BAT RESPONSE TO THE PUBLIC CONSULTATION ON EXCISE DUTIES APPLIED TO MANUFACTURED TOBACCO

British American Tobacco (BAT) would like to thank the European Commission for the opportunity to reply to this public consultation on excise duties applied to manufactured tobacco. The multiple-choice options presented in the consultation document did not always propose an option that accurately reflected our position, so we have produced this document to clarify our views on specific topics.

1 Executive summary

BAT is of the view that no far-reaching changes are required to the current Directive 2011/64/EU (the "Tobacco Excise Directive" or the "Directive"). We do, however, believe that there are some areas which should either be: (i) excluded from the Directive; or (ii) amended to potentially improve it. Our position is summarised below.

1.1 Electronic cigarettes

An excise duty or an EU-wide harmonised tax regime on electronic cigarettes (e-cigarettes) would be premature at this stage. We see no compelling evidence that would justify e-cigarettes being included in the current Tobacco Excise Directive. This is for a number of reasons:

- **E-cigarettes do not contain tobacco and are fundamentally different to products that do contain tobacco.**
- **Continuum of risk indicates no justification for taxing e-cigarettes.** There is growing consensus among many scientists and public health professionals that e-cigarettes are, in general, potentially significantly lower risk than conventional cigarettes and that a switch to e-cigarettes by smokers has the potential to lead to an unprecedented public health success in terms of tobacco harm reduction. If anything, it could be argued that they should be subsidised, not subject to an additional duty on their consumption.
- **Limited scope to raise significant excise revenues.** EU markets, like Italy and Portugal, that have levied an excise tax on e-cigarettes have not only negatively impacted legal sales volumes but also generated insignificant tax revenues:
  - ***In the first 9 months of 2016, Portugal raised c.€1.3 million tax revenue from e-cigarettes, equivalent to c.0.2% of the tax revenues raised from traditional tobacco products.***
  - ***In 2016, Italy collected €3 million from e-cigarettes, equivalent to c.0.3% of the tax revenues raised from traditional tobacco products.***
- **Levying a duty on these products would be costly, difficult to administer and to enforce and would have negative unintended consequences, as has been the case in Portugal and Italy.** E-cigarettes are unprecedented among other excise products in terms of the complexity, stability and scale of the category. Moreover, unlike conventional tobacco products, online sales of e-cigarettes are growing rapidly because online channels are better placed to meet consumer demand given the wide variety of products and accessories available. Terrestrial stores are unable to stock the range of products that consumers are seeking to purchase. This means that a tax administration system (which currently does not exist anywhere) would need to be designed and operated in a way that: (i) levies tax in an equitable way across all product types and channels, (ii) is flexible to future product developments, and (iii) is monitored appropriately.
- **It is advisable to wait until the impact of Directive 2014//40/EU (TPD) on this product category and its growth is fully understood.**

1.2 Novel tobacco products

Unlike e-cigarettes, Tobacco Heating Products (or Heat-not-Burn tobacco products), do contain tobacco, even if they do not involve a combustion process. It would be logical, therefore, to include

Tobacco Heating Products within the scope of the current Directive by introducing a new category of "manufactured tobacco" in Article 2(1), namely "*tobacco intended for use in electronic tobacco heating devices*". The term "*tobacco intended for use in electronic tobacco heating devices*" could be defined as: "***Tobacco that is heated inside an electronic tobacco heating device to produce nicotine-containing vapour to be inhaled by the consumer, without a tobacco combustion process".***

However, given the non-combustible nature of Tobacco Heated Products, and subsequent lower levels of toxicants, the excise rate applied should reflect the reduced risk profile of the category and be simple to manage and collect, i.e. a specific duty levied on the weight of the tobacco-in-use.

1.3 Combustible tobacco products

We believe that the excise rates and tax structures should remain as stated in the current Directive. There are still several Member States struggling to increase taxes to the current EU minima because consumers have not recovered from the effects of the economic crisis and illicit trade levels are already very high. Moreover, the current structures set out in the Directive are fit for purpose and allow sufficient flexibility for individual Member States.

Our view on raw tobacco and by-products is that they should remain outside the scope of the Directive. Introducing raw tobacco within the scope of excisable tobacco products would result in significantly high costs for tax administrators and economic operators, particularly tobacco growers in the EU. We believe that targeted control measures at a national level will be the most appropriate, efficient and effective way of tackling any associated illicit trade issues.

There are two areas of the current Directive which, we believe, could be improved upon to increase revenue raising options through excise available to Member States.

- **Revise the current Directive to allow Member States to differentiate between Make Your Own (MYO) and Roll Your Own (RYO) tobacco – two different tobacco product categories which are currently combined under the broad definition of "fine cut tobacco".**

  From a composition, usage and consumer viewpoint, MYO and RYO are dissimilar and not interchangeable. MYO is a direct substitute for cigarettes and is chosen by consumers as a cheaper alternative to cigarettes. RYO is less of a direct substitute and more a stand-alone tobacco consumption preference. Because of the composition of the product, MYO allows consumers to make two cigarettes out of the same weight of tobacco needed for a single factory made cigarette. And, since tax is levied on the weight of the tobacco, a MYO cigarette stick enjoys a substantially lower tax burden compared to an equivalent factory made cigarette stick. This has, in markets where MYO is prevalent, caused down trading from cigarettes to MYO, thereby significantly reducing government revenues.

  We suggest revising the Directive to differentiate between these two categories based on the compositional differences between the products. This will allow individual Member States the option to apply different tax rates to MYO and RYO tobacco products. We do not suggest that a new minimum rate should be imposed on MYO as we believe that Member States should retain flexibility in this area.

- **Revise the Directive to allow Member States to implement a dual or selective minimum excise duty (MED).**

  A dual MED has in the past been implemented in France, Italy and Spain and has proven effective in (i) discouraging operators from reducing their prices and safeguarding government revenues whilst not creating significant distortions in the market or incentivising switching to illicit products; and (ii) enabling governments to encourage a target price floor without the unintended consequence of penalising, for example, price segments above the weighted average price (WAP) (as can be the case with an excessive MED in Portugal, for example). Given the policy benefits of such a flexible minimum taxation mechanism compared to a single MED, we recommend revising the Directive to allow Member States the option to implement such a solution.

2 Electronic cigarettes

2.1 E-cigarettes do not contain tobacco and are fundamentally different to products that do contain tobacco

E-cigarettes are battery powered electronic devices which heat a nicotine solution to create vapour. An electronic heating element vaporises the liquid and the vapour condenses to form an aerosol, which is inhaled and exhaled. No combustion takes place, and therefore the user inhales vapour rather than smoke. E-cigarettes do not contain tobacco.

2.2 Continuum of risk indicates no justification for taxing e-cigarettes

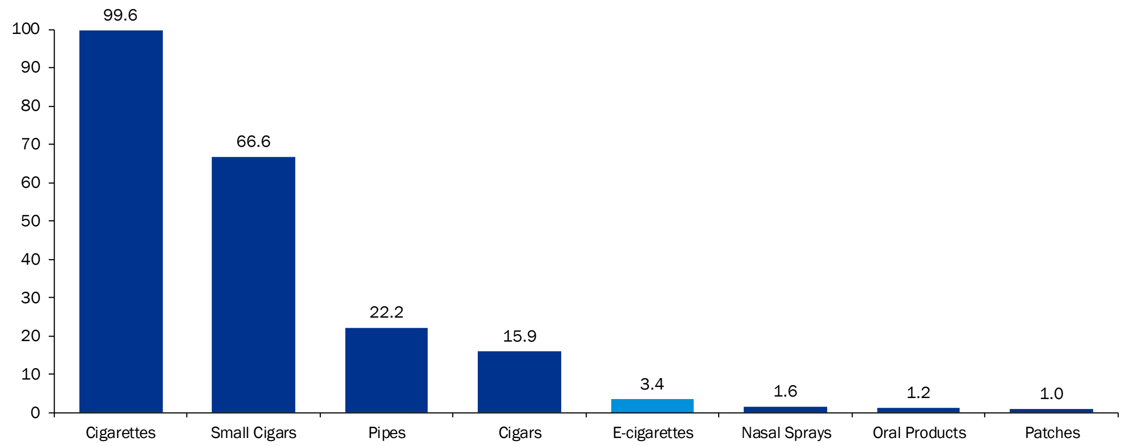
There is a general consensus from independent third parties that e-cigarettes are potentially less hazardous than combustible tobacco and provide an alternative to smokers which may be significantly less risky than combustible tobacco products.

