Eye on the tobacco industry

An update on current Canadian tobacco industry activity

July–September 2008

Rothmans and Imperial admit guilt in 1990s cigarette smuggling crimes

On July 31st Canada's two largest tobacco companies admitted their involvement in cigarette smuggling which occurred between 1989 and 1994.[1] Imperial Tobacco Canada (ITC) was ordered to pay a criminal fine of $200 million, and Rothmans, Benson & Hedges (RBH) paid $100 million — which the RCMP said are the largest fines ever levied in Canada.

The companies pled guilty to a single count each of "aiding persons to sell and be in possession of tobacco manufactured in Canada that was not packed and was not stamped in conformity with the Excise Act."

The tax avoidance scheme was designed to flood the Canadian market with cheap cigarettes, and it defrauded governments of billions of dollars.[2] [3] Millions of cigarettes were exported tax-free to the United States and then smuggled back into Canada, mainly by exploiting the porous border near Cornwall, Ontario, and the St. Regis and Akwesasne Mohawk communities.

In addition to the guilty plea and criminal fine, the federal and provincial governments entered into civil settlement agreements with the companies, requiring ITC to pay $400 million and RBH $450 million over the next 10-15 years.[4] A condition of the civil settlement was that all potential future civil claims are settled. In total, the fines and payments required will force the companies to pay $1.1 billion to the federal and provincial governments.

Despite having pled guilty and paying a significant fine, it has not taken long for Benjamin Kemball, president and CEO of ITC, to try to whitewash the legacy of his company's crimes. In a speech to the Quebec Federation of Chambers of Commerce, Kemball said that the resolution of the RCMP investigation "recognizes that the legal tobacco manufacturers have nothing to do with the problem of illegal tobacco sales today."[5]

However, the legacy of these crimes lives on today in some First Nations communities, albeit with a new twist — now some Mohawks are manufacturing the deadly and addictive cigarettes themselves at native-run plants.[6]

> "By the time Canada woke up and said, 'Let's drop the tax and make it harder for them to make a profit,' another idea had sprung to mind. 'Why do we have to transport Canadian cigarette products? Let's take a stab and see if we can manufacture it….'" (former Akwesasne grand chief Mike Mitchell)[7]

Jerry Montour, CEO of Grand River Enterprises (Canada's largest legal First Nations-run cigarette manufacturer), appearing before the House of Commons Standing Committee on Public Safety and National Security in May, said governments serious about ending the current contraband crisis would be wise to indict those who have aided or abetted cigarette smuggling. Jail time would send a message to all people that these types of crimes will be punished accordingly.

> "[F]irst nations people as a whole are asking, when was the last time a non-native person aiding and abetting this situation was indicted? […] Do you know how many Indians are in jail right now? Well, I guarantee you, there are no non-native CEOs in jail. If you start making them accountable for their activities, believe me, it will stop. That I'm sure of."

Two months later when Canada and the provinces announced the settlement, the agreement did not send a single person from ITC or RBH to jail for the crimes of the 1990s.

JTI-Macdonald and a number of its former executives and employees have also been charged for their alleged involvement in smuggling and tax evasion in the 1990s.

Governments betrayed public interest in plea bargain arrangement

Considering the damaging legacy to public health caused by the smuggling crimes, the settlements agreed to by the governments and companies were a major disappointment for public health groups.

Garfield Mahood, Executive Director of the Non-Smokers' Rights Association, concluded that "justice escapes us" because nobody went to jail:

> "There's no winners in this because the industry has addicted a whole bunch of young people who then became lifetime annuities for these companies. Over time the companies will financially benefit. And literally thousands of people will die in the future as a result of this crime."[8]

Cynthia Callard, Executive Director of Physicians for a Smoke-Free Canada (PSC), noted that governments received nothing to compensate for the revenue lost as a result of being manipulated into lowering tobacco taxes in 1994:

> "Throughout the 1990s, total government tax revenues were about $2 billion less each year than before the tax rollback. Only after 2001 did they return to the level of a decade below. In essence, the government has settled for only pennies on the dollar."[9]

PSC was also concerned that public input from the health community was not sought before the agreement was finalized behind closed doors with the companies. In addition, compensation to the victims of these crimes — those youth who began smoking in the 1990s due to the cheaper illicit cigarettes and are today still addicted — was not forthcoming.

