KPMG

Project SUN

A study of the illicit cigarette market in the European Union, Norway and Switzerland

2017 Results

Executive Summary

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Important notice

- This presentation of Project SUN key findings (the 'Report') has been prepared by KPMG LLP the UK member firm ("KPMG") for the Royal United Services Institute for Defence and Security Studies (RUSI), described in this Important Notice and in this Report as 'the Beneficiary', on the basis set out in a private contract dated 27 April 2018 agreed separately by KPMG LLP with the Beneficiary (the 'Contract').
- Included in the report are a number of insight boxes which are written by RUSI, as well as insights included in the text. The fieldwork and analysis undertaken and views expressed in these boxes are RUSI's views alone and not part of KPMG's analysis. These appear in the Foreword on page 5, the Executive Summary on page 6, on pages 11, 12, 13 and 16.
- Nothing in this Report constitutes legal advice. Information sources, the scope of our work, and scope and source limitations, are set out in the Appendices to this Report. The scope of our review of the contraband and counterfeit segments of the tobacco market within the 28 EU Member States, Switzerland and Norway was fixed by agreement with the Beneficiary and is set out in the Appendices.
- We have satisfied ourselves, so far as possible, that the information presented in this Report is consistent with our information sources but we have not sought to establish the reliability of the information sources by reference to other evidence.
- This Report has not been designed to benefit anyone except the Beneficiary. In preparing this Report we have not taken into account the interests, needs or circumstances of anyone apart from the Beneficiary, even though we have been aware that others might read this Report.
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- In particular, and without limiting the general statement above, since we have prepared this Report for the Beneficiary alone, this Report has not been prepared for the benefit of any manufacturer of tobacco products nor for any other person or organisation who might have an interest in the matters discussed in this Report, including for example those who work in or monitor the tobacco or public health sectors or those who provide goods or services to those who operate in those sectors.

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Glossary

Average Daily Consumption	Daily average consumption by the population of the legal smoking age
BAT	British American Tobacco plc
Bn	Billion
C&C	Counterfeit and Contraband, including Illicit Whites
CAGR	Compound Annual Growth Rate
Cigarette	Any factory-made product that contains tobacco and is intended to be burned under ordinary conditions of use
Cigarillos	A short, narrow cigar, which, like cigarettes, is often machine-made and sold in packs
Consumption	Actual total consumption of cigarettes in a market, including Legal Domestic Consumption (LDC) and illicit products as well as those legally purchased overseas
Contraband (CB)	Genuine products that have been either bought in a low-tax country and which exceed legal border limits or acquired without taxes for export purposes to be illegally re-sold (for financial profit) in a higher priced market
Counterfeit (CF)	Cigarettes that are illegally manufactured and sold by a party other than the original trademark owner. In this report, counterfeit volumes are reported from the manufacturers of BAT, ITL and PMI, all of which participate in the EPS. Additionally, in some markets such as Bulgaria, Luxembourg and Belgium, local manufacturers also participate
Country of origin	Country from which the packs collected are deemed to have originated. This is determined by either the tax stamp on the pack or in cases where the tax stamp is not shown, on the health warning and packaging characteristics
Domestic Whites	Domestic Whites are packs of domestic market variant, but those that are priced below the minimum tax yield. These products are treated as having not been legally sold in the country in question, and have therefore been reclassified as non-domestic
Duty Free	Cigarettes bought without payment of customs or excise duties. Consumers may buy Duty Free Cigarettes when travelling into or out of the EU (including Switzerland and Norway) by land, air or sea at legal Duty Free shops
EC	European Commission
EEA	European Economic Area
EPS	Empty Pack Survey
EU	European Union
EU Flows Model	The primary methodology for measuring consumption in a market. The model has been developed by KPMG on a bespoke basis for the specific purpose of measuring inflows and outflows of cigarettes in the scope of this project
EUTPD	European Union Tobacco Products Directive
FTZ	Free Trade Zone
Green Leaf	Uncut dried tobacco leaf, which smokers cut themselves
Illicit Whites (IW)	Cigarettes that are usually manufactured legally in one country/market but which the evidence suggests have been smuggled across borders during their transit to the destination market under review where they have limited or no legal distribution and are sold without payment of tax

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Glossary

Illicit Whites with no country specific labelling	Packs of Illicit White cigarettes which have "Duty Free" or no identifiable labelling on the packs
IMS	In Market Sales (the primary source of legal domestic sales volumes)
Inflows/Outflows	Inflows of non-domestic product into a market / outflows of product from a market
ITL	Imperial Tobacco Limited
JTI	JT International SA
LDC	Legal Domestic Consumption is defined as Legal Domestic Sales (LDS) net of outflows
LDS	Legal Domestic Sales of genuine domestic product through legitimate, domestic channels based on In Market Sales (IMS) data
M	Million
MPPC	Most Popular Price Category
MYO	Make Your Own tobacco products
ND	Non-Domestic product – product that originates from a different market than the one in which it is consumed
ND(L)	Non-Domestic (Legal) – product that is brought into the market legally by consumers, such as during a cross-border trip
NMA/TMA	National Manufacturers' Association / Tobacco Manufacturers' Association
OCG	Organised crime group
OLAF	Office Européen de Lutte Antifraude also known as the European Anti-Fraud Office
OTP	Other Tobacco Products (RYO/MYO, cigarillos, portions, rolls and cigars; excluding smokeless tobacco and water-pipe tobacco)
PMI	Philip Morris International Management SA
RUSI	Royal United Services Institute for Defence and Security Studies
RYO	Roll Your Own tobacco products
Smoking prevalence	The percentage of smokers in the total population of the legal smoking age
Tobacco taxes	The sum of all types of taxes levied on tobacco products, including VAT. There are two basic methods of tobacco taxation: Normal or specific taxes are based on a set amount of tax per unit (e.g. cigarette); these taxes are differentiated according to the type of tobacco. Ad valorem taxes are assessed as a percentage mark up on a determined value, usually the retail selling price or a wholesale price and includes any value added tax
Unspecified	Unspecified market variant refers to cigarette packs which do not bear specific market labelling or Duty Free labelling
UNWTO	United Nations World Tourism Organisation
WAP	The weighted average price for cigarettes calculated by reference to the total value of all cigarettes released for consumption, based on the retail selling price including all taxes, divided by the total quantity of cigarettes released for consumption. The WAP is provided by the European Commission Excise Duty Tables or other official sources

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Foreword by the Royal United Services Institute

Project SUN is a study that estimates the scale of the illicit cigarette market in the EU, Norway and Switzerland

Illicit trade is a global criminal activity driven by organised crime networks, posing a substantial threat to national security and public safety. Since 2014, the Royal United Services Institute (RUSI) has run a programme of research focused on better understanding this form of illicit activity, with the aim of informing and improving policy responses. As part of this workstream, as in 2016, this year RUSI has commissioned the 2017 iteration of Project SUN, which provides an estimate of the scale of the illicit cigarette market in the EU, Norway and Switzerland. RUSI commissioned this research with funding from BAT and PMI, provided for the Institute's illicit trade research. Alongside Project SUN, RUSI has produced an Occasional Paper to shed light on some of the main organised crime dynamics accompanying the trends revealed by the KPMG data.

This KPMG report presents the results of the range of statistical analyses conducted as part of Project SUN, covering all 28 EU countries, as well as Norway and Switzerland. The report follows an established quantitative methodology, with analyses covering the prevalence of illicit cigarette consumption in each country, the origins of non-domestic inflows, the destinations of outflows, and the brands most extensively consumed. This year, for the first time, the results are presented via hosted online platforms.

The Occasional Paper RUSI has produced this year builds on the quantitative analysis conducted by KPMG with qualitative research into some of the main organised crime dynamics accompanying the trends revealed by the data. This is based on desk-based research as well as in-depth consultations with a range of stakeholders from across the public and private sectors. In particular, RUSI's research has focused on two important factors driving the illicit trade landscape: the use of the internet, and the exploitation of postal and some fast parcel services.

