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Technical assessment of the experience made with the Anti-Contraband and Anti-Counterfeit Agreement and General Release of 9 July 2004 among Philip Morris International and affiliates, the Union and its Member States

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EXECUTIVE SUMMARY

The Anti-Contraband and Anti-Counterfeit Agreement and General Release of 9 July 2004 among Philip Morris International and affiliates ("PMI"), the Union and its Member States (hereinafter the "PMI Agreement") will expire on 9 July 2016.

The present document is intended to provide a technical analysis of the PMI Agreement's performance. For this analysis, the Commission has also been able to draw from Member States' experiences with the implementation of the PMI Agreement. This Staff Working Document is without prejudice to the legal, public health and political considerations to be done by the College.

The focus is on the PMI Agreement as it is the first one out of the four anti-fraud agreements with the major tobacco manufacturers concluded by the EU and Member States to expire. However some of the findings of this analysis will likely also be broadly informative for the other three agreements as well.

The Context

The EU and Member States have for some time made the fight against the illicit tobacco trade a priority, for several reasons:

- Member States generate fiscal revenue from legal tobacco sales of over € 90 billion annually. Measuring illicit trade in tobacco is methodologically challenging since illicit activities are not recorded by illicit traders. It is however conservatively estimated that smuggling of tobacco products costs national and EU budgets more than €10 billion annually in **lost public revenue**.

- The illicit tobacco trade is a main **source of revenue for organised crime**, and, in some case, terrorist groups. The new European Agenda on Security adopted in April 2015 recognises the need to cut off criminal groups from this revenue source.

- Cigarette smuggling undermines **public health policies**. Legislative restrictions and pricing policies are designed to deter smoking, not least amongst youngsters. The greater the availability of illicit cigarettes (often at a substantial discount), the greater the potential damage.

The present assessment focuses on the impact of the PMI Agreement on smuggling of PMI products. However, it should be noted that several factors shape the scale and specificities of cigarette smuggling, and while it is possible in methodological terms to assess covariance and trends, it is however not possible to establish direct causality.

In 2013, the Commission issued a comprehensive strategy to combat cigarette smuggling based on a range of policy initiatives to be implemented at national and EU level. The four anti-fraud agreements with the tobacco manufactures are one element in this strategy.

The 2004 PMI Agreement

Some 20 years ago, smugglers brought large amounts of smuggled contraband (i.e. genuine) cigarettes of the major tobacco manufactures onto the illicit EU market. From 2000 on, the European Commission and 10 Member States launched court cases regarding smuggling and

money laundering against several cigarette manufacturers in the United States, including Philip Morris. The 2004 PMI Agreement resolved this dispute with PMI.

Later, the EU and Member States concluded similar agreements with three other tobacco manufacturers (Japan Tobacco International ('JTI'), British American Tobacco ('BAT'), Imperial Tobacco Limited ('ITL')). These will run until 2022 for JTI and 2030 for BAT and ITL. Together, the four companies covered by the agreements account for more than 80% of legal EU cigarette sales.

The principal objective of the PMI Agreement was to reduce the illicit trade in PMI contraband. The PMI Agreement also addresses the issue of counterfeit and contains provisions to fight money-laundering often associated with smuggling activities.

To achieve these objectives, the PMI Agreement in essence forces PMI to exercise a stringent control of its supply chain including the vetting of its customer base, and restrains PMI in how payments are made. PMI agreed to:

- operational measures (such as track-and trace, due diligence, anti-money-laundering practices, and reporting obligations) which have been specifically crafted for PMI's business;

- share operational intelligence with Member States and EU (OLAF) investigators;

- financial incentives for compliance (€ 68.2 million in payments for seizures have been made by PMI as of 1 February 2016; these payments almost entirely go to the seizing Member States);

- make annual payments over a period of twelve years, under which the Member States and the EU, after deduction of legal fees receive a total of approximately USD 1 billion (with Member States receiving 90.3% and the general EU budget 9.7%); these payments may be used to assist the EU and Member States in the fight against contraband and counterfeit cigarettes.

The main findings of the technical assessment

1. The evidence suggests, even if no direct causality can be established, that the PMI Agreement has **effectively met its objective** of reducing the prevalence of PMI contraband on the illicit EU tobacco market, as shown by a drop of around 85% in the volume of genuine PMI cigarettes seized by Member States between 2006 and 2014. PMI has also put in place procedures to counter the risk of money-laundering.

2. At the same time the reduction of PMI contraband did not lead to an overall reduction of illicit products on the EU market, which the available data indicates to have broadly stayed stable in absolute terms and increased in relative terms (as the cigarette market continues to shrink) over the last years. In other words the smugglers found other products or ways to smuggle onto the EU market.

3. To consider whether the PMI Agreement has met its objective in an **efficient** manner, the cost and benefits as well as other relevant aspects need to be analysed:

a. The **benefits** of the PMI Agreement arise in the form of a +/- *85% drop* of PMI contraband on the EU *illicit market*. At the same time this benefit did not translate into an overall reduction of illicit products on the EU market.

   The PMI Agreement has also provided *financial benefits to public revenue* of around USD 1 billion to national budgets and, to a lesser extent, the EU budget. Under the Agreement, PMI has provided OLAF and Member States, on multiple occasions, with *information of direct investigative value*. This information has regularly led to seizures by Member States' enforcement authorities, and in many cases to arrests and criminal indictments. Transnational criminal organisations were dismantled and potential losses to Member States' and the EU budget of several million euros were prevented. The number of leads provided by the industry has been important for investigative work at national and European level. It can be argued, however, that the industry has a strong incentive to provide such leads independently from the existence of the agreements, in order to protect their legal operations.

b. Whilst the original negotiation of the Agreement was rather resource intensive, the **administrative costs** to Member States and the Commission linked to the implementation of the agreement were overall rather low. Member States' customs authorities are in any event engaged in seizing smuggled tobacco products. Effective border controls are and will remain the decisive tool to combat the import of illicit products into the EU. Other than the administrative costs related to the inspection of seizures and notifications, no additional costs were incurred by Member States and no additional savings could be made either.

   Low administrative costs were also partly due to the fact that the Commission has in the past underinvested in the full implementation of the PMI Agreement including the auditing of the compliance by PMI with the obligations under the Agreement, to which only limited resources were dedicated. Since 2014 the Commission has engaged in a progressive reform process of how the tobacco agreements are being implemented. This process includes improving the transparency of how the agreements are implemented (and the present assessment is part of that process); the creation of a new independent laboratory for the testing of seized cigarettes; new IT tools, etc. However, in times of shrinking resources in the Commission overall, the question is whether it is adequate to allocate the required resources to managing the PMI Agreement (in parallel to the other three agreements which are continuing), when the illicit market has undergone significant change.

c. As to **other relevant aspects**, the tobacco agreements are faced with certain criticism that they would bring anti-fraud policy, if not EU policy at large, too close to comfort to the tobacco manufacturers. This is essentially a matter of political appreciation and falls outside the scope and mandate of this technical assessment. Furthermore it needs to be considered that the tobacco industry has launched a legal challenge against the 2014 Tobacco Product Directive (TPD), which prompts some to question whether it is opportune for the EU to enter into a contract with an entity on policy issues related to the ones legally challenged. Moreover, any expectations by the industry as to the future

compatibility of track and trace solutions with the TPD requirements should be avoided.

4. Key issues of the present assessment are whether the Agreement is still relevant (a) in today's market environment, and (b) in today's legislative environment.

    a. As indicated, the illicit tobacco **market** in the EU has seen important developments. The contraband consisting of smuggled products from the large manufacturers has been increasingly replaced by other products including non-branded cigarettes ("cheap whites") typically produced in third countries by a variety of manufacturers. The EU began addressing the phenomenon of cheap whites more systematically with a 2013 strategy communication and announced its intention to review the situation.

    The four agreements with the main tobacco manufacturers are not intended to address smuggling of cheap whites into the EU. At the same time, contraband volumes of market leader PMI with well-known brands like *Marlboro* are still comparatively high, and with price differences between certain EU and neighbouring markets of up to 1:10, the economic incentives driving smuggling remain strong. Whilst there has been a clear shift in the composition of the illicit market, the volume and availability of illicit product on the EU tobacco market remains troubling. This means that the PMI Agreement, whilst achieving its objective of bringing down the smuggling of PMI contraband, could not prevent the overall availability of illicit products. This also means that there was no positive effect on public health stemming from the Agreement.

    b. The **legislative setting** has also changed significantly since the entry into force of the PMI Agreement. Noteworthy is in particular the new 2014 Tobacco Product Directive (TPD) containing track and trace measures for tobacco products. These need to be implemented until May 2019 for cigarettes and Roll-Your-Own. At global level an international agreement was negotiated, the WHO Framework Convention on Tobacco Control's Protocol to Eliminate Illicit Trade in Tobacco Products ("FCTC Protocol"), which is currently undergoing the ratification process in the EU. The key provisions of the Protocol on tracking and tracing will take effect five years after it enters into force, i.e. at the earliest in 2022 or 2023. Legally binding and enforceable instruments, if coupled with robust law enforcement, are the most efficient tool to ensure a significant reduction of the illegal trade of tobacco products.

        i. The *TPD* contains important new rules to better control the illicit trade in the EU, and for products destined for or placed on the EU territory (Articles 15 and 16). The PMI Agreement offers, in principle, a global geographic scope with respect to products from market leader PMI as concerns tracking at master-case level, but has only achieved partial global coverage in terms of marking at the lowest unit (i.e. pack) level and typically did not cover customers after the first customer. According to the figures available to OLAF, products manufactured outside and not destined for the EU market currently represent a high share of illicit products imported into the EU.