Rob Cunningham, Senior Policy Analyst with the Canadian Cancer Society, expressed similar concerns:

> "The settlement does little for the youths who took up smoking … because of the government-of-the-day's countermeasure in 1994, which was to slash excise taxes and markedly reduce the cost of smoking…. Many of them [these youth] are destined to die of smoking-related diseases."[10]

Even a former executive of Imasco (a holding company once owned by ITC), has called the fines levied a bargain. Paul Finlayson, an executive for 16 years at Imasco, called the $600 million that ITC was forced to pay "chump change", compared to what the company earned during the smuggling crisis. Finlayson told *The Montreal Gazette* that Imperial earned $600 million to $700 million every year during the smuggling era, and the company orchestrated a scheme that defrauded governments of billions of dollars.

> [T]he government did "not have the guts of a field mouse to go after the executives of the company."[11]

For more reaction, see *Imperial and Rothmans Admit Guilt in 1990s Cigarette Smuggling Crimes*.[12]

Government gives $286M to Ontario tobacco farmers

On August 1st, the day after the tobacco companies entered guilty pleas in court, the federal government earmarked $286 million of its settlement funds to a buyout package for Ontario tobacco farmers. The announcement included an additional $15 million in funding to help communities in the Southern Ontario tobacco belt find new business opportunities.

Agriculture Minister Gerry Ritz made the announcement at the Delhi Tobacco Exchange Auction: [13]

> "This is tobacco money for tobacco farmers, coming from manufacturers through the Consolidated Revenue Fund — that's Revenue Canada, folks — as a result of the [smuggling] settlement agreement announced yesterday," Ritz said.[14]

This move was surprising given the government's strong resistance to earmarking funds, for example, their steadfast refusal to earmark any tobacco tax revenue for tobacco control.

This is not the first time tobacco farmers have received a buy-out from the federal government to help them exit the industry. Between 1986 and 1999, the federal government contributed $69.5 million towards a tobacco diversification plan, intended to help farmers transition to other crops. The deal included a buy-out of basic production quota (BPQ). Since tobacco in Ontario is a supply-managed commodity, a producer must hold quota to be eligible to grow and/or market it. By buying up BPQ, the federal government was reducing the amount of tobacco that could be legally grown in Canada.

Again, in 2005, the federal government purchased BPQ from 120 farmers for a total of $67.17 million, under the Tobacco Adjustment Assistance Program. In 2005, the provinces also pitched in; Ontario and Quebec committed $50 million and $10 million, respectively. [15]

These costly schemes have not been effective in getting all tobacco farmers out of the business, nor was there any public health rationale for spending these large sums of money.

Ontario resists pressure to follow suit, this time

Tobacco farmers, municipal politicians, as well as some local MPs and MPPs, are pressuring the Ontario government to contribute to the latest buyout, but so far to no avail. Agriculture Minister Leona Dombrowsky says taxpayer dollars are better spent funding health promotion strategies, and that any further buyout should be funded by tobacco users.

Philip Morris International buys Rothmans Inc.

The world's largest tobacco company (outside of China) is set to take over Canada's second largest manufacturer, Rothmans, Benson & Hedges (RBH). Philip Morris International (PMI) announced the friendly, $2-billion takeover offer for Rothmans Inc., following the announcement of the smuggling settlement. The resolution of the smuggling investigation was a condition of the sale.

Rothmans Inc.'s sole holding is a 60% interest in RBH. The remaining 40% is currently owned by PMI. The two companies have been joint shareholders of RBH since 1986. The offer had the full support of the Board of Directors of Rothmans and received approval from the required two-thirds of its shareholders in September. The proposal includes a payment of $30 per share from PMI.

The takeover means the world's three largest publicly-traded tobacco companies (PMI, British American Tobacco, and Japan Tobacco) now own businesses in Canada.

