—Effect on the legitimate trade

4.2.1 Alcohol Fraud impacts on the UK beer market and is highly damaging to the fragile economics of the supply side of the industry. There is a concern that, in applying regulatory controls to reduce fraudulent activity, it is the legitimate trader who will be penalised and the measures will be disproportionate to the level of risk.

4.2.2 In order to tackle fraud we would advocate a risk-based approach. The BBPA considers that the majority of movements between sites within the same ownership and between brewing companies are low risk and are essential in order to facilitate consumer response times. The BBPA is not aware of any fraudulent activity connected with such movements.

13 EPD: The change to End Product Duty from 1 June 1993 meant that duty became chargeable when beer left the brewery or other registered premises. Previously duty was chargeable at the wort-stage of beer production.
4.2.3 It is considered that the higher risk areas are associated with movements to third-party warehouses. It is through a series of movements between warehouses where the fraudster, commonly with the collusion of a haulier, gains access to duty-suspended goods which are then diverted onto the UK market. It is in this area that the Association is strongly supportive of cooperation with Customs and Excise to assist in reducing the level of fraudulent activity.

4.2.4 A distinction should be drawn between large pack (keg and cask) where diversion fraud is not an issue at present and small pack (bottle and can) where there is potential risk. Currently, the large pack constitutes 60% of the UK market.

4.3 Guarantees

4.3.1 No guarantee system can ever effectively insure HMCE against the potential revenue loss in a fraud, as was found in the heyday of diversion fraud in the latter half of the 1990s. However, the guarantee requirement has the advantage that it clearly indicates on whose shoulders the liability for payment of excise duty falls in the event of an irregularity. Therefore the trade agrees that the liability should fall to the parties to a movement which are likely to have the most control over the movement of the goods.

4.3.2 It is suggested that HMCE, warehousekeepers, and transporters should all co-operate to formulate a written code of practice governing the use of guarantees in duty suspended movements: this would formalise and reinforce the advice given informally by HMCE on an ad-hoc basis. Also, steps should be taken to ensure that all those in an organisation involved in selling excise goods are aware of its contents.

4.3.3 The benefit of this proposal is that the use of the guarantee as a deterrent to potential fraudsters will become more potent. Many people embarking on fraudulent activities for the first time will probably lack the credibility and reputation which financial institutions will require before they will underwrite a guarantee. It cannot be stressed enough that when the guarantee procedures are diligently applied frauds are less able to get off the ground. Some fraudsters may be able to obtain guarantees themselves but, for others, this may make their fraud too risky to be worthwhile.

4.3.4 HMCE should ensure that its database of guarantees is kept up to date and that traders can check that guarantees used by others in the supply chain are valid. As this does not contain details of guarantees taken out in other EU member states, HMCE should re-affirm previous advice that the latter may not be used for movements starting in the UK.

5. The Brewing Industry’s Commitment to Tackling Fraud

5.1 The industry shares HMCE concern about the level of duty fraud and it is acknowledged that any level of fraud is unacceptable. There is a consequential impact on the UK beer market. In this regard, the brewing industry and HMCE are as one; fraudulent activity must be reduced in order to maintain sustainability of the sector and protect tax revenue.

5.2 In seeking to reduce fraudulent activity, the brewing sector agreed to participate in a Joint Beer Fraud Task Force to assist HMCE by supplying intelligence to identify criminal activity. Unfortunately, the focus on spirits tax stamps has diverted HMCE resource from this initiative.

5.3 The industry has also engaged with HMCE in trialling an electronic real-time notification system which could pave the way for meeting the UK obligations under the European Electronic Movement Control System (EMCS).

5.4 The brewing industry considers that this is an ideal opportunity to discuss a longer-term framework for improving revenue assurance and tackling fraud through simplification and modernisation of the duty collection system. A major objective would be to use HMCE resource more effectively. Sharing a joint vision of a desired future state would facilitate the development of more cost-effective systems. HMCE and the industry could capitalise on enabling technology (readily available to all enterprises) to improve the process for duty-suspended sales and movements and capitalise on the potential for managing data through trending and exception management. The industry has discussed ideas previously with HMCE, suggesting a “Barclaycard” approach in which it would be feasible to notify all duty-suspended movements and sales, not just those at high risk.

The brewing industry has worked closely with HMCE in the past to reduce fraud and diversion, and will continue to do so. An effective fight against fraud involves a meaningful exchange of information and a genuine partnership. For its part, the brewing industry is committed to providing such information and to working in such a partnership. However, we remain of the view that addressing the root of the cause of the problem—the high duty rate—is the only long-term solution.
Table 1a Duty paid imports of beer brought into the UK

Table 1b Duty paid imports of beer brought into the UK

<table>
<thead>
<tr>
<th>Year</th>
<th>Van trade (heavily-laden) (000) hls</th>
<th>All other passengers (000) hls</th>
<th>Total volume (000) hls</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>NA</td>
<td>732</td>
<td>732</td>
</tr>
<tr>
<td>1991</td>
<td>NA</td>
<td>829</td>
<td>829</td>
</tr>
<tr>
<td>1992</td>
<td>NA</td>
<td>927</td>
<td>927</td>
</tr>
<tr>
<td>1993</td>
<td>600</td>
<td>1,345</td>
<td>1,946</td>
</tr>
<tr>
<td>1994</td>
<td>728</td>
<td>1,415</td>
<td>2,143</td>
</tr>
<tr>
<td>1995</td>
<td>729</td>
<td>1,668</td>
<td>2,396</td>
</tr>
<tr>
<td>1996</td>
<td>875</td>
<td>2,001</td>
<td>2,876</td>
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<td>1997</td>
<td>825</td>
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</tr>
<tr>
<td>1998</td>
<td>772</td>
<td>1,938</td>
<td>2,709</td>
</tr>
<tr>
<td>1999</td>
<td>849</td>
<td>1,853</td>
<td>2,702</td>
</tr>
<tr>
<td>2000</td>
<td>566</td>
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<td>2001</td>
<td>107</td>
<td>1,870</td>
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</tr>
<tr>
<td>2002</td>
<td>107</td>
<td>1,369</td>
<td>1,476</td>
</tr>
<tr>
<td>2003</td>
<td>107</td>
<td>1,624</td>
<td>1,731</td>
</tr>
</tbody>
</table>

Note: These figures exclude duty-free purchases and smuggling in large freight consignment. Included is beer bought on-board ferries and at the Eurotunnel terminal post duty-free (from July 1999).

Table 2 Beer imports into France and the UK

<table>
<thead>
<tr>
<th>Year</th>
<th>Beer imports into France</th>
<th>Beer imports into UK</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>French import stats</td>
<td>UK import stats</td>
</tr>
<tr>
<td></td>
<td>000 Hls</td>
<td>000 Hls</td>
</tr>
<tr>
<td>1984</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>1985</td>
<td>14</td>
<td>18</td>
</tr>
<tr>
<td>1986</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>1987</td>
<td>21</td>
<td>14</td>
</tr>
</tbody>
</table>
Treasury Committee: Evidence  Ev 67

<table>
<thead>
<tr>
<th>Beer imports into France</th>
<th>Beer imports into UK</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>French</strong></td>
<td><strong>UK</strong></td>
</tr>
<tr>
<td>import stats</td>
<td>export stats</td>
</tr>
<tr>
<td>000 Hls</td>
<td>000 Hls</td>
</tr>
<tr>
<td>1988</td>
<td>14</td>
</tr>
<tr>
<td>1989</td>
<td>16</td>
</tr>
<tr>
<td>1990</td>
<td>16</td>
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<td>1998</td>
<td>883</td>
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<tr>
<td>1999</td>
<td>597</td>
</tr>
<tr>
<td>2000</td>
<td>311</td>
</tr>
<tr>
<td>2001</td>
<td>341</td>
</tr>
<tr>
<td>2002</td>
<td>345</td>
</tr>
</tbody>
</table>

Source: HMC&E, French Customs, Eurostat

Table 3 Beer exports and imports

<table>
<thead>
<tr>
<th>Beer exports: UK to USA</th>
<th>Beer imports: Germany to UK</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>USA</strong></td>
<td><strong>UK</strong></td>
</tr>
<tr>
<td>import stats</td>
<td>export stats</td>
</tr>
<tr>
<td>000 Hls</td>
<td>000 Hls</td>
</tr>
<tr>
<td>1998</td>
<td>1,051</td>
</tr>
<tr>
<td>1999</td>
<td>1,141</td>
</tr>
<tr>
<td>2000</td>
<td>1,250</td>
</tr>
<tr>
<td>2001</td>
<td>1,218</td>
</tr>
</tbody>
</table>

Source: Global Trade Information Services Inc. (May ’02)

Table 4 EU Beer Duty Rates (April 2004)
Memorandum submitted by the Road Haulage Association Ltd (RHA)

INTRODUCTION

1. The Road Haulage Association (RHA) was formed in 1945 to look after the interests of haulage contractors in various areas of the country, in effect, amalgamating local organisations that had been established. The Association has subsequently developed to become the primary trade association representing the hire-or-reward sector of the road transport industry. There are now some 10,000 companies in membership varying from major companies with over 5,000 vehicles down to single vehicle owner-drivers.

FRAUD IN THE OILS SECTOR

2. The RHA gave both oral and written evidence to the Northern Ireland Affairs Committee’s inquiries into the related subject of the impact in Northern Ireland of Cross Border Fuel Duty Differentials. Essentially our views remain as set out in that previous evidence.

3. In our previous evidence the RHA stated that fuel smuggling between Northern Ireland and the Republic was caused primarily by the huge differential between rates of excise duty applied to fuel in the UK and in Ireland. This remains the case. Excise duty on diesel in the UK is now 47.1 pence per litre (ppl) resulting in an average retail price of around 84 ppl (including VAT). In contrast, on the Continent the price for diesel is now typically around 20–25ppl cheaper than it is in the UK, resulting in a £200–£250 difference per tank of fuel (again based on 1,000l tank).

4. Since fuel represents approximately one-third of a haulier’s total business costs, there is a huge incentive to obtain fuel at the cheapest rate. There are two main options for achieving this: firstly by making legitimate purchases of fuel in another EU Member State—either by crossing the border to the Republic or whilst travelling on the Continent; secondly by purchasing smuggled or illegally laundered fuel. Although the first option is completely legal (subject of course to some limits on carrying capacity etc) both options result in loss of revenue to the Exchequer.

SCALE OF THE PROBLEM

5. The difficulty on putting a precise figure on the scale of the problem remains. However, the RHA is convinced that smuggling is now extremely widespread. Indeed, anecdotal evidence suggests that smuggled fuel is now finding its way into mainland UK (particularly in the North) as well as Northern Ireland extending the problem to hauliers based in that part of the country. The most recently published figures contained in HM Customs and Excise’s report “Measuring and tackling indirect tax losses” estimated that the revenue being lost to the Exchequer through fraud on diesel amounted to £1,000 million in the year 2000 plus a further £300 million as a result of legitimate cross-border purchases of diesel. This had risen to £850 million and £300 million for 2001 and £650 million and £300 million in 2002. Although the figures seem to demonstrate some improvement, the RHA believes further significant progress will be hampered by the current high fuel prices which simply increase the incentive to obtain fuel as cheaply as possible.

REMOVING THE INCENTIVE

6. Whilst we are aware that extra resources have been made available to HM Customs and Excise for enforcement in this area since the Northern Ireland Committee’s last inquiry, the RHA remains of the view that the only way that this problem can be eradicated altogether is to remove the differential that exists between fuel duties within the EU. The European Commission itself has recommended that in order to remove distortions of competition within the road freight industry, duties on fuel used for commercial purposes should be “harmonised” across the EU. The RHA has been campaigning on this issue for some time and although the Government has come forward with proposals to address the unfair competition UK hauliers face as a result of high fuel prices—the lorry road user charging scheme—we believe that this is unlikely to address the problems of smuggling and cross-border shopping for fuel.

Table 5  Changes in beer duty rates (local currency) since the start of the single market

<table>
<thead>
<tr>
<th>Finland</th>
<th>Ireland</th>
<th>UK</th>
<th>Sweden</th>
<th>Denmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>−39%</td>
<td>−7%</td>
<td>+28%</td>
<td>−35%</td>
<td>−36%</td>
</tr>
</tbody>
</table>

November 2004
ALCOHOL AND TOBACCO

7. The RHA’s main concerns surrounding alcohol and tobacco smuggling/fraud centre on the costs of compliance attached to the enforcement policies and procedures being implemented by HMCE. There are two key areas for concern outlined below:

— Vehicle out-turns—currently it is for enforcement officers operating at the ports to decide which vehicles they believe should be thoroughly inspected and whether or not that vehicle should be unloaded (out-turned) in order to facilitate the search. This process can take a considerable amount of time (typically between one and six hours) and attracts a charge. At present, this charge is being levied against the vehicle operator, irrespective of whether any illicit/smuggled goods are discovered. The RHA believes that this policy is unfair. The vehicle operators are not solely responsible for the goods they are carrying—for example, the consignor and/or the driver also have responsibilities. In addition, they are already facing the costs of the delays while the vehicle is being inspected. Whilst we accept that enforcement activity of this kind is necessary, the policy of charging vehicle operators for the out-turn should, we believe, be reviewed;

— Lorry drivers—a second area of concern is the policy adopted when lorry drivers are found with more than their “allowance” of goods. We have had many members who have had enforcement action taken against them, even when the driver of the vehicle has stated (and signed a declaration) that the operator had absolutely no knowledge of his actions. This clearly is not a satisfactory position. The RHA has, through discussions with HMCE policy officials, agreed a set of procedures which operators can use to demonstrate that they have done everything within their power to prevent smuggling (for example warnings to drivers in employment contract etc). But the enforcement officers on the ground do not always accept this. In addition the procedures themselves carry some significant compliance costs and problems, not least of which is that of checking drivers’ credentials prior to employment. Unless a driver has been prosecuted for an incident, an employer cannot know that he has been involved in such activity previously. Yet frequently prosecution is not the chosen option for enforcement officers. This situation must be rectified.

8. The RHA is supportive of efforts to ensure compliance with the law. But it is essential that such efforts do not carry disproportionate costs. For a haulier, any delay to a vehicle is a cost. The longer the delay, the greater the cost. Enforcement officers must recognise that in doing their job, they must minimise the unnecessary costs imposed on others—particularly innocent parties.

November 2004

Memorandum submitted by the Tobacco Workers’ Alliance

INTRODUCTION

The Tobacco Workers’ Alliance is a coalition of workers in all the unions involved in the tobacco manufacturing industry, comprising members from Amicus, Transport and General Workers Union and the GMB Union. The General Secretaries of these unions fully support the Tobacco Workers’ Alliance in their campaign to defend the jobs of their members.

SMUGGLING AND THE EFFECT ON THE ECONOMY

1. We cautiously welcome the Chancellor’s decision to make only an inflationary rise in tobacco taxation. We are encouraged by the added investment in HM’s Customs and Excise and the apparent, but small, decrease in tobacco smuggling. However, despite the best efforts of Customs Officers, smuggling is still of major concern to UK manufacturing jobs, legal sales and law and order.

2. The revenue loss to the Treasury is still at an extraordinary level. The Treasury is losing over £3 billion in unpaid duty.

3. European tax harmonisation does not look like a possibility in short to medium term. The cigarette tax burden compared with the overwhelming majority of our EU competitors is increasing as is the tax differential.

4. The idea that a reduction in tax would cost the Treasury money is without a doubt false. An increase in tax on tobacco at this stage will increase the smuggling market and decrease the retail market. This would surely not meet the criteria of a successful policy towards tobacco.

5. The Government’s policies towards tobacco are making only a small impact on what is still a major concern for those that are employed in the industry. The Tobacco Workers’ Alliance believes that public policy should be a two-way street. If a Government policy is not working it should listen to those involved as to why and act accordingly.
Points to note:
— Treasury is losing over £3 billion a year in unpaid duty
— Pack of cigarettes is £3.30 cheaper in Spain
— 50g pack of hand rolling tobacco costs £9.32 in UK, same pack in Belgium costs £2.50
— Smuggled cigarettes can be widely bought in the UK for around £2.50 a packet.
— Terrorists and criminal gangs are estimated to be making a billion pound profit each year from smuggled cigarettes.

RECOMMENDED ACTION
6. The Tobacco Workers’ Alliance calls upon the Government to take immediate steps to protect British tobacco manufacturing jobs by tackling the threat posed by bootlegged tobacco. These are:
— An immediate reduction or at least freeze in duty on tobacco products
— A full review of British tax policy on all tobacco products

7. We believe a reduction in tax could substantially reduce smuggling whereas a freeze in duty would go some way towards stabilising the rate of smuggling. Therefore helping to safeguard the jobs of the 7,000 people employed directly in the industry and some 120,000 indirectly, which are being put at risk by the Government’s present policy on tobacco taxation.
8. If the Government were to regain the £3 billion, it would be enough to cover the costs of buildings and equipment for the NHS.

LAW AND ORDER—THE CRIME OF SMUGGLING
9. The price differential with mainland Europe is now so great that organised criminal gangs and former drug smugglers have turned to tobacco smuggling in preference to other activities, because rewards are high, risks are low and the punishments, if caught, are relatively mild. In Northern Ireland, the percentage of gangs involved in cigarette smuggling has increased by 10% from 2002.¹⁴
10. Customs and Excise have admitted that the more successful they are getting at detecting smuggled goods the more sophisticated the criminals are becoming with their smuggling techniques. The smugglers are using well established routes which are enabling them to meet the demand of the British public for cut price cigarettes. They are increasingly turning to guns and violence to protect their lucrative trade.
11. The Government need to understand that the smoking population of the UK are not only disgruntled with the exorbitant taxes on tobacco products but are also reluctant to assist in preventing the crime of smuggling by purchasing their tobacco from the higher priced legal vendors.
12. If this continues there is a very real risk to the 6,800 jobs directly provided by tobacco manufacturing throughout Britain, with the majority of plants being in areas of high unemployment.

Is increasing tobacco duties the best policy for reducing tobacco consumption?
The answer to this is simply yes to a point but that point we believe as do many others has been well exceeded by the UK Government as can be easily demonstrated by the resultant disorderly market.

THE BUDGET AND TOBACCO TAXATION
— The British tobacco industry directly employs 6,800 people, supplies a home market worth £12 billion a year in sales, delivers £10 billion a year in tax revenue and achieved a balance of trade surplus of £691.5 million for the year 2000.
— The Government’s previous policy of increasing tobacco duties by a minimum of 5% in real terms each year has resulted in the highest level of tobacco taxation, not only in the European Union but also in the world.
— This widening gap between Britain and the rest of the European Union has resulted in escalating levels of tobacco smuggling—estimated by Customs and Excise to have been £3.3 billion in lost revenue during 2001–02.

SOCIAL AND ECONOMIC COSTS
13. Disproportionate tobacco taxation has led to a variety of social and economic problems:
— Organised and violently competitive criminal networks now dominate smuggling operations—Kent Police state: “These are professional criminals . . . here specifically to smuggle.”

¹⁴ Northern Ireland Threat Assessment 2003.
— High, regressive taxation discriminates against the poorest sections of society
— Due to the increase in contraband tobacco, children are increasingly exposed to tobacco products via illegal sources—street corner smugglers are under no moral restriction or obligation not to sell to underage teenagers and young children.
— The resulting loss of jobs in tobacco manufacturing would place great strains on local economies that have already suffered due to the general strains on the British manufacturing sector (interest rates, strength of the pound, globalization, etc).
— The destruction of the UK tobacco manufacturing sector as a result of a triumph of the disorderly market would place a great strain on the national economy—declining treasury revenue, increased law and order costs, poor balance of trade implications and increased social costs as a result of the loss of quality manufacturing jobs in areas that can least afford to lose them.

**IS HISTORY REPEATING ITSELF?**

14. The problem of spiralling cigarette bootlegging is starting to mirror what has happened to Hand Rolling Tobacco (HRT). Today an estimated 75% of all HRT consumed in Britain is from non-duty paid sources and consumption is on the rise. The price differential is so great that repeated freezes in duty have not impacted on the problem.

15. Trends show that the cigarette market is going the same way. It is already estimated that 22% of cigarettes consumed in Britain are from non-duty paid sources.

16. If the comparison with HRT is continued the result will be an increase in the consumption of cheaper continental brands, and more worryingly, unheard of brands from the Far East, South America and Eastern Europe.

17. This further threatens British tobacco manufacturing jobs, yet achieves nothing towards reducing tobacco consumption.

18. The amount of revenue lost to the Government rises as the problem of tobacco smuggling increases:
   — 1996 £680 million
   — 1997 £790 million
   — 1998 £1,700 million
   — 1999–2000 £2,600 million
   — 2000–01 £3,500 million
   — 2001–02 £3,300 million

19. The Government needs to address the serious issue of exorbitant taxation on tobacco products which has resulted in high levels of smuggling which is not only threatening our members jobs but also law and order.

November 2004

Memorandum submitted by Philip Morris International

Philip Morris International\(^\text{15}\) welcomes this opportunity to comment upon current strategies for tackling tobacco smuggling in the UK. We will address each of the issues upon which the Committee has invited comment.

1. **THE LEVEL OF FRAUD AND HOW IT HAS BEEN ESTIMATED**

1. By its very nature, the level of excise duty fraud is incapable of precise definition. Because illegal tobacco sales take place outside legitimate sales channels, there is no reliable way to calculate their exact volume. This problem is exacerbated further in the case of the UK because genuine non-domestic products found in the UK market but emanating from other EU Member States may or may not have been imported legally, depending on where and under what circumstances they were purchased, and by whom they were ultimately consumed.

2. There are several different methodologies for attempting to measure the level of illegal tobacco products in a domestic market.

   (1) **Market surveys** based on the collection of cigarette packs. These can confirm the existence or non-existence of genuine non-domestic products or counterfeit products in the relevant market at a particular point in time. However, it is only through repeated surveys in the same area and under

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\(^{15}\) Philip Morris International Management S.A. is responsible for the administrative functions of the tobacco businesses of affiliates of Philip Morris International Inc. including in the United Kingdom.
the same conditions that trends—upward or downward—can be detected. Even then, the level of illegal products cannot be determined with precision, since it depends upon the extrapolation of data from a sample and its application to the entire market. In our experience, depending in part on the underlying methodology and the collection techniques, these extrapolations can generate unreliable conclusions.

2. **Consumer surveys** are subject to the obvious and inherent bias that accompanies asking a consumer whether they have purchased cigarettes illegally. For this reason, consumer surveys have extremely limited utility in determining the size of the illegal market.

3. **Seizure statistics.** Again, these statistics can provide an indication of the presence of illegal products entering the UK. They can also be very useful in ascertaining trends—for example, the changing routes that smugglers use to gain access to the UK market—which can then be used to focus the resources of customs and police authorities more appropriately. However, absent some reliable ratio for the volume of seized products versus the volume of illegal products that escape seizure—a ratio that is constantly changing—it is impossible to use seizure statistics to measure the size of the illegal market.

3. In fact, none of these methodologies can account for the impact of legal intra-EU sales on the UK market. It is extremely difficult in practice to determine whether genuine products from other EU Member States that are found in the UK have been purchased in accordance with the relevant rules on free movement of intra-EU goods, or have been imported illegally from other EU Member States for re-sale on a commercial basis. There are other factors which have the potential to affect the size of the legitimate market such as declining smoking incidence and more people purchasing their cigarettes legally abroad, both of which would account for fewer legitimate sales of UK tax-paid products.

4. In short, we do not believe that there is any way of calculating the precise size of the illegal tobacco market in the UK. Each method suffers from one or more flaws, although taken together, they can provide information upon which to base a very general estimate. HMCE’s estimate of 18% of the cigarette market and 51% of the hand rolling tobacco market is such an estimate, and on that basis we do not disagree with its figures.

5. What we can say with some certainty is that the UK is one of the most attractive markets in the world for the illegal cigarette trade. This is the unfortunate consequence of the high retail price of cigarettes in the UK, which provides an economic incentive for the diversion of genuine products from other countries where the price is lower, or for the manufacture of counterfeit cigarettes for sale in the UK. A pack of cigarettes can be purchased at retail in some other countries, after the payment of taxes, for between a tenth and a twentieth of the cost in the UK. Even within the EU, the price can vary significantly, from just over £2 a pack in Portugal to over €7 per pack in the UK. In addition, we have seen multiple examples of our products being counterfeited in China with **UK Duty Paid** markings, clearly intended for export to the UK, and have been notified of such products being seized by HMCE in Britain. Sadly, so long as these huge price differentials with other countries remain, there will always be an economic incentive for the smuggling of cigarettes and other tobacco products into the UK market.

2. **The Steps Taken and Proposed to Reduce the Level of Fraud**

6. Absent some significant change in tax policy which would reduce the economic incentive for tobacco smuggling, we believe it is more constructive for us to discuss other possible measures to reduce the volume of illegal tobacco products reaching the UK market.

7. To date, the main thrust of the effort to reduce excise fraud has been enforcement action by HMCE, consisting of seizures in ports and in the domestic market, combined with aggressive prosecution of offenders. HM Customs has also expanded its efforts to include communications campaigns, aimed at educating consumers about the consequences of purchasing tobacco products in the illegal market. We welcome these initiatives, which we believe will go at least some way towards reducing the demand for these products. However, while HMCE’s efforts have met with success in the past several years, with increased seizures and prosecutions, the sheer scale of the problem means that, by HMCE’s own admission, the majority of smuggled and counterfeit products are still reaching the UK domestic market, and the price differentials mean that demand for these products will continue to exist. Thus, while we agree that increased resources will help HMCE to stem the tide of illegal products even further (in particular, for equipment such as fixed and mobile container scanners which have quickly proved self-financing in many European ports), we also believe that action on a policy level is necessary.

A. **A Secure Distribution Network for Tobacco Products**

8. Philip Morris International believes that the first step in preventing illegal tobacco products reaching the market is the creation of a secure distribution network. That is why we support the licensing of tobacco product manufacturers, importers, exporters, warehouse proprietors, transporters, distributors, and retailers. Any person trading in (or storing or transporting) cigarettes without a license would be subject to severe penalties. Any licensed person trading in genuine non-domestic or counterfeit cigarettes upon which UK taxes have not been paid should be subject to the same penalties, as well as forfeiture of their license.
9. Such a system, properly enforced, would see the elimination of the “unofficial” outlets—the street corners, the pubs, the flea markets, etc.—through which contraband and counterfeit cigarettes are sold, and would ensure that the legitimate distribution channel is the only place where cigarettes can be purchased. A more detailed version of our proposal for securing the legitimate distribution channel is available on our website at: www.pmintl.com/global/downloads/OBE/Confronting_contraband.pdf.

B. Intra-EU Sales of Tobacco Products

10. We also feel it would be helpful, in the context of the Committee’s inquiry, to examine the EU Commission’s recent proposals amending Directive 92/12, published in COM(2004)227 on April 2, 2004, which deal with the very complex issue of cross border sales.

11. We believe that these proposals have to be viewed from two different perspectives that are readily distinguished in addressing the internal market for excise goods, particularly cigarettes. Directive 92/12 and the proposals made by the Commission address two distinct aspects of the internal market: (1) rules applicable to manufacturers and traders on the holding and movement of excise goods for commercial purposes; and (2) rules applicable to consumers purchasing goods within the European Community. In assessing the effectiveness and efficiency of the current directive and the Commission’s proposals in relation to tobacco products, we come to very different conclusions with respect to those measures applicable to manufacturers and traders and those applicable to consumers. We think it is appropriate to view these distinct aspects of the market differently because of the unique nature of tobacco products and the tensions that need to be accommodated between public health goals pursued by the Commission and Member States in relation to these products and the desire to promote a single internal market.

12. Philip Morris International believes that the rules on the internal market for tobacco goods cannot be viewed in isolation, but must be seen in the larger context of regulations that exist and are being developed to achieve Government policy objectives to protect and grow excise revenues, to fight against fraud, and to reduce the harm caused by tobacco consumption. Indeed, we note that the Commission has acknowledged this reality in making proposals that treat cigarettes differently in relation to distance selling “on public health grounds”. We believe it is appropriate to review Directive 92/12 and the Commission’s proposals from the perspective not only of the internal market, but also in the broader context of achieving appropriate policy goals in relation to revenue protection, fraud prevention and the promotion of public health. We also believe that Directive 92/12 cannot be viewed in isolation in the framework of the Excise Duty Directives. On the contrary, we think that the discussion on, for example, indicative limits is intrinsically linked to the discussion on structures and rates (for which a review is planned for 2006). Our views seek to build a bridge to those important policy considerations and the EU Tobacco Excise Review 2006.

13. In our experience, the internal market for manufacturers is generally working well. We are able to manufacture cigarettes in any of our EU factories for any of the EU Member States, using the duty suspension procedures prescribed by the Directive, ensuring payment of the excise tax where due under EU principles. The procedures designed by the EU need to balance security and control of excise revenues with efficient and practicable operating procedures. We believe that such balance is best achieved by setting very high standards for licensed operators, whilst introducing new technology—such as the Excise Movement and Control System (EMCS)—such that these reliable operators are able to work in an efficient way. We believe that Directive 92/12 accomplished that objective and we see the proposed technical improvements to articles 7 and 10 of the Directive as sound measures to further secure that balance and to enhance the efficiency and security of the internal market and we thus fully support this part of the Commission proposals.

14. On the other hand, we believe that the internal market for consumers is not yet functioning as originally intended by the EU because the original goal of excise duty harmonization has not yet been achieved. For consumers able and willing to travel abroad, there is, depending on their country of residence, an imperfect internal market that is hampered by the inconsistency of rules and procedures applying indicative limits and the uncertainty and confusion for consumers that results from the concept of indicative limits.

15. In short, we feel that the EU rules for consumers are confusing and discriminatory. For policy makers we believe that it is appropriate today to decide, in relation to tobacco products:

— whether the promise of the internal market can be achieved at this moment in time, consistent with the necessity of preserving the policy goals in those other areas we have referenced (ie, revenue protection, fraud prevention and the promotion of public health); or

whether the objective of an internal market for consumers of tobacco products should be temporarily suspended until the duty levels on tobacco products within the EU-25 have reached a sufficient level of harmonization.