Concerning the substantive scope, the TPD creates a system for tracking and tracing at pack level for the EU and introduces security features facilitating law enforcement (including at customs controls). The TPD covers all manufacturers, in other words creates a level playing field. The PMI Agreement - on the other hand – also contains rules on other issues such as due diligence, anti-money laundering, seizure payments, and supports investigators. These other obligations will be largely covered by the future new rules under the FCTC Protocol.

ii. The new *FCTC Protocol* has a global reach and contains many provisions broadly similar to those of the tobacco agreements.

At this stage, the FCTC Protocol it is not yet in force (15 countries have ratified so far, including five EU Member States). It is also clear that some time will pass before it is effectively implemented by a critical mass of countries, including key source and transit countries in the illicit global trade. At the same time there is consensus that the combination of the TPD and the FCTC Protocol are the best instruments to fight illicit trade in the EU. In this light every effort needs to be made to ensure their effective implementation.

Conclusion

The PMI Agreement made an important contribution to fight PMI illicit trade in the past. The market and legislative framework has changed significantly since the entry into force of the Agreement.

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COMMISSION STAFF WORKING DOCUMENT

Technical assessment of the experiences with applying the Anti-Contraband and Anti-Counterfeit Agreement and General Release of 9 July 2004 among Philip Morris International and affiliates, the Union and its Member States

1. INTRODUCTION

The *Anti-Contraband and Anti-Counterfeit Agreement and General Release* of 9 July 2004 among Philip Morris International and affiliates ("PMI"), the Union and its Member States (hereinafter the "PMI Agreement") will expire on 9 July 2016. The present document evaluates the experiences with applying the Agreement since 2004. It is without prejudice to the legal, public health and political considerations to be done by the College.

The focus is on the PMI Agreement as the first one out of the four anti-fraud agreements with the major tobacco manufacturers (for details see Section 2.3) concluded by the EU and Member States to expire.

The present assessment is conducted in five main steps: First, the PMI agreement – and by extension the other three agreements – is placed in the current EU policy context of fighting the illicit tobacco trade (Section 2). Second, an overview of the main elements of the PMI agreement is provided (Section 3). Third, the document evaluates the cost and benefits of implementing the agreement in the past (Section 4). Finally, the document discusses to what extent agreements like the PMI Agreement are still relevant in today's regulatory and market conditions, which are different compared to the situation in 2004 (Section 5).

In drawing up the present assessment, the Commission has also drawn on experiences made by Member States in implementing the PMI Agreement at national level.

2. CONTEXT

2.1. Policy context

The EU and Member States have for some time made the fight against the illicit tobacco trade a priority, and this for several motives:

- To protect **public revenue** from the losses resulting from smuggling. The 28 EU Member States generate annual fiscal revenue from legal tobacco sales of more than € 90 billion[1]. Smugglers evade paying national taxes (excise and VAT) as well as customs duties. It is estimated that smuggling costs national budgets and, to a lesser extent, the EU budget more than € 10 billion annually in lost public revenue. Especially at a time of economic hardship, these losses need to be reduced as much as possible.

[1] Based on figures provided by Member States, the Commission's Directorate-General for Taxation and Customs Union provides an annual breakdown of Member States' revenue from excise duties and similar charges (the table does not list additional VAT revenue) from sales of manufactured tobacco: http://ec.europa.eu/taxation_customs/resources/documents/taxation/excise_duties/tobacco_products/rates/excise_duties_tobacco_en.pdf .

- The illicit tobacco trade has long been recognised as a main **source of revenue for organised crime**[2], and, in some cases, terrorist groups.[3] The new European Agenda on Security adopted by the European Commission on 28 April 2015[4] recognises the importance of fighting cigarette smuggling as a means of cutting off criminal groups from this revenue source.

- Cigarette smuggling undermines EU **public health policies**. Legislative tobacco control measures at EU and national level as well as tax and price measures set by Member States are designed to deter smoking, reduce consumption and to protect citizens, especially youngsters. In contrast, illicit tobacco products are available, also to young people, at a substantial, illegal discount in many places.

In trying to exercise better control over the illicit tobacco trade, the EU and Member States have in recent years taken a number of important initiatives:

- The EU's new **Tobacco Products Directive 2014/40/EU**[5] introduces a new EU-wide system to track and trace tobacco products (cigarettes by 2019 and other tobacco products by 2024) manufactured in, destined for, or placed on, the EU market. This new system involves all economic operators involved in the trade of tobacco products from the manufacturer to the last economic operators before the first retail outlet. They will have to record the entry and exit of all unit packets into and from their possession on the basis of a unique identifier on each packet. Moreover, the Tobacco Products Directive obliges Member States to require that all unit packets of tobacco products carry a tamper proof security feature, composed of visible and invisible elements.

- The EU had a leading role in the negotiation of a new Protocol to Eliminate Illicit Trade in Tobacco Products which was negotiated under the auspices of the WHO Framework Convention on Tobacco Control ("**FCTC Protocol**"). The EU signed the Protocol in December 2013 and on 4 May 2015 the Commission proposed to the Council to conclude the Protocol on behalf of the EU[6]. All EU Member States will be expected to ratify the Protocol and five have done so already. The FCTC Protocol is the first multilateral legal instrument which seeks to tackle the international problem of tobacco smuggling in a comprehensive manner. The Protocol will enter into force once 40 Parties have ratified it.

- The Commission in 2013 adopted a **strategy paper**[7] "*Stepping up the fight against cigarette smuggling and other forms of illicit trade in tobacco products*" which sets out a range of measures designed to combat the illicit tobacco trade. The strategy

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[2] See, for example, the Study *Examining the links between organised crime and corruption* (2010) prepared for the (then) Directorate General Justice, Freedom, and Security, pp. 125 *et seq*. http://ec.europa.eu/dgs/home-affairs/doc_centre/crime/docs/study_on_links_between_organised_crime_and_corruption_en.pdf .

[3] The United Nations Security Council also noted the link between cigarette smuggling and terrorism financing, the last time in UNSC Resolution 2199 of 15 February 2015 on Syria. See similarly the Financial Action Task Force (FATF), *Illicit Tobacco Trade* (June 2012), and Europol's 2013 *Review*.

[4] COM(2015) 185 final.

[5] Directive 2014/40/EU of 3 April 2014, OJ L 127, 29.4.2014, p. 1.

[6] COM(2015) 193 and 194 final of 4 May 2015.

[7] COM(2013) 324 final of 6 June 2013.

paper is accompanied by an **Action Plan**[8] with 50 items which the Commission and Member States are currently implementing in close cooperation. The Commission has committed to a review progress in implementing that strategy after three years. The 2013 strategy paper partially builds on an earlier *Action Plan to fight against smuggling of cigarettes and alcohol along the EU Eastern border*[9].

Some years before these initiatives, the Commission and Member States also concluded **anti-fraud cooperation agreements** with the four largest manufacturers (see Section 2.3) to oblige them to exercise a better control over their supply and distribution chains and to counter associated money-laundering. These agreements cover the global operations of the companies concerned, including beyond the EU. Collectively these four agreements cover more than an estimated four-fifth of cigarette sales in the EU and include cooperation in tackling the counterfeiting of the companies' respective brands.

2.2. Illicit trade in tobacco products

The Commission's 2013 strategy paper acknowledges the difficulty of measuring the illicit tobacco trade, which is by nature a clandestine activity, and refers to various studies undertaken in that respect[10]. The document also identifies China, the UAE, Vietnam, Malaysia, the Russian Federation, Singapore, Belarus and Ukraine as the main countries of provenance of illicit tobacco products.

Estimates by data-research company Euromonitor as of 11 June 2015 are that the total volume of the EU illicit cigarette market slightly increased from 64 billion to 66 billion cigarettes over the last five years. However, when measured against an overall declining market of tobacco consumption (see below), the penetration rate of the tobacco market has increased over that period, according to Euromonitor, from 9.7% to 13.3%.

An earlier report[11] contracted by the European Executive Agency for Health and Consumers estimated that the illicit cigarette market in the EU had increased over the last decade from 56.5 billion sticks (2000) to 80.5 billion sticks (2010).

Another market analysis carried out by KPMG on behalf of the tobacco industry ("Project Sun")[12] estimates the size of the illegal tobacco market in the EU at around 58 billion cigarettes in 2013. The Commission however can neither endorse nor verify these figures presented by stakeholders with commercial interests. What is available to the Commission directly is the data provided by the Member States of the total volume of cigarettes they seized in a given year. That volume has declined by 30% from over 4.53 billion in 2005 to 3.36 billion in 2014, see Figure 1, although that trend has now been reversed and seizures have increased again in 2014.

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8 SWD(2013) 193 final of 6 June 2013.