These platforms and services are increasingly exploited by organised crime groups involved in the illicit cigarette trade across Europe. However, there is considerable geographical variation. To explore this, the RUSI paper presents the results of research conducted across three key EU markets over 2018: the UK, France and Germany. All three are among the top five countries for illicit consumption in 2017, yet each has adopted different policy and practical approaches to the challenges posed by the use of the internet, e-commerce, postal and some fast parcel services to facilitate the illicit cigarette trade and associated organised criminality.

The RUSI paper seeks to shed light on these dynamics, highlighting their relevance to the broader illicit trade picture, and proposing a number of recommendations for more effectively addressing the challenges they pose. A number of the insights presented in the RUSI paper are summarised in this report. The full RUSI publication can be accessed at **https://RUSI.org/illicittrade2018** from October 2018.

The use of online and postal services are not challenges that are set to decline. As for many other forms of organised crime, the expansion in the use of e-commerce, postal and some fast parcel services has created numerous opportunities for those dealing in illicit products. Attention to these dynamics must now form a critical part of overarching efforts to tackle illicit trade in cigarettes and other tobacco products.

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Executive summary

Key findings

44.7bn

Counterfeit and contraband cigarettes consumed [(a)]

-3.6bn on 2016

-7% on 2016

8.7%

Of total consumption was C&C

-0.4ppt on 2016

€10bn

Tax revenue lost

€-209m on 2016

-2% on 2016

In 2017, the Counterfeit and Contraband (C&C) cigarette consumption in the EU is estimated at 8.7% of total consumption, accounting for 44.7 billion cigarettes

- The volume of C&C continued to decline in 2017; the 7.4% reduction was more pronounced than the legal domestic consumption decline of 2.5%
- The C&C proportion of overall consumption was the lowest since 2008
- Despite the overall C&C decline, counterfeit volumes increased by 8.6% from 2016, a total of 4 billion cigarettes and 9.2% of total C&C
- The volume of C&C resulted in a tax loss of €10 billion, making illicit cigarettes one of the largest sources of overall consumption

Despite the overall decline, C&C grew in countries with the largest price differences with source countries

- C&C in the UK and Ireland grew to 18% and 20% of consumption respectively; two of the highest rates in the study
- In these countries the price difference with non-EU countries was greater than €8 per pack. This may have led to smugglers diverting products to these higher priced countries
- The illicit cigarette trade remains a low-risk, high-reward activity for organised crime groups operating on a transnational scale. Illicit cigarettes are smuggled into the EU by sophisticated criminal networks, using well-developed international supply chains
- Research suggests the presence of organised criminal networks that regularly smuggle cigarettes into the EU in large quantities. However, within the EU, a sizeable proportion of all cigarette seizures remain small in volume, indicating an ongoing trend towards 'low volume, high frequency smuggling', including via fast parcels and postal services

C&C fell in markets where there was evidence of positive law enforcement activity or a favourable economic climate

- Law enforcement activities, especially the coordinated efforts on the Eastern EU border, appear to have reduced flows from Belarus and Ukraine
- In addition, positive changes in economic factors (such as GDP, unemployment rate, etc.) in many countries may have resulted in consumers switching to the legal market, whilst growing traveller numbers maintained non-domestic legal purchases
- Both Poland and Croatia saw falls in C&C, aligned with increased law enforcement activity and improved legislative frameworks
- C&C fell alongside positive changes in economic factors in Romania and Germany

Note: (a) Includes Illicit Whites

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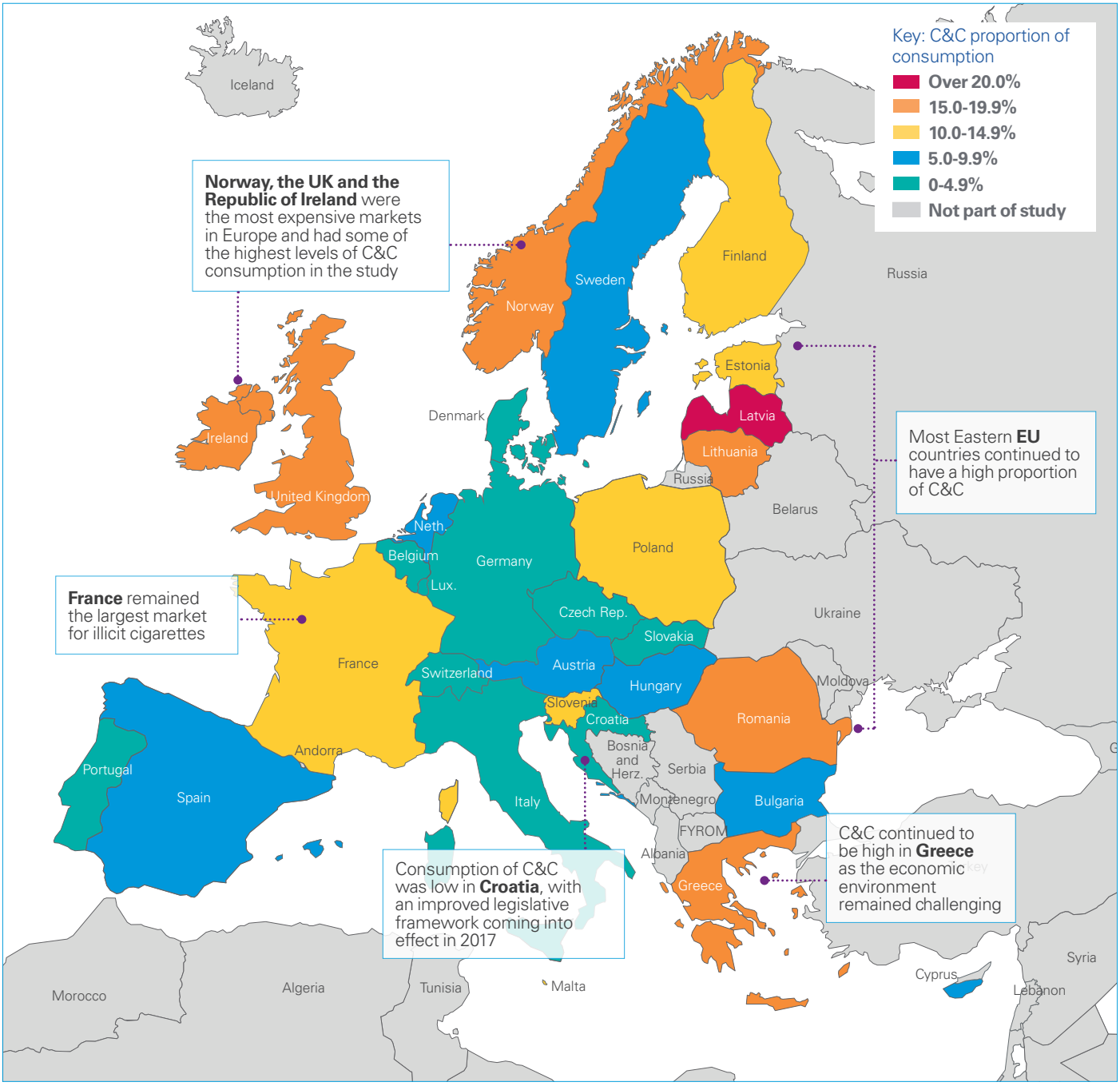
C&C consumption in the EU, Norway and Switzerland as a percentage of total consumption, 2017[1]