While we acknowledge that the full extent of the health impact of the vapour produced by e-cigarettes is not yet completely understood, the available third-party evidence suggests that:

i) the risk posed by vaping is potentially lower as compared to smoking combustible tobacco;
ii) the risk posed by passive vaping is potentially considerably lower than that posed by passive smoking; and
iii) the potential negative externalities from e-cigarette use on the environment are likely to be minimal.

A recent report by Nutt et al (2014) found that e-cigarettes were more than 95% less risky compared to cigarettes and concluded that: *"…attempts to switch to non-combustible sources of nicotine shall be employed as the harms from these products are much lower."*

FIGURE 1: THE RELATIVE RISK OF VARIOUS NICOTINE DELIVERY PRODUCTS



Source: Nutt D J, Phillips L D, Balfour D, Curran H V, Dockrell M, Foulds J, Fagerstrom K, Letlape K, Milton A, Polosa R, Ramsey J, Sweanor D. (2014) Estimating the harms of nicotine-containing products using the MCDA approach, European Addition Research, 20 (5). Pp. 218-225

Other experts have also agreed with this finding. For example, Public Health England commented in 2016 that: *"E-cigarettes carry a fraction of the risks of smoking. Experts have estimated they are around 95% less harmful than tobacco."*

Considering that most e-cigarette users have switched to e-cigarettes from combustible tobacco products, thus reducing the harm to those that consume them, we believe that there is no justification for taxing e-cigarettes in the same way as combustible tobacco to correct for negative externalities. If anything, it could be argued that they should be subsidised, not subject to an additional duty on their consumption.

2.3 Limited scope to raise significant excise revenues from e-cigarettes

The most common justification for levying an excise tax, in addition to VAT, is that tax authorities perceive that there is capacity for raising additional tax revenues.

For e-cigarettes to be a meaningful source of tax revenues, taxation on these products would have to:

i) be sufficiently large for material tax revenues to be raised (relative to the costs of administering and collecting the tax); and
ii) have a relatively small impact on sales volumes i.e. consumers would have to be relatively insensitive to prices such that any excise driven price increase would have negligible impact on sales volumes (and, in turn, not undermine the tax base).

Based on these two points, we believe that e-cigarettes are currently not strong candidates for an excise duty because any excise tax would: (i) generate relatively low levels of tax revenues compared to that collected on combustible tobacco; and (ii) have a significantly negative impact on sales volumes.

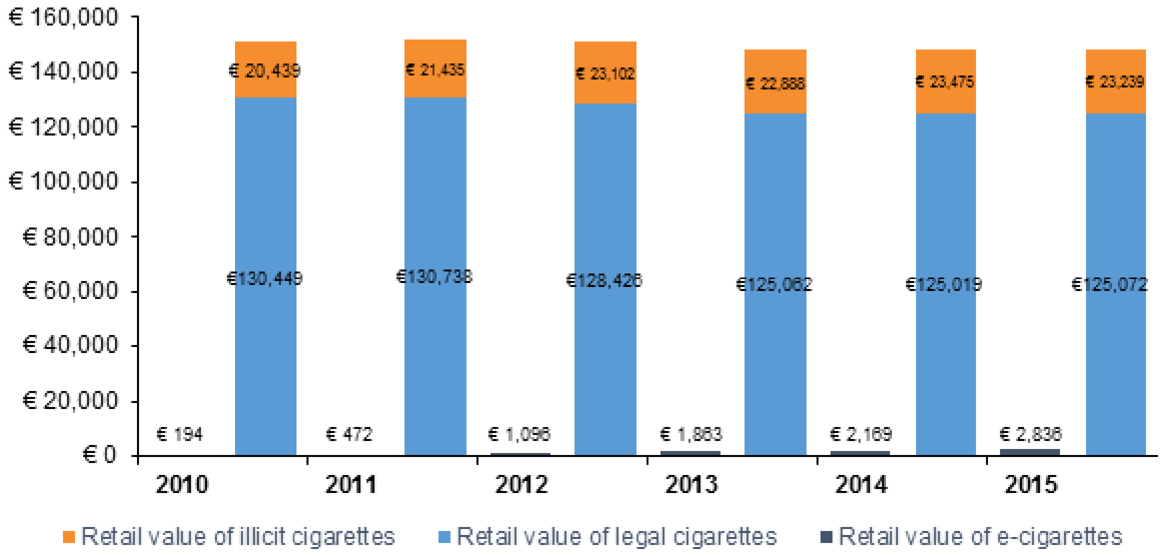
2.3.1 The e-cigarette category is small relative to tobacco and remains for now a limited potential source of tax revenues

The first e-cigarette device was developed more than 50 years ago but it was not until 2006 that e-cigarettes were formally introduced to the US and European markets.

Since then, the category has grown rapidly. According to Euromonitor, Europe has become one of the leading e-cigarette markets over the last 6 years. But while the market has grown, the e-cigarette category is still small relative to combustible tobacco products.

In 2015, the retail sales value of the e-cigarette market was only c.2.3% of the combustible cigarette market (which was valued at c.€125 billion) and c.1.9% of the total cigarette market when including sales from illicit cigarettes.

FIGURE 2: RETAIL SALES VALUE FOR E-CIGARETTES ACROSS THE EU BETWEEN 2010 AND 2015



Source: Euromonitor International, KPMG Project SUN report.

With the extra administrative burden and costs for establishing and operating any new taxation on e-cigarettes, the net potential tax revenues from this category would be only a fraction of those generated from tobacco, even if optimistic growth forecasts were to be achieved. This clearly indicates that there are limited revenue opportunities from e-cigarettes which are currently a nascent and evolving product category.

2.3.2 *Consumers are already price sensitive and any tax-induced price increase on e-cigarettes will have a substantial impact on sales volumes*

As e-cigarettes are a relatively new product category, there is limited time series data with which to estimate the price sensitivity of consumers in most countries.

However, there is one widely quoted study, by Huang, Tauras and Chaloupka, published in 2014, that estimates the price elasticity of demand (PED) for e-cigarettes. The authors estimate that the PED in the USA is:

- -1.2 for disposable e-cigarettes; and
- -1.9 for reusable e-cigarettes.

If European consumers are as price sensitive as this study suggests (which cannot be ruled out based on the evidence available) and taxes were fully passed on to consumers, the tax revenues generated would be small and sales volumes would be substantially lower.

The table below provides an illustrative example of the impact on sales volumes and tax revenues of an excise tax set at 20% and 50% of the price of a typical e-cigarette liquid.

TABLE 1: ILLUSTRATIVE EXAMPLE OF THE IMPACT OF A 20% AND 50% EXCISE TAX ON A 10ML E-LIQUID BOTTLE

	Now	With 20% duty	With 50% duty
2015 retail sales value (€ bn)	€ 2.836	€ 2.433	€ 1.694
Percent change		*-14%*	*-40%*
Average price per 10ml bottle	€ 5.00	€ 6.61	€ 12.75
Percent change		*32%*	*155%*
Sales volumes (bn)	0.57	0.37	0.13
Percent change		*-35%*	*-77%*
PED	-1.55	-1.55	-1.55
VAT (nominal rate)	21.55%	21.55%	21.55%
VAT (% of TIRSP)	17.73%	17.73%	17.73%
Excise (% of TIRSP)	0%	20%	50%
Pre-tax price	€ 4.11	€ 4.11	€ 4.11
VAT	€ 0.89	€ 1.17	€ 2.26
Duty	€ 0.00	€ 1.32	€ 6.37
VAT revenue (bn)	€ 0.50	€ 0.43	€ 0.30
Excise revenue (bn)	€ 0.00	€ 0.49	€ 0.85
Total tax revenue (bn)	€ 0.50	€ 0.92	€ 1.15

In this example, the excise duty revenues that would be raised from a 20% duty would be around €0.5 billion for the whole of the EU, and average only €17.4 million in revenue for each Member State. This represents only 0.65% of the €74.97 billion in excise revenues generated in 2016 from tobacco products in Europe. Not only would this generate insignificant revenues, it would also result in a reduction of c.35% of sales volumes.

If a 50% excise duty were considered, this would generate around €0.9 billion for the whole of the EU; c.1.1% of excise revenues generated from tobacco products in Europe. Not only would this generate insignificant revenues, it would also result in a reduction of c.80% of sales volumes[1].

This presents two practical problems:

- Firstly, with a product category that is still nascent, maximising short term tax revenues in this way will certainly damage longer term sales growth and longer term tax revenues.
- Secondly, it will substantially undermine the externalities and public health policy objectives that we discussed above.