9 SEC(2011) 791 final of 24 June 2011.

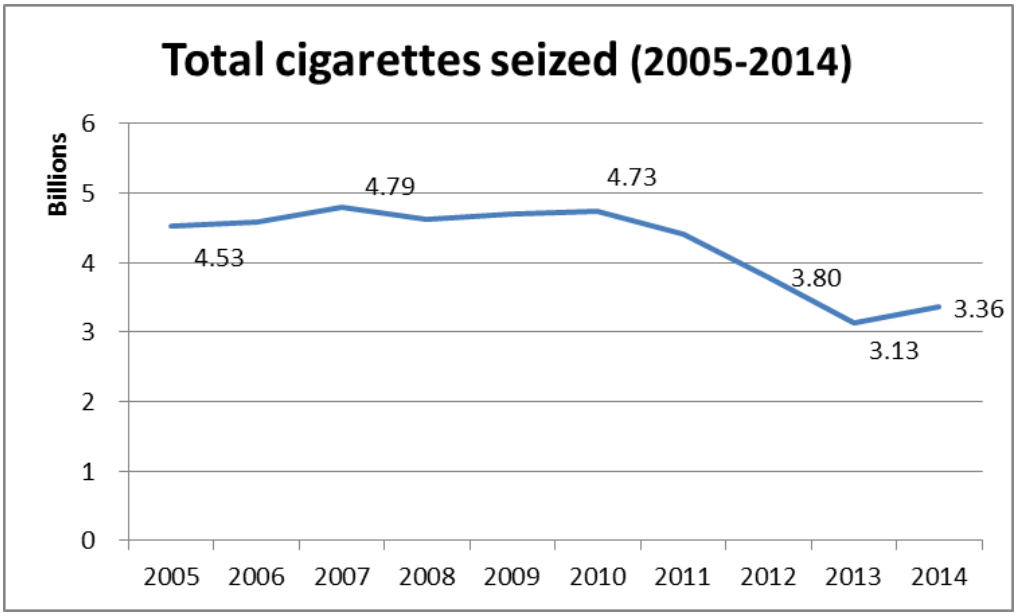
10 See COM(2013) 324 final of 6 June 2013, p. 6.

11 Matrix insight, *Revised Final Report Economic Analysis of the EU market of tobacco, nicotine and related products*, 20 September 2013.

http://ec.europa.eu/health/tobacco/docs/tobacco_matrix_report_eu_market_en.pdf

12 http://www.pmi.com/eng/media_center/media_kit/documents/sun%20report%202013.pdf

Figure 1: Volume of seized cigarettes as notified by Member States, in billion sticks (2005-2014)



Whilst this data is reasonably solid, the difficulty relies in extrapolating from these seizure volumes to the total size of the illicit tobacco market. This extrapolation requires estimating the rate of interception of smuggled products. Some observers use a broad assumption that maybe 10% of the illicit trade is intercepted, although the effective interception rate is likely to be lower, especially when comparing the resulting figures of the estimated illicit market to the figures calculated by Euromonitor and others.

The above figures on seizures and the size of the illicit market should be viewed in the context of the overall declining level of cigarette consumption in the EU. According to figures compiled by the Commission's DG for Taxation and Customs Union based on Member States' data[13], releases for consumption of cigarettes declined from 728 billion in 2005 to 486 billion in 2014. The decline is confirmed by other sources of data:

In spring 2015 Euromonitor estimated that the size of the cigarette market in the EU has shrunk over the last five years from 657 billion sticks (2009) to 498 billion sticks (2014).

According to a new Eurobarometer Survey published in May 2015[14], tobacco use has declined by two percentage points compared to the 2012 survey. When measured against the 2006 survey, the proportion of smokers is down by six percentage points.

For the present purposes, it is important to distinguish between the main categories of "illicit" tobacco products on the EU black market:

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[13] See: http://ec.europa.eu/taxation_customs/resources/documents/taxation/excise_duties/tobacco_products/tobacco_products_releases-consumption.pdf.

[14] Special Eurobarometer 429 "Attitudes of Europeans towards tobacco and electronic cigarettes", May 2015 based on fieldwork in November-December 2014.

- **Contraband** (genuine cigarettes bought in a low-tax third country which exceed legal import limits or acquired without taxes for export purposes but illegally re-sold for financial profit in a higher-priced market);
- **Counterfeit** (fake branded cigarettes that are illegally manufactured either inside or outside the EU and sold by a party other than the original cigarette brand owner or a licensed contractor);
- **Cheap whites** (unknown 'brands' typically without a legal distribution network in the EU; these are for the most part produced outside the EU).

One way amongst others how various types of illicit products are brought into the EU is by carrying out false exports. Thereby, legal entities in the EU simulate fictitious exports outside the EU, or carry out real exports to third countries and subsequently smugglers bring the cigarettes back into the EU without paying applicable customs duties and taxes.[15]

The Commission's 2013 strategy document identified important changes in how the various components of the illicit tobacco market in the EU have developed over the last decade:

- Whereas 15 years ago the illicit EU market was dominated by contraband from the four main manufacturers, the prevalence of contraband from these manufacturers has been declining.
- In contrast, today's market sees an ever-growing share of non-branded cigarettes ("cheap whites"). According to Member States' seizure data from 2013, 8 of the 10 most seized cigarette "brands" were "cheap whites". Of the more than 600 million cigarettes seized with support from OLAF in 2015, almost all were cheap whites.
- Counterfeiting was already a known phenomenon in 2004 and the copying of well-known brands constitutes a substantial part of the illicit tobacco market.

2.3. The tobacco agreements

The PMI Agreement is the oldest among the anti-fraud cooperation agreements concluded by the EU and Member States with the four main tobacco producers in Europe. Apart from its specific objectives (see Section 3.1 below), the agreement with PMI as the market leader in Europe was also intended to encourage other manufacturers to step forward and negotiate similar disciplines. This was hoped to reduce the illegal market of products from these manufacturers, to eradicate associated money-laundering as well as to provide quality intelligence information for law enforcement.

Indeed, the EU and Member States eventually concluded agreements containing broadly similar provisions with the other three main tobacco manufacturers:

(1) Cooperation Agreement of 14 December 2007 with Japan Tobacco International (duration: 15 years);

(2) Cooperation Agreement of 15 July 2010 with British-American Tobacco (Holdings) Limited (duration: 20 years);

[15] See the instructive case of a contraband network disbanded by Italian and German law enforcement authorities with OLAF support in November 2014 http://ec.europa.eu/anti_fraud/documents/press-releases/20141208_tobacco_network_dismantled_en.pdf .

(3) Co-operation Agreement of 27 September 2010 with Imperial Tobacco (duration: 20 years).

A main difference between the PMI Agreement and the three other agreements is a function of the point in time when they were negotiated. The PMI Agreement was initially negotiated on behalf of the EU and 10 Member States which had launched litigation against PMI before US courts from 2000 on. Once negotiations with PMI were under way, they took a fairly long time given the innovative approaches (such as track and trace) employed by policy-makers for the first time to fight the illicit tobacco trade. During the process, the EU enlarged from 15 to first 25 and later 28 Member States. A number of provisions in the PMI Agreement reflect that transition phase with new Member States coming in only gradually. No such transitional provisions were required for the subsequent agreements which could already build on the enlarged EU.

The four tobacco manufacturers having concluded anti-fraud agreements with the EU and Member States have an estimated cumulated share of the EU legal cigarette market of more than 80%. In other words, the bulk of legal cigarette consumption in the EU is covered by the disciplines imposed by the four agreements. These agreements, in principle, cover the global operations of the companies concerned, including beyond EU territory.

3. ORIGIN, OBJECTIVES AND DESCRIPTION OF THE PMI AGREEMENT AND ITS MAIN ELEMENTS

3.1. Main Agreement: origin and objectives

Before 2000, large amounts of contraband and counterfeit cigarettes reached the illicit EU market. This resulted in great economic loss to national and European treasuries. The availability of much cheaper illicit products also undermined public health policies which sought to set cigarette prices at a level so as to put downward pressure on demand.

The European Union (then European Community), represented by the Commission, and 10 Member States decided to launch legal proceedings against several cigarette manufacturers from 2000 on. The proceedings were initiated before US courts in view of the US establishment of several manufacturers, the availability of injunctive relief under US procedural law and the uncertainty as to whether EU or Member State law could be used to restrain the activities of non-EU companies for acts committed outside the EU.[16] Moreover, the EU had no direct access to the business records of Swiss-based PMI.

The primary purpose of the lawsuit was to obtain court ordered injunctive relief to permanently reduce or eliminate the introduction of contraband cigarettes into the EU and to put an end to any money laundering and illicit trade associated with that conduct.

On 19 February 2002, the District Court in New York dismissed the smuggling claims on the basis of the "revenue rule ", a technical rule according to which a U.S. court need not enforce a foreign tax claim. In its ruling, the District Court also held that the "revenue rule" does not necessarily apply to other aspects of the EU and Member States' claims and dismissed this part of the case "without prejudice".

[16] One case – against RJ Reynolds - is currently still pending before US courts.

The European Commission and the Member States appealed this ruling before the U.S. Court of Appeals for the Second Circuit in New York which however, on 14 January 2004, confirmed the dismissal.

With the outcome of the litigation uncertain, the European Commission and the participating Member States determined that the intended objective could be more effectively achieved by seeking to obtain the desired commitments from PMI in the form of a binding private law agreement that could be enforced in courts. After intensive negotiations an agreement was reached in July 2004 thus resolving the need for litigation. Both sides chose to move forward via an agreement which was voluntary yet binding and enforceable. In the meantime, all 28 Member States have become parties to the Agreement.

3.2. How the PMI Agreement works

3.2.1. The objectives of the PMI Agreement

Apart from resolving the need for further litigation, the objective of the PMI Agreement was to reduce the presence of genuine PMI tobacco products on the illicit EU market as well as to combat any associated money laundering.

Conversely, the Agreement was not designed to combat other problems related to the EU illicit market, in particular to address the currently dominant problem of cheap whites.

To meet these objectives, the PMI Agreement – like the agreements with the other three tobacco manufacturers - provides for a number of operational tools as well as financial incentives to foster compliance with relevant EU and Member States rules and with the Agreement itself. The Agreement also provides a framework for information sharing to the benefit of investigators at Member State and EU level (i.e. OLAF).