Rothmans market share increases on discount sales strength

RBH's overall market share in Canada grew 1.2% in the past year to 32.8%. RBH holds a 17% share of the premium market,[16] but dominates the Canadian discount cigarette category, with a share of about 47%.

The growth of the discount category has been good for RBH, which reacted quickly (when consumers began shifting to lower priced cigarettes) to reduce the price of some of its popular brands and developed new brands for the category. At the expense of the premium segment of the cigarette market, the discount segment has grown from 16% in 2003 to 54% in 2007.

Some shareholders did not like the move

Rothmans share value jumped 13% when PMI announced its intentions,[17] but pension fund manager Jarislowsky, Fraser Ltd. and securities traders said the offer should be increased by at least $1 per share.[18] Jarislowsky held a 14% stake in Rothmans, making it the largest shareholder after PMI. Jarislowsky President Len Rachioppo said the $30 per share offer fell short on several fronts. He told *The Globe and Mail*:

> We won't be tendering to the offer [agreeing to sell shares based on the offer], and we hope other shareholders won't tender either.[19]

Despite the resistance, the vast majority of shareholders agreed to the takeover bid and it was successful.

Implications of the takeover

Rachioppo said he expects PMI will streamline operations by closing one of two RBH cigarette manufacturing plants in Canada, with cigarette production shifting to PMI's Mexican facilities.[20]

Prior to the takeover, Adam Spielman, industry analyst with Citigroup (one of the world's largest banks), said he felt PMI was opening itself up to litigation risks in Canada, due to B.C.-style health care costs recovery legislation that provinces are enacting.[21]

The takeover means that RBH will change from being a Canadian-centric company to being a small part of a huge company, one that sees Canada as a testing ground for its ongoing efforts to adapt to a changing global marketplace. PMI recognizes Canada as perhaps the toughest market in the world (due to the government's commitment to tobacco control), and also knows that what happens here spreads elsewhere. PMI can be expected to use the opportunity of direct control of a Canadian company to figure out how to respond to new tobacco control measures.

In addition, PMI's marketing strength could lead to more competition amongst the major manufacturers here, and ultimately more cigarette brands being sold cheaply if they continue to compete vigorously for customers in the discount cigarette market segment.

Tobacco companies increase payments to retailers despite 'dark market'

Despite the fact that 12 of 13 provinces and territories in Canada have enacted, or will soon enact, legislation that prohibits the display of tobacco products at retail outlets, tobacco manufacturers continue to give retailers millions of dollars a year to sell and promote tobacco products.

Figures recently released by Health Canada indicate that $108 million was paid out in 2007, compared to only $74 million in 2001, a 46% increase.

Maclean's magazine reported on this upward trend in July:

> "Store owners receive money from tobacco companies for everything from sharing information on customer purchases to stocking certain cigarette brands on prime shelf space, even when it's behind those blank barriers."[22]

Prominent displays remain important for manufacturers because when the flap or cupboard door is opened, the packages are visible to everyone nearby, and because the larger the display the more brand families the retailer can stock.

Retailers are also being paid depending on how much of their sales are of a certain company's product, as well as for sales volumes, says Ron Funk, vice-president of corporate affairs for Rothmans, Benson & Hedges Inc.:

> "You set an objective with a store, and should that store meet the objective, they're compensated with a payment."[23]

Imperial Tobacco Canada also offers a "per-carton payout" to retailers.[24]

The following graph details the payments made across Canada, in millions of dollars, and the percentage change in payments from 2006 to 2007:

	2006	2007	change
Canada	$107.4	$108.2	0.7%
BC	$10.2	$11.9	16.9%
AB	$11.8	$13.4	12.9%
SK	$1.6	$1.9	19.4%
MB	$1.9	$4.9	162.4%
ON	$40.0	$32.0	-20.0%
QC	$32.8	$34.7	5.5%
NB	$2.4	$2.9	20.5%
NS	$4.0	$3.4	-14.9%
PEI	$0.3	$0.3	-5.1%
NL	$2.4	$2.8	19.2%
Territories	$0.031	$0.026	-16.8%

Table compiled by R Cunningham, Canadian Cancer Society. 18 July 2008

Retailers in Newfoundland and Labrador, the only jurisdiction in Canada which has not yet banned tobacco displays, saw their payments to retailers increase by 19% in 2007.