Source: (1) KPMG EU flows model 2017

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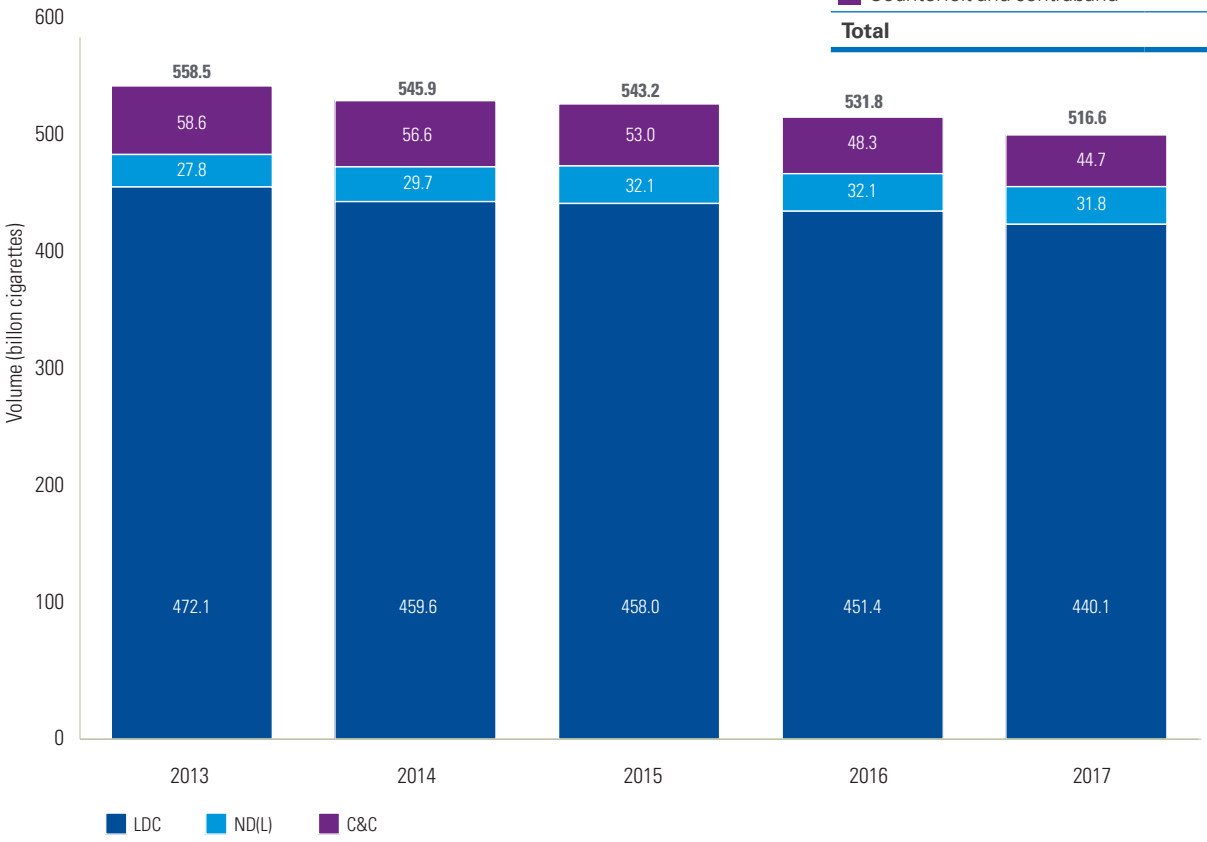
C&C consumption declined in 16 of the 30 countries in the study

- The C&C consumption decline of 7.4% in the EU from 2016 to 2017 was greater than the legal domestic consumption decline of 2.5%
- Although the volume of C&C declined, the total loss in tax revenue across the EU remained similar to the previous year at €10 billion
- C&C consumption remained high in countries such as the UK and Ireland, where high legal prices created strong consumer demand for C&C products
- Non-Domestic Legal remained stable supported mainly by travel flows between EU countries

Manufactured cigarette total consumption in the EU, 2013-2017[1]

CAGR (%)	2013-2017	2016-2017
Legal domestic consumption	(1.7%)	(2.5%)
Non-domestic legal	3.4%	(1.0%)
Counterfeit and contraband	(6.5%)	(7.4%)
Total	**(1.9%)**	**(2.9%)**



Sources: (1) KPMG EU flows model 2013-2017; (2) EC Excise Duty Tables, january 2018 (Part III – Manufactured Tobacco)
(3) KPMG analysis of UNWTO data

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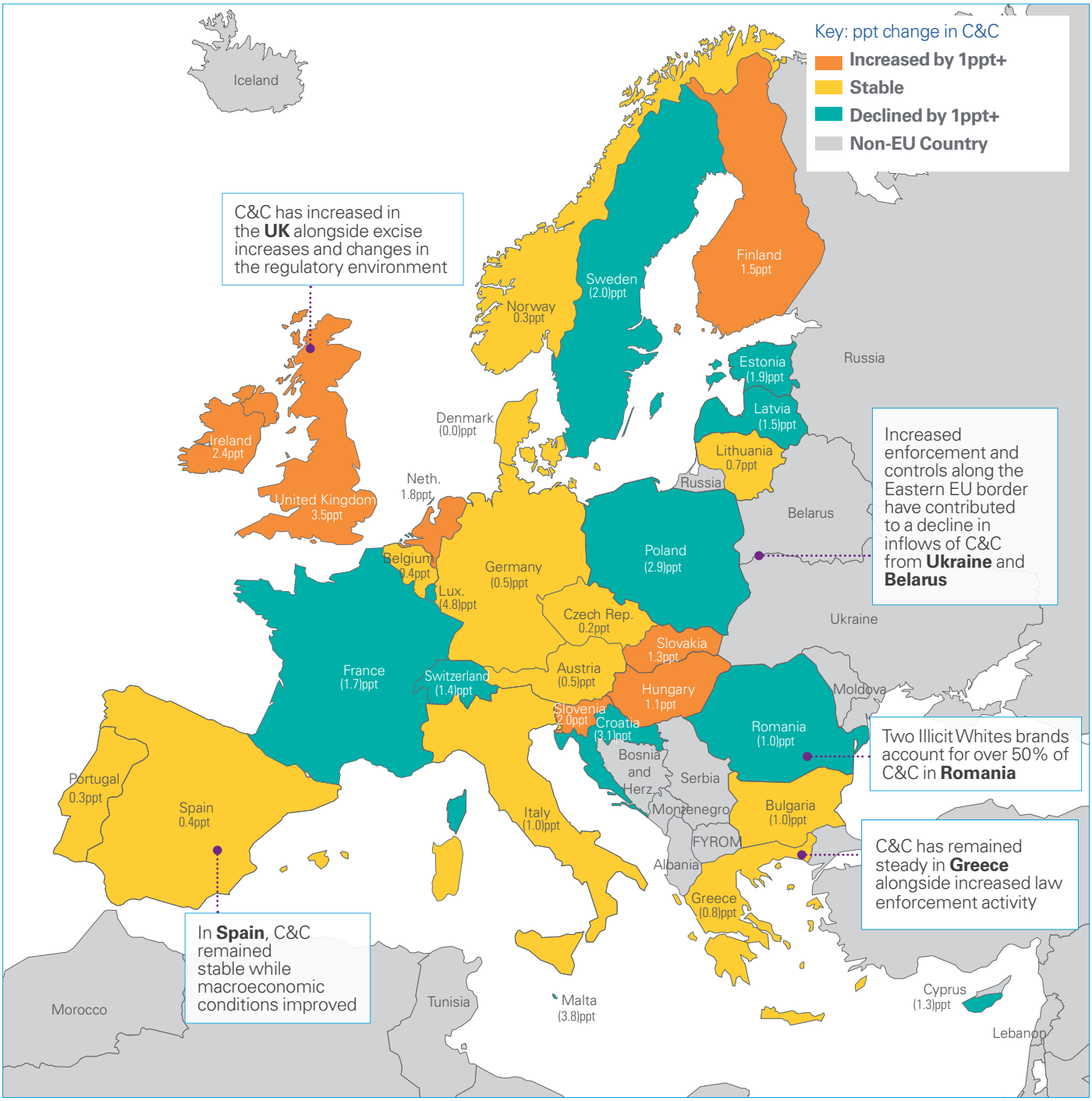
Percentage point change in C&C consumption in the EU, Norway and Switzerland as a percentage of total consumption, 2016 vs. 2017[1][a]



Note: (a) A percentage point, or ppt, is the unit for arithmetic difference between two percentages
Source: (1) KPMG EU flows model 2016-2017