16. A truly functioning internal market requires abolishing the indicative limits—as is proposed by the EU Commission—but in all respects. In such case, the internal market should enable mail order and distance selling with payment of excise duties in the country of origin as was proposed for alcohol. However, until tobacco duty harmonization is achieved, such an approach for tobacco products could have very significant consequences that are likely to raise grave concerns for the UK in relation to its desire to protect revenue, prevent fraud and promote the reduction of tobacco consumption. If history is any guide, it will likely lead to further displacement of duty paid sales towards those countries with the lowest excise rates.\textsuperscript{17} Such inevitable displacement of duty paid sales within the EU has very significant implications for individual Member States:

1. Countries with high excise taxes would suffer substantial revenue losses as consumers could legally—and not hampered by current restrictions—buy their cigarettes where taxes are lowest.
2. Illegal cross-border sales, where a resale of product occurs in the country of destination without payment of the appropriate excise tax, would become difficult to detect and fight.
3. It would become difficult for individual Member States to achieve public health objectives, as national excise tax policy—as a key tool for revenue generation and harm reduction—would be significantly undermined.

17 Therefore, we recommend changing the current unsatisfactory situation by proposing measures aimed at substantially reducing cross-border shopping of tobacco products in the European Union until the tax levels (excise and VAT) have come to a reasonable degree of harmonization.

18. We believe that an \textit{array of technical solutions and legal measures} could be developed, which, taken as package as opposed to being used in isolation, could enable Governments to achieve effective enforcement in their objective of significantly reducing cross-border sales of tobacco products. In our view, the package of measures should cover the following four areas:

\begin{itemize}
\item \textit{Introduce clear rules for consumers}\textsuperscript{17}
The current system of \textit{indicative} limits is not clear for consumers. Some EU Ministries of Finance have indicated to us that—in their opinion—the existence of clear, simple rules, adequately communicated to consumers, in itself would help to reduce cross-border sales. Their view is that the large majority of consumers will follow \textit{unambiguous and mandatory} rules, without any active enforcement in place. This view has for instance been expressed in several Nordic countries. Changing the indicative limit into a fixed limit—until duty harmonization takes place within the EU—seems also to be the position of France’s Minister of Finance.

\item \textit{Introduce measures at retail level}
The idea is to prevent retailers from selling to “unlicensed” private individuals quantities of cigarettes that cannot normally be assumed to be for private local consumption but are more likely to be used for cross-border supply. In practice it could mean that retailers can not sell more than, for example, 200/400/800 cigarettes in a single time period (e.g. day) to a consumer—and not following this rule could lead to withdrawal of the retail license. Such a rule already exists today in Spain—albeit for a higher limit.

\item \textit{Introduce rules on unlicensed possession of excessive quantities}
The idea is to introduce a simple rule that makes it unlawful for private (“unlicensed”) individuals to possess cigarettes in excess of a certain quantity. The relevant quantity may differ near the border or elsewhere. Such rule already exists in some EU Member States requiring certain fiscal documents to transport or hold cigarettes in excess of 2,000 cigarettes (within 30 km of the State border) and 10,000 cigarettes elsewhere.

\item \textit{Introduce measures to address mail-order, including mail-order by digital means}
The idea is to require a license for sending cigarettes by mail from one country to another. As part of such license, a number of administrative measures should be implemented as part of the conditions for the license (e.g. financial bond for any applicable taxes; a quarterly tax return,

\textsuperscript{17} Although such displacement could be prevented through a full EU harmonization of tobacco excise rates, we do not believe that this is economically and politically feasible in the next decade. Just to illustrate our point: today the excise duty level per thousand cigarettes varies between Euro 16 in Latvia and Euro 268 in the UK. Although taxes in Latvia are to increase significantly over time to meet EU minimum rates of Euro 64 level by the year 2010, this will still leave a significant gap between different EU Member States.
etc). Any cigarettes sent by a non-licensed retailer would be seized. In addition, it could be made unlawful for any post office or courier service to accept for “mailing” any cigarettes shipped by any person who has not registered in the country of deposit and the country of destination.

19. The quantities of the specific limits, i.e., number of cigarettes, applicable for measures in these different areas need to be determined by the ECOFIN Council of Ministers, but should depend on the particular behavior sought to be affected. Obviously, Governments are most interested in regulating commercial, as opposed to truly individual, behaviour; and, accordingly, the rules should focus on that type of behaviour, whether undertaken by individuals or entities.

20. We feel that our proposals could clarify for consumers and the retail trade what is allowed and what not. These rules are also easier to interpret for customs officials or other law enforcement agents, who today are forced to judge whether cigarettes are carried “for own use” or “for commercial purposes”—often not a clear-cut matter. With the disappearance of borders in the Schengen area, cross-border sales are anyway difficult to monitor, indicating that a new and comprehensive approach such as the one we suggest, may be preferable. This will gain further importance after the entry into Schengen of the new EU member states.

21. We should stress that these ideas require further thought and refinement, but we hope that sharing them with the Committee now may help to highlight some areas in which progress can be made, and move the debate forward in line with key Government policy objectives to protect and grow excise revenues, to fight against fraud, as well as to improve public health.

3. **The Impact These Steps Have Had on the Level of Fraud and on Compliance Costs**

22. HMCE estimates suggest that the level of illegal products entering into the UK has stopped increasing, which represents a significant success in itself for which HMCE should be commended. However, as noted previously, the sheer scale of the problem mandates additional action. The proposals we make here are not without cost in terms of compliance. For example, our proposed licensing system would impose some additional administrative burdens on the appropriate government agency and members of the legitimate trade. However, we believe that these incremental burdens are minimal when compared to the threat posed by the smuggled and counterfeit cigarettes. In our view, the benefits for all concerned—the Government, legitimate traders and consumers—far outweigh any possible disadvantages.

Thank you for the opportunity to comment on these important issues. We would be happy to provide further input or clarification concerning our positions on the issues should the Committee deem it necessary.

9 November 2004

Memorandum submitted by the Tobacco Manufacturers’ Association

1. This submission from the Tobacco Manufacturers’ Association (TMA) represents the views of its principal member companies who are responsible for the collection of £8 billion in excise duties each year. The growth in smuggling and crossborder shopping of tobacco products seen in the UK since the early 1990s is of great concern to us and has had a detrimental effect on the profitability of operations in the UK. Since 1993 sales of UK duty paid cigarettes have fallen by almost 40% and the value of the market has fallen by 30% in real terms. This has also had serious ramifications for thousands of retailers across the country.

**The Cause and Scale of the Problem**

2. The UK experiences a high level of tobacco smuggling and crossborder shopping—amongst the highest in Western Europe. In 2002–03 HM Customs & Excise (HMC&E) estimated that 18% of cigarettes and 51% of handrolling tobacco (HRT) consumed in the UK was smuggled with crossborder shopping accounting for a further 9% and 18% respectively. Smokers are tempted to buy this product because of its low price compared to that in the legitimate UK duty paid (UKDP) market. Illegal tobacco sellers are typically charging £2.50 for 20 cigarettes and £5 for 50g of HRT, which represent savings of over £2.00 and £4.50 respectively against the cost of the price in the legitimate UK retail market. Chart 1 shows the typical price of 20 cigarettes in each of the EU Member States and shows how much those who travel abroad themselves can save through crossborder shopping.

18 British American Tobacco, Gallaher Ltd & Imperial Tobacco Ltd.
CHART 1: PRICE OF 20 CIGARETTES ACROSS THE EU—OCTOBER 2004

Source: TMA based on price, tax and exchange rate information available on 1 October 2004.

3. As well as providing huge savings for the smoker, the fact that there are around 13 million cigarette and HRT smokers in the UK means that there is a potentially large and lucrative market for criminals seeking to exploit the demand for products that consumers see as a bargain.

4. It is obvious that HMC&E face a mammoth task in identifying and halting the volumes of tobacco being smuggled into the UK via freight, cross-Channel and air routes. In 2003 UK residents made over 61.4 million visits abroad, 45 million of these were to other EU Member States—an increase of over 70% since 1993. In 2002 there were over 14.9 million freight movements through UK ports, an increase of over 56% since 1993. The recent growth in cheap flights provides further opportunities for low price tobacco to enter the UK, legally or illegally.

5. Although HMC&E seized 1.9 billion cigarettes and 258 tonnes of HRT in 2002–03 they estimate that 13.5 billion cigarettes and 4,500 tonnes of HRT were smuggled into the UK, representing a seizure rate of 12% and 6% respectively. The loss of revenue to the Treasury from tobacco smuggling in this period was estimated to be £3 billion and since the first estimates of revenue loss from smuggling were made by HMC&E in 1996, over £15 billion has been lost.

6. HMC&E claim that, based on their seizure data, the majority of smuggled product comes from outside the EU. However, we believe that HMC&E underestimate the scale of cross-Channel smuggling or “bootlegging” and also legal crossborder shopping. This is due to its seizure policy being weighted towards extra-EU container traffic and so tending to uncover large volumes (2-8 million) of cigarettes at a time. Determining the extent of bootlegging is more difficult as HMC&E must differentiate between UK citizens exercising their right to buy tobacco for personal consumption and the bootlegger. Exchanges over the past two years between the UK Government and the European Commission have shown that enforcing this distinction is hard and therefore measuring it is that much more difficult.

7. The Government has sent out confusing signals about crossborder shopping. The change made to the UK’s Minimum Indicative Levels (MILs) in October 2002, which saw the allowances for cigarettes increase from 800 to 3,200 and for HRT increase from 1kg to 3kg, can only have helped further encourage crossborder shopping. While the decision in April 2004 to apply restrictions on the allowances available for travellers to some of the low tax/low price countries that were joining the EU in May 2004 demonstrates that there is concern about the possibility of further growth in crossborder shopping and bootlegging.

8. Although it is correct for HMC&E to concentrate on the illegal importation of tobacco into the UK, we believe that the level of legitimate crossborder shopping is also having serious consequences for the Government’s revenue and consumption objectives. In 2002–03 HMC&E estimate that 7 billion cigarettes and around 1,600 tonnes of HRT were legally brought into the UK, representing a revenue loss to the UK of £1.4 billion. The first estimate of revenue loss as a result of crossborder shopping was made in 1995 and was put at £50 million, since then almost £4.5 billion has been lost.

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22 The illegal sale in the UK of tobacco goods that have been bought, duty paid, in another EU Member State.
9. The TMA’s estimate (see Chart 2) for the total volume of the market that evades UK duty through all forms of smuggling and crossborder shopping does not differ markedly from HMC&E’s. For 2003 we estimated a level of non-UK duty paid (NUKDP) for cigarettes and HRT of 28% and 72% respectively, which is comparable to HMC&E’s estimate for 2002/3 of 27% and 69%. Unlike HMC&E we are not able to determine how much of this NUKDP volume is smuggled.

10. Our analysis, which is based on the analysis of cigarette packs found in regular large-scale pack collections and face-to-face consumer interviews, does not provide us with any insight as to whether they are legal or illegal imports. However, we are able to determine the product’s intended country of sale and whether it is genuine or counterfeit. Counterfeit cigarettes are a recent development in the UK and although small in volume—we estimate around 2 billion cigarettes out of the total UK consumption of 74 billion in 2003 were counterfeit—it is a growing problem.

CHART 2: TMA ESTIMATE OF UK CIGARETTE CONSUMPTION IN 2003

UK Duty Paid
53.5 bn (72%)

Non-UK Duty Paid
20.5 bn (28%)

Intra-EU
60%

Extra-EU
20%

Duty-Free
10%

Counterfeit
10%

Source: TMA

11. The high volume of Intra-EU product found in our surveys leads us to believe that the level of crossborder shopping and bootlegging is higher than HMC&E believe. We believe that the majority of the 7,200 tonnes of non-UK duty paid HRT that we estimate was consumed in the UK in 2003—72% of total HRT consumption—originates from other EU Member States.

HMC&E’S STRATEGY

12. Since 2001, when the measures outlined in the Tackling Tobacco Smuggling (TTS) strategy document started to come on stream, HMC&E appear to have halted the growth in the level of smuggling. This is very much welcomed by the TMA. When HMC&E release data showing their estimates for 2003–04 around the time of the forthcoming Pre-Budget Report, we hope to see the level of smuggling fall—for the first time—below the level reported at the beginning of the strategy.

13. However, it must be stressed that this strategy has been implemented during a period of fiscal restraint. It is no coincidence that cigarette smuggling took off in the UK following a prolonged period of above inflation tobacco duty increases and only levelled off when these ceased.

14. Two of the key markers for measuring the success of the TTS strategy—an increase in the price of cigarettes on the black market and the volume of product seized—show that HMC&E are not achieving the success they hoped for. With the introduction of scanners and the increase in manpower, HMC&E aimed to seize 5 billion cigarettes in 2002–03 but instead they seized 1.9 billion, still an enormous amount, but less than that seized in previous years. Part of the reason for this “failure” may be that the volumes found in seizures are now lower as smugglers instead dispatch a greater number of smaller loads thus minimising their chances of losing the whole volume. Ideally we would like HMC&E to be able to scan each and every one of the freight movements into the UK, but this is clearly impossible. However, more scanners and manpower would enable HMC&E to increase their detection rate and serve as a further deterrent.

15. The TTS strategy has also had little effect on the price charged for cigarettes on the black market. This remains, on average, £2.50 per pack of 20 and has remained largely unchanged over the last five years.
16. We believe that all this demonstrates that the drive against tobacco smuggling using enforcement measures alone is approaching its end. The long-term target to reduce cigarette smuggling to no more than 13% by 2007-0825 would still represent a high and unacceptable level of criminality. In addition there is no specific target to reduce HRT smuggling, nor is there any suggestion as to what level of crossborder shopping the Government is willing to accept.

17. As well as the targets to reduce smuggling and safeguard revenue the Government is committed to reducing tobacco consumption and smoking prevalence. While UKDP consumption has fallen the large volume of NUKDP product consumed in the UK has seen no change in overall tobacco consumption (see Chart 3) or smoking prevalence in the last 10 years. Indeed one of the Office for National Statistics’ most recent statements26 on the smoking habits of adults in Great Britain was headlined “Cigarette Smoking: Stable now for a decade.”

CHART 3: TMA ESTIMATE OF TOTAL UK TOBACCO CONSUMPTION 1993—2003

Source: TMA. Graph shows cigarette and cigarette equivalent of HRT consumption.

TMA ACTION

18. The growth in smuggling and crossborder shopping has adversely affected the UK operations of our member companies. The UK duty paid cigarette market is 40% smaller than it was 10 years ago while the value of this market is 30% lower in real terms; this has had a “knock-on” effect on the retail network. Surveys conducted by the Tobacco Alliance have shown that many retailers have cut jobs as a result of falling sales caused by the high level of NUKDP consumption and many have been forced to close.

19. The long-standing level of co-operation between the TMA, our member companies and HMC&E to combat smuggling has recently been formalised through a series of Memoranda of Understanding.27 The TMA’s member companies have themselves continued to take effective steps to reduce the supply of genuine product that may become available to smugglers. The success of these measures has been noted by HMC&E who, based on the increasing volume of counterfeit product found in their seizures, report that smugglers have turned to counterfeit product to satisfy consumer demand. In response TMA member companies have invested significant resources into initiatives with customs’ authorities around the world to identify likely sources of counterfeit production and close them down. We welcome HMC&E’s intention to develop a specific policy to deal with counterfeit cigarettes in the UK and we look forward to its implementation.

THE SOLUTION

20. We believe that despite the enforcement policies of HMC&E and the measure of success that TTS has delivered, the UK’s high level of NUKDP tobacco consumption will continue unless the fundamental reason for this unacceptable situation—the high level of UK tobacco tax—is addressed.

21. The TMA believe that the level of smuggling, bootlegging and crossborder shopping can be reduced through two complementary measures. The first is for HMC&E to be provided with increased resources, both scanners and manpower, to tackle large-scale container smuggling. The second, and in our view most important, is to realign the level of UK tobacco taxes to eliminate the incentives for bootlegging and

crossborder shopping. We do not believe that the necessary tax cuts would see any significant change in the level of overall tobacco consumption or in the Treasury’s revenue take, they would simply move the majority of NUKDP consumption back to the UKDP sector.

22. When we met with the Economic Secretary to the Treasury (EST) in February 2004 we made the following recommendations to address the problem of tobacco smuggling and crossborder shopping:

— Return UK price differentials with Europe to mid-1990 levels—this would require tax reductions of £1 for 20 cigarettes and £4 for 50g HRT
— Limit personal imports of cigarettes from the new EU Member States to 200 cigarettes

23. To address the continuing problems of tobacco smuggling and crossborder shopping we make the same recommendation regarding tax reductions to the Committee as we made to the EST. We also recommend that the restrictions applied to the “new” EU Member States be renewed when the Government reconsiders them in Spring 2005.

8 November 2000

Memorandum submitted by HM Customs and Excise

1. The Government is committed to tackling tax fraud in order to protect the revenue required for investment in public services, to protect legitimate businesses, and to protect society from organised crime.

2. Since 2000 HM Customs and Excise (Customs) has taken a new strategic approach towards tackling revenue losses, based on the achievement of outcomes which have a direct and measurable impact on the problems the Government is trying to solve. The approach has a number of key components:

— analysis: understanding of the nature of any revenue loss problem is an important first step in measuring its size, analysing the trends in its development, and ensuring the effective deployment of strategies to tackle them;
— estimates: it is also important to establish a robust baseline of the size of a problem against which targets can be set and monitored. Estimates of the revenue loss problems facing the indirect tax regimes are now published on a routine basis wherever possible;
— targets: the new approach has seen a switch from a focus on outputs to a balanced combination of activities designed to hit outcome targets. Each strategy needs to be geared towards a clear outcome in terms of its impact on the scale of the problem, so that the appropriate operational responses can be drawn up to meet those targets, and so the effectiveness of the strategy can be routinely measured;
— responses: each strategy must feature a range of measures which apply proportionate and well-targeted pressure at all levels of the problem. In some cases, where losses occur because of fundamental weaknesses in the way the tax is controlled, the first step must be to establish a sustainable control regime; and
— monitoring: performance in meeting the key outcome based targets is measured and reported on a regular basis, accompanied where relevant by operational data which shows progress in individual areas. The development of the problem must also be carefully monitored so that operational responses can be adapted accordingly, and new measures brought forward.

3. This memorandum covers fraud in the tobacco, alcohol and oils sectors. It describes the steps taken to reduce the levels of fraud in these sectors, the impact these have had on the level of fraud, and on the compliance costs of businesses in those sectors.

Measuring Excise Fraud

4. Measuring the scale of, and trends in, excise fraud is inherently problematic because of the difficulties in estimating total consumption from survey data. Customs first published an estimate of the scale of excise fraud for spirits, cigarettes and hydrocarbon oils, along with an explanation of our methodology, in 2001.\(^{28}\) We have updated our estimates and explained developments in our methodology annually since then. A complete set of the latest estimates are contained within the Customs’ paper “Measuring and Tackling Indirect Tax Losses” published at the time of Pre-Budget report (PBR) 2003, which is submitted here as part of our evidence to the Committee. The UK government is the first to produce systematic estimates for fraud in this way.

TACKLING TOBACCO SMUGGLING

5. Customs’ Public Service Agreement (PSA) target for the 2003–04 to 2005–06 period is to reduce the illicit cigarette market to 17% by 2005–06. The joint Revenue and Customs PSA target for the years 2005–06 to 2007–08 extends this target to reduce the illicit market to 13% by 2007–08. We have made good progress towards our targets. Since the introduction of the Tackling Tobacco Smuggling Strategy in 2000 we have reduced the illicit market to little more than half that projected for 2002–03 in the absence of a strategy—see Table 1 below. At this intermediate stage, we believe we are on course to meet our target to reduce the illicit market to 17% by 2005–06.

TABLE 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Market share</th>
<th>Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000/01</td>
<td>20</td>
<td>17</td>
</tr>
<tr>
<td>2001/02</td>
<td>25</td>
<td>17</td>
</tr>
<tr>
<td>2002/03</td>
<td>30</td>
<td>13</td>
</tr>
<tr>
<td>2003/04</td>
<td>35</td>
<td>13</td>
</tr>
<tr>
<td>2004/05</td>
<td>40</td>
<td>13</td>
</tr>
<tr>
<td>2005/06</td>
<td>45</td>
<td>13</td>
</tr>
</tbody>
</table>

MEASURING THE TOBACCO GAP

6. Estimates of consumption of cigarettes and HRT are calculated using the trend in the population and the trends in smoking prevalence for these products. The prevalence rates are taken from the General Household Survey (GHS), and from 1999 are combined with those from the Omnibus survey. An allowance is made for underreporting by taking a base time when there is considered to be no smuggling and applying the trend. For cigarettes the base time is 1992, and for HRT 1984.

7. UK duty paid consumption is taken directly from Customs’ clearance data, which records the volumes of cigarettes and HRT upon which duty has been paid. Because duty on cigarettes is paid when the products are removed from excise warehouses, rather than when they are sold for consumption, the monthly data on clearances are smoothed to remove the effects of “forestalling”, ie the stockpiling by the trade of “cheaper” products in advance of an anticipated duty increase.

8. EU duty paid cross-border shopping is estimated using the International Passenger Survey (IPS). The expenditures for cigarettes and HRT are converted into volume using prices of EU countries from which the products were purchased. The duty free and on board ferry sales cigarette volumes are provided by tobacco companies.

9. Our latest estimates, published in Pre-Budget Report (PBR) 2003 suggest that some £2.4 billion\(^{29}\) is lost annually due to tobacco smuggling. At the time of the last PBR, GHS results for 2002–03 were not available so the published estimate for that year is provisional. Updated estimates will be published in the forthcoming PBR.

NATURE OF THE FRAUD

10. The majority by volume of tobacco fraud detected by Customs involves large-scale organised smuggling of large quantities (typically between one to 8 million sticks at a time) in freight. These cigarettes are generally sourced from outside the EU and will carry little or no tax. Seizures of large-scale freight-smuggled cigarettes very rarely involve stock that has had duty paid anywhere within the EU. A typical smuggling operation will involve a number of independent groups working as links in a chain to get illicit product from source to the UK smoker. Each organisation involved in moving product along the illicit

\(^{29}\) In fact this is the figure for cigarette smuggling only in 2002–03—a further £580 million was lost due to the smuggling of hand rolled tobacco.
distribution chain will expect to profit from its part of the process. Typically there will be at least four links in the supply chain. Genuine products sourced in global wholesale markets may be obtained for as little as 70p per pack (significantly less still for counterfeit). The typical UK illicit street price is around £2.50 per pack.

11. At the lower end of the smuggled market more product is sourced EU duty paid and brought into the UK by large gangs of air passengers working as “runners” for organised groups.

12. When Customs’ strategy to tackle this problem began in 2000 the majority of product seized was of UK manufactured origin. Since then the preponderance of UK manufactured product has fallen steadily and an increasing proportion is counterfeit. In 2002–03 41% of seized cigarettes were counterfeit compared to 15% in the previous year.

**Smuggling Via the Internet**

13. For many years smugglers have used the international postal system to try to circumvent UK Customs’ controls on drugs, obscene material and excise goods. However the smuggling of cigarettes through the post is a relatively recent phenomenon. Cigarette seizures in postal depots increased significantly alongside the growth in use of the internet and the increasing numbers of websites illegally selling cheap cigarettes to UK customers. In 2002–03 over 13 million cigarettes were seized at postal depots. We have had some success in shutting down these sites but, given the nature of the internet and the ease with which sites can be set up and removed, it has not proved possible to eradicate the problem altogether.

**Tackling Tobacco Smuggling Strategy**

14. The Tackling Tobacco Smuggling Strategy (TTS) was launched in 2000 against a background of increasing growth in tobacco smuggling which, it is estimated, would have seen the illicit market grow to some 34% by 2002–03 if no action had been taken.

15. The strategy is based on attacking the economic profitability and risk/reward ratio of smuggling through an end-to-end strategy of disruption. It involves the suppression of supply of UK manufactured product, legislative change, the use of new technology, and increased resources both at the ports, overseas and inland. Taken together this has reduced the profits available to smugglers by driving up their costs and has increased the chance of their getting caught.

16. Prior to the introduction of TTS Customs adopted a tactical approach where success was defined in terms of outputs, such as increasing numbers of seizures. This approach did not provide the best focus on how we could achieve the desired outcome of reducing the size of the illicit market. TTS allowed us to refocus our activities in this area, and was funded by an extra £209 million over three years, which we have invested in increased resources and in new technology.

**Increased resources**

17. We have increased front-line and investigative staff by almost 1000 allowing better detection through improved intelligence. This has been successful both at the frontier and inland. We have also further developed our network of officers based overseas because of the crucial role they have to play, particularly in the Far East and Eastern Europe. The officers work closely with local enforcement agencies to detect tobacco (counterfeit or otherwise) targeted on the UK by international criminal gangs and provide tactical and profile intelligence enabling better targeting by detection and investigation staff.

**Investment in new technology**

18. We have installed a national network of x-ray scanners to detect high volume cigarette smuggling in freight. Since their introduction in 2001, these have detected over 700 million smuggled cigarettes and 45 tonnes of Hand Rolling Tobacco. In addition to their contribution to the tobacco strategy the scanners have also detected over 450 kg of Heroin, almost 600 kg of Cocaine and identified 1,600 illegal immigrants.

**Legislation**

19. The new legislative measures introduced “UK Duty Paid” fiscal marks on tobacco products to help prevent, detect and deter the handling, distribution, sale and purchase of smuggled tobacco. The introduction of the mark was accompanied by a range of new offences and penalties designed to crack down on the sale of illicit tobacco. In order more clearly to distinguish between smugglers and genuine shoppers, the guide levels for cigarettes and Hand Rolling Tobacco (HRT) were increased in October 2002 from 800 to 3,200 and from 1 kg to 3 kg respectively. These amounts represent a generous six months supply for the average smoker, and we are not aware of any other EU Member State having higher guide levels.
20. Eight of the Member States that joined the EU on 1 May 2004 were unable to raise their rates of tobacco excise duty to EU minimum levels so it was agreed that they should be granted a transitional period in which to do so. It was also agreed that until these rates are reached, existing Member States should be allowed to impose restrictions on the import of cigarettes and some other tobacco products bought in those countries for own use. Once the minimum rates are reached, travellers from these countries will enjoy the same benefits as those from countries already complying. The Member States to which the restrictions apply are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

Suppressing illicit supply in co-operation with the tobacco manufacturers

21. Customs now work very closely with tobacco manufacturers to apply control over their export markets. This is our principal means of applying pressure to the source of illicit product, and is achieved by targeting countries where supply has risen quickly and where there are questions about the ability of the domestic market to sustain the level of imports they are experiencing.

23. All three major UK manufacturers have now signed Memoranda of Understanding with Customs and have said that they want to do all they can to help Customs tackle smuggling. Co-operation at present is generally good with seizures of genuine cigarettes continuing to fall, both in volume and as a percentage of overall seizures.

24. Our work with the tobacco manufacturers has successfully restricted the availability of genuine tobacco products to smugglers, and as a result the smugglers have turned to counterfeit supplies of cigarettes. As stated above, 41% of cigarettes seized in 2002–03 were counterfeit compared to 15% the previous year. These fake cigarettes are completely unregulated and carry potentially increased health risks, and we continue to work closely with the Department of Health on these issues. This changing pattern in smuggling also demonstrates the ruthlessness of the criminals involved and their organised criminality.

Publicity

25. Customs has taken a proactive approach to publicity and in the course of the strategy has run a £3 million publicity campaign to remind would-be smugglers of the penalties for being caught, and to discourage ordinary members of the public from buying the illicit goods used to fund organised criminal networks.

Strategy Review and Refreshment

26. Customs monitors performance against all our strategies and we seek to adjust and enhance our approach both in anticipation of and in response to changing patterns of behaviour as the fraudsters react to our efforts. In the case of tobacco this has meant

— taking further measures to restrict the source of cigarettes for smugglers, through our work with the tobacco manufacturers and by working with overseas agencies to target the source countries for counterfeit product;
— continued targeting of organized criminals gangs responsible for the vast majority of smuggling volumes;
— making a long term impact on inland distribution and sales networks; and,
— undermining smoker’s confidence in “cheap cigarettes” by highlighting the greater risk of counterfeit product.

27. With the raised profile, publicity and increased success in tackling cross-channel smuggling, we have seen an increase in air-passenger smuggling. Deployments to tackle air-passenger smuggling need to be proportionate to the level of sector threat and its relative importance in delivering the PSA target. To tackle this growth in air smuggling we intend placing greater emphasis on inveterate offenders who are part of organised gangs.

The Impact These Steps have had on the Level of Tobacco Fraud and on Compliance

28. To measure delivery of the strategy, key targets were set for the percentage of the market accounted for by smuggled cigarettes for each year up to 2005–06. Since the introduction of TTS we have managed to slow, stabilise and reverse the growth in tobacco smuggling, reducing the illicit cigarette market share to 18% in 2002–03, against a target of 21%—see Table B below. The illicit market share of smuggled cigarettes for 2003–04 will be published at PBR.
TABLE B

<table>
<thead>
<tr>
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<tr>
<td>Smuggled Share Target (%)</td>
<td>21</td>
<td>22</td>
<td>21</td>
<td>20</td>
<td>18</td>
<td>17</td>
</tr>
<tr>
<td>Smuggled Share Actual (%)</td>
<td>21</td>
<td>20</td>
<td>18* nya</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

*Estimated using Omnibus data, may be subject to revision.

Cigarette Seizures

29. The volume of illicit cigarettes targeted on the UK has fallen sharply from a peak of over 18.5 billion sticks in 2000–01. As this has fallen, so the number of cigarettes seized, year on year, has also fallen. Large-scale commercial smuggling continues to account for the vast majority of seizures as shown by the chart below. However, increasingly smuggled loads are of mixed brands and are often well concealed. Air seizures have grown as a proportion of total seizures most probably as a consequence of a move to air smuggling by lower-level smuggling gangs that previously would have operated on the cross-Channel passenger routes. Inland seizures have reduced again this year, although fiscal marks appear to continue to be effective at preventing illicit cigarettes from penetrating the legitimate retail market.

Cigarette seizures by mode 2002/03

[Diagram showing cigarette seizures by mode]

Overseas figure represents cigarettes seized en route to the UK in cooperation with overseas agencies

Other Indicators

30. The first two years of the strategy saw an 81% reduction in all forms of cross-Channel passenger smuggling, representing a decrease in the cost of cross-Channel smuggling from £1.55 billion in 2000 to £290 million in 2002, and substantially exceeding the 10% year on year target set in 2000. In the same period we have seen a 42% rise in legal cross-border shopping for alcohol and tobacco, indicating that we have struck a good balance between protecting the rights of the travelling public to shop, whilst clamping down on smugglers.

