

Imperial Tobacco Limited



June 3, 1993

U.H.
REC'D - JUN 1993
Ans'd _____

R. Don Erwin
Chairman, President and
Chief Executive Officer

Mr. Ulrich Herter
B.A.T. Industries
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*Should check for
to proposals
in letter for use*

Dear Ulrich,

Let me express my appreciation for your taking time from your busy schedule to visit with us in Montreal. We enjoyed having you share our views of the Canadian industry's issues and Imperial's plans for continued growth. Further, we were all very appreciative of your openness and frankness regarding world tobacco and B.A.T.

As we discussed, I am writing in response to your letter of April 28, 1993 regarding our relationship with B.A.T. through our outstanding contractual relationship with Peter Jackson (Overseas) Ltd. Allow me to address the issues as outlined in your letter.

1. Temporary Royalty Rate Reduction:

The reduction of the Royalty rate from 5% to 2% for 1991 and 1992 was indeed intended to assist us with our increased marketing investment on du Maurier in the U.S. market. Roger is putting together the details regarding that investment, both in field costs to expand distribution and increase exposure, and advertising costs. The Royalty rate for 1993 has returned to 5%.

However, Federal tax increases here have created a difficult situation for us, and we ask your consideration of the following. As you are aware, smuggled cigarettes (due to exorbitant tax levels) represent nearly 30% of total sales in Canada, and the level is growing. Although we agreed to support the Federal government's effort to reduce smuggling by limiting our exports to the U.S.A., our competitors did not. Subsequently, we have decided to remove the limits on our exports to regain our share of Canadian smokers. To do otherwise would place the long-term welfare of our trademarks in the home market at great risk. Until the smuggling issue is resolved, an increasing volume of our domestic sales in Canada will be exported, then smuggled back for sale here. In the process, that (domestic) volume attracts Royalty.

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**THE PREVENTION OF TOBACCO
SMUGGLING IN CANADA: PROPOSALS
FROM AN EXPERT PANEL**

MONTREAL WORKSHOP

FEBRUARY 2005

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Participants

The idea for holding such a meeting followed a discussion within the Non-Smokers' Rights Association (NSRA) about the gradual comeback of tobacco smuggling in Canada over the past few years. The health community should be very cautious and not let the problem grow to a point where governments will seriously consider slashing tobacco taxes once again, as they did to resolve the smuggling crisis in 1994.

Therefore, the need to hold a meeting with tobacco smuggling experts to assess the current situation in Canada and put forth likely solutions to prevent another outbreak of the problem quickly became obvious. The NSRA would like to thank the following experts and other stakeholders who have accepted to be part of this initiative and to help overcome this critical public health challenge.

Facilitator

Mr. François Damphousse
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Experts

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Guests

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Introduction

Finding a solution to tobacco smuggling in Canada represents a significant challenge. Government authorities are fully aware that this issue represents a threat to one of our country's most important public health and fiscal policies: tobacco taxes. In fact, public health experts concur that increasing tobacco taxes is the most effective way for reducing tobacco consumption. In their reports to shareholders, tobacco companies have also often expressed their frustration with tobacco taxes since they seriously affect their market and their profits.

There is ample evidence showing the tobacco industry's role in smuggling, even at the international level, be it as a means to circumvent high tobacco taxes or overcoming economic barriers, such as state monopolies. This illegal activity has even led other shady players to get in on the action, notably by manufacturing counterfeit cigarettes and distributing them via existing channels established by the tobacco industry.

The fact that the tobacco industry is associated with smuggling should come as no surprise, particularly given that it is already involved in a major conspiracy to abstain from its legal obligation to market products that are not harmful to consumers or – at the very least – to properly inform smokers of the risks associated with tobacco use.

The federal and provincial governments responded by initiating legal action against the Canadian tobacco industry for its role in the smuggling market and implementing measures, such as an export tax, to try and curb the problem. Despite these initiatives, media reports indicate that since tobacco taxes began climbing again, contraband activity has also increased. This information should not be taken lightly, but rather, viewed by governments and the health community as a call to work harder still to find other solutions to the problem, which is the main reason why this meeting was convened. It served as a forum for key national and international experts in tobacco smuggling to look at what is happening in Canada and to suggest the proper course of action.