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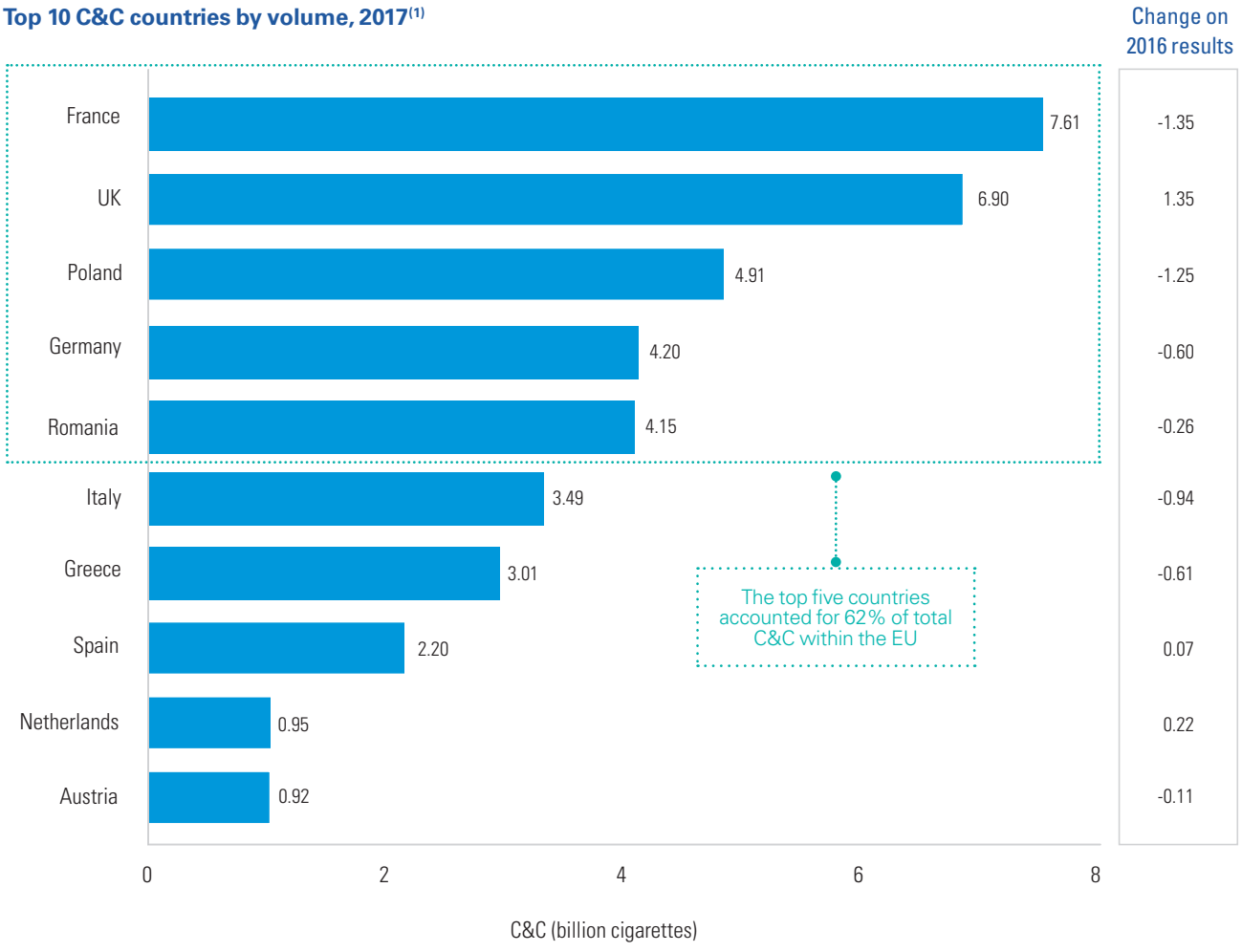
C&C volumes declined in 7 of the top 10 countries in this study

- Despite declining, France had the highest volume of C&C identified in the study
- C&C consumption also fell in Poland, Germany, Romania, Italy, Greece and Austria
- The UK experienced the highest increase in C&C consumption in volume terms
  - C&C in the UK was identified from Poland, Romania and countries that bordered the Eastern EU such as Belarus and Ukraine. Unlike in the rest of the EU, flows from these countries increased, demonstrating an incentive to smuggle cigarettes into the UK where the opportunity to profit from greater price differences was higher

Top 10 C&C countries by volume, 2017[1]



Source: (1) KPMG EU flows model 2017

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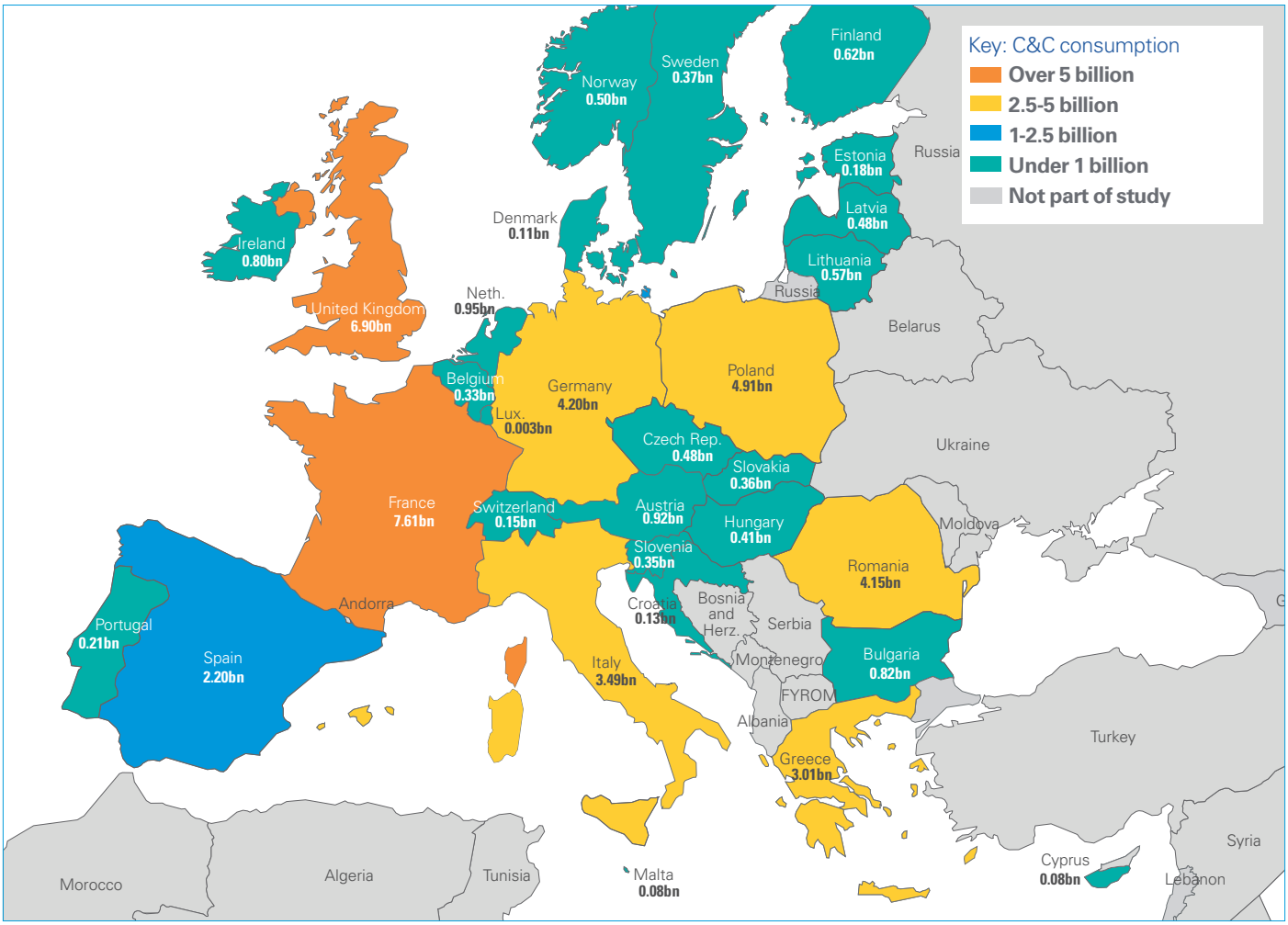
RUSI Analysis: The Internet and Social Media[2]

As for many other forms of organised crime, the growth of the internet and online marketplaces has created new opportunities for sellers of illicit cigarettes. Purpose-built websites are used to market products directly to consumers, who make purchases using debit or credit cards, with goods subsequently delivered using postal or courier services.