Tobacco manufacturers and retailers have worked together for years to scuttle government action intended to control the tobacco epidemic; for example, they frequently speak out against proposed tobacco tax increases or lobby for lower tobacco taxes. The President of the Canadian Convenience Stores Association, Dave Bryans, was formerly employed by tobacco company RJR-Macdonald Inc., now

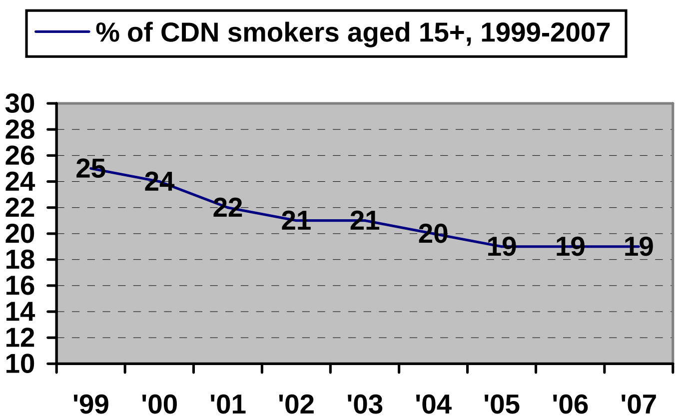
JTI-Macdonald Corp.:

> "Nobody better to teach people how to handle these products than me," he says.[25]

The close relationship between these vested interests is further solidified by these payments.

New data shows smoking rates have flat-lined; contraband blamed

Contraband cigarettes, sold for as little as $6 per carton, are being blamed by public health organizations for halting the decline in smoking rates across the country. Data from the Canadian Tobacco Use Monitoring Survey released in August indicate that for the past three years, 19% of Canadians reported being smokers.



Contraband cigarettes, which are sold tax-free and retail for $40-$60 less than fully-taxed cigarettes, are increasingly available across the country, but sales are mostly concentrated in Ontario and Quebec.

Contraband cigarettes are a booming business in about 12 First Nations communities in these two provinces, according to the RCMP, where they are being purchased en masse and then transported and sold in major cities and towns across Canada.

The RCMP says 90% of the tobacco it is seizing across the country originates from illegal manufacturing facilities located on the U.S.-side of the Akwesasne/St. Regis reserve.

Cigarettes are also being manufactured in Ontario at Six Nations and Tyendinaga, and in Quebec at Kahnawake. Communities in addition to those listed above identified by the RCMP as having a significant number of smoke shacks, where cigarettes are sold illegally to non-status Indians, include Kanesatake (west of Montreal), Kitigan Zibi (near Maniwaki, Quebec) and Curve Lake (near Peterborough, Ontario).

One critical solution to the contraband problem is for the Canadian government to insist that American authorities shut down the illegal manufacturing facilities on the U.S.-side of the Akwesasne/St. Regis reserve.

The wide availability of cheap cigarettes has devastating public health consequences because it ensures that teens have easier access to the products and that those already addicted will smoke more. It is difficult to imagine how Health Canada will achieve its goal of lowering smoking rates to 12 per cent by 2011, unless contraband is effectively controlled.

Canada commits $20 million to fight contraband

A $20 million investment in efforts to fight contraband tobacco, a sum to be paid out over the next four years, was announced by the federal government at the end of August.[26]

How the money will be spent was not made immediately clear, but considering the fact that up to $2 billion in government revenues is being lost annually due to the illegal tobacco trade, some might question whether $20 million is enough to effectively shut down this thriving black market.

Excise stamp delayed by nearly two years

Shortly following the announcement of new funding to combat contraband, the government *re-announced* its plans to require an excise duty stamp on tobacco products.[27] The new stamp is expected to be fully implemented by early 2010. Originally, it was proposed to have been implemented this past summer.[28] The government did not release any details as to why the implementation date has been delayed.