Conversely, were a duty on e-cigarettes to be levied in proportion to the relative risk associated with e-cigarette and cigarette usage, the Nutt study (described above) would imply that e-cigarettes should be taxed at 3.4/99.6, or 3.4%, of the duty on cigarettes (where excise duties represented, on average across the EU, 62% of the price of a pack of cigarettes in 2016). At this rate of excise on e-cigarettes, we calculate excise revenues would amount to only €0.06 billion across the EU, or €2.1 million of additional excise revenues per Member State on average.

Again, the revenues that could be raised are extremely small due to the current size of the category.

2.4 Levying a duty on e-cigarettes would be costly, difficult to administer and to enforce and would have negative unintended consequences, as has been the case in Portugal and Italy

The small scale of tax revenues that could potentially be generated from e-cigarettes in the EU needs to be offset against the potentially high costs of setting up and administering a system for collecting those taxes.

Unlike other excisable products, e-cigarettes are a complex and fragmented product category.

- There are thousands of stock keeping units (SKUs) on sale in many EU Member States, supplied by hundreds of manufacturers, distributors, wholesalers and online.
- There are multiple types of devices on sale. These include disposable closed systems and refillable open systems, each with a multitude of variations.
- The pace of change in technology and consumer preferences creates fiscal complexity
- Consumer purchasing behaviour is different for e-cigarettes versus traditional tobacco products. Online is a key channel to market.

Tobacco products, by contrast, are supplied by a small number of large manufacturers, making a system of bonded warehouses relatively easy to administer (it is still costly to do so, but tax revenues are large in comparison). The type of tobacco product (fine cut tobacco, cigarettes etc.) also tends to be relatively similar across the category, making it relatively easy to define and monitor the tax base. Consumers buy tobacco from well-known and established bricks-and-mortar retailers.

Fuel is a similarly standardised product when it comes to levying an excise.

Alcohol, arguably, shares some but not all of e-cigarettes' characteristics. There are, as with e-cigarettes, a large number of very small local producers, distributors and retailers, as well as multinationals. However, within the beer, wine and spirits categories, there tend to be far fewer product variants than for e-cigarettes. These product variants have not fundamentally changed for a very long time and an excise collection and monitoring system has been in place for decades for these products. Critically, the scale of sales and tax revenues are significantly greater for alcohol than they are for e-cigarettes. For e-cigarettes the scale of sales and tax revenues are currently insufficient to cover the costs of introducing and operating an excise collection and monitoring system.

[1] The reduction in sales is not calculated by multiplying the -1.55 PED by the price increase since this would imply an infeasibly large sales reduction and negative sales. Rather, we have calculated sales by applying a constant PED of -1.55 to a series of small, incremental, price increases.

In short, e-cigarettes are unprecedented among other excise products in terms of the complexity, stability and scale of the category. A tax administration system (which currently does not exist anywhere) would need to be designed and operated that levies tax in an equitable way across all product types and channels, is flexible to future changes in the category, and is monitored appropriately. This would be difficult, costly and time consuming to do; arguably, more so than for any other excise product in the EU.

These costs, as well as the limited tax revenues, would all have to be taken into account in any appraisal of the net benefits of introducing an excise duty on the category. The evidence from other EU markets (included in Appendix A) suggests a cautious approach to e-cigarette taxation.

For all these reasons, the Tobacco Excise Directive and this current review process is not an appropriate vehicle for the consideration of harmonised EU rules for e-cigarettes. A separate and bespoke process would be required and the opportunities for fiscal gain seem to not warrant such a process being undertaken at this time.

3 Tobacco Heated Products

3.1 Tobacco Heating Products should be included as a new category in the Tobacco Excise Directive but any excise rate should reflect the lower levels of toxicants produced compared to traditional tobacco products

Tobacco Heated Products (THPs) should be included in a revised version of the Tobacco Excise Directive because they are tobacco products.

THPs typically consist of two components that can only function in combination with each other: a heating device and an electronically heated tobacco stick. The tobacco stick is inserted into the electronic device and, once it is heated to the appropriate temperature, generates an aerosol (composed of water, glycerine, nicotine and flavour) which the user inhales.

THPs are made of 100% reconstituted tobacco. However, unlike traditional tobacco products, THPs function on the basis of heating as opposed to combustion, i.e. they generate an aerosol when heated rather than smoke, generated from the combustion of a traditional cigarette.

THPs should be included in a revised version of the Tobacco Excise Directive because, unlike electronic cigarettes, they do contain tobacco.

However, THPs should be clearly and appropriately defined, as well as having a new tax category within the revised Directive. Despite containing tobacco, the tobacco sticks cannot be smoked and can only function on the basis of heating and not combustion, unlike conventional tobacco products.

More specifically, THPs should be:

i) defined under the current Directive by introducing a new category of "Manufactured Tobacco" in Article 2(1) namely "*tobacco intended for use in electronic tobacco heating devices*". This can be further defined as: *"Tobacco that is heated inside an electronic tobacco heating device to produce nicotine-containing vapour to be inhaled by the consumer, without a tobacco combustion process"*; and
ii) subject to a specific excise duty only.

Finally, the excise applied to THPs should be calculated using the weight of tobacco within the consumable only.

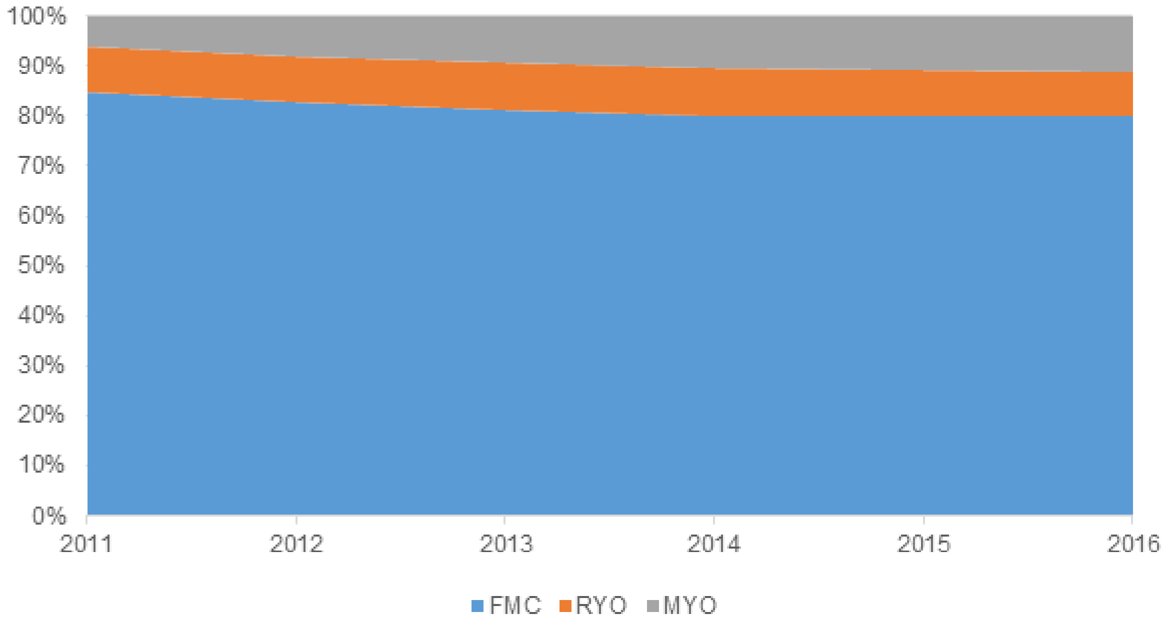
4 Fine cut tobacco products

4.1 A key driver of the growth in fine cut tobacco has been the emergence of make-your-own (MYO) tobacco

The fine cut tobacco category is formed of two distinct product categories: (i) roll-your-own (RYO) tobacco; and (ii) make-your-own (MYO) tobacco.

Fine cut has seen significant growth in recent years with sales volumes increasing by 6% between 2010 and 2015.[2] A key driver of this growth in some Member States has been the increasing popularity of MYO tobacco which now accounts for more than half of the fine cut volumes in the EU.

FIGURE 3: EVOLUTION OF FACTORY MADE CIGARETTE (FMC), RYO AND MYO TOBACCO VOLUMES ACROSS THE EU



Source: Internal market data
Basis for assessment: Conversion rate of 0.75g per stick used for RYO tobacco and 0.5g per stick for MYO tobacco.