However, over the past few years, social media platforms have overtaken these sites to become the primary medium through which illicit cigarettes are sold online. At the less organised end of the spectrum, individual opportunists who travel abroad and bring back more than the legal allowance use their profile pages to advertise surplus product to their friends. However, analysis also reveals the existence of sophisticated and organised criminal networks, members of which establish many different profiles and post in numerous private groups in order to reach a large consumer base. It is particularly difficult for law enforcement agencies to effectively respond to this threat, as much of this online activity takes place in a closed environment, including via private messaging services or invitation-only groups.

C&C consumption in the EU, Norway and Switzerland (billion cigarettes), 2017[1]



Source: (1) KPMG EU flows model 2017

(2) The RUSI Analysis boxes included in this executive summary draw on a range of sources, as outlined in the Methodology and Frequently Asked Questions sections of Project SUN

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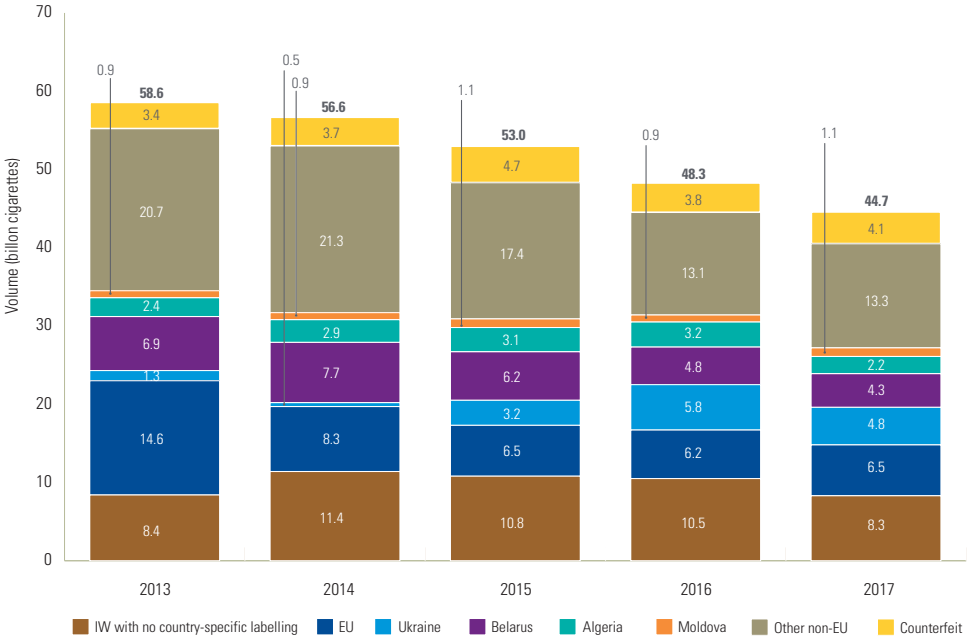
Cigarettes from non-EU countries accounted for the majority of C&C consumption in the EU

- Illicit Whites with no country specific labelling remained the largest source of C&C, despite a decline in volume. 59% of this flow displayed 'Duty Free' labelling [a]
- The share and volume of counterfeit grew, which continued to demonstrate the flexibility of illicit trade
- C&C from the largest source countries of Ukraine and Belarus declined by 17% and 10% respectively
  - Despite the decline, the introduction of visa-free travel from Ukraine may have facilitated low-volume high-frequency transfer of cigarettes across the border to higher-priced markets
- C&C flows from countries within the EU increased in volume by 5%. C&C from non EU sources formed 58% of C&C volume and declined by 7%

Sources of C&C by volume in the EU, 2017[1]



RUSI Analysis: Securing the Legal Supply Chain[3]

To stem flows of illicit tobacco products in the EU, the European Commission has pursued a range of policy approaches in recent years, including the introduction of new legislation. In this respect, the revision of the Tobacco Products Directive in 2014 and the EU's ratification of the World Health Organization Framework Convention on Tobacco Control (FCTC) protocol to eliminate illicit trade in tobacco products will alter the regulatory landscape in Europe. In June 2018, the protocol reached the forty signatures required for it to enter into force, which it is set to do on 25 September 2018.

Implementing acts issued by the European Commission require traceability and security features on tobacco products. These obligations will enter into force on 20 May 2019 for cigarettes and hand-rolling tobacco, and on 20 May 2024 for other tobacco products.[2] Unit packets of tobacco products produced or sold in the EU will be marked with unique identifiers (codes) provided to manufacturers by an independent third-party ('ID issuer'). Once marked with unique identifiers, products will be tracked throughout the legal supply chain until the last economic operator before the first retail outlet, enabling authorities to verify their movement.

Such track and trace and authentication capabilities are set to offer another useful tool in combatting flows of illicit tobacco products. However, while the legislation will provide more insight into and control over flows of tobacco products in the legal supply chain, the onus will continue to be on frequent, robust and coordinated law-enforcement action, as well as enhanced efforts to reduce consumer demand for illicit products.

Note: (a) See the glossary section at the front of this report for the definition of Illicit Whites

Sources: (1) KPMG EU flows model 2013-2017 (2) European Union, 'Directive 2014/40/EU of the European Parliament and of the Council of 3 April 2014 on the Approximation of the Laws, Regulations and Administrative Provisions of the Member States concerning the Manufacture, Presentation and Sale of Tobacco and Related Products and Repealing Directive 2001/37/EC', Official Journal of the European Union (L127/1, April 2014). (3) The RUSI Analysis boxes included in this executive summary draw on a range of sources, as outlined in the Methodology and Frequently Asked Questions sections of Project SUN

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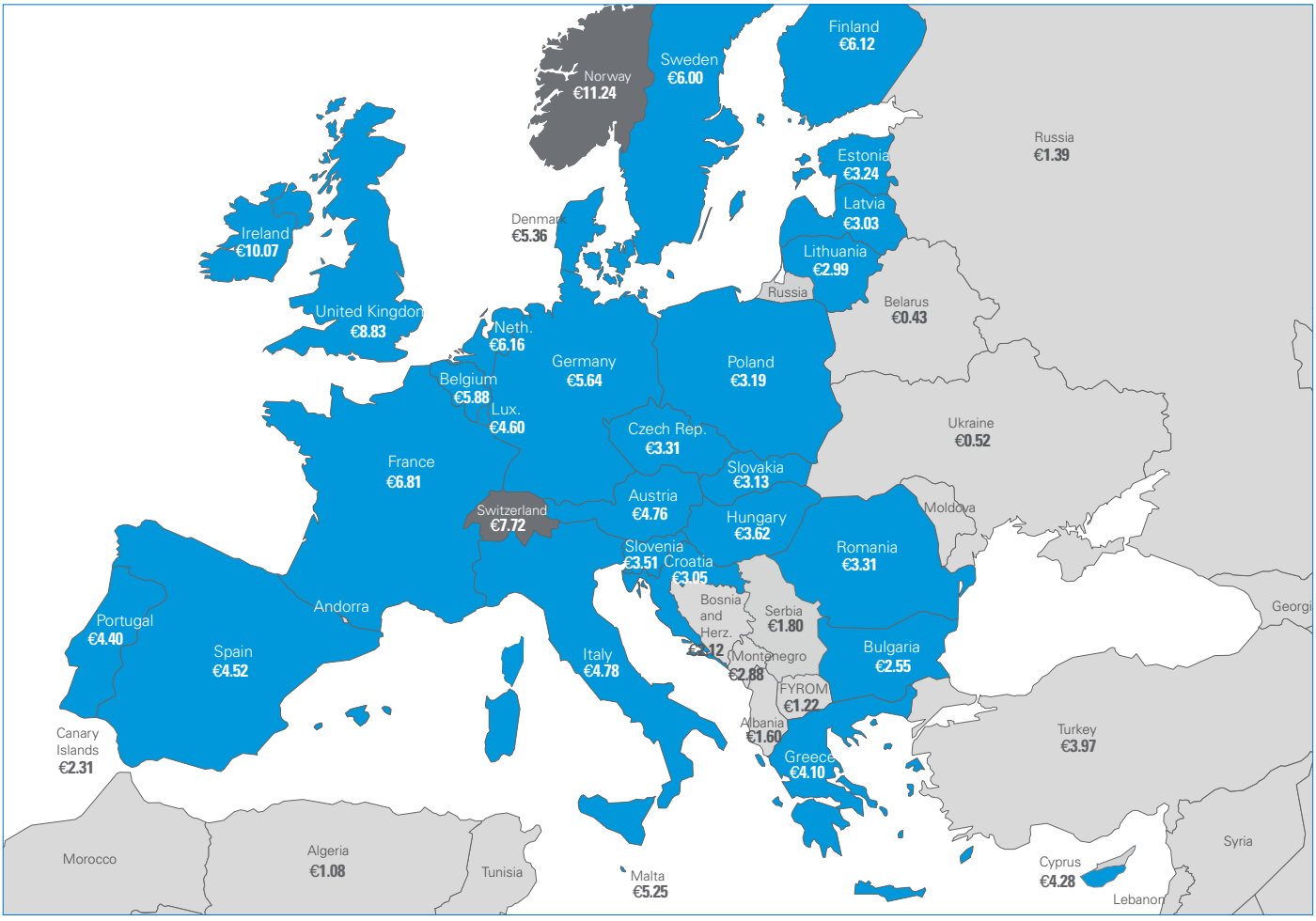
RUSI Analysis: Fast Parcels and Postal Services[4]