The cost of the stamp is to be covered by tobacco importers and manufacturers through the sale of the stamp.[29]

The new stamp will have sophisticated security features, similar to those found on Canadian currency. The new stamping regime will:

- provide a reliable indication of the duty-paid status of tobacco products;
- make counterfeit products easier to detect and seize by enforcement agencies;
- strengthen controls over the manufacturing and the distribution of tobacco stamps; and
- provide an additional enforcement tool for federal and provincial compliance and enforcement authorities.[30]

The stamps will be required on both domestically-produced and imported duty-paid products sold and distributed in Canada.

GRE sues Canada for failing to enforce laws, prevent contraband on reserves

Grand River Enterprises (GRE), the largest First Nations-owned and operated cigarette manufacturer in Canada, and four of its shareholders, filed a lawsuit in the Ontario Superior Court of Justice in July against the Government of Canada.

The statement of claim alleges that the government has failed to enforce laws and prevent contraband tobacco on First Nations reserves.

GRE is seeking $1.5 billion in damages, an amount equal to all federal tobacco taxes paid by the company since 1997. GRE also seeks damages for the losses in market share and sales it has suffered as a result of the growth in the contraband market. At times the contraband market has included counterfeit versions of two of its most popular brands, which are even available for sale on the Six Nations reserve where the company is located.

The federal government is essentially being sued for failing to enforce federal tobacco tax laws on reserves.

Kenneth Hill is one of four GRE shareholders suing the Government of Canada.

The statement of claim against the federal government notes that GRE has filed a separate case in the Tax Court of Canada, which challenges the ability of the federal government to apply tobacco taxes to GRE. By law, federal tobacco taxes apply under all circumstances, including to on-reserve manufacturers, but in complete contradiction of its other suit, GRE is contesting this law.

It appears as though the company and its shareholders are using these seemingly contradictory legal arguments as a strategy to ensure success, one way or the other.

First Nations in Saskatchewan urged to increase tobacco prices to benefit public health

Public health groups in Saskatchewan are urging First Nations to raise the price of tobacco products sold on their territories.

In early July, the Saskatchewan Coalition for Tobacco Reduction called on First Nations to impose their own levy on tobacco products to dissuade people from using and becoming addicted to cigarettes.[31]

Cigarettes sold on-reserve to Status Indians are exempt from provincial tobacco taxes, provincial sales tax and federal GST, thus making them several dollars cheaper per pack than products that are fully taxed.

But the Coalition would like to see the individual First Nations impose their own levies, thus increasing the price by an amount equal to the provincial tax rate. High prices on tobacco, usually achieved through taxes or levies, have been shown to be one of the most successful tobacco reduction measures available.

The pleas of Saskatchewan health groups are receiving both a positive and negative reception. Morley Watson, Vice-Chief of the Federation of Saskatchewan Indian Nations, has stated publicly that he will not champion or support the proposal. He says the decision whether or not to impose a tax is for individual communities to make.

In contrast, Doug Cuthand, an Aboriginal writer whose columns frequently appear in the Regina *Leader-Post*, says it is about time First Nations leaders start thinking about the responsibility they have to their membership, including the community's health:

> "Tobacco has been proven to be a major health hazard and our people seem to be the last ones to catch on. Also we are not operating in a vacuum. When our people end up in the cancer ward they are accessing the publicly funded medicare program and then it is a problem for the whole province.
>
> We can't continue to bury our heads in the sand and continue to allow our people access to cheap cigarettes. In the long run we will pay a terrible price."[32]

Tobacco farmers begin manufacturing their own cigarettes

Tobacco farmers in southern Ontario have started their own cigarette company and are marketing their products as "100% Canadian."[33]

The company, North Shore Tobacco Canada Inc., is selling cigarettes for about $61 a carton (including taxes), a full $7-8 less than the popular Number 7 discount brand manufactured by RBH.

The product is mostly being sold throughout Southwestern Ontario, but North Shore has indicated that they intend to start selling into the United States soon, too.