4.2 From a composition, usage and consumer viewpoint, MYO and RYO tobacco are dissimilar and not-substitutable

RYO tobacco is a narrow, thinner cut (0.3 - 0.5mm thickness) tobacco which is used with rolling paper to produce a hand rolled tobacco stick. These products are clearly different from traditional factory made cigarettes and their appeal to consumers is mostly driven by consumer preference for the category's particular attributes rather than their price, relative to factory made cigarettes. Although, for a minority of consumers this is an important factor. Consumers of these products wish to roll their own tobacco and prefer the hand-made end-result compared to factory-made cigarettes.

MYO tobacco is compositionally different. MYO tobacco is a wider cut (between 0.6 - 0.8mm thickness) expanded tobacco, which is not only cheaper to produce, but also allows consumers to produce cigarettes using pre-made filter tubes and a tubing machine. These MYO cigarettes are much more like factory made cigarettes than hand rolled RYO tobacco sticks. The lower humidity content of MYO (c.17% humidity vs c.20% for RYO tobacco) allows consumers to make cigarettes using machine tubing. Because of the composition of the product (i.e. the higher volume to weight ratio), MYO allows consumers to make two cigarettes out of the same weight of tobacco needed for a single factory made cigarette.

[2] TAXUD tables (http://ec.europa.eu/taxation_customs/business/excise-duties-alcohol-tobacco-energy/excise-duties-tobacco/excise-duties-cigarettes_en)

RYO consumers do not generally trade down to MYO tobacco because it delivers a suboptimal result compared to RYO. The clear majority of MYO consumers are those who trade down from factory made cigarettes.

FIGURE 4: DIFFERENCE BETWEEN MYO (LEFT) AND RYO (CENTRE) TOBACCO INCLUDING AN EXAMPLE OF THE MARKETING CLAIM ON MYO PRODUCTS (RIGHT) REGARDING THE NUMBER OF CIGARETTES THAT COULD BE PRODUCED

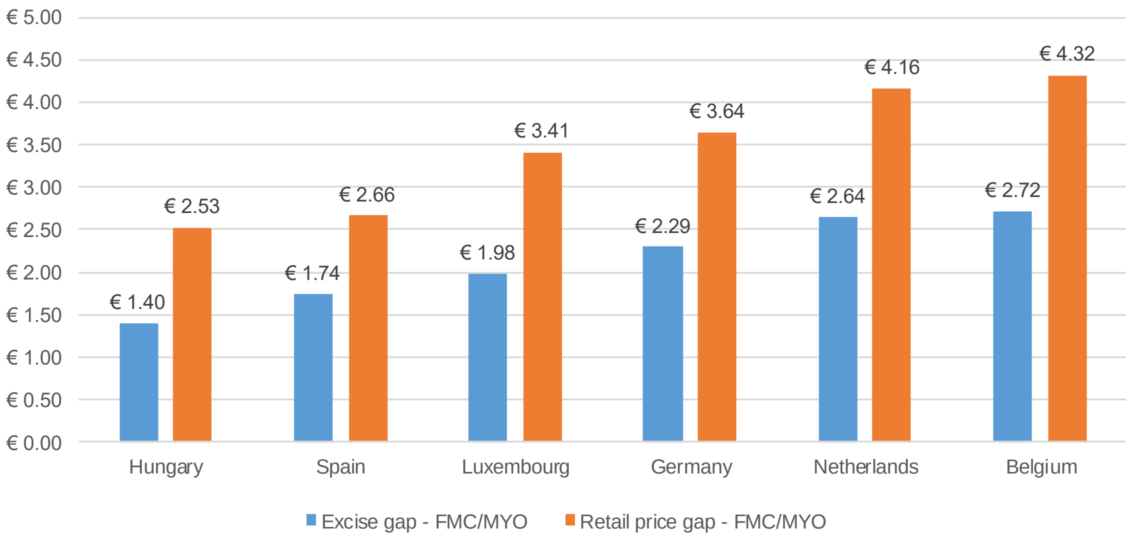
4.3 A MYO cigarette stick attracts a substantially lower excise compared to an equivalent factory made cigarette; making it a cheaper and more attractive proposition to which smokers can down trade

Despite the differences between these two categories, the current Tobacco Excise Directive does not distinguish between them and, as a consequence, Member States are not able to apply a tax rate to MYO that is different than the weight based rate applied to RYO tobacco.

This means that the tax levied on a MYO stick is not only lower than an equivalent RYO stick (due to the higher volume to weight ratio of MYO tobacco) but is also substantially lower than factory made cigarettes, despite the fact that MYO cigarettes are substituted for them.

The graph below shows the excise and price gap between a pack of 20 factory made cigarettes and an equivalent pack of 20 MYO sticks in a selection of EU markets.

FIGURE 5: EXCISE AND PRICE DIFFERENTIAL BETWEEN A PACK OF 20 CIGARETTES AND AN EQUIVALENT PACK OF 20 MYO TOBACCO STICKS IN THE LARGEST EU FINE CUT MARKETS



Source: Internal market data.

The graph shows that there is a wide disparity in the excise and price levied on two substitutable products. This means that the price of MYO cigarettes is between 60%-78% lower than factory made cigarettes which makes it a substantially cheaper alternative for smokers.

Not only are these products cheaper than factory made cigarettes but they do not attract the same level of tax per stick as an equivalent factory made cigarette, contributing to lower tax revenue collection in these Member States.

MYO is not so prevalent in every Member State. In some instances, the sales volumes of the MYO tobacco category is negligible but, in other markets, it can have a significant impact on the market dynamics.

4.3.1 Case study – MYO tobacco in Belgium

In Belgium, the excise levied on a pack of 20 factory made cigarettes was €3.28 in 2015. However, an equivalent pack of 20 MYO sticks attracted an excise of €0.56 – around €2.72 less excise per pack of cigarettes compared to factory made cigarettes. Not only does MYO tobacco enjoy a lower excise burden, it also contributes to lower tax revenues for the government.

Currently, the only way for the Belgian government to narrow the excise gap between MYO and factory made cigarettes would be to increase the duty rate on fine cut tobacco. If the government were to do so, such that the excise on a pack of 20 MYO tobacco sticks was two thirds of the excise on an equivalent pack of 20 factory made cigarette, this would have the additional consequence of increasing the excise burden on RYO from €0.67 to €2.60 per pack of 20 sticks i.e. 9% higher than the excise levied on an equivalent pack of factory made cigarettes.

This would of course significantly reduce RYO sales volumes and tax revenues, which currently generates c.15% of excise revenues in Belgium.

4.3.2 Case study – MYO tobacco in the Netherlands

In the Netherlands, the excise levied on a pack of 20 factory made cigarettes was €3.62 in 2015. However, an equivalent pack of 20 MYO cigarettes attracted an excise of €0.98 – around €2.64 less excise per pack of MYO cigarettes compared to factory made cigarettes. Again, this demonstrates that MYO tobacco enjoys a significantly lower excise burden.

Similarly, to Belgium, the only way to narrow the excise gap between MYO and factory made cigarettes would be to increase the duty rate on fine cut tobacco. If the government were to do this, such that the excise on a pack of 20 MYO tobacco cigarettes was two thirds of the excise on an equivalent pack of 20 factory made cigarettes, this would have the unintended consequence of increasing the excise burden on RYO from €1.00 to €2.46 per pack in 2015, i.e. an excise burden which is almost at parity with that of an equivalent pack of factory made cigarettes.

This would significantly reduce RYO sales volumes and tax revenues, which generates c.21% of excise revenues in the Netherlands.

4.4 Revising the current Directive to allow for the differentiation of MYO and RYO tobacco would also give Member States the option to apply different tax rates to these products

To tackle this issue, we suggest revising the current Directive to allow for the differentiation between the two categories of the fine cut tobacco market based on the compositional differences between the products previously described.

This would allow individual Member States to apply different tax rates to MYO and RYO tobacco products which would otherwise not be possible. The revision should clarify that the differentiated tax treatment of the category is not mandatory but rather an option for individual Member States to exercise should they so choose.

The following proposed amendments to Articles 5(2) and 14 of Directive 2011/64/EU would allow Member States the option to introduce a separate new category of fine-cut tobacco as distinct from fine-cut tobacco for the rolling of cigarettes, in order to be able to introduce more appropriate excise treatment for so-called "make-your-own tobacco" for the tubing of cigarettes. The proposed text of the recital for the amending Directive explains the rationale for the proposed amendments.