3.2.2. The nature of the Agreement

The PMI Agreement embodies obligations entered into under private law between public and private entities with the objective of combating illicit trade. The Agreement does not contain provisions binding on citizens or private entities other than PMI and also stipulates the supremacy of any EU or Member State law over any provision in the Agreement.[17]

In functional terms, the PMI Agreements relies on a combination of public and private enforcement against illicit tobacco trade. In that context, PMI accepted certain commitments that might have been difficult to impose by regulatory means, in particular seizure payments without requiring proof of fault. Moreover, the PMI Agreement provides for anti-money-laundering protocols that were not available through other means and have been specifically crafted to PMI's business.

Despite its voluntary nature, the Agreement is legally binding and enforceable[18] via a set of arbitration rules. The obligations are not only enforceable but are amplified in their effectiveness by significant financial obligations, staggered according to the quantities seized.

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[17] Section 13.06.

[18] This feature of the 2004 Agreement should also dispel concerns about its compatibility with Article 5.3 of the World Health Organisation Framework Convention on Tobacco Control (FCTC), which restricts authorities' dealings with the tobacco industry in the formulation of public health policies. Irrespective of whether the

3.3. The main features of the PMI Agreement

In essence, the Agreement contains the following main obligations:

- Electronic monitoring (track and trace) of the shipment of cigarettes;
- Due diligence ('Know Your Customer'): restricts sales and re-sales only to pre-approved contractors;
- Restriction in method of payment to prevent money laundering;
- Business volume limitation – sales must be commensurate with legitimate demand;
- Detailed analysis of seizures reported by Member States including, where applicable, shipping details and sales and customer information;
- Reporting duty: Detailed annual compliance report presented and discussed at an annual meeting with OLAF and Member States;
- Cooperation with OLAF and Member States' law enforcement agencies;
- Financial incentives for compliance (seizure payments).

3.3.1. Product scope

The Agreement focuses on the smuggling of genuine PMI cigarettes, including roll your own, and also provides a framework for investigations into cigarettes branded as PMI products by counterfeiters. In contrast, the Agreement does not cover the smuggling of pipe tobacco, or indeed raw tobacco. The Agreement does not cover e-cigarettes. These are, however, much less prominent in smuggling due to the absence of excise duties on such products.

3.3.2. Track and trace obligations

The Agreement's mandatory track and trace obligation requires a system allowing to monitor and verify the distribution, storage and shipment of cigarettes from the packaging until delivery to the first buyer.

The Agreement obliges PMI to mark master cases[19] with unique, machine scannable barcode labels prior to selling those master cases to the first customer. In combination with markings or codes on cigarette packs and/or cartons[20] concerning the intended market of retail sale, this data assists PMI as well as public authorities to see where genuine products have been diverted from the legal supply and distribution chain.

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fight against the illicit tobacco trade is to be considered part of public health policies, the Implementing Guidelines for Article 5.3 FCTC confirm that this does not prevent the conclusion of binding and enforceable agreements, such as the PMI Agreement.

[19] A master case holds 50 cartons of 200 cigarettes and is the standard unit for volume sales in the industry.

[20] A carton is the standard smaller packaging unit, holding 10 packs of 20 cigarettes.

PMI moreover obliges its first purchasers to refrain from any action to alter its identification markings.[21] This is to minimise the risk that the track and trace system would be circumvented at least at the first level of the commercial chain.

Furthermore, the Agreement also introduced the forward looking obligation for PMI to progressively roll-out scannable coding at a smaller unit level (carton and pack coding) in line with technological developments (*Appendix D section 7.02*). Pack coding technology covers 35% of total PMI cigarettes volume including duty free and carton level coding covers 50% of total PMI cigarettes volume including duty free. Originally, PMI applied the technology in various countries according to a risk profile. PMI is also expected to make commercially reasonable efforts to extend the tracing beyond the first purchaser, so as to cover subsequent commercial layers.

3.3.3. 'Know Your Customer' programme / due diligence and other sales restrictions

The Agreement restricts PMI's right to freely sell its cigarettes as *"PMI shall conduct business only with Approved Contractors"*[22]. This "Know Your Customer" (or due diligence) duty applies *"with respect to all of its Contractors, or Persons reasonably likely to be engaged by PMI as Contractors."*[23] *"If, following its Due Diligence, PMI is not satisfied […] PMI shall refuse to conduct business with that Applicant."*[24] As a consequence, the Agreement obliges PMI first to conduct a thorough "due diligence" inquiry of each potential customer prior to a sale. The data is available to Member States upon request.

Moreover, the Agreement further restricts the volume of cigarettes PMI can sell to "Approved Contractors". *"PMI shall sell and distribute Cigarettes in amounts that are commensurate with the Retail Demand in the Intended Market of Retail Sale"* and *"refuse to sell […] in volumes exceeding that amount."*[25]

3.3.4. Anti-money laundering

One of the objectives of the Agreement is to combat money laundering[26] associated with the illicit trade in cigarettes. To this effect, the PMI Agreement contains certain due diligence requirements and restrictions on cash payments, third party payments and off-invoice payments which are specifically crafted to PMI's business and restrict PMI in the way it can accept payments. This is an important step to hinder and detect money laundering and forcefully restricts PMI in its freedom to trade to avoid that it is selling cigarettes *"to persons, corporations and/or distributors that have been found to be unlawfully or knowingly engaged in […] Money Laundering"*[27]. This complements EU rules such as Directive (EU) 2015/849 on preventing the use of the financial system for money laundering or terrorist financing.

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[21] Appendix B, Protocol 3, section 3.01 (b).

[22] Appendix B, Protocol 2, section 2.01.

[23] Appendix B, Protocol 2, section 2.03.

[24] Appendix B, protocol 2, section 2.03 (d).

[25] Appendix B, Protocol 2, section 2.02.

[26] Article 2, section 2.01.

[27] Appendix B, Protocol 1, section 1.03 (b).

3.3.5. Reporting obligations

The Agreement obliges PMI to issue an annual report on compliance to OLAF and to Member States[28] *"describing PMI's fulfilment of the requirements of (i) the EC Compliance Protocols […] Appendix B of this Agreement, and (ii) the Tracking and Tracing Protocols […] in Article 5 and Appendix D [….]"*

This does not limit Member States' or OLAF's right to check at any time if PMI complies with the Agreement[29]. Being continuously exposed to potential enquiries from investigative bodies is meant to be an important incentive for compliance.

The Agreement also obliges PMI to meet annually with OLAF and Member States *"to confer and assess the functioning of the Agreement."*[30]

3.3.6. Financial incentives for compliance – seizure notices and payments

Under the terms of the Agreement (Article 4) a Member State may submit a seizure notice to OLAF when a minimum of 50,000 PMI cigarettes have been seized at once. On verifying the details OLAF will forward the seizure notice to PMI to make arrangements to inspect the seizure within 30 days of receiving the notice.

Seizure payments are due depending on whether cigarettes seized with the brand of a given manufacturer are deemed to be genuine or counterfeit, with the former potentially leading to seizure payments.[31]

If *counterfeit*, PMI's response must detail the reasons underpinning such conclusion. If there is any doubt as to the findings the seizing Member State or OLAF may conduct an independent laboratory test. Any consciously false declaration by the manufacturers would not only call into question the entire Agreement, but would likely trigger serious negative consequences such as civil, if not criminal liability. The analysis by PMI can be used as evidence in Court.

If *genuine*, the cigarettes may qualify for a seizure payment. If so, PMI will provide details of the calculation in their response. The seizure payment covers the taxes and duties that would have been due had the cigarettes been legally distributed for retail sale in the Member State of seizure.[32] The fact that seizure payments must be made without any need to prove fault on the part of PMI means that the Member States can receive the financial benefits of these seizures with little or no more cost than their normal law enforcement activities.

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[28] Article 2, section 2.02(a).

[29] Article 2, section 2.02 (c).

[30] Article 6, section 6.01.

[31] On the distinction between genuine and counterfeit in practice, see Box 1.

[32] In general terms, a seizure payment is usually several times the amount of profit that PMI would have earned by selling that case of cigarettes. Accordingly, seizure payments create an additional incentive to regulate the supply chain in that the amounts paid in seizure payments far exceed the potential profits of selling cigarettes to questionable customers.

Seizure payments are largely allocated to Member States, with a small part (on average less than 5%) being allocated to the general EU budget.[33]

If the genuine PMI cigarettes seized in the same calendar year exceed a baseline amount (now 450 million cigarettes[34]) then PMI is liable to make an additional payment of four times the amount of the calculated seizure payment due. The baseline was never reached so that these additional payments were never due. The baseline amount is intended to act as a deterrent.

3.3.7. Annual payments

PMI agreed to pay the EU and the initial 10 participating Member States USD 1 billion in annual instalments. The annual payments will end after the 12th year of the Agreement. It was foreseen that this money may be used to provide support for anti-contraband and anti-counterfeit initiatives. It should be highlighted that for historical reasons the other 18 Member States do not receive any annual payments under the Agreement.

The 10 Member States eligible for annual payments receive 90.3% of these payments with the general EU budget receiving 9.7%. OLAF does not receive any funds from the tobacco manufacturers.

3.3.8. Release from civil claims for past conduct

To draw a line under past civil litigation, the PMI Agreement also releases the company from civil liability for conduct prior to the date the PMI Agreement was signed. It should be noted that this release does not cover any hypothetical criminal responsibility on the part of PMI, nor does it release PMI for conduct after 9 July 2004.[35] Notably, PMI can still be the target of formal OLAF inquiries.