In recent years, seizure data from across the EU has shown that organised crime groups are using fast parcels and postal services to send smaller volumes of illicit goods with higher frequency. There is no internationally accepted definition of fast parcel services, with this term used to describe many different business models. While the major global express delivery carriers with end-to-end supply chain integration are less vulnerable to the illicit cigarette trade, smaller, less integrated services are commonly exploited. The postal system and these smaller fast parcel services represent a low-cost, low-risk means of transportation for illicit cigarettes. This form of trafficking is particularly difficult to enforce against given the sheer volume of parcels now being sent on a daily basis. Lack of data and intelligence to effectively target suspicious parcels further compounds these difficulties. Within the European Economic Area (EEA), there is no legal requirement to declare the contents, weight and value of consignments[3]. Capitalising on this vulnerability, a common modus operandi is for traffickers to mis-declare large consignments in order to import them into the EEA, before fragmenting these into smaller parcels for further distribution across Europe, minimising financial loss in the event of a seizure.

Weighted average prices for a pack of 20 cigarettes January, 2018[1][2][a]



Key:

EU countries

Non-EU countries

Non-EU country of study

Note: (a) Norway, Switzerland and all non EU countries use WHO 'Price of most sold brand of cigarettes'

Sources: (1) KPMG EU flows model 2017 (2) EU Excise Duty Tables, January 2018 (Part III – Manufactured Tobacco) (3) European Union, 'Consolidated Version of the Treaty on the Functioning of the European Union', Official Journal of the European Union (C 326, 26 October 2012), Article 28. (4) The RUSI Analysis boxes included in this executive summary draw on a range of sources, as outlined in the Methodology and Frequently Asked Questions sections of Project SUN

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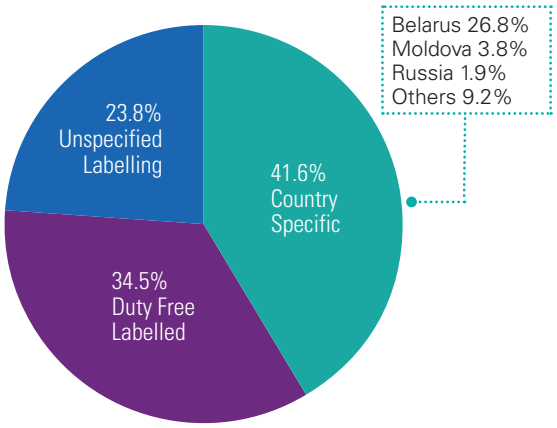
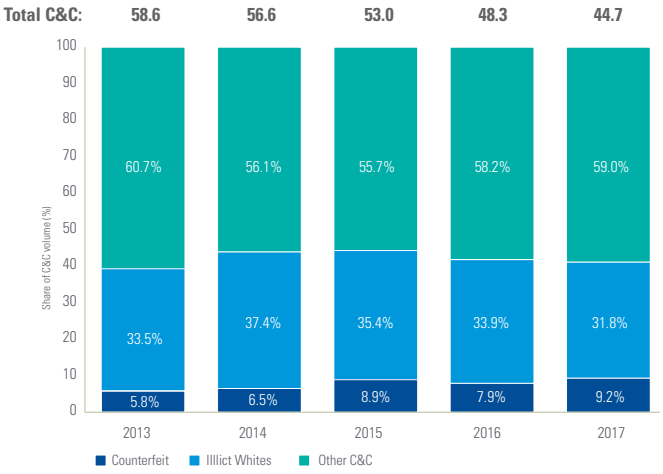
Illicit White brands continued to account for approximately one third of C&C, while counterfeit volumes increased by 9%

- 34.5% of Illicit White brand flows identified were labelled "Duty Free", however, they were not sold legally through travel retail channels
- 27% of Illicit Whites brand flows had Belarusian labelling. However, 58% of Illicit Whites brand flows had no identifiable source country labelling
- The 10 largest reported seizures (with available brand information) were identified as Illicit Whites, indicating the continued attempts of smugglers to transport these products into the EU
- Counterfeit also increased, the majority of which had Duty Free labelling in order to evade detection

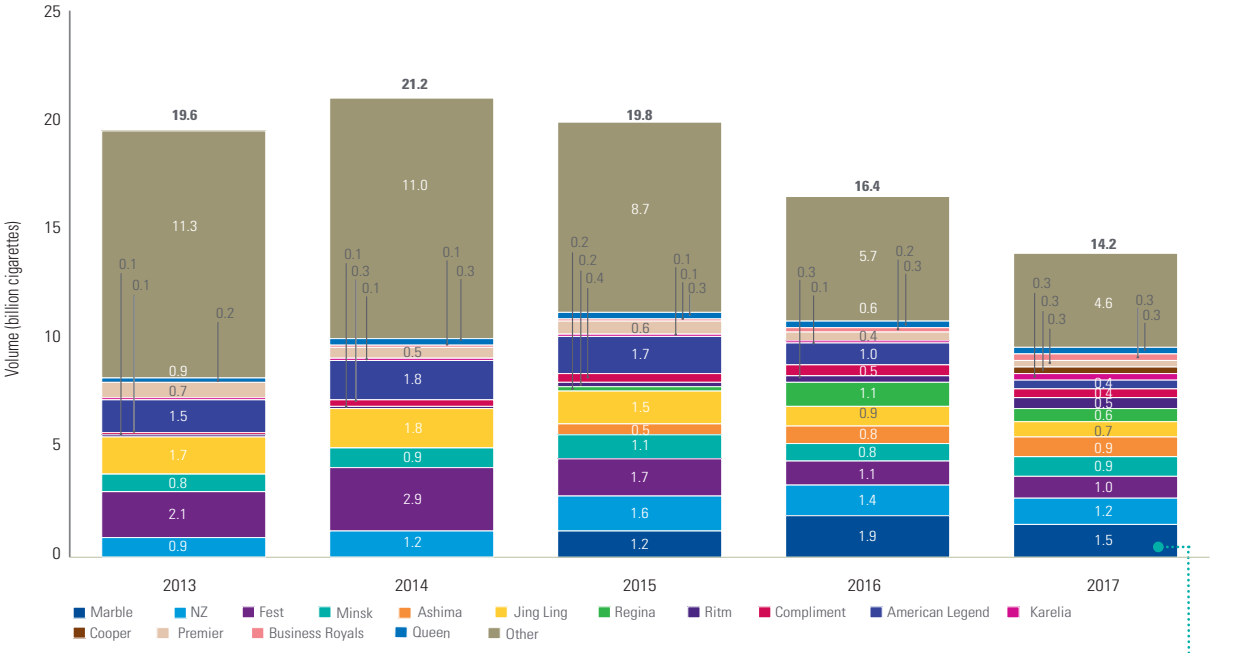
Illicit Whites labelling, 2017[b]