31. In the first three years of the strategy our activity has

— reduced the number of cigarettes successfully smuggled into the country by 2.5 billion sticks a year;
— disrupted 190 tobacco gangs;
— doubled the average length of sentences, which reflects the focus on major criminal gangs; and,
— raised receipts and protected some £3 billion of revenue.

32. During 2002–03, we:

— seized 1.9 billion cigarettes—1.2 billion in the UK and 641 million en route to the UK—making a total of more than 7 billion cigarettes seized during the first phase of the strategy;
— seized 400 million cigarettes by using our fleet of x-ray scanners, 50% of those seized at UK freight seaports.
33. Specific results are as follows:

**PROSECUTIONS**

<table>
<thead>
<tr>
<th></th>
<th>2000–01</th>
<th>2001–02</th>
<th>2002–03</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of People sentenced</td>
<td>884</td>
<td>431</td>
<td>106</td>
</tr>
<tr>
<td>Average Sentence</td>
<td>13 Months</td>
<td>17 months</td>
<td>27 Months</td>
</tr>
</tbody>
</table>

**VEHICLE SEIZURES**

<table>
<thead>
<tr>
<th></th>
<th>2000–01</th>
<th>2001–02</th>
<th>2002–03</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vehicles Seized*</td>
<td>10,219</td>
<td>11,064</td>
<td>8,616</td>
</tr>
</tbody>
</table>

*Vehicles seized for all offences.

**GANGS DISRUPTED**

<table>
<thead>
<tr>
<th></th>
<th>2000–01</th>
<th>2001–02</th>
<th>2002–03</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gangs Disrupted</td>
<td>43</td>
<td>60</td>
<td>87</td>
</tr>
</tbody>
</table>

**TACKLING OILS FRAUD**

34. Customs’ PSA target for the period 2003–04 to 2005–06 is to reduce the illicit diesel market in England, Scotland and Wales to no more than 2% by 31 March 2006. The joint Revenue and Customs PSA target for the period 2005–06 to 2007–08 is to ensure that the illicit market for all road fuels is no more than 2% by 2007–08. We also have a supporting target to maintain the upward trend in the delivery of legitimate road fuel in Northern Ireland, established in 2001. As a result of Customs’ strategic approach the level of diesel fraud reduced by almost one third between 2000 and 2002, and deliveries of legitimate road fuel into Northern Ireland were up 7% in 2002—the second successive annual increase following five years of decline.

![Illicit market share for GB DERV with and without the strategy](chart.png)

**MEASURING THE OILS GAP**

**Great Britain (GB)**

35. Consumption is measured differently for oils than alcohol or tobacco. Data published by the Department for Transport (DfT) on total vehicle kilometres travelled by vehicle type are divided by fuel efficiency figures to produce total fuel consumption. This is done separately for diesel and petrol vehicles.

36. Duty paid consumption is taken from Department of Trade and Industry (DTI) deliveries data, which give a measure of the legitimate supply of fuel by type, and UK country. Customs’ clearance data are not used as they do not split between GB and Northern Ireland (NI).

37. Cross border shopping estimates are based on a 2003, Customs sponsored, survey of hauliers making international trips.
38. Our latest published estimates (for the year to 31 December 2002 and published in PBR03) suggest that some £650 million is lost annually due to oils fraud in GB.

39. Customs publish estimates for non-UK duty paid petrol consumption in GB but as this is very small (under 2%) and there is no operational evidence of a petrol fraud problem Customs do not attempt to disaggregate this figure between fraud and legitimate cross-border purchases.

Northern Ireland (NI)

40. For Northern Ireland there is limited data on distances travelled, therefore a different approach has to be applied. Customs assume that negligible oils fraud and smuggling took place in NI pre-1997 when the duty rates were low in comparison with the Republic of Ireland (RoI). Delivery data for 1996 is, therefore, assumed to represent the total consumption for that year and this is the index point of the time series. The trend from this point is calculated by multiplying the change in fuel consumption per vehicle measured in GB by change in the NI vehicle population. When applied to the index point this gives an estimate of the total consumption.

41. Because of the difficulties in conducting a survey around the Irish land border, which is some 350 miles long and has over 500 crossing points, it is not possible to estimate the quantity of oils legitimately supplied into vehicles in the RoI and driven into NI for consumption in those vehicles (cross-border shopping). Therefore, rather than reporting the illicit share, Customs reports the proportion of the market that is non-UK duty paid, without distinguishing between illicit and legitimate cross-border shopping. For Northern Ireland, our latest published estimate suggests £230 million is lost annually due to oil consumption which is non-UK duty paid.

Nature of the Fraud

42. In Great Britain, Oils fraud revenue loss is principally a result of rebated fuels fraud—the laundering, mixing and misuse of red diesel and kerosene, and some oils used for industrial processes known as “tied” oils. Set out below are the key fuels that are involved in these frauds.

— Red Diesel—Carries a lower rate of duty, (4.22p per litre, compared with 47.1p for ultra low sulphur diesel (ULSD)) and is for use in heating and off road vehicles, such as farm machinery. A chemical marker and a red dye are added to identify it as a fuel only to be used in off-road vehicles.

— Kerosene—Also known as paraffin, it carries no tax when it is used for running domestic heating systems. It is chemically marked, and is now dyed yellow following the introduction of a Euromarker.

— “Tied” Oils—Also known as technical oils or base oils, this range of oils carry no tax when used for specific industrial purposes such as anti-rusting agents or lubrication oils and are duty free.

43. In addition to the fraud types above Northern Ireland has the problem of cross-border smuggling, where duty-paid fuel purchased in the Republic of Ireland is brought into Northern Ireland for re-sale, exploiting cross-border price differentials.

44. This exploitation of duty differentials, whether between UK and Irish fuels or domestically sourced rebated fuels and road fuels, provides the incentive behind all oils fraud. Given that fuel accounts for approximately 30% of the overheads for a business in the road transport sector (such as a coach, taxi or haulage company) the use of illicit fuel in a competitive market can offer a lucrative option for undercutting rival firms. With 50% of all diesel being used in HGVs the revenue effects for the Exchequer of any widespread misuse problem are clear.

45. The main fraud types are:

— laundering—the treatment of rebated and duty-free fuels with chemicals to remove their markers and dyes and make identification of use as a road fuel harder;

— mixing—combining rebated and duty-free oils to make an illegal road fuel or to dilute road diesel; and

— misuse—illegally using unadulterated rebated and duty-free fuels in road vehicles.

46. Although low-level and straightforward private and commercial use of rebated product in on-road vehicles has long occurred, the particular and growing threat has been the commercial scale supply of adulterated product, typically to large-scale commercial users of fuel.

47. The large-scale supply of the illicit market, particularly through laundering plants, is organised by criminal gangs producing millions of litres per year. The infrastructure required to buy, process, transport and sell such volumes of illegal fuel is only at the disposal of serious, organised criminality.
UK OILS STRATEGY

48. Our comprehensive strategy to achieve our PSA targets is focused on stopping large-scale criminal and commercial fraud by combining law enforcement action centred upon the large-scale supply and use of illicit fuel with a better control of the sale and distribution of red diesel, kerosene and “tied” oils. We have been given additional resources to deliver this outcome.

Legislation

49. Customs launched the oils fraud strategy in September 2002 introducing preventative controls higher up the supply chain and improved targeting of potential misuse. At its heart was the introduction of a control regime for suppliers of rebated fuels (the Registered Dealers in Controlled Oils (RDCO) scheme) which required all businesses selling them to be authorised by Customs, to exercise a duty of care when selling those fuels, and to record information on their sales and provide that data to Customs monthly.

Increased resources

50. The strategy also provided for extra officers, including Road Fuel Testing Unit (RFTU) staff to tackle commercial fraud, investigators to tackle the gangs behind the large-scale supply of the illicit market, and a new Oils Central Co-ordination Team to guide and co-ordinate all our operational responses to oils frauds.

51. Underpinning this was investment in a new testing technology and markers better to prevent and identify fraud, a national publicity campaign, and tougher sanctions. The strategy also introduced a new “Euromarker” to be applied to all rebated gas oils and kerosene in the EU to help identify fraud.

Priorities

52. Customs’ priorities in the UK Oils Strategy are:
   — to ensure compliance with the RDCO scheme so that it is increasingly difficult for fraudsters to get hold of rebated fuels to misuse, mix or launder;
   — to crack down on the large-scale illicit supply of illegal fuel by those laundering mixing or smuggling fuel;
   — to bear down on commercial fraud where businesses use illegal fuel as part of their business activities;
   — to maintain visible deterrence against private misuse of rebated fuels through increased challenge activity;
   — to maximise the intelligence available to target officers as effectively as possible using both internal and external data, information and intelligence;
   — to use the full array of sanctions at our disposal when we detect those engaged in the illicit supply chain or commercial scale misuse—including vehicle seizure, duty assessments, and prosecution in such mix as is necessary to recover lost revenues and prevent fraud recurring.

53. In Northern Ireland there is cross-border smuggling as well as rebated fuels fraud. In addition to implementing the UK Oils Strategy, Customs also deployed increased resources into Northern Ireland (from 25 officers in April 2000 up to up to 160 in January 2001) and led a multi-agency approach through the Organised Crime Task Force (OCTF) to maximise the impact of Government intervention in the whole road fuel sector.

IMPACT OF STRATEGY ON LEVELS OF OILS FRAUD AND ON COMPLIANCE

54. As a result of Customs’ strategic approach the level of diesel fraud on the British mainland has reduced by almost one third between 2000 and 2002, and deliveries of legitimate road fuel into Northern Ireland were up 7% in 2002—the second successive annual increase following five years of decline.

55. This has been achieved by increases in the pressure Customs exert on oils fraudsters, as shown in the table below. In particular Customs have increased:
   — the number of vehicles challenged from around 17,000 in 2001–02 to nearly 30,000 in 2002–03—up 80%;
   — the number of detections from around 3,500 in 2001–02 to 4,000 in 2002–03—up 18%;
   — the average value of each detection from £2,483 in 2001–02 to £3,337 in 2002–2003—up 34%;
   — the number of laundering plants from 38 in 2001–02 to 46 in 2002–03—up 21%; and
   — the value of assessments raised from £8.3 million in 2001–02 to £13.2 million in 2002–03—up 59%.
<table>
<thead>
<tr>
<th></th>
<th>2000–01</th>
<th>2001–02</th>
<th>2002–03</th>
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</thead>
<tbody>
<tr>
<td><strong>Vehicles</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vehicles challenged</td>
<td>20,861</td>
<td>16,313</td>
<td>29,302</td>
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<tr>
<td>Vehicles detected</td>
<td>2,295</td>
<td>3,342</td>
<td>3,956</td>
</tr>
<tr>
<td><strong>Laundering plants</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total disrupted</td>
<td>20</td>
<td>38</td>
<td>46</td>
</tr>
<tr>
<td>Great Britain</td>
<td>3</td>
<td>30</td>
<td>25</td>
</tr>
<tr>
<td>Northern Ireland</td>
<td>17</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td><strong>Gangs disrupted</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total disrupted</td>
<td>7</td>
<td>19</td>
<td>14</td>
</tr>
<tr>
<td>Great Britain</td>
<td>5</td>
<td>12</td>
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</tr>
<tr>
<td>Northern Ireland</td>
<td>2</td>
<td>7</td>
<td>1</td>
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<tr>
<td><strong>Assessments</strong></td>
<td>£6.1 million</td>
<td>£8.3 million</td>
<td>£13.2 million</td>
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<tr>
<td><strong>Prosecution figures</strong></td>
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<tr>
<td>(Great Britain)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>4</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>Number convictions</td>
<td>4</td>
<td>9</td>
<td>8</td>
</tr>
<tr>
<td>Average sentence</td>
<td>21 months</td>
<td>14 months</td>
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<tr>
<td>Confiscation orders</td>
<td>£143,000</td>
<td>£660,000</td>
<td>£374,000</td>
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<td><strong>Prosecution figures</strong></td>
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<tr>
<td>(Northern Ireland)</td>
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<td>Number convictions</td>
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<td>15</td>
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</tr>
<tr>
<td>Average sentence</td>
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<tr>
<td>Confiscation orders</td>
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</table>

**Compliance Costs**

56. Prior to introducing the UK Oils Strategy, and as part of our regulatory impact assessment, Customs consulted with the trade about the costs of the RDCO scheme. Responses to the consultations were varied, with little detail provided regarding the costs likely to be incurred as a result of implementing the proposals, and—where respondents did try to estimate the additional costs—considerable variation between their estimates.

57. For the RDCO scheme estimates of set-up costs ranged from £15,000 to £40,000, with estimates of ongoing costs ranging from £3,000 to £60,000 pa. Estimated costs of the tied oils scheme were much less (maximums of £5,000 set-up costs and £6,000 pa ongoing costs).

58. The variety of estimated costs from affected businesses (and the relatively small number of estimates offered) made it difficult to quantify the overall impact on businesses accurately. However, Customs’ own analysis indicated that costs were likely to fall towards the bottom of the range for tied oils. Costs may therefore be less in practice than those estimated, and we have just started a post implementation review of the RDCO scheme looking at compliance costs for registered distributors. We will be inviting the major trade bodies to contribute to this review.

59. In addition, Customs exercised a “light-touch period” in the first year of the RDCO scheme with an emphasis on educating and helping the trade comply with their obligations. In May 2004 a Business Needs Survey was conducted across a representative sample of the RDCO population. The response from the trade indicated they welcomed this approach with visits by Customs being well received by almost all those surveyed.

**Tackling Alcohol Fraud**

60. The joint PSA for HM Revenue and Customs for the period 2005–06 to 2007–08 includes a target to reduce spirits fraud by half by 2007–08.

**Measuring the Alcohol Gap**

**Spirits**

61. Spirits consumption is estimated by combining on-licence consumption from the Family Expenditure Survey (FES) with off-licence consumption from the National Food Survey (NFS). Since 2001–02 FES and NFS have been combined into EFS (Expenditure and Food Survey) but ONS and DEFRA are still responsible for publishing the FES and NFS equivalent data respectively.
62. Household surveys are typically characterised by under-reporting for alcohol consumption. In order to overcome this, Customs assume that in 1992 there was minimal smuggling and cross-border shopping and that overall consumption in that year was equal to UK duty paid consumption and legitimate duty free purchases. This assumption was informed by the expert opinion of those involved in assuring the alcohol regime at the time. This produces a baseline for consumption, and estimates for later years are produced by applying the trend in consumption observed from the surveys.

63. UK duty paid consumption is taken directly from Customs’ clearance data, which records the volumes of spirits upon which duty has been paid.

64. EU duty paid cross-border shopping is estimated using the International Passenger Survey (IPS). The expenditure for spirits is converted into volumes using French prices.

65. Our latest published estimates covering the year 2001–02 were published in December 2003. Updated estimates, including for 2002–03, will be published alongside this year’s Pre-Budget Report. The latest figures will also provide a range, in accordance with the National Audit Office’s recommendations concerning the uncertainty inherent in using survey data to estimate alcohol consumption.

66. The published results produce a trend and scale of fraud that are disputed by the industry. They have proposed an alternative methodology. Extensive discussions have been held between the trade and Customs on this point, and in March the National Audit Office (NAO) produced a memorandum for the Public Accounts Committee that examined both methodologies and offered the view that “there is uncertainty inherent in basing an estimate of spirits consumption on survey data” but also that “both methods were seen by professional statisticians as equally acceptable”. The NAO also highlighted that the methodologies differed critically in the choice of survey used to estimate the level of spirits consumption. As part of this process the NAO welcomed the offer of the Office for National Statistics to examine the datasets used, and provide a view on the most appropriate, and revisit one element of the NAO work on confidence intervals to describe the uncertainty in the estimates. The outcome of this review has not yet been published.

67. In addition the memorandum highlighted the uncertainty involved in using survey data to estimate consumption of alcohol, and the consequent effect on the uncertainty in the fraud estimates. This led the PAC to ask Customs to publish an indication of this uncertainty alongside estimates of levels of fraud. This will be done in the report due to be published alongside the next Pre-Budget Report.

**Beer and Wine**

68. “Measuring indirect tax fraud” highlighted the difficulties associated with using a top-down gap analysis to produce estimates of the scale of the illicit market in beer and wine. Over and above cross-Channel passenger smuggling (which represents only a proportion of revenue losses and has previously been estimated using a bespoke survey) it has not been possible to estimate the overall size of this fraud using our established gap methodology. A comparison of UK duty paid consumption with estimates of total consumption does not generate meaningful results. One reason for this could be that we are measuring something relatively small within a large market.

69. We continue to explore alternative methods to estimate the overall scale of beer and wine fraud. Although a robust quantification of the problem is not yet possible, the available operational evidence gives no clear indication that revenue losses resulting from beer or wine fraud are as substantial as those from spirits.

**EU Holding and Movement System**

70. Alcohol fraud occurs through exploitation of the EU Holding and Movement System, a trade facilitation system of considerable benefit to the UK alcohol industry. This allows for the movement of products under duty suspension. When duty suspended goods are removed to an approved excise warehouse within the EU, the movement must be underwritten by a guarantee, valid throughout the EU, to safeguard the potential amount of excise duty payable. This is supported by an Accompanying Administrative Document (AAD) for movements to other member states, or a form W8 for movements to other warehouses within the UK, which provides documentary evidence to support movement guarantees and is required to be produced for audit by Customs or when a vehicle carrying a consignment of alcohol is stopped en-route. The movement of alcohol under duty suspension facilitates the legitimate trade by avoiding the need for fiscal controls at frontiers, and the vast majority of these movements arrive safely.

31 Intra-EU duty free purchases are included. Intra-EU duty-free was abolished in June 1999.
Nature of Alcohol Fraud

71. Most spirits fraud is perpetrated through the diversion onto the UK market of product which is being moved under duty suspension ostensibly between excise-approved warehouses, often involving traders in different Member States of the EU. This can happen on import or export. Consignments of spirits, on which no tax has been paid, are obtained and diverted by fraudsters who cover their tracks with forged or duplicated paperwork. This illicit spirit is then sold mainly through licensed outlets at full (or close to) normal retail price. Neither the consumer, nor the honest trader, can distinguish illicit from licit goods.

72. Inward diversion occurs when duty suspended product is imported, ostensibly for a UK warehouse, but is diverted en-route and placed on the UK market without duty payment; outward diversion occurs when product described as destined for export never in fact leaves the country and is diverted onto the UK market. There are also other types of fraud including misdescription, duty paid in another EU Member State, unaccompanied (deep-sea) freight etc. but these account for a small proportion of the total tax losses.

73. Recent detected frauds have included one case where 11 lorry loads of spirits were apparently despatched from a UK warehouse to Italy. We now know that none left the UK and they were instead sold on without payment of duty through the illicit market. Although the UK warehouse held receipted paperwork from Italy this was all forged. The same warehouse sent a further 19 loads to Greece, which we suspect were also diverted under cover of false receipts—although checks are still on-going. In total we estimate that £2.25 million of revenue would have been lost from that single fraud had it gone undetected.

Our Strategic Approach to Alcohol Fraud up to 2004

74. In recent years Customs has taken a number of steps to improve our capacity to prevent and detect alcohol fraud. These have included implementing the vast majority of the recommendations made by the Roques report into excise diversion fraud, and increasing operational activity both inland and at the frontier.

75. Nevertheless we are aware that the EU system for the holding and movement of excise goods—which is designed to allow the free movement of such goods within the EU and to ensure duty is not payable until those goods are actually placed on the market—will continue to provide opportunities for fraud. In effect, fraudsters exploit a system that is designed to aid the honest trade.

76. Customs has taken a number of important tactical steps to improve capacity to prevent and detect alcohol fraud. These include:

— In April 2001 a specialist “discreditation” team was set up at Dover to support local frontier detection staff to identify alcohol loads intended for diversion. In April 2002 this team was expanded to take on a national role, becoming the National Discreditation Team;
— In July 2001 a tough HGV seizure policy was introduced, targeting those hauliers who play a key role in diversion fraud;
— In 2001 237 additional Holding & Movement (H&M) assurance officers were deployed to control and manage those traders involved in dealing with duty suspended and duty paid excise goods;
— In 2001 263 additional frontier detection staff were deployed at channel ports specifically to tackle cross-channel passenger smuggling;
— In 2002 further additional staff were placed in the Regional Excise Assurance & Compliance Teams (REACT); and
— In April 2004 the Customs specialist alcohol intelligence team was expanded, increasing the team to 11 staff.

Impact of Approach

77. Customs’ activity targeting alcohol fraud has yielded the following results:

<table>
<thead>
<tr>
<th>Protests</th>
<th>Spirits</th>
<th>*Mixed Excise</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Successful</td>
<td>Unsuccessful</td>
</tr>
<tr>
<td>*2001–02</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>2002–03</td>
<td>21</td>
<td>3</td>
</tr>
</tbody>
</table>

*Mixed cases include mixed alcohol or alcohol with other excise goods.
Ev 90  Treasury Committee: Evidence

GANGS DISRUPTED

<table>
<thead>
<tr>
<th></th>
<th>2000–01</th>
<th>2001–02</th>
<th>2002–03</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gangs Disrupted</td>
<td>5</td>
<td>2</td>
<td>24*</td>
</tr>
</tbody>
</table>

*Gangs disrupted figure for 2002–03 reflects the outcome of one major criminal investigation “Fulcrum”.

78. Customs’ efforts to tackle cross-Channel passenger smuggling (one element of overall alcohol fraud) have proved highly effective—in 2001 revenue losses from cross-Channel smuggling were down 76%, with cross-Channel passenger smuggling of beer almost eliminated and cross-Channel passenger smuggling of wine and spirits halved. In 2002 there was a further reduction of 22%, reducing alcohol cross-channel smuggling by 90% in two years.

79. Customs have worked closely with the trade to identify ways that they could help in combating alcohol fraud. The Joint Spirits Fraud Task Force was set up in May 2002 to provide a forum for these discussions. Progress has been positive but unfortunately, given the opportunities for fraud inherent in the EU Holding and Movement system, it was always going to be difficult, via essentially voluntary co-operation, successfully to combat the systematic attack by organised criminal gangs seeking huge profits.

STRATEGIC DEVELOPMENT

80. Customs monitors performance against all our strategies and we seek to adjust and enhance our approach both in anticipation of and in response to changing patterns of behaviour as the fraudsters react to our efforts. In the case of alcohol it became evident that a tactical approach to combating fraud would have only limited effectiveness whilst the environment in which the fraud took place assisted the fraudster by minimising the risks of being caught. Therefore Customs’ tactical initiatives to tackle fraud have been introduced alongside an extensive period of discussion with the industry aimed at developing strategic measures that would be effective against this large scale and highly organised criminal activity.

81. Customs Alcohol Strategy to date has centred on the most effective operational tactics available to us in identifying and tackling the fraudsters responsible for alcohol fraud and in stemming the revenue losses. A common strength of both the oils and tobacco strategies is the partnership of incisive operational activity with supporting legislative change. Introducing measures through legislation that narrow the scope for fraudsters to exploit weaknesses in the system is key in maximising operational effectiveness. The Chancellor’s announcement in December 2003 that he would introduce tax stamps on spirits from 2006 presents us, for the first time with the opportunity to broaden our strategic approach and to be optimistic that our efforts to significantly reduce spirits fraud will be successful.

82. The fundamental principles of the strategy are to:

- Make it as difficult as possible for a fraudster to deal with—and hide amongst—the legitimate trade, at all points along the supply chain;
- Make it easier for Customs, the trade and the public, to identify and trace illicit product; and
- Substantially drive up the costs—and thereby significantly reduce the profits—of being involved with spirits fraud.

83. We are supporting this work by:

- increasing our alcohol intelligence resources by some 30%
- improving information and analysis systems;
- increasing our detection resource by almost 10% in order to enforce the tax stamps regime;
- deploying more staff to prosecute tax stamps offences; and
- increasing assurance staff to combat any fraudsters who attempt to continue to operate within the Holding and Movements system.

TAX STAMPS

84. In 2002 Customs undertook a comprehensive consultation on the Roques report recommendation to implement a tax stamps system for spirits. The consultation established that tax stamps would have the advantage of allowing enforcement staff, the trade, and the public, to distinguish between legitimate and illicit spirits at the point of retail sale. The presence of a tax stamp would prevent the distribution of unstamped spirits at full market value and would increase the risks taken by anyone dealing in illicit spirits. The impact on fraud would be significant. However, the Government decided not to proceed with tax stamps at that time but asked Customs to work with the industry to tackle fraud and to explore alternative means of making progress in reducing the illicit market share. This work focused on the Joint Spirits Fraud Task force and an examination of how fraud could be stemmed through the strengthening of the existing regulatory framework.
85. In the summer of 2003 the Government consulted on a wide range of alternative options for reducing the opportunities available to commit fraud through the framework for holding and moving alcohol in duty suspension. Responses indicated that, while some of the measures would be acceptable to the industry and would have a small further impact in reducing fraud, the most significant proposals—radically to restrict the circumstances in which alcohol could be moved and sold in duty suspension—would not deliver an anti-fraud benefit that was proportionate to its compliance cost to the industry. The Government therefore concluded that tax stamps were the only way to combat spirits fraud effectively—both today and in the future.

86. In the 2003 Pre-Budget Report the Government announced the intention to implement tax stamps, but gave industry a final opportunity to put forward an alternative measure that would be as effective in tackling spirits fraud. The trade’s alternative proposals took the form of a package of proposed new controls on the alcohol supply chain, but it was concluded that the proposals would be significantly less effective in tackling fraud than tax stamps. The Chancellor therefore confirmed at Budget 2004 that tax stamps would be implemented early in 2006–07 and that primary legislation would be passed in the Finance Bill 2004.

87. The spirits industry estimated the compliance costs of tax stamps to be around £54 million annually with an additional £23 million set up costs in the first year. Recognising the potential impact of compliance costs on the industry, the Government announced a number of measures to offset and mitigate these costs. These were:

- A freeze on duty on spirits for the remainder of this Parliament;
- A £3 million capital grant to offset trade capital investment, eg in tax stamping equipment;
- Agreement that Government would meet the ongoing costs of printing and distribution of tax stamps, and;
- Subject to further detailed consideration and discussion with the trade, seek to operate a system requiring no advance payment for tax stamps in order to minimise adverse cash flow impact.

88. Since Budget 2004, Customs have worked collaboratively with the industry, through the co-chaired Joint Alcohol and Tobacco Consultation Group (JATCG) to explore alternatives to advance payment for tax stamps that strike a balance between reduced compliance costs and revenue protection. Detailed discussions have also taken place on a number of other issues including: the product scope of the tax stamps regime, and the physical design of the stamp. On this last issue, industry representatives made proposals to incorporate tax stamps within the back labels of spirits bottles, which they argued would reduce compliance costs significantly. In response to this, provisions were included in the Finance Act 2004 to allow that form of stamp if ministers judge that it is appropriate. During this extensive consultation process, industry representatives have had regular meetings with officials from Customs and HM Treasury and have also had several meetings with the Economic Secretary to the Treasury, most recently on 2 November.

REGULATORY CHANGE

89. In addition to tax stamps, the Government announced at PBR 2003 a number of regulatory changes that would strengthen the Holding and Movement system. These came out of Government consultations with the alcohol industry in the summer of 2003. The Government committed to introducing four of the proposed measures during 2004, following further discussion with the trade. These include changes to the regulations governing producers, warehousekeepers and owners of duty suspended alcohol, requirements for notification of cash transactions and advance payments, and a scheme for recognising transporters with good compliance histories.

90. Customs continue to work closely with the industry to prepare for implementation of these regulatory changes to support the wider alcohol strategy. Detailed discussion papers have been issued and Customs are in the process of analysing these responses.

November 2004

Memorandum submitted by The Scotch Whisky Association

EXECUTIVE SUMMARY

1. Fraud, by its nature, is difficult to estimate and seeking ways to tackle it is complex, but The Scotch Whisky Association (SWA)\(^{34}\) does not accept that the Customs estimates of fraud are accurate. It believes that the combined efforts of the spirits trade and HM Customs and Excise have resulted in a major reduction of fraud in recent years, a downward trend that continues to this day. Whatever the level, the industry has always been committed to working with the government in tackling fraud, as it hurts brands just as much as it impacts on government revenue.

\(^{34}\) The SWA is submitting this report on behalf of the spirits trade associations (SWA, Gin and Vodka Association, Wine and Spirit Association) on the Joint Alcohol Tobacco Consultation Group (JATCG) which represents the industry from producer through to retailer.
2. Following the accepted significant levels of fraud around 1997–98, measures taken to reduce illegal activity have delivered results. However, the Customs methodology for estimating revenue losses from fraud continued to suggest a rising trend into 2001–02. This ignores major co-operation between industry and Customs, steps taken by the industry and importantly, the success resulting from the considerable additional resources given to Customs to tackle the problem. Surprisingly, it implies that this combined and co-operative approach has had no impact. It is also inconsistent with the market reality.

3. The official fraud estimates suggest that legitimate sales and revenue should have been falling. This is contrary to the measurable market reality. Traders have seen a drop in market disruption caused by illegal sales. The government has benefited from rising revenue receipts. This points to successes in fighting illegal activity.

4. An analysis by the SWA has shown that official statistics do demonstrate the falling trend in fraud. As a result there is an urgent need for a reality check to be introduced to the Customs methodology and estimates of fraud.

I. The level of spirits fraud and how this has been estimated

5. The UK spirits market suffered rising fraud and disruption from 1993 to 1998. Since that period there has been a significant decline in fraud, leading to evidence of major fraud from inward and outward diversion being relatively scarce for at least the last year.

6. Rising fraud meant falling revenue. In 1997–98, spirits receipts fell to a low of £1.55 billion. Since then legitimate duty-paid clearances of spirits have risen continuously, by a total of 35% since the trough of 1997–98, delivering excise revenues up by nearly £600 million to £2.13 billion.

7. Producers, importers, distributors, warehousekeepers, wholesalers and retailers all shared this experience of the rise and fall of fraud. Thus the Customs estimates of the level of fraud for 1999 to 2002, and the suggestion of a still rising fraud trend, reaching a claimed £600 million revenue loss in 2001–02, are not consistent with the industry’s experience and market disruption that flows from fraud, or with other published data. There is growing evidence that both the estimates and the trend are incorrect, and based on a flawed calculation of the total consumption of spirits.