This preliminary report presents the expert panel's final recommendations. They were made after reviewing the history and the current situation of tobacco smuggling in Canada. The expert panel also examined what actions other countries have taken to deal with this threat. It also considered other innovative solutions that could be implemented in Canada to help control the smuggling problem.

Expert panel recommendations

Tracking and tracing

It is the expert panel's view that the introduction of a tracking and tracing system is an important step in controlling the contraband of tobacco products in Canada. Given how long the legislative process can take for the implementation of such a measure, this approach is considered a medium-term solution. Many nonetheless feel that the health community should begin working in this area immediately, so that a tracking and tracing system can be introduced as soon as possible. Such a system would provide information critical to monitoring changes in the Canadian tobacco market, which could prove beneficial for tobacco control.

This measure would be particularly effective in controlling counterfeiting. According to the panel, this activity does not yet seem to constitute a significant problem in Canada. Given Canada's relative isolation from the international market and its own "national" cigarette brands, counterfeiters may not consider our market lucrative enough.

Everyone is nonetheless aware that such counterfeit cigarettes may eventually become a more serious problem within our borders. As illustrated during the meeting, advances in the technology used to copy existing cigarette packaging has made it much more difficult to distinguish between legal and counterfeit cigarette packages. Given that even tobacco manufacturers must call upon specialized firms to help them identify counterfeit products, it is obvious that Canadian authorities are unable to do so in the course of their investigations.

Such a system would also be of great use in tracking stolen goods. Tobacco companies such as Imperial Tobacco have on a number of occasions issued press releases to disseminate information on stolen cargo, taking advantage of the opportunity to cast blame on high tobacco taxes. According to data gathered by the Non-Smokers' Rights Association, these instances only represent 1.3% of all cargo thefts in Canada since 2003. Another interesting statistic: the stolen product is equal to less than 0.1% of all cigarettes sold across the country in any given year. Despite these data, it must be remembered that authorities cannot track these cigarettes if resold by merchants.

A number of security levels can be adopted with regard to a tracking and tracing system. The expert panel recommends implementing a system similar to those adopted in Malaysia and California, which enable tracking every step of the distribution chain for tobacco products. According to the panel, markings must be printed directly on packaging or on a stamp that is then affixed to packages – two options that make copying such marks much more difficult for counterfeiters. The significant drop in contraband trade in Malaysia justifies implementing such a system in Canada as part of the effort to fight the various sources of tobacco contraband.

What must be specifically avoided is relying solely on the cellophane band as a security measure, for this band can easily be reproduced by smugglers. Once a package has been opened, moreover, authorities have no way of determining the origin of the product.

While such a security system may be introduced under the *Tobacco Act* or the *Excise Act*, the panel recommends doing so under the latter, given that it incorporates better enforcement mechanisms.

Native reserves

The expert panel acknowledges that a majority of tobacco smuggling in Canada originates from a few Native reserves. Natives are traditionally exempt from most taxes, with the exception of the federal excise tax, when purchasing cigarettes on reserves. This exemption, however, does not apply to non-Native consumers buying tobacco products on reserves. Natives must collect all applicable federal and provincial taxes, which they are currently not doing.

Cigarettes sold on reserves may be produced by Canada's primary tobacco companies or by Native manufacturers such as Grand River Enterprises or ADL Tobacco, which also legally sell cigarettes on the domestic market. The federal excise tax is collected once these products leave the plant, hence is included in the cost of such cigarettes sold on Native reserves. (As mentioned previously, Natives do not collect the other applicable taxes when selling cigarettes to non-Natives.)

This being said, other cigarettes sold on reserves represent an even greater problem. The contraband tobacco products in question are manufactured in St. Regis, the American section of the Akwasasne reserve. They are then transported into Canada and sold at numerous roadside kiosks throughout the Native reserves. In the case of these specific products, not even the federal excise tax is collected, and it is highly likely that such cigarettes are also illegally sold by merchants elsewhere in Quebec and Ontario. Interestingly enough, even Grand River Enterprises and ADL Tobacco, legitimate Native manufacturers of tobacco products, would like to see this particular problem taken care of.