3.3.9. Cooperation with OLAF and Member States law enforcement agencies

The Agreement also provides a framework encouraging PMI to share information on illegal consignments with law enforcement authorities at the national and EU level.

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[33] The split between the Member State and the EU shares of a seizure payment is based on the same formula as if the cigarettes had been legally distributed in the Member State of seizure.

[34] The baseline amount applicable to PMI has been modified since the entry into force of the PMI Agreement to take account of the enlarging EU (the baseline amount has remained unaltered for the other three agreements). The PMI Agreement distinguished in 2004 between those Member States in the EU before 1 January 2004 (EU15) and "new" Member States which acceded to the EU after that date. Only the former had immediate access to seizure payments, while the latter were provided progressive access to such payments. A formal modification to the PMI Agreement in 2014 extended the availability of seizures payments to all Member States, whilst, as a *quid pro quo*, raising the baseline amount in the PMI Agreement. The new baseline amount is based on parameters used in the subsequent agreements. The 2014 modification is available on http://ec.europa.eu/anti_fraud/investigations/eu-revenue/philip_morris_international_2004_en.htm

[35] Also the Agreements with JTI and ITL contain a release for past civil liability. In contrast, no release was agreed with BAT.

4. EVALUATION OF THE COST AND BENEFITS OF IMPLEMENTING THE PMI AGREEMENT

4.1. The approach

The European Commission is committed to evaluate the impact of major policy measures[36]. Measures should be evidence-based, well designed and deliver tangible and sustainable benefits for citizens, business and society as a whole.[37] Whereas such approach is geared to evaluate authoritative EU measures, the leading principles have been used to assess the impact of the PMI agreement, taking into account the fact that it is an agreement accepted by PMI through negotiations.

The technical review of the past experience with the implementation of the agreement can be based on qualitative and quantitative indicators and thus contribute to better policy-making. In particular, such an assessment can evaluate whether the initial objectives were reached.

In this assessment, the Commission Services have also drawn on discussions that have taken place since 2014 with national customs authorities and during which the effectiveness of the PMI Agreement to address the illicit tobacco trade has been evaluated. The present assessment focuses on the impact of the PMI Agreement on the smuggling of PMI products.

4.2. Effectiveness of the PMI agreement

The most important indicator of the extent to which the PMI Agreement has met its intended objective is whether there has been a notable decline in the contraband of PMI products smuggled into the EU.

As reported by Member States as of January 2016, genuine PMI cigarettes seized reported under the PMI Agreement (i.e. above the 50,000 threshold) have declined by more or less 85% between 2006 and 2014 as follows[38]:

Table 1: Total genuine PMI cigarettes seized in million sticks as reported by Member States to OLAF under the Agreement, 2006-2014[39]

Date of Seizure	2006	2007	2008	2009	2010	2011	2012	2013	2014	***Grand Total***
Total genuine	116.09	99.1	76.52	123.22	59.5	26.73	23.48	17.89	18.76	563.02

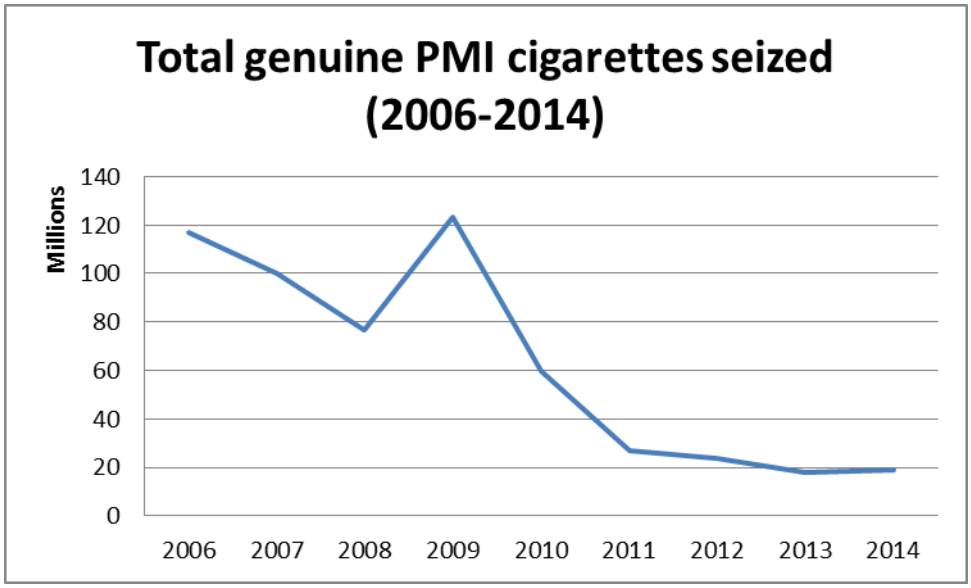
[36] European Commission, Better Regulation for better results – An EU agenda, COM(2015) 215 final of 19 May 2015. See already the Impact Assessment Guidelines, SEC(2009)92.

[37] COM(2015) 215 final of 19 May 2015.

[38] Member States are still reporting data for some earlier seizures. Based on data available as of 1 February 2016, the +/- 85% drop in genuine PMI cigarettes seized is estimated to apply also for the period 2006- 2015.

[39] For the purposes of calculating whether the 90 million baseline amount (see Section 3.3.6) was reached in a given year, only seizures made by the Member States which were part of the EU on 1 January 2004 were taken into account under the original PMI Agreement. The status of the 'new' Member States only changed following the modification to the PMI Agreement formally adopted in October 2014 which made all Member States eligible for seizure payments, and which also changed the definition of the baseline amount. Therefore, from the total contraband seizures made during the early years of the PMI Agreement, seizures made in the 'new' Member States had to be subtracted. Moreover, the PMI Agreements foresees a number of exceptions in Article 4, for example relating to cigarettes which were produced prior to 1 January 2004. The baseline has never been reached.

Figure 2: Total genuine PMI cigarettes seized in million sticks as reported by Member States to OLAF under the Agreement, 2006-2014



Seizures of genuine PMI products have dropped by more or less 85% since 2006. This trend is established irrespective of whether a given seizure relates to genuine or counterfeit product.

After an inspection PMI systematically provides OLAF with details of the findings of the inspection including a determination of whether the cigarettes are genuine or counterfeit.

Nonetheless, questions have been asked about the process of determining whether a given sample of seized cigarettes is genuine or counterfeit. These questions are addressed in **Box 1**.

Box 1: Analysis of seized cigarettes by laboratories independent of the manufacturers

Under the four cooperation agreements, seizure payments are due depending on whether cigarettes seized with the brand of a given manufacturer are deemed to be genuine (qualifying for payment), or counterfeit (no payment).

To place this issue in context: Member States' customs services have built up special expertise in the tobacco sector. Under the four agreements, almost 8000 seizures have been notified, and many more seizures take place on a daily basis outside the agreements. Customs officers regularly investigating tobacco smuggling can often determine themselves whether a given sample is likely to be counterfeit or not.

Moreover, important seizures will often lead to a formal customs investigation. Identifying – by autonomous means – the origin of the cigarettes seized is often a key element in such procedures, even if national practices vary. For example, a (large) Member State would typically send large seizures for analysis by the national customs laboratory as part of the national customs investigation. Another (large) Member State has over a certain period of time verified 124 determinations 'genuine or counterfeit' made by manufacturers, and not found any error. Member States have on occasion also used OLAF's contract with an independent laboratory, the Scottish Ocean Institute (SOI), to verify findings made by the manufacturers.

The Commission has now set up a new facility for the testing of seized cigarettes. To this effect, the Commission's own laboratory in the Joint Research Centre - Institute for Reference Materials and Measurements (JRC-IRMM) in Geel (BE) has been contracted. Within the

framework of this contract, the JRC-IRMM conducts an independent analysis of seized cigarettes on behalf of the Member States to verify whether those cigarettes are genuine or counterfeit.

There has been no evidence of incorrect reporting, and if there had been, the Commission would without doubt have contested a false determination via the designated laboratory foreseen by Clause 4.01(j) of the PMI Agreement.

It goes without saying that adequate control mechanisms need to be in place to minimise any risk of false determinations by the manufactures. In evaluating this risk, the risk of detection both at national and at European level needs to be considered. Especially with the new laboratory facility, it seems fair to say that there is a substantial risk for manufacturers that any false determination would be detected. As mentioned in Box 1, no clear evidence to that effect has ever surfaced.[40]

The question also needs to be addressed to what extent the drop in seizures of PMI products can be attributed to the implementation of the PMI Agreement.

In this respect, it should be acknowledged that it is not possible to demonstrate any direct 'causality' between the PMI Agreement and the decrease in seizures. Smuggling is a highly complex activity, and a range of parameters on both the supply and demand side will have an impact. On the supply-side, such parameters playing a role are controls in the country of origin, as well as disruption of transport routes and the intensity of border checks and domestic law enforcement. On the demand side, the price and availability of like products will impact the demand for a given smuggled product, as do changing consumer tastes. Any mono-causal explanation would do injustice to such a multi-facetted phenomenon.

Considering the specific parameters used in the PMI Agreement with a notification threshold of 50,000, the question is also sometimes raised whether the drop in reported seizures could be linked to different operational methods and notably an increase in 'ant trafficking' (i.e. repeated smuggling of smaller volumes). Available data on ant trafficking is limited since Member States rarely report below that threshold[41]. From the (limited) data available to OLAF on the basis of national statistics which do capture lower volumes as well, the overall reported volumes are limited compared to total seizures since the larger individual seizures are often in the 8-digit range[42]. However, the situation is likely to vary between Member States.