8. A conclusion that the industry does not take fraud seriously would not be supported by the history of its full commitment to efforts to stop fraud. Steps taken by the trade, and in partnership with Customs and others, are cited in Section II. While there is disagreement over the estimates of fraud, and some methods of tackling it, there is no disagreement as to the seriousness of the impact of and the need to drive out real fraud. Officials and Ministers have praised the industry’s commitment in this regard.

9. The background to the fraud estimates is given in Annex 1. It describes the signs of inconsistencies in the figures published with the Pre-Budget Report of 2001 (PBR01) and PBR02. Although concerns at the methodology were raised, Customs continued with their approach. In PBR03, estimated losses for 1999–2000 were again revised, and with the benefit of hindsight marked downwards to £350 million; those for 2000–01 were also revised downwards to £450 million; yet, new estimates published for 2001–02 showed a jump to £600 million, or circa 16% of the market. This was greeted with widespread surprise. Estimates for 2002–03 using this methodology have not yet been disclosed.

10. The whole trade immediately questioned the new figures. Both the scale (equivalent to 200,000 bottles every day), and especially the new suggestion of an upward trend in 2000–01, so contradicted market experience that, on behalf of the whole joint alcohol trade, The Scotch Whisky Association examined the basis for the methodology and figures in much greater detail.

11. This work quickly threw up a number of anomalies which were reported to Treasury and Customs. Other survey data on spirits consumption from the Office of National Statistics (ONS) emerged and contradicted the survey data relied on by Customs in both scale and trends. An alternative gap analysis, using this government data, suggested that the revenue gap was at its greatest in 1997–98 and then reduced significantly, that losses for 2001–02 could be less than a quarter of the official estimates and, importantly, on a downward trend.

12. Explaining all the trade’s work on the estimates is difficult without going into statistical detail, but the key points were as follows:

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35 Excluding ready-to-drink (RTD) products.
37 VAT receipts from spirits will be additional to the figures quoted.
38 See Ev 96
39 An SWA paper (11 pages plus appendices) will be made available.
— When Customs used an identical methodology to estimate beer and wine fraud, they abandoned it as unreliable as “it does not generate meaningful results.”

— Both the trade and outside observers such as John Roques, the National Audit Office and the Hon Mr Justice Butterfield were aware that Customs had taken some effective steps from 1997–98 onwards to curtail diversion fraud.

— Yet the Customs figures would imply that fraud levels had been immune to all the enquiries and many other measures and increased resources allocated to Customs since 1997–98.

— The trade estimates were plausible, consistent and compatible with Customs’ seizure and detection rates, and with the results of enforcement initiatives such as an inter-agency assurance exercise in London in 2003.

13. The Public Accounts Committee asked the National Audit Office (NAO) to study the differences in the estimates. The NAO, with advice from the London School of Economics (LSE), reported that the new trade method was reasonable, but “it was difficult to accept that both methods are reliable when they result in such widely different estimates of consumption . . . Great care is needed in determining what reliance is to be placed on the results at present available”. Working to a tight timescale and narrow remit, the NAO did not get to the bottom of the matter.

14. The Public Accounts Committee agreed it was “clear that further work needs to be done by the Office for National Statistics . . . to explain why there are such different estimates for consumption and therefore alcohol fraud”. Since then, the ONS has put much expert time and effort into understanding how Customs used ONS survey data to give a picture of spirits consumption and trends which differs from other evidence and surveys. We understand the ONS will report soon. The strategy for tackling spirits fraud should and will be assessed in the light of the ONS report and the most robust available further information and advice on fraud levels and trends. The control strategy of Customs, and the trade, over the last five years may yet be shown to be a story of laudable success in driving down fraud.

15. If measurements of leakage are “key measures of the effectiveness of the Department, and the key driver of requests for additional resources”, we suggest that measurements of leakage should be assessed by an independent expert body. Whilst they are one important indicator of performance, they should also be balanced by measuring the revenue, economic and trade benefits of efficient facilitation and control of the legitimate trade.

16. The Scottish Affairs Committee also examined the differing results to emerge from the analysis undertaken by the SWA and the Customs estimates. In its report the Committee commented “For any government to introduce important measures which could have major implications for industry and employment, based on what could be inaccurate figures, might be considered precipitate to the point of being reckless.”

II—The steps taken and proposed to reduce the level of fraud

17. The rise of fraud in the 1990s, and the involvement of organised crime, caused concern across the legitimate trade. Our members’ brands and distribution channels were undercut and undermined. The good reputation of Scotch Whisky and other spirits was threatened. Wholesalers and retailers clamoured about illegal competition. Targeted initiatives were taken across the supply chain to address the problems urgently. Among the actions taken by our members were:

— Companies monitored unusual sales patterns to particular warehouses/outlets, exchanged information on this with HM Customs and Excise and in several cases took steps to protect their products from being diverted onto the UK illicit market by restricting supplies to certain customers, or only supplying duty-paid; terms and conditions of sale were amended to reserve the brand owner’s rights if there was any suggestion of fraudulent misuse of products.

— Four major manufacturers representing 50% of the market share for wines and spirits joined with the Customs National Intelligence Division in preparing a strategic threat assessment and contributed commercial data to highlight suspicious factors and trading patterns.

— A working group developed industry guidance, “Preventing Duty Fraud—Tightening Security”, advising on ensuring the security of high-value consignments in transit, whilst safeguarding against exposure to duty loss resulting from criminal activity; it covered the three main areas of customer knowledge, movement of goods, and documentation.

— Workshops were organised with Customs officials to drive home the message about fraudsters’ activities and risk indicators.

42 http://www.parliament.uk/parliamentary_committees/committee_of_public_accounts/pac110304_a.cfm
43 John Roques—see Annex 1, para. 2.
45 Roques Report s.5.3.2.2.
18. Wholesalers also formed a duty fraud action group. It worked with the authorities to isolate and close off the illicit alcohol suppliers.

19. A great deal of effort, creativity and management time have been devoted by dedicated trade people to most of the following reviews:

- 1997—Alcohol and Tobacco Fraud Review
- 1999—Treasury Sub-committee Enquiry
- 2000-01—Roques review and report
- 2001—NAO Review: Losses to the Revenue from Frauds on Alcohol Duty
- 2003—Butterfield Review of Criminal Investigations and Prosecutions
- 2003—Consultation on Reducing Opportunities for Alcohol Fraud
- 2004—Scottish Affairs Committee Inquiry into the Proposed Whisky Strip Stamp.

20. These and other exercises led to many improvements, controls and other measures to detect, prevent and prosecute fraud, including:

- 1998—Excise Warehousing (Etc) Regulations
- 1999—Warehousekeepers and Owners of Warehoused Goods Regulations
- 2000-01—Restructuring of HM Customs and Excise
- 2001–02—146 more Customs and Excise warehouse assurance officers
  - New policies on warehouse approvals
  - Excise Duty Points etc Regulations
  - New National Discreditation Team at ports
  - Tougher action on vehicle seizures
- 2002–03—Excise Goods (Accompanying Documents) Regulations
  - Joint Spirits Fraud Task Force (with a range of new initiatives)
  - New initiatives on transporters
  - New mandatory monthly warehouse returns.

21. There has also been the commitment of many Customs officials, inland and at the frontier, trying to beat the fraudsters, and learn from experience built up in investigating methods of fraudulent activity.

22. The Customs estimates imply that, unfortunately, none of the above has made any impact in reducing the levels of spirits fraud. This is not credible (see Section I), but is also a disservice to the people involved.

23. Following the Budget 2002 decision to postpone tax stamps, The Scotch Whisky Association, Gin and Vodka Association and Wine and Spirit Association put major effort into establishing with Customs the Joint Spirits Fraud Task Force (JSFTF), whose creation was announced by the Chancellor. Its terms of reference are given at Annex 2.47

24. The industry’s long-standing belief is that close co-operation between Customs and the legitimate trade is the best way to identify, isolate and prevent the fraudster. The JSFTF is acknowledged by both sides to have been a highly valuable and effective partnership, bringing all relevant divisions of the Department together with industry to implement joint mechanisms and to exchange information, intelligence and ideas. Its impact has yet to feed into published fraud estimates, which to date cover a period before the Task Force's creation.

25. A detailed Memorandum of Understanding (MoU) between the associations and HM Customs and Excise was drawn up to formalise all the new areas of action and co-operation in the JSFTF, and was all but agreed. Our MoU was on the point of being launched in Glasgow in December 2003 when PBR03 was delivered the preceding day, announcing the imposition of tax stamps. In view of on-going discussions on the nature of the tax stamp regime since then, the draft MoU remains on hold.

26. The announcement at the same time that the government was after all proposing to introduce tax stamps on spirits was both a surprise and a blow to the entire spirits industry. Tax stamps are a barrier to free intra-EU and international trade and unhelpful to UK efforts to oppose trade barriers in some 200 markets worldwide from which Scotch Whisky contributes more than £2 billion to the balance of trade. International experience has shown tax stamps are of limited effectiveness in combating fraud. Therefore the industry associations and member companies submitted a comprehensive joint trade submission before the 2004 Budget, containing a package of 17 alternative measures—summarised in Annex 3—but regrettably this was rejected.

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47 See Ev 97
48 See also 1999 written evidence, para. 47.
49 Not printed.
50 See Ev 98
27. Long negotiations have continued since the 2004 Budget about the implementation of tax stamps. We welcomed government amendments to the Finance Bill which allow greater flexibility in selecting the form of the stamp—providing for the possibility that stamps could be incorporated into the back labels of bottles. Progress has been made on this and other aspects of the regime, including the important financial arrangements. All details are still uncertain but are understood to be close to decision.

28. Both the regulatory options on which the Government consulted in 2003, and the tax stamp proposals, may entail a belief that it is the system of duty suspension in which alcohol is traded that is the basic problem; but suspension of duty, with the duty not paid until the point of release for consumption, is a fundamental legal principle and right under the EU system.

To apply a stamp saying “duty paid” at the start of the supply chain, at the point of production, within a system where duty is not paid until the final point of release for consumption, often by a different trader, gives rise to complex issues with which Customs and the trade are grappling in the negotiations. Customs state that the stamp represents an amount equivalent to the duty, and not the duty itself.

29. The system of warehousing for alcohol and other goods, in which customs or excise duties can be “suspended”, dates back to the early 19th century. It particularly alleviated the difficulties of smaller traders who would otherwise have been compelled to pay large sums of duty before the goods were sold. It is possible to control such a system for spirits without much diversion fraud occurring, as happened for most of its history. Comparisons with the payment of duty by the tobacco and oil industries “at the factory gate” are inappropriate. They have far fewer traders. Much longer distribution chains, and the rich diversity of products, including fine wines and spirits, also distinguish the alcohol trade.

30. In 1999,51 we welcomed the EU’s proposals to replace the existing paper-based system for the movement of excise goods with a computerised system of documentation and control, and explained its potential benefits. Insufficient priority and attention have been given to this. The EU is now consulting on its functional specifications. It will secure further the duty suspension system.

31. Anti-fraud measures should in our view follow these principles:

— Revenue and enforcement controls should be targeted towards criminals, and the areas and traders of highest risk

— Legitimate traders with good compliance history, low risk, and high levels of responsibility and cooperation, should be facilitated and subject to lighter levels of control, creating wider economic benefits

— Blanket regulatory approaches which catch everyone in the same level of burdens, bureaucracy and trade barriers are not the right approach if similar or greater revenue objectives could be achieved by other focused methods which are less burdensome.

Section III—The impact of steps taken, and proposed, on fraud levels and on compliance costs.

32. Steps taken so far have been a success in reducing fraud levels without excessively burdening or obstructing legitimate trade (see Section I above). While sporadic instances of fraud may continue, it is an inevitable feature of any tax system—the general picture is of significant improvement.

33. In its Regulatory Impact Assessment52 (RIA), the government “cautiously estimates that the anti-fraud impact of tax stamps will be £160 million during their first year of introduction”.53 Customs’ calculation of this is proportional to revenue losses immediately prior to the introduction of stamps (by this method, revenue gains will be circa 27% of those losses), and assumes such losses will be £600 million, the same as the estimate for 2001–02. For the reasons set out, in our view this assumption is not justified.54

34. Estimates of revenue loss are “not necessarily equal to the additional revenue that the Government would gain if fraudulent activity was mitigated, as the relatively low prices of illicit goods mean that some illicit consumption may represent additional consumption as opposed to displacement of UK duty-paid consumption . . . Some estimates of revenue evaded may overstate the revenue gain that would result from eliminating fraudulent activity”.55 This may also reduce the revenue gain of tax stamps (or other measures) to some extent.

35. The Government’s implementation costs, including for all offsetting measures, should be subtracted from estimated gains.

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53 p 5.
54 JATCG submission before Budget 2004, Section 4.
55 “Measuring Indirect Tax Losses”, HM Customs & Excise, PRB01, para 2.6.
36. MPs may be aware of fraud in their constituencies from reports of alcohol being sold in and around pubs, clubs, street markets and car boot sales. Tax stamps do not prevent this type of fraud, known as “hawking”, and may encourage it, as well as theft of stamped products. Customs therefore exclude hawking from the 27% of losses they say tax stamps will recover. Stamps also do not prevent the practice of substitution from illicit bottles on optics in the on-trade, or cross-channel smuggling.

37. Under compliance costs, trade costs, and knock-on costs to the economy and other tax revenues if other countries are encouraged by the UK precedent to adopt tax stamps have not been taken into account. The RIA\(^56\) uses pan-industry estimates of compliance costs as £23 million one-off costs and £54 million a year of ongoing costs, adding a conservative estimate of around 15–20 pence on the average shelf price of a bottle. For SMEs this could be significantly higher. This estimate is based upon conventional strip stamps with up-front payment. (As the cost of offsetting measures should be subtracted from the government’s estimate of revenue benefits, so must any trade benefit from offsets be subtracted from compliance costs). The trade welcomes Ministers’ commitment to reduce these compliance cost figures. Allowing different forms of stamp, and avoiding up-front payment, could offer considerable reductions but quantifying these is difficult until final details are known.

38. Following the passing of the Finance Bill, the industry has been working constructively with the government to try and ensure that any tax stamp regime involves the minimum of cost and disruption being placed upon legitimate traders. However, concerns over the methodology that lies behind the estimates of fraud, and the trade’s experience of falling market disruption and increasing revenue receipts mean that the revenue benefit estimated to flow from the proposed policy reaction to the fraud estimates must be questionable. The Sub-committee’s Inquiry will, we hope, lead to greater clarity and understanding of this complex issue.

November 2004

Annex 1

BACKGROUND TO THE DEVELOPMENT OF THE OFFICIAL ESTIMATES OF FRAUD

1. The level of outward fraud in the mid-1990s is undisputed. Some cases, none involving producers, became notorious for the huge revenue losses involved. They have been independently investigated, including by the Treasury Sub-committee’s 1999–2000 enquiry into HM Customs and Excise, which foreshadowed the situation now. A difficulty was that the scale of losses from the frauds of the 1990s had not been accurately estimated. Our evidence\(^57\) called for “a much fuller, more accurate and open Government assessment of the scale and costs of the problems of smuggling and fraud”.\(^58\) The Committee recommended “that Customs and Excise, working with the relevant industries, formulates estimates of the revenue lost as a result of all forms of alcohol smuggling”.\(^59\)

2. After the Committee’s report, the further independent investigation by John Roques also placed “great emphasis on the need for the development of reliable estimates of revenue leakage and for the publication of such estimates . . . Measurements of leakage should be the key measures of the effectiveness of the Department, and the key driver of requests for additional resources”.

3. John Roques was shown\(^61\) in August 2000 a tentative new model for estimating fraud by the Customs Analysis Division, based on trying to estimate total spirits consumption using data from the Family Expenditure Survey (FES) and the National Food Survey (NFS). It was the precursor of the model on which the recent official estimates are also based, but in his report of July 2001, he noted that “none of the estimates produced to date has been made public, due to the belief by the Department that they are insufficiently robust”.\(^62\)

4. Mr Roques also made his own assessment, but using only “a very simplistic approach . . . intended as a reasonableness check of the estimates already made”. Interestingly this implied that fraud fell during 1999–2000, but he concluded that this was a mistake. He assumed that the high level of duty-paid spirits clearances in 1999–2000 was “explained by the Millennium celebrations”, and therefore instead extrapolated his results for 1998–99 to “estimate the current level of spirits revenue losses to be in the range of £500 million to £1,030 million per annum”.\(^63\) He did not know that clearances for the following year, 2000–01, would again rise significantly above the 1999–2000 figures, which were not therefore an aberration.

\(^{56}\) RIA, p 36.
\(^{57}\) http://www.publications.parliament.uk/pa/cm199899/cmselect/cmtreasy/885/9111016.htm (written);
http://www.publications.parliament.uk/pa/cm199899/cmselect/cmtreasy/885/9111017.htm and
\(^{58}\) SWA written evidence, para 13.
\(^{60}\) Roques Report, July 2001, s.5.1.
\(^{61}\) s. 5.3.2.2.
\(^{62}\) s.4.1.
\(^{63}\) s.5.4.3.
5. **PBR01** included the first official estimates of losses from spirits fraud and smuggling, for the period 1999–2000. This enshrined the methodology which John Roques had tentatively been shown the preceding summer. FES (on-trade) and NFS (off-trade) data are grossed up to estimate total UK spirits consumption. From this, estimates of legitimate consumption (principally the clearance figures) are deducted to give an estimate of the revenue gap—a technique known as gap analysis.

6. The Treasury was so concerned at the alleged losses (£450 million, including both excise and VAT—or circa 15% of the total market) that, among other things, it launched a consultation about the possible introduction of tax stamps, believing them the right response. This had been one of many recommendations made by John Roques, but not one to which he attached priority.

7. Following representations from the industry the government decided in the 2002 Budget not to proceed with tax stamps at that time. One of many areas of concern raised by the Association was the new estimate of the illicit market. It was inconsistent with other evidence showing that fraud had begun to fall in 1999–2000.

8. In **PBR02**, estimated losses for 1999–2000 were revised upwards to £500 million, and new estimates for 2000–01 were published—also £500 million. The Treasury began consultations, continuing through 2003, on a package of seven possible regulatory approaches to tackle the apparent levels of fraud. The Association participated in a pan-industry response by the Joint Alcohol and Tobacco Consultation Group (JATCG). An even stronger case was made in this October 2003 submission that there were deficiencies in the fraud estimates. They were inconsistent with the healthy recovery in revenue receipts which continued during 2000–01. The figures also implied such a growth in consumption since 1992–93 at odds with the experience of all in the market that spirits trends had been flat.

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**Annex 2**

**JOINT SPIRITS FRAUD TASK FORCE (JSFTF)**

**Terms of Reference**

The JSFTF is an initiative between HM Customs and Excise and the UK spirits industry which aims to improve the efficiency and effectiveness of Customs activity to tackle spirits smuggling and fraud to their mutual benefit.

The JSFTF will achieve this by:

— Involving the main trade representatives for the UK spirits producers (the Scotch Whisky Association and the Gin and Vodka Association of Great Britain), spirits importers (the Wine and Spirit Association), spirits transporters and warehousekeepers, and (as appropriate) individual companies;

— Meeting on a regular basis at working level, as a single forum or in sub-groups as appropriate, and with occasional meetings at senior (Chief Executive and, if appropriate, Ministerial) level;

— Building a shared understanding of the scope and nature of the problem;

— Developing and maintaining innovative ways of jointly combating fraud and of minimising the impact of HMC&E activity on the legitimate trade, making best use of technology wherever possible;

— Establishing and maintaining a network of two-way “fast track” contacts to help:
  — HMC&E identify and discredit illicit spirits consignments and to disrupt the associated supply chains, and
  — the spirits industry and trade to detect and prevent fraud and the sale of illicit and counterfeit product;

— Establishing and maintaining procedures and pathways, within a legal framework, for the structured and regular two-way exchange of data and intelligence;

— Agreeing and implementing Memoranda of Understanding between HMC&E and the spirits industry and trade, as appropriate;

— Promoting good practice;

— Liaising with other Government departments and agencies as appropriate in support of the JSFTF objectives; and

— Regularly assessing and reporting the impact of the JSFTF work.

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65 JATCG response, October 2003.
ALTERNATIVE WAYS TO STAMP OUT FRAUD

In the 2003 Budget Report the Chancellor set the spirits industry a challenge, to find a better way of tackling fraud than the Government believed would be achieved by tax stamps. The alcohol trade, as represented by the Joint Alcohol Tobacco Consultation Group (JATCG), across the production and supply chain rose to the challenge and developed a forward-looking package of alternative proposals. These aimed to go to the heart of the problem, to focus on areas where the opportunity for fraud arises and to strike directly at the fraudster rather than the legitimate trade. The key benefits included:

- *The industry believed its package of measures could remove at least 50% of spirits fraud*
- *Faster implementation than tax stamps and delivery of an earlier revenue gain—by end of FY 2004–05*
- *More enduring effectiveness*
- *Multi-faceted and flexible*
- *Based on current success and partnership and offer a proportionate response to actual current fraud levels.*

Details of the industry proposals are contained in the attached table, but in summary cover:

**Tighter System of Guarantees**

- All diversion fraud takes place during movement. Without an excise guarantee, there can be no movement of spirits. Warehousekeepers will not provide a guarantee for high-risk movements. The trade will introduce the new system as best practice in 2004. This forces fraudsters into the guarantee system or out of business. As a fraudster is unlikely to survive the financial scrutiny necessary to obtain a guarantee, this measure alone could effectively stop outward diversion (over 50% of fraud level).

**Winning in Partnership**

- Implementation of the already negotiated industry/government Memorandum of Understanding (MoU) introducing restrictions on supplies of highest risk, notification of other movements fitting risk profiles, and assisting C&E with detailed information about supply routes and customers.
- Establishment of a new Joint Warehouse Fraud Task Force, with early implementation of a new warehousekeepers/government MoU. Improved approval, control and analysis of warehouse stocks, movements, sales and ownership of goods to pick up high-risk or illicit transactions.
- Early implementation of new initiatives, such as the introduction of a “recognised transporters” scheme, and the fuller use of a number of other recent C&E controls and databases.

**New Warehouse Controls**

- Better identification by C&E of risk and unusual trends through improved use of warehouse returns now being submitted by the trade. C&E will have this in place by mid-2004. Rigorous review of warehouse approvals, and cancellation in cases of irregularity. Professional accreditation and better training of warehousekeepers. C&E assurance officers could also be placed in the highest-risk warehouses, which are small in number.

**Using Existing Systems More Effectively**

- Increased collaboration via the existing Joint Spirits Fraud Task Force to extend C&E’s ability to tap into industry expertise in identifying and tracking illicit spirits. “Fast track” contact details can be provided for all investigations, to identify sources of illicit supply. Call up producers to assist in tracing where fraud has occurred.

**Innovative Solutions**

- All businesses selling spirits throughout the supply chain would require licences. Tighter C&E links to the licensing of all wholesalers and retailers to cut off fraudsters’ markets for illicit supplies. Infringement would lead quickly to loss of licence.
- Introduction of a new machine to uniquely number and process movement documentation. This would counter the use of forged signatures and stamps on documents.
— Development of the electronic European Movement Control System and we will co-operate in its design, development and implementation. This EU-wide scheme should be at the heart of a secure and efficient supply chain.

— Enhanced co-operation between different EU Member States on cross-border movements will help clamp down on fraudulent trade.

— Extended use of bar coding technology and lorry tracking to enhance traceability.

— Full participation in current government plans to modernise excise law—tax stamps would be a backward step.

**A Two-Way Exchange**

— Industry/C&E partnership, on a privileged basis if necessary, to identify fraud as it happens, to target C&E assurance resources where fraud is most prevalent, such as high-risk owners, sales and movements at high-risk warehouses, and to build on success in tackling inward diversion.
<table>
<thead>
<tr>
<th>Proposal</th>
<th>Initiative</th>
<th>Benefits</th>
<th>Tackles Outward Diversion</th>
<th>Tackles Inward Diversion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implement Memorandum of Understanding with producers and importers</td>
<td>Implementation of already negotiated industry/government MoU introducing restrictions on supplies of highest risk, notification of other movements fitting risk profiles, and assisting C&amp;E with detailed information about supply routes and customers.</td>
<td>Targeting of resources on relatively small number of abnormal loads.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Target high-risk owners, sales and movements</td>
<td>Improved approval, control and analysis of warehouse stocks, movements, sales and ownership of goods should pick up high-risk or illicit transactions very quickly.</td>
<td>Establish the normal, challenge the abnormal.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Revised system of guarantees</td>
<td>No excise guarantee, no movement of spirits.</td>
<td>New system as best practice in 2004 and stiff penalties would be imposed. Fraudsters forced into the guarantee system or out of business. End to outward diversion.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>New warehousekeepers’ Memorandum of Understanding</td>
<td>Begin work on the early implementation of a new MoU with warehousekeepers.</td>
<td>Partnership approach to target high risk warehouses.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>New Joint Warehouse Fraud Task Force</td>
<td>A new Joint Warehouse Fraud Task Force should be set up.</td>
<td>Sharing intelligence to tackle abnormal trade.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Improved use of warehouse returns</td>
<td>Improved use by C&amp;E of industry warehouse returns to identify better where risk lies and allow faster spotting of unusual trends.</td>
<td>C&amp;E will have system in place by June 2004.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Review of warehouse approvals</td>
<td>Rigorous review of warehouse approvals, and cancellation if there is irregularity.</td>
<td>Removal from trade of unsuitable operators.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Training and accreditation for warehousekeepers</td>
<td>Professional accreditation and better training of warehousekeepers.</td>
<td>Better awareness of trade and C&amp;E requirements.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Proposal</td>
<td>Initiative</td>
<td>Benefits</td>
<td>Tackles Outward* Diversion</td>
<td>Tackles Inward† Diversion</td>
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<tr>
<td>C&amp;E assurance officers in highest risk warehouses.</td>
<td>C&amp;E assurance officers placed in the small number of highest risk warehouses.</td>
<td>C&amp;E presence has been shown to halt unusual trades</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Strengthened licensing system</td>
<td>C&amp;E licences required by all businesses selling spirits.</td>
<td>Tighter C&amp;E links to the licensing of all wholesalers and retailers will help to cut off fraudsters’ markets for illicit supplies.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>New machine for stamping documents</td>
<td>Introduction of a new machine to uniquely number and process movement documentation.</td>
<td>Would counter the use of forged signatures and stamps on documents.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Enhanced controls on transporters</td>
<td>Early implementation of new initiatives, such as the introduction of a “recognised transporters” scheme, and the fuller use of a number of other recent C&amp;E controls and databases.</td>
<td>Disrupts opportunities for diversion and encourages the transporter to take responsibility for ensuring correct delivery of load.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Better use of trade intelligence</td>
<td>Co-operation by producers within Joint Spirits Fraud Task Force has allowed C&amp;E to tap into industry expertise in identifying and tracking illicit spirits. Far more can be made of this collaboration, including exchange of information on a privileged basis if necessary.</td>
<td>“Fast track” contact details provided for all investigations. Better use by C&amp;E of trade contacts to identify the sources of illicit supply and routes to market. Producers can assist in tracking where fraud has occurred - even identifying where bottles have been removed. Facilitates targeting of resources in identified high risk areas.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

* Outward Diversion is where the paperwork indicates that the goods are scheduled for export, but are diverted into the UK market and never leave the country. C&E figures indicate that this currently accounts for more than half of the revenue loss from spirits.

† Inward Diversion is where imported goods do not reach the destination warehouse and again appear in the UK market.
Letter to the Clerk of the Sub-committee from the British Beer and Pub Association, providing further information

Following the Treasury Sub-committee session on 8 December to take evidence on Excise Duty Fraud, we enclose a memorandum to detail the brewing industry’s concept on modernisation and simplification of the duty system. This gives more information on points raised with the Sub-committee, since time restrictions meant that we were unable to cover the specific details during the inquiry.

As I briefly explained, this concept would utilise current IT systems to combat fraud. We have approached HM Customs and Excise on several occasions to present these ideas and have gained some level of support but we are keen to take this forward. The BBPA is currently developing a multimedia presentation to outline and demonstrate the benefits to both HMCE and the trade. We appreciate the opportunity to provide this information and would like this to be incorporated in the Sub-committee’s further deliberations.

10 December 2004

Supplementary memorandum submitted by the British Beer and Pub Association

The Trade Association representing 98% of the UK brewing industry and interests of owners and operators of over 35,000 public houses throughout the UK. The BBPA welcomes this inquiry; since duty fraud is damaging the beer market as well as the revenue stream.

BBPA PROPOSALS ON MODERNISATION AND SIMPLIFICATION

1. The BBPA has been attempting to engage HMCE in a joint approach on the modernisation of the alcoholic drinks production industry for several years. The industry believes that the implementation of their proposals would be of benefit to both HMCE and the trade. Modernising and simplifying would reduce compliance costs to the trade and give greater duty assurance to HMCE and hence reduce fraud.

2. The modern brewing industry has evolved in a manner and speed such that legislation struggles to keep pace. The outcome has been that the current legislation places too onerous a burden on the industry in compliance costs, as well as making it difficult and expensive to quickly respond to marketing opportunities.

3. In addition, the Government and HMCE’s response to fraud, particularly in the spirits sector, is a concern to the brewers. Regardless of the absolute level of spirits fraud, all parties accept that beer fraud is significantly lower. However, brewers would not want to see those measures currently being introduced in the spirits sector being adopted for beer if there were displacement in fraudulent activity away from spirits. Nor would we wish to see tax stamps introduced for reasons of “consistency” of treatment within the alcohol sectors.

4. Some of the BBPA proposals have already been incorporated into HM Customs & Excise own thinking on modernisation. However, the industry’s ideas go much further than those of HMCE, whose main driver is “e” enablement and the unification of the alcohol, tobacco and hydrocarbon industries under a single umbrella of the Customs and Excise Management Act.

5. The BBPA’s main proposals are:

   (i) Registration of multiple site operations producing a variety of tax type drinks, with a single registration as an alcohol drinks manufacturer.

       A prerequisite for this would be the appointment by each company of a duty specialist trained to an approved standard. This approach would also allow the removal of HMCE’s current interpretation of adjacent premises as those within a 5km radius. Instead, adjacent would be determined by functionality.