Illicit Whites as a percentage of total C&C in the EU, 2013-2017[1][a][c]



Illicit Whites by brand in the EU, 2013-2017[b]



Romanian Marble was included in the Illicit White definition in 2017 as the majority of inflows of this brand displayed Duty Free Labelling

Notes: (a) Duty Free labelled brands may be classified as Illicit Whites as they are unavailable in Duty Free outlets (b) KPMG cannot determine if Illicit Whites are counterfeit. Counterfeit flows highlighted in this report are restricted to the analysis of packs conducted by the Empty Pack Survey participants PMI, BAT, JTI and ITL (c) Other C&C consists of EU labelled and non-EU labelled C&C

Sources: (1) KPMG EU flows model 2013-2017

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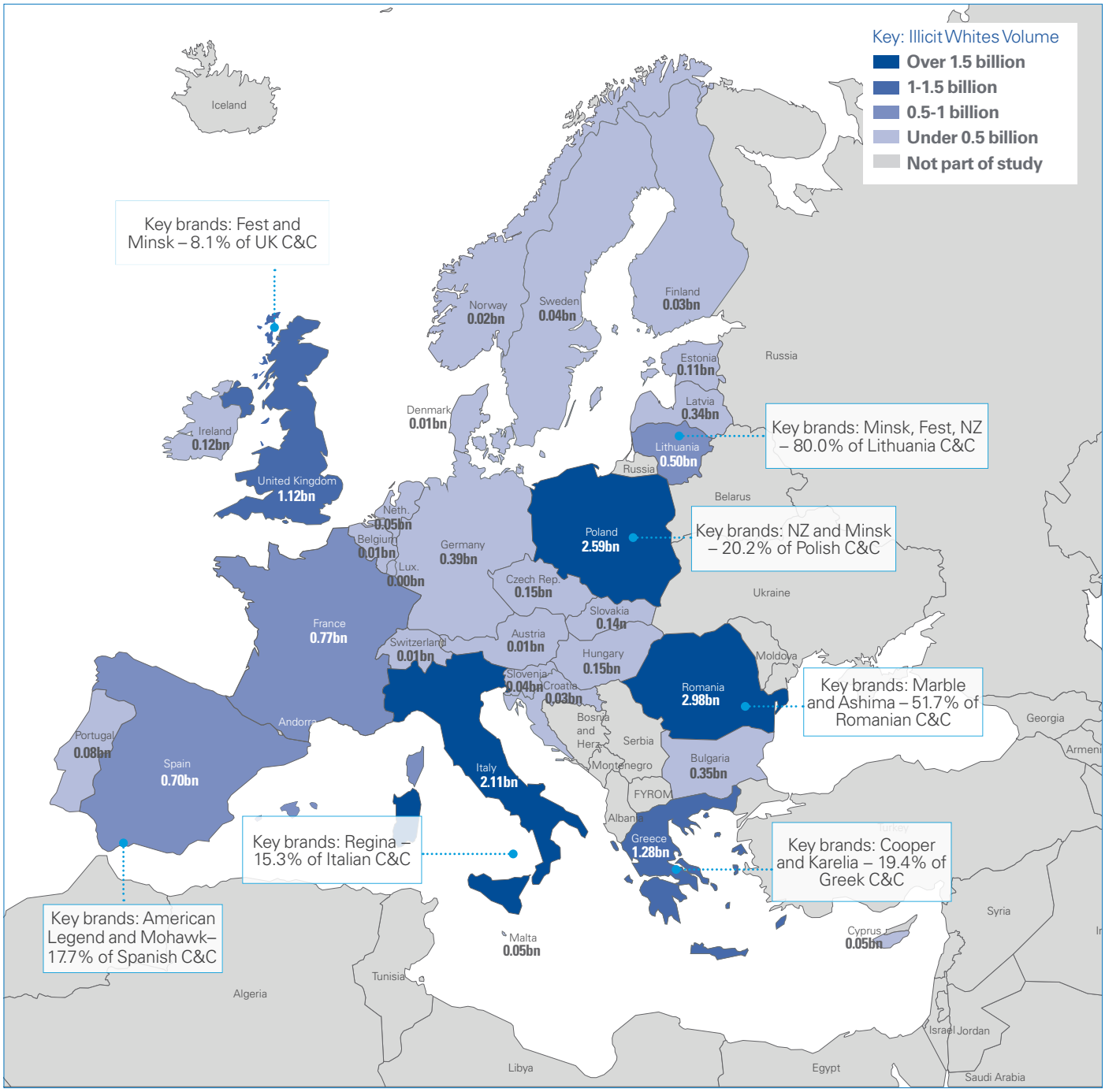
Illicit Whites Volume in the EU, Norway and Switzerland, 2017[1]



Source: (1) KPMG EU flows model 2017

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RUSI Analysis: Free Trade Zones[5]

Free trade zones (FTZs) are a perfect habitat for smugglers and counterfeiters. Owing to their limited oversight and advanced infrastructure, many of these special economic areas are used to ship, sell, store and produce counterfeit or contraband goods, including cigarettes and other tobacco products[1]. As the World Health Organization Framework Convention on Tobacco Control (FCTC) protocol to eliminate illicit trade in tobacco products recognises, the production and smuggling of illicit tobacco products via FTZs poses a global threat to the legal supply chain[2].

Individuals, companies and criminal organisations employ a range of methods to capitalise on these environments, in light of the lax oversight to which they are subject. In particular, Illicit Whites are known to be smuggled in large volumes from or via FTZs into the European market. Illicit Whites are often declared correctly for export from an FTZ but are then rerouted using forged documentation for import into their intended market destination. Smugglers also take advantage of simplified customs procedures to mis-declare goods in transit, transferring them instead to local warehouses before smuggling them on to higher-priced marketplaces, evading excise duties in the process. Evidence also suggests that the manufacturing process itself can be conducted in FTZs.

Tobacco smuggling, however, is part of a much larger illicit trade picture surrounding FTZs. A 2018 study by the Organisation for Economic Cooperation and Development and the EU Intellectual Property Office points to a positive correlation between the level of exports of counterfeit and pirated goods from a country, on the one hand, and the number and size of the FTZs that it hosts on the other. Indeed, according to the study, establishing an additional FTZ within an economy was associated with an average 5.9% increase in the value of counterfeit exports from that economy in the time period 2011–13[3].

Whilst it has proven difficult to persuade governments to strengthen FTZ oversight, the FCTC protocol is notable for the stricter enforcement it implies in relation to tobacco control. Article 12 of the protocol demands not only that all parties ban the intermingling of tobacco with non-tobacco products

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at the time of export, but also that they adopt control and verification measures on the manufacture of tobacco products in FTZs.

The protocol will enter into force in September 2018, giving FTZ operators in parties to the protocol three years to implement the required changes. With countries including Brazil, India, Turkey, Panama and Qatar having ratified the Protocol, this has the potential to bring about positive outcomes in addressing illicit trade activity. However, some of the most important players, such as the UAE, Malaysia, Belize and Singapore, remain missing from the list of parties to the protocol[4].

FTZs are undoubtedly a boost to many economies around the world; however, a more effective balance must be found between facilitating legal trade and ensuring security. The ITTP is a positive step, but not all countries will choose to opt in. As such, a broader set of global actions are required to stem the flow of illicit tobacco – among other illicit products – from FTZs.