Recital for the amending Directive:

Member States should have the ability to distinguish between two types of fine-cut tobacco, namely fine-cut tobacco for the rolling of cigarettes and a new category of "make-your-own tobacco", which is generally used for the so-called tubing of cigarettes. Tubing is a process whereby the consumer by using a specialist device fills a cigarette tube with make-your-own tobacco of their choice. Make-your-own tobacco generally tends to be drier than fine-cut tobacco for the rolling of cigarettes and is therefore less suitable for rolling. Due to its comparative dryness, make-your-own tobacco is lighter and therefore has more volume per unit of weight than fine-cut tobacco. Consequently, it is appropriate to allow Member States to impose a higher level of excise duty on make-your-own tobacco than on fine-cut tobacco for the rolling of cigarettes.

Article 5(2) (proposed new text underlined)

> *2. Smoking tobacco, in which more than 25 % by weight of the tobacco particles have a cut width of less than 1,5 millimetres, shall be deemed to be fine-cut tobacco for the rolling of cigarettes.*
>
> *Member States may also deem smoking tobacco, in which more than 25 % by weight of the tobacco particles have a cut width of 1,5 millimetres or more and which was sold or intended to be sold for the rolling of cigarettes, to be fine-cut tobacco for the rolling of cigarettes.*
>
> *Member States may introduce an additional separate category of fine-cut tobacco, namely make-your-own tobacco, which is sold or intended to be sold for the tubing of cigarettes. Make-your-own tobacco shall contain at least 5% by weight tobacco particles with a cut width of 0,5 millimetre or more.*

Article 14 (proposed new text underlined)

> *3. The rates or amounts referred to in paragraphs 1 and 2 shall be effective for all products belonging to the group of manufactured tobaccos concerned, without distinction within each group as to quality, presentation, origin of the products, the materials used, the characteristics of the firms involved or any other criterion.*
>
> *4. By way of derogation from paragraph 3, Member States may impose a higher excise duty on make-your-own tobacco for tubing than on other fine-cut tobacco intended for the rolling of cigarettes.*

5 Minimum Excise Duty

A minimum excise duty (MED) is typically used to: (i) increase the price of lower priced cigarette brands; and (ii) safeguard government excise revenue collection from changes in the price of cigarettes. Essentially it establishes a minimum level of excise payable irrespective of whether the prevailing duty rates imply a lower level of excise at a particular price point.

This is explained further in Appendix B.

5.1 A single MED is not always effective at discouraging operators from reducing their prices and risks creating distortions between brands

As demonstrated (in Appendix B), a MED can discourage manufacturers from pricing below the threshold at which the MED takes effect. However, this is not always the case.

In some markets, manufacturers have reduced the price of some brands below the point at which the MED takes effect which has:

- Reduced government revenues (through a reduction in ad valorem excise and VAT revenues); and
- Forced other brands to reduce their price in order to effectively compete, again, negatively affecting government revenues.

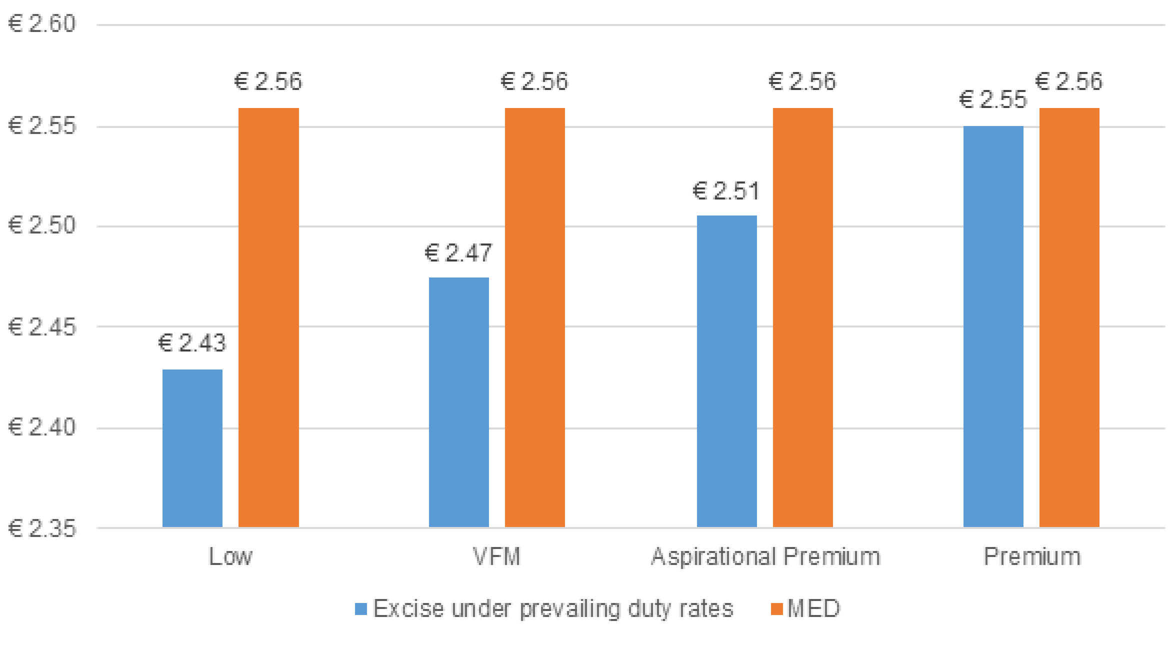
When this happens, Member States only have one possible option which is to increase the level of the MED.

Increasing the level of the MED increases the threshold at which the MED kicks in but it is not always effective at discouraging manufacturers from pricing below this threshold. Moreover, not only will a higher MED replace the excise system with what is, in effect, a wholly specific tax, it would create significant distortions between brands, as has happened in Portugal.

In Portugal, the government currently levies a MED at 104% of the excise on the most popular price category (MPPC). This means that the MED is in effect at every segment of the market thereby replacing the mixed excise system with a wholly specific tax.

This is shown in Figure 6.

FIGURE 6: IMPACT OF AN EXCESSIVELY MED ON EACH SEGMENT OF THE MARKET IN PORTUGAL



Source: Internal market data.

Replacing the prevailing excise duties, above the WAP, with a wholly specific excise tax is in contravention of the Directive. Article 7 (4) states that the excise duty on cigarettes may include a minimum tax component provided that the mixed structure of taxation and the band of the specific component of the excise duty, as specified in Article 8, is "*strictly respected*". This is clearly not the case in Portugal and in some other Member States.

Not only is it in contravention of the Directive but it also creates competitive distortions in the market. This unfairly penalises low, value-for-money (VFM) and Aspirational Premium brands by substantially increasing the excise level relative to what is levied on Premium brands.

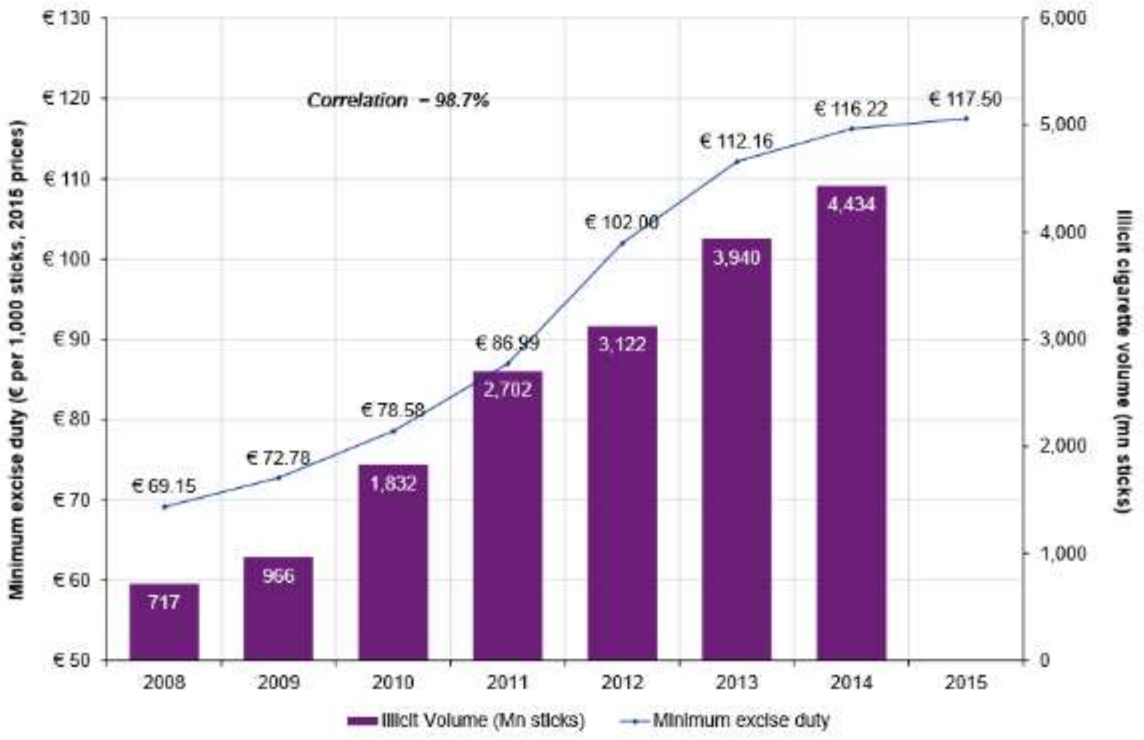
5.2 Excessively high increases in the MED rate could also lead to consumers switching to duty-avoiding products

A high MED, or even excessively high increases in the rate, could also incentivise consumers to switch to duty-avoiding products which will have a negative impact on government revenues, as in the case of Greece.