At the moment, North Shore has a contract with Bastos du Canada, which operates out of Louiseville, Quebec, to manufacturer the cigarettes. Eventually North Shore would like to buy their own manufacturing equipment, but will not do so until they have a secure market for their products.

Tobacco industry not pleased with Stephen Harper's promise to ban candy-flavoured products

On September 17th, Stephen Harper announced that, if re-elected, a Conservative government

Prime Minister Stephen Harper.

would ban “kiddy packs” of cigarillos; and flavours and additives in tobacco products that appeal to children. The Prime Minister also said that the Conservative government will set a minimum package size “to require that cigarillos be sold in packages of no fewer than 20 units”; and will ban “all tobacco advertising and promotion in print and electronic media which may be viewed and read by youth.”[34]

Imperial Tobacco Canada reacted to the news by calling on the Prime Minister to “include in this crackdown the rampant illegal tobacco market that currently plagues Canada, targets Canada’s youth and undermines all of Canada’s tobacco control policies.”[35] Imperial stressed that it does not sell cigarillos or flavoured cigarettes, other than mentholated cigarettes, nor does it “target minors in any of its marketing practices.”

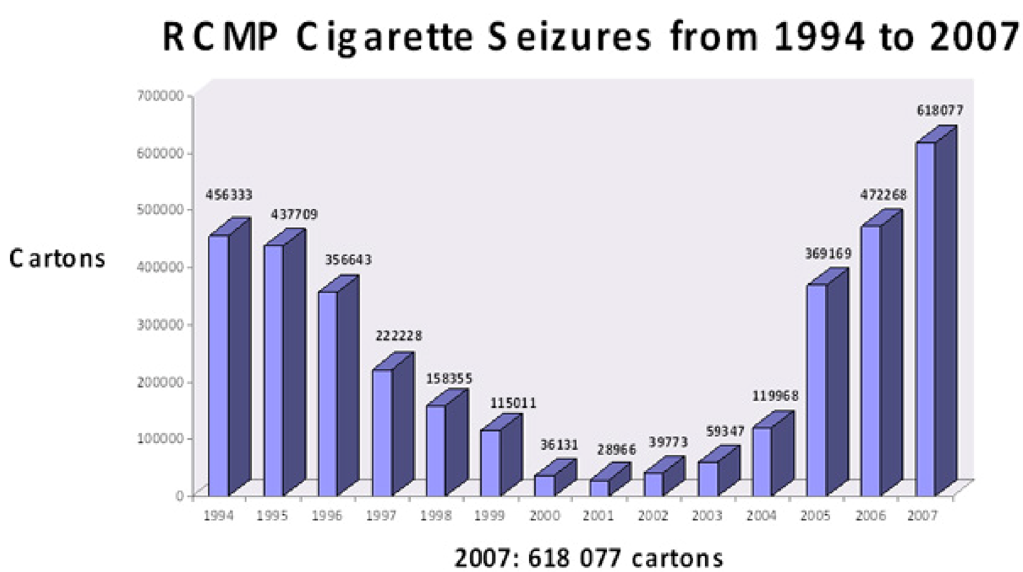
CASA CUBANA

Casa Cubana, on the other hand, said the Conservative Party’s promise is “dangerously misguided.”[36] The Montreal-based company sells the majority of flavoured cigarillos across Canada and is clearly worried that a ban on candy flavours will negatively impact its bottom line.

Contraband tobacco smuggling, cigarette seizures, related arrests keep police busy

In 2007, the RCMP seized 618,077 cartons of contraband cigarettes in Canada — a record that will be exceeded in 2008 if arrests and seizures in recent months are any indication. The Ontario division of the RCMP posted more than 30 press releases on its website from July to September, detailing arrests of individuals in possession of contraband cigarettes and fine cut tobacco.

In total, in just three months, many millions of cigarettes have been seized, as have many thousands of kilograms of fine cut tobacco. Many of the arrests were made in coordination with the Akwesasne Mohawk Police Service, the Canadian Border Services Agency, and the Ontario Provincial Police.



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