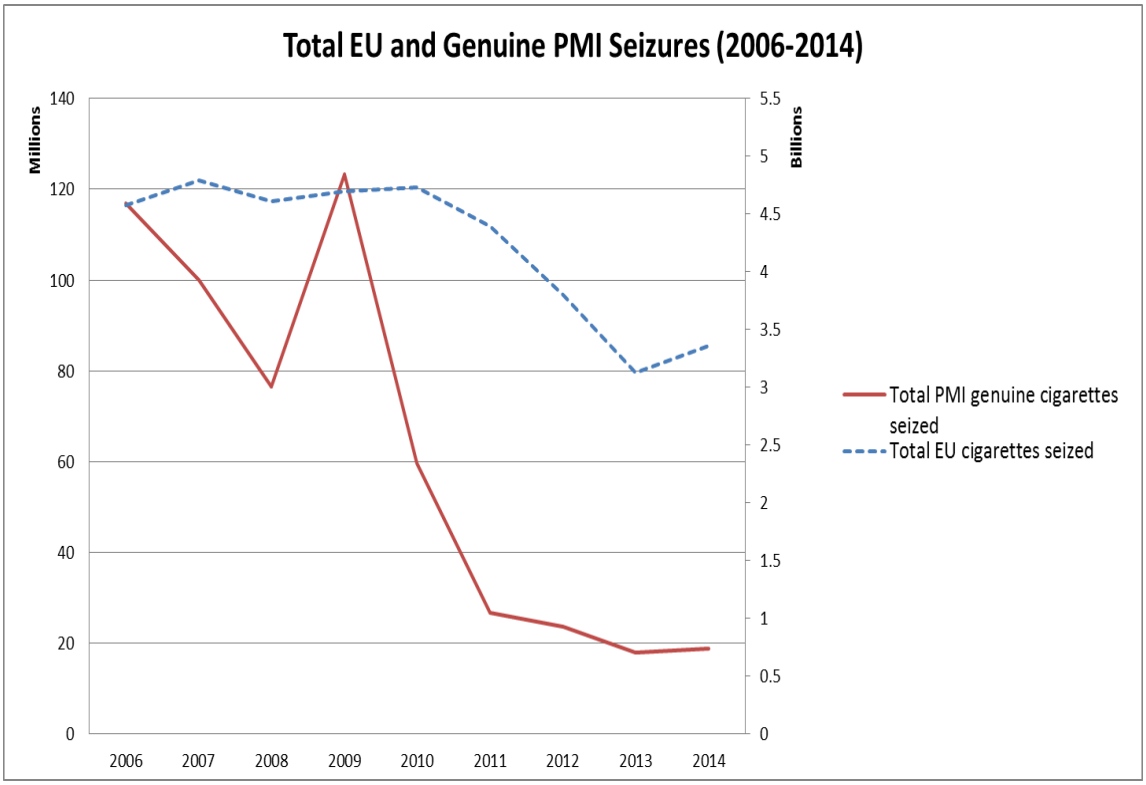
A decrease in seizures could in theory also be attributed to declining resources made available in Member States to fight illicit trade. However, the decline in total seizures for PMI products is significantly larger than the 30% decline in total seizures reported by MS.

[40] Any risk of misbehaviour on the part of the companies is not only determined by the likeliness of getting caught, but also by the strength of the (financial) incentive to make a false determination. For example, PMI reported net revenue of USD 29.8 billion in 2014. The payments in individual seizures are often as little as a few thousand euros.

[41] This threshold corresponds also to Member States' reporting practice for (anonymised) seizure notices to the CENComm statistical database of the World Customs Organisation (WCO).

[42] A standard twenty-foot container can hold approximately 10 million cigarettes.

Figure 3: Total genuine PMI seizures (left-hand scale) compared to total seizures (right-hand scale) as reported by MS between 2006 and 2014[43]



Ultimately, it remains a plausible hypothesis that in the past in the EU, the combination of (i) better supply chain control on the part of PMI and (ii) stronger enforcement pressure from both public authorities as well as PMI protecting its brand, has moved smugglers to shift to other segments of the illicit market focusing on the brands where these enforcement pressures are felt to a lesser extent. Such a displacement effect is also fully coherent with the observation that there has been a corresponding increase in the smuggling of non-branded cigarettes.

4.3. Implementation of the key operational provisions by PMI

The PMI Agreement forced PMI to put in place operational mechanisms to contain the risk of legal products being diverted from the supply chain. The Commission/OLAF has on occasions in the past visited some of the factories to take stock of how the provisions of the Agreement were implemented. However, the Commission does not have the resources to monitor PMI's obligations in each and every of its factories and distribution channels spanning more than 100 countries.

4.3.1. Track and trace obligations

As part of its annual reporting obligations, PMI has informed Member States and the EU in 2014 that track and trace at the master case levels have now been implemented almost everywhere in the world, i.e. in significantly more markets compared to the early years of the Agreement.

[43] Consolidated data for 2015 total EU seizures is not yet available.

Moreover, PMI has been moving the level of tracking and tracing from master cases down to carton level in an increasing number of markets. That technology has been progressively implemented and was stated to cover close to 50% of total PMI volume including duty free sales.

In addition, PMI has informed the authorities that it has begun to also implement pack level tracking, and expects to cover 80% of its global sales by the end of 2017, i.e. a year and a half prior to pack-level tracing becoming mandatory within the EU under the new Tobacco Products Directive.

PMI, like the other three manufacturers, on the basis of its track and trace information has provided additional information on a number of seizures notified by Member States over the last five years in many countries.[44]

In many consumer good areas, the concept of traceability has gained importance and the technological means have developed over the last years. A track and trace concept for tobacco products has meanwhile been adopted in the FCTC Protocol as an efficient tool to better control the supply chain of tobacco products through regulatory requirements. Overall, it seems fair to say that the principle of the track and trace system as such – irrespective of any particular technology used – has allowed both PMI and public authorities to identify weaknesses in the supply chain.

4.3.2. Compliance with other operational obligations

As set out in Section 3.3. above, the PMI Agreement contains a wide range of commitments which constrains PMI's commercial freedom of choosing their customer, how to make daily payments, etc.

PMI is obliged to inform Member States and OLAF about the way the company has implemented other obligations. In particular, PMI has issued every year a 'certificate of compliance'[45] detailing how it has complied with the obligations of the Agreement. Each year, at the mandatory annual meeting, PMI present its compliance with the Agreement and Member States and OLAF discuss with PMI how the various commitments have been implemented in practice.

Since the beginning of the PMI Agreement, almost 5000 notices of seizure were processed and analysed; these often provided valuable information for both OLAF and national investigators.

Moreover, for each seizure reported by Member States under the Agreement, PMI has issued an official response to OLAF setting out the available details (factory, customers, intended market of retail sale, shipment details etc.) pertaining to the seized products.

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[44] Including Albania, Algeria, Andorra, Argentina, Australia, Austria, Belarus, Brazil, Canary Islands, Costa Rica, Czech Republic, Egypt, Georgia, Germany, Greece, Indonesia, Ireland, Italy, Japan, Jordan, Kazakhstan, Lebanon, Lithuania, Macedonia, Malaysia, Netherlands, Philippines, Poland, Portugal, Romania, Russia, Senegal, Serbia, South Africa, Spain, Switzerland, Turkey, Ukraine, UK, and the US. The majority of these notices come from PMI.

[45] Annual compliance reports have been made publicly available upon request.

Where necessary for investigative purposes, OLAF has made use of some of the regulatory tools provided under the PMI Agreement. For example, on several occasions OLAF has addressed requests to PMI for information in relation to on-going investigations. OLAF investigators have not found it necessary to invoke some other sub-sections of the PMI Agreement for investigative purposes as some of those sub-sections were primarily designed to address a scenario that seizures of PMI contraband would increase significantly.

The Commission has in recent years brought improvements to the way how the PMI Agreement is managed in practice, even if resources remain stretched. For example, there is now a more detailed monitoring of PMI's compliance with its commitments. Based on the special information powers granted by the PMI Agreement, OLAF has also addressed a number of formal enquiries to PMI to scrutinise commercial behaviour in a number of regional markets. OLAF has also invested in upgrading its statistical capabilities, and has in October 2014 rolled out a new IT tool[46] for a more efficient processing of seizure notices. The same improvements have also been made for the other three agreements.

Box 2: Tobacco Seizure Management Application (ToSMA)

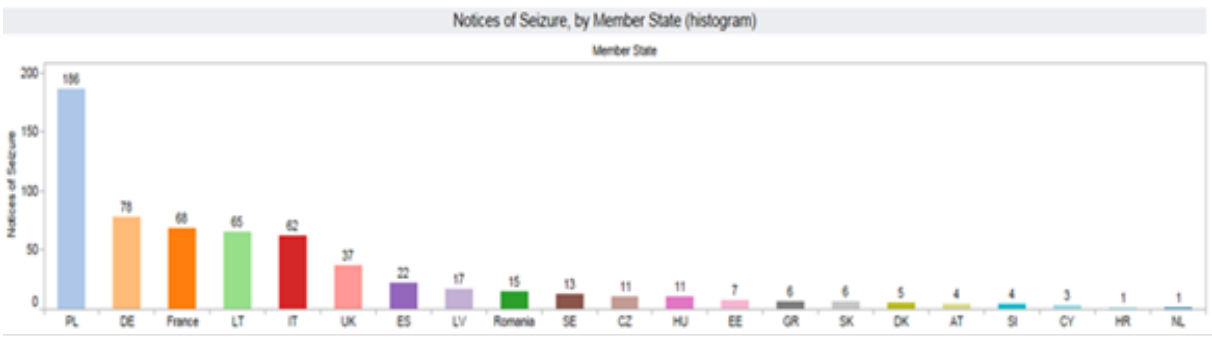
The Tobacco Seizure Management Application (ToSMA) is part of the IT applications part of the EU's Anti-Fraud Information System (AFIS). AFIS is an umbrella platform for a set of antifraud applications operated by OLAF under a common technical infrastructure aimed at the timely and secure exchange of fraud-related information between Member States administrations and between Member States and EU. AFIS also provides storage and analysis capabilities.