Halting production in St. Regis

Jurisprudence is very clear with regard to tobacco contraband and Native reserves. In fact, the Supreme Court of Canada and U.S. courts have passed legislation prohibiting Natives from transporting consumer products across the Canada-U.S. border, for the purposes of trade, without paying the applicable customs duties. This reserve's geographic location, however, makes the law difficult to enforce, as Canadian authorities cannot intervene in matters on U.S. territory. Moreover, tobacco manufacturers in St. Regis apparently do not have the necessary licences and are therefore breaching U.S. federal laws. Hence, the expert panel recommends that measures be initiated by both the health community and government authorities to exert pressure on American agencies, conveying the seriousness of the situation and exhorting them to take action.

Introducing quotas

Another solution proposed by the expert panel consists of imposing quotas on cigarette shipments to Native reserves (such quotas are already in force in certain other provinces, such as British Columbia and Nova Scotia). If governments are reluctant to apply their laws to ensure that tobacco taxes are collected on reserves, the expert panel proposes action outside of the reserves themselves, through limits on volumes shipped. An effective tracking and tracing system could prove highly useful in ensuring that such a solution is enforced. Quotas would be set according to each Native community's population size and needs. Any manufacturer exceeding set quotas would be severely penalized. This measure could also apply to distributors doing business with Native peoples.

Similar measures may also be implemented to eliminate the illegal manufacturing of cigarettes on reserves (and could possibly be extended to include illegal manufacturers located off-reserve). If governments are not in a position to take action to put a stop to the activities of illegal manufacturers producing cigarettes that are sold tax-free on Native territory, an effort should be made to block all shipments of raw materials used in the manufacture of these tobacco products. The manufacturers in question most likely obtain their materials off-reserve, hence governments could impose severe penalties on the specific suppliers involved. Note that these penalties should be sufficiently harsh so as to incite suppliers to refuse to deal with the groups in question.

The power of taxation

The expert panel also recommends that First Nations be granted the power to tax tobacco products as a means of generating revenue. According to a recent report on health among First Nations peoples, an alarming 62% of Natives are smokers. Given that taxation is considered the most effective measure for decreasing tobacco consumption, it would be appropriate to encourage First Nations peoples to increase the price of cigarettes as quickly as possible, as a means of protecting their communities from the harms of tobacco use.

A number of Native reserves in Quebec will be unwilling to increase the price of cigarettes since the price advantage gives them a strong competitive edge. However, some Native communities in Western Canada have struck an agreement with the federal government whereby they receive the GST revenues from their cigarette sales, a solution that might be effective in Quebec and should be further considered. The lure of additional revenue may be an incentive for increasing the price of cigarettes sold on Native territory, with a resulting decrease in the price gap of these products and “legal” cigarettes.

Manufacturing licences

Licensing by the federal government is another problem area. In fact, according to the information reviewed by the expert panel, the federal government over the past year

issued no fewer than 9 licences to producers from the Kahnawake reserve, thereby significantly increasing the likelihood that these entities will sell non-taxed cigarette products. With such actions, the federal government is effectively negating its own efforts at controlling tobacco use in Canada. However, there is a possibility that licensing authorities have their hands tied and cannot refuse an application that has been filed in due form.

The expert panel recommends that the federal government amend the conditions for obtaining such licences, rendering them much more stringent. According to one specific measure, the government would require a significantly larger licensing bond. Some panel members even suggested that a figure of \$1 million would be appropriate, as it would probably deter many shady entrepreneurs. Another option involves making licence holders responsible for the shipping and sale of the products they manufacture. For example, if a certain quantity of a given producer's cigarettes were discovered on the black market, an amount equal to three times the value of this product would be retained from the original bond deposit. The producer would then have one month to reimburse this amount and bring its bond back to the original required amount. Non-compliant producers would lose their licences.

A panel member also suggested that an interdepartmental committee, including the Health Ministry, be formed to evaluate all permit applications. Tobacco control must represent a priority for the federal government, rather than only for Health Canada. A situation where the manufacture and sale of tobacco products is encouraged on the one hand while important resources and dollars are invested in tobacco control, on the other, is totally unacceptable. Such an interdepartmental committee could assess each request, with due consideration given to the potential impact of any new tobacco production plant on public health.