Figure 7 shows that there is a very strong relationship between the increase in illicit cigarette consumption and the MED rate in Greece.

Each time the MED increased, the gap between duty-paid cigarette prices and illicit cigarette prices increased. This increased the incentive for cigarette consumers to switch to illicit cigarettes between 2008 and 2015 and, importantly, did not prevent government revenues from falling significantly.

FIGURE 7: THE RELATIONSHIP BETWEEN DUTY-AVOIDING CIGARETTE CONSUMPTION AND THE MED IN GREECE



Source: KPMG Project Sun and EC Excise Duty Tables for Manufactured Cigarettes.

In short, the tools available to tax authorities to meet their fiscal policy objectives have proven to be lacking, in that they do not allow Member States to meet certain policy objectives without (a) contravening the principle of the mixed system of taxation in the Directive; (b) severely distorting competition in the market; or (c) triggering illicit trade increases.

5.3 A dual MED is potentially another option for Member States to consider if they want a tax measure to ensure that brands do not price below the government threshold and that does not distort competition between brands

Some Member States (such as Spain, France and Italy) have in the past implemented a second selective MED (dual MED) which ensures that brands priced below the MED threshold pay a higher level of tax than those priced at the MED threshold. (The specific mechanics of how a dual MED works are further explained in Appendix B.)

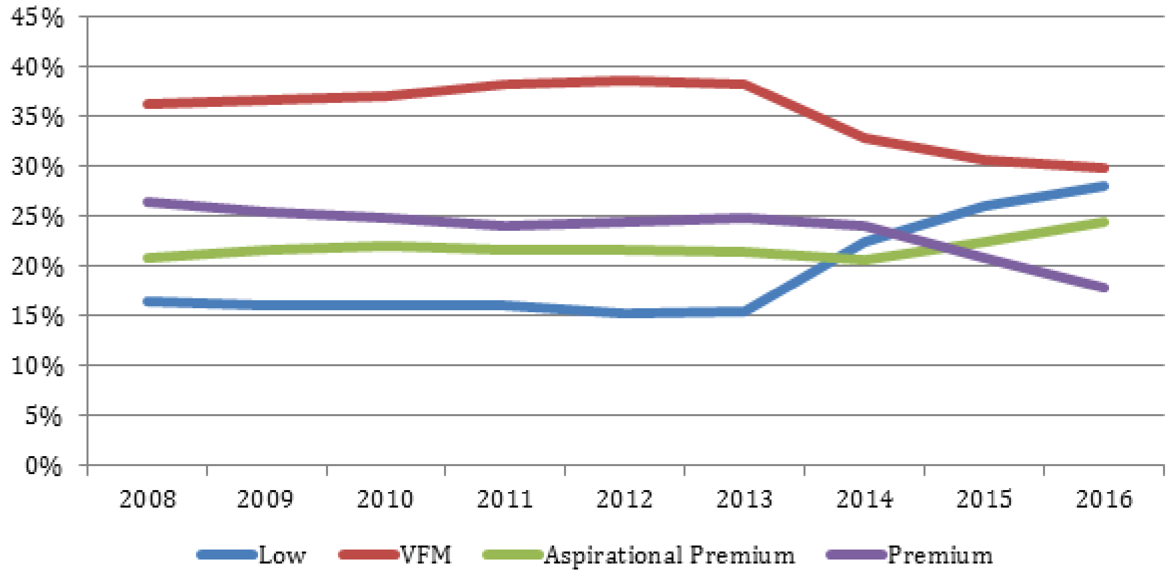
Naturally, this increases the cost of discounting below the government's target threshold much more than a single MED arrangement. If set at an appropriate rate, dual MED has proven to effectively discourage operators from reducing their prices – safeguarding government revenues whilst avoiding the creation of significant distortions in the market. This is because it avoids the penalisation of price segments above the price threshold – a policy objective which the government wants to achieve via a minimum excise mechanism.

It is, therefore, a more effective tool for governments to meet their policy objectives without necessarily distorting the market via consequential impacts on brands priced above the government target threshold. It has proven, in markets that have deployed it, to be an effective mechanism of preventing excessive price reductions and price wars. Importantly, this does not imply that it is a minimum price mechanism. It is in fact an excise measure, which, depending on the rate set, can significantly reduce the incentive for manufacturers to reduce their prices compared to when single level MED mechanism is in place.

In Italy, for example, a dual MED regime was in place from May 2011 until March 2014. During that time, the dual MED did not affect the overall market dynamics. In fact, changes in the market were due to a number of other factors; such as the economic downturn, tax and VAT increases, and changes in consumer consumption habits.

However, after the dual MED was removed in 2014, there was substantial growth in the Low price segment of the market, driven by a reduction in the price of some brands despite there being a MED in place. The result was an increase in volumes of Low price brands by c.80% since the dual MED was removed. Between 2013 and 2016, there has clearly been a shift in the market with more consumers moving toward these lower priced products. This is shown in Figure 8 below.

FIGURE 8: MARKET SHARE IN EACH SEGMENT OF THE MARKET IN ITALY BETWEEN 2008 AND 2016



Source: Internal market data.

5.4 Given the clear benefits of a dual MED, we would recommend a revision of the current Directive to give Member States the option to implement such a solution

A dual MED increases the cost of discounting below the government's target threshold much more than a single MED arrangement can. When set at an appropriate rate, it has proven to:

- more effectively discourage operators from reducing their prices – safeguarding government revenues whilst not creating significant distortions in the market or incentivise switching to illicit products; and
- provide governments with the ability to avoid penalising price segments above the WAP (as is the case in Portugal where there is an excessively high single MED).

There have been legal challenges to the use of dual MED systems in the past based on the current version of the Directive. However, given the clear benefits that a flexible minimum taxation mechanism (like a dual MED) can have, we recommend that the Directive is amended to allow Member States greater flexibility to implement a solution that best suits their needs.

The following proposed amendments to Articles 7, 8 and 15 of the Directive would allow for the introduction of variable levels of minimum taxation depending on the retail price of cigarettes. The proposed wording for a recital to be included in an amending Directive explains the rationale for the proposed amendments.

Recital

While a universal minimum tax component can be an effective means of increasing the price of cigarettes, there are circumstances in which a Member State can legitimately take the view that its policy objectives can be better achieved by flexible minimum taxation arrangements allowing a Member State to impose different levels of minimum taxation in light of the retail price of cigarettes. Such flexible mechanisms should not be applied in a manner that has a disproportionate impact on trade between Member States.

Article 7

2. The rate of the ad valorem excise duty and the amount of the specific excise duty must be the same for all cigarettes, subject to the right of Member States to impose more than one level of minimum excise duty for cigarettes.

4. Where necessary, the excise duty on cigarettes may include minimum tax components, provided that the mixed structure of taxation and the band of the specific component of the excise duty as laid down in Article 8 is strictly respected.

Article 8

6. Subject to paragraphs 3, 4 and 5 of this Article and the second subparagraph of Article 7(1), Member States may introduce one or more levels of minimum excise duty for cigarettes.

Article 15

1. Manufacturers or, where appropriate, their representatives or authorised agents in the Union, and importers of tobacco from third countries shall be free to determine the maximum retail selling price for each of their products for each Member State for which the products in question are to be released for consumption, whilst remaining compliant with the applicable level of minimum excise duty imposed.

We want to emphasise that any flexible minimum taxation measure should not have a disproportionate impact on the market or on trade between Member States. Moreover, this would be a flexible measure which Member States can apply should they so choose, rather than a measure that is mandatory across every Member State.

Appendix A: Case studies of Portugal and Italy regarding the introduction of an excise duty on e-cigarettes

Portugal

Portugal introduced a tax on e-cigarettes on 1 January 2015 which was justified on "…*grounds of protecting public health and tax equity* …". The tax was set at €0.60 per millilitre of e-liquid and only applied to nicotine containing liquid.