   (ii) Robust risk analysis of duty-suspended movements. The BBPA contends that movements between different sites within the same company ownership present minimal risk to the revenue.

       Financial security to be provided on all duty-suspended movements, excluding those within companies’ own sites within the UK.

       It would be compulsory for all independent hauliers to hold a movement guarantee.

   (iii) Non-intra company duty suspended movements would be pre-advised to HMCE electronically, this to include the duty liability associated with the consignment.

       All such movements would have to be verified against the SEED database and authorised. If necessary the system would require the consignee to verify that they were expecting the consignment.
The consignee would be required to confirm receipt in the system and the duty liability would be automatically transferred.

All of this functionality would be based on the requirements of the European Electronics Control and Movements System.

(iv) Numerous other changes around method of reporting and payment of duty, including agreed reporting periods.

6. The BBPA believes that that electronic notification and approval of non-intra company duty-suspended movements would significantly reduce fraud.

December 2004

Memorandum submitted by British American Tobacco

1. British American Tobacco has a relatively small share of the UK market. Our principal cigarette brands in the UK are Dunhill, Rothmans and Rothmans Royals. Sales are around 3 billion cigarettes, giving a market share of 6%. Our market share of the roll your own market is also relatively small at 6.5%. Our principal roll your own brand is Cutters Choice.

2. According to HM Customs & Excise, there has historically been little evidence of any significant volume of genuine British American Tobacco products, either cigarettes or roll your own, entering the UK market through illicit channels. Figures for seizure of products by HM Customs & Excise indicate that 80%–90% of the purportedly British American Tobacco products seized are in fact counterfeit. Notification of seizures by HM Customs & Excise for the calendar year up to November 2004 are that 30 million British American Tobacco brands were seized; of these 24 million were counterfeit and only 6 million were genuine cigarettes equivalent to 0.001% of our global cigarette volume (792 billion—Directors’ Report and Accounts 2003).

3. We do not know what volume of our products enter the UK market from cross-border shopping, although we would expect our share of total cross-border volumes to be consistent with our share of the UK duty paid market. We do not know how much of this is brought in and on-sold, rather than being for personal use by the carrier.

4. Although we have only a small share of the UK domestic market, and there is little incidence of genuine British American Tobacco products being smuggled into the UK, we recognise that we can support the UK Government in its fight against illicit trade, principally through working with HM Customs & Excise. This includes assisting in identifying product that is seized and advising on information we have about illicit trade targeting the UK. The working arrangements governing this relationship were formalised in a Memorandum of Understanding (MOU) signed in 2002. Co-operation with HM Customs & Excise had been ongoing for a long period beforehand.

5. We believe that MOUs have an important part to play in combating illicit trade and in developing close working relationships with the relevant authorities. MOUs provide both an acknowledgement of the determination to work against illicit trade and the opportunity to establish a practical and meaningful way of working together. Our experience of MOUs in action around the world has shown the benefits of this approach.

6. Whether or not MOUs are in place, we work actively with authorities around the world, either formally or informally. We are continuing to try to develop an extensive investigation and intelligence network aimed at discovering the sources and flows of illicit product, so that action can be taken against it. This includes the seizure of illicit product and, in the case of counterfeit products, raids on manufacturing sites and producers (such as printers of counterfeit packaging) and the seizure of machinery and production materials.

7. We have also continued to strengthen our internal controls within all our markets in order to reduce the risk of our own products being diverted in commercial quantities into illicit trade channels. These measures involve tighter control over whom our companies sell to, including termination of supply where a customer is suspected of knowing or recklessly allowing product to enter the illicit trade channel, and controlling quantities sold to ensure that they are commensurate with legitimate retail demand.
8. We have to work against illicit trade in most of our markets because illicit trade is a worldwide phenomenon. The nature of illicit trade means it is usually very difficult to measure with any great accuracy. Our analysis and information shows that, in the case of our brands, products are mostly counterfeit; that China is the main source of counterfeit British American Tobacco brands; and that of the genuine products being smuggled, relatively little of this is our brands. As from 2005 our brands will carry a covert marking device to enable immediate detection of counterfeit product.

9. Most counterfeit cigarettes, including many of those coming into the UK, originate from China. To address this particular problem in China, a coalition was established by a number of international cigarette manufacturers and Chinese authorities to identify and de-commission the factories making counterfeit cigarettes. Three of the companies appearing before the Treasury Sub-committee, British American Tobacco, Imperial and Philip Morris International are members of this coalition together with JTI, and the fourth, Gallaher has been invited to join. The coalition has been operating for several years and has achieved considerable success. In 2004 alone nearly 400 factories in China were raided and 350 cigarette making machines were seized.

10. A major factor in illicit trade is the relative ease with which cigarettes can be transported and the high return in terms of the profitability to cost ratio. We believe that it is important to increase controls on the movement of cigarette products to enable these to be better monitored by customs and enforcement authorities. For this reason, we are advocating an Export Bond system to cover the export of cigarettes. This would require any exporter of cigarettes to take out a bond equivalent in value to the excise duty payable on those cigarettes in the country to which they are declared as being exported. If the cigarettes did not arrive and obtain customs clearance at the stated country of destination within a certain time, the bond would be forfeit. The customs authorities would be responsible for administering and enforcing the system. The proceeds from any bonds that were forfeited would be allocated between the customs authorities. As well as covering any costs, we believe this will encourage customs authorities to participate in the Export Bond system. To be effective, the Export Bond system would require universal adoption by governments and to this end company representatives have been talking to a number of authorities, including HM Customs & Excise.

11. Any discussion of illicit trade and measures to counter it has to recognise the critical role that governments have in terms of policy and enforcement. Without a consistent approach on this, illicit trade will continue to flourish. Sensible taxation of cigarettes, which means taking into account the willingness of the consumer to pay the tax paid price, combined with appropriate regulation and effective enforcement, are key. The fact that cigarettes in the UK are the most expensive in Europe, and that the UK has the highest incidence of illicit trade of any EU state, is no coincidence. As UK duty paid prices of cigarettes continue to increase as a result of rises in excise, more consumers are switching to non UK tax paid product and smugglers and counterfeiters are generating higher profits at the expense of the UK taxpayer.

12. We have made significant efforts to combat the growth in illicit trade in terms of implementing controls over the sale of our own product and in developing a series of anti-illicit trade initiatives. We remain committed to working with all governments to find ways of reducing the adverse impact which illicit trade has on government revenues, legitimate industry and the consumer.

13. Further information on British American Tobacco’s policy and efforts to combat illicit trade is available on our website www.bat.com

17 December 2004

Supplementary memorandum submitted by HM Customs & Excise

TOBACCO SMUGGLING

BACKGROUND

1. During the mid 1990s, the problem of cigarette smuggling was growing rapidly. By March 2000, cigarette smuggling was draining an estimated £2 billion a year from public funds and it was estimated that if no additional action were taken to tackle the problem it would account for a quarter of the market by 2001 and more than a third by 2003.

2. The Tackling Tobacco Smuggling strategy was designed to slow and stop the growth of tobacco smuggling and then to reduce it. To measure delivery of this outcome, the Government has set Customs PSA targets for year-on-year reductions in cigarette smuggling until 2007-08. The following table shows illicit market share performance to date.
Table 1

MARKET SHARE OF SMUGGLED CIGARETTES (PER CENT)

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Illicit Market Share</td>
<td>21</td>
<td>20</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Cross-Border Shopping*</td>
<td>6</td>
<td>8</td>
<td>9</td>
<td>9</td>
</tr>
</tbody>
</table>

*Includes duty free as well as EU duty paid. A definitional change was made to the distinction between cross-border shopping and smuggling during 2002. Estimated using Omnibus data and may be subject to revision when GHS data becomes available.

3. In the first two years of the Tackling Tobacco Smuggling strategy Customs seized over 5 billion cigarettes, either in, or en route to the UK. At the time, the majority of these cigarettes were originally manufactured in, and exported from, the UK. So, although the vast majority of UK exports did not feed the UK smuggled market, most smuggled cigarettes were UK manufactured UK brands. This was not surprising as UK smokers are predisposed to purchase cigarette brands they are familiar with, hence these brands were the most popular with smugglers.

4. A key element of Customs’ strategy is to reduce the supply of cigarettes available to smugglers. In respect of genuine product we aim to work closely with all the major tobacco manufacturers in order to tackle the smuggling problem and they have all publicly stated a wish to see an orderly market in the UK for their products and to co-operate with Customs.

5. In order to formalise this co-operation, Customs have entered into Memoranda of Understanding with all three major UK manufacturers. These agreements are designed to reinforce co-operation in tackling tobacco smuggling into the UK, particularly the large-scale organised freight smuggling that dominates the illicit supply. Customs signed a Memorandum of Understanding with Gallaher in April 2002, with British American Tobacco in October 2002 and with Imperial in June 2003.

6. Within these agreements Customs look to the manufacturers to ensure that they supply product only where there is a legitimate demand for it in the intended final market, sharing their understanding of that demand with Customs as necessary.

7. Customs also look to the manufacturers to help identify the supply routes of any suspect export trade and to refuse sales where the end-sale (consumption) destination is in doubt. Where it is discovered that any particular distributor has been shown to be behaving improperly, Customs expect that manufacturer to revisit the trading relationship in question with a view to discontinuing it.

8. Within this control context, but not as part of the Memoranda of Understanding, Customs introduced a voluntary system to raise concerns about particular customers of tobacco manufacturers. This involved Customs notifying the manufacturers of cases where repeated seizures were made of stock originally supplied to specific distributors and which appeared disproportionate. This process and the resultant requests that manufacturers take action to address those particular supplies by either restricting or ceasing future supply was known as the yellow and red card system.

9. Cards have been issued where Customs believe that there is a serious risk of a high proportion of further supplies to a specific customer illegally re-entering the UK market. Customs expect manufacturers to take action against such customers and would fully expect customers who are given a yellow card to be the subject of enquiries by the manufacturer. Customs has not issued any red or yellow cards in the last two years.

**The Licit UK Tobacco Market**

10. Two tobacco manufacturers, Imperial Tobacco and Gallaher, dominate the UK tobacco industry. Together they hold more than 80% by value of the UK tobacco market share.

* Licit UK Market Share 2003
  * Imperial—44%
  * Gallaher—38%
  * BAT—6%
  * Phillip Morris—6%
  * Other—6%
Imperial Tobacco Ltd

11. Imperial brand cigarettes have taken a steadily declining share of Customs seizures over the past three years. It is already a matter of public record following an earlier enquiry by the Public Accounts Committee that in 2001–02, prior to agreeing an MoU with Imperial, Customs had serious concerns about the percentage share of the smuggled market made up by their product. In 2001 this exceeded 50%. Analysis at the time showed that the return rate for Regal and Superking cigarettes, manufactured by Imperial, was something in the order of 65%, as opposed to an overall return rate for all brands of 16%.

12. Very large volumes of Regal and Superking cigarettes were being exported to countries such as Latvia, Afghanistan, Moldova and Andorra. Customs had serious concerns about the ability of these economies to support the purchase of the more expensive UK brands, and believed the domestic market for those brands was limited.

13. Since 2002 there has been a consistent and sustained downward trend in seizures of smuggled cigarettes across key Imperial brands and their share of the smuggled market has fallen considerably.

<table>
<thead>
<tr>
<th>Table 2</th>
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</thead>
<tbody>
<tr>
<td>CIGARETTE SEIZURES* AND COMPONENT ELEMENTS</td>
</tr>
<tr>
<td>2002–03</td>
</tr>
<tr>
<td>Counterfeit</td>
</tr>
<tr>
<td>Genuine UK brands</td>
</tr>
<tr>
<td>comprising:</td>
</tr>
<tr>
<td>Sovereign (Gallaher)</td>
</tr>
<tr>
<td>Superkings (Imperial)</td>
</tr>
<tr>
<td>Regal (Imperial)</td>
</tr>
<tr>
<td>Dorchester (Gallaher)</td>
</tr>
<tr>
<td>Other UK</td>
</tr>
<tr>
<td>Non UK Brands</td>
</tr>
<tr>
<td>Other**</td>
</tr>
</tbody>
</table>

*For 2002–03 Individual Seizures of over 500,000 sticks (76% of all seizures in the UK)
**Includes those seizures not identified as counterfeit or genuine, or those consisting of mixed brands not separately identified.

Gallaher

14. The pattern of smuggling Gallaher brands has also changed considerably since the start of the Tobacco Strategy in March 2000. Analysis of large seizures shows that in 2000–01, of the Gallaher brands, Benson and Hedges**66 accounted for 16% of seizures. In the following year, the position was broadly unchanged with Benson and Hedges accounting for 19% of seizures, but the majority of these were believed to be counterfeit. Of the other Gallaher brands, Sovereign accounted for around 10% of seizures with no other brand recording significant seizures.

15. In 2002–03 over 90% of seizures of Benson and Hedges were counterfeit, but of the seizures of genuine product, 40% were Sovereign. Customs and Gallaher met regularly to discuss concerns about the levels of seizures being made in relation to supplies to one distributor, and on 30 April 2002 Gallaher terminated their distribution agreement with that distributor. During the course of the year over two-thirds of Sovereign seizures eventually related to product previously supplied to this distributor.

16. In 2003–04 Sovereign accounted for 58% of cigarettes seized that were genuine. In addition, another Gallaher brand, Dorchester, accounted for a further 19% of these seizures. Although there were still seizures relating to the same distributor that had ceased to be supplied in April 2002, there were increasingly significant seizures arising from product supplied to the replacement distributor. This replacement distributor was appointed at the same time as the contract was terminated for the original distributor.

17. Despite the contractual measures and the steps taken by Gallaher to tackle the problem, Customs raised concerns in the early part of this year that the action was not proving to be effective and in June 2004 asked that Gallaher take further steps to minimise the smuggling risks. Gallaher decided to suspend supply of Sovereign cigarettes to this distributor in June 2004.

**66 This is a brand manufactured by both Gallaher and BAT and is also regularly counterfeited so we are not able to say how many of these were actually manufactured by Gallaher.
18. Customs’ work with the tobacco manufacturers has resulted in fewer exports of UK brand cigarettes to high-risk destinations outside the EU, and all the evidence Customs have shows that large seizures of almost all UK manufactured brands are reducing in line with a falling market and a restricted supply to smugglers.

19. Co-operation at present is generally good with seizures of genuine cigarettes continuing to fall both in volume and as a percentage of overall seizures. In 2000–01 genuine cigarettes made up some 85% of seizures, falling to 28% in 2003–04 and at the same time Customs estimate the overall size of the illicit UK market has contracted from 16 billion to 10.5 billion cigarettes.

20. As a result of our work with the tobacco manufacturers to reduce the availability of genuine products, large scale organised smuggling gangs who supply most of the illicit market have increasingly switched their attention to counterfeit product and as result there has been a significant increase in the volume of counterfeit cigarettes seized. In 2003–04, 54% of cigarettes seized were counterfeit. This represents a more than three-fold increase over 2001–02.

21. Counterfeit cigarettes are completely untaxed and unregulated. Research on these cigarettes indicate that counterfeit cigarettes contain on average markedly higher concentrations of arsenic (three times the level of their genuine counterparts), cadmium (5 times) and lead (5.8 times)—all of which are listed by the International Association for Research in Cancer (IARC) as carcinogens—as well as increased levels of tar and nicotine. This research has identified that habitual smoking of counterfeit cigarettes has significant potential harm to human health from these heavy metals and adds substantially to the considerable risks already associated with smoking cigarettes.

22. Commercial smuggling continues to account for the vast majority of our seizures (between 70% and 80% of the total), but more loads are of mixed brands and are now often well concealed. Air passenger seizures have grown as a proportion of all seizures (to around 20%), increasing the incidence of EU duty-paid in the illicit market.

23. Customs’ initial target was to reduce the illicit market to 17% by 2005–06 and in SR04 had that PSA target extended to 2007–08 by which it is expected to further reduce the illicit market share to 13%. Figures published at the time of the November 2004 Pre Budget Report show that Customs have already succeeded in pushing the illicit cigarette market down below the 17% target. In 2003–04 the illicit market share was down to 15% representing a cut of almost a third in the illicit market share from its peak and a reduction of more than 5 billion sticks in successfully smuggled volumes.

17 December 2004

Memorandum submitted by Imperial Tobacco Group PLC

EXECUTIVE SUMMARY

Imperial Tobacco is the leading manufacturer for the UK cigarette market, with a market share of around 45%. The Company is the fourth largest international tobacco company and employs around 15,000 people worldwide, including 2,600 in the UK—its principal market. Imperial Tobacco has been and continues to be committed to reducing the smuggling of tobacco products into the UK, both through the Company’s internal procedures and its co-operation with HM Customs and Excise and other Customs Authorities throughout the world. Set out below is a summary of the main points from the body of this submission—

— Imperial Tobacco believes that smuggling into the UK is the direct result of the high tax-paid retail price differentials for both cigarettes and handrolling tobacco that exist between the UK and other EU Member States and most of the rest of the world. Following more modest (inflation only) annual cigarette duty increases in the UK since 2001, there is evidence that smuggling has been decreasing. However, there is a growing problem of counterfeit products entering the UK market.

— Imperial Tobacco has evolved and enhanced the Company’s Supply Policy based on experience in the UK market. This Policy incorporates a number of comprehensive pre-supply procedures and post-supply checks. In order to reduce the risk of smuggling into the UK, Imperial Tobacco ceased trading with almost 30 customers between end-1999 and mid-2001, a period when UK smuggling escalated.

— Imperial Tobacco continues to invest considerable resource, expertise, time and money in working to prevent illicit trade in both genuine and counterfeit products. To combat this illicit trade, Imperial Tobacco has a team of 25 specialists operating internationally in conjunction with Customs Authorities. The Company is the only manufacturer with a dedicated team employed to disrupt the retail sale of illicit product in the UK.
— Imperial Tobacco has signed six Memoranda of Understanding (MoUs) with Customs Authorities in Europe, including the most comprehensive MoU in the UK with HM Customs and Excise. Discussions are progressing in over one dozen countries to finalise further MoUs in various parts of the world.

— Seizures of genuine Imperial Tobacco cigarettes by HM Customs and Excise in the year ended September 2004 show a 92% reduction from the 2001 level. However, this reduction in seizures of genuine Imperial Tobacco cigarettes has been mirrored by an increase in counterfeit seizures.

— In the six months ended September 2004, counterfeit versions accounted for 93% of all large seizures of Imperial Tobacco cigarette brands by HM Customs and Excise.

— In the year ended September 2004, the cost to Imperial Tobacco of mounting a series of anti-illicit trade operations was £1.2 million. This produced a potential profit benefit for Imperial Tobacco in the UK market of £11 million and a revenue benefit to the UK Exchequer of £85 million.

— Imperial Tobacco supports the HM Customs and Excise opinion, expressed to the Treasury Sub-committee on 17 November 2004, that licensing of the distribution chain would do little to combat tobacco smuggling, as smuggled product is rarely sold through the legitimate distribution chain.

— In order to further improve the effectiveness of HM Customs and Excise in tackling tobacco smuggling, Imperial Tobacco advocates:

   — Even closer “front-line” operational co-operation between tobacco manufacturers and HM Customs and Excise to counter illicit trade.

   — In support of recent civil legal actions taken by Imperial Tobacco in The Netherlands and Belgium, HM Customs and Excise and overseas Customs Authorities should be given the power to seize smuggled genuine product, that has been correctly declared as cigarettes, being diverted through the legal warehousing regime by third parties who do not own the trademark rights.

   — The requirement for all exporters of cigarettes to ensure monetary guarantees for the worldwide supply of cigarettes. If cigarette movements between fiscal regimes are not covered by a guarantee bond, or are misdeclared, they would be liable to seizure by Customs Authorities. In essence, this would extend the existing EU Community Transit Guarantee system onto a worldwide basis.

   — Increased involvement with the suppliers of the materials necessary for cigarette manufacture in order to prevent counterfeiters from obtaining these materials.

   — It should be recognised that the root cause of tobacco smuggling into the UK is the excessively high rates of UK tobacco taxation. Therefore both UK cigarette and handrolling tobacco taxation should be reduced to nearer the levels in other EU Member States. In particular, a reduction in UK handrolling tobacco taxation is required in order to prevent the influx of non-UK duty paid consumption, sourced almost entirely from other EU Member States. Imperial Tobacco believes that tax reductions would be more effective in reducing the illicit trade in tobacco products than adopting strict cross-border volume limits which, in any event, may be unenforceable under EU legislation.

1. Background

1.1 Imperial Tobacco is the leading manufacturer for the UK cigarette market with a share of around 45%. The Company is the world’s fourth largest international tobacco company and manufactures its products in 33 factories worldwide. Imperial Tobacco employs a total of around 15,000 people, including 2,600 in the UK—its principal market.

1.2 Imperial Tobacco endorses the Tobacco Manufacturers’ Association submission to the Treasury Sub-committee in November 2004, and welcomes this additional initiative to examine, together with the other leading UK tobacco companies, HM Customs and Excise strategies in relation to the following areas:

   — The level of excise duty fraud and how this has been estimated.

   — The steps taken and proposed to reduce the level of excise duty fraud.

   — The impact these steps have had on the level of excise duty fraud and on compliance costs.

2. The Estimated Level of Excise Duty Fraud

2.1 Large scale cigarette smuggling into the UK is a relatively new phenomenon. It commenced in 1997, with product coming almost entirely from lower-taxed EU Member States, and grew significantly in 1999 and 2000, as smugglers scoured the world to obtain brands which would appeal to British consumers. Smuggling continues today, and now also involves counterfeit product.
2.2 The growth in cigarette smuggling into the UK is a direct result of successive cigarette excise tax increases during the 1990s at a level of 3% above inflation, greatly exacerbated in 1997 by the introduction of a policy of excise tax increases at 5% above inflation. Following more modest, inflation only, cigarette excise tax increases over the past four years since 2001, there is evidence to show that smuggling has been decreasing.

2.3 From pack collections undertaken by manufacturers, it is not possible to differentiate between the volumes of non-UK duty paid cigarettes that are smuggled and those that have been legally purchased through cross-border shopping. However, if we accept HM Customs and Excise estimates of the proportion of the UK cigarette market that is accounted for by legal cross-border shopping then, from Imperial Tobacco estimates of the total non-UK duty paid market, the implied proportion of total UK cigarette consumption that is smuggled, has moved as follows since 1996:

<table>
<thead>
<tr>
<th>Year</th>
<th>Non-UK Duty Paid</th>
<th>Legal Cross-Border Shopping</th>
<th>Smuggling</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>7%</td>
<td>6%*</td>
<td>1%</td>
</tr>
<tr>
<td>1997</td>
<td>8%</td>
<td>7%*</td>
<td>1%</td>
</tr>
<tr>
<td>1998</td>
<td>16%</td>
<td>7%*</td>
<td>9%</td>
</tr>
<tr>
<td>1999</td>
<td>25%</td>
<td>5%</td>
<td>20%</td>
</tr>
<tr>
<td>2000</td>
<td>31%</td>
<td>6%</td>
<td>25%</td>
</tr>
<tr>
<td>2001</td>
<td>30%</td>
<td>8%</td>
<td>22%</td>
</tr>
<tr>
<td>2002</td>
<td>26%</td>
<td>9%</td>
<td>17%</td>
</tr>
<tr>
<td>2003</td>
<td>27%</td>
<td>9%</td>
<td>18%</td>
</tr>
<tr>
<td>2004</td>
<td>27%</td>
<td>n/a**</td>
<td>?</td>
</tr>
</tbody>
</table>

* Imperial Tobacco estimates of the market share held by legal duty-free purchases. HM Customs and Excise estimates of legal cross-border shopping are unavailable for these years.

** Estimate not yet available from HM Customs and Excise.

2.4 Imperial Tobacco is concerned that smuggling may have increased slightly in 2003 to 18% of the total market. This estimate compares with the HM Customs and Excise figure of 15% for the year ended March 2004, although both parties agree that there has been a downward trend in smuggling since its peak in 2000.

2.5 The huge tax differentials that exist between the UK, the rest of the EU and most of the world creates the situation whereby—

— There is a strong economic incentive for smugglers to smuggle.

— Tobacco smuggling is an international activity and it appears that, as smugglers are unable to obtain supplies from one overseas market, they switch to another.

— The supply policies introduced by all UK manufacturers in order to assist HM Customs and Excise to combat smuggling, including the stringent supply policy implemented by Imperial Tobacco, have not prevented cigarette smuggling, as smugglers have:
  — increasingly turned to the smuggling of counterfeit versions of preferred UK brands (an activity favoured by organised criminal gangs);
  — smuggled other brands from overseas which they consider would be acceptable to UK smokers;
  — bootlegged supplies of preferred UK brands from much lower-taxed EU Member States.

2.6 Imperial Tobacco estimates that for the calendar year 2004, total UK cigarette consumption was around 72 billion. This comprises a UK duty paid market of 52 billion, with a further 20 billion (27%) accounted for by both legal and illegal imports on which no UK excise tax has been paid. Imperial Tobacco’s pack collection data indicate that almost 70% of non-UK duty paid consumption originates from other EU Member States, or is purchased in duty free outlets. The remaining 30% of non-UK duty paid consumption comes into the UK from the rest of the world.

2.7 Counterfeit products account for an increasing share of total non-UK duty paid cigarette consumption. Imperial Tobacco estimates that at least 2 billion counterfeit cigarettes (3% of total consumption) were smoked in the UK in 2004, and the figure could be as high as the HM Customs and Excise “mid-range” estimate of 4 billion (5.5% of total consumption).

2.8 Counterfeit cigarettes bear no excise tax and therefore represent the cheapest source of supply for smugglers. However, even within the EU there are significant tax-paid retail price variations between the same brands (see Chart 1). These retail price differentials reflect the wide variation in cigarette taxation between EU Member States (see Chart 2). In many countries outside the EU, tax-paid retail prices are substantially lower than the cheapest EU retail prices.
2.9 Within the EU, tax-paid retail price differentials for handrolling tobacco are even more marked than for cigarettes. These significant retail price differentials already existed when the Single European Market was established in January 1993. The combination of these tax-paid retail price differentials and the opening of the Single Market resulted in the rapid growth of cross-border shopping and bootlegging of handrolling tobacco into the UK from 1993 onwards. The latest figure from HM Customs and Excise indicates that non-UK duty paid handrolling tobacco accounted for 71% of total UK consumption in 2003–04, which is broadly in line with Imperial Tobacco’s estimates.
3. Steps taken and Proposed to Reduce the Level of Excise Duty Fraud

3.1 Imperial Tobacco commends and supports the efforts made by HM Customs and Excise through their Tackling Tobacco Smuggling strategy, in what is a very difficult environment. We can only agree with the sentiments expressed by HM Customs and Excise to the Treasury Sub-committee on 17 November 2004 that—

"Obviously the UK is an attractive place for fraudsters because of our relatively high tax rates. Inevitably that makes us a target to exploit."

3.2 In addition to the “front-line” activities undertaken by HM Customs and Excise, Imperial Tobacco has undertaken a number of initiatives in order to help combat the level of tobacco smuggling, and is continuing to build upon and develop these initiatives.

Working relationship with HM Customs and Excise

3.3 It is the policy and practice of Imperial Tobacco to co-operate with Customs Authorities worldwide, since if Customs and the tobacco industry do not work together, the only winners will be the smugglers. In order to further this co-operation, regular meetings to discuss strategy and exchange information are held with HM Customs and Excise to combat all forms of illicit trade, although the issue of counterfeit products now predominates.

3.4 Imperial Tobacco’s commitment to reducing smuggling into the UK through both its internal controls and through working with HM Customs and Excise has been demonstrated by the Company terminating supplies of its brands to distributors in countries where international brands are widely available and that have been targeted by smugglers. This was possible by internal tracking and tracing procedures linked to seizure information provided by HM Customs and Excise. Between end—1999 and mid—2001, a period when cigarette smuggling escalated, the Company ceased trading with almost 30 customers, the vast majority at Imperial Tobacco’s own initiative and before concerns about certain distributors were expressed to Imperial Tobacco by HM Customs and Excise.

3.5 As part of Imperial Tobacco’s continued commitment to assist HM Customs and Excise, the Company has provided Customs with witness statements to support the prosecution of tobacco smugglers. These have numbered over 400 statements in the last two years alone. Imperial Tobacco has also provided expert witnesses to appear in court on behalf of HM Customs and Excise in high profile smuggling cases, often resulting in jail sentences for smugglers.

3.6 Imperial Tobacco has initiated unilateral court proceedings in both The Netherlands and Belgium which have been supported by HM Customs and Excise. These court proceedings involve the diversion of genuine product by third parties from their original tax-paid destination market. These are civil actions based on trade mark infringement, funded entirely by Imperial Tobacco, and represent the first such actions taken by a tobacco manufacturer to prevent the diversion of genuine product, that has been correctly declared as cigarettes, being transported through the legal warehousing regime. The court proceedings taken by Imperial Tobacco have enabled the cigarettes to be held in both The Netherlands and Belgium and, if successful, the cigarettes will be destroyed by the Customs Authorities in these countries. HM Customs and Excise are keen to promote similar actions by other tobacco manufacturers.

3.7 In addition, Imperial Tobacco has recently provided HM Customs and Excise with comments and information in support of the launch in December 2004 of the HM Customs and Excise Media Handbook on Counterfeit Tobacco Products.

Stringent supply policy

3.8 With the growth of cigarette smuggling into the UK, Imperial Tobacco has further developed control criteria and parameters relating to the supply of tobacco goods from the UK.

3.9 The Company’s Supply Policy has evolved and been enhanced over time and, based on experience in the UK, is now applied worldwide across Imperial Tobacco.

3.10 Embedded within the Supply Policy, Imperial Tobacco has developed a number of pre-supply procedures, together with post-supply checks.

3.11 Pre-supply procedures are in place to ensure:

— Validation and verification of a customer’s good standing—bona fide in both reputation and performance;
— The destination market is clearly specified;
— Product supplied conforms to mandatory health warnings and any tax stamp requirements for that market;
— Product identification records are established including coding on individual retail packs, 200s cartons of cigarettes and 10,000 cigarette mastercases;
— Shipment arrangements are secure;
— Payment/settlement arrangements satisfy credit-worthiness checks;
— The product is appropriate for the destination market and that the quantities requested/ordered by the customer are commensurate with anticipated sales in that market;
— Establishment of arrangements for the orderly conduct of business, all of which are recorded on a masterfile;
— A sign-off policy across Company functions before supply;
— Customs Authorities are informed before supply to a new customer is commenced.