ToSMA was released in Q3 2014. It enables Member States to send to OLAF information about tobacco seizures under the four agreements, as well as to follow the state of play of their seizure reports. At the same time, ToSMA is used by OLAF to make the details of the findings of the manufacturer available to the Member States.

ToSMA provides the added value of having all the data related to tobacco seizures available in one single repository, which enables the Member States and OLAF to generate statistical reports and respond to requests for information coming from various stakeholders.

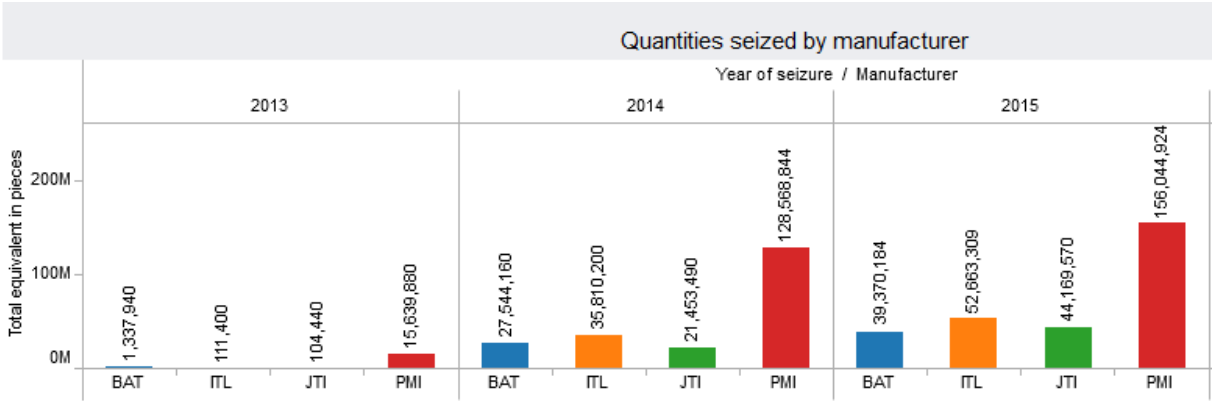
Ongoing development work is being undertaken on ToSMA, in order to import data related to tobacco seizures before its release in 2014 (so-called historical data).

Since the launch of ToSMA in October 2014, Member States have recorded seizures in ToSMA as follows:



[46] ToSMA – Tobacco Seizures Management Application.

Since October 2014, Member States have notified the following genuine and counterfeit seizures under the respective agreements for the last three years:



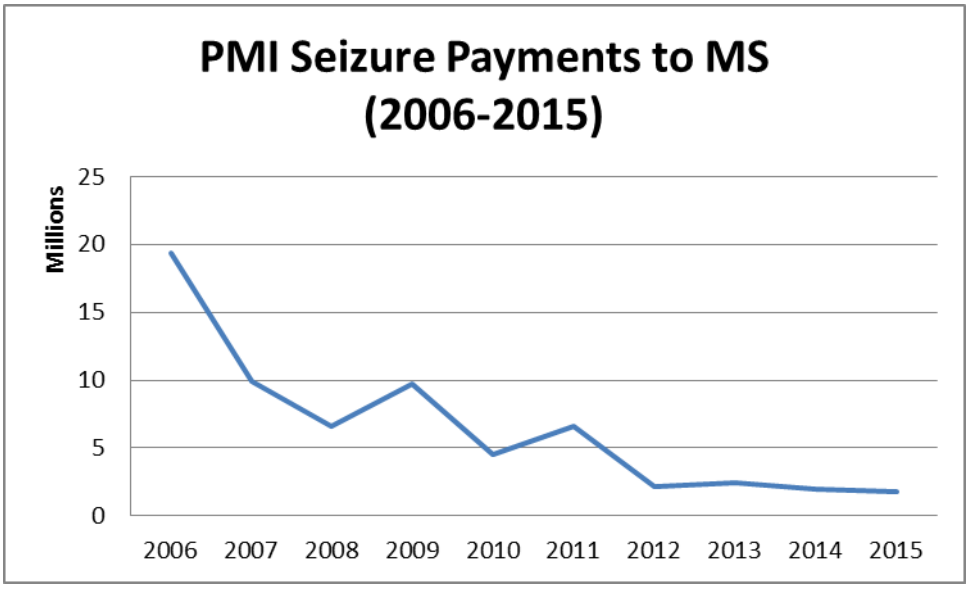
4.4. Efficiency of the PMI agreement

4.4.1. Financial incentives for compliance – seizure notices and payments

The Agreement has been conceived in such a way that the legal obligations are complemented by financial incentives for compliance. Each time Member States seize certain quantities of genuine PMI products, PMI has to make certain payments, irrespective of whether there has been any fault on its part.

From the start of the Agreement to 1 February 2016, PMI has paid approximately € 68.2 million in seizure payments (see ***Annex 1)***.

Figure 4: Total PMI Seizure Payments as paid to Member States under the Agreement from 2006 to 2015



However, as indicated in the graph above, the bulk of these seizure payments occurred in the early years of implementing the Agreement. As seizures of PMI products have come down significantly in recent years (see Section 4.2), inevitably also seizure payments have decreased.

That development, as welcome as it should be from an anti-fraud perspective, has however also given rise to legitimate questions whether the parameters agreed in 2004 determining the level of seizure payments are still in tune with today's very different market conditions.

A similar question concerns the baseline amount, i.e. the seizure volume threshold which would trigger, if surpassed, elevated seizure payments. As mentioned in Section 3.3.6, the threshold in the PMI Agreement has never been reached. Market observers have reported that the average volume size of seizures has declined. With today's notably smaller seizure volumes, it could be argued that the high baseline amount in the PMI Agreement has essentially lost its intended deterrent effect.

4.4.2. Annual payments

Under the agreed annual payments over the 12-year duration of the Agreement the Member States and the EU will, after deduction of legal fees, have in total benefitted from payments reaching approximately USD 1 billion.

4.4.3. Enforcement activities

The Agreement has facilitated the transmission by PMI of information of substantial investigative interest to OLAF and national law enforcement agencies such as customs. PMI has provided substantial intelligence and operational information that led to cigarette seizures and arrests. Even where information provided by PMI did not immediately lead to a seizure, it has often been useful and was used by OLAF and Member States as background for on-going casework related to the illegal trade and illegal production of cigarettes.

PMI has also been supporting investigative work by gathering information on counterfeit cigarette seizures made in the EU and by analysing these seizures. Sample taking and fingerprints from the producing machines enable links to be made between different smuggling lines. Importantly, by providing information under the framework of the Agreement, PMI has contributed to the closure of a substantial number of illegal cigarette factories inside the EU.

In general, the data supplied by the manufacturers to OLAF in case of seizures of their genuine cigarettes in the EU (place of production, first and any known subsequent purchasers of the cigarettes, intended market of destination) have been used by Member States and OLAF in their investigations. This information has also enabled the Commission and Member States to target available resources effectively.

From an intelligence gathering perspective, investigative authorities such as OLAF – as the EU's investigative authority – and the customs authorities in many Member States have highlighted the value-added of the Agreement to their investigative activities. However, it can also be argued that PMI's incentives in this type of assistance to enforcement might as well be independent from the existence of the PMI Agreement.

4.4.4. The cost of the Agreement

Whilst the main policy and financial benefits of the PMI Agreement can be measured as set out above, a fair balance of the experiences of applying the Agreement also needs to consider the costs of its implementation.

As regards the costs of the Agreement to PMI, they are part of **PMI**'s agreed commitments and thus need not be evaluated, nor would the Commission be in a position to do so.

As for the costs for the EU and Member States, it is important to recall that the obligations set out in the PMI Agreement fall essentially on PMI. Sufficient resources are however required at EU and national level to audit and monitor compliance and to ensure an efficient implementation of the Agreement.

As for the **Member States**, it can be assumed that they would in any event investigate suspicious consignments and seize illicit products. If a Member State issues a seizure notice in a given case, then there would be an expectation that they facilitate the inspection of seized product by the company. Without involvement of the manufacturer, it is not possible to trace the seizure back to the original supply chain. This in turn allows for a potential seizure payment by PMI. Member States wishing to benefit from seizure payments thus need to put into place national capacities and procedures to allow for the due processing of seizure notices. However, the Commission does not possess data to quantify the administrative resources used by Member States to specifically implement the PMI Agreement. It could however be expected that there are some synergies arising out of implementing four similar agreements.[47]

The administrative costs for the **EU** of implementing the PMI Agreement are the following:

- *Human resources*: Inside the Commission, OLAF employs two full time staff members to implement all four anti-fraud cooperation agreements[48]. Between two and four further Commission staff spend a part of their time on duties arising in the context of the four tobacco agreements. Also in the Legal Service, one staff member spends a part of his/her time on issues arising from the tobacco agreements, next to many other assignments. In addition, support from external legal advisers was sought in particular in the early stages of the agreements and for their negotiations. Furthermore, the original negotiation of the Agreement has been rather resource intensive.