Prior to the tax being introduced, the cost of 1ml of e-liquid was €0.30 while the cost of an equivalent cigarette was c.€1.45 (based on their assumption that 7 cigarettes is equivalent to 1ml of e-liquid).

After the introduction of the tax:

- The price differential (excluding the device) between factory-made cigarettes and e-liquids reduced by 52% (from €1.15 to €0.55).
- EcigIntelligence reported that consumers started to look at cheaper alternatives as a consequence of higher prices of e-liquids. They found that some consumers had either started importing e-liquid, or were creating their own home-made e-liquid by combining untaxed nicotine-free e-liquid and nicotine. Not only are taxes lost on these products but the home-made e-liquid is unregulated and poses a health risk to consumers.
- There was an overall slowdown in industry growth. EcigIntelligence reported that the tax contributed to the closure of numerous vaping shops between 2014 and 2015.
- Initial estimates suggested that the introduction of the tax would result in around €105.9 million in tax revenues from e-liquids in 2015 while also reducing e-cigarette usage for *"… reasons of public health …"*. However, the slower than anticipated implementation of the tax – due to logistical and IT issues – meant that tax revenues were not fully realised.
- The Portuguese Exchequer collected c.€1.3 million in tax revenues from the c.500,000 units that were released for consumption in the first 9 months of 2016. This is an insignificant amount raised when compared to the €0.6 billion in tax revenue raised from tobacco products in 2015 and after offsetting the costs of administering and enforcing the tax.

The negative impact of this tax on the market most likely played a key role in the government's decision to reduce the excise on e-liquids from to €0.60/ml to €0.30/ml as of 1 January 2017. The lessons from Portugal underline the importance of taking a cautious approach to the taxation of e-cigarettes, especially considering the nascent and constantly evolving nature of the market.

Italy

Italy introduced a tax on all e-cigarette related products which came into effect from 1 January 2014.

The primary justification for the tax was to offset falling revenues from combustible tobacco products, where tobacco excise revenue on cigarettes and fine cut tobacco declined by around 12% between 2011 and 2014 (in 2014 prices).

Initially, policy makers considered setting the excise level to exactly that levied on combustible cigarettes. This was later dismissed by the Italian courts on the grounds that it was unreasonably high. Instead, the Customs and Monopolies Agency introduced a tax of €3.73 per 10 millilitres of e-liquid. This equated to 50% average tax burden levied on combustible tobacco and was calculated based on their assumption that 5 cigarettes were equivalent to 1ml of e-liquid.

Unlike Portugal, the tax applies to both e-liquids with and without nicotine. As a result of the introduction of the excise tax:

- The price of a 10ml bottle of e-liquid increasing by over 60% overnight and, in the first 5 months of 2015, contributed to a 70% fall in the consumption of e-cigarettes (consistent with the lower bound of the Huang et al price elasticity estimates).

- Consumers were incentivised to purchase products online from other countries, which now account for more than 80% of Italian e-cigarette purchases.[3]
- The number of domestic e-cigarette shops and businesses fell from 4,000 to 1,000, jeopardising, it is argued, more than 8,000 jobs.[4]
- There were lower than expected tax revenues due to the sharp decline in sales volumes. Instead of increasing tax revenue, it is thought the tax led to a drop in overall tax collections due to a sharp decline in sales volume and therefore a loss in VAT revenues.
- The Italian Exchequer collected, in the first 11 months of 2016, only an estimated c.€3 million in tax revenues from e-cigarettes, c.0.3% of the tax revenues generated from tobacco products.[5]

[3] https://agivapenews.com/2015/06/30/vaping-wwars-italy-ecig-pmi-lobby-protest/
[4] ibid
[5] Situazione dei Debiti e Creditit di Tesoreria, Supplemento straordinario n. 2 alla Gazetta Ufficiale, 30/1/2017

Appendix B: Mechanics of a MED and dual MED

A MED on cigarettes is already used in 25 EU Member States in addition to the ad valorem (expressed as a percentage of the price) and specific (expressed as an amount per thousand or per weight regardless of the price) duties, which are levied on all products in the market.

The MED is a pre-specified level below which excise tax is not allowed to fall.

If, at the prevailing duty rates, the retail price implies a total excise tax below the MED, then the MED replaces the ad valorem and the specific excise duties.

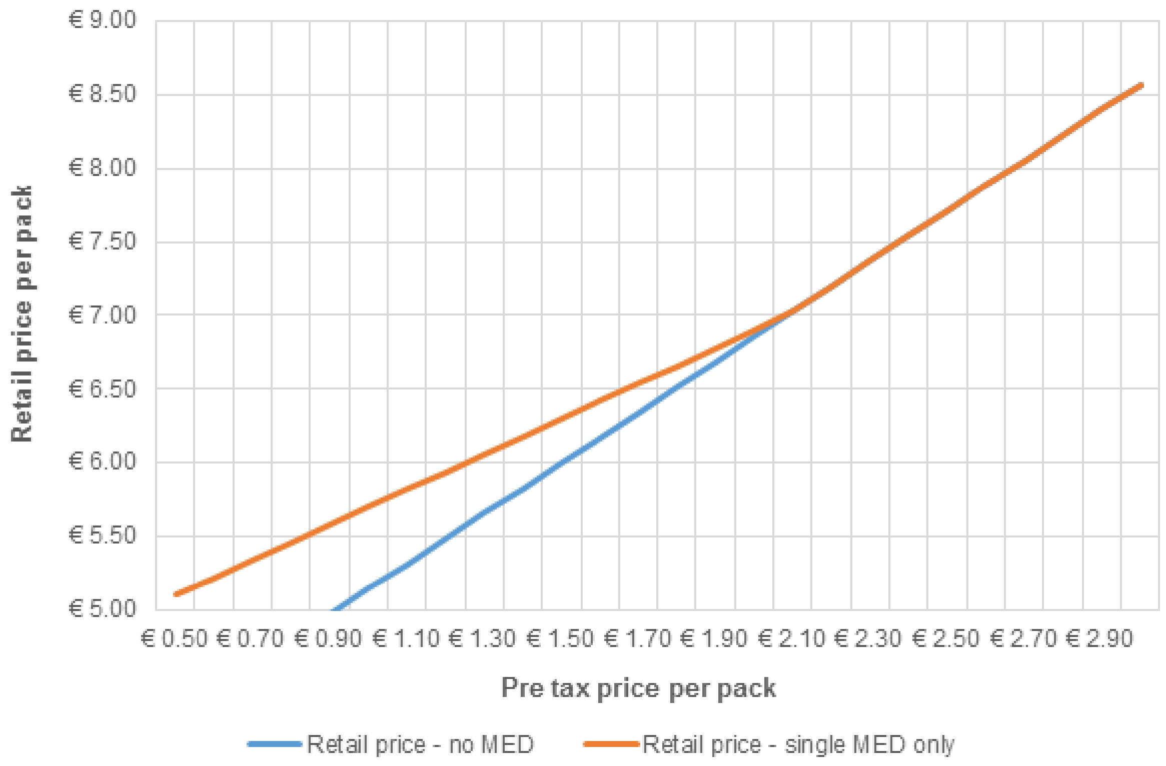
The way in which the MED affects retail prices is illustrated in Figure 9.

On the horizontal axis is the pre-tax price, on the vertical axis, the retail price. The blue line shows, for an illustrative mixed excise system, the relationship between pre-tax price and retail prices. The orange line shows how retail prices are affected by the MED (set at €3.75 per pack in this example).

When pre-tax prices are so high that the total excise exceeds the MED, the two lines are the same. But when pre-tax prices are lower, the MED is triggered. The retail price, for any given pre-tax price, is higher compared to when no MED is in place.

For this reason, the MED does place a partial floor on the retail price. Moreover, the MED creates a disincentive to manufacturers to further reduce the pre-tax price, further increasing the retail price.