3.12 Post-supply checks include:
— Evidence (in the form of delivery documents, market visits etc) that the goods have been exported to and entered into the intended destination market;
— Confirmation that the product is present and supported in the market by permissible promotional activity and that future deliveries are justified;
— Review of seizure records to ensure that there is no material evidence of the product being diverted into other markets;
— Ongoing market/customer monitoring checks.

3.13 Through these measures, Imperial Tobacco ensures that its products are supplied directly into the intended destination market for retail sale. Diversion fraud for tobacco products is virtually unknown, unless the goods are stolen whilst being moved from the manufacturing location to the intended destination market.

Anti-Ilicit Trade Strategy

3.14 Imperial Tobacco continues to invest considerable resource, expertise, time and money in working to prevent illicit trade in its products and the counterfeiting of its products. This is a pro-active approach, often in conjunction with other tobacco manufacturers, and always with the support of Customs Authorities.

3.15 The anti-illicit trade initiatives favoured by Imperial Tobacco for their proven effectiveness and the fact that they are predominantly pro-active, rather than merely being re-active to seizures after smuggling has occurred, are as follows:
— Memoranda of Understanding (MoUs): A programme of developing and signing MoUs with Customs Authorities is ongoing both at an industry and individual Company level. Imperial Tobacco has signed six MoUs with Customs Authorities in Europe, including the most comprehensive MoU in the UK with HM Customs and Excise. Discussions are progressing with Customs Authorities in over one dozen other countries to finalise further MoUs in various parts of the world.
— Supply Policy: Imperial Tobacco considers a robust Supply Policy is essential for the controlled distribution and sale of its products. As such, Imperial Tobacco continually vets, monitors and re-assesses its customers to ensure the tightest possible control of distribution in the intended destination market. Market-based employees continue to be fully briefed and trained in all aspects of the Supply Policy and are actively involved to ensure compliance.
— Tracking and Tracing: Pack and carton coding procedures are in place to identify the precise time, machine and location of manufacture and the final destination market. Database procedures capture and record the first distributor/customer for the Company’s products and the volume and date of supply to that customer.
— Cigarette Component Materials: Initiatives are being explored, in conjunction with other tobacco manufacturers, with the suppliers of the materials necessary for cigarette manufacturing to prevent counterfeiters from obtaining these materials. In addition, Imperial Tobacco scraps any surplus machinery it may have arising from factory reorganisation, unless the machinery can be sold back to the original supplier, rather than sell it onto the second hand market.
— Export Bonds: This initiative is being discussed with Customs Authorities as an industry proposal. The onus would be on all exporters of cigarettes worldwide to ensure that monetary guarantees are in place and the goods are correctly declared for the movement of cigarettes between fiscal regimes. If cigarette movements between fiscal regimes are not covered by a guarantee bond, or are misdeclared, they would be liable to seizure by Customs Authorities. In essence, this would extend the existing EU Community Transit Guarantee system onto a global basis.
Imperial Tobacco’s Anti-Ilicit Trade Operations

3.16 To enable Imperial Tobacco to combat illicit trade, the Company has a team of 25 specialists operating internationally, in conjunction with Customs Authorities and outside agencies employed by Imperial Tobacco.

3.17 This team operates a co-ordinated strategy to disrupt tobacco smuggling by:

— Identifying and attacking the source of manufacture of counterfeit products, either acting on a unilateral or industry basis, in partnership with regulatory authorities. For example, in China, Imperial Tobacco works closely with Customs and the Chinese State Monopoly, in conjunction with British American Tobacco, Philip Morris and Japan Tobacco, to disrupt counterfeit production.

— Seizing containers of both genuine and counterfeit smuggled product en route to markets, and liaising with Customs Authorities, including HM Customs overseas fiscal liaison officers, to share intelligence on illegal distribution networks.

— Investigating retail sales of illicit product in the UK market and working with HM Customs, Trading Standards and the Police Authorities to seize such product.

3.18 Imperial Tobacco is the only tobacco manufacturer which has a dedicated team employed to disrupt the retail sale of illegal product within the UK market. The work of this team clearly demonstrates that smuggled product is rarely being sold through the legal distribution chain but is virtually all sold through informal channels, such as car boot sales, street markets, on street corners or from private homes. Therefore, Imperial Tobacco supports HM Customs and Excise opinion, as expressed to the Treasury Sub-committee on 17 November 2004, that licensing of the distribution chain would do little to combat smuggling.

4. IMPACT OF THESE STEPS ON THE LEVEL OF EXCISE DUTY FRAUD AND COMPLIANCE COSTS

4.1 From HM Customs and Excise seizure data, it is clear that their activities, together with the efforts of the manufacturers, have resulted in a dramatic reduction in seizures of genuine product in recent years. However, this has been partly offset by the growth of counterfeit product.

4.2 HM Customs and Excise began providing Imperial Tobacco with detailed seizure information for its cigarettes from mid-2000. Based on large cigarette seizures by HM Customs and Excise (defined by them as over 0.5 million), seizure volumes of both genuine and counterfeit versions of Imperial Tobacco’s cigarettes have moved as follows:
4.3 Seizures of genuine Imperial Tobacco cigarettes have fallen markedly and the latest annual figure of 66 million for the year ended September 2004 shows a 92% reduction from the level of seizures in 2001. The Company believes that the reason there is still the occasional large seizure of genuine Imperial Tobacco cigarettes is that it is mainly old stock still circulating. For example, the largest seizure in the last year, some 20 million in January 2004, was originally sold by Imperial Tobacco in October 1999, over four years previously.

4.4 The decline in large seizures of genuine Imperial Tobacco cigarettes is so marked that in the four months to September 2004 (the latest period for which data is available from HM Customs and Excise) total large seizures of the Company’s cigarettes have amounted to under 3 million.

4.5 The latest reported HM Customs and Excise seizure data of all cigarettes for the year ended March 2004 indicate that seizures of genuine UK brands accounted for only 28% of total large seizures, as the following chart published by HM Customs and Excise in December 2004 illustrates:

4.6 The above chart shows that, within the seizures of genuine UK brands, Imperial Tobacco’s Superkings accounted for only 9% of total seizures. This compares with Imperial Tobacco’s overall UK cigarette market share of 45%.

4.7 HM Customs and Excise have reported that the percentage of seizures of all manufacturers’ brands accounted for by counterfeit product has risen from 15% in the year ended March 2002 to 54% in the year ended March 2004. During this period, for Imperial Tobacco seizures, the proportion accounted for by counterfeit versions of the Company’s cigarettes increased from 12% to 79%. More recently, in the six months to September 2004, this figure has risen to 93%.

4.8 In view of the extremely low level of seizures of genuine Imperial Tobacco product, the Company’s ongoing anti-illicit trade activity is increasingly directed against counterfeit product. Imperial Tobacco’s anti-counterfeiting operations, against criminals with the UK as the target market, were successful in achieving the following results during the year ended September 2004:

- Thirty one counterfeit factory closures.
- Eleven warehouse raids.
- Twenty printer/packing house closures.
- Forty-five containers of counterfeit cigarettes seized.
- Total seizures of 473 million cigarettes. This is comparable with the total volume of large seizures of Imperial Tobacco cigarettes notified to the Company by HM Customs and Excise in the same period.

4.9 The cost to Imperial Tobacco of mounting the above series of anti-illicit trade operations in the year ended September 2004 was £1.2 million. This produced a potential profit benefit for Imperial Tobacco in the UK market of £11 million and a revenue benefit to the UK Exchequer of £85 million.
5. Conclusion and Recommendations

5.1 In the UK, the co-operation between Imperial Tobacco and HM Customs and Excise has been particularly successful, resulting in a 92% reduction in large seizures of genuine Imperial Tobacco cigarettes between 2001 and 2004, although the smuggling of counterfeit versions of the Company’s cigarettes are a growing concern.

5.2 Imperial Tobacco and HM Customs and Excise continue to build on this co-operation and hold regular meetings to exchange ideas and information on how tobacco smuggling into the UK could be further reduced. The latest Imperial Tobacco proposals to assist in the reduction of tobacco smuggling into the UK include:

- Closer “front-line” co-operation with HM Customs and Excise to counter the illicit trade in tobacco products.
- Increased involvement with the suppliers of the materials necessary to manufacture cigarettes to prevent counterfeiters from obtaining these materials.
- A worldwide export bond system to assist in detecting the diversion of smuggled cigarettes.
- Enhanced powers for HM Customs and Excise to seize genuine as well as counterfeit product.
- UK cigarette and handrolling tobacco tax reductions to nearer the levels in other EU Member States.

5.3 This submission demonstrates the commitment and effectiveness of Imperial Tobacco’s work with Customs Authorities worldwide to combat the illicit trade in tobacco products.

December 2004

Memorandum submitted by Gallaher Group Plc

1. Summary of Recommendations

1.1 Increased resources should be made available to HMCE to target existing and developing contraband channels—ports, airports and inland mail sorting centres.

1.2 Increased resources should be provided to local authorities, trading standards authorities and HMCE to target sellers of contraband tobacco products, where it occurs—street sellers, markets, etc. These agencies should work more closely not only to close down illicit operations but also to trace and prosecute the suppliers to those markets.

1.3 The “negative” licensing system being proposed to prevent sales to persons under the age of 16 should be extended to include sellers of counterfeit and contraband products.

1.4 HMCE should liaise further with other EU Customs agencies to establish more accurately the scale of cross border smuggling and cross border shopping from other EU Member States. Fixed limits for personal consumption should be introduced across the EU to regulate cross-border purchasing.

1.5 HMCE and tobacco manufacturers should establish a joint working party to seek to adopt a common approach for assessing legitimate and smuggled UK cigarette consumption, if need be using an independent third party.

1.6 Handrolling tobacco sourced from Belgium and elsewhere in Europe should be separately targeted by HMCE.

1.7 HMCE, together with manufacturers where appropriate, should continue to raise awareness of the issues associated with smuggling and counterfeit tobacco products with the general public and retailers on a continuous basis.

1.8 HMCE should examine the opportunities for closer co-operation with key non-tobacco material suppliers to the tobacco sector with the aim of preventing raw materials reaching the counterfeiters.

1.9 A common approach should be adopted across the EU (and in future accession states) dealing with seized contraband or counterfeit products. Destruction of seized, illicit products should be the only course of action.

1.10 Given the high tax differentials between the UK and the rest of Europe, the UK Government should acknowledge that as HMCE reduces the level of illegally sourced cigarettes reaching the UK, smokers will increasingly turn to cross-border shopping to avoid UK duty. A closer alignment of UK tobacco tax rates with those existing elsewhere within the EU would assist. Accordingly, UK cigarette duty rates should be frozen until the gap is closed and the duty on handrolling tobacco should be reduced.
2. Foreword

2.1 Gallaher Group Plc (“Gallaher”) welcomes the opportunity to make this submission to the Treasury Sub-committee inquiry into Excise Duty Fraud (“the Committee”) and to appear before the Committee to respond to questions.

2.2 In this submission, Gallaher sets out:

(a) the company’s understanding of the background to the growth in the consumption of non-duty paid and counterfeit cigarettes, within the UK, in recent years and the scale of that growth;

(b) the company’s approach to the control and management of its sales;

(c) the company’s relationship with HMCE, including the importance placed upon its Memorandum of Understanding;

(d) the impact of smuggling and cross border purchasing on the UK tobacco market; and

(e) some ideas on the way forward.

2.3 The differentials in taxes imposed by some countries, including the UK, compared with others within the European Union (“EU”) and elsewhere, has created a situation where cigarettes and other tobacco products are seen as high value commodities. As a consequence, consumers have and will continue either to avoid tax by buying cigarettes legally abroad or to evade tax by buying illicit cigarettes (either manufactured legitimately or counterfeit) from smugglers.

2.4 The issue is exemplified by the position within the EU. Although there is an EU Directive aimed at providing minimum excise levels, there are in practice very large differentials in tobacco tax between member states. Recently, the situation has been compounded by the accession of many low tax countries within Central and Eastern Europe. Tax levels in the EU now range between £3.77 (UK) and £0.37 (Latvia), for a pack of twenty, typical cigarettes. In the absence of harmonisation across the EU, or indeed any significant steps towards convergence in the foreseeable future, British travellers will continue to purchase cigarettes and other tobacco products legitimately from elsewhere for their own personal use. This issue is real and difficult to address until tax rates come in line across the EU. Differentials in tax are also likely to create further problems as and when additional low tax countries successfully apply for accession to the EU.

2.5 Smuggling undermines the legitimate markets for tobacco products. Specifically, it creates illicit channels for distribution, including pubs, clubs, car boot sales, street corners etc, where sales are neither regulated nor controlled and in which children can gain access to tobacco products. It also results in considerable loss of revenue to Government, legitimate retailers and Gallaher.

2.6 Since the 1990s, we have taken numerous steps (summarised at Appendix A67), often following consultation or in conjunction with HM Customs and Excise (“HMCE”), to ensure control and management of our sales globally. Despite the extensive measures that we have put in place, we are extremely concerned that smugglers have targeted some of our brands in the last few years. In the recent HMCE publication “Measuring and tackling indirect tax losses—2004”, two of our brands, Sovereign Classic and Dorchester International, are identified as the most seized legitimately manufactured brands in the UK. We fully acknowledge that this is an unacceptable position. It is one that we have and are continuing to address with HMCE’s support. A significant element of the seizures, reported in 2003 and 2004, relate to supplies to a distributor that we stopped trading with in 2001. This illustrates that even after termination of business relationships, smugglers continue to be able to source such products and traffic them to the UK market. The other material element results from control and management issues relating to a replacement distributor in the Middle East. In June 2004, we formally withdrew Sovereign Classic from that distributor’s portfolio and we have not made any further supplies of any other cigarettes, pending the outcome of discussions with it relating to future control and management. HMCE has been kept fully informed on the position throughout.

2.7 Gallaher has and will continue to work closely with HMCE in this country and other regulatory authorities abroad, to seek to prevent its products forming part of contraband trade. Gallaher is also committed to a pro-active approach against the illicit trade in tobacco products. We strongly support the extra resources provided to HMCE to stamp out smuggling and believes these should be further enhanced.

3. Gallaher Group PLC

3.1 The business of Gallaher began in 1857 in Londonderry, Northern Ireland. Today, the Gallaher Group is the fifth largest international tobacco manufacturing and wholesale company, with leading positions in Austria, Germany, Kazakhstan, Republic of Ireland, Russia, Sweden and the UK. Gallaher’s brand portfolio includes Amber Leaf, Benson & Hedges, Blend, Condor, Dorchester, Hamlet, LD, Mayfair, Meine Sorte, Memphis, Old Holborn, Ronson, Silk Cut, Sobranie, Sovereign, and Troika.

3.2 Gallaher employs around 10,000 people, with manufacturing plants in Austria, Kazakhstan, Poland, Romania, Russia, Sweden, Ukraine and the UK.

67 Appendix A provides an historic overview of the steps we have taken.
3.3 Within the UK, cigarette production is located in Lisnafillan, Country Antrim where hand-rolling and pipe tobacco are also manufactured. The company is one of the largest employers in Northern Ireland. In addition, cigars are produced in Cardiff. Gallaher’s head office is based at Weybridge and its distribution centre for the UK is situated in Crewe.

3.4 Gallaher readily acknowledges that tobacco is seen by some as a controversial business sector. Nevertheless, we take our responsibilities very seriously and our publication “Behaving Responsibly” summarises our approach to the key issues surrounding the sector, including tobacco smuggling.

3.5 In 2003, Gallaher sold some 160 billion cigarettes across the world, although predominantly it is a Eurasian business (CIS 82.5 billion; Europe 50.5 billion; UK 20.3 billion; Rest of World 6.9 billion). In the UK, Gallaher currently has a cigarette market share of around 39%.

3.6 Gallaher’s shares are listed on the London Stock Exchange and its American Depository Receipts are traded on the New York Stock Exchange. Gallaher is currently around the fifty-fifth largest company within the UK. In 2003, it had a global turnover, including duty and associate companies, of £9.0 billion and delivered pre tax profits of £379 million.

3.7 Gallaher made duty and tax payments of around £3.7 billion to the UK Exchequer in 2003. It also made duty and corporation tax payments to other Governments amounting to over £2.4 billion.

4. Excise Issues and the Level of Fraud

Historical perspective

4.1 Prior to 1992, there was little evidence of tobacco or cigarette smuggling into the UK. Following the introduction of the Single Market in that year and the relaxation of border controls, hand-rolling tobacco sourced from Belgium and Luxembourg began to appear in the UK. Low excise duties in those countries provided an incentive for both UK travellers to Europe and bootleggers alike to bring hand-rolling tobacco into the UK without paying UK duty. The demand grew rapidly. By the end of the 1990s the Tobacco Manufacturers’ Association (“TMA”) estimated that some 78% of UK consumption of hand-rolling tobacco was sourced abroad. In other words, four out of five hand-rolled cigarettes smoked domestically had no UK duty paid on them.

4.2 By contrast, until 1997, with the exception of duty free cigarettes purchased at airports and on aeroplanes and ferries, there was little evidence of non-UK duty paid cigarettes being smoked in the UK. However, as a consequence of the series of above-inflation tax increases on cigarettes throughout the 1990s, the price differential between the UK and the rest of the world increased significantly. From 1997, there was a rapid acceleration in the then already existing long-term rate of decline of purchases of legitimate cigarettes in the UK, while overall consumption appeared broadly static. By 2000, nearly one in three of all cigarettes smoked in the UK were being sourced from overseas markets. Throughout this period, Gallaher shared its understanding of the growth of smuggling and the measures it was taking to counter this threat in respect of its brands, with HMCE and the Government.

4.3 From 2001, Government action to combat smuggling, including increased resources for HMCE, the strengthening of the working relationship between HMCE and UK cigarette manufacturers, and the abandonment of above-inflation tax increases on tobacco products, curtailed the growth and subsequently reduced the volume of illegal cigarette sales.

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68 Not printed.
69 2003 is the latest year for which full year figures have been published by Gallaher.
70 CIS (Commonwealth of Independent States) includes Russia, Kazakhstan, Ukraine and several small CIS markets.
71 Europe includes current EU-25 countries (with the exception of UK) and Balkans.
72 RoW— includes Africa, Middle East, Asia Pacific (including China), Latin America and contract manufacture.
73 Based on market capitalisation.
74 Gallaher has a 31 December year-end. It cannot comment on its full 2004 year-end results until its audited accounts are published in March 2005 and will be in a “closed period” as of 2nd January 2005. Tax payments include corporation tax and VAT.
Currently, the most popular price class ("MPPC") of cigarettes in the UK is £4.82 for a packet of 20, compared with around £1.50–£2.00 for similar products sold in Greece and Spain and even less in other EU countries. Elsewhere in the world, taxes and prices are lower still. To illustrate the position, the following chart shows the tax payable on the MPPC in each of the EU Member States and demonstrates the savings smokers can make by cross border shopping.

As can be seen, the tax on a typical packet of cigarettes is £3.77 in the UK, £1.05 in Spain and £0.61 in the Czech Republic.
4.5 The proliferation of cheap airfares to European destinations has also provided an increased opportunity for cross-border shopping. By way of illustration, UK residents made 61.5 million trips abroad in 2003, of which approximately 45 million were to other EU countries. As a consequence, cross border purchasing within the EU appears to be eroding an increasing proportion of the UK duty paid market. It has also opened up the possibility of alternative smuggling routes for tobacco and other goods.

4.6 Given the margins that smugglers can make by legitimately sourcing products from one or more duty paid markets and illegally importing the cigarettes into the UK, the scale of the problem is not surprising. Currently, smuggled cigarettes in the UK are sold on street corners or at car boot markets etc, for around £2.50 a packet. Those who make such sales do not care to whom they are made. These illegitimate sales points need to be targeted vigorously, along with the suppliers to those markets.

4.7 High tobacco taxation in the UK not only provides an incentive for smugglers to source genuine brands from other markets, but also for illicit manufacturers and smugglers of counterfeit products to target the UK. Whilst HMCE’s policy, working in co-operation with legitimate manufacturers, has been successful in limiting the opportunities for smugglers to gain access to genuine brands that are attractive to UK smokers, counterfeit products are growing in volume. Counterfeit products are not subject in any way to the robust quality controls and regulatory regimes that govern the manufacture, distribution and sale of legitimately manufactured products. Given the absence of any such controls and the potential additional risks inherent with counterfeit products, the growth in this trend also needs to be attacked.

**Measurement of illegal market**

4.8 While we have made repeated attempts, using information available to us, to assess accurately the volume of illegal cigarettes smoked in the UK, we readily recognise there are limitations in the research. This means that only regular comparisons between the various approaches used by HMCE and ourselves can give any indication of the scale of the issue and provide an understanding of the trends. Even then, the results must be assessed in the broadest of terms. Having said that, our approach includes:

**Pack surveys**

4.9 From 1998, Gallaher began assessing the penetration of non-UK duty paid cigarettes on a monthly basis using what are termed “pack swap surveys”. The surveys are carried out across the UK (with the exception of Northern Ireland) by an independent research agency which collects smokers’ cigarette packaging while undertaking general market research. The analysis of the collected packs—some 500–600 per month—has provided us with a basis for understanding trends in the level of non-UK duty paid cigarettes. We regularly share the results of these surveys with HMCE.

4.10 The specific information that we derive from these pack swap surveys of non-UK duty paid products includes:

(a) a breakdown between EU, non-EU and duty free products being smoked in the UK;
(b) the regional differences in consumption of non-UK duty paid products; and
(c) most importantly, the long term trends.

4.11 Such surveys cannot, however, determine whether or not the cigarettes were purchased by travellers abroad and legally imported into the UK, or illegally imported by smugglers, or in what proportions.

4.12 Generally, since Gallaher began undertaking these surveys, our impression is that the overall level of non-UK duty paid packs collected has under-recorded what we believe is the actual figure. This is partly due, we think, to people not being willing to provide their non-UK duty paid packs to the researchers. Furthermore, some areas, where the propensity for use of illicitly sourced products may be higher, are not visited by researchers for reasons of personal security.

4.13 The results of the Gallaher pack swap surveys are shown in Appendix B. They indicate that in recent years the proportion of cigarettes imported from the EU has increased while the proportion from outside the EU has decreased. This suggests that the scale of wholesale “container” cigarette smuggling from outside the EU has declined. We believe that, with the increase in legal cross border purchasing within the EU, the trends indicate that the level of smuggling generally has also decreased.

4.14 The pack swap survey results also show regional differences in non-UK duty paid consumption (see Appendix C). The highest incidence rates appear to be in the North East, North West and the Yorkshire/ Humberside regions.

4.15 Other market surveys, such as the collection of packs discarded after race meetings and football matches, also suffer shortcomings, because they are non-representative samples. However, taken together with our pack swap surveys, they assist in providing a broadbrush indication of non-UK duty paid volumes.
4.16 Given the difficulties in identifying such products from the packaging information alone, counterfeit cigarettes pose a particular challenge for pack swap and other similar surveys. In conjunction with other UK tobacco companies, packs which are collected in our survey are sent to the relevant trademark owner and an analysis of the counterfeit packs is provided to the TMA. Currently, the TMA’s analysis suggests that some 2.3% of all packs reviewed are counterfeit.

4.17 Extrapolating the results of the surveys arithmetically, we conclude that at least two billion cigarettes smoked in this country are counterfeit. These findings are again shared with HMCE.

4.18 Taking the survey data as a whole, we broadly concur with HMCE’s estimate that, currently, around 27% to 28% of all the cigarettes smoked in the UK are non-UK duty paid.

Seizure statistics

4.19 Seizure information both assists HMCE in focusing its resources and helps us to identify specific contraband supply routes thereby enabling us to take additional action to prevent smuggling of our brands. However, seizure information, taken alone, does not provide a reliable measurement of the scale of the illicit market. Having said that, the data does confirm a reduction in the incidence of legitimately manufactured smuggled cigarettes being seized, albeit that counterfeit is an increasing threat.

4.20 Taken alone, HMCE’s analysis of seizures suggests that contraband cigarettes appear to be almost entirely sourced from outside the EU. By contrast, the pack surveys and our analysis of pack discards indicate that around 60% of non-UK duty paid cigarettes come from markets inside the EU. We believe that this points to a higher level of cross border shopping and lower levels of smuggling than HMCE may envisage. Further research by HMCE in conjunction with other EU customs authorities could help to establish more accurately the scale of smuggling from other EU countries, thereby enabling the supply routes to be focused upon and controls to be put in place.

Handrolling tobacco

4.21 Gallaher makes no individual estimates of the scale of handrolling tobacco sourced outside the UK market. We rely on data provided by the TMA, which has made a separate submission to the Committee. As far as we know, there is currently no robust measurement tool to assess the extent of handrolling tobacco excise fraud. Nevertheless, we understand that the majority of handrolling tobacco brought into this country from abroad is likely to be Belgian or other EU country duty paid product. One of our recommendations is that HMCE should enhance the existing focus upon targeting illicit trade in this product category.

General

4.22 We, and other tobacco manufacturers, have suggested that HMCE and the companies affected by smuggling and counterfeiting should review their respective methodologies for estimating the total UK market for cigarettes and hand-rolling tobacco, and the proportions of smuggled and legitimate consumption. The aim of the review would be to try to obtain a common understanding and agreement on consumption figures, using an independent third party, if need be. The implementation of such a methodology is another of our recommendations.

5. Prevention of Fraud

HMCE activity

5.1 We fully support the “outcome” led approach of HMCE, which focuses on reducing the overall level of fraud. We believe that the combination of extra resources provided to HMCE by the Government in its Tackling Tobacco Smuggling strategy in 2000, which led to increased staff and technical equipment (such as mobile x-ray scanners) and challenging targets for HMCE, has had, and will continue to have, a significant impact on smuggling.

5.2 Given the continuing unacceptable level within the UK of counterfeit cigarettes and smuggled products, we think that providing HMCE with extra resources would be of further benefit in seeking to minimise fraud. To date, HMCE’s main focus has been on prevention of entry to the country of illegal products. There should also be a strong visible presence of HMCE staff preventing street sellers and car boot dealers etc operating openly in and around London and other towns and cities. Adopting this approach may also help HMCE to track and trace the suppliers. This suggestion draws on the success in the Republic of Ireland, when it experienced high cigarette smuggling levels in the mid 1990s. During that period, a very active and conspicuous domestic policing policy virtually eliminated smuggling.

5.3 In this context, and particularly in relation to counterfeit cigarettes found in the retail chain, we believe that there should be consideration of closer links between HMCE and trading standards agencies. We are aware that local authority and trading standards agencies in this country also want more resources to enable them to be more active in the area of enforcement.
5.4 An intelligence-led approach, in which information about problematic individuals, distributors, trading regions etc is shared between manufacturers and HMCE and under which smuggling routes and specific container movements are targeted, produces clear results. In particular, the sharing of information between us and HMCE has meant that, in practice, whenever we become aware of any container movements of either genuine or counterfeit cigarettes which appear to be contraband, we do, as a matter of course, liaise with the authorities here or elsewhere with the aim of preventing the products illegally entering this market. It would assist if the legal complexities associated with the steps to seize contraband products across the EU were simplified and harmonised.

5.5 Over the years, there have been HMCE communication campaigns aimed at informing smokers about the consequences of buying smuggled products. We believe these have had a positive effect in raising public awareness. Indeed, we have carried out our own campaign to support the messages HMCE are seeking to get across. The end consumers of smuggled cigarettes often do not understand the social and criminal aspects associated with such supplies, which involve organised gangs across many continents. Consequently, there need to be long-term publicity campaigns highlighting directly to the general public the unlawful activities in which such gangs engage and that such purchases can fund organised international crime.

5.6 In December 2004, HMCE commenced a campaign aimed at raising awareness of counterfeit cigarettes. We support this initiative which should be regularly reviewed and updated to maintain media interest, thereby increasing public awareness of the potential additional risks inherent in smoking counterfeit products.

5.7 Another manufacturer has proposed to the Committee a global licensing system for the whole supply chain of tobacco products, from manufacturers to retailers including exporters. As an alternative to a formal licensing system, we understand that the Department of Health is planning to propose a system of “negative licensing” for retailers found to be repeatedly selling tobacco products illegally to persons under 16 years of age (ie retailers could be banned from selling tobacco products). The scope of such legislation could be extended to include effective sanctions against retailers who sell counterfeit products or products illicitly sourced from abroad and against car boot markets etc where such practices are allowed to occur.

5.8 In relation to counterfeit cigarettes, the prevention of raw materials reaching the counterfeiters is important. To that end, we consider that HMCE should examine the opportunities for closer co-operation with key non-tobacco material suppliers to the tobacco sector.

Co-operation with HMCE

5.9 We consider that our long-standing and constructive relationship with HMCE has been and remains an important aspect of our approach to combating contraband trade. Taking into account the views of HMCE upon the ever-changing patterns and approaches of those involved in smuggling has assisted Gallaher in developing and enhancing appropriate operational control policies.

5.10 Gallaher was the first UK manufacturer to be offered a Memorandum of Understanding (“MoU”) (see Appendix D) which was signed in April 2002. That step was a recognition that we had already been at the forefront of industry co-operation for some time. We continue to work closely with HMCE to share information on contraband and counterfeit products. The MoU has, nevertheless, undoubtedly reinforced our business relationship with HMCE officials at all levels and the ways in which we are able to combat smuggling of our brands.

5.11 Sharing information with HMCE, such as customer, sales and market data, in a way which is easily useable is important. It enables HMCE readily to understand the approaches of manufacturers to combating and seeking to minimise any threat of smuggling of brands. Such an approach also enhances HMCE’s ability to understand the tobacco sector generally.

Our approach to combating fraud

5.12 We summarise below our approach to combating fraud:

(a) We have a formal policy on International Trade (see Appendix E) which is the cornerstone of the control and management of our sales and which focuses in particular on developing and emerging markets. This was first introduced in early 2001. The key elements of the policy require management to take proactive actions to seek to ensure that we only supply our products where there is legitimate demand in markets and to bona fide distributors. To ensure compliance, we utilise our Group internal audit and security functions. In the light of our experience, we continue to review and improve our “know your customer” procedures. We promptly share market information with HMCE, as and when requested.