Sources: (1) Clare Ellis, 'On Tap Europe: Organised Crime and Illicit Trade in Tobacco, Alcohol and Pharmaceuticals', Whitehall Reports, 2017. (2) World Health Organization Framework Convention on Tobacco Control, 'Protocol to Eliminate Illicit Trade in Tobacco Products', Article 12 (Geneva: World Health Organization, 2013), <http://www.who.int/fctc/protocol/illicit_trade/protocol-publication/en/>, accessed 10 July 2018. (3) Organisation for Economic Cooperation and Development and EU Intellectual Property Office, 'Trade in Counterfeit Goods and Free Trade Zones: Evidence from Recent Trends', 2018. (4) World Health Organization, 'The Protocol to Eliminate Illicit Trade in Tobacco Products: Questions and Answers', <http://www.who.int/fctc/protocol/faq/en/index1.html>, accessed 10 July 2018. (5) The RUSI Analysis boxes included in this executive summary draw on a range of sources, as outlined in the Methodology and Frequently Asked Questions sections of Project SUN

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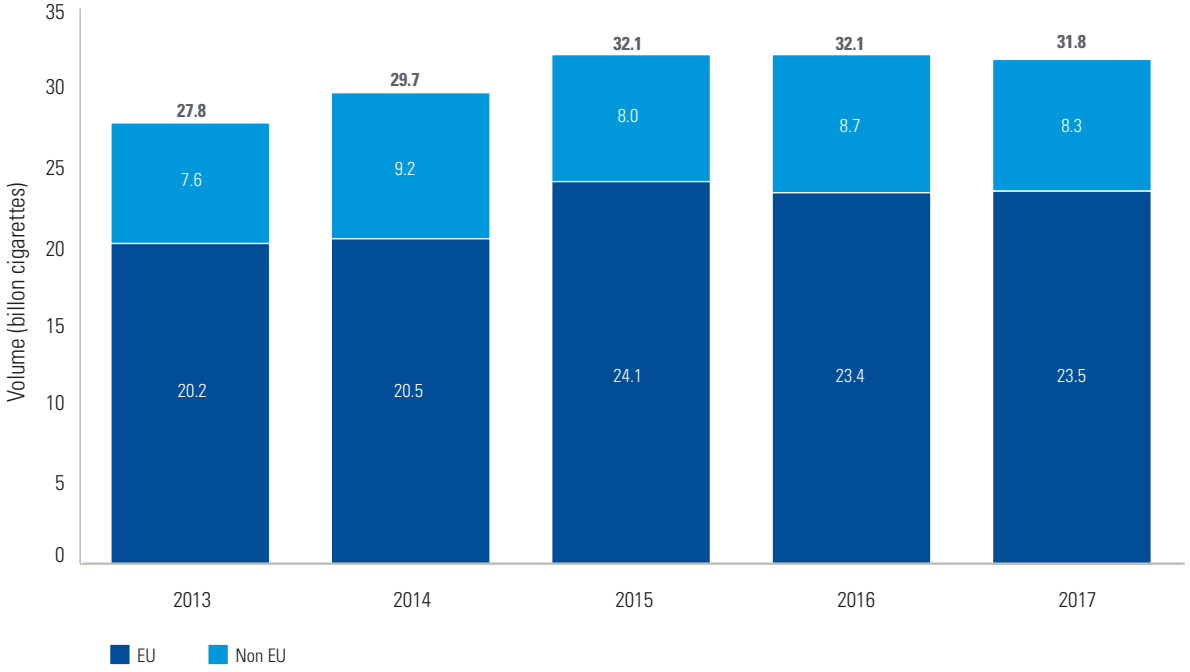
Non-domestic legal (ND(L)) flows remained stable, supported by high travel volumes between countries

- ND(L) represents cigarettes that are purchased and transferred legally from one country to another, mainly as a result of travel flows between countries and price differences
- ND(L) reflects the legal allowance of cigarettes that smokers are able to bring into the country individually multiplied by the number of travellers moving between each country
- The legal allowance between EU countries is generally a guideline amount of 800 cigarettes, whilst for non-EU to EU countries it is restricted to 200 cigarettes, or 40 cigarettes in some circumstances on the Eastern EU border
- Major flows of ND(L) typically come from within the EU where there are large price differences and a lot of travel between countries. These flows include those from the Czech Republic and Poland to Germany and from Spain to France
- ND(L) flows are also high when large numbers of tourists travel from a higher priced country to a lower priced country, such as flows from Spain to the UK

Source of ND(L) in the EU, 2013-2017[1]



Note: (a) 800 is the generally indicated limit for cigarettes the EU members have put in place for travel within the EU (b) 200 is the Duty Free allowance for travel into and out of the EU

Source: (1) KPMG EU flows model 2013-2017 and KPMG analysis of UNWTO data

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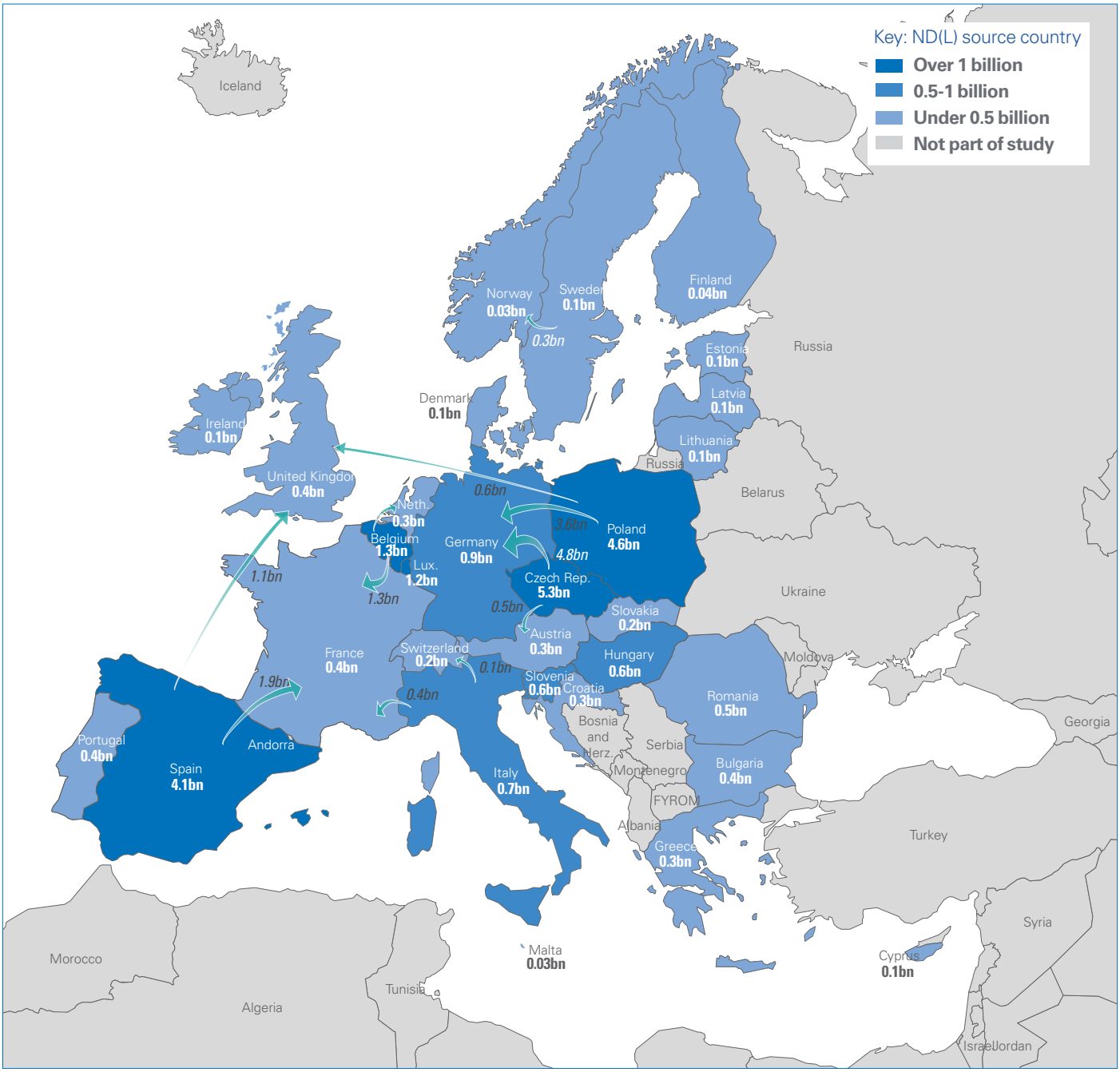
Total volume of ND(L) by source country, 2017[1]



Source: (1) KPMG EU flows model 2017

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