- *IT costs*: The cost of developing and operating the new IT tool (now used for all four tobacco agreements, see Box 2) has been estimated for the period 2011-2014 to amount to some € 945,000.

In mere monetary terms, and as far as the **EU** budget is concerned, the revenue of €3.2 million generated as of 1 February 2016 by seizure payments from PMI alone broadly covers the administrative expenditure on all four tobacco agreements. **Member States**, for their part, have received up to 1 February 2016 seizure payments totalling € 65.0 million from PMI, although less in recent years (see ***Figure 4***).

It must also be noted that the EU and the Member States have concluded the PMI Agreement while releasing PMI of civil liability for past conduct (see Section 3.3.8). From an economic perspective it could thus be argued that in return for the payments from PMI, Member States

[47] For Member State not receiving annual payments the cost of administration – considered on its own – may outweigh its financial benefits. For illustrative purposes between 2007 and 2015 one Member State reported more than 660 seizures to OLAF representing over 390 million cigarettes: seizure payments received were on average EUR 50,000 per year with administrative cost likely to exceed the seizure payments.

[48] This is without counting OLAF investigators working on tobacco cases.

and the EU had to give up valid civil claims. Nonetheless, the litigation in the US has demonstrated the difficulty to pursue these claims within a reasonable time period.[49] Moreover, as far as seizure payments are concerned, under the PMI Agreement, these are made without any need for Member States to prove fault on the part of PMI. It is a matter for speculation how many of these claims would have been enforced in practice, not to mention the cost of doing so.

4.4.5. Other relevant aspects

The tobacco agreements are faced with certain criticism that they would bring anti-fraud policy, if not EU policy at large, too close to comfort to tobacco manufacturers, as the agreements involve regular operational contact with the industry and could appear in some eyes like a form of enforcement partnership.

This criticism may be amplified when combined with concerns about an underinvestment in the authorities' auditing compliance. However, it should be acknowledged that the Commission has since 2014 engaged in a reform process of how the tobacco agreements are being managed. This process includes introducing gradually more transparency into the process, the creation of a new laboratory for the testing of seized cigarettes, new IT tools, etc. This is essentially a matter of political appreciation and falls outside the scope and mandate of this technical assessment.

Furthermore, it needs to be considered that the tobacco industry has launched a legal challenge against the TPD, which prompts some to question whether it is opportune for the EU to enter into a contract with an entity on policy issues related to the ones legally challenged. Moreover, any expectations by the industry as to the future compatibility of track and track solutions with the TPD requirements should be avoided.

5. THE SITUATION TODAY

5.1. Vigilance and action

Despite the overall decline in seizures of PMI cigarettes and the brands of the other three main tobacco manufacturers, the volume and availability of illicit product on the EU tobacco market remains troubling.

However, today's regulatory and market environment is notably different compared to the situation when the PMI Agreement was originally conceived:

- First, there is a gradual process of displacement of illicit tobacco products on the illicit EU market whereby an ever increasing share of smuggled cigarettes are not contraband from the big four manufacturers, but, as noted in the Commission's 2013 strategy paper, non-branded ("cheap whites") cigarettes.[50] Also counterfeits remain prominent.

- Second, today's regulatory environment is different, with important legislative initiatives taken at EU (TPD) and global (FCTC Protocol) level.

[49] To illustrate this point, the litigation against RJR before US courts has gone on for 15 years now.

[50] OLAF has in 2015 contributed to a record level of about 600 million cigarettes being seized by Member States. Virtually all of these seizures concerned cheap whites.

In light of these developments, the question arises as to the continued relevance, or regulatory pertinence, of such agreements with the manufacturers of the leading tobacco brands. In other words, is a contractual arrangement like the PMI Agreement still a suitable tool, or do other available regulatory means offer today a sufficient remedy to control the illicit tobacco trade?

The PMI Agreement was never designed to combat the more recent phenomenon of cheap whites. Even if some of the smuggling groups involved in trafficking cheap whites may be the same as those smuggling contraband (and indeed some containers intercepted reveal loads composed of various types of illicit product), the actors at the manufacturing end are different.

In light of the increasing importance of cheap whites, is it thus still worthwhile, considering also the administrative and reputational costs to public authorities, to continue using a cooperation agreement with a manufacturer like PMI? In this context and in times of shrinking resources in the Commission/OLAF overall, the question is also whether it is adequate to allocate the required resources to managing the PMI Agreement (in parallel to the other three agreements) which are continuing, when the illicit market has undergone significant change.

5.2. Available legislative tools

5.2.1. EU Tobacco Products Directive 2014/40

The EU Tobacco Products Directive (TPD)[51] deals with a variety of issues relating to the manufacture, presentation and sale of tobacco and related products. The objective of the Directive is to facilitate the functioning of the Internal Market whilst ensuring a high level of health protection.

The TPD provisions will, once mandatory, provide for the full traceability of unit packs across the entire manufacturing and distribution chain in the EU. Articles 15 and 16 TPD contain key provisions which become mandatory as from May 2019 for cigarettes: (i) unit packets of tobacco products are to be marked with a unique identifier; (ii) based on this unique identifier, the movement of the tobacco products are to be recorded so that they can be tracked and traced throughout the EU; (iii) tobacco products have also to be equipped with a security feature which will facilitate the verification of whether or not tobacco products are authentic.

These TPD rules, once in force, will apply both to tobacco products manufactured in the EU, as well as to products manufactured outside the EU which are destined for, or placed on, the Union market (Articles 15 and 16 TPD). In contrast, the PMI Agreement offers a global geographic scope with respect to products from market leader PMI as concerns tracking at master-case level, but has only achieved partial global coverage in terms of marking at the lowest unit (i.e. pack) level and typically did not cover customers after manufacturing. According to the available figures products manufactured outside and not destined for the EU market currently represent a high share of illicit products imported into the EU.[52]

Concerning the substantive scope, the TPD creates a system for tracking and tracing at pack level for the EU and introduces security features facilitating law enforcement (including at customs controls). The TPD covers all manufacturers, and thus creates a level playing field. The PMI Agreement - on the other hand – also contains rules on other issues such as due

[51] Directive 2014/40/EU, OJ L 127 of 29 April 2014, p.1.

[52] It should be noted that this comparison is not an assessment of the technology used by PMI or its compliance with legal requirements.

diligence, anti-money laundering, financial incentives for compliance (i.e. seizure payments), and supports investigators. These additional obligations will be largely covered by the future new rules under the FCTC Protocol (see below).

5.2.2. WHO FCTC Protocol

An effective global regime to combat the illicit trade in tobacco products is arguably the best policy response to this cross-border phenomenon. Today, the FCTC Protocol is the main global initiative to tackle tobacco smuggling. It contains provisions on tracking and tracing (taking effect 5 years after entry into force), due diligence, money laundering, sanctions and other relevant aspects. It does not include compulsory financial incentives for compliance such as seizure payments.

The EU signed the Protocol in December 2013 and is currently preparing to ratify it. The Protocol uses many concepts well-known to the EU authorities are familiar from the agreements with the tobacco manufacturers as well as from the TPD with regard to track and trace provisions.

The Protocol will enter into force once 40 Parties have ratified it. As of 15 February 2016, fifteen have done so, including five EU Member States[53]. It is clear that some time will pass before the FCTC Protocol is effectively implemented[54] by a critical mass of countries, including key source and transit countries in the illicit global trade.

6. CONCLUSIONS

The PMI Agreement made an important contribution to fight PMI illicit trade in the past. The market and legislative framework has changed significantly since the entry into force of the Agreement.

[53] See the overview on http://www.who.int/fctc/protocol/ratification/en/.

[54] See the short overview of unique marking systems in the survey by the WHO FCTC Convention Secretariat, FCTC/COP/INT-IT/4/INF.DOC./1, available at http://apps.who.int/gb/fctc/PDF/it4/FCTC_COP_INB_IT4_ID1-en.pdf

ANNEX 1: PMI SEIZURE PAYMENTS EU AND MEMBER STATE SHARE

	Grand Total by Member State (2006-2015)		
	PMI Payment	**EU - share**	**MS share**
BE	898,697.29	53,090.52	845,606.77
BG	-	-	-
CZ	31,520.13	2,095.67	29,424.46
DK	1,590,093.25	24,422.88	1,565,670.37
DE	19,304,646.31	856,678.95	18,447,967.36
EE	255,802.98	16,838.53	238,964.45
IE	89,677.78	3,190.49	86,487.29
EL	240,540.33	9,328.46	231,211.87
ES	529,400.50	23,008.14	506,392.36
FR	3,098,797.41	120,507.65	2,978,289.76
IT	14,490,050.05	820,360.65	13,669,689.40
CY	110,457.16	6,952.29	103,504.87
LV	210,873.07	11,207.96	199,665.11
LT	264,703.23	16,627.76	248,075.47
LU	-	-	-
HU	5,951,503.36	334,805.15	5,616,698.21
MT	19,000.50	1,090.63	17,909.87
NL	4,366,754.57	162,946.62	4,203,807.95
AT	1,131,718.42	49,436.34	1,082,282.08
PL	414,560.08	19,897.81	394,662.27
PT	-	-	-
RO	-	-	-
SL	174,699.21	9,022.73	165,676.48
SK	195,389.35	12,621.69	182,767.66
FI	8,253,707.68	340,113.71	7,913,593.97
SE	4,330,051.65	222,210.96	4,107,840.69
UK	2,275,471.07	102,014.18	2,173,456.89
Total	**68,228,115.38**	**3,218,469.77**	**65,009,645.61**