(b) In emerging and developing markets in particular, we ensure that the cigarette packaging used is readily distinguishable from that used on domestic brands in the UK.

(c) To help to identify any distributor or sub-distributor who may be acting improperly, we place codes on packets of cigarettes manufactured in the UK for export, identifying the intended destination markets and the customer to whom we are making the sale. We are extending this approach to other manufacturing locations.
(d) We undertake market visits and background checks upon those we are proposing to do business with and/or are doing business with as a matter of course. Our findings are shared with HMCE.

(e) We incorporate provisions within our terms of business that make it clear that we will revisit any trading relationships with any customer believed to be acting improperly and if we conclude that a distributor is a smuggler, we will terminate the trading relationship. We also require our distributors to adopt a similar approach to their customers. Indeed, both we and our distributors have terminated distribution and contract manufacturing relationships where there have been concerns about the customer’s ability or willingness to control and manage our products appropriately.

(f) We involve HMCE and seek guidance whenever a specific issue arises. In this context, we have, for instance, arranged direct meetings between a distributor and HMCE in order to give HMCE a better understanding of the distributor’s business.

(g) We give considerable support to HMCE by providing manufacturing, sales, shipping and other associated information relating to any seized products which may be used in the prosecution of smugglers. We also provide witness statements and support HMCE/Trading Standards in court with the prosecution of smugglers and those involved in illicit retail selling.

(h) We have established a Group brand protection unit to combat counterfeiting of our brands. Led by the Group Security Manager, the team uses sophisticated software to assist tracing and seizures. Again, we share such information with HMCE.

Red and yellow cards

5.13 One of the principal elements underpinning HMCE’s approach to UK cigarette manufacturers is the concept of “red” and “yellow” cards in relation to issues with the control and management of brands by specific distributors. We have fully endorsed this approach and have found it helpful in reinforcing the need for proper control and management with our own distributors.

Seizures

5.14 As stated in our foreword, despite the extensive measures that we have put in place, we are extremely concerned that smugglers have targeted some of our brands in the last few years. In the recent HMCE publication “Measuring and tackling indirect tax losses—2004” two of our brands, Sovereign Classic and Dorchester International, are identified as the most seized legitimately manufactured brands in the UK. We fully acknowledge that this is an unacceptable position. It is one that we have and are continuing to address with HMCE’s support. A significant element of the seizures reported in 2003 and 2004 relate to supplies to a distributor that we stopped trading with in 2001. This illustrates that even after termination of business relationships, smugglers continue to be able to source such products, and traffic them to the UK market. The other material element results from control and management issues relating to a replacement distributor in the Middle East. In June 2004, we formally withdrew Sovereign Classic from that distributor’s portfolio and we have not made any further supplies of any other cigarettes, pending the outcome of discussions with it relating to future control and management. Again, HMCE has been kept fully informed on the position throughout.

5.15 Previously, in the autumn of 2000, when it became clear that Mayfair had been targeted by smugglers in the Middle East, we immediately withdrew the brand from sale in that region. It is particularly frustrating that Mayfair cigarettes seized by the Greek authorities at that time have subsequently been sold by them and have again recently been found in the hands of smugglers, this time in the UK.

Diversion

5.16 In the Committee’s questioning of Mr Mike Wells, acting Director of Strategy for HMCE, on 17 November 2004, reference was made to the warehousing regime for tobacco products within the UK. A comparison was also made with the alcohol sector, in which there have been a number of well-publicised prosecutions for diversions. To be clear, the control regime for tobacco products in the UK ensures that they are not diverted. To the best of our knowledge and belief, there has never been diversion of our products in the UK other than from thefts and hijacks on which UK duty has subsequently been levied by HMCE.

5.17 Nevertheless, we fully support the introduction of the proposed computerised Excise Movement and Control System (“EMCS”). It will enable legitimate operators to work effectively. We also supported the EU introduction of the New Computerised Transit System (“NCTS”), which provided additional controls on the movement of tobacco products for export through and outside of the EU.
Indicative limits

5.18 Mr Wells was also asked to clarify the “indicative limits”, laid down under EU Directive 92/12, for UK travellers returning from the EU. In the absence of any apparent possibility of harmonisation of tobacco excise taxes in the foreseeable future or significant convergence of tobacco taxes in Europe, the concept of an “internal market” for tobacco products creates significant difficulties for high tobacco tax countries, such as the UK. The current EU rules allow travellers to bring back into the UK as many cigarettes as they want as long as they are for personal consumption. This creates both uncertainty for HMCE in defining “personal consumption” and for travellers who have or claim to have difficulty in understanding indicative limits. Consequently, until harmonisation occurs, we would support a set limit within the EU for personal import from one member state to another.

5.19 As to other measures relating to quantitative limits for selling and possession of cigarettes proposed by another manufacturer in its submission to the Committee on 17 November, we believe that, at face value, they may have merit, although deeper consideration of the practicalities and legal implications of their proposals is required. We accordingly propose that a joint working party of representatives of HMCE and the tobacco manufacturers is established to assess any proposals HMCE or the Committee believe have merit.

Enhanced enforcement

5.20 One area where we believe progress could also be made is to introduce a simplified seizure procedure across the EU. Additionally, a common directive that requires seized contraband products to be destroyed (as opposed to sold off by customs’ authorities) would be beneficial and reduce the risk of seized products re-entering the illicit supply chain.

5.21 In our dialogue with HCME, we provide information for its database of genuine and counterfeit seizures. The existing systems have some shortcomings, and independent of this enquiry, we have suggested to HMCE that we could assist with software development for a PC based solution using our own in-house expertise.

6. Impact of Smuggling

6.1 As we have stated earlier in this submission, it is difficult to assess accurately the level of cigarette smuggling into the UK and, therefore, the perceived or actual economic impact.

6.2 In summary:

(a) We, of course, readily acknowledge that the UK’s high tobacco taxation policy has two objectives: to reduce the incidence of smoking and to raise revenue for the Treasury. The policy has, however, resulted in unintended consequences, as smokers have avoided or evaded excise duties, as opposed to quitting.

(b) The combination of smuggling and legitimate cross-border purchasing of tobacco products by smokers results in a considerable loss of revenue for the Government: in excess of £4 billion per annum.

(c) A major step towards eradicating this loss would be the harmonisation of tobacco taxation rates across the European Union. We believe that the Government should focus on this issue and, in particular, the closer realignment of the UK tobacco tax rates with those found in the rest of Europe. We recommend that cigarette excise duty rates should be frozen until the gap is substantially closed and that there should be a reduction in duty rates on hand rolling tobacco.

(d) Smuggling undermines the legitimate market for cigarettes in the UK and elsewhere. Within the UK many small shops rely upon the income from tobacco to support their businesses. Tobacco smuggling accordingly exacerbates the precarious financial position of many small retailers and we understand that around 25,000 shops have closed in recent years. Furthermore, a survey by a Gallaher sponsored Independent Retail News “Stamp out Smuggling” campaign earlier this year, found that retailers reported an average loss of turnover of over £25,000 per retailer in the previous 12 months.

(e) Tobacco smuggling is also as much a law and order issue as a revenue issue. Smugglers are often organised international gangs of criminals who, for instance, have no concerns about selling to underage purchasers. Many retailers in inner urban areas are in despair, as illegal
street sellers set themselves up outside their shops, intimidating both the shopkeepers and their customers. Against this background, it is not surprising that some retailers find themselves, often unwillingly, drawn into illicit activity.

(f) As the ability of smugglers to gain access to genuine cigarettes has declined, smugglers have increasingly turned to counterfeit cigarettes to supply the demand for cheaper products.

(g) The “outcome led” approach of HMCE has meant that the smuggling of legitimate cigarettes has decreased. Nevertheless, there is evidence that consumers are increasingly turning to European duty paid countries to source their products legally.

(h) Given that the tax on a packet of typical cigarettes in the UK is £3.77 and that HMCE considers that tobacco smuggling costs the country £2.65 billion, extra resources targeted on ports of entry, airports, international mail sorting centres and local areas where cigarettes are sold illicitly would appear to be cost-effective options.

(i) Finally, we believe that the Tackling Tobacco Smuggling strategy is working, that smuggling has decreased and has been a cost-effective way to stem the tide of ever-increasing contraband. Nevertheless, given the focus that achieving targets creates and for all the other reasons outlined above, HMCE’s targets should continue to be revised downwards, particularly if HMCE are provided with extra resources.

7. Conclusion

Since the publication of HMCE’s Tackling Tobacco Smuggling strategy, a great deal has been accomplished. By working and liaising closely with HMCE real results have been achieved. Even closer co-ordination between manufacturers, HMCE, the Treasury and customs and regulatory authorities within the EU and countries seeking accession would enhance the progress that has been made to date.

8. Appendix A

Overview of Gallaher’s approach to control and management

— Began process of regular meetings with HMCE and Treasury on the growth of hand rolling tobacco and cigarette smuggling dating back to the late 1990s. Includes meetings with “tobacco tsar” Martin Taylor, ministers, head of HMCE fraud prevention etc.

— Continuous provision of pack swap information on non-UK duty paid consumption from 1998.

— Early warning on sales growth exceeding normal market expectations.

— Frequent meetings with HMCE at all levels, including six monthly meetings at a policy level, on Gallaher sales performance and to assist the assessment by HMCE of the UK duty paid markets.

— Following the period of co-operation since the 1990s, Memorandum of Understanding signed with HMCE in April 2002.


— Incorporation of existing and new policies on international trade into internal codes of practice including “know your customer” procedures.

— Provision of market demand information to HMCE promptly whenever requested.

— Use of packaging in emerging and developing markets that is readily distinguishable from product sold in the UK.

— UK style health warnings not used on cigarettes distributed in emerging and developing markets that do not have local “warning” requirements.

— Voluntary restrictions on sales to certain territories and distributors.

— Voluntary cessation of supplies of all brands or some brands to distributors.

— Stopped selling Mayfair cigarettes for export to the Middle East, when an issue about the control and management of that brand first arose and, in June 2004, withdrew Sovereign from sale in that region.

— Sharing information on counterfeit cigarettes including addresses of shops and locations where they are sold.

— Formation of a Group brand protection unit to combat counterfeit.

— Ready provision of internal audit information relating to a distributor’s business to HMCE.

— Joint Gallaher/HMCE meetings with distributor.

— Protocol developed and agreed between Gallaher, HMCE and a distributor regarding sales, shipment arrangements and documentation.

— Prompt responses for information on all tracking and tracing requests.
— Provision of evidence statements relating to seizures to assist in prosecutions and attending court proceedings in this country and elsewhere.
— Market visits to verify proposed sales plans and to monitor them and the provision of that information to HMCE.
— Support for Crimestoppers (Northern Ireland and through the Tobacco Manufacturers Association).
— Generating publicity to support HMCE including sponsoring Independent Retail News “Stamp out Smuggling” campaign.
— Providing and distributing HMCE hotline posters for retailers on smuggling/counterfeit cigarettes.

8. Appendix B

Pack swap surveys

From 1998, Gallaher began assessing the penetration of non-UK duty paid cigarettes on a monthly basis using what are termed “pack swap surveys”. The surveys are carried out across the UK (with the exception of Northern Ireland) by an independent research agency which collects smokers’ cigarette packaging while undertaking general market research. The analysis of the collected packs—some 500–600 per month—has provided us with a basis for understanding trends in the level of non-UK duty paid cigarettes.

<table>
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<th>Non-UK Duty Paid</th>
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<td>2002</td>
<td>81.1%</td>
<td>18.9%</td>
</tr>
<tr>
<td>2003</td>
<td>77.2%</td>
<td>22.8%</td>
</tr>
<tr>
<td>To Oct 2004</td>
<td>77.8%</td>
<td>22.2%</td>
</tr>
</tbody>
</table>

Regional source of Non-UK Duty Paid

<table>
<thead>
<tr>
<th>Region</th>
<th>%</th>
<th>%</th>
<th>%</th>
<th>%</th>
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</tr>
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<tr>
<td>EU</td>
<td>11.5</td>
<td>50</td>
<td>10.9</td>
<td>53</td>
<td>11.2</td>
<td>59</td>
</tr>
<tr>
<td>Non EU</td>
<td>9.6</td>
<td>42</td>
<td>7.9</td>
<td>39</td>
<td>5.6</td>
<td>29</td>
</tr>
<tr>
<td>Duty Free</td>
<td>1.7</td>
<td>8</td>
<td>1.7</td>
<td>8</td>
<td>2.2</td>
<td>12</td>
</tr>
</tbody>
</table>
8. **APPENDIX C**

Non UK duty paid packs collected October 2003 - October 2004

pack swap survey regional differences

12 mths to Oct 2004

Percentages relate to the proportion of non-UK duty paid packs collected and analysed in each region, compared to all the packs collected in each region.

**Regions**

- A Scotland
- B North
- C North West
- D Yorks & Humberside
- E East Midlands
- F Wales
- G West Midlands
- H East Anglia
- I South West
- J Greater London
- K South East (excl. Greater London)

Source: Gallaher pack swap survey
8. **Appendix D**

**MEMORANDUM OF UNDERSTANDING BETWEEN HM CUSTOMS & EXCISE AND GALLAHER LIMITED**

The purpose of this MoU is to set the framework of co-operation between HM Customs & Excise and Gallaher Limited (“Gallaher”) in order to minimise any obstacles to legitimate trade while minimising the smuggling of exported UK manufactured cigarettes back into the UK.

Within the limits of “commercial-in-confidence” obligations, statutory restrictions and data protection legislation, HM Customs & Excise will:

- work and share information with Gallaher to identify, prevent and deter trade in counterfeit product;
- make Gallaher aware of any concerns about specific traders or destinations from which significant volumes of UK manufactured cigarettes are seized being smuggled back into the UK;
- forward to Gallaher samples from significant seizures of cigarettes purporting to be their brands for analysis;
- respond to any case specific information supplied by Gallaher on the illicit trade in tobacco; and
- meet regularly with Gallaher to review progress in tackling tobacco smuggling and the effectiveness of these co-operative arrangements.

HM Customs & Excise and Gallaher will respect the “commercial-in-confidence” status of information provided by either party to each other subject always to any overriding legal obligations affecting either party to this MoU.

Gallaher already has a Policy on International Trade. It maintains that Policy, which relates to its exports of UK manufactured tobacco products, with the aim of minimising the presence of the company’s brands in the UK illicit (duty evaded) market. From time to time that Policy may be revised and in such event HM Customs & Excise will be provided with a copy of the new policy.

To that end Gallaher:

- only supplies products where there is a legitimate demand for the product in the intended final markets and as necessary will share their understanding of that demand with HMC&E;
- takes action where information indicates any substantial smuggling of its products to identify, so far as is reasonably practical, the supply routes and suspect export trade;
- refuses sales where the end-sale (consumption) destination is in doubt;
- if it discovers that any particular distributor has been shown to be behaving improperly or has reasons for believing that they may be, re-visits that trading relationship with a view to discontinuing that relationship, if appropriate. In particular, if Gallaher concludes that any distributor is a smuggler of Gallaher products or that distributor is knowingly or recklessly supplying a smuggler with such products it will terminate that trading relationship with immediate effect;
- provides Customs, upon request, with all relevant information about the intended destination of export consignments; and
- provides Customs with prompt access to data about export sales, including specific in-house codings and translations of those codings.

8. **Appendix E**

*International Trade Policy—Re-issued January 2004*

**Gallaher Group Plc**

**Policy Objective**

Gallaher Group Plc (“Gallaher”) is an international tobacco company with headquarters in the United Kingdom. It commands market-leading positions in Austria, the Republic of Ireland, Russia, Sweden and the United Kingdom. Gallaher is committed to being a good corporate citizen. It operates legally and openly and is regulated and taxed by Governments around the world.
Gallaher is committed to the expansion of its international business and has a strategy that is designed to develop long-term growth globally. The aim of this policy is to set out the principles that govern the basis on which that strategy should be undertaken. Underpinning the policy is Gallaher’s desire to ensure that its products are not smuggled.

**Policy Statement**

To develop market shares for Gallaher in countries and regions identified as areas for growth, either at the expense of local manufacturers in those countries and/or Gallaher’s international competitors and/or, where appropriate, to accommodate smokers who wish to acquire cigarettes for their own consumption when abroad. To that end, where Gallaher is unable to develop business opportunities directly, Gallaher is committed to seeking distributors, joint venture partners, licensees etc. who have the necessary knowledge and experience to develop markets for Gallaher’s products. The countries in which such parties will be authorised to sell or distribute the company’s products either directly or in conjunction with Gallaher, will be set out in contractual documentation or recorded in the standard terms of business of the appropriate member of the Gallaher Group.

— It is implicit that all employees will conduct themselves in accordance with the Group Policy statements 006 (Employee Conduct) and 009 (Foreign Corrupt Practices Act), notably that all personnel will exercise integrity in their business conduct and in strict observation of, and compliance with, all applicable international laws and local requirements relating to the conduct of business in each country of operation.

— Gallaher deplores smuggling and has a long history of co-operating with Customs globally. Gallaher not only supports and endorses the “policing” measures that have been introduced by domestic regulatory authorities to address the cigarette smuggling issue, but has also established the following compliance procedures that should be followed:

  — Gallaher will take all reasonable precautions to ensure that Gallaher only trades with bona fide distributors.
  
  — Gallaher will only supply products where there is a legitimate demand for the product in the intended final market.
  
  — Gallaher requires distributors to provide prior notification of the final destination market for sales. Furthermore, cigarettes manufactured by Gallaher in the UK for export will be marked with a code to indicate the final destination market and Gallaher’s first customer (excludes duty free sales to airport shops, RMOs, airlines etc.).
  
  — Any valid request from local customs officers will be dealt with in accordance with the Group policy relating to governmental or regulatory enquiries and in conjunction, where appropriate, with Gallaher’s Corporate Affairs and Legal functions. Gallaher, as a matter of course, will provide customs officers with records of its distributors, their addresses, the brands and quantities of products that they order, pricing information, the delivery destinations and other information that may be requested by customs officers relating to supply routes.
  
  — In its corporate domicile, Gallaher assists UK Customs & Excise by providing statements detailing manufacturing and sales records relating to any seized products, which may be used in prosecuting smugglers, along with regular weekly updates of any retailer believed to be involved in selling counterfeit cigarettes. In response to valid requests from customs officers in each country of operation a similar approach will be required.

— Gallaher requires all customers seeking to purchase Gallaher’s products manufactured for emerging markets to confirm in writing that they have read this policy, that they will abide by its terms and accept that it will form part of their contract with the appropriate member of the Gallaher Group. Subject always to applicable domestic and international laws and regulations, sales of Gallaher cigarettes (and other products) will only be made available to distributors, joint venture partners, licensees etc. who are prepared to provide the following commitments to Gallaher that:

  — They share Gallaher’s vision to build business in legitimate markets and are prepared to devote the necessary resources to develop trade in those countries;
  
  — They will only sell products supplied by Gallaher into countries where applicable duty will be paid (excluding duty free outlets) and that they will comply with all applicable laws and local requirements relating to the importation of cigarettes into those countries;
  
  — They will take no action to promote or facilitate the resale of products to their customers in violation of applicable laws and regulations;
  
  — They will not sell products supplied by Gallaher into countries where Gallaher has other distribution arrangements in place for such products or infringe Gallaher’s trade marks;
  
  — They will not trade with those that they know are or have reason to believe are involved in smuggling cigarettes. Indeed, they will make the necessary enquiries to satisfy themselves that their customers in turn will behave responsibly; and
— They will co-operate with Gallaher in allowing Gallaher representatives to visit emerging markets for the purpose of auditing the supply chain to those markets and to inspect stocks in the possession of distributors, wholesalers and retailers.

— In the event that Gallaher discovers that any particular distributor has been shown to be behaving improperly or Gallaher has reasons for believing that they may be, Gallaher will revisit that trading relationship with a view to discontinuing that relationship, if appropriate. In particular, if Gallaher concludes that any distributor is a smuggler it will terminate that trading relationship with immediate effect. In turn, Gallaher will expect its distributors to endorse a similar policy in respect of their customers.

— Ex-factory cigarettes (or other products), on which duty has not been paid, will not be supplied to distributors with whom members of the Gallaher group of companies have not previously undertaken business, without first taking steps to establish their credentials in accordance with operational requirements established by the functional divisions and adopted by the company. Compliance with these policies will be monitored independently. Furthermore, Gallaher will not supply, ex-factory cigarettes, on which duty has not been paid, to distributors on FOB or other such equivalent or analogous trading terms which would allow distributors to change the pre-agreed delivery points, whilst products are in transit. From time to time, Gallaher acknowledges that small quantities of tobacco products may need to be delivered FOB to bonded warehouses, to be consolidated with shipments of other products supplied to duty free outlets etc.

Gallaher Group Plc recognises that each division/company within the Group is subject to and must abide by its own local legislation. Prior to implementation, the Group has endeavoured to ensure that its policies support rather than conflict with local legislation. However, in the event that local legislation conflicts with or provides more stringent regulation than the terms of this policy, the local legislation shall prevail and employees must comply with it. It is the responsibility of each division/company to ensure that its employees are aware of any such differences when implementing these policies at an operational level. If you are in any doubt, please contact your legal department for specific advice.

21 December 2004

Memorandum submitted by Action on Smoking and Health (ASH)

1. The legal agreement between Philip Morris and the EU on smuggling is the gold standard by which all cigarette manufacturers attempt to control excise tax fraud should be judged from now on. A summary of the main elements is set out below but key is that specific, measurable, achievable, relevant and timed targets have been set and penalty payments are exacted from PMI if these are not met.

2. In contrast the “Memoranda of Understanding” that the HMCE has with each of the UK manufacturers are inadequate. They rely entirely on the goodwill of the companies and have no measurable outcomes. (see below for more detail).

3. At the time the Philip Morris agreement was signed in July 2004 ASH wrote to John Healey urging that the UK sign up to the Philip Morris agreement and renegotiate its agreements with the UK manufacturers to match the PMI standards. The response was negative (see attached letters—Annexes A and B).

4. The smuggled market has changed significantly in recent years. Assuming, as was assumed by the PAC, that Imperial’s share of seizures reflects its share of the total market, something like eight billion sticks of Imperial cigarettes were smuggled into the UK in 2000–01. By 2003–04 this had fallen to only about 350,000. What this means is that the overall decline in smuggling is accounted for by a fall in the number of Imperial cigarettes being smuggled into the UK.

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Total smuggled (sticks)</td>
<td>19 billion</td>
<td>14 billion</td>
<td>13 billion</td>
</tr>
<tr>
<td>Successfully smuggled</td>
<td>16 billion</td>
<td>12 billion</td>
<td>11 billion</td>
</tr>
<tr>
<td>Seized</td>
<td>3 billion</td>
<td>2 billion</td>
<td>2 billion</td>
</tr>
<tr>
<td>% Imperial</td>
<td>50%</td>
<td>11%</td>
<td>3%</td>
</tr>
<tr>
<td>% Gallaher</td>
<td>12%</td>
<td>21%</td>
<td></td>
</tr>
<tr>
<td>% Counterfeit</td>
<td>41%</td>
<td>54%</td>
<td></td>
</tr>
<tr>
<td>% other (UK and non-UK)</td>
<td>36%</td>
<td>22%</td>
<td></td>
</tr>
</tbody>
</table>

Source: HM Customs and Excise.

5. This illustrates the success of a strategy of effectively controlling the smuggling of genuine cigarettes. At the time of the PAC report Imperial claimed credit for ceasing supplies to 30 international suppliers. In so doing it acknowledged that the company was supplying rogue suppliers in the first place and that it could control them. However, without tightly controlled agreements there is no guarantee that Imperial’s
proportion of the smuggled market won’t increase again. And Gallaher’s share has increased in the last few years and is not being effectively controlled, a clear indication that the MOU HMCE has with the company is not effective.

6. This illustrates that effective agreements are needed to ensure that the Tobacco Manufacturers control smuggling effectively. We would urge the Treasury Select Committee to call on HMCE to renegotiate the Memoranda of Understanding that it has with the tobacco companies up to the Philip Morris standard and to sign up to the PMI agreement.

REVIEWs BY THE NATIONAL AUDIT OFFICE

7. In 2004 the NAO carried out a review of HMCE’s work tackling smuggling of counterfeit cigarettes. The report was finished months ago but has not been finalised—our understanding is that it is held up in HMCE. Our understanding is also that it includes recommendations for how tackling smuggling of counterfeit could be improved. These include better targeting of resources to gather local intelligence from countries where counterfeit cigarettes originate from, such as the far east and the Balkans, and better use of electronic data for intelligence gathering. We have asked for this report and it would help if the TSC would also push for this report to be published.

8. Overall smuggling has declined, but this decline needs to continue to meet PSA targets of no more than 13% by 2007-08. Even at these levels 1 in 8 cigarettes smoked in the UK will be smuggled. The HMCE tobacco smuggling strategy is four years old now and we believe still has weaknesses, as shown by the inadequacy of the MOUs. Therefore, we have urged the NAO to carry out a detailed review and recommend improvements. It would help if the TSC also urged the NAO to carry out such a review and to ensure that it is reported to the Public Accounts Committee and published.

KEY QUESTIONS FOR THE TOBACCO COMPANIES

9. These include:

For all UK companies

1. Why do your MOUs not have specific, measurable and timed targets like those in the PMI agreement with the EU?

2. In particular why do you not have comprehensive tracking and tracing processes to ensure that the origin of your cigarettes can easily and quickly be identified, and supply this information online to customs?

For Gallaher

1. Why has Gallaher’s proportion of cigarettes smuggled into the UK gone up so significantly in the last couple of years and what are you doing to tackle this?

For PMI

1. What are the main advantages of the agreement you have with the EU, both for controlling smuggling of your product and for controlling smuggling of counterfeit product?

10. DETAILED COMPARISON OF THE EXISTING MOUs BETWEEN HMCE AND BAT, IMPERIAL AND GALLAHER AND THE PMI AGREEMENT WITH THE EU

The existing MOUs all rely on the goodwill of the tobacco manufacturers, rather than legally enforceable and measurable outcomes. For example:

— In none of the MOUs are there seizure payments to compensate for any losses due to smuggling as there are with PMI.

— The PMI agreement requires comprehensive tracking and tracing processes to ensure that the origin of cigarettes can be easily identified.

— The PMI agreement requires the company to approve contractors and provide customs with online information so that Customs can directly trace back any PMI smuggled cigarettes to the purchaser who originally bought them from PMI.

In contrast

— Gallaher only says it “takes action where information indicates any substantial smuggling of its products to identify, so far as is reasonably practical, the supply routes and suspect export trade” (bullet 2).
— BAT only agrees “to investigate the original sale by BAT with the aim of identifying the first customer outside the BAT group” (2.31) where the company’s product is found to have been smuggled into the UK, and to supply information “on request” (2.32).

— Imperial says it will “provide HM Customs and Excise with accurate and comprehensive responses to tracking and tracing requests, with the aim of being able to provide promptly details of the first export customers of seized packs following the receipt of samples of these packs” (3.6).

— Imperial says it “will remain committed to taking proactive steps to seek to ensure that all its customers are similarly committed to taking action to prevent product being diverted by smugglers” (3.11). How is not specified.

— Imperial says it will allow its brands “to be sold in such a mix of brands and in such quantities as are consistent with Imperial Tobacco’s understanding of the domestic consumption in that market and the permissible requirements of the travelling consumer.” (3.1.2) The definition of retail demand is left to Imperial to determine, there is no independent verification.

For more information see Memoranda of Understanding with BAT and Imperial and Gallaher (links attached).

11. KEY FEATURES OF THE PHILIP MORRIS AGREEMENT

The key feature of this agreement is that from now on Philip Morris International (PMI) will be heavily penalised if it does not control smuggling of its cigarettes. This is far more significant than the $1.25 billion that the company have agreed to pay the EC over the next 12 years which is of symbolic value only as it is believed to represent only a tiny portion of the amount the EC has lost through smuggling, due to unpaid duties, fees and other taxes.

Control of smuggling will be exercised through

1. Seizure payments—penalising PMI if any of its products produced anywhere in the world and then smuggled into the EU are seized.

2. Compliance protocols—requiring PMI to tightly control and regulate the contractors it supplies with cigarettes, and to stop supplying them if they are found to be complicit in smuggling.

3. Tracking and tracing protocols—allowing customs to independently identify smuggled cigarettes so that they can be traced back to the contractor who bought them from PMI.

This agreement can serve as a model for other agreements: firstly with other companies such as JT International and RJ Reynolds which are still party to a court case with the EC in the US; secondly with other tobacco companies, in particular the UK companies Imperial Tobacco, British American Tobacco and Gallaher; and thirdly for a worldwide protocol under the Framework Convention on Tobacco Control.

The agreement does not constitute an admission of liability by PMI, but following its signature the EC, and the other plaintiffs, agree to drop their court case against PMI which is currently underway in the US courts. The original court case involved 10 other plaintiffs in addition to the EC. These were the EU Member States Belgium, Finland, France, Greece, Germany, Italy, Luxembourg, Netherlands, Portugal and Spain and these states are all parties to the agreement. They also receive seizure payments on any PMI cigarettes being smuggled into their jurisdictions, as set out below.

Any member state not party to the agreement can become a participating member by executing a copy of the agreement and delivering it to PMI. Accession countries can too, but their participation will be phased in over six years.

The Director of OLAF (the European anti-fraud office) is the designated representative of the EC in the operation of the agreement. If OLAF makes a settlement with another company that is more favourable than that with PMI it can renegotiate with the EU, which may, but is not required to, grant treatment which is at least as favourable.

The agreement will be reviewed annually (see Article 6). If there are any proposed changes which are not agreed by both sides, there will be an independent arbitration process (Article 12). The Arbitrator has to be acceptable to both OLAF and PMI (see Appendix J for names).

The agreement comes into full effect six months after signing and lasts for 12 years, except for tracking and tracing which will continue. It will be renegotiated two to three years before it comes to an end.

1. Seizure payments (Article 4 p 14)

— For any seizure of smuggled PMI genuine product PMI pays 100% of all taxes due at member State and at EU level (where the member State is party to the agreement) (Article 4).