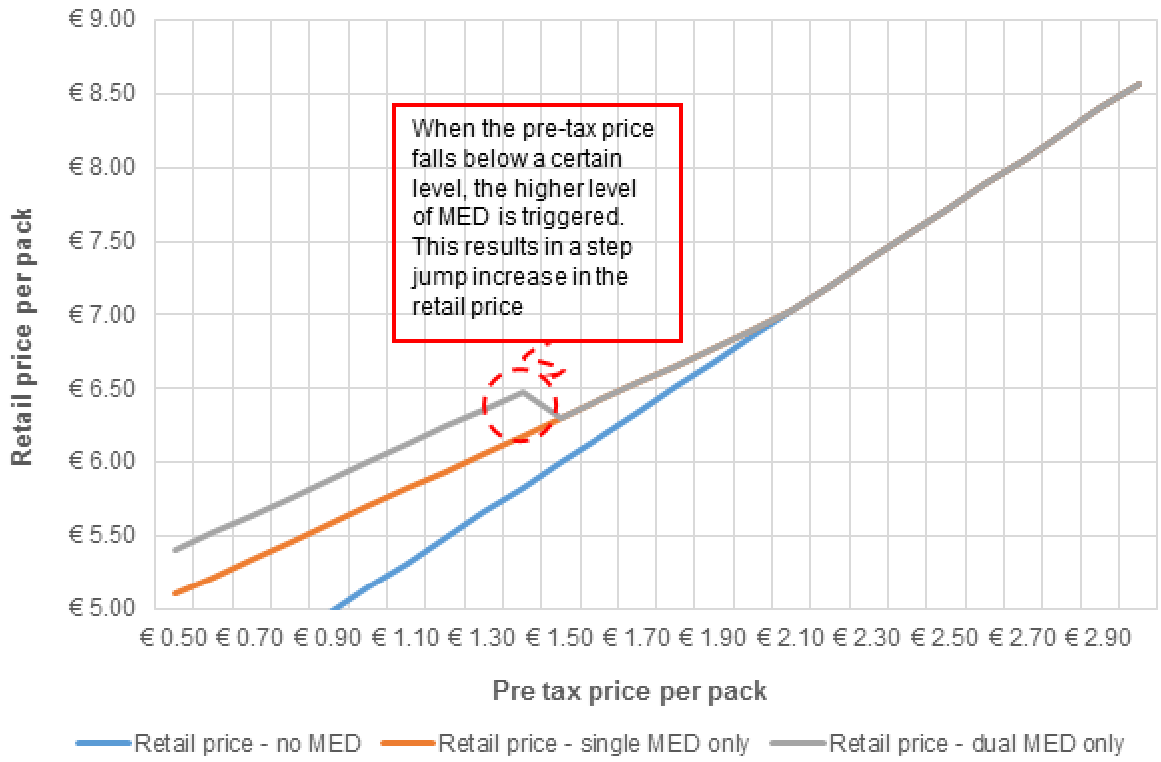
FIGURE 9: ILLUSTRATIVE EXAMPLE OF THE IMPACT OF A MED ON MARKET PRICES



The mechanics of a dual MED are broadly similar to a single MED except that there is a point at which a higher level of excise kicks in below a certain pre-tax price.

Figure 10 illustrates the relationship between the pre-tax price and the retail price under a dual MED system.

FIGURE 10: ILLUSTRATIVE EXAMPLE OF THE IMPACT OF A DUAL MED ON MARKET PRICES



The graph shows that below a pre-tax price of around €2.00 per pack, retail prices are affected by the lower level of the dual MED (set at €3.75 per pack) i.e. a similar impact to the single MED system shown in Figure 9.

However, below a pre-tax price of €1.40 per pack, the higher level of the dual MED is invoked (set at €4.00 per pack) (as shown by the kink in the grey line). This sharp increase in the retail price creates a much stronger disincentive for operators to reduce prices compared to a single level MED. This is because the tax burden increases by so much that operators would have to take a substantial cut in their pre-tax price to reduce the overall price per pack.

Error! Not a valid bookmark self-reference. provides a worked example of this showing how a dual MED places a greater disincentive on operators to reduce their price.

In our worked example, we begin with the base case (column A) with a retail price of €6.00 a pack, a specific excise duty of €2.00 a pack, an ad valorem duty rate of 25% (as a percentage of the retail price) and a nominal rate of VAT of 20% (equivalent to 16.67% of the retail price). At this retail price and tax rates, the pre-tax price is €1.50 without any MED in place.

In column B, we introduce a dual level MED.

The lower level of the dual MED, set at €3.75 per pack in our example, works in exactly the same way as a single level MED. If, at the prevailing pre-tax and retail price, the excise taxes implied by the ad valorem and specific duty rates fall below the MED, the lower level MED is triggered. Either the retail price increases to compensate and/or the pre-tax price falls.

There are two key parameters that define the higher level MED: the trigger retail price (row 8 of Table 2); and the higher level of the dual MED.

When the retail price falls below the price at which the higher MED level applies, then the higher rate of the MED automatically comes into force. In our worked example, the trigger retail price is set at €6.00 a pack and the higher level MED is €4.00 a pack.

In Column B of **Error! Not a valid bookmark self-reference.**, the retail price of €6.00 a pack, is only just at a level where the higher MED is not triggered. But the lower level MED is triggered such that the operator has to reduce their pre-tax price by c.16% to maintain the same price per pack (i.e. €6.00 per pack).

In Column C, we illustrate the effect of a relatively small, 5%, reduction in the retail price, to €5.70 a pack. Because the retail price is now below the price at which higher minimum excise applies (i.e. €6.00 per pack), the higher level of the dual MED applies such that the excise increases from €3.75 to €4.00 per pack.

With the excise at €4.00, and VAT at 16,67% of the retail price, operators would have to reduce their pre-tax price by 50% to maintain a pack price of €5.70. However, when a single MED applies and the price is reduced by 5% (Column E), operators would only have to reduce their prices by c.33% to maintain a price of €5.70 per pack. A dual MED, because of this effect, creates an even stronger disincentive for manufacturers and retailers to reduce their own prices, preventing price wars from taking place at the low end of the market, thereby protecting government tax revenues.

Table 2: Worked example showing how a dual MED places a greater disincentive on operators to reduce their prices compared to a single MED

			Tax rates and prices with no MED	Tax rates and prices with dual MED	Taxes and margins after a 5% TIRSP cut	Tax rates and prices with single MED	Taxes and margins after a 5% TIRSP cut
			(A)	(B)	(C)	(D)	(E)
	1	Tax inclusive retail selling price (TIRSP) per pack	€6.00	€6.00	€5.70	€6.00	€5.70
	2	*Difference from current level*		*0%*	*-5%*	*0%*	*-5%*
1	3	Specific excise duty per pack	€2.00	€2.00	€2.00	€2.00	€2.00
	4	Ad valorem excise duty (% of TIRSP)	25%	25%	25%	25%	25%
	5	Total excise (implied by prevailing specific & ad valorem duty rates	€3.50	€3.50	€3.43	€3.50	€3.43
2	6	Minimum excise tax per pack - lower level	€0.00	€3.75	€3.75	€3.75	€3.75
	7	Is total excise (implied by prevailing specific and ad valorem duty rates) below the lower level of the MED?	No	Yes	Yes	Yes	Yes
3	8	Retail price at which a higher minimum excise applies	€0.00	€6.00	€6.00	€0.00	€0.00
	9	Minimum excise tax per pack - higher level	€0.00	€4.00	€4.00	€0.00	€0.00
4	10	Retail price below the threshold i.e. is the higher MED triggered?	No	No	Yes	No	No
	11	Total excise - basis of calculation	Prevailing duty rates apply	Lower MED triggered	Higher MED triggered	Lower MED triggered	Lower MED triggered
5	12	Total excise burden per pack	€3.50	€3.75	€4.00	€3.75	€3.75
	13	VAT (% nominal)	20%	20%	20%	20%	20%
	14	VAT (% of the retail price)	16.67%	16.67%	16.67%	16.67%	16.67%
	15	VAT burden per pack	€1.00	€1.00	€0.95	€1.00	€0.95
	16	Total tax per pack	€4.50	€4.75	€4.95	€4.75	€4.70
6	17	Pre tax price per pack	€1.50	€1.25	€0.75	€1.25	€1.00
	18	*Difference from current level*		*-16.7%*	*-50.0%*	*-16.7%*	*-33.3%*

1. The specific and the ad valorem duty rates apply when the retail prices exceed the lower level MED.

2. When the total excise implied by the prevailing specific and ad valorem duty rates at the prevailing retail price (row 5) fall below the lower level MED, this replaces the specific and the ad valorem duties.

3. When the retail price (row 1) falls below a defined level, the rate of MED automatically applies.

4. The higher rate MED that is levied whenever the retail price falls below the defined level (row 8).

5. If the retail price is lower than the higher rate MED threshold, then the higher MED always prevails. Otherwise the lower MED applies unless the prevailing specific and ad valorem duty rates take total excise above this level.

6. The pre-tax price is what is left for the manufacturers, distributors and retailers given the prevailing retail price and the taxes it triggers.