Controlling tobacco crops

The expert panel is also concerned by the lack of control over tobacco crop shipments. Currently, the federal government has no way of knowing if tobacco farmers are growing tobacco and selling it to illegal cigarette manufacturers. According to one of the farmers, who spoke with a panel member, this is exactly what is happening. A national register, mandatory for all tobacco farmers, must be implemented, along with a system for monitoring shipments, as proposed for cigarettes. Legislation should also include provisions for severe penalties, in order to discourage all those tempted to supply tobacco for the manufacture of illicit cigarettes.

The panel also considered the issue of international trade missions, including tobacco farm representatives hoping to sell their tobacco in other countries. This practice should be reviewed. Notably, the Canadian tobacco industry has observed on a number of occasions the growing presence of counterfeit cigarettes likely manufactured in Asia. Given that Canadian smokers have an affinity for cigarettes with a particular taste (as compared to smokers in other countries), one must wonder whether tobacco exports may be used to produce counterfeit cigarettes for eventual sale in Canada. More to the point,

allowing the export of Canadian tobacco for the production of cigarettes in other countries is deplorable, given that tobacco control is currently a national public health priority within our own borders.

Framework Convention on Tobacco Control

As a longer-term solution, the expert panel encourages the Canadian government to become involved in establishing the protocol on the illegal trade of tobacco products, as part of the Framework Convention on Tobacco Control (FCTC). Canada notably played an important role in the negotiations leading up to the FCTC, a convention that came into effect on February 27, 2005. It should therefore maintain its leadership role, striving to ensure that the protocol is as stringent as possible.

Tobacco smuggling is a serious international problem that calls for a very tough response. The countries affected by this phenomenon find it hard to bring it to a halt, particularly since contraband networks operate mostly outside their jurisdiction. A good example of this is the current situation regarding the production of cigarettes on the St. Regis reserve in the United States. This international treaty constitutes an appropriate platform for implementing joint measures for more effectively addressing this issue.

Undoubtedly, tobacco companies currently benefiting from smuggling activities will do all they can to limit the protocol's scope. As recommended by the expert panel for Canada, the FCTC is relying heavily on the introduction of a tracking and tracing system to curb smuggling. The protocol will establish the minimal standard required for the type of system that needs to be implemented. The international community would obviously be well served by choosing the most effective system possible. The Canadian government should be pushing for such an option.

Conclusion

The health community advocates a comprehensive approach as the most effective strategy for reducing tobacco consumption in Canada. Such a strategy works very well if we consider the impact of the various tobacco control initiatives introduced nationwide over the past ten years. Tobacco advertising is now subject to severe restrictions, and tobacco manufacturers must print pictured health warnings on their packaging. Smoking bans are more and more popular in public and workplaces and finally, provincial governments have started, once again, to increase tobacco taxes significantly.

The expert panel recommends adopting a similar strategy to protect tobacco taxes. The fact that taxation represents the single most important public health policy to reduce smoking further justifies such an approach. Given that it also allows for generating billions of dollars in government revenue, it is unacceptable that law-breaking individuals and corporations continue to threaten this policy through smuggling. The panel concurs that Canada must first and foremost implement an effective tracking and tracing system in this regard. However, we have to tighten the noose as much as possible on this illegal activity. A comprehensive approach, which calls for the introduction of a series of initiatives, is the best solution for achieving such an objective.

These measures will not necessarily call for massive government investments. The smuggling problem in Canada originated with the tobacco industry; consequently, they should be responsible for a major portion of the costs for implementing such measures (such as a tracking and tracing system). Tobacco companies, moreover, would benefit from a drop in contraband activity since it is their own market that is currently being taken over by other sources.

The response to the smuggling crisis in February 1994 was catastrophic in terms of public health and government revenue. Tobacco consumption increased, especially in Quebec, and governments lost billions in tax dollars. Tobacco companies were clearly the only winners in this affair. And yet, the evidence available today clearly shows that these same companies were heavily involved in smuggling at the time. Such a mistake must not be allowed to happen again. Governments must take every measure possible to ensure that such a catastrophe is not repeated.