— Above a baseline calculated at the average of seizures over 2001-02 of 9x40 foot containers = 90 million cigarettes (Article 1 p 4), PMI will pay an additional 400% of taxes due in compensation (Article 4). This is the baseline for the whole of the 10 current signatories.
— If cigarettes are seized in an EU state which is not a signatory state then the EU will get its taxes and duties paid but not the non-signatory State level.
— If there is a dispute over whether the cigarettes are genuine or counterfeit they will be sent to an independent laboratory agreed by OLAF/PMI for testing. (The UK government lab is likely to be chosen for this role). (Article 4.01 j p 17).

2. Compliance protocols (Article 3 and Appendix B)
Designed to protect against smuggling and money laundering.
— PMI can only sell to approved contractors—approval on principle of “Know Your Customer”. To be approved PMI has to have visited the customer and place of operation, got details of nos employed, their DOB passport, tax regulation numbers, assessed their ability to identify subsequent purchasers, have investigated their sales plan, checked for criminal records, got full details of their bank account through which payments must be made etc. Checks must be made on an annual basis. (Appendix B protocol 2)
— PMI has to provide invoice and payment details and identify first and any known subsequent purchasers.
— Approved purchasers can only purchase in line with retail demand for the intended market (see protocol 2.02). If there are disputes over what this is it will go to independent arbitration.
— If OLAF has sufficient information that an approved contractor is not complying with the terms of the agreement for example they are in receipt of a criminal conviction or lose a civil action for smuggling/money laundering they become blocked contractors and will no longer be supplied. They are blocked for a minimum of five years. (protocol 4)
— PMI has to maintain files on approved contractors for five years. (protocol 4)
— Approved contractors must pay by wire or cheques. (protocol 5)
— Compliance report on all contractors has to be supplied to OLAF every year. There is a full audit and performance review process. (Article 2.01 and Protocol 7.10,11,12)

3. Tracking and tracing protocols (Article 5 and Appendix D)
— Identify date and place of manufacture—Packs and cartons are marked with embossed codes giving date of manufacture, manufacturing facility, machine and production shift. (Appendix D protocol 2)
— Country of intended destination is identified. (protocol 2)
— First and any known subsequent customer—master cases have unique machine scannable markings identifying first purchaser (unless already identified because sole purchaser in that market)
— Provide OLAF with 20 copies of the manual with all marks and nos of all products. (protocol 2)
— There will be a query only database of all pack information to enable identification of product and purchaser information for any seizure. This is to be accessible online 24 hours a day, by nominated officials at OLAF and in every signatory state. In the event of the database not being online, access must be provided by phone or fax. (protocol 3)
— The information in the database relates to all PMI factories worldwide not just within the EU.
— Information obtained from the database in respect of a seizure can be shared with other law enforcement agencies.
— During the term of the agreement PMI has to carry out research and supply a yearly report on new technologies to improve tracking and tracing.
— First purchaser database has to be up and running and searchable within three months of the execution date of the agreement.
— PMI has also developed second purchaser tracking system laptop scanner etc being provided to first purchasers so they can use it. There will be quarterly reports from PMI to OLAF on second layer tracking. (protocol 4)
— If new technology enables better systems, PMI will implement these where feasible.

4. Compensation payments
These will total up to $1.25 billion over the term of the agreement which is 12 years.
— $100 million within 60 days of the execution of the agreement.
— A further $150 million by first anniversary.
— A total of $500 million within three years.
— Remainder before 12 years of the agreement is up.

This financial agreement will not exempt PMI from criminal charges or settle any tax liabilities from before the execution date. Nor does it exempt the company from any legal action arising from its activities after the execution date.

January 2005

Annex A

Letter from Deborah Arnott, Director, ASH to John Healey MP, Economic Secretary, HM Treasury

RE: PHILIP MORRIS AGREEMENT WITH THE EC

You may remember that I wrote to you almost exactly a year ago when the UK government signed a Memorandum of Understanding (MOU) with Imperial Tobacco. This was because of our concerns that the MOU was not sufficiently rigorous to prevent the diversion of Imperial Tobacco cigarettes on to the smuggled market.

I am writing again because having seen the detailed agreement running to more than 50 pages between Philip Morris International and the EC we are now convinced that the Imperial Tobacco MOU, and indeed those with BAT and Gallaher too, are inadequate.

We feel the time has now come for the UK government to reopen negotiations with all three companies. Nothing less than the terms of the Philip Morris agreement with the EC is now acceptable. We are the victims in this country of some of the highest levels of smuggling in Europe—each year the government loses over £3 billion in taxes because of smuggling. The MOUs the UK has with UK tobacco manufacturers are pitiful compared to the PMI agreement. They rely entirely on the goodwill of the companies, there are no penalty payments incurred for cigarettes diverted into the smuggled market, no properly monitored systems and no measurable outcomes. (For more detail see the attached ASH brief)

Furthermore, although the UK is not party to the PMI agreement because it was not one of the 10 Member States which entered into the civil action in the US, entering into the agreement is easy and we would recommend that the UK do so as soon as possible, given the benefits that accrue from it.

"Section 13.15 Additional Participating Member States

Any Member State may become a Participating Member State by executing a copy of this Agreement in the appropriate form and delivering a counterpart thereof to Philip Morris International and the other Parties thereto."

This agreement is a major step forward in the control of smuggling and will set a standard for negotiating an effective smuggling protocol as part of the Framework Convention on Tobacco Control, which will shortly be ratified.

9 July 2004

Annex B

Letter from John Healey MP, Economic Secretary, HM Treasury to Deborah Arnott, Director of ASH

Thank you for your letter of 9 July about the Anti-Contraband and Anti-Counterfeit (AC&AC) Agreement between the European Community and Philip Morris International (PMI).

I have noted your comments about this agreement and your concerns about the current Memoranda of Understanding (MOUs) that Customs have with the UK tobacco manufacturers (Gallaher, Imperial Tobacco and British American Tobacco).

A key element of the Government’s strategy to reduce tobacco smuggling is for Customs to work closely with all UK major tobacco manufacturers in order to help reduce the amount of UK brand cigarettes that fall into the hands of smugglers. The MOUs, signed as early as July 2002, show the level of cooperation and the outcomes that can be achieved, demonstrating a full and consistent long-term commitment to preventing smuggling. Since its peak in 2000–01, the illicit market has been successfully reduced by more than 2.5 billion sticks and the incidence of UK manufactured cigarettes being smuggled into the UK has fallen markedly from about 75% of large seizures to 31% in 2002–03. This substantial fall is testament to the success of Customs work with UK Manufacturers and I know that they are jointly committed to continuing that downward trend.
In your letter, you refer to the key elements of the AC&AC Agreement and, in comparison, raise concerns that the MOUs with the UK tobacco manufacturers are now inadequate. However, Customs assessment is that their MOUs have proved very effective and that, with the exception of the compensation and seizure payments, the protocols defined in the AC&AC Agreement are broadly similar to the current MOUs and the activities already undertaken by the UK tobacco manufacturers.

Customs regularly assess and publish details of the size and composition of the illicit market in the UK, and take the measures they consider will continue their successful strategy of reducing smuggling. Indeed the UK is a leader in Europe in the work it carries out and publishes on the size and nature of its illicit market.

Customs aims to continue their successful strategy to reduce cigarette smuggling and to that end they keep all elements of that programme under review.

I hope you find this response helpful.

6 September 2004

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**Supplementary memorandum submitted by Imperial Tobacco Group PLC**

**ILLEGAL UK COUNTERFEIT TOBACCO MANUFACTURING OPERATIONS**

At the Treasury Sub-committee meeting on 12 January 2005, Mr McFall asked if Imperial Tobacco would provide a paper on counterfeit tobacco operations in the UK market.

Imperial Tobacco is the only tobacco manufacturer which has a dedicated team employed to disrupt the retail sale of illegal product, including counterfeit, in the UK market. As such, we work very closely with HM Customs and Excise in identifying any sources of counterfeit production in the UK.

Our first experience of the counterfeiting of tobacco products in the UK occurred in late 2000 and, to date, Imperial Tobacco is aware of a total of six UK counterfeit production locations, all of which have been successfully raided by HM Customs and Excise. A summary of these counterfeit operations is as follows:

<table>
<thead>
<tr>
<th>Date of HMC&amp;E Raid</th>
<th>Brand Counterfeited</th>
<th>UK Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Late 2000</td>
<td>“Modern” cigarettes</td>
<td>Birmingham</td>
</tr>
<tr>
<td>November 2001</td>
<td>“Drum” handrolling tobacco</td>
<td>Ryton-on-Dunsmore, Coventry</td>
</tr>
<tr>
<td>December 2001</td>
<td>“Golden Virginia” handrolling tobacco</td>
<td>Glasgow</td>
</tr>
<tr>
<td>February 2002</td>
<td>“Drum” handrolling tobacco</td>
<td>Private House, Houghton le Spring</td>
</tr>
<tr>
<td>May 2003</td>
<td>“Golden Virginia” handrolling tobacco</td>
<td>Kilmarnock</td>
</tr>
</tbody>
</table>

January 2005

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**Letter to the Chairman of the Sub-committee from the Director, Europe, British American Tobacco**

**EXPORT BOND**

At our meeting with the Committee on 12 January 2005, reference was made to the British American Tobacco initiative in the fight against contraband—the Export Bond.

For the information of the Committee, we are pleased to provide a short briefing on the basic concept of the Export Bond and the issues that it is structured to address. We believe that the implementation of an Export Bond system as a measure adopted by customs authorities globally, would provide an effective means of addressing illicit trade, and one that goes further than part measures such as product tracking.

As part of our dialogue programme in respect of this initiative we can advise the Committee that to date we have shared the proposal with various organisations, governments and individuals including:

- The World Customs Organisation (WCO) HQ, Brussels
- The WCO Regional Director for North Africa and Middle East
  - including a formal presentation at its Regional Conference of 17 member countries
- The South Africa Revenue Service
- The WCO ASEAN Secretariat
- The ASEAN Directors of Enforcement
- The Singapore Customs Deputy Director General

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76 See Annex.
The Department of Home/and Security, USA
The Alcohol, Tobacco and Trade Bureau, USA
The Bureau of Alcohol, Tobacco, Firearms and Explosives, USA
The Department of Justice, USA
The International Anti Counterfeit Coalition
The Transatlantic Business Dialogue
The Oceanic Customs Group
The Global Business Dialogue

Also, we have shared the details of the Export Bond with each of the MOU signatories we have in Europe, the Middle East and Africa—28 in total. In addition we have briefed and secured support from other tobacco manufacturers notably Imperial, Gallaher, Japan Tobacco and Altadis.

During 2005 we aim to continue discussing the proposal with governments and organisations around the world that are seeking to address the illicit trade problem. As a genuine cross-border issue, reducing illicit trade requires cross-border solutions and global action—which is why our approach is international.

Should the Committee wish to have a more detailed briefing on our Export Bond proposal we would be happy to make our Head of Customs and Excise, Tobacco Operations available to provide further information.

27 January 2005

Annex

WINNING THE WAR AGAINST CONTRABAND
THE EXPORT BOND SOLUTION

THE ILICIT TRADE PROBLEM

The illicit trade in tobacco products is a growing and significant problem for a number of countries around the world. As well as the loss of tax revenue to the countries concerned, it undermines respect for law and order, promotes criminality in the community and in some cases is increasingly being linked to organised crime and terrorist groups.

A number of factors contribute to the conditions which cause illicit trade. These include high prices, whether because of high duty rates or as compared to the prices in neighbouring countries or relative to consumers’ purchasing power, weak border controls, poor law enforcement, and a lack of resources and/or commitment to deal with the problem.

A reduction in tax rates, and the harmonisation of rates between countries, would be one way of attacking the high price problem. However, it is unlikely that such a solution, whether for fiscal, public health or other reasons, would be agreed by a sufficient number of governments. Therefore, other options need to be developed.

One area that can be addressed is the exercise of a greater degree of control over the movement of tobacco products. This would reduce the potential and opportunity for them being diverted out of the legitimate supply chain into the illicit trade and distribution channels. One way to do this is to apply a system of fiscal guarantees to the export of tobacco products. This would take the form of an export bond. If a sufficient number of countries were to adopt a co-ordinated export bond system, then the operations of the illicit traders would be dramatically reduced.

ISSUES

— To be effective the system will need to be adopted by a sufficiently large number of countries.
— The system can be based on the transit system currently in place in the EU, the EU Community and Common Transit System, which requires guarantees for the movement of excisable goods in the EU.
— Procedures will need to be simple and straightforward in order to keep the costs and administration for exporters and the authorities to a minimum.
— Funds from forfeited bonds can be used to support and pay for the administration of the system.

THE BASIC CONCEPT OF THE EXPORT BOND

— Any person wishing to move finished tobacco products in commercial quantities from one country or customs regime to another would be required to post a bond in the form of a bank guarantee or similar instrument.
— The exporter would be required to specify the initial destination of the export. The bond would be equivalent in value to the duties and taxes payable on the exported quantity in the stated country of destination.

— For exports to a tax free or free trade zone, the bond amount would be set as if the product were to be sold duty paid in that country. For exports to a country with relatively low tax rates, a minimum level would be set for the export bond.

— The bond would be discharged on confirmation from the receiving country that the products have arrived and complied with the customs formalities in the stated country of destination.

— The bond would be forfeited if no such confirmation was received within a specified time limit and the exporter was unable to provide documentation, such as the relevant import and customs papers, to prove that the goods had in fact been properly imported and the duties discharged.

— Any products not accompanied by a valid bond would be liable to seizure and destruction.

CONCLUSION

A world-wide export bond system would be an effective means of attacking illicit trade. It is hard to see why legitimate exporters and traders should object.

There will be many practical and technical issues to be worked out. Commitment to do this would signal the resolve and determination of the international community to solve the problem of illicit trade.

Whilst there will be some additional costs and administration, this should be strongly outweighed by the benefits. These include more revenue to governments, through duty paid sales rather than sales of smuggled product, and the increased ability to identify, target and isolate those involved in the illicit trade.

January 2005

Memorandum submitted by the European Anti-Fraud Office (OLAF)

ANTI-CONTRABAND AND ANTI-COUNTERFEIT AGREEMENT BETWEEN THE EUROPEAN COMMUNITY AND 10 MEMBER STATES AND PHILIP MORRIS

On 9 July 2004, the European Community (“EC”) and 10 Member States (Belgium, Finland, France, Germany, Greece, Italy, Luxembourg, the Netherlands, Portugal and Spain) and Philip Morris International, Inc. (“PMI”) signed an Anti-Contraband and Anti-Counterfeit Agreement (the “Agreement”).

The aim of the Agreement is to combat the large scale and often organised illegal trade in contraband and counterfeit cigarettes which causes the EC and Member States to lose hundreds of millions, if not billions, of Euros per year. The Agreement is a new and promising approach to address this illegal trade in tobacco products. It reinforces the strict action that the EC and the Member States have always taken against smuggling by establishing an efficient system to fight against future cigarette smuggling and counterfeiting.

The Agreement is a landmark which is unique in scope and innovative in method. This may be seen in the three following examples:

First, PMI has agreed a comprehensive set of rules that it must follow as to how it sells and receives payment for cigarettes in order to significantly reduce the capability of third parties to smuggle cigarettes into the EC. These rules:

— include strict criteria concerning “know your customer”;
— regulate the ways in which PMI can receive payment for cigarettes to eliminate money laundering;
— require PMI to sell cigarettes only in volumes that are commensurate with the legitimate demand in a given market for their cigarettes;
— require record keeping and the providing of records to law-enforcement personnel; and
— compel compliance with many of these rules by PMI customers and the customers of those customers.

Second, the parties have agreed tracking and tracing procedures, to assist law-enforcement efforts to combat future smuggling and counterfeit. They include extensive obligations for PMI in regard to:

— Marking of designated master cases.
— Marking of cigarette cartons and packs.
— The establishment of a master case database and scanning information into that database.
— Provision of immediate access at all times for designated EC and Member State officials to information in the master case database concerning seized master cases of cigarettes.
— Protocols for the tracking of cigarettes, and other necessary requirements to allow the EC and/or the Member States to track and trace contraband cigarettes.

The Agreement also requires PMI to conduct additional research and to apply new scanning and coding technologies as they become feasible.

Third, in the event of any significant seizure (of five or more master cases, i.e., 50,000 cigarettes or 500 packs) of authentic PM cigarettes, PMI must make a “Supplemental Payment” to the EC and the Member State which seized the cigarettes equal to the total amount of lost duties and taxes which would have been due on those cigarettes if they had been legally distributed for retail sale in the Member State of seizure. Moreover, in the event of such seizures, PMI will supply law enforcement authorities with the origin and destination of genuine PM cigarettes.

The Agreement also establishes a “Baseline Amount” based upon the average number of authentic PM Cigarettes seized throughout the EC in the years 2001 and 2002. In the event that there are seizures of authentic PM Cigarettes in excess of the Baseline Amount in any given year, PMI will make an additional payment as to each cigarette seizure (of at least 5 master cases) in an amount equal to four times the duties and taxes that would have been assessed on those cigarettes. In other words, PM will pay a total amount equal to five times (500%) of the customs duties and taxes owed on those cigarettes. This guarantee by PMI of monetary payments in the event of seizures of any genuine PM products demonstrates its commitment to prevent the smuggling of PM cigarettes into the EC.

These European level commitments greatly exceed those of any individual Memorandum of Understanding between a cigarette manufacturer and a Member State. The Agreement also goes beyond the terms of the Framework Convention on Tobacco Control (“FCTC”) of the World Health Organisation (“WHO”) regarding combating the smuggling of cigarettes.

The Agreement has two further unique features which distinguish it from other individual agreements. First, it is legally binding and subject to a specific enforcement mechanism. Second, it provides for substantial payments by PMI, up to a total of some $1.25 billion over the next 12 years, which could be used to combat smuggling and counterfeit.

While all these provisions are forward-looking, the Agreement also contains the parties’ resolution of all past disputes relating to contraband cigarettes. In particular, the Agreement also brings to an end all litigation between the European Community and the ten Member States and Philip Morris International relating to contraband cigarettes.

Over the last six months, the parties have demonstrated that the Agreement will provide an effective basis for strong co-ordinated action between the European Commission through OLAF [European Anti-Fraud Office], national law enforcement authorities and PMI in the battle against contraband and counterfeit cigarettes.

The EC sincerely hopes that the Agreement will serve as a model for other manufacturers who are willing to work with the EC and its Member States to combat the illegal trade in their products.

Finally, it should be noted that the Agreement provides that any Member State has the unconditional right to become a party.

31 January 2005

Letter to the Chairman of the Sub-committee from the Economic Secretary providing further information

During my evidence session with the Committee for your inquiry into Excise Fraud on 2 February 2005, I promised to provide you with a note with further information on a number of points. This additional information is set out below.

CROSS-BORDER SHOPPING OF ALCOHOL PRODUCTS (QUESTIONS 382-385)

Our latest estimates for the revenue loss as a result of cross-border shopping of alcohol is set out in the table below:

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<th>2000–01</th>
<th>2001–02</th>
<th>2002–03</th>
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<tr>
<td>Beer</td>
<td>£100m</td>
<td>£50m</td>
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<tr>
<td>Wine</td>
<td>£200m</td>
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Note—EU duty paid only, includes duty and VAT and estimates are rounded to the nearest £50 million.
Tobacco Manufacturers and the EU-Philip Morris International Agreement (Questions 432–435)

The European Commission, together with ten Member States, will receive payments of $1.25 billion over 12 years in 13 instalments, which may serve as a source of additional funding for anti-contraband and anti-counterfeit initiatives. The agreement has not simply come about because of a shared concern by Philip Morris International (PMI) and the EU in relation to smuggling, but a crucial aspect of the agreement is the resolution of all past disputes between PMI and the EU and the ten member states, in particular, the litigation cases relating to contraband cigarettes.

Although not entitled to a share of this payment, it is open for the UK (or other member states) to co-sign the Agreement and invoke protocols for the receipt of supplementary payments.

Supplementary payments would be made by PMI in the event of certain future genuine product seizures in the European Community above defined quantities (50,000 sticks per seizure). These arrangements do not, however, apply to products manufactured before specified dates or to products tax-paid in one EU member state that are smuggled elsewhere in the EU. Based on the 2003–04 seizure volumes, Customs believe that the supplementary payments to the UK for smuggled PMI cigarettes would have been well under £1 million.

Co-operation with China to Combat Counterfeit Cigarettes (Question 443)

An inter-governmental MoU on cooperation in criminal matters was signed in October 2002 between UK and China and since then UK Customs have been involved in training and development of Hong Kong Customs Officers, including training in profiling. There is a UK Fiscal and Drugs Liaison Officer based in Hong Kong who strives for continual improvements in bilateral communication and co-operation. Examples of the successful results of this co-operation include the seizure of nine million counterfeit cigarettes at two UK ports and 12 million in Slovenia and Belgium bound for the UK market.

In addition, UK Customs are constantly examining ways to maximise the effectiveness of co-operation with the China and other countries.

Liverpool Bonded Warehouse (Questions 459–460)

I have ensured that officials made enquiries with the Scotch Whisky Association but these have been unable to produce any further detail on the bond or the director than those given during their evidence before the Committee on Wednesday 8 December 2004.

Checks have been carried out on all Company House registered Directors of third party warehouses in the Liverpool area from 2002 to date. Checks for this time period show that none of the businesses have or have had a director with a previous conviction for fraud.

Customs X-Ray Scanners and Official Vehicles (Questions 461–467)

Customs currently has 2,518 official vehicles and comprises of the following:

— 2,404 cars, vans, motorbikes and specialist units;
— 14 mobile scanners;
— 10 forklift trucks; and
— 90 trailers

Customs Action under the Proceeds of Crime Act (Question 479)

Since the commencement of the Proceeds of Crime Act on 30 December 2002, Customs have seized in excess of £51 million.

I hope this information is helpful.

11 February 2005
Supplementary memorandum submitted by The Scotch Whisky Association

1. The Sub-Committee asked for a note of our concerns about the printing arrangements for duty stamps incorporated in rear labels. We also include supplementary comments on two other topics raised in oral evidence sessions.

Printing arrangements for back label stamps

2. We welcome the Government’s adoption of the industry’s “back label” proposal and its announcement that, subject to further work, it is also minded to allow further flexibility on stamp format in the form of conventional “strip” stamps—over the cap—or self-adhesive duty stamps—on the glass.

3. Practical, logistical and cost considerations are of vital importance given an estimated total potential demand for c.0.8m duty stamps per day (rising significantly higher at times of peak seasonal demand), across nearly 3,000 different spirits brands/bottle sizes—a trade which is far more complex than, say, the UK tobacco market. Controlling supply of stamps through one or two security printers would potentially create a logistical bottle-neck with serious competition issues at stake when choices on prioritisation of orders were involved.

4. This calls for flexibility in the choice of printer while maintaining the stamp security required by Custom & Excise (C&E). We recommend practicable solutions in which the whole back label, including the stamp, can be produced by the brand owner’s contracted printer, using the typical range of label papers and processes; and which keep both the printer’s and brand owner’s compliance costs, and logistical impacts, to a minimum. At the same time, the incorporated stamps need to contain robust security features. The solutions also have to be available to overseas printers on an equitable basis compared with UK printers, but without any corresponding loss of security or C&E control.

5. As the Economic Secretary reported to the Sub-committee on 2 February 2005, we—jointly with the printing industry—are currently discussing these questions closely and constructively with C&E officials. We have recommended some innovative options and security technologies to meet the high standards which C&E are demanding. These options, which we understand are now being considered, would largely allow producers to continue to use their current label printers.

Duty stamps as an international trade barrier

6. It was suggested to the Economic Secretary that duty stamps could be contrary to the Single Market. This is a crucial point deserving continued emphasis. Our consistent view is that all tax stamp regimes are by their nature a barrier to intra-EU and international free trade. They require, for each market, separate specifications and bottling runs, and separate warehouse and distribution handling; they effectively fragment the EU Single Market and other international trading areas, as goods earmarked for one market cannot be sold in another without “re-working”. The point above about overseas printers further illustrates this: although we welcome efforts to make the scheme as streamlined and fair as possible, there will now be a new technical barrier to foreign spirits producers, and their printers, before importing to the UK.

7. The Scotch Whisky industry has campaigned for many years against overseas tax stamp regimes, and the barriers to market access they cause. This has often been with valued support from HM Government and British Embassies overseas. Our exports to 200 markets are worth more than £2 billion per year to the UK balance of trade.

8. The introduction of UK tax stamps will be an unhelpful precedent to UK efforts to oppose similar barriers in other countries. ( Shortly after problematic changes to Portugal’s strip stamps system were announced, for example, the British Embassy in Lisbon indicated it would now be unable to support the industry position.) We remain concerned that little assessment has been made, or account taken, of the potential consequences for EU Single Market and international trade. There are already reports that some European countries are contemplating tax stamps with a new interest following the UK announcements. We fear that, compared with the UK, other countries introducing stamps may be less pragmatic, and less scrupulous about fairness between domestic and imported spirits—causing real difficulties for the international Scotch Whisky trade.

Levels of seizures and detections of duty-evaded spirits

9. The Sub-committee asked the Economic Secretary about evidence of UK-produced spirits implicated in recent cases of diversion. Mr Gerrard of C&E quoted two seizures (believed to date from 2004) of 12,500 litres of UK-made vodka and 15,000 litres of Scotch Whisky, each approximately a single lorry-load, or c.£100,000 of excise duty.

10. Despite improved detection levels and techniques, we understand that recent seizures (generally examples of inward fraud) are few in number, well down on the already declining levels published with the Pre-Budget Report.\textsuperscript{78} We are aware of just two major seizures, since April 2003, involving Scotch Whisky produced by our members, one being the incident quoted by Mr Gerrard, the other of a similar size—in all, just three lorry-loads or so in 21 months, equivalent to a duty loss of less than £250,000.

11. The Economic Secretary also referred to recent detection of a major inward fraud involving 84 consignments of non-UK product. The Sub-committee might wish to ask C&E for a breakdown of all seizure and detection figures for (a) inward fraud and (b) outward fraud since April 2003, to put in context the examples quoted in evidence.

12. It remains difficult to square these seizure and detection figures with an alleged revenue loss of £250 million per year. This is one of the market reality checks which help clarify the uncertainty created by survey-based estimates of total spirits consumption. The various checks are:

   - Low levels of market disruption, greatly reduced compared with the 1990s
   - Strongly increased excise receipts, up by £600 million since 1998
   - Other official data and evidence on consumption at odds with C&E estimate
   - Greatly reduced levels of seizures and detections, and of enquiries to producers from outfield enforcement officers
   - Data on where consumers buy spirits—a £250 million excise loss would mean half of all spirits in independent retail outlets and corner shops were fraudulent.

13. We await the findings of the Office of National Statistics study to reconcile the use of different surveys to estimate spirits consumption.

14. The Association is ready to provide any further information or assistance which might be required.

*February 2005*

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**Supplementary memorandum submitted by Imperial Tobacco Group PLC**

**CHINESE STATE TOBACCO MONOPOLY ADMINISTRATION/ TOBACCO COALITION—ANTI-COUNTERFEIT CO-OPERATION: BACKGROUND**

The Chinese State Tobacco Monopoly Association (STMA) and the Tobacco Coalition of Imperial Tobacco, Philip Morris, British American Tobacco and Japan Tobacco have a formal memorandum of understanding to combat the counterfeiting of tobacco products in China.

There is a joint strategy of targeting illicit factories, packing houses, printers, transit warehouses and containers in transit and the Tobacco Coalition employs a wide variety of agencies in China to support the activities of the Chinese Authorities.

The Tobacco Coalition meets formally with the STMA about four times a year. Through the STMA and provincial Tobacco Monopoly Associations (TMAs), the Tobacco Coalition has developed solid relationships with other key anti-counterfeiting agencies in China including the Ministry of Public Security (MPS), the General Customs Administration (GCA), the People’s High Court (PHC) and the People’s High Procurate (PHP). Consequently, the Tobacco Coalition is able to mount sophisticated joint surveillance operations with the Authorities. Imperial Tobacco has also developed a project with the Hong Kong police using the local money laundering regulations, with a view to taking criminal action against major traders in counterfeit product who use Hong Kong as a financial base.

The vast majority of counterfeit production in China is directed at local Chinese brands but it is estimated that about 2,500 containers of the Coalition’s brands are produced each year (between 20 to 25 billion cigarettes). Some of the counterfeiters are small family/village groups, who produce about 20% of the counterfeit cigarettes and handrolling tobacco. The remaining 80% of the counterfeiters are organised criminal syndicates, who produce 80% of the counterfeit product.

In the year ended September 2004, Imperial Tobacco was directly involved in achieving the following results:

   - Thirty-one counterfeit factory closures.
   - Eleven warehouse raids.
   - Twenty printer/packing house closures.
   - Forty-five containers of counterfeit cigarettes seized.
   - Total seizures of 473 million “British” cigarettes. This is comparable with the total volume of large seizures of Imperial Tobacco cigarettes notified to the Company by HM Customs and Excise in the same period.

\textsuperscript{78} 2000–1—3m litres; 2001–2—2.1m litres; 2002–3—0.9m litres (equal to c.£7 million in excise duty).
The cost to Imperial Tobacco of mounting the above series of anti-illicit trade operations in the year ended September 2004 was £1.2 million. This produced a potential profit benefit for Imperial Tobacco in the UK market of £11 million and a revenue benefit to the UK Exchequer of £85 million.

Overall, Tobacco Coalition operations in recent years closed 177 factories, 49 printers, 45 packing houses and seized 94 in-transit loads. It can be assumed that at some point in the past or future, those destroyed production facilities would have been making UK brands.

Currently, operations are getting more difficult and protracted as the counterfeiters increasingly adopt anti-surveillance methods, with some factories concealed underground. They also appear to be shifting some operations from Fujian province, opposite Taiwan, and Guangdong Province, around Hong Kong, to the Shanghai region where liaison is less effective. Activity in the less regulated areas of Northern Vietnam and North Korea, which are not part of the Coalition agreement, is also increasing.

The STMA takes the anti-counterfeiting issue extremely seriously—as their brands are counterfeited significantly more than international brands in China. Their efforts against the production, distribution and sale of counterfeit cigarettes include 50,000 full time STMA officers engaged in anti-counterfeit work, a combined central budget of US$75 million dollars (US$50 million from Ministry of Finance and US$25 million from the Chinese National Tobacco Corporation (CNTC)) in addition to provincial TMA budgets of up to US$17 million per province.

February 2005
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* Government Responses are usually received in the same session as the Report was published. Accordingly, the HC number refers to that session unless otherwise indicated.